Statement of

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on behalf of the

National Association of Independent Insurers

before the

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The National Association of Independent Insurers appreciates the opportunity to present its views on insurance regulation and competition in the insurance industry.

It is an honor to share my views on several important issues affecting the insurance industry and the millions of stakeholders whose private or business life is in some way touched by insurance. The Subcommittee's deliberations and conclusions will have implications for individual insurance consumers, insurance investors, the business community, the insurance industry and its regulators, and countless other stakeholders. We commend you for taking the initiative to learn more about these subjects and I offer the support of my company and the NAII as the Subcommittee continues its research.

I address the Subcommittee in my capacity as Chairman of the Board of Governors of the National Association of Independent Insurers (NAII) and as the chief executive of the GEICO Group of property-casualty insurance companies. The views I will share with the Subcommittee are based on my own business experience over 40 years in the industry, and the perspective of the NAII, a 700+ member company trade association that was founded in 1945 after Congress enacted the McCarran-Ferguson Act. Since that time NAII has supported the McCarran-Ferguson Act, which reserved the role of insurance industry oversight to state government on the principle that insurance markets in which competition is the primary regulator of rates best serves consumers.

GEICO is the largest direct marketer of insurance products, the fifth largest private passenger auto insurance company, and the 10th largest property-casualty insurer in the United States.

GEICO has assets of $10.6 billion, employs 18,000 associates and protects more than 4.7 million policyholders and over 7 million automobiles.

GEICO's commitment to customer service, efficiency and financial stability makes us a major stakeholder in the effort to modernize and enhance the state regulatory system. I have taken the time to personally visit with insurance regulators and the National Association of Insurance Commissioners (NAIC) in recent months to discuss ways to update and strengthen the state regulatory system. I am convinced that the states are up to the challenge of improving the regulatory system.

NAII is one of the nation's largest full-service property-casualty insurance trade associations, representing the most diverse membership. NAII's membership accounts for $98 billion in annual premiums, comprising 31 percent of the industry's total property-casualty premium volume and 43.9 percent of the total personal lines market. Member companies range in size from billion-dollar national companies to multi-line regional groups to single-state and niche/specialty writers. They include mutuals, stock companies, surplus line carriers, and reciprocals: all the traditional corporate insurance structures. In fact, NAII represents the broadest cross-section of insurers of any national trade organization. NAII members transact most types of property-casualty insurance, use every type of distribution system, and have experience operating under the regulatory environment in each of the 50 states. The diversity in membership is one of the association's greatest strengths and provides NAII with a unique perspective on insurance regulation. Since the bulk of our membership consists of smaller personal lines oriented companies, NAII is very qualified to speak on behalf of the unique needs and local markets that those insurers serve.

The NAII membership is distinguishable by the diversity in business models and markets, yet the companies all share the same common vision that competition and market-oriented regulation is in the best interest of the industry and the customers they serve. NAII's express mission is to foster a competitive insurance marketplace, which not only promotes the successful operation of its members, but enhances the welfare of their customers.

Nearly 60 years after its founding, the NAII – more than any other trade group in the industry – still firmly believes in the concept of competitive markets, and advocates regulatory principles that make competition thrive.

GEICO and NAII support the state regulation of insurance and oppose federal involvement in the regulation of the insurance business. However, we agree with the vast majority of insurers, agents, regulators, state legislators, and Members of Congress that the insurance regulatory system must improve. We recognize that support for state insurance regulation is dependent in large part on the willingness of the states to institute meaningful reforms to modernize regulation so that it reflects the way our business is conducted today and so that it will be adaptable to the way we will conduct business in the future. We strongly urge Congress to give the states ample opportunity to improve the state regulatory system to meet the concerns that have been articulated in these hearings and in legislative and regulatory proceedings in state houses across the nation. NAII is deeply committed to working with the National Association of Insurance Commissioners, individual state regulators, state legislators, and all other interested parties to improve the state regulatory system. However, until the momentum for regulatory modernization takes hold in the states, NAII is ready to evaluate with an open mind all proposals offered to enhance the regulatory system.

As the committee considers the future of insurance regulation, we have been requested to present our views on financial regulation and examinations, solvency, auditing requirements, accreditation programs and data sharing, as well as our views on regulatory modernization.

Solvency Regulation

Solvency monitoring is the most important aspect of state regulation. Insurance is a promise that the insurer will make a future payment in the event of a covered loss. Solvency regulation's role is to make sure that the insurer is financially able to keep that promise but security cannot be the only goal of regulation. NAII strongly believes that the benefits to the public of a free and competitive marketplace are as important as the security of the insurance promise itself.

Accordingly, NAII believes that the objective of regulators should be to balance the interests of security and free enterprise. There will always be insurer insolvencies in a free market economy. The primary regulatory objective is not to eliminate all insolvencies, but to minimize their costs in terms of dollars and human suffering. It is this balance that NAII believes is essential in the financial regulation system. While the current state system does not achieve a perfect balance, it is improving and there are steps underway to improve it further.

The overall record of state insurance regulation in preventing insolvencies in the last ten years has improved, as measured by individual company failures, as compared to the five-year period just before and just after the House Energy and Commerce Committee's "Failed Promises" congressional report. According to data reported by the A.M. Best Co., during the years 1987-

1991, 203 property-casualty insurers became insolvent, an average of 40.6 per year. During the period 1992-2001, a period which includes both the effects of Hurricane Andrew in Florida and the recent Reliance insolvency, a total of 214 companies became insolvent, an average of 21.4 per year. As A.M. Best points out, "Since 1994, insolvency rates for the property-casualty industry have generally stabilized. A. M. Best attributes this trend, in part, to competition in the market, which has encouraged healthy insurers to rescue ailing insurers before they become insolvent . . . In addition, regulatory oversight has improved while many states have increased their capital requirements."

It is true that the Reliance insolvency was the failure of a major national insurer, and its full effects cannot yet be measured. It should also be noted, however, that the tragic events of September 11, 2001, which caused the largest insured loss in history, are not expected to cause the insolvency of a single U.S. insurer. We think that this is testimony to the general success of the state solvency regulatory system.

The last time that state regulation of insurance was seriously called into question was when the House Energy and Commerce Committee issued its "Failed Promises" report on the Mission and Transit insolvencies in 1989. This report challenged the ability of state regulators to regulate large, multi-state insurers. Since that time the NAIC, state insurance departments and the insurance industry have undertaken many significant improvements in the state financial regulatory system. Among these improvements are:

- Financial Regulation Accreditation and Standards program (Adopted in 1990)
- Audited financial statements (Adopted in 1989, effective in 1991)
- Risk-based capital (Adopted in 1993 for both life and P/C insurers)
- Model Law on Examinations (Adopted in 1991)
- Investments in Medium and Lower Grade Obligations Model Regulation (Adopted in 1991)
- Codification of statutory accounting principles (Effective 2001)

There is certainly no guarantee that federal regulation or an optional federal charter approach would improve insurance solvency regulation. Federal regulators have failed to prevent major financial institutions from failing. The savings and loan industry meltdown during the late 1980s was a national scandal and cost U.S. taxpayers billions of dollars. Even today, major depository institutions fail despite regulatory oversight from multiple agencies. The recent Superior Bank failure illustrates this point. The federal insurance regulator under an optional federal charter system would not have any greater operational knowledge than state regulators with respect to financial oversight. And the state regulatory system has demonstrated an ability to respond promptly when circumstances warrant as was the case a decade ago when the NAIC's Accreditation Program was adopted and implemented. Our judgment is that state regulation in this area is improving, and that its past performance does not warrant federal intervention.

NAII was asked to share its insights on how solvency regulation works in practice. Under state regulation, solvency regulation can be divided into four major functional areas: (1) financial reporting; (2) financial analysis; (3) financial examination; and (4) corrective action. Since they don't fit neatly into any of these baskets, we will take up investment regulation and reinsurance separately.

As we discuss these issues, it is imperative that policymakers keep in mind that financial regulation at the state level is a comprehensive and complex process developed over many years. Significant changes in the system of the type that might occur as the result of federal encroachment should not be undertaken lightly – their potential to disrupt a system that has worked well over the years is significant.

The Basis of Authority for Financial Regulation

Insurers are subject to strict financial regulation by the states. Each state's statutes give its insurance commissioner (or similar official) the responsibility and power to regulate the financial condition of the insurers licensed to do business in that state. There is significant similarity, however, in these statutes. Almost all states have adopted, either through statute or regulation, the financial regulation requirements in the NAIC Financial Accreditation Standards program. Among other requirements, this includes incorporating (generally by reference) the NAIC's annual and quarterly financial statements, accounting manual, auditing and actuarial requirements, risk-based capital and examination model laws. Thus the NAIC is a very significant actor in the financial regulation process, not as a regulator but as a forum for regulators to develop standards that are incorporated generally in each state's statutes.

Financial Reporting

Financial reporting consists of how insurers keep track of their own financial condition and operating results and disclose such information to regulators, investors, policyholders and the public in general. This requires an accounting system and a standard reporting format.

Accounting Practices and Procedures Manual

In theory, insurers could use GAAP (Generally Accepted Accounting Principles), the accounting system used by all publicly-traded corporations in the United States. Indeed, publicly traded insurance companies use GAAP for their financial statements to shareholders and investors. Insurance regulators, however, believe GAAP's system of income and liability recognition is not conservative enough for the purpose of determining whether an insurer has sufficient assets to pay its claim liabilities to policyholders.

Since the early 1900s, state regulators through the NAIC have maintained their own accounting system, commonly known as "statutory accounting principles" (SAP). Each insurer must use statutory accounting to file its financial statements with the state regulators in the states in which the insurer is licensed to do business. SAP is primarily focused on the needs of regulators to assure solvency, rather than the needs of investors for information relevant to an entity's future performance. In a gross oversimplification, SAP differs from GAAP in that it recognizes liabilities earlier and/or at a higher value and recognizes assets later and/or at a lower value. For these reasons, companies will generally show higher surplus and earnings under GAAP than under SAP.

Statutory accounting has just undergone a major revision, called the "codification of statutory accounting principles," ultimately published as the NAIC's new *Accounting Practices and Procedures Manual*. The new Accounting Manual, which became effective January 1, 2001, is significantly more comprehensive than prior SAP and should provide much more comparability in insurer financial statements. The guiding principles of the manual are "conservatism, consistency and recognition," and, while it has grown closer to GAAP, the accounting manual remains significantly more conservative.

Annual and Quarterly Statements

The NAIC also produces a standard Annual and Quarterly Statement that the great majority of insurers are required to file with, in the case of the Annual Statement, all of the states in which each insurer is licensed. The Annual Statement is also filed with the NAIC, and is used to populate the NAIC's financial database, which is available for use by all states. The Annual Statement is a far more comprehensive financial statement than normal GAAP statements. For example, along with including a balance sheet, income statement and cash flow statement, the Annual Statement contains an extensive schedule showing the history of how company loss reserve estimates have varied (developed) over time, and another schedule that contains separately-reported data on each security that the company owns. The Quarterly Statement is a more limited statement that provides basic financial data on a quarterly basis, and is also filed with the NAIC if a company is licensed in a state that requires the filing.

Audited Financial Statement

All but the very smallest insurers are now required to have their annual statutory financial statements audited by an independent certified public accountant. The NAIC's Model Regulation requiring Annual Audited Financial Statements is one of the NAIC's Financial Accreditation Standards, and is also part of the Annual Statement Instructions, which are incorporated by reference in all states. The audited financial statements include the balance sheet, statement of operations, statement of cash flows, statement of changes in capital and surplus, and notes to the financial statements.

Actuarial Opinion

The Annual Statement Instructions require nearly all property-casualty insurers to include with the statement the opinion of an actuary or otherwise qualified person as to whether the company's loss and loss adjustment expense reserves make a "reasonable provision" for the company's future claim and expense liabilities. Since, unlike general businesses, the great majority of an insurer's costs are incurred after its revenues are received, insurance accounting requires companies to establish reserves for claims and claim-related expenses as the claims are incurred, generally at the insurer's estimate of the ultimate cost of those claims and expenses. Since loss and loss expense reserves are by far the largest liabilities on an insurer's balance sheet, their accuracy is critical. Since they involve the estimation of future events, however, they cannot be exact. Therefore, review by an actuary or individual with similar expertise is necessary. The Actuarial Opinion and Actuarial Report (the proprietary material that backs up the Opinion) are used by regulators to analyze whether the insurer's reserves are adequate.

Financial Analysis

Once a company has filed its financial statements with the states in which it does business and the NAIC, regulators need to be able to analyze what the statements mean and whether they indicate that a company is in good financial health or needs help. Following are several tools that state regulators use in this process.

IRIS ratios

The Insurance Regulatory Information System (IRIS), which is part of the NAIC's Financial Solvency Tools (FAST, discussed further below), has often been called the "Early Warning System." Its purpose is just that, to alert regulators to developing problems early enough for them to take effective action. For property-casualty insurers, IRIS consists of a series of 12 financial ratios, for which ranges of "normal" results have been calculated. These ratios are aimed at several different concerns, including capital adequacy, changes in business patterns, underwriting results, reserve inadequacy and asset liquidity. It is not unusual for a company to have abnormal results for one or two ratios, but regulatory interest is increasingly attracted the higher the number of abnormal results. After the ratios are generated, a team of state financial examiners and analysts prepares confidential reports analyzing each company's results and ranking them in terms of increasing danger of insolvency to aid state regulators in giving the proper financial analysis and examination priority to each company.

FAST ratios

The FAST system also includes other ratios focusing on profitability, asset quality, investment yield, affiliate investments, reserves, reinsurance, liquidity, cash flows and leverage. Higher FAST scores suggest a greater danger of insolvency. These confidential results provide another tool for state regulators to use in prioritizing companies for their attention.

Risk-Based Capital

Each state's statutes prescribe a minimum level of capital and surplus for insurers writing particular types of business in the state. In the early 1990's the NAIC questioned the adequacy of these statutory standards and developed a system that prescribes capital requirements corresponding to the level of risk of the company's various activities. The result was the NAIC's separate risk-based capital (RBC) formulas for life, property-casualty and health insurers. Each formula applies separate RBC "charges" for an insurer's asset risk in affiliates, asset risk in other investments, credit risk, underwriting risk, and business risk. In doing so the formula establishes a hypothetical minimum capital level that is compared to a company's actual capital level to develop a ratio. Another part of the RBC system is the Risk-Based Capital Model Law, which is an accreditation standard and has been adopted in all but one state. The Model Law sets four levels of required company and/or regulatory action, ranging from the Company Action Level (for companies with RBC ratios between 150 percent and 200 percent, where the company must develop a plan to raise its RBC ratio) to the Mandatory Control Level (for companies with RBC ratios below 70 percent, where the domestic regulator must place the company either into rehabilitation or liquidation).

While the RBC system is intended to prescribe minimum capital levels, regulators also expect it to function as an early warning system, with decreasing RBC ratios over time indicating a higher danger of insolvency.

Financial Analysis Working Group/NAIC Financial Analysis Division

This group of regulators and the NAIC staff division that supports it focus on the financial condition of "nationally significant insurers," defined as companies that write business in 17 or more states and write more than $30 million in gross premiums. This process, which is confidential, provides regulatory peer review of the actions domiciliary regulators take to improve the financial condition of larger insurers.

Financial Examination

The final method that regulators use to determine a company's financial condition is the financial examination. The NAIC's Model Law on Examinations, adopted in essence by nearly every state, requires each state's insurance department to conduct an on-site examination of each company domiciled in that state every three (in older versions of the law) or five years. These examinations are to be conducted according to the NAIC's Financial Condition Examiners Handbook, an extensive compilation of schedules, procedures, outlines and other guidance. According to the Handbook, the purposes of the examination system are "(1) Detecting as early as possible those insurers in financial trouble and/or engaging in unlawful and improper activities, and (2) Developing the information needed for timely, appropriate regulatory action." Within the confines of the five-year limit, regulators are encouraged to prioritize examinations of companies that are in the most troubled financial position, and the NAIC also provides a Troubled Insurance Company Handbook to help prioritize these companies and prescribe actions.

States can conduct either full-scope or limited-scope examinations. Full-scope exams are extremely thorough, and can encompass review of the company's management and internal controls, plan of operation, corporate records, accounts, financial statements, business in force, loss experience, reserves, asset quality and reinsurance. It is not uncommon for full-scope exams to take several months to a year or more to complete. The basis of the current full-scope exam is verification that the company's balance sheet as of a particular date is correct. A limited-scope exam usually focuses on one or more aspects of a company's operations, and may be called if financial analysis indicates regulatory concern in a particular area.

Corrective Action

Once a state regulator determines that a company's financial condition is endangered, state statutes provide regulators with broad authority to require companies to take corrective action. The final sanctions include the state's ability to rescind the company's license to do business or, if the company's condition warrants, to take control of the company or to liquidate it. Another accreditation requirement is that a state must have adopted in substance the NAIC's Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous

Financial Condition. This regulation provides standards for regulators to use in determining whether an insurer is in hazardous financial condition, and sets forth a list of actions the insurance commissioner may take or require such a company to take. These include steps such as requiring the company to reinsure more of its business, reduce or suspend the volume of new or renewal business, divest itself of certain investments or discontinue particular investment practices, and filing additional financial reports.

Investment and Reinsurance Regulation

Two important areas of financial regulation that do not fit neatly into the four functions described above are regulation of insurer investments and reinsurance.

Investment Regulation

As compared to general corporations, insurers hold a far higher percentage of their assets in securities, real estate, mortgages and other investments. This is because an insurer's primary business involves holding funds provided by policyholders to pay future claims and expenses. An insurer must invest those funds until they are used to pay claims. It is obviously critical to solvency that an insurer invests those funds in assets of high quality (to protect solvency) and that also produce a reasonable return (to reduce costs to insureds). Those assets should also be reasonably liquid, and the insurer's portfolio should be diversified.

Each state has a fairly detailed investment law that specifies which types of assets domestic insurers may hold. Many of those laws also prescribe limits on the amounts of each type of asset that an insurer may hold, as well as limits on the amount of investments in a single issuer that an insurer may hold. The NAIC has also drafted two model investment laws that states may either adopt in whole or in part when they feel the need to modernize their investment laws. One model law is designed for use by states whose laws prescribe limits for most asset types (the so-called "pigeonhole" model), and the other is intended for states whose laws rely more on the manner in which insurer management conduct their investment policy (the so-called "prudent person" model). A separate NAIC model, the Investments in Medium Grade and Lower Grade Obligations Model Regulation, limits the amount of non-investment grade obligations in which an insurer may invest.

Statutory accounting principles also contain the concept of "admitted assets", which are intended to be readily convertible into cash in order to pay claims. Generally, the limits in state investment laws provide that, to the extent a company's investments exceed the limits, they are "nonadmitted" and the company cannot take credit for them on the Annual Statement's balance sheet.

Finally, companies must value their investments correctly. Under the NAIC's accreditation standards, each accredited state must require that securities be valued according to the rules of the NAIC's Securities Valuation Office (SVO), and that other invested assets be valued according to the rules of the NAIC's Financial Condition (E) Committee. The SVO is a NAIC staff office that assigns asset quality designations (NAIC-1 for the highest quality, through NAIC-6 for obligations in default) and valuations.

Reinsurance Regulation

A final piece of the regulatory structure is regulation of how companies reinsure their liabilities. This is also critical to the primary company's solvency, since generally if a reinsurer becomes insolvent, the primary insurer remains liable to its insureds with respect to business it has reinsured. The NAIC and the states addressed this concern through the accreditation process by enacting the NAIC's Model Credit for Reinsurance Act. This law provides standards for when companies can reduce their unearned premium or loss reserve liabilities or take credit for reinsurance recoverable as an admitted asset. Companies may take credit for reinsurance from reinsurers that are licensed or accredited in the ceding company's domestic state. These reinsurers have submitted themselves to the domestic state's regulatory authority. If the assuming company is unaccredited, the ceding company may take credit only if the assuming company maintains a U.S. trust fund or acceptable, segregated collateral or a letter of credit in at least the amount of the ceding company's liabilities.

Regardless of whether the reinsurer is accredited or unaccredited, primary insurers have their reinsurance portfolio monitored by regulators via the Annual Statement and the financial examination process. There is great detail about a primary insurer's reinsurance program set out in the various parts of Schedule F of the insurer's Annual Statement. Additionally, the general interrogatories of the Annual Statement also include information about the reinsurance program of the insurer.

Finally, in order to more fully assure that funds are available to pay claims in the event of an insolvency of the primary carrier, for a primary company to obtain credit for reinsurance, the reinsurance agreements must contain a provision that the reinsurance is payable by the assuming insurer on the basis of the liability of the ceding insurer under the contracts reinsured without diminution because of the insolvency of the ceding insurer.

From this it is clear that, absent licensing in a state, a reinsurer generally is not regulated directly. Insurance regulation has taken a market-based approach to effectively regulate the reinsurer in the context of regulating the primary insurer. Without reinsurance meeting certain qualifications, the primary insurer cannot obtain credit for the reinsurance. This allows for numerous alternatives to secure that credit, as the insurer sees fit and finds available in the marketplace. It also permits insurers to find reinsurance to strengthen their financial position regardless of the credit for reinsurance, if that insurer so chooses.

Improvement Needed

The NAII and others in the industry have been critical of several aspects of state financial regulation in recent years. We believe that portions of the regulatory system are unnecessarily costly and inefficient. There has been a tendency to "layer" new reporting, analysis and examination tools on top of existing procedures without determining what procedures are now unneeded and can be eliminated. There are indications that the NAIC and the states are beginning to respond. Two new NAIC groups, the Risk Assessment Working Group and the Examination White Paper Focus Group, have been created to respond to regulatory and industry concerns that the financial examination system needs to be improved. Although there are no guarantees, we are working with these groups to eliminate costly inefficiencies in the examination process, and to refocus the examination so that it is not exclusively balance sheet oriented but evaluates how management is assessing and dealing with future business and other corporate risks. The objectives are to lessen the intrusiveness of the financial regulation process and increase its effectiveness in minimizing the financial impact of insolvencies. We continue to believe, however, in state regulation. The states have responded and we believe that our efforts to work with the states to improve the process will yield positive results.

NAIC Accreditation Program

One of the reasons why GEICO and NAII continue to believe in state regulation is because it has responded in the past when challenged. For instance, the NAIC's Financial Regulation Standards and Accreditation Program is a testament to the resilience of the state system. In response to an unprecedented wave of insurer insolvencies in the late 1980s, state regulators and the NAIC responded by crafting and implementing a program designed to enhance solvency regulation. It was based on the premise that each state should have minimum criteria or standards (laws, regulations, implementation and personnel practices) for monitoring solvency. Under the NAIC's accreditation system, a state must have enacted each model law, regulation and practice specified in the program in order to receive "certification". Examples of "Part A" of the accreditation standards include the NAIC Model Insurance Holding Company System Regulatory Act, Model Law on Credit for Reinsurance, and Model Rule Requiring Annual Audited Financial Reports.

"Part B" of the standards comprises regulatory practices and procedures relating to implementation of the "Part A" standards. NAIC and the states sought to assure that each jurisdiction not only had the requisite statutes and regulations in place, but that they were interpreting and enforcing them appropriately. Further, "Part C" of the standards seeks to assure that each jurisdiction has met minimum standards for organizational and personnel practices relating to the solvency regulatory function.

Every state has adopted most of the accreditation requirements, and all but two states are currently certified.

The Accreditation Program has been a clear success in that it met the two original goals of 1) improving state regulation for solvency, and 2) helping to defuse the call for federal solvency regulation prevalent in the early 1990s. At a minimum, the Accreditation Program has assured that states meet a baseline of solvency regulatory standards.

In the years since establishment of the original standards, the NAIC working in conjunction with state legislators continues to refine the Accreditation Program, carefully adding newer solvency regulatory tools to keep pace with evolution in the marketplace. Recently added standards include the modified NAIC Accounting Practices and Procedures Manual (more commonly known as "codification"), and the model rule requiring annual audited financial reports.

Following consultation with groups of state legislators including the National Conference of State Insurance Legislators (NCOIL), the NAIC in 1998 created a revised process for adding new standards to the program. The system helps assure flexibility, including addition of new standards if there is true consensus the given model, provision or practice can effectively enhance solvency regulation. The process includes procedural safeguards and opportunity for input from all interested parties.

The NAII has commended the NAIC for crafting the Accreditation Program, and state legislators for adopting the legislative standards where necessary. The Accreditation Program serves the U.S. insurance-buying public well. The key to the Program's adoption in the states lies in the true underlying consensus among state legislators and regulators regarding the need for solvency regulatory reform. Our hope is that similar underlying consensus will grow among state policymakers regarding the need for modernization of other aspects of state regulation, especially those pertaining to rates and forms, market conduct, and licensing procedures.

Adoption of these new standards or tools does not prove by itself that state solvency regulation has improved. Nevertheless, the pace at which the NAIC developed and states implemented the requirements of the accreditation standards does show, however, that the states can react quickly when sufficient need is shown.

Safety Net - State Guaranty Funds

While financial oversight is arguably the most important role of regulators over financial institutions, the reality is that banks, savings and loans and insurers will, on occasion, fail. This scenario can arise, regardless of whether an institution is regulated by a single regulator or multiple regulators as in the case of banks (by the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (FDIC).) Since there have been periodic failures in the insurance business, the "safety net" function of the state guaranty funds is critical.

Our observations are exclusively in reference to property-casualty insurance guaranty funds. These funds have been in existence since the late 1960s in all states. Above all else, it must be said that guaranty funds have consistently fulfilled their role as guarantors of payment when an insurance company fails. They are largely inconspicuous claim payment and financial assessment mechanisms. In just over 30 years, the funds have paid out over $9 billion in claims, often under crisis-like conditions due to multiple failures over a short time period or because of major natural disasters. For example, in the mid-eighties, the insolvencies of six insurers meant guaranty fund payouts totaling over $2.5 billion. Hurricane Andrew devastated south Florida and other states in 1992 generating insured losses exceeding $15.5 billion, yet while the Florida guaranty fund was strained due to a spate of insolvencies, covered claims were paid. Hurricane Iniki in 1993 destroyed an estimated $1.6 billion in property in Hawaii, yet could not bring down the Hawaii guaranty fund. Indeed, the state guaranty funds have "weathered many storms" and adapted to very difficult situations.

State guaranty funds operate in accordance with local statutory provisions, with coverage terms varying somewhat depending on the state. They are tailored to the insurance market conditions of each state. So, appropriately, states may set differing caps on fund payments. Generally these caps are $300,000 per claim or higher, with no cap on workers' compensation. Compare that to the $100,000 cap the FDIC administers in conjunction with federally insured deposits.

When an insurer is declared insolvent and ordered liquidated by a court, the guaranty funds step in and act like the insurer, processing and paying claims. Claim payments are subject to state laws which outline procedures such as the time to file claims (bar dates) and other payment limitations (for example, net worth of the insured/claimant, unearned premium amounts, punitive damages). More significantly, claim payments are handled subject to the terms of the policy the insolvent insurer issued, with variances relating to company, state statutes, local conditions, state tort and state contract law. Guaranty funds differ from the FDIC in that the former entities do not merely replace funds that were maintained in an account. Rather, guaranty fund operations are about the processing of insuring claims swiftly, but prudently, so as to prevent fraud and identify claims without merit. This explains why the insurance industry has a hands-on role in administering state guaranty funds.

Insurance industry involvement is also appropriate because private insurance companies are assessed to provide the capital or cash flow for the guaranty funds. Insurance company officers and legal staff are frequently on the boards of state guaranty funds, providing guidance to state fund managers. Generally, state guaranty funds do not assess insurers until a need for funds materializes. This "post-assessment" system helps insurers maintain the capital needed for their own investment and claim payment. Additionally, unlike the banking industry where the FDIC is pre-funded to meet immediate cash needs of depositors, guaranty funds, like any property-casualty insurer, do not pay until there is a determination that a claim is covered. In addition, claim payment is often not immediate due to a pending legal action. This "lag" permits a post-assessment system to work.

Currently, the annual assessment capacity of state guaranty funds (on a countrywide basis) is over $4 billion and growing. In the 30-plus years of state guaranty funds, the largest annual capacity utilization was under 35%. Since property-casualty insurance claims are often spread out over a number of years, this moderates the immediacy needs of guaranty fund assessments. For example, some of the insolvencies of the mid-1980s still have claims outstanding.

Since 1969, property-casualty insurer insolvencies have averaged 14 a year. This rate of insolvency should be weighed in the context of the number of firms in the industry. According to the NAIC, in the year 2000, there were over 3,200 property-casualty insurance companies licensed in the U.S.

State guaranty funds are one aspect of the state system of regulation that has worked extremely well over their history. NAII is very skeptical of any federal intervention that would abolish or modify the state guaranty fund system. For instance, an optional federal charter bill that establishes federal standards for state funds or a standby federal guaranty fund in the event of a state failing to match federal requirements would be of great concern. These measures would undermine state coverage terms and rules that were developed to match local market conditions, and they could threaten the assessment capacity of the state funds if companies chartered at the federal level were exempted from assessment at the state level.

Insurance Data

Data reporting and availability is one element of insurance regulation that is especially important to NAII and its member companies. A substantial number of NAII members are small property-casualty writers. These companies operate as single-state insurers, or regional writers that transact business in a limited number of states. Because of smaller books of business, these companies are not able to develop actuarially credible rating information through their internal loss experience alone. They depend on the availability of aggregated industry loss cost data in order to develop rates. Without advisory loss cost data, smaller insurance companies would be unable to compete with larger companies that are able to rely on their own loss experience to develop accurate rates.

In addition, many property-casualty insurers (both small and larger, regional companies) rely on the availability of supplemental rating information developed by licensed advisory organizations such as the Insurance Services Offices (ISO) in order to administer their rating programs. This advisory information would not be available if all insurance companies did not report data or were constrained from reporting data as the result of federal antitrust law exposure. On the other hand, if it were available at all, the cost might be prohibitive because the statistical agent organizations that collect, aggregate and publish data would have fewer companies over which to spread their production expenses.

The state regulatory system respects the value of advisory loss cost and similar data to insurance market competition by (1) compelling insurance carriers to report data; and (2) authorizing the compilation/publication of such data by licensed advisory organizations. This data contains key information regarding insurance coverages and recent premium and loss experience related to such coverages. Laws and regulations in all states require insurers to report statistical data, and state insurance regulators use statistical data for a variety of purposes. For example, the data helps regulators analyze trends in loss experience under various types of policies, and evaluate the appropriateness of rates and rating plans being used in their states. In most jurisdictions the regulators appoint statistical agents to perform the data collection function, and NAII serves as a statistical agent. The NAIC Statistical Handbook specifies the content of the reports that these statistical agents produce. The statistical agents in turn develop more detailed statistical plans that are continuously reviewed and updated as necessary.

The McCarran-Ferguson Act provides another essential statutory provision in respect to the availability of advisory data. The Act's limited antitrust exemption provides the legal framework under which statistical agents for the state can collect data, and insurance companies can pool and use aggregated loss information. Under the current statutory and regulatory framework at the state level, all insurers regardless of size must report relevant loss experience. This pooling of data allows regulators to carry out their functions and also provides insurers with sufficiently credible data to assure the ability to compete on price. Advisory loss cost data has helped to maintain a blend of both large national firms and small community level and regional underwriters in the property-casualty insurance markets.

In response to various proposals over the years that could have altered the limited antitrust exemption and the permissibility or requirement for all companies to report data, NAII has consistently pointed out the linkage between advisory data availability and competitive insurance markets. In the absence of such data, smaller insurers would confront increased operating expenses, due to data acquisition expenses or less competitive pricing. Over time, it could threaten the small company franchise. The absence of data would also have a chilling effect on the ability of some insurers to expand into new markets or new product lines, or perhaps to continue in current markets.

If an optional federal charter system made data reporting discretionary or abolished the McCarran Act antitrust law safe harbors, many companies would be forced to either do business with less accurate pricing or to restrict underwriting. The statistical reporting framework currently in place in the states facilitates and enhances competition. A number of studies including those by the U.S. Justice Department, state insurance departments and respected economists consistently conclude that the insurance industry is very competitive under classic economic tests.

If insurers chartered at the federal level were exempted from mandatory data reporting requirements (either explicitly in the legislation or post-enactment through a preemption of state law by a federal regulator), the ability of rate advisory organizations to develop credible rating information tools could be jeopardized. The current statistical data collection and pooling system, effectively overseen by state regulators and the NAIC, serves regulators, industry and consumers well. Regulators are afforded insightful statistical information to help them carry out their regulatory functions. Through the required reporting of statistical data by all insurers, companies and the consumers they serve enjoy the benefits of enhanced competition and wider availability of coverage.

Regulatory Modernization

Changes in the economy, globalization of markets, new technologies, and convergence in the financial services industry in recent years have spurred demands for regulatory reform and modernization. NAII has in fact taken the lead in calling for a number of significant changes at the state level. Demands for change have also been echoed at the federal level and there are currently two comprehensive bills being discussed in Congress calling for the creation of an optional federal charter regulatory system.

Virtually all segments of the insurance industry see the need for insurance regulatory improvements, but no single solution is supported across the board. Certain segments of the industry favor a single, centralized regulator, others support adoption of federal standards, while a large segment proposes further improvements to the state system.

In the post September 11 insurance environment, there has been significant interest in whether the property-casualty insurance industry will be able to absorb multiple financial hits of the size of the World Trade Center disaster. Much debate has taken place over the last six months on whether Congress should enact a high level federal financial backstop over private sector insurance coverage in the event of future terrorism losses. If regulators and lawmakers are concerned about future underwriting capacity in the private insurance market, they should work to assure that the insurance regulatory system is structured so as to encourage the natural infusion of private capital into the industry. Regulatory rules, procedures and philosophies should be geared toward stimulating market competition, not impeding it. For example, there are over 1,400 companies writing automobile insurance in the U.S., however, only 350 of those companies on average write auto insurance in any given state.

If an industry's regulatory system is oppressive, inefficient, or bureaucratic, it will discourage investment and venture capital from entering that industry. That at least partly explains why much of the new capital coming into the insurance sector subsequent to 9-11 has gone to offshore enterprise. Regulation, whether based at the state or federal level, must be market-oriented and based on the premise of competition, the free enterprise system, and assure an adequate return on equity.

Similarly, the regulatory system must provide a means through which layers of risk can be redistributed efficiently, including to the capital markets. This is especially critical today as our society learns that risks such as terrorism and large natural disaster events have the potential to generate huge claim losses that can drain significant financial capacity out of the private insurance industry. As a result, regulatory modernization should include the requisite corporate structural authority for underwriters and investors to partner in risk securitization transactions. Regulators and lawmakers should be interested in setting policies in insurance and tax laws that encourage greater access to capital markets, long term reserving for terrorism and other disasters, and new investments in the insurance industry.

GEICO and the NAII agree there is reason for, and room for, change in the insurance regulatory framework. GEICO believes that state regulation can and should be given the opportunity to respond to the call for change, and so does NAII. We strongly believe that states must be given ample opportunity to make needed changes to their regulatory systems and are deeply committed to working with the NAIC, individual state regulators and legislators, as well as Congress, to encourage reform.

GEICO and the NAII continue to support the state regulatory system. First and foremost, insurance markets are local in nature. Property-casualty insurance products and the regulatory systems reflect significant variances in state laws relating to tort liability-injury compensation rules, contract standards, motorist obligations, the role of government, and for that matter, local variances in social and economic values. For instance, some states have elected to have a third party tort liability system govern personal injury reparations. Insurance laws and coverage therefore follow those statutory standards. In contrast, other states have opted for a comprehensive, no-fault auto insurance plan, and accordingly, insurance contracts must be structured along first-party and third-party lines. Because of the economic disparities (as manifested by variances in per capital income levels), law- makers in some states have chosen more modest financial responsibility limits, low cost auto insurance programs or created uninsured motorist waivers. These factors help explain why state regulation is the “best fit” insofar as insurance markets are concerned. State regulation has served, and continues to serve, as the foundation for competitive insurance markets, which afford consumers the greatest choice among service providers, pricing options, and insurance products.

State level supervision also encourages regulatory experimentation. While a bad regulatory policy at the state level can hurt local market conditions, at the national level it could disable the entire market. Some states are willing to correct regulatory systems that no longer work or have hurt competition.

While our trust in state regulation remains solid, both GEICO and NAII realize that the state system must undergo reform. Current regulatory systems in some states cause delays in introduction of new products and slow rate approvals. In some states, the company and agent licensing processes are lengthy and cumbersome. Conversely, in other states, the market withdrawal process is both bureaucratic and punitive in nature. Financial and market conduct examinations are often disjointed and inefficient, and suffer from a lack of coordination. These areas of state regulation must be updated, simplified, and greater uniformity must be achieved among the states.

Fortunately, a number of regulators are beginning to take action to address these problems. A number of states have initiated the process of enacting reciprocal agent licensing laws. Congress expressed its concern over this issue during debate on Gramm-Leach-Bliley and the states have taken steps to address the concerns. A number of states have enacted reforms in recent years that have significantly simplified the product and rate approval requirements for some commercial line contracts.

The NAIC commitment to regulatory reform has been encouraging also. For instance, the NAIC has identified procedural reforms that can simplify or expedite some aspects of regulatory compliance (e.g., Uniform Regulation Through Technology program) and have shown interest in procedures that can improve "Speed-to-Market" time. They have also put some regulatory concepts on the table (e.g., the Coordinated Advertising Rate and Form Review Authority, Interstate Insurance Compact for Multi-state Life Products, etc.) that evidence a willingness to engage the industry in a dialogue on regulatory modernization.

It is thus too soon to dismiss state regulatory modernization. Furthermore, we think it premature to doubt the sincerity of state officials to embrace change and take action. Congress must give the states time to move forward.

Although we believe it premature for congressional intervention, congressional attention to these issues may prove instructive. For instance, the congressional spotlight could encourage state regulators and the NAIC to reassess their reform agenda and self-critique the sufficiency and swiftness of the response to date. If Congress is sending a message by its actions, let it be that the states need to make their reforms more robust, that reform must extend to additional states, that reform must incorporate more product lines (including personal and main-street business lines), and that the pace of reform should quicken.

Federal Intervention – The Optional Federal Charter

GEICO and NAII are deeply committed to working with the NAIC, individual insurance commissioners, state legislatures, and other stakeholders on improvements to modernize the state regulatory system. While working with the states on regulatory improvements, we are also analyzing all other proposals for regulatory reform. Until such time as regulatory modernization has taken hold in all states, our industry must be ready to evaluate proposals advanced by others for improving insurance regulation. It is in this context that NAII is studying the optional federal charter system, including the two Congressional proposals.

The optional federal charter plans that have appeared so far envision a very ambitious but complicated regulatory system. They contemplate two separate regulatory regimes – one at the federal level, one at the state level – which ideally would foster regulatory competition between federal and state supervisors. In theory, such competition would yield more modernized and efficient regulation in the most critical areas, including rates and forms, market entry/exit, and company examination. In addition, a federal charter could be attractive to companies operating on a multi-state basis if regulatory compliance involved adherence to one set of standards administered at the federal level, rather than varying standards administered by several states.

The plans present interesting suppositions and theories, but to rush into a new system without thoroughly examining the consequences would be shortsighted. Both GEICO and NAII have apprehensions over the premature abandonment of exclusive state regulation without a full examination of the effects on the industry and consumers.

First and foremost, insurance regulatory reform is highly complex. The industry is extremely diverse. While the banking system has a dual charter structure, banking is an entirely different business franchise than insurance, and that industry's ties to our nation's monetary system and the economy provide a compelling justification and historical basis for federal oversight. There is however no comparable, intrinsic justification for a federal role in insurance oversight.

When it enacted the McCarran-Ferguson Act in 1945, Congress recognized the complex nature of insurance and concluded that the industry should be regulated at the state level. Unless the states prove themselves unworthy of retaining their exclusive role as insurance regulators, we urge Congress to refrain from intervention.

Second, the proposals raise issues for consumers, policyholders, and taxpayers as well as insurers themselves. In its analysis of optional federal chartering legislation, NAII has identified 10 major areas that present significant complexities and challenging public policy issues. For example:

- Optional federal charter systems that replicate state standards at the federal level will merely duplicate the shortcomings of the state system. This approach is evidenced by the treatment of rate and forms in federal bills. As a result it is difficult to see how a federal system duplicating the problems of the state system could result in regulatory competition or improvements on the state system.
- Current legislative proposals fail to establish explicit standards for acquiring a federal charter and could result in an unlevel playing field for certain insurers, particularly single state or niche writers. Unless all bona fide insurance companies regardless of their size, business plan, or method of delivery have a legitimate opportunity to acquire a federal charter the regulatory advantages under the federal charter could undermine market competition. A highly competitive market provides the greatest benefit to consumers. As a result, it is difficult to appraise the workability and practicality of an optional federal charter plan if critical regulatory standards are not enumerated.
- An optional federal charter system that precludes, restricts, or even discourages the production of advisory loss costs and supplementary rating information could seriously undermine competition and place smaller and regional firms at a disadvantage. Proposals for optional federal charters would alter the McCarran-Ferguson Act antitrust safe

harbor provisions that currently allow data sharing. They would also weaken state data reporting mandates. The inability of small companies and regional market firms to access needed data could significantly impair their ability to compete.

- An optional federal charter system that results in overlapping or dual regulation would significantly increase the cost of doing business. Financial or market conduct oversight at both the federal and state levels would needlessly drive up operating costs, and insurer solvency could be jeopardized.
- An optional federal charter system that established a national solvency fund for federally chartered companies could impair the financial capacity of state insolvency funds.
- An optional federal charter system that did not specifically authorize corporate structural flexibility and mobility between charters could result in unlevel playing fields. Even if insurance firms were given the regulatory flexibility to adjust their corporate structure in relation to their chartering needs, some companies would accrue significant, new business costs (e.g., setting up holding companies, demutualizing, acquiring a federal charter) to remain competitive under an optional federal charter system.
- An optional federal charter system that incorporates market-based regulation at the federal level for some business lines but not others would create "winners" and "losers" with adverse affects on market conditions and consumer choice.

Enacting and implementing a comprehensive optional federal charter that avoids serious design flaws would be a lengthy and Herculean task. The stakes are high and the pitfalls numerous. If Congress inadvertently failed in any of these critical areas, the resulting damage to market competition would harm consumers and further delay necessary reforms.

A Report Card on State Modernization

The states have been slow to embrace needed regulatory reforms that benefit all types of property-casualty insurers. NAII was encouraged several years ago when legislators in South Carolina repealed a number of laws that had prevented automobile insurance companies from competing aggressively in the state. By virtue of the state actions, that auto insurance market is undergoing staged regulatory re-engineering, and the benefactors will be local consumers who will eventually have more choices and more competitive insurance pricing. There are indications that the number of companies writing auto insurance has doubled in the few short years since the regulatory reforms were enacted (1999). More consumers in South Carolina will be insured by private insurance companies rather than involuntary market pools/facilities. NAII remains optimistic that South Carolina regulatory reforms will serve as a catalyst for similar actions in other states. What is especially significant about South Carolina's actions is that they affected personal lines insurance underwriting.

Legislative reform affecting personal lines insurance in 2002 however was minimal. One state enacted a law calling for a study of the insurance rating system. The New Jersey General Assembly is considering measures to reform their insurance regulatory system. The reforms would include a more competitive rating system. If New Jersey enacts regulatory modernization, it could spur action in other states with significant insurance markets.

For commercial lines, it is anticipated that by the end of 2002 approximately three states will have adopted some statutory changes, and most of these follow through on prior reforms. For example, the South Carolina Legislature has made it easier for businesses to be insured under streamlined risk placement and rating rules. New Mexico and Michigan are in the process of adopting commercial reforms, refinements of earlier legislative activity.

NAII and other industry groups have engaged individual regulators and the NAIC in a continuing dialogue on regulatory modernization over the last several years. These interactions resulted in the NAIC launching several "speed-to-market" initiatives and developing a regulatory concept for expediting product and price review (the NAIC's Coordinated Advertising Rate and Form Review Authority or CARFRA Program). While both sides still disagree on some of these measures, ideas have been exchanged. The dialogue has included exploratory discussions with regulators in a number of states on the prospect of moving from prior approval rating to competitive rating principles, and in correcting insurance department practices that slow the filing and approval process. These efforts have produced a number of operational reforms at the NAIC and a commitment from several individual insurance departments to reevaluate their rate and form filing procedures.

As NAII noted in its congressional testimony last summer before this Subcommittee, the NAIC's Improvements to State-Based Systems Working Group in 2000 produced a number of operational suggestions that, if individual state regulators adopted, would expedite the process of product approval somewhat. Those suggestions include elimination of desk-drawer rules, and specific timeframes for action by insurance departments on proposed rate and form changes. Individual state insurance departments must take the initiative to adopt procedures that enhance operational efficiencies and make certain they are implemented and adhered to by their staff.

To gauge the level of operational changes in the various insurance departments, the NAIC is moving toward a system of "self-certification" by the departments. Feedback from NAII members and others in the industry thus far indicates that the depth and breadth of the NAIC reforms and state regulatory implementation has not gone far enough. It is clear that the NAIC and state regulators will need more time. NAII has encouraged members of the NAIC to work more closely with legislators in their own states to help achieve the more important statutory reforms. Thus far, the NAIC has yet to take definitive action on recommendations to the states for statutory reforms affecting personal lines. Operational (insurance department) reforms will have a marginal effect at best if they are implemented in a state with an anti-market statutory framework for rate/form regulation.

Conclusion

We trust Congress will give the states more time to make meaningful advancements in their statutory and regulatory systems for commercial and personal lines insurance. Ongoing oversight by this Subcommittee can help impress upon the states the importance of improving and modernizing state insurance regulation. States need to understand that non-action in this area will only encourage federal intervention and potentially the abdication of their role as regulators-policy setters. On the other hand, if states move forward with regulatory modernization in a more aggressive manner, there will be renewed confidence in state regulation. There will also be a payoff to consumers, investors, and other stakeholders as property-casualty insurance markets become more competitive than they are today.

Thank you for the opportunity to present the views of GEICO and the NAII.