Testimony of the National Association of Insurance Commissioners

Before the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Committee on Financial Services
United States House of Representatives

Regarding:
Impact of the SMART Act on State Insurance Regulation

June 16, 2005

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Testimony of Diane Koken, President
National Association of Insurance Commissioners

Introduction

My name is Diane Koken. I am the Commissioner of Insurance for the Commonwealth of Pennsylvania, and this year I am also serving as President of the National Association of Insurance Commissioners (NAIC). I am pleased to be here on behalf of the NAIC and its members to provide the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises with the views of state insurance regulators. State insurance regulators are public servants representing the same people who are your Congressional constituents. We share your goal regarding the importance of regulation that balances the need for vigorous consumer protection with vigorous business competition to provide a healthy insurance marketplace for consumers.

Today, I would like to make three basic points –

- First, the NAIC is an organization of state government officials who are sworn to faithfully administer the laws enacted by our respective state legislatures and governors on behalf of our citizens. We are not a trade association. NAIC members recognize that protecting American consumers is our top priority and the reason for regulating insurers and producers. We are proud that responsive and effective consumer protection is the hallmark of state insurance regulation. As an organization of state officials, the NAIC has long been actively engaged in providing Congress and the federal government with technical expertise and policy guidance on insurance issues.

- Second, the states and the NAIC are on time and on target to modernize state regulation where improvements are needed, while preserving the benefits of consumer protection that is our real strength. In some areas, the goal is to achieve

national uniformity because it makes sense for both consumers and insurers. In areas where different standards among states reflect regional needs, we are harmonizing state regulatory procedures to ease compliance by insurers and agents doing business in those markets. In short, the state regulatory system has already recognized and is working to address legitimate modernization concerns. The states, more importantly, are committed to a continuing process of modernizing our nation's regulatory system as the marketplace continues to evolve, and to do so without sacrificing important consumer protections.

- Third, the draft SMART Act incorporates unacceptable levels of federal preemption that would create both legal and practical problems for the insurance industry and its customers. A thorough analysis of the SMART Act by 117 insurance regulatory experts from your home states identifies concerns where the bill would preempt many important state laws that protect consumers from unfair or discriminatory marketing, inadequate or excessive rates, and unsound products. Federal preemption of state insurance regulation denies your Congressional constituents the benefits of important state services and protections, as has already been proven in existing federal programs, such as FEMA in its administration of the National Flood Insurance Program, and ERISA through its taking away state authority to assist your constituents. The states believe it is constructive to point out basic constitutional, legal, and operational problems that would undermine the SMART Act's stated purposes.

Protecting Consumers is the First Priority of State Insurance Regulation

Paying for insurance products is one of the largest annual consumer expenditures of any kind for most Americans. Figures compiled by the NAIC show that an average family can easily spend a combined total of $4,500 each year for auto, home, life, and health insurance coverage. This substantial expenditure – often required by law or business practice – is typically much higher for families with several members, more than one car,

or additional property to insure. Consumers clearly have an enormous financial and emotional stake in making sure the promises made by insurance companies are kept.

Because they are typically complex and involve subjective decisions by insurers about policy coverage, rates, and paying claims, insurance products can generate a high level of customer dissatisfaction that requires a high level of regulatory responsiveness. When problems arise, state insurance departments are fully-staffed to handle consumer inquiries and complaints quickly with a local phone call. State regulatory staff are local residents who understand the contract and tort laws that govern insurance products in their state. As regulators of insurance, we are responsible for making sure the expectations of American consumers – including those who are elderly or low-income – are met regarding financial safety and fair treatment by insurance providers. The entire state-based system of insurance regulation and solvency guaranty funds is authorized, funded, and operated by the states, with no cost to the federal government.

As government officials responsible for operating the state system, we understand that any government regulation of business – including insurance – can be inconvenient and occasionally frustrating to commercial entities that wish to do business on their own terms. State regulators are constantly improving our standards and procedures to meet those concerns. Although some industry representatives complain about the state regulatory system being inefficient and burdensome, there is nothing in our experience to indicate that a single federal regulatory solution setting national standards could anticipate and handle insurance supervision as well as the state system had done.

The states believe that consumers are best served by knowledgeable insurance department employees who are accessible in the state to the consumer, and who understand the local issues impacting the insurance marketplace in their state. During 2003, state insurance departments handled approximately 3.4 million consumer inquiries and complaints regarding the content of their policies and their treatment by insurance companies and agents. This service to consumers is provided at little or no cost to them, and has resulted in the recovery of substantial consumer restitution.

NAIC and the states reject the notion that consumer protection is incompatible with a vibrant and competitive insurance industry. In fact, we know the opposite to be true. Effective consumer protection is integrally related to maintaining positive business climates in our states. The American insurance industry is the most successful in the world, with countries around the globe seeking to emulate our balanced regulatory environment in order to achieve the kind of consumer and investor confidence necessary to expand their insurance markets.

A few short years ago, there was much talk in the property and casualty industry about rate regulation being a major contributing cause to the industry's anemic financial results. Today, however, the property and casualty industry is sitting on record surpluses, with loss ratios and other key financial indicators being the best in thirty years. Had it not been for the four hurricanes in Florida last year, the industry would have had its best year since the 1950's. While state regulation can be improved, we should be cautious about making radical changes to a regulatory system that delivers for both consumers and insurers.

States Are Well on the Way to Achieving Modernization Goals in the SMART Act

Through testimony, meetings, and correspondence with the Financial Services Committee, NAIC members have consistently supported many of the regulatory modernization goals embodied in the draft SMART Act. We have a state-based action plan to achieve those goals that is on-time and on-target to achieve legitimate changes sought by the insurance industry. Like you, we want to accomplish needed modernization using the existing state regulatory system that has served our nation well for more than 100 years.

The NAIC's strong commitment to regulatory modernization is set forth in its modernization roadmap document, "Framework for a National System of State-Based Regulation". Here is an update on where we stand:

Life Insurance

- Where appropriate, NAIC and the states are working to achieve full regulatory uniformity to benefit both consumers and insurance providers. Marketing life insurance is an area where we agree with industry that greater uniformity is needed. To accomplish this, the NAIC negotiated development of an appropriate interstate compact, with full input from industry and consumer representatives. An interstate compact is the best way to get the job done while preserving effective state consumer protections.

- The NAIC finalized model legislation for the Interstate Insurance Product Regulation Compact in July 2003. The Compact creates an interstate commission that will develop national product standards for life insurance, annuities, disability income insurance and long-term care insurance products, as well as create a central point for insurers to file their products. The Compact becomes operational once 26 states or states representing 40% of the premium volume join the Compact.

- Since the NAIC adopted the model legislation in 2003, the Compact has been adopted by a growing number of states. In 2004, nine states enacted the Compact legislation (CO, HI, IA, ME, NH, RI, UT, VA and WV). So far this year, Compact legislation has been enacted in six more states (KS, ID, IN, MD, NE and WA). In two other states (TX and VT), the Compact legislation has been passed by the legislature and is awaiting the governor's signature.

- This means the number of states in the Compact will soon grow to 17, which represents approx 23% of the premium volume in this country. We expect this number to grow throughout the year. Compact legislation remains pending in a handful of other states, and we are optimistic about the chances for passage. Moreover, we anticipate the Compact will become operational in 2006. This will

be a remarkable achievement, considering the general rule of thumb for compacts is that it takes anywhere from seven to ten years to get them from the planning stage to becoming operational.

- The NAIC's Interstate Compact National Standards Working Group has developed 33 sets of standards for products that are covered by the Compact. There are 16 life insurance standards, 15 annuity standards, and standards for individual long term care insurance and individual disability income insurance. This preliminary planning will allow the Compact to become operational much more quickly once the requisite number of states have enacted the compact legislation. These standards were thoughtfully drafted and thoroughly vetted by regulators with input from state legislators, the insurance industry, and consumers.

Speed to Market

- Much progress has been made since 1999 to improve the situation for insurers regarding speed to market. While the effort is a work-in-progress that will continuously be enhanced and improved, there have already been many successes. In 1999, the NAIC's System for Electronic Rate and Forum Filings, commonly known as SERFF, was in its infancy. There were 1,009 product filings processed through SERFF. Last year, SERFF had grown to 151,064 filings with an average filing turnaround of 23 days. The SERFF system offers a true speed-to-market opportunity to the 1,575 insurers that choose to use this optional regulatory efficiency tool.

- Not all insurers choose to use SERFF, despite the speed to market that it offers. One of the great state regulatory successes is development and implementation of filing review standards checklists. These checklists have been implemented in 46 states, the District of Columbia, and Puerto Rico. They provide the tools needed for insurers to assemble product filings that comply with state regulatory and

consumer protection requirements. The checklists contain concise lists of the steps an insurer needs to take to submit a compliant product filing. Those insurers choosing to use the checklists have given regulators positive feedback, and report improvements in the timeliness of the product approval process.

Company Licensing

- Efforts to improve standardization and consistency in the licensing of insurers has made significant progress. A best-practices handbook was adopted by the NAIC this year. Among other things, it provides for states to rely on the domiciliary state regulator when assessing the financial condition and executive management of an insurer, and to apply a risk-based methodology for assessing the qualifications of an applicant insurer. A model law on company licensing was initiated this past week at the NAIC Summer National Meeting in Boston. We have already designed a uniform application and electronic system for facilitating the licensing process.

- Regulation and financial reporting of reinsurance transactions has taken center stage at the NAIC during the past three months. The NAIC moved quickly to design enhanced disclosures for evaluating the use of finite reinsurance by property/casualty insurers. Additionally, the NAIC has been working effectively with U.S. Treasury staff and European regulators regarding the requirement that non-U.S. reinsurers post collateral supporting their liabilities to U.S.-based insurers. State insurance regulators have also been cooperating with the European Commission and its member countries to assist with implementing the EU Insurance Group Directive.

- Financial solvency monitoring and insolvency regulation continues to consume a significant portion of the NAIC agenda. Insurance financial reporting is being further refined to allow earlier detection of troubled insurers. State regulators are adopting a more risk-focused assessment framework toward assessing the

solvency position of insurers. Capital adequacy standards are evolving to "principle-based" versus the present formulaic approach. Insurance regulators are pro-actively considering how best to improve the industry's corporate governance practices.

- The NAIC has also been working effectively with members of the International Accounting Standards Board. During our Summer National Meeting in Boston, the NAIC Financial Condition Committee began deliberations on a comprehensive model act designed to modernize and strengthen the authority of insurance regulators regarding insurer conservation, receiverships, and liquidations. The new model, which is expected to replace the Uniform Receivership Law, will be presented to the full NAIC membership in September.

Market Conduct

- The NAIC is implementing a more effective and efficient market regulatory system based upon the following five primary elements: (1) centralized data collection, (2) structured and uniform market analysis, (3) uniform examination procedures, (4) interstate collaboration, and (5) broader regulatory responses to address general business practices, with specific provisions for targeted examinations.

- To facilitate state collaboration, the NAIC created a Market Analyst's Scorecard to track state actions for the following areas: (1) appointment of a market analysis coordinator, (2) completion of core complaint analysis, (3) coordination with the NAIC's Market Analysis Working Group regarding nationally significant companies, and (4) participation in the NAIC's Market Information Systems. Forty-eight states and the District of Columbia successfully completed the goals outlined in the Market Analyst's Scorecard.

- In 2004, the NAIC published the Market Analysis Handbook to coordinate state market analysis nationally. A critical component is interstate collaboration on consumer problems through the NAIC's Market Analysis Working Group, which was formed in 2003. Increased analysis and coordination have resulted in fewer duplicative regulatory efforts.

- In 2002, the NAIC adopted a comprehensive set of Uniform Examination Procedures, to which 42 states have certified compliance. Uniform procedures make exams more efficient and enhance state collaboration.

- In 2006, the NAIC expects to develop more uniform and better standards for: (1) market analysis, (2) regulatory responses, (3) state authority to analyze, investigate and examine companies and (4) interstate collaboration. The NAIC Market Conduct Annual Statement Project, which will further unify and coordinate state market conduct data requests, became permanent in 2005 with involvement by 17 states. Additional states are expected to participate in 2006.

- Last year, the NAIC adopted a Market Surveillance Model Act providing that targeted or "for cause" examinations be conducted by states using uniform procedures based upon patterns or practices that deviate significantly from industry norms.

Producer Licensing

- As of today, 42 states have satisfied the producer licensing reciprocity mandates in the NARAB section of the Gramm-Leach-Bliley Act.

- The NAIC has moved well beyond the reciprocal licensing required by the Gramm-Leach-Bliley Act towards the NAIC's goal of achieving licensing uniformity. The NAIC adopted a uniform application that is used for both resident and non-resident licensing. Thirty-two states and the District of

Columbia are using these applications for resident licensing, while forty-eight states and the District of Columbia are using these applications for non-resident licensing. Another example of state uniformity and coordination is the well-established State Producer Licensing Database, which facilitates faster licensing of non-resident applicants, as well as better tracking and coordination of regulatory actions among states. Every state and the District of Columbia participate in this database, which has been the centerpiece for creating greater efficiency in producer licensing and greater consumer protections.

- The NAIC is also moving well beyond the Gramm-Leach-Bliley mandates calling for licensing reciprocity in a paper environment. The NAIC continues to call for licensing uniformity in a modern-day electronic environment that addresses: (1) licensing qualifications, (2) pre-licensing education, (3) producer licensing testing, (4) background checks, (5) application process, (6) appointment process, (7) continuing education requirements, and (8) limited line uniformity.

- The NAIC has partnered with producers and companies to create the National Insurance Producer Registry (NIPR), which offers an expanding array of electronic services to facilitate multi-state licensing, appointments, and other producer-related business. Use of the NIPR has grown impressively.

- The NAIC continues to seek enhanced state access to the FBI database and resolve the federal prohibition against sharing such information among the states.

- The NAIC has electronic procedures in place for: (1) appointments and terminations, (2) application process for non-residents, (3) automatic notice of regulatory actions to states, (4) creation of a national producer number, and (5) electronic home state certifications for non-resident licensing.

- The NAIC and state insurance regulators have been working with the Federal Emergency Management Agency (FEMA) to assist it with its mandate contained

in Section 207 of Senate Bill 2238. This provision requires the Director of FEMA to work with states and the insurance industry to establish minimum training and continuing education requirements for insurance producers that sell flood insurance.

- The NAIC and state insurance regulators have also been working with the Federal Crop Insurance Corporation's Risk Management Agency (RMA) on producer and adjuster licensing. The RMA would like states to provide a limited lines license for the nation's more than 25,000 crop insurance agents. Fifteen jurisdictions already have a limited lines license, and discussions are underway on improvements to agent education, testing and continuing education. Licensing of crop insurance adjusters is also being discussed.

Impact of the SMART Act on State Consumer Protections

As currently structured, the SMART Act would result in regulatory gaps and market uncertainty for both insurance companies and consumers because it broadly preempts existing state laws and regulations used to supervise insurance companies and producers. The NAIC and its members know very well from hands-on experience that modernizing complex regulatory rules in these areas must be handled very carefully, with full and ongoing input from regulatory experts, consumers, and industry. Even well-intended and seemingly benign federal laws can have a substantial adverse impact on state laws and regulations that protect insurance consumers if they preempt state regulatory authority. This has already been proven by ERISA regulations and the National Flood Insurance Program.

In December 2004, the NAIC undertook a thorough review and analysis of the draft SMART Act using seven teams of insurance commissioners and senior state staff totaling 117 regulatory experts. The SMART Act's provisions were evaluated to determine their potential impact on the NAIC's modernization roadmap and state regulatory authority. A final version of the NAIC SMART Act Review Team report was transmitted to Chairmen

Oxley and Baker on April 22, 2005. The report focuses on concerns about the negative impact of the SMART Act's fundamental structure, which would employ broad federal legal preemptions and second-guessing of state regulatory decisions to achieve its goals.

Here are the summary findings of the NAIC Review Teams report (a complete copy of the report is attached at the end of this testimony):

1. The SMART Act would substantially and negatively impact state regulatory authority to supervise property/casualty, life, and health insurance, as well as reinsurance, by establishing federally-mandated standards and preempting state laws. As a result, insurance consumers would be denied the benefits of important state consumer protection laws and regulations.

2. The SMART Act would create regulatory confusion in insurance markets by subjecting state regulatory authority to second-guessing and possible interference by a new federal entity called the State-National Insurance Coordination Partnership. In addition to raising a host of serious legal and practical concerns regarding its composition, powers, and administration, this Partnership would encourage time-consuming and expensive litigation by persons who disagree with state regulatory actions. The legitimacy of state actions would hang under a cloud of doubt until a final resolution is reached in federal courts, causing uncertainty in the marketplace.

3. The SMART Act would remove the ability for independent judgment and action by state regulators to protect consumers under state laws and regulations in such important areas as supervising rates and conducting market conduct exams. Even in Illinois, which has often been cited by SMART Act proponents as the model rate system for all states, the Act would undercut or negate important provisions of state law that make the Illinois rate system work.

4. Most specified time limits for states to implement the SMART Act's requirements are unrealistically short. In addition, many of the Act's provisions seem unworkable or detrimental to state consumer protection efforts.

5. Federal legislation is generally not needed to implement the various provisions of the NAIC's Roadmap for regulatory modernization. However, the NAIC welcomes federal legislation that would permit equal access by all state insurance regulators to the FBI's criminal database, enable sharing of confidential regulatory information, and grant states equal receivership powers with the federal government

The NAIC wants to play a positive role in helping the House Financial Services Committee evaluate the draft SMART Act by providing technical assistance as regulatory experts and policy input as state officials. However, the NAIC cannot support any federal legislation that includes broad federal preemption of state consumer protection laws or federal supervision of state insurance regulation. Unwise federal interference could undermine or negate state consumer protections, while also causing confusion among insurers, producers, and policyholders concerning "who is in charge" of important regulatory decisions.

As the SMART Act has not yet been formally introduced as a bill, it is premature for the NAIC to take a position to support or oppose it. However, we have expressed the NAIC's fundamental concerns regarding the structure and impact of the SMART Act during meetings and correspondence with Members and staff of the Financial Services Committee. For these reasons, the NAIC has long expressed concerns about how an optional federal charter for insurance companies would erode state authority and undermine consumer protections.

Conclusion

The system of state insurance regulation in the United States has worked well for 125 years. State regulators understand that protecting America's insurance consumers is our first responsibility. We also understand the difference between regulatory oversight of personal lines and commercial lines, and are taking necessary steps to modernize regulatory procedures for the benefit of consumers.

We ask Congress and insurance industry participants to work with us to implement the NAIC's modernization initiatives through the state legislative system. We believe that is the most practical way to achieve necessary changes quickly in a manner that preserves state consumer protections for the benefit of consumers. The state process rewards the citizens and consumers in each state by giving them control over important aspects of insurance and claims procedures that affect their financial security in the communities where they live.

The NAIC and its members have cooperated fully over the years with important inquiries by Congress into the adequacy of the state regulatory system. We believe these inquiries have demonstrated clearly that local and regional state regulation of insurance is the best way to meet the demands of consumers for this unique financial product. We will continue to work with Congress and within state government to improve the national efficiency of state insurance regulation while preserving its longstanding dedication to protecting American consumers.

Revised April 22, 2005

NAIC's SMART ACT REVIEW TEAM FINDINGS

CONTENTS

Background……………………………………………………………………… Page 2

Summary of Key Findings by the SMART Act Review Teams………………… 3

General SMART Act Legal Issues Regarding State Insurance Regulation,
Federal Preemption, Federal Oversight Entity, and Rate De-regulation……... 4

Federal Preemption of State Laws and Regulations………………….. 4

Examples of Federal Preemption in the SMART Act…………………... 4

Federal Standard-Setting in the SMART Act…………………………… 5

Legal Issues Regarding Smart Act Preemption Of State Insurance Laws. 6

Federal Supervision of State Regulation Using the "Partnership" –
SMART Act Title XV…………………………………………….…….. 8

Legal and Operational Issues Related to the Partnership………………... 9

Mandatory Federal Rate De-Regulation – SMART Act Title XVI……… 10

Examples of SMART Act's Negative Impact on Rate Laws in New Hampshire,
Illinois, Texas, and Ohio…………………………………………… 11

The SMART Act's Impact On Health Insurance – SMART Act Titles XII and XVI. 15

Company Licensing & Financial Surveillance – SMART Act Titles III and XIV… 17

Surplus Lines, Reinsurance & Receivership – SMART Act Titles VIII, IX, and XIII 18

Market Conduct, Agent Licensing, & Antifraud – SMART Act Titles II, IV, and X 20

Life Insurance and Viatical Transactions – SMART Act Titles V and XI……….. 22

Commercial P&C, Personal P&C, and Price Controls – SMART Act Titles VI, VII,
and XVI………………………………………………………………………. 25

The NAIC's Roadmap for Regulatory Modernization – "Framework for a National
System of State-Based Regulation"………………………………………….. 26

Analysis of the Draft SMART Act's Impact on the NAIC's Roadmap: *"Framework for a National System of State-Based Regulation"*

Background

- In December 2004, the NAIC's Government Affairs Task Force decided that state insurance regulators should undertake a detailed analysis of the Oxley-Baker SMART Act discussion draft released in August 2004. The SMART Act is a collection of many different regulatory goals combined under the umbrella of a central federal enforcement mechanism that preempts conflicting state laws and regulations.

- The proposed SMART Act is lengthy and complex, with 17 separate titles covering a broad range of state insurance regulatory practices. These include producer licensing, company licensing, commercial and personal rate supervision, reinsurance, surplus lines insurance, regulatory information sharing, access to FBI criminal data files, life insurance, viatical transactions, and health insurance. In each area, the SMART Act would require that states adopt uniform regulatory practices that meet specific federal requirements. The Act's regulatory standards and practices would be enforced by federal preemption of conflicting state laws. A new federally-mandated "partnership" organization would be created to supervise implementation of the Act's statutory requirements.

- The Government Affairs Task Force approved using teams of state regulatory experts to review specific sections of the SMART Act in order to assess their impact on state insurance supervision authority and regulatory modernization efforts. As a result, seven review teams were created to evaluate and issue separate reports on each title of the SMART Act discussion draft. The NAIC review teams were comprised of 117 commissioners and senior regulatory experts from state insurance departments and the NAIC.

- The NAIC's ongoing state regulatory modernization program, entitled *"Framework for a National System of State-Based Regulation"* (nicknamed the NAIC Roadmap), was used as the focal point for evaluating specific provisions of the draft SMART Act. The review teams evaluated how the SMART Act's provisions would affect state implementation of the NAIC Roadmap and state supervision authority generally if the Act became law. Each SMART Act review team was asked to evaluate its assigned sections of the Act with the goal of answering three basic questions:

  (1) Are the NAIC's Roadmap goals adequate?
  (2) Is federal legislation necessary to reach NAIC's goals?
  (3) How does the SMART Act impact state regulation?

Summary of Key Findings by the SMART Act Review Teams

6. The SMART Act would substantially and negatively impact state regulatory authority to supervise property/casualty, life, and health insurance, as well as reinsurance, by establishing federally-mandated standards and preempting state laws. As a result, insurance consumers would be denied the benefits of important state consumer protection laws and regulations.

7. The SMART Act would create regulatory confusion in insurance markets by subjecting state regulatory authority to second-guessing and possible interference by a new federal entity called the State-National Insurance Coordination Partnership. In addition to raising a host of serious legal and practical concerns regarding its composition, powers, and administration, this Partnership would encourage time-consuming and expensive litigation by persons who disagree with state regulatory actions. The legitimacy of state actions would hang under a cloud of doubt until a final resolution is reached in federal courts, causing uncertainty in the marketplace.

8. The SMART Act would remove the ability for independent judgment and action by state regulators to protect consumers under state laws and regulations in such important areas as supervising rates and conducting market conduct exams. Even in Illinois, which has often been cited by SMART Act proponents as the model rate system for all states, the Act would undercut or negate important provisions of state law that make the Illinois rate system work.

9. Most specified time limits for states to implement the SMART Act's requirements are unrealistically short. In addition, many of the Act's provisions seem unworkable or detrimental to state consumer protection efforts.

10. Federal legislation is generally not needed to implement the various provisions of the NAIC's Roadmap for regulatory modernization. However, the NAIC welcomes federal legislation that would permit equal access by all state insurance regulators to the FBI's criminal database, enable sharing of confidential regulatory information, and grant states equal receivership powers with the federal government

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The SMART Act's Impact on State Regulatory Authority

TEAM #7
General SMART Act Legal Issues Regarding State Insurance Regulation, Federal Preemption, Federal Oversight Entity, and Rate De-regulation

The current draft of the SMART Act presents myriad legal issues, ranging from fundamental constitutional issues concerning the relationship between the federal government and the states to a variety of issues presented by the draft language of the statute itself. What follows is an attempt to identify and categorize the legal issues presented in the draft Act. It is not intended as an exhaustive list of those issues, nor is it intended to provide answers to the fundamental questions presented.

Federal Preemption of State Laws and Regulations

The SMART Act draft provides for extensive use of federal legal preemption as a means of achieving uniformity. Preemption of state law is expressly called for in the following Titles: Title II (Market Conduct and Uniform Standards), Title III (Insurer Licensing), Title IV (Producer Licensing), Title V (Life Insurance), Title VI (Commercial Property and Casualty Insurance), Title VII (Personal Lines Property and Casualty Insurance), Title VIII (Surplus Lines and Independently Procured Insurance), Title IX (Reinsurance), Title XI (Viaticals), Title XIII (Receivership), Title XIV (Financial Surveillance), Title XV (Partnership), and Title XVI (Creating Competitive Insurance Markets).

Examples of Federal Preemption in the SMART Act

The draft Act uses different mechanisms to effect the preemption of state law. Several examples are set out below.

1. The most prevalent form of preemption language requires that states must either enact a model or updated laws within a certain time period (generally three years) or their laws governing the same area will be preempted. Preempted state laws would be replaced by standards prescribed in the model law, even if not adopted by the particular state, or as specified in the Act. (Titles II, III, IV, V, VI, VIII, IX, XI, XIII and XIV.)

2. To the extent any state law would prohibit the state insurance commissioner from complying with Title II concerning Market Conduct Uniform Standards, that state law is preempted. §207(c).

3. States are prevented or face restrictions from exercising their authority to conduct examinations, take enforcement action, collect examination fees or assessments, deny licenses, or collect license fees unless they meet certain standards. The following provisions are examples of this form of preemption:

   §202(a)- For Cause Examinations
   §203(c)- Collection of Examination Fees

§301(d)- Insurer Licensing
§401(b)- Producer Licensing
§401(c)- Licensing Fees

4. States are not allowed to use residence or place of business as a basis to impose requirements limiting or conditioning activities. §401(b).

5. States are restricted from imposing fee increases or establishing new fees in those areas where required laws have not been put in place. §401(c) (Producer Licensing Fees); §601(c) (Property & Casualty Filings); §701(c) (Personal Lines Filings). Titles VI and VII also include proposed restrictions on a state's ability to implement fee increases or new fees unless the state demonstrates at a public hearing that the direct costs of insurance regulation are expected to exceed the sum of all insurance-related fees or insurance specific taxes. §601(c)(2); §701(c)(2).

6. After a specific time period (i.e., two years from the effective date of the Act), states are restricted from exercising authority over any rate charged for an insurance policy by an insurer. (Title XVI)

Federal Standard-Setting in the SMART Act

Although some proponents of the SMART Act describe its provisions as merely an opportunity for states to develop their own uniform standards of insurance regulation, there are multiple instances where federal standards are in fact directly imposed on the states, either by having those standards set forth in the Act or by requiring the inclusion of certain standards within a specified model act. Examples include:

1. §201(c) sets a restrictive standard of home state deference unless there is a "for cause" examination.

2. §202(a) sets a restrictive examination threshold under which a state may call a "for cause" market conduct examination only if there is an immediate danger or identification of patterns or practices that deviate significantly from the norm or pose a potential risk.

3. § 203(c) establishes a new procedural argument under which a multi-state insurer shall not be liable to pay any fee, assessment, or other charge to a state that conducts a "for cause" market conduct examination that was not performed in material compliance with Title II.

4. §301(a-d) provides that a non-domiciliary state may only request certain information from an insurer licensed in another state, and may only grant or deny licensure based on standards set out in the Model Licensing Act.

5. §501(c)(3)-(d) sets out standards a state must use for approving any life insurance policy form in the event that state does not use the Uniform Multistate Filing System.

6. §600(2) dictates that required commercial and property filing standards include certain elements, including recognition of single-state governance of policy form requirements.

7. §601(b) sets standards for a nationwide filing system.

8. §803(c) sets out federal standards for the allocation of premium taxes among the states.

9. Subtitle B of Title XIII is essentially a detailed federal standard for insurance receiverships.

Legal Issues Regarding Smart Act Preemption Of State Insurance Laws

Two sets of legal issues that give rise to numerous questions and concerns are presented by the draft SMART Act. First, there are a variety of constitutional issues presented, and second, there are issues related to the specific language used in the draft Act. These two sets of issues are addressed in turn below:

1. Constitutional Issues Related to Preemption

a. The Full Faith and Credit Clause (Art. IV, Sec. 1) requires that each state give full faith and credit to the acts of every other state. The proposed "majority interpretation" requirement (§209(7)) that governs when state law will be preempted by the SMART Act or a specified Model Act is potentially in conflict with this constitutional premise. Using the definition of "majority interpretation" in the draft Act, the interpretation of 10 state courts or 10 insurance departments could override the interpretation of the highest court of an individual state. There are questions as to whether Congress has legal authority to enact a legislative exemption from the Full Faith and Credit Clause or create a circumstance in which 10 states would determine the law of the land. There is also a question as to whether a "majority interpretation" means a majority of 10 insurance departments, i.e., six of 10.

b. The Tenth Amendment provides that all powers not delegated to the federal government are reserved to the states. The doctrine of "Cooperative Federalism" differentiates between permissible federal laws that regulate state activities and impermissible federal interference with state regulation of private parties. Compare *New York v. United States*, 112 S. Ct. 2408, 505 U.S. 1434, 120 L. Ed. 2d 120 (1992) with *Printz v. United States*, 521 U.S. 898, 117 S. Ct. 2365, 138 L. Ed. 914 (1997). There are concerns that the draft Act, specifically Titles VI and XVI,

essentially requires states to enact federal laws, enforce federal statutes, and enforce an unfunded federal program.

c. Various provisions of the draft Act establish federal "goals" for state law developments. See, e.g., §801(b) concerning goals for state tax obligations on surplus lines insurance transactions. There are concerns as to whether creating a quasi-judicial body like the Partnership or granting NAIC the power to determine whether those goals have been met constitutes a legislative incursion into judicial powers in violation of the doctrine of Separation of Powers.

d. The draft Act provides in several instances that, upon a State's failure to act on certain provisions, federal law will prohibit state collection of certain fees and taxes. There are concerns as to whether the Commerce Clause enables federal law to impose such a broad restriction on the general taxing powers of states.

e. Pursuant to Section 1037 of the draft SMART Act, the United States Government Accountability Office (GAO) would be given an overly broad grant of authority to conduct audits of state insurance departments, i.e., to gain access to all records and information for the purpose of conducting an audit. If a State insurance regulator refuses to grant access to the GAO, Section 716 of Title 31 of the U.S. Code allows the GAO to subpoena the requested records. Section 716 also authorizes the GAO to bring a civil action to enforce the subpoena. For those failing or refusing to obey a court order requiring production of records, a court may issue a citation for contempt of court. As state insurance departments are legally authorized, administered, and funded under state laws, there are concerns such actions by GAO would unconstitutionally violate a state's sovereignty.

2. Legal Issues Regarding Application of Preemption Language

a. Who determines whether a state law is "substantially similar" to a Model Act? Is "substantially similar" the same as "materially identical"? (See e.g. §204(d)) What does "inconsistent" mean? (See e.g. §204(d)(2)). If a law, regulation or provision is inconsistent, does that also mean it is not "materially identical" or "substantially similar"?

b. Who determines whether a state law is different or in conflict with a Model Act? (See e.g. §301(f)(3)(B)). Does "identical" mean identical in every respect? (See e.g. §301(f)(2)). Is identical the same as "materially identical"?

c. Is the determination of substantial similarity made globally or on a section-by-section basis?

d. What is the effect of amendments by the NAIC to its Model Acts or by the states to their own regulations?

e. Are the Model Acts themselves preempted when there is no corresponding draft SMART Act provision?

f. What constitutes a "majority interpretation"? (§209(7)). In defining "interpretations" under Title II, the SMART Act draft refers only to opinions of state insurance commissioners, and limits those interpretations to legal opinions, letters, and bulletins. Do rules or other decisions promulgated by a state insurance department qualify under the Act? What about opinions of state courts and state attorneys general? Will interpretations of an insurance commissioner control even if superseded by other state authorities?

g. In providing that states must follow the majority interpretation of states, the draft does not define when an interpretation is final as to a particular state, or when the other states may rely upon that interpretation. What if 10 states have one interpretation and 10 other states have a different interpretation? Once a majority interpretation is established, does the requirement that all states follow that interpretation prohibit any state from ever adopting a contrary interpretation? If so, how can a majority interpretation ever be amended or resolved? As mentioned earlier, there is a question as to whether a "majority interpretation" means a majority of 10 insurance departments, i.e., six of 10.

h. If the interpretation of an insurance commissioner is changed by a trial court, reversed on appeal, and then sent to the Partnership, does this interpretation change the ten-state threshold regarding a majority interpretation and result in conflicting regulatory actions?

i. Title IV prohibits a non-resident state from denying licensure for non-resident producers on any ground other than failure to hold a resident license or failure to pay license fee. Does limiting the authority of a non-resident state to deny licensure also limit the nonresident state's right to revoke a license for other grounds, such as fraudulent acts committed in a nonresident state?

Federal Supervision of State Regulation Using the "Partnership" (Title XV)

Title XV of the SMART Act creates a separate federal entity – termed the "State-National Insurance Coordination Partnership" – that would play a significant role in developing and overseeing the relationship between state insurance regulation and federal goals. Membership of the Partnership would consist of three insurance commissioners, designees from the SEC, Treasury, and the Federal Reserve, and a commissioner-

nominated, non-voting Chair approved by the President. Although the Chair must have extensive insurance industry background, he or she is not required to have any insurance regulatory experience and will not be a state or federal government official. The Federal Advisory Committee Act will apply to meetings of the partnership. Expenses of the partnership are to be paid in equal portions by the state and federal government members.

Primary responsibilities of the Partnership include: (a) promoting uniformity, (b) advising the President and Congress on international insurance issues and federal financial policy affecting the insurance marketplace, (c) making determinations regarding state compliance with the Act, (d) mediating and resolving conflicts among governmental agencies, and (e) conducting arbitrations of inter-agency conflicts. The Partnership would have the authority to: (a) hold hearings and take testimony, (b) conduct non-binding arbitrations, (c) request any information from state insurance departments that may be of use to the Partnership in carrying out its duties, (d) issue interpretations and participate in court proceedings, with equal weight given to its interpretations, and (e) make determinations that could result in the preemption of state laws.

Arbitrations presided over by the Partnership include disputes among or between federal and state agencies and disputes between the Partnership and a given state. After an arbitration decision has been made, either the Partnership or the state may petition the United States Court of Appeals for the D.C. Circuit to be heard on the outstanding issues. Finally, in the case of a conflict regarding whether a state law, rule, regulation, order or interpretation is properly treated as preempted under the Act or is in compliance with the standards established by the Act, either the state or the Partnership may seek expedited judicial review of the Partnership's determination in the U.S. Court of Appeals for the D.C. Circuit.

The establishment and operation of the Partnership present a number of legal issues. Some of these issues are presented below. The questions raised below are based on a preliminary review of the draft legislation. Additional issues are likely to be identified as the analysis becomes more refined over the next few months.

Legal and Operational Issues Related to the Partnership

a. "Partnership" is a well-defined term in statutory and common law, and its principal utility in the law is to describe the relative economic interests of the participants in the arrangement. Because this is a not-for-profit entity without assets, the term may create ambiguities. There are concerns about these ambiguities.

b. The Partnership is described as an "independent establishment." What does this term mean? Will the Partnership be governed by the operational rules that govern a federal agency? If not, what rules will apply? There are no express provisions in the draft Act governing compensation, job titles, etc. How will those issues be resolved?

c. Although the activities of the Partnership are to be governed by the Federal Advisory Committee Act, the powers granted to the Partnership to issue interpretations, make policy decisions, determine compliance, conduct arbitrations and mediations, and initiate legal actions are not consistent with an advisory body. Is it normally within the scope of a federal advisory committee to have these powers?

d. Does formation of the Partnership and the requirement that state commissioner members of the Partnership perform certain duties and pay certain costs amount to a commandeering of a state and its assets to administer a federal law? Aside from the legal issues presented, are the states and/or the NAIC prepared as a practical matter to make the required financial commitment to the Partnership?

e. The draft SMART Act provides that states may be parties to arbitrations or injunctive actions initiated by the Partnership. What court would have jurisdiction over those proceedings? Would initiation of such actions violate the Eleventh Amendment?

f. With regard to the Model Laws and other standards that will be used to determine uniformity, there is no clear guidance in the draft Act regarding the criteria or procedures used to determine compliance with those standards. For example, §603(f) states that the Partnership in consultation with the NAIC will determine if the states have met a SMART Act goal, but it is unclear if the Partnership has the authority to make individual state preemption determinations or if this is merely an aspect of its own opinion to be included in an advisory report to Congress. How will compliance with SMART Act standards and goals be determined and what criteria will apply?

g. There are concerns as to whether the draft legislation essentially makes the Partnership a "regulator of state insurance regulators" as a result of its power to make determinations regarding preemption of state law, its ability to request information from state insurance departments, and its arbitration role that would effectively create a super insurance regulatory body.

h. Given the powers identified above, as well as the ability of the Partnership to maintain an office and hire staff, the Partnership appears to be a precursor to a federal insurance regulator.

Mandatory Federal Rate De-Regulation (Title XVI)

Title XVI provides that after the expiration of a two-year period, no state may require the approval or prior review of any rate charged for an insurance policy by an insurer. A flex-band phase-in will be incorporated for covered lines to phase in competitive rating. The flex-band will be based upon the increase or decrease in the aggregate rate for all such coverages. The flex-band will not apply on an individual insured basis, and an insurer may make only one rate filing during any 12-month period. The flex-band will be 7% during the first 12-month period, and 12% during the second 12-month. Credit insurance,

title insurance, mortgage insurance, gap insurance, medical malpractice insurance will be excluded from the covered lines of insurance. Health insurance will not be excluded.

Nothing in Title XVI preempts States from requiring the informational filing of rates; from establishing or recognizing rating or advisory organizations; and nothing in this section preempts State statutes, rules, regulations or orders that prohibits the use of race, color, religion, creed, ethnicity, or national origin as an underwriting or rating factor or classification.

In general, the SMART Act as currently drafted moves property and casualty rates to a file and use open competitive rating environment. It does so, however, without any fail-safe mechanism in case competitive forces are not working to serve the interests of the insurance buying public. Most state competitive rating laws have a fail-safe mechanism that reinstates a form of rate regulation if competition is found to be lacking. There are many examples of instances where competition among insurers has been found to be deficient. Under the SMART Act, there would be no remedy if that were to occur. The Act also does not define what level of competitiveness needs to exist or how one is to determine if a market is truly competitive. Further, the SMART Act does not have a remedy if a policyholder is aggrieved by a rating action taken by an insurer. This is an important element that gives the insurance buying public some redress if an insurer has misclassified the risk or otherwise charged an inaccurate premium.

Several examples follow showing how the SMART Act would have a negative impact on state rate regulatory frameworks.

Examples of SMART Act's Negative Impact on Rate Laws in New Hampshire, Illinois, Texas, and Ohio

Title XVI would have a negative impact on a number of important state insurance laws. For example, New Hampshire uses a file-and-use or use-and-file approach, except for workers' compensation, and more importantly allows the existence of competition to be the primary regulator of rates. Implementing a flex-band system, as described in the draft legislation, would very likely be viewed as a step backwards for insurers doing business in the state.

Illinois and its rating system have often been cited by proponents of the SMART Act as the model for other states to follow. Yet in Illinois and other states, Title XVI would preempt laws that provide important protections against excessive rates, unfairly discriminatory rates, inadequate rates, and inadequate notice of premium increase, etc. The authority of the state to regulate the adequacy (from a financial solvency perspective) or fairness (from an insurance classification perspective) of rates is crucial to the ability of the state to maintain an insurance marketplace based on competition while providing for financial solvency and consumer protections necessary to oversee the marketplace. Similarly, it is the policy in Illinois and other states to permit market driven rating only to the extent a truly competitive marketplace exists.

1) **Illinois** – Following are specific examples of Illinois law that would be preempted under the draft SMART Act:

a. *Excessive rates:* Illinois law allows the Director to disapprove a workers' compensation rate if the rate is excessive. However, by definition, a rate in a competitive workers' compensation marketplace is not excessive. The authority to disapprove a rate in a noncompetitive marketplace is crucial to the effective regulation of this market because a marketplace cannot operate to establish fair rates in the absence of true competition. (See 215 ILCS 5/456)

b. *Unfairly Discriminatory Rates:* Illinois workers' compensation law prohibits price differentials that fail to reflect equitably the differences in expenses and losses. A rate may be unfairly discriminatory if different premiums result for policyholders with like exposures and similar expenses. (Id.)

c. *Unfair Practices:* Illinois law allows the Director to take action against any company when the Director has reason to believe that any method of competition is unfair or that an act or practice is unfair or deceptive, or that a proceeding in respect thereto would otherwise be in the public interest. The Director's authority includes the authority to identify and define unfair practices not already explicitly defined and prohibited, and to order their discontinuance. (See 215 ILCS 5/427)

d. *Inadequate Rates:* Illinois law prohibits workers' compensation rates from being inadequate. A rate is inadequate if it is clearly insufficient to sustained projected losses and expenses in a class of business to which it applies and the use of such a rate may have the affect of substantially lessening competition or the tendency to create a monopoly in any market. (See 215 ILCS 5/456)

e. *Long Term Care Insurance:* In Illinois, long term care rates must be approved before the policy can be sold, and rate increases must be approved as well. There is ample evidence from recent experience to show that an overly competitive market can actually hurt companies and consumers. There have been cases where companies charged low initial rates to "buy" market share, rates that were driven by the desire to sell lots of policies, not by actuarial adequacy. However, long-term care policies may be in force for 20 or more years before any benefits are paid out. These products rely heavily on rates being adequate from the start. By the time it becomes apparent that premiums are too low the situation is irretrievable. Rate increases only mitigate a company's losses while forcing people who have had a policy for a long time to drop their coverage. In extreme cases, a company's solvency has been threatened. (e.g., Penn Treaty, Conseco Senior Health)

f. *General Powers:* The Director may take action against a company any time (s) he deems that such a proceeding is in the public interest. Such an action could be for rating purposes or other business practice. (See 215 ILCS 5/429)

g. *Conditions for Applicability of Increases to Existing Policies:* The draft Act contains provisions that would preempt more protective Illinois laws, specifically in the area of conditional renewals. The draft legislation allows for "conditional renewal" premiums, for insurers to mail renewal notices to the address shown in the policy, and to mail renewal notices 30 days prior to the renewal date. Illinois law does not allow "conditional renewal". The only reasons for which an insurer may change the premium after the renewal date are for a change in exposure or reinsurance cost not contemplated in the original quote. Illinois law requires companies to provide 60 days advance notice for any premium increase greater than 30%, or if the insurer imposes a change in deductible or coverage that materially alters the policy, which allows a commercial insured (whose business is more complex) time to shop the competitive marketplace. Illinois law requires insurers to mail notices to the last known mailing address.

2) **Texas** – Effective December 1, 2004, Texas changed to a file and use state. The draft SMART Act would impact the following Texas laws.

a. Under Texas Insurance Code Articles 1.02(b) (general application): "Rates used under this code must be just, fair, reasonable, adequate, not confiscatory and not excessive for the risks to which they apply, and not unfairly discriminatory."

b. Under Texas Insurance Code Article 5.13-2(4)(d) (P&C application): "Rates established under this article may not be excessive, inadequate, unreasonable, or unfairly discriminatory for the risks to which they apply."

c. Article 5.13-2 §5A (a) allows for prior approval of rates in these three circumstances:

- An insurer's rates require supervision because of the insurer's financial condition;
- An insurer's rates require supervision because of the insurer's rating practices; or a statewide insurance emergency exists;
- A statewide insurance emergency exists.

In Texas, inadequacy of rates was a problem until the late 1980's when a number of non-rate-regulated companies were acquired by MGA's and used to generate cash flow through the sale of large numbers of policies at below-market rates, only to end up in receivership within a short time. Texas law has since been strengthened to prevent these types of activities. However, with no provision for effective rate oversight, the SMART Act may effectively undo these improvements in Texas.

3) **Ohio** – The following is a list of Ohio insurance statutes that would be preempted if proposed Title XVI of the SMART Act were enacted:

a. 3935.03. Rating regulations -- General Requirements set forth - Actuarially sound rates meet the general requirements. Rates should result from an analysis of the company's own data, with consideration given to marketing and underwriting strategies, company operations, systems and policy writing constraints, targeted rates of return, and all other pertinent information.

b. 3935.04. Filing of rates and schedules with superintendent; procedure -- Requires that every form of a policy, endorsement, rider, manual of classification, rules, and rates to be filed. Establishes ratemaking statutory requirements; generally, a rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer.

c. 3935.05. Processing of filings -- Sets forth the process for the Superintendent to disapprove a filing that does not meet the requirements of section 3935.01 to 3935.17 of the Revised Code.

d. 3935.07. Deviation from rates filed by bureau -- Requires every member of a rating bureau to adhere to the filings made on its behalf by the bureau, but allows any member insurer to make written application to the Superintendent for permission to file a deviation. Establishes the procedure to review such applications.

e. 3935.10. Reporting loss and expense experience; interchange of data and co-operation with other states -- The Superintendent shall promulgate rules and statistical plans which shall be used thereafter by each insurer in the recording and reporting of its loss and expense experience, in order that the experience of all insurers may be made available at least annually in such form and detail as is necessary to aid the Superintendent in determining whether rating systems comply with the standards set forth in section 3935.03 of the Revised Code.

f. 3937.02. Basic provisions for rate making -- General Requirements set forth - Actuarially sound rates meet the general requirements. Rates should result from an analysis of the company's own data, with consideration given to

marketing and underwriting strategies, company operations, systems and policy writing constraints, targeted rates of return, and all other pertinent information.

g. 3937.03. Classifications; rules; rates; rating plan -- Requires that every form of a policy, endorsement, rider, manual of classification, rules, and rates to be filed. Establishes ratemaking statutory requirements; generally, a rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer.

h. 3937.04. Hearing on rates and filings -- Sets forth the hearing procedure when the Superintendent finds that a rate to which sections 3937.01 to 3937.17 of the Revised Code apply does not comply with those sections.

i. 3937.06. Deviation from filings -- Requires every member of a rating organization to adhere to the filings made on its behalf by that organization, but allows any such insurer to file with the Superintendent a uniform percentage decrease or increase to be applied to the premiums produced by the filed rating system.

j. 3937.12. Report of loss experience; interchange of rating plan data -- The Superintendent may promulgate reasonable rules for the reporting by each insurer of its loss experience, in order that such experience of all insurers may be made available, at least annually, to aid the Superintendent in determining whether rating systems comply with the standards set forth in division (D) of section 3937.02 of the Revised Code.

k. Additionally, the following Ohio statutes may be preempted:
   3937.22. Raising premium when insured not at fault prohibited
   3937.23. Premium increase restriction as to uninsured motorist accidents
   3901.20. Unfair or deceptive acts prohibited
   (Specifically 3901.21(M) defining, as an unfair or deceptive act, "unfair discrimination between individuals of the same class and of essentially the same hazard in the amount of premium, policy fees, or rates . . .")

The SMART Act's Impact On Health Insurance

TEAM #6
NAIC Roadmap: Health Insurance
SMART Act Titles XII and XVI

a. The SMART Act draft bill would definitely impact state regulation of health insurance. Section 1200(1) of the Act discusses uniform standards for internal and external reviews by insurance plans. This terminology is very specific to health insurance. (There is a question as to how broadly these provisions would

apply since "insurance plans" is not defined.) Section 1200(2) regarding an interstate compact for single point of filing and coordinated review of lines of insurance provisions specifically applies to lines of insurance other than those addressed in Title V (Life), Title VI (Commercial Property and Casualty) and Title VII (Personal Property and Casualty). Section 1601 on rate de-regulation applies to covered lines, and there is no exception for health insurance.

b. The impact of the SMART Act provisions on health insurance is quite substantial. For example, states now have a variety of requirements for internal and external reviews. Careful study of the issue is required so that existing consumer protections are not lost, since there are a variety of models to choose from, particularly on external review. These models range from the insurance commissioner being the ultimate arbiter of a claim denial to the insurance company setting up the review entirely on its own with no regulatory oversight. This matter is further complicated by a recent U.S. Supreme Court case on ERISA. The regulatory structure for external review must be carefully considered so that it does not violate ERISA.

c. The single point of filing and coordinated review of lines of insurance provisions in the SMART Act presume that an interstate compact is the best solution to deal with speed-to-market issues. Regulators, industry, and consumers have not agreed with that proposition regarding major medical insurance. The Act would require the states to set up a process that none of the players have concluded is in the best interests of anyone. Further, benefits and rates are driven by local factors, such as the demographics of the population and the composition of the provider community. Given those differences, this area may be less suitable for national uniform standards than other aspects of insurance. The NAIC has a thorough process for exploring common ground on various potential solutions on speed-to-market issues.

d. The most detrimental impact of the draft SMART Act is in Title XVI, entitled "Creating Competitive Insurance Markets." By phasing in total de-regulation of rates for all covered lines, including health insurance, the bill would effectively eliminate health insurance as an instrument of social policy. Although the health insurance system is not shaped exclusively by rate regulation, other requirements such as guaranteed issue, guaranteed renewal, and portable coverage would become almost meaningless if insurers were allowed to increase rates on individual consumers at any time, by any amount, and for any reason other than the handful of civil rights factors specifically enumerated in section 1601(d) (from which gender discrimination is absent, even for lines of insurance where there is no compelling actuarial justification for allowing sex discrimination). Such a fundamental change in national health care policy should be debated in the context of health care legislation, and not included in a bill whose purpose is to reform insurance regulation.

e. Section 1601(b), entitled "Protection of State Residual Market Requirements", provides that a state may not set rates for a residual market insurance entity that are less than the entity's expected losses (e.g. high risk pool). In other words, subsidization of a state high risk pool by assessment or otherwise would be prohibited. This provision vitiates the very purpose of a state high risk pool, which is to provide affordable coverage for the uninsurable. High risk pools would no longer be effective if such a provision became law. This provision also runs counter to HIPAA, which recognizes the NAIC model law (with its subsidization of pool losses) as an acceptable alternative mechanism for guaranteed issue in the individual market.

f. Legislation dealing with health insurance issues included in the SMART Act is typically handled by the House Energy & Commerce Committee rather than the Financial Services Committee.

NAIC Review Team Findings Regarding Specific Regulatory Practices Mandated by the SMART Act

The following sections present findings of Review Teams #1, 2, 3, 4, and 5. Those teams analyzed and reported on areas of the SMART Act that impact specific types of state insurance regulation.

TEAM #1
NAIC Roadmap: Company Licensing & Financial Surveillance Enhancements
SMART Act Titles III and XIV

Company Licensing

Federal legislation is not needed to reach national uniformity on company licensing.

Since the NAIC is already working successfully toward achieving national uniformity on company licensing, the SMART Act would have little impact on achieving this goal. Similarly, there would be little impact toward reaching the goal of streamlining the process for considering proposed mergers and acquisitions involving multiple jurisdictions due to the NAIC's modernization work in this area. The review team believes the NAIC's Financial Regulations Standard & Accreditation (F) Committee should consider amendments to NAIC's Accreditation Standards regarding company licensing and processes surrounding mergers and acquisitions. The original Regulatory Modernization Action Plan, adopted in September 2003, contemplated making such changes to Accreditation Standards.

Financial Surveillance

The SMART Act could introduce harmful ambiguity to accomplishing the NAIC Roadmap goals. Federal legislation is not needed in this area.

The NAIC's goals are adequate regarding review of corporate governance under the Model Audit Rule. The NAIC is currently in the process of implementing the risk-focused surveillance framework and passing amendments to the NAIC Model Audit Rule regarding the responsibilities of independent auditors. Federal legislation is not needed to implement the Model Administrative Supervision Act, as the model is expected to become part of the NAIC Accreditation Program.

The NAIC has already effectively accomplished national implementation of the Accounting Practices & Procedures Manual through development of a formal policy and communication strategy. Permitted practices are by nature rare exceptions to the codified body of statutory accounting. The SMART Act's requirement for notification of requested permitted practices has already been accomplished through a revision to the Preamble of the NAIC Accounting Practices and Procedures manual. This fact makes item (b)(6) of Section 1400 of Title XIV of the SMART Act redundant, since item (b)(5) requires adoption and implementation of the NAIC Accounting Practices and Procedures manual. Inclusion of this section in the SMART Act legislation is unnecessary.

There is no need for federal legislation regarding state examinations of insurers. Regarding different examination cycles among the states, it is unclear which cycle would be preempted in Section 1407, item (b) of Title XIV of the SMART Act. Ambiguity in the SMART Act could cause unintended consequences by hindering the ability of states to examine insurers.

TEAM #2
NAIC Roadmap: Surplus Lines, Reinsurance & Receivership
SMART Act Titles VIII, IX, and XIII

Surplus Lines

Either federal legislation, or another alternative such as an Interstate Compact, may be needed at some point to resolve conflicting state laws regulating multi-state transactions. The area where this will most likely be necessary is surplus lines premium tax allocation. Federal legislation might also be one option to consider to enable multi-state property risks to access surplus lines coverage in their home states under a single policy subject to a single set of requirements.

The draft SMART Act's timelines for implementing a centralized tax system and uniform eligibility standards are unrealistically short. The Act provides a period of 3 years to implement the central tax system, but does not actually create a central tax system that can be implemented. This is a complicated issue that will impact multiple agencies and

state revenues. If federal legislation is enacted in this area, there should be at least a minimum 5-year implementation period. Likewise, even if uniform surplus lines eligibility standards are accepted as a valid public policy goal at the federal level, the current lack of consensus on appropriate standards in this (inherently non-standardized) market makes a 2-year implementation period highly unrealistic.

As drafted, the bill also appears to preempt state restrictions on opening up the surplus market (especially for sophisticated commercial purchasers) to lines of insurance where there is consensus that surplus lines coverage is inappropriate, such as workers' compensation, health insurance, and life insurance. There is even an express reference to life insurance: Section 814(c)(2)(D) of the SMART Act refers to a purchaser that "procures its life insurance through the use of a risk manager."

Reinsurance

Federal legislation is not needed in this area. The NAIC's goals for implementing reinsurance reforms through the Credit for Reinsurance Model Act are the right approach. The SMART Act could have serious negative consequences on regulation of reinsurance compared with using the NAIC Roadmap process.

The primary concern with the substance of Title IX of the SMART Act is that it addresses uniform financial statement filings, deference to the home-state regulator, and a uniform solvency regime without addressing the critical issue of indirect regulation of foreign and alien reinsurers.

Federal preemption of state regulatory controls would have a significant impact on the regulation of reinsurers compared to enforcing uniformity for critical portions of the reinsurance regulations through the NAIC Roadmap. As drafted, the reinsurance Title of the SMART Act does not address reinsurance-specific items, but rather all licensed entities since there is no separate solvency or reporting regime for reinsurers versus primary insurers. It should also be noted that proposals to prevent "extraterritorial" regulation of reinsurance contracts could have serious unintended consequences. It is essential for the ceding insurer's state of domicile to have jurisdiction over some aspects of reinsurance contracts for purposes of solvency oversight, fraud prevention, and the administration of insolvent insurers' estates.

Receivership

Federal legislation is needed to establish parity between insurance receivership estates and federal bankruptcy estates. However, the SMART Act does not implement the federal legislative changes needed by NAIC, and instead would harm states by mandating and inefficient and outdated receivership law rather than the NAIC's Insurer Receivership Model Act.

As noted in the NAIC Roadmap, federal legislation will be needed to achieve parity between insurance receivership estates and federal bankruptcy estates regarding (1) the

applicability of liquidation bar dates to federal claims, and (2) tax-exempt status of receivership estates. However, these issues are not addressed in the SMART Act, and they affect different regulatory concerns that would be better addressed by targeted legislation. At least one of these issues is more likely within the jurisdiction of the Judiciary Committee.

The draft SMART Act would override the use of NAIC's greatly-modernized Insurer Receivership Model Act that is part of the NAIC Roadmap over the next four years. The incomplete and out-of-date receivership model in Title XIII of the draft SMART Act would increase costs, slow the liquidation process, make rehabilitations all but impossible, and cause claimants to be paid later and less (increasing frustration with and decreasing confidence in the insurance industry). Adding to its problems, the draft SMART Act uses only parts of an outdated receivership model that was at least highly integrated, complex and carefully drafted to balance competing interests. If parts of the model are used out of context (as is done in the draft SMART Act), then problems are likely to result.

TEAM #3
NAIC Roadmap: Market Conduct, Agent Licensing, & Antifraud
SMART Act Titles II, IV, and X

Market Conduct

The NAIC's Roadmap goals are generally adequate to achieve uniform market conduct standards. Federal legislation is not needed. On the surface, the SMART Act seems to share NAIC's goals. However, the specific requirements of the SMART Act would unduly restrict a state's ability to conduct specific market conduct exams and regulatory actions when needed.

Section 209(5) of the SMART Act defines market analysis in such a way that potentially limits a state's analysis to information that is filed schedules and other reports required under law to be submitted by an insurer on a regular basis, as well as other publicly available data. The NAIC does not believe market analysis should limited to information required under law to be submitted by an insurer on a regular basis. A state should collect and use data as the commissioner deems appropriate.

Pursuant to section 202(a) of the Act, a state may call a "for cause" examination if there is an immediate danger or identification of patterns or practices that deviate significantly from the norm or pose a potential risk, as long as the issue has not been addressed by another state in the past five years, or has been addressed by another state in the past five years but has not been appropriately addressed within a reasonable period of time by the insurer. The NAIC believes a commissioner should have the discretion to conduct targeted, on-site market conduct examinations when the commissioner determines that other market conduct actions are not appropriate.

Pursuant to section 203(c) of the SMART Act, a multi-state insurer shall not be liable to pay any fee, assessment, or other charge to a state for conducting a "for cause" market conduct examination that was not performed in material compliance with Title II. The NAIC believes it is inappropriate for an insurer to have the ability to nullify a state's examination findings because of a procedural argument.

Section 203(a) of the Act limits a state's authority to impose a sanction or fine to the extent the state's interpretation is not a majority interpretation. This subsection provides that no state conducting a market conduct examination may impose any sanction for a violation of a market conduct standard or requirement unless the standard or requirement is based on a majority interpretation. This is an unacceptable preemption of a state's authority to interpret and enforce its laws.

Section 201(c) of the SMART Act calls for home-state deference unless there is a "for cause" examination. While the NAIC recognizes the benefits of domestic deference, the NAIC also believes there are other appropriate forms of interstate collaboration.

Producer Licensing

Federal legislation is needed to assist states in gaining equal access to the FBI's criminal database for background checks. Otherwise, federal legislation is not needed to achieve national producer licensing.

While current federal law allows individual states to gain access to the FBI fingerprint database through law enforcement channels, states need broader federal legislation to authorize all other states and the NAIC to gain routine access for background checks and share information received from the FBI. Title X of the SMART Act provides for establishing an Antifraud Network that appears to provide states with the means to obtain and share criminal history record information with the NAIC and each other, although the process would be more complicated than that used by banks and securities firms.

The state implementation timeframes in the SMART Act are too short, especially in light of the fact that one of the biggest hurdles for states with the uniform standards is adopting the uniform renewal cycle. This could have some impact on how quickly states are able to adopt laws necessary to implement the uniform license cycles and synchronized renewal times. Apart from the overly aggressive timetable set forth in the SMART Act, states are already in the process of moving to electronic processing for both resident and non-resident applications and renewals.

The SMART Act raises concerns regarding its impact on the appointment process for state licensing directors and the exact requirements of a national producer database. The draft SMART Act would require changes to current uniform appointment procedures that are in place in almost all states currently processing appointments. The NAIC Uniformity Licensing Standards relating to the appointment process should be reviewed and updated so states could start making changes in their laws and rules to implement a quarterly electronic registration process. Most states use NIPR for initial appointments

and terminations, which are filed individually for each person seeking an appointment. Pursuant to the Producer Licensing Model Act, appointments occur within "within 15 days of an insurer contracting with the producer."

Finally, the SMART Act should be revenue neutral to the states, especially for producer licensing.

Anti-fraud

Federal legislation is needed in this area to implement the NAIC's Roadmap goals. Overall, Title X of the draft SMART Act should help implement and support the NAIC's regulatory modernization action plan. The SMART Act appears to provide for the sharing of public final disciplinary and formal enforcement actions, as well as direct sharing of "confidential supervisory information" among federal and state financial regulators. There are also protections for NAIC to handle and transmit regulatory information on behalf of state regulators.

The SMART Act draft also provides a new avenue for state insurance regulators to access FBI criminal database files for purposes of conducting background checks on persons seeking to be licensed as producers. However, this new grant of authority for states to gain access is not the same as the authority granted to banks and securities firms because it will involve a screening process to remove certain information from a person's file before it is given to a state regulator. In addition to practical problems associated with screening the criminal database files, the FBI has indicated that it is not prepared to operate a screening process as required by the draft SMART Act. These potential problems will need to be resolved if the Title X of the Act is to be effective.

TEAM #4
NAIC Roadmap: Life Insurance and Viatical Transactions
SMART Act Titles V and XI

Life Insurance

The review team noted a number of concerns with the SMART Act draft legislation that raised questions because the provisions were unclear. Team members could not envision how they would work within the framework of the Interstate Insurance Product Regulation Compact.

1. The group felt that defining "life insurance" to include two health products (long term care insurance and disability income insurance) will create confusion and lead to difficulty, especially in rating. First of all, if the Compact decided to expand its reach to other products, for example Medicare supplement insurance, this legislation might make that expansion difficult. Secondly, the fact that rates for long term care insurance and disability income insurance are included in the Compact argues for treating them differently, instead of calling them life insurance. Rates for health insurance products will vary in different parts of the

country, and the goals of uniformity urged in the SMART Act could be more difficult to achieve in this area. There is no mention of how these rating issues would be treated.

2. The legislation as drafted is confusing. Some review team members felt the legislation requires every state to change its laws to match the standards in the Compact. The NAIC's goal in developing the Interstate Compact was to avoid taking the time for each state to change the laws and regulations necessary to create a uniform set of product filing standards. If the SMART Act requires that states join the Compact and, in addition, put in place "updated" laws and regulations materially identical to the uniform filing standards of the Compact, the process will be very time consuming and difficult. The penalty provided in the SMART Act for not completing this task within a very short three-year period is severe. Even though a state has joined the Compact and companies can file products through the Compact for uniform adoption, state laws could be preempted, and file and use provisions put into effect. If the goal is the ability for companies to be able to file products in a uniform manner with the Compact, there seems to be no motivation to take away the ability of companies to file with the state a product that does not meet the uniform standards. Perhaps the state law provides for products with greater consumer protections. Perhaps state law allows products that do not contain all the consumer protections, but meet the needs of a particular consumer and are available at a reduced cost. Perhaps the state has a simplified filing or no-file law in place that a company would want to utilize. These provisions could greatly limit the flexibility of companies and states. The Compact provisions allowing for an opt-out from a standard could be made inapplicable because of the SMART Act.

3. The review team found the concept of "sophisticated purchaser" to be unclear and possibly unworkable. Insurers generally do no create separate forms for purchasers that meet the definition in the SMART Act. Does this legislation envision a complete review of the form for general use and an expedited review of the same form if the company indicates it will be used for sophisticated purchasers? The review team felt the differences for a sophisticated purchaser would be in the required disclosures, not the policy form provisions. Neither the SMART Act nor the Compact covers marketing materials.

4. The review team suggests changing the NAIC Roadmap goals to refer to an "electronic system" rather than SERFF. That would match the language in the SMART Act and would allow more flexibility in the development of the system used. If a better system is developed or the NAIC chose to change the name of the SERFF system, the Roadmap goals should not stand in the way. The focus should be on the concept of one unified electronic system for form filing.

5. The provisions of the SMART Act that talk about disapprovals of products are unclear. They apparently apply to state review of filings, rather than those made by the Compact. It is not clear who will make this "majority determination"

or on what standards it will be based. If the Compact works as intended, there will be few state filings, so state interpretations may not be easy to obtain. The "majority interpretation" provisions also may raise separation of powers constitutional concerns by purporting to invalidate judicial interpretations of a state's laws if contrary to a "majority interpretation" by other states' regulators.

Viatical Transactions

The SMART Act undercuts the NAIC model law in important areas by allowing the alternative adoption of the weaker NCOIL model. The Act is also unclear, and could tie the hands of viatical fraud investigators.

1. One problem that was immediately identified is the reference to the NCOIL model. A model was drafted by NCOIL after the NAIC adopted its model act, so in the parlance of the SMART Act, it is an "updated law." However, significant protections in the NAIC model are not included in the NCOIL model. Since much of the NCOIL model is based on the NAIC model, it will be difficult to determine if and when five states have adopted the NCOIL model, as state legislatures tend to pick and choose among provisions of the existing model, earlier versions, and amendments suggested by legislators and representatives from the viatical industry. The text on the top of page 9 of Title XI of the SMART Act was also subject to differing interpretation by members of the review team. Does "model act" mean either of those? Is the correct interpretation to consider (b) OR (c)(1) OR (c)(2)? The only positive part of this provision is that it seems to recognize the possibility that NAIC may need to update its model to address changes in the viatical settlement marketplace.

2. The provisions related to viatical fraud may have unintended consequences. The SMART Act seems to imply that viatical fraud occurs only in the sale of viaticated policies to investors. While the majority of publicity has occurred in that side of the transaction, the review team was concerned that the wording of the bill would tie their hands in investigating fraud in other parts of the transaction, or even put into question on-going investigations of viatical fraud. Allowing three years for a study of viatical fraud creates additional problems for existing investigations.

3. Because the SMART Act specifically excludes the bracketed sections of the NAIC model, which are related to the investment side of the transaction, the consumer protections of the model are preserved only for viators.

4. The provisions of the SMART Act that speak of uniform or reciprocal licensure of brokers as a goal are unclear. Currently some states allow all life insurance producers to act as viatical settlement brokers and some require a separate license. Would they be required to be reciprocal only where the laws are similar to their own?

TEAM #5
NAIC Roadmap: Commercial P&C, Personal P&C, and Price Controls
SMART Act Titles VI, VII, and XVI

Commercial Property/Casualty Lines

Implementation of the SMART Act Titles VI and XVI as currently drafted would be detrimental to consumers, industry, and state governments. These sections create a confusing and inconsistent regulatory framework that would overlay current state laws and remove state legislators from decisions regarding important public policy matters that could affect a state's economy. These include decisions regarding the use of a residual market mechanism to advance public policy decisions, the movement of advisory organization loss costs away from prior approval, and the elimination of local decisions regarding the appropriate regulatory framework for workers' compensation and other commercial lines of insurance.

Federal legislation is not needed in this area. States have done much to relax rate regulatory requirements for large commercial insurance purchasers over the last decade. Perhaps the one area where Congressional activity would be helpful is to require that states implement the concept of home-state governance of a multi-state policyholders' insurance policy.

Personal Property/Casualty Lines

The SMART Act Titles VII and XVI as currently drafted would be detrimental. They would overlay a confusing and inconsistent regulatory framework over current state laws and remove state legislators from any decisions regarding important public policy matters that could affect their constituents' well-being. In addition, the SMART Act draft leads to the absurd result of having commercial lines property and casualty rates more closely regulated than personal lines rates. Important consumer protections would be lost that provide adequate recourse for citizens aggrieved by the application of an insurer's rating systems.

Diversity to meet local market conditions is one of the strengths of state regulation. This is particularly true for homeowners and personal auto insurance coverage. State demographics and markets vary widely. Urban areas face different market conditions than do rural communities, and sometimes they call for different regulatory frameworks to address market dynamics. Furthermore, state civil justice systems differ widely, particularly for auto insurance, and do not call for a "one-size-fits-all" approach. In at least one case, a public referendum led to the adoption of the state's current regulatory framework. State legislators should retain exclusive authority over this area of insurance regulation.

The NAIC's Roadmap for Regulatory Modernization
"Framework for a National System of State-Based Regulation"

Table of Contents

Subtitle A	Market Conduct Uniform Standards
Subtitle B	Company Licensing
Subtitle C	Agent Licensing
Subtitle D	Life Insurance
Subtitle E	Property/Casualty Commercial Insurance
Subtitle F	Property/Casualty Personal Lines
Subtitle G	Surplus Lines
Subtitle H	Reinsurance
Subtitle I	Antifraud Network
Subtitle J	McCarran-Ferguson Antitrust Exemption and Rate Regulation
Subtitle K	State-National Insurance Coordination Partnership
Subtitle L	Viaticals
Subtitle M	Interstate Compact for Health Insurance Processes
Subtitle N	Enhancing Financial Surveillance
Subtitle O	Receivership

Subtitle A - Market Conduct Uniform Standards

NAIC Roadmap

The NAIC is implementing a more effective and efficient market regulatory system based upon the following five primary elements: (1) centralized data collection, (2) structured and uniform market analysis, (3) uniform examination procedures, (4) interstate collaboration and (5) a broader continuum of regulatory responses designed to address general business practice, with specific provisions for targeted examinations.

In 2004, the NAIC published the Market Analysis Handbook, with procedures for data collection and systematic market analysis of consumer complaint trends, financial data and other relevant market data that will lead to nationally-coordinated state market analysis programs. A critical component of state market analysis efforts is interstate collaboration on consumer problems of concern to multiple states through the NAIC's Market Analysis Working Group, which was formed in 2003. In 2002, the NAIC also adopted a comprehensive set of Uniform Examination Procedures, to which 42 states have certified compliance. Use of uniform procedures makes exams more efficient and plays a key role in enhancing collaborative efforts.

During the Fall National Meeting, the NAIC adopted a Market Surveillance Model Act, based on a model recently approved by NCOIL. In addition to providing statutory

direction for market analysis, the model will enumerate a broad continuum of regulatory responses to problems identified through market analysis. The model provides for targeted or "for cause" examinations to be conducted under uniform procedures by states based on identified patterns or practices that deviate significantly from industry norms or other indicators suggesting company practices or market conduct conditions that pose a potential risk to insurance consumers. The process includes review of prior examination reports to ensure that the identified issue has not already been adequately addressed.

One issue not addressed in the model act is routine oversight to determine whether companies have effective compliance systems in place. To accomplish this purpose, the NAIC is developing a nationally-coordinated system for periodic review of company compliance policies and procedures. This responsibility will be shared between the domestic regulator and other states having a significant premium volume or other special interest, and will include appropriate coordination with Best Practices Organizations as provided for in the NAIC's *Best Practices Organizations White Paper.*

The sharing of confidential information among state and federal financial regulators is critical to the effective coordination of state regulatory efforts. States generally have the necessary confidentiality procedures in place, but a federal statute that enables the exchange, maintenance, and use of confidential regulatory information among state and federal financial regulators, either directly or through entities such as NAIC that perform such functions on behalf of regulators, would create a uniform framework for achieving the appropriate coordination of state regulatory efforts.

As provided for in the NAIC's Uniform Examination Procedures, each state will devise a set of consistent and uniform enforcement guidelines based upon criteria, such as the willful or inadvertent nature of a violation.

A formal state accreditation process should be implemented to ensure uniform implementation of the five primary elements of market regulation.

Subtitle B – Company Licensing

NAIC Roadmap

The NAIC has created uniform applications and filing forms regarding a certificate of authority, i.e. ALERT, that are accepted in all U.S. jurisdictions. Electronic filing systems have also been created to facilitate these filings among state insurance departments.

Significant work is underway to streamline the licensing application form, adopt best practices, set standard licensing requirements and minimum review procedures to help ensure consistent and efficient reviews. These projects are expected to be completed in early 2005. The NAIC has adopted a plan to draft a model company licensing act.

Using NAIC's model company licensing act, states should codify ALERT system forms, including the Uniform Certificate of Authority (UCAA), related licensing/acceptance standards, and minimum review procedures by 2005. Using best practices guidance, states should leverage knowledge and experience of a company's domestic state, as well as current admission work done by NAIC Accredited states.

As an interim measure, states should continue to accept electronic filings under the ALERT System, including but not limited to the UCAA, company name changes, and adding/deleting lines of business. Deviations from ALERT filing requirements should be repealed or discontinued, as appropriate.

States should also: (1) Streamline the process for considering proposed mergers and acquisitions of domestic insurers involving multiple jurisdictions; (2) Establish Memorandum of Understanding based upon the NAIC lead-state framework to defer most inquiries and regulatory interaction to the designated lead state or states; and (3) Address regulatory requirements regarding reappointment of producers and policy/rate re-filings to streamline multiple state approvals.

Subtitle C – Producer Licensing

NAIC Roadmap

The NAIC supports the implementation of a centralized, electronic licensing system for producers through the following:

1. Implementing 100% licensing reciprocity among all jurisdictions, *provided*: (1) states have direct access to FBI fingerprint database similar to other regulators, and (2) states can share such information on a protected, confidential basis. An essential part of the background process will be the implementation of an electronic fingerprinting process;

2. Enacting/implementing NAIC Uniform Licensing Standards addressing: (1) licensing qualifications, (2) pre-licensing education, (3) producer licensing testing, (4) background checks, (5) application process, (6) appointment process, (7) continuing education requirements, and (8) limited line uniformity;

3. Implementing a uniform NAIC national producer licensing database;

4. Implementing electronic resident and non-resident licensing and licensing renewals; and

5. Streamlining the appointment process by implementing a registration system whereby insurers maintain a list of producers with whom they have a contractual relationship. Insurers will be required to electronically file this list on a quarterly

basis with the appropriate state insurance department, remit a fee in accordance with the current state appointment fee structure and immediately report any contractual relationships that are discontinued "for cause" because of a producer's inappropriate conduct.

Subtitle D – Life Insurance

NAIC Roadmap

State regulators believe effective regulatory modernization and uniformity for life insurance products can be achieved as follows:

1. State adoption of the Interstate Insurance Product Regulation Compact.

2. States will develop for implementation via the Compact high quality national insurance product standards to protect consumers.

3. States and the NAIC will work for continued enhancement and implementation of the SERFF system.

Subtitle E – Property/Casualty Commercial Lines

NAIC Roadmap

[Note: The NAIC recommends that subtitles E, F and J be combined into a single section that deals with property and casualty insurance products. There is too much overlap to address them separately, and to do so risks conflicting provisions of law.]

The NAIC supports the following actions related to speed to market for commercial lines property and casualty insurance products:

- Continued enhancement and implementation of the SERFF system to provide a single point for electronic filing of both commercial lines and personal lines insurance products with state regulators;

- For all commercial lines of business except title insurance, workers' compensation and medical malpractice, adoption of the NAIC Property and Casualty Commercial Rate and Policy Form Model Law (Condensed) or a similar regulatory framework that implements:

    - A Use and file competitive rating regulatory framework for rates and rating systems;
    - A File and use regulatory framework for policy forms with a 30 day waiting period; and

- o A provision that requires the commissioner to adopt reasonable regulations to provide that a particular state's policy form requirements shall apply only to insurance written for individual commercial risks that are primarily located in the state.

- Codification of a uniform national definition of "sophisticated/large commercial purchasers" borrowing from a similar definition contained in the NAIC white paper: *The Regulatory Re-engineering of Commercial Lines Insurance;*

- Development of filing review standards checklists that clearly spell out what is required by state law or regulation of insurers to submit a compliant filing;

- Development of a uniform filing transmittal document(s) to expedite the filing process where feasible; and

- Development of a common product filing nomenclature that allows both filers and reviewers to communicate effectively about the products being filed.

Subtitle F – Property/Casualty Personal Lines

NAIC Roadmap

[Note: The NAIC recommends that subtitles E, F and J be combined into a single section that deals with property and casualty insurance products. There is too much overlap to address them separately, and to do so risks conflicting provisions of law.]

Diversity to meet local market conditions is one of the strengths of state regulation. This is particularly true for homeowners and personal auto insurance coverage. The NAIC supports the following actions related to speed to market for personal lines property and casualty insurance products:

- Continued enhancement and implementation of the SERFF system to provide a single point for electronic filing of both commercial lines and personal lines insurance products with state regulators;

- Recognition that states face different circumstances regarding the regulatory framework for personal lines property and casualty insurance products and, while encouraging a movement toward various forms of competitive rating where feasible, allowing state legislatures to continue to determine the appropriate regulatory framework for personal lines;

- Development of filing review standards checklists that clearly spell out what is required by state law or regulation of insurers to submit a compliant filing;

- Development of a uniform filing transmittal document(s) to expedite the filing process where feasible; and

- Development of a common product filing nomenclature that allows both filers and reviewers to communicate effectively about the products being filed.

Subtitle G – Surplus Lines

NAIC Roadmap

The NAIC has long advocated an equitable premium tax allocation method on a countrywide basis and has done substantive work to support this position. Substantive discussions have also occurred with respect to defining sophisticated purchaser in the surplus lines market, however, concerns regarding the potential adverse impact to consumers outweighed the efficiencies that may be seen through an "automatic export" option.

Regarding allocation of taxes, states should codify the NAIC Model Regulation (Allocation of Surplus Lines and Independently Procured Insurance Premium Tax on Multi-State Risks), thereby requiring payment of premium tax to the states where the risk resides. Working through the NAIC, states should develop a dispute resolution mechanism or arbitration process where there is conflict between states. States should explore creation of an interstate compact or other mechanism to manage tax collection and reallocation to relevant states.

Regarding uniform licensing standards, states should mandate full implementation of the NAIC Producer Licensing Model Act to achieve reciprocal licensing standards. With regard to single point licensing, state participation in the NAIC national producer database should be mandated. Surplus lines producers should be added to state efforts to build upon licensing reciprocity by implementing a uniform, centralized electronic licensing system for individuals and business entities that sell, solicit or negotiate insurance.

States should codify the definition of "sophisticated/large commercial purchasers" by borrowing from a similar definition contained in the NAIC white paper: *The Regulatory Re-engineering of Commercial Lines Insurance*. States should also re-evaluate the NAIC Non-Admitted Insurance Model Act to accommodate recognition of sophisticated/large commercial purchasers.

Subtitle H - Reinsurance

NAIC Roadmap

Regarding extraterritorial application of state laws, states should move toward greater financial standardization through the NAIC Accreditation Program, including financial

reporting, credit for reinsurance, investment limitation and actuarial reserves. Through statute, regulation and practice, states should conform to the relevant NAIC Accreditation Standards as the interpretations of these Standards will be tightened to reduce deviations.

The NAIC has tabled discussion of a reduction in collateral requirements for unauthorized reinsurance. Informal meetings between commissioners and interested parties have been held in an attempt to arrive at a commercial solution.

(Also see Subtitle O – Receivership)

Subtitle I - Anti Fraud Network

NAIC Roadmap

State insurance regulators need Congress to enact federal legislation that would give them:

- Direct access to the FBI criminal history database in a manner similar to other regulators.
- Protection for confidential regulatory information shared among state and federal regulators.
- Liability immunity for NAIC using its database facilities as the means for state regulators to share confidential regulatory information.
- Coordination of regulatory information sharing with NASD.

As set forth in NAIC's May 19, 2004 letter to the Senate Finance Committee, Congress should enact a federal privilege and a statutory structure for coordination of investigations between federal agencies and the states. The privilege and structure should safeguard the confidentiality of communications among states and the federal government for the purpose of facilitating investigations into unauthorized insurance activity.

Subtitle J - Price Controls/Anti-Trust Exemption

NAIC Roadmap

Reaffirmation of the McCarran-Ferguson Act as the law of the land so that small and medium sized insurers are able to benefit from the limited anti-trust exemption, share information about loss costs, and have some hope of competing with larger insurers.

Subtitle K - Coordination and Enforcement of Insurance Policy

NAIC Roadmap

In preparing this document, the NAIC conducted a thorough review of modernization initiatives and pending reform proposals. As a result, the NAIC's roadmap represents a comprehensive proposal to address regulatory inefficiencies and promote workable national standards. The NAIC and states currently have the tools and mechanisms needed to implement these reforms, and believe that implementation and enforcement of these roadmap goals should be left to the states. However, where required as a matter of federal law, state insurance departments are committed to enforcing federal rules, whatever they may be.

State regulators are concerned that any organization established under federal law to interpret and oversee implementation of national regulatory standards would inevitably raise troublesome questions of "who's in charge" of state insurance regulation. Regulatory confusion in the dynamic insurance marketplace would breed harmful uncertainty that is counter-productive to achieving reforms. State regulators are also concerned that a federally-established body asserting federal powers to preempt state consumer protection laws could become controversial, as with the OCC's preemption of state predatory lending laws for banks. Congressional policy oversight is very helpful to state officials trying to resolve national issues, but federal administrative intrusion could be detrimental.

Subtitle L – Viaticals

NAIC Roadmap

The NAIC adopted a revised Viatical Settlements Model Act in 2001. Previously, viatical regulation only applied to sales of policies for people who were terminally or chronically ill. The model adopted in 2001 responded to changes in the marketplace and provided coverage for any sale of a life insurance policy for less than its expected death benefit. The model also included fraud provisions, advertising standards, and enhanced disclosures. Amendments to the Viatical Settlements Model Regulation (which accompanies the 2001 Model Act) were adopted in June 2004. The regulation includes licensing requirements and informational forms to be filed with the states.

The NAIC members feel strongly that each state should enact consumer protections for these policy owners, and believe a minimum standard of protection based on the NAIC Model Act and regulation is appropriate.

Subtitle M – Interstate Compact for Health Insurance Processes

NAIC Roadmap

To date, this issue has not been raised within the NAIC, nor has the basic concept been raised to the NAIC by health insurers. The NAIC is open to methods of achieving greater standardization, especially with respect to external reviews.

Subtitle N – Enhancing Financial Surveillance

NAIC Roadmap

While the state based solvency regulation system has proven to be generally effective and efficient, the States recognize that further "enhancements" will provide consumers with greater protection against financial loss. The following solvency monitoring enhancements are underway in the NAIC Financial Condition Committee.

1. Institute national practices regarding:

    - Periodic meetings between an insurer's executive management and financial regulators for the purposes of evaluating business strategies, financial projections, capital adequacy, etc.; Update: This work is under consideration through the risk assessment initiative and amendments to the NAIC model audit rule.

    - The evaluation of "corporate governance" matters and promoting best practices among non-public insurers; and Update: This work is underway through amendments to the NAIC model audit rule.

    - The use of confidential Administrative Supervision authority and best practices.

2. The NAIC Accounting Practices & Procedures Manual should become the national standard for operating insurers. Limit state permitted accounting practices to extraordinary circumstances. Implement interstate communication mechanism for state permitted accounting practices.

3. Institute standard financial surveillance practices regarding affiliated insurers, i.e. insurance groups.

    - Coordinate on-site examination scheduling, planning, and fieldwork on affiliated insurers to better allocate examination resources and strengthen examination results; Update: The Insurance Holding Company Working Group initiated correspondence with all states

urging development of plans to coordination examinations of their domestics affiliated in other states. The Working Group has also identified 12 insurance groups, which they plan to work with the states of domicile to help ensure coordination and to better understand the impediments.

- Standardize the exchange of information on affiliated insurers to help ensure a group-wide perspective; and

- Fully implement the NAIC lead-state surveillance framework to enhance financial monitoring activities and examination planning. Update: The Financial Examiners Handbook Technical Group is revising handbook language regarding requirements for coordination examination schedules and field work.

Subtitle O – Receivership

NAIC Roadmap

State regulators believe effective regulatory modernization and uniformity for insurer receiverships should be achieved as follows:

- Congress should amend the Federal Priority Statute so that insurer receiverships receive the same treatment allowed to federal bankruptcy estates.

- States should be required, under Part A of the NAIC Accreditation Program, to enact laws substantially similar to the updated Insurer Receivership Model Act currently being completed by the NAIC:

    - Rights and obligations of policyholders, reinsurers, state guaranty associations (SGAs) and other claimants and debtors to the estate,
    - Commissioners and supervising court's roles,
    - Priority of distribution,
    - Special deposits being deemed to be general assets, unless to benefit of SGA's (Create uniformity and consistency in the use of and access to special deposits),
    - Reciprocity and interstate cooperation,
    - Transparency and financial reporting (including to the Global Receivership Database),
    - Immunity and indemnification of receiver and others working for benefit of estate, and
    - Coordination and cooperation between the state guaranty system, receivers, and regulators.

There is already a requirement that states have "a scheme" for handling receiverships in the NAIC Financial Accreditation Program. Tightening this requirement is consistent with the concept that the accreditation process should cover more than solvency, including broader assurance that claims are paid to protect consumers and maintain confidence in the industry.