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Testimony of

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Good afternoon. My name is Peter Kochenburger and I am a professor at the University of Connecticut School of Law and the Executive Director of the School's Insurance Law Center. Thank you for the opportunity to appear today and to submit this written testimony.

A Clear Need for International Cooperation in Insurance Regulation

Insurance is both a global industry and one increasingly integrated within the broader financial services markets. These developments challenge traditional insurance regulatory systems which are based on sovereignty at the national or regional level, and frequently segregated from oversight of other financial services providers such as depository institutions. Fortunately, many governments have taken important steps to address these changes, including the creation of the International Association of Insurance Supervisors (1994), the European Union's "Single Market" and attempts to harmonize European insurance and financial services law, and within our country, the creation of the Federal Insurance Office (FIO), and the National Association of Insurance Commissioners' (NAIC) current focus on regulatory consistency and international cooperation. Individual states have also developed useful relationships with insurance regulatory authorities abroad, such as the recent Information Exchange Agreement reached by my home state of Connecticut and the IAIS.

Unquestionably international regulatory coordination is essential to maintaining the solvency of insurers and other financial institutions. Our insurers, reinsurers, agents and brokers also need fair access to markets outside the United States, and recent agreements in South Korea and China are very positive developments, as several speakers may discuss today. Similarly, our markets must be open to international competition, but they present unique challenges given our state-based regulatory structure. Congress, state regulators and the NAIC are familiar with the barriers historically presented by multiple reinsurance collateral requirements, licensing and filing procedures, solvency standards, and the need to work with state regulators who differ not only on the scope of their regulatory authority, but also on how to wield it.

We should also acknowledge many of the advantages of our country's state-based regulatory structure as well as the NAIC's accomplishments at modernizing insurance regulation nationally, and serving as a major voice for our country internationally. However, the federal government should clearly take the lead role in representing US regulatory interests internationally and negotiating insurance-related trade agreements. Individual states do not have the legal authority to negotiate on behalf of the U.S., nor the national perspective and mission which must necessarily fall to our federal government. While the NAIC plays an important role internationally and is the repository of significant experience and expertise, it is also a private organization not suited for concluding treaties abroad.

The FIO was established with this specific role in mind when it was created in 2010 and while still a work in progress, its mission is indispensable and cannot be undertaken by state-based or private entities. The FIO's statutory powers and limitations were carefully, and no doubt painfully, crafted to provide the FIO with the minimal powers necessary to represent U.S. interests internationally and to provide a participatory (rather than regulatory) voice related to domestic insurance regulation. The FIO's "Advance coordination" requirements (31 U.S.C. § 313(e) (4)), which limit the FIO's authority to even approach insurers with information requests, and its restricted subpoena power (31 U.S.C. § 313(e) (6)), should mean that insurers will receive few FIO regulatory requests for information, and even fewer subpoenas. FIO's statutory authority emphasizes communication and information sharing with state and federal regulatory agencies, which have clear incentives to cooperate with it.

Consumer Protection and International Cooperation

Regulatory modernization is not a code word for deregulation and international cooperation should not be an opportunity or rationale to dilute consumer protection standards in the United States. While insurance regulation in the U.S. has significant gaps, we also have a tradition of consumer protection at the state (and sometimes federal) level more rigorous than found in many other countries. As international cooperation

increases, some will likely pick and choose among regulatory provisions in other countries to argue that those that are least restrictive are also the most appropriate and should be imported to the U.S., while also ignoring more protective regulatory regimes. Healthy industry self-interest makes this selection process predictable, but it should not be condoned by legislators and regulators.

Consumer protection standards are rooted within specific legal and regulatory structures and responsive to local (i.e., national and regional) conditions. These differences include common law versus civil law legal systems, political philosophies about the role of the state and public regulation of private sector transactions, and the use of private litigation in enforcing consumer rights. This is historically true in insurance, which has been considered a matter of "local" (i.e. state) concern and treated differently than other financial products.

For example, in our country personal lines rate and form regulation are long-used and important regulatory tools and should not be weakened or jettisoned because some foreign jurisdictions do not employ them.[1] Courts and legislatures in the US have recognized for decades that a classic freedom of contract approach is often an inappropriate regulatory standard when applied to modern adhesion contracts like insurance policies, and have adopted a variety of measures and standards which, if not leveling the playing field, at least have reduced its tilt. In addition to regulatory review, these methods include common-law doctrines such as the duty of good faith and fair dealing and enhanced "bad faith" damages applied to insurer conduct, and allowing consumers to recover attorneys' fees when successful in litigation against a commercial party (as is common in many federal and state civil rights and consumer statutes). State consumer protection statutes also empower regulatory authorities and private parties to

[1] For example, EU countries may not employ rate regulation, though member states may regulate policy forms if in the "public good." Third non-life Council Directive 92/49/EEC, articles 27-31, 39; for life insurance, Directive 2002/83/EC, article 34. In contrast, China is experimenting with both rate and form regulation. CIRC Ordinance No. 2004-6: Administrative Measures on Examination, Approval and Filing of Personal Insurance Products, http://www.circ.gov.cn/web/site45/tab2727i38782.htm.

investigate and remedy unfair or deceptive practices, though their application to insurance transactions varies by state.

In some areas the FIO can promote the value of our consumer protection tools, such as regulatory authority to review whether insurance policies are not only clear and transparent, but also fair, and the ability for private parties to enforce their own legal rights and not leaving to over-burdened and under-resourced regulators the sole responsibility for investigating and challenging insurer behavior. At a minimum, changes in traditional consumer protection standards, such as further reducing rate and form regulation (as advocated by many insurers and which previous Optional Federal Charter legislative drafts would have largely accomplished), should come from a domestic review of insurance markets and an appreciation of where these standards fit within the overall regulatory scheme, and not in the guise of international comity.

State Insurance Regulation as a Regulatory Obstacle?

The United States is unique in regulating insurance on a state rather than national level. The reasons for state-based insurance regulation are historical, political and practical. When insurance first became regulated in the US around the mid nineteen hundreds,[2] the federal government's overall regulatory responsibilities were still minimal and insurance was considered an issue of local concern. The Supreme Court protected state regulatory control in *Paul v. Virginia* where it determined that insurance was not interstate commerce and thus could not be regulated by the federal government.[3] The Court reaffirmed *Paul* over the next six decades until 1944 when it came to a different conclusion in *U.S. v. South-Eastern Underwriters Association*, ruling that the insurance business was sufficiently inter-state in character to permit federal regulation.[4] Congress responded quickly, upon the urging of the NAIC, state regulators, agents and insurers, and in 1945 passed the McCarran- Ferguson Act, 15 U.S.C. 1011, which grants insurers limited immunity to federal antitrust laws and more significantly, reconfirmed an explicit

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[2] The New York Insurance Department was established in 1860.
[3] 75 U.S. 168 (1868).
[4] 322 U.S. 533 (1944).

preference for state insurance regulation. Congress of course can still regulate the business of insurance simply by making its intent clear and McCarran-Ferguson, whatever its drawbacks, is not an obstacle to an increased federal role. However, outside of several discrete areas, and now health insurance, Congress has left insurance regulation to the states. The FIO's regulatory authority – as opposed to its information gathering function – is largely limited to preempting discriminatory state laws inconsistent with international treaties related to solvency regulation. It has yet to use this authority.

That insurance regulation is still state-based tells us little about the effectiveness of our system. While we would be highly unlikely to create a state-based regulatory structure for insurance if we were writing on a blank slate today, it has worked surprisingly well in some areas, especially in maintaining insurer solvency. For example, while the 2008 economic crisis can be attributed to many causes, the failure of federal regulatory agencies to police their industries is an important one. In contrast, the insurance industry was the one solvent and dependable financial services sector in 2008 and beyond. It was also the only one whose solvency was regulated largely by state rather than federal agencies. While the federal government should play a lead role in international regulatory issues, we do not have a reassuring model for either dual ("optional") or exclusive federal regulation of financial services.

Undeniably state insurance regulation creates delays and duplication of effort by both the insurance industry and insurance regulators. However, we have a Constitutional structure that acknowledges significant state regulatory authority and federalism necessarily assumes a certain degree of duplication and inefficiency. The question is whether these costs are worth the benefits, not whether their existence is an excuse by itself to reduce state regulatory control. Regulatory modernization should not become a pretext for eliminating significant state regulatory authority and diluting vital consumer protection laws. At a minimum, we should allow the FIO time to assert its role internationally and reduce regulatory obstacles created by our state-based system, before we attempt significant changes in our own domestic regulatory structure.

The Need to Regulate Insurance

While the form of insurance regulation can differ significantly from country to country, they all attempt to address the same basic concerns. A private sector economy depends on a competitive and fair private insurance market. Insurance is a product that consumers, whether individuals or businesses, legally or practically must obtain to safeguard their assets and to engage in activities central to a market economy – driving, purchasing a residence, owning and operating a business or practicing a profession. Insurance is also a contract where the policyholder's premium is consideration for the insurer's promise to pay a covered claim that may occur years in the future and where the amount of the claim is likely to be much greater than the premium collected. Once the premium is paid, the policyholder becomes dependent on the insurer's ongoing ability and willingness to pay the claim should an insured loss occur, as it cannot contract with another insurer to cover a known loss.

Insurance policies are also standard form agreements drafted exclusively by the insurer and for which there is little or no bargaining over terms other than price.[5] The lengthy and complex structure of such contracts virtually makes certain that the great majority of consumers will neither read nor necessarily understand them. Policyholders often only become aware of important terms and limitations in their contract when an insurer denies a claim, which is also the time of their greatest vulnerability.[6]

These contractual arrangements usually benefit the contracting parties and society as a whole, but ensuring that they do, and that the insurance policies are fairly written and

[5] As stated by the Pennsylvania Supreme Court: "The rationale underlying the strict contractual approach reflected in our past decisions is that courts should not presume to interfere with the freedom of private contracts and redraft insurance policy provisions where the intent of the parties is expressed by clear and unambiguous language. We are of the opinion, however, that this argument, based on the view that insurance policies are private contracts in the traditional sense, is no longer persuasive. Such a position fails to recognize the true nature of the relationship between insurance companies and their insureds. An insurance contract is not a negotiated agreement; rather its conditions are by and large dictated by the insurance company to the insured. The only aspect of the contract over which the insured can 'bargain' is the monetary amount of coverage." *Brakeman v. Potomac Ins. Co.*, 371 A.2d 193, 196 (Pa. 1977). This description is even more applicable in 2012.

[6] In most instances, policyholders can only review their actual insurance contract after purchasing the policy, a situation contrary to basic concepts of contract law.

applied, must be achieved through regulatory oversight as well as market competition. The central features of the insurance relationship provide unique challenges to government regulators in ensuring that policyholders obtain their benefit of the insurance bargain. The primary focus in evaluating insurance regulation, whether internationally or domestically, should not be just on market efficiency, but on its effectiveness in meeting these goals and protecting policyholders and our national economy.