American Insurance Association

Statement by

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before the

Committee on Financial Services

Subcommittee on Insurance, Housing and Community Opportunity

United States House of Representatives

"The Federal Insurance Office's Report

on Modernizing Insurance Regulation"

February 4, 2014

Thank you, Chairman Neugebauer, Ranking Member Capuano and Members of the Subcommittee. My name is Stef Zielezienski and I am senior vice president and general counsel of the American Insurance Association ("AIA"). I appreciate the opportunity to participate in today's hearing on a subject that is critical to AIA and its members: the state-based system of insurance regulation and recommendations for strengthening that system for the benefit of all interested parties.

AIA represents approximately 300 major U.S. insurance companies that provide all lines of property and casualty insurance to consumers and businesses in the United States and around the world. AIA members write more than $117 billion annually in U.S. property-casualty premiums and approximately $225 billion annually in worldwide property-casualty premiums.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), enacted in the wake of the 2008 financial crisis, established the Federal Insurance Office (FIO) as the first federal agency principally focused on the business of insurance. Among other functions, Dodd-Frank requires the FIO to ". . . study and submit a report to Congress on how to modernize and improve the system of insurance regulation in the United States." As FIO prepared its report, AIA submitted extensive comments (see Appendix A) that identified key concerns with the state system and recommended improvements. Notably, AIA did not view the FIO report as a chance to revisit old debates about the situs of insurance regulation, but as an opportunity to focus attention on substantive concerns with the existing U.S. insurance regulatory system, and identify ways to make the state-based system more effective and efficient.

As is the case with our testimony today, our comments to FIO were guided by AIA's long-held view that the insurance regulatory system should be focused on the core functions of financial solvency and market conduct regulation, while leaving pricing and policy form decisions to the marketplace. We have consistently held that the regulatory system – domestically and internationally - should support the growth of competitive markets. Advancing market competition empowers consumers and provides them with purchasing options, which in turn enhances affordability and availability. Competition is the best regulator of insurance rates, using market discipline as the instrument of enforcement and appropriately focusing regulation on sound financial condition and a company's actions in the marketplace. With that in mind, we believe that the most constructive way to look at the report - "How to Modernize and Improve the System of Insurance Regulation in the United States"- is to view it as a forward-looking document intended to address the many regulatory challenges facing the industry today and to provide a platform for market-oriented solutions to those challenges. As we stated upon its release, FIO's report provides a valuable guidepost for collectively working toward improvements that lead to greater regulatory effectiveness, efficiency, and marketplace competition.

Our perspective is also shaped by the recent financial crisis and the ongoing implementation of Dodd-Frank. As a result of these events, insurers must manage their businesses in a tripartite environment in which state regulation, federal bank holding company and systemic risk supervision, and international harmonization and convergence must be balanced and navigated without disruption. As such, it is imperative that the industry and the U.S. financial services regulatory community work toward the common goals of ensuring and promoting vibrant and competitive insurance markets.

EFFICIENCY AND EFFECTIVENESS

In the areas of effectiveness and efficiency of the state-based insurance regulatory system, FIO addresses numerous issues and makes a series of recommendations that we believe are intended to increase uniformity among the states and thus improve efficiency and effectiveness. While AIA agrees that there is a need for greater regulatory uniformity across the states, that should not be the sole objective. Uniformity should be viewed through an outcomes-based lens that also considers whether or not uniformity enhances the market environment. We will highlight a few areas in the FIO report of particular importance and would refer you to the appendix for a more comprehensive discussion of the issues, including specific examples.

Commercial Lines Product Regulation Reform

AIA concurs with FIO's conclusion that commercial lines insurance regulation should continue to be modernized so that insurers may best meet the needs of their commercial customers with new and innovative products. The FIO report notes that "[r]egulatory approval of policies sold to sophisticated commercial policy holders, . . . often impose substantial delay."[1] To address this concern, FIO calls on the states to develop standardized policy forms or ". . . some

[1]Federal Insurance Office, U.S. Department of the Treasury, "*How to Modernize and Improve the System of Insurance Regulation in the United States*" p. 51 (December 2013) ("FIO Report").

mechanism for interstate reciprocity, to streamline and improve the regulation of commercial products." Establishing or broadening the interstate compact to encompass commercial lines policy forms is a recommendation worth exploring, particularly if it leads to a shorter timeline for the introduction of new commercial policy forms into the marketplace. However, while the alternative recommendation to develop standardized commercial lines policies may produce uniformity, it is unlikely to be effective because commercial insurance buyers demand differentiated products tailored to their varied business needs and evolving risks. Indeed, as FIO and the states explore the streamlining of government product controls for commercial lines policies, they may well find that prior review and approval are outdated regulatory tools that are inhibiting business innovation.

Government price controls: Rate regulation vs. risk classifications

As we stated in our comments to the FIO, the effectiveness of the state system is undercut by government rate and policy form regulation. Substantial evidence and examples indicate that the effect of rate and form regulation has over time produced rate suppression and limited product innovation. In the worst cases, government price and product controls threaten company solvency, increase the growth of residual markets, and limit consumer options. An increasingly populated residual market should not be a by-product of government regulation. Where government price controls are exercised in a muscular way to suppress rates below the level of the risk, that increase may also be accompanied by a flight from the state of insurers willing to write policies. This is a toxic regulatory mix, creating an environment that constrains private market capacity and concentrates risk in these markets of last resort. As government rate suppression persists in such an environment, the real costs of risk are masked and are not well understood by consumers. The report acknowledges these harmful effects by noting the "many empirical studies [that] suggest rate regulation, particularly in auto and homeowner insurance, may adversely impact market supply resulting in higher prices and an increase in market share of the residual markets."[2] FIO recommends that states identify rate regulatory practices ". . . that best foster competitive markets for personal lines insurance."[3]

At the same time, however, the report contemplates the adoption of uniform federal standards for use of risk assessment tools. Risk classification and assessment is a part of the underwriting and rating process. Thus, if the latter recommendation is pursued, the result would be just another form of rate regulation at a more granular level. If insurance rate regulation is harmful, it should be jettisoned in favor of competitive pricing and not be "reintroduced" in the form of national risk classification/assessment standards.

AIA stands ready to work with the states and FIO to identify rate and form regulatory practices that limit competition and consumer choice and replace them with policies that enhance competition and empower consumers through expanded options.

Market conduct regulation reform

Periodically, the states carry out market conduct and financial examinations of insurance companies. In general, financial exams are coordinated among the state regulators with the company's domiciliary regulator taking the lead. The processes employed by states to conduct

[2] FIO Report, p. 54.
[3] FIO Report, p. 54.

market conduct exams are far from uniform. FIO's report makes several recommendations to streamline and improve the process by which the exams are conducted. AIA supports the recommendations in this area, particularly the adoption of uniform examination standards and the establishment of standards for contract examiners.

COMPETITIVENESS

Any statement or report on the future of insurance regulation would be incomplete without addressing the significant challenges facing insurers with U.S. operations at the international level. Today's insurance market is global and is becoming increasingly more complex. As such, it is useful to view this set of issues through the prism of competitiveness. Last June, this Subcommittee held a hearing entitled "The Impact of International Regulatory Standards on the Competitiveness of U.S. Insurers." That hearing highlighted the importance of international regulatory issues and the need for cooperation among all regulators to ensure a level playing field for all market participants. AIA supports the call for a unified approach by the U.S. financial services regulators.

We continue to stress the need to develop a single consistent U.S. position that removes barriers to U.S. competitiveness while at the same time preserving the domestic laws and regulations that currently work for insurers and consumers. This is certainly easier said than done due to existing constitutional and statutory limitations that apply to those charged with developing, negotiating, and implementing any new rules for a complicated set of issues, including capital standards, accounting rules, the designation of Globally Systemically Important

Insurers (GSIIs), and group-wide supervision. The stakes are high and we must all be pulling in the same direction to get it right.

In this regard, one specific international recommendation in the report concerns the U.S. Treasury Department (Treasury) and the United States Trade Representative (USTR) pursuit of a covered agreement on reinsurance collateral in line with the National Association of Insurance Commissioners' (NAIC) credit-for-reinsurance model law and regulation. This could be a positive development in the states with uniform implementation of the NAIC's own reinsurance collateral model.

Beyond this specific example, AIA continues to support FIO's engagement on international issues to present a unified U.S. position, in coordination with the NAIC and state regulators, and – now - the Federal Reserve. That said, FIO should defend the U.S. state-based regulatory system where it has worked and strive to avoid duplicative -- or worse, contradictory -- regulatory standards that will erode the competitiveness of the U.S. insurance industry.

Conclusion

The overall objective of modernizing and improving U.S. insurance regulation should be to promote the growth of healthy, competitive insurance markets at home and abroad that will ultimately benefit and protect insurance consumers while emphasizing safety and soundness. The FIO report affirms these essential goals. Achieving these goals will require that all stakeholders - FIO, state insurance regulators, international bodies, and federal financial regulators – work together. While we have identified several areas of significant importance, it is important to remember that they should not be considered in isolation. They are all essential pieces of the insurance regulatory puzzle. All stakeholders must cooperatively find a way to fit those pieces together to ensure and promote vibrant and competitive insurance markets. AIA stands ready to work with all stakeholders to advance these goals.

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December 16, 2011

VIA FEDERAL eRULEMAKING PORTAL

Department of the Treasury
Federal Insurance Office
MT 1001
1500 Pennsylvania Ave., N.W.
Washington, DC 20220

RE: Public Input on the Report to Congress on How to Modernize And Improve the System of Insurance Regulation in the United States

Ladies and Gentlemen:

The American Insurance Association ("AIA") appreciates the opportunity to submit comments on the Federal Insurance Office's ("FIO") notice published in the October 17, 2011, Federal Register entitled "Public Input on the Report to Congress on How to Modernize and Improve the System of Insurance Regulation in the United States." ("FIO Study Request")[1] AIA represents approximately 300 major U.S. insurance companies that provide all lines of property-casualty insurance to U.S. consumers and businesses, writing more than $117 billion annually in premiums. Our membership includes U.S. insurers that write insurance only within the U.S., U.S. insurers that write insurance inside and outside the U.S., and the U.S. subsidiaries of multi-national insurers. This diversity gives us the ability to analyze issues from many perspectives and enables us to draw on the global experience and expertise of our companies with many forms of insurance regulation.

[1] 76 Fed. Reg. 64174 (October 17, 2011).

As regulated insurance companies, our members have a substantial stake in maintaining an effective and efficient system of insurance supervision that fosters the growth of vibrant private, competitive insurance markets. Moreover, because AIA's members also provide property-casualty insurance in every significant international market, we have a considerable interest in making certain that the U.S. regulatory system does not lead to market disruption or disadvantage U.S. competitiveness abroad.

For many years, AIA has urged Congress to consider market-oriented optional federal chartering ("OFC") proposals. Our support for OFC has never been based solely on regulatory situs, but grounded principally on the need to re-focus the American insurance regulatory system on core functions such as financial solvency and market conduct regulation while leaving pricing and policy decisions to the marketplace. We also believe that government regulation should be employed in ways that support the growth of competitive, private markets. Government participation in the marketplace is appropriate primarily to provide a safety net when consumers cannot obtain insurance through the private market or where there is long-term private market dysfunction (such as that associated with insuring against the risk of loss from terrorism, given the characteristics of that risk). Under no circumstance should the regulatory system be a source of risk to insurers and consumers. To the extent that reforms can be achieved in the state-based system, we have consistently supported them, as well. This has achieved limited success in some states, but the current supervisory system has been unable to effectively respond on a national basis.

Our members' interest in an effective and efficient regulatory system that promotes open, private insurance markets is likewise aligned with consumers' interest in having a broad range of price and insurance product options offered by financially sound companies. In fact, such a system would empower consumers by enabling insurance supervisors to focus their scarce regulatory resources in a more effective manner.[2]

[2] The FIO Study Request also asks for public comment on the degree of consumer protection in the U.S. insurance regulatory system, including "access by traditionally underserved communities and consumers, minorities, and low- and moderate-income persons to affordable insurance products." 76 Fed. Reg. at 64175. Consistent with our submission, AIA believes that allowing rates and product options to be open to competition in the private marketplace (rather than subject to government oversight) is the best way to maximize the availability of policy options for those communities and consumers at prices that both reflect the risk and are sharpened by competition.

SUMMARY AND RECOMMENDATIONS

Title V of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") establishes the FIO and empowers that office, through this study, to examine the state-based insurance regulatory system in the United States in light of the global financial crisis, and make recommendations to improve and modernize that system. We believe that the areas for public input identified in the FIO Study Request fall into three broad categories: (a) effectiveness, (b) efficiency, and (c) competitiveness.

Our comments are ultimately guided by the fundamental belief that the insurance supervisory system should protect consumers and further their interest by regulating for solvency and encouraging the maximum amount of private insurance competition.

Effectiveness. AIA believes that the effectiveness of the state-based regulatory system is undercut by government rate and policy form regulation. Both of these regulatory functions – where utilized as tools to artificially suppress rates or to keep insurance products from the marketplace – discourage companies from writing policies and run counter to the financial solvency regulatory mission, generating regulatory risk. Perhaps more importantly, use of these tools by regulators harms consumers. Government price controls inevitably mask other societal problems and generate moral hazard by encouraging consumers to amass more risk without pricing that risk appropriately or promoting the use of mitigation tools that would reduce the cost of insuring against that risk. States that employ heavy-handed, often politically motivated, rate regulation have seen residual market populations increase exponentially while the number of competing insurers declines.[3]

In many cases, as government efforts to control insurance rates increase, insurance prices become more volatile and subject to cross-subsidization.[4] In the worst instances, companies are forced to flee the jurisdiction to maintain a healthy business model, triggering growth in residual markets or the creation of restrictive government mechanisms that replace the private market in order to further suppress rates below those commensurate with the level of risk presented. Government product controls can similarly limit the range of product choices available to consumers by discouraging new market entrants, as well as existing competitors from developing new products. This adversely affects insurance rates and denies consumers the

[3] *See, e.g.,* Philip O'Connor and Eugene Esposito, "Modernizing Insurance Rate Regulation: Tacking to the Winds of Change," at pp. 10 – 13 (Apr. 26 2001) (presented to the National Conference of Insurance Legislators) ("O'Connor & Esposito").

[4] *Id.* at pp. 10 & 14.

benefits of robust market competition. Ironically, in commercial lines, such barriers have also led to businesses being forced to transfer their risks to alternative market mechanisms that create greater consumer risk and provide less consumer protection.

Recommendation: To address concerns with the effectiveness of the regulatory system, AIA recommends that the FIO study the effects of U.S. rate and policy form regulation of property-casualty insurers in personal and commercial lines, including the extent to which such regulation undermines competition in private markets, decreases consumer choice and detracts from the goals of financial solvency oversight. The study should be comprehensive and build on the large body of existing work. The FIO should set forth recommendations to align the system more closely with safety and soundness/solvency goals and to foster the growth of private property-casualty insurance markets.

Efficiencies. The nature of the state-based regulatory system results in a patchwork of standards. Even when the states signal their intent to adopt a single standard (e.g., via a National Association of Insurance Commissioners ("NAIC") or National Conference of Insurance Legislators ("NCOIL") model), that standard is prone to inconsistent implementation and enforcement across states. Inconsistent application of regulatory standards is compounded when states fail to coordinate effectively on a particular issue. These inefficiencies result in added costs of providing the insurance products and, in some instances, may affect the ability of consumers to obtain needed coverage. The costs and burdens associated with lack of uniformity or inconsistent application of standards from state to state are self-evident for insurers that do business regionally or nationally, and can generate excessive costs in many critical areas, including conforming rate and product filings, licensing, corporate governance, market conduct, financial reporting and accounting, and taxation. This problem is exacerbated by differing case law that may apply from jurisdiction to jurisdiction.

Where states adopt varying regulatory standards or inconsistently apply them in response to a perceived local insurance problem, regulations often live on long after market or environmental developments have overtaken the need for them. In those instances, the continued application of outdated regulations hampers the insurance market and denies consumers access to product benefits or reduced rates.

Recommendation: Charge the FIO with developing a non-regulatory role to coordinate state supervision, establish more uniform regulatory standards, help assure uniform and rigorous cost/benefit analysis consistent with international norms, and foster consistent application of

those standards. Catalogue instances where states continue to apply regulation even where the standards have outlived their utility, and prioritize those standards for sunset.

Competitiveness. While the growth of healthy, competitive private markets should be an overarching goal of any sound regulatory system, AIA believes that there is a particular need to emphasize this objective in the current global regulatory debate. The debate demands that the U.S. develop a consistent position on outcomes-based regulation that removes the U.S. regulatory system as an impediment to U.S. competitiveness abroad and promotes increased trade and market access on a level competitive playing field, as opposed to heightening the risk of market disruption. In this regard, it is imperative that the U.S. support those domestic laws and regulations that work for U.S. insurers. Conversely, consistent with our approach to examining the effectiveness and efficiency of the state-based regulatory system, the U.S. should be open to scrutinizing those aspects of regulation that have no place in our modern regulatory era. For instance, the U.S. system of rate regulation for property-casualty insurance does not exist in other countries and creates immediate, fundamental structural differences in regulatory approach that lead to unsound outcomes. The states, even when acting through the NAIC or NCOIL, have not been able to provide an *authoritative* U.S. voice on these matters at the international level. This does not reflect poorly on the state regulators or legislators, but is simply a consequence of their limited jurisdiction. Moreover, even if the states were legally capable of speaking with one voice, the U.S. Constitution vests the foreign affairs power exclusively in the federal government.

Recommendation: The FIO's authority to engage at the international level on prudential insurance matters should be fully implemented and expanded where necessary to preserve U.S. competitiveness and promote sound regulatory policy. In addition, the FIO should be encouraged to coordinate with the state insurance regulators, the NAIC, and the industry on an outcomes-based regulatory approach that works for all interested parties.

BACKGROUND

The "Federal Insurance Office Act of 2010" enacted as part of the Dodd-Frank Act, establishes the FIO within the Treasury Department and grants it non-regulatory authority in a number of areas related to "all lines of insurance except" health, long-term care, and crop insurance.[5] Included within the FIO's sphere of authority are several reporting obligations to the President and the Congressional committees of jurisdiction, including a requirement that the FIO Director "conduct a study and submit a report to Congress on how to modernize and improve the

[5] Dodd-Frank Act § 502.

system of insurance regulation in the United States."[6] The study and report are required to include consideration of the following factors: (a) systemic risk regulation of insurance; (b) capital standards and the relationship between capital allocation and liabilities; (c) consumer protection; (d) uniformity of regulation; (e) consolidated regulation of insurers and affiliates; and (f) international coordination of insurance regulation. The study and report must also evaluate the potential for full or partial federal insurance regulation, including the ability of such a regulatory system to eliminate or minimize regulatory arbitrage and protect policyholders and other consumers, as well as the influence of foreign insurance regulation and the impact of any federal resolution authority.

The FIO Study Request seeks public input on all of these considerations. AIA's position on the costs and benefits of federal insurance regulation – specifically, market-oriented OFC proposals – is well-documented. The public record is replete with studies that support or oppose OFC legislation and outline the ability of a federal regulator to carry out traditional supervisory functions and avoid regulatory arbitrage. Similarly, our position in opposition to the designation of regulated property-casualty insurers as "systemically important financial institutions" and the attendant application of heightened supervisory standards and a federal resolution alternative have been directly provided to the Financial Stability Oversight Council ("Council" or "FSOC") on several occasions over the past year and are on the public record. Accordingly, this submission will not address those areas of the study.[7]

Instead, AIA's comments focus on the overall objective of modernizing and improving U.S. insurance regulation, taking this opportunity to provide our perspective – as a trade association of leading U.S. property-casualty insurance companies engaged in commerce throughout the United States and around the globe – on those elements of state regulation that, for reasons of effectiveness, efficiency, or competitiveness, inhibit the U.S. system from maximizing the growth of healthy competitive markets to the ultimate benefit and protection of insurance

[6] Dodd-Frank Act, § 502(a) (31 U.S.C. § 313(p)).

[7] *See* Comments of the American Insurance Association in Response to Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies Pursuant to Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Docket No. FSOC-2010-0001) (Nov. 5, 2010) (available at www.regulations.gov, *Doc. ID FSOC-2010-0001-0029 through FSOC-2010-0001-0029.3*) ("AIA ANPR Comments"); Comments of the American Insurance Association in Response to Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies Pursuant to Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, (Docket No. FSOC-2011-0001) (Feb. 25, 2011) (available at www.regulations.gov, *Doc. ID FSOC-2011-0001-0027*) ("AIA NPR Comments"); Comments of the American Insurance Association in Response to Second Notice of Proposed Rulemaking and Proposed Interpretive Guidance Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies Pursuant to Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, (Docket No. FSOC-2011-0045) (Dec. 16, 2011) (available at www.regulations.gov,) ("AIA Second NPR Comments").

consumers. By doing so, and providing examples of regulatory risk in the U.S. system in the process, AIA hopes that its preliminary recommendations will provide a platform for the FIO to undertake further study and public discussion that will establish the foundation for improvements to that system.

U.S. Insurance Regulation

In the United States, property-casualty insurance companies are chartered and obtain licenses to conduct business at the state level. Marketing, advertising, and policyholder service practices are regulated separately by each state in which a company conducts business in accordance with that state's laws and regulations governing such practices.[8] States also assess the solvency of insurers, with principal responsibility being carried by a company's domiciliary regulator. In connection with solvency oversight, companies are required to prepare quarterly and annual financial statements based on statutory accounting principles and to file those statements with their respective domiciliary regulators, other state regulators in jurisdictions where the company does business, and with the NAIC. Much of the uniformity of the state financial regulatory architecture is an outgrowth of Congressional scrutiny in the early and mid-1990s of the state system, led by Representative John Dingell (D-MI), following a number of large insurance company insolvencies in the late 1980s.[9] This inquiry, coupled with the threat to take away regulatory authority from the states, also resulted in the NAIC's financial solvency regulation accreditation process for state insurance departments. Accreditation has now grown to include every U.S. state and the District of Columbia.

States also conduct periodic (once every three to five years) financial and market conduct examinations of companies. While financial examinations are largely coordinated among the state regulators and led by a company's domiciliary commissioner, market conduct examinations are far less uniform and predictable.

Each state also regulates the terms of the property-casualty insurance policy forms marketed and sold to consumers in the states. States require companies and licensed advisory organizations to file each policy form used in the state for review. A number of states require regulatory approval before the form is used in the state – particularly for personal lines forms

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[8] Congressional Research Service Report for Congress, "Insurance Regulation: History, Background and Recent Congressional Oversight," at CRS-3 (Feb. 11, 2005) ("CRS Report on Insurance Regulation").

[9] U.S. Congress, Committee on Energy and Commerce, Subcommittee on Oversight and Investigations, "Failed Promises: Insurance Company Insolvencies," 101st Congress, 2nd sess., Committee Print 101-P (Washington: GPO, 1990); U.S. Congress, Committee on Energy and Commerce, Subcommittee on Oversight and Investigations, "Wishful Thinking: A World View of Insurance Solvency Regulation," 103rd Cong., 2nd sess., Committee Print 103-R (Washington: GPO, 1994).

such as private passenger automobile and homeowners' insurance – while others simply retain the authority to review the form for compliance with state law, along with the right to disapprove that form after it has already been marketed, should the state determine the form is noncompliant. The regulation of policy terms and the degree of review and approval varies from state to state (and sometimes from property-casualty line to property-casualty line within a given state), and can depend on state court decisions construing policy language as a matter of state common law of contracts.

Likewise, every state except Illinois regulates insurance rates for one or more property-casualty lines, with the level of regulation ranging from "prior approval" of rates to "flex bands" that permit an insurer to adjust rates upward or downward within a percentage range to "use and file" review that permits an insurer to use the rates in the market, but requires that insurer to file the rates with the state for review.

Rate regulation is unique to the property-casualty insurance sector, which remains as perhaps the only competitive U.S. industry that is still subject to government price controls. Like policy form regulation, the degree of regulation and the process applied to insurance rates depends on state law and the political environment at any particular time.

Historically, property-casualty rate regulation has its roots in protecting insurers against numerous company insolvencies in the wake of large catastrophic losses. Prior to the advent of federal antitrust laws, in the 1800s, fire insurers formed rating cartels that were based on maintaining insurance rates that were high enough to allow for adequate reserves to cover future large fire losses. The cartels were buttressed by state agencies that collected financial condition information and established reserving standards.[10]

In the wake of the mass fire insurer failures following catastrophic losses from the 1906 San Francisco Earthquake, many states followed New York's lead in recommending the creation of rating bureaus to ensure rate adequacy and help protect against future insolvencies.[11] The U.S. Supreme Court's seminal decision in *U.S. v. South-Eastern Underwriters Association*[12] challenged the rating bureau activities under federal antitrust law, which paved the way for the McCarran-Ferguson Act. That Act, in turn, created an incentive for states to regulate the business of insurance comprehensively, including rates, so that supervisory authority over insurance would remain at the state level. It also created an incentive for insurers to support

[10] CRS Report on Insurance Regulation at CRS-6.

[11] *Id.* at CRS-6 through 7.

rate regulation as a means of protection from the adverse, unknown consequences of federal antitrust litigation over their rate-making activities.

The rate regulatory construct that emerged in the states prohibited rates that were "excessive, inadequate, or unfairly discriminatory" and required the licensing and supervision of the rating bureaus. As rate regulation has evolved, it is safe to say that regulatory emphasis has been placed squarely on preventing so-called "excessive" rates, while the "inadequacy" portion of the rating standard has taken a backseat and has largely become irrelevant as stronger financial regulatory tools and standards have advanced.

Interestingly, both rate and policy form regulation have been justified because of the consumer's unequal bargaining position to insurers with respect to the terms of the insurance contract, a principle that often forms the basis for state court decisions construing the rights and obligations of parties to contracts.[13] In addition, rate regulation has also been defended with respect to those insurance products that consumers are "mandated" by state law to purchase. Thus, while the McCarran-Ferguson Act was enacted largely to delegate regulatory authority over the business of insurance – a product under the interstate commerce jurisdiction of the federal government - to the states and to balance regulatory and antitrust policy favoring competition, the rate regulatory aspects and rationales have largely tilted in favor of regulation while ignoring the counterbalance of market competition.

Lessons Learned from the Global Financial Crisis

The Dodd-Frank Act represents the first comprehensive national legislative response to the global financial crisis. Indeed, the United States is the only country thus far to enact legislation geared toward major regulatory reform in the wake of the crisis. While the legislation covers a wide range of areas of financial oversight, there is an understandable emphasis on identifying those institutions and activities that could be a potential source of systemic risk. Once identified, the legislation provides authority to recommend additional standards to oversee systemically risky activities on an industry-wide basis, and to apply federal heightened prudential regulation to "systemically important" firms and an orderly resolution alternative should those firms fail. The Dodd-Frank Act's focus on containing systemic risk is recognition that financial solvency and safety and soundness regulation are the highest and best consumer protections.

The treatment of insurance under the Dodd-Frank Act largely reflects Congress' conclusion that, with a few notable exceptions, the regulated "business of insurance," while undoubtedly

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[12] 322 U.S. 533 (1944).
[13] *Id.* at CRS-2.

important to our economy, does not threaten U.S. financial stability. For example, Title II of the Act establishes an orderly liquidation alternative for failing systemically important financial institutions, but then expressly defers to the existing state-based insurance resolution system where insurance companies are part of such a failing institution.[14] Thus, while the legislation preserves the ability to address unregulated activities and companies whose range and scope of activities in the financial system may warrant scrutiny, it implicitly acknowledges that regulated insurance companies represent a low level of systemic risk.

Congress' conclusion with respect to the treatment of insurance under the "systemic risk" provisions is grounded in the nature of the business itself and the supporting regulatory architecture. In many ways, the conclusion is compelled by the industry's business model. Insurance companies – especially property-casualty insurers - operate under a different business model than other financial firms, based on an "inverted cycle of production"[15] where premiums are received up-front. "This means that the product - the contractual promise to pay an agreed amount only if a particular event occurs in the future - is sold at a price, the insurance premium, which has to be estimated before knowing the actual cost of the product which depends on probabilities of occurrence and severity of future events."[16] The property-casualty industry business model is premised upon collecting sufficient premiums in advance from each customer to fund likely covered claims from all similarly situated customers. Hence, there is less need for a well-managed property-casualty insurer to borrow, which means that there is a much lower likelihood of becoming highly leveraged. When insurance companies do borrow, they generally do so through the issuance of long-term debt or surplus notes in the public and sometimes private placement markets, for the purpose of long-term strategic positioning. They do not continuously tap very short-term funding vehicles such as commercial paper issuance for their day-to-day funding requirements. In short, the nature of the insurance business itself – which requires sufficient capital on hand to pay anticipated, but unknown losses covered by contract - promotes increased financial stability.

The primary risks for insurance firms are underwriting and market risks. With regard to market risks, insurance assets and liabilities are generally linked, and risks are comparatively longer term and more diversified than in sectors such as banking. Relevant types of risks pooled are typically "real events" such as theft, fire, sickness, death and natural hazards. These are

[14] Dodd-Frank Act § 203(e).

[15] "Systemic Risk and the Insurance Sector," International Association of Insurance Supervisors, p. 2 ("IAIS Paper") (Oct. 25, 2009).

[16] IAIS Paper at 2.

exogenous events and mostly independent in nature, as opposed to other types of financial risk.

The insurance business model also helps shield property-casualty insurers from the so-called "run on the bank" scenario frequently used to describe the contagion effect of systemic risk. Unlike customer deposits held by banks, payment of insurance policy claims depends on the occurrence of a covered event. Therefore, as a practical matter, insurance consumers do not have "on-demand" access to insurance assets as they do with other financial institutions that do not operate according to an inverted cycle of production.

Not even extreme natural disasters such as a major hurricane are likely to produce a systemic risk on the part of any property-casualty insurer. Even when a particular insurer is imperiled, that insurer's financial condition is highly unlikely to present systemic issues for the financial system because of the insurance guaranty fund system and the ability to effect an orderly wind-down of that insurer's operations through the state-based solvency laws. Indeed, our consistent experience with these types of mass natural catastrophes is that the crisis is short-lived, unless otherwise prolonged by regulatory intervention, because additional capacity is promptly supplied by new market entrants due to the lower barriers to entry for property-casualty insurance (as was the case with property insurance capacity following Hurricanes Andrew and Katrina).[17] Perhaps most importantly, natural catastrophes and other extreme insured events have little or no correlation to the stability of the broader financial markets, suggesting the absence of any interconnectedness. Even insurers' investments in other financial services do not create systemic interconnectedness because of the insurance business model, regulatory constraints and the competitiveness of property-casualty lines of insurance.

In addition to aiding a rapid response to any capacity shortages, the competitive market structure in property-casualty insurance further reduces the possibility that any individual company could be a source of systemic risk. There are thousands of property-casualty insurers operating in the United States. According to the most recently available data from A.M. Best based on insurer 2010 Annual Statements filed with the National Association of Insurance Commissioners ("NAIC"), there were 361 homeowners insurers, 305 personal automobile liability insurers, 338 commercial automobile liability insurers, 276 workers' compensation

[17] Following Hurricane Katrina, Ariel Reinsurance Ltd. commenced operations with an initial focus on property catastrophe excess coverage with $1 billion of equity capital. *See, e.g.*, http://www.arielredev.com/arielre/sites/default/files/ArielRe_181205.pdf. With respect to man-made catastrophes such as terrorism that have different insurability characteristics, the capacity response has involved both federal legislation (the Terrorism Risk Insurance Act and its two legislative extensions of the program) and the private market. For example, with respect to the latter, AXIS Capital commenced operations in late 2001, with approximately $1.7 billion available to provide terrorism risk insurance. *See* http://www.axiscapital.com

insurers, 333 commercial multi-peril (non-liability) insurers, and 291 commercial liability insurers writing those lines of business in the United States. None of these lines was considered to be even moderately concentrated when applying a traditional Herfindahl-Hirschman Index ("HHI") concentration analysis.[18]

Even if a "large" property-casualty insurer failed and no longer wrote business in these major lines, based on the number of competing companies and lack of market concentration in those lines, there would be no capacity shortage or substantial market disruption because other insurers would be in a position to step in promptly and provide insurance protection for the failed company's policyholders. Indeed, competition within the property-casualty industry remains vigorous. Even at the height of the global financial crisis and accompanying decline in asset values, property-casualty insurers remained well-capitalized by any historical measure. A review of year-end surplus levels shows that the property-casualty sector continued its robust recovery from the modest recessionary dip of 2007-2008 with regulatory capital (surplus) increasing by 18.2% in 2010 to $580.5 billion.[19] To illustrate the financial strength and capacity of property-casualty insurance, we note that insurance regulators raise red flags when premium to surplus ratios exceed 3 to 1. With a 2010 surplus of $580.5 billion and aggregate net written premiums of approximately of $430.1 billion,[20] the property-casualty insurance industry currently is operating at a ratio of 0.74 – well within the financial adequacy comfort zone. The Council, in its annual report, both recognized the capacity of the property-casualty industry to withstand the financial crisis, as well as its current stability.[21]

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[18] In 1982, the Antitrust Division of the U.S. Department of Justice adopted specific guidelines for challenging mergers based on the Herfindahl-Hirschman Index (HHI) of market concentration. The HHI takes into account the market share of *each* firm in an industry. The HHI has since gained wide acceptance as the public and private sector standard for measuring market concentration and assessing the competitiveness of markets.

The HHI is calculated by squaring the percentage market share of each firm in the industry and then adding those squares. For example, in an industry with only 3 firms, the HHI would be calculated as follows: HHI = (market share of firm 1)^2 + (market share of firm 2)^2 + (market share of firm 3)^2. In an industry consisting of 100 firms, each with an equal share of the market, the HHI would equal 100. In an industry with one firm, a pure monopoly, the HHI would equal 10,000 (or 100^2). Thus, the index is smaller the more firms there are in the industry and the more equitable the distribution of market shares between firms. In general, markets with an HHI of 1,000 or less are considered relatively unconcentrated, whereas markets with an HHI of 1,800 or greater are considered highly concentrated. (If an industry has an HHI value between 1,000 and 1,800, the Justice Department will challenge any merger that increases the HHI by at least 100 points).

[19] "Financial and Market Conditions," Insurance Information Institute (August 2011) (http://www.iii.org/issues_updates/financial-and-market-conditions.html).

[20] Best's Aggregates & Averages, Property/Casualty, United States & Canada (2011 edition).

[21] Financial Stability Oversight Council 2011 Report for Congress (July 22, 2011) ("FSOC Annual Report"), available at http://www.treasury.gov/initiatives/fsoc/Documents/FSOCAR2011.pdf. Specifically, the FSOC Annual Report provided the following conclusions with respect to insurance business and investments:"A key role of financial

DISCUSSION & EXAMPLES

Due to the stable nature of the industry, one might be tempted to conclude that there is no need to modernize the U.S. insurance regulatory system. Yet, such a conclusion would ignore the realities of a state-based regulatory structure along with how that structure has evolved in certain respects. In order to illustrate the need for reform, AIA has set forth below some specific examples where regulation has impeded the benefits of private market competition and is actually harming consumers in the marketplace. While by no means exhaustive, we hope that these examples provide the opportunity for further FIO engagement and public debate and discussion. The examples are not intended to denigrate hard-working, well-intentioned state regulators because, in many instances, local political and environmental conditions influenced the policy direction.[22]

AN EFFECTIVE INSURANCE REGULATORY SYSTEM PROTECTS CONSUMERS BY PROMOTING FINANCIAL SOLVENCY AND AVOIDING THOSE AREAS OF REGULATION THAT DETRACT FROM SOLVENCY

"The purpose of insurance regulation, stated classically, is to protect consumers by monitoring the solvency of insurers and their business practices."[23] If the effectiveness of regulation is judged by these twin consumer protections, any effort to improve the system should identify regulations that detract from those objectives. Florida's struggle with property insurance regulation, the ebb and flow of automobile insurance rate regulation in certain states, and our

markets and institutions is to allocate risk efficiently across households and businesses. The insurance market is a key market in financial risk transfer. Unlike most cases of credit intermediation, in which borrowers receive a large payment at the start and then repay the obligation over time, insurance policies typically involve upfront customer payments (premiums) in exchange for a contractual promise from the insurer to pay benefits upon a specified event in the future. *The traditional U.S. insurance market largely functioned without disruption in payments to consumers throughout the financial crisis and the recovery*." (emphasis supplied) (p. 24)

"The insurance industry is an important source of long-term funding to the economy through its investment of premium income. *Insurance companies, with some notable exceptions, generally withstood the financial crisis and have since strengthened their balance sheets.* Their investment portfolios have improved along with general financial market conditions. The segment of the industry that provided financial guarantees on mortgages and mortgage-related assets experienced severe difficulties." (emphasis supplied) (p. 61).

[22]A number of the examples are drawn from multi-jurisdiction compliance surveys that AIA prepares for its members. Those surveys set forth the state-by state standards in a wide variety of areas, including personal and commercial lines rate and policy form requirements, restrictions on defense within limits provisions in commercial lines policies, punitive damage exclusions in automobile policies, and standard fire policy terrorism exclusions. Should the FIO want any more detail on examples set forth here or in other aspects of insurance regulation, please contact us directly.

[23]CRS Report on Insurance Regulation at CRS-2.

members' experience with policy form requirements, amply illustrate the ways in which regulation can create risk, rather than reducing it.

<u>Florida Property Insurance</u>

Florida's enormous coastal hurricane exposure,[24] coupled with a fast-growing population and land-use and tax policies geared toward property development, have generated enormous property insurance challenges in the state. Regulatory controls and restrictions adopted by the Florida legislature in 2007 have largely served to increase public exposure to natural catastrophe losses, rather than reduce such exposure or engender a more functional private market environment. [25]

Following catastrophic losses and insolvency concerns in the wake of Hurricane Andrew, legislation was enacted to create the Florida Residential & Casualty Joint Underwriting Association ("JUA"), [26] expand the Florida Windstorm Underwriting Association ("FWUA"), [27] and establish the Florida Hurricane Catastrophe Fund ("Cat Fund"). [28] The first two efforts – the JUA and an expanded FWUA – were residual markets intended to provide consumers with a near-term safety valve that would provide property insurance for those unable to purchase coverage privately, as well as a long-term safety net. The Cat Fund is a government program from which private insurers must purchase government reinsurance for a substantial portion of their catastrophic hurricane exposures regardless of whether those insurers already have reinsurance. [29] The cost for Cat Fund reinsurance is less than the private market, as a means of maintaining insurance capacity in the state.[30] While in theory there is nothing wrong with establishing similar government mechanisms to address private market dysfunction due to catastrophic risk of loss, their political evolution has only exacerbated potential public exposure

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[24] Though it has certainly grown, total coastal insured value was $2.5 trillion in 2008. *See Granularity in the Florida Property Insurance Market* at 5, Florida Catastrophic Storm Risk Management Center, FLORIDA STATE UNIVERSITY, http://www.stormrisk.org/admin/downloads/Granularity%20in%20the%20Florida%20Property%20Insurance%20Market%208-09.pdf . Seventy-nine percent of the state's insured value consists of coastal exposure. *Id*. (citing AIR Worldwide, 2008).

[25] Stronger building codes also have been adopted in the state. 1998 Fla. Sess. Law Serv. Ch. 98-287; 2000 Fla. Sess. Law Serv. Ch. 2000-141. While that has helped to strengthen new construction against future storms, it has not done anything to slow down the pace of such construction in exposed areas.

[26] The former JUA was created by act of the Florida Legislature in December 1992 (Florida Stat. Ann. §627.351(6)).

[27] The former FWUA was created by act of the Florida Legislature in 1970 (Florida Stat. Ann. §627.351(2)).

[28] The Cat Fund was created by act of the Florida Legislature in November 1993 (Florida Stat. Ann. §215.555).

[29] Florida Stat. Ann. §215.555.

[30] *Id.*

without facilitating solutions. Several "reforms" were a legislative response to bad storm years. In 1997, the legislature increased the ability of these entities to charge assessments unilaterally, while also increasing their capacity to write insurance.[31] Five years later, the legislature combined the JUA and the Windstorm Underwriting Association to form the Citizens Property Insurance Corporation ("Citizens") as a state authorized and run property insurer.[32]

In 2005, following a particularly heavy 2004 storm season, the legislature adopted another series of reforms, including: (a) creation of a hurricane loss mitigation program, (b) mandatory offer of seasonal deductible policies to consumers, (c) reduction in size of the Cat Fund, and (d) permission for Citizens to compete with private property insurers in the Florida Keys.[33]

The 2007 reforms,[34] in contrast, were a political response to a storm of public protest following rate increases and insurance company profits[35] during the relatively mild storm season preceding those legislative actions. Instead of a balanced proposal aimed at growing the private market, the bill enacted by the legislature in the wake of Governor Crist's election called for numerous provisions aimed squarely at containing rates without regard to the risk of loss. With respect to Citizens, the legislation made numerous changes designed to make Citizens a state-created market competitor rather than a market of last resort, including: (a) repeal of the requirements that Citizens rates be non-competitive and that they include a catastrophe loading factor;[36] (b) a rate rollback on Citizens' January 2007 increases;[37] (b) a two-year rate freeze for Citizens;[38] (c) an elimination of Citizens' 1-in-100 year storm reserve requirement; (d) a trigger allowing Citizens the right to sell property insurance to any Florida resident quoted a rate 25% higher than Citizens' rate;[39] (e) a repeal of the requirement that Citizens purchase

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[31] 1997 Fla. Sess. Law Serv. Ch. 97-55.

[32] 2002 Fla. Sess. Law Serv. Ch. 2002-240.

[33] 2005 Fla. Sess. Law Serv. Ch. 2005-111.

[34] Florida Enrolled CS/HB 1A (2007).

[35] While it is true that insurers had some return to profitability in the mid-2000s, it is important to remember that insurers had a lost decade in Florida after Hurricane Andrew. *See* Insurance Information Institute, "Florida's Insurance Markets: An Overview," p. 3 (Sept. 2010) ("Florida's property insurers have been operating in the red on a cumulative basis since Hurricane Andrew struck in 1992. It took 11 years for insurers to break even after the losses paid out from Hurricane Andrew. Companies returned to profitability in 2003, and then slid back into the red with back-to-back hurricanes in back-to-back years (2004, 2005)." Indeed, "19 percent of all U.S. insured losses from 1980 -2006 impacted the state." *Id*. at 2.

[36] Florida Enrolled CS/HB 1A *at* § 21.

[37] *Id*.

[38] *Id.*

[39] *Id.*

private reinsurance; (f) expansion of the Citizens assessment base;[40] and (g) provisions that made it easier for policyholders who had left Citizens to return, as well as language allowing consumers that were accepted by Citizens to obtain immediate coverage. In particular, the expansion of Citizens' ability to write policies for any consumer that received a quote over 25% above the Citizen's rate created a *de facto* rate ceiling for all property insurers operating in the state.

Other legislative provisions: (a) expanded the Cat Fund for all insurers, allowed very small insurers to purchase even more reinsurance from the Fund, and mandated a rate rollback (reduction in insurance rates) to reflect the availability of this additional coverage from the Cat Fund (even if an insurer chose not to buy the additional coverage);[41] (b) established a tax on so-called "excess" profits of insurers;[42] (c) created "lock-in" features requiring Florida auto insurers to also write homeowners' insurance if they wrote that line anywhere else in the country;[43] and (d) mandated a claims decision within 90 days of receiving notice of the claim.[44]

Also noteworthy in the 2007 legislation (HB 1A) was the adoption of an expanded mandate that insurers provide catastrophic ground cover collapse or "sinkhole" coverage.[45] Not surprisingly, within two years of the expanded sinkhole mandate, which included substantial new investigatory costs and obligations for insurers, the cost of sinkhole claims doubled from $209 million before passage to $406 million two years after passage.[46] The uptick in claims and their cost along with widespread allegations of fraud and misbehavior was so profound that the legislature substantially reformed the sinkhole law this past spring, only 4 years after its original passage.[47]

Enactment of these provisions had the comprehensive impact of increasing the debt ceiling and leverage of Citizens and the Cat Fund, while encouraging their growth and not permitting rate

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[40] *Id.*

[41] Florida Stat. Ann. § 215.555(4), (16) & (17)

[42] Florida Enrolled CS/HB 1A (2007), § 26.

[43] *Id.*, § 42 ("Effective January 1, 2008, no insurer writing homeowners' insurance in another state, but not in Florida may continue to write private passenger automobile insurance in Florida unless the private passenger automobile insurer is affiliated with an insurer writing homeowner's insurance in Florida.").

[44] Florida Stat. Ann. § 627.70131.

[45] Florida Stat. Ann. § 627.706.

[46] Florida Office of Insurance Regulation, *Report on Review of the 2010 Sinkhole Data Call*, at 5 (November 8 , 2010) (http://www.floir.com/siteDocuments/Sinkholes/2010_Sinkhole_Data_Call_Report.pdf).

[47] Florida Senate Bill 408.

increases or other prudent financial measures needed to offset the growth in exposure. Insurance exposures and losses were not reduced by these legislative changes, which instead were focused on reducing the upfront price of property insurance.[48]

At the same time, the legislation effectively capped the ability of private insurers to compete on price, while adding restrictions on their claims and other business practices. "Property insurance rates actually dropped between 2007 and 2009, due to state-mandated discounts … Reductions were mandated despite evidence that current rates were not adequate to cover anticipated claims. This additional loss in premium income prompted many insurers to lose money even without a major hurricane striking the state, and they responded by further curtailing their business."[49] An Insurance Information Institute Report documenting these trends also indicates that the Office of Insurance Regulation ("OIR") has started to reverse course, and to review insurer financial data in light of rising claims costs. However, just as a rapid rise in insurance rates preceded the 2007 reforms, it would not be wise to assume that the OIR will allow rate increases that would bring insurance charges in line with the property risk.

To add insult to injury, the 2007 legislation did not curb the unilateral assessment authority for Citizens or the Cat Fund, ensuring that exposure to catastrophic hurricane losses in Florida would not be limited, but could possibly affect all Florida policyholders and insurers.[50] In fact, by not reducing insurance exposures or losses, the 2007 legislation dramatically increased the reliance of the market on post-event bonds issued by Citizens and the Cat Fund in order to fund losses, a situation that became absolutely untenable when bond markets suffered a near collapse in 2008. In a classic "pay me now or pay me later" scenario, the State of Florida chose to pay for losses after the fact, undermining the very fundamentals of the insurance risk transfer mechanism in order to achieve temporarily lower upfront premiums.

The rise in the number of Florida property insurers entering the market does not provide any comfort either. Aon Benfield summarized the Florida property market dynamics at the end of 2009:

- "Approximately 75 percent of Florida HO premium is written by insurers with an A.M. Best rating lower than "A-" or by those that are unrated. Citizens … has a market share

[48] Insurance Information Institute, "Florida's Insurance Markets: An Overview," pp. 3-4 (Sept. 2010).

[49] *Id.* at 4.

[50] *Id.* at 3 ("Citizens does not collect enough premium to pay the claims that would result from a major storm, and when it runs out of money, it assesses its policyholders and all other Floridians, even those with insurance in the private market, including auto insurance policies.").

of more than 14 percent, which adds materially to the State's exposure to insured catastrophes.[51] The State's exposure also includes $23.2 billion of projected capacity from its [Cat Fund]. Even with the State's catastrophe leverage high, it is difficult for Citizens to gain the rates it says it needs. In an October rate filing hearing, Citizens indicated a 40 percent rate increase is necessary to make rates actuarially sound. In November, a 5.3 percent average rate increase was approved by regulators."

- "Despite operating in the world's peak catastrophe market, most Florida-based HO insurers are capitalized at lower levels than their non-Florida peers, as measured by NAIC's risk-based capital (RBC) ratio."[52]

In the ensuing two years, the situation in Florida has gone from bad to worse. In the 21 months ending in September, Citizens' policies-in-force increased 42% to 1.46 million.[53] Indeed, since January 1, 2011, the Citizens policy-in-force count grew over 14% to 1,482,707, with over $***515 billion*** in exposure.[54] According to AM Best data, Citizens is the largest homeowners insurer and largest total property insurer in the state with over 16% of the homeowners market and 17.5% of the entire property insurance market in Florida.[55]

Hallmarks of this state-based property insurance regime are post-event assessments.[56] Citizens, the Cat Fund and the Florida Insurance Guaranty Association all rely upon them to cover funding shortfalls by assessing policyholders and often across broad ranges of coverage that are not property insurance by nature, including auto and liability insurance. These

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[51] "Florida's state-run insurer has increased its total exposure to loss by 163 percent since 2002 – to $406 billion in 2009." *Id.* at 4.

[52] Aon Benfield Analytics, "Florida Homeowners Market…At the Tipping Point?" p. 2 (Dec. 2009).

[53] http://www.propertycasualty360.com/2011/10/13/floridas-citizens-property-insurance-corp-board-ra

[54] *Id*.; https://www.citizensfla.com/about/corpfinancials.cfm

[55] AM Best data is for the last full year available—2010. Given its growth this year, we expect Citizens to be an even bigger market participant.

[56] Newman, *Residual Market Subsidies in Florida Property Insurance Market: A Conceptual and Historical Framework* at 8, Florida Catastrophic Storm Risk Management Center, FLORIDA STATE UNIVERSITY, http://www.stormrisk.org/admin/downloads/Residential%20Market%20Subsidies%20in%20Florida's%20Property%20Insurance%20Market%2007-09.pdf As Newman notes:

> "Florida has followed the traditional approach of recovering residual market deficits by imposing identical percentage assessments on full policy premiums of insurance companies and policyholders. This approach may be acceptable for lines of insurance with minimal catastrophic loss exposure because rates for these lines of insurance can be set with reasonable accuracy based on accepted actuarial principles and historical experience that ordinarily does not vary significantly from year to year." *Id.* at 8.

assessments are *post hoc* liquidity meant to account for reserve and rating inadequacies and to spread those inadequacies more broadly among Floridians. In this way, Florida's state-based approach is the antithesis of customary insurance based upon the "inverted cycle of production" model discussed earlier.

Moreover, this after-the-fact assessment process results in substantial cross-subsidization by non-coastal Floridians of coastal risks. In this way, the Florida approach again defies customary insurance principles. As James Newman, of the Florida Catastrophic Storm Risk Management Center at Florida State University, put it:

> "The Florida Legislature may not have intended the deficit assessment processes set forth in Florida Statutes for Citizens, FHCF and FIGA to produce sizeable subsidies from policyholders in some parts of the state to residential property insurance policyholders in parts of the state with higher hurricane exposure; however, this is the result of the current statutory assessment procedures."[57]

In its report to the Florida Cabinet in April 2010, Citizens anticipated what assessments may be needed for a variety of storm scenarios—a 1-in-50 year storm would require nearly $3 billion in assessments, while a 1-in-100 year storm would require nearly $11 billion in assessments. [58] Moreover, the Cat Fund recently announced it could have a $3.2 billion deficit next year.[59] It is fair to say that Florida's property insurance market is "challenging."

To summarize, the Florida property insurance market situation has produced a vicious circle where financial solvency of private market insurers has been stressed by rate regulation and other related regulatory constraints while the legislature has further empowered government-run insurance mechanisms that rely on post-event funding to finance catastrophic losses. Because the mechanisms collectively siphon away customers from the private market, yet assess that same market to pay for unfunded losses, Florida has instituted a regulatory apparatus that increases public exposure and cross-subsidization while eroding competitive private markets or ensuring the financial instability of those that write there. This government-centric approach adopted by Florida to spare its residents needed, transparent insurance rate

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[57] *Id.*

[58] *Florida's Insurance Markets: An Overview* at 5, Insurance Information Institute (September 2010). "A 1-in-100 year storm means there is a one percent chance that an event can occur in any given year, comparable to a major Category 4 hurricane." *Id*.

[59] Report Prepared for the Florida Hurricane Catastrophe Fund: Claims Paying Capacity at 9 (http://www.sbafla.com/fhcf/LinkClick.aspx?fileticket=Pwe5xIr5kmc%3d&tabid=991&mid=3404) "This estimate results in an initial season 12 month funding shortfall of approximately $3.2 billion."

increases in the short-term will almost certainly prove to be a regulatory catastrophe in the long-term.

Auto Insurance Rate Regulation

Rate regulation, whether in its most intrusive form of "prior approval" or in the less intrusive forms of "use and file" or "file and use" rate regulatory systems, is in place in most states for auto insurance and allows state governments to determine market prices, often in a politically charged environment. Regardless of how it is defined, this extensive regulatory authority is virtually unknown throughout the rest of the world for insurance and has largely disappeared in the U.S. economy for other sectors. Repeated efforts to reform or limit this authority on a national level through existing structures, including the NAIC, have not produced positive results, with some exceptions in individual states that are discussed below.

The authority of government to set prices does not always result in market crises, but it always carries the risk of creating a toxic regulatory environment when other factors, such as rising costs, create the political impetus to use it to suppress rates over-all or for some elements of the population. The U.S. experience with these rate regulatory systems demonstrates they do not provide consumer value and instead can lead to decreased competition and consumer choice, large residual market populations, higher or more volatile rate levels than would occur under free market competition, and in the worst case, market failures.

Three states, South Carolina, New Jersey and Massachusetts serve as good examples of both the inherent dangers of government rate regulation, and the consumer benefits when even modest pro-competitive reforms are introduced. Meanwhile, California, with a voter initiative-installed prior approval rate regulatory system has similar problems, but it has so far been unable to reform itself because of the super-legislative majorities required to modernize its regulatory system.

South Carolina

For decades, South Carolina maintained a rigid prior approval system and suffered from high prices and a bloated residual market that covered 42% of the state's drivers. Companies also were exiting the market, with the number of insurance companies dropping from 80 in 1990 to 55 in 1996.[60]

In 1997, the legislature responded to the crisis by enacting a law that, among other reforms, replaced state-mandated risk classifications and rating territories with insurers being allowed to

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[60] Martin F. Grace, Robert W. Klein and Sharon Tennyson, "The Effects of Regulatory Reforms in the South Carolina Auto Insurance Market," presented at the American Risk and Insurance Association meetings (San Diego, 2011).

compete by using their own underwriting criteria. It also permitted insurers to reject applicants that did not meet their standards and replaced the reinsurance facility with a conventional assigned risk plan.[61] The positive results for consumers came almost immediately. By 1999, when the law took effect, the number of insurance companies doubled. Over-all rate reductions were provided by many companies and the residual market depopulated.[62]

New Jersey

The New Jersey insurance regulatory system suppressed rates below the level of risk, forced companies to take drivers who did not fit their underwriting standards, and forced huge numbers of drivers into the state residual market at unsustainable subsidized rates. The New Jersey Department of Banking and Insurance in its 2004 report described the scene before reform: " … the New Jersey automobile insurance market was immersed in an availability crisis of epic proportions. New Jersey's 30-year history of piling regulation on top of regulation had brought us to a breaking point: carriers fed up with the restrictive over-regulation were fleeing New Jersey. Good drivers were spending weeks or months shopping for a policy. With more than 40 carriers leaving New Jersey during the last 10 years, and major carriers threatening to leave, consumers were facing an availability problem for the first time."[63]

Then-Governor McGreevey called for legislation that would "create a competitive marketplace … and give consumers more choices, protection and empowerment."[64] The legislature responded by enacting legislation that rolled back many of the restrictive regulations and provided the companies more rating and underwriting freedom. Again, the benefits for consumers became visible almost immediately. Existing companies stayed and expanded; new companies entered the market; and the increased competition lowered rates by an estimated $86.6 million in the first year alone. Insurance Commissioner Bakke summarized the results this way: "The competitive marketplace created by the reforms is benefiting drivers, feeding a growing economy, generating more employment opportunities for agents and allowing companies to expand. We anticipate this momentum to continue, further increasing consumer options and downward pressure on rates."[65]

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[61] South Carolina Department of Consumer Affairs, "Automobile Insurance," available at http://www.scconsumer.gov/publications/insuring_automobile.htm.

[62] Todd Bauer, "Auto Insurance Reform at Hand," Augusta Chronicle (Feb. 28, 1999).

[63] "In the Driver's Seat: A Report on the Status of Auto Insurance Reform in New Jersey," New Jersey Department of Banking and Insurance (2004).

[64] *Id.*

[65] Press Release, New Jersey Department of Banking and Insurance (July 29, 2004).

The issue came up recently when current Republican Governor Chris Christie commented on New Jersey's auto insurance reforms: "I've got to give a shoutout to [Democrat] Governor McGreevey … He did a very good job on that while he was governor and our auto insurance, while still high, is not anywhere near as high as it used to be about a decade ago. And that's because we went to market-based solutions that brought more folks in here, created more competition, and now you have lower rates."[66]

Massachusetts

Massachusetts exercised direct control over auto insurance rates through uniform underwriting and pricing mandates. It also had a very large residual market and comparatively few insurers. The state finally acted to inject some additional elements of free market pricing, called "managed competition." The Insurance Division summarized the results as follows: "Since the Patrick-Murray Administration introduced managed competition auto insurance reform two years ago, drivers in Massachusetts have saved nearly a half-billion dollars, and many were able to maximize savings by shopping around for a better premium. Since the start of managed competition in April 2008, 11 new companies have entered the marketplace, bringing more choice to consumers and offering better rates for better drivers."[67]

In summary, prior to reforms, each of these states engaged in intrusive rate regulation that resulted in fewer companies, high prices and large residual markets. In each case, these conditions and the related market disruptions continued for decades before the political will was mustered to make the necessary changes. After even modest pro-free market reforms, consumer choice increased, prices were reduced and residual markets shrank.

North Carolina

This state currently shares all of the hallmarks of the other states prior to pro-competitive reforms. The government effectively sets uniform prices through its approval of the base rate. Rather than the state allowing companies to charge higher prices according to risk, the state effectively forces insurers to cede many insureds to the state's residual market. The state's reinsurance facility now has 20% of the state's drivers (compared to a 0.95% national average) and accounts for 80% of the country's total residual market population. Cross-subsidies are rife and reformers estimate that competition would lower rates for 85% of the drivers.[68] Yet, the

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[66] Steve Adubato, "Gov. Chris Christie Credits Former Gov. Jim McGreevey for a Decrease in New Jersey Auto Insurance Rates," Politifact - New Jersey Star-Ledger (June 16, 2011).

[67] "Auto Insurance Premium Comparisons," Massachusetts Office of Consumer Affairs & Business Regulation.

[68] Press Release, Insurance Federation of North Carolina, (Apr. 13, 2011).

defense of this system is led by the elected commissioner, apparently immune from solvency concerns and market disruptions that this system causes.[69]

California

Proposition 103 ("Prop 103") was narrowly approved by California's voters in 1988. The Proposition was sold to the electorate as an initiative to reduce auto insurance premiums, but was drafted to cover the regulation of almost all property-casualty insurance lines, except workers' compensation.

Prop 103 replaced the state's competitive rating system with prior approval for most property-casualty insurance. In addition, it froze rates and mandated a 20% rollback. The result has been the creation of a highly-politicized, complex and intrusive state insurance regulatory system that is extremely costly for all involved and that at the same time less accurately measures and prices for risk, when compared to the regulatory systems in other states. By doing so, Prop 103 has resulted in—

- Less accurate auto insurance premiums;
- Higher than necessary costs for consumers due to a very convoluted and expensive regulatory apparatus;
- Less rapid reduction in premiums when costs are reduced, due to the extensive government intrusion into pricing; and
- False assertions by Prop 103's advocates that the overall reduction in auto insurance premiums in recent years has been the result of Prop 103, when the truth is that those reductions have been the result of other factors such as: safer cars; older and more experienced drivers; the greater use of seat belts; more vigorous law enforcement; the insurance industry's own anti-fraud efforts; and a relative reduction in overall driving miles occasioned by the recession.

As Milliman Actuary David Appel found in a 2004 report: " … in the long run insurance rates are a function of insurance costs … Despite the broad claims of success that are made by the proponents of state-administered pricing regulation—the key feature of Proposition 103—our analysis came to a very different conclusion about the recovery of the California auto insurance market."[70]

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[69] Insurance Federation of North Carolina, PowerPoint presentation on S.B. 477.
[70] Dr. David Appel, "Revisiting the Lingering Myths about Proposition 103: A Follow-Up Report," page 2, Milliman, Inc., Sept., 2004.

Not only did Prop 103 create an expensive, politically-charged insurance regulatory system, it loaded costs on insurers as well. Those costs are embedded in California insurance rates. For insurers that operate in many states or across the country, this means that separate regulatory management systems need to be created for one state, with all the costs and inefficiencies inherent in maintaining that separate system. Prop 103 advocates say that the big insurers can well afford to absorb these costs, but the fact is those costs ultimately are borne by consumers. Beyond their own costs, insurers are also liable for the government's own costs of operating this system. The assessments for one year, FY 2010-11, were $23, 864,234.[71]

Despite the obvious shortcomings of the system, reform in California has not occurred. That is because, unlike the other states, reform in California has been hampered by the mandate for a 2/3 super-majority in each house of the legislature in order to make any significant changes to Prop 103.

Policy Form Regulation

While it is relatively easy to measure the harm caused by rate regulation in terms of residual market size, fewer competitors, and trapped costs, the adverse consequences of policy form regulation are less obvious, but no less important. Where states deny insurance consumers the opportunity to purchase a product or delay its introduction, insurance policies become more commoditized and less responsive to innovations, which tends to harm consumers in general, but commercial insureds in particular. Insurers, in turn, are effectively discouraged from investing resources in policy development, as the enormous variation in state rules amounts to a *de facto* prohibition against selling the same policy form countrywide.

Professor Richard J. Butler, studying the impact of policy form supervision, found that commercial insurance form regulation imposes both an "approved tax" and a "never approved" tax on insurers and their commercial lines customers. In turn, this results in a flight of risk transfers from regulated insurers to less regulated and less secure alternative risk transfer mechanisms. He concluded that " … complete deregulation of forms would increase traditional insurer market share by $18.3 billion."[72]

In many instances, the product restrictions are the result of outdated public policy or inherent suspicion of anything new. In those instances, commercial consumers in one jurisdiction that

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[71] "Proposition 103 Assessment Fee Calculation FY 2010-11 Schedule of Actual Costs vs. Actual Collections," Exhibit E, California Department of Insurance.

[72] Butler, Richard J., "Form Regulation in Commercial Insurance," in J. David Cummins, ed., *Deregulating Property-Liability Insurance* (Washington DCL American Enterprise Institute-Brookings Institution Joint Center for Regulatory Studies 2002), p. 356.

allows coverage may have an advantage over businesses in another neighboring jurisdiction that does not permit the coverage. In other cases, the repetitive filing mandates delay or discourage innovation in commercial lines. These regulatory hurdles restrict the ability of regulated insurers to timely meet the insurance needs of America's businesses, which in turn has negative implications for them and their ability to expand, hire and be globally competitive. We have outlined below several examples where policy form regulation has effectively hindered private market development.

Insurability of punitive damages

States differ in their public policy views of the insurability of punitive damages. In fact, states are almost evenly split as to whether punitive damages are insurable. Punitive damages is an area where severity far outweighs frequency, so having predictable coverage certainly lessens a commercial insured's exposure and minimizes coverage gaps that plaintiff's attorneys often try to exploit in settlement negotiations.

Of those jurisdictions that permit punitive damages to be covered, many will only allow an insurer to pay when the award of those punitive damages is the result of vicarious liability. Choice-of-law provisions in policies often come into play for corporations operating across multiple jurisdictions with varying laws. For a multi-state insured that requires such coverage, but does business in states that prohibit insurance coverage for punitive damages, it will be impossible for that insured to meet its coverage needs. For example, Missouri permits insurance policies to cover punitive damages, while Kansas prohibits that coverage.[73] If the NAIC, an entity based in Kansas City, Missouri, were a product manufacturer looking for punitive damages coverage around the country, it would be able to obtain the needed coverage in Missouri, while being foreclosed in Kansas.

Defense within Limits

States have varying limits on the types and size of policies where the form can provide for payment of defense costs within coverage limits. As a result, commercial insureds with difficult insurance risks that would benefit from greater availability of this type of coverage may practically be prevented from obtaining it in the admitted market if they do business in one of the states that either prohibit the coverage or place burdensome restrictions on it. Defense costs are a major driver of claims costs (more so than indemnity payments in certain lines), so requiring carriers to provide unlimited defense cost coverage results in either fewer carriers

[73] *Colson v. Lloyd's of London,* 435 S.W.2d 42 (Mo. Ct. App. 1968); *Hartford Acc. & Indem. Co. v. American Red Ball Transit Co., Inc.,* 938 P.2d 1281, 1293 (Kan. 1997), *cert. denied,* 118 S. Ct. 372, 139 L. Ed. 2d290.

offering complex coverages or the encouragement of unsound underwriting practices. Here are some examples of the variations in treatment of defense within limits:

- *Arkansas:* Defense within limits is only permitted where the insurer offers a separate limit equal to the annual aggregate limit of liability in the policy, but defense within limits is prohibited altogether in auto liability policies.[74]
- *Minnesota:* Bars defense within limits provisions with the exception of professional liability policies in excess of $100,000, large commercial risks and environmental impairment liability insurance.[75]
- *Montana:* Effectively bars defense within limits as within the scope of the statutory prohibition on "inconsistent, ambiguous, or misleading clauses."[76]
- *New York:* Insurance Department regulations permit defense within limits provisions only in certain circumstances and the amount of expenses that can reduce the policy limits is capped at 50% of the policy limits unless the insured is given control of its defense.[77]
- *Oregon:* Provides that liability insurance containing defense within limits provisions must be filed and approved by the Director of the Department of Consumer and Business Services.[78]
- *Vermont:* Defense within limits is not permitted in commercial multi-peril policies, but the Insurance Department will consider a separate defense limit equal to the limit of liability.[79]

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[74] Ark. Code Ann. § 23-79-307(5)(A). Notably, on December 8, 2011, the Arkansas Insurance Department issued a bulletin indicating that electronic filings for package (multiple lines) filings would no longer be accepted by the Department because "the acceptance of [such] filings has resulted in the approval of some lines that are not in compliance with the defense outside the limits requirements or applicable exemption order requirements" under this provision of the Arkansas Insurance Code. Directive 3-2011, Arkansas Insurance Department (Dec. 8, 2011), "Directive on SERFF Filings Submitted Under Incorrect Type of Insurance ("TOI") Code and Subsequent Noncompliance with Defense Outside the Limits of Liability Requirements of Ark. Code Ann. § 23-79-307(5)(A) and Applicable Aid Exemption Orders (Dec. 8, 2011).

[75] Minn. Stat. § 60A.08 subdivision 13.

[76] Mont. Code Ann. § 33-1-502.

[77] N.Y. Comp. Codes R. and Regs. tit. 11, § 71.3.

[78] Or. Rev. Stat. § 742.063(1).

[79] "Rate & Forms Filing Review Requirements," Vermont Department of Banking, Insurance, Securities and Health Care Administration, available at http://www.bishca.state.vt.us/category/sections/insurance/rates-forms?page=4.

Claims-made Policies

States have many different rules for claims-made policies, which complicates product development enormously since many types of professional liability, errors and omissions and management liability (e.g., directors and officers, employment practices liability) include both claims-made and defense within limits provisions. This is also an example of outdated regulation, as many of these regulations date back to the mid-1980s when the Insurance Services Office introduced policy "simplification" and it was not yet clear which products would ultimately be sold on a claims-made basis. However, competition over the years and consumer needs have established the market for which coverages can and should be sold on a claims-made basis. New York and Maryland provide examples of difficult claims-made rules. New York requires claims-made policies to trigger coverage on a different basis than any other state.[80] Maryland requires claims-made policies to include an unlimited reporting period, which effectively turns such policies into occurrence-based policies.[81]

Uninsured/Underinsured Motorists Coverage in Automobile Policies

The staggering variation in state rules governing this coverage, which is mandatory in many states, makes compliance by insurers costly and complex in virtually all phases of an insurance transaction, including underwriting, policy issuance and claims handling. A number of states have strict rules governing mandatory offers of coverage and the acceptable methods for applicants to select or reject this coverage. These rules make consummation of automobile insurance transactions difficult and time-consuming, a particular problem when insurance customers are waiting to take delivery of a recently purchased vehicle. Numerous inconsistencies also exist between jurisdictions that impact the claim settlement process, including variations with respect to the ability to stack UM/UIM coverage on an inter-policy[82] or intra-policy[83] basis (or not at all)[84], variations on when and how coverage is triggered, and the ability, state-by-state, to offset UIM by the at-fault driver’s insurance. Inconsistencies from state to state also exist with regard to when an insurer must make a UM/UIM offer on an excess/umbrella policy.[85]

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[80] N.Y. Ins. Law § 3420.

[81] Bulletin 10-36, Maryland Insurance Administration (November 3, 2010).

[82] Va. Code Ann. § 38.2-2206(B).

[83] Ind. Code § 27-7-5-5.

[84] W.Va. Code R. § 114-63-5.10.

[85] For example, Virginia law requires a UM/UIM offer be made on an excess/umbrella policy (Va. Code. Ann. § 38.2-2206), while West Virginia does require that the offer be made (W. Va. Code § 33-6-31).

Mine subsidence coverage in homeowners' policies

The mine subsidence coverage in homeowner's policies of some states underscores the variety of different ways similar coverage issues are handled in the states. All states requiring the coverage require that insurers provide mine subsidence coverage unless waived in writing. That is where the similarities end, however. In some states, the state mine subsidence fund alone sets the premiums and requires that it be separately stated on the declarations page and invoices. Other states do not have similar requirements. Some states require that the form or endorsement be approved by the state, while still others promulgate the form themselves. Still other states completely remove the insurer from the process and offer coverage for loss resulting from mine subsidence directly from the state itself.[86] Thus, while limited in nature, mine subsidence coverage demonstrates the patchwork of regulatory approaches taken by the states without any seeming coordination at all.

Group personal lines policies

States have many different rules regarding treatment of and limitations on group personal lines policies. Some states limit the lines that can be offered[87]; others place unique "front end" restrictions on the qualifications of the groups.[88] As a result, employers with employees in multiple jurisdictions that allow this coverage may be prevented from offering it as a benefit to all of their employees, if at all. It should be noted that limitations on group health insurance drove Congress to pass ERISA, taking regulatory jurisdiction over group health plans away from the states.

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[86] Illinois and Kentucky law both require separately stated premium, but neither specifies that a separate endorsement is required. (*See* 215 ILCS 5/805.1; Ky. Rev. Stat. § 304.44-030). The Kentucky fund plan of operations includes a sample waiver form, but no specific endorsement. However, the Department of Insurance webpage states that insurers must "offer a mine subsidence endorsement." Indiana requires mine subsidence coverage be "available as an additional form of coverage" and that the premium must be separately stated. (*See* Ind. Code § 27-7-9-8). Ohio requires including mine subsidence coverage on basic property and homeowners insurance in certain counties, but only requires an offer of coverage in other counties. (*See* Ohio Rev. Code Ann. § 3929.56). West Virginia requires "only those coverage forms ... which have been approved by both the Board and the Insurance Commissioner" and provides the form to be used. Insurers may reproduce the form under the name of the issuing insurance company. (*See* W. Va. Code St. R. § 115-1-3). Oklahoma does not mandate offering coverage, leaving it as voluntary "upon the request by the policyholder." (*See* Okla. Stat. 36 § 999.4). States without private insurers and only state funds include Pennsylvania, Ohio, Colorado and Wyoming. *See* www.pamsi.org (Pennsylvania's Coal and Clay Mine Subsidence Insurance Fund); www.ohiominesubsidence.com (Ohio Mine Subsidence Insurance Underwriting Association); www.mining.state.co.us/AM:Subsidence.htm (Colorado); http://deq.state.wy.us/ (Wyoming).

[87] *See, e.g.,* Ohio Admin. Code 3901-1-31.

[88] *See, e.g.,* MCLA 500.2105(2); MCLA 500.2103; MCLA 500.2403; MCLA 500.2113; Mich. Ins. Bull. 80-22; Mich. Bull. 2006-05-INS.

AN EFFICIENT REGULATORY SYSTEM VALUES UNIFORMITY AND CONSISTENCY

As many of the above policy form regulatory examples illustrate, one consequence of state-based regulation is that each state is free to make its own policy choices for its own citizens. While that may merit admiration for the states as "laboratories of democracy," the result is non-uniformity among states and inconsistent application where uniformity is achieved. Again, the regulators and state legislative organizations are not the source of blame, as both the NAIC and NCOIL has adopted numerous model laws and regulations in a variety of areas. Yet, the failure of states to actually enact many of the models is a strong silent witness to the inefficiencies of the U.S. system.

This problem is exacerbated where the federal government expresses its national intent and the states fail to act, or act in a disparate way. In recent years, Congress has attempted to accommodate two powerful interests: the continuation of state insurance regulation and the resolution of national insurance issues. These efforts began with the enactment of the Gramm-Leach-Bliley Act ("GLBA")[89] in 1999, which was the first attempt since the 1930s to modernize financial regulation. GLBA was followed by the Terrorism Risk Insurance Act of 2002 ("TRIA"),[90] which was a response to the September 11th terrorist attack on the United States. And most recently, Congress enacted the Dodd-Frank Act in 2010 as a response to the financial crisis of 2008, with the goal of establishing new regulatory mechanisms to prevent a repeat of that crisis.

While TRIA was focused solely on insurance, both GLBA and the Dodd-Frank Act centered principally on the banking and securities industries. Those laws also included insurance because insurance is an important component of the financial system. Banking and securities, however, are principally regulated by the federal government, while insurance – particularly property-casualty insurance – is regulated by the states, pursuant to the McCarran-Ferguson Act.

Thus, when there are banking or securities issues, the legislative and policy approach is straightforward: legislatively develop policy and then direct the appropriate federal agencies to carry it out. With insurance, however, the legislative and policy challenges are more complex. This complexity has arisen from the Congressional need to address national insurance problems while, at the same time, retaining an important, independent regulatory role for the states.

This has resulted in Congress trying four different approaches:

[89]Also known as "The Financial Services Modernization Act of 1999," Pub. L. No. 106-102, 113 Stat. 1338 (Nov. 12, 1999).
[90] Pub. L. 107-297 (Nov. 26, 2002).

(1) Establish a federal legal structure that partially pre-empts state law on a particular matter, but leaves most state law in place. This is what Congress did in TRIA.

(2) Establish a legal structure that describes minimum requirements for the states, but permits the states to go beyond those requirements. This is what Congress did on the GLBA privacy issues.

(3) Establish a legal structure that urges the states to undertake certain activities, but essentially leaves it up to them to carry out this federal request. This is what Congress did in GLBA with regard to the establishment of a state-based national regulatory licensing regime for agents and brokers, threatening to establish a National Association of Registered Agents and Brokers (NARAB) if the states failed to take sufficient action.

(4) Establish a legal structure that contains elements of all of these approaches, which is what Congress did in writing the Dodd-Frank Act. The Act includes some very limited pre-emption of state law in the area of international insurance negotiation on prudential insurance matters. And it urges the states to take actions with regard to surplus lines and reinsurance regulation to create elements of a state-based national regulatory system for them.

The results of these approaches to date have been mixed, but it is fair to say that none of them has provided the United States with the national uniformity that the federal legislation envisioned. While it may be too early to say that these efforts will ultimately fail to create national uniformity, it is not too early to say that most of these efforts are failing, today. The two most obvious examples are the total failure of the states to be able to come together with common standards to carry out the Congressional mandates on NARAB and the surplus lines marketplace.

The TRIA example is also discouraging. While TRIA has never been tested – and hopefully never will be tested – state resistance occurred almost immediately after initial passage in the area of rate and form regulation. TRIA expressly included a one-year preemption of state rate and form prior review or approval laws for terrorism risk insurance: "[R]ates and forms *for terrorism risk insurance covered by this title and filed with any State* shall not be subject to prior approval or a waiting period under any law of a State that would otherwise be applicable."[91] Yet, despite the plain meaning of that language, New York issued a draft circular letter opining that the TRIA preemption provision was "limited" to an "exemption" of state "prior approval of

[91] TRIA § 106(a)(2)(B).

rates and forms *intended* to provide terrorism risk insurance covered by the Act …," and that the federal "exemption does not apply to rates and forms that exclude or limit coverage for terrorism risks…."[92] On this basis, the New York insurance department refused to permit terrorism exclusions even though commercial insureds were requesting them where they had rejected coverage made available pursuant to TRIA and TRIA clearly intended to preempt the states from interfering with the promulgation of terrorism-related policy language.

Further, the fact that certain states have continued to mandate that insurers cover terrorism-created fire losses for those customers who actively decided <u>against</u> purchasing terrorism insurance has undercut one of TRIA's principal purposes: to create a uniform national response to the terrorism threat where responsibilities are fairly shared among insurers, customers and the federal government. While numerous states have modified their statutory fire policies over the years since TRIA's enactment, others have not done so.

The GLBA privacy rules are different in one important respect: Congress clearly intended to let the states go their own way on privacy rules beyond the federal rules – but in allowing the states to go their own way, they have added costs while doing nothing noticeable to enhance privacy protection. In 2006, the 109th Congress passed the "Financial Services Regulatory Relief Act," directing 8 federal agencies to develop a model form, which may be used by financial institutions as a safe harbor for compliance with the GLBA privacy disclosure requirements.[93] The model privacy form is intended to create a clear, conspicuous and comprehensible disclosure that enables consumers to easily identify and compare the information sharing practices of various financial institutions.[94]

In 2010, the NAIC adopted the "[GLBA] Privacy Notices" bulletin incorporating the federal model disclosure. Indeed, NAIC efforts to implement a uniform model privacy notice in the states do not appear to be working. States were encouraged to adopt the model disclosure form without changes, but, of the 4 states that have adopted the form thus far (Virginia, Kentucky, Maine, and Nebraska), only Kentucky adopted the NAIC disclosure form intact. For example, Virginia identified that their laws require state-specific privacy disclosures and, therefore, amended the model form to include the state-specific information.[95] Maine recognized that they have state-specific requirements, but allow this information to be included

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[92] Draft Circ. Letter No. 25, New York State Insurance Department, – "Applicability, Guidelines and Procedures for Compliance with the Provisions of the Terrorism Risk Insurance Act of 2002; Guidelines for the Use of Limitations for Acts of Terrorism in Commercial Property/Casualty Policies", pp. 6-7 (Dec. 17, 2002).

[93] 15 U.S.C. § 6803(e).

[94] 15 U.S.C. § 6803(e) and 17 CFR 160.1 et seq.

[95] Admin. Letter 2011-06, Virginia Bureau of Insurance (July 18, 2011).

on the model form or on a separate document.[96] This lack of uniformity (through adoption of the NAIC model form) reduces the availability of a meaningful optional safe harbor for GLBA compliance that applies across state lines and business units.

The NARAB and surplus lines regulatory failures are also worthy of special note. On NARAB, Congress tried through GLBA to get the states to put a uniform agent licensing system in place. That effort – now more than a decade old - has essentially failed. Indeed, the failure is so palpable that new legislation has been introduced to supersede it.[97] This failure has not been for lack of trying, but because of the predictable difficulty in getting 50 or more separate and independent jurisdictions to agree on a common approach. Although a majority of states have enacted some sort of licensing reform, the Council of Insurance Agents and Brokers has testified that "[m]ost states retain a variety of individual requirements for licensing, and they all differ with respect to fees, fingerprinting and certifications, among other requirements. Even more problematic are the disparities among the states regarding business entity licensing … The inefficiencies and inconsistencies that remain in producer licensing affect every insurer, every producer and every insurance consumer."[98]

The National Association of Insurance and Financial Advisers has succinctly stated the underlying problem: "It has proved to be very difficult for state regulators and their legislatures to unilaterally correct the identified deficiencies in state insurance regulation. Both practical and political realities dictate that, if identical bills are proposed in 50 state legislatures, 50 different bills will emerge from those 50 separate legislative processes. There are numerous reasons for this lack of success – lack of will, disagreements over substantive details, structural impediments, and the fact that it is simply very difficult to get 50 different jurisdictions to act in a coordinated fashion, and act quickly in a constantly changing global marketplace."[99]

Similar frustrations have been publicly aired about the inability of the state insurance regulatory system to put into place the surplus lines reforms set forth in the Dodd-Frank Act.[100] As described by the National Association of Professional Surplus Lines Offices, the Dodd-Frank

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[96] Bulletin 379, Maine Bureau of Insurance (August 3, 2011).

[97] *See* H.R. 1112, the "National Association of Registered Agents and Brokers Reform Act" ("NARAB II"), introduced by Representatives Randy Neugebauer (R-TX) and David Scott (D-GA), which would create an interstate producer licensing clearinghouse and which has been approved several times by the House Financial Services Committee.

[98] Written Statement of the Council of Insurance Agents and Brokers at a hearing of the House Financial Services Committee's Subcommittee on Insurance, pp. 12-13 (July 28, 2011).

[99] Written Statement by National Association of Insurance and Financial Advisers at a hearing of the House Financial Services Committee's Subcommittee on Insurance, p. 3 (July 28, 2011).

[100] *See* Dodd-Frank Act, §§ 511 – 542 (Subtitle B), the "Nonadmitted and Reinsurance Reform Act of 2010."

Act reforms were "passed to address the inconsistent way in which states manage their premium tax allocation and remittance schedules… For almost two decades, the National Association of Insurance Commissioners (NAIC) tried, unsuccessfully, to solve the problem through initiatives to harmonize the inconsistencies. Over time, however, the severity of this problem (has) increased … The genesis of this problem lies in the contradictory and inconsistent state regulatory and tax laws, which make multi-state surplus lines transactions complicated, confusing, and very costly to all parties."[101] The Dodd-Frank Act reforms were designed to streamline and make more uniform the process of surplus lines regulation. However, the Act "is being implemented in many states (even as promoted by the NAIC) in such a way that they'll make things worse – not better – for surplus lines stakeholders."[102]

We cite these examples not to criticize state insurance regulation, but to point out what everyone knows to be true, even if few want to publicly acknowledge it. The state insurance regulatory system is well-suited to be the laboratory of democracy for experimenting with different approaches to state-based problems, but it is not designed to be – and never can be – the instrument of national uniformity for issues of a national or international nature, or for insurers whose business is multi-state, national or international. To the extent that we do not acknowledge this truth, we will continue to see regulatory failure and frustration. And we will continue to see individual state policy frustrating national goals and defeating the benefits of consumer choice.

U.S. COMPETITIVENESS AND THE GROWTH OF PRIVATE MARKETS SHOULD BE AN IMPORTANT REGULATORY GOAL

While a good part of AIA's submission focuses on those aspects of the U.S. regulatory system that are not effective or efficient, it is worth noting that the FIO's approach to this study should also be to view the system in the context of the global regulatory debate. Over the past three years, international financial supervisors have intensified discussions of regulatory standards and principles that may be applied to financial institutions, including property-casualty insurance companies, in the future. The global financial crisis has propelled these discussions, as regulators try to determine whether adjustments to regulation need to be made to prevent or mitigate the next crisis. These discussions, and any regulatory resolution, are complicated by different regulatory standards, philosophies, and cultures inherent in each country, as well as the different business models utilized by each financial industry.

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[101] Written Statement of Letha Heaton, President, the National Association of Professional Surplus Lines Offices at hearing of the House Financial Services Committee's Subcommittee on Insurance, p. 3 (July 28, 2011).

[102] *Id* at 5.

For the property-casualty insurance industry, there are 3 initiatives at the international level that are commanding attention: (1) the International Association of Insurance Supervisors ("IAIS") process for developing criteria to determine whether any insurers are global systemically important financial institutions ("G-SIFIs"); (2) the European Union's Solvency II equivalence process for third countries; and (3) the IAIS Common Framework for the Supervision of Internationally Active Insurance Groups ("ComFrame").

Systemic Risk Determination. The IAIS has engaged in a data collection exercise as it responds to a Financial Stability Board assignment to recommend a methodology for determining whether and which, if any, insurance companies pose a threat to the stability of the global financial system. Companies could be designated G-SIFIs and subjected to heightened prudential regulatory standards. This process is parallel to the process under Section 113 of the Dodd-Frank Act. So far however, unlike the domestic rulemaking process, the IAIS has not yet announced the criteria for G-SIFI designation, the ramifications of being designated a G-SIFI, or the impacts of the G-SIFI process on parallel national processes, such as the SIFI designation process under the Dodd-Frank Act. It is vitally important that all of the designation criteria be as uniform as possible to prevent the waste of public and private resources that would result from multiple designation procedures under differing criteria and that the IAIS criteria reflect the Dodd-Frank Act criteria, including the degree of regulation.

Solvency II Equivalence. Solvency II, the EU's new insurance regulatory system, is due to come into effect on January 1, 2013, with enforcement beginning on January 1, 2014. For companies based outside of the EU to be treated on the same basis with regard to such important matters as capital and corporate structure with European companies in the EU, the regulatory system in place where the company is based must be deemed "equivalent" to Solvency II. The significant amount of trans-Atlantic insurance commerce, the many policyholders that benefit from the coverage that results from it, and the good solvency oversight record of the U.S. insurance regulatory system, strongly support the position that the U.S. regulatory system is, and should be deemed to be, equivalent to Solvency II. In the absence of equivalence, U.S. companies would be disadvantaged and retaliation from the U.S. would not be unexpected.

Despite the obvious benefits on both sides of the Atlantic that would be derived from a U.S. equivalence determination, the standards for this determination, the process and the timing have not yet been finalized. For example, the U.S. is not in the "first wave" for equivalence findings so it could not be deemed equivalent by the start-up date for Solvency II. On the other hand, a transitional equivalence process may apply to the U.S., but the implementing measures for that process have not been finally determined. It is critical, therefore, that the U.S. be deemed equivalent.

Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). This IAIS work was intended to respond to regulatory issues raised by insurance groups doing significant business in more than one country. The ComFrame concept paper, including some specific proposed regulatory mandates and new reporting measures, was issued for consultation this summer and received significant commentary from regulators and insurer representatives, including AIA. Although intended to bring about some efficiencies in regulating internationally active insurance groups, ComFrame is perceived to have created a new layer of prescriptive regulation for the internationally active insurance groups, even as it fails to clearly designate which supervisors are responsible for which parts of it. ComFrame will undergo additional drafting and consultation. It is important that ComFrame not add undue burdens and costs to U.S. companies doing business internationally and that the global regulatory system avoids duplicative and contradictory supervision.

Consistent with our testimony before Congress this past July, we believe it is critical for the FIO to engage on these and other international initiatives to ensure that an authoritative and unified U.S. position is presented. "Congress envisioned this role for the FIO when it authorized the office 'to coordinate Federal efforts and develop Federal policy' on prudential international insurance matters, represent the U.S. before the IAIS, assist the Treasury in negotiating bi-lateral or multi-lateral insurance agreements on prudential issues, and to make recommendations to the FSOC regarding SIFI designations involving insurers."[103]

Where the system works for insurance consumers and the industry, it should be defended. However, where it does not align well with a regulatory emphasis on solvency or the growth of healthy private markets, it should be examined. Given the context and ongoing debate, AIA has prepared the attached principles for outcomes-based regulation, which represent our views on the macro-regulatory considerations under review at the international level. We further believe that the FIO should be fully empowered to engage on these issues and to represent the U.S. internationally to ensure that the U.S. insurance industry remains competitive, and that sound regulatory principles that promote market competition for the benefit of consumers are advanced.

[103] Written Statement of Leigh Ann Pusey, President, AIA, on behalf of AIA & the Financial Services Roundtable at a hearing of the House Financial Services Committee Subcommittee on Insurance, p. 9 (*quoting in part* 31 U.S.C. § 301 note – Federal Insurance Office Act of 2010 [§ 313(c)]) (July 28, 2011).

CONCLUSION

AIA appreciates the opportunity to provide input as the FIO develops its study of the state regulatory system, and we look forward to continuing to be a resource to the Office going forward.

Respectfully submitted,

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