Statement of John L. Van Osdall, CPCU, Chairman, The Council of Insurance Agents + Brokers

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

"Insurance Regulation and Competition for the 21st Century"

June 18, 2002

This statement is submitted on behalf of the members of **The Council of Insurance Agents + Brokers** ("The Council"). The Council is a national trade association founded in 1913 as the National Association of Casualty and Surety Agents. For 89 years, The Council of Insurance Agents + Brokers has provided industry leadership while representing the largest, most productive and most profitable commercial insurance agencies and brokerage firms in the U.S., and around the globe.

The Council's member firms operate in over 3,000 locations and place nearly 80% - well over $100 billion - of the U.S. commercial property/casualty premiums. In addition, The Council's members specialize in a wide range of insurance products and risk management services for business, industry, government and the public. The Council's members operate nationally and internationally and administer billions of dollars in employee benefits.

My name is John Van Osdall, and I am Senior Vice President of USI Insurance Services Corporation. I am serving as The Council's Chairman this year, as well as a member of the Board of Directors. USI Insurance Services Corporation is a growing and diversified insurance and financial services firm focused on providing fully integrated distribution of general and specialty property and casualty insurance and financial services such as employee benefits outsourcing and related consulting. With operations in 20 states, USI Insurance Services is the 6th largest insurance brokerage firm in the United States and one of the top employee benefits brokers in the U.S.

I'd like to thank you, Chairman Baker, for giving me the opportunity to testify before the Subcommittee today. The Council commends you for holding this series of hearings to examine the shortcomings in the state-based insurance regulatory system and to explore the different approaches that have been advanced to modernize that regulatory system. The Council regards itself as a pioneer within our industry on the modernization issue – though reform is a frustratingly long process. We formed our first internal committee to address the problems of interstate insurance producer licensing more than 60 years ago. Our efforts were finally rewarded with the enactment of the NARAB provisions of the Gramm-Leach-Bliley Act a few years ago – a first step on the road to insurance regulatory modernization. We thank you, Mr. Chairman, and the other members of this committee on both sides of the aisle, for your active support of the NARAB provisions during the conference on the Gramm-Leach-Bliley Act.

NARAB was a true provision of modernization in the Gramm-Leach-Bliley Act. Were it not for the tenacious support and initiative from you and Congresswoman Kelly, and the leadership of Chairman Oxley, things assuredly would not be changing for the better - particularly at their current pace. This initiative was bipartisan, and provides a very good model for a carrot-and-stick, goals-and-timetables approach that can effectively move insurance regulation forward toward goals of efficiency.

The NARAB approach to regulatory modernization is but one of the approaches that your Subcommittee has been examining in these hearings. The Council has also been studying the different routes for achieving modernization in the insurance regulatory process. To that end, The Council's Foundation for Agency Management Excellence (FAME) last year commissioned an independent study of the economic costs and benefits of these various proposals (the "FAME Study").

While it is abundantly clear to Council members that the current system of state-by-state regulation is not working, we wanted to see a full, economic analysis of the alternatives for reform. Our study, entitled "Costs & Benefits of Future Regulatory Options for the U.S. Insurance Industry," provides an in-depth examination of the pros and cons of the regulatory options available for oversight of the business of insurance. We are pleased to release this study today as a part of this hearing, and hope that it will be a useful tool as the Subcommittee continues its examination of various regulatory alternatives. A copy of this study is attached for the record, and we will refer to the study's findings as we discuss the various proposals for regulatory reform.

Even though the states have made some strides in recent years in simplification and streamlining – thanks to the enactment of the NARAB provisions of Gramm-Leach-Bliley – there are still several problem areas in the interstate licensing process that cost our members time and money unnecessarily. Insurance companies also face problems in doing business on a multi-state basis, and recent efforts by the states to streamline rate and policy form approval processes have not proven to be very successful. These continuing issues with the state-by-state regulatory process lead us to the following conclusion: relief is needed, and it is needed now. We urge the Committee to enact relief, and to do it soon.

The Council believes that it is critical to the long-term viability of the U.S. insurance industry that Congress pass legislation creating an optional federal charter for insurers. Council members know that broader reforms to the insurance regulatory system are necessary to permit the industry to operate on a more efficient basis. Such broader reforms, like an optional federal charter, are also necessary to enable the insurance industry to compete in the larger financial services industry and to be able to compete internationally. However, The Council realizes that there is a need for more immediate reforms that cannot wait for the resolution of the federal charter debate. We've taken a look at all of the proposals for regulatory reform that have been advanced in recent months, and we support them all. The Council does not believe that any of the reform proposals that have been introduced are mutually exclusive – there are opportunities for both short-term and long-term reforms that will not negate the future need for either set of reforms.

The Council has been asked to discuss the securities regulation model and its applicability to the reform of insurance regulation. We will restrict our remarks to the regulation of registered securities representatives.

A large portion of the regulation of registered securities representatives is done through the National Association of Securities Dealers (NASD), which is a self-regulatory organization established by Congress and overseen by the Securities and Exchange Commission. Registered securities representatives must still procure licenses in all states in which they wish to sell securities, but they can procure those licenses by going through one central location – the NASD's Central Registration Depository (CRD). The CRD processes registrations for the NASD and for six other securities exchanges. An individual seeking licensure with multiple organizations and/or states need only submit a uniform registration form and payment of the requisite fees. The NASD also provides a centralized authority for the enforcement of securities laws and the development of national enforcement policies. The NASD's Enforcement Division prosecutes securities violations discovered by the NASD and also receives enforcement referrals from the SEC and the various state securities regulators.

The Council believes that self-regulatory organizations (SROs) like the NASD provide a good model that could easily be modified to address the regulation of insurance producers. We would like to note at the outset that SROs are used quite commonly to regulate professional activities. For example, state bar associations are SROs that provide oversight of the legal profession. The Council's concerns with state-by-state licensing for insurance producers has never had anything to do with state regulation of insurance producers. Rather, our concerns have arisen from the myriad of idiosyncratic requirements that often have little or nothing to do with the professionalism of our members. The Council would prefer to see a single set of licensing requirements and rules of conduct that are meaningful in terms of expertise and proficiency, even if that means meeting the highest of standards that currently exist.

The Council would also like to mention that the provisions of Gramm-Leach-Bliley that provide for the formation and organization of the National Association of Registered Agents and Brokers are modeled after the NASD. It appears as though the requisite 29-state threshold has been met (under the conditions of the Gramm-Leach-Bliley Act) to avert the creation of NARAB, though at this time such a certification has not been made. However, assuming it were ever to come into being, the National Association of Registered Agents and Brokers would function in a manner similar to the NASD. It would create a national licensing clearinghouse where multistate insurance producers could obtain multiple licenses through a single point of filing. It would likely set a higher standard for licensure than currently exists in any one state, but one that is based on the professional qualifications of the individual. The National Association of Registered Agents and Brokers would also provide a centralized enforcement mechanism that would enable regulators to get bad actors out of the system sooner rather than later.

The Subcommittee should strongly consider the use of an SRO to address the continuing problems in interstate producer licensing, whether as part of an optional federal charter bill or as part of any other interim reforms that the Subcommittee would consider. The Council believes that using a supervised SRO to regulate industry activities might result in significant efficiencies and savings for consumers without diminishing the consumer protections in place today.

The Council would like to note that nothing in the federal securities laws authorizes any specific entity to act as the SRO for securities brokers; rather it provides for the creation of SROs to regulate securities broker/dealers subject to SEC oversight. The Council believes that this same approach would work well in the insurance industry, as it would permit each segment of the producer marketplace (life, health, and property/casualty) to address its own unique issues. The supervising regulator could be housed in either an independent commission or as a part of an existing agency. Council members do not feel strongly about either approach, and would likely support either one.

The Council believes that the SRO concept fits well with the optional federal charter proposals advanced by several of the groups who have already testified before this Subcommittee. We hope that you would consider adding it to any optional federal chartering legislation drafted by the Subcommittee. However, The Council also believes that the SRO concept is a good example of a goal that could be achieved as an interim step towards optional federal charter legislation. There are some other problems with the state-by-state system of insurance regulation that deserve immediate attention and that could also be stepping stones in the path towards the optional federal charter. While these problems appear to affect insurance companies more than insurance agents and brokers, we would argue that the restraints imposed by the state-by-state regulatory system on these areas affect our members just as much as the companies.

The Council's members sell and service primarily commercial property/casualty insurance. This part of the insurance industry is facing some severe challenges today due to a number of factors, including the losses incurred as a result of the terrorist attacks on September 11, 2001; increased liabilities for asbestos, toxic mold, D&O liability and medical malpractice; and years of declining investment returns and consistent negative underwriting results. Some companies have begun to exit different insurance markets as they realize that they can no longer write these coverages on a break-even basis, let alone at a profit. The end result is increased prices and declining product availability to consumers. This situation is only being exacerbated by the current state-by-state system of insurance regulation.

The FAME study mentioned earlier in our testimony notes that the current U.S. system of regulation can be characterized as a prescriptive system that generally imposes a comprehensive set of *ex ante* constraints and conditions on all aspects of regulated entities' business operations. Examples of *ex ante* requirements include things like prior approval or filing of rates and policy forms. The prescriptive approach is designed to anticipate problems and prevent the before they happen. However, this approach to regulation hinders the ability of the insurance industry to deal with changing marketplace needs and conditions in a flexible and timely manner. Consequently, it also hinders the ability of regulators to quickly address emerging problems. The Council would also argue that the prescriptive approach to regulation encourages more regulation than may be necessary in some areas, while directing precious resources from other areas that may need more regulatory attention.

It is also important to note that states wishing to do business on a national basis must deal with 51 sets of *ex ante* requirements. This tends to lead to duplicative requirements among the jurisdictions, and excessive and inefficient regulation in these areas. As the FAME study points out, the insurance industry is very concerned with the efficiency of regulation, since inefficient regulation directly affects the industry's compliance costs. However, the study also notes that while efforts aimed at improving inefficient or unneeded regulation may be easier to achieve than the total elimination of such regulation, they have the unintended result of confirming the need of the regulation in the first place.

We are then faced with this question: what should the true focus of regulation be? Are we more concerned with focusing on achieving more efficient but possibly unnecessary regulation, or should we be more focused on achieving more effective regulation that focuses on the goals of regulation – industry solvency and consumer protection?

The Council strongly believes that the primary focus of regulation should be insurance company solvency. This is, after all, the ultimate consumer protection – ensuring that companies will be around to pay claims. The Council believes that focusing on increasing the efficiency of *ex ante* requirements, like rate and policy form approval, instead of focusing on the effectiveness of industry regulation, like financial safeguards that ensure insurer solvency, is anathema to the primary objective of the insurance regulatory system.

State reform efforts in recent years have been focused on improving the efficiency of regulation to the exclusion of improving the effectiveness of regulation. Regulators are heading in the wrong direction, and The Council is concerned that dire consequences could result if regulators do not change their course. Last year, Reliance was placed into receivership and then shortly thereafter placed into liquidation. The total hit to the state guaranty funds from this insolvency has already reached $1 billion, and it's possible that number will increase due to unknown long-tail liabilities.

This is one of the largest insolvencies ever in the insurance industry, yet there has been very little discussion either in the media or among the regulatory community about Reliance's downfall. However, we have seen efforts from the states over the past two years to improve the efficiency of state-based rate and policy form filings. The Council believes that regulatory resources would be better spent in areas that improve the effectiveness of industry regulation, e.g., solvency regulation, than in areas that merely improve the efficiency of regulation that may not be necessary at all, e.g., eliminating state-based rate and policy form filings.

There is also a tension among the state insurance regulators themselves that serves as a barrier to more effective regulation. There has been a push among the states over the past several years to develop more uniform or reciprocal laws and regulations. Much of this has come in response to the enactment of the NARAB provisions of the Gramm-Leach-Bliley Act, but the states' efforts have included areas other than insurance producer licensing. Essentially, the NARAB provisions of Gramm-Leach-Bliley gave the states three years to develop a uniform or reciprocal system of nonresident insurance producer licensing. If a majority of states did not reach either uniformity or reciprocity within that time frame, then the National Association of Registered Agents and Brokers, a centralized clearinghouse for nonresident insurance producer licensing, would be formed at the federal level.

The National Association of Insurance Commissioners (NAIC) pledged not only to reach reciprocity in producer licensing, but also to reach uniformity in producer licensing as their ultimate goal. The NAIC amended its Producer Licensing Model Act (PLMA) to meet the NARAB reciprocity provisions, and worked to get the PLMA enacted in all licensing jurisdictions. As of today, forty-six states have enacted some sort of licensing reform. Most of those states have enacted the PLMA, but four states have enacted only the reciprocity portions of that Model Act. Of the states that have enacted the PLMA, there are several states that have deviated significantly from the original language of the Model Act. One state has enacted licensing reform that in no way resembles the PLMA. And the two largest states in terms of insurance premiums written, New York and California, have not enacted legislation designed to meet the NARAB reciprocity threshold at all.

The NAIC has said that it will certify by the end of June that a majority of states have met the NARAB reciprocity provisions, thereby averting the creation of NARAB. This is a commendable accomplishment, but The Council believes there is still much work to be done to reach true reciprocity and uniformity in all licensing jurisdictions, and we're not sure that the NAIC will be able to meet that goal. We finds this to be troubling, given the threat of federal intervention that was implicit in the NARAB provisions of Gramm-Leach-Bliley.

The FAME study notes that all of the regulatory modernization efforts put forward by the NAIC in the past several years have been the direct result of major external threats – either the threat of federal intervention, or the wholesale dislocation of regulated markets. It concludes that there is no guarantee that the state-based system will adopt further meaningful reforms without continued external threats to its jurisdiction, and offers the states' progress on producer licensing reform as a prime example. The Council wholeheartedly agrees with this conclusion, and urges this Subcommittee to continue to press the states to enact meaningful reforms to the insurance regulatory system.

Chairman Baker, The Council believes that you and others on your Subcommittee were absolutely on target when you talked about the need for immediate Congressional action to address the continuing problems in the state-based regulatory system. While The Council ultimately supports the enactment of an optional federal charter, we know that we can't wait for that debate to play out before getting some relief from duplicative and inefficient regulation that has little impact on the effectiveness of the insurance regulatory system. There are several targeted reforms that the Congress could address now that will benefit not only the insurance industry but also the consumers we serve. The Council believes that the areas deserving immediate attention include further reforms to the producer licensing system and speed-to-market issues that eliminate prior approval of rates and policy forms, similar to the successful model used in Illinois. The Council believes these reforms will be the easiest to achieve in the short-term.

Mr. Chairman, you have asked witnesses at the past two hearings to give you a timeline for achieving additional reforms in the insurance regulatory system, but you were not able to get a direct answer. We'd like to give you our suggestions for how to proceed with future reforms.

The Council believes that the reforms to the producer licensing system and speed-to-market reforms mentioned above need to occur as soon as possible – preferably, within the next year. These reforms will provide the most immediate relief from inefficient and duplicative regulation for the industry.

The NAIC is working on further reforms that are currently in their fledgling stages, like an interstate compact to facilitate a single point of filing and approval for life insurance products. Additionally, the NAIC is in the process of developing standards for coordination of market conduct examination. While we support the efforts of the NAIC in these areas, our experience with NARAB cautions us to be wary of their success. We would suggest that the Subcommittee continue to monitor the progress on these initiatives over the next 18 months and to be ready to act if to implement reforms in these areas if the states' efforts should fail to take hold.

The Council urges the Subcommittee, however, to continue with its work on the optional federal charter even as it develops interim reforms. The Council supports the enactment of an optional federal charter, and believes it is essential to the U.S. insurance industry's long-term survival. While there are more immediate reforms that can be made to the insurance regulatory system, those reforms in no way preclude the ultimate need for an optional federal charter. Our FAME study mentioned above has come to the same conclusion:

> Regardless of whether the states undertake significant further reforms, the inexorable trend seems to lead away from continued state regulation. If states fail to undertake significant reforms, the state system will become increasingly unsuitable to the current environment and generate tremendous pressure for wholesale change. If, on the other hand, the states undertake significant reforms and achieve a greater degree of uniformity, reciprocity and comity, those reforms will help set the stage for a further move toward federal regulation.

There is one other consideration that the Subcommittee should keep in mind as it begins its work on reforming the insurance regulatory system. The Council believes that it is critical for the Subcommittee to continue to monitor the progress made by the states in all areas of regulatory modernization. As noted above, improvements in the state insurance regulatory system have come about largely because of the leadership of this Committee, and through your continued oversight of the reform process. The Council thanks you for your attention to this critical issue, and also thanks Chairman Oxley and Rep. Kanjorski for their leadership in this area. The Council hopes that you will continue these efforts, as they benefit not only the insurance industry, but also the consumers that we serve.

In sum, Chairman Baker, The Council strongly agrees with your early statements that Congress needs to consider short-term and long-term solutions. We need state-based reforms, we need continued federal oversight and pressure to reach uniformity in state laws, and we need you to continue laying the foundation for an optional federal charter. The Council urges this Subcommittee to begin work now on those reforms that are easily obtainable in the short-term – such as further producer licensing reforms and speed-to-market – as well as the long-term reforms, like an optional federal charter, that may require further examination and debate before enactment. The Council thanks you, Mr. Chairman, for the opportunity to testify on this important issue, and stands ready to assist you in meeting these important goals.

FAME

FOUNDATION FOR AGENCY MANAGEMENT EXCELLENCE

COSTS & BENEFITS OF FUTURE REGULATORY OPTIONS FOR THE U.S. INSURANCE INDUSTRY

An Analytical Framework

Prepared for the Foundation for Agency Management Excellence by

Georgetown Economic Services, LLC and Adam K. Lee (Independent Consultant)

EXECUTIVE SUMMARY

The Council of Insurance Agents + Brokers is pleased to release **Costs & Benefits of Future Regulatory Options for the U.S. Insurance Industry — An Analytic Framework.**[1] The study, a project of the Foundation for Agency Management Excellence ("FAME"), was prepared to educate Council members about the economic impact of regulatory options for oversight of the business of insurance.

FAME retained Georgetown Economics Services, an independent economics consultant, to provide the analysis. Its publication is timely, as federal and state policymakers are initiating their investigations into these important questions.

That the current state-based system of insurance regulation needs repair is beyond question. Duplicative and sometimes conflicting regulatory requirements from state to state often-times make compliance by both insurers and agents and brokers difficult if not impossible, and can lead to confusion and frustration among consumers. Indeed, state regulators themselves have long recognized the need for modernization.

> "The Commissioners [of Insurance] are now fully prepared to go before their various legislative committees with recommendations for a system of insurance law which shall be the same in all States — not reciprocal, but identical; not retaliatory, but uniform."

This statement was made by George W. Miller, the New York Insurance Commissioner, in **1871** at the close of the inaugural meeting of the National Association of Insurance Commissioners which he chaired. Unfortunately, as we sit here today — over 130 years later — the full promise of that good intent still has not been realized.

The questions we now face both as an industry and as a country are how best to resolve these problems and how to regulate the business of insurance as we enter the 21st century. This project was not designed to answer that question directly but to develop an objective framework in order to evaluate and compare the various regulatory structure options that are available to ensure a quality regulatory environment going forward. The next step in the process is to analyze the regulatory options available through this framework and apply the lessons learned during the initial phase of the study. We believe, however, that the framework itself and the findings and conclusions on which it is based help to shed light both on the extent of the regulatory problems that currently exist and on the costs and benefits of the potential structural reforms that have been identified to date.

1 The publication, **Costs & Benefits of Future Regulatory Options for the U.S. Insurance Industry — An Analytic Framework**, is available from The Council of Insurance Agents + Brokers at CIAB@CIAB.com or 202-783-4400.

OVERVIEW

The purpose of this study is to develop an objective framework in order to evaluate and compare the costs and benefits of various regulatory structure options available to the industry. The differentiation between the scope of regulation (what is regulated) and the structure of regulation (how/by whom it is regulated) is crucial to this framework.

In the context of this study, the interaction between scope and structure is a critical dynamic and might be seen as a strong rationale for structural change as an impetus toward achieving improvements in the scope of regulation. The existing structure's inherent tendency toward non-uniformity, redundancy and distortions (via externalities) often produces inefficient regulations, whether with respect to developments in emerging areas or reforms in existing areas of oversight.[2] Once implemented, non-uniform regulations tend to perpetuate the scheme that created them — i.e., once state-by-state requirements are adopted, state-by-state monitoring and enforcement usually follows. Consequently, structure becomes a critical influence on those regulations under conditions of change and reform.

The structure of the state regulatory system in an increasingly interstate or even international market makes it prone toward generating externalities.[3] While state-by-state variations in regulatory requirements (i.e., *scope*) are a product of the system's structural weaknesses, they also exacerbate the state system's inherent tendency toward non-uniformity, redundancy, and generating unintended consequences. The generation of negative externalities — when other states accrue a cost without a corresponding benefit as a result of the regulatory actions of another state — is key in this context. While variations in the scope and conduct of regulation often appear to be the root cause of many externalities, in most cases, they are facilitated by the structural limitations of the regulatory scheme.

Certainly, there are compelling and legitimate reasons for maintaining functional and/or geographical elements in the structure of regulation. For example, historical expertise and the endorsement by GLBA are prime reasons for maintaining functional boundaries, while local market familiarity, legal standards, and sunk "investment" costs are prime reasons for maintaining state oversight. Nevertheless, as the insurance industry becomes less functionally distinct and more international in breadth, interim and incremental improvements along traditional functional and geographic lines may prove to be only a temporary panacea.

The perspective from which regulators approach their oversight responsibilities can have an important bearing on the relative efficiency and effectiveness of any given combination of alternatives and options. The two basic variations in regulatory perspective are ***prescriptive approaches*** and ***prudential approaches***. The prescriptive approach characterizes the current U.S. system of regulation and utilizes a detailed set of generally *ex-ante* restrictions or requirements on regulated entities with regard to each aspect of their operations. The prudential approach, more evident in European regulation, provides greater overall flexibility and fewer specific restrictions, but relies on greater *ex-post* emphasis in oversight, such as more intensive regulatory monitoring and greater discretion for intervention by regulatory authorities.

2 At the same time, these characteristics of the state-based structure provide certain advantages. Non-uniformity is not a fault by itself if it is founded on legitimate economic or other (localized) considerations. Moreover, while redundancy rarely constitutes the most *efficient* approach, it can lead to more *effective* regulation since the collective activities of multiple regulators have the potential to produce broader and better-rounded solutions. The key point is whether these advantages represent a reasonable and necessary trade-off for the cost of the inefficiencies and distortions that tend to be characteristic of this structure.

3 Externalities are costs or benefits that arise from an economic transaction which are borne by parties not involved in the transaction and results from the failure of the transaction price to account for the externality. Externalities involve the unfair or inadvertent shifting of costs and benefits such that a single event gives rise to both positive externalities (to the recipient of the benefit) and negative externalities (to the bearer of the cost). The immediate discussion is focused on negative externalities and omits consideration of the corresponding positive externalities that also are generated.

GENERAL CONSIDERATIONS

- One of the primary contributors to the inefficiency of regulation, whether in terms of its excessive costs or capacity to introduce distortions into the market, is its tendency to be oriented toward outcomes in the short-run, rather than processes in the long-run. This is understandable since outcomes are more tangible and obvious than processes, and ultimately, regulators are more directly responsible for the outcomes, rather than the method or efficiency with which those outcomes are achieved.

- Indirect and unintended effects of regulation often are adverse and undermine the benefits accruing from the achievement of the regulatory goals. By extension, efforts to reform and modernize regulation will likely alter the incidence (impact) of those costs and benefits, as well as generate their own indirect and unintended effects.

- Regulations that interfere with incentives for loss control or with the relationship between expected loss costs and premium levels go far beyond the basic rationale for regulation — to correct or minimize market failures. In fact, such regulations tend to exacerbate, if not promote, market failures, and increase the overall cost of risk to the overall economy.

- The optimal regulatory structure must meaningfully address the costs and distortions to the market directly related to regulation.

- At the very minimum, alternative regulatory structures must demonstrate adequate performance on the core regulatory objectives of solvency and consumer protection. However, most of the potential efficiency gains will come from improved performance in the secondary or peripheral areas of regulation (e.g., licensing and rate and form approval) ideally by reducing the scope of regulation (deregulation) rather than by reengineering existing processes.

- While agents and brokers may be affected uniquely or discretely by regulation vis-à-vis other segments of the industry, the regulatory structure that best serves the industry as a whole likely will prove optimal for agents and brokers as well. While agents and brokers play a key role in the market by helping to mediate and minimize conflicts between insurers and consumers, as well as reduce information constraints on both sides of insurance transactions, they are neither designed nor equipped to undertake direct regulatory responsibilities for either insurers or consumers. Transferring such responsibilities to agents and brokers will decrease the effectiveness and the efficiency of regulation.

- The market has the inherent capabilities of performing its functions much more efficiently and competently if permitted, while still remaining within the bounds of effective regulation.

- Deregulation often is preferable to lesser reforms, even though the later may constitute a necessary interim step

POLICY CONSIDERATIONS

- Both regulators and politicians have demonstrated increased awareness that unnecessary regulatory distortions, frictions and costs have become less tolerable to the industry given the competitive and fast-changing market conditions in which it is operating. These factors have been transformed from costs and inconveniences to potential competitive disadvantages that threaten the long-term health and performance of the industry.

- An increasing proportion of insurance transactions is migrating beyond the reach and direct control of state regulators to alternative markets and other non-traditional risk-financing mechanisms, with little evidence of adverse ramifications. This shift has important implications regarding the cost/benefit profile of regulation, whether information constraints still constitute a legitimate market failure, whether such constraints can be overcome by the industry and consumers, and whether the overall system faces greater or lesser risk as a result of this migration.

- The business environment is being transformed by financial services convergence and modernization, e-commerce and globalization, all of which have accelerated and sharpened competitive forces. Under these conditions, the costs of regulation are magnified, particularly given their potential to produce significant disadvantages vis-à-vis new domestic and foreign competitors (or products) that are not subject to the same regulatory constraints. While this applies to the costs of even minimally necessary regulation, it is most relevant when regulatory constraints begin to impose significant burdens and inefficiencies without attendant benefits or even suitable underlying rationales.

- The tendency of insurance regulations to produce distortions and other unintended effects, regardless of the structure in which they are administered, can generally be attributed to two fundamental causes — the undermining of competitive market forces that generate incentives for loss control and the interference with the normal relationship between premium levels and expected loss costs.

- Efficiency concerns are critically important to the industry, since they affect its direct compliance costs. Under such circumstances, the efficient conduct of unnecessary or excessive regulation becomes the next best alternative to more effective regulation generally, in order to minimize both its direct and indirect costs. The critical point is that the focus on achieving the next best alternative — making unnecessary regulation less costly and more efficient — may come at the expense of the best alternative — eliminating such regulation altogether. To a certain extent, efforts focused on improving the conduct of, or otherwise curbing, ineffective and unnecessary regulation, while perhaps more achievable than seeking its complete elimination, inadvertently tend to validate the necessity of such regulation in the first place. Nevertheless, this focus is understandable given how firmly entrenched and resistant to change many of these regulatory processes have become.

STRUCTURAL CONSIDERATIONS

- The limitations of traditional regulatory structures under current competitive conditions have tended to increase jurisdictional and functional disputes among the regulating agencies and other authorities as they compete to either protect their turf or try to reestablish clear dividing lines among their responsibilities. In addition, however, regulating agencies and authorities are recognizing the need for a more flexible and holistic approach to regulating financial services that relies more on cooperation, information exchange and shared responsibility. Regardless, the continuing trend toward convergence in financial services has shifted the burden of adjustment to the regulators.

- As the insurance industry becomes less functionally distinct and more national and international in breadth, interim and incremental improvements in regulation along traditional functional and geographic lines may prove to be only temporarily palliative. Even worse, limited reforms may tend to further entrench structures and practices that may not be suitable or optimal for the industry in its new competitive environment.

- Two of the primary rationales for maintaining the state regulatory structure of insurance are its abilities to tailor products and services to unique state market conditions and requirements, and to offset consumer information problems and deficiencies. These advantages are offset by inefficiencies related to redundancies and diseconomies of scale that are characteristic of decentralized authority.

- The state-based structure's primary weakness may be its susceptibility toward generating negative externalities. Consequently, assessments of alternative structures must address this issue and the extent to which this particular susceptibility can be reduced or minimized. A related problem concerns geographical limitations within the state structure, which often require that regulatory determinations be made on a state-by-state basis. The fundamental question is whether such state-specific analyses are meaningful in an increasingly national and international market.

- Congress has focused repeatedly on the industry's solvency problems, citing numerous and persistent examples of ineffective solvency oversight by state regulators as prime factors. State regulators have been quick to respond by undertaking reforms and other actions to avert direct federal involvement. Nevertheless, past insolvencies have raised the question of whether regulators can identify company-specific problems, such as aggressive pricing and the understatement of reserves, on a reliable and sufficiently early basis. Corollary issues include concerns regarding the regulatory reach and expertise of regulators with respect to foreign markets and insurers, nontraditional markets and products and reinsurers (who play a relatively low profile but key role in market functioning).

- All of the major reforms accomplished under the existing state structure have occurred only in response to major external threats of federal intervention or wholesale dislocations in the regulated markets. Based on these precedents, there is no assurance that the state-based system will enact meaningful further reforms absent a significant level of continuing threat and pressure. The experience with NARAB and producer licensing to date supports this conclusion.

- The imposition of minimum standards within the existing state system could potentially improve uniformity. There is considerable evidence, however, that when these standards are set relatively low or when they continue to permit significant state discretion and variation, much of the potential benefits are undermined. There also is increasing evidence that the lack of uniformity among the states acts as a shaky foundation for improvements in reciprocity.

- Regardless of whether the states undertake significant further reforms, the inexorable trend seems to lead away from continued state regulation. If states fail to undertake significant reforms, the state system will become increasingly unsuitable to the current environment and generate tremendous pressure for wholesale change. If, on the other hand, the states undertake significant reforms and achieve a greater degree of uniformity, reciprocity and comity, those reforms will help set the stage for a further move toward federal regulation. Nonetheless, the state structure will remain under pressure whether the states move ahead or obfuscate.

ALTERNATIVE/FUTURE STRUCTURAL CONSIDERATIONS

- The optimal regulatory structure must meaningfully address the most problematic regulatory areas identified — primarily company and producer licensing as well as rate, risk classification and form regulation — even though these are less critical areas than solvency and consumer protection. Regulatory conduct in these areas is generally excessive, inefficient and often ineffective, if not harmful, to market functioning. In this context, deregulation likely is preferable to lesser reforms, even though the latter may constitute a necessary interim step.

- Convincing support for one structural alternative or another must be characterized by an improvement in regulatory effectiveness as a threshold matter, particularly given the growing indications that the current structure may lack the capacity to manage its functions adequately, particularly under adverse business conditions.

- In evaluating alternative regulatory structures, the industry is advised to give greater weight to alternatives that facilitate deregulation rather than those that facilitate specific changes in existing regulations. While the state structure has shown it can achieve deregulation, it tends to occur on a non-uniform and piecemeal basis. Moreover, such efforts have been most successful under the threat of federal intervention.

- Universal options and regulatory perspectives — the net benefits of each of the regulatory alternatives (including maintaining the existing system) would tend to be maximized if the alternative incorporated certain universal options or approaches that are not specific to each structure. These include broader versus narrower application of changes and participation by regulating entities, the degree of self-certification or self-regulation allowed, the reorganization of regulation along distinct product or consumer segments and the adoption of a prescriptive versus prudential approaches to regulation more generally.

- Any alternative that reduces the number of potential jurisdictions (e.g., interstate compact, mandatory or optional federal regulation in any form, or financial services super-regulator) has the potential to achieve rapid or wholesale deregulation, as well as improvements in uniformity (or even make uniformity cease to be an issue).

- The Gramm-Leach-Bliley Act, while offering significant near-term regulatory improvements, also has set the industry upon a potentially conflicting course in the longer-term. While the Act simply synthesizes and embodies a number of forces already at work, it likely will trigger further changes in the financial services industry as a whole that will continue to strain the regulatory structure. The Act encourages less functional differentiation within the industry while maintaining functionally distinct oversight. Without further changes, maintaining functional regulation as the industry continues to converge, integrate and globalize will produce many of the same problems as maintaining state regulation in an increasingly interstate and even international market.

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