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PERSPECTIVES ON MODERNIZING INSURANCE REGULATION

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE STATE OF THE INSURANCE INDUSTRY, REVIEWING HOW INSURANCE IS REGULATED AND WORKING TO MODERNIZE THE REGULATORY STRUCTURE

MARCH 17, 2009

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PERSPECTIVES ON MODERNIZING INSURANCE REGULATION

TUESDAY, MARCH 17, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:40 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. Let me welcome our witnesses and colleagues who are here this morning. I thank them for coming out. The audience has gathered here this morning to hear our hearing on the perspectives on modernizing insurance regulation. I will share some opening comments, and then I will turn to Senator Shelby. And given the fact we have got just a few members here, I will ask them if they have any opening comments they would like to make as well before we get to our witnesses.

I want to thank our witnesses. We have got an extra long table here for you this morning to accommodate all of you, and I appreciate immensely your willingness to participate in this discussion this morning. It is a critically important one as we go forward.

As I mentioned, this morning the Committee will continue the series of hearings that we have been conducting this month on modernizing the regulation of our financial system. Today's focus will be on the vital component of our economy: the insurance industry.

Before we do that, I want to say a few words about the furor surrounding AIG and the hundreds of millions of dollars, taxpayer dollars, being paid out in retention bonuses. The American people, as we all understand, are outraged, and they should be. All of us are. The Chairman of the Federal Reserve has said that the Government's efforts to prevent AIG from failing outright are akin to a neighbor smoking in bed and setting the house on fire. With these bonuses, what we are seeing is the folks responsible for picking the pockets of the firefighters and stealing the hubcaps off the fire truck. It is outrageous.

This Committee wants to hear what steps the Fed is taking to address this situation. We want and expect an immediate and full briefing from the Federal Reserve and the Treasury, and we also want answers regarding where the Fed has been on conditions for

these types of bonuses since this rescue effort began back in September.

Second, it was in this Committee room 2 weeks ago that we insisted on knowing who the counterparties were that so much of the $170 billion in taxpayer funds were going to. Who, we asked, are we rescuing, exactly? Since that time, we have learned who they are, and here, again, I am hopeful that we will have a full and complete accounting of this situation.

The administration wants to explore every legal means to recoup this funding, and I pledge today that if they need the help of this Committee to do so, they will get that assistance. At a time when we are both trying to put out the fire so that we can begin the process of rebuilding public confidence, public dollars must be used for one purpose and one purpose alone, and that is the public good. What happened at AIG should not, in my opinion, be confused with the industry with which it is most closely associated—that is, the insurance industry itself. But, nonetheless, that is what is in the public mind today, and they expect answers, and this Committee intends to be a part of finding those answers.

More than 6 decades ago, the Supreme Court said, and I quote:

> Perhaps no modern commercial enterprise directly affects so many persons in all walks of life as does the insurance business. Insurance touches the home, the family, and the occupation or the business of almost every person in the United States.

The Supreme Court said it exactly right in so many ways. Insurance is a critical underpinning of our economy, something that every person and every business depends upon literally every day to provide the certainty we need to live and work in an uncertain world. Insurance protects families and properties from harm and provides stability to every sector of our economy.

Coming from Connecticut, a State with a long and proud history of providing insurance for families and businesses throughout the Nation, I am well aware that a strong and vibrant insurance marketplace is essential to the well-being of our Nation, the financial security of American families, and, of course, the growth of our economy.

That is why we are very proud that we have been able to bring two insurance experts from my State today, Mr. Houldin and Mr. Berkley, to share their knowledge and experience with the Committee to help chart a course forward for the insurance industry, our economy, and the Nation.

It is almost impossible to imagine a single transaction taking place in our economy today that does not involve insurance in some way, shape, or form. When a consumer buys a car or a family purchases a home, they need insurance. When a small business owner opens a store or a company builds a factory, they need insurance. And when parents seek to protect against unforeseen tragedies and provide their children with financial security, they need insurance, too.

As I said in the Committee's hearing on AIG 2 weeks ago, if credit is the lifeblood of our economy and a healthy banking system is the heart that pumps the blood through that economy, then our insurance companies are the lungs that provide the oxygen we need to make sure that credit flows. For businesses to function, to create

jobs, they need access to insurance to protect their investments. And during a financial crisis in which credit is frozen, the critical role of insurance cannot be overstated.

As this Committee has established over many hearings in this Congress and the last, our Nation's regulatory structures are outdated and in need of significant overhaul. If we are going to build an economy to compete in the 21st century, then we are going to need a modernized regulatory structure that is rooted in core principles, such as consumer protection and sound underwriting. And while the current financial crisis did not have its origins in the insurance sector, its adverse effects have been felt keenly by participants in the insurance marketplace.

Our goal must be to maintain a healthy, viable insurance industry that can and will play a critical role in bringing us out of the recession that is hurting families throughout our country, hurting them certainly in each of our respective States. Going forward, we must review how we regulate insurance in this country and carefully work to modernize the regulatory structure as appropriate.

Unlike other sectors in the financial system, such as banking and securities, insurance is primarily regulated at the State level. The State-based system has been in place, as most in this room know today, since the 19th century and has been a source of innovation and consumer protection alike.

However, in recent decades, the insurance industry has become increasingly national—in fact, international, and some insurance companies have engaged in very complex and sophisticated transactions made possible by modern advance in financial engineering. In response, many have observed that the regulation of insurance needs to be modernized accordingly. Various approaches have been proposed, and I would hope this hearing this morning will provide an opportunity to better understand and evaluate those approaches and produce a record upon which to determine future Committee action as we move forward in the modernization of financial regulations.

Given the importance of insurance to our financial system and our economy, this Committee has held hearings in the last Congress to examine the state of the insurance industry and the regulatory framework in which it operates. Insurance regulation has also been the subject of hearings of this Committee in previous Congresses, and I commend Senator Shelby for his attention to this important issue in the past as Committee Chairman.

I also want to take this opportunity to acknowledge the hard work of Senator Tim Johnson, who sits in this chair next to me, who has been a leader in efforts to modernize the regulation of insurance, and we appreciate his efforts.

And, finally, I want to thank the witnesses who are here this morning. I look forward to hearing from you. I thank them for their time, their interest in the subject matter, and their suggestions on how we ought to proceed as we evaluate these very difficult set of questions that must be a part of our efforts to modernize the financial regulatory system.

With that, let me turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Chairman Dodd.

Today, the Committee will once again consider insurance regulatory reform. The structure of our insurance regulatory system, as Senator Dodd has reminded us, dates back to the 19th century, a time when few insurance companies operated in one State, let alone globally.

Even before the start of the present financial crisis, there were legitimate questions about whether our insurance regulatory system was adequate for the 21st century. Recent events—most prominently, the stunning collapse of insurance giant AIG—have only further demonstrated the pressing need for a review of our insurance regulatory structure.

Two weeks ago, this Committee held a hearing on AIG which revealed the problems with the company's State-regulated insurance entities and the role they played in the company's collapse. AIG's insurance subsidiaries suffered more than $20 billion in losses from their securities lending operations and had to be recapitalized with a loan from the Federal Reserve. In addition, this past weekend, AIG disclosed that more than $40 billion of the $170 billion in Federal aid was used to pay off counterparties to its securities lending operation.

The circumstances that permitted AIG's securities lending operation to potentially threaten the solvency of several of its insurance companies and their counterparties suggests that our regulatory system has not been keeping up with developments in the market. For example, it appears that AIG sought to conduct its securities lending operations on a nationwide basis by pooling the resources of approximately a dozen separate insurance companies regulated by five different States. Because insurance is still regulated at the State level, it is unclear whether any single State insurance regulator was responsible for overseeing AIG's entire securities lending operation. This, of course, raises some serious questions about the adequacy of State supervision.

Given the importance of insurers in our markets and overall economy, I believe we should at least consider whether additional Federal oversight is needed. If insurers are managing risk on a national basis, it may make sense to consider regulating them on a national basis as well.

We also need to examine whether the existing insolvency regime can handle the failure of a large insurer. If insolvency needs to be managed at the national level, then once again a Federal insurance regulator may be our only option.

Finally, the collapse of AIG has also raised the question of whether the U.S. needs a Federal systemic risk regulator. Attempting to regulate insurers for systemic risk, however, presents now many difficult challenges. For example, it would likely involve the complex task of ascertaining if and to what extent Federal regulation would preempt State insurance regulation. On the other hand, if we establish a systemic risk regulator and leave insurance regulation to the States, what opportunities for regulatory arbitrage would we create? And would it actually undermine a systemic risk regulator?

Given the complexity of insurance regulation, the Committee, I believe, needs to understand all of the promises and pitfalls of the various approaches to regulatory reform before it can begin to craft its own solution. While we cannot hope to cover the full range of issues in one hearing, we can make a good start today, Mr. Chairman, and thank you for scheduling this hearing.

Chairman DODD. Thank you, Senator Shelby. A very good statement as well.

Let me turn to Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. Thank you for your leadership on these key issues associated with modernizing our regulatory system. Quite understandably, the American people want to know if the insurance industry is well run and well regulated. Families pay insurance premiums year in and year out so that when a crisis hits, they will be protected. That is how much of the industry has operated and how it continues to operate.

Columbus, Ohio, in my State is the second largest insurance hub in the country. Ohio has scores of insurance companies that have faithfully and prudently invested the premiums of their policyholders. But over the past few decades, the best and the brightest minds on Wall Street have, in a word, belittled this business model as behind the times. At AIG, it was not enough to insure lives or property or health. A largely unregulated corner of the company decided it would make enormous bets on exotic financial arrangements, providing insurance where there were no actuarial tables, almost no actual experience, and no Government regulation and no oversight.

You would think that such a colossal miscalculation would lead to contrition. In the world of Wall Street, you would be wrong. Americans have a hard time understanding why we need to spend hundreds of billions of dollars to prop up large financial institutions in the first place. Paying out hundreds of millions of dollars of bonuses to the employees of a company that is essentially insolvent smacks of greed, arrogance, and worse.

The Federal Government—that is, taxpayers—has invested $173 billion in AIG because its collapse would signal disaster for everyday Americans and the global financial system as a whole. We know it is that serious. But we should not be financing one dime of bonuses for AIG employees, for executives whose actions took the form of reckless endangerment, and we need to know was AIG so arrogant that they used taxpayer dollars, tens of billions of dollars, to pass through to their customers, rewarding those bad business decisions of both their customers and themselves—Societe Generale, Deutsche Bank, Barclays, Goldman Sachs. The list is pretty long.

We need tough insurance regulations that promote common sense and prevent Wall Street from building castles in the sand at Main Street's expense. We need to fix the regulatory system that created the AIG monster and let a bubble grow so large that when it burst, it took our Nation's economic and the world's economic stability with it.

We can design that system if we focus on doing what is best for the American people and the U.S. economy in the long run. That means solid safeguards to prevent another financial meltdown in a regulatory environment defined by zero tolerance for snake oil salesmen.

With common-sense rules, we can allow honest brokers literally and figuratively to earn an honest living, and we can allow policyholders to have confidence that the policy they bought will be there when they need it.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much.

Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. This is one of those interesting hearings where I find myself in complete agreement so far with every one of my colleagues. I will not try to repeat everything, but I do want to say that as we approach this hearing, clearly in the context of regulatory reform, many of us are looking far beyond simply the insurance industry but to the entire financial system that we have in our country. And one of the obvious questions is whether we need to create a very broadly empowered systemic risk regulator.

If we do need to create such a systemic risk regulator, would that regulator have authority over insurance for systemic risk regulation? If we do have that kind of insurance-covered systemic risk regulator with broad powers, how does that regulator coordinate with the functional or solvency regulator? And if that regulator is not just a single additional Federal regulator, how do we coordinate with the 50 States and deal with the kinds of issues that both our Chairman and Ranking Member have raised today?

Those kinds of questions are important for us to answer as we move forward in the larger context of what our broad regulatory system will be for our financial institutions in this Nation, and I look forward to guidance from our witnesses on that today.

I just want to mention one other item very quickly. I note that at least one of our witnesses has raised the possibility that it is not likely that there is any single insurer that is too big to fail. Obviously, we thought that AIG was too big to fail, and there are now analysts who are starting to question this notion of too big to fail, whether it be in the insurance industry or in other parts of our financial system.

I am interested in that notion. If there are institutions that are too big to fail, how do we identify that? How do we define the circumstance where a single company is so systemically significant to the rest of our financial circumstances and our economy that we must not allow it to fail? And what does "fail" mean? Often, we are, in the context of AIG, now talking about whether we should have allowed an orderly Chapter 11 bankruptcy proceeding to proceed? Is that failure? And is that consequence something that we cannot work into our system of dealing with systemic risk and the larger questions of how the Federal Government will approach large multinational and systemically significant companies?

I know that this raises a lot of almost ethereal questions that are going to be very difficult for us to answer, but the fact is that Americans are increasingly asking themselves why. Why are we going down these paths?

When we first started putting resources into AIG, after the first tranche was put in, it was very commonly said by many to us here in Congress that, "Well, this is not just an expenditure of taxpayer dollars that are going to be lost. In fact, as we unwind AIG and as we liquidate its assets, the taxpayers are going to make a profit." Anybody here hear that? That was the first tranche.

Now we have gone through number 2, number 3, and number 4. Nobody is saying that anymore. And the question that I have is: As we move into this, we need to have a better idea of what this notion of too big to fail is, what it means in different aspects of our industry, and what our proper response to it should be. Should we regulate in such a way that we do not get into situations like that? Or should we have a regulatory system that contemplates circumstances where we face companies that are too big to fail and somehow puts together a rational approach to prop them up, or as some say, nationalize them?

Now, I am very concerned by the implications of this entire question, and I realize we are not going to answer the question in today's hearing entirely. But I would be interested in the observations of our witnesses on this issue.

Thank you very much, Mr. Chairman.

Chairman DODD. Thank you, Senator Crapo.

Senator Merkley.

STATEMENT OF SENATOR JEFF MERKLEY

Senator MERKLEY. Thank you very much, Mr. Chairman, for convening this hearing. The task of modernizing the insurance regulatory system is absolutely essential. Over the past 2 years, the American people have been outraged to discover the existence of a $50 trillion insurance industry that was entirely unregulated; outraged that this industry could avoid regulation by the New York insurance regulators by using the term "credit default swaps" rather than "credit default insurance"; outraged that firms within this industry went regulator shopping to avoid effective oversight; outraged that the activities of these firms created an asset bubble, the collapse of which has left millions of Americans out of work and millions more with their life savings obliterated; and absolutely enraged that the very same industry that did all these things is richly rewarding its employees with perks and bonuses funded with taxpayer funds. The situation is offensive to me; it is offensive to the American people.

Mr. Chairman, we have a duty and obligation to fix our insurance regulatory system, to address regulatory arbitrage, to address systemic risk, to make sure that this situation does not ever arise again.

Thank you.

Chairman DODD. Thank you very much.

Senator Corker.

Senator CORKER. As is my custom, I will wait until the witnesses—out of respect for you, I will wait until you testify. I do look forward to that.

Chairman DODD. Senator Tester.

STATEMENT OF SENATOR JON TESTER

Senator TESTER. Thank you, Mr. Chairman. Thank you, Ranking Member Shelby.

Before we get into the modernization of our insurance regulatory system, I do want to just say a couple things about AIG, specifically about what has transpired over the weekend on the $165 million bonuses.

It was about 6 months ago that Secretary Paulson came into this Committee and said that we need some significant money invested in the financial system; otherwise, we will experience a financial meltdown. There were a lot of very, very difficult decisions that were made over the next few days that many people lost sleep over. A lot of taxpayer dollars were doled out. And there was a lot of discussion about additional compensation, particularly bonuses, to companies who were led down the wrong path, who were on the verge of going bankrupt.

And now, once again, this weekend we hear of a company—AIG in particular—who has received $173 billion in taxpayer money doling out some $165 million in bonuses to their employees because supposedly it was the contract. Well, the fact is what would those contracts have been if the taxpayers would not have bailed them out. That company would have been broke. Those people would be part of the 600,000 unemployed that occur in this country a month, every month, and they would be on the street.

So what do the taxpayers get for thanks for throwing $173 billion into a company like AIG? Continued bonuses, the same old way of doing business. And what do we hear? We hear, "Well, these bonuses have to be given out because this is our professional workforce."

I can tell you that this is incredibly unacceptable, and the fact is that these companies going broke, companies like AIG, it makes perfect sense to me now. If anybody did business like these folks do business, they would be in the same boat. And all I have to say, before I get into my brief statement, is that if this is the way Wall Street and AIG and all the others continue to do business, we cannot help with any amount of money we put forth to them. This is ridiculous.

And, hopefully—hopefully—we will find some way—I do not care. Litigate it in court. This just is not right to be occurring. It is not right to be occurring because this company would be out of business, and those people would be on the street. And they need to understand that the only reason that they even have a job is because of the taxpayers and their ability to put forth money to this.

Thank you, Mr. Chairman. I just want to say a few things about the modernization.

I believe that you have put together a great panel of witnesses today to help provide perspective on this issue that we are about to confront, and that is regulatory reform in the financial sector, particularly insurance. And while I believe there is a need to act

quickly to instill consumer confidence through the regulatory modernization, I believe we also need to be cautious. We do not want to overregulate, but we want to do it in a targeted, effective manner. And I feel that insurance regulation may be viewed by some as a candidate for wholesale regulatory overhaul where more deliberative measures would be more effective.

However, I am interested in the spectrum of ideas. I truly do look forward to hearing from the witnesses so we can come up with some common-sense solutions for regulation in the marketplace.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Tester. And, again, we thank our witnesses for being with us this morning.

I think you have heard as well here from all of us on the AIG matter, and one way or another, we are going to try and figure out how we are going to get these resources back.

I would note as well, though, at the same time they were announcing the bonuses, there was a second story, and the second story was—my colleagues will recall at this hearing where we asked who the counterparties were 2 weeks ago, and there was reluctance, of course, to share with the Committee who the counterparties were, and for obvious—I understand why there was reluctance. But in that story we are discovering that there were companies that were getting as much as $12 billion, dwarfs the $165 million in a sense. And so that story ended up being sort of a secondary story because bonuses obviously attract more attention. But I would point out to my colleagues that the counterparty story is a much bigger story in many ways. Because the question I asked, I think at the outset of the hearing is: Who did we bail out? Who in a sense was rescued? And we are now discovering that they were companies, including foreign operations, that were receiving billions of dollars at 100 percent value.

So while we can get angry about, and should, over the bonus issue, there is a secondary story that seems to be playing a second level that ought to be a source of far more aggressive action on our part to determine how that happened, why 100 percent value, why the collateral that was left in their hands. There are many other questions in addition to the bonus issue that we need to address. But I am confident we can come up with—at least we should be able to try to come up with an answer on how to get back the bonus issue.

Senator SHELBY. Mr. Chairman, along those lines, if I can just make a brief comment. I hope that you as Chairman of the Committee will bring up the Inspector General of TARP, Mr. Barofsky, again, as he is doing his work, because I believe the American people want transparency and accountability on where all this TARP money went, including AIG, a lot of the money to the auto companies, who is benefiting from it, and so forth. And we just got a little of it, and we have had to extract that piece by piece. And I want to commend you, Mr. Chairman, for pursuing this.

I think everybody on this Committee wants to know where this money went, who benefited, where it is. We have gotten a little, but there is a lot more to come.

Chairman DODD. That is a good suggestion, Senator, and we will follow up with that. Let me welcome our panel here and move on to the subject matter in front of us today.

Michael McRaith is the Director of Insurance for the State of Illinois, and he is testifying on behalf of the National Association of Insurance Commissioners, and we thank you very much for being with us.

Second is Frank Keating, who is President and CEO of the American Council of Life Insurers, a position that Mr. Keating has assumed since 2003, following his service as the Governor of Oklahoma. We thank you very much, Frank, for joining us.

I mentioned during my remarks Bill Berkley, Chairman and CEO of the W.R. Berkley Corporation, and since founding the company in 1967, he has managed its growth into a Fortune 500 property/casualty insurance company headquartered in my State of Connecticut. He serves, as well, as Vice Chairman of the Board of Trustees of the University of Connecticut. We thank you, Bill, for joining us.

Spencer Houldin is the President of Ericson Insurance Advisers, which is headquartered in Washington Depot, Connecticut. We thank you for joining us. Mr. Houldin is testifying on behalf of the Independent Insurance Agents and Brokers of America, where he has served as Chairman of the Government Affairs Committee since 2008.

John Hill is President and Chief Operating Officer of Magna Carta Companies, a commercial lines insurance headquartered in New York City, and we thank you, Mr. Hill, for being with us.

Frank Nutter is the President of the Reinsurance Association of America, a position he has held since 1991. And, Frank, we thank you for being with us.

Robert Hunter serves as the Director of Insurance for the Consumer Federation of America. I had the pleasure of addressing the Consumer Federation of America last week, and, once again, always important to have you at the table when matters like this are being discussed. So we thank you for joining us.

We will begin with you, Mr. McRaith. We are going to try and limit you because we have a large panel. Try and keep your remarks to 5 minutes. I will not bang down the gavel, but if I am raising it, it means you should wrap it up.

STATEMENT OF MICHAEL T. MCRAITH, DIRECTOR, ILLINOIS DEPARTMENT OF FINANCIAL AND PROFESSIONAL REGULATION, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. MCRAITH. Chairman Dodd, Ranking Member Shelby, members of the Committee, thank you for inviting me to testify. I am Michael McRaith, Director of Insurance for the State of Illinois, and I speak today on behalf of the National Association of Insurance Commissioners.

The insurance industry, even in these difficult times, has withstood the collapses that echo through the other financial sectors.

Today, we may not agree on everything, but we likely do agree that insurance regulation must not only serve the industry, but most also prioritize U.S. consumers. Consumer protection has been,

is, and will remain priority one for State regulators. We supervise 36 percent of the world's insurance market. Our States include four of the top ten, 28 of the top 50 world markets, and alone we surpass two, three, and four combined. With the world's most competitive market, we, your States, are the gold standard for regulation in developing countries.

Some in the industry take the opportunity of our crisis to clamor for the so-called option Federal charter or deregulation. Respectfully, this decade-old rhetoric does not warrant the important time of this Committee.

To be sure, as with any dynamic industry, insurance regulation must modernize, and it does. We have worked with producers to improve national licensing uniformity and reciprocity. Working with producers, we commented in support of a proposal to improve how States deal with surplus lines. State regulators adopted a comprehensive reinsurance reform proposal and are presently developing implementation details. The Interstate Compact, a single portal for approval of annuity and life products, has been adopted by 34 jurisdictions.

The NAIC maintains the world's largest insurance financial data base, a consumer information resource, licensing for more than 4 million producers, and other subject matter data. We want to ensure that this information serves Congress and the Federal executive branch.

The NAIC is active internationally, collaborates regularly with our counterparts overseas, serves as technical adviser to the USTR, works with the OECD, the Joint Forum, and others. But accepting the limits of Article I, Section 10 of the Constitution, we acknowledge the need for a coordinator of Federal policy on international insurance matters. For these reasons, we work constructively to narrow aspects of preemption and supported creation of the Office of Insurance Information.

With respect to Solvency II, the mythology of this EU directive far exceeds its factual merits. Details of the plan remain in dispute and incomplete, and agreement among the EU nations is a wilting aspiration.

State regulators do support systemic risk regulation based on the principle of integration, but not displacement of functional regulators. State-based insurance regulation and national or international systemic regulation are inherently compatible. Information sharing and confidentiality protocols can be established, and coordination among financial regulators can be formalized.

State regulators know that effective regulation coincides with corporate governance and comprehensive risk management, and supervisory colleges can require both. Preemption of any functional regulator should occur only with material risk to the solvency of the enterprise, the demise of which would threaten systemic stability.

We must be ever vigilant, though, not to preempt the State-based consumer protections and solvency standards that serve our public so well. While conversation most often centers on industry concerns, in 2008 State regulators replied to over 3 million consumer inquiries and complaints. Like you, we know that a single mother in a car wreck racing between jobs needs local and prompt assist-

ance. And we know that an elderly gentleman on a fixed income sold an indexed annuity cannot wend his way through a Federal bureaucratic morass.

After every incident, our consumers, your constituents, need to know that the company that collected their premiums, often for years, has the wherewithal to pay the claim.

To conclude, we support systemic regulation, pledge our good-faith interaction, and renew our commitment to engage constructively with this Committee.

Thank you for your attention, and I look forward to your questions.

Chairman DODD. That was right on 5 minutes to the second. Very good, Mr. McRaith.

Mr. Keating?

STATEMENT OF FRANK KEATING, PRESIDENT AND CEO, THE AMERICAN COUNCIL OF LIFE INSURERS

Mr. KEATING. Mr. Chairman, Senator Shelby, Members of the Committee, thank you for giving me this opportunity to speak to the subject of regulatory modernization.

The ACLI is the principal trade association for U.S. life insurance companies, and its 340 member companies represent 93 percent of life insurance business and 94 percent of the annuity business in the United States.

There are three points I would like to emphasize to the Committee this morning. The first is that the life insurance business is systemically significant, not only in terms of the protection and retirement security it provides to millions of Americans, but also in terms of the role it plays in capital formation in our economy. Decisions and initiatives addressing regulatory reform and economic recovery of the financial sector must reflect that fact.

The second point is that, absent a Federal insurance regulator, the ability of Congress to fully and effectively implement whatever national financial regulatory policy you establish will be problematic, at best, with respect to insurance.

And third, as Congress and the administration address the deepening crisis in the financial sector, decisions are being made that have a profound effect on the life insurance business. Unfortunately, Mr. Chairman, those decisions are being made without any real understanding of how our business operates and without any significant input from our regulators.

Financial regulatory reform is focused at the moment on systemic risk, as we agree it should be. But if reform initiatives do not encompass all those segments of financial services that are systemically significant, there will almost certainly be gaps in systemic risk regulation. With our financial markets as interlinked as they are today, gaps relative to any one sector present an unacceptably high likelihood of widespread problems down the road.

My written statement details the facts demonstrating that life insurance is by any measure a systemically significant component of U.S. financial services. Let me touch, though, on a few highlights.

First, life insurance products provide financial protection for some 70 percent of U.S. households. There is over $20 trillion in life insurance in force, and our companies hold $2.6 trillion in an-

nuity reserves. Annually, we pay out almost $60 billion in life insurance benefits, over $70 billion in annuity benefits, and more than $7 billion in long-term care insurance benefits.

We are the backbone of the employee benefits system. More than 60 percent of all workers in the private sector have employer-sponsored life insurance, and our companies hold over 22 percent of all private employer-provided assets. Life insurers are the single largest source of corporate bond financing and hold approximately 18 percent of total U.S. corporate bonds.

The last thing this Congress or this administration wants is for any one of those critical roles that life insurers play to be jeopardized. Placing the highest priority on measures designed to stabilize the payment system is appropriate, but doing so while ignoring other systemically significant segments of financial services or doing so at the expense of those other segments is not.

My second point is on policy implementation. Whatever legislation Congress ultimately enacts will reflect your decisions on a comprehensive approach to financial regulation. Your policy should govern all systemically significant sectors of the financial services industry and should apply to all sectors on a uniform basis without any gaps that could lead to systemic problems.

Without a Federal insurance regulator, on an optional basis, and without direct jurisdiction over insurance companies, and given clear constitutional limitations on the ability of the Federal Government to mandate actions by State insurance regulators, how will national regulatory policy be implemented with respect to the life insurance industry?

The situation would appear to be very much analogous to privacy under Gramm-Leach-Bliley. Federal bank and securities regulators implemented that policy for banking and securities firms, but Congress could not compel insurers to subscribe to the same policies and practices on privacy. You could only hope that 50-plus State regulators would individually and uniformly decide to follow suit. Hope may have been an acceptable tool for implementing privacy policy, but it should not be the model for reform of U.S. financial regulation. The stakes are simply too high.

My last point deals with the fact that critical decisions are being made in Washington affecting our business, but they are being made without any significant import or involvement on the part of our regulators. Some examples include the handling of Washington Mutual, which resulted in life insurers experiencing substantial portfolio losses, the suspension of dividends on the preferred stock of Fannie and Freddie, which again significantly damaged our portfolios and directly contributed to the failure of two life companies.

The badly mistaken belief by some that mark-to-market accounting has no adverse implications for life insurance companies and more recently the cramdown provisions in the proposed bankruptcy legislation that would result, certainly could result in the unwarranted downgrades to life insurers' AAA-rated residential mortgage-backed securities investments.

Those actions were all well intended, but in each instance, they occurred with little or no understanding of their effects on life insurance companies. And in each instance, the only voice in Washington raising concern was that of life insurers and their agents.

Acting without input from an industry's regulators runs a high risk of unintended adverse consequences. And by "input," I mean day in, day out, week in, week out. Insurance is the only segment of the financial services industry that finds itself in this unacceptable situation, and that must be changed.

Let me conclude by reiterating that reforming U.S. financial regulation and stabilizing the financial markets must take into account all segments of the financial services industry, including life insurers. We urge Congress to recognize the systemic importance of our business to the economy and to the retirement and financial security of millions of Americans and to tailor reform and stabilization initiatives accordingly.

We pledge to work closely with this Committee to help craft the best possible system for overseeing all segments of our financial markets.

Thanks again, Mr. Chairman and members, for giving us this opportunity to comment on these extraordinarily important matters.

Chairman DODD. Thank you very much.

Mr. Berkley.

STATEMENT OF WILLIAM R. BERKLEY, CHAIRMAN AND CEO, W.R. BERKLEY CORPORATION, ON BEHALF OF THE AMERICAN INSURANCE ASSOCIATION

Mr. BERKLEY. Thank you, Chairman Dodd, Ranking Member Shelby, and members of the Committee. I am testifying today not just as CEO of W.R. Berkley Corporation, but as Chairman of the Board of the American Insurance Association.

I believe that I bring a unique and broad perspective to this discussion. I have been involved in the insurance business as an investor or manager for over 40 years. I am a leading shareholder of insurance and reinsurance companies, and I am also a majority shareholder of a nationally chartered community bank. I have witnessed the ebbs and flows of business cycles during that time, with the only constants being the existence of risk and the need to manage it. It is that challenge that brings us here today—the imperative of examining, understanding, and measuring risk on an individual and systemic level—and retooling the financial regulatory structure to be responsive to that risk. With that context in mind, I would like to focus my remarks today on three major themes.

First, property/casualty insurance is critical to our economy, but it does not pose the same types of systemic risk challenges as most other financial services sectors.

Second, because property/casualty insurance is so essential and is especially critical in times of crisis and catastrophe, Federal insurance regulation will enhance the industry's effectiveness, provide for greater consumer protection, and should be included as part of any well-constructed Federal program to analyze, manage, and minimize systemic risk to our economy.

Third, given the national and global nature of risk assumed by property and casualty insurers, establishment of a Federal insurance regulator is the only effective way of including property/casualty insurance in such a program.

Property/casualty insurance is essential to the overall well-being of the U.S. economy. We purchase close to $270 billion in State and

municipal bonds, pay almost $250 billion annually in claims, and, importantly, employ over 1.5 million hard-working Americans. Property/casualty insurance protects individuals and businesses against unforeseen risks and enables them to meet their financial responsibilities. Insurance allows all businesses to function effectively, Main Street and large businesses alike.

Property/casualty insurance remains financially strong through this current crisis. There are several reasons for that, but importantly, property/casualty insurance operations are generally low-leveraged businesses, with low asset-to-capital ratios. They are more conservative investment portfolios and more predictable cash-flows that are tied to insurance claims rather than on-demand access to assets.

Yet, despite the industry's strong financial condition during this crisis, there are compelling reasons to establish Federal regulation for property/casualty insurance in any regulatory overhaul plans. The industry could always face huge, unforeseen, multi-billion-dollar loss events such as another natural disaster or terrorist attack. It makes little sense to look at national insurance regulation after the event has already occurred, but a lot of sense to put such a structure in place before the crisis to help avoid the consequences or mitigate those consequences that are unforeseen. However this Committee resolves the debate on Federal financial regulatory modernization, the only effective way to include property/casualty insurance would be to create an independent Federal regulator that stands as an equal to the other Federal banking and securities regulators.

I continue to believe this, with all due respect to the State insurance regulatory community. The State-based insurance regulatory structure is fragmented and frequently not well equipped to close the regulatory gaps that the current crisis has exposed. Each State only has jurisdiction to address those companies under its regulatory control. Even where the States have identical laws, the regulatory outcomes may still be inconsistent because of diverse political environments and regulatory interests. If this crisis has revealed anything, it is the need for regulatory efficiency, coordinated regulatory activity and sophisticated market analysis, and the ability to anticipate and deal with potential systemic risk.

In addition, virtually all foreign countries have national regulators who recognize that industry supervision goes well beyond solvency. Effective contemporary regulation also must examine erratic market behavior by companies in competitive markets to ensure that those markets continue to function properly and do not either encourage other competitors to follow the lead of irrational actors or impede the competitive ability of well-managed enterprises.

The reality is that no one State can effectively deal with mega-events or cross-border issues that impact multiple States, and no State can handle a global crisis. The American Association and its members have supported the National Insurance Act sponsored by Senator Johnson in the last Congress as the right vehicle for smarter, more effective insurance regulation.

Yet we recognize that even the best legislative vehicle must be updated to be responsive to the evolving economic climate and to enhance strong consumer protections.

Let me close by thanking the Committee again for opening the dialog on this critical issue. The time is ripe for thoughtful, measured, but decisive action. We stand ready to work with you on a regulatory system that restores confidence in our financial system.

Thank you.

Chairman DODD. Thank you very much, Mr. Berkley.

Mr. Houldin.

STATEMENT OF SPENCER M. HOULDIN, PRESIDENT, ERICSON INSURANCE SERVICES, ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS AND BROKERS OF AMERICA

Mr. HOULDIN. Good morning Chairman Dodd, Ranking Member Shelby, members of the Committee. My name is Spencer Houldin, and I am pleased to be here on behalf of the Independent Insurance Agents and Brokers of America. Thank you for the opportunity to provide our association's perspective on insurance regulatory modernization.

The insurance arena is not immune from the effects of the current crisis, but I am happy to report that my business and much of the insurance marketplace remains healthy and stable. While the insurance business would benefit from greater efficiency and uniformity, we should be extremely cautious in the consideration of wholesale changes that could have a disruptive effect. We also believe that it is critically important to keep in mind how potential regulatory changes could impact small businesses.

Few have been left unscathed by the recent economic crisis, and like most Americans, the property and casualty market has suffered investment losses due to the stock market decline. But the property and casualty insurance market is stable and continues to serve consumers well. There has not been one property/casualty insurer insolvency in the past year, and not one property/casualty insurer has sought access to TARP funds.

If there is one thing to take from my testimony today, it is that the property and casualty insurance market continues to operate very well without the need for the Federal Government to provide any type of support.

Some groups have pointed to the failure of AIG to drive their deregulation agenda, such as through an optional Federal charter. AIG is a unique institution in the financial services world and its holding company has a Federal regulator—the OTS. AIG is not Exhibit A for day-to-day Federal regulation, especially an OFC.

Most observers agree that State regulation works effectively to protect consumers. State officials continue to be best positioned to be responsive to the needs of the local marketplace and local consumers.

Additionally, it should not be overlooked that the State system has an inherent consumer protection advantage in that there are multiple regulators overseeing an entity and its products, allowing others to notice and rectify potential regulatory mistakes or gaps. Providing one regulator with all of these responsibilities could lead

to more substantial problems where errors of that one regulator lead to extensive problems throughout the entire market.

This crisis also has provoked a discussion of risks to the entire financial services system as a whole. While a clear definition of "systemic risk" has yet to be agreed upon, we believe the crisis has demonstrated a need to have special scrutiny of the limited group of unique entities that engage in services or provide products that could pose systemic risk to the overall financial services market. Federal action, therefore, is likely necessary to determine and supervise such systemic risk concerns.

While State regulation continues to protect consumers and provide market stability, we have long promoted the use of targeted measures by Congress to help reform the State system in limited areas. By using limited, as-needed Federal legislation, we can improve rather than dismantle the current State-based system.

For example, to rectify the problem of redundant and costly licensing requirements, we strongly support targeted legislation that would immediately create a National Association of Registered Agents & Brokers, known as NARAB, to streamline nonresident insurance agent licensing. Given the economic crisis in which we find ourselves today, it is somewhat surprising that we have to address the issue of an optional Federal charter. We oppose OFC because we believe it would worsen the current financial crisis as its theory of regulatory arbitrage has been cited as one of the key reasons why we find ourselves in the current situation. President Barack Obama and Treasury Secretary Geithner have both made comments that we should not allow regulated entities to cherry-pick from competing regulators. Does anyone really think that allowing AIG to choose where it was regulated would have solved their problems?

Creating an industry-friendly optional regulator also is at odds with one of the primary goals of insurance regulation, which is consumer protection. OFC legislation deregulates several areas currently regulated at the State level, flying in the face of the nearly universal call today for stronger and more effective regulation of the financial services industry.

As I previously mentioned today—and it bears repeating one last time—we believe that with the exception of a properly crafted systemic risk overseer, targeted modernization is the prudent course of action for reform of day-to-day insurance regulation.

IIABA again appreciates the opportunity to testify, and we remain committed to continuing to work to improve State insurance regulation for both the consumers and market participants.

Chairman DODD. Thank you, Mr. Houldin.

Mr. Hill, welcome to the Committee.

STATEMENT OF JOHN T. HILL, PRESIDENT AND CHIEF OPERATING OFFICER, MAGNA CARTA COMPANIES, ON BEHALF OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Mr. HILL. Thank you, Chairman Dodd.

Good morning, Chairman Dodd, Ranking Member Shelby, and members of the Committee. My name is John Hill, and I am President and COO of Magna Carta Companies. As someone who grew

up in modest circumstances in rural New Jersey, it is truly an honor to testify before you on these important issues at this point in our Nation's history.

Magna Carta was founded in New York in 1925 as a mutual insurance carrier for the taxicab industry. Today we employ 240 individuals and write in 22 States. We very much remain a small mutual insurer with $170 million in direct written premiums.

I am here today on behalf of the National Association of Mutual Insurance Companies to present our views on insurance regulation. NAMIC represents more than 1,400 property and casualty insurance companies ranging from small farm mutual companies to State and regional insurance carriers to large national writers. NAMIC members serve the insurance needs of millions of consumers and businesses in every town and city across America.

I also have the privilege of serving as Chairman of NAMIC's Financial Services Task Force, which was created specifically to develop NAMIC's policy response to the financial services crisis. Our Nation faces an unprecedented financial crisis, and we commend the Committee for holding this hearing to explore the role of insurance regulation.

To begin, it is important to understand the distinction between the property and casualty insurance industry and other financial services, including life insurance. For one, property/casualty insurers maintain a significantly higher ratio of capital to assets than do life insurers and other financial institutions. This means that property and casualty insurers are less affected by investment risk. Today, as other financial services companies are failing and seeking Government assistance, property and casualty insurers continue to be well capitalized and neither seek nor require Federal funding.

We support a reformed system of State regulation. Property and casualty risks are inherently local in nature, and insurance contracts are dependent on State tort and contract law. The industry is competitive, solvent, and generally well regulated.

The hallmarks of insurance regulation are solvency oversight and consumer protection. State regulators resolve literally millions of consumer inquiries each year. They also actively supervise all aspects of the business of insurance by establishing and enforcing strict solvency and investment standards and limiting unrelated activities of insurance affiliates. Moreover, in the rare event of an insurer insolvency, the State guarantee system provides another layer of protection for consumers.

In 2008, 25 banks failed and an additional 17 have failed already this year, demonstrating a weakness in Federal banking solvency regulation. Now, contrast that with the property and casualty insurance industry which has had an excellent solvency record in 2008 in spite of a large drop in investment income and Hurricane Ike, the fourth most expensive hurricane in U.S. history. The State-based insurance regulatory system has, in fact, proven to be one of the few bright spots in our Nation's regulatory structure.

We are painfully aware of the extraordinary measures that the Federal Government has been forced to take to prevent the collapse of AIG. Although it has been described as the insurance giant, AIG is, in fact, a financial conglomerate that is not typical of the insur-

ance industry as a whole. The extraordinary problems experienced by AIG were largely caused by its non-insurance Financial Products unit. AIG's failure does not provide justification to supplant State-based insurance regulation.

The current crisis demands that Congress act, but Congress must act prudently and responsibly, focusing limited resources on the most critical issues. We encourage Congress to adopt a measured approach to the problems at hand and avoid the inclination to rush to wholesale reform.

As policymakers work to develop long-term solutions to our present financial crisis, NAMIC urges Congress to keep in mind the dramatic differences between Main Street organizations, continuing to meet the needs of their local markets and those institutions that caused this crisis and have either gone out of business or required unprecedented Government financial intervention.

We recommend the following reforms to strengthen our Nation's financial regulatory system:

One, address systemic risk by focusing on financial products that pose a risk to the entire financial system rather than particular institutions.

Two, establish an Office of Insurance Information to inform Federal decisionmaking on insurance issues and facilitate international agreements.

And, three, expand the President's Financial Working Group to include State regulators.

We believe such reforms are measured, appropriate, and timely responses to the present crisis. As the process moves forward, we stand ready to work with the Committee to address the current problems and regulatory gaps while keeping in mind the legitimate interests of Main Street businesses and consumers.

Again, we thank you for the opportunity to speak here today.

Chairman DODD. Thank you very much, Mr. Hill.

Mr. Nutter, thank you.

STATEMENT OF FRANKLIN W. NUTTER, PRESIDENT, THE REINSURANCE ASSOCIATION OF AMERICA

Mr. NUTTER. Chairman Dodd, Ranking Member Shelby, thank you for this opportunity and for holding this important hearing.

Reinsurance is a risk management tool for insurance companies—if you will, the insurance of insurance companies. And as such, it is probably the most global of the insurance businesses. My statement documents a number of statistics related to that. The majority of U.S. premiums ceded are assumed by reinsurers domiciled in ten countries throughout the world, but the entire global market is required to bring much needed capital and capacity to support the extraordinary risk exposure in the U.S. and to spread the risk throughout the world's capital markets.

We believe that a streamlined national U.S. regulatory system will result in reinsurers conducting business more readily through U.S. operations and U.S.-based personnel. Thus, the RAA supports the modernization of the current regulatory structure and advocates a single national regulator at the Federal level. Alternatively, the RAA seeks Federal legislation that streamlines the current State system.

An informed Federal voice with the authority to establish Federal policy on international issues is critical not only to U.S. reinsurers, which do business globally and spread the risk throughout the world, but also to foreign reinsurers, who play an important role in assuming risk in the U.S. marketplace.

The U.S. State regulatory system is an anomaly in the global insurance regulatory world. In our view, the U.S. is disadvantaged by the lack of a Federal entity with authority to make decisions for the country and to negotiate international insurance agreements. International entities, like reinsurers, need an international regulatory framework. A single national regulator with Federal authority could negotiate an agreement with the regulatory systems of foreign jurisdictions that can achieve a level of regulatory standards, enforcement, trust, and confidence with their counterparts outside the U.S.

There are several different ways to address meaningful modernization, including a Federal exclusive regulator for reinsurance, or Federal legislation that streamlines and modernizes the current State system. Although the RAA prefers a Federal regulator, the Nonadmitted and Reinsurance Reform Act, also called the "surplus lines and reinsurance bill," twice passed by the House of Representatives, is a good start, but could be augmented by the recent NAIC-endorsed reinsurance modernization framework. The RAA supports the NAIC proposal to modernize this framework through a system of regulatory recognition of foreign jurisdictions, a single State regulator for U.S.-licensed reinsurers, and a port of entry for non-U.S.-based reinsurers.

Given the challenges of implementing changes in all 50 States and questions of constitutional authority for State action on matters of international trade, the NAIC's support for Federal legislation to accomplish this proposed framework is encouraging.

I urge the Congress to move reinsurance regulatory modernization forward regardless of the ongoing debate about a systemic risk regulator—the subject of my concluding testimony.

Various witnesses have addressed this Committee about issues associated with a systemic risk regulator. As has been mentioned by other witnesses, property/casualty insurers generate little counterparty risk, and their liabilities are for the most part independent of economic cycles or systemic failures. While the property/casualty reinsurance industry plays an important role in the financial system, it may not necessarily present a systemic risk. There are clear distinctions between risk finance and management products that are relatively new financial tools developed in unregulated markets, and risk transfer products like reinsurance whose issuers are regulated and whose business model has existed for centuries.

Those addressing the authority of a systemic risk regulator envision traditional regulatory roles and standards for capital, liquidity, risk management, collection of financial reports, examination authority, authority to take regulatory action as necessary and, if need be, regulatory action independent of any functional regulator.

Reinsurers are already regulated in much the same way as is being proposed for the systemic risk regulator. Thus, we are concerned the systemic risk regulator envisioned by some would be re-

dundant with this system. This raises concerns that, without financial services and insurance regulatory reform, a Federal systemic risk regulator would be an additional layer of regulation, with limited added value; could create due process issues for applicable firms; and be in regular conflict with the existing multi-State system of regulation.

Should Congress proceed with broad financial services reform, we ask that it be recognized that reinsurance is by its global nature different from insurance, and that the Federal Government currently has the requisite constitutional authority, functional agencies, and experience in matters of foreign trade to easily modernize reinsurance regulation.

It is our recommendation that reinsurance be included in any meaningful and comprehensive financial services reform through the creation of a Federal regulator having exclusive regulatory authority over the reinsurance sector so there is no level of redundancy with State regulation. This should occur whether or not there is a systemic risk regulator included in financial services reform.

Alternatively, Congress should create a single national regulator for reinsurance at the Federal level, but retain a choice or option for companies to remain in the State system. We recommend that any such financial reform incorporate authority for a system of regulatory recognition to facilitate and enforce foreign insurance regulation relationships.

If Congress should choose not to include reinsurance in broader financial services reform, we encourage the enactment of legislation along the lines of the NAIC's reinsurance modernization proposal to streamline the State system as it relates to reinsurance by federally authorizing a port of entry for foreign reinsurers and single-State financial oversight for reinsurers licensed in the United States.

Thank you very much.

Chairman DODD. Thank you very much, Mr. Nutter.

Mr. Hunter, thank you for being with us.

STATEMENT OF J. ROBERT HUNTER, DIRECTOR OF INSURANCE, THE CONSUMER FEDERATION OF AMERICA

Mr. HUNTER. Thank you, Chairman Dodd, Mr. Shelby, members. I am Bob Hunter. I am Director of Insurance for the Consumer Federation. I was the Federal Insurance Administrator under Presidents Ford and Carter, and Texas Insurance Commissioner before.

CFA is in the midst of a detailed review of our policy positions on insurance regulation to reflect the lessons we are learning from the economic meltdown. Here are some of our tentative conclusions.

First, there is a need for an expanded role for the Federal Government in regulating insurance.

Second, there are significant systemic risk issues associated with insurance that require oversight by a Federal systemic risk regulator. An example would be the guarantee associations, post-assessment plans everywhere by New York with no money to pay if an insurer goes under. They have to collect it later.

With several life insurers in trouble today, the life insurance guaranty associations nationwide could muster under $9 billion if they were called upon. As I put it in my testimony, that would hardly pay the bonuses that these companies are offering.

It is ironic that State regulators boast about the effectiveness of their capital and surplus requirements in stabilizing the insurers against systemic risk, even though several States at the individual level had to loosen these requirements today.

Regarding consumer protection and prudential regulation, CFA places our focus on quality rather than who does it. At this stage of our research, it appears that a Federal office is needed to deal with more than just systemic risk, but also to be a repository of insurance expertise, to engage in international issues, and to monitor and enforce, if States opt not to, high consumer protection and prudential minimum standards set by Congress.

The minimum standards to protect consumers must address all key consumer issues, such as claims abuses, unfair risk classes, unavailability of needed insurance, *et cetera.* They must contain, among other things, the capacity to regulate rates and classifications.

Tough, thoughtful regulation, our study shows, is the most effective at protecting consumers while working well for insurers and enhancing competition. California has a system that I would encourage you to look at as a standard.

CFA will oppose any system not based on high standards for consumer protection or which would have the potential to undermine the States that are doing a good job.

Rather than enforcing congressional minimum standards through a Federal regulator, a State-based entity might be empowered by Congress. That would probably be the NAIC. But we are skeptical about the NAIC. If you do that, you need to have standards for the NAIC to prevent several problems. They need to have notice, comment rulemaking, on-the-record voting, accurate minutes, rules against *ex parte* communication, *et cetera,* like a real regulator and not like a trade organization, which they act like.

As Congress attempts to create an agency that has knowledge about insurance, it should consider restoration of the ability of the FTC to study insurance, too.

A Federal office should not be granted vague and open-ended powers of preemption regarding State laws, but only in areas where Congress has explicitly said we want to preempt. Nor should preemption apply to needed consumer protections.

While CFA supports a greater insurance role, we vigorously oppose the optional Federal charter. Such a system cannot control systemic risk. It is impossible. It has failed miserably in protecting banking consumers. Thirty banks have left the Federal regulatory regime, according to a Washington Post article. And it sets up conditions for regulatory arbitrage. Our review determined there are regulatory functions that the States can do better than the Federal Government, such as complaint handling and other functions that would be done more effectively at the Federal level, such as systemic risk.

The research suggests a role for the States in dealing with direct consumer needs while the Federal Government's role appears best

addressing macro systemic trends and issues that cross State borders. These differential capacities suggest some sort of hybrid approach. This leads us to conclude that minimum Federal standards might be a preferred approach.

Our research also supports differential treatment for property/casualty insurers compared to life insurers. Property/casualty insurers have local issues like catastrophic risk and legal requirements that are different State by State, versus life insurance, which is more national in scope and may lend itself more readily to Federal regulatory requirements.

I emphasize these are our current ideas, and we are still studying it, still under some debate at CFA, and yet to be vetted with other consumer organizations, but I wanted to give you the advantage of our early thinking.

I want to take just one final moment to reflect on what led to the situation we are in today.

Reasonable profits are necessary in a vital insurance industry, but over decades, there has been a change in the insurer corporate cultures that led from a focus on policyholder interests to one that became obsessed with quarterly profits and stock price. Insurance professionals were pushed aside by financial gurus. For decades, the undoubted champion of insurer greed has been AIG. This is no surprise.

Hank Greenberg, cheered on by Wall Street, maximized profit, every penny he could get a hold of, and he was well known on Insurance Street as someone if you had a claim against, you were going to be fought so that he could maintain his cash-flow.

AIG's arrogance is manifest in partying and bonusing away taxpayer money, but encouraged by rating organizations, trade organizations, and compliant regulators, AIG gleefully did bid-rigging uncovered by Spitzer, did credit swaps and other things, exposing their clients constantly to danger to make more money.

Other insurers have followed suit, seeing the praise and money being lavished on AIG. For example, Allstate has maximized its profit in part by using computer systems that arbitrarily underpay claims, and the leader who brought that innovation is now running AIG. So what do you expect? A perfect person to run AIG, and the resulting tone deafness that we are now all outraged—I have heard the outrage mentioned several times. Why would a party or a bonus be an issue if the corporate culture is totally focused on greed? It is no issue to them. That is why you see arrogant letters.

This overarching insurance industry corporate culture of greed over policyholder interest is why Congress must look not only at the single fruit of greed known as systemic risk, but at the other greed that manifests throughout insurance, particularly the willingness to do harm to policyholders. A classic, current iteration of greed is the request for optional Federal charters so that insurers can flit back and forth to the regulator least interested in protecting people over greed.

So, please, Mr. Chairman, Ranking Member, protect the policyholders as you work on this issue. We look forward to working with you on it.

Chairman DODD. Thank you very much, Mr. Hunter. Once again, you were very compelling in your comments and we thank you for being with us this morning.

I will put the clock on here for about 5 minutes apiece so we can get to as many of our members here. And again, it is a strong panel. We thank you all for being with us.

Let me just first of all ask you, I think we would all agree there is certainly a lack of expertise at the Federal level in insurance issues, generally speaking. Mr. Hunter pointed that out. While Congress has created Federal offices to handle specific insurance where there is a Federal involvement, including TRIA, flood insurance, obviously examples where there has been a Federal involvement in national programs, there is no central repository of information and analysis on insurance at the Federal level. I wonder if you might just express by maybe just even raising your hands how many would support creating the Office of Insurance Information within the Treasury Department. Is that something you would—we will start out with a unanimous position. That is a good start here.

[Laughter.]

Chairman DODD. So I thank you for that. But I was going to make the point as well, I was just going over last night in preparing for this morning's hearing, and as someone who comes from a State that has a strong national and historic interest in the subject matter of insurance, just for the purposes of information—maybe my colleagues were aware of this—I wanted to give you some idea.

According to public information, there are 2,723 property and casualty insurance companies in the United States and 1,190 life-health insurance companies in the United States. We have a tendency to hear about the large companies we are all aware of, but almost 4,000 insurance companies around, most of which are not national companies or well-known, but to give you some idea of the magnitude of the number of companies that are out there. I thought you might find that interesting.

Let me ask you, Mr. Hunter, if I can, I have made the case over and over again that I thought if we can get back to the point of consumer protection being the basis upon which you begin to look at these issues, then you have a totally different perspective, that we have bought into this notion, I think, for too long, at least too many have, that consumer protection is antithetical to economic growth, and you are making the point here that if you begin by thinking about the policy holder on this issue, begin thinking about the consumer and start from that point of view, that the issues of economic growth fall naturally into place.

Do you believe that Federal regulation is necessarily weaker in terms of consumer protection than State regulation? This has been the case made over the years with people like the commissioners who come before us. My own commissioner has talked to us about it, independent agents and others have made the issue to Congress over the years that if you, in fact, have a Federal regulator, that almost guarantees weaker regulation than if you do it at the State level, where people are on the ground, watching it every day, more concerned, more sensitive of the consumer interest because they are there on the ground, at the level.

I know you mentioned a hybrid kind of situation, but where do you come out on this issue today? And I realize it is an evolving issue, but nonetheless, where is the greater protection for consumers?

Mr. HUNTER. It has been my experience, having served both in the Federal and State areas, that it really has a lot to do with the laws and the people who are administering them. I think the Federal Government could do a great job. That is why I said earlier that consumers care a little less about the locus of regulation than the quality of it. And we see within the State system, there are some States that are pathetic in terms of protecting consumers and there are others that are very good. As I mentioned earlier, there are some States, like California, that have very tough regulation, but they have the highest Herthandal indices of competition and the profits are reasonable for the insurance companies, *et cetera.* So competition can work in a way that protects consumers, be very good for the industry, and still be a very competitive system. They don't have to—one does not displace the other.

I think either the Federal Government or the State could do it. The reason I suggested a hybrid is they are seeing some things like three million complaints. I can't imagine a Federal agency would be doing a very good job with it. Now, it is possible, but you would have to set up a regional system to do that, I think.

Chairman DODD. How about any other comments on this? Mr. McRaith, what is your answer on that? I mean, I appreciate Mr. Hunter's answer, but I think venue does have an impact on whether or not you get good regulation or not. If it just is going to be dispersed among 50 jurisdictions, then you are going to end up with a spotty system. Some places it works, some places it doesn't, and that is hardly what I think consumers need. So depending on where you happen to live, you get good protection or you don't, as opposed to the idea, at least at a national system, you could have one strong system of rules that would at least raise the prospect of having a stronger set of regulations.

Mr. MCRAITH. Mr. Chairman, you cited a number of approximately 4,000 companies earlier. The number that we have is actually closer to 7,700 companies, and as I mentioned in my opening comments, we are—the United States and the combination of States are the largest market in the world. We surpass two, three, and four combined.

So the real question is what is the problem that we are trying to solve, and if the problem is one of consumer protection, it is important to understand, I think, that different States view that differently. Not all of them Mr. Hunter is comfortable with, of course, but what is appropriate for a consumer in the State of Illinois, for example, is going to be different from what is appropriate for a consumer on the coastline in Florida, or in California, for example. There is no secret about that. But that is not to say that one State has more or less protection. It is to say that those States, when determining what is appropriate public policy for their consumers, have made different decisions.

When it comes to solvency, again, if we ask what is the problem or question we are trying to answer, the State system of financial solvency is coordinated. Fifty States are looking at national compa-

nies. You have multiple sets of eyes reviewing the financial status of any one company, whether it is a Connecticut-based company, an Illinois-based company. We, of course, also have a proud legacy of property and casualty insurers in our State. We work with other States and it is not one sole regulator who is determining whether that status, the financial status of that company is sufficient. It is multiple regulators with multiple skill sets evaluating a company from top to bottom.

Chairman DODD. Well, I appreciate your answer on that.

Let me jump to the systemic risk, and this will be my last question. I am already violating the clock a little bit, but I wanted to get to the systemic risk regulator because most of you have advocated a systemic risk regulator. I think, Mr. Nutter, you may be the one exception, and that is in the reinsurance industry, at least you didn't speak for one, so I will let you respond to this in a minute.

But let me begin by asking this. Excluding AIG, do any of you believe here that there are systemic important insurance or reinsurance companies per se out there at this moment? You mentioned whether it is 7,000 or 4,000. Are we looking at another company out there, aside from AIG, that could pose systemic risk as you see them today? Does anyone have a comment on that? Can anyone identify a company that we should be aware of?

My interest in this, and again, if I look at a systemic risk regulator, I am more interested in practices rather than someone declaring themselves to be a certain type of company and then falling within a regulator or not. But the kind of practices that company engages in, and then on the basis of that, determining whether or not those practices pose systemic risk. So there are specific insurance products that are common practices among insurance or reinsurance companies that pose a risk to the financial system. I wonder if you might comment briefly.

Why don't we begin with you, Mr. Nutter, because you took the position apparently of not necessarily endorsing the idea of a systemic risk regulator.

Mr. NUTTER. There is a concern that if you have a systemic risk regulator as described by Chairman Bernanke of the Fed, you really have a redundant system of regulation and a duplicate system for a functional regulator. Our point was, if you are going to do that, you really ought to have a Federal regulator for the reinsurance sector that would work with a systemic risk regulator. It wasn't to oppose a systemic risk regulator.

It is hard for us to see how a systemic risk regulator is going to coordinate with a 50-State system of regulation with the complexity of that, at least in the area of a global marketplace like reinsurance, where frankly, the most important regulatory relationships between a regulator and a systemic risk regulator would be with other international regulators in other countries, trading partners, if you will. We just see that occurring more effectively at a Federal level with a Federal regulator.

Chairman DODD. Mr. Berkley, do you want to comment on this? You have been in the business for 40 years.

Mr. BERKLEY. I think that, first, one has to understand what happened at AIG, and that is the good credit of the insurance busi-

ness was used to guarantee the performance of other elements of the holding company. If there had been a Federal regulator overseeing AIG, they would have said, hey, what you are doing is you are suddenly changing the character of the risk and you are putting the good creditworthiness of the insurance company and allowing them to use it, in the case of financial products, to take a substantial risk. But there was no one overseeing it.

The benefits of some Federal oversight is you get to look at the whole picture. It is not that there was particular risk in AIG's insurance business. Certainly, there is no systemic risk in their property casualty business. Even though they were the largest participant, the industry could have absorbed that business. It is that they effectively guaranteed the exposures in the financial products, something none of the other competitors did. All of the other big banks had independent subsidiaries without cross-guarantees in the financial products business. AIG guaranteed the performance of the financial products.

Chairman DODD. Let me turn to Senator Shelby, and I will come back. We will have a couple of rounds here.

Senator SHELBY. Thank you, Senator Dodd.

Mr. McRaith, five AIG insurance companies are regulated by the State of Illinois, it is my understanding. Are you aware of any financial problems with any of those insurance companies in Illinois, and what steps have you taken to ensure that those insurers are prudently managed during this disorderly time for AIG overall, and are you aware of any attempt by AIG to pay retention bonuses to any employees of its insurance companies, and if so, would State insurance regulators have the power to call back such payments?

First—I will go over it again. Are you aware of any financial problems with any of the five insurance, AIG-owned companies that are regulated by the State of Illinois?

Mr. MCRAITH. Senator, the insurance companies that are domiciled in Illinois, we regulate those companies now and we have regulated them as long as they have been domiciled in our State, or, for that matter, in other States on a regular basis, quarterly, annually, top to bottom exams on a regular basis, as well. Those companies, like many companies, are encountering the turbulence of the current economic time, but as we have heard from other witnesses today, the insurance industry, including those companies, Senator, are in relatively good shape compared with other financial sectors.

Senator SHELBY. What does "relatively" mean?

Mr. MCRAITH. Well, that means——

Senator SHELBY. You say they are in "relatively" good shape.

Mr. MCRAITH. First of all, I would never say publicly whether any one company were in trouble, but at the same time, I am not going to mislead you, Senator. The companies that we are regulating, we are comfortable with their financial status.

Senator SHELBY. Are you aware of any attempt by AIG to pay retention bonuses to any of these employees?

Mr. MCRAITH. Senator, I think it is an important question and it is important to distinguish that the bonuses that have been publicized recently are those bonuses that would be paid to the Financial Products employees, and we all know the colossal disaster that that division of AIG has caused. And frankly, I agree with every-

thing that you and your colleagues said, for whatever my humble opinion is worth, that those bonuses should not be paid to Financial Products division employees of AIG. However, the insurance enterprises of AIG, as you know, are generally solid companies and their employees have performed, generally speaking, well. Now, I don't know whether any one employee has received a bonus or not within the insurance companies domiciled in our State.

Senator SHELBY. In recent weeks, and I will pick up on what Senator Dodd was asking a few minutes ago, Federal Reserve Chairman Ben Bernanke has discussed publicly the inadequacy of our insolvency regime for large global financial conglomerates, such as AIG. Chairman Bernanke has called for a new resolution regime that can better manage the insolvencies of systemically important firms while minimizing the risk to taxpayers. Do you agree, sir, with Chairman Bernanke that a new resolution regime is needed in America for companies like AIG?

Mr. MCRAITH. Well, thankfully, there aren't a lot of companies like AIG, and we can hope we don't see another one anytime soon. The Chairman also made the comment that AIG was essentially a hedge fund attached to large stable insurance enterprises. As State regulators, we are proud of the fact that their insurance companies are the primary assets of AIG and its holding company. The solvency regime that we have for insurance companies is solid, and frankly, some of the concerns I have read expressed in testimony submitted today, I think are misplaced.

Senator SHELBY. Are you—go ahead.

Mr. MCRAITH. If, for example, one company were to have financial challenge and to be placed into receivership, other companies, first of all, can fill the void in the marketplace but can also purchase the policies of that company, and that happens frequently because those policies themselves are viable, strong assets and other companies will pick them up right away. So the demands on the system will not be as outrageous as some would have us believe today.

Senator SHELBY. Are you telling us that the State insurance guaranty system could handle the insolvency of AIG or a similarly large company like that, the spread and all kinds of things?

Mr. MCRAITH. What I am—well, when you say the insolvency of AIG, if we were talk——

Senator SHELBY. We are talking about AIG as a conglomerate——

Mr. MCRAITH. Right.

Senator SHELBY.——you know, the insurance and otherwise.

Mr. MCRAITH. Well, there is no system that is built to withstand an insolvency the size of the notional value of the credit default swaps AIG was invested in, which was, I believe, $2.4 trillion, which, of course, exceeds the gross domestic product of France as a country. However, their insurance operations, which as we know are strong assets of the holding company, if those were to encounter financial trouble, the State guaranty system is designed and would allow for an orderly disposition of those claims. But we also expect that many of those policies—and this is, again, completely hypothetical because those companies are financially strong at this point—that other companies would purchase the policies or groups

of policies within an insurance company because those are assets. Other companies would want them.

Senator SHELBY. But aren't credit default swaps an insurance against default of something? In other words, it is an insurance product of some kind.

Mr. MCRAITH. Well, I would agree with you, Senator, that credit default swaps as AIG was involved in those transactions did include a form of financial guaranty.

Senator SHELBY. Sure.

Mr. MCRAITH. Unfortunately, OTS, of course, as we know, the Office of Thrift Supervision, was the primary regulator for the AIG holding company, and let us talk about the reality here, which is not whether there is a regulator. It is whether there is an effective regulator. And what we see with the AIG insurance companies is effective regulation. What we saw at the holding company level was a regulator who was not effective.

Senator SHELBY. Mr. Hunter, do you agree with his statement? What is your take on it.

Mr. HUNTER. I didn't hear him answer the question.

Chairman DODD. He did——

Mr. HUNTER. I don't think it could handle—I don't think the guaranty funds could handle it, no.

Senator SHELBY. Couldn't handle it——

Mr. HUNTER. That was your question, and I don't think they——

Senator SHELBY. It would be too big for them to handle, would it not?

Mr. HUNTER. Of course. Yes.

Senator SHELBY. I thought so, too. Thank you.

Governor Keating, the Federal insurance regulation and systemic risk, an area you have done a lot of work in, your testimony cast doubt upon whether a Federal systemic risk regulator, Governor, could be established without a Federal insurance regulator also being created. You argue that without a Federal insurance regulator to coordinate and to implement policy with respect to insurers, Federal systemic regulation could be rendered ineffective. Along those lines, how should a Federal insurance regulator interact with a Federal systemic risk regulator to ensure that insurers are properly supervised for systemic risk as well as for solvency and consumer protection, the company itself?

Mr. KEATING. Well, Senator Shelby——

Senator SHELBY. It looks to me like they would be intertwined some.

Mr. KEATING. On a going-forward basis, it is important, as you well know, to get this right so we don't face again the kind of problems that we have faced in the recent past. But if the systemic risk regulator is a 30,000- or 40,000-foot entity, is it product specific or is it size-specific, and that is something obviously that members of this Committee are going to have to resolve.

It is our view that to have a functioning and efficient system, you need to plug all the holes. Systemic could look at, for example, on size or on product the credit default swap. I mean, that is allegedly an insurance product, and yet there were no reserves. There was no ability to play claims, which is stunning to me that the State regulatory apparatus as well as the OTS didn't identify that early.

Sixty-trillion dollars of those instruments are floating around the world.

But what we would like to see on an optional basis, if you do have a functional regulator at the Federal level that would speak with one voice to our international and national players that more than likely would seek a functional regulator at the Federal level—most of our members, by the way, would remain State regulated—but we would like to see an ability on the part of somebody to break a tie. The systemic regulator would have to be that person to break a tie. If he or she sees conduct or activity or an entity that simply is threatening the system, it is systemic, then that individual ought to be able to tell the functional regulator what to do, or, for that matter, the State regulator what to do. Otherwise, we would have a multiplicity of the problems we faced recently.

Senator SHELBY. Governor, over the past year, our largest bond insurers have teetered on the edge of collapse due to imprudent bets on the value of mortgage-backed securities. The problems of the bond insurers have impacted our national economy as bonds they insured have rapidly gone down in value. Although the bond insurers played an important role in our overall market, they remain regulated at the State level. If the bond insurers had been regulated by a Federal regulator, if you can envision that, do you believe that their problems would have been addressed more effectively than what we have today?

Mr. KEATING. Well, I am in favor as an industry, and we represent the life insurance, annuity, long-term care, and disability income business, a regulator and a regulatory system that works, that is effective, that is tough, that is action-oriented. I think Mike McRaith is right. It is not particularly always where the regulator is housed. What is the regulator doing? Obviously, the OTS appeared to be looking the other way on credit default swaps, and in the bond insurance business, obviously somebody was looking the other way, and that is simply the antithesis of effective and appropriate regulation.

Senator SHELBY. Where was the New York Insurance Commission on all this, too? They were the regulator of the insurance part, were they not?

Mr. KEATING. Well, you might want to invite him in and have a conversation.

Senator SHELBY. We have had him in once. We will bring him back.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Mr. MCRAITH. I would be happy to answer that question, too.

Chairman DODD. Yes. Let me get a chance to go to Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair.

Mr. McRaith, AIG has been described as an insurance company that had a hedge fund piggy-backed on it. Should the future regime basically prevent insurance companies dealing in areas like property insurance and life insurance and so forth from getting into the insurance of financial products with instruments like credit default swaps?

Mr. MCRAITH. Senator, the problem with AIG and the challenge for this Committee, which I appreciate your wrestling with in a substantive manner, is how do you regulate a large enterprise like AIG when there are multiple services or products sold by one company, and some people would even say AIG had as many as several thousand individual companies or subsidiaries within its larger holding company.

At the insurance company level, again, those insurance companies remain primary assets for the AIG holding company in solid financial condition today. So the question is what is the problem we are trying to solve? The problem is not the efficacy of State regulation. The problem is how do we integrate all of the different functional regulators so that they are coordinated and working together, and in that situation, the State system can work, coalesce with the other functional regulators, and to the extent that at some point there might be an enterprise whose viability is threatened, that the demise of that enterprise would threaten the stability of the system, that is when the systemic regulator can take the comprehensive action with respect to the enterprise as a whole.

Senator MERKLEY. Thank you. If I could reframe what you just said, your answer to my question was, no, that the answer is not to prevent companies engaged in property life insurance from doing hedge fund-style activities, but to simply have a better regulatory system.

Mr. MCRAITH. Let me be more clear. I think we need to be very cautious about allowing regulated enterprises that have direct consumer obligations from participating in hedge fund or hedge fund-like transactions. We have seen the risk of that. I think from a consumer protection perspective, we need to revisit and really answer the question you are asking, and my answer to your question is absolutely not.

Senator MERKLEY. Thank you.

Mr. Hunter, do you have any different perspective on that? Do you share that view?

Mr. HUNTER. No, I don't have a different perspective. I think the Congress should look at GLB again and see whether or not it led to some of these problems.

Senator MERKLEY. GLB?

Mr. HUNTER. Gramm-Leach-Bliley.

Senator MERKLEY. Thank you.

So a broad question to all of you is whether the size and complexity of large firms like AIG basically defies effective regulation at the State level. I think in many cases, I understood your testimony to say we do need some Federal coordination, but I just want to reclarify that, if anyone wishes to comment on that.

Mr. BERKLEY. I would like to just comment. I think, first of all, large parts of AIG were outside of the realm of State regulation. A huge amount of their business was overseas. It was an international business. Lots of other activities were outside of the realm of State regulation.

You know, I think that you only can regulate what is within your purview, and part of the problem of AIG is so much was outside of the purview, and part of the problem of coming up with a solution were so many other non-U.S. authorities had control over

pieces of the assets and we had no Federal regulator who could go and discuss with those various authorities how to have a solution.

So in the case of AIG, it was not something that we had within our powers to deal with.

Senator MERKLEY. Thank you.

Mr. Hunter, before I run out of time, I wanted to ask about one aspect of your testimony, in which you noted that the Congress should repeal the antitrust exemption of the McCarran-Ferguson Act and, quote, "collusion in pricing should not be allowed." Can you expand on your commentary in that case?

Mr. HUNTER. Sure, and I would refer you to the testimony I gave before the Senate Judiciary Committee, too, for a very full explanation, but back when the U.S. Supreme Court ruled for the first time that insurance was interstate commerce, and the States therefore were going to lose the regulatory authority, the States ran to Washington and got the McCarran-Ferguson Act. Congress debated whether or not to apply antitrust laws. In fact, they decided to apply antitrust laws after a moratorium.

If you read the debates at the time, Senator Pepper raised the issue, well, this language could possibly be interpreted as being a permanent prohibition on applying the antitrust laws. McCarran and Ferguson both jumped up and said, "No, no, that is not what we mean." But apparently the Supreme Court never read the legislative history because when it came before the Supreme Court, the Supreme Court decided that antitrust laws would not apply to insurance generally, except for coercion, intimidation, and boycott. And so we now have a situation where, like baseball, insurance is not subject to the antitrust laws.

Senator MERKLEY. Thank you very much.

Chairman DODD. Thank you very much, Senator.

Senator Corker?

Senator CORKER. Mr. Chairman, thank you, and I thank all of you for your testimony. Many of you have been in and out of our offices or you have had representatives in and out talking about this particular issue. Unlike some of the things we have dealt with most recently here on the Committee, and let me set AIG aside. I know we are talking about AIG today because of most recent occurrences. This is really not a hearing necessarily about AIG but about how we regulate the insurance industry in general.

This feels not like a big issue for the country as much as it does sort of a family squabble, if you will, within the insurance industry throughout our country. This is more about competing interests, it feels to me, than it does about systemic risk.

And so I know that everybody—Mr. Nutter agrees with the systemic regulator concept, it seems, or at least that is what everybody seemed to indicate, which might deal with sort of the AIG kind of thing. And it seems to me that a solution to this might be to have on the reinsurance side and on the life insurance side a Federal regulator, and even the guys that represent the insurance folks all around our country, the independent insurers that we all know and see when we go home on the weekends, even you all agree that it is really not about life insurance. It is really about property and casualty. I know you are worried about the camel

nose under the tent, if you will, and if we do that on life insurance, we might do it on property and casualty.

But why wouldn't we just look at the systemic regulator—except for Mr. Nutter—why wouldn't we just have a Federal regulator for reinsurance and life insurance and leave property and casualty like it is with State regulators, with the Office of Insurance Information that apparently everybody seems to like? Why wouldn't we just deal with this issue in this way and move on to something else? Anybody that wants to respond.

Mr. HOULDIN. If I may, Senator.

Senator CORKER. OK.

Mr. HOULDIN. My agency particularly, we work—about 20 percent of our income comes from life insurance. I would like to address that specifically. Down on Main Street, America, the consumer concerns and complaints that we get, we feel are very well addressed at the State level. I can call Commissioner Sullivan at the Connecticut Insurance Department, or his team, anyway, and get immediate reaction to a concern, and with all the baby boomers coming up that are going to have life insurance questions in the next decade or so, I think keeping the consumer protection at the State level is extremely important, and for that reason is why we don't support any Federal——

Senator CORKER. You know, there are very few complaints. I mean, life insurance is not what drives complaints at your State Insurance Commissioner's officer, really, is it? It is just a small percentage, is it not?

Mr. HOULDIN. Well, certainly the Commissioner can answer that better than I can, but the concerns that I get at my firm is you buy an insurance product, a life insurance product 30 years prior and when it comes up, or your parent passes away and you look at his document, you don't even know who the agent was that sold it. You don't even know who this company is. You don't even know if it is still active. And so I get a lot of questions from my clients saying, "I know you didn't sell me this policy, but can you please help me? I have no idea if this is active or if I can collect on it," and those types of questions, I think, are asked on a consistent basis. But the Commissioner can comment on that.

Senator CORKER. Yes, sir, Mr. Berkley or somebody?

Mr. BERKLEY. Well, I think that the part where your view goes awry is for large companies. Of those 3,000 insurance companies that were referred to by Senator Dodd, probably 2,500 of them would exactly fit the bill that you are talking about, but the others wouldn't and those are the larger companies that do business across frequently 50 States, frequently in other countries.

So when I set up a business in Latin America, I had no Federal insurance regulator. I had to set up a new company in that country. When I went to the U.K., there were no reciprocal arrangements. There was no way I could license my U.S. company there straightforward. There was on dialog, even. I had to set up a new company there. The same, in fact, in Australia and——

Senator CORKER. This wouldn't solve that, though.

Mr. BERKLEY. Yes. A Federal regulator would then open up a dialog, just like the company in the U.K. does business throughout the E.U. The national regulators have this dialog to allow you to

do business in broader areas. I believe if we had a national regulatory policy for the largest companies, we could have a very different dialog and it would be a reciprocal arrangement because the large companies overseas have the same desire to do business here, and one of their big problems is the licensing State by State is very complicated. This is also addressed by Mr. Nutter's issues for reinsurers overseas.

Mr. MCRAITH. Senator, if I might reply briefly, life insurance and annuity questions come into our offices with great regularity. The exact numbers, I don't know, but we get calls State by State probably in the hundreds, if not thousands, every year on these issues. We can't diminish the importance of each one of those calls. And the importance of a senior, for example, as I mentioned in my opening statement, who sold an indexed annuity. Where does that senior turn when they are on a fixed income and that annuity is not generating the income they were told they would receive?

The real challenge for us as we talk about this is in your concept probably the largest expansion of Federal regulatory authority in the financial sector since the 1930s. As we talk about this, what is the question we are trying to answer? What is the problem we are trying to solve?

Senator CORKER. It appears to me like a family squabble we are trying to solve——

Mr. MCRAITH. But let me explain. As I mentioned——

Senator CORKER. Which is not that interesting, candidly, so I would like to know what it is we are trying to solve.

Mr. MCRAITH. Right. Exactly. So if the question is speed to market issues for life companies, they want to be able to introduce their products more quickly. Thirty-four jurisdictions have adopted the Interstate Compact, which gives a single portal, single approval opportunity for product that can then be sold in all 34 of those jurisdictions. Now, as a factual matter, we might need Congressional support to require all 50 States to join that Compact.

When it comes to reinsurance, we have—all States have adopted or supported a proposal for comprehensive reinsurance reform. Now, we might, as we have adopted that proposal and spent a couple years working through the details, we might need Federal assistance—in fact, I am sure we will need Congressional assistance—in adopting that uniformly throughout the States. These are issues that we have addressed, are working to address every day in an even better fashion than we do already.

When it comes to international collaboration, just with respect to Mr. Berkley's comments, the E.U. is far less coordinated than the 50 States are. We are significantly larger, remember. The State of Connecticut is larger than Spain in terms of its insurance marketplace. So as we talk about the E.U. as if it is a panacea, let us look at the reality. They not only have 23 different languages, they cannot agree on what exactly even their solvency framework should be.

So yes, we can improve. We are working to improve and we look forward to working with you to help accomplish some of the uniformity goals that we all share.

Mr. HILL. Senator, I would just like to make one other comment. At NAMIC, we clearly support your position with respect to prop-

erty casualty. That is where our interest lies, and we do not see a role for a Federal charter with respect to property casualty.

With respect to the international issues, as we have all talked about, we fully support the establishment of OII. We think that can be an excellent conduit to deal with the international issues and the cross-border issues like that. So again, that is our position on that.

Mr. NUTTER. Senator, if I might comment, I wouldn't want to come across as being opposed to a systemic risk regulator, though I have been characterized as that. I think the point that we were trying to make was that the descriptions of what a systemic risk regulator have been seem redundant to us of what a Federal regulator would be and that some assimilation of that may be appropriate. At a Federal regulatory level, you have greater capability of achieving that than you do in a system of 50 State regulators and trying to overlay that on a global business like reinsurance, where many of the major companies are headquartered in trading partner countries and you need a constitutionally authorized system of recognition between the United States and those countries to deal effectively with global regulatory issues.

Mr. HUNTER. I just wanted to say that Congress—there are some systemic PC issues that Congress needs to study, including bond insurance. Directors and officers insurance is becoming widely unavailable and very high priced for banks. Now, you may try fixing the banks, but if they can't get D&O insurance, what is going to happen? That is a question the guaranty associations issue and reinsurance that can actually melt down beyond reinsurance into the primary market if reinsurers aren't there to back up because of a "black swan" or something with the hurricanes and terrorism all at once or something like that.

Chairman DODD. Very good. Senator Tester?

Senator TESTER. Thank you, Mr. Chairman.

A couple of questions to start with. How many folks on this panel are in favor of the optional Federal charter? Raise your hands.

[Show of hands by Mr. Keating, Mr. Berkley, and Mr. Nutter.]

Senator TESTER. Three. How many of those three are in favor of the premium taxes? Since we are talking a little turf here, we will talk a little money, the premium taxes staying with the State. Raise your hand.

[Show of hands by Mr. Keating, Mr. Berkley, and Mr. Nutter.]

Senator TESTER. OK. The question I have for you three is that there is an historic issue with the Federal Crop Insurance Corporation. When it was first started out, those premium taxes were supposed to go to the State. A long story short, there was a lawsuit that said the State had no reason because they were federally preempted and they no longer could collect those premium taxes anymore. Do you see the same kind of scenario if an optional Federal charter was implemented? Do you see a similar situation with those premium taxes? Mr. Keating?

Mr. KEATING. Senator Tester, you know as a former legislator in your State, and I think probably many of the States represented around this table, premium taxes are a significant part——

Senator TESTER. It is $40 million in Montana, which is a lot of money in Montana.

Mr. KEATING. It is a significant part. But to show you how very frustrated and even desperate some of these companies are to be able to compete on a level playing field with the banks and securities, the companies that we represent are willing to have the premium tax remain in the States. Now, it would be up to the Congress to decide whether or not you someday down the line would ever attempt to preempt. Our view would be we are willing to pay for the cost of regulation for a variety of reasons, and it appears on occasion to be sort of a household spat, but we are an interstate and international marketplace. Our products are virtually the same from sea to shining sea.

For us, and here is one example, I think, that you would be interested in, several years ago, one of the real serious black eyes to the life insurance industry were military base sales, abusive sales practices on military bases. The NAIC said, we have no jurisdiction there to address those, which was horribly frustrating to us because there was no Federal ability to stop it, so we were attempting to do it ad hoc basically industry by industry group, going to try to stop these practices. So that is the frustration we face, Senator.

Senator TESTER. So what you are saying is you believe that the premium tax will be able to stay with the State, that it is a legislative prerogative regardless if it is taken to court?

Mr. KEATING. We certainly concur on that.

Mr. BERKLEY. We have no reason that it shouldn't stay there.

Senator TESTER. OK.

Mr. NUTTER. And Senator, with respect to the reinsurance, generally the reinsurers share in the cost of premium taxes with the underlying ceding company, wherever that tax is paid.

Senator TESTER. OK. So the next question is, and I will focus this back, Mr. Keating, and I would ask you to be a little more concise, but in Montana, and I am sure it is the same way around the country, this money goes to fund the Office of the Insurance Commissioner. So if the optional Federal charter was put into place, that money would have to come from the general fund of the Federal Government and I assume you would be in support of that, for the regulating portion of an optional Federal charter?

Mr. KEATING. We are willing to pay for our regulation.

Senator TESTER. OK. So you would be open to it—to another tax over and above the premium tax?

Mr. KEATING. I don't view that as a tax. I mean——

Senator TESTER. No, that is a fee out of——

Mr. KEATING.——the cost of regulation, because regulation is important——

Senator TESTER. OK. So you would be willing to pay for the additional level of regulation of an optional Federal—is everybody OK with that? All right. Sounds good.

Mr. Hunter, in the questions by Senator Merkley, you had answered a question saying that we may want to revisit parts of Gramm-Leach-Bliley——

Mr. HUNTER. Yes.

Senator TESTER.——to see if it led to some of the AIG-related problems. That is an interesting point. I want you to expand upon it.

Mr. HUNTER. Well, before GOB, the banks and insurance companies could mix, for example, and securities dealers and insurance companies could mix some of the kinds of things that were involved there. They wouldn't have been there. And so I think it is just a question of if we join together all these different financial services, are we really creating a systemic risk situation that wasn't there before? So I think given the current situation, it might be worth another look at the role that GOB played in this.

Senator TESTER. So the next step would be, do you think it is reasonable to, if we are going to take a look at it, to really look at splitting them back out? Do you think that that is a reasonable solution in this——

Mr. HUNTER. If you find that the systemic risk can't be controlled in a joined-together organization, I think that is what Congress should look at, then I think you have to at least consider splitting them back out.

Senator TESTER. All right. I just want to thank all the members of the panel. Thank you very much. I wish we had more time, which we do, but I don't, so thank you very much, Mr. Chairman.

Chairman DODD. Thank you, Senator Tester.

Senator Warner?

Senator WARNER. Thank you, Mr. Chairman. This has been very helpful education-wise for me.

I want to go back to where Senator Corker was heading in trying to understand—I think I have got the frame of the challenge between the State versus the Federal regulation framing. Tell me if anyone on the panel—it does seem that Mr. Nutter's comments about reinsurance being more of a national and international business and less direct involvement on the consumer's standpoint, even if I didn't go as far as Senator Corker did, just from a first impression standpoint, that a Federal regulator at the reinsurance standpoint, particularly because of the international nature of a lot of this reinsurance, makes some sense to me. Give me a counterargument.

Mr. MCRAITH. Senator, I think—Mr. Berkley——

Mr. BERKLEY. Go ahead.

Mr. MCRAITH. OK. Senator, I think it is important to understand that from a regulatory perspective, the quality of reinsurance, particularly on the P&C side, helps a regulator determine the viability or the financial status of a company. So reinsurance involves the seeding of risk by a primary carrier.

Senator WARNER. I understand.

Mr. MCRAITH. In the event that reinsurance is in any way jeopardized or the status or financial condition of the reinsurer is in any way jeopardized, it has a direct impact on consumers.

Senator WARNER. But that again presupposes that you at the State level are going to better be able to assess that national or international reinsurer's ability to pay off that risk than a Federal regulator, doesn't it?

Mr. MCRAITH. You are asking questions that have been the subject of several years of discussion and overwrought commentary at the NAIC and the State regulatory level, and I am happy to report that in December, the States adopted a reform proposal and we are right now implementing details that we intend to present to your

colleagues and you to adopt as a national reinsurance standard for all the States to adopt.

Senator WARNER. I will be anxious to see it, but it would still seem to me that, at least in this area on reinsurance, because of the national and international nature of reinsurance, that a national standard amongst States—you have still got a point to convince me that that is still better than simply repositoring that information or that oversight at a Federal level.

Mr. Nutter?

Mr. NUTTER. Senator Warner, if I could address that, to its credit, the NAIC has endorsed a reform proposal that would ask the Congress to pass legislation to create a single port of entry for non-U.S.-based reinsurers and a single licensing for U.S.-based reinsurers. The challenge for all of that, which goes to your point, is that the constitutional authority to deal with international trading partners in the E.U. or other parts of the world really lies with the Federal Government, and therefore Federal regulation is clearly going to be a preferred way for our country to deal with the global nature of the reinsurance marketplace. Alternatively, we would support the NAIC's approach, but we don't think that is the preferred one.

Senator WARNER. I have got a couple more questions, but my time is about up. Governor Keating, could you share with me one of your earlier comments when you described the life insurance industry, and this is a little off topic, but 18 percent of the corporate bonds, obviously a lot of other long-term holds in the debt market, I have had life insurers come by and because of the uncertainty at this point dramatically increasing the cash portions in their balance sheet and not being participants as actively in the marketplace right now because of regulatory and other concern and saying that many of the programs initiated by the Treasury and the Fed to kind of unlock the credit flows have benefited other areas, but we are leaving out one of the largest purchasers of these debt instruments, the life insurance industry, and I would love to hear your comments on that and what we should be looking at beyond the regulatory standpoint to make sure we get you folks back in the marketplace buying.

Mr. KEATING. Well, Senator Warner, I know metaphors sometimes are tired, but we look upon this really, or should, as a three-legged stool. We have $15 trillion in mutual fund assets, $10 trillion in banking assets, and $5 trillion in life insurance assets. By anybody's definition, that is systemic. The Congress in its wisdom put the life insurance industry in the TARP as a result of that very systemic belief, and yet when we first met with several of our CEOs with then-Secretary Paulson, because we have no Federal presence, Secretary Paulson said, well, I cannot—we don't know your industry. I can't put my arms around your industry. I can't figure out how to do it.

How about maybe a couple or three insurance commissioners? And Mike is a superb insurance commissioner, but the reaction immediately was, well, the other 47 would be mad they are not at the table, or 48. Well, that won't work. So let us make it where you all have to buy a thrift. But remember, this is not for the walking wounded or for terminal cases. These are for robust companies that

will use this money to buy bonds to get the wholesale side of the economy moving again. We have not heard back, because they still can't understand how to put their arms around this industry. And I think for the sake of the country and the growth of the economy, that is a real tragedy.

Senator WARNER. Mr. Chairman, I might add that I think, at least in recent press reports, we are still waiting for the Treasury to give some guidance in this area and an entity that has such a potential stimulative effect in terms of getting the credit markets reopened again, we need them at the table participating and the sooner we can get that answer from the Department on how or why or why not the industry can't participate in the TARP, I think the better for all of us.

Chairman DODD. I agree with that very much——

Senator WARNER. Thank you, Mr. Chairman.

Chairman DODD.——and know that history very well, Governor, and those days. Of course, the irony was in some cases, you had some industries actually out looking to actually get TARP money to buy the thrift in order to qualify to be at the table.

Senator WARNER. Mr. Chairman, I have got an entity that went through that, bought their S&L and then in the transition kind of got left out on the paperwork. It seems a little crazy that they had to go through this additional step to try to benefit from this program that we all want you to be involved in to get these credit markets open. And again, since you hold these for long, long term, these assets that may be not priced very well at this point, but if anybody is going to hold them for a long-term maturity, it seems to be your industry.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Warner.

Senator Johnson?

Senator JOHNSON. Thank you, Senator Dodd. I apologize for coming in late.

Governor Keating, there seems to be some consensus that part of any regulatory modernization proposal must include a systemic risk regulator. Is there a regulator that you believe should begin this responsibility? What powers would this entail, and what kind of sanctions or other tools does this risk regulator need at his disposal?

Mr. KEATING. Well, Senator Johnson, our insistent message is that this industry, this $5 trillion industry benefits to retirees and to near-retirees precisely at a time the economy is suffering from people with limited savings and life insurance policies are used by business partners and staffs for annuitants, to make sure you can live in comfort for the rest of your life. These are very, very important pieces of the economy, and to consider these systemic, as I said to Senator Shelby, is hugely important, whether you focused on individual products that need regulation because of the systemic danger to the system or if you look at the size of the company. That is, of course, at the Senate and Congress's discretion. But we just need to make sure that the very noisy voice of this hugely significant part of the economy is part of that approach.

Senator JOHNSON. For all the witnesses, going forward, what is the most logical way to regulate holding companies of insurance subsidiaries? Mr. McRaith?

Mr. MCRAITH. Thank you, Senator. I think prior to your arrival, there was some discussion. Senator Merkley asked a similar question and I want to pick up on a comment made by Mr. Hunter, and that relates to Gramm-Leach-Bliley, which I know you are familiar with. I think it is important to go back to 1932 and the Glass-Steagall Act, which established those firewalls that served our country so well by separating commercial banks and investment banks insurance companies. And as we look at regulating holding companies with insurance subsidiaries, I think we need to revisit the deterioration of those firewalls that Gramm-Leach-Bliley caused and I think we need to really answer the question of how to best protect consumers and at the same time allow our financial services to grow. There needs to be better regulation at the holding company level and we can be a part of that.

Senator JOHNSON. Governor Keating?

Mr. KEATING. I want to say that during the course of this conversation this morning, Mr. McRaith and I have disagreed on a number of subjects, but on this one we agree, so it is a good way to end our conversation.

Senator JOHNSON. Mr. Berkley?

Mr. BERKLEY. I think that—obviously, I think we need some kind of oversight of holding companies because part of the problem is, and starting with AIG, with sophisticated financial tools, many of those old regulations have disappeared in their effectiveness. So, in fact, what we saw at AIG is the guaranty and the cross-collateralization from the industry companies to their other vehicles created substantial problems. So I think old legislation had the right idea, but I think we would need much more contemporary regulation, which is why we think Federal legislation is really required, because it is a much more sophisticated world we live in today. It is not just corporations under a holding company. It is legal obligations that cross one to another.

Senator JOHNSON. Mr. Houldin?

Mr. HOULDIN. Senator, I certainly think that an overseer is necessary as long as they don't get involved with the day-to-day regulation of insurance. More of a treetop approach certainly makes sense in light of what we have seen.

Senator JOHNSON. Mr. Hill?

Mr. HILL. Yes, Senator Johnson. We think part of the solution would be the establishment of the systemic regulator because we believe by focusing more product-based as opposed to institution-based, that regulator will then be able to foresee the problems that will occur with these various products. I mean, if we look at the sophistication of the credit default swaps, I think having someone with the expertise to regulate those products and products of that nature, that is the solution as opposed to looking to just target a holding company structure per se.

Senator JOHNSON. Mr. Nutter?

Mr. NUTTER. Senator Johnson, the reinsurance sector is probably the most global of the insurance sectors. We have testified that you really do need a Federal regulatory regime that has authority to

enter into agreements with non-U.S.-based regulators in other countries in order to achieve what you are talking about, that is the ability to look at a company holistically, both in the U.S. and outside the U.S.

Senator JOHNSON. Mr. Hunter?

Mr. HUNTER. Thank you, Senator. It is part of the systemic risk. I think the systemic regulator would have to monitor set standards and then be able to bring down a company so that a company would never be too big to fail. Now, that would include the holding company and we think the logical approach is that financial institutions would have capital standards put on them based upon an analysis of their risk and not by just size, but other kinds of things—the type of activities, the interconnection to other financial markets, *et cetera,* and then that would obviously sweep in a holding company if it was part of another arrangement.

Senator Johnson.

[Presiding.] My time has expired. Mr. Shelby, do you have anything?

Senator SHELBY. I have no other questions, Mr. Chairman. I think we had a distinguished panel here today and I think everybody knows what our challenges are. In other words, how do we deal with problems in a new 21st century financial market, is so intertwined. Obviously, when AIG got in real, real trouble, the Feds got problems in dealing with it. The Chairman has said that. The States couldn't really deal with it. There is blame everywhere, but how do we prevent this from happening in the future? I think that's one of our problems, but I think that as we hold more hearings, we are going to see that this is very complex. We know that. And we have got to do this, and whatever we do, we do it right, because I think we are going down the road of looking at a very comprehensive regulator for all our financial system. I can see it coming down, and maybe we can make it happen this year. I hope we can.

Mr. Hunter, you look like you want to comment on something.

Mr. HUNTER. Oh, no, no. I was just enrapt.

Senator SHELBY. OK.

[Laughter.]

Senator SHELBY. I don't think you are in rapture of anything, but Mr. Hunter, do you agree with that, that that is our challenge, and our goal is there——

Mr. HUNTER. Yes. I think you have said it exactly right, Senator.

Senator SHELBY. In other words, we are dealing in the 21st century now.

Mr. HUNTER. Yes.

Senator SHELBY. And we are dealing with all kinds of new products. People think them up. A lot of them have not been approved, so to speak. A lot of people didn't realize the risk out there to our whole financial system. But the risk is real. We are feeling it every day. The taxpayer feels it big today as we speak.

Thank you, Mr. Chairman.

Senator JOHNSON. Senator Merkley, do you have anything else?

Senator MERKLEY. No. Thank you.

Chairman DODD. With that, I thank you for coming and this hearing is adjourned.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR JON TESTER

Thank you, Mr. Chairman, for holding this important hearing. I am pleased to be a member of this Committee as we begin the discussion about the next transportation reauthorization bill.

In Montana, transit—buses especially—are critically important for transportation across the State. When we lose Essential Air Service, or a large air provider pulls out of an airport, it's generally intercity bus service that takes its place to move people hundreds and hundreds of miles across the State.

There's no doubt about it—you cannot have economic development without a smart, effective transportation system. And transit is a key part of that, even in rural America. Five years ago, a significant increase in transit spending allowed rural States like Montana to expand intercity bus service, as well as local transit services, to almost all of our counties. It is critical that we maintain this important funding that has helped safely connect folks in isolated areas to commerce, medical care, and family members. However, there is still more to do. For instance, we must ensure that all paratransit vehicles are wheelchair accessible, and that transportation for veterans is also accessible for vets with disabilities.

In Montana, we also have a high fatality rate for drivers on rural roads. I'd like to see—in the very least—students and elderly folks have access to a safe transit option to get to school, medical appointments, and local meetings.

I appreciate you all coming today. As the Senate begins to look forward to the upcoming transportation reauthorization bill, I am hopeful that our Committee will be able to craft a transit portion that is fair to small and rural communities, where transit ridership has increased dramatically, even as the economy has gone into a downturn. I look forward to working with the new Secretary of Transportation, Secretary LaHood, the Chairman and this Committee to ensure a strong rural component to future transit and transportation infrastructure legislation.

PREPARED STATEMENT OF MICHAEL T. McRAITH

DIRECTOR OF INSURANCE, ILLINOIS DEPARTMENT OF FINANCIAL AND PROFESSIONAL REGULATION, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MARCH 17, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for inviting me. My name is Michael McRaith. I am the Director of Insurance for the State of Illinois, and I testify on behalf of the National Association of Insurance Commissioners (NAIC). I am pleased to discuss efforts to modernize the State-based structure of insurance supervision and to offer a regulator's description of the fit for that system within the broader context of financial regulatory reform.

Having regulated the U.S. insurance industry for over 135 years, State insurance officials have a demonstrable record of successful consumer protection and industry oversight. Consumer protection has been, is and will remain priority one for State insurance officials. Each day our responsibilities focus on ensuring that the insurance safety net remains available when individuals, families and businesses are in need. We advocate for insurance consumers and objectively regulate the U.S. insurance market, relying upon the strength of local, accountable oversight and national collaboration.

With continually modernized financial solvency regulation, State insurance regulators supervise the world's most competitive insurance markets. Twenty-eight (28) of the world's fifty (50) largest insurance markets are individual States within our nation. As a whole, the U.S. insurance market surpasses the combined size of the second, third and fourth next largest markets. More than 2,000 insurers have been formed since 1995—leading to a total of more than 7,661 in the United States—with combined premiums or more than $1.6 trillion. States derive $17.5 billion in taxes and fees from insurers, with approximately 8 percent (8 percent) used to support regulation and the remainder supporting State general funds. With this proud record of success, State insurance regulation constantly evolves, innovates and improves to meet the needs of consumers and industry. My testimony today will focus on the prominent place for State-based insurance regulation within systemic risk regulation and discuss continuing State efforts to improve functional insurance regulation.

Insurance companies are integral capital market participants and are not immune from the unprecedented global economic turmoil. However, insurers have not caused the turmoil and, as a whole, the industry is a source of calm in an otherwise turbu-

lent time. Vigilant, engaged and effective prudential supervision by the States fosters this insurance marketplace stability, and we urge caution in any Federal initiative that may jeopardize the State-based platform for such oversight.

To be clear, any reforms to functional insurance regulation should start and end with the States. Federal assistance may be necessary if targeted to streamline insurance regulator interaction and coordination with other functional regulators, but that initiative should not supplant or displace the State regulatory system. The insurance industry, even in these difficult times, has withstood the collapses that echo through other financial sectors.

States Oversee a Vibrant, Competitive Insurance Marketplace

In addition to consumer protection, State insurance officials are adept stewards of a vibrant, competitive insurance marketplace which, in turn, provides tremendous economic benefits for the States. When State insurance markets are compared to other national insurance markets around the globe, the size and scope of those States' markets—and therefore the responsibility of State regulators—typically dwarfs the markets of whole nations. For example, the insurance market in Connecticut is larger than the insurance markets in Brazil or Sweden. Likewise, the markets in California, New York and Florida are each larger than the markets in Canada, China or Spain, and the markets in Ohio and Michigan are each larger than the markets in India, Ireland or South Africa. Each of these markets demands a local, accountable and responsive regulator.

Systemic Risk: State/Federal Partnership

State insurance regulators support Federal initiatives to identify and manage national and global systemic risk. When defining a "systemically significant" institution, empirical or data-driven factors aid but do not conclude an analysis. As described in the Group of Thirty (G30) report released on January 15, 2009, State insurance regulators agree that four considerations are essential: (1) size, (2) leverage, (3) scale of interconnectedness, and (4) the systemic significance of infrastructure services.[1]

Insurance is one part of a far larger financial services economic sector. Insurance companies are not likely to be the catalyst of systemic risk but, rather, the unfortunate recipient of risk imposed by other financial sectors, as exemplified by the American International Group (AIG).

Given that the U.S. has the world's most vibrant and competitive insurance marketplace, it is unlikely that any one insurer is "too big to fail." If an insurer were to fail, regardless of size, State-based guaranty funds would protect existing policyholders and pay claims. As history demonstrates, competition and capacity allow other insurers to fill marketplace voids left by the failed insurer. States also operate residual markets to cover those unable to obtain an offer of insurance in the conventional market. Therefore, even a major insurer failure, while traumatic in terms of job displacement and, perhaps, for shareholders, will generally not impose systemic risk.

Insurance risk management differs from risk in the banking sector because insurers are generally less leveraged than banks. Less leverage allows insurers to better withstand financial stress. State insurance regulators impose strict rules on the type, quality and amount of capital in which an insurer can invest. Also, insurer liabilities are generally independent of economic cycles in that the ripeness of a claim is not a function of economic conditions. This long-term reality reduces the likelihood an insurer will have to liquidate assets to satisfy short-term obligations.

An insurance business having special interconnectedness to capital markets may be capable of generating systemic risk, however. The financial and mortgage guaranty lines, for example, have encountered difficulty because of mortgage-related securities which, in turn, have adversely impacted public sector and mortgage loan financing.

Even strict accounting and investment standards do not inoculate insurers from the risks of recent systemic failures. A wholesale collapse of the stock market (to a greater degree than what we have recently seen) or the bond market would have a dire effect on insurance companies and could lead to insurance company failures. A collapse of the dollar and rampant inflation would increase claims costs for property and casualty insurers. A mixture of high inflation and a declining economy (stagflation) and low investment returns could create a perfect storm for all aspects of the economy. Regulation, of course, cannot ensure that insolvencies will not occur in extreme circumstances.

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[1] See *Financial Reform, A Framework for Financial Stability,* Group of Thirty, January 15, 2009, p. 19.

Systemic Risk: Functional Regulators Work Together

Unmanaged risk in one sector can deleteriously affect the viability of other sectors. The current financial crisis illuminates the need for a collaborative approach to regulation of financial conglomerates, or those enterprises of such magnitude that a failure would jeopardize the financial stability of an economy, or a segment of an economy. Cooperation and communication among the functional financial services regulators should be formalized in order to harmonize regulatory dialog and efficacy.

State insurance regulators support Federal initiatives to ensure or enhance financial stability, while preserving State-based insurance regulation. Functional regulators can work and coalesce in a manner that protects consumers and promotes financial stability. State regulators support financial stability regulation that incorporates the following principles:

(1) *Primary Role for States in Insurance Regulation:* For systemically significant enterprises, the establishment of a Federal financial stability regulator, *e.g.,* the Federal Reserve, will integrate but not displace State-based regulation of the business of insurance. Consumer access to State-based, local regulatory officials will remain the bulwark of consumer protection. A Federal financial stability regulator will share information and collaborate formally with other Federal and State financial services regulators. Appropriate information sharing authority and confidentiality protocols should be established between all Federal and State financial services regulators, perhaps including law enforcement.

(2) *Formalization of Regulatory Cooperation and Communication:* Federal financial stability regulation should ensure effective coordination, collaboration and communication among the various and relevant State and Federal financial regulators. A Federal financial stability regulator should work with functional regulators and develop best practices for enterprise-wide and systemic risk management. A fundamental aspiration for any supervisory oversight should include the preservation of functional regulation of the business being transacted by each independent entity.

(3) *Systemic Risk Management:* Preemption of functional regulatory authority, if any, should be limited to extraordinary circumstances that present a material risk to the continued solvency of the holding company, or "enterprise," the demise of which would threaten the stability of a financial system. With the experience of decades of an evolving practice, State regulators know that effective regulation inevitably coincides with comprehensive risk management. "Supervisory colleges" can be utilized to understand the risks within a holding company structure, and can be comprised of regulators from each financial services sector represented within the enterprise. The financial stability regulator should operate in a transparent, accountable and collaborative manner, and should defer to the functional regulator in proposing, recommending or requiring any action related to a regulated entity's capital, reserves or solvency. One company within a holding company structure should not be compromised for the benefit of another company within another sector.

American International Group (AIG) exemplifies the circumstance in which systemic stability regulation must be bolstered. All reasonable minds accept as fact that AIG's State regulated insurance businesses did not cause AIG's problems. AIG's Financial Products subsidiaries, though, embraced risks that threaten not only the AIG parent company but also may cause reputational harm to AIG's insurers. AIG's insurance companies were not immune from the ripple effects created by the Financial Products division, as the subsequent downgrade of AIG due to credit default swap exposure put pressure on the insurers' securities lending practices when counterparties attempted to unilaterally terminate those transactions. Despite these challenges and others, AIG's commercial insurance lines—its core insurance businesses—generated significant underwriting profit during 2008.

Subject to State regulatory oversight, insurance companies have weathered these extraordinary economic times relatively well while coping with both natural catastrophes (*e.g.,* Hurricane Dolly, California fires) and challenging marketplace conditions. State regulators caution that partnership with Federal and other functional regulators is not acquiescence to Federal preemption. On the contrary, State insurance regulators have risk management, accounting standards and investment allocation expertise that can inform any Federal initiative.

Office Of Insurance Information (OII)

The most effective way to anticipate and mitigate systemic risk, both within a holding company and within an economy, is to understand where, and to what extent, that risk exists. The Federal Government does need relevant information and

financial data on insurance to facilitate that effort. In its final form during the last Congress, the NAIC supported House legislation creating a Federal Office of Insurance Information (H.R. 5840 from the 110th Congress). The OII would construct an insurance data base within the Department of Treasury and be available to provide directly to the Congress and Federal agencies the encyclopedic insurance-related data and information presently compiled by the States. State regulators worked constructively to narrow the preemption aspects of the initial proposal.

We agree that, as a key component of financial stability, insurance must be factored into an all-inclusive view of the financial system at the Federal level. This shared objective can, of course, be achieved without a Federal insurance regulator and without preempting State authority over the fundamental consumer protections, including solvency standards.

Modernization Proposals: Optional Federal Charter—A Misguided Solution

While contemplating perspectives on insurance regulatory reform, a group of the world's largest insurers continue to advocate for parallel Federal and State regulation. For more than 10 years, insurance industry lobbyists have called for the creation of a massive new Federal bureaucracy known as an optional Federal charter ("OFC"). The current climate of instability and insolvency in the banking sector illustrates this concept cannot work. An optional system where the regulated enterprise chooses the regulator with the lightest touch—as evidenced by AIG—leads to regulatory arbitrage, gaps in supervision, ineffective risk management and disastrous failures.

Through the OFC, some of the largest insurers seek to unravel basic consumer protections and the essential solvency requirements that have nurtured the world's largest and most competitive insurance markets. The State-based system benefits both consumers and industry participants. The facts do not support the need for an OFC—it is a solution in search of a problem.

Modernization Proposals: OFC Alternative—Interstate Insurance Compact

Life insurers argue that life insurance provides wealth protection and, as a product, competes against banking products. This, in turn, warrants a streamlined approval process for entry into the national marketplace. While agreeing with the premise, insurance regulators know that such streamlined regulatory approval cannot come at the cost of consumer protection and solvency regulation. Insurance regulators have worked successfully to bring more cost-effective and sound insurance products to the market more quickly. Central to this effort has been the Interstate Insurance Compact ("the Compact") for filing and regulatory review of life, annuities, long-term care and disability insurance products. The States heard the call for a more competitive framework in the life insurance sector, and have responded.

The Compact is a key State-based initiative that modernizes insurance regulation to keep pace with global demands, while upholding strong consumer protections. Under the Compact, insurers file one product under one set of rules resulting in one approval in less than sixty days that is valid in all Compact Member jurisdictions. This example of State-based reform allows insurers to quickly bring new products to market according to strong uniform product standards. At the same time, the Compact preserves a State's ability to address front-line problems related to claims settlement, consumer complaints, and unfair and deceptive trade practices.

States have overwhelmingly embraced the Compact, as to date 33 States and Puerto Rico have joined by passing enabling legislation.[2] Over one-half of U.S. nationwide premium volume has joined the Compact. More States are expected to come on board in the near future, with legislation pending in Connecticut, New York, New Mexico, and New Jersey.

Modernization Proposals: Producer Licensing Reform

By developing and utilizing electronic applications and data bases, State insurance officials have created much greater efficiencies in licensing insurance producers. Nevertheless, State insurance officials continue efforts to achieve greater uniformity in the producer licensing process.

The National Insurance Producer Registry (NIPR) is a non-profit affiliate of the NAIC that assists regulators and insurers when reviewing an agent or broker li-

[2] Currently, 34 jurisdictions have joined the Interstate Insurance Product Regulation Commission (IIPRC). Compacting members are Alaska, Colorado, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin and Wyoming.

cense. With information on more than 4 million producers, NIPR also provides an electronic format for non-resident producer licensing.

In 2008 State insurance regulators worked with the Independent Insurance Agents and Brokers of America (the "Big I"), and others, to offer refinements on H.R. 5611 ("NARAB 2") designed to achieve the non-resident licensing uniformity goals of the 1999 Gramm-Leach-Bliley Act ("GLB"). While States were in compliance with nearly every aspect of GLB, State regulators continue to work to improve the system and efficiency of producer licensing. The NAIC supported the compromise legislation and continues working with the Big I to address the Constitutional concerns raised by the Department of Justice. Producer licensing is a topic that would benefit from uniformity nationwide, and State regulators are not averse to Federal Government involvement to achieve such uniformity. Our good faith, constructive efforts demonstrate our commitment to achieve the best possible insurance regulatory system.

Modernization Proposals: Surplus Lines and Reinsurance Reform

In both the 109th and 110th Congress, a bill known as the "Non-admitted and Reinsurance Reform Act" (the "Act") was introduced and passed the House of Representatives. Title I of the proposed Act refers to "Non-admitted Insurance." State insurance regulators, through the NAIC, testified publicly in support of uniformity and modernization of surplus lines multi-State placement and recognize the need to improve uniformity for tax collection, form filing and non-admitted carrier eligibility. Working collectively, in April, 2008, State insurance regulators also submitted proposed improvements to Title I of the Act to Senator Jack Reed, Chairman Dodd, and others.

Title II of the Act refers to "Reinsurance" and contains provisions wholly opposed by State regulators. While espousing principles in support of reinsurance reform, the NAIC opposed the Title II provisions as overtly threatening the solvency and other financial standards for ceding carriers. Consumer protection cannot be sacrificed to ease the industry's financial standards. Through the NAIC, State insurance regulators adopted a framework to modernize the regulation of reinsurance in the United States, and are drafting a specific legislative proposal to implement the reforms. State insurance regulators have publicly stated that implementation of the reform will necessarily include Congressional involvement.

Consumer Protections: Strong Prudential Supervision

As the current financial crisis graphically illustrates, effective solvency supervision is the ultimate consumer protection. The concepts of prudential supervision and consumer protection are not severable because the core obligation of an insurer is a promise to pay. Since 1989, when the NAIC adopted a solvency agenda designed to enhance the ability of State regulators to protect insurance consumers from the financial trauma of insurer insolvencies, State insurance departments have continually improved this most elemental consumer protection. At the very core of those improvements is the NAIC's accreditation program, which requires each State to have statutory accounting, investment, capital and surplus requirements embedded in State law to further strengthen the solvency of the industry. Many of these laws increase regulators' ability to identify and act when a company's financial condition has weakened. These laws further benefit from the coordinated activity of the States.

Financial Analysis Working Group

The NAIC's Financial Analysis Working Group ("FAWG") is a confidential, closed-door forum that allows financial regulators to assess nationally significant insurers and insurer groups that exhibit characteristics of trending toward financial trouble. FAWG evaluates whether appropriate supervisory action is being taken.

Through FAWG and other standing committees and reporting mechanisms, States work together and form a complex network of "checks and balances," ensuring that even basic judgments of one primary financial regulator are subject to the oversight of a similarly skilled colleague from another State. These improvements have allowed regulators to identify more easily when insurers are potentially troubled and react more quickly to protect policyholders and consumers.

Solvency II

The myth of the "Solvency II" directive, currently under consideration by the European Union, has been touted as the beacon of global insurance regulatory reform. In fact, Solvency II would lower reserve requirements—appealing to a large insurer, of course—that would threaten the independent solvency standards of U.S.-based insurers. At this moment in our nation's history, given that the paradigm of financial institutions appropriately pricing and managing risk has largely unraveled, a reduc-

tion in reserve requirements for insurers would not serve the interest of the consumer or the investing public. Today's headlines illustrate that an industry motivated by profit and market pressures does not always have the consumer's best interests at heart.

Solvency II is years away from implementation. Under the current timetable, the Directive is not scheduled to be implemented by the various member countries until 2012. However, at this time, even the previously agreed upon standards are being re-evaluated and many will likely be disposed of entirely. Several smaller EU States have expressed reservations about its effect on their resident insurance consumers. Solvency II is far from a reality, even where it originated, and has a lore that far outshines its factual merits.

State regulators are carefully evaluating aspects of Solvency II and principles-based regulation for potential application within the State-based system. We urge careful analysis of any proposal to achieve modernization of insurance supervision in the United States by applying global standards. Even well intended and seemingly benign "equivalence" standards can have a substantial adverse impact on existing State protections for insurance consumers.

Consumer Protections: Local, Personal Response in the States

Consumer protection has been, is, and will remain priority one for State insurance regulators. State insurance supervision has a long history of aggressive consumer protection, and is well-suited to the local nature of risk and the unique services offered by the insurance industry. State regulators live and work in the communities they serve, and respond accordingly. In a year, we resolve 400,000 formal complaints and respond to nearly 3 million consumer inquiries. This kind of consumer-oriented local response is the essential hallmark of State insurance supervision.

Insurance is a uniquely personal and complex product that differs fundamentally from other financial services, such as banking and securities. Unlike banking products, which provide individuals credit to obtain a mortgage or make purchases, or securities, which offer investors a share of a tangible asset, insurance products require policyholders to pay premiums in exchange for a legal promise. Insurance transfers risk while investments and even deposits are an assumption of risk.

Insurance is a financial guarantee to pay benefits, often years into the future, in the event of unexpected or unavoidable loss that can cripple the lives of individuals, families and businesses. The cost to insurers to provide those benefits is based on a number of factors, many of which are prospective assumptions, making it difficult for consumers to understand or anticipate a reasonable price. Unlike most banking and securities products, consumers are often required to purchase insurance both for personal financial responsibility and for economic stability for lenders, creditors and other individuals. Most consumers find themselves concerned with their insurance coverage, or lack thereof, only in times of critical personal vulnerability—such as illness, death, accident or catastrophe. State officials have responded quickly and fashioned effective remedies to respond to local conditions in the areas of claims handling, underwriting, pricing and market practices.

State insurance regulators encourage consumers to be aggressive, informed shoppers. Through the NAIC, State regulators have proactively developed the latest and best tools to educate consumers on important insurance issues. These have included outreach campaigns, public service announcements and media toolkits. With its landmark *Insure U—Get Smart about Insurance* public education program, (*www.insureuonline.org*), the NAIC has demonstrated its deep commitment to educating the public about insurance and consumer protection issues. Insure U's educational curriculum helps consumers evaluate insurance options to meet different life stage needs. Available in English and Spanish, the Insure U Web site covers basic information on the major types of insurance—life, health, auto and homeowners/renters insurance. Insure U also offers tips for saving money and selecting coverage for young singles, young families, established families, seniors/empty nesters, domestic partners, single parents, grandparents raising grandchildren and members of the military.

Conclusion

State insurance regulators, working together through the NAIC, are partners with Congress and the Obama Administration, sharing jointly in pursuit of improvement to the financial regulatory system and, ultimately, improving consumer protections. The State-based insurance regulatory system includes critical checks and balances, eliminating the perils of a single point of failure and opaque or omnipotent decision-making. With a fundamental priority of consumer protection, and with a system that has fostered the world's largest, most competitive insurance market, State insurance regulators embrace this opportunity to build on our proven regime.

The NAIC and its members—representing the citizens, taxpayers, and governments of all fifty States, the District of Columbia and U.S. territories—commit to share our expertise with Congress and to work with members of this Committee, and others. We welcome Congressional interest in our modernization efforts. We look forward to working with you.

Thank you for this opportunity to testify, and I look forward to your questions.

Appendix 1:

State Insurance Regulatory Reform Efforts

Area of Reform	States Response	Status
Life Insurance – Speed-to-Market: Life companies want to get products approved under one set of rules and into the market quickly to keep pace with global demands and to compete with banks.	The Interstate Compact: Creates a single point of speed-to-market filing for life, annuity, long-term-care, and disability insurance. Products are approved by the Compact under Uniform Standards in under 60 days and can be rolled out in every participating State.	34 Jurisdictions have adopted the Compact to date: Alaska, Colorado, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, Pennsylvania, Puerto Rico, Rhode Island, South Carolina (1/1/09), Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.
Solvency Oversight and Accreditation Program	Dramatically enhanced statutory & regulatory authority over the last 15 years through the NAIC accreditation program to ensure strong, harmonized solvency oversight. All accredited States must pass numerous common laws/rules to ensure consistency nationwide.	49 States are now accredited by the NAIC. Reforms have led to a 65 % reduction in insurer insolvencies. Investment holding limitations and disclosure requirements have limited the insurance industry's exposure to the instability in the debt and equity markets today. Standardized accounting and reporting allow for comparability and advanced financial analysis techniques to identify potentially troubled insurers at an earlier date.
Consumer Assistance & Education	Establishment of proactive consumer education program: www.insureuonline.org Bilingual advice about life, health, auto, and homeowners/renters ins. Assistance for families, seniors, military service-members, singles, & domestic partners	Over 850 million impressions since the launch in March of 2006. The program won the American Society of Association Executives' Award of Excellence and was a finalist for a 2007 SABRE Award.
Fraud Detection	Developed online fraud reporting mechanism to allow for interstate coordination Minimized industry data requests & increased	System has allowed for focused fraud detection where problems arise. Continued regulatory collaboration avoids duplicative and excessive data requests that delay responses from the producer and insurer industries and hinder appropriate State regulatory action.

	collaboration	
Rate Form & Filing	NAIC developed the System for Electronic Rate and Form Filing (SERFF). SERFF offers a decentralized point-to-point, web-based electronic filing system. The system is designed to improve the efficiency of the rate and form filing and approval process and to reduce the time and cost involved in making regulatory filings.	Used by 50 States, D.C., Puerto Rico, and 3000+ insurance companies and third parties. • 2001 – 3,694 Filings • 2002 – 25,528 Filings • 2003 – 76,932 Filings • 2004 – 143,818 Filings • 2005 – 183,362 Filings • 2006 – 269,101 Filings • 2007 – 381,377 Filings
Producer Licensing	Conducted nationwide on-site State producer licensing assessment to evaluate State practices for resident and non-resident licensing. Worked with interested parties and Congress on legislation to improve non-resident licensing.	State regulators are committed to non-resident producer licensing reciprocity in all States and will work with Congress as necessary.
Company Licensing	NAIC established the Uniform Certificate of Authority Application, an electronic system and support designed to help insurers navigate State-specific requirements and provide a single entry opportunity when filing in all jurisdictions	Using the UCAA, Berkshire Hathaway was licensed by 49 States in less than 3 months.

PREPARED STATEMENT OF FRANK KEATING

PRESIDENT AND CEO, AMERICAN COUNCIL OF LIFE INSURERS

MARCH 17, 2009

Mr. Chairman and members of the Committee, my name is Frank Keating, and I am President and CEO of the American Council of Life Insurers. The ACLI is the principal trade association for U.S. life insurance companies. Its 340 member companies account for 93 percent of total life insurance company assets, 94 percent of the life insurance premiums, and 94 percent of annuity considerations in the United States.

All sectors of U.S. financial services are at a critical juncture given the current state of the domestic and global markets. I appreciate the opportunity to discuss with you today the views of the life insurance industry on how insurance regulation can be modified to improve the current structure and how insurance regulation can be integrated most effectively with that of other segments of the financial services industry as well as with overall systemic risk regulation.

Addressing systemic risk in the financial markets—both domestically and globally—has emerged as the driving force behind regulatory reform efforts. My comments today reflect that perspective and begin with the premise that the life insurance business is, by any measure, systemically significant.

The Life Insurance Industry Is Systemically Significant

Life insurance companies play a critically important role in the capital markets and in the provision of protection and retirement security for millions of Americans. Life insurers provide products and services differing significantly from other financial intermediaries. Our products protect millions of individuals, families and businesses through guaranteed lifetime income, life insurance, long-term care and disability income insurance. The long-term nature of these products requires that we match our long term liabilities with assets of a longer duration than those of other types of financial companies.

Life insurers are the single largest U.S. source of corporate bond financing and hold approximately 18 percent of total U.S. corporate bonds. Over 42 percent of corporate bonds purchased by life insurers have maturities in excess of 20 years at the time of purchase. The average maturity at purchase for all corporate bonds held by life insurers is approximately 17 years. As Congress and the Administration continue efforts to stabilize the capital markets and increase the availability of credit, the role life insurers play as providers of institutional credit through our fixed income investments cannot be overemphasized. We are significant investors in bank bonds and consequently are an important factor in helping banks return to their more traditional levels of lending.

Life insurers are also the backbone of the employee benefit system. More than 50 percent of all workers in the private sector have life insurance made available by their employers. Life insurers hold approximately 22 percent of all private employer-provided retirement assets.

Our companies employ about 2.2 million people, and the annual revenue from insurance premiums alone was $600 billion in 2007, an amount equal to 4.4 percent of U.S. GDP. Some 75 million American families—nearly 70 percent of households—depend on our products to protect their financial and retirement security. There is over $20 trillion of life insurance coverage in force today, and life insurers hold $2.6 trillion in annuity reserves. In 2007 life insurers paid $58 billion to life insurance beneficiaries, $72 billion in annuity benefits and $7.2 billion in long-term-care benefits.

Individual Company Systemic Risk

We do not presume to suggest to Congress any definitive standard for determining which, if any, life insurance companies have the potential to pose systemic risk. We assume, however, that relevant factors for Congress to consider in this regard would include: the extent to which the failure of an institution could threaten the viability of its creditors and counterparties; the number and size of financial institutions that are seen by investors or counterparties as similarly situated to a failing institution; whether the institution is sufficiently important to the overall financial and economic system that a disorderly failure would cause major disruptions to credit markets or the payment and settlement systems; whether an institution commands a particularly significant market share; and the extent and probability of the institution's ability to access alternative sources of capital and liquidity.

We do offer three general observations in this regard. First, moral hazard and the potential risk of competitive imbalances can be minimized by avoiding a public, bright-line definition of systemic risk and by keeping confidential any role a sys-

temic risk regulator plays with respect to an individual company. Second, systemic risk regulation should have as its goal the identification and marginalization of risks that might jeopardize the overall financial system and not the preservation of institutions deemed "too big to fail." And third, and specific to life insurance, systemic risk regulation must not result in the separation of those elements of life insurance regulation that together constitute effective solvency oversight (*e.g.,* capital and surplus, reserving, underwriting, risk classification, nonforfeiture, product regulation). Having different regulators assume responsibility for any of these aspects of insurance regulation would result in an increase in systemic risk, not a reduction of it.

Structural Considerations

Without a clear indication of how Congress intends to address systemic risk regulation, we make two fundamental assumptions for purposes of this testimony. The first is that the role of a systemic risk regulator will focus on industry-wide issues and on holding company oversight but will not extend to direct functional (solvency) oversight of regulated financial service operating companies (*e.g.,* insurers, depository institutions and securities firms). The second is that the systemic regulator will be tasked with coordinating closely with functional (solvency) regulators and will facilitate the overall coordination of all regulators involved with the oversight of a systemically significant firm.

The absence of a Federal functional insurance regulator gives rise to several important structural questions regarding how systemic regulation can be fully and effectively implemented *vis-a-vis* insurance. We urge Congress to keep these questions in mind as regulatory reform legislation is developed.

Policy Implementation

The first question involves the implementation of national financial regulatory policy. Whatever legislation Congress ultimately enacts will reflect your decisions on a comprehensive approach to financial regulation. Your policies should strongly govern all systemically significant sectors of the financial services industry and should apply to all sectors on a uniform basis without any gaps that could lead to systemic problems.

Without a Federal insurance regulator, and without direct jurisdiction over insurance companies, and given clear constitutional limitations on the ability of the Federal Government to mandate actions by State insurance regulators, how will national regulatory policies be implemented with respect to the insurance industry? The situation would appear to be very much analogous to the implementation of congressional policy on privacy reflected in the Gramm-Leach-Bliley Act. Federal bank and securities regulators implemented that policy for banking and securities firms, but there was no way for Congress to compel insurers to subscribe to the same policies and practices. Congress could only hope that 50+ State insurance regulators would individually and uniformly decide to follow suit. Hope may have been an acceptable tool for implementing privacy policy, but it should not be the model for reform of U.S. financial regulation. The stakes are much too high.

Coordination of Systemic and Functional Regulators

As noted above, we assume that one aspect of effective systemic risk regulation will be close coordination between the systemic risk regulator and the functional (solvency) regulator(s) of a systemically significant firm. Moreover, we assume that the systemic regulator will be called upon to interact with the functional regulators of all financial service industry sectors to address sector risks as well as risks across sector lines. For firms deemed systemically significant, we also assume there will be a Federal functional regulator with whom the Federal systemic regulator will coordinate.

If there are insurance firms that are deemed systemically significant, the question arises as to how the Federal systemic risk regulator will be able to coordinate effectively with multiple State insurance regulators? How will Federal policy decisions be effectively coordinated with State regulators who need not adhere to those policy decisions and who may differ amongst themselves regarding the standards under which insurance companies should be regulated?

International Regulation and Coordination

Today's markets are global, as are the operations of a great many financial service firms. Consequently, systemic risk regulation necessarily involves both domestic and global elements. While State insurance regulators are certainly involved in discussions with financial regulators from other countries, they do not have the authority to set U.S. policy on insurance regulation nor do they have the authority to negotiate and enter into treaties, mutual recognition agreements or other binding agree-

ments with their foreign regulatory counterparts in order to address financial regulatory issues on a global basis. How can multinational insurance companies be effectively regulated and how can U.S. policy on financial regulation—systemic or otherwise—be coordinated and harmonized as necessary with other countries around the globe?

Regulators, central governmental economic policymakers and legislators in Europe, Japan, Canada and many other developed and developing markets point to the lack of a comprehensive Federal-level U.S. regulatory authority for financial services as one factor that led to the current instability of at least one of the largest U.S. financial institutions. Discussions at the upcoming G20 meetings in London will focus on the need to coordinate a global response to the economic crisis will include representatives of the comprehensive financial services regulators of 19 nations, with the only exception being the U.S. because of its lack of a Federal regulator for insurance.

The G20 work plan includes mandates for two working groups. The first is tasked with monitoring implementation of actions already identified and making further recommendations to strengthen international standards in the areas of accounting and disclosure, prudential oversight and risk management. It will also develop policy recommendations to dampen cyclical forces in the financial system and address issues involving the scope and consistency of regulatory regimes. The second working group will monitor actions and develop proposals to enhance international cooperation in the regulation and oversight of international institutions and financial markets, strengthen the management and resolution of cross-border financial crises, protect the global financial system from illicit activities and non-cooperative jurisdictions, strengthen collaboration between international bodies, and monitor expansion of their membership.

We believe Congress needs to fill this systemic regulatory gap through the creation of a Federal insurance regulatory authority like every other member of the G20. This Federal authority is necessary so there can be a comprehensive approach to systemic risk allowing U.S. regulators to respond to a crisis nimbly and in coordination with other major global regulators. Only in this way will policymakers and regulators have confidence in the equivalency of supervision, and the authority to share sensitive regulatory information and the ability to provide mutual recognition as appropriate.

Monitoring the U.S. Financial System

A significant aspect of the mission statement of the Treasury Department is ensuring the safety, soundness and security of the U.S. and international financial systems. Long before the advent of the current economic crisis, the Treasury Department found it difficult to derive a clear and concise picture of the health of the insurance industry. In considering steps that might be taken to enhance the ability of Treasury to carry out these objectives—which now appear far more important than in the past—one must ask how, absent a Federal functional regulator with an in-depth understanding of the industry, vital information on the insurance industry can be effectively collected and analyzed?

The Effects of Federal Decisions on a State Regulated Industry

As Congress considers how to address systemic risk regulation and how it might be applied to the insurance industry, it is important to take into account the ramifications of recent Federal actions on the industry. Crisis-related decisions at the Federal level have too often produced significant adverse effects on life insurers. Examples include: the handling of Washington Mutual which resulted in life insurers, as major bond holders, experiencing material portfolio losses; the suspension of dividends on the preferred stock of Fannie Mae and Freddie Mac and the fact life insurers were not afforded the same tax treatment on losses as banks, which again significantly damaged the portfolios of many life insurance companies and directly contributed to the failure of two life companies; the badly mistaken belief on the part of some Federal policymakers that mark-to-market accounting has no adverse implications for life insurance companies when in fact its effects on these companies can be more severe than for most other financial institutions; and more recently the cramdown provisions in the proposed bankruptcy legislation that could potentially trigger significant downgrades to life insurers' Triple-A rated residential mortgage-backed investments.

These actions were all advanced with the best of intentions, but in each instance they occurred with little or no understanding of their effects on life insurers. And in each instance the only voice in Washington raising concerns was that of the industry itself. In this stressed market environment, legislators or policymakers can ill-afford miscues resulting from a lack of information on, or a fundamental mis-

understanding of, an important financial industry sector. Actions taken without substantial input from an industry's regulators carry with them a much higher likelihood of unintended and adverse consequences. Insurance is the only segment of the financial services industry that finds itself in this untenable position as decisions critical to our franchise are debated and decided in Washington.

Conclusion

There is no question that assuring the stability of our payment system is of paramount concern. However, reforming U.S. financial regulation and advancing initiatives designed to stabilize the economy must take into account the interests and the needs of all segments of financial services, including life insurance. Unfortunately, the absence of a Federal insurance regulator all too often means that we are afterthought as these important matters are advanced. We urge Congress to recognize the systemic importance of our industry to the economy and to the retirement and financial security of millions of consumers and tailor reform and stabilization initiatives accordingly. Failure to do so runs the very real risk of doing grave harm to both. We pledge to work closely with this Committee and with others in Congress to provide you with factual, objective information on the life insurance business along with our best ideas on how a comprehensive and effective approach to regulatory reform can be implemented. I am sure we all share the goals of maintaining confidence and strength in the life insurance business and restoring stability to the entire spectrum of U.S. financial services.

PREPARED STATEMENT OF WILLIAM R. BERKLEY

CEO OF W.R. BERKLEY CORPORATION, ON BEHALF OF
THE AMERICAN INSURANCE ASSOCIATION

MARCH 17, 2009

Thank you, Chairman Dodd, Ranking Member Shelby, and members of the Committee. My name is Bill Berkley. I am the CEO of W.R. Berkley Corporation, a multi-billion dollar commercial lines property-casualty insurance and reinsurance group that I founded in 1967, which is headquartered, Mr. Chairman, in Greenwich, Connecticut. I am testifying today not just as CEO of W.R. Berkley, but as Chairman of the Board of the American Insurance Association. I appreciate the opportunity to be here to discuss issues of great importance during this time of economic upheaval and to participate in the important work of reshaping our regulatory landscape to confront future challenges and protect insureds.

I believe that I bring a unique and broad perspective to this discussion. I have been involved in the insurance business as an investor or manager for over 40 years. I am a leading shareholder of insurance companies that protect U.S. businesses of all sizes from the risk of loss and that provide reinsurance, but I am also a majority shareholder of a nationally chartered community bank. I have witnessed the ebbs and flows of business cycles during that time, with the only constants being the existence of risk and the need to manage it. It is that challenge that brings us here today—the imperative of examining, understanding and measuring risk on an individual and systemic level—and retooling the financial regulatory structure to be responsive to that risk, recognizing that you cannot forecast every problem.

With that context in mind, I would like to focus my remarks today on three major themes:

1. Property-casualty insurance is critical to our economy, but it does not pose the same types of systemic risk challenges as most other financial services sectors.
2. Nonetheless, because property-casualty insurance is so essential to the functioning of the economy and is especially critical in times of crisis and catastrophe, functional Federal insurance regulation will enhance the industry's effectiveness and thus should be included as part of any well-constructed Federal program to analyze, manage and minimize systemic risk.
3. Given the national and global nature of risk assumed by property and casualty insurers, establishment of an independent Federal insurance regulator is the only effective way of including property-casualty insurance in such a program.

Property-casualty insurance is essential to the overall well-being of the U.S. economy. Insurance contributes 2.4 percent to the annual GDP, with property-casualty insurance accounting for more than $535 billion in capital, purchasing close to $370 billion in State and municipal bonds, paying almost $250 billion annually in claims and, importantly, directly or indirectly employing 1.5 million hard-working Americans. Because property-casualty insurance protects individuals and businesses

against unforeseen risks and enables them to meet financial demands in the face of adversity, it is the engine that propels commerce and innovation. Without the critical coverage provided by property-casualty insurance, capital markets would grind to a halt: Main Street and large businesses alike.

While property-casualty insurance plays an essential role in our economy, it has been successfully weathering the current crisis. It has had to carefully navigate through some heavy turbulence to do so, but the sector remains strong overall, today. There are several reasons for that, but importantly property-casualty insurance operations are generally low-leveraged businesses, with lower asset-to-capital ratios than other financial institutions, more conservative investment portfolios, and more predictable cash outflows that are tied to insurance claims rather than "on-demand" access to assets.

Yet, despite the industry's relative stability in this crisis, there are compelling reasons to establish Federal functional regulation for property-casualty insurance in any regulatory overhaul plans even though it has not presented systemic risk. The industry could always face huge, unforeseen, multi-billion dollar loss events such as a widespread natural disaster or another terrorist attack on U.S. soil. It makes little sense to look at national insurance regulation *after* the event has already occurred, but all the sense in the world to put such a structure in place to help either avoid the consequences of an unforeseen event altogether or to temper them through appropriate Federal mechanisms, ultimately minimizing potential industry disruption.

However this Committee resolves the debate on Federal systemic risk oversight, the only effective way to include property-casualty insurance would be to create an independent Federal functional insurance regulator that stands as an equal to the other Federal banking and securities regulators.

I continue to believe this after much deliberation and with great respect for the State insurance regulatory community. The State-based insurance regulatory structure is inevitably fragmented and frequently not well-equipped to close the regulatory gaps that the current crisis has exposed. Each State only has jurisdiction to address those companies under its regulatory control, and only to the extent of that control. Even where the States have identical insurance codes or regulations, the regulatory outcomes may still be inconsistent because of diverse political environments and regulatory interests. If this crisis has revealed anything, it is the need for more—not less—regulatory efficiency, coordinated activity or tracking, sophisticated analysis of market trends and the ability to anticipate and deal with potential systemic risk before the crisis is at hand.

In addition, virtually all foreign countries have national regulators who recognize that industry supervision goes well beyond a focus on solvency. Effective contemporary regulation also must examine erratic market behavior by companies in competitive markets to ensure that those markets continue to function properly and do not either encourage other competitors to follow the lead of irrational actors or impede the competitive ability of well-managed enterprises. Further, the U.S. Constitution prevents the States from exercising the foreign affairs and foreign commerce powers. Therefore, if we are to coordinate with other nations and their financial regulators to address global crises like the current one, we need a single insurance voice at the Federal level to do so. In sharing these observations, I want to be clear: This is not a criticism of State regulators; it is a conclusion about the inevitable limitations and gaps inherent in separate State regulation from one who has been in the business for decades.

Equally important, functional Federal insurance regulation allows a single agency to be well-informed about all of the activities within the insurance sector, including those types of unforeseen mega-events that could affect other sectors of the economy. It also provides the foundation for equitable regulatory action in times of crisis and when the insurance sector is functioning normally. As even-handed as every State regulator may try to be, without the broadest responsibility exercised by a national regulator, we cannot expect to get that treatment where issues affect more than one State. The reality is that no one State can effectively deal with mega-events or cross-border issues equally, and among multiple States, the ability to deal with such events or issues on a global level declines dramatically.

A centralized regulator at the Federal level would also have authority to examine the related issue of mathematical models. The methods of examining and measuring risk have undergone significant evolution during my 40-plus years in the insurance business. I believe there has been a growing and unhealthy over-reliance on numbers-driven models in the assumption of risk, and to the use of these models to the exclusion of common sense and underwriting experience. Although such models have an important role in insurance like they do in other financial services industries, risk evaluation and management inevitably suffer where such models are used in a vacuum.

The AIA and its members have long supported the National Insurance Act sponsored by Senator Johnson as the right vehicle for smarter, more effective functional Federal insurance regulation. That bill already focuses on safety and soundness supervision, financial regulation, and rigorous market conduct oversight as core consumer protections. It even requires the national insurance commissioner to conduct an enterprise-wide review of financial data when examining national insurers. This—in and of itself—importantly distinguishes the National Insurance Act from current State regulation.

Yet, we recognize that even the best legislative vehicle must be updated to be responsive to the evolving economic climate and to enhance strong consumer protections. As a result, we support amending the legislation to prevent even the theoretical ability of insurers to "arbitrage" the Federal and State regulatory systems by switching back-and-forth to try and escape enforcement actions.

Let me close by thanking the Committee again for opening the dialog on this critical subject. The time is ripe for thoughtful, measured, but decisive action. We stand ready to work with you on a regulatory system that restores confidence in our financial system.

PREPARED STATEMENT OF SPENCER M. HOULDIN

ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS AND BROKERS OF AMERICA

MARCH 17, 2009

Good morning Chairman Dodd, Ranking Member Shelby, and Members of the Committee. My name is Spencer M. Houldin, and I am pleased to be here today on behalf of the Independent Insurance Agents and Brokers of America (IIABA). Thank you for the opportunity to provide our association's perspective on insurance regulatory modernization. I serve as Chairman of the IIABA Government Affairs Committee as well as the Connecticut representative on the IIABA Board of Directors. I am also President of Ericson Insurance, a Connecticut-based independent agency that offers a broad array of insurance products to consumers and commercial clients across the country.

IIABA is the nation's oldest and largest trade association of independent insurance agents and brokers, and we represent a network of more than 300,000 agents, brokers, and employees nationwide. IIABA represents small, medium, and large businesses that offer consumers a choice of policies from a variety of insurance companies. Independent agents and brokers offer a broad range of personal and commercial insurance products. Specifically regarding commercial property-casualty insurance, and some may be surprised to learn this, independent agents and brokers are responsible for over 80 percent of this market segment.

Introduction

Over the past several months, we have endured and continue to experience a financial crisis that few of us could ever have envisioned. We have seen the Federal Government take unprecedented action and spend hundreds of billions of dollars in attempts to rectify the problems and right our country's economic ship. And, unfortunately, we all know that our troubles are not over. We must carefully examine the causes of the current crisis, and determine how or if regulatory policy should change to ensure we do not repeat the mistakes of the past. It is a daunting task, and as a small businessman who must conduct business in the regulatory environment of the future, I implore policymakers to act judiciously and make sure that when you act, you get it right. Change for change's sake may result in regulations that do not further protect consumers, help to promote solvency or successfully address systemic threats.

It is too soon to gauge the effectiveness of the substantial Federal actions of the past year, but policymakers must remain mindful of the moral hazard implications of such significant Federal intervention. We should strive for a system that promotes market discipline and protects taxpayers in the future. Much has gone wrong in the recent past, but there is still much which is very good in the current regulatory framework. I ask you to keep this in mind as you move forward.

For a variety of reasons that I will outline in the course of my testimony, the insurance sector (and the property-casualty industry in particular) is weathering the financial storm with greater success than the banking, securities, and other elements of the financial services world. The insurance arena is certainly not immune from the effects of the current crisis, but I am happy to report that my business and much of the insurance marketplace remains healthy and stable. Accordingly, as you consider how to address this financial crisis in the short-term and begin the process of considering broader reforms to protect against similar problems in the fu-

ture, I urge the Committee to be mindful of the differences between the recent experiences of the insurance industry and the other financial sectors and to be judicious and precise in your actions. While the insurance business would unquestionably benefit from greater efficiency and uniformity in regulation, we should be extremely cautious in the consideration of wholesale changes that could have an unnecessarily disruptive effect on the industry. Unlike other financial services markets, the insurance market, particularly property-casualty, is stable and does not need risky indiscriminate change of its current regulatory system. IIABA also believes that it is critically important to keep in mind how potential regulatory changes could impact small businesses. We want to ensure that there are no unintended consequences to main street businesses from regulatory reform, especially in light of the fact that a lot of attention and discussion of this crisis and reform has centered on large financial institutions.

Some of my industry colleagues believe that now is the time to pursue deregulatory proposals and to establish a new and untested functional Federal regulator for the insurance industry. IIABA has long believed that the establishment of an optional Federal charter (OFC) system is misguided and will result in regulatory arbitrage, with companies choosing how and where they are regulated thereby pitting one regulatory system against the other in a race to the bottom. Such a proposal, which turns its back on over a century of successful consumer protection and solvency regulation at the State level, seems to make little practical sense in this current market environment. Some industry proponents are trying to use the failure of American International Group (AIG) to promote OFC and its deregulation of the insurance market. While AIG's troubles may strengthen the call for systemic risk oversight at the Federal level, we believe that the health of AIG's property-casualty insurance units, which were and are heavily regulated at the State level, point to the stability of the property-casualty marketplace. Improvements can certainly be made to insurance regulation (and are perhaps overdue), but State regulators have done and continue to do a solid job of ensuring that insurance consumers are protected and receive the insurance coverage they need.

Today, I would like to provide IIABA's perspective on the financial services crisis, paying particular attention to the stability of the property-casualty insurance market in comparison to other financial services sectors. Central to the health of this market is the success of State regulation and its strong consumer protections—the primary goal of insurance regulation. I will therefore discuss the dangers of making blanket regulatory changes that could disrupt this system that works well to protect consumers and ensure market stability. With that said, though, no regulatory system is perfect, so I also will discuss methods that can be used to modernize and improve State insurance regulation. I will also provide IIABA's opinions on how best to address the issue of systemic risk and how to provide the insurance market with both a Federal and international voice without altering the day-to-day regulation of insurance.

Financial Services Crisis

Healthy Property-Casualty Market

The recent economic crisis has impacted nearly every sector of the financial services industry, from small local financial institutions to the largest financial services conglomerate in the world. Few have been left unscathed, and it is clear that all participants in this broad market, regardless of responsibility, must work together to pull us out of this mess and make sure that we take precautions to prevent this from happening again. While IIABA is committed to helping improve the system, it is worth noting that relative to other segments of the financial services industry, the property-casualty insurance market has remained solid and vibrant. Even though, like most Americans, the property-casualty market has suffered investment losses due to the stock market decline, earlier this month A.M. Best reported that the outlook for the U.S. commercial and personal lines insurance markets remains stable. As we continue to endure almost daily bad news regarding some of our largest and most complex financial institutions, the property-casualty insurance market continues healthy operations and has not been a part of the overall crisis. In fact, while approximately 40 banks have failed since the beginning of 2008, there has not been one property-casualty insurer insolvency during this time. Additionally, since the implementation of the Troubled Assets Relief Program (TARP) late last year, not one property-casualty insurer has sought access to these Federal funds. **In short, the property-casualty insurance industry continues to operate without the need for the Federal Government to step in to provide *any* type of support.**

Along with being financially sound, it is also widely acknowledged that the property-casualty insurance industry today is intensely competitive and has sufficient

capital to pay potential claims. In 2007, there were over 2,700 property-casualty insurance companies operating in the United States. Policy surpluses are at solid levels and credit ratings have remained stable with actually more property-casualty upgrades than downgrades in ratings during the past year. IIABA therefore believes that given the current health of the property-casualty market, policymakers should resist any temptation to enact measures that could unbalance this competitive environment and jeopardize the level of solvency regulation and consumer protection currently being provided.

AIG

While property-casualty insurers are financially healthy, some groups have pointed to the failure of AIG and the Federal Government's commitment of over $180 billion to this conglomerate to somehow suggest that the insurance industry is unstable and in need of sweeping regulatory restructuring. Others have used the problems of AIG to justify and resuscitate imprudent proposals, such as measures to establish an OFC for the insurance market or to mandate day-to-day Federal regulation of insurance. It is important to remember that AIG's property-casualty insurance subsidiaries have been, and continue to be, healthy and stable and were not the cause of its failure.

AIG is a unique institution in the financial services world and an anomaly in the insurance industry. Only approximately 1/3 of its subsidiaries were insurance-related, and it played heavily in exotic investments and made gigantic unhedged bets on credit default swaps (CDSs), which are unregulated at the Federal and State level. The catalyst of AIG's downfall was problems with its London-based Financial Products division (the main AIG player in CDSs), the collateral calls on those CDS transactions, and the rush of others to separate themselves from the company once its credit ratings were downgraded. These factors created a liquidity crunch for AIG and led to the Federal Government's decision to step in and attempt to save this company. It is true that AIG experienced significant losses with its securities lending operations related to its life insurance subsidiaries. However, these losses became a Federal concern because of the larger problems facing the company. Quite simply, AIG is not Exhibit A for a functional Federal insurance regulator, because there is no reason to believe that such a Federal regulator would have handled AIG's issues in a more effective manner that would have averted its collapse. It certainly does *not* make the case for an optional Federal charter, where AIG could have chosen where it was regulated. In fact, the Office of Thrift Supervision admitted in testimony in front of this Committee just twelve days ago that it was the consolidated supervisor of AIG and, by extension, the operations of AIG's Financial Products division. Clearly then, just the fact that an entity is federally regulated does not mean that it is effectively and responsibly regulated. Despite the fact that AIG's property-casualty insurance subsidiaries were sufficiently capitalized and likely had substantial assets that would have more than covered claim obligations if the overall company had failed, one of the lessons you can take from AIG is that systemic risk oversight may be necessary to prevent this from happening in the future.

State Insurance Regulation Protects Consumers

Policymakers have made it clear that financial services regulatory reform—including a debate over how to address systemic risk—is at the top of the agenda for this year and rightfully so. But as we undertake a review of current regulations in place and consider strengthening existing laws or adding additional ones, we must ensure that we do not simply toss out regulatory systems that work in an effort essentially to wipe the slate clean and start over. Unlike some Federal regulators of other financial industries, State regulators have done a commendable job in the area of financial and solvency regulation, which ensures that companies meet their obligations to consumers, and IIABA is concerned that direct Federal regulation of insurance would not provide the same level of protection. Insurance regulators' responsibilities have grown in scope and complexity as the industry has evolved, and State regulatory personnel now number approximately 13,000 individuals. Most observers agree that State regulation works effectively to protect consumers, which has been proven once again during this crisis.

State officials also continue to be best-positioned to be responsive to the needs of the local marketplace and local consumers. Unlike most other financial products, which are highly commoditized, the purchaser of an insurance policy enters into a complex contractual relationship with a contingent promise of future performance. Therefore, the consumer will not be able to determine fully the value of the product purchased until after a claim is presented—when it is too late to decide that a different insurer or a different product might have been a better choice. When an insured event does occur, consumers often face many challenging issues and per-

plexing questions; as a result, they must have quick and efficient resolution of any problems. If one believes that a Federal regulator would better handle consumer issues, consider that according to the most recent annual numbers, the Office of the Comptroller of the Currency (OCC) received more than 90,000 calls, compared to just the New York State Insurance Department alone that responded to 200,000 calls (nationally there are over 3,000,000 consumer inquiries and complaints annually).

Unlike banking and securities, insurance policies are inextricably bound to the separate legal systems of each State, and the policies themselves are contracts written and interpreted under the laws of each State. Consequently, the constitutions and statute books of every State are thick with language laying out the rights and responsibilities of insurers, agents, policyholders, and claimants. State courts have more than 100 years of experience interpreting and applying these State laws and judgments. The diversity of underlying State reparations laws, varying consumer needs from one region to another, and differing public expectations about the proper role of insurance regulation require officials who understand these local complexities. What would happen to this body of law if insurance contracts suddenly became subject to Federal law? How could Federal courts replicate the expertise that State courts have developed? How would Federal bureaucrats be able to quickly develop knowledge of regional differences that are embedded in State insurance laws? These are some of the extremely difficult issues that could be posed by direct Federal insurance regulation.

Protecting policyholders against excessive insurer insolvency risk is one of the primary goals of State insurance regulation. If insurers do not remain solvent, they cannot meet their obligations to pay claims. State insurance regulation gets very high marks for the financial regulation of insurance underwriters. State regulators protect policyholders' interests by requiring insurers to meet certain financial standards and to act prudently in managing their affairs. The States modernized financial oversight in the 1990s and have a proven track record of solvency regulation. When insolvencies do occur, a State safety net is employed: the State guaranty fund system. If the worst case scenario does occur and an insurer does fail, other companies are well positioned to fill the gap as the marketplace is very competitive with many insurers competing for business. Additionally, it should not be overlooked that the State system has an inherent consumer-protection advantage in that there are multiple regulators overseeing an entity and its products, allowing others to notice and rectify potential regulatory mistakes or gaps. Providing one regulator with all of these responsibilities, consolidating regulatory risk and essentially going against the very nature of insurance of spreading risk, could lead to more substantial problems where errors of that one regulator lead to extensive problems throughout the entire market.

Systemic Risk Oversight

Along with the discussion of AIG and other financial services conglomerates that have been considered "too big to fail" or "too interconnected to fail" is the consideration of risks to the entire financial services system as a whole. While a clear definition of systemic risk has yet to be agreed upon, IIABA believes the crisis has demonstrated a need to have special scrutiny of the limited group of unique entities that engage in services or provide products that could pose systemic risk to the overall financial services market. Federal action therefore is likely necessary to determine and supervise such systemic risk concerns.

Coupled with the stability of the insurance markets and the strength of State regulation, though, is the fact that few, if any, participants in the property-casualty market and few, if any, lines of property-casualty insurance, save for financial guaranty insurance, raise systemic risk issues. Again, the regulatory structure in place at the State level, specifically the State guaranty fund mechanism, and the general nature of the insurance business make it unlikely that a systemic risk to the financial services industry could emanate from property-casualty insurance markets. Therefore, while there may be a need to have some form of limited systemic risk oversight for a certain class of unique financial services entities at the holding company level, such oversight should not displace or interfere with the competent and effective level of functional insurance regulation being provided today. To avoid mission creep, any systemic risk regulator should have carefully defined powers and operate under a tight definition of what entities or activities are systemically significant. Such an entity should have the authority to receive data, analyze risk and at all times work through existing State regulators if problems are identified, but should not engage in day-to-day insurance regulation.

As mentioned above, States already have strong financial and market regulations in place for insurers and effective solvency regulations to protect consumers. IIABA

is concerned that the insurance market could be grouped with other financial services industries under a systemic risk umbrella that could include insurer solvency regulation. While IIABA is not in the position to assess whether other financial services industries need more effective solvency regulation at the Federal level, insurance solvency regulation, especially for the property-casualty segment, should remain the province of the functional regulators—the States.

In the discussion of systemic risk and the need for more Federal insurance expertise, IIABA also believes that consideration should be given to establishing an Office of Insurance Information. This office could fill the void of insurance expertise at the Federal level and help solve the problems faced by insurance industry participants in the global economy. This legislation also is an example of the type of Federal reforms that are needed for the insurance market—Federal legislation that mandates uniformity where needed and when necessary via preemption and national standards without creating a Federal regulator.

Targeted Insurance Regulatory Reform

While State regulation continues to protect consumers and provide market stability, IIABA has long promoted the use of targeted measures by the Federal Government to help reform the State system in limited areas. However, Congress should only modernize the components of the State system that are working inefficiently and no actions should be taken that in any way jeopardize the protection of the insurance consumer. We believe that the best method for addressing the deficiencies in the current system continues to be a pragmatic approach that utilizes targeted legislation to establish greater interstate consistency in key areas and to streamline oversight. By using limited Federal legislation on an as-needed basis to overcome the structural impediments to reform at the State level, we can improve rather than dismantle or seriously impair the current State-based system and in the process produce a more efficient and effective regulatory framework. Especially given today's tough economic environment, such an approach would not jeopardize or undermine the knowledge, skills, and experience of State regulators by implanting an unproven new regulatory structure. Unlike other ideas, such as OFC, this approach does not threaten to remove a substantial portion of the insurance industry from local supervision.

The most serious regulatory challenges facing insurance producers (agents and brokers) are the redundant, costly, and sometimes contradictory requirements that arise when seeking licenses on a multi-State basis, and the root cause of these problems is the fact that many States do not issue licenses on a consistent or truly reciprocal basis. State law requires insurance agents and brokers to be licensed in every jurisdiction in which they conduct business, which forces most producers today to comply with varying and inconsistent standards and duplicative licensing processes. These requirements are costly, burdensome, and time consuming, and they hinder the ability of insurance agents and brokers to effectively address the needs of consumers.

To rectify this problem, IIABA strongly supports targeted legislation that would immediately create a National Association of Registered Agents & Brokers (NARAB), as first proposed in the Gramm Leach Bliley Act in 1999, to streamline nonresident insurance agent licensing. This approach would be deferential to States' rights as day-to-day State insurance statutes and regulations, such as laws regarding consumer protection, would not be preempted. By employing the NARAB framework already passed by Congress and utilizing the experiences and insights obtained over recent years to modernize this concept, Congress can help policyholders by increasing marketplace competition and consumer choice through enabling insurance producers to more quickly and responsively serve the needs of consumers. Such reform would eliminate barriers faced by the increasing number of agents who operate in multiple States, establish licensing reciprocity, and create a one-stop facility for those producers who require nonresident licenses. The NARAB Reform Act, which passed the House last year with broad industry and bipartisan congressional support, incorporates these principles and accomplishes the goal of agency licensing reform, and IIABA strongly supports this legislation.

IIABA also supports targeted legislation to apply single-State regulation and uniform standards to the nonadmitted (surplus lines) and reinsurance marketplaces. As with the admitted market, surplus lines agents and brokers engaging in transactions that involve multi-State risks currently must obtain and maintain general agent or broker licenses and surplus lines licenses in many if not every jurisdiction in which the exposures are located. Some States require that these agents and brokers obtain and maintain corporate licenses as well. This means that a surplus lines broker or agent could potentially be required to obtain and maintain up to 100 separate licenses in order to handle a single multi-State surplus lines transaction. These

duplicative licensing requirements cause administrative burdens which impede the ability of agents and brokers to effectively and efficiently service their customers' policies. Perhaps most importantly, these onerous licensing requirements create expenses which ultimately impact policyholders. The Nonadmitted Insurance and Reinsurance Reform Act alleviates the burdens of duplicative licensing requirements by relying on the insured's home State for licensing. IIABA is a strong supporter of this targeted Federal legislative reform.

Optional Federal Charter

I am actually quite surprised that, given the economic crisis in which we find ourselves today, I have to address the issue of an optional Federal charter for insurance. Most policy leaders seem to be in agreement that regulated entities should not be able to engage in regulatory arbitrage, where one regulator is pitted against another in a race for the regulated institution. An OFC would set up a system that would allow just that scenario to occur—under OFC a company like AIG could have avoided strong regulation by choosing where it was regulated. This clearly would only have exacerbated problems, not solved them. OFC legislation also would deregulate several areas currently regulated at the State level, flying in the face of the nearly universal call today for stronger or more effective regulation of the financial services industry. IIABA therefore continues to oppose this illogical call for a regulatory system that has the potential to negatively impact a market relatively unaffected by the recent crisis.

Most importantly, we oppose OFC because it would worsen the current financial crisis as its theory of regulatory arbitrage has been cited as one of the key reasons why we find ourselves in the current situation. In announcing his seven principles for financial services regulatory reform on February 25th, President Barack Obama said his sixth principle is that "we must make sure our system of regulations covers appropriate institutions and markets, and is comprehensive and free of gaps, and prevents those being regulated from cherry-picking among competing regulators." And just last Thursday, Treasury Secretary Timothy Geithner said one of the problems with the current financial regulatory system is that financial institutions were allowed to choose their regulators and create products in a way so as to avoid regulation. He said it is important to create a new regulatory structure that prevents "this kind of regulatory arbitrage." can't say it any better than they have, but I will just pose this one question, does anyone really think that allowing AIG to choose where it was regulated, the Federal or State level, would have solved their problems?

Creating an industry-friendly optional regulator, as OFC legislation is expected to provide, also is at odds with one of the primary goals of insurance regulation, which, as discussed earlier, is consumer protection. The best characteristics of the current State system from the consumer perspective would be lost if some insurers were able to escape State regulation completely in favor of wholesale Federal regulation. As insurance agents and brokers, we serve on the front lines and deal with our customers on a face-to-face basis. Currently, when my customers are having difficulties with claims or policies, it is very easy for me to contact a local official within the State insurance department to remedy any problems. If insurance regulation is shifted to the Federal Government, I would not be as effective in protecting my customers. I am very concerned that some Federal bureaucrat will not be as responsive to a consumer's needs as the local cop, the State insurance regulator.

Even though it is commonly known as "optional," the establishment of a Federal insurance charter would not be optional for agents. Independent agents represent multiple companies, and, under this proposal, presumably some insurers would choose State regulation and others would choose Federal regulation. In order to field questions and properly represent consumers, independent agents would have to know how to navigate both State and Federal systems, making them subject to the Federal regulation of insurance—meaning OFC would not in any way be optional for insurance producers. Even more importantly, "optional" Federal charter would not be optional for insurance consumers. The insurance company, not the insurance consumer, would make that determination.

Over the past several years, OFC supporters have pointed to the dual banking system as an example of how regulatory competition could work. But this is a comparison that should raise many concerns, not the least of which being the current State of Federal financial services regulation. Additionally, there are fundamental differences between banking and insurance. The banking industry has no distribution force like the insurance industry, nothing similar to the claims process exists in the banking industry, and unlike many insurance products, banking products are commoditized and national in scope. However, even as recently as earlier this month, in the face of the failure of several banks and Federal Government support

of numerous others, OFC supporters continue to stress that the insurance industry needs the equivalent of an OCC. But, as we have seen in recent years with the OCC's forceful assertion of preemption, Federal regulatory schemes can do grave harm to State consumer protection regulations. IIABA therefore believes it would be unwise to subject insurance consumers to a similar potential fate.

Prior OFC proposals also would create a confusing patchwork of solvency/guaranty regulation, the crux of insurance regulation and consumer protection. This dual structure proposed could have disastrous implications for solvency regulation by largely bifurcating this key regulatory function from guaranty fund protection. The States would not be able to regulate insurers on the front end to keep them from going insolvent, but would be responsible for insurer failures on the back end through the guaranty fund mechanism. With the recent failures in Federal financial oversight, this is a tremendous risk to take. In essence, these proposals would create an insurance version of the OCC without the integration of an FDIC into that supervisory system. Such proposals cherry-pick the features from several of these Federal banking laws to come up with a model which lacks the consumer protections found in any one of them and ignores the problems it would create for State insurers, guaranty funds, and their citizens. The equally unacceptable alternative would be to attempt to create a new Federal guaranty fund mechanism from scratch, and even if this initially was financed by industry, it ultimately would be guaranteed by taxpayers raising a whole host of additional concerns.

Conclusion

It is indisputable that our country, this Congress, and the new Administration have a lot of challenges ahead and difficult decisions to make in working to stabilize our economy and put us back on the road to growth and prosperity. Every participant in the financial services market must pitch in to help get us back on the right track, and IIABA stands ready to assist in any way possible. With the discussion of reforming financial services regulation, IIABA believes that such consideration presents a good opportunity to improve and modernize the State system of insurance regulation. But, as I've mentioned often today and it bears repeating one last time, IIABA believes that, with the possible exception of a properly crafted systemic risk overseer at the Federal level, targeted modernization is the prudent course of action for reform of insurance regulation. Therefore, any efforts to use this crisis and the failure of AIG as an opportunity to promote misguided measures that would allow a regulated insurance entity to choose its own regulator should be summarily dismissed as unacceptable in today's financial environment. Additionally, because the foremost goal of insurance regulation is consumer protection, any proposals that have the potential to disrupt the strong consumer protections in place at the State level should be rejected. Even though we have historically opposed measures such as OFC in the best of economic times, it is even more clear in these difficult times that the solution is not to displace effective regulation with an unproven regime harmful to consumers that could have the unfortunate effect of adding to, not solving, our country's financial problems. IIABA again appreciates the opportunity to testify today, and we remain committed to continuing to work to improve State insurance regulation for both consumers and market participants.

PREPARED STATEMENT OF JOHN T. HILL

PRESIDENT AND CHIEF OPERATING OFFICER,
MAGNA CARTA COMPANIES, ON BEHALF OF THE
NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

MARCH 17, 2009

The National Association of Mutual Insurance Companies (NAMIC) is pleased to offer comments to the Senate Banking, Housing, and Urban Affairs Committee on insurance regulatory reform.

My name is John T. Hill. I address the Committee in my capacity as chairman-elect of NAMIC and as the president and chief operating officer of the Magna Carta Companies. I also chaired NAMIC's board-appointed task force on Financial Regulatory Reform, which completed its work earlier this year. The views I will share with the Committee are based on my own 28 years experience in the property/casualty insurance industry and the perspective of more than 1,400 NAMIC members.

Founded in 1895, NAMIC is the largest full-service national trade association serving the property/casualty insurance industry. NAMIC members are small farm mutual companies, State and regional insurance companies, and large national writers. The breadth of association members gives us an excellent perspective on the

relationship between the recent financial crisis and the property/casualty insurance business. Our companies share a belief that competition and market-oriented regulation is in the best interest of the industry and the customers they serve. As mutual insurance companies, it is this goal of competitive markets that informs and shapes our views on insurance regulatory reform.

Magna Carta Companies was founded in New York City in 1925 as a mutual insurance carrier for the taxicab industry. Throughout the decades, we have continuously expanded our product offering and underwriting territory. Today, Magna Carta specializes in underwriting the commercial real estate industry, and we are one of the largest mutual carriers of commercial business in America.

Let me make clear upfront that NAMIC is a property/casualty insurance trade association. The products of the property/casualty insurance business are different than those of the other two major components of the insurance business, life and health. We believe that our products have played little or no role in the present crisis, that they are well regulated at the State level for solvency, and that any Federal systemic risk regulatory scheme should build on the strength of the State-based system and not supplant it. My testimony goes into detail on how the State system works, and makes suggestions for how Congress might structure a systemic risk regulator and encourage regulatory coordination and cooperation and information exchange.

As the Committee contemplates reform of the nation's financial services sector, it is essential to consider what is the best structure for all constituents, including consumers, taxpayers, insurance companies, agents, and others affected by the insurance underwriting process. NAMIC's conclusion, reached through years of member involvement and research, is that the best construct is a reformed system of State insurance regulation, in which State officials coordinate and cooperate with other functional, prudential regulators and State governments and Congress exercise an appropriate oversight role. It is the closeness of these State regulators that is the essential ingredient to understanding unique regional property/casualty insurance markets.

Prudential Insurance Regulation

The first requisite of a good financial regulatory system is a prudential financial regulator, one that assures the safety and soundness of the institutions it regulates. For insurers, those regulators are the State insurance departments. This system is the direct result of Federal legislation.

Following the Supreme Court decision in *United States v. South-Eastern Underwriters Association,* 322 U.S. 533 (1944), that insurance was interstate commerce and subject to regulation by the Federal Government, Congress, in 1945, enacted the McCarran-Ferguson Act (15 USC 1011, *et seq.*). The McCarran-Ferguson Act recognizes the local nature of insurance and provides for the continued regulation of insurance by the States coupled with a narrow exemption from the general Federal antitrust laws.

The State-based functional regulatory system and the corresponding application of the McCarran-Ferguson Act limited Federal antitrust exemption have worked well for decades to promote and maintain a healthy, vibrant, and competitive insurance marketplace. There are more than 7,000 insurers operating in the United States, the majority of which are relatively small. A number of studies over the years, including those conducted by the U.S. Department of Justice, State insurance departments, and respected economists and academics, have consistently concluded that the insurance industry is very competitive under classic economic tests.

The national system of State regulation has for more than a century served consumer and insurer needs well, particularly in relation to the property/casualty insurance business. The State-based insurance regulatory system has proven to be adaptable, accessible, and effective, with rare insolvencies and no taxpayer bailouts. Each State has adopted specific programs and policies tailored to the unique needs of its consumers. State regulators and legislators consider and respond to marketplace concerns ranging from risks related to weather, specific economic conditions, medical costs, building codes, and consumer preferences. In addition, State regulators are able to respond and adapt to inconsistencies created by various State contract, tort, and reparation laws.

Property/casualty insurance is inherently local in nature. The United States has 54 well-defined jurisdictions, each with its own set of laws and courts. The U.S. system of contract law is deeply developed and, with respect to insurance policies, is based on more than a century of policy interpretations by State courts. The tort system, which governs many of the types of contingencies at the heart of insurance claims, particularly those covered by liability insurance, is also deeply based in State law including, for example, the law of defamation, professional malpractice,

premises liability, State corporation law, and products liability. State and local laws determine coverage and other policy terms. Reparation laws affect claims. Local accident and theft rates impact pricing. Geographical and demographic differences among States also have a significant impact on property/casualty coverages. Climate—hurricanes, earthquakes, *etc.*—differs significantly from State to State.

With the ability to respond to unique local issues, the individual States serve as a laboratory for experimentation and a launch pad for reform. State-based regulators develop expertise on issues particularly relevant to their State. Insurance consumers directly benefit from State regulators' familiarity with the unique circumstances of their State and the development of consumer assistance programs tailored to local needs and concerns. State regulators, whether directly elected or appointed by elected officials, have a strong incentive to deal fairly and responsibly with consumers.

The State insurance regulatory system, however, is not without its shortcomings. State insurance regulation receives justified criticism for overregulation of price and forms, lack of uniformity, and protracted speed-to-market issues. NAMIC continues to work with State legislators and regulators to address outdated, redundant, and conflicting regulatory policies and procedures and to modernize the insurance regulatory system to meet the needs of a 21st century marketplace.

Consumer Protection

The hallmarks of insurance regulation are solvency oversight and consumer protection. In the case of property/casualty insurance, State insurance officials and attorneys general play complementary and mutually supportive roles in consumer protection. The current regulatory structure works well to address consumer protection issues. State officials are keenly attuned to the needs of their residents and are accountable and accessible, both geographically and politically, to their consumers.

The most important insurance consumer protection is ensuring the ability of the carrier to provide the promised coverage or service at a future date. Thus, ensuring the solvency and financial integrity of the financial service provider is the fundamental consumer protection. In addition, States enforce a variety of other consumer protection laws and regulations designed to ensure disclosure, fairness, and competitive equity.

State insurance regulators actively supervise all aspects of the business of insurance, including review and regulation of solvency and financial condition to guard against market failure. Public interest objectives are achieved through review of policy terms and market conduct examinations to ensure effective and appropriate provision of insurance coverages. Regulators also monitor insurers, agents, and brokers to prevent and punish activities prohibited by State antitrust and unfair trade practices laws and take appropriate enforcement action.

Insurers are subject to comprehensive review of all facets of their operation, including business dealings with customers, consumers, and claimants. The examination process allows regulators to monitor compliance with State insurance laws and regulations, ensure fair treatment of consumers, provide for consistent application of the insurance laws, educate insurers on the interpretation and application of insurance laws, and deter bad practices. Comprehensive examinations generally cover seven areas of investigation, including insurance company operations and management, complaint handling, marketing and sales, producer licensing, policyholder services, underwriting and rating, and claims practices.

State insurance regulators also interact directly with consumers. As an example, nationwide, State insurance regulators handle and respond to more than 3.7 million consumer inquiries and complaints in a single year. Inquiries range from general insurance information to content of policies to the treatment of consumers by insurance companies and agents. Most consumer inquiries are resolved successfully.

Guaranty Funds

Although solvency and financial integrity are essential in the regulation of all financial services industries, the level and degree of regulation of financial institutions with explicit government guarantees differs from that of financial institutions without the same governmental financial responsibility. Unlike banking and pension interests, insurance products carry no Federal guarantee, but are backed by other insurance companies through the guaranty fund system.

State guaranty associations provide a mechanism for the prompt payment of covered claims of insolvent insurers. All States and territories, with the exception of New York, have created post-assessment guaranty associations. In the event of insurer insolvency, the guaranty associations assess other insurers to obtain funds necessary to pay the claims of the insolvent entity. In the case of New York, the

New York Security Fund and certain funds that cover only workers' compensation utilize a pre-assessment mechanism.

Insurance companies writing property/casualty lines of business covered by a guaranty association are required to be a member of a guaranty association of a particular State as a condition of their authority to transact business in that State. Guaranty associations assess member insurers based upon their proportionate share of premiums written on covered lines of business in that State. Separate life and health insurance guaranty association systems also exist.

Each guaranty association has established detailed procedures for handling of assets, filing of claims, and making assessments. With the exception of California, Michigan, New York, and Wisconsin, the guaranty association acts of the States and territories are based on, and are similar in most respects to, the National Association of Insurance Commissioners (NAIC) Model Act. State legislators and regulators have crafted statutes and regulations regarding the creation and operation of the funds based on the specific needs of policyholders and in coordination with State laws. The funds operate to ensure payment of claims by other industry companies, rather than utilize State or Federal financial backstops. The insurance guaranty system and the State regulatory and oversight structure function well for insurers and consumers. The current system avoids catastrophic financial loss to certain claimants and policyholders and maintains market stability, without governmental financial guarantees. As such, regulation and oversight of the guaranty fund system is appropriate at the State level and Federal oversight is unnecessary in the context of the industry-funded State-based system.

Risk Regulation in the Property/Casualty Insurance Industry

The heart of insurance is risk management. Insurers manage their individual risk through a variety of techniques including risk diversification, reinsurance, and securitization. Carriers avoid concentration of risk, assist policyholders in risk mitigation, invest in diversified investment portfolios, and carry adequate reinsurance coverage, among other techniques to ensure that they are not overly exposed to any particular risk and have adequate resources to meet their financial obligations. In addition to risk management practiced by individual companies, State regulators oversee risk within the industry.

Risks to the health of the insurance industry as a whole include the financial stability of individual market players and the level of market concentration. To address these risks, State regulators subject insurers to strict financial and market regulation. State statutes give insurance regulators authority to supervise and regulate the financial condition of insurers licensed to do business in their State and to review market practices. Almost all States have adopted, either through statute or regulation, the financial regulation requirements in the NAIC Financial Accreditation Standards program, including the NAIC's annual and quarterly financial statements, accounting manual, auditing and actuarial requirements, and risk-based capital and examination model laws.

Accounting standards for insurers are generally more conservative than other financial institutions. Statutory Accounting Principles (SAP) focus on solvency and, as a general rule, recognize liabilities earlier and/or at a higher value and recognize assets later and/or at a lower value than traditional Generally Accepted Accounting Principles (GAAP).

In addition to more conservative accounting standards, insurers must maintain minimum levels of capital and surplus. In the early 1990s, the NAIC developed a system that prescribes capital requirements corresponding to the level of risk of the company's various activities. The risk-based capital (RBC) formulas apply separate charges for an insurer's asset risk in affiliates, asset risk in other investments, credit risk, underwriting risk, and business risk, and each formula recognizes the correlation between various types of risk. The Risk-Based Capital Model Law also establishes levels of required company and/or regulatory action, ranging from company corrective action to termination of the entity. While the RBC system is intended to prescribe minimum capital levels, more and more, it is also regarded as an early warning system.

The NAIC's financial solvency tools (FAST), including the insurance regulatory information system (IRIS), provides another early warning system to regulators on the financial condition of insurers. Based on specific company information, regulators examine a series of ratios designed to focus on critical financial conditions, including capital adequacy, changes in business patterns, underwriting results, reserve inadequacy, asset liquidity, cash-flows and leverage, profitability, asset quality, investment yield, affiliate investments, reserves, and reinsurance.

State solvency regulation also includes model investment laws specifying the types of permitted investments, expectations regarding how insurer portfolios are

selected, and limitations on what assets receive regulatory credit. A separate division of the NAIC, the Securities Valuation Office, provides warnings on suspect securities and advice to State financial examiners. States also uniformly impose requirements for professional actuarial review of reserve liabilities, require reporting of audited financial statements, and establish guidelines for selection of auditors.

In addition, the State regulators participate in the NAIC Financial Analysis Working Group. This group of regulators and NAIC staff focus on the financial condition of nationally significant insurers. This process, which is confidential, provides regulatory peer review of the actions domiciliary regulators take to improve the financial condition of larger insurers. During quarterly calls with Federal regulators, State regulators routinely discuss the financial condition of the industry and specific players.

Systemic Risk

Traditional financial risk has focused on risks *within* the financial system; systemic risk focuses on risks to the financial system. Systemic risk refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components. The precise meaning of systemic risk, however, is ambiguous; it means different things to different people, but must not be used to define the downturns resulting from normal market fluctuations.

Some define systemic risk as the probability that the failure of one financial market participant to meet its contractual obligations will cause other participants to default on their obligations leading to a chain of defaults that spreads throughout the entire financial system and, eventually, to the nonfinancial economy. This conception of systemic risk is likened to the risk of a chain reaction of falling dominoes.

Others conceive systemic risk as the risk of a major external event, or "macroshock," that produces nearly simultaneous, large, adverse effects on most or all of the financial system rather than just one or a few institutions such that the entire economy is adversely affected. In this conception of systemic risk, the threat to the system is a market-oriented crisis rather than an institution-oriented crisis. Market-oriented crises tend to begin with a large change—usually a decline—in the price of a particular asset; the change then becomes self-sustaining over time.

The domino theory definition has little relevance to the current situation, as the crisis was not caused by a single institution producing a contagion effect that spread to otherwise healthy interconnected institutions. The macroshock definition comes much closer to describing what has happened. Investors around the world suddenly realized that certain types of asset-backed securities and credit derivatives might not have been as safe as their ratings implied because of their often-hidden exposure to risky subprime mortgages. This sudden realization among investors was the large external shock that led to systemic failure, as the market for asset-backed securities suddenly dried up and intermediaries holding these securities were forced to sell them at distressed prices, leading to massive write downs and the freezing of the world's credit markets.

Inasmuch as the current crisis was caused not by the risky behavior of a single institution or even a small group of institutions, but rather by an exogenous event—a shock to the system—it is difficult to imagine how similar crises could be avoided in the future by focusing regulation on particular institutions that are presumed *ex ante* by regulators to be systemically significant, as opposed to potentially significant events in the market.

It must be noted that such market-oriented events could come from any number of sources. In the present crisis, while public attention has focused on the spectacular deterioration of certain large financial institutions, it was a common shock that led to their demise—a rapidly deflating housing bubble combined with a failure on the part of investors, intermediaries, and rating agencies to accurately assess subprime mortgage risk. That failure was facilitated in part by the growth of the "originate to distribute" model of mortgage lending, which served to create a disconnect between the ultimate bearer of risk and the initiator of credit, thus reducing the incentive to understand and monitor risk.

Future crises are likely to arise from other types of asset bubbles, or other instances of widespread failure by market participants in evaluating certain types of risk. Past financial crises also suggest that market-oriented systemic risk is of greater concern than risk associated with supposedly systemically significant institutions. For example, the 1987 stock market crash was not precipitated by any particular institution or group of institutions, nor was it the proximate cause of the failure of any large bank. Instead, it was a market-oriented crisis that was viewed—at the time and since—as an event with potentially systemic consequences that warranted official-sector intervention. In addition to the 1987 stock market crash, examples of such crises might include the widening of interest rate spreads and decline

in liquidity following the collapse of Long-Term Capital Management in 1998 and the collapse of the junk bond market in 1989–90.

Creating a systemic risk regulator focused on particular institutions designated as systemically significant would do little to prevent a recurrence of the type of market-oriented systemic breakdown that has led to the current crisis, and which is likely to be the cause of future crises. Moreover, such an approach could have harmful side effects, particularly for the property/casualty insurance industry and its consumers if certain property/casualty insurance companies are deemed systemically significant and are regulated as such.

The majority of the entities under scrutiny for systemic risk are regulated by one or more Federal or State regulators. The underlying operations of these entities are complex, and regulatory supervision requires a high level of expertise in the specific business. As such, it is imperative that any regulatory model both fill in existing gaps in the regulation of specific products and coordinate and complement the existing supervisory bodies.

Systemic Risk in the Insurance Industry

In the wake of problems facing the financial services industry, there have been calls for the creation of a Federal or international systemic risk regulatory body. As a trade association that represents property/casualty insurers, NAMIC's primary concern is the potential impact of institution-oriented systemic risk regulation on our member companies and the consumers they serve.

The six primary factors that affect the probability that a financial institution will create or facilitate systemic risk are leverage, liquidity, correlation, concentration, sensitivities, and connectedness. NAMIC believes that an examination of these factors will demonstrate that there is no basis for regulating property/casualty insurance companies for systemic risk because, simply, they don't present such a risk. Again, let me emphasize that I am addressing only property/casualty insurance products, which are far different, in particular, from life insurance products that may offer investment features quite similar to bank and securities products and, as such, may warrant a different regulatory structure.

- **Leverage**

Very few property/casualty insurers use commercial paper, short-term debt, or other instruments that may be used to leverage their capital structures, a fact that makes them less vulnerable than highly leveraged institutions when financial markets collapse. Because of their basic business model and strict capital requirements imposed by State regulators, property/casualty insurers are much more heavily capitalized in terms of their asset-to-liabilities ratios than banks and hedge funds. For these reasons alone, the banking system's perennial moral hazard of being "too big to fail" has no equivalent in the insurance industry. This, of course, is a completely different model than the banking world where leverage is a central component of the enterprise.

- **Liquidity**

Unlike most other types of financial institutions, the nature of the products that property/casualty insurers provide makes them inherently less vulnerable to disintermediation risk. While banks are exposed to the risk that customer withdrawals can exceed available liquidity, the risk of a liquidity shortfall is minimal for insurance companies. Insurance companies are financed by premiums paid in advance, and payments are subject to the occurrence of insured events. Insurance policies are also in force for a contracted period of time, the terms of which are agreed to by both parties. If an insurance customer cancels a policy before the end of the contract, the premium is refunded on a pro rata basis and coverage is canceled. Whereas bank liabilities are short term and assets are long term, insurance has liquid assets but longer-term liabilities. Thus, for both business and regulatory reasons property/casualty insurers carry a liquid investment portfolio. As long as the insurance company has built up reserves and its investments are calibrated to match the statistically anticipated claims payments, there is no liquidity risk and no possibility of a "run-on-the-bank" scenario.

- **Correlation**

Property/casualty insurers use underwriting tools specifically designed to identify and control certain types of correlation, including market concentration, in order to control catastrophe and underwriting exposures. Identifying and managing risks are at the core of insurance and these tools allow insurers to accurately price and underwrite risk. The side benefit of rigorous underwriting is a reduction in systemic risk exposure. It is also important to note the difference between asset-backed secu-

rities and other derivative products, where the underlying risk is financial or market (such as credit, price, interest rate, or exchange rate), and property/casualty insurance, where the underlying risk is a real event, such as an automobile accident, fire, or theft. While the former risks are likely to be correlated in that they will be affected by similar cyclical economic or financial factors, the latter are largely individual, non-cyclical idiosyncratic risks. Banking risks are often highly correlated, particularly in economic downturns. Traditional insurance, in contrast, pools uncorrelated idiosyncratic risks, and is not subject to systemic crises in the same way as banks.

- **Connectedness/Sensitivities/Concentration**

Property/casualty insurers manage concentrations of investments and have regulatory limitations on both the type and concentrations of the assets in which they invest. These realities have the effect of reducing the property/casualty insurance industry's connectedness and sensitivity to the actions and conditions of other sectors of the financial services industry. The one possible exception to this rule is the small subset of monoline financial guaranty insurers that offer specialized products such as bond and mortgage insurance. Because financial guaranty insurance is by definition directly connected to financial products, it is conceivable that these specialty insurers could play a role in propagating systemic risk.

The atypical business model of financial guaranty insurers, however, hardly provides justification for subjecting mainstream property/casualty insurers to systemic risk regulation. While property/casualty insurers, like virtually all investors, have suffered investment losses, no financial contagion has spread throughout the industry or to other financial markets. Even when a property/casualty insurer is held by a holding company that also holds other types of financial services companies, regulatory restrictions designed to protect policyholders operate to isolate the property/casualty insurer's capital and protect it from incursions caused by any problems of the other subsidiaries. Unlike the obligations of lightly regulated financial institutions such as investment banks and hedge funds, most of the obligations of property/casualty insurers are protected by the insurance guaranty fund system. This nationwide system, financed by the property/casualty insurers of each State, reduces the systemic impact of any failing property/casualty insurer by providing most customers or claimants with assurance that the insurer's obligations will be satisfied on a timely basis.

Potential Adverse Consequences of Institution-Oriented Systemic Risk Regulation: How a Too-Big-to-Fail Regime of Regulation Would Create Moral Hazards and Unfair Competition that Could Lead to a Replication of the Problems with Government-Sponsored Entities

Systemic risk regulation and oversight focused on particular institutions based on size, nature of business or perceived significance may well miss market-oriented events and trends that are the true sources of systemic risk. Some commentators have suggested that systemic risk regulation should focus on particular financial institutions that are considered to be "systemically significant." While the criteria for determining which companies are systemically significant are unclear at this point, most proponents of this approach seem to have in mind companies that are thought to be "too big to fail" or "too interconnected to fail."

The act of identifying and regulating "systemically significant institutions" is likely to have unintended negative consequences, particularly if property/casualty insurance companies are among the institutions designated as systemically significant. If an insurance company is deemed, or suspected to be, systemically significant, investors and consumers will see it as an official declaration that the company will not be allowed to fail. This is because the whole purpose of regulating systemically important insurers is to prevent them from failing, because their failure would have an adverse systemic impact on the financial system or the economy generally.

It seems quite likely that insurers designated as systemically important would gain a competitive advantage over other insurers. Companies carrying the official "systemically significant" designation would be able to attract more customers and investment capital than their rivals thanks to the perception that "systemically significant" insurers will be backed by the Federal Government. Moreover, the implicit guarantee of a government backing for systemically significant insurers would create a moral hazard that could manifest itself in regulatory arbitrage, which is a strategy of identifying and exploiting loopholes in the systemic risk regulatory apparatus that would enable the company to engage in riskier, but potentially more profitable, underwriting or investment practices.

To counteract the moral hazard produced by the "systemically significant" designation, the systemic risk regulator might err on the side of caution by preventing

systemically significant insurers from engaging in any business practice that, in its view, could even remotely contribute to systemic risk. Overly restrictive regulation of this kind could decrease the availability of insurance coverage while increasing its cost. While systemic risk poses economic costs, so does regulation. The costs, both direct and indirect, of a systemic regulatory system could be high and care must be taken to avoid situations in which the costs outweigh the benefits. In addition to the direct costs of additional regulation, Congress must be wary of the moral hazard and disruption of the efficient evolution of markets that can result from inappropriate regulatory intervention.

Options for Reform

Single Financial Regulator

The 2008 Treasury Blueprint for Financial Services Reform ("Blueprint") proposed the creation of a single Prudential Financial Regulatory Agency ("PFRA"). Citing the experience of international trading partners, other proposals have advocated the consolidation of existing Federal functional regulators as well as the expansion of Federal authority to include insurance regulation.

A single financial market regulator would prove more problematic in the United States than in other countries. Unlike the majority of countries that utilize a unitary legal system, the United States has 54 well-defined jurisdictions, each with its own set of laws and courts. As noted, the U.S. system of contract law is deeply developed, and with respect to insurance policies, is based on more than a century of policy interpretations by State courts. The tort system, which governs many of the types of contingencies at the heart of insurance claims particularly those covered by liability insurance, is also deeply based in State law.

There are also significant differences between property/casualty insurance and other insurance and financial service products that necessitate different specific regulatory treatment. Geographical and demographic differences among States would similarly pose additional difficulties for a single financial market regulator. NAMIC believes that attempts to establish a single financial regulator would threaten the fundamental underpinnings of the property/casualty marketplace.

Federal Insurance Charter

Proposals for a Federal insurance charter raise serious design and implementation questions. Enacting and implementing comprehensive insurance regulatory reform such as a Federal charter opens the door to numerous unanticipated problems and pitfalls. Inadvertent failure to properly act in any of a number of critical areas could damage the nation's insurance market by reducing competition and harming consumers.

Numerous specific concerns arise when considering Federal regulation of insurance. Specifically:

- Insurance inherently differs from other financial products and services in that it is a promise of future financial protection, making solvency and consumer protection paramount. Federal regulation has proven no better than State regulation in addressing market failures or protecting consumer interests. Unlike State regulatory failures, Federal regulatory mistakes can have disastrous economy-wide consequences. The current high-profile failures of 25 federally regulated banks in 2008 and 16 more already this year have shown weaknesses in Federal solvency regulation. Contrast this with the property/casualty insurance industry which had an excellent solvency record in 2008 in spite of a large drop in investment income and the fourth most expensive natural disaster in U.S. history. The State guaranty system continues to work well to protect consumers without taxpayer bailouts and State regulators respond to thousands of consumer inquiries each year. In addition an optional Federal charter (OFC) system that establishes a national solvency fund for federally chartered companies or permits insurers operating under different financial regulatory standards to participate in State guaranty funds could impair the current guaranty system.
- Regulatory competition between State and Federal regulators could create an unlevel playing field favoring large national writers or specific lines of insurance. Despite assurances that all players could choose the regulatory system best matching their business model and consumer needs, the reality is that transaction costs as well as retooling and retraining expenses would effectively lock smaller and mid-size insurers into their original choice of regulator.
- As previously noted, the property/casualty insurance business is highly dependent on State and regional differences. These differences are particularly critical for personal lines property/casualty coverages (auto, homeowners, personal liability) making "national" products and regulation difficult.

- A Federal regulatory system that results in overlapping, dual or conflicting regulation would create regulatory confusion and significantly increase the cost of doing business for all insurers. It is foreseeable that insurers, even those opting for State regulation, would find themselves subject to a plethora of new Federal rules and regulations. The health insurance market is a vivid example of the pitfalls and confusion of dual regulation for consumers and insurers. This dual regulatory system must be avoided for the property/casualty insurance industry.

Office of Insurance Information

In April 2008, Rep. Paul Kanjorski, D-Penn., chairman of the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, introduced H.R. 5840, the Insurance Information Act of 2008. The legislation would create an Office of Insurance Information (OII) within the U.S. Department of the Treasury with jurisdiction for all lines of insurance, except for health insurance, to provide advice and counsel regarding domestic and international policy issues.

The OII would be empowered and directed to collect, analyze and disseminate information and data; establish and enforce international insurance policy; and coordinate with the States with respect to insurance-related issues.

NAMIC worked closely with Chairman Kanjorski and the Committee to resolve concerns related to the scope and authority of the OII, the confidentiality of the data, and the composition of the Advisory Group, and supported passage of the amended legislation.

The establishment of a properly crafted OII within the Department of Treasury could play a vital role in the effort to streamline and modernize the State-based insurance regulatory system and provide essential information to Congress and the Federal Government.

Federal Standards

Uniformity is beneficial and achievable when State needs are similar and unnecessary regulatory differences significantly impede effective competition within the existing functional regulatory framework. Solvency regulation, for example, is basically uniform among the States. Financial reporting standards and financial examination standards do not suffer from inconsistencies and vagaries among the States. In recent years, insurers, regulators and legislators have turned their attention to promoting greater coordination and uniformity in other aspects of insurance regulation beyond financial reporting and solvency. While NAMIC opposes an OFC and consolidation of insurance regulation under a single Federal financial regulator, we believe Congress could play a role in achieving specific targeted reforms to achieve national uniformity and consistency.

This approach has been adopted by the House in its approval of "The Nonadmitted and Reinsurance Reform Act of 2007," which streamlines regulation for nonadmitted insurance and reinsurance carriers and surplus lines companies. Similar uniformity would be achieved by adoption of the "National Association of Registered Agents and Brokers Reform Act of 2008" ("NARAB II"), which would establish licensing reciprocity for insurance producers that operate in multiple States. The approach embodied in these bills allows Congress a meaningful role in modernizing the insurance regulatory system while leaving the day-to-day regulatory control at the State level. NAMIC supports NARAB II and the Nonadmitted and Reinsurance Reform Act and urges Congress to approve the bills in the 111th Congress.

As Congress considers insurance regulatory reform proposals, NAMIC urges lawmakers to identify specific areas of reform that lend themselves to national standards. In addition to nonadmitted and surplus lines regulation and agent and broker licensing, NAMIC encourages Congress to consider Federal standards prohibiting States from limiting property/casualty insurers' (1) ability to set prices for insurance products, except when the insurance commissioner can provide credible evidence that a rate would be inadequate to protect against insolvency and (2) use of underwriting variables and techniques, except when the insurance commissioner can provide credible evidence that a challenged variable or technique bears no relationship to the risk of future loss. Targeted Federal legislation, such as the outlined proposals, could be more easily achieved and with less government interference, which would lead to more expeditious insurance regulatory reform.

Interstate Compacts, Domiciliary Deference and Model Laws

Interstate compacts are contracts between States that allow States to cooperate on multi-State or national issues while retaining State control. Interstate compacts have a deep history dating from their specific mention in the U.S. Constitution. There are more than 200 interstate compacts and the average State participates in 25 separate contracts. As such, interstate compacts offer one method for resolving

differences in State insurance regulation. Thirty-three States have adopted the Interstate Insurance Product Regulation Compact to develop uniform national product standards; establish a central point of filing for these insurance products; and review product filings and make regulatory decisions related to life insurance, annuities, disability income, and long-term-care insurance. Interstate compacts have also been suggested for natural disaster risks.

Domiciliary deference vests responsibility with the regulator of an insurer's State of domicile to take the lead role in specified regulatory functions. In financial regulation, States focus on their domestic insurers and rely on the State of domicile to monitor the solvency and financial condition of foreign insurers doing business in their State. States also utilize the concept of domiciliary deference in other examinations, agreeing to forego routine or comprehensive exams and relying on the home State while retaining the right to examine targeted issues. The concept could be expanded to streamline regulatory processes and avoid redundant examinations and document productions.

Model laws and regulations serve to increase uniformity and reduce inconsistencies among regulatory jurisdictions. Model laws and regulations have encountered difficulties in obtaining approval in a critical number of States; however, there are examples of the success of model laws. The NCOIL Credit-Based Insurance Scoring Model Act is an example of the effective use of model language. To date, laws or regulations in 27 States are based on the model.

Effective Regulation

NAMIC believes that the fundamental and significant differences among the wide variety of financial services and products argues against consolidation of financial services regulation for all industries and products under an umbrella supervisory body. Prudential regulation, particularly in the case of property/casualty insurance, continues to work well to meet consumer needs and should be preserved. Correspondingly, NAMIC believes that any effective regulatory reform proposal must sustain and enhance the regulatory strengths of the existing system of prudential regulation, including industry specific expertise, experience and focus.

The current crisis demands that Congress act, but Congress must act prudently and responsibly, focusing limited resources on the most critical issues. We encourage Congress to focus with laser precision on the problems at hand and avoid the inclination to rush to wholesale reform. We believe there are a number of finite and concrete reforms that Congress could undertake to strengthen our nation's financial regulatory system, including enhanced regulatory coordination, improved international information sharing, creation of an Office of Insurance Information, adoption of selected national standards, and targeted, national focus on identifying, analyzing and addressing systemic risk.

Likewise the national system of State-based insurance regulation is appropriate and well-suited to effectively regulate products and services that are local in nature, such as property/casualty coverages. There is no evidence that a Federal regulator would prove more effective in improving insurance solvency regulation, would have any greater operational knowledge than State regulators with respect to financial oversight, or be more responsive to consumers. NAMIC opposes the creation of a Federal charter for property/casualty insurers and cautions Congress against disrupting a fundamental bedrock of the financial fabric of our country, particularly during a period of economic crisis.

NAMIC recognizes the interconnectedness of the industry segments within the financial industry and of the U.S. and international financial communities. We acknowledge the need for greater coordination and cooperation among and between U.S. prudential regulators and foreign regulatory bodies. We believe, however, that it is not necessary to replace the current functional regulatory framework to successfully achieve Federal interests in these areas. NAMIC believes Congress must maintain the State-based insurance regulatory system; however, we recognize that improvements can and should be made. Specifically, NAMIC supports:

- **Formalized coordination between functional prudential regulators.** A closer and more formalized working relationship between State regulators and their Federal counterparts is essential to ensure timely and effective information exchange and coordination of regulatory actions. Expansion of the President's Financial Working Group to include participation by State regulators, coupled with enhanced information sharing between and among the participants would provide a unique forum to integrate and coordinate financial services regulation, while preserving the benefits of prudential regulation.
- **Enhanced international regulatory cooperation and coordination.** Enhanced cooperation and coordination among the various global financial services

regulatory bodies is needed. However, such cooperation and coordination should not come at the cost of abrogation of regulatory authority to foreign jurisdictions or quasi-governmental bodies.

Movement of capital that is intended for risk or insurance generally flows freely at the present. Coordination of reporting or presentation standards to permit review and evaluation help to foster greater regulatory transparency and encourage competition. Present cooperation between the European Union and U.S. provide a sound basis for further collaborative efforts.

U.S. insurance regulators through the NAIC participate in the International Association of Insurance Supervisors (IAIS). The IAIS develops international standards for insurance supervision, provides training to its members, and fosters cooperation between insurance regulators, as well as forging dialog between insurance regulators and regulators in other financial and international sectors. Regulators and staff participate in the work of the IAIS on a variety of issues, including international solvency supervision, accounting standards, reinsurance regulation and other issues of regulation of the business of insurance.

- **Creation of an Office of Insurance Information.** Legislation introduced by Rep. Paul Kanjorski in the 110th Congress would have also provided greater autonomy to the Department of the Treasury through a newly created Office of Insurance Information (OII) to engage with foreign jurisdictions on insurance matters. NAMIC supports greater coordination and limited preemptory authority over international insurance issues.

Similarly, NAMIC acknowledges the need for increased insurance industry information at the Federal level. Rep. Kanjorski's legislation would also have authorized the OII to collect and analyze insurance industry information and make recommendations to Congress. NAMIC supports the creation of an OII with proper protections for the privilege and confidentiality of company data.

- **Targeted Product-Focused Systemic Risk Regulation.** With respect to systemic risk, NAMIC believes that regulators should work to identify, monitor, and address systemic risk. However, a systemic risk regulator should complement existing regulatory resources. Furthermore, NAMIC does not believe that the business or legal characterization of any institutions should be used as a basis for assessing systemic risk. Oversight and regulation of systemic risk should focus on the impact of products or transactions used by financial intermediaries.

Attempting to define and regulate "systemically significant institutions" on the basis of size, business line, or legal classification—such as including all property/casualty insurers—would do little to prevent future financial crises. Indeed, a regime of systemic risk regulation that is institution-oriented rather than focused on specific financial products and services could divert attention and resources from where they are most needed, while at the same time producing distortions in insurance markets that would be harmful to consumers.

However, at this time there is no evidence that the property/casualty insurance industry contributes any substantial amount of systemic risk to the global financial system. A new systemic risk regulator should not be tasked with supervising property/casualty insurers that are arbitrarily presumed to be "systemically significant." Instead, any new systemic regulatory system should be given the flexibility to adapt to changing developments in the marketplace, and to anticipate events that could potentially cause a cataclysmic shock to the financial system and the broader economy.

The classic rationale for regulation of financial institutions is that it should serve the public interest by efficiently mitigating market failures. For regulation to achieve this objective, however, there should be substantial evidence showing that existing or proposed regulatory interventions will efficiently address the failure. In other words, efficient regulation necessarily involves matching the appropriate regulatory tool to the specific market failure. Moreover, the benefits of regulation should outweigh its direct and indirect costs. This is particularly true as Congress debates fundamental reform of the nation's financial services industry.

Conclusion

NAMIC supports a strong, transparent, market economy. We encourage the Committee to fully explore all options for addressing the various challenges, including systemic risk, confronting the nation's economy. As the Committee and Congress evaluate solutions, NAMIC, on behalf of our member companies and their customers, encourages members to carefully weigh the costs and benefits of proposed regulatory processes. It is critical that any solution address real regulatory gaps,

without implementing duplicative and ineffective new regulations where none are needed.

As policymakers work to develop long-term successful solutions to our present financial crisis, NAMIC urges Congress to keep in mind the dramatic differences between main street organizations continuing to meet the needs of their local markets, and those institutions that have caused this crisis and have required unprecedented government financial intervention.

PREPARED STATEMENT OF FRANKLIN W. NUTTER

PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA

MARCH 17, 2009

My name is Frank Nutter and I am President of the Reinsurance Association of America (RAA). The RAA is a national trade association representing property and casualty companies that specialize in assuming reinsurance.

I am pleased to appear before you today to provide the reinsurance industry's perspective on regulatory reform. I commend Chairman Dodd and Ranking Member Shelby for holding this important hearing and welcome the opportunity to address the Committee about the current system for regulating the marketplace in light of recent developments in the financial markets. My testimony will highlight the function of risk management; how reinsurers doing business in the United States are regulated; why the current State-based insurance regulatory system does not work well for the sophisticated global reinsurance marketplace; the RAA's position in support of a single national regulator at the Federal level for the reinsurance industry, or alternatively, Federal legislation that streamlines the current State-based system; and the concept of a systemic risk regulator.

I. BACKGROUND ON REINSURANCE

a. The U.S. Reinsurance Market

Reinsurance is critical to the insurance marketplace. It is a risk management tool for insurance companies to reduce the volatility in their portfolios and improve their financial performance and security. It is widely recognized that reinsurance performs at least four primary functions in the marketplace: to limit liability on specific risks; to stabilize loss experience; to provide transfer for insurers of major natural and man-made catastrophe risk; and to increase insurance capacity.

Reinsurers have assisted in the recovery from every major U.S. catastrophe over the past century. By way of example, 60 percent of the losses related to the events of September 11 were absorbed by the global reinsurance industry, and in 2005, 61 percent of Hurricanes Katrina, Rita and Wilma losses were ultimately borne by reinsurers.

Reinsurance is a global business. Encouraging the participation of reinsurers worldwide is essential to providing the much needed capacity in the U.S. for both property and casualty risks. This can be best illustrated by the number of reinsurers assuming risk from U.S. ceding insurers. In 2007, more than 2,500 foreign reinsurers assumed business from U.S. ceding insurers. Those 2,500 reinsurers were domiciled in more than 70 foreign jurisdictions.[1] Although the majority of U.S. premiums ceded offshore is assumed by reinsurers domiciled in ten countries, the entire market is required to bring much needed capital and capacity to support the extraordinary risk exposure in the U.S. and to spread the risk throughout the world's financial markets. Foreign reinsurers now account for 56 percent of the U.S. premium ceded directly to unaffiliated reinsurers; a figure that has grown steadily from 38 percent in 1997.

b. U.S. Reinsurance Regulation—Direct and Indirect

U.S. reinsurers are currently regulated on a multi-State basis. While the current State-based insurance regulatory system is primarily focused on solvency regulation with significant emphasis on regulating market conduct, contract terms, rates and consumer protection, reinsurance regulation focuses almost exclusively on ensuring the reinsurer's financial solvency so that it can meet its obligations to ceding insurers.

Reinsurance is regulated by the States utilizing two different methods: direct regulation of U.S.-licensed reinsurers and indirect regulation of reinsurance transactions. States directly regulate reinsurers that are domiciled in their State, as well

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[1] Reinsurance Association of America (RAA), Offshore Reinsurance in the U.S. Market 2007 Data (2008).

as those U.S. reinsurers that are simply licensed in their State, even if domiciled in another State. These reinsurers are subject to the full spectrum of solvency laws and regulations to which an insurer is subject, including: minimum capital and surplus requirements, risk-based capital requirements, investment restrictions, required disclosure of material transactions, licensing, asset valuation requirements, examinations, mandated disclosures, unfair trade practices laws, Annual Statement requirements and actuarial-certified loss reserve opinion requirements. Because the reinsurance transaction is between two sophisticated parties, there are no regulatory requirements relating to the rates that are negotiated between the parties or the forms used to evidence contractual terms.

There is also indirect regulation of reinsurance transactions through the credit for reinsurance mechanism, which is the financial statement accounting effect given to an insurer if the reinsurance it has purchased meets certain prescribed criteria. If these criteria are met, the insurer may record a reduction in its insurance liabilities for the effect of its reinsurance transactions. One of the most widely discussed criteria is the "collateral" requirement that a non-licensed reinsurer must either establish a U.S. trust fund or other security in the U.S., such as a clean, irrevocable and unconditional letter of credit issued by an acceptable institution, to cover its potential liabilities to the insurer. This provision is based on the historic premise that State regulators do not have the regulatory capability or resources to assess the financial strength or claims paying ability of reinsurers that are not authorized or licensed in that State.

For several reasons, including the cumbersome nature of a multi-State licensing system, capital providers to the reinsurance market have in recent years opted for establishing a reinsurance platform outside the U.S. and conducting business through a U.S. subsidiary or by providing financial security through a trust or with collateral. Following the events of September 11, 2001, 12 new reinsurers with $10.6 billion capital were formed. After Hurricane Katrina, at least 38 new reinsurance entities with $17 billion of new capital were formed. Nearly all of this new capital came from U.S. capital markets, yet no new reinsurer was formed in the United States. Other than the U.S. subsidiaries of some of these new companies, not one U.S.-domiciled reinsurer has been formed since 1989. For these startups, the ease of establishment, capital formation, and regulatory approvals in non-U.S. jurisdictions contrasts with the cumbersome and protracted nature of obtaining licenses in multiple U.S. States. We believe that a streamlined national U.S. regulatory system will result in reinsurers conducting business more readily through U.S. operations and U.S.-based personnel.

II. KEY ISSUES FOR THE U.S. REINSURANCE INDUSTRY

The RAA seeks to modernize the current regulatory structure and advocates a single national regulator at the Federal level. Alternatively, the RAA seeks Federal legislation that streamlines the current State-based system. There are a number of key problems and inefficiencies with the current State-based framework for reinsurance regulation.

a. The Need for a Single Federal Role

As has been noted by a variety of commentators, as well as the 2008 U.S. Treasury Blueprint for Financial Regulatory Reform ("the Treasury Blueprint"), the U.S. State-based insurance regulatory system creates increasing tensions in the global marketplace, both in the ability of U.S.-based firms to compete abroad and in the allowance of greater participation of foreign firms in the U.S. market. Foreign government officials have continued to raise trade barrier issues associated with dealing with 50 different U.S. insurance regulators, which makes coordination on international insurance issues difficult for foreign regulators and companies.

An informed Federal voice with the authority to establish Federal policy on international issues is critical not only to U.S. reinsurers, which do business globally and spread risk around the world, but also to foreign reinsurers, who play an important role in assuming risk in the U.S. marketplace.

The fragmented U.S. regulatory system is an anomaly in the global insurance regulatory world. As the rest of the world continues to work toward global regulatory harmonization and international standards, the U.S. is disadvantaged by the lack of a Federal entity with authority to make decisions for the country and to negotiate international insurance agreements, or alternatively, the lack of Federal-enabling legislation which empowers a single State regulator to do so.

b. Mutual Recognition

U.S. States impose a highly structured and conservative level of regulation on licensed reinsurers. However, it has long been recognized that there are several globally recognized methods of conducting reinsurance regulation.

The RAA was encouraged by the inclusion of a system of mutual recognition among countries in "The National Insurance Act of 2008" (S. 40), introduced in the last Congress. Mutual recognition seeks to establish a system where a country recognizes the reinsurance regulatory system of other countries and allows reinsurers to conduct business based on the regulatory requirements of its home jurisdiction. If such a system were established, European reinsurers would be permitted, for example, to assume reinsurance risk from the U.S. without having to obtain a U.S. license and without having a requirement in law to provide collateral for their liabilities to U.S. ceding insurers. In return, such a system would allow U.S. reinsurers to conduct business in the mutually recognized country based on U.S. regulatory oversight.

A single national regulator with Federal statutory authority could negotiate an agreement with the regulatory systems of foreign jurisdictions that can achieve a level of regulatory standards, enforcement, trust, and confidence with their counterparts in the U.S.

c. Extra-Territorial Application of Law

The RAA also believes there is a need for greater efficiency in the regulation of reinsurance in the U.S. As a result of our 50-State system of regulation, significant differences have emerged among the States with respect to reinsurance regulatory requirements. Multi-State systems add extra costs to transactions. These costs are ultimately reflected in the premiums paid by consumers. The NAIC and State regulators are to be applauded for their efforts toward greater uniformity in the adoption of model laws and regulations and the creation of the accreditation system; yet, this has not prevented some States from pursuing varying and sometimes inconsistent regulatory approaches. One of the best examples of this is the extra-territorial application of State laws.

Thirteen States apply at least some of their regulatory laws on an extra-territorial basis, meaning that the State law not only applies to the insurers domiciled in that State, but to insurers domiciled in other States if the extra-territorial State has granted a license to the insurer. For example, an insurer domiciled in a State other than New York, but licensed in New York, will find that New York asserts that its laws apply to the way it conducts its business nationwide. Since most U.S.-based reinsurers are licensed in all 50 States, this extra-territorial application of State law results in inconsistencies among State laws.

As Congress proceeds to review the current regulatory structure and consider a new one for the future, we encourage the Committee to focus on streamlining reinsurance regulation to allow U.S. reinsurers to be more competitive in the global marketplace, maximize capacity in the United States, and make us a more attractive place for companies to locate their business. Any structure that is adopted should eliminate duplicative and inconsistent regulation like that which is caused by the extra-territorial application of State laws. Such a provision was included in the House-passed Nonadmitted and Reinsurance Reform Act of 2008, although it lacked the necessary enforcement authority.

III. GOALS OF EFFECTIVE REINSURANCE REGULATION AND CORE CHARACTERISTICS OF A REINSURANCE REGULATORY REGIME

As we move forward with modernization efforts, the goals of effective reinsurance regulation in the United States should be to promote:

1. Financially secure reinsurance recoverables and capacity that protects the solvency of U.S. ceding insurers.
2. A competitive and healthy reinsurance market that provides sufficient capacity to meet ceding insurers' risk management needs.
3. Effective and efficient national reinsurance regulation.

The core characteristics of an appropriate reinsurance regulatory structure that would assist in achieving these goals should include:

1. A single Federal regulator or regulatory system for reinsurance with national regulatory oversight and the power to preempt conflicting or inconsistent State laws and regulations in an effective and efficient manner.
2. The single regulator's authority should provide for the recognition of substantially equivalent regulatory standards and enforcement in other competent regulatory jurisdictions.
3. The regulatory structure should support global capital and risk management, taking into account capital adequacy, assessment of internal controls, recognition of qualified internal capital models and effective corporate governance.

4. The regulatory structure should provide for financial transparency that encourages and supports the cedents' ability to assess counter-party credit risk, including information regarding the reinsurer's financial condition and the reinsurer's performance in paying covered claims.
5. Regulators should have access to all necessary financial information with appropriate provision for the confidentiality of that information, as currently provided for under State law and regulatory practice.
6. The regulatory structure should have an effective transition mechanism between the current system and any future regime that is consistent with these core characteristics. Absent mutual agreement of the parties, any reduction in existing collateral requirements should only apply prospectively.
7. The regulatory structure should utilize principles-based regulation where appropriate.

There are several different ways to address meaningful modernization. Changes to the current reinsurance regulatory structure to achieve these goals and core characteristics include, but are not limited to: (1) a Federal regulator for reinsurance, or (2) Federal legislation that streamlines and modernizes the current State system. Although the RAA prefers a Federal regulator, the Nonadmitted and Reinsurance Reform Act, also called the surplus lines and reinsurance bill, passed twice by the House, is a good start, but could be augmented by the recent NAIC-endorsed reinsurance modernization framework. The RAA supports the NAIC proposal to modernize the U.S. reinsurance regulatory system through a system of regulatory recognition of foreign jurisdictions, a single State regulator for U.S. licensed reinsurers, and a port of entry State for non-U.S. based reinsurers.

The NAIC has acknowledged that "in light of the evolving international marketplace, the time is ripe to consider the question of whether a different type of regulatory framework for reinsurance in the United States is warranted." The proposed NAIC framework, if implemented appropriately, would, in the words of the NAIC, "facilitate cross-border transactions and enhance competition within the U.S. market, while ensuring the U.S. insurers and policyholders are adequately protected." Given the challenges of implementing changes in all 50 States and questions of constitutional authority for State action on matters of international trade, the NAIC's support for Federal legislation to accomplish this proposed framework is encouraging.

IV. THE NEED FOR A SYSTEMIC RISK REGULATOR?

I urge Congress to move reinsurance regulatory modernization forward regardless of the ongoing debate about a systemic risk regulator—the subject of my concluding testimony.

If, as House Financial Services Committee Chairman Barney Frank indicated during a February 3 press conference, there is a preference for systemic risk regulation "covering all forms of financial activity," significant issues about a systemic risk regulator remain unanswered, including, but not limited to:

1. What are the criteria for defining entities or markets that present a systemic risk?
2. How broad will this regulator's authority be?
3. How will this regulator's powers interact with those of the prudential regulator?
4. To what extent will the systemic risk regulator present duplicative regulation?
5. How will U.S. companies that are part of an international group headquartered outside the United States be treated?
6. How will the systemic risk regulator coordinate with the other international regulators?

In general, property casualty insurers generate little counterparty risk and their liabilities are, for the most part, independent of economic cycles or other systemic failures. Even during the current financial turmoil, rating agency A.M. Best continues to maintain a stable outlook for the global reinsurance sector based on its sound underlying operating earnings generated over the most recent timeframe, strong underwriting discipline, and capital adequacy. While the reinsurance industry plays an important role in the financial system, it may not necessarily present a systemic risk. In its 2006 report, "Reinsurance and International Financial Markets," the Group of 30 found "no evidence" that the failure of a reinsurer "has given rise to a significant episode of systemic risk."

Reinsurance is an important part of the risk transfer mechanism of modern financial and insurance markets. Yet, there are clear distinctions between risk finance

and management products that are relatively new financial tools developed in unregulated markets, and risk transfer products like reinsurance whose issuers are regulated and whose business model has existed for centuries. In the case of reinsurance, regulatory reform is necessary to improve its regulatory and market efficiency and maximize capacity in the United States, but not to address the fundamental risk transfer characteristics of the product.

Those addressing the authority of a systemic risk regulator envision traditional regulatory roles and standards for capital, liquidity, risk management, collection of financial reports, examination authority, authority to take regulatory action as necessary and, if need be, regulatory action independent of any functional regulator. At a speech before the Council of Foreign Relations last week, Federal Reserve Board Chairman Ben Bernanke acknowledged that such a systemic regulator should work as seamlessly as possible with other regulators, but that "simply relying on existing structures likely would be insufficient."

As I noted earlier in my testimony, the purpose of reinsurance regulation is primarily to ensure the collectability of reinsurance recoverables and to maintain a method of accurate reporting of financial information that can be relied upon by regulators, insurers and investors. Because reinsurance is exclusively a sophisticated business-to-business relationship, reinsurance regulation is functionally different from insurance, and has other critically different characteristics: no rate or form regulation and no consumer protection because there is no legal relationship to insurance consumers. Reinsurance companies are already regulated in much the same way as is being proposed for the systemic risk regulator—financial reporting, risk-based capital analysis, examination, and regulatory authority to take action to address financial issues. If licensed in the United States, reinsurers are regulated in this way by the various States. If domiciled in a non-U.S. jurisdiction, reinsurers are similarly regulated in their home country. We are concerned the systemic risk regulator envisioned by some would be redundant with this system. This raises concerns that, without financial services and insurance regulatory reform, a Federal systemic risk regulator would: (1) be an additional layer of regulation with limited added value; (2) create due process issues for applicable firms; and (3) be in regular conflict with the existing multi-State system of regulation.

V. FINANCIAL REGULATORY MODERNIZATION

Most, if not all participants in the dialog about financial services modernization, acknowledge that most financial markets are global and interconnected. Federal Reserve Chairman Bernanke noted that the global nature of finance makes it abundantly clear that any reform in the financial services sector must be coordinated internationally. Among the financial services providers, no sector is more global in nature than reinsurance.

Should Congress proceed with broad financial services modernization, we ask that it be recognized that reinsurance is by its global nature different from insurance, and that the Federal Government currently has the requisite constitutional authority, functional agencies and experience in matters of foreign trade to easily modernize reinsurance regulation. We believe that multiple State regulatory agencies in matters of international trade are at best inefficient, pose barriers to global reinsurance transactions, and do not result in greater transparency.

It is the recommendation of the Reinsurance Association of America that reinsurance regulatory modernization be included in any meaningful and comprehensive financial services reform through the creation of a Federal regulator having exclusive regulatory authority over the reinsurance sector so there is no level of redundancy with State regulation. This should occur whether or not a systemic risk regulator is included in financial services reform.

Alternatively, Congress should create a single exclusive national regulator for reinsurance at the Federal level, but retain a choice or option for companies to remain in the State system. We recommend further that any such financial reform incorporate authority for a system of regulatory recognition to facilitate cooperation and enforcement with foreign insurance regulators.

If the Congress should choose not to include reinsurance in broader financial services reform, we encourage the enactment of legislation along the lines of the NAIC's reinsurance modernization proposal to streamline the State system as it relates to reinsurance by federally authorizing a port of entry for foreign reinsurers and single-state financial oversight for reinsurers licensed in the United States.

Should Congress proceed first with a systemic risk regulator and defer financial services modernization, we encourage the Committee to provide a road map for addressing reinsurance regulatory reform along the lines described in this testimony.

The RAA thanks Chairman Dodd, Ranking Member Shelby and members of the Committee for this opportunity to comment on regulation, and we look forward to working with all members of the Committee as it considers this most important issue.

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TESTIMONY OF

J. ROBERT HUNTER,
DIRECTOR OF INSURANCE
CONSUMER FEDERATION OF AMERICA

BEFORE

UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

REGARDING

PERSPECTIVES ON MODERNIZING INSURANCE REGULATION

MARCH 17, 2009

Good morning Chairman Dodd, Ranking Member Shelby and members of the Committee. My name is Bob Hunter, and I am Director of Insurance for the Consumer Federation of America (CFA). Thank you for inviting me here today to discuss perspectives on modernizing insurance regulation. I have served as Federal Insurance Administrator under Presidents Ford and Carter and as Texas Insurance Commissioner. I have 50 years of experience in insurance, including in the private sector, in state government, in the federal government and with consumer groups.

CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education.

CFA Is Reviewing Its Policy Positions on State and Federal Regulation

CFA is in the midst of a detailed review of our policy positions on insurance regulation to take into consideration the new lessons we are learning from the economic meltdown. We are also reviewing the problems and successes of state regulation that occurred before the current crisis erupted. We expect to have the review completed shortly and will present our findings to date in this testimony.

I can report to you today that some issues are settled in our minds, including the need for an expanded role for the federal government in regulating insurance generally (our research strongly suggests accomplishing this via the establishment of federal minimum standards for state enforcement) and specifically through inclusion of insurance in a federal systemic regulatory framework.

Five specific conclusions are already clear to us from our review of the situation:

1. There are significant systemic risk issues associated with insurance that require oversight by a federal systemic risk regulator.

2. Regarding consumer protection and prudential regulation, CFA will continue to place our focus on the quality rather than the locus of such regulation. At this stage of our research, it appears that a federal office is needed to deal with systemic risk, be a repository of insurance expertise, engage in international insurance issues and to monitor and enforce (if a state chooses not to regulate) high consumer protection and prudential minimum standards set by Congress. Regulation to protect consumers must address all key consumer issues, such as claims abuses, unfair risk classification criteria and the unavailability of needed insurance. In order to properly accomplish this, any emerging regulatory system must contain, among other things, the capacity to regulate rates and classifications. Our study of decades of auto insurance data from all states proves that tough, thoughtful regulation, including rate regulation, is most effective in protecting consumers. Such a system also works well for insurers and does not decrease competition in the states with tough regulation. A federal insurance office should be knowledgeable about insurance matters to help Congress and the Administration sort

through the tremendous complexities of this industry. However, this office should not be granted vague and open-ended powers of preemption regarding state laws or rules in areas that Congress has chosen not to explicitly preempt. Furthermore, preemptive authority granted to the office, if any, should not cover any state consumer protection requirements.

3. While CFA supports a greater federal insurance role, we vigorously oppose an optional federal charter, since such a system cannot control systemic risk, has failed miserably in protecting banking consumers and sets up pressures that can only lead to reduced consumer protections through regulatory arbitrage.

4. Repeal of the antitrust exemption in the McCarran-Ferguson Act must be part of any efforts by Congress to reform insurance regulation. Collusion in the pricing of property/casualty insurance should not be allowed in the 21st Century.

5. As Congress attempts to create an agency that has knowledge about insurance, it should restore the ability of the FTC to study insurance from a consumer protection perspective.

I will briefly discuss each of these conclusions and then I will highlight the CFA research on the future of insurance regulation that is underway.

Systemic Risk and Insurance

In the past year, the government has stepped in to bail out or otherwise rescue a number of financial institutions not backed by an explicit federal guaranty, from Bear Stearns, to Fannie Mae and Freddie Mac, to AIG. The government's decision not to bail out Lehman Brothers is blamed by many for the sudden freezing of global credit markets last fall and the precipitous stock market decline that ultimately convinced Congress to put hundreds of billions of dollars of taxpayer money on the line to prevent a broader financial collapse. This chain of events has prompted a nearly universal call for improved systemic risk regulation as an essential component of any regulatory reform package.

The fact that one of the institutions rescued, AIG, is a major insurance firm and the fact that some insurers have lobbied to receive rescue funds, puts insurers in the middle of that debate. As a result, decisions about how best to regulate insurance must take into account issues related to systemic risk. The decisions Congress makes about how to regulate systemic risk could, in turn, have implications for other types of insurance regulation issues, particularly the issue of whether a federal insurance regulator is needed.

Some in the insurance community have argued – correctly, to a degree[1] – that it was not AIG's insurance activity that created the systemic risk that prompted its rescue. Instead, it was AIG's ties to other financial institutions through hundreds of billions of dollars in unregulated credit default swaps that caused the government to conclude that a failure at AIG would have devastating consequences for the global financial system. Many observers have concluded that,

[1] It appears that some $21 billion in losses in the AIG life insurers "securities lending program" did occur and was the basis for some federal taxpayer-backed relief.

although there are some very large insurers, their failure would be unlikely to pose a comparable systemic risk. Although there would doubtless be temporary market disruptions from such a failure, the existence of numerous competitors ready to step in and assume the coverage they provided would mitigate the risk to consumers. The existence of state guaranty funds is also cited as a factor that limits the systemic risk associated with an insurance company failure. Finally, state insurance regulators have been quick to note that capital standards, reserve requirements, and investment limitations imposed on insurers to guaranty their ability to pay claims have protected them from taking on the excessive risks that have proved so troubling for their colleagues in commercial and investment banking.

Although there is some validity to these arguments, they have their limitations. It is ironic, for example, that state regulators are boasting in Congress about the effectiveness of their capital and reserve requirements in stabilizing insurers even as several states act quietly at the individual state level to loosen those requirements. Meanwhile, the state guaranty funds may create the illusion of safety where it does not exist. While the funds might be able to absorb the failure of a single large insurer, it is almost certain that they would not be able to handle the simultaneous failure of several large insurers in a timely fashion.[2] Moreover, there are other specialized insurers, most notably the bond insurers, whose role in the financial markets has clear systemic implications. The credit downgrade of bond insurers last year spilled over into the credit default swap market in ways that contributed to the freezing of credit markets. Current concerns with Directors and Officers Insurance for banks, where prices have doubled and the availability of insurance is questionable for some banks may threaten to undermine bank recovery. Clearly, enough insurance-related systemic risk potential exists for insurers to be included in any plan to enhance systemic risk regulation.

Although proposals on how to regulate to mitigate systemic risk are just taking shape, it appears likely that systemic risk will consist of at least three components:

1. Efforts to better monitor the financial system for the build-up of risks that could have systemic implications;

2. Standard-setting to reduce the risk of failure at a large or otherwise systemically significant institution; and

3. Creation of a mechanism to allow the orderly failure of non-bank financial institutions similar to the power the Federal Deposit Insurance Corporation (FDIC) currently has with regard to banks. Many have further suggested that a systemic risk regulator also needs FDIC-like authority to intervene in troubled financial institutions before a crisis to force them to take corrective actions to head off a threatened failure.

As Congress moves to provide for enhanced regulatory focus on systemic risk, insurers are clearly among the financial institutions that should expect to have their activities monitored. Beyond that, however, the issues for insurance regulation become more complicated. The following are among the key issues that need to be resolved:

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[2] CFA has grave doubts about the Guaranty Funds and even think they might present some systemic risk, as discussed below.

- What authority should a federal systemic risk regulator have to restrict conduct by insurers that it views as posing a systemic risk?

CFA believes the ability to monitor for risks without the ability to act to constrain those risks is meaningless. Whether this authority is accomplished through preemption of state solvency regulation, as some have suggested, will depend in part on the model of systemic risk regulation that Congress adopts. Should Congress decide to designate a single, central systemic risk regulator, it is likely to give that regulator authority at a minimum to override any state or federal risk-related regulations, such as capital and liquidity standards, that it believes are insufficiently rigorous to protect against a risk to the financial system. It could go further, authorizing the systemic risk regulator to directly set such standards for institutions or practices deemed to be systemically significant, a category that would almost certainly include some insurers, or to intervene at such institutions to demand corrective actions under certain circumstances.

On the other hand, should Congress adopt a model of systemic risk regulation in which a "college" of financial regulators, presumably an expanded and refocused version of the Presidential Working Group on Financial Market Stability, works together to monitor systemic risk, actions to constrain those risks are likely to be carried out through the existing regulatory entities. State insurance regulators could reasonably expect to play a direct role in that coordinating council. Even under this latter model, however, state securities regulators could find themselves under intense pressure to act according to federal directives regarding systemic risk. The difference is that they are likely to have a more active role in developing those policies. To the degree that state insurance regulators want to be taken seriously as partners in the effort to constrain systemic risks, they would strengthen their case if they would call an immediate halt to state-level measures designed to loosen industry capital and reserve requirements being pushed by insurers who are reluctant to acknowledge the shakiness of their finances at a time of economic crisis. They also need to reform the National Association of Insurance Commissioners (NAIC), which acts more like a trade organization than a regulator, with ex-parte meetings, secret meetings, no freedom of information requirements, no limits on leaving NAIC office and immediately start lobbying for the regulated entities and other such failings (discussed in greater detail below).

- Will all insurers be affected by federal systemic risk regulation or only the largest, most "systemically significant" insurers?

Here again, the degree of intrusiveness of federal systemic risk regulation into the insurance industry will depend on the model of regulation Congress chooses to adopt. Some have suggested designating certain institutions as "systemically significant" and subjecting them to heightened regulatory standards to prevent them from taking on excessive risks. Because only a small number of insurers would likely be designated as systemically significant, this approach would likely require the least federal intrusion into insurance regulation, even though that role could be extensive with regard to that small number of systemically significant insurers. This view is based on a too-narrow focus on preventing the failure of large institutions. To be effective, systemic risk regulation must focus not just on risks within large institutions, but also

on risks in smaller institutions or in particular markets with the potential to infect the broader market.

Moreover, CFA shares the views of those who have argued that designating institutions as "systemically significant" is unworkable. Decisions about where to draw the line would be hopelessly arbitrary. Systemic risk is likely to be determined by an interaction of various factors, including at a minimum size[3], the nature of activities engaged in, and degree of interconnection with the financial markets as a whole. Even if you could set a meaningful dividing line based on these various factors, it would require constant adjustments based on changing market conditions and constant monitoring of institutions on the borderline. A far more logical approach is to monitor all, or nearly all, financial institutions and to impose capital standards on those institutions that ratchet up significantly as the institution takes on more risk – either by growing to a size that makes it "too big to fail," by engaging in risky activities, or by entering into risky relationships with other players in the broader financial markets. Such a model is likely to affect a far broader segment of the insurer population and, in doing so, prompt a debate about the need to preempt state standards.

Another approach that would lessen the possible systemic impact of insurance is simply to restrict insurance companies to the business of insurance and prohibit companies or conglomerates from mixing insurance with credit, investment banking and other financial services (i.e., repeal part of the Gramm Leach Bliley Act). Standing alone as pure insurers, most insurers have little systemic risk.

- Would large insurers be subject to a federal system for the orderly failure of non-financial institutions or do state guaranty funds suffice to fill that role for the insurance industry?

One of the misconceptions about systemic risk regulation is that its intent is to protect large financial institutions from failure. CFA is convinced that the possibility of failure must be restored in order to provide accountability for assuming excessive risks. To accomplish that goal, a key focus of systemic risk regulation must be on creating a mechanism to allow the orderly unwinding of large non-bank financial institutions comparable to the authority the FDIC already has with regard to banks. After all, it was the absence of such a mechanism that forced the government to improvise in devising its rescue strategies.

The question for the insurance industry is whether insurers would be covered by such a mechanism or whether they would continue to rely on state guaranty funds to serve this function. CFA has grave concerns about the adequacy of state guaranty funds, particularly with regard to their ability to handle the simultaneous failure of several large insurers. At a minimum, large insurers facing failure would be expected to rely on a federal mechanism and therefore should be expected to contribute to its funding, assuming it is to be funded through some form of insurance premium. An alternative approach, and one that would be clearer in its applicability, would be to expand access to the program to a larger population and to impose premiums based on the degree of risk posed by those institutions. If the program included regulatory authority to intervene in

[3] This determination would have to be made for entire groups of insurance companies, not individual members of the group, since reinsurance and other cooperative arrangements within groups often share risk across the corporate enterprise.

advance of a crisis to force corrective actions, insurers could expect greater federal involvement in certain types of regulatory issues.

CFA's concerns with the state guaranty associations are that the associations, being post-assessment plans in nearly every case (New York is the exception), are very vulnerable to a large failure. It is very possible that the system could be overwhelmed by a series of large failures and stop functioning to promptly restore policyholders and claimants to their pre-insolvency position in a timely way.

The guaranty associations can assess for claims beyond the ability of a failed insurer. They do this by assessing the remaining, solvent insurers. So today, with several life insurers in some trouble, a string of failures would put a call for money on other already stressed insurers. To ease this problem, these assessments for money are capped at various percentages of premiums from the last (or recent) year(s) and that would mean that, once the limits on assessments are exceeded, claims and demands for money from an insured's account could not be fully paid. So the risk is not just that the system taps insurers at a time of weakness, but that insureds, including individuals and businesses, might not be able to collect the money they need to get back to normal activity, adversely impacting the recovery of a stressed economy. Thus, the guaranty associations have a degree of systemic risk built into their structure.

Let's focus on life insurance, currently more at risk of seeing failures (beyond AIG) than the property/casualty industry. In 2007, life insurance premiums were $142.7 billion and annuities premiums were $314.6 billion. (Property/casualty insurance premiums were $452.4 billion in 2007.)[4]

If failures happen, the national capacity for life insurance is limited by two factors in a state: the way assessments are limited and the way accounts are set up in the state.

Assessment limits vary. In most states, it is two percent of premiums from the previous year.[5] But there are exceptions. In Alabama, for example it is one percent of premiums from the previous year. In California, it is one percent of the average of the premiums for the prior three years. In Connecticut it is two percent of the average premiums over the last three years. It would be reasonable to estimate the national assessment capacity at two percent of the latest year premium.[6]

The second limit on assessment is the state account structures that divide the life insurance premiums into various categories. For instance, Alabama has three accounts, life

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[4] Life and annuity premiums from ACLI's "Life Insurance Fact Book," 2008 and P/C premiums from Best's "Aggregates and Averages," 2008. Health insurance premiums written by life insurers were $151.5 billion, excluding Blue Cross/Shield and HMOs and some health insurance written by P/C insurers. I should note that New York is a pre-funded plan, but over the years money has been taken out of the fund by the government for other purposes and replaced by an IOU.

[5] State-by- state data are available at www.nolhga.com/factsandfigures/main.cfm/location/lawdetail/docid/16.

[6] In fact, this estimate is somewhat high as some states have a one percent assessment cap and others use averages, which, since premiums are growing, are lower than simple use of the latest year.

insurance, disability insurance and annuities.[7] Florida breaks it down as health, life and annuity. Sometimes life and annuity are combined in one account.

It is safe to say that the national assessment capacity is far less than $9.1 billion (this figure is calculated as two percent of the total of life and annuity premiums from 2007). This is a very high estimate of potential money available to help in the situation of life insurer and annuity insurer insolvencies in the first year because: (1) the premiums from the pre-funded state of New York are included; (2) two percent is more than would be achieved on average as discussed above; (3) some states split life and annuity into separate funds, further minimizing the available funds, and (4) the available premiums for assessment would drop because the amount of premium of the insurers that become insolvent (or appeal the assessment because of being in fragile solvency condition) being removed from the calculation.

Less than $9 billion would not go far should even one major insolvency involving a deep "hole" (shortfall) occur. Heck, it would hardly cover AIG's bonuses and parties! Insureds would be unable to get their money out of the funds, perhaps for years. Some claims would not be fully paid (even without the insolvency funds melting down, there are limits on what these funds pay out – usually in the range of $100,000 to $300,000 per policy) perhaps for many years, if ever, in the case of a series of insolvencies.

CFA believes enhanced systemic risk enforcement is an essential component of regulatory reform and that the focus should be broad. As such, we believe it is both inevitable and appropriate that insurers be brought under a system of systemic risk regulation. Because issues of systemic risk regulation are directly relevant to the broader policy debate over insurance regulation, these two issues cannot easily be divorced. We would note, however, that those who have sought to use the focus on systemic risk regulation to argue for an optional federal charter have the issue exactly backwards. Whatever else it is, systemic risk regulation is not optional. For systemic risk regulation to be effective, the regulator must have broad authority to determine the scope and extent of their authority. Moreover, if we have learned nothing else from the current crisis, we should have learned that giving financial institutions the ability to choose their regulator seriously undermines the quality of oversight and the rigor of regulation. That, in turn, has the potential to create serious systemic risks.

- What potential systemic risks might insurers pose to the nation?

Congress should study the potential systemic risk of bond insurance and reinsurance. Reinsurance and retrocession spread risk around the world in ways that normally lower risk but could, in certain circumstances, cause massive failure if a series of major impacts were to be felt at once – (i.e., a "black swan" could cause great failure worldwide if reinsurance failed to deliver in its secondary market function). Major storms, earthquakes, terrorism attacks and other catastrophes could occur at about the same time that might bankrupt some of these significantly inter-connected secondary-market systems, for instance.

[7] The Account Structure information on a state-by-state basis is found at www.nolhga.com/factsandfigures/main.cfm/location/lawdetail/docid/1.

Currently, banks are paying double last year's rates for directors and officers' coverage, if they can get it at all. If the degree of unavailability grows, Congress should study just what are the systemic implications if banks cannot hire officers or get directors to serve due to the lack of D&O coverage. Would the recovery of a bank be retarded by the flight of directors and officers from the institution if no insurance protection was available to protect them from shareholder or consumer suits?

Some state regulators themselves have recently introduced an element of systemic risk because of their willingness to cut consumer protections for life insurance by slashing reserves and other dollars of policyholder cushion at this time of great risk. Their theory seems to be that when consumers do not need to worry about the soundness of insurers they will keep high cushions of protection, but when policyholders most need this protection, they will change accounting standards at the request of insurers. Several states have lowered capital and reserve requirements for life insurers despite the fact that the NAIC ultimately refused to do so. NAIC acknowledged that it had not done the due diligence necessary to determine if the proposed changes would weaken insurers excessively. (See attachment 2 for the detailed comments I made prior to the NAIC action to not adopt the ACLI proposals.)[8]

In summary, CFA has come to a number of conclusions about the proper role of systemic risk regulation of insurance:

1. Insurance should be covered by any systemic risk regulatory structure that Congress develops.
2. Systemic risk regulation of insurance must include monitoring and enforcement components that are mandatory for insurers, not optional. An optional approach to systemic risk will fail.
3. Systemic risk regulation of insurance should take into consideration bond insurance, the possible impact on other financial sectors of the unavailability or unaffordability of certain lines of coverage (such as the emerging difficulties for banks in obtaining Directors and Officers Insurance) reinsurance, where very large risks are shared among many insurers, post-assessment guaranty funds and possibly other insurance risks.
4. Dividing the insurance industry "systemically significant" and non-significant companies is not feasible. Instead, the regulator should monitor all, or nearly all, insurers to impose capital standards on those institutions that ratchet up significantly as the institution takes on more risk – either by growing to a size that makes it "too big to fail," by engaging in risky activities, or by entering into risky relationships with other players in the broader financial markets.
5. Congress should consider taking several steps that would lower the overall systemic risk of the insurance industry, including repealing the provisions of the Gramm-Leach-Bliley Act that allow firms to sell insurance in conjunction with other financial services, particularly credit and securities products.
6. Insurance systemic risk could also be lowered by eliminating post-assessment guaranty funds and replacing them by state directed, nationally based, pre-assessment funds, or by a federal insurance guaranty agency modeled on the FDIC.

[8] See Attachment 2.

Consumers Do Not Care about the Locus of Regulation, but Care a Great Deal about the Quality and Effectiveness of Consumer Protections. CFA's Ongoing Study of Insurance Regulation and the Impact of the Financial Meltdown On the Prospects for State or Federal Regulation.

A) What is better, state or federal regulation of insurance?

There are certain regulatory functions that the states can do better than the federal government, and other functions that could potentially be more effective at the federal level. For example, it is very likely that a federal complaint handling system would not be as consumer-friendly as is the present state system. Contrarily, a state system would likely not approach the effectiveness of a federal system when it comes to systemic risk identification and control.

Here is a chart of some major areas comparing state and federal system capacities:

Item	Federal	State
Experience overseeing all aspects of insurance regulation?	No	Yes
Responsive to local needs?	No	Yes
Handle individual complaints promptly and effectively?	No	Some States
Limited impact if regulatory mistakes are made?	No	Yes
Not subject to political pressure from national insurers?	No	No
Not subject to political pressure from local insurers?	Yes	No
Efficient solvency regulation?	No	Yes*
Effective guaranty in event of insolvency?	Yes	No
Adequately restricts revolving door between regulators and industry?	Maybe	No
More uniform regulatory approach?	Yes	No
Can easily respond to micro-trends impacting only a region or a state?	No	Yes
Can easily respond to macro-trends that cross state borders?	Yes	No
Has greater resources, like data processing capacity?	Yes	No
Systemic risk analysis and control	Yes	No
Web page information excellence	Maybe	Yes

* Jury still out on this issue as the economy falters and some states lower capital standards for life insurance.

This sort of chart provides several indications of how to change the current insurance regulatory system to make it more effective. For instance, the states have more experience, are more responsive to local needs and better at handling complaints, and may be better at solvency monitoring than federal agencies. This argues for a role for the states in dealing with consumer's needs at the ground level. However, the federal government is likely to be better at the very important big issues of assessing macro-trends that cross state borders, as well as determining and controlling systemic risk. This argues for federal oversight of national risks.

These differential capacities thus may suggest some sort of hybrid approach that allows states to deal with local issues and the federal government to deal with over-arching issues that might impact the nation, such as bond insurance and other systemic risks cited above. The state

expertise might also imply a strong role in the overall decision-making process once macro trends are identified by the federal systemic regulator.

The chart may also support differential treatment of property/casualty insurers, where local issues such as weather catastrophes and legal requirements (e.g., no-fault vs. tort for auto) are vital matters for regulation, whereas the life insurance market is more national in scope and may lend itself to federal regulatory requirements.

I should warn you, as I am sure you already know Mr. Chairman, to beware of insurers seeking to help you create their "new" regulatory system. Insurers have, on occasion, sought federal regulation when the states increased regulatory control and the federal regulatory attitude was more laissez-faire. Thus, in the 1800s, the industry argued in favor of a federal role before the Supreme Court in *Paul v. Virginia*, but the court ruled that the states controlled because insurance was intrastate commerce.

Later, in the 1943 *SEUA* case, the Court reversed itself, declaring that insurance was interstate commerce and that federal antitrust and other laws applied to insurance. By this time, Franklin Roosevelt was in office and the federal government was a tougher regulator than were the states. The industry sought, and obtained, the McCarran-Ferguson Act. This law delegated excusive authority for insurance regulation to the states, with no routine Congressional review. The Act also granted insurers a virtually unheard of exemption from antitrust laws, which allowed insurance companies to collude in setting rates and to pursue other anticompetitive practices without fear of federal prosecution.

From 1943 until about seven years ago, the insurance industry has violently opposed any federal role in insurance regulation. In 1980, insurers successfully lobbied to stop the Federal Trade Commission from investigating deceptive acts and practices of any kind in the insurance industry. They also convinced the White House that year to eliminate the Federal Insurance Administration's work on insurance matters other than flood insurance. In other words, the industry killed the federal insurance office they now covet. Since that time, the industry has successfully scuttled any attempt to require insurers to comply with federal antitrust laws and has even tried to avoid complying with federal civil rights laws.

Notice that the insurance industry is very pragmatic in its selection of a preferred regulator. They always favor the least regulation. It is not surprising that, the industry would again seek a federal role at a time, seven years ago, when they perceived little regulatory interest at the federal level. But, rather than going for full federal control, they have learned that there are ebbs and flows in regulatory oversight at the federal and state levels, so they seek the ability to switch back and forth at will. Thus an "O" is added to their preferred approach, the "OFC" – the Optional Federal Charter. And, even though the federal government now seems more intent on regulating as a result of the economic lessons of late, the industry can still support an OFC since they do not have to opt for a federal regulator now if they choose against it.

Further, the insurance industry has used the possibility of an increased federal role to pressure NAIC and the states into gutting consumer protections over the last seven years.

Insurers have repeatedly warned states that the only way to preserve their control over insurance regulation is to weaken consumer protections.[9]

This strategy of "whipsawing" state regulators to lower standards benefits all elements of the insurance industry, even those that do not support any federal regulatory approach. Even if Congress does nothing, the threat of federal intervention is enough to scare state regulators into acceding to insurer demands to weaken consumer protections.

Unfortunately for consumers, the strategy has paid off. In the last few years, the NAIC has moved to sharply cut consumer protections adopted over a period of decades. The NAIC is terrified of Congressional action and sees reducing state consumer protections as the way to "save" state regulation by placating insurance companies and encouraging them to stay in the fold. This strategy of saving the village by burning it has made state regulation more, not less vulnerable to a federal takeover.

The NAIC has also failed to act in the face of a number of serious problems facing consumers in the insurance market.

NAIC Failures to Act

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[9] The clearest attempt to inappropriately pressure the NAIC occurred at their spring 2001 meeting in Nashville. There, speaking on behalf of the entire industry, Paul Mattera of Liberty Mutual Insurance Company told the NAIC that they were losing insurance companies every day to political support for the federal option and that their huge effort in 2000 to deregulate and speed product approval was too little, too late. He called for an immediate step-up of deregulation and measurable "victories" of deregulation to stem the tide. In a July 9, 2001, *Wall Street Journal* article by Chris Oster, Mattera admitted his intent was to get a "headline or two to get people refocused." No commissioner challenged Mattera and many commissioners went so far as to beg industry representatives to grant them more time to deliver whatever the industry wanted.

Jane Bryant Quinn, in her speech to the NAIC on October 3, 2000, said: "Now the industry is pressing state regulators to be even more hands-off with the threat that otherwise they'll go to the feds." As a result, other observers of the NAIC see this pressure as potentially damaging to consumers.

Larry Forrester, President of the National Association of Mutual Insurance Companies (NAMIC), wrote an article in the *National Underwriter* of June 4, 2000. In it he said, "...how long will Congress and our own industry watch and wait while our competitors continue to operate in a more uniform and less burdensome regulatory environment? Momentum for federal regulation appears to be building in Washington and state officials should be as aware of it as any of the rest of us who have lobbyists in the nation's capital...NAIC's ideas for speed to market, complete with deadlines for action, are especially important. Congress and the industry will be watching closely...The long knives for state regulation are already out..."

In a press release entitled "Alliance Advocates Simplification of Personal Lines Regulation at NCOIL Meeting; Sees it as Key to Fighting Federal Control" dated March 2, 2001, John Lobert, Senior VP of the Alliance of American Insurers, said, "Absent prompt and rapid progress (in deregulation) ... others in the financial services industry – including insurers – will aggressively pursue federal regulation of our business..."

In the NAIC meeting of June 2006, Neil Alldredge of the National Association of Mutual Insurance Companies pointed out "states are making progress with rate deregulation reforms. In the past four years, 16 states have enacted various price deregulation reforms...(but) change is not happening quickly enough...He concluded that the U.S. Congress is interested in insurance regulatory modernization and the insurance industry will continue to educate Congress about the slow pace of change in the states (Minutes of the NAIC/Industry Liaison Committee, June 10, 2006)."

1. Failure to do anything about abuses in the small face life market. Instead, NAIC adopted an incomprehensible disclosure on premiums exceeding benefits, but did nothing on overcharges, multiple policies, or unfair sales practices.

2. Failure to do anything meaningful about unsuitable sales in any line of insurance. Suitability requirements still do not exist for life insurance sales even in the wake of the remarkable market conduct scandals of the late 1980s and early 1990s. A senior annuities protection model was finally adopted (after years of debate) that is so limited as to do nothing to protect consumers.

3. Failure to call for collection and public disclosure of market performance data after years of requests for regulators to enhance market data, as NAIC weakened consumer protections. How does one test whether a market is workably competitive without data on market shares by zip code and other tests?

4. Failure to call for repeal of the antitrust exemption in the McCarran-Ferguson Act as they push forward deregulation model bills. Indeed, the NAIC still opposes repeal of the antitrust exemption even as they deregulate...effectively seeking to deregulate cartel-like organizations.

5. Failure to do anything as an organization on the use of credit scoring for insurance purposes. In the absence of NAIC action, industry misinformation about credit scoring has dominated state legislative debates. NAIC's failure to analyze the issue and perform any studies on consumer impact, especially on lower income consumers and minorities, has been a remarkable dereliction of duty.

6. Failure to end use of occupation and education in underwriting and pricing of auto insurance.[10]

7. Failure to address problems with risk selection. There has not even been a discussion of insurers' explosive use of underwriting and rating factors targeted at socio-economic characteristics: credit scoring, check writing, prior bodily injury coverage limits purchased by the applicant, prior insurer, prior non-standard insurer, education, occupation, not-at-fault claims, not to mention use of genetic information, where Congress has had to recently act to fill the regulatory void.

8. Failure to heed calls from consumer leaders to do something about contingency commissions for decades (until Attorney General Spitzer finally acted).

9. Failure to even discover, much less deal with, the claims abuses relating to the use of systems designed to systematically underpay claims for millions of Americans.

10. Failure to do anything on single premium credit insurance abuses.

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[10] Florida has held hearings on the practice.

11. Failure to take recent steps on redlining or insurance availability or affordability. Many states no longer even look at these issues, 30 years after the federal government issued studies documenting the abusive practices of insurers in this regard. Yet, ongoing lawsuits continue to reveal that redlining practices harm the most vulnerable consumers.

12. Failure to take meaningful action on conflict-of-interest restrictions even after Ernest Csiszar left his post as South Carolina regulator and President of the NAIC in September 2004 to become President of the Property Casualty Insurers Association of America after negotiating deregulation provisions in the SMART Act desired by PCIAA members. Other recent NAIC Presidents took similar lobbying and other jobs in the industry and about half of all commissioners come from and return to their industry perches.

13. Failure to act to create regional catastrophic pools to spread hurricane risks or to effectively deal with inappropriate short-term, unscientific models which have sharply raised consumers' home insurance prices along the coasts.

NAIC Rollbacks of Consumer Protections

1. The NAIC pushed through small business property/casualty deregulation, without doing anything to reflect consumer concerns (indeed, even refusing to tell consumer groups why they rejected their specific proposals) or to upgrade "back-end" market conduct quality, despite promises to do so. As a result, many states adopted the approach and have rolled back their regulatory protections for small businesses.

2. States are rolling back consumer protections in auto insurance as well. New York, New Jersey, Texas, Louisiana, and New Hampshire have done so in the last few years.

3. NAIC has terminated free access for consumers to the annual statements of insurance companies at a time when the need for enhanced disclosure is needed if price regulation is to be reduced.

4. NAIC is currently actively considering adoption of personal lines (auto and home insurance) regulatory framework guidance to the states that would severely reduce consumer protections. Just a couple of months ago, an NAIC Working Group passed the White Paper calling for this home and auto insurance deregulation, remarkable in the midst of national recognition of the perils of deregulation.

5. NAIC almost cut the safety of life insurance capital and surplus cushions protecting consumers, but relented at the last minute after it became obvious that the basic research on whether this was wise and would not lead to insurer failure was not finished. After the NAIC acknowledged that this was not ready for action, many states proceeded to implement the very same changes anyway, sharply weakening consumer protection in the face of the mounting danger of insurer failure.

B) CFA's research into best regulatory systems in the states: Why competition alone does not control unfair classes or hold down price increases and why price regulation is necessary in insurance.

In April 2008, CFA released a detailed, national study of automobile insurance regulation over the last two decades that found that rates have risen more slowly in the fifteen states that require insurers to receive advance approval of rate increases from the state.[11] States with "prior approval" regulation also performed well in spurring competition and generating reasonable profits for insurers. The top-performing state in keeping rates down and providing comprehensive consumer protections was California. Among the worst performing states were those with weak or no regulation of rates at all. These states had the steepest rate increases, less competitive markets and among the highest profits for insurers.

The study assessed automobile insurance regulation in all 50 states and the District of Columbia. It examined a number of factors that are important to consumers and insurers, including rate increases from 1989 through 2005, insurer profits from 1997 through 2005, as measured by return on net worth, and the current level of competition.

The chart below shows the results for each of these factors for the six different systems that states use to oversee insurance rates. With the exception of the one state that mandates the rates insurers can charge, the fifteen states that require insurers to receive approval for rate changes before they go into effect had the smallest increase in rates (54 percent) from 1989 through 2005. In fact, column 3 shows that the weaker the regulatory system, the greater the price increase consumers have faced. States with a prior approval regime also had a similar level of competition and slightly lower, but reasonable, insurer profits compared to states with different forms of regulation. According to the widely used Herfindahl-Hirshman Index (HHI), states with prior approval rules have insurance markets that are on the border between competitive and moderately concentrated. The states that provided the lowest level of consumer protection used the regulatory system known as "Competition," in which the state has no authority to control rates. These states had sharper rate increases, higher profits and greater market concentration than all other regulatory systems other than the one state that set prices for insurers.

PRIVATE PASSENGER AUTO INSURANCE

Column 1	Column 2	Column 3	Column 4	Column 5
Regulatory System	**Number of States Using the System**	**1989/2005 Change in Expenditure**	**1997/2005 Return on Net Worth**	**HHI Index**
State Set	1	52.8%	6.4%	1371

[11] "State Automobile Insurance Regulation: A National Quality Assessment and In-depth Review of California's Uniquely Effective Regulatory System," April 2008, at http://www.consumerfed.org/pdfs/state_auto_insurance_report.pdf.

Prior Approval	15	54.0%	8.6%	984
File & Use	23	68.1%	9.0%	1016
Use & File	8	70.0%	9.7%	935
Flexible	2	70.8%	7.0%	1292
Competition	2	73.9%	9.6%	1111

State Set: state establishes rates insurers can charge.
Prior Approval: insurers cannot put rate changes into effect without state approval.
File and Use: rate changes can take effect without state approval, but must be filed with the state before use and can be later disapproved.
Use and File: rate changes can go into effect without state approval but must be filed after use and can be later disapproved.
Flexible: rate changes can be filed and used without approval unless they change by more than a particular amount, when filing and approval are required.
Competition: state has no authority to control rates.

California's regulatory system, which was adopted by state residents when they voted for Proposition 103 in 1988, performed well in virtually every category examined by the report, including all of the factors cited above. Two exceptions were insurer profit levels over the longer term (1989 through 2006), which were somewhat high, and a large population of uninsured motorists. The California system's positive results for consumers include the following:

- Generated estimated savings of $61.8 billion for consumers over the sixteen years that Proposition 103 has been in effect;
- First among all states in holding down rate increases (to 12.9 percent);
- Fourth in market competitiveness as measured by the HHI (716);
- The only state to totally repeal its antitrust exemption for automobile insurers;
- The only state to put reasonable limits on expenses passed through to consumers, such as fines and excessive executive salaries;
- Has a very low number of residents participating in higher cost "assigned risk" insurance plans;
- Among the eleven states with the highest ranking from the Insurance Institute for Highway Safety for strong seat belt laws;
- One of only four states that guarantees that good drivers can receive a policy that can be renewed from an insurer of their choosing;
- The only state to require that a person's driving record is the most important factor in determining insurance rates, followed by the number of miles driven and years of driving experience. All other factors used by insurers must have less impact on rates than these criteria;
- One of only three states to ban the use of credit scoring for setting rates or granting coverage;
- The only state to require that insurers offer consumers the lowest price available from all of the companies in the insurer group;

- The only state that funds consumer participation in the ratemaking process if a substantial contribution is made. [12]

Consumers, who over the last 30 years have been the victims of vanishing premiums, churning, race-based pricing, creaming, and consumer credit insurance policies that pay pennies in claims per dollar in premium, are not clamoring for such policies to be brought to market with even less regulatory oversight than in the past. The fact that "speed-to-market" has been identified as a vital issue in modernizing insurance regulation demonstrates that some policymakers have bought into insurers' claims that less regulation benefits consumers. We disagree. We think smarter, more efficient regulation benefits both consumers and insurers and leads to more beneficial competition. Mindless deregulation, on the other hand, will harm consumers.

The need for better regulation that benefits both consumers and insurers is being exploited by some in the insurance industry to eliminate the most effective aspects of state insurance regulation such as rate regulation, in favor of a model based on the premise that competition alone will protect consumers.[13] We question the entire foundation behind the

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[12] "State Automobile Insurance Regulation: A National Quality Assessment and In-Depth Review of California's Uniquely Effective Regulatory System," April 2008, http://www.consumerfed.org/pdfs/state_auto_insurance_report.pdf.

[13] If America moves to a "competitive" model, certain steps must first be taken to ensure "true competition" and prevent consumer harm. First, insurance lines must be assessed to determine whether a competitive model, e.g., the alleviation of rate regulation, is even appropriate. This assessment must have as its focus how the market works for consumers. For example, states cannot do away with rate regulation of consumer credit insurance and other types of insurance subject to reverse competition. The need for relative cost information and the complexity of the line/policy are factors that must be considered.

If certain lines are identified as appropriate for a "competitive" system, before such a system can be implemented, the following must be in place:

- Policies must be transparent: Disclosure, policy form and other laws must create transparent policies. Consumers must be able to comprehend the policy's value, coverage, actual costs, including commissions and fees. If consumers cannot adequately compare actual costs and value, and if consumers are not given the best rate for which they qualify, there can be no true competition.
- Policies should be standardized to promote comparison-shopping.
- Antitrust laws must apply.
- Anti-rebate, anti-group and other anti-competitive state laws must be repealed.
- Strong market conduct and enforcement rules must be in place with adequate penalties to serve as an incentive to compete fairly and honestly.
- Consumers must be able to hold companies legally accountable through strong private remedies for losses suffered as a result of company wrongdoing.
- Consumers must have knowledge of and control over flow and access of data about their insurance history through strong privacy rules.
- There must be an independent consumer advocate to review and assess the market, assure the public that the market is workably competitive, and determine if policies are transparent.

Safeguards to protect against competition based solely on risk selection must also be in place to prevent redlining and other problems, particularly with policies that are subject to either a public or private mandate. If a competitive system is implemented, the market must be tested on a regular basis to make sure that the system is working and to identify any market dislocations. Standby rate regulation should be available in the event the "competitive model" becomes dysfunctional.

assumption that virtually no front-end regulation of insurance rates and terms coupled with more back-end (market conduct) regulation is better for consumers. First of all, there are many reasons why competition in insurance is weak (see below). The track record of market conduct regulation has been extremely poor in most states. Insurance regulators rarely are the first to identify major problems in the marketplace.

Given this track record, market conduct standards and examinations by regulators must be dramatically improved to enable regulators to become the first to identify and fix problems in the marketplace and to address market conduct problems on a national basis. From an efficiency and consumer protection perspective, it makes no sense to lessen efforts to prevent the introduction of unfair and inappropriate policies in the marketplace. It takes far less effort to prevent an inappropriate insurance policy or market practice from being introduced than to examine the practice, stop a company from doing it and provide proper restitution to consumers after the fact.

The unique nature of insurance policies and insurance companies requires more extensive front-end regulation than other consumer commodities. And while insurance markets can be structured to promote beneficial price competition, deregulation does not lead to, let alone guaranty, such beneficial price competition.

Front-end regulation should be designed to prevent market conduct problems from occurring. It should also promote beneficial competition, such as price competition and loss mitigation efforts, and deter destructive competition, such as selection competition, and unfair sales and claims settlement practices. Simply stated, strong, smart, efficient and consistent front-end regulation is critical for meaningful consumer protection and absolutely necessary to any meaningful modernization of insurance regulation.

The insurance industry promotes a myth: that regulation and competition are incompatible. This is demonstrably untrue. Regulation and competition both seek the same goal: the lowest possible price consistent with a reasonable return for the seller. There is no reason that these systems cannot coexist and even compliment each other. They do very successfully, as we have documented in California under the pro-competitive but tough regulatory system created by the adoption of Proposition 103 by the people of that state.

Insurance cannot be effectively regulated by competition alone. There are several key reasons for this truth:

1. ***Insurance is a Complex Legal Document***. Most products are able to be viewed, tested, "tires kicked" and so on. Insurance policies, however, are difficult for consumers to read and understand -- even more difficult than documents for most other financial products.

If the industry will not agree to disclosing actual costs, including all fees and commissions, ensuring transparency of policies, strong market conduct rules and enforcement then it is not advocating true competition, only deregulation.

For example, consumers often think they are buying insurance, only to find they bought a list of exclusions.

2. ***Comparison Shopping is Difficult.*** Consumers must first understand what is in the policy to compare prices.

3. ***Policy Lag Time.*** Consumers pay a significant amount for a piece of paper that contains specific promises regarding actions that might be taken far into the future. The test of an insurance policy's usefulness may not arise for decades, when a claim arises.

4. ***Determining Service Quality is Very Difficult.*** Consumers must determine service quality at the time of purchase, but the level of service offered by insurers is usually unknown at the time a policy is bought. Some states have complaint ratio data that help consumers make purchase decisions, and the NAIC has made a national database available that should help, but service is not an easy factor to assess.

5. ***Financial Soundness is Hard to Assess.*** Consumers must determine the financial solidity of the insurance company. One can get information from A.M. Best and other rating agencies, but this is also complex information to obtain and decipher.

6. ***Pricing is Dismayingly Complex.*** Some insurers have many tiers of prices for similar consumers—as many as 25 tiers in some cases. Consumers also face an array of classifications that can number in the thousands of slots. Online assistance may help consumers understand some of these distinctions, but the final price is determined only when the consumer actually applies and full underwriting is conducted. At that point, the consumer might be quoted a much different rate than he or she expected. Frequently, consumers receive a higher rate, even after accepting a quote from an agent.

7. ***Underwriting Denial.*** After all that, underwriting may result in the consumer being turned away.

8. ***Mandated Purchase.*** Government or lending institutions often require insurance. Consumers who must buy insurance do not constitute a "free-market", but a captive market ripe for arbitrary insurance pricing. The demand is inelastic.

9. ***Incentives for Rampant Adverse Selection.*** Insurer profit can be maximized by refusing to insure classes of business (e.g., redlining) or by charging regressive prices.

10. ***Antitrust Exemption.*** Insurance is largely exempt from antitrust law under the provisions of the McCarran-Ferguson Act.

Compare shopping for insurance with shopping for a can of peas. When you shop for peas, you see the product and the unit price. All the choices are before you on the same shelf. At the checkout counter, no one asks where you live and then denies you the right to make a purchase. You can taste the quality as soon as you get home and it doesn't matter if the pea company goes broke or provides poor service. If you don't like peas at all, you need not buy any. By contrast, the complexity of insurance products and pricing structures makes it difficult

for consumers to comparison shop. Unlike peas, which are a discretionary product, consumers absolutely require insurance products, whether as a condition of a mortgage, as a result of mandatory insurance laws, or simply to protect their home or health.

It is clear that regulation and competition, working together, produce the most effective results in insurance. Price regulation, particularly when markets are stressed, as in the cities for auto insurance and the coasts for home insurance, is essential in protecting consumers. A critical aspect of price regulation, one that is often overlooked and never disclosed by proponents of no price regulation, is that classifications are part of price in insurance. Classes must be regulated since they can be arbitrary, unfair, discriminatory and not based on any factor relating to the risk being insured, thereby undermining one of insurance's most vital social benefits, incentive for risk reduction. If an insurer decided to use race as a class, existing regulations would stop it. However, most states allow insurers to use a number of classifications that are proxies for race and income that have a very negative impact on lower income and minority consumers. For example, many auto insurers today use a combination of credit scores (exposing the poor and unemployed to higher rates, education (more education results in lower rates), occupation (higher paying jobs equal lower rates, unemployment means very high charges), limits of bodily injury insurance with the previous insurer (high limits means lower prices, if you buy only the minimum level that the state requires you pay more, a penalty for obeying the law), homeownership (yes means lower prices.). Classes and, therefore, prices, must be regulated.

C) CFA favors creation of a federal insurance office, with caveats.

When I was Federal Insurance Administrator, I was in charge of several statutory programs, the most important of which was the National Flood Insurance Program (NFIP). The White House also charged FIA with studying insurance and helping other federal agencies with insurance issues. So we worked on national no-fault auto insurance with the Department of Transportation, national health insurance with the Department of Health and Human Resources, risk retention proposals with several agencies and workers' compensation insurance with the Commerce Department), to give you just a few examples.

The insurance industry, which now seeks to create such an office, successfully urged President Reagan to kill the work other than that mandated by statute, thus assuring that the federal government had no insight into one of the most important industries in the nation. Interestingly, at about the same time, the industry lobbied Congress and the Administration to take away FTC's ability to study insurance, further handicapping Washington's capacity to understand insurance.

It simply makes no sense for the federal government to remove any insurance expertise. Such an office should be approved, but it must not be allowed to preempt or undermine consumer protections at the state level, or given vague, open-ended authority to conclude or interpret international agreements that include such preemption.. As discussed below, the FTC should also be allowed to study insurance.

At a time when systemic risk is an obvious danger, when losses due to natural catastrophes have caused severe dislocations in some states, where international terrorism is an

ever-present threat, and consumers are coping with a diverse array of insurance problems, including some problems (like the unavailability and unaffordability of D&O insurance) that are related to the economic meltdown, it is essential that the federal government has an office with insurance expertise to advise the Administration and Congress on pressing domestic and international insurance matters.

CFA supports the creation of the office because there is a strong need for a federal office to investigate and advise on insurance matters that adversely affect consumers, as well as issues that would have a serious effect on the economy. We believe it is most likely that the office should be part of any agency dealing with systemic risk.

D) CFA is updating its study of insurance regulation to reflect the lessons of AIG and other recent regulatory failures.

As I indicated earlier, CFA is evaluating all regulatory options to see what is the most effective system or combinations of systems for protecting consumers and taxpayers, while fostering a viable insurance market. Even in these exceptional economic times, we believe that the burden of proof remains on those who now want to shift away from 150 years of state insurance regulation to show that they are not asking federal regulators and American consumers to accept a dangerous "pig in a poke" that will harm consumers. We are assessing both the history of insurance regulation and recent developments, such as the AIG debacle. We are evaluating the quality of state regulation from the consumer perspective, including the major flaws and successes of state regulation. We are also updating the principles we use to measure the quality of insurance regulatory systems (see Attachment 1) to reflect lessons from the current economic crisis. We will attempt to provide a detailed plan for dealing with systemic risk, while maximizing regulatory efficiency and assuring that needed consumer protections are in place.

The range of proposals under consideration include such ideas as:

- Full federal takeover of insurance regulation.
- A Federal systemic risk regulator only for systemically significant insurers.
- Partial federal takeover, with federal oversight of systemic risk and state consumer protection and assistance authority. Another hybrid approach would vest authority over property causality insurance at the state level and life insurance at the federal level. (See explanation above.)
- Federal minimum standards to be enforced or improved upon at the state level. Federal regulation would only occur in states that do not comply or on issues that are truly national or international in scope, such as implementation of international treaty requirements.
- Federal minimum standards for the states plus a national ("national" as opposed to federal) regulator to do the regulation in states that fail to comply with the minimum

standards (authorized by a federal bill to empower the NAIC to act in areas requiring more uniformity).

At this stage of our consideration of these questions, our research points toward a system that looks something like this:

- A federal office of insurance to regulate systemic risk and deal with international issues related to treaties, but which does not have authority to preempt any state consumer protection standards unless such authority is explicitly defined in statute.

- Congress would also establish federal minimum consumer protection and prudential standards for the states to enforce. The standards would be based on best practices of the states, such as California's excellent auto regulation system. CFA will oppose any proposed system that is not based on high minimum standards or which has the potential to undermine the few states that have decent consumer protections in place.

- The federal office would regulate in states that chose not to enforce the federal minimum standards. This could also be done by a congressionally authorized organization such as the NAIC, but only if the NAIC makes significant changes to its deeply flawed practices, as discussed below.

I emphasize that this idea is CFA's current thinking and that might well change as we complete our research. These ideas and other possibilities are still under debate at CFA and will be vetted with other consumer organizations.

Rather than enforcing Congressional minimum standards through a federal regulator, a state-based entity could be empowered to do so. The most likely contender for that role is the NAIC.

Because of its historical domination by the insurance industry, however, consumer organizations are extremely skeptical about NAIC's ability to confer national treatment in a fair and democratic way. It is essential that any federal legislation to empower the NAIC include standards to prevent undue industry influence and ensure the NAIC can operate as an effective regulatory entity, including:

- Democratic processes/accountability to the public, which must include: notice and comment rulemaking; on the record voting; accurate minutes; rules against ex-parte communication; public meeting/disclosure/sunshine rules/FOIA applicability.
- A decision-making process subject to an excellent Administrative Procedures Act.
- Strong conflict of interest and revolving door statutes similar to those of the federal government to prevent undue insurance industry influence. If decision-making members of the NAIC have connections, past or present, to certain companies, the process will not be perceived as fair.
- Independent funding. The NAIC cannot serve as a regulatory entity if it relies on the industry for its funding. The bill should establish a system of state funding to the NAIC at a set percentage of premium so that all states and insured entities equally fund the NAIC.

To offset industry domination, an independent, national, public insurance counsel/ombudsman's office with significant funding is needed. Consumers must be adequately represented in the process for the process to be accountable and credible.

Whatever proposals emerge relating to insurance regulation, Attachment 1, *Consumer Principles and Standards for Insurance Regulation* provides detailed standards that we will use to test proposals to make sure that they properly protect consumers, whether at the state, multi-state or national level. In our study, we are reviewing all of these standards to update them regarding lessons from the economic crisis, AIG and the abdication by many states of strong consumer protection standards.

CFA Opposes Legislation to Create an Optional Federal Insurance Charter

The bills that have been drafted by trade associations like the American Bankers Association and the American Council of Life Insurers would create a federal regulator that would have little, if any, authority to regulate price or product, regardless of how non-competitive the market might be for a particular line of insurance.[14] The bills submitted to Congress so far offer little or no improvement in consumer protection or information systems to address the major problems insurance consumers have today.[15] Insurers would be able to choose whether to be regulated by this weak federal regulator or by state regulators, who would almost certainly "compete" for insurance companies to regulate by weakening standards or keeping them low.

Consumer organizations strongly oppose an optional federal charter that allows the regulated company, at its sole discretion, to pick its regulator. This is a prescription for regulatory arbitrage that can only undermine needed consumer protections. Indeed the industry drafters of such proposals have openly stated that this is their goal. If elements of the insurance industry truly want to obtain uniformity of regulation, "speed to market" and other advantages through a federal regulator, let them propose a federal approach with high consumer protection standards included that does not allow insurers to run back to the states when regulation gets tougher than they want. The merits of that type of approach are obvious. CFA and the entire consumer community stand ready to fight optional charters with all the strength we can muster.

As stated above, allowing insurers to choose who regulates them is a prescription for disaster when it comes to systemic regulation. The dual charter banking system has been proven to provide banks with an easy way to run away from regulation. "At least 30 banks since 2000 have escaped federal regulatory action by walking away from their federal regulators and moving under state supervision," says a Washington Post report.[16] State chartered banks have also used the threat of switching to a national charter to convince state regulators to keep

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[14] In the 110th Congress, the bill was introduced in the House as H.R. 3200 by Representatives Bean and Royce and in the Senate as S. 40 by Senators Johnson and Sununu.

[15] See Testimony of Travis Plunkett, CFA's Legislative Director, of July 29, 2008 for a full discussion of the problems, which include unfair classifications (a key part of rate regulation), improper claims practices, insurance availability issues, particularly along the coasts and in inner cities and other issues.)

[16] By Switching their Charters, Banks Skirt Supervision," Appelbaum, Washington Post, January 22, 2009.

standards low.[17] Systemic risk regulation cannot be optional. No regulation, including consumer protection regulation of any sort, can be optional and have the necessary teeth to assure insurer compliance.

CFA Favors Repeal of McCarran-Ferguson's Antitrust Exemption[18]

The history of the McCarran-Ferguson Act is replete with drama, from an industry flip-flopping on who should regulate it to skillful lobbying and manipulation of Congressional processes in order to transform the bill's short antitrust moratorium into a permanent antitrust exemption in the confines of a conference committee.

In fact, the insurance industry has long-standing anti-competitive roots. In 1819, local associations were formed to control price competition. In 1866, the National Board of Fire Underwriters was created to control price at the national level, but states enacted anti-compact legislation to control price fixing.

This increased state regulatory activity led insurers to seek a federal approach to preempt the state system. In 1866 and 1868, bills were introduced in Congress to create a national bureau of insurance, but the insurer effort was unsuccessful. Failing in Congress, the industry shifted to a judicial approach.

The case on which rode the industry's hope for court-initiated reform was *Paul v. Virginia*, 75 U.S. (8 Wall) 168 (1868). But the insurance industry's hopes were dashed when the Supreme Court ruled that states were not prohibited by the Commerce Clause from regulating insurance, reasoning that insurance contracts were not articles of commerce in any proper meaning of the word. Such contracts, they ruled, were not interstate transactions (though the parties may be domiciled in different states the policies did not take effect until delivered by the agent in a state, in this case Virginia). They were deemed, then, local transactions, to be governed by local law.

For the next 75 years, insurance regulation remained in the states, despite repeated insurance industry litigation seeking federal preemption. (Ironically, the industry would later adopt the Paul rationale to fend off enhanced federal scrutiny of its activities under the Sherman and Clayton Antitrust Acts.)

Until 1944, state regulation of insurance was secure, based on the rationale that insurance was not interstate commerce. But that assumption was repudiated in the 1944 Supreme Court decision *United States v. South-Eastern Underwriters Association*. That case brought the insurance industry's swift return to Capitol Hill to seek exactly the opposite type of relief from what it had previously advocated.

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[17] Testimony of Travis Plunkett, Consumer Federation of America, before the Senate Banking Committee on July 29, 2008 regarding the State of the Insurance Industry: Examining the Current Regulatory and Oversight Structure.

[18] For a complete discussion of the reasons we favor repeal of the antitrust exemption of McCarran, see my March 7, 2007 testimony, "The McCarran-Ferguson Act: Implications of Repealing the Insurers' Antitrust Exemption," before the Committee on the Judiciary of the United States Senate.

Three months after the Supreme Court denied a motion for rehearing in South-Eastern Underwriters, Senators McCarran and Ferguson introduced a bill that would become the Act bearing their names. The bill was structured to favor continued state regulation of insurance, but also, ultimately, to apply the Sherman and Clayton Antitrust Acts when state regulation was inadequate.

Within two weeks of the bill's introduction, and without holding any hearings on the new measure, the Senate had passed it and sent it to the House of Representatives. As it was sent over, the McCarran-Ferguson Act provided only a very limited moratorium during which the business of insurance would be exempt from the antitrust laws.

The House Judiciary Committee also approved the bill without holding a hearing. The House floor debate indicates that House Members believed the language of the original bill already comported perfectly with the Senate amendment's stated goal of creating a limited moratorium during which the Sherman and Clayton Acts would not apply to the business of insurance.

However, despite the clear intent of both houses not to grant a permanent antitrust exemption, the conference committee proceeded to drastically transform the limited moratorium into a permanent antitrust exemption for the insurance industry. The new language provided that after January 1, 1948, the Sherman, Clayton, and Federal Trade Commission Acts "shall be applicable to the business of insurance to the extent that such business is not regulated by State law."

The House approved the conference report without debate. The sole expression of the House's intent regarding the conference report containing the new section 2(b) proviso is the statement of House managers of the conference, which indicates they intended only to provide for a moratorium, after which the antitrust laws would apply. The Senate, in contrast, debated the conference report for two days. After repeated assurances that the proviso was not intended to preclude application of the antitrust laws, the Senate passed the bill, and President Roosevelt signed it into law on March 9, 1945.

The legislative history shows that the Senate had a serious debate on the antitrust exemption, unlike the House. Senator Claude Pepper contended that the new conference language enabled the states to evade the federal antitrust laws by mere authorizing legislation. Senator O'Mahoney stated that section 2(b) of the conference report simply provided for a moratorium, after which the antitrust laws would "come to life again in the field of interstate commerce." The "state action" doctrine of *Parker v. Brown* would apply fully, he said, so that "no State, under the terms of the conference report, could give authority to violate the antitrust laws." Therefore, he concluded, "the apprehensions which [Senator Pepper] states with respect to the conference report are not well founded." Senator McCarran likewise reassured Senator Pepper that "he is in error in his whole premise in this matter."

Unfortunately, the courts construing the Act did not make these inferences. When presented with the question of what Congress meant by "regulated," the courts found no standard

in the text of the statute and, declining to search for one in the legislative history, reached the very conclusion that Senator Pepper had anticipated and vainly struggled to forestall.

The antitrust exemption has been studied on several occasions by federal authorities; each time with the determination that continued exemption was not warranted. For example:

- In 1977, when I was Federal Insurance Administrator under President Ford, the Justice Department concluded, "an alternative scheme of regulation, without McCarran Act antitrust protection, would be in the public interest."[19]

- In 1979, President Carter's National Commission for the Reform of Antitrust Laws and Procedures concluded, almost unanimously, that the McCarran broad antitrust immunity should be repealed.

- In 1983, then FTC Chairman James C. Miller III told the House Subcommittee on Commerce, Transportation and Tourism that he saw no legitimate reason to exempt the insurance industry from FTC jurisdiction.

- In 1994, the House Judiciary Committee issued its report calling for a sharp cutting back of the antitrust exemption.

For centuries, property/casualty insurers have used so-called "rating bureaus" to make rates for several insurance companies to use. Not many years ago, these bureaus required that insurers charge rates developed by the bureaus (the last vestiges of this practice persisted into the 1990s).

In recent years, the rate bureaus have stopped requiring the use of their rates or even preparing full rates because of lawsuits by state attorneys general after the liability crisis of the mid-1980s was caused, in great part, by insurers sharply raising their prices to return to ISO rate levels. ISO is an insurance rate bureau or advisory organization. Historically, ISO was a means of controlling competition. It still serves to restrain competition since it makes "loss costs" (the part of the rate that covers expected claims and the costs of adjusting claims) which represent about 60-70 percent of the rate. ISO also makes available expense data to which insurers can compare their costs in setting their final rates. ISO sets classes of risk that are adopted by many insurers. ISO diminishes competition significantly through all of these activities. There are other such organizations that also set pure premiums or do other activities that result in joint insurance company decisions. These include the National Council on Compensation Insurance (NCCI) and National Insurance Services Organization (NISS).

Today the rate bureaus still produce joint price guidance for the large preponderance of the rate. The rating bureaus start with historic data for these costs and then actuarially manipulate the data (through processes such as "trending" and "loss development") to determine an estimate of the projected cost of claims and adjustment expenses in the future period when the costs they are calculating will be used in setting the rates for many insurers. Rate bureaus, of

[19] Report of the U.S. Department of Justice to the Task Group on Antitrust Immunities, 1977.

course, must bias their projections to the high side to be sure that the resulting rates or loss costs are high enough to cover the needs of the least efficient, worst underwriting insurer member or subscriber to the service.

Legal experts testifying before the House Judiciary Committee in 1993 concluded that, absent McCarran-Ferguson's antitrust exemption, manipulation of historic loss data to project losses into the future would be illegal (whereas the simple collection and distribution of historic data itself would be legal – which is why there is no need for safe harbors to protect pro-competitive joint activity). This is why there are no similar rate bureaus in other industries. For instance, there is no CSO (Contractor Services Office) predicting the cost of labor and materials for construction of buildings in the construction trades for the next year (to which contractors could add a factor to cover their overhead and profit). The CSO participants would go to jail for such audacity.

Further, rate organizations like ISO file "multipliers" for insurers to convert the loss costs into final rates. The insurer merely has to tell ISO what overhead expense load and profit load they want and a multiplier will be filed. The loss cost times the multiplier is the rate the insurer will use. An insurer can, as ISO once did, use an average expense of higher cost insurers for the expense load if it so chooses plus the traditional ISO profit factor of five percent and replicate the old "bureau" rate quite readily.

It is clear that the rate bureaus[20] still have a significant anti-competitive influence on insurance prices in America.

- The rate bureaus guide pricing with their loss cost/multiplier methods.
- The rate bureaus manipulate historic data in ways that would not be legal absent the McCarran-Ferguson antitrust law exemption.
- The rate bureaus also signal to the market that it is OK to raise rates. The periodic "hard" markets are a return to rate bureau pricing levels after falling below such pricing during the "soft" market phase.
- The rate bureaus signal other market activities, such as when it is time for a market to be abandoned and consumers left, possibly, with no insurance.

CFA Favors Allowing FTC to Study Insurance

I once attended a hearing here in a Senate committee where the Chairman asked the FTC Chairman to comment on a current insurance issue. The Chairman said that if he had the knowledge to answer, he would be breaking the law and was excused. The insurance industry

[20] By "rate bureaus" here I include the traditional bureaus (such as ISO) but also the new bureaus that have a significant impact on insurance pricing such as the catastrophe modelers (including RMS), other non-regulated organizations that impact insurance pricing and other decisions across many insurers (credit scoring organizations like FAIR Isaac is one example) and organizations that "assist" insurers in settling claims, like Computer Sciences Corporation (using products like Colossus).

had successfully lobbied Congress to take away the FTC's authority to study insurance. The triggers for this lobbying were twofold, a study of life insurance that warned consumers about whole life insurance interest rates paid to customers on the cash value of their policies that were grossly inadequate (which the life insurers hated) and a not yet completed study of redlining by property/casualty insurers (that the P/C industry wanted stopped).

It makes absolutely no sense for Congress to continue to handcuff federal agencies that have the expertise to examine the effect of certain insurance practices on consumers. The FTC should be authorized to study insurance and draw conclusions as it sees fit. Consumers will be protected and the industry made stronger when it leads to a reduction in improper industry practices.

Comments on Other Federal Legislation Related to Insurance Regulation

State Modernization and Regulatory Transformation (SMART) Act

The State Modernization and Regulatory Transformation (SMART) Act was proposed by former House Financial Services Chairman Michael Oxley and Representative Richard Baker as a discussion draft in 2005. Rather than increase insurance consumer protections for individuals and small businesses while spurring states to increase the uniformity of insurance regulation, this sweeping proposal would have overridden important state consumer protection laws, sanctioned anticompetitive practices by insurance companies and incite state regulators into a competition to further weaken insurance oversight. It was quite simply one of the most grievously flawed and one-sided pieces of legislation that we have ever seen, with absolutely no protections for consumers. The consumers who would be harmed by it are our nation's most vulnerable: the oldest, the poorest, and the sickest.

For example, the discussion draft would have preempted state regulation of insurance rates. Imagine the impact on homeowners on the Gulf Coast of that proposal, or on companies trying to purchase D&O or bond insurance today. This would leave millions of individual and business consumers vulnerable to price gouging, as well as abusive and discriminatory insurance classification practices. It would also encourage a return to insurance redlining, as deregulation of prices would include the lifting of the modest state controls on territorial line drawing. States would be helpless to stop the misuse of risk classification information, such as credit scores, territorial data, education, occupation and the details of consumers' prior insurance history, for pricing purposes. The draft approach goes so far as to deregulate cartel-like organizations such as the Insurance Services Office and the National Council on Compensation Insurance, while leaving the federal antitrust exemption fully intact, thus allowing deregulated cartel behavior!

Non-admitted Insurance/Reinsurance Regulation

H.R. 1065 passed the House of Representatives in 2007 and was introduced by Senators Martinez and Nelson as S.929. This bill preempts states only in the regulation of surplus lines of insurance and reinsurance. It provides for a method of collecting state premium taxes for surplus lines and allocating this income to the states. CFA has several concerns with this legislation:

1. Contrary to the stated intent of the authors of this legislation, this bill appears to open the door to the increased sale of poorly regulated, non-admitted personal lines of insurance to individual consumers, not just commercial insurance sold to sophisticated corporations. The bill does not exclude non-admitted personal lines of insurance from its provisions. If the bill fosters a sharp growth in under-regulated, non-admitted insurance – as it is intended to do – it could seriously harm consumers who buy non-admitted insurance, since purchasers of such coverage have no guaranty fund protection, a real danger in the present economic circumstances.

2. Great regulatory confusion and ineptitude would likely result when the state of domicile for an insured party regulates all parts of that entity's insurance transaction. (The approach prohibits any state from overseeing surplus lines of transactions other than the home state of an insured party.) Consider how Michigan might regulate a transaction in which General Motors, or another large company based in the state, has purchased a commercial automobile policy for its cars on the West and Gulf Coasts from non-admitted insurers. In all likelihood, Michigan regulators know very little about dealing with earthquake risk in California or hurricane risk in Florida in pricing insurance policies, or in handling claims resulting from such weather events if GM's cars are damaged. Moreover, since Michigan is a no-fault state for auto insurance, regulators there would likely know very little about tort laws in other states and how pricing and claims should be handled. How can 50 regulators each become experts in the laws of all 50 states? This is regulatory super-complexity, not regulatory simplification.

3. The bill was based on the incorrect assumption that the domiciled state of an insured party or reinsurance company will provide adequate oversight. The bill handcuffs states that would have a legitimate interest in acting to protect residents harmed by clearly abusive insurance practices. For example, suppose a non-admitted insurer for a company like GM acts in bad faith and refuses to pay legitimate claims regarding unsafe automobiles that harmed drivers in other states? These states would have no ability to investigate or sanction that insurance company while the state of Michigan, with limited resources and very little in-state impact, would have much less of an incentive to get to the bottom of the problem.

Moreover, a "home state" regulator has the greatest interest in pleasing a large insured party – and employer – based in that state. This could lead the regulator to lower insurance standards that protect residents and consumers who use that company's products and services across the country.

The bill would also allow large commercial insured parties to seek coverage from non-admitted insurers without determining whether the same coverage is available from an admitted carrier, which most states now require. It is not in the public interest to foster the growth of a segment of the market that does not have to meet state standards – unless admitted insurance is truly not available. For example, guaranty associations in all states do not cover claims for surplus lines insurers from other states when an insured entity and its insurer become insolvent. This may be a minor problem for the defunct policyholder and the defunct insurer, but it certainly is not minor for the people that the policyholder may have injured who are left without guaranty association protection.

Similarly, the bill only allows the domiciled state of a reinsurance company to regulate that company's solvency. What if insured entities in the state of domicile are covered by only

one percent of the reinsurance written by a particular company but entities in another state are covered by seventy-five percent of the reinsurance? Moreover, allowing a domiciliary state to essentially act as a national regulator promotes forum shopping by insurers to secure the most favorable regulatory environment. The state of domicile is often under the greatest political and economic pressure not to act to end harmful business practices by a powerful in-state insurer. When I was Insurance Commissioner of Texas, I had to investigate and take down an insolvent insurer in another state because the commissioner of that state refused to do so, as several ex-governors were on the Board of the insurer.

4. Several deregulatory provisions of the bill are based on the faulty assumption that large buyers of insurance do not need protections that would normally be provided in an insurance transaction, such as prohibitions on deceptive practices and mandated verification of the legality of policy forms. (For example, the bill prohibits any state from overseeing surplus lines transactions other than the home state of an insured party.) The investigations and settlements pursued by New York Attorney General Eliot Spitzer refute this assumption. Large, sophisticated corporations were victimized by insurers and brokers through bid rigging, kickbacks, hidden commissions, and blatant conflicts of interest.

A Pro-Consumer Approach to National Insurance Regulation: The Insurance Consumer Protection Act of 2003

The drafters of this legislation--introduced by Senator Hollings before he retired, considered the consumer perspective in its design. S. 1373 of 2003 would have adopted a unitary federal regulatory system under which all interstate insurers would be regulated. Intrastate insurers would continue to be regulated by the states.

The bill's regulatory structure requires federal prior approval of prices to protect consumers, including some of the approval procedures (such as hearing requirements when prices change significantly) being used so effectively in California. It requires annual market conduct exams. It creates an office of consumer protection. It enhances competition by removing the antitrust protection insurers hide behind in ratemaking. It improves consumer information and creates a system of consumer feedback.

If federal regulation is to be considered, S.1373 should be the baseline for any debate on the subject.

Attachment 1

CONSUMER PRINCIPLES AND STANDARDS FOR INSURANCE REGULATION

1. **Consumers should have access to timely and meaningful information about the costs, terms, risks and benefits of insurance policies.**

   - Meaningful disclosure prior to sale tailored for particular policies and written at the education level of the average consumer sufficient to educate and enable consumers to assess a particular policy and its value should be required for all insurance; it should be standardized by line to facilitate comparison shopping; it should include comparative prices, terms, conditions, limitations, exclusions, loss ratio expected, commissions/fees and information on seller (service and solvency); it should address non-English speaking or ESL populations.
   - Insurance departments should identify, based on inquiries and market conduct exams, populations that may need directed education efforts, e.g., seniors, low-income, low education.
   - Disclosure should be made appropriate for medium in which product is sold, e.g., in person, by telephone, on-line.
   - Loss ratios should be disclosed in such a way that consumers can compare them for similar policies in the market, e.g., a scale based on insurer filings developed by insurance regulators or an independent third party.
   - Non-term life insurance policies, e.g., those that build cash values, should include rate of return disclosure. This would provide consumers with a tool, analogous to the APR required in loan contracts, with which they could compare competing cash value policies. It would also help them in deciding whether to buy cash value policies.
   - A free look period should be required; with meaningful state guidelines to assess the appropriateness of a policy and value based on standards the state creates from data for similar policies.
   - Comparative data on insurers' complaint records, length of time to settle claims by size of claim, solvency information, and coverage ratings (e.g., policies should be ranked based on actuarial value so a consumer knows if comparing apples to apples) should be available to the public.
   - Significant changes at renewal must be clearly presented as warnings to consumers, e.g., changes in deductibles for wind loss.
   - Information on claims policy and filing process should be readily available to all consumers and included in policy information.
   - Sellers should determine and consumers should be informed of whether insurance coverage replaces or supplements already existing coverage to protect against over-insuring, e.g., life and credit.
   - Consumer Bill of Rights, tailored for each line, should accompany every policy.
   - Consumer feedback to the insurance department should be sought after every transaction (e.g., after policy sale, renewal, termination, claim denial). The insurer should give the consumer notice of feedback procedure at the end of the transaction, e.g., form on-line or toll-free telephone number.

2. **Insurance policies should be designed to promote competition, facilitate comparison-shopping and provide meaningful and needed protection against loss.**

   - Disclosure requirements above apply here as well and should be included in the design of policy and in the policy form approval process.
   - Policies must be transparent and standardized so that true price competition can prevail. Components of the insurance policy must be clear to the consumer, e.g., the actual current and future cost, including commissions and penalties.
   - Suitability or appropriateness rules should be in place and strictly enforced, particularly for investment/cash value policies. Companies must have clear standards for determining suitability and compliance mechanism. For example, sellers of variable life insurance are required to find that the sales that their representatives make are suitable for the buyers. Such a requirement should apply to all life insurance policies, particularly when replacement of a policy is at issue.
   - "Junk" policies, including those that do not meet a minimum loss ratio, should be identified and prohibited. Low-value policies should be clearly identified and subject to a set of strictly enforced standards that ensure minimum value for consumers.
   - Where policies are subject to reverse competition, special protections are needed against tie-ins, overpricing, e.g., action to limit credit insurance rates.

3. **All consumers should have access to adequate coverage and not be subject to unfair discrimination.**

   - Where coverage is mandated by the state or required as part of another transaction/purchase by the private market (e.g., mortgage), regulatory intervention is appropriate to assure reasonable affordability and guaranty availability.
   - Market reforms in the area of health insurance should include guaranty issue and community rating and, where needed, subsidies to assure that health care is affordable for all.
   - Information sufficient to allow public determination of unfair discrimination must be available. Geo-code data, rating classifications and underwriting guidelines, for example, should be reported to regulatory authorities for review and made public.
   - Regulatory entities should conduct ongoing, aggressive market conduct reviews to assess whether unfair discrimination is present and to punish and remedy it if found, e.g., redlining reviews (analysis of market shares by census tracts or zip codes, analysis of questionable rating criteria such as credit rating), reviews of pricing methods, and reviews of all forms of underwriting instructions, including oral instructions to producers.
   - Insurance companies should be required to invest in communities and market and sell policies to prevent or remedy availability problems in communities.
   - Clear anti-discrimination standards must be enforced so that underwriting and pricing are not unfairly discriminatory. Prohibited criteria should include race, national origin, gender, marital status, sexual preference, income, language, religion, credit history, domestic violence, and, as feasible, age and disabilities. Underwriting and rating classes should be demonstrably related to risk and backed by a public, credible statistical analysis that proves the risk-related result.

4. **All consumers should reap the benefits of technological changes in the marketplace that decrease prices and promote efficiency and convenience.**

   - Rules should be in place to protect against redlining and other forms of unfair discrimination via certain technologies, e.g., if companies only offer better rates, etc. online.
   - Regulators should take steps to certify that online sellers of insurance are genuine, licensed entities and tailor consumer protection, UTPA, etc. to the technology to ensure consumers are protected to the same degree regardless of how and where they purchase policies.
   - Regulators should develop rules/principles for e-commerce (or use those developed for other financial firms if appropriate and applicable.)
   - In order to keep pace with changes and determine whether any specific regulatory action is needed, regulators should assess whether and to what extent technological changes are decreasing costs and what, if any, harm or benefits accrue to consumers.
   - A regulatory entity, on its own or through delegation to an independent third party, should become the portal through which consumers go to find acceptable sites on the web. The standards for linking to acceptable insurer sites via the entity and the records of the insurers should be public; the sites should be verified/reviewed frequently and the data from the reviews also made public.

5. **Consumers should have control over whether their personal information is shared with affiliates or third parties.**

   - Personal financial information should not be disclosed for purposes other than the one for which it is given unless the consumer provides prior written or other form of verifiable consent.
   - Consumers should have access to the information held by the insurance company to make sure it is timely, accurate and complete. They should be periodically notified how they can obtain such information and how to correct errors.
   - Consumers should not be denied policies or services because they refuse to share information (unless information is needed to complete the transaction).
   - Consumers should have meaningful and timely notice of the company's privacy policy and their rights and how the company plans to use, collect and or disclose information about the consumer.
   - Insurance companies should have a clear set of standards for maintaining the security of information and have methods to ensure compliance.
   - Health information is particularly sensitive and, in addition to a strong opt-in, requires particularly tight control and use only by persons who need to see the information for the purpose for which the consumer has agreed to the sharing of the data.
   - Protections should not be denied to beneficiaries and claimants because a policy is purchased by a commercial entity rather than by an individual (e.g., a worker should get privacy protection under workers' compensation).

6. **Consumers should have access to a meaningful redress mechanism when they suffer losses from fraud, deceptive practices or other violations; wrongdoers should be held accountable directly to consumers.**

   - Aggrieved consumers must have the ability to hold insurers directly accountable for losses suffered due to their actions. UTPAs should provide private cause of action.

- Alternative Dispute Resolution clauses should be permitted and enforceable in consumer insurance contracts only if the ADR process is: 1) contractually mandated with non-binding results, 2) at the option of the insured/beneficiary with binding results, or 3) at the option of the insured/beneficiary with non-binding results.
- Bad faith causes of action must be available to consumers.
- When regulators engage in settlements on behalf of consumers, there should be an external, consumer advisory committee or other mechanism to assess fairness of settlement and any redress mechanism developed should be an independent, fair and neutral decision-maker.
- Private attorney general provisions should be included in insurance laws.
- There should be an independent agency that has as its mission to investigate and enforce deceptive and fraudulent practices by insurers, e.g., the reauthorization of FTC.

7. **Consumers should enjoy a regulatory structure that is accountable to the public, promotes competition, remedies market failures and abusive practices, preserves the financial soundness of the industry and protects policyholders' funds, and is responsive to the needs of consumers.**

- Insurance regulators must have a clear mission statement that includes as a primary goal the protection of consumers:
- The mission statement must declare basic fundamentals by line of insurance (such as whether the state relies on rate regulation or competition for pricing). Whichever approach is used, the statement must explain how it is accomplished. For instance, if competition is used, the state must post the review of competition (e.g., market shares, concentration by zone, etc.) to show that the market for the line is workably competitive, apply anti-trust laws, allow groups to form for the sole purpose of buying insurance, allow rebates so agents will compete, assure that price information is available from an independent source, etc. If regulation is used, the process must be described, including access to proposed rates and other proposals for the public, intervention opportunities, etc.
- Consumer bills of rights should be crafted for each line of insurance and consumers should have easily accessible information about their rights.
- Regulators should focus on online monitoring and certification to protect against fraudulent companies.
- A department or division within the regulatory body should be established for education and outreach to consumers, including providing:
    - Interactive websites to collect from and disseminate information to consumers, including information about complaints, complaint ratios and consumer rights with regard to policies and claims.
    - Access to information sources should be user friendly.
    - Counseling services to assist consumers, e.g., with health insurance purchases, claims, etc. where needed should be established.
- Consumers should have access to a national, publicly available database on complaints against companies/sellers, i.e., the NAIC database. NAIC is implementing this.)
- To promote efficiency, centralized electronic filing and use of centralized filing data for information on rates for organizations making rate information available to consumers, e.g., help develop the information brokering business.
- Regulatory system should be subject to sunshine laws that require all regulatory actions to take place in public unless clearly warranted and specified criteria apply. Any insurer claim

of trade secret status of data supplied to the regulatory entity must be subject to judicial review with the burden of proof on the insurer.

- Strong conflict of interest, code of ethics and anti-revolving door statutes are essential to protect the public.
- Election of insurance commissioners must be accompanied by a prohibition against industry financial support in such elections.
- Adequate and enforceable standards for training and education of sellers should be in place.
- The regulatory role should in no way, directly or indirectly, be delegated to the industry or its organizations.
- The guaranty fund system should be prefunded, national fund that protects policyholders against loss due to insolvency. It is recognized that a phase-in program is essential to implement this recommendation.
- Solvency regulation/investment rules should promote a safe and sound insurance system and protect policyholder funds, e.g., providing a rapid response to insolvency to protect against loss of assets/value.
- Laws and regulations should be up to date with and applicable to e-commerce.
- Antitrust laws should apply to the industry.
- A priority for insurance regulators should be to coordinate with other financial regulators to ensure consumer protection laws are in place and adequately enforced regardless of corporate structure or ownership of insurance entity. Insurance regulators should err on side of providing consumer protection even if regulatory jurisdiction is at issue. This should be stated mission/goal of recent changes brought about by GLB law.
    - Obtain information/complaints about insurance sellers from other agencies and include in databases.
- A national system of "Consumer Alerts" should be established by the regulators, e.g., companies directed to inform consumers of significant trends of abuse such as race-based rates or life insurance churning.
- Market conduct exams should have standards that ensure compliance with consumer protection laws and be responsive to consumer complaints; exam standards should include agent licensing, training and sales/replacement activity; companies should be held responsible for training agents and monitoring agents with ultimate review/authority with the regulator. Market conduct standards should be part of an accreditation process.
- The regulatory structure must ensure accountability to the public it serves. For example, if consumers in state X have been harmed by an entity that is regulated by state Y, consumers would not be able to hold their regulators/legislators accountable to their needs and interests. To help ensure accountability, a national consumer advocate office with the ability to represent consumers before each insurance department is needed when national approaches to insurance regulation or "one-stop" approval processes are implemented.
- Insurance regulator should have standards in place to ensure mergers and acquisitions by insurance companies of other insurers or financial firms, or changes in the status of insurance companies (e.g., demutualization, non-profit to for-profit), meet the needs of consumers and communities.
- Penalties for violations must be updated to ensure they serve as incentives against violating consumer protections and should be indexed to inflation.

8. Consumers should be adequately represented in the regulatory process.

- Consumers should have representation before regulatory entities that is independent, external to regulatory structure and should be empowered to represent consumers before any administrative or legislative bodies. To the extent that there is national treatment of companies, a national partnership, or "one-stop" approval, there must be a national consumer advocate's office created to represent the consumers of all states before the national treatment state, the one-stop state or any other approving entity.
- Insurance departments should support public counsel or other external, independent consumer representation mechanisms before legislative, regulatory and NAIC bodies.
- Regulatory entities should have a well-established structure for ongoing dialogue with and meaningful input from consumers in the state, e.g., a consumer advisory committee. This is particularly true to ensure that the needs of certain populations in the state and the needs of changing technology are met.

Attachment 2

Comments of J. Robert Hunter before the Public Hearing Of the NAIC Capital and Surplus Working Group January 27, 2009

Good morning Mr. Chairman and members of the Working Group, my name is Bob Hunter. I am Director of Insurance for the Consumer Federation of America. I have served as Commissioner of Insurance in Texas and as Federal Insurance Administrator under Presidents Ford and Carter. I am delivering these remarks on behalf of CFA and also on behalf of the Center for Economic Justice.

The Economic Situation and Life Insurance Risk

Here is Page 1 of Saturday's (1/24/09) Washington Post:
"DOWNTURN ACCELERATES AS IT CIRCLES THE GLOBE",
"OBAMA TO DECIDE SOON WHETHER TO ADD TO BAILOUT,"
And on Page 1 of the BUSINESS Section "LIFE INSURERS TAKE A HIT"

As the economy of the world melts around us, consumers require more protection from all of its financial service regulators. Even Alan Greenspan understands that now is the time to toughen up consumer protections.

In the entire world, the only people involved in regulation apparently unable to understand that consumers need more protection, not less, is the NAIC. Just last week, an NAIC Working Group voted to recommend that states deregulate auto and home insurance. Today you are posed to recommend that NAIC remove dollars of protection that consumers have in their life insurance products. It is a shocking thing for you to even be considering lowering the dollars that consumers have today as protection as the balance sheets of their insurers are in crisis.

The Post life insurance article is very instructive about some of the risks facing the life insurers, whose stock index has fallen by one-third in this month on top of a similar drop late last year. The risks include a sharp drop in the values of bonds they hold, the likelihood that the ratings of some of these bonds will be cut and further declines ensue, the probability that some bonds will default, the fact that some life insurance products (such as annuities) of some insurers include guaranty returns no longer supported by the assets underlying those annuities, and the fact that analysis's are alarmed that current financial reports may reflect capital levels that are not truly reflective of the lowered values of the assets they hold. Further, captive reinsurance might artificially increase capital and appear to lower risk, while in fact the economics of such transactions do not improve the enterprise risk.

The article also points out that regulators have been trying to stop dubious accounting transactions such as deferred premium assets that already make capital look artificially high. The article says that the ACLI has opposed any retroactive action to correct this because, as the article quotes ACLI, that "would be like deconstructing an already baked cake."

Apparently, ACLI believes cakes that might protect life insurers by keeping capital artificially high cannot be sliced but the cake of consumer protection can be crumbled retrospectively to year-end 2008 and earlier.

NAIC Process Biased

This bias in the process is but one of several major problems with the deeply flawed process NAIC has followed. ACLI has a vested interest in helping its member companies lower consumer protections to pump up capital. When they propose reserve and other changes, the proposals uniformly work to lower dollars and RBC ratios currently protecting consumers. It is ACLI's job not to balance consumer interest with that of their members.

NAIC claims that its job is to protect consumers but you have not done so. Had you been doing so, the first step in a fair review is not to just look at ACLI's list of one-sided suggestions but to determine if the overall consumer protections are truly excessive before considering action to lower protection. For instance, NAIC should have studied aggregate reserves to determine if they are redundant before considering specific items suggested by a biased source. If you were sure aggregate reserves are excessive, surely you would have advised the public how excessive and why by revealing the calculations, before looking at individual items for change. Even then change should be both ways. You should not limit changes to one direction, against the consumer.

NAIC Process Rushed

The second flaw in the process is the big rush to do everything in 2 months. You should not attempt to make changes that would apply to the Annual Statements for 2008. The rush endangers the foundation of statutory accounting of valuing assets and liabilities conservatively to ensure insurers have cash to meet their claims. The explosion in affiliate investments and captive reinsurance agreements already undermines this conservatism. The current economic upheaval does too, in completely unknown ways.

Throughout the subprime and financial crises, state regulators have claimed that insurance companies are strong and that state-based regulation has protected insurance consumers as federal regulators have failed to do.

Given these claims, why has the industry sought and regulators conceded emergency and rushed treatment of these proposals? Absent a compelling reason for emergency action, these proposals should not be adopted in an emergency fashion, but should be treated according to normal procedures.

NAIC Process Closed and Secret

The NAIC Process has been unnecessarily closed and secret. When we asked why, the NAIC responded as follows:

> "The NAIC Executive Committee established the Capital and Surplus Working Group to perform its charges in an expedited manner. Given the ACLI proposals are asking about changes to reserves and other accounting requirements, many of the regulatory discussions were likely to involve company specific questions and comments. Per the NAIC open meetings policy, the discussion of company specific information is a key reason for holding regulator-to-regulator meetings."

This response is inappropriate and unacceptable. Not only has there been no company-by-company analysis, and therefore, no need to close meetings to the public, but the proposals all deal with industry-wide actions – changes in manuals and procedures affecting the entire industry. The argument that, because an individual company might be discussed, the meeting should be non-public is absurd. Using this logic, there would never be an open meeting of any sort. All meetings should be open and executive session used after the open meeting concludes if company info needs to be discussed

And how does the possibility of a specific insurer being discussed justify NAIC's secret, ex-parte meetings with ACLI? The fact that NAIC has already met secretly with ACLI undermines the argument that open meetings cannot be held because it is possible that an individual insurer's situation might come up, because that logic would preclude meetings with ACLI too.

The NAIC has refused to hold itself publicly accountable to the same type of open government standards with which state agencies must comply, even though the NAIC is taking actions that have the force of law. This is why we have challenged the actions of the NAIC as violations of state public meeting, public records and administrative procedures acts. As long as the NAIC continues to respond in this way we will continue to pursue these challenges.

Consumer Questions Remain Unanswered

NAIC's responses to our questions were incomplete or simply non-responsive in several instances.

QUESTION 1: We asked for the evidence to show that changes in reserves were needed. In response, we were told that life and annuity reserves are too conservative and that movement towards principles based reserving – relying on actuaries to certify reserve adequacy instead of relying on rules – is necessary to give industry greater flexibility and set reasonable reserve requirements.

We reject these arguments. First, where is the evidence we sought that reserves are excessive? Industry has cited "studies" by Milliman – studies done on behalf of and paid for by industry. Had Milliman determined current reserves requirements were inadequate, would we have seen that study?

Second, the concept of principles-based reserving is the same type of self-regulation by parties with conflicts of interest that led to the subprime meltdown and financial crisis worldwide. Reliance on actuaries who depend upon industry for their livelihood suffers from the same conflict found with rating agencies in the credit crisis.

QUESTION 2: We asked the NAIC to tell us the results of regulator analyses of the impact of these proposed changes on capital, surplus, reserves and RBC ratios for the industry and for individual companies most impacted by the changes.

We were astonished by your response that reads, "the impact of these proposed changes on stated versus meaningful capital and reserves *for the industry* or a particular company was not used as an analysis criteria."

This response, of course, immediately raises not only the question of why meetings were not open to the public but also questions like:

- Upon what basis is the NAIC determining that these changes will accomplish anything?
- What is the impact on the safety and soundness of insurers and will these changes leave policyholders vulnerable?

A sign of undue haste by the regulators is the complete lack of understanding of the impacts of the actions on America's policyholders.

To act without this knowledge would be irresponsible.

QUESTION 3: We asked how policyholders would be affected by the proposals, if adopted by NAIC. We were told, "Final adoption of these ACLI proposed items will not have an adverse effect on the insurance company's ability to pay its policyholder obligations." Yet no support or analysis is provided to justify this statement. Of course, this answer is, at best, misleading. It is impossible for these actions not to have an adverse effect on an insurer's ability to pay; the question is whether that adverse effect is material and necessary for insurers to remain solvent. The NAIC has refused to answer this question and instead has provided a misleading statement.

QUESTION 4: We asked if the regulators believed that the rating agencies would see these changes as an actual strengthening of capital and reserve requirements and not just cosmetic.

The NAIC did not answer this question. The reason it should be answered is that, at least at ACLI, the reason for the proposals (and for the great haste) is largely to reduce the possibility that rating agencies will lower the ratings of insurers when 2008 Statements are released.

Professor Joseph Belth's research on this question implies that the rating agencies will not be influenced by these changes, at least not in any significant way. If the reason to rush to judgment is to mollify rating agencies, then there is no need to rush if Professor Belth's research is correct. If it is not the reason why NAIC is rushing this proposal through, what is?

QUESTION 5: We asked how the various proposals would be implemented. The NAIC did not respond.

We are concerned with implementation because, in some cases, NAIC action, such as a change to certain NAIC manuals, will automatically make the adopted change effective in most states.

Therefore, the NAIC's failure to use an open public process, including the use of secret meetings and closed meetings, may violate the laws of states that require notice and open meetings, if and when they vote for such a change that becomes effective in their state.

QUESTION 6: We asked if the NAIC would help America's life insurance and annuity policyholders understand what their actions mean by demonstrating the "before and after" effect of the proposed changes on individual insurer's capital and reserve requirements.

The response was "the NAIC would simply recommend the adoption of the proposed item and the domestic regulators will have the ability to require before and after documentation."

This will pull the wool over the eyes of millions of Americans holding life and annuity contracts today. The NAIC indifference to the policyholders is troubling. Just why can the NAIC not adopt national proposals to help consumers at the very time the NAIC is adopting national proposals in undue haste to help insurers? Transparency should not be left to individual states to consider adopting if they think of it, especially since there would be insufficient time for action by the states before the 2008 Annual Statements are due on March 1, 2009, one month from now.

We propose the following language for adoption by the NAIC as part of any approval of the ACLI proposals:

> *Transparency*
>
> *In order to assist policyholders, there shall be full transparency for policyholders of what the financial impacts are from these changes adopted by the NAIC. During a transition period of the first 2 years starting with the first time these changes are applied, key capital, surplus and reserve amounts in the Statutory Annual Statement and Quarterly Statements and risk-based capital ratios shall be calculated showing amounts based on current and revised accounting and reserving rules and procedures.*

Conclusion

In conclusion, we oppose adoption of any of these changes unless the necessary research is undertaken by NAIC to justify the changes, and the important questions we have raised are answered fully and factually. We oppose allowing any of these items to be rushed into use in the 2008 Annual Statement.

If you do go forward, we request that any votes of the Executive Committee and Plenary on any recommendations from the Capital and Surplus Relief Working Group be recorded roll-call votes, so that the public can identify which regulators voted for or against the proposals.

If you move forward, we strongly urge adoption of the Transparency language we proposed earlier. We also suggest that states voting no to these proposals act to keep these proposals from becoming automatically effective in their states by asking for state exceptions to items that would automatically become effective, such as actuarial guidelines and the Accounting Practices and Procedures Manual. Finally, if you move ahead now, we offer comments on the individual

Working Group proposals as contained in my written statement. We object most strenuously to the Working Group's recommendation regarding the Deferred Tax Asset as I explain in my statement.

Answer to NAIC's Question

I would like to take one minute to respond to NAIC's written question to opponents of these proposals.

You asked: Why should NAIC not act on the request(s)? What specifically will happen if the requests are granted (how will consumer protection be decreased)?

First, NAIC should not act because there has been no analysis of the need for these capital and reserve relief proposals, no articulation of what the goals of these proposals are, no explanation of how these proposals will accomplish those goals, no analysis of the expected impact on capital and reserve levels for the industry as a whole or for individual insurance companies, and no analysis proving that consumers would not be harmed by adoption of the proposals. We ask how could any regulator responsibly vote on these proposals without these questions answered? The answer, of course, is that they cannot.

There are several specific things that will happen if you act on these proposals, including these four important ones:

1. The proposals are lessening the capital and surplus required to protect consumers. This is not my opinion -- it is the factual intent of the proposals. In some cases, the requirements for reserves will be lessened, in other cases, the amount of liquid assets representing surplus will be reduced. So the question, how will consumers be harmed is the wrong question -- the proposals by definition are harming consumers. The question really is -- will the reduction in reserves and capital requirements put consumers at a materially greater risk. The problem with the proposals -- and with the entire decision-making process -- is that regulators have not answered this primary question. There are general statements about redundant reserves, but no independent analysis. By what measure have regulators determined reserves are redundant? A study by Milliman paid for by insurers? Please. By what measure have regulator determined that a reduction in liquid assets supporting capital -- the effect of the DTA plan -- will not put some insurers at solvency risk? The fact that regulators have not analyzed - or provided the analysis to the public -- of what the impact on capital and risk based capital ratios will be is incomprehensible for us. What will the impact of these changes be -- on average and in the extreme cases? How can you vote for these proposals if you don't know whether you are increasing the reported capital by 1%, 10% or 20%? Or what the impact on reserves is for specific products? The absence of this type of analysis means that regulators cannot answer your own initial question -- how do you know the impact on consumers will not be material?

2. Consumer faith in life insurance products will be reduced.

3. If there is no transparency as part of the action, consumer groups will have to warn all persons calling that we are unable to know the impact of these changes on their specific company and that they should be more cautious than ever before about purchase or maintenance of life insurance products.

4. The consumer faith in state regulation, already falling faster than the Dow, will be dealt another blow. To give you one key indicator, for the first time CFA is actively rethinking our long support of state regulation and may be soon proposing a very significant federal role.

Attachment 3

THE AMERICAN COUNCIL OF LIFE INSURERS' PRINCIPLES ON REGULATORY REFORM: HOW WELL WILL THEY PROTECT CONSUMERS?

1. "The ACLI remains committed to pursuing as a top priority a comprehensive plan to make a state-based system of life insurance regulation more efficient."

The top priority in protecting consumers should be regulatory effectiveness, not efficiency. Efficiency can be helpful or harmful, depending on whether consumer protection standards are high. Given the trouble that life insurers now find themselves in – trouble that has caused them to call for new leniency on reserve requirements – shouldn't the top priority be to crack down on risky conduct and do a better job of protecting investors?

2. "The ACLI remains committed to making federal insurance regulation available on a voluntary basis to life insurance companies and agents to the extent consistent with the appropriate regulation of systemic risk. Such federal regulation must be equally available to life insurers regardless of their corporate form (stock, mutual, mutual holding company, fraternal) and equally accommodate insurers regardless of size. In addition, federal and state life insurance regulatory systems must be mutually exclusive."

Systemic risk regulation is, by definition, not optional – neither opt in nor opt out. If the failure of an insurer poses a systemic risk, or if the insurer is engaged in activities that create a systemic risk, it should be subject to systemic risk regulation, whether the insurer likes it or not. Moreover, why do state and federal regulation have to be mutually exclusive? For example, why not require federal solvency/capital standards/risk regulation for companies that pose a systemic risk and state consumer protection regulation that meets federal minimum standards at the same time? The combination of state and federal regulation in securities works fairly well, with states pulling up the slack when federal regulators fall down on the job, and vice versa.

3. "Any changes to the insurance regulatory system must preserve effective capital solvency oversight and investment diversification of life insurance companies..."

Capital solvency oversight needs to be strengthened with an eye to ensuring that life insurance companies are not taking on undue risks and have created adequate reserves to back the commitments they've made to policyholders and annuities investors. The diversification of investments by insurers must meet these strengthened risk standards. It is important to remember that risky investment diversification by banks and investment banks is what got them into financial trouble.

4. "Insurance is, and must continue to be, regulated differently from banking, securities and other types of financial services. The risks assumed by life insurance companies and the obligations that attach to those risks are inherently different than those of other financial intermediaries and call for unique regulatory requirements."

Although insurance is different in some ways from other financial services products, there are also similarities. In terms of protecting consumers, the basic tenants of meaningful insurance regulation have much in common with effective regulation of some securities and banking products. Advice offered by insurance agents ought to be subject to a fiduciary duty, just as investment advice is. Sales of insurance products should be subject to a suitability requirement, just as they should be with risky mortgage products. Systemically significant insurers should be subject to constraints on their risk-taking designed to protect taxpayers. When they fail, they should be subject to a mechanism for orderly failure like that which currently applies to banks and needs to be adopted for other non-bank, systemically significant institutions.

That said, there is an argument to be made for having systemic risk regulation done by those who know a particular industry best, rather than throwing everybody into some one-size-fits-all approach to systemic risk regulation. The argument is weakest, however, with regard to insurers where there is no existing federal insurance regulator to take on that role.

5. "Where insurance regulation is housed at the federal level (e.g., in an independent agency, in an office or department of an existing agency, as part of a consolidated federal financial regulator or otherwise) is not as important as assuring that the expertise necessary to appropriately regulate the insurance business is present."

This is true, as far as it goes. However, in addition to needing expertise, the regulator also needs to have the independence from the insurance industry to regulate effectively, something that has been sorely lacking in state insurance regulation. Moreover, if Congress does move toward federal regulation in some form, it must also create a well-funded office to advocate on behalf of insurance consumers.

6. "Regulatory reform must not result in any increase in overall state or federal corporate or policyholder tax burdens."

This statement should give lawmakers great pause, if they are considering offering their support to ACLI's proposals for greater federal regulation of insurance. What ACLI appears to be saying is that the federal government should create another layer of insurance regulation but that life insurers aren't willing to pay enough for it to make it effective.

Systemic Risk & Structural Principles

1. Systemic risk regulation "...must include a federal insurance regulatory component." Why? This may be a good idea, as long as it is not part of an optional federal charter, but why exactly does federal regulation need to extend beyond systemic risk regulation? Why can't the federal systemic risk regulator coordinate with state regulators on its own? Moreover, if a federal role for insurance regulation is authorized, it should in the form of minimum federal standards for the states to enforce or exceed as necessary.

2. "For those companies that do not have a federal functional regulator, the federal systemic regulator should be required to coordinate only directly with a life insurer's primary domestic regulator(s).

The systemic risk regulator has to be able to talk to and coordinate with whomever they choose. Maybe they should only be *required* to coordinate directly with the primary domestic regulator, but they should be *free* to coordinate with anyone they think may have relevant information about risky conduct.

3. "The federal insurance regulatory authority must have the stature and authority to represent the U.S. internationally on all relevant insurance issues, including mutual recognition agreements, ..."

Yes, regulators need to do a better job of cooperating to regulate global markets at the highest level. However, mutual recognition isn't cooperation, it is deferral. It encourages regulatory arbitrage in much the same way that an optional federal charter would and should be viewed by Congress as nothing more than back-door regulation.

4. "Systemic risk regulation should have as its goal the identification and marginalization of risks that might jeopardize the overall financial system. Its goal should not be the preservation of institutions deemed "too big to fail."'

Systemic risk regulation should have as its goals identifying risks that jeopardize the overall financial system, taking steps through regulation to minimize those risks, and providing a mechanism through which systemically significant institutions can be allowed to fail in an orderly fashion, much as already exists for banks, so that they can fail without posing an undue systemic risk. However, the fact that the government does not protect institutions against failure does not mean that it doesn't regulate the conduct of those whose failure would otherwise harm the overall financial system, with an eye toward making that failure less likely.

5. "Existing authority of life insurance holding companies to engage in non-financial activities must be preserved."

This decision should be left to a systemic regulator, which should have the power to prohibit any financial or non-financial activity if it is deemed to create an unacceptable risk.

Insurance Guaranty Mechanism

1. "There should be a uniform, industry-run, mandatory insurance guaranty mechanism covering all life insurance companies that is funded through post-event assessments on insurers."

2. "The states should be required to establish uniform coverage limits and operating requirements. Preemption of states not meeting uniform standards and reliance on a national, industry-run guaranty association for non-compliant states would be

accomplished as set forth in the ACLI's optional federal charter legislative proposal."

As explained in the testimony above, creating an optional federal charter for insurance is a failed idea that will inevitably create great pressure on regulators to lower standards. CFA agrees that the current guaranty system is dangerous. However, as explained above, continuing the funding of guaranty funds through post-event assessment is very risky.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM MICHAEL T. McRAITH

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need to reevaluate the weaknesses of Federal and State functional regulation for large, interconnected, and large firms like AIG?

A.1. The creation of a Federal systemic risk regulator is distinct from an examination of the effectiveness of functional regulation for large firms like AIG. As you know, AIG's 71 U.S.-based insurers subject to State-coordinated oversight have met all obligations to policyholders and claimants. From an insurance regulator's perspective, our functional regulation proved a key element in preserving the value in the AIG insurance subsidiaries and protecting AIG's insurance consumers. With conservative but reasonable capital requirements, solvency standards and accounting principles, State insurance regulators ensured that the AIG insurance companies were, and remain, healthy enterprises within the larger corporate structure. Greater functional regulatory coordination is necessary to understand fully the risks posed by all sectors of a financial conglomerate, and to guard against threats to one subsidiary due to the demise of another.

State-based and State-coordinated insurance regulation is inherently compatible with systemic regulation. State insurance regulators support Congressional initiatives to enhance financial stability through systemic risk regulation provided that such proposals preserve State-based insurance regulation. Working with the myriad functional regulators, the Federal Government should have fingertip access to information and the requisite authority to supervise or undertake corrective action, if necessary. Of course, such corrective action by a financial stability regulator should be undertaken only to prevent or minimize the risk of a financial conglomerate imposing undue burden on the larger financial system. Preemptive authority, though, should be limited to extreme instances of systemic risk and not displace State insurance regulation or other functional regulation.

State insurance regulators, through the NAIC, recognize areas for improvement within the functional regulation of insurance at the State level. To that end, we are implementing and developing proposals to enhance regulatory efficiency.

Also, our regulatory expertise and experience can be relied upon to improve financial regulation more broadly, protect consumers. We welcome the opportunity to partner with other functional regulators. Supervisory colleges comprised of functional regulators may prove useful if not essential in understanding the potential areas and impacts of systemic risk within an individual enterprise.

To discard the expertise and demonstrable success of State insurance regulators would be a grave mistake, especially if based on misconceptions about the efficacy of State regulators to respond to a financial crisis. Insurance companies have generally fared better than other financial institutions. Of course, insurers encounter

challenges based on the overall economy, but the vast majority are withstanding the stress better than other financial service sectors. Some large life insurers attempt to use the current economic stress in other financial sectors as support for an optional Federal charter or other broad regulatory reform. However, any such attempt to blame State insurance regulators for the overall downturn in the capital markets should be understood as transparently misplaced, particularly when the same companies have repeatedly criticized State regulation as too conservative.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move away from functional regulation to some type of single consolidated regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. Without critiquing the merits of each of the above approaches, State insurance regulators refer the Committee to our regulatory modernization principles. Our principles recognize the need for greater collaboration among financial services regulators at the State and Federal level while also preserving, securing and maintaining expertise through effective functional regulation. This can be achieved through enhanced regulation at the holding company level, possibly through the introduction of supervisory colleges comprised of functional regulators.

However, supervisory colleges should not be utilized to override functional regulators. Rather, supervisory colleges can—and should—be effectively utilized to understand the risks within the holding company structure. Functional regulatory expertise, as exemplified by State insurance regulators, has proved a key mitigating factor in averting an even larger financial crisis. Accordingly, preemption of functional regulatory authority, if any, should be limited to extraordinary circumstances that present a material risk to the continued solvency of a systemically significant holding company, or a risk that threatens the stability of a financial system.

Any proposal should avoid the dual regulatory regimes that present the concurrent risks of both regulatory consolidation and regulatory arbitrage. A single consolidated regulator presents inherent risk. Simply put, regulators make mistakes. With only a single regulator, or a single perspective associated with a large, integrated conglomerate, the consequences of regulatory failure expand proportionately and become potentially systemic and catastrophic. Large complex institutions that have the potential for systemic failure need additional scrutiny, not less. Existing regulatory resources should be leveraged. As the State insurance regulatory model has shown, having coordinated oversight of multiple regulators reduces the likelihood of an industry push toward the regulator with the "lightest touch." This collaborative model has proved effective in the case of State insurance regulation, through which

many States coordinate the regulation of any one company, and could be applied to larger-scale functional regulatory collaboration.

Q.3. What is the most effective way to update our rules and regulations to refute the assumption that any insurer or financial services company is too big to fail?

A.3. For State insurance regulators, the issue involves managing risk within the larger financial system rather than refuting assumptions about particular companies. The regulatory modernization principles of State insurance regulators support systemic risk oversight and the utilization of supervisory colleges within a framework that preserves and enhances functional regulation.

Of course, insurance is premised upon insurance companies assuming or receiving risk not creating risk. This principle also applies to systemic risk, which provides ample motivation for policymakers to move toward elimination of regulatory gaps in order to encourage greater financial stability. Insurers' exposure to systemic risk, though, typically results from linkages to the capital markets.

Insurance also illustrates the difference between systemic risk and the risk of large failures. Most lines of insurance have numerous market participants and ample capacity to absorb the failure of even the biggest market participant. For example, if the largest auto insurer in the U.S. were to fail, its policyholders could be quickly absorbed by other insurers, and that insurer would be further supported by the State guaranty fund system. This scenario does not pose systemic risk since the impact is isolated, does not ripple to other financial sectors, and does not require extraordinary intervention to mitigate. Also, the State-based insurer guaranty fund system rewards policyholders and claimants as a priority in the event of an insolvency. Any system of financial stability regulation should focus on truly systemic risk, and not create redundant mechanisms for dealing with isolated disruptions.

Q.4. Last week the WSJ had an article titled, The Next Big Bailout Decision: Insurers. It mentions the fact that a dozen life insurers have pending applications for aid from the government's $700 billion Troubled Asset Relief Program. What is the market-wide risk of life insurance and property and casualty insurance?

A.4. The nature of life insurance and property and casualty insurance is to assume, pool, and spread existing risk, not create new sources of risk. Aside from a handful of mono-line financial guaranty and mortgage guaranty insurers, insurers' normal business operations have generally not been exposed to the larger financial crisis. As a result, insurance does not contribute to market-wide or systemic risk. Even where insurers are directly exposed to capital markets through direct investments and securities lending programs, State insurance regulators impose systems and controls that are constantly improved. As a result, economic downturns can be managed and policyholder dollars remain secure. Insurers play an important role in the capital markets, particularly in the area of long-term investments, such as corporate bonds and commercial and residential mortgages, but State insurance regulators balance a company's desire for increased participation in the capital markets with underlying policyholder obligations.

Insurers' investment portfolios have been exposed to the same market forces as those of other investors. Unlike other investors, though, insurer exposure to market turmoil is reduced by State insurance laws that limit the percentage of assets an insurer can invest in particular asset classes. These investment limitations are one aspect of the conservative but reasonable State solvency regime that aids insurers with preservation of the critical ability to meet obligations to policyholders and claimants. While a handful of life insurance companies may have applications pending for TARP funds, State insurance regulators believe such applications stem from the inherent risk for any investor rather than shortcomings in any insurer's core life insurance operations. To be sure, insurers remain significant participants in capital markets. Insurer participation in the TARP program, therefore, may be consistent with the intent of the Emergency Economic Stabilization Act and may contribute to the strengthening of the economy.

Capital investments by the Department of the Treasury through the Capital Purchase Program (CPP), as accessed by insurers with bank holding company status, indicate insurance sector strength. CPP is not a bailout and Treasury has been clear that participation in CPP is reserved for healthy, viable institutions. State insurance regulators agree with the positive implications of insurer participation in CPP to the extent that such participation relieves liquidity concerns and alleviates consumer concern about the financial health of specific insurance companies and the insurance industry.

Please do not hesitate to contact me if you have more questions, or if you would like additional information in relation to this or any other topic. Thank you again for the opportunity to present to your Committee.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM FRANK KEATING

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need to reevaluate the weaknesses of Federal and State functional regulation for large, interconnected, and large firms like AIG?

A.1. Although we understand the interest of Congress in considering the establishment of a systemic risk regulator, the ACLI has no position on that approach as a solution to the economy's current situation. However we do believe that, should a systemic risk regulator be created and should that office have authority over insurers, it will be important for that office to have constant access to a regulatory office that understands the fundamentals of the insurance industry, and we don't think the Federal Government will have that resource without the creation of a Federal functional regulator.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move away from functional regulation to some type of single consolidated

regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. Although the ACLI has not done an analysis of one of these approaches over the other, we do feel strongly that whichever approach is taken to reform and modernize financial service reform regulation must include the establishment of a Federal insurance regulator. Not doing so would result in the continuation of a 19th century regulatory system being applied to a critical part of the financial services industry.

Q.3. What is the most effective way to update our rules and regulations to refute the assumption that any insurer or financial services company is too big to fail?

A.3. The ACLI has not done the in-depth analysis needed to adequately reply to this question.

Q.4. Last week the WSJ had an article titled, "The Next Big Bailout Decision: Insurers." It mentions the fact that a dozen life insurers have pending applications for aid from the government's $700 billion Troubled Asset Relief Program. What is the market-wide risk of life insurance and property and casualty insurance?

A.4. The ACLI can only respond with regard to the life insurance industry. Life insurers play a vital role in our nation's credit markets. We are the nation's largest holder of corporate bonds, and we have substantial investments in commercial real estate and other areas. If the county's credit markets are going to begin functioning normally again, lending by life insurance companies must be a part of that. So to the degree life insurers receive funds intended to unfreeze the credit markets, it is a totally appropriate action.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM WILLIAM R. BERKLEY

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need to reevaluate the weaknesses of Federal and State functional regulation for large, interconnected, and large firms like AIG?

A.1. The lessons of AIG—and indeed the broader financial crisis—have further underscored the fact that Congress must reevaluate the weaknesses of the current regulatory structure. Thus, as Congress considers the creation of a systemic risk regulator to "fill in the gaps," it must address the lack of an effective and efficient Federal insurance regulator. As I stated in my testimony, the only effective way to include property-casualty insurance under a systemic risk regulator would be to create "an independent Federal func-

tional insurance regulator that stands as an equal to the other Federal banking and securities regulators."

While stricter financial regulatory standards may have helped preserve the capital value of AIG's property and casualty subsidiaries, the fragmented State-by-State regulatory structure did not prevent the collapse of AIG as an enterprise and it has not stopped AIG's insurance subsidiaries from experiencing significant property and casualty underwriting losses, as well as historic losses in its life insurance operations from securities lending. With respect to the enterprise, the State regulatory system made it impossible for any one regulator to exercise comprehensive authority or supervision of the company across State lines, let alone across U.S. borders. Even if each State regulator did an outstanding job supervising entities in their jurisdiction, their inability to see transactions in the aggregate with companies outside their jurisdiction presents a challenge. Thus, no State could intercede to address an enterprise-wide problem because of limited nature of this regulatory jurisdiction. Moreover, this structure prevents risk evaluation on a regional, national, or global scale, something that we now know is imperative in the wake of the financial crisis.

If a Federal insurance regulator is established, regulation should be comprehensive, not divided. For example, creation of a Federal solvency regulator while keeping the existing prudential regulation of insurance at the State level would lead to bifurcated, ineffective regulation and significant unintended consequences.

If this crisis has revealed anything, it is the need for more—not less—regulatory efficiency, coordinated activity or tracking, sophisticated analysis of market trends and the ability to understand and anticipate as well as deal with potential systemic risk before the crisis is at hand. Yet, establishing systemic risk oversight without addressing the structural problems that exist in the current State insurance regulatory system will only defer those problems until the next crisis. To solve such as crisis there must be knowledge and expertise at the Federal level.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move away from functional regulation to some type of single consolidated regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. As a practical matter, it might currently be impossible to put in place an entirely new financial services regulatory structure for the United States. At the same time, the serious regulatory flaws revealed during this crisis need to be addressed in a way that positions U.S. financial services companies—including property and casualty insurers—to compete effectively at home and abroad, while ensuring a healthy and vibrant financial services marketplace that works to the benefit of U.S. consumers. The 2008 Department of the Treasury Blueprint for a Modernized Financial

Regulatory Structure and the Group of Thirty Framework for Financial Stability are both very serious and thoughtful discussions regarding a more efficient and more effective structure for financial regulation. The Treasury Blueprint calls for specific reforms in the way banking and securities are regulated at the Federal level, including the creation of an optional Federal charter regulatory regime to oversee insurers. The Group of Thirty report is designed to discuss financial regulation in broad concepts that can be applied to any country that has recently experienced financial disruption.

Both the Treasury Blueprint and the Group of Thirty report explicitly recommend the "establishment of a Federal insurance regulatory structure" and a "framework for national level consolidated prudential regulation and supervision over large internationally active insurance companies." Such a modern regulatory regime for insurance would benefit consumers and protect taxpayers by ensuring uniform rules and regulations, allow new products to quickly be brought to market, and enhance international competitiveness of American insurance companies. Moreover, a national regulatory structure supervising insurance companies would most certainly fill the gaps that exist under the current system.

Q.3. What is the most effective way to update our rules and regulations to refute the assumption that any insurer or financial services company is too big to fail?

A.3. It is more important for a regulator to understand risk and to set clear rules to mitigate risk in financial services conglomerates than it is to simply look exclusively at the size of a company. In the example of AIG, the good credit standing of the insurance business was used to guarantee the performance of the holding company. Thus the guarantee from the insurance company created intercompany exposure which was not clearly considered. A Federal regulator for insurance should be in place to oversee companies that fail to manage risk responsibly, and, for the reasons discussed above, should be available to others who need the expertise for risk oversight.

The widely discussed concept of "too big to fail" is subjective in my view. Regulators should not be monitoring or regulating only the size of a company but rather regulating the practices, conduct and activities in which it engages. The level of a company's interconnectivity in the financial system doesn't necessarily correlate to one's size; the more important principle is to understand a company's transactions and its counterparties. Rather than monitoring a company for size, it would seem to be far more effective to take steps to encourage transparency so a regulator can monitor and detect risk by better understanding a company's business activities.

Q.4. Last week the WSJ had an article titled, "The Next Big Bailout Decision: Insurers." It mentions the fact that a dozen life insurers have pending applications for aid from the government's $700 billion Troubled Asset Relief Program. What is the market-wide risk of life insurance and property and casualty insurance?

A.4. The property and casualty insurance industry has managed its risks well and is financially stable. Ours are generally low-lever-

aged businesses with conservative investment portfolios. The industry is systemically important in that huge, unforeseen multi-billion-dollar losses could occur with events such as another natural disaster or terrorist attack. No single State can effectively deal with such mega events, thus a Federal insurance regulator would be a smarter, more effective way to understand and manage risk in the industry.

My expertise and experience is in the property and casualty industry so my comments will mostly be confined to that particular sector. However, it is instructive to the debate over regulatory reform that the dozen life insurers which applied for TARP funds were told by the Treasury Department that they needed to purchase thrifts—putting them under the regulatory oversight of the Office of Thrift Supervision—in order to be eligible for these capital injections. That condition was imposed apparently because Treasury did not feel comfortable providing significant capital to companies that are not under Federal supervision and that the Federal Government knows very little about. This would seem to be another compelling argument for national oversight of insurance.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM SPENCER HOULDIN

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need to reevaluate the weaknesses of Federal and State functional regulation for large, interconnected, and large firms like AIG?

A.1. The idea of a single entity to oversee systemic risk at the Federal level might make sense for the market, but specifically regarding insurance, it must collaborate and rely upon State insurance regulation, which is doing an excellent job of regulating day-to-day insurance operations of companies and producers. IIABA believes the financial services crisis may have demonstrated such a need to have special scrutiny of the limited group of unique entities that engage in services or provide products that could pose systemic risk to the overall financial services market. IIABA therefore believes that while limited systemic risk oversight should be considered, this should not displace or interfere with the competent and effective level of day-to-day State insurance regulation provided today.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move away from functional regulation to some type of single consolidated regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. Speaking only on the insurance industry, IIABA believes that the current State regulatory structure has many positive elements that should not be disregarded, including expertise and resources in place from decades of regulatory experience, and strongly opposes consolidating functional regulation in one Federal regulator. The State insurance regulatory system has an inherent consumer-protection advantage in that there are multiple regulators overseeing an entity and its products, allowing others to notice and rectify potential regulatory mistakes or gaps. Providing one day-to-day regulator with all of these responsibilities, consolidating regulatory risk, could lead to more substantial problems where the errors of that one regulator lead to extensive problems throughout the entire market. IIABA believes insurance regulation should be modernized but strongly opposes day-to-day Federal regulation of insurance, whether through a mandatory consolidated regulator or through establishing an optional Federal charter for insurance, as proposed in the Treasury Blueprint. IIABA also opposes efforts to federally regulate segments of the property-casualty market, such as commercial or large commercial property-casualty. Along with its belief that limited Federal systemic risk oversight may be necessary for large financial services entities, IIABA also believes that consideration should be given to legislation that would create an Office of Insurance Information (OII) at the Federal level. However, such an office should not portend the creation of a Federal insurance regulator, because an OII would help fill the void of insurance expertise in the Federal government and help solve the problems faced by insurers in the global economy without day-to-day regulation of insurance at the Federal level.

Q.3. What is the most effective way to update our rules and regulations to refute the assumption that any insurer or financial services company is too big to fail?

A.3. II ABA believes that Federal systemic risk oversight may be necessary to prevent an AIG-type collapse and resulting government bailout from happening in the future. Entities that engage in services or provide products that could pose systemic risk to the overall financial services market likely need Federal oversight at the holding company level.

Q.4. Last week the WSJ had an article titled, "The Next Big Bailout Decision: Insurers." It mentions the fact that a dozen life insurers have pending applications for aid from the government's $700 billion Troubled Asset Relief Program. What is the market-wide risk of life insurance and property and casualty insurance?

A.4. Speaking only of the property-casualty market, of which our members are primarily engaged, IIABA believes that few, if any, participants or lines in this insurance market raise systemic or market-wide risk issues.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JOHN T. HILL

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need to reevaluate the weaknesses of Federal and State functional regulation for large, interconnected, and large firms like AIG?

A.1. The passage of the Gramm-Leach-Bliley Act (GLBA), financial services modernization legislation, eliminated Glass-Stegall's firewall and opened the door for greater integration within the financial services industry and convergence of products and services. Despite the projections for significant integration between other financial services firms—*e.g.,* banks, securities firms—and insurers prior to the passage of GLBA there has not been widespread integration or convergence of products within the property and casualty sector. A few large insurers under holding company structures have non-insurance financial affiliates; however, the large majority of the more than 3,000 property and casualty insurers are not involved in the convergence of financial products and services. Joint marketing agreements and affinity projects are evidenced, but large acquisitions or mergers have generally not occurred.

GLBA properly maintained functional regulation for the separate financial functions. Functional regulation provides the specialized expertise necessary to regulate highly complex, unique financial products and services. However, greater cooperation and coordination among all applicable regulators, including State insurance regulators, should have been formalized to ensure full regulatory supervision for large complex financial institutions. Proper, well coordinated regulatory oversight by functional regulators working cooperatively would identify regulatory gaps, expose weaknesses and provide a complete picture of the activities of integrated, multi-layered enterprises, while maintaining the expertise and concentrated focus of specific substantive regulation.

NAMIC believes a closer and more formalized working relationship between State regulators and their Federal counterparts is essential to ensure timely and effective information exchange and coordination of regulatory actions. Expansion of the President's Financial Working Group to include participation by State regulators, coupled with enhanced information sharing between and among the participants would provide a unique forum to integrate and coordinate financial services regulation, while preserving the benefits of prudential regulation. Similarly, enhanced cooperation and coordination among the various global financial services regulatory bodies would improve regulation of multi-national entities. However, such cooperation and coordination should not come at the cost of abrogation of regulatory authority to foreign jurisdictions or quasi-governmental bodies.

With respect to systemic risk oversight, NAMIC believes that regulators should work to identify, monitor, and address systemic risk. However, a systemic risk regulator should complement, rather than duplicate or supersede, existing regulatory resources. Further-

more, NAMIC does not believe that the business or legal characterization of any institutions should be used as a basis for assessing systemic risk.

Oversight and regulation of systemic risk should focus on the impact of products or transactions used by financial intermediaries. Attempting to define and regulate "systemically significant institutions" on the basis of size, business line, or legal classification—such as including all property/casualty insurers—would do little to prevent future financial crises. Indeed, a regime of systemic risk regulation that is institution-oriented rather than focused on specific financial products and services could divert attention and resources from where they are most needed, while at the same time producing distortions in insurance markets that would be harmful to consumers.

NAMIC member companies understand that Federal policymakers must have better information about the insurance industry, and confidence in the financial health of property/casualty insurers. To that end, NAMIC has supported the creation of a Federal Office of Insurance Information. That measure, coupled with effective systemic risk regulation, could accomplish important policy objectives that are not currently being met.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move away from functional regulation to some type of single consolidated regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. A single consolidated financial market regulator would prove more problematic in the United States than in other countries. Unlike the majority of countries which utilize a unitary legal system, the United States has 54 well-defined jurisdictions each with its own set of laws and courts. As noted, the U.S. system of contract law is deeply developed, and with respect to insurance policies is based on more than a century of policy interpretations by State courts. The tort system, which governs many of the types of contingencies at the heart of insurance claims, particularly those covered by liability insurance, is also deeply based in State law.

There are also significant differences between insurance and other financial services and products which necessitate specific regulatory treatment. Geographical and demographic differences among States would similarly pose additional difficulties for a single financial market regulator.

Another option for reform that has been proposed is a transition to principles-based regulation. The current legal and regulatory system in the United States is primarily "rules-based." Recent attempts to adopt "principles-based" approaches have been to add to, rather than replace existing "rules-based" regulations. NAMIC supports efforts to streamline the regulatory process and provide greater flexibility to respond to rapidly changing economic and

market conditions. However, as regulators evaluate "principles-based" regulation careful attention must be given to legal and operational issues. Regulatory or accounting decisions based on principles, however, may not always be transparent or consistent with one another, and this can have significant competitive effects.

Legal certainty is also a serious consideration when developing and implementing principles-based regulation. Whether a particular way of doing business conforms to the principle involved can be a matter of a particular regulator's opinion, and as regulators and circumstances change, so do interpretations. In addition, civil liability concerns must also be addressed if principles-based regulation is adopted. In the United States companies are subject to liability in private class actions in both Federal and State courts, civil rule enforcement by Federal and State regulators, and criminal enforcement by both the U.S. Justice Department and State attorneys general. Lack of legal certainty could create extreme vulnerability for regulated firms if not properly addressed in conjunction with such a shift in the regulatory paradigm. NAMIC urges regulators and lawmakers to carefully weigh all issues, including ensuring proper legal protection and regulatory transparency and avoiding arbitrary regulator conduct.

The recent G30 Report urges international adoption of enhanced regulatory supervision to eliminate gaps and increase transparency. NAMIC agrees with the goals; however, our members oppose the recommendation for national level regulation of internationally active insurers. A dual regulatory structure in which some insurers are regulated at the State level and some at the national level would lead to competitive inequities and cause consumer confusion. Property and casualty insurance is inherently local in nature and State regulation remains appropriate.

Regulatory processes must be flexible and dynamic to meet the changing market conditions and strong enough to avoid abrogation to the courts. Regulatory reform efforts should concentrate on targeting regulatory activities and maximizing existing resources.

Q.3. What is the most effective way to update our rules and regulations to refute the assumption that any insurer or financial services company is too big to fail?

A.3. State insurance regulators actively supervise all aspects of the business of insurance, including review and regulation of solvency and financial condition to ensure against market failure. Public interest objectives are achieved through review of policy terms and market conduct examinations to ensure effective and appropriate provision of insurance coverages. Regulators also monitor insurers, agents, and brokers to prevent and punish activities prohibited by State antitrust and unfair trade practices laws and take appropriate enforcement action, where appropriate.

Specifically, insurers are subject to systematic, comprehensive review of all the facets of their operation in their business dealings with customers, consumers, and claimants. The examination process allows regulators to monitor compliance with State insurance laws and regulations, ensure fair treatment of consumers, provide for consistent application of the insurance laws, educate insurers on the interpretation and application of insurance laws, and deter

bad practices. Comprehensive examinations generally cover seven areas of investigation, including insurance company operations and management, complaint handling, marketing and sales, producer licensing, policyholder services, underwriting and rating, and claim practices.

Coordination among regulators is essential to effective regulation. To effectively evaluate the financial condition of national insurers, State regulators participate in the NAIC Financial Analysis Working Group. This confidential process provides regulatory peer review of the actions domiciliary regulators take to improve the financial condition of larger insurers. Expansion of such regulatory coordination between other financial services regulators would improve oversight of consolidated firms.

The guaranty fund system also provides effective protection for insurance consumers against catastrophic disruptions from a single entity. A centerpiece of the State insurance regulatory system is the existence and operation of State guaranty associations. State guaranty associations provide a mechanism for the prompt payment of covered claims of an insolvent insurer. In the event of an insurer insolvency the guaranty associations assess other insurers to obtain funds necessary to pay the claims of the insolvent entity.

Q.4. Last week the WSJ had an article titled, "The Next Big Bailout Decision: Insurers." It mentions the fact that a dozen life insurers have pending applications for aid from the government's $700 billion Troubled Asset Relief Program. What is the market-wide risk of life insurance and property and casualty insurance?

A.4. There is little market wide risk within the property/casualty industry. A recent survey conducted of the NAMIC membership indicated that members are confident in their ability to pay claims and overwhelmingly do not need and are not interested in receiving Federal money under TARP. As an industry, property/casualty insurance companies, particularly the nation's mutual insurance companies, are well capitalized and have adequate reserves to pay claims. Prudent management and the State-based regulatory systems under which these companies operate include strict solvency requirements that effectively build a protective barrier around their assets and, ultimately, their customers. Even the property/casualty subsidiaries of AIG are solvent and remain fiscally strong.

Very few property/casualty insurers use commercial paper, short-term debt or other leverage instruments in their capital structures, a fact that makes them less vulnerable than highly leveraged institutions when financial markets collapse. Likewise, the nature of the products that property/casualty insurers provide makes them inherently less vulnerable to disintermediation risk. For business and regulatory reasons property/casualty insurers carry a liquid investment portfolio. Because property/casualty insurance companies have built up required reserves and their investments are calibrated to match the statistically anticipated claims payments, there is little liquidity risk and virtually no possibility of a "run on the bank" scenario.

Some life insurers have been particularly hard hit by this downturn in the markets because their products, solvency regulations, and practices differ so dramatically from property/casualty insur-

ers. Weak balance sheets have led to the credit ratings of many struggling life insurance companies being downgraded. This, in turn, makes it more difficult for the companies to raise cash, further weakening their balance sheets. The injection of Federal money directly into these companies will help them avoid further downgrades and alleviate the need to raise capital under onerous terms.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM FRANK NUTTER

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need to reevaluate the weaknesses of Federal and State functional regulation for large, interconnected, and large firms like AIG?

A.1. It has been suggested that the authority of a systemic risk regulator should encompass traditional regulatory roles and standards for capital, liquidity, risk management, collection of financial reports, examination authority, authority to take regulatory action as necessary and, if need be, regulatory action independent of any functional regulator. At a recent speech before the Council of Foreign Relations, for example, Federal Reserve Board Chairman Ben Bernanke acknowledged that such a systemic regulator should work as seamlessly as possible with other regulators, but that "simply relying on existing structures likely would be insufficient." The purpose of reinsurance regulation is primarily to ensure the collectability of reinsurance recoverables and reporting of financial information for use by regulators, insurers and investors. Because reinsurance is exclusively a sophisticated business-to-business relationship, reinsurance regulation should be focused on prudential or solvency regulation. The RAA is concerned the systemic risk regulator envisioned by some—one without clear, delineated lines of Federal authority and strong preemptive powers—would be redundant with the existing stated-based regulatory system. We also note that without reinsurance regulatory reform and a prudential Federal reinsurance regulator, a Federal systemic risk regulator would: (1) be an additional layer of regulation with limited added value; (2) create due process issues for applicable firms; and (3) be in regular conflict with the existing multi-State system of regulation.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move away from functional regulation to some type of single consolidated regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. As regards regulation of reinsurance, the RAA seeks to minimize duplicative regulation while ensuring continued strong solvency regulation. The current 50-State system of regulating reinsurance is inefficient and does not adequately address the needs of a global business. An informed Federal voice with the authority to establish Federal policy on international issues is critical not only to U.S. reinsurers, who do business globally and spread risk around the world, but also to foreign reinsurers, who play an important role in assuming risk in the U.S. marketplace. The current multi-State U.S. regulatory system is an anomaly in the global insurance regulatory world. Following the recent financial crisis, the rest of the world continues to work towards global regulatory harmonization and international standards. The U.S. is disadvantaged by the lack of a Federal entity with Constitutional authority to make decisions for the country and to negotiate international insurance agreements. In the area of reinsurance, there is a need for a process for assessing the equivalence and recognition on a reciprocal basis of non-U.S. regulatory regimes. This process would assist non-U.S. reinsurers that supply significant reinsurance capacity to the U.S. insurance market by facilitating cross-border transactions through binding and enforceable international supervisory arrangements.

Q.3. What is the most effective way to update our rules and regulations to refute the assumption that any insurer or financial services company is too big to fail?

A.3. Any change to the current regulatory structure should minimize duplication while ensuring the application of strong, uniform regulatory standards. It will be important to ensure that any grant of regulatory authority is fully utilized and that there is structured coordination and communication among applicable regulators so that a company's corporate structure, its role in the marketplace and its products are fully understood so as to contain potential systemic risk.

Q.4. Last week the WSJ had an article titled, "The Next Big Bailout Decision: Insurers." It mentions the fact that a dozen life insurers have pending applications for aid from the government's $700 billion Troubled Asset Relief Program. What is the market-wide risk of life insurance and property and casualty insurance?

A.4. No property casualty reinsurers have applied for TARP funds. The industry is conservatively invested and therefore would not appear to be of concern regarding a "bailout."

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM ROBERT HUNTER

Q.1. The convergence of financial services providers and financial products has increased over the past decade. Financial products and companies may have insurance, banking, securities, and futures components. One example of this convergence is AIG. Is the creation of a systemic risk regulator the best method to fill in the gaps and weaknesses that AIG has exposed, or does Congress need to reevaluate the weaknesses of Federal and State functional regulation for large, interconnected, and large firms like AIG?

A.1. Systemic risk regulation, while a useful supplement to function regulation, does not address all concerns. We believe improved functional regulation is essential. That should include closing regulatory gaps that allow certain products, institutions, and markets to operate outside the system of prudential regulation. It was AIG's involvement in the sale of unregulated credit default swaps and other structured finance vehicles that caused its downfall and led regulators to conclude that Federal intervention was necessary to prevent even further economic repercussions. Also, as the GAO study on regulatory oversight revealed, the quality of risk management oversight provided by the regulatory agencies was severely lacking. The attached testimony, which CFA Legislative Director Travis Plunkett presented to the House Financial Services Committee, provides greater detail on our views about the primary importance of strengthening functional regulation in enhancing the quality of financial oversight and the stability of financial markets.

Q.2. Recently there have been several proposals to consider for financial services conglomerates. One approach would be to move away from functional regulation to some type of single consolidated regulator like the Financial Services Authority model. Another approach is to follow the Group of 30 Report which attempts to modernize functional regulation and limit activities to address gaps and weaknesses. An in-between approach would be to move to an objectives-based regulation system suggested in the Treasury Blueprint. What are some of the pluses and minuses of these three approaches?

A.2. CFA does not believe that our regulatory failures were primarily structural in nature—with the notable exception of the banking arena where the ability to charter shop exerted a strong, downward pressure on regulatory protections. It is worth noting that the FSA model proved no more effective than the U.S.'s "patchwork" system in preventing abuses or addressing problems once they arose. We have attached our detailed critique of the Treasury Blueprint and a study CFA recently issued on regulatory reform more generally.

Q.3. What is the most effective way to update our rules and regulations to refute the assumption that any insurer or financial services company is too big to fail?

A.3. CFA strongly believes that we must restore the potential for failure for capitalism to work. Part of the approach is to create disincentives designed to discourage companies from becoming too big or too interconnected to fail—by significantly increasing capital requirements, for example, as companies increase in size or complexity. This method could also be used to discourage companies from adopting other practices that increase their risk of failure, such as taking on excessive leverage. Capital requirements for products traded away from an exchange could be set significantly higher than capital requirements for similar products traded on the exchange to reflect the heightened risk associated with this practice. In addition, we need to create a mechanism to allow for the orderly failure of non-bank financial institutions. One reason for the ad hoc nature of the current rescue efforts has been that lack of resolution authority for companies like AIG, Bear Stearns, and

Lehman Brothers that got into financial difficulties. Providing that mechanism would give regulators more tools to use—and a more consistent basis for dealing with—insurers, investment banks, or others whose failure might otherwise destabilize the financial system and economy as a whole.

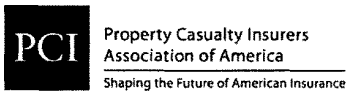
Q.4. Last week the WSJ had an article titled, "The Next Big Bailout Decision: Insurers." It mentions the fact that a dozen life insurers have pending applications for aid from the government's $700 billion Troubled Asset Relief Program. What is the market-wide risk of life insurance and property and casualty insurance?

A.4. The systemic risk of insurance companies is relatively low, particularly for property/casualty insurance companies. Now there are some significant exceptions to this low risk requiring investigation as discussed in my testimony. For instance, Congress should study the potential systemic risk of:

- Bond insurance.
- Reinsurance and retrocession spread risk around the world in ways that normally lower risk but could, in certain circumstances, cause massive failure if a series of major impacts were to be felt at once—(*i.e.,* a "black swan" could cause great failure worldwide if reinsurance failed to deliver in its secondary market function). Major storms, earthquakes, terrorism attacks and other catastrophes could occur at about the same time that might bankrupt some of these significantly inter-connected secondary-market systems, for instance.
- Periodic "hard markets" that significantly impact a specific area of the economy, such as the periodic medical malpractice insurance shortages related to the economic cycle of property/casualty insurers. Another example currently is that banks are paying double last year's rates for directors and officers' coverage, if they can get it at all. If the degree of unavailability grows, Congress should study just what are the systemic implications if banks cannot hire officers or get directors to serve due to the lack of D&O coverage. Would the recovery of a bank be retarded by the flight of directors and officers from the institution if no insurance protection was available to protect them from shareholder or consumer suits?
- Some State regulators themselves have recently introduced an element of systemic risk because of their willingness to cut consumer protections for life insurance by slashing reserves and other dollars of policyholder cushion at this time of great risk. Their theory seems to be that when consumers do not need to worry about the soundness of insurers they will keep high cushions of protection, but when policyholders most need this protection, they will change accounting standards at the request of insurers. Several States have lowered capital and reserve requirements for life insurers despite the fact that the NAIC ultimately refused to do so. NAIC acknowledged that it had not done the due diligence necessary to determine if the proposed changes would weaken insurers excessively.
- Eliminating post-assessment guaranty funds could also lower insurance systemic risk and replacing them by State directed,

nationally based, pre-assessment funds, or by a Federal insurance guaranty agency modeled on the FDIC. For instance, the current life insurance solvency crisis is backed by State guarantee funds with no money on hand and the capacity to generate a mere $9 billion in the entire country should the dominoes fall.

- Insurance systemic risk that could be generated by insurers being owned by other businesses or vice-versa could be lowered by repealing provisions of the Gramm-Leach-Bliley Act that allow firms to sell insurance in conjunction with other financial services, particularly credit and securities products.



Testimony of David A. Sampson
President & Chief Executive Officer
Property Casualty Insurers Association of America (PCI)
Before the Committee on Banking, Housing, and Urban Affairs
United States Senate
Tuesday, March 17, 2009

Chairman Dodd, Ranking Member Shelby, and other Members, PCI appreciates the invitation to provide testimony for the hearing on "Perspectives on Modernizing Insurance Regulation." PCI is the leading property-casualty trade association representing more than 1,000 insurers of all different lines and sizes.

Last fall, PCI formed a special board committee of 14 CEOs who spent a significant amount of time developing a responsive and responsible proposal to restore investor confidence and prevent another economic crisis from reoccurring. The details of this proposal have been previously provided but are further summarized below with some suggestions for additional legislative inquiry.

The systemic risk of a financial institution is the likelihood and the degree that the institution's activities will negatively affect the larger economy such that unusual and extreme federal intervention would be required to ameliorate the effects. Simply stated – if the government has to step in to bail out a company to protect the larger economy, that is a systemic risk.

Traditional antitrust analysis focused on "Too Big to Fail," using the Herfindahl-Hirschman Index for market concentration. Recent government intervention decisions, however, have shifted towards "Too Interconnected to Fail" (TICTF). TICTF is measured by the degree a company's activities are leveraged throughout the economy such that its impairment would cause additional failures; and the extent to which its failure risk is correlated with other systemic downturns. For example, failure of a large auto insurer would not require significant deleveraging by hedge funds and other third parties and would not create a ripple effect of supply company failures. Its market share would be quickly absorbed by competitors, policyholders are protected by guaranty funds, and the number of auto accidents does not increase in a recession. Conversely, some small credit default swap and financial guaranty providers have highly leveraged counter-parties and their impairment can freeze related capital markets; recessions increase their likelihood of default, and their default or impairment further exacerbates the downward systemic cycle. Thus, the critical measure is not size, but rather the amount of interconnectedness with the larger economy that creates systemic risk.

The Gramm-Leach-Bliley Act made the Federal Reserve Board the systemic risk umbrella supervisor for financial holding companies. PCI proposes extending this existing oversight more broadly to all systemically risky financial entities. While PCI shares reservations with many Members of Congress about giving the Board too much authority or compromising its core mission, the Board has the greatest institutional expertise and oversight over market stability of any existing agency, and the independence necessary to minimize political pressures that might exacerbate systemic cycles. However, the Federal Reserve Board's systemic risk oversight should be completely separate from its other bank holding company responsibilities.

The Board's systemic risk powers should be flexible and include the authority to require the following:

1. Appropriate **transparency and disclosure** to the Board for all entities engaged in activities that create systemic risk beyond incidental or de minimus amounts to allow the Board to monitor marketplace movements;
2. Escalating **information sharing** about a holding company's financial statements and transactions among the Board, other U.S., and international overseers as the company's level of systemically risky activities increase;
3. Scalable **risk management standards** for specific entities whose financial activities present a significant systemic risk; and
4. **Coordinated resolution** of failed systemically risky entities, including resolution of holding company financial subsidiaries without a primary functional regulator.

However, systemic risk oversight powers would not include the following:

1. Solvency oversight for individual companies;
2. Business conduct oversight, such as licensing, market conduct, or product approval;
3. Duplicative disclosure or information requirements;
4. General federal compliance, such as privacy standards; and
5. Other elements of bank holding company oversight.

Risk management standards should increase with systemic risk, and should include:

1. Establishing standards for holding company capital and group risk management;
2. Monitoring of affiliate transactions and significant off-balance sheet obligations;
3. Collecting and sharing information related to group systemic risk and holding company solvency;
4. Requiring coordination of examinations and visits regarding systemic risk; and
5. Eliminating duplicative oversight of holding companies.

PCI proposes increasing coordination to detect financial fraud and improve early risk monitoring through enactment of the Financial Services Antifraud Network that passed the House in 2001. This legislation would also maintain confidentiality and privilege protections as company financial information is shared among regulators. PCI also proposes requiring the Presidential Working Group on Financial Markets to implement limited information sharing

coordination and protocols with international overseers regarding potential threats to cross-border market stability.

This systemic risk oversight framework fills the current gaps and loopholes in existing law without necessitating the creation of new bureaucracies or radically changing the financial regulatory structure. Implementation would, however, help restore investor confidence in our marketplace, reduce the likelihood of this crisis reoccurring, and provide an orderly, predictable process for managing risk failures to minimize moral hazard and taxpayer exposures.

Detailed documents analyzing systemic risk are attached and can be found with supporting documentation on the PCI website at www.pciaa.net/reg-reform.

Additional Background on Systemic Risk

Health of the Property-Casualty Industry

Last year, there were no significant property-casualty insolvencies despite suffering the fourth most expensive hurricane in our history and the greatest market crash in half a century. The vast majority of industry credit ratings were stable last year, with AM Best actually announcing more property-casualty rating upgrades than downgrades and continuing to rate the industry as stable for 2009. The surplus that stands behind our policies remains at relatively strong and historically high levels and almost all segments of the property casualty marketplace remain stable and sound. Unlike the capital and credit markets, insurance operations have proceeded uninterrupted. The historical level of insolvencies in the p/c industry over the last several decades as a percentage of industry assets continues to be lower than that of the banks and far lower than that of the perennially troubled thrift industry. Property-casualty insurer failures are also relatively uncorrelated with larger economic downturns, unlike other financial segments. That is why PCI has reiterated publicly that our industry neither needs nor wants federal bailouts or assistance for insurance operations.

Our industry has suffered deeply from this crisis, however, in the same manner as any other American consumer – significant investment losses and decline in economic activity. Unlike many other financial providers, we invest our own money. While we do so very conservatively without excess leveraging, we have the same interest Congress does in stabilizing the market and fixing the systemic risk regulatory gaps.

The Need for Systemic Risk Oversight

According to the Commerce Department, last quarter our country's GDP fell 6.2%, exports fell 23.6%, business and residential investment fell 19 and 22%, and aggregate equity losses are now estimated to exceed 40 trillion dollars, exceeding 2/3rds of last year's global GDP. Individual pensions have been decimated, unemployment and foreclosures have skyrocketed, consumer confidence has fallen to an all time low and we are expected to suffer the longest and deepest global economic contraction since the Great Depression.

The Government Accountability Office released a report this January stating that:

> *Significant reforms to the U.S. regulatory system are critically and urgently needed.... Regulators have struggled, and often failed, to mitigate the systemic risks posed by large and interconnected financial conglomerates and to ensure they adequately manage their risks. The portion of firms operating as conglomerates that cross financial sectors of banking, securities, and insurance increased significantly in recent years, but none of the regulators is tasked with assessing the risks posed across the entire financial system.... The current system has important weaknesses that, if not addressed, will continue to expose the nation's financial system to serious risks.*

Former Federal Reserve Board Chairman Greenspan admitted to Congress that the current crisis was caused in part by the failure of financial institutions to monitor and manage their capital and risk positions, and the failure of our existing regulatory system to limit such risks. Congress created systemic risk oversight in the Gramm-Leach-Bliley Act in 1999. According to Governor Laurence Meyer in a speech immediately following GLBA's enactment:

> *the Board will need to focus on "the systemic risks posed by large, complex, and diversified financial services companies [while having] to avoid imposing an excessive or duplicative regulatory burden and avoid creating a false impression that the benefits of the federal safety net extend to nonbank activities....We must be cautious, however, in assuming that the more diversified banking organizations will be inherently less risky and hence less likely to be a source of systemic risk. Past experience with consolidation in banking and geographic diversification suggests that banking organizations often use the benefit gained from diversification to increase the risk of individual components of their portfolios....What remains clear, however, is that appropriate disclosure and strong risk-management practices will become even more important in the years ahead, especially for larger banking organizations.... These challenges will require a new relationship between the Federal Reserve and the functional regulators of banks' insurance and securities affiliates. And they will place a premium on cooperation and appropriate information sharing [with] the Federal Reserve as umbrella supervisor...."*

Ironically, ten years ago the Board described exactly what needed to be done and the course that led to our failure.

So what went wrong? The Board was given systemic risk oversight only over financial holding companies, not thrifts or thrift holding companies such as IndyMac, Countrywide, Merrill Lynch, and Washington Mutual; not investment bank holding companies such as Lehman Brothers or Bear Stearns; and not other entities such as derivatives firms not subject to GLBA systemic risk oversight. Not only did systemic risk oversight apply to a too-limited universe of entities, but the focus was on the risk of other affiliates to the bank and the systemic risk of the banks to the larger economy. We now understand that systemic risk is not solely bank-centric. Greenspan now admits that the risk models created were inadequate, particularly to guard against irrational systemic behaviors. And the need for institutionalized and systematic information sharing envisioned at the time was never adequately realized.

These are the precise gaps that need to be addressed, and that can be fixed with minimal unintended consequences using the existing regulatory structure, freeing Congress to then move

onto the next phase of carefully and thoughtfully reviewing larger regulatory restructuring issues. The Federal Reserve Board already sets consolidated capital requirements, monitors affiliate transactions, and guards against systemic risks. As required under GLBA, it also relies on the primary regulators, such as the SEC and state insurance regulators, to oversee the solvency and business conduct of the individual subsidiaries and to pass along critical information. Solving the systemic risk crisis does not require a vast new bureaucracy or radical restructuring of our regulatory system. It does require plugging the loopholes and refocusing the existing system of holding company systemic risk regulation, that in hindsight was clearly too limited. Congress can ensure that a strengthened systemic risk overseer and information sharing system is neither duplicative nor optional, and works in tandem with the existing primary functional regulators.

Systemic Risk v Solvency

Solvency regulation plays a very separate and distinct role from systemic risk oversight, although the public discussion is sometimes blurred as part of a "Super-Size Us" regulatory agenda. Solvency regulation is intended to minimize failure by individual financial subsidiaries. It focuses on: (1) ensuring a financial company has enough capital to fulfill its promises and (2) limiting individual consumers' losses from failed financial companies. In insurance, it protects the policyholder; in banking, the deposit holder; and in the securities industry, the investor. Each financial industry has certain solvency requirements that reduce the likelihood a financial company will fail to fulfill its promise, and a consumer protection fund (GF, FDIC, SIPC) that limits certain consumer losses from such failures. Solvency regulation is currently conducted by the functional regulators separately in each marketplace.

Systemic risk regulation is macro oversight by the Federal Reserve Board to prevent a failure from contaminating other markets and the larger economy. It ensures that when failures do occur, the holding company has adequate risk management and capital to contain the failure and to allow resolution of the failure in an orderly and predictable manner without spreading to other industries and the global economy. Solvency regulation is conducted by the primary functional regulator for each subsidiary to avoid its failure. Systemic risk regulation is conducted by the consolidated umbrella supervisor to control the contagion affect of subsidiary failures when they occur.

This distinction was enshrined in current law by GLBA, with the Board overseeing systemic risk to a limited extent and relying on the primary/functional regulators to oversee solvency. The distinction is also recognized in the Treasury Blueprint's recommendation that Congress should separate systemic risk oversight and solvency into separate regulatory compartments. Confusion of these concepts led the debate back towards the "Super-Size Us" approach and the potential creation of omnibus regulators that are Too Big to Fail and too unwieldy not to fail.

Moral Hazard

Federal Reserve Board Vice Chairman Kohn testified at the end of your March 5th Committee hearing that "The US government is on record saying that it will not countenance, it will not allow, a disorderly failure of a systemically risk institution." The lack of a robust systemic risk oversight system to manage failures of companies that are Too Interconnected to Fail has created an enormous moral hazard that will continue to expose taxpayers to massive

liabilities until corrected. Irrational exuberance and the attendant booms and busts of the economic cycle are inevitable and the government cannot and should not eliminate risk innovation and the ability to fail. Systemic risk oversight must allow failure, by creating an orderly resolution process with risk management protections imposed in advance that minimize the public costs. This will reduce any notion of an implicit government guaranty. PCI also proposes to allow companies to voluntarily submit to Board systemic risk oversight. This is critical not only for international equivalency regulation purposes, but also to avoid moral hazard should the marketplace place a greater benefit than cost on additional federal oversight. PCI has also suggested that systemic risk oversight be scalable, so that the standards become increasingly protective as a company's activities make it more systemically risky, such that the marketplace can balance the increased perceived risk level and regulatory costs with the increased oversight.

Additional Research Needed

PCI has spent the last several months working intensively on systemic risk and regulatory restructuring frameworks in order to be responsive to Congressional imperatives. However, there are several areas of inquiry we suggest your Committee may still wish to consider pursuing:

(1) Historical Systemic Risk Analysis: While the Board's systemic risk analysis needs to be flexible and principles based, there are several potential historical measurements that could provide the Committee with more insight in providing guidance. For example, the contraction of supply in the marketplace after a company fails may be a good indicator of interconnectedness for each of the industries – when a derivatives firm fails, how did that impact the supply of capital in other markets? When a bank fails, how did that affect the credit markets? The Committee may wish to consider and build upon the data that PCI has been developing on average failure rates in each industry and their failure correlation with economic downturns. For example, from 1934 (earliest available) through 1979, the FDIC reports bank failures (including those with assistance transactions) of $9.17 billion in assets. In the last 5 quarters alone, there have been 42 banking failures involving almost $1.7 trillion in assets. From 1980-2008, bank failures as an annual percentage of industry assets have averaged 0.65%, while thrift failures have averaged 3.19%. The failure rate of property-casualty companies during the first part of that period was only 0.27% according to CBO. Interestingly, the failure/assistance rate of property-casualty insurers during peak financial crisis in 1991 and 2008 is less than 0.1% of industry assets. This contrasts with comparable rates for banks and thrifts in 1991 of 1.8% and 8.67% and several times that level for banks and thrifts in 2008.

(2) Federal Reserve Board Authority: While the Board is currently a systemic risk regulator for financial holding companies, Vice Chairman Kohn admitted in his recent testimony that the Board was perhaps stretching its authority somewhat in some of its dedicated responses to the current crisis. GLBA's Fed-lite authority focuses on allowing the Board to identify bank related systemic risks and require corrective actions within 180 days or order a divestiture of the banking subsidiaries. The Board's powers with respect to other bank holding companies are broader and the Board has additional emergency authority in unusual and exigent circumstances. This Committee might consider delineating much more specifically the Board's corrective powers with respect to broader systemic risk oversight and to make it less bank-centric.

(3) Resolution coordination between the Board and the primary regulators: The boundaries between the Board and the primary functional regulators are somewhat unclear when

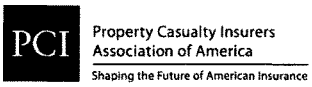
the government effectively owns or manages a company. The Committee may wish to consider carefully delineating the resolution authority of various regulators when a company fails, to address potential conflicts and ensure additionally that the systemic risk regulator has adequate authority to provide an orderly failure resolution for subsidiaries without a solvency regulator.

Timing of Reform

Regulatory adjustments in our financial system can have enormous unintended and dangerous consequences, as we recently learned with the changes of mark-to-market accounting rules. Congress needs to carefully plan the first phase of regulatory reform and perform the necessary due diligence to ensure any reforms are creating more certainty and result in more investor confidence rather than less. Congress will not have time or the resources to focus on all necessary reforms at once. The most critical reform that Congress can work towards, and the clear breakdown that allowed the current crisis to occur, is systemic risk oversight. This is also the area with broadest agreement where consensus is possible and it can be accomplished without necessitating a new bureaucracy or major transfer of power. PCI hopes that the Committee will focus first on this most critical phase of reform and gather the necessary information to carefully shape and complete this key foundational restructuring before building out the individual industry regulation rooms.

PCI's Commitment to Responsible Cooperation

PCI is committed to working with this Committee and the Congress on market stability reforms, and to be responsive and responsible in helping the Committee address its needs as this process evolves. We appreciate this opportunity to present testimony on our systemic risk framework to the Committee.



Systemic Risk Oversight Proposal

Systemic Risk Definition (abbreviated)	The systemic risk of a financial institution is the likelihood and the degree that the institution's activities will negatively affect the larger economy such that unusual and extreme federal intervention would be required to ameliorate the effects. "Too Interconnected to Fail" (TICTF) is the appropriate measure of the likelihood and amount of medium-term net negative impact to the larger economy of an institution's failure to be able to conduct its ongoing business. The impact is measured not just on the institution's products and activities, but also the economic multiplier of all other commercial activities dependent specifically on that institution. It is also dependent on how correlated an institution's business is with other systemic risks.
Overseer	The Federal Reserve Board should be the systemic risk overseer. It has the appropriate institutional culture, mission, and expertise. However, the FRB's systemic risk oversight should be completely separate from its other bank holding company oversight powers.
Oversight Jurisdiction	Any institution engaged in financial activities that present a significant systemic risk. Also any institution engaged in financial activities that chooses to submit to federal systemic risk oversight (e.g., typically for international equivalency treatment).
Oversight Powers	Authority to require: (1) Appropriate transparency and disclosure to overseers for all entities within the regulatory jurisdiction. (2) Coordination with other US and international overseers. (3) Risk management for systemic risk for specific entities whose financial activities present a significant systemic risk. Systemic risk oversight should not include: • Solvency oversight for individual companies. • Business conduct oversight (licensing, market conduct, product approval). • Duplicative disclosure or transparency information requirements. • General federal compliance (with privacy standards, etc.). • Other elements of bank holding company oversight.

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Oversight of Risk Management	Systemic risk oversight standards might consist of: • Overseeing holding company capital standards and group risk management. • Monitoring of affiliate transactions and significant off-balance sheet obligations. • Collecting and sharing information related to group systemic risk and holding company solvency. • Requiring coordination of examinations and visits regarding systemic risk as appropriate. • Eliminating duplicative oversight of holding companies.
Authority to coordinate with international oversight	Greater global financial harmonization is necessary to prevent global regulatory arbitrage. The FRB should coordinate systemic risk standards within its jurisdiction with international overseers after a full public review, including an examination of the effects on small companies. The overseer should not delegate oversight, and should retain the ability to provide exceptions or withdraw its deferral or mutual recognition as necessary.

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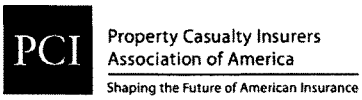

Regulatory Distinctions between Solvency and Systemic Risk Regulation

- Solvency measures whether a company has enough capital to meet its obligations. Solvency regulation is focused on (1) ensuring a financial company has enough capital to fulfill its promises and (2) limiting individual consumers' losses from failed financial companies. In insurance, it protects the policyholder; in banking, the deposit holder; and in securities, the investor. Each financial industry has certain solvency requirements that reduce the likelihood a financial company will fail to fulfill its promise, and a consumer protection fund (GF, FDIC, SIPC) that limits certain consumer losses from such failures. Solvency regulation is currently conducted by the functional regulators separately in each marketplace.

- Systemic risk measures the likelihood and the degree that a company's activities will negatively affect the larger economy, requiring federal intervention to mitigate the effects. Systemic risk regulation is focused on protecting the economy from major failures of mostly holding companies.

- While solvency regulation focuses on individual financial consumers within each marketplace (micro), systemic risk regulation focuses on limiting the spread of failure risks from one market segment to other industries and the global economy (macro). Solvency regulation is conducted by the primary functional regulator for each subsidiary. Systemic risk regulation is conducted by consolidated umbrella supervisors.

- The Gramm-Leach-Bliley Act (GLBA) created limited umbrella systemic risk regulation for financial holding companies (FHC). Insurance and securities activities can be conducted in the same holding company as banking only if the depository subsidiaries are well managed and capitalized and meet certain credit-rating thresholds. According to the Federal Reserve Board (FRB), which oversees FHC regulation, it supervises the consolidated organization, monitoring "the systemic risks posed by [FHCs]", while the OCC, FDIC, OTS, SEC, and state insurance regulators (the primary regulators) regulate each holding company subsidiary. The FRB oversees overall FHC risk-taking to judge how the parts and the whole may affect affiliated banks to avoid bank failures creating systemic risks to the economy.

- In theory, the FRB shares information with the primary regulators to protect against systemic risks while avoiding duplicative or excessive burdens. GLBA's "Fed-lite" provisions allow the FRB to examine and require reports from the FHC parent, but generally not the functionally regulated subsidiaries. FHCs that fail to meet FRB risk standards must enter into an agreement to correct the deficiencies. If not corrected within 180 days, FHCs may be required to divest all banking subsidiaries.

- There are several critical gaps in the current GLBA systemic risk oversight laws. GLBA focused FRB oversight on protecting banks from insurance/securities risks and resulting systemic risks from banks to the economy. However it did not address systemic risks flowing

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from non-bank subsidiaries to the economy, nor does GLBA allow FRB oversight of holding companies without banks (such as thrift, insurance, or investment bank holding companies). The FRB's risk management practices oversight may also need to be strengthened, to better account for broader market instability, liquidity risks, and enterprise risk-management.

- Solvency and systemic risk regulation are separate oversight regimes with distinct goals, standards, and remedies. Solvency regulation in each industry is being reexamined by functional regulators. However, the major vulnerability that allowed the current crisis and that needs to be quickly addressed to prevent its reoccurrence is a lack of broader systemic risk regulation beyond the limited GLBA/FRB/FHC construct. Fixing GLBA's systemic risk regulation deficiencies can be easily enacted and implemented, using current models, without requiring changes in solvency regulation or responsibilities.

For more information, please go to: www.pciaa.net/reg-reform.

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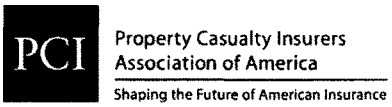

Information Sharing Proposal

Needs

- Increase oversight of holding companies by promoting cross-industry information sharing between and among various financial services overseers, both nationally and internationally, to detect potential problems earlier and help avoid another meltdown.
- Increase coordination of oversight efforts to prevent and detect financial fraud, both domestically and internationally.

Holding Company Solvency Information Sharing

- Require the Presidential Working Group (PWG) on financial markets to develop and implement a plan for information sharing coordination with international overseers regarding holding company solvency and potential threats to cross-border market stability in a manner that:
  - does not exceed the scope of domestic information sharing activities;
  - protects the confidentiality and privileges of both the overseer and the subject companies;
  - clearly designates a lead holding company overseer and its responsibilities, and is preemptive with respect to duplicative information requests;
  - is based on cost-benefit analysis, so that the benefits of the information outweigh the collection costs; and
  - is limited to currently reported group level financial information related to solvency, such as capital levels and off-balance sheet or significant cross-affiliate obligations.
- Direct the overseers, pursuant to the PWG plan, to establish regular information sharing protocols and transfers with other domestic and foreign overseers, consistent with the above objectives, so that the lead overseer of a holding company collects and redistributes to the other relevant financial overseers appropriate information on the holding company's solvency.

Antifraud Network Act (summary of key provisions as passed the House in 2001)

- Require the financial overseers to establish an automated system for sharing antifraud information, primarily to cross-check public disciplinary information for background checks on key individuals and companies.
- Create a confidentiality supervisory information privilege – anything collected by a financial overseer related to its supervisory role can only be publicly disclosed with the permission of the originating overseer.
- Ensure that any existing confidentiality protections follow the information.
- Provide limited legal immunity to overseers for good faith actions within the scope of duty.

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- Create a streamlined agent background check: requiring the FBI to do fingerprint background checks on insurance professionals and the NAIC to act as a clearing house that all states could rely on each record check for a year.

For more information, please go to www.pciaa.net/reg-reform.

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