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REGULATORY MODERNIZATION: PERSPECTIVES ON INSURANCE

HEARING

BEFORE THE

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

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE MODERNIZATION OF INSURANCE REGULATION

JULY 28, 2009

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C O N T E N T S

TUESDAY, JULY 28, 2009

WITNESSES

REGULATORY MODERNIZATION: PERSPECTIVES ON INSURANCE

TUESDAY, JULY 28, 2009

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

The Committee met at 9:35 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 this morning. Let me just announce that when we have a quorum, we have an executive calendar nomination to consider that has been cleared on both sides, a very competent and talented woman, Deborah Matz, to be the Board Member designee of the National Credit Union Administration. And so if we achieve that number, we will interrupt the hearing for that purpose, and if not, then I will try and schedule it off the floor after a vote that is convenient for everyone, either this morning or later this afternoon.

But pending the arrival of 12 Members, I want to thank our witnesses this morning and those who have gathered in the hearing room to listen to our hearing this morning entitled "Regulatory Modernization: Perspectives on Insurance." We had a hearing back in, I think, March on the subject matter, and this is an important issue, obviously, for all of us. As we talk about the modernization of financial services, insurance plays a very, very critical role. The insurance industry provides millions of Americans, as we know, in our country with the safety net they need both as individual homeowners, small businesses, as well as larger enterprises. And in times such as these, people are already faced with uncertainty. Millions have lost their jobs, their homes, and their retirement. We need to provide them with the peace of mind to protect the policyholders as well and make sure that our insurance industry is strong and stays strong during this time of economic difficulty.

But it is a critically important industry, and it has played a very, very important role in capital formation throughout a good part of the 20th century, and as we get into the 21st century, the role of insurance is going to be even that more important.

So we live in an uncertain world, as we all know these days. The economic crisis has claimed as casualties millions of our fellow citizens who have lost jobs and homes, retirement savings, and their family's economic security. But even in the best of times, there is always risk, and that is why the insurance industry exists: to provide stability to families and businesses.

Today's hearing is the latest in a series examining our financial regulatory system and exploring ways to modernize it for the 21st century. At issue is what should be done to better regulate the insurance industry. As always, our primary concern is protecting working families in this Nation who have paid the highest and the most unfair price for our regulatory deficiencies.

What to do about insurance regulation is complicated. Some have called for Federal regulation of insurance, while others strongly defend the current system of State regulation. It is important, obviously, that we get this right. A strong economy requires the effective flow of capital. Insurance, and the security it brings, is a key element in getting credit moving again.

In my home State of Connecticut, we have had a long and proud history of acting as a home, the major home to insurance firms that provide a foundation of security for all manner of transactions, from the purchase of a home to the building of a new factory. And so there is a solid case to be made that State-based regulation of insurance has worked well for more than a century. Millions of American families, too, have relied on one form of insurance or another in a time of crisis—when they needed to rebuild their homes after a devastating fire or such loss or needed economic security after the loss of a breadwinner in their family.

But there is also a case to be made that it is time for change. Insurance companies have become more global and more complex, and even though the insurance industry did not create the economic crisis, like almost every other industry, it has been hit hard, and as a result, many are calling us to modernize regulations and reflect the 21st century in which the insurance industry exists.

The Administration's plan for regulatory modernization would create an Office of National Insurance within the Treasury to collect information and coordinate insurance policy at the Federal level. It is one of the many ideas that we will be considering in the coming weeks, and so today we have assembled an impressive panel of academics and experts. I am grateful to each and every one of you for being here. You are extremely knowledgeable on the subject matter and can provide some insight and thoughts as to how we might progress in this area of modernizing our financial regulatory structure, and particularly with emphasis on insurance and the insurance industry. So I thank you all for coming.

I am going to turn to Senator Shelby for any opening comments he may have, and then unless my colleagues would care to be heard on the subject matter at the outset, we will turn right to our witnesses. Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Over the past 2 years, we have seen how problems in our insurance markets can disrupt our national economy. The crumbling of our largest bond insurers called into question the value of financial guarantees these firms had issued on billions of dollars of securities. In addition, the spectacular failure of AIG sent shock waves throughout our economy and led to a $170 billion bailout by the Federal Government.

These events revealed that comprehensive insurance regulation must be a part of our reform effort. Unfortunately, I believe the Administration has taken a pass on comprehensive insurance reform thus far. Under the President's proposal, the Federal Reserve would regulate only insurance companies that it deemed to be systemically significant. The President also proposes the creation of an Office of National Insurance that would collect information and advise the Treasury Secretary on insurance matters. While this concept may have some merit, it certainly is not comprehensive reform and leaves unanswered the difficult question of whether and how insurance regulation should be modernized for the vast majority of insurers.

The goal of today's hearing is to answer that question, as well as to examine the President's reform proposal as it relates to insurance. In particular, I am interested in learning whether our witnesses believe that the Fed is an appropriate regulator for insurers. Does it have the expertise necessary to supervise complex insurance companies? Would establishing a separate Federal insurance regulator be a better choice? If a Federal regulator is established, should all insurers have the option of being regulated at the Federal level? If a Federal regulator is not established, what steps need to be taken to ensure that there is proper coordination? Last, how do we make sure that there are no gaps in our regulatory system like those that appear to have played a role in the collapse of AIG?

Reforming our insurance regulation will be complex and very challenging. The level of difficulty should not prevent us from seeking a comprehensive solution to financial regulation that includes insurance.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Do any of my colleagues want to make any quick opening comments? If not, your opening statements will all be included in the record. And let me just say to our witnesses because I know, having read over some of your testimony last evening, you are going to want to have it included in the record, I presume, because I do not know how—Travis, there is no way in 5 minutes you are going to have your testimony included in this record in 5 minutes. So I will make sure that your comments and thoughts and additional ideas will be a part of the record. I will say that at the outset so you do not have to ask consent to that. With that, let me introduce our panel.

Travis Plunkett is the Legislative Director of the Consumer Federation of America. He is a regular fixture in this Committee, has been sitting at that desk on numerous occasions, at least during my tenure in the last 2½ years, on numerous, numerous issues that have come before us, and we thank you once again for being here today.

Baird Webel is the Specialist in Financial Economics at the Congressional Research Service, which provides nonpartisan analysis and research for members of Congress. Mr. Webel has authored and contributed to a number of reports related to insurance and the regulation of insurance, and for those of us who have been here and I note for new Members that the Congressional Research Service is an invaluable service for us up here. It has been a great source of nonpartisan information, and we thank you immensely.

Hal Scott is certainly well known on this subject matter, the Nomura Professor and Director of the Program of International Financial Systems at Harvard Law School, where he has taught since 1975. He is also the Director of the Committee on Capital Markets Regulation. Professor Scott, we thank you for being here. We appreciate your participation.

Martin Grace is the James Kemper Professor of Risk Management at Georgia State University. He was the Associate Director and Research Associate for the Georgia State Senate for Risk Management and Insurance Research. He is currently an associate editor of the *Journal of Risk and Insurance,* and, again, we appreciate your knowledge and background and experience in the subject matter as well, and we thank you for joining us today as a witness.

With that, Travis, we will begin with you, and, again, I am not going to be rigid on the clock here. But, nonetheless, if you try and keep it at 5 to 7 minutes, I would appreciate it very much. Then we will turn to our colleagues for questions.

STATEMENT OF TRAVIS B. PLUNKETT, LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. PLUNKETT. Thank you, Mr. Chairman, Ranking Member Shelby, and Members of the Committee. Once again, it is a pleasure to be before you to talk about insurance regulation and reforming and modernizing insurance regulation.

Unfortunately, our insurance director, Bob Hunter, could not be here today. He sends his apologies. He is tending to a sick family member. As he mentioned in his testimony before the Committee in March, we are revisiting our policy positions on insurance regulation to learn from the regulatory failures that contributed to the economic meltdown.

The first lesson that we have learned is that Congress should, in fact, create a systemic risk regulator for insurance. Our analysis indicates that there is some systemic risk in insurance requiring a regulator. In order to fully understand and control systemic risk in this very complex industry, the Federal Government should take over solvency and prudential regulation of insurance as well.

This conclusion is made even in light of the fact that, looking backward, a strong case can be made that the States have done a pretty good job of solvency regulation of insurers in recent years, primarily because of the creation of NAIC's accreditation program. That track record was stained, however, last winter when NAIC agreed in secret meetings to fast-track several significant changes to life insurance accounting and reserve practices which would have weakened the financial condition of life insurers and misled the public about the financial strengthen of some of these insurers. Although NAIC eventually backtracked and rejected these changes, they were adopted by several regulators in important States with large insurers. Looking forward, we see no other way to understand and control national systemic risk other than under a single solvency prudential regulator.

The second lesson for us is that the Federal systemic risk regulator should be housed in an agency that is also tasked with prudential and insolvency regulation. The office should be a repository of insurance expertise. It should engage in activities like data colleague and analysis. While this office should be completely knowledgeable about all aspects of insurance, it should not be granted vague and open-ended powers of preemption regarding international agreements that would affect State consumer protection laws or rules in areas that Congress has chosen not to explicitly preempt.

The third lesson for us is that we need to create a financial consumer protection agency to put minimum standards on the books regarding credit-related insurance transactions, including credit and title insurance. The agency should also study insurance matters that are important to consumers and small businesses and appear before the States or the courts on behalf of consumers regarding personal lines of insurance, such as auto and homeowners coverage.

That is what we would recommend that Congress do for starters regarding regulatory restructuring. Here is what we would recommend that Congress not do.

First is to block the States from being the primary insurers of insurance regarding consumer protection. The States are well established in insurance regulation with great expertise and experience. They regulate over 7,000 insurers. They have 10,000 staff working on insurance matters. Over the years, we have documented many weaknesses in this State-based system, but the truth is that they are very good at some things, especially handling complaints for consumers, and their capacity to do so far outstrips current Federal capacity, for example, on banking in terms of handling complaints.

However, we should not set up an optional Federal charter system. That system, we think, is designed to reduce consumer protection to exert downward pressure on the quality of insurance regulation. It has failed miserably at the banking level. Banks and thrifts switch charters freely at the Federal level and between the State and Federal level to avoid strong regulation, leading to sharp downward pressure on the quality of regulation. The results are obvious, and they have affected our economy. So we very strongly encourage this Committee not to take that approach to regulatory modernization.

Finally, let me conclude by just saying that insurance is a mandatory aspect of life today for American consumers. States and lenders require many different types of coverage. If they do not require it, the need to act responsibly to protect one's family in the event of an unexpected emergency means that purchasing other insurance products is a virtual necessity. Consumers can easily be misled by the fine print, and we urge this Committee to continue, as it has, to put a strong focus on consumer protect when it looks at insurance regulation.

Thank you all.

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

Mr. Webel.

STATEMENT OF BAIRD WEBEL, SPECIALIST IN FINANCIAL ECONOMICS, CONGRESSIONAL RESEARCH SERVICE

Mr. WEBEL. Good morning. My name is Baird Webel. I am a Specialist in Financial Economics at the Congressional Research Service, and I would like to thank you, Chairman Dodd, Senator Shelby, and the rest of the Members of the Committee for having me here. I appreciate the opportunity to provide whatever assistance I can to the Committee as it considers insurance regulatory modernization.

My written testimony provides a range of options that Congress could consider as it approaches revamping the insurance regulatory system, and I would like to highlight some particular aspects.

To begin, I would just highlight that the options that I present, and many of the other options, are not mutually exclusive. Insurance is a very wide-ranging business. It is quite possible to envision an approach that takes different regulatory approaches for different aspects of the insurance business. You have extreme differences between life insurance and property-casualty insurance, between personal lines and commercial lines that are about big businesses. You could approach large and small insurers differently. You can approach market conduct and consumer protection differently than you might solvency regulation. This is not to say that one single regulatory body might not be the way to go, but there are numerous options to consider as you consider.

The insurance regulatory reform debate is not new. It goes back really all the way to 1868 or so. It has been spurred along by this financial crisis, but many of the proposals that may come before Congress really predated the financial crisis.

To some degree, many of these proposals have been in legislative language for quite some time. There has been a chance to vet them and to examine the language for various interest groups to consider what this language might mean, and for the people to line up on one side or the other as they have the battle over whether or not you would want to see a proposal enacted.

There are some new proposals, however, and these I think really have not been vetted to the same degree that the older ones have, which is not to say that they are not good proposals. There are certainly old proposals that have been on the table for a long time and left on the table for a reason. And there are new proposals that maybe we do not know exactly what the impact might be but might be the right thing to do.

The newest proposal, of course, is what was released by the Administration in the last week with legislative language coming out of the Treasury, and I think that particularly with regard to the insurance aspect of it, the Obama administration's plan leaves insurance relatively intact in the current regulatory system. The States remain the primary regulators of insurance under the plan. The principal two ways that the plan touches insurance is through the aforementioned Office of National Insurance, which would have some preemptive powers over State laws, and through the systemic risk regulator language.

What is interesting, though, is that the systemic risk regulatory language that was released hardly mentioned the term "insurance." I think that the primary way that it does is actually in the phrase

"Federal deposit insurance." So that presumably insurers are included under the very broad definition of "financial company" that is in the law, but it does not treat a lot of the questions that would arise when you have the systemic regulator on top of the current system. And I think that these questions are sort of magnified by the split between a State and a Federal regulatory body.

The relationship between two Federal regulatory bodies may be a little different than when you have a Federal regulatory body and a State regulatory body. I think there are some constitutional or legal questions that come up in terms of how does a Federal regulatory body interact, what kind of preemptive powers does it have, that are operative in the insurance realm that really do not apply to the same degree in the banking realm. And I think that the Administration's proposal is really sort of silent on exactly how these issues may be resolved.

Of interest as well is the fact that the Financial Services Oversight Council that is foreseen in the legislation does not appear to have any specific representative with an insurance background on it. You have the heads of the various Federal regulatory bodies, but the draft that I saw did not include the head of the new Office of National Insurance on the Financial Services Oversight Council, did not see any representation from the State insurance regulators as well. And I think that that is just an interesting aspect of how, once again, insurance to a large degree at the Federal level is being seen—I mean, I would not say as a second-class citizen, but it is secondary to the banking system and, to some degree, the securities system, primarily because the Federal Government has not had the direct oversight over insurance in the past.

I will be happy to answer any questions that the Committee has.

Chairman DODD. Thank you very much, Mr. Webel. I appreciate it.

Mr. Scott, thank you again for being with us.

STATEMENT OF HAL S. SCOTT, NOMURA PROFESSOR OF INTERNATIONAL FINANCIAL SYSTEMS, AND DIRECTOR, COMMITTEE ON CAPITAL MARKETS REGULATION, HARVARD LAW SCHOOL

Mr. SCOTT. Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee, for permitting me to testify before you today on regulatory modernization as it relates——

Chairman DODD. Mr. Scott, that microphone of yours, you have to pull it up close to you, too. I am sorry about that.

Mr. SCOTT. OK. Should I start over?

Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee, for permitting me to testify before you today on regulatory modernization as it relates to the insurance industry.

As the Committee knows, the insurance industry represents an important place in the U.S. financial system. As of the first quarter of 2009, the total assets of U.S. life and property-casualty insurers were $5.7 trillion, quite significant when compared with total assets of U.S. commercial banks of $13.9 trillion. Despite being a national—indeed, international—business, insurance, unlike the banking and securities sector, is regulated almost exclusively by each of the 50 States instead of the Federal Government.

I favor changing the system by creating an optional Federal charter, OFC, and I have three major reasons for taking this position.

First, the current framework of multistate regulation is inefficient. One study finds that the total additional cost of having multistate regulation of the life insurance industry is about $5.7 billion each year. These costs are ultimately borne by the purchasers of insurance.

Second, the current framework impedes achieving uniformity of standards and regulations. NAIC's attempts to attempts to reduce these costs have not been entirely successful. The surest way to solve this problem is to have Federal rather than State regulation.

Third, the current system puts the insurance industry at a competitive disadvantage to other financial services firms offering competing products. Federally regulated financial institutions can ask their Federal regulators for nationwide approval of a product and receive one approval within a relatively shorter period of time than it takes insurers to obtain multistate approvals.

And, finally, the creation of a Federal chartering agency would enable greater cooperation in the international arena among the various national insurance regulators.

Some contend that an OFC may lead to reduced consumer protection since State regulators may be more responsive to local complaints and concerns than a Federal regulator, and I think to some extent this has been true in the past. However, the Obama administration's proposal for a new consumer financial protection agency, which I think should have jurisdiction over federally regulated insurers, should greatly alleviate that concern.

Where should the new Federal regulator fit in the current regulatory structure? From a broad perspective, I believe the overall U.S. financial regulatory structure is in need of significant reform.

In May 2009, the Committee on Capital Markets Regulation issued a comprehensive report entitled "The Global Financial Crisis: A Plan for Regulatory Reform" that called for the U.S. financial system to be overseen by only two or, at most, three independent regulatory bodies: the Federal Reserve, a newly created independent U.S. Financial Services Authority called the USFSA, and possibly another new independent investor/consumer protection agency. I believe this model is the right one to replace our highly fragmented and ineffective regulatory structure.

If this proposal were to be adopted, regulation of federally chartered insurance companies would be shared, as it was for banks and securities firms between the Federal Reserve, the USFSA, and this third investor/consumer protection agency, and we would envision that the Treasury Department would resolve regulatory conflicts for insurance companies as well as other financial institutions between these two or three bodies.

Two final points. First, my testimony has assumed that Federal chartering will be optional. However, Federal regulation, if not Federal chartering, should be mandatory for large insurance companies since the failures of such firms pose risk to the financial system and taxpayers, as demonstrated by AIG.

Second, the Federal Government must require these large insurance firms to have sufficient capital as a buffer against their failure and the expenditure of taxpayer funds. Our committee would have lodged that capital regulation authority with the Federal Reserve.

However, we must bear in mind that these requirements for capital will have to be different than for banks, as insurance firms engage in very different activities and, thus, incur different risks.

Thank you. I look forward to answering your questions.

Chairman DODD. Thank you very much, Professor Scott.

Mr. Grace, Professor Grace.

STATEMENT OF MARTIN F. GRACE, J.D., PH.D., JAMES S. KEMPER PROFESSOR OF RISK MANAGEMENT, AND ASSOCIATE DIRECTOR, CENTER FOR RISK MANAGEMENT AND INSURANCE RESEARCH, GEORGIA STATE UNIVERSITY

Mr. GRACE. Thank you. Mr. Chairman, Ranking Member Shelby, and Members of the Committee, good morning and thank you for giving me the opportunity to testify before you today on the topic of insurance modernization.

My name is Martin Grace, and I have spent my entire career at Georgia State University conducting research in insurance regulation and taxation. Since the industry is regulated at the State level, this has been predominantly an exercise in the study of State regulation. However, the question of whether the State is the appropriate level of regulation is becoming more important, and I have spent the last 4 to 10 years, depending on how you count it, thinking about that regulation.

This brings me to what I am going to talk about today.

First is the value of regulation in the insurance industry. There are valid rationales for insurance regulation, but the business of insurance is quite different than banking and has a need for a different style of regulation.

Second, I have a mild but, nonetheless, important critique of the current proposals to regulate the insurance industry. An optional Federal charter is not necessarily the only way to think about insurance regulation, and I would like to concur with Professor Scott that maybe there are certain companies that should be regulated and certain companies that have the option of being regulated at the Federal level. However, the current proposal is cobbled together from a Federal banking law that goes back quite some time and decades old State insurance protection—consumer protection model laws.

My third point is that something like the Office of National Insurance as a source of expertise and advice to the Federal Government about the insurance industry is needed, but it should not by itself be used to restructure the relationship between Federal and State regulation through its use of preemption.

Well, we have probably heard a number of different people throughout the last year or so talking about why we regulate insurance, but I want to compare the historical rationale with insurance regulation to the current way people are thinking about it.

Historically, insurance has been regulated to reduce asymmetric information between consumers and producers and shareholders and policyholders, and also to reduce the cost of alleged market power in certain product lines. These historical arguments are really not why we are here today. The more important and immediate application of regulation concerns systemic risk, and this is that regulators should prevent market failures caused by the externality of one company leading to the loss of consumer or commercial confidence in the financial system.

Historically, insurers did not present a real contagion risk to the financial system, but this may no longer be true. Financial companies are interconnected in ways that are without historical precedent. A bank with an insurance operation can extend the contagion risk to those insurance operations.

In insurance, the focus of regulation has been on the individual company and not on the group or holding company. This needs to change at some level to allow for the proper accounting of systemic risk. A State regulator cannot realistically regulate an insurer for its possible systemic risk or its effect on national and international markets especially in situations where the insurer within the State is a separately organized corporation from the corporation which might induce a systemic risk issue.

We can talk a little bit about what level the regulation of insurance should be laid out, whether optional Federal chartering makes sense. You have probably heard most of these arguments, so I am going to skip to my final point, which has to do with the current role for the Federal Government in insurance regulation.

The proposed Office of National Insurance is an important first step in any role the Federal Government may have in the future. Even if the Federal Government decides in the near future to pass on regulating insurance completely, the Office of National Insurance still may be an important innovation for three main purposes. First, there is a paucity of individuals at the Federal level who know its component industries, its market structures, its products, its taxation, or its pricing. Second, because of the unique nature of insurance—premiums are received now but claims are paid at some time in the future—there are a number of important technical accounting and actuarial issues that need to be understood regarding reserving and pricing. This type of knowledge currently resides at the State level.

Finally, there is an important issue that may arise depending upon the powers granted to the Office of National Insurance. However, while it does provide the opportunity to provide information to the Federal Government, especially with international treaties regarding solvency regulation, the main point here is not likely information provision to the negotiators of the Department of Commerce but a real possibility of the office having or eventually obtaining significant ability to preempt State laws inconsistent with international accords. This would be a piecemeal change of the insurance regulatory system that would likely lead to real disruptions in regulations. However, a top-down reexamination of the regulation of the industry would provide for a more systemic or systematic review of the proper role of the Federal and State regulatory powers.

Thank you, and I would be happy to answer any questions.

Chairman DODD. Those were very, very helpful, very knowledgeable. And again, your full statements, I found tremendously illuminating. They were very comprehensive and I regret we don't have more time for you to go into greater detail, at least in your opening comments, but I appreciate very much what you have submitted to the Committee.

Let me sort of pick up, if I can, Mr. Grace, on your last point and just quickly ask the rest of you, and again, I am not suggesting that those of you who have recommended more, that that be excluded, but at least to begin with the notion of the Office of National Insurance. Is it fair to assume, based on what I have heard, that all of you would agree that this is, at the very minimum, this is a step that ought to be taken? Is that correct? Mr. Scott, do you agree with that, as well?

Mr. SCOTT. Yes.

Chairman DODD. Mr. Webel.

Mr. WEBEL. There does seem to be a lack of information at the Federal level on insurance.

Chairman DODD. And Mr. Plunkett, you agree with that, as well?

Mr. PLUNKETT. Yes, Mr. Chairman.

Chairman DODD. I thank you. That helps. In fact, in March, I asked a very similar question of the panel and had a similar response, but I think it is helpful, at least to begin on a point of common interest in all of this.

Let me turn to you, Mr. Plunkett, and ask you, I have said many times before, I believe that consumer protection is a fundamental principle that should guide our deliberations, in thinking about that shareholder, that depositor, that borrower, that policy holder, if we begin by what is in their interest. Obviously, you want stability of your financial institutions as a critical component. But obviously, the confidence and optimism of that individual who goes and buys that policy, deposits that check, buys that share, takes out that mortgage, obviously you have got to restore the confidence of those individuals for them to succeed.

But what is your view of the proper role of the Federal Government? We have heard the conversation here about the systemic risk issues, which obviously contributed significantly. Insurance plays a critical role. And while AIG's problems were not related to its insurance activities—at least, I think most people come to the conclusion their problems occurred as a result of alternative activities that were not part of the main function that had built AIG over the years—there is this risk and danger that if we don't really take a greater central role in the regulation of this major industry in the 21st century, that, in fact, we will be leaving a gaping whole in the systemic risk obligations.

If we all acknowledge that that is a critical risk and the role that these industries could play in systemic risk, then why wouldn't you, while not necessarily at this juncture here, make that transition to a Federal charter rather than leaving this at the State level?

Mr. PLUNKETT. Mr. Chairman, we have proposed new regulation by the Federal Government. In particular, we do believe there is systemic risk in insurance—some—for particular lines especially, like bond insurance. And as a result, we believe that prudential regulation is very associated with proper systemic regulation. Our recommendation is to shift prudential regulation from the States to the Federal level. You can't do systemic regulation without having the capacity to do prudential regulation at the same time.

Regarding consumer protections, though, as we have heard, the States have the expertise. Some States have a much better track record than others. But we are leery of shifting consumer protection regulation from the State to the Federal level at the current time, in particular because the insurance industry has made it clear that they will vehemently oppose what we view as core aspects of consumer protection regulation.

Finally, we have proposed a minimum standards role, as the President has. We have endorsed the President's call for this new Consumer Financial Protection Agency to regulate credit-related insurance policies—like title insurance, credit insurance, mortgage insurance—because they are so closely associated with the credit matters that this agency will have authority over, but only on a minimum standards basis so the States could improve on those standards, if necessary.

Chairman DODD. Let me jump, if I can, and if any of you want to comment on this point as I ask other questions, you certainly may do so. I was intrigued, Mr. Grace, in what you call a mild but nonetheless important critique of the current proposals in your prepared statements. You say that an optional Federal charter is not necessarily the only way to proceed, and again, you made this point in your presentation to us this morning, and that the current proposal is cobbled together from a Federal banking law that is decades old, and I don't disagree with that conclusion.

And yet as you point out, there has been little discussion of other insurance reform ideas outside of the optional Federal charter. I can't recall if it was you or Mr. Scott who made the point about having the charter—drawing a distinction between the charter obligations and the regulatory obligations. I think it was Mr. Scott who made that point.

I worry about this notion of arbitrage, regulatory arbitrage that goes on. In fact, I wish we would take the word "optional" out of this discussion altogether because I think it is sort of an antiquated idea in light of events over the last couple of years. Either you are going to be one or the other, it seems to me, and this idea of bouncing around, trying to choose where you want to be, I think has contributed in some significant way to the problems we are facing today.

But anyway, let me ask both of you, if I can, do you think there should be a systemic discussion of modernizing insurance regulation that could review all of the available ideas, and again, the Office of National Insurance thing does that to some degree, but share with us if you would, Mr. Grace, some of these other ideas you think which we should be considering other than just the optional Federal charter.

Mr. GRACE. I was thinking that there are a number of different ways you could go with this, but there would have to be some thought about are there some companies that really are interstate, international in scope, and should they have the option to become a Federal charter? I would say, if they want to, yes, of course.

But what if there were certain companies that were interstate, international in scope and decided not to want to become a federally chartered insurer? Would there be an ability by the Federal Government to say, you know, you really are a different type of organization, and because of your ties to a holding company system, because of your ability to perhaps become systemically related to a banking concern or some other kind of financial services company, that you become very important to us?

Well, I would think that the Federal Government would want to have sort of the reverse option, if you will, of bringing that company within the Federal charter, however you might want to think about it.

Chairman DODD. So it wouldn't be necessarily—you are not leaving the decision up to the industry, but rather the Federal Government ought to be saying, in light of the activities you are engaged in, you don't have the option.

Mr. GRACE. Right. That is the second option. The first option is people—smaller companies might want to be federally regulated for whatever reason. And then larger companies, though, because of their activities, might need to be federally regulated, which I am agreeing with what you are saying. So it is an option that the Federal Government would have based upon certain characteristics of the complexity of the firm, the markets it is in, the types of activities its activities are related to. That would be enough to make it—I don't want to call it systemically important, because that is not really what I am saying. I just think that the company is significantly complicated and organized in such a way that a single State regulator has a difficult time putting the entire company together under its jurisdiction.

Chairman DODD. Mr. Scott, do you want to quickly comment on this notion of that distinction between charter and regulation? Is that a distinction without difference in the sense of allowing sort of this migration back and forth when it comes to the industry deciding where it wants to be? And obviously, the problems seem related.

Mr. SCOTT. Well, on the charter point, what I was thinking is if you had an optional Federal charter system, not all insurance companies get a Federal charter. But on the other hand, you might build in on top of that a requirement—and, by the way, anyone that did get a Federal charter would be federally regulated, obviously. You might build on top of that mandatory chartering/regulation for large insurance institutions, and I say large and I am not saying systemically important—it is not an accident—because I think it is inherently difficult to define what is a systemically important institution and they are going to change from time to time and it has negative moral hazard problems, as has been widely discussed in recent weeks.

So I think if we picked them on large, we wouldn't be branding people right off the box. We might get some that really didn't have that much real systemic risk, but if they are large enough, it seems to me that most of those very large insurance companies could, if they engaged in certain activities, result in systemic risk.

So I would have at the Federal level an option for everybody, large or small, but large would have to be mandatorily regulated at the Federal level.

Chairman DODD. Thank you very much.

Senator Shelby.

Senator SHELBY. Professor Scott, in the derivatives area, are a lot of the derivatives insured by insurance companies, in other words, credit default swaps and things like that?

Mr. SCOTT. Well, they write—insurance companies do.

Senator SHELBY. They write insurance?

Mr. SCOTT. Yes. Not in the regulated insurance company, but like in their holding company. I don't know that anyone has done it to the extent that AIG has done it.

Senator SHELBY. If an insurance company is involved in derivatives on the national, international scale, how could States regulate them?

Mr. SCOTT. Well, I don't think very successfully.

Senator SHELBY. They haven't, have they?

Mr. SCOTT. I would just generalize that problem to say that if you are talking about interstate and international activities, there is a limited ability of the States acting individually to address this problem, even when they are coordinated by some kind of association.

Senator SHELBY. Professor Grace, have you studied how many insurance firms would actually be considered as a systemic risk, generally speaking, of the insurance companies in this country?

Mr. GRACE. No, sir.

Senator SHELBY. Shouldn't that be an appropriate study somewhere? I am not suggesting to you academics what to do, but——

Mr. GRACE. I agree to some——

Senator SHELBY. ——that work could help us some.

Mr. GRACE. I agree to some extent that the problem is we don't—in order to study something, we have to know what it is, and I think that is sort of a chicken-and-the-egg problem.

Senator SHELBY. In how you define it?

Mr. GRACE. Exactly, sir.

Senator SHELBY. How you define it. I guess what I am trying to get at, what percentage of insurance companies would be subject to bringing the system, the financial system down?

Mr. GRACE. I thought about that question sort of hypothetically and then I said, how many companies look like AIG? I said, how many in the United States? And I couldn't come up with any. I said, how many worldwide, and there might be some. I am not an expert on international companies. But their organization was so different than the typical United States insurer. But there are other types of risks that insurers engage in that in different circumstances might yield problems.

Like one of the things, and I am not an expert in this area, but the National Association of Insurance Commissioners is concerned about lending of securities by life insurers, which has some option-like characteristics and how do you reserve for those types of things is very important.

Senator SHELBY. Sure.

Mr. GRACE. And most State regulators may not even be aware of the extent of this type of activity because it is just not public. People don't talk about it. They don't think about it.

Senator SHELBY. But aren't a lot of the problems that we have encountered that insurance, and, of course, banks, too, are involved in things without adequate capital to back up what they are involved in, the risk that they take?

Mr. GRACE. Yes, I agree, and this leads me to—perhaps not in this testimony, but in other things I have written, I have been critical of the NAIC for not really pushing on capital adequacy. Thirty years ago, Congress pressed the NAIC on solvency regulation quite hard and they did a number of things to modernize how they examined and how they thought about risk-based capital for insurers. But, you know, those laws are now 15 years old and there are many other approaches that are probably more sophisticated. Whether or not they are totally a major improvement, I am not sure, but there are just a lot of things that have been talked about and done, the States just haven't moved on yet.

Senator SHELBY. Professor Scott—and I will address this question to both of you professors here—do you believe that the States can adequately oversee the failure of other large insurance companies, looking at how involved and how complex they are, not only in this country, but internationally?

Mr. SCOTT. In short, no, I don't believe they can, and Senator, I think it has to do with the way the States deal with insurance companies. As you know, one insurance company can be licensed for different products in multiple States. So the problem is, where is the overview? What does it all add up to, when we take each of these separate State operations, because what we saw in the financial crisis were problems for firms, OK, as a result of their cumulative activity in many areas, and certainly in the banking system.

And so most States can have the overall view, it seems to me, of what is going on in a particular insurance company which is composed of all these separate companies that are chartered in individual States.

Senator SHELBY. Professor Grace, have you got any comment?

Mr. GRACE. Yes. I think it is very difficult for States to resolve insurance insolvencies, if you are talking about after the bankruptcy. And in part, because——

Senator SHELBY. You are speaking of large insurance companies?

Mr. GRACE. Yes.

Senator SHELBY. Ones that are really involved in everything?

Mr. GRACE. In part, because States do not have a bankruptcy code the same way the Federal Government does and there is no bank, or corresponding uniform bank bankruptcy code that applies to insurance. So it is a State-run enterprise from top to bottom and there are no State bankruptcy judges. There are just a lot of costs involved in dealing with these things and they are just not experienced at it.

Senator SHELBY. I know you said you hadn't done any studies. You have done a lot of research, both of you, in this area. But we have, I don't know how many insurance companies doing business in our country, State to State, 50 States. Most of them would not cause or bring about a systemic risk. So I think whatever we do, that has got to be separated, has it not, at some level. Otherwise, we are wasting our time and we are waiting for the next crisis, are we not?

Mr. GRACE. The NAIC has something they call a Nationally Significant Company, and it has a certain level of assets and writes in 17 or more States. That is a nice dividing line. That group of companies writes about, I want to say 50 percent of the business in the entire United States.

Senator SHELBY. Was AIG considered one of those——

Mr. GRACE. Yes, it was. Yes, it was. And there probably, if you think about just the insurance groups, there may be only 350 groups. But if you think of State Farm, for example, they have 20 companies within their group. So the number of agents that you have to oversee in this is a countable number. There are 7,000, I think we heard, companies in the United States, but——

Senator SHELBY. Quickly, is the Fed really the appropriate agency to regulate insurance companies, because they have no history there. In my judgment, I think they have failed as a regulator of the holding companies. And if it has no expertise, no history in insurance regulation, does it have a good record on consumer protection? A lot of people, including my Chairman here, would probably argue against that. What do you think, Professor Scott?

Mr. SCOTT. Well, I would distinguish, Senator, between regulation and supervision. So if we talk about regulation, let us take probably the most important form of regulation, which is capital requirements——

Senator SHELBY. Is that a question of degree there, supervision, regulation?

Mr. SCOTT. Supervision is sort of going in and examining what people are doing and checking, sort of like we do with large banks, or actually all banks——

Senator SHELBY. OK.

Mr. SCOTT. ——as opposed to writing rules, OK, as to what people can do. Now, I think if you are going to pick an agency that had expertise in capital, it would be the Fed. Yes, it is true that the Fed has not regulated the capital for insurance, but I think it is true that the Fed has thought much more deeply than any other regulatory agency about capital in general. They have been part of the Basel process, *et cetera*.

On supervision, however, OK, that is hands-on supervision of insurance companies, I don't think the Fed should do that. Indeed, our committee doesn't think, or had thought maybe—some thought would be an option—I, personally, would say we should have a unified prudential regulator, OK, who should do that for insurance, banking, and securities, not the Fed.

Senator SHELBY. Do you have any comment? I know my time is up, but——

Mr. GRACE. I think I agree with Professor Scott. I would think someone whose focus is capital, you know, all they are doing is thinking about prudential regulation, would have a much stronger interest in doing it properly.

Senator SHELBY. Thank you.

Chairman DODD. Thank you very much.

Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and welcome.

Professor Scott, with an optional Federal charter, I presume, and I want your opinion, that we would also have to construct a Federal guarantee fund, a Federal reinsurance fund to complement——

Mr. SCOTT. In my written testimony, Senator, I talk about this. I think in large part, there has been pretty good experience with State guarantee funds, but that said, I don't think it is feasible to have Federal regulation and State guarantee funds. I mean, it is sort of the opposite of what we had with State chartered banks. You have the States chartering the banks and regulating them, and if they didn't do a good job, the Federal Deposit Insurance Corporation paid the bill. This would be the reverse. You have the Federal Government regulating them but the States paying the bill if they fail. So I think you have to put those two things together, and so we should have to create a Federal guarantee fund for the federally chartered or mandatorily regulated insurance companies.

Senator REED. Another aspect of this is that to the extent that State laws would be preempted, would your view be a total preemption of State laws or leave it to us?

Mr. SCOTT. I don't know if I would go total, and, of course, what is total given the court's recent decision is questionable. I certainly wouldn't go so far as to preempting State Attorney Generals from enforcing the law.

But when it comes to consumer protection, which I think is the sort of crux of the matter of preemption here, yes, I would say if they are federally regulated, there should be preemption now. I think there is a very legitimate question, OK, as to whether Federal consumer protection would be adequate. As long as it was left with the banking agencies, I think there would be a big question about that. But if at the same time we create this Federal authority, we have a strong Federal Consumer Protection Agency, OK, then I think that concern should be greatly alleviated.

Senator REED. Mr. Plunkett, just a quick comment on this issue of the consumer protection and then I am going to turn to Professor Grace. Go ahead, please.

Mr. PLUNKETT. Senator, thank you. We actually agree with the professor on one key point, which is that prudential regulation needs to be at the Federal level, but not through an optional charter. It should not be optional. That drives standards down.

On consumer protection, we propose the opposite kind of competition to improve standards, which means on the agency that the President has proposed, we start with credit-related insurance products and we set minimum standards at a high level. That will assure quite a bit of uniformity, And then if there are exceptional circumstances, the States can exceed that. That is the right way from our point of view to do consumer protection for starters.

Senator REED. Thank you. Professor Grace, it seems that there are two general ways insurance companies can get in trouble. They can have a subsidiary, like AIG Financial Products, that deals with credit default swaps that is very loosely regulated, and not by the insurance regulator, or their own underwriting and insurance investing is the problem. In fact, AIG had both of those things.

I would suspect whatever we do, is that subsidiary company with the subsidiary that might get in trouble will be a financial holding company regulated by the Federal Reserve. I think our approach would be to give that—not to be deferential to the functional regulators, but to have the whole broad suite, particularly for large companies. So in effect, I think that that part will be addressed quite specifically. It will be a financial holding company that will fall in like all the other financial holding companies.

The other part, though, is I think where we really have to focus some attention. That is the investments and the underwriting of the insurance company, which now is traditionally done by the States. Traditionally, it is done by the States. So to what extent should we have a company that has no subsidiaries, it is a vanilla insurance company, because of size alone, does it make sense to bring that into the Federal orbit?

Mr. GRACE. It depends on what comes with that. I would think that if there are benefits to the insurer for basically saying—having one standard for consumer protection across every State, they are going to want to do that. But you are right that the plain vanilla insurance company is not going to have the same kind of problems, insolvency-related problems, that one that has multiple different types of subsidiaries doing all different types of financial services products. But if the insurer thought it was in its best interest to get, in exchange for some Federal oversight, but to get that one set of duplicative costs wiped off its books, I think it would want to do that.

But I just want to comment a little——

Senator REED. Go ahead.

Mr. GRACE. Sorry. I think optional Federal regulation, if we just went with that, is a one-way street. Unlike banks, I think it would be very difficult for insurers to go back to being regulated by the State, because I think at the biggest companies, they are already being regulated by 50 different States. And they go to one, the Federal regulator, they are not going to want to go back to the 50. It is not like going from bank regulator to bank regulator. It is a very different regulator.

Senator REED. Thanks very much. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank each of you for your testimony.

Mr. Plunkett, on the consumer protection piece, just based on your experience, is there a different level of need for life insurance than there is for property and casualty?

Mr. PLUNKETT. It is a very good question——

Senator CORKER. At the State level.

Mr. PLUNKETT. Yes. There are some differences. Life insurance, especially term, is more of a national market. Property-casualty, often regional markets, local markets. So the uniformity already exists in many cases in the types of products that are being offered. Whether life is overseen at the State or the Federal level, though, we have to ensure that there is not this, once again, regulatory structure that keeps standards lower than they should be for life insurance.

Senator CORKER. So there is a greater need at the State level for consumer protection in property and casualty, generally speaking, than there is in life?

Mr. PLUNKETT. Well, I think what I was saying, Senator, is there is greater variance at the State level. The need is just as high. But in terms of the differences between the policies, the need for local know-how in regulating, it is greater with property-casualty.

Senator CORKER. OK.

Mr. PLUNKETT. I mean, think about all the hazards in your State that might be different than, say, earthquakes in California.

Senator CORKER. OK. Mr. Grace, you have focused some on capital requirements. In that same vein, is it not different for life insurance companies than it is for property and casualty as it relates to capital requirements?

Mr. GRACE. Well, the capital requirements are different, but I don't know if the regulation of them needs to be done by two different people. I don't know if that makes a lot of sense. The difference really is that a life insurance contract is generally a long-term contract so investments are made for long-term, while a P&C contract is really a short-term contract and investments are made for short-term. So even though the risk-based capital formulas are different, they are not so different that we need to have two different levels of regulation to look at them.

Senator CORKER. But I guess from our perspective, there are two issues at hand. There is the one of trying to figure out the issues of risk to the public, systemic risk, and then there is the issue of trying to resolve this sort of family feud that exists between whether these guys are going to be regulated at the State or Federal level. Those are two different issues. And from the standpoint of just us looking at overall systemic risk, there is a difference, is there not?

Mr. GRACE. Well——

Senator CORKER. I mean, are we going to find much systemic risk in the P&C category?

Mr. GRACE. Oh, OK. No, I don't—well, it just depends on who—because AIG really was a P&C company with some life business and financial products. So it just depends on what you—the plain vanilla P&C company is going to be simple, in essence. But who knows what the company looks like.

Senator CORKER. Well, then to that point—and then we will get you, Mr. Webel—Mr. Scott, you were mentioning that large companies, quote, "need to be regulated at the Federal level." How large is large?

Mr. SCOTT. I cannot answer that, Senator, but I don't think that is an unanswerable question. In the area of capital regulation at the Fed, Members may be aware, we took the 20 largest banking organizations and separated them out to different ways of calculating their capital. I don't know where that cutoff, I don't recall what it was, but we made a cutoff, OK. And I think you could make a cutoff here. It is not going to be perfect, but I would submit it is better than trying to figure out who is systemically important.

And remember, that could change from day-to-day. I mean, people invent new products. Look at AIG. If we looked at them 10 years before they came into financial products, they would have looked a lot differently. So I think you are generally going to—you are not going to capture everybody. It could be over-inclusive to some extent and under-inclusive. But you are going to get it 95 percent right with size and I think that is as good as you can do.

Senator CORKER. So I am going to ask one last question and start with you, Mr. Webel, since you have been raising your hand at a couple of these, and you might answer the other questions, too. But we keep talking about systemic risk and it is in vogue how because of the things that have happened. I just wonder, is our emphasis on systemic risk or having a regulator to see all, the Fed or the Council or whoever it might be, is that misplaced and would we be better off just making sure that the regulation we have for entities, you know, the issue of a clearinghouse for derivatives, looking at what mortgage brokers are doing out there as it relates to the type of loans that are being originated, looking at rating agencies, would we be better off focusing on the individual regulatory pieces, or are we sort of bailing out, if you will, by trying to create somebody who is the Wizard of Oz or who knows all and can solve all by being a systemic risk? Mr. Webel, since—and that is my last question.

Mr. WEBEL. Senator, I think—I mean, I think it is a very well-phrased question and a very good one. It has been easy to go that route of a systemic risk regulator because we were just presented with a systemic crisis. But I will admit I do have—I have had a little bit of difficulty as I have thought about it, coming up with the situation where if you had really good prudential regulation at the firm, that you would end up with a systemic crisis coming out of the firm.

That essentially if, to take the example, the Office of Thrift Supervision had done perhaps a better job overseeing AIG and had either made them keep more capital for the derivatives they were writing, if the securities lending program had operated in a better way either through OTS or through the insurance regulators, AIG shouldn't have failed. If AIG doesn't fail in the way they do, there isn't a systemic risk.

So I think it is a very good point that if you rerun the crisis the way it happened, what would a systemic risk regulator have done? There were papers coming out of the Fed in 2005 that there is a housing bubble. Well, is the Fed going to act in 2005 to drive down the value of all the houses in the United States? I don't think it is going to happen. So we may be putting a little too much faith in the idea that we are going to have someone at 20,000 feet that is going to stop these kind of things.

Mr. GRACE. I agree, if I could interrupt. The chance of that—we had a number of different regulators looking at AIG and one more looking at it and being right, I don't know how high it is. I mean, I think everybody was looking at AIG but sort of passing the buck. I guess the only thing is if there wasn't a buck-passer but one that was relied upon at the bottom to make a decision, that is the only reason that a systemic risk regulator would work. But we had regulators looking at AIG, as you were saying.

Chairman DODD. Thank you very much.

Senator Warner—or Senator Johnson.

Senator JOHNSON. Mr. Plunkett, Professor Scott, and Professor Grace, late last week, the Treasury sent up its legislative language to create an Office of National Insurance. In your opinion, is anything missing in this proposal that, if included, would make it more effective in monitoring and regulating insurance companies? Does this proposal do enough to address the insurance issues brought to light by the AIG situation? Mr. Plunkett.

Mr. PLUNKETT. Thank you, Senator. We support the information function of the office. We support eventually considering the office as the prudential or systemic regulator for insurance. And as you know, we have proposed systemic and prudential regulation to be vested at the Federal level, but not optionally.

The big question in our mind is the authority granted in the legislation to the agency and the Secretary of the Treasury regarding preemption, interpretation of international treaties, and then preemption. It does exclude, from what we can tell, some State consumer protection functions, such as insurance rates, premiums, sales, underwriting, antitrust, and insurance coverage.

We are going to be examining that language, though, to make sure it is not too broad and does not lead to a conclusion of an international agreement then that, directly or indirectly, preempts State efforts to improve consumer protection.

Senator JOHNSON. Professor Scott.

Mr. SCOTT. Senator, I do not think it goes far enough. As I have testified, I think we need a system for optional Federal charters, plus mandatory regulation for large insurance companies, which is beyond what the Administration has recommended.

I would also say that if we go in that direction, I do not believe that this regulator should be part of the Treasury Department, that is, an office. I think it should be independent of the executive branch, much as the SEC and the Fed are.

Senator JOHNSON. Professor Grace.

Mr. GRACE. Thank you, Senator. I guess the way I am thinking about it now, this is a good first step, and let us see how the first step goes. I would not want to—I mean, I agree with Professor Scott in sort of the long-run game here, but I would like to actually have a discussion—or I would like to conceive of the Federal Government having a discussion of what to do next after it has information. And, you know, just adding things right at this stage does not make sense yet.

Mr. JOHNSON. For all the panelists, the Treasury's regulatory restructuring, the white paper, says that it will support proposals which increase national uniformity through either a Federal charter or effective action by the States. Do you believe a Federal chart or action by the States will be most effective in increasing national uniformity? Mr. Plunkett.

Mr. PLUNKETT. Senator, for now, for the most part, we would like to keep consumer protection regulation at the State level. We have supported authority in the President's Consumer Financial Protection Agency to, on a minimum standards basis, regulate credit-related insurance products, credit insurance, title insurance, *et cetera.*

The NAIC has to do a better job on consumer protection from our point of view, and we are looking to you all to spur them along on that front.

Senator JOHNSON. Mr. Webel.

Mr. WEBEL. If the goal is uniformity, I do not know that a Federal charter is absolutely necessary, but I think that Federal action certainly is. The NAIC has been in existence with the goal of harmonization since 1871. Getting 50 State legislatures together to try to enact the same sets of laws I think has proven to be unrealistic. So whether it is a Federal push that says we are going to have the States set standards and it is going to apply it everywhere, or whether it is the Federal standards directly, I think one can debate over which is better. But I think that if you want uniformity, you need a Federal push.

Senator JOHNSON. Mr. Scott.

Mr. SCOTT. I agree with that, but I would also add that in order to achieve this uniformity, you would have to have Federal preemption. Otherwise, you would not achieve uniformity because each State in the consumer protection area would be free to enact laws that were different than what the Federal standard was.

Again, I would come back that I would not lightly want to see this happen unless we were very confident that we had a very strong Federal consumer protection presence, which I think, by the way, the Obama proposal would give us.

Senator JOHNSON. Professor Grace.

Mr. GRACE. I think I agree in substance with what everyone has said—well, the last two speakers. The States are just not proactive, and even if you have a proactive State that wants to do a better job, getting its neighbor or the other 48 to go along with it is a long, long, hard process. If you look at just the harmonization efforts that have been going on, model laws are proposed all the time, and, you know, 30 or 40 is a good number. We rarely see 50. There might be some, but it is only a handful.

So I would suggest that a Federal charter would do better at increasing uniformity.

Senator JOHNSON. My time is expired.

Chairman DODD. Thank you very much, Senator.

Senator Johanns.

Senator JOHANNS. Mr. Chairman, thank you, and I find it to be a fascinating conversation. I will warn each of you that the guy asking the questions now is a former Governor and a former mayor. And here is what troubles me about what I am hearing today, and I am not picking on you, Professor Grace. But, you see, if I took your argument to a logical extreme, the solution to all the world's problems is to pass a Federal law that preempts every State law on every subject, and then we will just have a big powerful Federal Government that kind of tells the States what to do in every area. And, you see, as a former Governor and mayor, I am just so enormously troubled by that. I do not even think the Constitution anticipated that.

Here is what my comment is leading to, however. It seems to me that we are mixing things up today. Maybe there is a policy reason for a Federal charter. Maybe there is not. But I think that is a policy debate that we somehow have to hash out and figure out whether that is the right approach. And there are pros and cons on both sides of that.

Then there is this whole other issue of the kind of risk that AIG engaged in, which, upon reflection, looks stupid to me, but it is the kind of risk that literally could bring the economy down.

Now, that seems to me a whole different area of regulation than whatever you want to call it—Federal charter, optional Federal charter, *et cetera*. And by, you know, working these two together, it seems to me like we are ending up with a gummed-up mess here.

Anyone want to wade into that and offer some comments on that? Professor, I started on you, so I think it is fair you get the first shot at this.

Mr. GRACE. Thank you, Senator. Anyone who knows me thinks of me as, I guess, a small-government libertarian, and when they hear me talk about this, their eyebrows go up. But I am focusing on a very narrow segment of the industry, I think. I am thinking about big companies who operate nationwide, and if you think about the optional Federal charter, they would have one regulator. That would lower their costs. If you think about the types of burdens imposed by State regulation that do not necessarily have any value—if 50 States are doing exactly the same thing slightly differently, is that slight difference really valuable? And I think the answer to that is not always. So that is why I have sort of gone to that level of allowing companies to opt to have a single standard for regulation.

But going to your second point, if you have a company that engages in significant activities that are different than insurance outside the jurisdiction of the insurance regulator and that imposes a risk to the entire economy, the State cannot do that. So these two types of regulation, as you rightly pointed out, are different. But they get mixed together for the reason I am just discussing.

Senator JOHANNS. Mr. Webel.

Mr. WEBEL. I think the gummed-up mess that you are seeing is partly because we have taken the old debate that you had preexisting, and then we had a financial crisis, and so everybody piles the new arguments on to the old ones, and particularly——

Senator JOHANNS. If I might just interject there, because I think you have touched upon something. Post-9/11, everything became if you could box it under the title of "national security," then you had a better chance of getting this, that, or the next thing done, or getting a Federal grant or Federal funding or Federal something. And that is almost what I am sensing here today, is we do have a policy issue here on the Federal charter or the optional Federal charter, but I think that is really a very vastly different debate than regulating systemic risk engaged in by insurance companies.

Mr. WEBEL. Well, I think the question, the place where they intersect, besides just an opportunism to try to get ones you previously wanted passed passed, is sort of coordination between the regulatory bodies. You know, if you envision a Federal Reserve or a new Federal systemic risk regulator interacting with Federal banking regulators, that is a little easier, to some degree, to envision how that is going to work than interacting with 50 different State insurance regulators—which is not to say you could not set up a good systemic system where you had a Federal systemic risk regulator and the 50 insurance regulators. It is something that it is kind of an easy thing to say, well, you know, if we are going to have this Federal body at the top doing the systemic risk, you know, doesn't it make sense to some degree to have a Federal body that they interact with that is actually overseeing especially the day-to-day operations of these huge insurers?

Senator JOHANNS. Mr. Plunkett.

Mr. PLUNKETT. Senator, if I could just jump in on one part of your comment, I think you are absolutely right to be skeptical of the notion that Federal preemption is going to solve all problems. We only have to look at to the banking sector, in the Office of——

Senator JOHANNS. Look at the Madoff case.

Mr. PLUNKETT. ——the Comptroller of the Currency, or the OCC preempting the States on lending and then replacing those State standards with virtually nothing. So Federal preemption does not solve all problems, and uniformity by itself should not be the goal. The goal should be high-quality regulation at the highest level of uniformity that is possible.

Senator JOHANNS. Yes, Professor.

Mr. SCOTT. I think you are right that we are mixing two issues together, but they are both important issues. The objectives of the optional Federal charter, of course, which was a debate that we got engaged in long before the financial crisis, were to achieve efficiency and uniformity and to reduce cost. That is the objective.

The objective with mandatory regulation of large or systemically important institutions is addressed to the risk to the financial system of insurance companies or others engaging in certain activities. A totally different concern.

On the other hand, both involve possible Federal action, either because we would allow a particular insurance company to get a Federal charter or we would require a particular insurance company. Both would lead to some kind of Federal regulation of insurance companies.

So I think it is for that reason that we are putting them together, but you are quite right, the objectives that are sought to be achieved by an optional Federal charter and mandatory regulation are very different.

Senator JOHANNS. I am out of time, Mr. Chairman, but I will just wrap up with this thought: Your testimony, your written comments, the Chairman is right, they were really very good, very thought provoking. If there is any research that is done out there or if there is any interest to offer some thoughts on this issue of systemic risk management, regulation, whatever, versus this whole other issue of optional charter, Federal charter, or Federal charter, I would be happy to receive it, because, again, I see a distinction here. I have met with so many people on the Federal charter, and they come in and they talk about, "Well, you know, Mike, when you were Governor in your State, we could get things done, but in other States we could not, and that is not efficient." And so it threw me for a loop when all of a sudden systemic risk and optional Federal charter got entangled together. I do see the intersection, but I do think there are some pretty fundamentally different policy issues here.

I would hate to have this get swept along on this whole issue of systemic risk management when really I think there is a pretty important States rights issue here. There are efficiency issues. I mean, there are good arguments on both sides of this, and I would hate to get that all mixed together in a way that does not make sense.

Thank you, Mr. Chairman.

Chairman DODD. Well, Senator, thanks very much. I tell you, you bring a wonderful perspective to this, I think. It is a very clear point you were making. It is sort of what we have been wrestling with on all these matters and how to move, and to some extent I suppose argues for the notion of having this Office of Insurance at the Federal level to allow this to go forward. At the same time, again, I think there was a legitimate point made by Senator Corker on systemic risk. We can get so fixated on something that we lose sight of the means by which to deal with things. But that one probably has a more immediacy to us to be able to identify that when that occurs. But you raise some very, very good points, I think, and I thank you for it immensely as well.

Senator JOHANNS. You know, if I just might warn the panelists, I think the next Senator up is also a former Governor.

Chairman DODD. I was going to make that point. It is going to be a tough road here.

Senator Warner, former Governor of Virginia.

Senator WARNER. Thank you, Mr. Chairman, and I want to thank my colleague from Nebraska for, I think, teeing up—I think you teed up a very good point that—you know, and I come as a nonbiased party to this optional Federal charter or State charter debate, and this panel has been helpful.

I do think, though, that, you know, of the various frustrations sitting on this Committee, one of the most frustrating aspects, for me at least, in this last 6 months has been our Federal Government response to the AIG crisis. And I think one of the things, you know, sitting here time after time when we hear Administration officials and others say we have got to pay out 100 cents on the dollar to counterparties and a complete lack of knowledge at the Federal Government level of how to even get their arms around this entity, does argue in some form, whether it is this Office of National Insurance or something else, at least somebody in the Federal Government understanding what is happening in the insurance world and being prepared to deal with consequences in the case of AIG, where there was no appropriate resolution ability at the State level and the American taxpayers ended up getting—footing the bill.

So I want to comment, again, following up on Senator Corker's comments as well, I do think we kind of struggle to define what a systemic risk is going to be. And we have not got it right. Senator Shelby and I have talked about this at times. But my hope—and, again, one of the reasons why I am not a fan on giving this responsibility to the Fed and thinking an independent systemic risk council with an independent chair is a better option—is that the very presence of that type of entity out there, hopefully never having to be called upon, can be that check on the day-to-day prudential regulators to do a better job so they never have to get one of their problems bumped up to a systemic risk council. My hope would be we would have a systemic risk council that would have this ability to see above the silos, but hopefully rarely, if ever, have to be called upon to act.

So I want to come back to the panel on as we struggle through, one of the things we have not talked about this morning, you know, one of the things we hear on the financial side a lot are the "too-big-to-fail" issues, something that, again, I think most of us never want to hear again after the resolution of whatever reform we put forward.

I would like the panel to comment, though, on, you know, one of the ways we have thought about on the financial side is can we put in place higher capital requirements, so, in effect, the way Chairman Bair from the FDIC has constantly said, let us put a price on getting too big. We cannot draw an arbitrary line. I think that is too much intervention in the marketplace. But can we put a price of getting too big? Is there also ability to have additional capital requirements or some other burdens that we could put on for those entities—AIG, again, being a classic example that seems to have gotten away from the traditional insurance model and went off into this whole new product range that clearly had ramifications not only for its new products division or its financial services division, but indirectly had implications for its insurance division, which was still relatively healthy. How do we—what are the kind of barriers to prevent the "too-big-to-fail" circumstances within the insurance area? Increased capital being one. Are there other increased capital or other requirements that might be put on different product placements? Anybody on the panel.

Mr. GRACE. I will start. I think you are right. In fact, I have had numerous conversations with my colleagues about how do you make something too big to fail, and you essentially increase the cost of holding capital, and so companies will not—it has to be the right cost. I am not just talking about a crazy tax. I am talking about one that reflects the social cost of having to bail the company out.

Senator WARNER. A smart tax?

Mr. GRACE. No. An intelligent tax. But the idea being that it would be related to the risk of the company, not just an *ad hoc* tax placed on all companies. So it would be basically having significantly relevant risk-based capital holdings.

Senator WARNER. So both increased capital, but then as you got into——

Mr. GRACE. Yes.

Senator WARNER. If you choose to do a whole series of what would be viewed by someone as a risky product line, there would be additional cost to it.

Mr. GRACE. Right. Every type of activity has some risk to it, and you would be charged for engaging in that risk. But it would be—as I said, it is not a tax unrelated to the company. It is a tax directly related to what the company does.

Senator WARNER. If everybody could answer fairly quickly, because at the Chairman's discretion, I would like to get one more question.

Mr. SCOTT. Senator, I think capital is our first line of defense against systemic risk, and there should be more capital for more risk.

That having been said, our track record on setting those capital requirements for banks has not been very good. So let us not fool ourselves——

Chairman DODD. I was going to make that point to you, by the way, especially the Fed be the one to set capital standards. Had the

Fed gotten its way earlier, we would be in much deeper trouble on this point.

Mr. SCOTT. I would say that there is a collective responsibility here in all the regulatory agencies, and the fact that the Fed did not get it right, in my view, is not the reason not to give it to the Fed in the future, because I still think they have more expertise. But putting that aside, as I said in my written testimony—and I think in my oral testimony—capital requirements for insurance companies are a different set of issues than they are for banks because their activities are different. And so we do not have Basel process. Some insurance companies have used Basel, but we have to think very hard about how to set capital requirements.

In terms of, yes, should riskier firms have more capital, for sure. Banning——

Senator WARNER. But somebody still has to define whether you are a riskier firm by your product line.

Mr. SCOTT. Exactly. So I am saying, you know, our whole risk-based capital approach depends on an adequate determination of risk.

Senator WARNER. Which would be a difficult assessment to make at a State level.

Mr. SCOTT. Exactly. It has been for banks, so let us not fool ourselves it is going to be easy for insurance companies.

Then I think there is another part of your question which says should we kind of ban certain activities. I mean, if you are kind of creating a bomb that is going to blow up, maybe this is not a capital issue, this is should we have these kinds of products. And, you know, I think if we could be sure we were just doing that on a very selective basis, it would be OK. But, again, you know, to be now defining exactly what products firms can offer *per se* I think gets you into a very difficult——

Senator WARNER. Mr. Webel.

Mr. WEBEL. I would just point out one other thing that you are going to hear as you start talking about this, and that would be essentially the competitiveness of the American financial services industry. And right now, in noninsurance financial services we run a very, very large trade surplus in the financial services.

There will be people who will come to you when you start talking about putting on higher capital charges and say essentially, you know, you are going to be costing American jobs that are going to go to London or go to Tokyo or go to wherever where they do not put these same kind of requirements on. It is an argument—whether or not it is a good one——

Senator WARNER. We heard that before, and it was not like the U.K. was spared——

Mr. WEBEL. Well, the extreme to this, I think, can go to Iceland, where you end up with banks that are several times GDP and do you really want a financial——

Senator WARNER. Buyer beware——

Mr. WEBEL. ——services industry that large. But I just wanted to—you will hear that.

Senator WARNER. Mr. Chairman, can I get one—I know Mr. Plunkett quickly, and can I get one more question in?

Chairman DODD. Go ahead.

Mr. PLUNKETT. Senator, I will just add, of course, looking at capital is important for proper risk assessment. Risk assessment can also relate to not necessarily size but the sensitivity of the line of insurance that is being offered, bond insurance being the obvious example there, but also lines you might not necessarily think of first, such as title insurance, highly concentrated market, handful of insurers control the market, if one of them got in trouble financially actually could have effect, especially regionally, on mortgages and the real estate market in some parts of the country.

Senator WARNER. Mr. Chairman, thank you for letting me have one more question in. One issue that has not been that touched on today and something that Senator Corker and I have been working on, I think we both share a frustration that we have not had a robust enough resolution authority in the financial sector, and Senator Corker has taken the lead and I am supportive of his efforts to look at how we can, at least in the financial sector, deal with the FDIC with some level of expanded authority and a premise that when somebody is failing, we ought to have a mechanism to allow that entity to go ahead and fail and not simply be propped up by taxpayer funds and limp along.

One challenge is to kind of put a ring around some of that area, resolution in the financial sector, as we kind of get into the notion of resolution in the insurance field. My rudimentary understanding is that at the State level you have got kind of mutual funds that insure each other, but as we see in the case of AIG, when you have got these behemoths, you know, no single State resolution authority is going to be nearly enough. And how do we get to a resolution authority around these larger institutions in insurance, number one? And, number two, do you have any ideas on—I personally believe we need to have some mechanism in a sense of a prefunding of resolution so that we do not end up as taxpayers being caught basically footing the bill for the resolution of an actor that has taken undue risks. And even if you then have a *post facto* charge to the remaining players in the industry, the bad actor never has it all contributed beforehand to paying for their own demise.

So a long question about resolution authority. Again, if we can go down the line quickly, realizing I have gone way beyond my time.

Mr. GRACE. Yes, I agree. There is just—you have asked a very complicated but important question. The States, the way they have been set up to deal with this, the amount that they would bear depends upon the number of policies or the value of the policies that are in their State, and they are net of any—they are only for the extraordinary amounts above whatever assets are left in the company. So the amount that the States actually have to bear is not very much, but remember, most States that deal with this, deal with very small companies failing. They do not deal with a big company failing.

And so I know really do not know, you know, the ability, what would happen—you know, I guess I can conjecture all sorts of bad things, but I do not really have a feeling for what the bad things might be for a State that is subject——

Senator WARNER. The big question we have, we have no resolution authority for the whole nonbank half of the financial world that in many ways caused our problem.

Mr. SCOTT. Senator, I applaud your efforts in addressing this issue because I think it is very important.

I think we would—the Committee on Capital Markets Regulation recommended that there be an extended resolution authority, something like the Obama administration has proposed.

I think where that would fit into insurance is that any federally chartered, either as a result of an optional charter or mandatorily chartered and regulated because of systemic risk, that any of those companies should be subject to the same resolution authority that hedge funds would be, *et cetera,* some Federal mechanism.

In terms of the funding, which I think is extremely difficult, I really think we need to study that more carefully. I do not think there have been any good studies of the advantages or disadvantages of prefunding, *ex post* funding for this new resolution authority. So I do not have a view on that right now.

Mr. WEBEL. The lack of resolution authority certainly seems a hole in the aftermath of the crisis. I have heard some interesting arguments, though, that, you know, maybe the regular bankruptcy procedure which is in place—Lehman went through it—was not as disruptive in Lehman's case as everybody sort of thought it was going to be going in. So that I think that it is—it may be interesting to try to do some thought experiments of, OK, if AIG had gone into bankruptcy what happens? You know, there may be some lesson learned from Lehman having gone through bankruptcy versus AIG not having gone through bankruptcy.

Mr. PLUNKETT. Senator, I will just flag for you the situation with the State guarantee funds when you bring the very important discussion you are having on resolution down to sort of the consumer level, we have in our testimony an assessment of the fragility in some cases of the State guarantee funds, particularly regarding life insurance, and our concern that they may not be able to handle multiple—not just a single, but multiple failures. And with the exception of New York, to your point on prefunding, these funds are not prefunded. They are postfunded. And that is a concern.

Senator WARNER. I apologize, Mr. Chairman, for going on so long.

Chairman DODD. Not at all. This is very important. This is a good discussion.

Let me pick up on something Senator Corker raised earlier. Again, all of us who go around talk about these issues, at every gathering you go to, if there is any interest in the subject matter, we spend a lot of time talking about the various lines of insurance, types of insurance, and the tendency to sort of lump everything together here, I think raises some issues.

I mean, basically, States under the present system do three things. One is you deal with solvency. Two, you set rates. And three, market activities, what your responsibilities are to consumers at a local level.

And it seems to me that there are different risk assumptions based on the various kinds of insurance products. Obviously, you have title insurance, automobile insurance, for instance, property and casualty in a way also falls in this where there are some unique qualities or characteristics that make sort of a local involvement—at least I understand the value of that.

Going back to the point you made earlier, Travis, about the one I have made a distinction on in terms of life insurance, again, in the term area, there seems to be more of a national scope on that. There are different risk assumptions, as you point out. There are different capital needs and requirements in a life insurance industry than there is in an automobile insurance or property and casualty-related areas.

And I wonder if in a sense you might pick up on this. I can't recall whether or not just Mr. Plunkett responded to this question, but do the rest of you have any—I guess you did, Mr. Webel, you talked about it a little bit—this distinction here. My impression was that at the conclusion of Senator Corker's question, you didn't think the distinctions were that significant that they would warrant necessarily treating these different insurance products differently from a State regulatory standpoint or a national or a Federal charter.

Do all of you sort of agree with Travis Plunkett about that, or Mr. Webel, that really is a distinction here we shouldn't dwell on so much? Go ahead.

Mr. SCOTT. I sort of would agree with your statement, but I would add and come back to another point, which is I am troubled by splitting up the regulation of the same firm at the Federal level with some product, at multiple State levels with other products. Where is the big picture? It is the failure of the overall firm that is going to impact the financial system, not just a subsidiary in a particular State. So I think this is a risk of the separation and say, oh, let us keep property and casualty at the States. Let us have life insurance at the Federal level. Then you have a single firm being regulated by multiple States and the Federal Government for different parts of their business.

Chairman DODD. How do you do that, though? I mean, some States have tough laws on who gets to drive a car. They have written tough laws about kids being in the car alone, driving at night and so forth. So there is going to be a different—some States say, at age 15, go ahead and drive the car, and that is about it. I mean, I am exaggerating here to some degree, but the point is, now you are an insurance company. There are two very different models and you are going to charge at different rates, and certainly I have the right to do it, it seems to me, based on State law in that area.

Having a Federal regulator try and sort that out and set rates in two different States with two various sets of laws that are very different seems to me to raise some very serious questions about——

Mr. PLUNKETT. Senator, there is one more difference, as well, at the State level. They have different insurance regimes. Some States are no fault. Some States aren't, for example, with auto.

Chairman DODD. Yes?

Mr. WEBEL. I don't know whether—well, first of all, under the optional Federal charter bills that have been introduced, the answer to that question is the States can't set rates. So the way that the bills to some degree answer that is, well, you are not going to worry about that because we are specifically saying the States can't set rates.

I think that the thing is, I mean, the insurance companies have to do this. I mean, the insurance companies are operating in all these States in these different regimes. It seems—I mean, I think that there really are very good arguments on both sides, that yes, on the one hand, it is local. The local insurance regulators are going to understand that market the best. But you have a national insurance company that is able to operate in these States. You are telling me that a national insurance regulator would be incapable of figuring it out, too? As I said, there doesn't—there seem to be really good arguments on both sides.

Chairman DODD. Senator Shelby.

Senator SHELBY. Senator Dodd and I have been on this Committee together more years than people would dream, over 50 years, and I believe we are grappling here in the Banking Committee with maybe the most challenging, complex piece of legislation or proposed legislation that we have ever had. I was just thinking a minute ago, bifurcated regulation, how do you do this and what are the consequences of it?

I can see, and I don't know, I think I asked Professor Grace how many insurance companies do we have in this country that are doing business? What size are they? What are their risks? How many would be subject to systemic meltdown? And I think a lot of that would be size and what they are involved in. I can see an optional Federal charter for some people, but others, maybe they don't want to. Maybe they are too small. Maybe they don't operate in enough States. I don't know that.

But whatever we do, and Senator Warner, Senator Corker, Senator Johanns, and I guess all of us to some extent have raised these questions. We haven't fleshed it out yet, but we have got to do this and do it right.

Something comes to mind. If you have a systemic regulator to companies that are systemic risk, what you want to do is prevent a meltdown and so forth. In a sense, if you create the systemic regulator, you are creating a Federal Insurance Czar, at least for certain big companies that are in this area. So how this intersects the so-called "Insurance Czar," someone to deal with things that Senator Corker and Senator Warner are trying to grapple with, how do we create some entity that could deal with another AIG, for example, and wrap it up, take it over, do something? We don't have that mechanism today, but will this do it? I don't know. I see some intersections here, but they are not clear yet and maybe all of you guys can help us clear it.

Thank you, Mr. Chairman.

Chairman DODD. Senator Corker.

Senator CORKER. Yes, sir, Mr. Chairman. Thank you for another great hearing. I was just going to make a closing statement, but something was brought up I just want to chase for a second.

Mr. Scott, you mentioned that the Capital Markets Group you are a part of has recommended supporting what the Administration has come forth with as it relates to resolution. We actually—I thought it was——

Mr. SCOTT. Senator, something like it. We are not on all fours with it, but in that direction, yes.

Senator CORKER. We have been working on—I mean, I think a lot of people have felt that what the Administration has brought forth is really sort of codifying TARP. In other words, they have the ability per what they have laid out to actually use taxpayer monies not to resolve a company, but actually to keep a company alive through conservatorship and then put it back out. And I think many of us have thought we would be better off just having a resolution entity that could resolve it appropriately, but certainly not create the moral hazard that I just described that we see in the Administration's proposal. I am not trying to harp on them. I don't think most people are going to buy that anyway, but I just wondered if you would give any editorial comments in that regard.

Mr. SCOTT. Senator, I think for most institutions, we should resolve them and the shareholders and the debt holders should take a hit. But we still have to build into the system, and we have got it for banks today without any reform, call it open bank assistance, call it what you want, to keep alive a bank, the significantly large, systemically important bank whose failure, that is resolving it, closing it in a sense, would have a huge impact on the financial system. We have to build in the possibility of doing that.

We should do it on only extreme circumstances, OK, and maybe AIG, if we had had resolution authority, we wouldn't have had to have kept it alive. But we have to build a system to give us that capability. But bound it, OK, in having it go through a lot of hoops, get approvals, maybe ultimately the President or whatever, but I think you have got to have that capability in any system you design.

Senator CORKER. Thank you. I am not sure I agree with that answer, but I appreciate you clarifying that.

Mr. Chairman, we have had a number of hearings and they have been very good. I think today, we saw that there is a difference between the financial risk to citizens versus other kinds of risk that exist. I know you chased that, talked about that some in your questioning.

I fear that we have this sort of personality culture here even in our Government. We have a lot of czars to solve problems. It is like instead of doing the heavy lifting, really getting to the bottom of issues, we find some person that we have a lot of faith in, and a lot of proposals have certainly talked about the Fed coming in, and certainly the Fed is an important position in our country.

I do hope that we will examine—I know you made a comment later—this whole systemic risk issue. I mean, do we need to be concerned about systemic risk? Yes. But do we need someone who does that and in doing so takes on large amounts of powers, and in essence it keeps us from actually digging in and creating legislation to solve many of those problems ourselves. Instead, we sort of punt, if that makes any sense, to some omnipotent person that is going to in essence solve all these problems.

So I really appreciate some of the comments you made and I do hope that we might even consider having a hearing that is sort of an antisystemic regulator hearing, where we have people come in and talk about solving it by actually putting in place proper disciplines throughout the system that would actually keep that from happening.

But again, I thank you so much for——

Chairman DODD. No, not at all, and I appreciate you coming. And this is, as Senator Shelby and I have said, this is a very dynamic process we are involved in. I make this point over and over again. Maybe people are not believing me on this. But being involved in both the health care debate and this discussion is instructive to me, because in a sense, the health care debate is just loaded with ideology and politics. We have all come to that.

This discussion, the fundamental difference is that my sense of the 23 or 24 of us that sit on this Committee particular, is there is a great appetite for trying to figure out what works. Now, maybe there are some who are going to bring some luggage to this debate that will show up along the way. But my sense is, and certainly in every conversation I have had with Senator Shelby, with Senator Corker, with others, is let us figure out what works and draft something and try to put something together that makes sense, recognizing that this is a unique opportunity—and but, frankly, but for the crisis, if you want to call it that, we are in, we probably wouldn't get close to doing it. But the fact of the matter is, we don't want to miss the opportunity that the crisis has posed to really go back and reflect—not that we are going to solve every problem.

I take great exception to people who think, if we do this, we will never, ever, ever again face problems like this. Yes, we will. I promise you, we will. And so we ought to get rid of that notion altogether.

We are trying to look back in that rear view mirror and say what happened here, where were the flaws. If there was an absence of regulation, do we need some? If there was regulation but it wasn't being exercised, why, and what is happening? I think that deliberate approach in thinking this thing through has been tremendously rewarding, I think, for all of us.

And it is still very dynamic, Bob, I tell you. I am certainly—I am still very agnostic on a lot of these questions. I am very anxious to hear debates. I am intracted about the Council idea and the Fed. But I am not there yet. I am willing to listen to that debate about the Fed and the role it can play. And I am willing to listen to smart, bright people who spend their lives thinking about this before I settle on an answer.

So I want to confirm your ambition here, and that is that we are going to do our job here over the coming weeks, even in this break in August, our staffs working, meeting with people, talking about these various ideas, and then try to come together as a group of Democrats, Republicans, but more importantly, as Members of this Committee who I think share that notion of trying to figure this out and get together around some ideas here that make some sense, with the full knowledge we are not going to solve every problem known to mankind and we are not going to necessarily create Mount Olympus here with people who sit on high and are going to solve every problem in the future we may have. So it is a good point and I thank you for making it.

Senator SHELBY. Mr. Chairman.

Chairman DODD. Senator Shelby.

Senator SHELBY. I think we have got ourselves in a real jam in this country when we come up with the doctrine of "too big to fail" and then we say, gosh, we have got to create a systemic regulator to deal with this. How do we prevent it in the future? There will be failures in the future.

Mr. Webel brought up something earlier, and I think I understood it. I thought we always had a resolution authority for companies who did not make it on their own, and that is the Bankruptcy Court. We will never know what would have happened to AIG or to the markets and everything else. But the sky didn't fall when Lehman went under, and as he mentioned, a lot of people thought Lehman maybe came out of that better than a lot of people thought. That is arguable.

But I believe if we enshrine—and that is where we are headed—the "too-big-to-fail doctrine," we are going to have problems down the road because we are picking companies, our banks, insurance companies. That is going to become an unsettling event or syndrome in the marketplace of banks, securities, insurance, and so forth, and I think we had better deal with this.

Mr. Webel, I think you wanted to say something.

Mr. WEBEL. Yes. I have agreed with some of the people who that have started to talk about size instead of systemically significant, because size is a lot easier to deal with than systemic significance.

Senator SHELBY. Yes.

Mr. WEBEL. Where it kind of starts to break down, though, is the experience with bond insurers. These were not huge companies. These were companies that, by all rights, they weren't complicated. They weren't necessarily even complicated companies. I mean, the State of New York did——

Senator SHELBY. Bond insurance?

Mr. WEBEL. Right.

Senator SHELBY. Regulated by the States?

Mr. WEBEL. You know, the State of New York oversaw most of them, and I think the people there are pretty competent. They could have done—I don't think it was outside of their absolute competence to oversee companies of that size.

So the question is, when you are thinking about systemically significant, where do you slot the bond insurance experience into the narrative? Would that have been covered by a systemic regulator? If not, were they systemically significant? I mean, they certainly had a huge ripple impact on all of our States and municipalities and how they were able to borrow, or not borrow, as the case may be. So that sort of outlier is just something to think about as we go forward.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Let me just say, too, because again, Bob Corker has raised this and I couldn't agree more on this whole notion—if you don't need any better example, I think the AIG one. Had there been a resolution mechanism as an alternative to what we confronted in September of last year——

You know, again, it has been pointed out, Richard Breeden, the former Chairman of the SEC, he and I have had lengthy conversations. He was the one, I think the trustee, I think on WorldCom, if I am not mistaken. It took 4 years, but they disassembled that operation. It exists today and employs thousands of people. I am told they are a rather vibrant company in many ways. It didn't disappear, but it was reorganized and restructured in a way that didn't involve—no one was involved in shoring it up. I mean, there was a mechanism by which you could deal with it.

And I think your point that you made, Mr. Scott, is worthwhile, and that is sort of where I am on this, and that is I want to get rid of this "too-big-to-fail" notion altogether and that you ought to have the flexibility and the creativity and the imagination enough to be able to respond to situations in a variety of ways. Today, we have two, and that is pump billions of dollars into them or let them fail. It seems to me to be creative enough to say there are circumstances in which you ought to be able to manipulate this in a way that doesn't end up costing the taxpayer billions of dollars, and simultaneously doesn't cost thousands of jobs if you can reorganize something.

I think that could have been done with AIG, in a way. So I appreciate your point. How that works is challenging, but clearly, a resolution mechanism is critical. I don't know how we word that, but I sense among our Members up here there is a strong appetite for including something like that, and I think the point, Bob, you made a week or so ago, I think, that had that alone been in place, you might have had a different response to a lot of what occurred, in a sense. Had that vehicle been out there, that in itself might have had the desired effect of slowing things down. I think that was the point you were making a week or so ago.

Anyway, thank you all very much. It has been very instructive. We may have some additional questions from Members who couldn't be here this morning, so we will keep the record open for a while and we thank you. We would like to have you stay in touch with us on this matter, obviously a complicated one, and we invite your participation with us.

The Committee will stand adjourned.

[Whereupon, at 11:28 a.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Thank you, Mr. Chairman. Over the past 2 years, we have seen how problems in our insurance markets can disrupt our national economy. The crumbling of our largest bond insurers called into question the value of the financial guarantees those firms had issued on billions of dollars of securities.

In addition, the spectacular failure of AIG sent shockwaves throughout our economy, and led to a $170 billion bailout by the Federal Government. These events reveal that comprehensive insurance regulation must be a part of our reform effort.

Unfortunately, the Administration has "taken a pass" on comprehensive insurance reform. Under the President's proposal, the Federal Reserve would regulate only insurance companies that it deemed to be "systemically significant."

The President also proposes the creation of an Office of National Insurance that would collect information and advise the Treasury Secretary on insurance matters. While this concept may have some merit, it certainly is not comprehensive reform and leaves unanswered the difficult question of whether and how insurance regulation should be modernized for the vast majority of insurers.

The goal of today's hearing is to answer that question, as well as to examine the President's reform proposal as it relates to insurance. In particular, I am interested in learning whether our witnesses believe that the Fed is an appropriate regulator for insurers.

- Does it have the expertise necessary to supervise complex insurance companies?
- Would establishing a separate Federal insurance regulator be a better choice?
- If a Federal regulator is established, should all insurers have the option of being regulated at the Federal level?
- If a Federal regulator is not established, what steps need to be taken to ensure that there is proper coordination?
- Lastly, how do we make sure there are no gaps in our regulatory system, like those that appear to have played a role in the collapse of AIG?

Reforming insurance regulation will be complex and challenging. The level of difficulty, however, should not prevent us from seeking a comprehensive solution to financial regulation that includes insurance. Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Mr. Chairman, I am pleased you are holding an insurance hearing today. As this Committee considers financial regulatory restructuring proposals, I have said many times that insurance regulation must be a component of reform. I appreciate your recognition of that with this hearing.

During the last two Congresses I introduced legislation to modernize the current system of insurance regulation. I remain concerned that the State-by-State regulatory system is outdated, inefficient, and bad for consumers. I am also deeply troubled that there remains no Federal agency to collect data on insurance companies, products and risks, to provide a voice on national insurance issues, and to represent our country on international insurance issues. Insurance plays a key part in a functioning economy and it should have appropriate regulation.

Late last week, the Treasury sent up their legislative proposal to create an Office of National Insurance within the Department of the Treasury. I think this is a step in the right direction. I look forward to hearing the witnesses' views on this proposal and other proposals to modernize the regulation of insurance.

PREPARED STATEMENT OF TRAVIS B. PLUNKETT

LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

JULY 28, 2009

CFA Consumer Federation of America

1620 I Street, N.W., Suite 200 * Washington, DC 20006

TESTIMONY OF

TRAVIS B. PLUNKETT
LEGISLATIVE DIRECTOR
CONSUMER FEDERATION OF AMERICA

BEFORE

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

REGARDING

REGULATORY MODERNIZATION: PERSPECTIVES ON INSURANCE

JULY 28, 2009

Good morning Chairman Dodd, Ranking Member Shelby and members of the committee. My name is Travis Plunkett, and I am the legislative director for the Consumer Federation of America (CFA).[1] Thank you for inviting me here today to discuss perspectives on modernizing insurance regulation. Our insurance director, Bob Hunter, wanted to be here today but could not because he is taking care of a sick family member.

CFA Is Reviewing Its Policy Positions on State and Federal Insurance Regulation

CFA is nearing the end of a detailed review of our policy positions on insurance regulation, taking into consideration the lessons we are learning from the economic meltdown. We are also reviewing the problems with 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 generally in regulating insurance and protecting insurance consumers.

WHAT THE FEDERAL GOVERNMENT SHOULD CONSIDER REGULATING

Our review shows that there is systemic risk in insurance, requiring a federal systemic risk regulator. In order to fully understand and control systemic risk, we believe that the federal government should take over solvency/prudential regulation of insurance. We have reached this conclusion even in light of the fact that, looking backward, a strong case can be made that the states have done a good job in solvency regulation of insurers in recent years. Looking forward, however, we see that a single solvency/prudential regulator with national systemic risk as part of its portfolio is required to eliminate any potential national systemic risk. Therefore, Congress should consider the following actions:

1. There are significant systemic risk issues associated with certain lines of insurance. Congress should consider creation of a systemic risk regulator for insurance.

2. In order to properly oversee insurer financial condition, CFA believes that the federal government should be the solvency/prudential risk regulator for all insurers. This federal oversight office would also be a mechanism to monitor any systemic risk. It is difficult to understand how a systemic regulator could function properly without the sort of understanding gained from total solvency/prudential analysis.

3. A federal office, similar to the Office of National Insurance proposed by the President, should be a repository of insurance expertise, data collection[2] and analysis, and should

[1] CFA is a non-profit association of over 280 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education.

[2] The federal government should require insurers to report HMDA-style market performance data. The same type of salutary effects HMDA has brought to the mortgage market could happen with insurance. State regulators and state

also engage in international insurance issues. While a federal insurance office should be knowledgeable about insurance matters to help Congress and the Administration sort through the tremendous complexities of this industry, the office should not be granted vague and open-ended powers of preemption regarding state consumer protection laws or rules in areas that Congress has chosen not to explicitly preempt.

4. A federal consumer protection agency with jurisdiction over credit markets should be granted authority to put minimum standards on the books regarding credit-related insurance transactions. The Consumer Financial Protection Agency should also be authorized to study insurance matters that are important to consumers and appear before the states or the courts on behalf of consumers on issues regarding personal lines of insurance, i.e., homeowners and automobile insurance.

WHAT THE FEDERAL GOVERNMENT SHOULD NOT CONSIDER REGULATING

The states are well established in insurance regulation with great expertise and experience. States regulate over 7,000 insurers using over 10,000 staff working on insurance matters, spending well over a billion dollars a year on the effort. CFA has cited many weaknesses in state insurance regulation but there are some functions we find that the states perform that the federal government cannot match. In particular, these tasks relate to dealing directly with insurance consumers. States handle almost a half million complaints and an additional 3 million requests for information. Several states average more insurance inquiries and complaints than the entire federal banking system does. The Federal Reserve Board (the Fed) and the Office of the Comptroller of the Currency (OCC), combined, only handled about 130,000 calls and written complaints for the entire nation, which is less than the number of inquiries that states like California, Florida and Texas handle on insurance. Our recent study of state web sites found that many states provided quite good information for consumers, and that state websites are consistently improving.[3] While many states perform inadequately in regulating insurance rates and forms and in market conduct examinations (litigation uncovers much more that really hurts consumers than the states do), we believe that, with some notable exceptions, there has been less gouging in state-regulated insurance pricing than in, for example, credit card, mortgage lending and other federally regulated lender practices.

The states, being nearer to the people, seem to be more responsive to consumer needs. Here is what we think the federal government should not be tasked with doing:

1. While CFA supports a greater federal insurance role in several targeted areas, we vigorously oppose an optional federal charter (OFC), since such a system cannot control

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legislatures have shown themselves unable or unwilling to provide consumers with any meaningful market performance data. Despite insurers using credit scores for close to 15 years in insurance, there is not one state insurance department that collects any data to monitor the impact of insurance scores on the availability or affordability of insurance – even during the current severe economic downturn. The availability of these data would create much greater transparency of the job performance of insurance regulators and would enable the public to gain market power needed to create more competitive insurance markets.

[3] "State Insurance Department Websites: A Consumer Assessment," Consumer Federation of America, November 10, 2008, http://www.consumerfed.org/pdfs/state_insurance_websites.pdf.

systemic risk, has failed miserably in protecting banking consumers and sets up pressures that can only lead to reduced consumer protections through regulatory arbitrage.

2. Consumer protection is often best accomplished at a government regulatory level close to the people. We, therefore, believe that the states should continue to handle consumer protection regulation at this time. Such regulation must address all key consumer issues, such as claims abuses, unfair risk classification criteria, the unavailability of needed insurance, complaints and requests for information on insurers, prices and other information. In order to properly accomplish consumer protection, any emerging regulatory system must contain, among other things, the capacity to regulate rates (including classifications) and policy forms. Our study of decades of auto insurance data from all states proves that tough, balanced regulation, including rate regulation, is most effective in protecting consumers. Such a system also works well for insurers and enhances competition in the states with tough regulation.

3. As detailed below, we do think it is necessary for a new federal consumer protection agency to be able to set minimum standards only for lines of insurance that are closely linked to (or would not exist without) credit transactions. Credit-related insurance lines include title, mortgage, credit and creditor-placed home insurance. These lines are unique because the coverage is typically selected not by the consumer but by a third party, such as a lender, real estate agency, car dealer, or closing attorney. The entity selecting the insurance usually receives compensation from the insurer (such as commissions, free or below-cost services, and other payments), leading the selection of the insurance to focus on the size of such payments, which drives up premiums paid by borrowers in a process that has become known as "reverse competition." These types of insurance are typically a very poor value for consumers and have generally been weakly regulated by the states.

OTHER IMPORTANT STEPS CONGRESS SHOULD CONSIDER

1. 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. CFA endorses H.R. 1583, the "Insurance Industry Competition Act of 2009," introduced by Rep. Peter DeFazio.

2. As Congress considers creating an Office of National Insurance with knowledge about insurance, it should also either restore the ability of the FTC to study insurance or, if a Consumer Financial Protection Agency is created, grant this authority to the new agency. This would allow the federal government to assist the states in identifying consumer protection issues that have national ramifications.

After responding to the questions you raised in your letter of invitation, Mr. Chairman, I will briefly discuss each of these conclusions and then I will highlight the CFA research on the future of insurance regulation that is nearing completion.

KEY QUESTIONS ON REGULATORY MODERNIZATION OF INSURANCE

1. There is a wide spectrum of options with regard to how or whether the federal government should oversee insurance. What are the basic options and the pros and cons of each?

The range of options extends from the status quo to a full federal takeover of insurance regulation. Many of the options are discussed in the following testimony. A listing of advantages and disadvantages of federal vs. state regulation is in the testimony that follows. We conclude that it is not as simple as the states or the federal government being the sole regulator, so the status quo or a full federal takeover, the end points of the spectrum of options, should be rejected. The states have better experience and staffing, are better able to provide information and greater access for individual consumers. The federal government is better at dealing with bigger issues, national trends, and international and systemic issues. An optional charter approach, where the insurer chooses a regulator, is inherently dangerous for consumers, impossible to use for systemic risk regulation, and would create an unacceptable regulatory arbitrage situation. We conclude that some combination of state and federal oversight other than an OFC is required. The general regulatory division that best deals with the strengths and weaknesses of each level of government is to have the federal government deal with systemic risk, solvency and international issues but to have the states deal with consumer protection, complaints and market conduct issues. (An exception would be granting the new Consumer Financial Protection Agency minimum standards authority over credit-related insurance transactions.)

I should point out that neither the federal or state regulatory systems have distinguished themselves recently. The Federal government has failed to adequately deal with both financial and market regulation (e.g., no action on predatory lending, attempts to usurp state efforts to control it, and failure to adequately monitor the financial condition of many institutions).

The federal government's involvement in insurance has also been grossly negligent. For instance, the National Flood Insurance Program that I once administered has failed to do the sort of loss mitigation or stop building in uninsurable areas that it was intended to do. Flood maps are antiquated and the Write Your Own Program is inefficient, all leading to huge taxpayer subsidies of unwise construction and poor insurance administration. Another example is ERISA health insurance where consumer requests for help often go unheeded.

As to the states' performance – by and large, all substantive regulation is done either by the biggest states – New York, Florida, Texas, and California[4] or through National Association of Insurance Commissioner (NAIC) models. State insurance regulators have a weak record of consumer protection and a long history of being captured by the industry they regulate.

It appeared to us that the various multi-state accreditation programs had provided greatly improved consistency of financial regulation across states. It also appeared that states had incentives to maintain strong financial solvency regulation for domestic insurers, so that insurers would not fail. Recent events have proved us wrong.

[4] These four states account for about half of the staff and financial resources used nationally to regulate insurance.

In 2008, the life insurance industry approached NAIC officers. In secret meetings, the NAIC decided to fast-track several significant accounting and reserve practices; rules for how much money insurers must have readily available for paying claims. The proposed changes would have, in our opinion, weakened the financial condition of insurers, while maintaining the appearance of a strong financial condition. The changes would have reduced the amount of money insurers needed to hold in reserve, or allowed non-liquid assets to be counted as the capital cushion to protect consumers in the event reserves were inadequate. After strong opposition from consumer groups, the NAIC voted not to adopt these changes, stating that the industry had not made the case the changes were needed. However, a dozen individual states started allowing "permitted practices," which were state exceptions to accounting rules that resulted in the creation of billions of dollars of capital or reserves. The states that allowed these exceptions were responding to political pressure from domestic insurers. This debacle laid bare the problem with state-based financial regulation.

As for market conduct regulation, the states have a poor record. Some states at some times have done well for consumers, but states as a group routinely fail to identify market problems or proactively protect consumers.

2. Should the Federal Government collect information on the insurance industry to start building a knowledge base?

Absolutely. The federal government needs to know how insurance works, what the systemic risks are, how consumers are treated, what the national macro trends in insurance are and such information. HMDA-type information is critically needed to protect low-income and minority consumers of insurance. Both the proposed Office of National Insurance and the Consumer Financial Protection Agency should be allowed to collect information and study various insurance issues, with the CFPA focusing on issues of special importance to individual consumers and small businesses.

3. Should the Federal Government monitor insurance as a part of systemic risk oversight?

Yes. First, Congress should consider re-imposing restrictions similar to those of the Glass-Steagall Act, so insurers are not engaged in risky non-insurance practices.

Second, whether systemic risk exists depends on the type of insurer. Bond insurers and mortgage guaranty insurers have shown themselves to be able to wreak havoc on the bond and mortgage markets. One aspect of this problem is the small number of such insurers and the high market concentration of just a few insurers. One approach would simply be to limit the market share of any insurer to, say, 10 percent of the market to avoid the failure of a single insurer bringing down an entire market.

Title insurers also may pose systemic risk. Two companies hold over two-thirds of the national market and the failure of one or both of these insurers could be catastrophic. Title insurance policies would become void and there is no guaranty fund system in the vast majority of states. Banks require title on mortgages, so there could be havoc in the mortgage markets.

Life insurers, by virtue of their holdings of financial assets and investments, might also pose systemic risk.

Property/casualty insurers, other than bond, private mortgage, and title insurance, have little systemic risk, but there is risk from a weak guaranty fund system and from reinsurance, in a combination of extreme loss events. A pre-funded federal guaranty fund system, modeled after FDIC, would be much superior to the current state-based system.

The best way to avoid systemic risk is not through a systemic regulator. The best approach is to limit the activities and size of insurers to avoid any danger of systemic risk. However, a systemic risk regulator would be needed to accomplish the identification of size and activity risk and is therefore part of the solvency/prudential regulator we suggest be created.

4. Does the difference in accounting for insurers (statutory accounting) versus other financial services institutions (GAAP) pose a difficulty in how the federal government can assess an insurer's financial health?

No. There are relatively simple crosswalks between SAP and GAAP that the federal government can use to understand the strength of an insurer. Insurers could be required to report both ways in any event. Publicly traded insurers report their financials both ways already.

5. Is federal resolution authority needed for insurance holding companies? If so, how should it interact with the current state regulator and guaranty fund resolution powers?

If Congress creates or designates a separate systemic risk regulator and houses the resolution authority in that entity, then that entity would need to have authority to demand corrective actions if an insurer is, in their view, taking on undue risks. In that case, should they simply supersede state regulatory authority or should they seek to work with state regulators? We think the systemic risk regulator has to have ultimate authority in such cases, particularly given the lack of independence of so many state insurance regulators.

You could, for example, encourage the systemic risk regulator to work with the state regulator to implement corrective actions, but give the systemic risk regulator ultimate authority to act should state regulators prove uncooperative or ineffective. Congress could also encourage the systemic risk regulator to communicate any concerns about emerging risks to state regulators in order to enhance state regulators' ability to police companies for risky conduct before it becomes a problem that results in a failure that requires resolution.

Later in the testimony we show that state guaranty funds have serious problems and could fail if one or more large insurers failed. Surely companies that are too large to fail should not be handled through the state guaranty funds but should be handled by a federal resolution authority. Such a determination should not be made at the point of failure, however, since any company subject to federal resolution should also be subject to federal corrective action authority. If the federal systemic risk regulator has authority to conduct broad surveillance of the insurance industry, then that regulator should be given authority to determine when a particular company would be subject to federal resolution authority. This is why systemic risk regulation should not be separated from solvency/prudential risk regulation.

If Congress decides to create a systemic risk panel, instead of giving this authority to a single regulator, then state insurance regulators would presumably be part of that panel. If they were, they could help to make the determinations with regard to resolution authority. Whether state regulators would be inclined to try to retain maximum authority or to dump as much as possible onto the federal regulator is an important question. Based on their behavior in recent years, it likely that the states would fight to retain their "turf." Congress should study just what are the implications of such a state approach, which is another reason why we are inclined to support a single federal systemic risk/solvency/prudential regulator.

If Congress creates a federal insurance regulator, then that regulator would presumably work with the systemic risk regulator/resolution authority in the same way that would federal banking and securities regulators. Again, the agency that bears the responsibility for resolution should have the authority to require corrective actions.

If Congress puts resolution authority in one place (for example, with the FDIC) and systemic risk regulation authority in another, there would obviously need to be coordination between these two agencies. There is a potential for problems if the two agencies disagree about the nature or extent of any risks and the need for corrective actions. This may be an argument for keeping these two functions together in the same agency. On the other hand, there also is a case for giving resolution authority to the FDIC, which already has expertise in that area.

6. Is there a need for a Federal regulator of insurance? Who should determine which insurers should be regulated at the Federal level?

We believe that the situation in the nation has reached a point where the federal role in insurance regulation must be increased. Our position is that the federal government should regulate all insurers for systemic/solvency/prudential risk and international issues, with the states generally regulating market conduct and consumer protection matters, as discussed in detail in this testimony. A federal Consumer Financial Protection Agency should have authority to set minimum standards for credit-related insurance products.

7. Do certain insurance products or companies impact the national economy? If so, how should they be regulated?

Yes, as detailed elsewhere in this testimony. Imagine a situation where insurers refuse to write insurance because of economic damage or other issues. Hazard insurance on the coasts of America are an example. There, insurance is not available at affordable prices so states have had to create pools and take on risks themselves. Doctors march on state capitals when the economic cycle of insurers cause periodic price spikes for medical malpractice insurance. What if bond insurers fail? What if guarantee associations fail? All of these pose significant risks that impact millions of Americans and can undermine the nation's economy. As a Presidential commission once noted, "Communities without insurance are communities without hope."[5] Insurance has

[5] "National Advisory Panel on Insurance in Riot-affected Areas," 1968.

become a necessity, not an option. States require it, lenders require it, and people and businesses cannot function without insurance protection. Insurance has taken on a role not unlike a public utility, essential to grease the wheels of our economy.

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[6] – 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, 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 massively loosen those requirements to make their domestic life insurers look better on their 2008 balance sheets. 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

[6] 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.

failure of several large insurers in a timely fashion.[7] 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 are 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:

1. 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.

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

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).

2. 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. Also, the use of reinsurance to spread risk around the world can also have systemic impacts on the primary insurance markets should one or more large reinsurers fail.

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[8], 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

[8] 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.

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. This is part of the reason why CFA now believes that solvency/prudential regulation should be handled by the federal government in the future.

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.

3. 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 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.[9]

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

[9] Some will argue that the system could tolerate a large failure, but even they will admit to do so would require freezing funds for quite a long time, likely bringing knock-on impacts to the economy.

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.)[10]

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.[11] 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.[12]

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 insurance, disability insurance and annuities.[13] 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

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[10] 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.

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

[12] 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.

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

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.

4. What potential systemic risks might insurers pose to the nation?

Congress should study the potential systemic risk of bond insurance, title insurance, mortgage guarantee 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.

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.)[14]

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, title insurance, the possible impact on other financial sectors of the unavailability or un-affordability 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 into "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. Regulation for solvency/prudential regulation should be moved over to federal control in order to properly understand and control risk.
6. 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.
7. 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. We favor a federal guaranty system based on the FDIC approach.

The Consumer Financial Protection Agency (CFPA) and Insurance

We strongly support the CFPA legislation proposed by the Administration that would give the new agency jurisdiction over four credit-related insurance products: credit insurance, title insurance, mortgage insurance, and mortgage guarantee insurance, also known as private mortgage insurance since it is a form of credit insurance. (See Attachment 3 for a description of the various types of credit insurance.) All of these products are sold in connection with a credit transaction and are intertwined with loans. For this reason, we believe the CFPA should have the

[14] See Attachment 2.

same authority over these products that it has over other credit-related financial products.

The states have generally done a very poor job of protecting consumers of credit-related insurance products. These are products sold in connection with a consumer loan and have often been part of the arsenal used by predatory lenders. For example, the Departments of Housing and Urban Development and Treasury found in 2000 that the sale and financing of single premium credit insurance was "unfair, abusive, and deceptive"..." [15] Importantly, it has not been the states that have been at the forefront of efforts to limit or stop lenders" use of financed single premium credit insurance for mortgage or consumer loans.

Under the legislation, the agency would not have jurisdiction over either investment-type products, such as annuities, or other personal insurance products, such as personal auto, residential property, and other consumer property and casualty insurance products. In general, CFA believes this is the appropriate division of responsibility, with three exceptions:

- Creditor-placed (also known as "forced place") insurance, which is a form of credit-related insurance that often involves policies that are significantly overpriced and third-parties that provide kickbacks to the banks, should be covered by the CFPA.

- To prevent regulatory arbitrage, products that are similar to credit insurance, such as debt cancellation contracts sold by banks, should also be regulated by the CFPA. From a consumer"s perspective, they are equivalent products, but they are regulated differently because federal banking regulators have declared them to be banking products. (For additional information on these products, see Attachment 4.)

- The CFPA should have the authority to advocate for and represent consumers of personal insurance products (such as auto or homeowners and other property insurance) before the state insurance regulators and in the courts. Some have said that this consumer advocacy authority should rest with the proposed new Insurance Office within the Department of Treasury, but CFA believes consumer advocacy is better placed in CFPA, an agency whose mission is to protect consumers.

Problems for Consumers Buying Insurance Products Related to Lending Transactions

Reverse Competition Hurts Consumers: The dominant characteristic of insurance markets related to credit transactions throughout the country is *reverse competition.* The consumer who pays for the product does not select the insurer; rather, the parties receiving compensation for the insurance select the insurer. For example, an insurer might sell a credit insurance group policy to a lender. The lender then sells the credit insurance to the borrower on behalf of the credit insurer and issues a certificate of insurance under the group policy to the borrower. This market structure leads insurers to bid for the lender"s business by providing higher commissions and other compensation to the lender. As a result, greater competition for the lender"s business leads to higher, often unfair prices of credit insurance to the borrower. In fact, CFA"s Director of Insurance, J. Robert Hunter, was once at a credit insurance hearing in

[15] Available at http://www.huduser.org/publications/pdf/treasrpt.pdf, page 7.

Virginia at which Prudential was asked why they wrote so little credit insurance in the state. The Prudential witness said they were non-competitive because their rates were "too low." The same sort of system holds in title insurance and mortgage guarantee insurance, which are covered under the President"s plan, and forced-place insurance, which is not.

In addition to raising prices, reverse competition also harms consumers by limiting consumer choice, often to products that offer little real value to consumers. This results from the fact that, in a reverse-competitive market, the consumer is unable to effectively exert normal competitive pressure on the original seller of the product. In credit insurance, mortgage guarantee insurance, title and forced place insurance (but not mortgage insurance), the lender is almost always involved in the selection of the insurer, while the ultimate consumer " the borrower " is effectively limited to accepting or rejecting the package offered. If a consumer purchases a product and finances the purchase at one store or auto dealer, he or she cannot decide to go elsewhere to purchase the credit-related insurance for that loan. There is no marketplace for the insurance separate from the lender financing the purchase. As a result, lenders are able to dictate the terms of the credit insurance sale, determining what coverages will be offered, for example. Because the credit-related insurance transaction is typically a minor aspect (to the borrower) of a larger transaction " the loan to purchase a car, jewelry or furniture " consumers are willing to go along, particularly if they believe they must or are strongly encouraged to purchase the credit-related insurance to get the financing to buy the product they want.

As a result of this market dynamic, lenders rather than borrowers are the primary beneficiaries of credit-related insurance sales. First, the lender"s loan is protected against events that impair the borrower"s ability to repay. With credit-related insurance in place, the lender need not incur any costs to force payment from the surviving spouse or relative of a deceased borrower or from a borrower who has become disabled or unemployed. Second, the lender often gets substantial commission and other revenue from the insurance premium. Commissions and other compensation are typically 40 percent or more of the premium.

Consumers, on the other hand, often obtain little if any benefit. The best measure of overall value of credit insurance to consumers is the loss ratio " the ratio of benefits paid on behalf of the consumer to the premiums paid by consumers. Consumer groups have advocated regulation to ensure that consumers receive a loss ratio of at least 60 percent, meaning that, on average, at least 60 percent of the premiums paid by borrowers should be ultimately paid out in claim benefits on behalf of borrowers.

The chart below shows consumers have received poor value from the main types of credit insurance coverage for many years. The low loss ratios for credit unemployment are particularly disturbing. The amount of overcharges for just these three types of credit insurance is in the billions of dollars.

	Credit Life Premium ($M)	Loss Ratio	Credit Disability Premium ($ Millions)	Loss Ratio	Credit Unemploy-ment Premium ($ M)	Loss Ratio
1999	2,255	41.5%	2,457	44.2%	1,143	7.6%
2000	2,206	40.8%	2,374	46.4%	1,108	6.0%
2001	2,243	40.9%	2,382	50.0%	1,077	8.8%
2002	2,110	41.4%	2,199	49.3%	911	13.7%
2003	1,857	42.9%	1,933	47.2%	727	13.5%
2004	1,624	43.1%	1,797	46.9%	551	9.6%
2005	1,559	41.3%	1,679	40.4%	477	10.4%
2006	1,442	43.1%	1,570	39.4%	431	8.1%
2007	1,348	42.8%	1,514	36.8%	395	14.2%
2008	1,257	44.0%	1,410	38.3%	383	13.1%

Some states do much better than the average, but some states do much worse than the average. In 2008, the best and worst states for these coverages were:

2008		Credit Life Loss Ratio		Credit Disability Loss Ratio		Credit Unemployment Loss Ratio
Worst	NV	24.6%	SD	20.7%	AR	0.0%
2nd Worst	LA	27.4%	NV	22.8%	MI	0.0%
2nd Best	RI	67.3%	VT	66.0%	PA	33.2%
Best	ME	69.8%	ME	72.8%	VA	39.7%

One of the worst examples of the failure of state regulators to protect credit insurance consumers is a coverage called credit family leave, which is supposed to make monthly payments on the consumer's loan in the event the consumer goes on an approved family leave. In the five years since data has been collected for this product, the loss ratio has been almost zero: about 2 (two) dollars in benefits paid for every $1,000 dollars of premium collected. Consumer groups have alerted insurance regulators to these egregious results since 2005, yet regulators continue to allow insurers to sell a worthless product, a product which insurers told regulators would pay out at least 50 cents on the dollar in benefits.

	Family Credit Leave Premium	Claims Paid	Family Credit Leave Loss Ratio
2004	$50,396,018	$82,163	0.2%
2005	$39,851,001	$93,388	0.2%
2006	$29,179,076	$63,975	0.2%
2007	$25,486,677	$55,849	0.2%
2008	$22,508,468	$52,978	0.2%
	$144,912,772	$295,375	0.2%

State regulators have also done a poor job with creditor-placed insurance, which lenders purchase for and charge to the borrower in the event the borrower does not maintain the required auto or property insurance for the vehicle or property loan. This type of insurance is big business: over $600 million in creditor-placed auto and almost $2 billion in creditor-placed property insurance. The loss ratios in 2007 and 2008 have been dismal, in the low 20s.

	Creditor Placed Auto		Creditor Place Home		Credit Personal Property	
	Premium (Millions)	Loss Ratio	Premium (Billions)	Loss Ratio	Premium (Millions)	Loss Ratio
2007	$500,	24.3%	$1.402	20.5%	$183	14.2%
2008	$628,	21.2%	$1.991	23.2%	$328	7.8%

These creditor-placed premiums are inflated by commissions paid to lenders and by other unreasonable expenses, which state regulators have endorsed instead of limiting. Lenders get a commission or other forms of compensation that create a significant profit center from virtually every force-placed policy, despite the fact that the policy is being placed to protect the lender. Moreover, the premium often includes expenses for tracking consumer loans to ensure insurance is in place, including for the borrowers that are not forced-placed and would never be, because their insurance is paid out of escrow. Thus, two to three percent of the borrowers who are forced-placed pay for the escrow tracking for 100 percent of the lender's portfolio.

Title insurance loss ratios are truly dismal. Over the 20 years prior to 2007, title insurance paid out benefits averaging 6.1 percent of premium. Over the decade prior to 2007, the number dropped to 4.9 percent.[16] In 2008, the loss ratio 'jumped' to 11.7 percent.[17]

In summary, state regulation of credit-related insurance products has, for most consumers, failed to protect them from unreasonable prices and practices. There is great variation among the states, with some states doing a good job on some products, but most states doing a poor job on most products.

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[16] Source: 'U.S. Title – 2007 Market Review, A. M. Best Special Report,' October 13, 2008, Page 4.
[17] Missouri Department of Insurance, Financial Institutions and Professional Regulation, at http://www.insurance.mo.gov/reports/lossratio

The special interests determination to hold off reform at any cost has proven highly effective. For these reasons, we believe America's consumers need CFPA to cover credit-related insurance products.

The agency should study credit-related insurance products to determine exactly what actions are needed to protect consumers from the ravages of reverse competition. The agency should, for example, be involved in the process of rate regulation by the states, advocating before the states for minimum loss ratios consistent with fair consumer value. The agency should also be advocating for states to develop real (as opposed to reverse) competition in these lines of insurance and should develop ideas for accomplishing this. Possible approaches might include: educating consumers about their rights to shop for alternative sources of coverage; breaking up the cartel-like control over information about who needs such insurance so that other providers of coverage could contact consumers in time to compete for the sale; and abolishing the kickback arrangements that leave low-priced competitors unable to sell their products.

The agency should seek to learn from those firms that are struggling to break down the walls with lower prices, but who are thwarted by the cartel relationships and big kickbacks, and from other agencies that have been successful in adopting reforms. Iowa, for example, succeeded in reforming the market for title insurance, and other nations have also apparently broken the cartel-like arrangements. These examples, and systems such as Torrens[18] rather than title insurance, should be reviewed for possible use in this country.

Can Solvency Regulation be Separated from Consumer Protection Regulation?

Insurers argue that splitting solvency regulation from consumer protection regulation would be dangerous since consumer protection regulation would include regulation of rates so that the rate regulator, not being involved in solvency regulation, would have no pressure to keep rates adequate. We disagree.

First of all, our extensive search of large insolvencies over the decades has not found one insolvency in insurance history directly attributable to rate regulation. Congress has not found such effects either, to our knowledge.[19] Secondly, our research into the best systems of auto insurance regulation found conclusive evidence that the state with the best consumer results, California, had the toughest rate regulation producing the lowest rate changes in the nation but with very healthy insurer profits (and with the fourth most competitive auto insurance market in the nation as well). Third, any new system Congress develops will require close coordination between the federal regulator and the state regulators, at least through a lengthy transition period. No state would fail to respond to the federal regulator's call for a review of a situation that might be problematic from a solvency point of view. In fact, federal control of solvency would allow a national perspective on insurance trends that would help in controlling risk of solvency. One of the few times insurers might under price is at the end of the so-called "soft market" in the "cycle" of insurance profits. Property/casualty insurance profits are cyclical and the pattern typically is several years, around 8 to 10 years, of a soft market where prices are flat to down, followed by a short, 2 to 3 year hard market, where prices spike. A national solvency regulator

18 Torrens is a system of registration of land titles that makes title insurance unnecessary.

[19] See, e.g., "Failed Promises," House Commerce Committee, 1990.

would, for the first time, have the data and national focus to be ahead of the cycle and could alert states to upcoming price trends and conditions, thus easing the cycle's impact.

In short, there are simply no major, irresolvable issues stemming from splitting solvency from consumer protection when regulating insurance.

Consumers Do Not Care about the Locus of Regulation, but Care a Great Deal about the Quality and Effectiveness of Consumer Protections. (From 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 is 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 consumers' 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 the federal systemic regulator identifies macro trends.

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.[20]

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.

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[20] 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)."

NAIC Failures to Act

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.[21]

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.

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[21] Florida has held hearings on the practice.

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

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 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.[22] 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.

[22] "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.

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
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. [23]

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.[24] We question the entire foundation behind the

[23] "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.

[24] 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.

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.

- 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.

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.

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. 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.

The President and several key members of Congress have called for the creation of a federal insurance office.[25] When our insurance director, Bob Hunter, was Federal Insurance Administrator, he 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. The agency 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, for example.

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

[25] The President recently proposed the creation of an Office of National Insurance within the Department of the Treasury in his regulatory restructuring "White Paper." Such an office was first proposed by Representative Paul Kanjorski last year. (The bill number for this Congress is H.R. 2609.)

take away FTC's ability to study insurance, further handicapping Washington's capacity to understand 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 un-affordability of Directors & Officers insurance) that are related to the economic meltdown, it is essential that the federal government has insurance expertise to advise the Administration and Congress on pressing domestic and international insurance matters.

It simply makes no sense for the federal government to not have insurance expertise in the executive branch. 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. In particular, this office should play a significant role in regulating insurance systemic risk or in working with any federal body charged with regulating systemic risk. On consumer matters, it should follow the lead of the new Federal Consumer Protection Agency, which should have the authority to offer minimum standards for credit-related insurance products and to study insurance.

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 combination 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 (including us) 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 have attempted 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 includes 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/casualty 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, solvency/prudential regulation 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.
- Continued state regulation of consumer protection. While consumer protection standards of the states must be raised, the states have a better chance of achieving excellence in consumer protection regulation than the federal government does, we believe.
- A federal Consumer Financial Protection Agency to offer minimum standards on credit-related insurance products and to be an advocate for consumers in personal lines of insurance, i.e., homeowners and auto insurance.

Because of its historical domination by the insurance industry, however, consumer organizations are extremely skeptical about NAIC's ability to establish national minimum standards in a fair and democratic way. It is essential that the NAIC take steps so that it 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 NAIC should establish a system of state funding to the NAIC at a set percentage of premiums so that all states and insured entities equally fund the NAIC.

The NAIC should also support the creation of an independent, national, public insurance counsel/ombudsman's office with significant funding to deal with NAIC and state insurance offices, as part of the CFPA. Such a presence could assist the NAIC in making the case that a deeper federal role in insurance regulation is not needed, if the states improve the quality of their consumer protection regulation. Consumers must be adequately represented in the NAIC and state regulatory processes for the process to be accountable and credible. The current consumer participation program of the NAIC, which only pays expenses of a handful of consumer representatives to attend meetings, is woefully inadequate.

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.[26] 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.[27] 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.[28] State chartered banks have also used the threat of switching to a national charter to convince state regulators to keep standards low.[29] Systemic risk regulation cannot be optional. No regulation, including consumer

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[26] In this Congress, the bill was introduced in the House as H.R. 1880 by Representatives Bean and Royce.

[27] 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.)

[28] By Switching their Charters, Banks Skirt Supervision," Appelbaum, Washington Post, January 22, 2009.

[29] 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.

protection regulation of any sort, can be optional and have the necessary teeth to assure insurer compliance.

H.R. 1880 would be a disaster for consumers. First, the idea of the regulated choosing its regulator is a discredited idea whose time has passed. Banks have proven the ineffectiveness of this concept.

Second, the bill would not regulate prices. Good consumer protection requires that these items be regulated. Prices include not only overall rate level but also classifications of risk. There has been an explosion of questionable classes that have caused an uproar in many states, including the use of credit scores, education and occupation, prior limit purchased, homeownership and other anti-poor, anti-minority classes to price insurance. The lack of price regulation hurts poor and minority consumers as well as those living in coastal America.

The bill also is hugely biased in favor of the insurers. For example, the insurers do not have to contribute to fund the guarantee association until after an insolvency, recreating the same systemic risks the current state system poses. There can be no logical reason for this except that this is what the insurers want. The FTC Act is not imposed on insurers. While the policy forms must be filed, there is no authority for the federal regulator to disapprove a form, setting up a competition in fine print that would leave consumers exposed to lack of coverage surprises when a claim is filed. Rulings on policy form questions are not public. The insurers even get an Ombudsman with power to request a stay in a ruling on behalf of an insurer as if they need help in complaining to a regulator.

The bill includes a dangerous section on International Agreements that seems to seek a lowest common denominator approach to consumer protection in the name of "uniformity" and "competition."

Federal insurers would have to participate in residual markets such as assigned risk plans, but there is a mischievous provision, doubtless authored by an insurer lobbyist that is an exception to such participation if it "results in rates in effect for an assigned risk plan, mandatory joint underwriting association, or any other mandatory residual market mechanism that fails to cover the expected value of all future costs associated with insurance policies written by such residual market mechanism." In other words, if a state has the audacity to reject the often bloated requests of insurers for prices, requests far above reasonable levels, the insurers can walk away from the people of the state, leaving them scrambling for insurance or requiring the state chartered insurers to pick up all of the high risks. If anyone thinks that insurers would not walk away from those they insure, I call your attention to State Farm and Allstate"s odious behavior in Florida home insurance.

CFA, and all of the consumer community, vigorously opposes H.R. 1880.

CFA Favors Repeal of McCarran-Ferguson's Antitrust Exemption[30]

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.

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.

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[30] 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.

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."[31]

- 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 over 100 years, 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 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

[31] Report of the U.S. Department of Justice to the Task Group on Antitrust Immunities, 1977.

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[32] 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 endorses H.R. 1583, the –Insurance Industry Competition Act of 2009,– introduced by Rep. Peter DeFazio, which would repeal the antitrust exemption that insurers enjoy today.

CFA Favors Allowing a New Financial Consumer Agency or the FTC to Study Insurance

Our insurance director, Bob Hunter, once attended a hearing here in a Senate committee where the Chairman asked the FTC Chairman to comment on a current insurance issue. The FTC Chairman said that if he had the knowledge to answer, he would be breaking the law and was excused. The insurance industry 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

[32] 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).

not yet completed study of redlining by property/casualty insurers (that the property-casualty 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 new Consumer Financial Protection Agency or 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 incited 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. 2571 (D. Moore) and S. 1363 (Martinez) would preempt 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.

Conclusion

Congress should consider expanding the federal role in insurance regulation regarding solvency/prudential/systemic risk, minimum standards for credit-related insurance products and in studying insurance issues that affect consumer. Congress should not weaken state consumer protection regulation and should strengthen consumer protection by requiring the CFPA to adopt minimum standards on credit-related insurance lines and to advocate for insurance consumers.

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.

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

Description of Types of Consumer Credit Insurance Coverage

Credit insurance refers to a group of insurance products sold in conjunction with a loan or credit agreement. Credit insurance makes payments for the consumer to the lender for a specific loan or credit agreement in particular circumstances. The common types of credit insurance sold include:

- *Credit Life* pays off the consumer's remaining debt on a specific loan or credit card account if the borrower dies during the term of the coverage.

- *Credit Accident and Health,* also known as *Credit Disability,* pays a limited number of monthly payments on a specific loan or credit card account if the borrower becomes disabled during the term of coverage.

- *Credit Involuntary Unemployment* pays a limited number of monthly payments on a specific loan or credit card account if the borrower becomes involuntarily unemployed during the term of coverage.

- *Credit Personal Property* typically pays to repair or replace property that is serving as collateral for a loan.

- *Creditor-Placed Insurance* is auto or property insurance placed by a lender if the consumer fails to maintain the insurance required by the terms of the auto or home loan.

- *Credit Family Leave* makes monthly payments if the borrower goes on an approved family leave.

- *Credit GAP* pays the difference – or gap – between the amount owed on the auto loan and the amount paid by the insurance company on the auto insurance policy in the event there is an accident resulting in a total loss to the vehicle and the amount of insurance payoff is less than the amount owed on the loan. GAP is sometimes used as acronym for Guaranteed Auto Protection.

- *Non-Filing* pays the lender in the event loan documents have not been correctly filed.

- *Mortgage Guaranty* pays the lender in the event the borrower defaults on the mortgage loan.

Attachment 4

Properly Regulating Credit Insurance "Look Alike" Products

Many insurance products are perfect or near-perfect substitutes for financial products; it is logical for the CFPA to represent consumers on all substantively similar products.

Consumer credit insurance products are – from the consumer's perspective – equivalent to debt cancellation contracts and debt suspension agreements – products which federal banking regulators have declared to be banking products.

Debt Cancellation Contracts (DCCs) and related products like Debt Suspension Agreements (DSAs) are products sold in connection with a consumer loan and which promise to provide some debt relief to the consumer if certain events occur. The events triggering the benefit under the DCCs/DSAs are typically events that impair the borrower's income or place a financial burden on the borrower. DCCs/DSAs are part of the group of payment protection products that include credit insurance and which promise, among other things, to preserve the borrower's credit rating in adverse circumstances.

Since 2000, lenders have shifted their payment protection product offerings from credit insurance to DCCs/DSAs, initially in connection with credit cards and more recently in connection with closed-end loans. One of the earliest forms of DCC sold in connection with a closed-end loan was GAP Waiver sold in connection with auto loans.

To a consumer, DCCs and credit insurance are very similar – or even identical – products. For a one-time or monthly fee, DCC will cancel the debt or make monthly payments if certain events occur – just as credit insurance performs. For example, a credit card credit insurance program containing credit life, credit disability and credit involuntary unemployment coverages provides the identical benefits for a consumer as a DCC program for death, disability and involuntary unemployment.

The major difference between credit insurance and DCC is in regulatory oversight. Federal banking regulators have declared DCC to be a banking product and, consequently, not subject to state insurance regulation if sold by banks or credit unions with federal charters. Although state insurance regulators challenged these decisions, claiming that DCC was an insurance product, banks who sought the federal oversight of DCC and the federal agencies have prevailed in legal challenges. State regulation of DCCs offered by state-chartered financial institutions has generally followed the federal rules.

The rationale for not regulating DCC as an insurance product is that, unlike credit insurance, where a borrower, a lender and an insurance company are involved, there are only two parties involved with DCC – the borrower and the lender. The DCC is an addendum to the loan contract that states that, under certain circumstances, the lender will cancel the debt or the monthly payment. So, in theory, no insurance company need be involved.

In practice, DCC programs are administered in almost the same manner as credit insurance programs. Credit insurance companies provide the same administrative and sales services as with credit insurance. The lender purchases a contractual liability policy from the credit insurance company, and this policy pays any claims made under the DCC program offered by the lender. Credit insurance companies, including CUNA Mutual, now sell and administer DCC programs as well as credit insurance programs.

The difference in regulatory oversight of DCC versus credit insurance is dramatic. With credit insurance, the products (policy forms) must be approved by state insurance regulators prior to use and the rates subject to prima facie maximum rate regulation. A credit insurer wishing to offer a national program must obtain approvals in all states and comply with different rates in all states as well as variations in product requirements among the states. Under rules promulgated by the Office of the Comptroller of the Currency (OCC) and other federal financial regulators, lenders can offer a single DCC product nationally. Lenders have moved from credit insurance to DCC for several reasons:

- No oversight or limitations on fees charged
- Few limitations on product design and benefit provisions – no restrictions on bundling, flexibility in product design
- Ability to use one product nationally
- No agent licensing requirements
- No form or rate filing requirements
- No premium taxes

DCCs and DSAs generally provide much worse value to consumers than credit insurance – higher prices, fewer benefits and fewer consumer protections. In prior reports and testimony, CFA has estimated the loss ratio for DCCs and DSAs to be less than 5%. In addition to lower benefit payouts, the administrative costs for DCCs are lower than for credit insurance because of the ability to utilize a single program across the states, the absence of product filings and approvals, and the absence of a premium tax.

Failure to allow the CFPA to represent insurance consumers will lead to regulatory arbitrage – the shifting of banking products to insurance products.

When the federal banking regulators declared debt cancellation contracts to be banking products – and not subject to state insurance regulation – lenders started changing their products from credit insurance to debt cancellation or debt suspension to take advantage of the more favorable (to lenders) regulatory structure for the debt cancellation and debt suspension products. This is one example of regulatory arbitrage – regulated entities playing off competing regulators for the most advantageous – to the regulated entities – regulatory regime. Failure to include credit-related insurance products under the jurisdiction of the CFPA would reverse that trend, encouraging financial institutions to shift from use of regulated bank products to less regulated insurance products. Consumers would be the losers.

PREPARED STATEMENT OF BAIRD WEBEL

SPECIALIST IN FINANCIAL ECONOMICS, CONGRESSIONAL RESEARCH SERVICE

JULY 28, 2009

Mr. Chairman, Ranking Member, my name is Baird Webel. I am a Specialist in Financial Economics at the Congressional Research Service. Thank you for the opportunity to testify before the Committee. This statement responds to your request for hearing testimony aiding the Committee's deliberations about modernizing the regulation of insurance. It begins with a brief introduction focusing on insurance and the recent financial crisis, and differentiating between lines of insurance. Following this is a discussion of seven broad options for the Federal Government's role in insurance regulation. These options should be seen as encompassing a continuum, and it may be possible to combine aspects from different options, particularly for different lines of insurance. Finally, the testimony includes a brief summary of recent proposals addressing insurance regulation at the Federal level.

CRS's role is to provide objective, nonpartisan research and analysis to Congress. CRS takes no position on the desirability of any specific policy. The arguments presented in my written and oral testimony are for the purposes of informing Congress, not to advocate for a particular policy outcome.

Insurance Regulation and the Recent Financial Crisis

As reaffirmed by Congress in the McCarran-Ferguson Act of 1945,[1] the primary locus of insurance regulation currently rests with the individual States. Since the passage of this act, however, both Congress and the Federal courts have taken actions that have somewhat expanded the reach of the Federal Government into the insurance sphere. Examples of this include Employee Retirement Income Security Act of 1974 (ERISA),[2] which effectively federalized health insurance regulation for a large swath of the American population; various court decisions limiting the phrase "the business of insurance" contained in McCarran-Ferguson;[3] and the Liability Risk Retention Act (LRRA),[4] which preempted the ability of nondomiciliary States to regulate certain types of property/casualty insurance.

Nevertheless, the Gramm-Leach-Bliley Act of 1999 (GLBA),[5] which enacted the most sweeping financial regulatory changes since the Great Depression, specifically continued to recognize the States as the functional regulators of insurance. GLBA also removed legal barriers between securities firms, banks, and insurers. This legal freedom, along with improved technology, has been an important factor in creating more direct competition among the three groups. Many financial products have converged, so that products with similar economic characteristics may be available from different financial services firms with different regulators and different regulation.

Increasing competition between insurers, banks, and securities firms has played a role in increased industry demands for a wide-ranging federalization of the insurance industry. These demands have typically focused on various inefficiencies in navigating the multiple regulators in the State system as well as what some characterize as the overbearing content of some State regulation, particularly State rate and form regulation.

The financial crisis can at least partly be traced to failures or holes in the financial regulatory structure. This has given increased urgency to calls for overall regulatory changes and Federal oversight of insurance. While insurers in general have appeared to weather the crisis reasonably well so far, the insurance industry has seen two significant failures, one general and one specific. The first failure was spread across the financial guarantee or monoline bond insurers. Before the crisis there were only about a dozen bond insurers in total, with four large insurers dominating the business. This type of insurance originated in the 1970s to cover municipal bonds but the insurers expanded their businesses since the 1990s to include significant amounts of mortgage-backed securities. In late 2007 and early 2008, strains began to appear due to exposure to mortgage-backed securities. Ultimately some smaller bond insurers failed and the larger insurers saw their previously triple A ratings cut significantly. These downgrades rippled throughout the municipal bond markets, causing unexpected difficulties for both individual investors and munici-

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[1] 15 U.S.C. §§1011–1015.

[2] P.L. 93-406, 88 Stat. 829.

[3] See CRS Report RL33683, *Courts Narrow McCarran-Ferguson Antitrust Exemption for "Business of Insurance": Viability of "State Action" Doctrine as an Alternative,* by Janice E. Rubin.

[4] P.L. 97-45 as amended by P.L. 98-193 and P.L. 99-563, 15 U.S.C. §3901 *et seq.*

[5] P.L. 106-102, 113 Stat. 1338.

palities who might have thought they were relatively insulated from problems stemming from rising mortgage defaults.

The second failure in the insurance industry was a specific company, American International Group (AIG).[6] AIG had been a global giant of the industry, but it essentially failed in mid-September 2008. To prevent bankruptcy in September and October 2008, AIG was forced to seek more than $100 billion in assistance from, and give 79.9 percent of the equity in the company to, the Federal Reserve. Multiple restructurings of the assistance have followed, including up to $70 billion through the U.S. Treasury's Troubled Asset Relief Program (TARP). AIG is currently in the process of selling off parts of its business to pay back assistance that it has received from the Government; how much value will be left in the 79.9 percent Government stake in the company at the end of the process remains an open question.

The near collapse of the bond insurers and AIG could be construed as regulatory failures. One of the responsibilities of jobs of an insurance regulator is to make sure the insurer remains solvent and is able to pay its claims. Since the States are the primary insurance regulators, some may go further and argue that these cases specifically demonstrate the need for increased Federal involvement in insurance. There are aspects of both the bond insurer crisis and AIG's failure that may mitigate the arguments for Federal involvement, particularly because AIG was also regulated by the Federal Office of Thrift Supervision.

Lines of Insurance and Federal Involvement in Insurance

The insurance industry is not monolithic, but rather very diverse, serving multiple markets. Companies range in size from multiline insurers serving the entire country to small "captive" insurers that may insure a single company. In general, insurers fall into two broad segments: life insurers and property/casualty insurers. Some companies are organized as stock companies, whereas others operate as mutual or fraternal companies. Some companies are very large in size, whereas others are midsize or small. Some companies specialize in large commercial accounts, whereas others write personal lines of business such as homeowners, automobile, or individual life and health policies. Still others concentrate on reinsurance, or the selling of insurance to insurance companies to assist them in spreading their risks.

Life Insurance

Life insurers[7] in general face long-term and relatively stable risks and losses. Life insurance contracts typically last decades and actuarial tables are well developed. It may be impossible to estimate which individual people are going to die in a given year, however, with a large pool, actuaries can be very accurate in projecting the overall number of deaths and thus the overall losses a life insurer will likely incur. This increases the importance of the investment side of the life insurance business to generate profits. If life insurers face solvency problems, it is likely to be a result of poor investment decisions rather than huge unexpected losses. The risks covered in life insurance are much more uniform across the country and policyholders are relatively likely to be covered by a policy purchased in a different State from their current residence. Life insurers also offer many annuity products, which combine aspects of insurance and investment products. These annuity products also represent a significant exposure to investment gains and losses for life insurance companies.

Property/Casualty Insurance

Property/casualty insurers face a very different set of economic challenges. Most property/casualty contracts are relatively short-term, often 6 months or 1 year. The risks to these insurers can be much more variable than those faced by life insurers. In some lines, catastrophic losses can occur that will wipe out years of previously accumulated premiums. Accordingly, investment returns are important to the business, but to a lesser degree than they are in life insurance. Property/casualty policies can be much more localized and tailored to specific risks in specific areas. With relatively short-term contracts, policyholders are much less likely to maintain their policies as they move from State to State. Property/casualty policies are often required by a third party. For example, purchase of State licensed auto insurance is a common requirement for auto licensing and banks often require specific insurance purchases for a property loan. The near mandatory nature of some property/casualty insurance purchases has tended to engender increased regulatory oversight and various mechanisms to ensure availability and affordable pricing for consumers.

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[6] See CRS Report R40438, *Ongoing Government Assistance for American International Group (AIG),* by Baird Webel.

[7] Health insurers are often included within the category of life insurers. Since health insurance is largely outside of the scope of the Committee's interest, this analysis concentrates purely on life insurance.

Such differences have led to suggestions for different Federal involvement for different lines of insurance. The most common proposal in the past has been to provide for a Federal charter for life insurers while leaving property/casualty insurers in the State system. During the recent financial crisis, life and property/casualty insurers sometimes favored different Government policies. Several life insurers have sought and received assistance through TARP, even going so far as to convert their corporate form to a Federal bank or thrift holding company to qualify for the assistance. Property/casualty companies have generally shunned Federal aid, with one industry group arguing strenuously that property/casualty insurers typically do not present systemic risk and the Federal Government should avoid providing assistance to them. [8]

Options for Insurance Regulatory Reform

Seven particular options for Federal involvement are presented in the following sections. These options range from minimal, or no, Federal involvement to a Federal takeover and complete restructuring of insurance regulation. To some degree many of these options have elements that are not mutually exclusive. Congress could take various aspects and apply them differently, for example, to different lines of insurance or to different aspects of regulation. Most of these options have been present in some form in proposals that predate the recent crisis.

1. Do Nothing

While insurers have unquestionably been affected by the financial crisis, the instruments and practices generally identified as driving the crisis, the outsized losses, and the bulk of the Federal assistance are concentrated in other areas of the financial services industry. This may be due to good regulation, good business practices, or simply good fortune for insurers, and it may very well change in the future, but for the moment the financial crisis is focused elsewhere. It could be argued that effort and attention should also be focused on the areas in crisis. One could even go further and argue that in such a time of general market uncertainty, it is not helpful to the market to introduce additional regulatory uncertainties. "First do no harm" may be applicable to sick financial markets as well as sick medical patients. On the other hand, making regulatory changes now, before insurers might be facing failure, could help prevent such failures from occurring at all.

2. Create a Federal Office of Insurance Information

One of the correlates of the absence of direct Federal regulatory authority over insurance has been a relative lack of awareness, information, and expertise on non-health insurance matters within the Federal Government. Other testimony before Congress has indicated that the Office of Thrift Supervision, which oversaw AIG, had only one insurance expert on staff[9] and informal inquiries have indicated to CRS that the Treasury Department does not have all that many more.

This lack of information and insurance expertise has been noted before the crisis, and how large an impact it had on the crisis may be debated; however, the crisis has generally shown how important accurate information can be. Much of the market uncertainties can be traced to lack of information about specific companies' exposures to mortgage-backed securities. Lack of information on the size of and exposures to the credit default swap market has also complicated regulatory responses to the crisis. Should a significant crisis event arise involving large insurers, additional information and expertise on the issues at the Federal level would likely be helpful.

Some, particularly those strongly supporting the current State regulatory system, have expressed concern that such a Federal office might be essentially a precursor to an eventual Federal regulator. An alternate response to address such concerns might also be to increase cooperation and communication between Federal officials and the National Association of Insurance Commissioners (NAIC). The NAIC is currently a major source of information regarding insurance issues and would likely be significant source of information for any Federal office. This would particularly be the case if, as was included in the proposed Insurance Information Act (H.R. 5840

[8] See, for example, an op-ed by the President and CEO of the Property Casualty Insurers Association of America, David A. Sampson, "Property, casualty insurers don't pose systemic risk", *The Hill,* April 27, 2009, available at *http://thehill.com/opeds/property-casualty-insurers-dont-pose-systemic-risk-2009-04-27.html.*

[9] Testimony by Max Stier, President and CEO, Partnership for Public Service, before the House Oversight and Government Reform Subcommittee on the Federal Workforce, Postal Service, and the District of Columbia, April 22, 2009. Retrieved through *CQ* Congressional Testimony.

in the 110th Congress/H.R. 2609 in the 111th Congress), the Federal office would be largely limited to collecting publicly available data.

3. Harmonization of State Laws Via Federal Preemption

Most stakeholders in the insurance industry recognize the need for some harmonization, if not uniformity, of insurance regulation among the different State regulators. The NAIC has served as the primary forum for this since its founding in 1871. For harmonization to occur through State efforts, however, every State legislature must pass substantially similar legislation, a very difficult task. Federal law, however, would have the power to preempt State legislation and create such harmonization without State legislative approval. This is the approach, for example, taken by the Liability Risk Retention Act, which preempts most State insurance regulation of risk retention groups, except for regulation by the home State regulator. Application of similar principles to other areas, such as surplus lines or the licensing of agents, has been a feature of several bills in the past few years. Federal preemption of State regulation of the business of insurance is a congressional prerogative, and even the McCarran Ferguson Act which declared a policy of "the continued regulation and taxation by the several States of the business of insurance,"[10] recognizes the congressional authority to regulate the insurance industry.

This approach could be argued to be a "best of both worlds" approach, combining the experience and many of the strengths of the State regulatory system while ensuring greater efficiency through the ability of insurers to operate throughout the country. Much of the effectiveness of this approach, however, would depend on the specific details chosen. As an approach, it is very broad. Congress could choose to preempt specific aspects relating to a single line of insurance, or a State's entire approach to insurance regulation. Without specifics about what State laws are being preempted and what they might be replaced with, it is difficult to analyze the partial preemption approach. If one were specifically trying to address issues related to the financial crisis, it may be difficult to do so through piecemeal Federal preemptions. Much of crisis management and avoidance will be a question of individual regulatory decisions, which are more difficult to address through broader preemption efforts.

4. Create a Federal Systemic Risk Regulator

One new regulatory option being discussed in the current financial crisis is the concept of a "systemic risk regulator." The Committee has held an entire hearing devoted to the subject, so I will focus on the systemic risk regulator and the insurance system.

Given the near systemic collapse that the financial system experienced last September, the need for someone to look after the entire system may seem self-evident to some. As concepts for a systemic risk regulator have become more advanced, however, the difficulties of going from the concept of needing someone to look after the system to how this concept would work in practice have become more apparent. Particularly with regard to the insurance regulatory system, there are a number of questions to consider, including:

- *Do any insurers present a systemic risk? If so, what criteria would be used to identify these systemically significant institutions?*

  In the past, a familiar concern was that financial institutions may become too big to fail. In the recent crises, however, the concept of "too interconnected to fail" has also been injected into the debate. Metrics for "interconnectedness" are even less clear than those for size. Historically, insurers have generally not been considered to present systemic risks; insurers' liabilities are much more stable than those of banks and insurers have not suffered from depositor runs like banks have. The recent crisis, however, has brought a different sort of run on financial institutions, namely the withdrawal of short term credit and demand from other counterparties for collateral payments. Such a "run" brought AIG down and other insurers might be vulnerable, although none have failed since AIG.

- *Who would make the decision on which institutions would fall under the systemic regulator's purview?*

  The State insurance regulators would most likely expect some role in the process of identifying systemically significant insurers. If the insurance regulators and the systemic regulator disagree, however, a mechanism must be in place to arrive at a final decision.

[10] 15 U.S.C. §1011.

- *Would a systemic regulator have day-to-day oversight over insurers judged to be systemically significant?*

  If it were to have day-to-day oversight, then the systemic risk regulator would be tantamount to a Federal insurance regulator, which is the heart of the Federal chartering debate and will be explored further later in this testimony.

- *If not, what specific preemptive powers would a systemic regulator have over the State regulators' decisions?*

  A particularly controversial aspect of such preemptive powers may surround regulation of insurance rates. Many States require specific regulatory approval for insurance rates. If these rates were insufficient to cover an insurer's risks, thus making insolvency more likely, it could directly concern a systemic risk regulator.

- *Would the systemic regulator have resolution authority over failed systemically significant institutions or would this be left to the State regulators and the guarantee funds?*

  The failure of large institutions like AIG and Lehman Brothers, who did not fall under existing resolution provisions as banks do, has been identified by many as a particular issue to be addressed by a systemic risk regulator. Broader Federal resolution authority could, however, have a significant impact on the current system for resolving insurance company failures. Under current law, failed insurance companies are resolved by the State insurance regulators and guarantee funds. Generally, insured policy holders are paid off by the guarantee funds under certain guidelines with the guarantee funds then occupying a senior position with regard to claims on insurer assets. What position individual policyholders or guarantee funds might have under a Federal resolution authority, however, is up to whatever laws would be approved by Congress. The current Treasury proposal for resolution authority does not change the current authority over insurance subsidiary assets. If the enacted resolution authority did change this, a systemic risk regulator might have an incentive to use the assets of a company such as AIG to satisfy creditors who are themselves systemically significant rather than directing these assets to satisfy policyholder claims.

- *What impact would identifying particular insurers as systemically significant have on the marketplace, particularly on competitors of these firms?*

  Competitors of AIG today have voiced many complaints that AIG is using Federal support to undercut their prices. If an insurer were identified as systemically significant, and thus presumably one that is not allowed to fail, this could give such firms a competitive advantage. If this occurs, others would presumably seek to merge or otherwise grow in size so they might gain this advantage. This could have the paradoxical effect of making a future crisis worse as more financial institutions would have the potential to spread systemic harm in the event of their collapse.

- *Would being identified as systemically significant promote risk taking in these institutions, and thus make future crises more likely?*

  This problem of "moral hazard" is well known in the insurance industry. In order to deal with it on the individual level, insurers institute a variety of policies, such as deductibles and copayments. Identifying an institution as systemically significant implies it will not be allowed to fail, which also creates moral hazard. To address this, a systemically significant designation could also include other policies, such as increased capital requirements or other regulatory scrutiny.

5. Create a Federal Solvency Regulator

Regulation of insurers can be broken down broadly into oversight of the company's interaction with customers (market conduct or consumer protection regulation) and oversight of its future ability to pay claims (solvency or prudential regulation). In the United States, regulation of both aspects is done by the individual States. Some other countries, however, separate these functions and have two distinct agencies for the two tasks. In theory, this could allow for increased focus on both tasks as each agency only has one goal. Adapting this approach to the United States could lead to the possibility of assigning consumer protection functions to the individual States, while giving solvency regulatory powers to the Federal Government. Such an approach would also dovetail with some arguments already advanced in the optional Federal chartering debates. Proponents of the State regulatory system often cite consumer protection as a particularly successful area for the States and one in which the States can give much more individual attention to citizens than they are likely to receive from a Federal bureaucracy, while proponents of a Federal chartering system cite the increased complexity of financial instruments and company balance sheets which makes solvency regulation more difficult, thus requiring additional expertise which would presumably come with a Federal regulator.

The operation of such a mixed system would ideally include substantial communication and trust between the consumer protection regulators and the solvency regulators. Establishing this trust in the aftermath of a Federal takeover of solvency regulation could be a challenge. Another flashpoint might be the regulation of rates, as mentioned previously. Rates have a direct impact on insurer solvency, but regulation of rates is seen by many as a bedrock aspect of consumer protection. To limit conflict between the States and Federal regulators, implementing legislation would need to clarify what power the Federal solvency regulators might have to overrule State regulators, or *vice versa*.

6. Establish a Federal Insurance Charter

The debate over the possibility of a Federal charter for insurers has been ongoing for the past several years with the Committee hearing previously from both the proponents and opponents of the idea. A common proposal has been for an Optional Federal Charter (OFC) for insurers modeled on the dual banking system.

Current focus on the idea of a Federal insurance charter dates largely to the passage of GLBA, which specifically reaffirmed the States as the functional regulators of insurance but also unleashed market forces encouraging a greater Federal role. This has led to increasing industry complaints of overlapping, and sometimes contradictory, State regulatory edicts driving up the cost of compliance and increasing the time necessary to bring new products to market.

Arguments advanced for Federal chartering have included the following:

- The regulation of insurance companies needs to be modernized at the Federal level to make insurers more competitive with other federally regulated financial institutions in the post-GLBA environment.
- The recent financial crisis has shown that some insurers present systemic risk and should be regulated by a regulator with a broad, systemic outlook.
- Insurance needs a knowledgeable voice and advocate in Washington, DC.
- The current system is very slow in approving new products, putting insurers at a distinct disadvantage in product creation and delivery.
- Insurers have difficulty in expanding abroad without a regulator at the national level.
- Consumers will benefit from a greater supply of insurance and lower cost to consumers as insurance companies are forced to compete on a national scale.

Arguments advanced for State regulation have included the following:

- State regulated insurers have performed relatively well through the financial crisis, underscoring the quality of State regulation.
- State insurance regulators have unique knowledge of local markets and conditions and are flexible and adaptable to local conditions.
- The diversity of State regulation reduces the impact of bad regulation and promotes innovation and good regulation.
- Strong incentives, such as direct election, exist for State regulators to do the job effectively at the State level.
- A substantial and costly new Federal bureaucracy would need to be created in a Federal system.
- States would suffer substantial fiscal damage should State premium taxes be reduced by the Federal system.
- A "race to the bottom" could occur under an optional Federal charter as State and Federal regulators compete to give insurers more favorable treatment and thus secure greater oversight authority and budget.

In the abstract, the Federal chartering question could be simply about the "who" of regulation. Should it be the Federal Government, the States, or some combination of the two? In practice, however, OFC legislation has had much to say about the "how" of regulation. Should the Government continue the same fine degree of industry oversight that States have practiced in the past? The OFC bills that have been introduced to this point have tended to answer the latter question negatively—the Federal regulator that they would create would exercise less regulatory oversight than most State regulators. This deregulatory aspect of past and present OFC bills can be as great a source of controversy as the introduction of Federal regulation itself.

7. Completely Reform the Financial Services Regulatory System

The question of Federal involvement in insurance regulation could expand beyond the confines of insurance and instead be subsumed within a more comprehensive reform to the whole approach to regulating the U.S. financial system. General financial regulation in the United States is carried out by an overlapping set of bodies created at various periods during the past 150 years. Historically, the regulatory body was dictated by the charter of a given institution: banks were regulated by various banking regulators, thrifts by thrift regulators, insurers by insurance regulators, *etc.* Although GLBA aimed to refocus the system along functional lines, so that, for example, insurance regulators would regulate insurance activity whether it was carried out by banks or by insurers, regulation has still largely fallen along institutional lines. Simplification of the regulatory system is not a result that most observers would ascribe to GLBA. Even before the financial crisis, arguments were advanced that the system needed a significant overhaul, perhaps by combining overlapping institutions or completely rethinking the structure of the regulatory system. Several other countries have confronted similar policy choices in the past two decades with two regulatory models gaining favor: a "unitary" regulator and a "twin peaks" model.

A unitary model calls for a single regulator to oversee financial institutions regardless of the charter type or business activity that the institutions engage in. Such a regulator could oversee all aspects of financial activity, from systemic stability to individual institution solvency to consumer protection. Advantages of such an approach include a focus on financial regulation that avoids consumer confusion about who to call in the case of problems; clear regulatory authority over innovations in the financial system; and no possibility that financial institutions would "game the system" by playing one regulator off against another. The strengths of a unitary system when the regulator gets things right, however, are also its weakness if the regulator gets things wrong. With only one regulatory body, there are few checks and balances. If a mistake is made, it can more easily affect the whole system rather than be isolated within a particular type of institution or geographic area. Examples of countries adopting a unitary approach include Japan and the United Kingdom.

A twin peaks model typically separates the regulatory authority between solvency and consumer protection functions, with separate entities responsible for each. Such an approach arguably can offer many of the same advantages of a unitary system with relative uniformity of regulation across different financial institutions regardless of charter and an even clearer regulatory focus within each of the two regulators. Overlap between the two regulators could be minimized, but having two voices in the system offers at least the possibility of minimizing the impact of regulatory mistakes rippling throughout the system. Examples of countries adopting a twin peaks approach include Australia and the Netherlands.

Recent Proposals/Legislation Reforming the Insurance Regulatory System

President Obama's Financial Regulatory Reform Plan

In June 2009, the Treasury Department released a report entitled "Financial Regulatory Reform: A New Foundation," outlining President Obama's plan to reform financial regulation in the United States. Since the release of the overall plan, legislative language to implement various aspects of the plan has also been released. The plan is generally portrayed as a middle of the road approach to reform the overall system. It does not foresee revamping the entire system following the unitary or twin peaks model, but it would substantially change the financial regulatory system, including explicitly introducing systemic risk oversight by the Federal Reserve, combining the Office of Comptroller of the Currency and the Office of Thrift Supervision into a single banking regulator, and creating a new Consumer Financial Protection Agency.

Most of the regulatory changes under the President's plan would be focused on areas other than insurance. Most insurance products, for example, are excluded from the jurisdiction of the new Federal consumer protection agency. In general, the States would continue their preeminent role in insurance regulation. Insurance regulation, however, would be specifically affected through two aspects of the President's plan, the regulation of large financial companies presenting systemic risk and the creation of a new Office of National Insurance (ONI) within the Treasury.

Systemic risk regulation would be the primary responsibility of the Federal Reserve in conjunction with a new Financial Services Oversight Council made up of the heads of most of the Federal financial regulators. The powers to regulate for systemic risk enumerated in the draft legislation extend to all companies in the United States engaged in financial activities. While the draft legislation does not specifically name insurers as subject to Federal systemic risk regulation, the language would seem to include them under the Federal jurisdiction. Companies judged to be a possible threat to global or U.S. financial stability may be designated Tier 1 Financial Holding Companies and subject to stringent solvency standards and additional examinations. Such companies would also be subject to the enhanced resolution authority rather than standard bankruptcy provisions. While the draft language does make reference in some places to State functional regulatory agencies, it is unclear exactly how the Federal Reserve as regulator of the financial holding company would interact with the State regulators of the individual insurance subsidiaries. Under the current regulatory system, where there are some federally regulated holding companies that are primarily insurers, the Federal regulators generally defer to the State insurance regulators. Whether or not this deferral would continue under the new legislation may be an open question.

While systemic risk regulation would likely apply to a relatively small number of insurers, the called-for creation of an Office of National Insurance (ONI) could have a broader impact. Unlike the similarly named office in other legislation, such as H.R. 1880, President Obama's ONI would not oversee a Federal insurance charter and have direct regulatory power over insurers. This ONI would operate as a broad overseer and voice for insurance at the Federal level, including collecting information on insurance issues, setting Federal policy on insurance, representing the United States in international insurance matters, and preempting State laws where these laws are inconsistent with international agreements. These functions are similar to those of the Office of Insurance Information (OII) to be created by H.R. 2609. The ONI under President Obama's plan would seem to have more authority, however, than the OII under H.R. 2609. For example, the ONI would have subpoena power to require an insurer to submit information rather than relying voluntary submissions and publicly available information.

The National Insurance Consumer Protection Act (H.R. 1880)

Representatives Melissa Bean and Edward Royce introduced H.R. 1880 in the House on April 2, 2009.

This bill would create a Federal charter for the insurance industry, including insurers, insurance agencies, and independent insurance producers. The Federal insurance regulatory apparatus would be an independent entity under the Department of the Treasury and would preempt most State insurance laws for nationally regulated entities. Thus, nationally licensed insurers, agencies, and producers would be able to operate in the entire United States without fulfilling the requirements of each individual 50 States' insurance laws.

H.R. 1880 would also address the issue of systemic risk by designating another entity to serve as a systemic risk regulator for insurance. The systemic risk regulator would have the power to compel systemically significant insurers to be chartered by the Federal insurance regulator. Thus, although the bill shares some similarities with past optional Federal charter legislation, and would allow some insurers to choose whether to obtain a Federal charter, it can not be considered purely an optional Federal charter bill.

The National Association of Registered Agents and Brokers Reform Act of 2009 (H.R. 2554)

This bill was introduced by Representative David Scott along with 34 cosponsors on May 21, 2008.

H.R. 2554 would establish a National Association of Registered Agents and Brokers (NARAB). NARAB would be a private, nonprofit corporation, whose members, once licensed as an insurance producer in a single State, would be able to operate in any other State subject only to payment of the licensing fee in that State. The NARAB member would still be subject to each State's consumer protection and market conduct regulation, but individual State laws that treated out of State insurance producers differentially than in-State producers would be preempted. NARAB would be overseen by a board made up of five appointees from the insurance industry and four from the State insurance commissioners. The appointments would be made by the President and the President could dissolve the board as whole or suspend the effectiveness of any action taken by NARAB.

The Nonadmitted and Reinsurance Reform Act of 2009 (H.R. 2571/S. 1363)

Representative Dennis Moore and 21 cosponsors introduced H.R. 2571 on May 21, 2009, while Senators Mel Martinez, Bill Nelson, and Mike Crapo introduced S. 1363 on June 25, 2009.

These bills would address a relatively narrow set of insurance regulatory issues. In the area of nonadmitted, or surplus lines, insurance, the bills would harmonize, and in some cases reduce, regulation and taxation of this insurance by investing the "home State" of the insured with the sole authority to regulate and collect the taxes on a surplus lines transaction. Those taxes that would be collected may be distributed according to a future interstate compact, but absent such a compact their distribution would be up to the home State. These bills also would preempt any State laws on surplus lines eligibility that conflict with the NAIC model law and would implement "streamlined" Federal standards allowing a commercial purchaser to access surplus lines insurance. For reinsurance transactions, they would invest the home State of the insurer purchasing the reinsurance with the authority over the transaction while investing the home State of the reinsurer with the sole authority to regulate the solvency of the reinsurer. [11]

The Insurance Information Act of 2009 (H.R. 2609)

Representative Paul Kanjorski and four cosponsors introduced H.R. 2609 on May 21, 2009.

This bill would create an "Office of Insurance Information" for nonhealth insurance in the Department of the Treasury. The Deputy Assistant Secretary heading this office would be charged with collecting and analyzing insurance information and establishing Federal policy on international insurance issues, as well as advising the Secretary of the Treasury on major insurance policy issues. State laws or regulations that the head of the office finds to be inconsistent with the Federal policy on international insurance issues would be preempted, subject to an appeal to the Secretary.

The Increasing Insurance Coverage Options for Consumers Act of 2008 (H.R. 5792, 110th Congress)

This bill was introduced by Representative Dennis Moore, along with Representatives Deborah Pryce, John Campbell, and Ron Klein, on April 15, 2008.

H.R. 5792 would have amended the Liability Risk Retention Act (15 U.S.C. 3901, *et seq.*) to allow risk retention groups and risk purchasing groups to expand into commercial property insurance, while adding requirements on corporate governance including the addition of independent directors on risk retention group boards and a fiduciary duty requirement for group directors. The bill would have required risk retention groups be chartered in a State that has adopted "appropriate" or "minimum" financial and solvency standards. It would also have strengthened the current preemption from State laws enjoyed by risk retention and risk purchasing groups. [12]

2008 Treasury Blueprint

In March 2008, then-Secretary of the Treasury Henry Paulson released a "Blueprint for a Modernized Financial Regulatory Structure." Although the recent financial crisis had begun at that time, the Treasury blueprint was not primarily a response to the crisis, but instead an attempt to create "a more flexible, efficient, and effective regulatory framework" [13] A wide-ranging document, the blueprint foresaw a completely revamped regulatory structure for all financial services. The final structure envisioned in the Treasury blueprint has been described as "twin peaks plus." The 2008 Treasury model was to ultimately create a prudential regulator overseeing the solvency of individual companies, a business conduct regulator overseeing consumer protection, and a market stability regulator overseeing risks to the entire system. As an intermediate step, it made two specific recommendations on insurance regulation. First, it called for the creation of a Federal insurance regulator to oversee an optional Federal charter for insurers as well as Federal licensing for agents and brokers. Second, recognizing that the debate over an optional Federal charter was ongoing in Congress, it recommended the creation of an "Office of Insurance Oversight" in the Department of the Treasury as an interim step. This office would be charged with two primary functions: (1) dealing with international regulatory issues, including the power to preempt inconsistent State laws, and (2) collecting information on the insurance industry and advising the Secretary of the Treasury on insurance matters.

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[11] See CRS Report RS22506, *Surplus Lines Insurance: Background and Current Legislation,* by Baird Webel.

[12] See CRS Report RL32176, *The Liability Risk Retention Act: Background, Issues, and Current Legislation,* by Baird Webel.

[13] U.S. Treasury, "Treasury Releases Blueprint for Stronger Regulatory Structure", press release, March 31, 2008, *http://www.ustreas.gov/press/releases/hp896.htm.*

PREPARED STATEMENT OF HAL S. SCOTT

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Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee for permitting me to testify before you today on regulatory modernization as it relates to the insurance industry.

As the Committee knows, the insurance industry represents an important place in the U.S. framework of financial regulation. As of the first quarter of 2009, the total assets of U.S. life and property-casualty insurers were $5.7 trillion, quite significant when compared with total assets of U.S. commercial banks of $13.9 trillion.[1] Despite being a national (indeed international) industry within the financial sector whose size can be measured in the trillions, insurance—unlike the banking or securities sector—is regulated almost exclusively by each of the 50 States instead of the Federal Government.

This structure comes from a bygone era and, in the wake of the ongoing global financial crisis, must be reconsidered and changed. I believe reform, at least initially, should come by way of establishing an optional Federal charter (OFC).

My testimony is organized in three parts.[2] Part I addresses the case against the *status quo* and the need for an OFC. Part II outlines how an OFC regime should be structured, and Part III introduces some additional issues to consider in reforming insurance regulation in the United States.

I. The Need for an Optional Federal Charter

In contrast to other financial services, such as securities and banking, Congress has not sought to exercise either concurrent or preemptive authority over insurers. Indeed, the McCarran-Ferguson Act of 1945 explicitly found State regulation of insurance to be in the public interest and provided that no Federal law should "invalidate, impair, or supersede" any State insurance regulation or tax.[3] The net result of congressional abstention has been that more than 50 regulators currently regulate insurance within their jurisdictions. Yet it has not always been assumed that the States should be the exclusive regulators of insurance. There have been numerous proposals for a Federal role in insurance regulation since the time of the National Banking Act, which set up the dual-chartering provisions for the banking industry in the 1860s. Indeed, many such proposals have been put forward recently. For example, in April 2009 Representatives Melissa Bean (D-Ill.) and Ed Royce (R-Calif.) introduced H.R. 1880, the National Insurance Consumer Protection Act, which sets forth a scheme for an OFC for life and property-casualty insurers (as well as reinsurers), largely modeled on the National Bank Act of 1864.

A. The Case for Abandoning the Status Quo

The *status quo* is undesirable for at least three reasons: (1) State-based regulation is inefficient; (2) the current system stifles uniformity, innovation, and speed to market; and (3) the fragmented framework puts the insurance industry at a competitive disadvantage with other firms offering the same products. We need to create an OFC to remedy these problems, although I acknowledge the political difficulties of doing so.

1. State-Based Regulation Is Inefficient—The most basic problem with the current framework of multistate regulation is its sheer inefficiency. The precise costs of that inefficiency are somewhat difficult to calculate. A simple cost comparison between current State and Federal financial regulatory systems is only partially informative, because each State agency has a slightly different mission. For example, some States expend a great deal of time on rate regulation and issues related to pricing, profitability, and market conduct. Other States have relatively little price regulation but may spend more resources and time on other issues salient to voters in the State.

Scholars and economists that have attempted to quantify the costs associated with multistate regulation agree they are significant. For example, Professor Steven Pottier of the University of Georgia finds that the total additional cost of having

[1] Federal Reserve, Statistical Release Z.1 (June 11, 2009).

[2] Portions of this testimony are excerpted from my prior work on the subject, namely Martin F. Grace & Hal S. Scott, "An Optional Federal Charter for Insurance: Rationale and Design", in *The Future of Insurance Regulation in the United States* 55–96 (Martin F. Grace & Robert W. Klein, eds. Brookings Press, 2009), and the Committee on Capital Markets Regulation's recent report entitled "The Global Financial Crisis: A Plan for Regulatory Reform" (May 2009).

[3] P.L. 15, March 9, 1945 (codified at 15 U.S.C. §§1101–15).

multistate regulation of the life insurance industry is about 1.25 percent of net premiums annually.[4] This translates into approximately $5.7 billion each year. While these figures are for the life insurance industry, one would expect similar results for property-liability firms.

Like many others, I believe that if a significant portion of insurance regulation was aggregated at the Federal level, many of these duplicate costs would be eliminated. The outcome would be lower regulatory costs to the Government and lower compliance costs to the regulated firms. For example, every State undertakes regulation of insurance agents. According to Professor Laureen Regan of Temple University, the average life agent has about nine State licenses.[5] This cost is born by the agents, their employers, and their customers. Further, every State licenses the companies operating within its jurisdiction. The average property-liability company holds 16 State licenses and the average life-health company holds twenty-five.[6] An optional Federal charter with one licensing regime could eliminate these multiple layers of cost.

A particular industry or product should be regulated at the jurisdictional level best able to capture all the costs and benefits of regulation within its limits. In layman's terms, the more interstate the business, the stronger the argument is for Federal regulation. There was a time in American history when the sale and provisioning of insurance of differing kinds was primarily a local business. But that time has long passed. Based on information available from the National Association of Insurance Commissioners (NAIC), Professor Martin Grace and I calculated that for 2006, out-of-State insurers provided over 80 percent of all insurance in the United States.[7] In certain categories of insurance, the numbers are even more striking. While the in-State market share for property-liability insurers is 18.13 percent, for life-health insurers the average in-State market share is only 7.52 percent.[8]

2. State-Based Regulation Threatens Uniformity, Innovation, and Speed to Market—Related, but distinct from the inefficiency of multistate regulation, is the potentially negative effect of the *status quo* on the uniformity of standards and regulations, product innovation, and the speed with which new products enter the marketplace. The promulgation of Federal laws and regulations—particularly those with the requisite force to preempt State laws—would, by definition, be uniform throughout the United States. Uniformity not only produces greater cost efficiency but also enables consumers and regulators to monitor the compliance of a particular company or product with a set of standards applied across State boundaries.

Multistate regulation has arguably impeded the ability of the insurance industry to provide consumers with improved products. If products are approved quickly, then firms can compete more efficiently on product innovation and design. However, if products are approved slowly, the incentive for insurers to develop and market new ideas is reduced. The problem is exacerbated if a product is approved in one State with a certain set of conditions and in another State with a different set of conditions, as is presently the case. NAIC's attempts to reduce these costs have not been entirely successful. Most recently, NAIC has tried to improve the process by the formation of the Interstate Insurance Product Regulation Commission (IIPRC) for life insurance, an interstate compact. According to information on the IIPRC, 36 States and related jurisdictions were members as of July 2009. However, five large insurance States are missing from the compact: New York, California, Illinois, Florida, and Connecticut.[9]

3. State-Based Regulation Creates Horizontal Inequity with Other Financial Industries—A final point is that the current multistate framework puts the insurance industry at a competitive disadvantage to other financial services firms offering competing products. Noninsurance financial institutions can ask their Federal regulators for nationwide approval of a product and receive an answer within a relatively short period of time, compared to the time it takes for insurers to obtain State approval. This provides these other financial institutions a significant advan-

[4] Steven W. Pottier, "State Insurance Regulation of Life Insurers: Implications for Economic Efficiency and Financial Strength," in *Report to the American Council of Life Insurers* (2007).
[5] Laureen Regan, "The Option Federal Charter: Implications for Life Insurance Producers" in *Report to the American Council of Life Insurers* (2007).
[6] National Association of Insurance Commissioners, Annual Statement (Kansas City, MO, 2006).
[7] Martin F. Grace & Hal S. Scott, *supra* note 2 at 61–64.
[8] *Id.* at 65.
[9] See *http://www.insurancecompact.org/*. New York, Illinois, and California do have proposed legislation.

tage over insurers for the marketing of similar products.[10] Furthermore, States are often more restrictive on product offerings than is the Federal Government. For example, federally regulated financial institutions are permitted to use relatively aggressive hedging strategies, which can reduce their risk, whereas insurers typically are not.[11] The market is quickly and dramatically changing, yet States typically resist allowing insurers to use the strategies commonly used by other financial institutions. It may be that State regulators are apprehensive because they lack the resources to monitor and evaluate these strategies. A Federal regulator with better analytical resources could permit life insurers to engage in investment and hedging strategies that would be more appropriate, more efficient, and less risky.

B. The Benefits of an OFC

As explained above, the *status quo* no longer represents an effective means of regulating the U.S. insurance industry. The question thus becomes whether the addition of an optional Federal charter[12] will bring more benefits than costs. Although there are costs arising from maintaining regulation at two levels of Government, such costs should be more than offset by the efficiencies of the emerging Federal system. Some also contend an OFC may lead to reduced consumer protection since State regulators may be more responsive to local complaints due to the political consequences of not doing so. However, the Obama administration's proposal for the new Consumer Financial Protection Agency, which, as discussed below, should have jurisdiction over federally chartered insurers, may greatly alleviate that concern. Furthermore, an OFC would reduce the negative externalities imposed on out-of-State customers and insurers resulting from the current State-based regulatory system. Finally, the creation of a Federal chartering agency would enable greater cooperation in the international arena among the various national insurance regulators. In sum, the need for an OFC is clear, and the ongoing financial crisis presents a compelling reason and an unparalleled opportunity for meaningful reform of U.S. insurance regulation.

II. Design of the Regulator of Federally Chartered Insurance Companies

Apart from possessing the requisite technical expertise, the Federal entity created to regulate, supervise, and enforce a new OFC regime will have to be situated within the U.S. financial regulatory structure. There is also an important issue of whether the Federal regulator should charter lines of business or firms.

A. Place in the Regulatory Structure

From a broad perspective, I believe the overall U.S. financial regulatory structure is seriously in need of reform. A rapidly dwindling share of the world's financial markets is supervised under the fragmented, sectoral model still employed by the United States. In May 2009, the Committee on Capital Markets Regulation (CCMR) issued a comprehensive report entitled *The Global Financial Crisis: A Plan for Regulatory Reform* that called for the U.S. financial system to be overseen by only two, or at most, three independent regulatory bodies: the Federal Reserve, a newly created independent U.S. Financial Services Authority (USFSA), and possibly another new independent investor/consumer protection agency.[13] I believe this model is the right one to replace our highly fragmented and ineffective regulatory structure.

Under the CCMR approach, the Federal Reserve would retain its exclusive control of monetary policy and its lender of last resort function as part of its key role in ensuring financial stability. In addition, its regulatory power would be enhanced to deal with systemic risk, such as exclusive control of capital, liquidity and margin requirements, as well as payment and clearing and settlement. The USFSA, on the other hand, would regulate all other aspects of the financial system, including market structure, permissible activities, and safety and soundness for all financial institutions (and possibly consumer/investor protection with respect to financial products if this responsibility were lodged within the USFSA). It would comprise all or part of the various existing regulatory agencies, such as the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodities Futures

[10] Kelly Greene, "Mutual Funds Pitch Alternative to Annuities", *Wall Street Journal,* at D8 (Jun. 9, 2008).

[11] Martin F. Grace, *et al.,* "Insurance Company Failures: Why Do They Cost So Much?" (Washington: American Council of Life Insurers 2007).

[12] At this time, I do not advocate a mandatory Federal charter for all insurance companies, though a mandatory role for the Federal Government may be necessary with respect to certain large insurance firms. *See* Part III.A.

[13] Committee on Capital Markets Regulation, *The Global Financial Crisis: A Plan for Regulatory Reform* 203-210 (May 2009), available at *http://www.capmktsreg.org/research.html.*

Trading Commission. For its part, the Treasury Department would coordinate the work of the two (or perhaps three) regulatory bodies, and would be responsible for the expenditure of public funds used to provide support to the financial sector.

If the U.S. financial regulatory structure is consolidated and improved as CCMR has recommended, then regulation of federally chartered insurance companies would be shared, as it would be for banks, between the Federal Reserve and the USFSA. The chartering authority itself would reside within the USFSA, which would also have resolution authority over all insolvent institutions, including federally chartered insurance companies. Regulation of insurance would thus be independent of the Executive Branch, insulated to some extent from political pressures while, at the same time, integrated into the overall supervisory framework. The USFSA would work closely with the Federal consumer-investor protection regulator—whether it is a division within the USFSA or an independent entity along the lines of what the Obama Administration envisions. If there is to be a Federal charter, then Federal—rather than State—consumer protection laws should apply to those institutions.[14] Some have opposed an OFC out of concern that consumer protection would be weakened but this need not be the case if a strong, dedicated agency or division of a USFSA were created. Furthermore, if a robust Federal consumer protection regulator is created, any regulations promulgated by it should entirely preempt any relevant State laws or regulations. The same should be true with respect to other financial services industries where strong Federal consumer protection laws and regulations apply. The need for State enforcement may exist under our current weak Federal protection of consumers—a need, with its attendant multistate inefficiencies, which would not exist in the presence of strong Federal consumer protection.

We must also consider what a Federal regulator should look like if the current sectoral regulatory structure remains in place, *i.e.,* if no USFSA-type structure is created. In this respect, it is useful to consider how State insurance regulators are organized and funded. The typical State insurance regulator is constituted as an autonomous agency, formally part of the executive branch, with one chief official appointed by the governor. No State insurance regulator appears to operate through a multimember commission. A minority of States has an elected chief official for insurance, but this structure cannot be constitutionally replicated within the Federal administrative structure. Another minority of States brings insurance regulation within another executive department, which is usually devoted either to commerce and consumer affairs or to banking and other financial services. State experience suggests that the Federal regulator of insurance should be independent of the executive branch—unlike the recommendation of the Bush Treasury Department's Blueprint which proposed an Office of National Insurance to be part of the Treasury Department.[15]

In addition, the latitude currently given to State insurance departments in the setting and collecting of fees suggests that a Federal insurance regulator should be self-funding, at least in part. Self-funding would further enhance the regulator's degree of independence from the political process.

B. Licensing of Firms or Products

Currently, insurance companies are organized and chartered by the States as life-health companies, as property-liability companies, or as specialty companies such as title insurers. Legally, a life-health insurer can offer various lines or products within its general area, such as term life policies, whole life policies, and annuities. Similarly, a property-casualty insurer may offer personal auto and homeowners, as well as commercial lines like commercial multiperil and workers' compensation. So one insurance firm may be chartered through different companies to conduct different insurance businesses in the same State. Thus, it is common for a number of affiliated insurance companies to belong to a group owned by a parent or holding company.

Some prior proposals, such as the Bush Treasury Department's Blueprint, have contemplated Federal chartering by business line, as currently exists among the

[14] Note that the Consumer Financial Protection Agency proposed by the Obama Administration does not have consumer protection authority over insurance companies. This makes sense as long as these insurance companies are exclusively State-regulated. Otherwise, there could be irreconcilable conflicts between State safety and soundness and Federal consumer protection requirements. To the extent that Federal consumer protection requirements overrode State safety and soundness concerns, the States, through State guaranty funds, would have to bear the cost. If insurance companies become federally chartered, however, both safety and soundness and consumer protection regulation could be conducted, and reconciled in some fashion, at the Federal level.

[15] U.S. Dep't of the Treasury, "Blueprint for a Modernized Financial Regulatory Structure" 126-133 (Mar. 2008), available at *http://www.treas.gov/press/releases/reports/Blueprint.pdf.*

States.[16] Many have advocated keeping property and casualty insurance at the State level. Thus, for a given insurance holding company or parent firm, some of its companies and products would be chartered and regulated at the Federal level and others at the State level. It would therefore be possible for firms to have the choice of being regulated at the Federal level for some businesses but not others.[17] I might note that there is a very strong case for a Federal licensing option for reinsurance, as this is not a consumer product that directly affects the welfare of the citizens of a particular State. Although proposals for the Federal chartering of distinct business lines have merit, I do not believe they are optimal.

The cleanest and most efficient solution would be to license firms, rather than sectors, lines, or functions. Indeed, we have no Federal historic experience with the licensing of lines of business: the entire national bank or securities firm experience is based on the chartering or licensing of firms, not products. I see no reason to depart from that practice in this context. Indeed, the financial crisis teaches us that one regulator should have authority over an entire firm. It is bad enough to divide responsibility at the Federal level for a single firm; it would be even worse to do so as between Federal and several State authorities.

An important question related to the operations of the Federal regulator is whether it should establish a guaranty fund system similar to those present in many States. These funds are in place to compensate for the losses suffered by third parties and policyholders due to insurance company insolvency. If licensing and regulation of insurance activities were to be conducted at the Federal level, for firms choosing Federal charters, State guaranty funds would then be at risk for Federal regulatory failures. This is the reverse of our past problems with State-chartered banks whose regulation put the Federal deposit insurance system at risk. This is an inherently unstable situation.

I recommend simply installing a Federal guaranty fund for federally chartered insurers. Such a fund would successfully tie Federal regulation to a Federal guaranty. There might also be some subsidiary benefits of a Federal fund. It would imply uniformity of protection for federally chartered insurers. In addition, if a diverse group of insurers choose to operate under Federal charter, then there might be better pooling of risk as compared with State funds, which have a more limited geographic base from which to draw members.

III. Additional Issues To Consider: Mandatory Federal Charter and Capital Requirements

As I hope to have demonstrated above, State-by-State regulation is simply not an effective means of regulating what is truly a complex national industry. What is more, I hope to have established a persuasive case for an optional Federal charter. Before I bring my testimony to a close, there are two additional issues I would like to raise for the Committee's consideration.

A. Mandatory Federal Charter for Large Institutions

The above discussion assumes that Federal chartering will be optional. However, it may well be that Federal regulation, if not chartering, should become mandatory for large insurance companies over a certain asset threshold. Firms that are too big, too interconnected, or too complex to fail impose added costs to the Government and, ultimately, the taxpayer in the form of Government assistance. These institutions are "systemically important," although I do not recommend that they be so identified *ex ante* and publicly by regulators, in order to minimize moral hazard and avoid an implicit Federal guarantee. In addition, such determinations will be difficult to make and could rapidly change for some firms, like hedge funds. In most cases, use of a simple metric like size would avoid these problems.

A traditional insurance company may pose less of a systemic risk than the typical bank for a number of reasons—they have less leverage and interconnectedness. Nev-

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[16] See U.S. Dep't of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* 129 (Mar. 2008), available at *http://www.treas.gov/press/releases/reports/Blueprint.pdf* ("An OFC should be issued specifying the lines of insurance that each national insurer would be permitted to sell, solicit, negotiate, and underwrite.").

[17] Minimum capitalization requirements vary by line and by State. During the 1990s the National Association of Insurance Commissioners (NAIC) sought to harmonize State regulation by adopting model minimum risk-based capitalization (RBC) requirements for most lines (including life and property-casualty). See for example N.Y. Ins. L. sec. 4103; see also. Kathleen Ettlinger, *et al.,* "State Insurance Regulation" (Malvern, PA: Insurance Institute of America 2005). A multistate, multiline insurer generally must meet the greater of its minimum RBC requirements or the minimum capital requirements of each State in which it is licensed to do business. There is no reason that a Federal regulator could not promulgate solvency regulations that would be not only equally sensitive to the different risks posed by different product lines but also more uniform.

ertheless, as the AIG case shows, there are certain large insurers that have a potential for imposing systemic risk on the economy. To date upwards of $150 billion in taxpayer funds have been used in some form or another to bail out AIG. If such firms are to be rescued by the Federal Government, it seems reasonable to insist that the Federal Government have supervisory and regulatory powers over such firms. To be sure, AIG was the exception rather than the rule in the insurance industry. AIG's troubles stemmed not from its traditional insurance activities but from the derivative business of its holding company. That said, the key derivative was the credit default swap, which is essentially a type of insurance against the default of a specified firm. The failure of an insurance company to honor either its derivative or insurance obligations could raise systemic risk concerns.

B. Capital Regulation

The final issue—but in many ways the most fundamental of all—is how to establish an effective capital adequacy regime for insurance companies as well as more traditional financial institutions. At the center of the global financial crisis was the complete failure of our regulatory system to ensure that financial institutions maintained sufficient capital cushions. When banks found their individual balance sheets unable to sustain declining asset values, capital firewalls proved inadequate to prevent the contagion from spreading throughout financial markets.

The case of AIG, as noted above, illustrates the potential for insurance companies to suffer similar erosion in their capital bases, which can lead to systemic tremors and Government bailouts. A mandatory Federal charter for certain large institutions will bring with it Federal prudential supervision. But I believe more than supervision is needed for large insurers—they should also be subject to robust capital requirements established by Federal regulation in conjunction with those requirements set for other similarly sized, federally regulated financial institutions. The overall methodology for setting capital adequacy standards for insurance firms should be different than that used for banks and lending institutions, taking into account the differing nature and risk of the industry. [18] Exactly how to set such capital requirements for insurance companies—particularly in light of the failure of the existing Basel II framework for banks—is beyond the scope of this hearing but should be an important part of this Committee's agenda.

Thank you and I look forward to answering your questions.

PREPARED STATEMENT OF MARTIN F. GRACE, J.D., PH.D.

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Introduction

Mr. Chairman, Ranking Member Shelby, and Members of the Committee good morning and thank you for the opportunity to testify before the Committee on the topic of modernizing insurance regulation.

My name is Martin Grace. I am the James S. Kemper Professor of Risk Management at the J. Mack Robinson College of Business at Georgia State University. I am also the Associate Director of the Center for Risk Management Research and an Associate at the Andrew Young School of Policy Studies. I have been at Georgia State for 21 years coming to GSU from the University of Florida where I earned a law degree and a Ph.D. in economics. Previous to that I attended the University of New Hampshire where I earned my undergraduate degree.

My entire career at Georgia State has been spent conducting research in insurance regulation and taxation. Since the industry is regulated at the State level, this has been predominately an exercise in the study of State regulation. However, the question of whether the State is the appropriate level of regulation is becoming more important and I have spent the last 4 years thinking about that question.

This brings me to what I have been asked to talk about today. I will focus on three main points in today's testimony.

- First is the value of regulation in insurance industry. There are valid rationales for insurance regulation, but the business of insurance is quite different than banking and has a need for a different style of regulation.

[18] See Hal S. Scott, ed., *Capital Adequacy Beyond Basel: Banking, Securities, and Insurance* 3-14 (Oxford University Press 2005).

- Second, is a mild but nonetheless important critique, of the current proposals to regulate the insurance industry. An Optional Federal Charter (OFC) is not necessarily the only way to think about insurance regulation. The current proposal is cobbled together from a Federal banking law and decades old State insurance model laws.
- Third, something like the Office of Insurance Information, as source of expertise and an advice to the Federal Government about the insurance industry is needed, but it should not by itself be used to restructure the relationship between Federal and State regulation.

The question of who should regulate the insurance industry has been debated in the United States since the time of the Civil War. Insurance continues to be regulated by the States despite several challenges to their authority over the years. The States' authority over insurance was supported in various courts' decisions until the Southeastern Underwriters case in 1944. In Southern Underwriters, the Supreme Court determined that the commerce clause of the Constitution applied to insurance and that insurance companies (and agents) were subject to Federal antitrust law. The Court's ruling caused the States and the industry to push for the McCarran-Ferguson Act (MFA) in 1945, which delegated the regulation of insurance to the States.

At that time, the majority of insurance companies favored State over Federal insurance regulation. However, today the bulk of insurance is written by national (and international) companies operating across State borders. Many of these insurers have come to view State regulation as an increasing drag on their efficiency and competitiveness: these insurers now support a Federal regulatory system. This is reflected in recent proposals that would establish an optional Federal charter (OFC) for insurance companies and agents. The proposal would allow them to choose to be federally regulated and exempt from State regulation. As you are quite aware, there is fierce opposition to an OFC from the States and from State-oriented segments of the industry.

One of the main problems with the OFC approach is that it is based upon a structure designed in the 1860s through the National Banking Act and cobbled together with State consumer protection language. The OFC approach is based on a view of the world that had changed significantly in the last 2 years. While the authors of the proposal now add a systemic risk regulator to the mix, they still beg some questions about who should be subject to Federal regulation.

The current problem facing insurance regulation, though, is quite different from regulatory issues of the past century. Today's problem is not based on regulation of solvency, market conduct, or insurance pricing which have been undertaken by the States. It is, instead, the problem of systemic risk which, for the most part, has not been an issue with the insurance industry. Further, systemic risk is of national rather than State in scope. Specifically, the types of market failures used historically to justify regulation of the insurance industry have been ones that pertain to local markets. This is in direct contrast to the effects a failure of a company like AIG has on national and international markets.

Why Regulate Insurance?

Economists believe the role of Government is to rectify market failures. [1] In the insurance industry, potential market failures are due, in essence, to imperfect information. Customers cannot, for example, observe the behavior of insurance company management. For a life insurance consumer, this might be important because of the long time between when a contract is purchased and when a payout might occur. Also, there is no effective way to discipline the insurer's management. For example, a life insurance consumer cannot "punish" a "bad" company by exchanging his long term policy for one with another insurer. Thus, economists would argue that Government can and should monitor a firm's solvency position and take action to prohibit insurer actions which reduce the value of life insurance contracts.

A second potential market failure is related to the imperfect information embodied in the insurance contract itself. An insurance contract is a complicated financial agreement, so the Government could standardize contracts or approve contract language to reduce errors and misunderstandings in the contracting process. [2]

[1] See Skipper and Klein (2000) for a more thorough treatment of how economists think about the regulation of insurance.

[2] This standardization is common in personal lines products (like homeowners and auto), but it does not always solve all problems as there are new problems with contract interpretation that are costly to resolve. The Katrina wind/water litigation is just an example of this problem.

A third informational problem might arise from an insurer's strategy and marketing structure. Because insurers have different marketing (direct versus independent agents) approaches and different levels of capital backing, shopping for the right policy is costly to consumers because they do not have the information to make accurate judgments about the services and the quality of services provided by insurers. Arguably, the Government could guarantee a level of service after a claim or set prices so that a consumer would know that the contract is priced fairly. In addition, prices could be set to keep insurers from using their market power to exploit consumers through higher prices. This last rationale is often provided for price regulation of insurance, even though most personal lines insurance markets (which are the most likely to be regulated) are competitive markets. There are many competitors in these markets which reduces the likelihood of any one of firms being able to influence prices (Tennyson, 2007).

These arguments form the standard historical rationales for insurance regulation. A further rationale, with a more immediate application in banking regulation, is that regulators should prevent market failure caused by the externality of one bank failure leading to a loss of consumer confidence in the financial system and other bank failures should be prevented. Banks have solvency regulation to protect depositors and to defend the banking system from contagion risk. Historically, insurers did not present a real contagion risk to the financial system, but this may no longer be true. Financial companies are now interconnected in ways that are without historical precedent. Holding companies have evolved which contain many different types of regulated and unregulated firms. A bank with an insurer as part of its operations can extend the contagion risk to its insurance operations. Alternatively, an insurer with a large and unregulated derivative trading business which suffers large losses can trigger questions about the overall soundness of the insurance operations. Counter parties to trades by such an unregulated entity can cause significant harm and potentially disrupt the banking system. In insurance, the focus of regulation has been on the individual company and not on the group or holding company. This needs to change, at some level, to allow for the proper accounting of systemic risk. [3] A State regulator cannot realistically regulate an insurer for its possible systemic affects on national and international markets especially in situations where the insurer within the State is a separately organized corporation from the corporation which might induce a systemic risk issue.

The Level at Which Regulation Should Be Applied

Ideally regulation should be applied at the level where the greatest costs and benefits due to the regulation arise. A simple example would be the proper placement for restaurant safety inspections versus airplane safety inspections. Local governments would be the obvious choice for restaurant cleanliness because local patrons would obtain the benefits and bear the costs of the safety inspections. In contrast, airplane safety inspections costs and benefits are national in scope and air travel is conducted nationwide. Thus it makes sense for air safety to be regulated at the national level.

A large percentage of insurance premiums are written interstate. If there are interstate externalities to insurance regulation, then it makes sense for the Federal Government to regulate it. Phillips and Grace, in a 2007 paper, document some of these interstate externalities in terms of how States can export the costs of regulation to other States. The authors were not able to measure the benefits of regulation, so it is not possible to provide a conclusion about the role of Federal versus State regulation.

Some of the benefits of State regulation are that local tastes and preferences are best met by State legislatures responding to local voters' concerns about the insurance industry. This is often touted as a rational for federalism. Yet, I suspect that with some exceptions (price regulation, for example) a few voters could discuss their State's insurance regulations. Due to diverse State regulations, nationwide companies often have significant compliance costs which increase the price of insurance without providing any benefits provided by a federalist laboratory. States do not look to see if there is a better way to regulate insurance. So, there is tremendous inertia in State's regulatory processes and it is a rare event that causes all States to act together.

[3] Prior to the introduction of the National Insurance Consumer Protection Act and the creation of a systemic risk regulator, I thought legislation that granted the Federal Reserve the right to assess systemic risk through the use of normal administrative agency powers of investigation would be sufficient for any firm that might create systemic risk. New legislation which sets up a formal systemic risk regulator will likely spell out these powers and their scope in more detail.

If the criterion for a State-based insurance regulatory system to be successful is that States must regulate to minimize compliance costs, then the current State regulation of insurance is doomed to failure. One of the major rationales for Federal regulation is reduction of nationwide insurer costs of trying to satisfy multiple States' regulators. The NAIC has stated that it is trying to reduce these types of costs through model legislation and interstate compacts. Its good intentions notwithstanding, it is not capable of getting the States to operate quickly and efficiently together. Even Congress cannot obtain quick compliance from the States. In the Gramm-Leach-Bliley Act of 1999, Congress mandated that the States set up a nationwide licensing system for agents. After 10 years, not all of the States participate in this system to reduce multistate licensing costs.[4]

In 2007, for example, the NAIC proposed the Military Sales Model Practices Regulation as a result of a law enacted by Congress in 2006. This regulation is designed to protect young soldiers, sailors, marines, and airmen from aggressive sales tactics directed at military personnel. As of late last year, only 18 States have enacted it. Presumably, this was an important issue for Congress, yet it has not been adopted by a majority of States in its first 2 years. Depending on universal action among the States to enact laws that prompt action is just not feasible. Grace and Scott (2009) document a number of other examples which suggest that joint actions by the States are never going to be able to solve national problems regarding compliance costs and uniformity quickly and efficiently.

The Potential Federal Role and Regulatory Modernization

There is a role for the Federal Government in insurance regulation. Where it can succeed and be economically valuable is in the area of removing the costs of conflicting State laws and reducing the effect of systemic risk on all financial markets. Reduction of compliance costs is the rationale behind the 2009 OFC proposal introduced by Representatives Bean and Royce called the National Insurance Consumer Protection Act. The new proposal includes the role of a systemic risk regulator who will have the authority to mandate that certain insurers be federally chartered companies.[5] With the exception of this concept, there is little modern thinking in the NICPA about how insurance regulation should work.

The authority of the systemic risk regulator is very important. It is only now being discussed. However, how this is undertaken can cause significant disruptions in markets. If the risk regulator's authority is associated with a "too-big-to-fail" certification, then the underlying competitive insurance market might be at risk. Firms designated as "too big to fail" will have an implicit incentive to take on more risk (sell more insurance and other risky products) knowing the Government will provide assistance. A rational firm may decide not to compete in that market. Thus underlying insurance markets are likely to wither away leaving only those firms that are too big to fail.

If all insurers are subject to the systemic risk regulator's jurisdiction, there is no signal that every firm is too big to fail. However, most insurers will never be systematically important but will be subject to another layer of regulation that does little for its customers, its shareholders, or society in general. Even large, significant insures operating nationwide are not necessarily important from a systemic risk perspective. So the question becomes how does one determine whether a firm should be subject to risk regulation? Ideally, one would want firms undertaking risk outside of insurance risks to fall under the authority of the risk regulator. For example, suppose a future AIG-like company petitions its primary regulator to exempt its "Financial Products" subsidiary from insurance regulation. Because of that exemption, the firm should fall under the jurisdiction of the risk regulator. The risk regulator can examine the risk and require appropriate reserving techniques if needed.[6] By having to show the risk regulator the insurer's underlying business model a specific finding can be made if a systemic risk is possible and remedies to mitigate the sys-

[4] A recent report (NAIC, 2008) states that 43 States are in compliance. What is important is that three important States (FL, NY, and CA) are not in compliance some 9 years after enactment of the Gramm-Leach-Bliley Act. Without the large States participation, compliance costs are not reduced and the supposed benefits of increased State cooperation as a reason for avoiding an OFC bill are illusory.

[5] Essentially, there is a double option on the table now. From the description in the press, insurers could opt to become federally chartered, but the Federal Government could opt to regulate a State chartered company if part of a holding company that might create a systemic risk.

[6] Note, though, that if New York did not exempt the AIG Financial Products subsidiary and treated it like a bond insurer it would have had some level of reserves. Further, because it would have to place reserves for each new bond insured it would have also limited the scope of the sale of CDSs as well as the scope of the eventual losses.

temic risk can be implemented. Ideally what the risk regulator's job would be is to prevent possible systemic risks through evaluation by a competent regulator.

One of the dangers of merely just prohibiting financial innovation is that economically valuable innovations would never evolve. However, permitting financial innovation without proper reserving is also harmful to society. Thus, the risk regulator must be more sophisticated about these products than a typical State insurance department in two ways. First, it must be able to understand the product and its risks. Second, it must appreciate the rewards of such innovation.

Problems With Current Federal OFC Proposals

As mentioned above, the OFC proposal is cobbled together from banking and insurance law. There has been little discussion of the structure of a regulatory body from a fresh perspective. A recent paper by Grace and Scott (2009) examined a portion of the issue from an administrative law viewpoint and showed how little discussion there was of how a Federal insurance regulator should be organized. There are a number of regulatory models available in the United States. For example, there is the multicommissioner, administrative body like the SEC. This is in direct contrast to the single administrator overseeing the Office of the Comptroller of the Currency. There is also an independent (from the executive branch) administrative agency like the Federal Reserve Board of Governors. Again, this contrasts directly with the administrator of the Office of the Comptroller of the Currency. The fact that the 2009 OFC proposal merely copies the structure of the banking system and begs the question why is the national banking system structured this way? The Treasury Blueprint as well as others (see, *e.g.,* Brown (2008)) discuss other options. What is noteworthy is that these options were not conditioned on the current financial crisis. The Blueprint's proposal is to use a three-pronged regulatory approach with a systemic risk regulator, a solvency regulator, and a market conduct regulator that would oversee all financial services including securities and commodities trading. This would be a major innovation in financial regulation in the United States. The OFC bills, in contrast, are not innovative from the perspective of what is regulated or how the regulation is accomplished as the approach in both bills (with the exception of a systemic risk regulator) is to shift traditional regulatory powers from the States to the Federal Government.

Other methods of regulation of the insurance industry are also possible. Some insurers have joined unofficial self-regulatory organizations like the Insurance Marketplace Standards Association (IMSA) to increase their ability to understand their customers and to increase the likelihood that their policies will more closely meet the needs of those customers. These types of standards are different from State-based rules which are often decades old and have not suffered an across-the-board reexamination, except after a regulatory failure. From a practical point of view, Congress is not likely to delegate monitoring powers to private entities for some time. The approach of organizations like IMSA, can assist in the development of modern approaches to market conduct regulation.

In sum, there has been no real systematic discussion of modernization of the regulatory approach over the last decade outside of allowing for greater integration of financial services through enactment of the Gramm-Leach-Bliley Act of 1999 (GLB). Other than allowing banks and insurers to be owned by a common parent, GLB did not change the content of insurance regulation beyond mandating that States attempt to resolve interstate differences in agency licensing. Other important substantive aspects of insurance regulation have not been reexamined. For example, there has been little, until recently, discussion of the proper and economically efficient regulation of risk.

In addition, solvency regulation has not been scrutinized since Congress made States and the NAIC do so in the late 1980s and early 1990s. Bank regulators have adopted aspects of the Basel accords, but insurance regulators have not. Many insurers are complying with Basel II by developing their own capital models and the tests which support the models. They are not required to do so by law but are doing it to be responsible stewards of capital. To be fair, there has been an attempt to standardize certain product approval processes through the use of the new Interstate Insurance Product Regulation Commission. However, the Commission has taken time to get started and was created, at least in part, to stave off any OFC type of regulation. This history of insurance regulation suggests that State regulation in this area is reactive. Regulation only changes because of a crisis or Congressional pressure. It is interesting that Congress (and not the States) also proposed the SMART Act that would have preempted the States' ability to regulate and transferred that authority to the Federal Government. This proposed Act started a conversation about regulation, but it did not address the fundamentals—just what level of regulation is appropriate for insurance. The OFC bills have structured this debate in such as way as to eliminate discussion of reform. Given that many aspects of regulation are important, more reform ideas should be on the table.

A Role for an Office of Insurance Information

A proposed Office of Insurance Information (OII) is an important first step in any role the Federal Government may have in the future. Even if the Federal Government decides in the near future to pass on regulating the insurance industry the OII still may be an important innovation for three main purposes. First, there is a paucity of individuals at the Federal level who know its component industries, its market structures, its products, its taxation or its pricing. Further, because of the unique nature of insurance (*e.g.,* premiums are received now and claims are paid at some future time), there are a number of important technical accounting and actuarial issues that need to be understood regarding reserving and pricing. This type of knowledge currently resides at the State level.

One could argue that the NAIC or National Council of Insurance Legislators (NCOIL) could provide this type of information to the Federal Government, but there is no real incentive for them to do so unless these organizations think by doing so they can postpone or reduce the likelihood of any eventual Federal regulation. Further, having to rely upon other organizations which have their own agendas for the needed insurance expertise has its own costs.

Finally, there is an important issue that may arise depending upon the powers granted to the OII. Because financial markets are international in scope the Federal Government is often on the forefront of negotiation with other countries about regulation and international cooperation in regulation. By providing negotiators with information about the industry better policy can be made. However, the main point here is not likely information provision to negotiators, but the real possibility of the OII having (or eventually obtaining) the ability to preempt State laws inconsistent with international accords. Many foreign companies (and governments) view State insurance regulation as a barrier to entry (See, *e.g.,* Cooke and Skipper, 2009). The OII and the Federal Government, through preemption, could conceivably dismantle the current system of State regulation.

This would be a piecemeal change of the insurance regulatory system that would likely lead to real disruptions in regulation. However, a top down reexamination of the regulation of the industry would provide for a more systematic review of the proper role of the Federal and/or State regulatory power.

The Role of the State and Federal Governments in the Future of Insurance Regulation

The future role of States in insurance regulation is in question. There are serious barriers to coordination among the States which prohibit them from being effective regulators on certain issues. There is also a dearth of expertise on insurance at the Federal level. In addition, because of the predominance of nationwide operations, there are potential externalities that can be remedied by a Federal approach to regulation. To be fair, there are also potential problems with Federal regulation that need to be addressed. State regulation does protect the industry from bad regulation in the sense that if a State were to make a serious error regarding regulation, the negative effects of the error will likely be most felt in the State with the "bad" regulation. In contrast, a mistake at the Federal level hurts the entire industry nationwide. Further, merely copying State regulation without thinking about the merits of the regulation is also inefficient. A third and final problem with Federal regulation is the possibility that risks that previously were insured in private markets may become more socialized in the sense that Federal regulations may reduce the ability of private insurers to set risk based prices.

Conclusion

The policy debate regarding the regulation of insurance concerns the appropriate level of regulation for the industry. Ideally, the appropriate level of Government would be the one that would be able to contain all of the benefits and costs of regulation within the State (or Federal level) borders. Further, it is possible solvency and market regulation conduct arguably can be conducted at the Federal level at lower cost to society than separate State regulation of these same activities. Evidence suggests there are some economies of scale in these activities and the costs of regulation are spread beyond the borders of a single State.

Insurance regulation needs to move beyond this level of discussion. It is important, but the other aspects of regulatory improvements must not be forgotten. The proposed 2009 version of the OFC bill does address the issue of systemic risk. While this is important to prevent future events like AIG, it is not clear how relevant it is for a supermajority of other insurers. However, if a risk regulator bill is passed, one could predict we would have a better understanding of the relationships between various aspects of the financial service industries. This is a beneficial aspect of the law, but there is still avoidance of real subject matter regulatory reform.

Finally, I am pessimistic about the role for the State in the future of insurance regulation. States have absolutely no ability or incentive to be proactive. At best they are reactive and cannot reach anything like a consensus when one is needed. The perfect example is the inability for every State to integrate its agency licensing system or join an interstate product licensing commission, even in the face of Federal preemption of a significant part of regulatory authority. Thus, a State-based understanding and appreciation of systemic risk and how it should be treated in a holding company structure is not likely to be implemented on a relatively uniform base any time soon.

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RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM TRAVIS B. PLUNKETT

Q.1. If Congress were to establish an optional Federal charter, how can we be sure that there would be effective consumer protections, for the products and services offered and stringent regulation of the qualifications of insurance professionals?

A.1. The Consumer Federation strongly recommends against creating a Federal insurance charter that is optional. Allowing insurance companies to chose whether they are regulated at either the Federal or State level puts pressure on both sets of regulators to reduce consumer protections through regulatory arbitrage. Any Federal role in insurance regulation must not be optional for insurers. The best way to keep the strengths of State insurance regulation, while improving consumer protections and uniformity of regulation, would be to establish Federal minimum standards. That is the approach the President has recommended regarding credit-based insurance in his proposal to establish a Consumer Financial Protection Agency.

Q.2. Could the implementation of an optional Federal charter for the insurance industry create an environment for regulator shopping?

A.2. Yes. That is exactly what has happened with the dual charter banking system, and with multiple Federal banking charters, which is a model we should seek to avoid with insurance regulation.

Q.3. The Administration's proposed Consumer Financial Protection Agency (CFPA) would have authority to regulate credit insurance, mortgage insurance, and title insurance. Should the CFPA also have authority to regulate other insurance products and services? What would be the benefits and drawbacks of giving the CFPA that authority?

A.3. CFA strongly supports providing the CFPA with authority to establish minimum regulatory standards for credit-related insurance, such as credit insurance, mortgage insurance and title insurance. The sale of these products is obviously closely tied to credit transactions over which the CFPA would have authority and have been the subject of many abusive practices, such as deceptive sales practices and significant overpricing. Providing the CFPA with authority to set minimum consumer protection standards for other property-casualty insurance products and services might well be a very good idea and should be studied. The main advantage of such an approach would be to require the many States that have not had the will or the resources to establish meaningful consumer protection requirements regarding insurance rates, forms and claims practices, while allowing the States that have been effective regulators to continue to establish strong standards. A potential disadvantage is that insurance companies could try ensure that these standards are weak, as they have successfully done in many States, and then federally preempt effective regulation in the handful of States that now guarantee strong consumer protection standards.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM BAIRD WEBEL

Q.1. If Congress were to establish an optional Federal charter, how can we be sure that there would be effective consumer protections, for the products and services offered and stringent regulation of the qualifications of insurance professionals?

A.1. Under an optional Federal charter, the substance of protections for insurance consumers and the qualifications for insurance professionals would be determined by the Federal regulator according to the law enacted by Congress. While some optional Federal charter proposals have been criticized as containing fewer consumer protections than current State regulations, the substance and the locus of regulation are issues that can be considered separately. If a particular State were considered to have effective consumer protection regulation, the Federal system could adopt a similar approach.

Q.2. Could the implementation of an optional Federal charter for the insurance industry create an environment for regulator shopping?

A.2. Yes. This is a danger in any system where the regulated can choose their regulator. One central factor would be the ease of changing from one regulator to another, either in a legal sense or in a practical sense. It is possible that a Federal charter might have specific restrictions on changing regulators, such as those contained in H.R. 1880, which specifically gives the Federal regulator the power to deny a conversion from the Federal to the State system. It is also possible that practical factors may limit the attractiveness of switching regulators. For an insurer to convert from a Federal insurance charter to operating in the current State system would require regulatory submissions and approvals in the individual States, which could potentially be costly and time consuming.

Q.3. The Administration's proposed Consumer Financial Protection Agency (CFPA) would have authority to regulate credit insurance, mortgage insurance, and title insurance. Should the CFPA also have authority to regulate other insurance products and services? What would be the benefits and drawbacks of giving the CFPA that authority?

A.3. Giving the CFPA the authority to generally regulate insurance products and services would be a substantial increase in direct Federal authority over insurance. This could make it more straightforward for Members of Congress to address concerns that might arise over insurance products. Under the current system, should a Member of Congress have a specific concern over, for example, whether or not auto insurance rates should change based on a driver's zip code, the Member may consider two questions. First, is the substance of the regulatory change desirable, and second, should it be the Federal Government, as opposed to the States, regulating insurance in this way? If so, it may also be unclear who in the Federal Government would enforce the desired regulation. Including all forms of insurance under the CFPA would resolve many questions about the locus, though not the substance, of proposed Federal regulation.

Currently, insurance regulation at the State level has resulted in a patchwork system with somewhat different consumer protections across States. CFPA authority over insurance could significantly harmonize this system, could leave it essentially intact, or could result in even more disparities due to overlapping State and Federal regulation. Which outcome might occur depends largely on future CFPA regulations and court decisions.

Under the proposed CFPA language, Federal consumer protection regulations are essentially a floor—the Federal law would not preempt State laws and regulations that provide greater consumer protection than the Federal regulation. The CFPA itself decides what constitutes greater consumer protection, subject to court review. Federal banking regulators have historically interpreted broadly their preemption powers over State regulations; however, whether this would continue under the CFPA is unclear. What the substance of the CFPA regulations might be with regard to insurance is especially hard to predict as there is little existing Federal law dealing with insurance consumer protection.

One particular flashpoint could be a CFPA decision as to whether rate regulation in insurance constituted greater or lesser consumer protection, and thus whether it might be subject to Federal preemptions. Many States have forms of direct control over insurance rates. Such controls have largely been removed from Federal banking and securities regulation. Some argue that rate regulation should be considered a fundamental form of consumer protection, while others argue that it harms consumers through market distortions.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM BAIRD WEBEL

Q.1. What would be the effect of an optional Federal charter on State guarantee funds and State budgets? How are these issues addressed in legislation in Congress or proposed by the Administration?

A.1. State budgets receive significant revenues from the insurance industry. State taxes on insurance premiums amounted to more than $15 billion in 2008 and assessments, fines, and fees added approximately $3.3 billion to this. Federal chartering legislation typically has included language (*e.g.,* Section 321 of H.R. 1880) giving States the authority to continue taxing the premiums of national insurers. Assuming such language, an optional Federal charter should have little impact on State premium tax revenues. The money received by States in assessments, fines, and fees, however, may be affected. The extent of the impact would depend on precisely how many insurance companies and producers left the State system for a Federal charter or license. This is very difficult to predict, as it would largely depend on the specific details of Federal regulation and possible responses by the States to make the State system more attractive.

How State guarantee (or guaranty) funds might be addressed under a Federal charter is less straightforward than the premium tax issue, since guaranty funds are typically connected in some way to the safety and soundness regulation designed to prevent failure in the first place. CRS Report RL32175, Insurance Guaranty Funds, addresses guaranty funds in detail, and I will summarize some of the issues here. State guaranty funds are largely integrated into the State insurance regulatory system, so that those who oversee the insurers day-to-day are also essentially responsible for dealing with insurer failures if they occur. In nearly every State, the funds needed to pay for insurer insolvencies are raised by after-the-fact assessments on insurers licensed in the State. Thus, the regulatory incentives and power are relatively closely aligned and focused on avoiding insurer insolvency. Creating a dual regulatory system could change these incentives in that the day-to-day insurance regulators may no longer be the primary actors responsible for addressing insurer failures, or the funding to pay for an insurer failure may come from insurers outside the purview of the entity overseeing the insolvency. Some fear that this could weaken the focus on preventing insurer insolvency.

The treatment of guaranty funds has differed in past Federal chartering legislation. The current National Insurance Consumer Protection Act (H.R. 1880) would create a Federal guaranty fund to handle insolvencies of national insurers, while also requiring national insurers to participate in the State guarantee fund system. In the 110th Congress, the National Insurance Act of 2007 (S. 40/H.R. 3200) would have required all federally licensed insurers to participate in State guaranty funds, with the possibility of a Federal guaranty fund if the State guaranty funds do not treat national insurers in the same manner as State insurers. Versions of the National Insurance Act (S. 2509/H.R. 6225) were also introduced in the 109th Congress. In the 108th Congress, the Insurance Consumer Protection Act of 2003 (S. 1373) would have established a prefunded national insurance guaranty association and required all interstate insurers to pay into the fund. In the 107th Congress, the Insurance Industry Modernization and Consumer Protection Act (H.R. 3766) would have required all insurers electing Federal regulation to participate in State guaranty associations.

Guaranty funds, along with the vast majority of insurance regulation, are not addressed in the financial regulatory reform proposals recently advanced by the Administration.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM HAL S. SCOTT

Q.1. If Congress were to establish an optional Federal charter, how can we be sure that there would be effective consumer protections, for the products and services offered and stringent regulation of the qualifications of insurance professionals?

A.1. This could be done by creating a new consumer financial protection agency that had jurisdiction over these matters. Perhaps preferable would be to lodge this function in a division of a new consolidated supervisor and regulator, a U.S. Financial Services Authority. These options are discussed in the May 2009 Report of the Committee on Capital Markets, The Global Financial Crisis: A Plan for Regulatory Reform.

Q.2. Could the implementation of an optional Federal charter for the insurance industry create an environment for regulator shopping?

A.2. Clearly the option of a Federal or State charter does provide this opportunity. This issue could be addressed by having a mandatory Federal charter for the largest or most interstate insurance companies.

Q.3. The Administration's proposed Consumer Financial Protection Agency (CFPA) would have authority to regulate credit insurance, mortgage insurance, and title insurance. Should the CFPA also have authority to regulate other insurance products and services? What would be the benefits and drawbacks of giving the CFPA that authority?

A.3. It is problematic to have Federal consumer regulation of any services provided by State regulated insurance companies. This concern would become even more serious if the scope of CFPA regulation of insurance products were expanded. In general, Federal regulation of consumer protection for insurance products would create the situation in which Federal regulation could make insurance providers less financially sound, with the potential consequence that State guaranty funds would bear the costs. While excluding consumer regulation of banking products from the purview of the banking agencies also raises the conflict between consumer protection and safety and soundness, that conflict is entirely at the Federal level and thus is more easily resolved. The same could be said for federally regulated insurance companies (as a result of either optional or mandatory Federal charters), assuming there were also Federal guaranty funds.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM MARTIN F. GRACE

Q.1. If Congress were to establish an optional Federal charter, how can we be sure that there would be effective consumer protections, for the products and services offered and stringent regulation of the qualifications of insurance professionals?

A.1. Answer not received by time of publication.

Q.2. Could the implementation of an optional Federal charter for the insurance industry create an environment for regulator shopping?

A.2. Answer not received by time of publication.

Q.3. The Administration's proposed Consumer Financial Protection Agency (CFPA) would have authority to regulate credit insurance, mortgage insurance, and title insurance. Should the CFPA also have authority to regulate other insurance products and services? What would be the benefits and drawbacks of giving the CFPA that authority?

A.3. Answer not received by time of publication.