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EMERGING ISSUES IN INSURANCE REGULATION

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SECURITIES, INSURANCE, AND INVESTMENT

OF THE

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BANKING, HOUSING, AND URBAN AFFAIRS
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ON

EXAMINING EMERGING ISSUES IN INSURANCE REGULATION

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C O N T E N T S

WEDNESDAY, SEPTEMBER 14, 2011

WITNESSES

EMERGING ISSUES IN INSURANCE REGULATION

WEDNESDAY, SEPTEMBER 14, 2011

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 9:30 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Jack Reed, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. Let me call the hearing to order. First, unfortunately, Senator Crapo is slightly under the weather and will not be able to join us, and I regret that because he is an extraordinarily insightful, competent, and thoughtful person when it comes to these issues and a whole range of issues. But I am sure he will be back before we know it, and that is good news for us.

I want to welcome everyone to the hearing on emerging issues in insurance regulation. We take our responsibilities in this Subcommittee very seriously, Senator Crapo and I, and one of our major issues is insurance. And, frankly, this is an opportunity for us to get up to speed with experts about the current status of the industry, the challenges that the industry faces, particularly in the context of a globalized world economy and the changes that are resulting from Dodd-Frank.

The 2008 financial crisis revealed many levels of interdependencies within the financial system. Insurance companies are a vitally important component of the financial system and as investors in the financial system. Insurance companies also face challenges as asset prices fell and noncore activities of the groups such as securities lending produced large losses. However, according to recent figures provided by the Financial Stability Oversight Council, only 28 of the approximately 8,000 insurers within the United States became insolvent, and State regulators are ensuring the orderly resolution of these insurers.

The United States and international regulators are continuing to assess the financial system, and both have challenges in developing approaches to enhance the stability of the financial system in the wake of the 2008 financial crisis. Understanding the interdependencies and connections is key to assessing where the stress points can become cracks and where cracks become fissures and deep chasms.

Banking and insurance are related, but the insurance industry is fundamentally different, and our approach toward regulators must consider those differences. The Dodd-Frank Wall Street Reform and Consumer Protection Act, the Dodd-Frank Act, contains certain provisions that affect insurance regulation in a number of ways. The Dodd-Frank Act created the Federal Insurance Office, FIO, within the Treasury Department to gather information about the insurance industry and to advise the Treasury Secretary and Financial Stability Oversight Council on domestic and international insurance policy matters.

The Dodd-Frank Act recognizes the importance of having individuals with deep insurance industry expertise and experience in key roles. It also recognizes the importance of ensuring that the perspectives of insurance regulators, industry participants, and affected constituencies are considered.

Accordingly, the Dodd-Frank Act provided for an individual with insurance expertise to serve as an independent voting member of the Financial Stability Oversight Council. Further, the Dodd-Frank Act required a nonvoting member to be a State insurance commissioner.

The Treasury Department has also formed the Federal Advisory Committee on Insurance, FACI, which will provide a forum to provide advice and recommendations to the Federal Insurance Office. According to Treasury officials, members of this Committee will be announced shortly.

The Dodd-Frank elements are important considerations. However, the focus of this hearing is assessing the current state and looking forward. What is the current state of the insurance industry? How have the insurance industry and its regulations changed since the passage of the Dodd-Frank Act? What are the current emerging issues in insurance regulation? What international issues affect domestic insurance regulation? What changes or improvements, if any, can or should be made to improving the functioning of insurance regulation?

The insurance industry is vitally important, and I look forward to hearing from all of our witnesses on the emerging issues affecting insurance regulation.

One final point I might stress is that traditionally the insurance industry has been regulated by States, and I think that tradition was recognized in Dodd-Frank, and that is the context, the great context, as we proceed forward.

Now, let me introduce the witnesses and then ask them to make their statements.

First, Baird Webel is a specialist in financial economics with the CRS Government and Finance Division. He has worked at CRS, the Congressional Research Service, for more than 8 years. His focus is on financial institution policy, particularly nonhealth insurance issues, as well as the Troubled Asset Relief Program and other actions taken to address the recent financial crisis. Before joining CRS, he worked as a congressional staffer for 7 years handling a wide variety of issues. Thank you very much.

Dr. Therese "Terri" Vaughan is the chief executive officer of the National Association of Insurance Commissioners, a position she assumed in February 2009. As CEO, Dr. Vaughan oversees the operations of the NAIC and serves as the association's primary representative and chief spokesperson in Washington, DC. Over her career Dr. Vaughan has held a variety of positions in academia and regulation. Prior to her current position, she was the Robb B. Kelley Distinguished Professor of Insurance and Actuarial Science at Drake University, where she focused on the regulation and management of financial institutions. From 1994 to 2004, she was the Iowa insurance commissioner. Thank you, Doctor.

Dr. Mary Weiss is a professor, indeed the Deaver Professor of Risk, Insurance, and Healthcare Management at the Fox School of Business of Temple University. She is editor of Risk Management and Insurance Review and an coeditor for the *Journal of Risk and Insurance*. Her research has focused on financial services conglomeration, efficiency measurement of insurers, no-fault automobile insurance, reinsurance, regulation, and underwriting cycles. Dr. Weiss has been on the faculty of Temple University since 1986. Between 2009 and 2010, she served as a distinguished scholar at the NAIC's Center for Insurance Policy and Research. Thank you, Dr. Weiss.

Finally, Mr. Daniel Schwarcz, Professor, is an associate professor of law at the University of Minnesota Law School, where he teaches insurance law, health care regulation and finance, contract law, and commercial law. His research focuses on consumer protection and regulation in insurance markets with an emphasis on property casualty markets. Professor Schwarcz is also a funded consumer representative to the National Association of Insurance Commissioners. Thank you, Professor Schwarcz.

All of your statements, your written statements, will be made part of the record so you could summarize, and we ask you to keep your remarks initially to about 5 minutes, and we will start with Mr. Webel. Mr. Webel, please.

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

Mr. WEBEL. Senator Reed, thank you very much for having me here to testify today. As you said, my name is Baird Webel. I am a specialist in financial economics at the Congressional Research Service, and my written testimony covers really a wide gamut of issues that the Congress might consider in insurance. I would like to highlight two of them in my testimony here.

The first has to do with the oversight of insurers, particularly from a systemic risk perspective. Historically, insurers have always been seen as presenting very low systemic risk, and the regulatory system reflected that. The financial crisis, however, very much challenged this view both with the specific failure of AIG and the failures of the smaller bond insurers. And the question that we really faced since then is: Were these failures one-off events that were caused by a specific characteristic of the insurers? Or should these failures really cause us to challenge our previous view that insurers did not present systemic risk?

I think that if you examine the regulatory changes that have occurred both in Dodd-Frank and at the State level, to a large degree at least the implicit conclusion is that the insurers do not present large scale systemic risk. And so the focus has been on relatively smaller changes, for example, the elimination of the OTS, which was AIG's holding company regulator during the crisis.

The one change that was done in Dodd-Frank, the creation of the Financial Stability Oversight Council, really does have a promise for broad systemic risk oversight. But it really remains to be seen how much of an impact that is going to have on insurance companies. The FSOC has yet to release the list of the companies it would consider systemically significant, and at least judging by comments that were made when they put out proposed rules and the general argumentation certainly within the industry itself very much seems to be that to a large degree the insurance companies are going to remain outside of this systemic risk regulation structure that we have in the United States. And even if to the degree that the insurance holding companies may come under the purview of the Fed, it is not really clear how much of an interest or expertise the Fed has in overseeing insurance companies. It has not been a role that the Federal Reserve has played to a great deal in the past. So I think that is very much an open question as to whether or not the systemic risk provisions that were instituted will have an impact or perhaps should have an impact on insurance companies.

The other issue I think I would like to highlight is what I have termed "the convergence of financial products," and by this I mean for the past years, decades, we have seen a number of different financial products come to market that have been introduced by different types of companies, by banks or by securities firms or by insurance companies, but with relatively similar economic characteristics. This, as I said, long preceded the financial crisis. To some degree it was a spark for the 1999 Gramm-Leach-Bliley Act, and examples of what I am talking about are things like credit default swaps and financial guarantee insurance.

If you look at the economic characteristics of these things, they are pretty similar. But one is produced largely by securities firms, or at least as a securities product under securities rules. The other is an insurance product, and it is regulated by States. The content of that regulation can be very different, and when you look at it in the crisis, I think the outcome can be very different between this different content of regulation. This has happened in several other areas as well.

For example, if you look at the comparison between checking accounts and money market mutual funds, one is a banking product, one is a securities product. From an economic point of view, these things are almost identical. During the crisis we saw what was essentially a run on money market mutual funds. That was a very big event during the crisis. We did not see a run on banks. To a large degree that was because of the difference in the regulatory system, particularly, obviously, the Federal Deposit Insurance System.

Now, a functional regulatory system, which at least was envisioned in Gramm-Leach-Bliley in 1999, could take care of some of these problems by insisting that an insurance product gets regulated by an insurance regulator, regardless of whether it is a bank or an insurance company that is producing it. But in practice, we have largely continued to see a system where the regulation of the product is determined by the charter of the company that is producing it. And I think it is a particular problem in the insurance realm because with the insurance being regulated by the States, if there is a State–Federal conflict, typically it is going to be the Federal regulator that wins out.

With that, I will finish.

Chairman REED. Well, thank you very much.

Dr. Vaughan, please.

STATEMENT OF THERESE M. VAUGHAN, CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Ms. VAUGHAN. Thank you very much, Senator.

Chairman REED. Turn on your microphone.

Ms. VAUGHAN. Is that on? OK. Thank you. Thank you for the opportunity to testify today. I am Terri Vaughan. I am the CEO of the National Association of Insurance Commissioners, the standard-setting and regulatory support organization of the chief insurance regulators from the States and territories.

The NAIC is heavily focused today on international activity and issues. We are a founding member of the International Association of Insurance Supervisors, the international standard-setting body for insurance, similar to the Basel Committee and IOSCO. While the IAIS activity is nonbinding, the potential impact of its work warrants our significant involvement to ensure that our perspective is appropriately reflected.

Through the IAIS we are revising insurance core principles which form the basis of the IMF Financial Sector Assessment Program, or FSAP. During the most recent U.S. FSAP review in 2010, the IMF found that State insurance regulators observed or largely observed 25 of the 28 principles, and they noted the overall resilience of our sector through the financial crisis. Indeed, they stated that elements of our system are world leading.

The NAIC is also active in the development of the IAIS' ComFrame. This project will establish a multijurisdictional approach to group supervision for internationally active insurance groups, emphasizing robust oversight and cooperation while protecting home authorities and avoiding prescriptive new requirements.

Regulators are increasingly focused on identifying systemic risks to the financial system. Related FSOC activity could affect some insurers, and the only insurance regulator representative to FSOC is John Huff, the director of Missouri's Department of Insurance. He highlights the differences between banking and insurance to ensure that FSOC decisions will not create unintended consequences for our sector while ensuring that any potential for systemic risk, however remote, is identified and mitigated.

Meanwhile, the Financial Stability Board is addressing systemic risk through the identification of global systemically important financial institutions, or G–SIFIs. The FSB has asked an IAIS committee, vice-chaired by the NAIC, to develop the indicators for identifying globally systemic insurers in this effort. We continue to stress that the insurance business model needs to be distinguished from the banking business model when considering any new regulatory requirements.

The day-to-day supervision of insurance in the United States requires extensive coordination among State regulators. Similar efforts to coordinate at the international level are evolving. We actively pursue memoranda of understanding that support information exchanges, and we are promoting the use of supervisory colleges to assess globally active insurers.

The NAIC also chairs the IAIS' Supervisory Forum, which allows regulators to discuss emerging issues and trends and foster candid dialog on the challenges of oversight.

The NAIC engages in regulator dialogs with representatives from jurisdictions around the world along with our fellow U.S. financial regulators and agencies. We provide technical assistance to foreign regulators and have hosted more than 143 foreign insurance regulators from 24 countries in our fellowship program.

Last week a delegation of State insurance regulators, NAIC staff, and a staff member of the FIO traveled to Germany for a dialog with European counterparts. Europe is pursuing reform through Solvency II and the U.S. through our Solvency Modernization Initiative. While Solvency II is still a few years away from being operational, it will assess the solvency supervision of third countries to determine equivalence. We in the U.S. do not intend to implement Solvency II in the States, and there are clear differences between the regulatory and legal structure of our markets. We do believe that our system of supervision is at least equivalent to Solvency II on an outcomes basis.

SMI is the backbone of our domestic efforts to refine insurance oversight in the United States. It is a top–down review of our regulatory requirements, our solvency system, and it focuses on capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting, and reinsurance.

We have made changes to our model laws and regulation for holding company supervision, giving more insight into activities within a company. We are moving forward on an Own Risk and Solvency Assessment tool, which requires insurers to provide self-assessments of their risk to regulators.

Apart from SMI, we have been reducing our reliance on rating agencies, and we have worked with insurers to assess the exposure of the industry to RMBS and CMBS on a security-by-security basis. Insurer regulators are working both domestically and internationally to ensure a strong and competitive U.S. insurance market.

Thank you for the opportunity to testify today, and I look forward to answering any questions.

Chairman REED. Thank you very much, Dr. Vaughan.

Professor Weiss.

STATEMENT OF MARY A. WEISS, DEAVER PROFESSOR OF RISK, INSURANCE, AND HEALTHCARE MANAGEMENT, TEMPLE UNIVERSITY

Ms. WEISS. Thank you very much for the chance to be here. Most of my comments today will be focused on emerging issues in insurance regulation, including international issues. And so the following, I believe, are important issues in insurance regulation. Supervision of insurance groups, Federal chartering of large insurers, developments under Solvency II and the Swiss Solvency Test which might be implemented in the United States—actually, Dr. Vaughan touched on some of what I wanted to say already—leverage in the U.S. life insurance industry, and development of global accounting standards.

First let us consider the supervision of insurance groups. Most insurance in the United States is carried out by a member of an insurance group, and insurance groups are families of insurance companies under common ownership. Insurance groups can be complex and opaque in nature, and this makes regulating them very difficult. So questions have begun to be asked as to whether insurance groups or even individual insurance companies are systemically risky. And all of the evidence to date seems to indicate that insurance activities are not systemically risky. (In saying that, I am excluding credit guarantee insurance, so that might be an exception.) But most of the evidence says that insurance is not systemically risky.

However, many groups are involved in noninsurance activities, and these noninsurance activities are usually done through the subsidiary of the holding company for the group. So these subsidiaries involved in noninsurance activities may—if they are involved at all in capital markets, for example, involved in banking or if they are involved in providing credit guarantees—might be considered systemically risky. So I guess the moral of the story is insurance activities themselves are not systemically risky, but noninsurance activities that may be somewhat associated with a group can be systemically risky, and it is these noninsurance activities that really deserve the regulatory attention.

Many groups operate internationally. In spite of this, at least to date, most regulation of insurance has been national and domestic in nature. And so it would be desirable, as Dr. Vaughan mentioned already, for the regulators of a group to coordinate with each other to be able to assess the overall riskiness and the overall performance of a group. And this could be done through supervisory colleges. Supervisory colleges are in use today, but usually they are used on an ad hoc and kind of intermittent basis. And what I would suggest is that these be used on a more permanent basis so that we can avoid financial distress in a group because we would know beforehand what the riskiness of the group is.

Now let us consider optional Federal chartering of insurers. I realize you started out by saying that State regulation is the way that we are going, which I am very glad to hear about. However, if you Google *insurance,* you are going to come up with this Federal chartering of insurance issue, and I think that there are some efficiency arguments in favor of Federal chartering. However, I think that there are better arguments not to go down that road.

For example, if optional Federal chartering were to become the norm, then it would probably be the large insurers which would participate in the Federal charter, and these large insurers could present an extremely powerful lobbying force for the Federal insurance regulator so that the regulator might be subject to regulatory capture. And regulatory capture theory is an economic theory that says that regulators tend to end up serving the regulated industry rather than pursuing the traditional goals of insurance regulation.

The next thing I would like to talk about are changes in insurance regulation in Europe. As Dr. Vaughan indicated, under Solvency II companies will be required to file with regulators an Own Risk Solvency Assessment document, or an ORSA document, and I do think that that would be a good idea for the United States.

Under the Swiss Solvency Test, insurers are required to respond to very detailed questionnaires concerning corporate governance and internal controls, and some of these questionnaires are at the group level. I think that these sorts of things could also be very useful and help to enhance insurance regulation.

The fourth issue then is that although insurer assets are generally considered to be liquid and of high quality, there may be some danger signals in the life insurance industry. So life insurers have a significant investment in mortgage-backed and asset-backed securities, and these account for 18.4 percent of their assets. Even more startling is that this accounts for 169.8 percent of their surplus or their equity. And the capital-to-asset ratio for life insurers seems to be rather low. The capital-to-asset ratio for life insurers was 6.3 percent in recent years, and this compares unfavorably with banks where the capital-to-asset ratio was 10.9 percent.

The last thing I would like to talk about is global accounting for insurance. Much U.S. solvency insurance regulation relies on statutory statements. For example, capital requirements under RBC are found by multiplying factors with items that are in the statutory statements, and the NAIC also conducts extensive financial ratio analysis of insurers. But a new global accounting system is now in force in over 100 countries in the world, and insurers in Europe under Solvency II and under the Swiss Solvency Test are required to report their statements using market values. Therefore, I think that there might be a lot of pressure on U.S. insurance regulators to adopt these global standards. And if that were to happen, that would require the revamping of some of the solvency regulation that is taking place.

So these are my comments. Thank you for your time.

Chairman REED. Thank you very much, Professor Weiss.

Professor Schwarcz, please.

STATEMENT OF DANIEL SCHWARCZ, ASSOCIATE PROFESSOR, UNIVERSITY OF MINNESOTA LAW SCHOOL

Mr. SCHWARCZ. Thank you very much, Senator. State insurance regulation consists predominantly of relatively strict rules, such as capital requirements and underwriting restrictions. Such rules are often appropriate mechanisms to regulate as complex an industry as insurance. Unfortunately, State insurance regulators have historically ignored an equally vital, and much less intrusive, regulatory strategy: promoting transparency.

Currently, most States do a remarkably poor job of promoting transparent insurance markets. This failing occurs at two levels. First, most States do not empower consumers to make informed decisions among competing carriers. For instance, in personal lines markets—such as home, auto, and renters insurance—consumers have no capacity to identify or evaluate the substantial differences in carriers' insurance policies. Consumers cannot acquire policies before, or even during, purchase; instead, they receive them only weeks after the fact. Meanwhile, no disclosures warn consumers to consider differences in coverage, much less enable them to evaluate those differences.

Similar deficiencies prevent consumers from comparing carriers' claims-paying practices. Consumers neither receive nor access reliable measures of how often or how quickly carriers pay claims.

Finally, consumers are almost never informed that ostensibly independent agents typically have financial incentives to steer them to particular carriers who may not provide optimal coverage. Given this lack of transparency, it is hardly surprising that several large national companies have started to hollow out their coverage and embrace aggressive claims-handling strategies.

The failure of State regulators to provide consumers with sufficient information extends to life insurance markets as well. Perhaps the most notable example is that consumers have virtually no means of comparing prices or costs for the cash value life insurance products that different companies offer. When combined with skewed—and nondisclosed—salesperson incentives, this too has produced distressing results. For instance, a substantial majority of life insurance sold in this country is cash value, even though less expensive—and, for insurers, less profitable—term coverage is a better option for the vast majority of individuals.

The second broad transparency failing of State insurance regulators involves the absence of publicly available market information. Unlike the consumer disclosures discussed above—which must be simple, focused, and properly timed—this second form of transparency involves making detailed market information broadly available, typically through the Internet. Most consumers, of course, are unlikely to consult such information. But this form of transparency is nonetheless crucial for markets to operate effectively and efficiently because it allows market intermediaries—including consumer-oriented magazines, public interest groups, and academics—to police marketplaces, identify problems, and convey relevant information to consumers, newspapers, and lawmakers.

Currently, insurance regulation does a dismal job of making publicly available the information that market intermediaries need to perform this watchdog role. For instance, carriers' terms of coverage are not generally publicly accessible. Insurers do not post their insurance policies online, and most State insurance regulators do not maintain up-to-date or accessible records on the policies that different companies employ. Company-specific market conduct information—including data on how often claims are paid within specified time periods, how often claims are denied, how often policies are nonrenewed after a claim is filed, and how often policyholders sue for coverage—is also hidden from public scrutiny and treated as confidential. Virtually no States make available geocoded, insurer-specific application, premium, exposure, and claims data, similar to that required of lenders by the Home Mortgage Disclosure Act. Product filings with the States and the Interstate Insurance Product Regulation Commission are not made public before approval, thus precluding public comment. And even companies' annual financial statements are only accessible on the Internet for a fee, in notable contrast to the public availability of companies' SEC filings.

To be sure, the National Association of Insurance Commissioners has started to address some of these issues. But the results to date have ranged from preliminary to simply inadequate. Its model annuity and life disclosure regulations, for instance, rely on generic buyers' guides and broad standards for insurer disclosure without affirmatively developing tools that consumers need to make cross-company comparisons, such as the mortgage disclosure forms that the Consumer Financial Protection Bureau has developed in recent months. Work in the personal lines context has only recently started after years of consumer pressure. And in many domains, the NAIC has affirmatively rejected transparency. Examples include its refusal to make publicly available data on carriers' market conduct or on the availability and affordability of property insurance in specific geographic areas.

In sum, State insurance regulation has generally failed at a core task of consumer protection regulation—making complex markets comprehensible to consumers and broadly transparent to those who may act on their behalf. This type of transparency is fundamental to fostering competitive and efficient markets. Historically, State insurance regulators have responded promptly to Federal pressure: in the face of such scrutiny, they shored up solvency regulation, coordinated agent licensing, and streamlined product review. The Federal Government should apply similar pressure on State regulators to develop a robust and thoughtful transparency regime. Specifically, Congress should press the new Federal Insurance Office to work with consumer groups to assess transparency in consumer insurance markets. That office should compare the state of affairs with the transparency standards under development at the Federal level in the context of consumer credit and health insurance. The sharp contrasts that are revealed will hopefully either prompt States to correct these problems or precipitate Federal regulation doing so.

Thank you.

Chairman REED. Well, thank you very much. This is excellent testimony and I am in a very fortuitous position. I know Senator Crapo wanted to be here and would have added immensely to the hearing. He cannot, so I am left with a panel of extremely bright and knowledgeable people and the opportunity to ask lots of questions, so please bear with me.

Let me begin with Dr. Vaughan. I am going to try to cover a broad swath. But first, recently, there was an article in the *New York Times* with respect to the attempts by certain States to lure captive insurance companies to come in by making it a really attractive offer in terms of sort of the lowering what were traditional standards. In fact, the implication was that, typically, they wanted to pull some of these offshore entities into the particular States.

And it raises a question of a race to the bottom, of competition between States by lowering regulations, by being not transparent but very opaque so that companies will come there. And the question, I think, is should we be concerned? What is NAIC doing? And I think, again, sort of in response to many of the points that Professor Schwarcz raised, the goal should be sort of transparency, market information, not making it attractive to sort of, you know, hide out. So, Dr. Vaughan, you can start, and if others have comments, please.

Ms. VAUGHAN. Yes. Thank you very much, Senator. And first, I think maybe I have to explain a little bit how the NAIC operates with respect to areas outside of the captives, and then I will come back to the captives. Unless the Congress has taken some action to preempt our ability to influence each other, then we do influence each other through pressure on—we pressure the domestic State on how they regulate a company by the actions in other States with respect to whether that company can do business in their State. So if State Farm wants to do business in Iowa, the Iowa regulator has to be comfortable that Illinois is regulating State Farm effectively.

The only place where we run into difficulty in terms of the possibility of a race to the bottom is where the Congress has limited our ability to do that, and that is where we have to be very clear that we have standards at the NAIC that are going to compel States to have high quality regulation. We do that with risk retention groups. We have been working in our accreditation program to have a more effective set of standards around risk retention groups.

But I think one of the areas that the *New York Times* article had touched on was specifically in the area of life insurance, and if I could talk about that for just a minute and clear up some misunderstanding. We have had a reserving standard in insurance for life insurance companies that is what we call formula based. It is an old system, and given the complexity of some of the products that we have today, is something that needs to be updated. So we have been working on updating that.

The reserves that it establishes for some products are excessive, and we know this. And for some products, they are not adequate, and we are working on that. So we are improving that standard. In the meantime, while we improve our system of setting reserving requirements, we needed a short-term fix in order to allow companies to rightsize their reserves and that is where the use of captives in the life insurance area came up.

This is something where the regulators are watching the companies in how they are using it. We have got a lot of activity at the NAIC around making sure that what the States are doing is appropriate. And so we are, I think, comfortable that we are moving in the right direction on that. And once we get principles-based reserving in place, our reserving issues in life insurance and the use of captives should go away.

Chairman REED. Before I open it up to comments—other panelists might have comments, it is not necessary, on this particular issue—you touched on a point that has always intrigued me, which is there are different capacities at the State level to regulate insurance.

Ms. VAUGHAN. Yes.

Chairman REED. So the point that one of the checks on the operation of an insurance company home based in Illinois is that they will not be able to write insurance in Rhode Island. Well, guess what. One, we would have a very small group of people who are working very hard, but they are not aware of everything that is going on. And two, frankly, and this might be sort of urban legend, is that there is always the implicit threat, particularly in smaller States, that you are not big enough for us to worry about, so if you give us any problems, we just do not write in your State. And the commissioners are faced with the choice of do they want more products in the State or do they want to force it out. So it is a variable response.

Ms. VAUGHAN. Yes.

Chairman REED. If you are New York State or you are Illinois or you are California and you are talking to insurance companies, you talk with a lot more authority than, I would suspect, many of the other States. How does NAIC deal with that if——

Ms. VAUGHAN. Yes, and I think this goes to the process of developing national standards. Through our accreditation program, we have set some national standards that States are expected to adhere to in order to be accredited and, therefore, for their companies to be able to do business more seamlessly on a national basis.

And the process of developing those standards is very much a thorough vetting of proposals. It goes through a process where all of the States are engaged and they will participate and offer guidance. It is very transparent. We get lots of input, education from industry and consumer groups. As Professor Schwarcz mentioned, we have a funded consumer group so that they can also provide input. And so when it comes through the NAIC process, it has been very well vetted and it is something that the States are able to buy into, by and large.

You know, one of the other things I would add is that not every State—the great strength of the State system is that you do not have to have all of the expertise in every State. We do a great job of leveraging each others' expertise. So we have actuaries in a given State who will say, what is the—I have a problem in this area. Who has expertise here? And they reach out and they get help from the other State. So it is a very collaborative system, and I will say it has not always been that way. This is something that has taken us years to get to. And the NAIC has staff support that helps to make sure that that collaboration occurs when it needs to occur.

Chairman REED. Any other comments on this issue? Professor Schwarcz.

Mr. SCHWARCZ. So, notably, you will see that my testimony was focused on different issues than many of the other witnesses, and that is because it is true that solvency regulation is in many ways the core of insurance regulation. And so I think that it is a very important issue, and I actually do think that it is true that the NAIC has done a good job with its accreditation program, of monitoring one another, of ensuring that if a State is falling below levels that other States are watching. So if Rhode Island, for instance, is falling below the standards that are set at the national level, then that is not only a problem for Rhode Island. That is a problem for other States, and they are constantly watching one another.

Now, I say this to contrast it with market conduct and other forms of consumer regulation because there is no accreditation program on the market conduct side. There is no real effective way by which States pressure one another to ensure that claims are paid fairly, that issues are transparent, that policies are available.

And so I think one of the—and again, Dr. Vaughan mentioned the fact that, well, it took us a while to get to this accreditation program. How did they get there? They got there because the solvency regime was completely inadequate, resulting in a lot of insolvencies in the 1990s, and the Federal Government started noticing this, writing reports. They wrote a very well known report in insurance circles, "Failed Promises." It led to massive change at the NAIC and I do think it has been very effective.

But there has not been that level of focus on the types of issues that I am talking about, on simple issues. If you buy insurance, you should have some ability to know what that policy provides. You should have some ability to say, hey, can I see the policy beforehand? Can you tell me how it is different than other carriers? The lack of transparency is distressing and it really is a theme, I have tried to emphasize, and I think it comes from the fact that there has been such an emphasis on solvency—and rightly so. I am not saying that solvency is not important, but we have not seen action——

Chairman REED. Before—I do want to recognize—I think Professor Weiss wants to comment and Mr. Webel, too, but I think it is encouraging that both you and Dr. Vaughan have said very positive things about the solvency regime. But going back to your point about buying insurance, it is very difficult for consumers to know which is the stronger company versus which is the weaker company, particularly when you get into some of these esoteric insurance annuity products where you have to be betting that the company is there 25 years from now. I wonder if you might want to comment on that very briefly, and then Dr. Vaughan very briefly, because that issue of how do we tell people in a Web site that, yes, well, this company has a very, very good product but it is on our D list, not our A list.

Quickly, Mr. Schwarcz and then Dr. Vaughan, and then I know, Dr. Weiss, you have other comments.

Mr. SCHWARCZ. One thing I would say on that is that a simple way to do this would be to require insurers to disclose what their financial ratings are. That is another thing that States do not do that seems like a simple, easy thing to do, and they have not done it.

The other thing is we need to focus not just on the claims paying capacity but on the products. You need to be able to say, well, is the State Farm policy better than the Allstate policy? Is this annuity product better than some other? What are the costs? There needs to be—I mean, I think what we have recognized at the Federal level is it is not enough to have sort of disclosures that just inundate, that just overwhelm consumers. We need to help consumers.

Chairman REED. Dr. Vaughan, and then Dr. Weiss. I have not forgotten. Very quickly.

Ms. VAUGHAN. Thank you very much, Senator. The first thing I want to say, I agree with Professor Schwarcz that the level of our collaboration in market regulation is behind the level of collaboration in solvency regulation and that is something we have been working on for a number of years, to try to increase the collaboration.

I think we have made some great progress. We are doing more. For example, if we find a company that has a problem paying claims, we are tending to take action more on a multi-State basis now than we did 10 or 15 years ago, for example. So that is happening.

With respect to your question on how do consumers know that a company is going to be around 15 years from now, that is a critical question and that is why the solvency and the solidity of insurance companies is so important, not just on a short-term but on a long-term basis. It is a really, really tough thing. It is a tough thing for regulators to be able to say, we know that this company is going to be around in 20 years, because the marketplace changes so much.

You know, one thing is the ratings, which Professor Schwarcz mentioned, ratings by organizations like A.M. Best and Moody's and S&P. But then on the other hand, you want to not have excessive reliance on ratings. We have seen that was a problem in the financial crisis.

Chairman REED. Right.

Ms. VAUGHAN. So what we try to do is educate consumers about the critical importance of this issue. We spend a lot of money on consumer education. We created a Web site, Insure U Web site, for consumers to go to to get information so that they can make some decisions on—they have some understanding of how to look at these issues. We provide some very basic financial information on companies.

I think it is a tough one. There are not any real answers. But educating consumers about the kinds of questions that they can ask, I think, is a start.

Chairman REED. Mr. Webel, do you have a comment, because I have a broader question for Professor Weiss which I think will allow you to respond on not only this one but another aspect.

Mr. WEBEL. Yes. I was just going to circle back briefly to the captives question, and I think that it is important to recognize that different captives are doing different things. If you have captives that, for example—if a large company, if Wal-Mart wants to set up a captive to provide fire insurance for all of its stores, there may be legitimate tax and accounting reasons and risk management reasons for them to do that as opposed to not purchasing insurance at all, which is, of course, an option. And so I think that that, depending on how a captive is used and what it is doing, it presents very different questions.

I was actually struck in that *New York Times* article when they talked about the insurance companies themselves setting up captives because that is not what you typically think of.

Chairman REED. Right.

Mr. WEBEL. And the experience with the risk retention groups, the Federal Act and the captives underneath that which are limited to liability insurance and commercial insurance, has generally paralleled the experience that you have with, quote-unquote, "regular" insurance companies.

Chairman REED. I think that is an excellent point, because if this was a commercial enterprise, rather than self-insuring on a balance sheet, setting up a company for tax reasons, accounting reasons, that is a lot different than an insurance company thinking of a very sophisticated way to do something which——

Mr. WEBEL. Yes.

Chairman REED. ——to date has not been done a lot. So I would urge the NAIC to look closely at the point that Mr. Webel has raised.

Dr. Weiss, not only in response to this question——

Ms. WEISS. Shoot. That was going to be my comment.

[Laughter.]

Chairman REED. Well, I am going to give you a chance to make some comments——

Ms. WEISS. OK.

Chairman REED. ——because I thought, again, like all the testimony, yours was really superb. But you point out sort of the nature of insurance companies. Now, it is not your grandfather's or grandmother's insurance company. There are very complicated groups of different issue subsidiaries. AIG is the poster child for why we are having this conversation today, in a way, and I will over-simplify.

They had a Financial Products Group that dealt in very complicated, sophisticated products, credit default swaps, and Professor Schwarcz has talked about that sort of notion of if it is not vanilla life insurance, then we have got an issue of who regulates it. Is it the charter regulator or is this functional regulator. I think that was Mr. Webel's point, too. That is one aspect of the AIG problem, and it went colossally bad.

But one of the ironies, I recollect, is at the point they recognized in London, their Financial Products, that this was problematic and started trying to disengage, ironically, the company regulated by the Insurance Commission of New York began to start lending their securities for cash and investing that cash in mortgage-backed securities, which one hand was not talking to the other. But it raises the issue at the heart of your testimony.

You know, if this is just an old fashioned, let me say, insurance company that is writing life policy, that is reserving, *et cetera,* but now they are just—how do we deal with these different aspects of sophisticated products in one division, maybe a captive now, and we just raised that issue, and then the traditional sort of regulation by the insurance commissioner of solvency and products that are pretty much vanilla. So I will give you that opening.

Ms. WEISS. OK. Thank you. I talk a little bit about this in my written testimony, but one thing that would have prevented the AIG fiasco is if there were more cooperation among the different regulators for the subsidiaries of the holding company. So in my talk, I mention that it would be nice for insurance regulators to work together from different countries. Well, it really should extend beyond that. You should also bring in the regulators involved with the noninsurance subsidiaries so that way you will have a better idea of what goes on in the group.

And it would be sort of an example of what happens at the NAIC. The more eyes you have looking at a problem, the more likely you are to see a problem when it arises. So I think that if we had had more complete regulation or a more complete overview of AIG and all of its operations with the participation of all the regulators, that the AIG crisis would not have occurred.

You know, there are a lot of changes anticipated both in insurance regulation and in regulation of other financial institutions. So it is very important that this regulation be consistent across the different types of institutions. Otherwise, regulatory arbitrage would occur if products or capital requirements for one type of institution were different than for competing institutions.

If I can go back for just a minute about the captives and the captive article——

Chairman REED. Yes.

Ms. WEISS. ——I think that the presentation of captives in that article was a little stilted. This murky backroom kind of business is not really the way that most people think about captives. So most companies form captives because they really want to retain the risk, and if they are going to retain it, it would be nice to have a tax benefit associated with it. Otherwise, firms form captives because they really want insurance, but they want access to the reinsurance market and the captive allows them to have access.

So another thing that happens with captives, and this is particularly true for workers' compensation and for providing employee benefits through a captive, is that the captive is required to use a fronting insurer. In other words, the company that owns the captive actually has an insurance policy from a regulated insurer and then there is an understanding that that insurance company will reinsure the business with the captive. But if the captive goes broke, it is still the insurance company, the fronting insurer, that would be responsible for paying losses. So it is not quite as murky as what was made out in the article.

Chairman REED. Well, thank you.

Let me raise another issue, Professor Weiss, that you in your written testimony highlighted. You said that there are some danger signals in the life insurance industry that leverage might well be a problem for many life insurers, and we have understood from the crisis that leverage is a, not a double-edged sword, it could be a——

Ms. WEISS. It could be a contributing factor. So it is something that could allow a financial crisis, I think, to spread, that is, can spread more easily if companies are more levered. I did not bring out everything before, but also many of the investments that life insurers have are illiquid, for example, privately placed bonds. And again, if you add up private placement of bonds with all the asset-backed and mortgage-backed securities, and you compare those to insurance companies' surplus or equity, then you are talking about 300 percent of insurers' equity or a policyholder's surplus.

Now, the only thing that has to be kept in mind is that these numbers that I am throwing around are based on statutory statements and statutory accounting is very conservative, which means that it tends to understate assets and overstate liabilities. So the situation is probably not quite as serious as the initial numbers would seem to make out. Nevertheless, I think that there may be something worthwhile to investigate here, and I would hope that the investigation would show that there is nothing wrong, but I think that it does raise questions.

Chairman REED. Let me put a plug in for the Office of Financial Research, which was created under Dodd-Frank. This is one of those topics that is very important and would be something that they could provide, we hope, the kind of analytical, apolitical analysis together with NAIC, *et cetera*, so that we really do have a sort of a forecast, if you will, or whether there is a storm growing or this is just, you know, sort of background.

Ms. WEISS. Yes.

Chairman REED. But thank you very much for that point.

Let me shift back, again, to Dr. Schwarcz, but if someone has comments, please feel free. You have made the point, I think very articulately, about the opaqueness of the system from the consumer's perspective. Typically, in my very limited responsibility, you buy insurance based upon two things: One, either the brand or the company you like, or the agent who is the Little League coach in your neighborhood. So a lot of what we presume is being done in terms of guiding consumers through this, you know, the solvency of the company, the appropriateness of product, is being done by the agents.

One of the points you make in your testimony is the potential conflict of interest of agents being steered to particular products because of compensation. We saw this dramatically and disastrously in the mortgage broker business. But let me raise the issue specifically about your point about the steering phenomenon, but more importantly the role of the agents. Do they know enough, and it goes back to Dr. Vaughan, *et cetera,* and are they, in terms of the licensing requirements, have the kind of responsibilities to their clients that would force them, require them to search out some of the information that you think is very opaque. Professor Schwarcz.

Mr. SCHWARCZ. Thank you very much. So I think it is a very important issue. Let me first distinguish between two types of agents that really populate these markets. There are captive agents, which work just for one company, and those tend to dominate many of the consumer lines. So you go to the agent that you know. You maybe go to a company. But at that point, you have already made a choice about a company.

So you have gotten zero guidance from the marketplace, from the NAIC, from public information, about, well, does Allstate pay claims more quickly than State Farm? Do they tend to deny claims more? Is their policy less restrictive? Can I find out if their policy is less restrictive? Can I even get a copy of that policy and compare it if I happen to be sophisticated? So there are not—so many consumers bypass that type of guidance because it is cheaper. Now, there is something to be said for that. But the fact that we have agents, even if we had really great independent agents, would remedy that problem.

But there are independent agents and independent agents have the capacity to probably, or to potentially solve some of these problems. The problem is, even these independent agents, first, do not have some of the information I am talking about. They do not know—all they have is sort of their own personal experience. They do not have concrete information on how quickly different carriers pay claims. They may have the policy forms, but if you actually talk to a lot of independent agents, they do not necessarily have the expertise to say, well, gee, this policy is more generous or less generous than others. Some do. Many do not, though.

But the final point is that even with respect to the independent agents, and that is maybe, depending on the market, 20, 30 percent of agents out there, they—very often, they are going to get higher commissions for sending you from one company to another. Sometimes, that will be really clear, because one agent will get 17 percent from one company and 15 percent from another. Sometimes, it is very opaque, because the way that the commissions are calculated is based on a year-end calculation and it is very hard to actually say how the incentives are going to work out. I mean, you may have—it creates all sorts of dynamics that are not really obvious.

So a simple solution is to say you cannot call yourself an independent agent unless you receive the same compensation from all companies. Otherwise, you are not really independent and you have to provide a disclaimer. Nothing like that is done.

And what is shocking to me is that so much attention was paid to this issue when Eliot Spitzer sued Marsh and Aon many years ago and it became a huge issue in the commercial insurance market, all sorts of regulations to deal with it. Nothing happened in the consumer insurance market. There is no disclosure, by and large. New York has been trying to do it. No other State has really tried to deal with this issue. No States have tried to pressure independent agents to disclose their commissions or to accept—so to me, it is shocking that something that really is about consumer or purchaser information, so much more emphasis was placed on the commercial market where we expect buyers to be sophisticated and root out this information and nothing has been done where we actually think—where it is much more likely that the problem will occur. I am still mystified by that.

Chairman REED. Dr. Vaughan, I think you want to respond.

Ms. VAUGHAN. Thank you very much, Senator. I share Professor Schwarcz's passion for consumer disclosure, consumer information, and educated consumers. I think an consumer is—they are the front line in making sure that the right decisions are made. And we have spent—I have already mentioned to you some of the things that we have tried to do at the NAIC in terms of consumer outreach, creating our Insure U Web site and having a consumer information source where consumers can go and get some basic information about the company, including, for example, the complaints about—complaints that have been made about companies and how the level of complaints compares to others. More recently, we have done consumer guides for homeowners and auto insurance.

But I think the more interesting project is one that Professor Schwarcz is actually providing some input into and that is our new Working Group on Transparency and Readability of Consumer Information. This was something that the funded consumer representatives recommended, that we have greater focus on consumer disclosures, and so we have a working group that is looking at things like should we have some kind of a guide that will help consumers better understand variations in coverage, answers to specific coverage questions, underwriting guidelines, how rates are determined, mandatory coverages and discounts. What kinds of rate disclosures, rate comparison guides should we recommend that States have? How can we better give consumers the ability to comparison shop on the basis of differences in coverage?

So this work is ongoing. We have recently, as a result of the Patient Protection and Affordable Care Act, health insurance reform, we have worked on disclosures for health insurance and so we have some experience in how these might work and this working group is moving forward.

Chairman REED. Just in response to Professor Schwarcz's comments about the compensation arrangements with the agents, are you working on that issue, because again, my experience in Rhode Island is these people are not only very competent and very decent, but community leaders, *et cetera,* so they are good people——

Ms. VAUGHAN. Right.

Chairman REED. ——except when you have a situation where the economics is such that you can direct people to one policy, which is not a bad policy but it might not be the best policy. Are you working on that?

Ms. VAUGHAN. Right. Well, after the activities related to—that Professor Schwarcz mentioned——

Chairman REED. Right.

Ms. VAUGHAN. ——Attorney General Spitzer's activities, the NAIC did have a group that worked on this issue and made some changes to our producer licensing, Model Producer Licensing Act, that addressed disclosure. I would be happy to go back and see what has happened with that and whether anything further has——

Chairman REED. Just let me make a comment, too, and again, I think the NAIC has been doing a very good job, but it is like every institution. It is a competition. You play at a high level if the competition is there. Interestingly enough, some of the discussion of the Federal charter, I think, energized the States and NAIC to be much more proactive because, frankly, a lot of arguments about the Federal charter was, well, you know, it would be better in terms of protecting consumers, better in terms of solvency, *et cetera.* And the Attorney Generals' actions, not just New York but around the country, that is a human phenomena. But again, these issues are coming at us so fast and so furiously. Your work is not only appreciated, but——

Ms. VAUGHAN. Thank you. Thank you, Senator.

Chairman REED. Keep it up, and——

Ms. VAUGHAN. Thank you, Senator. I have——

Chairman REED. Keep moving faster.

Ms. VAUGHAN. All right. I have to say, I have always said I appreciate that Congress puts some pressure on us because it makes us up our game.

Chairman REED. Well, that is—I think the purpose of this hearing is not so much pressure, but this is an important set of issues and we want to devote ourselves to listening but also providing at least support for your efforts and suggestions based upon the panel of places we have to do more.

Let me just turn to another, just a comment. That is, in your notion, too, about simplifying, *et cetera,* the Consumer Financial Protection Bureau, and Professor Schwarcz mentioned this, has now modeled mortgage sort of language. I presume that you are working toward, your comments, sort of model language for disclosures, for transparency. Is that——

Ms. VAUGHAN. That is what we did in the health insurance side.

Chairman REED. Right.

Ms. VAUGHAN. And that is—this working group is discussing how to do that. I have to say, my suspicion is it is going to be a little harder in insurance given the variety of the products. It is a little more complex than it is in the mortgage area.

Chairman REED. Right. But I think for that reason also it might be even more necessary so that your efforts are appreciated and should be expedited.

Let me just open this question up, and, again, it is probably Dr. Vaughan and Dr. Weiss, but anyone—and Mr. Webel. In the crisis several insurance companies got help from the Fed, and because of liquidity issues, because of other issues. Stepping back, are you concerned about companies that in a very difficult time—and this goes back to the point that Dr. Weiss raised in her testimony about the stress test essentially that Europeans are using. Are you contemplating or is NAIC contemplating or States contemplating the kind of stress testing that is done now routinely in Europe that will essentially at least help us predict those companies that may be in a range, that would need assistance? Because the point is that after Dodd-Frank the appetite by the Fed, even, to come up with these ingenious ways to help is much less, and certainly the public appetite is probably nonexistent.

Ms. VAUGHAN. Senator, thanks very much for raising that subject. I have to say that often what we do at the NAIC we do not talk about a lot publicly, and so while there was a lot of public discussion about stress testing in the banking sector and the insurance sector in Europe, this is something that we have done behind the scenes for some time. Insurance companies have to provide cash-flow testing that looks at the results of their cash-flows over a period of time in the future under different scenarios. This is a requirement we have had for life insurance companies for some time. They have to look at what the results would be under a variety of interest rate scenarios. So we have looked at low interest rate scenarios for some time to see what the impact might be.

There is a constant sort of improvement, sort of continuous improvement that goes on in insurance regulation through the States and through the NAIC, and as a result of this crisis—and I think Mary's comments about liquidity—not liquidity issues, the leverage issues in the life insurance industry, are very well taken. As she pointed out, you have to be careful about the numbers because the accounting regimes are different. And our tradition in insurance regulation has been to have very conservative financial statements, so we have certain assets we do not count. We do not let the insurance companies count them. We have conservative liabilities, and this is something that has helped us during times of financial crisis.

As we move forward, we know that, you know, the markets are changing, things are getting more complex. There are more complicated ways for companies to take risk now, and we have to continue to improve our tools in order to understand how that risk is being taken. That is why we have recently amended our holding company model so that we can get more information from other areas of the firm and do a better job of group supervision and looking at risks throughout the group. We have created a new reporting requirement for insurance companies, an enterprise risk filing requirement where they have to report to us the risks and their management of those risks. We are looking at some kind of a group capital assessment. So we are constantly, constantly creating new tools in recognition of the complexity that is there.

Stress testing is not a new tool for us. We just have not been as public about it as some.

Chairman REED. I should know the answer, but let me ask the question. You promulgate model codes and best practices, *et cetera,* but the States are not required to take them up. In fact, I would assume that the State Assembly would have to pass the laws to effectively actuate what you recommend. So other than moral suasion, how do you get the States—because there is—again, with the issue of arbitrage, there is always the attractiveness of saying, yes, this is a great model, but if we do not have it, then we can—they can flock to us.

Ms. VAUGHAN. Right.

Chairman REED. And the other context of that is just, you know, one of the big discriminators among States is their tax regimes. But just the question of how do you sort of ensure that all of this good stuff is being done by every State and not just the most progressive?

Ms. VAUGHAN. This is where our accreditation program comes in. The accreditation program, we have a committee of regulators that are constantly looking at States to make sure that they have the standards that we have set for the accreditation program in place. We annually look at the laws of the State. We go in every 5 years actually for an onsite visit to see: Does the State do examinations properly? Do they do analysis properly? Do they get the kind of company reports that they should be getting?

And the accreditation program, the hook in the accreditation program is that it is a stamp, sort of a Good Housekeeping Seal of Approval on a State system of solvency regulation. So that if a State is not accredited, then other States are not going to accept that State's supervision of its domestic companies.

I recall a time back when I was a commissioner, so this goes back many years, we had a State that had some issues. We went in, looked at their examinations, and had concerns about the way they were doing examinations, and their accreditation was suspended for a period of time. They had a very large national company that was based in that State, and as a result, we said—the rest of the State said we are not going to accept the examination that you do on this company. And we had to put together a team of examiners from other States to go in and examine the company.

So that is how this multi-State peer pressure and checks and balances work, and I personally think it is a very effective system.

Chairman REED. Dr. Weiss, please.

Ms. WEISS. I would just like to add, since Dr. Vaughan did not mention it, there is also the work of the Financial Analysis Working Group. I will let Dr. Vaughan talk about it because she is more familiar with it. But I think that that also goes to your question.

Ms. VAUGHAN. Thank you, Dr. Weiss. The Financial Analysis Working Group was created in the early to mid-1990s, and it is the top insurance regulators from around the country. I cannot remember, 14 or 16 of the most senior regulators. They have been through the wars. They have had troubled companies. They know how to look at financial statements. They know what things companies do when they start to get into trouble. And it serves as a kind of peer review and support mechanism for a State that has a company that might be in trouble.

We have a team of people at the NAIC called the Financial Analysis Division that is constantly monitoring nationally significant insurance companies. They are looking at things like their annual statements that they file with the NAIC. They are looking at public company statements, the SEC filings, credit spreads on the company's debt, short sales of the company's stock—just anything that you can get your hands on, constantly scanning. If they see an issue, then it is referred to the Financial Analysis Working Group, and the Financial Analysis Working Group will either send a letter to the State saying, "Tell us about this." Or they will say, "Come on in and talk to us about this." And then the regulator from that State will go in and be asked a series of questions that they are sort of expected to be able to answer.

So I have used the phrase sometimes, you know, there is always a question who watches the regulators, and one of the great strengths of our system is that we watch each other. We call each other on the carpet. And that was very effective during the financial crisis when we had—you know, everyone was concerned about a variety of issues, and it was a way to get the right level of communication and coordination across the States around companies that people had questions about.

Chairman REED. Thank you.

Just a quick question to Professor Schwarcz, and then I want to wind up by sort of polling you all on what questions we missed and what insights you want to leave with us. But in your testimony, Professor Schwarcz, you talked about in terms of homeowner insurance, systematically more expensive and less available in certain low-income urban areas, which is a problem, obviously. It harkens back to red-lining and things like that. How can we deal with that? That is a problem, I presume.

Mr. SCHWARCZ. Yes. The truth of the matter is we do not have enough evidence. The reason we do not have enough evidence—we have some States that make data available on a geo-coded basis so you can see in specific regions is the insurance systematically less available and more expensive. But very few—the vast majority of States do not make this information available, and it is the exact same information that is required at the Federal level by mortgage lenders under the Home Mortgage Disclosure Act.

Now, there is a provision in Dodd-Frank that authorizes the Federal Insurance Office to collect this information, but what is unclear—and I do not know the answer to this—is, one, whether they are required to collect this information; and, two, whether they are going to disclose it. And I just want to emphasize the way to watch the regulators is to have transparent information so that the public can see what they are doing and can call them on the problems. We do not have that transparency in all of the respects that I talk about in my written testimony. And to me that is the fundamental problem.

So the way to do is very simple. Require States to—or have the Federal Insurance Office to disclose this information.

Chairman REED. Let me just follow up with another quick question raised by your testimony. You point out the number of bond issuers that have failed causing higher costs to municipalities. Baird, this is your question. Some of it is because regulators failed to appreciate the additional risks that they were taking on, that they were getting into mortgage-backed securities as well as a much more placid market for municipal securities. And I wonder, what actions have you seen to address this problem, and what actions would you suggest?

Mr. WEBEL. Well, I think that—as you said, what happened is they moved from municipal securities into mortgage-backed securities, thinking that since, among other things, housing prices had never gone down in the United States, it should not be a problem. To a large degree it has really been the market response that has taken care of the problem in the sense that people are not really trusting the financial guarantee insurers anymore. I think it is questionable whether the market needs this kind of guarantee insurance or whether it was just sort of a historical accident that it still existed.

There has been, I think, increased oversight on it by the State regulators, an appreciation of the dangers there, because what had largely happened is the State regulators were concentrated on an overall solvency question; whereas, the companies themselves were depending on AAA ratings. So the downgrade of the bond insurers essentially ended their business even though the companies may have still been completely solvent, but the regulators were not at the time paying attention to that. Now, of course, they appreciate those risks much more. But at the moment, I think there is only one monoline insurer that is still actually actively writing insurance. Warren Buffett created a new one to get into the market and then has largely suspended operations because he does not see it as a profitable place to be. So whether or not the entire sectors served the market need or will it continue to exist is a very open question.

Chairman REED. Well, let me go ahead and ask you now just a final open-ended question. What are the issues we have missed? What are your big concerns going forward in terms of the industry that we should focus on or we should encourage the State regulators to focus on? Baird, you might start out.

Ms. WEBEL. I think one of the things that was now—it was certainly touched on, the international aspects, the European Union Solvency II, the question of equivalence. There will inevitably be—if it comes to the point where the Europeans are not going to recognize the American system as equivalent—certainly a great hue and cry about disadvantages that it might put our insurers at, and I just would want to bring up a question of, whether, sometimes an equivalency decision, if it is not truly equivalent, can cause greater problems than it solves. AIG largely became an OTS holding company because it wanted equivalency with Europe, and got it. And then 10 years later, because the OTS supervision was not equivalent to it——

Chairman REED. The British FRA, too.

Ms. WEBEL. Right. This is where we ended up. So sometimes the concept of having an internationally competitive financial services industry leads you down the road to Iceland, and I think that that is something that probably needs to be kept in mind going forward.

Chairman REED. And I think that is also something, with these new members, the FSOC, the new office in Treasury, is something that they have to be acutely aware of, because, you know, one of the sort of institutional impediments is that we had, you know, the NAIC that was representing the States, but we had this sort of gap between NAIC and who is going to be negotiating with the G–7, G–20, and the EU in terms of these standards.

Mr. WEBEL. Yes.

Chairman REED. So that is a point well taken and one that is clearly within our framework of what we should be worrying about at the Federal level.

Your generalized comments and conclusion, Dr. Vaughan?

Ms. VAUGHAN. I would say I just agree with Baird completely that the international is an area to pay attention to. Since the financial crisis, the International Association of Insurance Supervisors has become more and more important, and the activities of the Financial Stability Board in the area of insurance have become more important. There are certain pressures coming down to the IAIS from the Financial Stability Board, and a lot of this is driven by the question of how do we supervise internationally active insurance groups. Internationally active insurance groups tend to be among the most complex of the groups, and so how do we do it?

I do not know if Baird exactly said this. You raised some questions about the whole concept of equivalence, and I share sort of the questions he raised. The NAIC's view is that this really should not—the ultimate answer is not about a series of bilateral equivalence assessments—you know, the U.S. and Europe, the U.S. and Japan, Japan and Europe, Bermuda and the U.S. That is not the way to do this. The way to do this is to do it at an international level through the International Association of Insurance Supervisors and focus on building a system with the kinds of checks and balances that we have that we know work when you have entities that are operating in multiple jurisdictions—something that is focused on collaboration and communication. We are working very, very hard to try to make sure that that philosophy gets into the international arena.

Chairman REED. Thank you.

Dr. Weiss, again, your insights, conclusions, what we have missed and what we should be thinking about.

Ms. WEISS. I would just follow up on what Dr. Vaughan said. International cooperation and commitment should really involves all regulators associated with the activities of the groups so that we actually have cooperation from banking regulators and the regulators from other financial institutions.

One other comment I might make is that it seems that when Dr. Vaughan and Mr. Schwarcz were talking about consumer affairs, it occurred to me that the conversation that was going on was at two different levels. So I heard Dr. Vaughan saying that the NAIC is very much concerned with educating consumers and has put a lot of effort into trying to explain underwriting. But it seemed to me that what Mr. Schwarcz was talking about was much more specific, for example, being able to compare insurance products at different institutions and actually post—it almost sounded like recommendations—as to which insurers might have the best policies. And I am not sure that advocating certain insurance companies is really the best thing for the insurance regulator to be directly involved with. This is just something that I cannot quite connect in my brain.

Chairman REED. Thank you very much.

Professor Schwarcz.

Mr. SCHWARCZ. Thank you. It is true that there is a disconnect in terms of what the NAIC is doing and what a lot of people are talking about in terms of my testimony. The NAIC's approach has been: We will tell you about insurance; we will teach you about insurance. We are not going to tell you anything about any particular company because God forbid we recommend someone and then we have that company coming in lobbying us.

Well, the way you have to have disclosure is not by telling people here is what insurance is and here are the questions you need to think about. You need to provide them with the information they need to make decisions. That is what the Consumer Financial Protection Bureau is doing with their mortgage disclosure document. They are not recommending particular carriers, but they are saying: Here is what you need to know. Here are the numbers you need to know and compare. Here are the important terms you need to know and compare. They are empowering consumers to make decisions, because we have realized that it is not the case that consumers can navigate immensely complex markets.

So I really just want to fundamentally disagree with the notion that we can just provide generic buyers' guides and general information and not take seriously the fact that empowering consumers is hard, and it means providing good information that is tested, that is specific, and that may make some companies look bad and then force them to do a better job. You know, if that is the market response, that helps the market.

The other thing I just want to finish up on is it is true that the NAIC did a fantastic job on health insurance disclosures, and contrast that with what they have done in other areas and ask why. It is because they were forced to by PPACA, which required them or told them to draft this type of disclosure, that their disclosures were inadequate, that they were not fostering a transparent market. And then they acted, and they did an admirable job.

So my claim is not that State insurance regulators cannot do this. It is that they do not do it until they are pressured. We saw the same thing in solvency regulation where now they are—as I said, they are doing a nice job after the pressure. And you made that point, too. So I really want to—I hope that you and your fellow Senators and policymakers keep the pressure up and say: What are you doing on these disclosures? Why is there such a difference in health insurance versus other areas? Why can't I know whether my agent who is telling me something has financial incentives to sell me a particular policy? Why can't I compare cash value products and have some sense of what is going on in the marketplace? Because the notion—I mean, it really is a problem, and it is a problem that is underaddressed because everyone is so focused on solvency that they forget all these other important regulatory issues.

Chairman REED. Well, thank you all very, very much. This has been an extraordinarily thoughtful panel, and I have had, as I said, the luxury of being able to ask a number of questions and engage in, I think, a very interesting and collaborative discussion on these issues. I thank you all. Your testimony has been thoughtful, and it will be of great assistance to us as we go forward.

Again, we do recognize that this is typically the province of States, and the NAIC, whether of their own volition or because of the encouragement, has been taking a lead in many important issues. But we still have important Federal areas and particularly as we get to the international arena.

Now, my colleagues may have written statements which they will submit for the record or additional questions, and we will get those questions to you. I would ask that any of my colleagues, who obviously are not present but very well may have questions, submit them by Wednesday, September 21st, and then we will get them to you and ask the witnesses to respond as quickly as possible, within 2 weeks if you can.

Again, thank you. We will note that the record will be closed after 6 weeks in order that we can print it, but if there is additional material you would like to submit or anything else, responses, please do so.

With that, again, let me thank the panel for extraordinarily insightful testimony, and the hearing is adjourned.

[Whereupon, at 10:55 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN JACK REED

I want to welcome everyone to our hearing this morning entitled "Emerging Issues in Insurance Regulation."

The 2008 financial crisis revealed many levels of interdependencies within the financial system. Insurance companies are an important component of the financial system. They are also investors in the financial system. During the financial crisis of 2008, insurance companies also faced challenges as asset prices fell and noncore activities of the group, such as securities lending, produced large losses. However, according to recent figures provided by the Financial Stability Oversight Council, only 28 of the approximately 8,000 insurers became insolvent.

Since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), U.S. and international regulators are continuing to assess the financial system. Both have challenges at developing approaches to enhance the stability of the financial system. Understanding the interdependencies and connections between financial players is one of the keys to assessing where the stress points can become cracks, and where cracks can become holes.

Banking and insurance are related, but the insurance industry is fundamentally different and our approach toward overseeing such firms must consider those differences.

Dodd-Frank Act contains a number of provisions that affect insurance firms and regulation of insurance in a number of ways. The Dodd-Frank Act created a Federal Insurance Office (FIO) within the Treasury Department to gather information about the insurance industry and to advise the Treasury Secretary and Financial Stability Oversight Council on both domestic and international insurance policy matters.

The Dodd-Frank Act also recognizes the importance of having individuals with deep insurance industry expertise and experience in key oversight roles. In particular, the Dodd-Frank Act provided for an individual with insurance expertise to serve as an independent voting member of the Financial Stability Oversight Council and required a State insurance commissioner to be a nonvoting member.

The Treasury Department also has decided to form a Federal Advisory Committee on Insurance (FACI), which will provide a forum to provide advice and recommendations to the new Federal Insurance Office. According to Treasury officials, members of this committee will be announced shortly.

Although the new provisions affecting the business of insurance in the Dodd-Frank Act are important considerations, the focus of this morning's hearing is assessing the current state and of the insurance industry. How has the insurance industry and its regulation changed since the passage of the Dodd-Frank Act? What are the current issues in the area of insurance that Congress and regulators should be paying attention to? What international issues affect insurance regulation? What changes or improvements, if any, can or should be made to improve the functioning of insurance regulation? The American insurance industry is vitally important, and I look forward to hearing from all of our witnesses on this topic.

PREPARED STATEMENT OF BAIRD WEBEL

SPECIALIST IN FINANCIAL ECONOMICS, CONGRESSIONAL RESEARCH SERVICE

SEPTEMBER 14, 2011

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 addressing issues in insurance regulation that may be the focus of the Committee's attention. It begins with a brief introduction on the insurance sector and the regulation of insurance. Following this is a discussion of the role insurance played in the recent financial crisis, the recent Dodd-Frank Act, and the issues arising from the crisis and Dodd-Frank. Finally, my testimony will briefly summarize current proposals addressing insurance regulation at the Federal level and the ongoing issues that this legislation addresses.

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.

The Insurance Industry and the Regulation of Insurance

Insurance companies constitute a major segment of the U.S. financial services industry. The industry is often separated into life and health insurance companies, which also often offer annuity products, and property and casualty insurance companies, which include most other lines of insurance, such as homeowners insurance, automobile insurance, and various commercial lines of insurance purchased by businesses. Premiums for life/health companies in 2010 totaled $543.4 billion and life/health companies held $5.3 trillion in assets. Premiums for property/casualty insurance companies totaled $424.7 billion and these companies held $1.6 trillion in assets.[1] In general, the insurance industry has weathered the recent financial crisis and its aftermath fairly well. A.M. Best, an insurance rating firm, reports a total of 29 insurer impairments from 2008 to 2010.[2] In contrast, the Federal Deposit Insurance Corporation's (FDIC's) Failed Bank List includes more than 320 banks in the same time period.[3] The current year could prove challenging with insurer exposure to sovereign debt and a relatively large number of catastrophic weather events.

Different lines of insurance present very different characteristics and risks. Life insurance is typically a longer-term proposition with contracts stretching into decades and insurance risks that are relatively well defined in actuarial tables. Property/casualty insurance is typically a shorter-term proposition with 6 month or 1 year contracts and greater exposure to catastrophic risks. Health insurance has evolved in a very different direction, with many insurance companies heavily involved with healthcare delivery including negotiating contracts with physicians and hospitals and a regulatory system much more influenced by the Federal Government through Medicare, Medicaid, the Employee Retirement Income Security Act of 1974 (ERISA),[4] and the Patient Protection and Affordable Care Act (PPACA).[5] When this testimony refers to "insurance," it addresses life insurance and property/casualty insurance unless health insurance is specifically included.[6]

Insurance companies, unlike banks and securities firms, have been chartered and regulated solely by the States for the past 150 years. One important reason for this is an 1868 U.S. Supreme Court decision.[7] In *Paul v. Virginia*, the Court held that the issuance of an insurance policy was not a transaction occurring in interstate commerce and thus not subject to regulation by the Federal Government under the Commerce Clause of the U.S. Constitution. Courts followed that precedent for the next 75 years. In a 1944 decision, captioned *U.S. v. South-Eastern Underwriters Association,* the Court found that the Federal antitrust laws were applicable to an insurance association's interstate activities in restraint of trade.[8] Although the 1944 Court did not specifically overrule its prior holding in Paul, South-Eastern Underwriters created significant apprehension about the continued viability of State insurance regulation and taxation of insurance premiums. By 1944, the State insurance regulatory structure was well established, and a joint effort by State regulators and insurance industry leaders to overturn the decision legislatively led to the passage of the McCarran-Ferguson Act of 1945.[9] The Act's primary purpose was to preserve the States' authority to regulate and tax insurance.[10] The Act also granted a Federal antitrust exemption to the insurance industry for "the business of insurance."[11]

Since the passage of McCarran-Ferguson, both Congress and the Federal courts have taken actions that have somewhat expanded the reach of the Federal Government into the insurance sphere. The two large overhauls of financial regulation in the last two decades, the Gramm-Leach-Bliley Act of 1999 (GLBA)[12] and the Dodd-

[1] Statistics from A.M. Best, 2011 Statistical Study: U.S. Property/Casualty—2010 Financial Results, March 28, 2011, and A.M. Best, 2011 Statistical Study: U.S. Life/Health—2010 Financial Results, March 28, 2011. Premium amounts used are net premiums written; assets amounts are admitted assets.

[2] A.M. Best, "Best's Impairment Rate and Rating Transition Study—1977 to 2010", May 16, 2011.

[3] *http://www.fdic.gov/bank/individual/failed/banklist.html*

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

[5] P.L. 111-148, 124 Stat. 119.

[6] For more information on health insurance, see CRS Report RL32237, "Health Insurance: A Primer", by Bernadette Fernandez.

[7] *Paul v. Virginia,* 75 U.S. (8 Wall.) 168 (1868).

[8] *U.S. v. South-Eastern Underwriters Association*, 322 U.S. 533 (1944).

[9] 15 U.S.C. Sec. 1011 *et seq.*

[10] Richard Cordero, "Exemption or Immunity From Federal Antitrust Liability Under McCarran-Ferguson (15 U.S.C. 1011-1013) and State Action and Noer-Pennington Doctrines for Business of Insurance and Persons Engaged in It", 116 ALR Fed 163, 194 (1993).

[11] 15 U.S.C. §1012(b). The Supreme Court has made clear that the business of insurance does not include all business of insurers. *Group Health and Life Insurance, Co. v. Royal Drug, Co.,* 440 U.S. 205, 279 (1979). For further explanation of this distinction, *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.

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

Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank),[13] expanded the Federal role in insurance to some degree but the States continued as the primary regulators of insurance following these acts.

GLBA removed legal barriers between securities firms, banks, and insurers, allowing these firms to coexist under a financial holding company structure. Such a holding company was overseen by an umbrella regulator—the Federal Reserve for holding companies, which included bank subsidiaries, or the Office of Thrift Supervision (OTS), for holding companies with thrift or savings association subsidiaries. Within the holding company, GLBA established a system of functional regulation for bank, thrift, securities, and insurance subsidiaries of holding companies. This meant that insurance company subsidiaries within a bank or thrift holding company were functionally regulated by State insurance authorities, with limited oversight by the Federal regulator of the holding company. Should there be no functional regulator for a subsidiary, the financial holding company regulator assumed primary regulatory responsibility for that subsidiary.

The Dodd-Frank Act altered the GLBA structure, although to a large degree it left the basic functional regulatory structure intact. It appears that the Act will affect insurance regulation in three primary ways: (1) the creation of a Federal Insurance Office (FIO) with information gathering and very limited preemptive powers; (2) the provisions addressing systemic risk, such as the creation of a Financial Stability Oversight Council (FSOC) with the authority to oversee systemically important nonbank financial firms, including insurers; and (3) the provisions harmonizing[14] the tax and regulatory treatment of surplus lines insurance and reinsurance (the Nonadmitted and Reinsurance Reform Act).[15] Under Dodd-Frank, primary regulatory power over insurance firms continues to rest with the individual States and there is no Federal chartering authority.

Issues Arising From the Recent Financial Crisis

In the past, insurance has generally been seen as presenting little systemic risk. The recent financial crisis brought this assumption into question with the individual failure of American International Group (AIG) and the multiple failures of monoline bond insurers. These failures brought issues to the fore that are likely to remain issues before Congress and financial regulators in the future.

AIG and the Oversight of Large and Complex Insurers

The failure of AIG was one of the most prominent business failure during the financial crisis and might be used as a case study of what can go wrong in overseeing a large, complex financial institution. AIG was a large company, with more than 175 subsidiaries identified by the National Association of Insurance Commissioners (NAIC). It listed a total of more than $1 trillion in assets in its 2007 annual filing with the Securities and Exchange Commission (SEC). Although most of the subsidiaries of AIG were, and are, insurance companies, AIG also had a thrift subsidiary, which put the entire holding company under the umbrella supervision of the OTS. AIG's derivatives operation, its Financial Products division (AIGFP), dealt in financial products not within the jurisdiction of any of the Federal functional regulators. OTS as umbrella regulator of the AIG holding company was responsible for overseeing AIGFP. Thus, the Federal regulator of the thrift industry, OTS, had broad oversight over a holding company with approximately $1 trillion in assets that listed its business as "insurance and insurance-related activities"[16] and specific oversight on a derivatives subsidiary with $2 trillion in notional value of derivatives outstanding.

AIG's failure is generally perceived to have resulted from risk-taking that flourished in holes created by overlapping, but incomplete oversight. AIGFP took on billions of dollars in liabilities from credit default swaps (CDS) tied to the U.S. housing market while securities from the insurance subsidiaries were being transferred to another AIG subsidiary for a securities lending program. The collateral for this securities lending was also invested in securities tied to the U.S. housing market. Paradoxically, the securities lending program was increasing its exposure to the housing market at the same time (2006) that AIGFP had concluded that it was overexposed to this market and was attempting to reduce its risks. As the housing mar-

[13] P.L. 111-203, 124 Stat. 1376.
[14] These provisions had been introduced as separate legislation before being included in Dodd-Frank.
[15] For more information on the specific insurance provisions in the Dodd-Frank Act, *see,* CRS Report R41372, "The Dodd-Frank Wall Street Reform and Consumer Protection Act: Insurance Provisions", by Baird Webel.
[16] American International Group, Annual Report (Form 10-K) for the fiscal year ended December 31, 2007, February 28, 2008, p. 3.

ket slumped and the financial markets reached a panic state in September 2008, billions of dollars flowed out of AIG as a result of losses in both CDS and the securities lending program. Ultimately, the Federal Reserve and U.S. Treasury extended approximately $200 billion in financial commitments to prevent an AIG default.

Regulatory lapses associated with AIG have been indentified at multiple levels. In hindsight, it appears that whatever company-wide risk assessments were performed by AIG or by OTS underestimated the scope of its exposure to the housing market. It also appears that OTS either did not understand the risk inherent in the CDS being sold by AIG or did not seriously consider scenarios as destabilizing as the housing bust that sparked the crisis. The functional regulators of the insurance subsidiaries were focused on the condition of the individual subsidiaries and did not effectively exercise what authority they did have over the holding company, such as overseeing what was done with the securities that originated with the insurance subsidiaries.

The perceived regulatory lapses associated with AIG have largely been addressed in some way in the aftermath of the crisis. Dodd-Frank abolished the OTS and dispersed its functions among the Federal banking regulators, making the Federal Reserve the sole regulator of bank, thrift, and financial holding companies. The Act's systemic risk provisions provide for increased oversight of insurers deemed systemically important. In addition, derivatives in general were brought under Federal oversight and regulation split between the SEC and the Commodity Futures Trading Commission (CFTC). At the State level, the insurance regulators responded with new model laws and regulations increasing oversight on insurance holding companies generally and on securities lending in particular. The effectiveness of these steps, of course, may not be clear until the next financial crisis. It may be worth remembering that, for example, large banking institutions overseen by the Federal Reserve, such as Citigroup and Bank of America, also required exceptional, multibillion dollar rescues from the Federal Government during the crisis.

The statutory framework that Dodd-Frank has established addressing the perceived regulatory failures may have been put into place, but such statutory changes are only a beginning step. At the Federal level, regulators first promulgate regulations implementing the new law and then undertake ongoing regulatory action to see that these regulations are indeed followed. This latter step, regulators fully enforcing both letter and spirit of the law over the years or decades following adoption, is perhaps the most important, and underestimated, step.

Of particular interest going forward will be the decision by the FSOC as to which, if any, insurers might be designated as systemically important and what actions the Federal Reserve takes in its role of overseeing systemically significant insurers. Insurers are generally arguing that the precrisis view that the sector presents little systemic risk was correct and that AIG was an outlier. The overall expectation seems to be that few insurers will be deemed systemically important. At the State level, the process may take longer because the NAIC model laws must first be adopted by the individual State legislatures in order to take effect. This process can take substantial amounts of time and, in addition, State legislatures are not required to pass the NAIC models as suggested by the organization. This may alter the effectiveness of the models or introduce variation in regulation among different States.

The Bond Insurer Failures and Oversight of Smaller Insurers

With arguments being made, and possibly accepted, that even large insurers present little systemic risk, one might expect the oversight of smaller insurers to receive at best passing mention in testimony such as this. The experience with the failure of several "monoline" insurers who focused on insuring municipal bonds and moved into insuring mortgage-backed securities (MBS), however, raises issues that may bear future consideration.

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 have expanded their businesses since the 1990s to include significant amounts of MBS. In late 2007 and early 2008, strains began to appear due to exposure to MBS. Ultimately some smaller bond insurers failed and the larger insurers saw their triple-A ratings cut significantly. Some insurers are still operating, but the volume of insurance is greatly reduced. The insurer downgrades rippled throughout the municipal bond markets, causing unexpected difficulties in sectors previously perceived as unrelated to rising mortgage defaults. Individual investors in auction rate securities, which had been marketed as liquid and safe investments, found their assets frozen because the markets had depended on the bond insurers' high ratings as backing for the securities. Municipalities, particularly smaller ones, faced great difficulty and higher costs in accessing credit markets to fund projects like roads, sewer systems, and schools. While the bond insurer failures had unexpected spillover effects, whether or not such insurers would, or should, be considered systemically important under the systemic risk regulatory structure created by Dodd-Frank is an open question.

The failure of the bond insurers, unlike that of AIG, was not a story of multiple regulators and holes in regulatory oversight. The bond insurers were, and are, State-regulated entities, operating as permitted by the regulators. What occurred was a failure by both regulators and insurers to appreciate the additional risks being undertaken when the insurers moved from their initial business of insuring State and municipal debt into insuring MBS. In addition, the danger of a ratings agency downgrade, as opposed to the actual inability of the insurers to pay claims, was not well understood. The regulatory failures coupled with the spillover effects that occurred prompted some to call for Federal regulation of the financial guaranty insurance with an amendment to do so being offered, and then withdrawn in the House Financial Services Committee markup of the insurance titles of the Dodd-Frank Act.

Issues Arising Directly From Dodd-Frank

Implementation of the Federal Insurance Office

Title V, Subtitle A of the Dodd-Frank Act creates a Federal Insurance Office (FIO) inside the Department of the Treasury. FIO is to monitor all aspects of the insurance industry and coordinate and develop policy relating to international agreements. It has the authority to preempt State laws and regulations when these conflict with international agreements. This preemption authority is somewhat limited. It can only apply when the State measure (1) results in less favorable treatment of a non-U.S. insurer compared with a U.S. insurer and (2) is inconsistent with a written international agreement regarding prudential measures. Such an agreement must achieve a level of consumer protection that is "substantially equivalent"[17] to the level afforded under State law. FIO preemption authority does not extend to State measures governing rates, premiums, underwriting, or sales practices, nor does it apply to State coverage requirements or State antitrust laws. FIO preemption decisions are also subject to *de novo* judicial review under the Administrative Procedure Act.[18] The monitoring function of FIO includes information gathering from both public and private sources. This is backed by subpoena power if the director issues a written finding that the information being sought is necessary and that the office has coordinated with other State or Federal regulators that may have the information.

Since the passage of the Dodd-Frank Act, the FIO has begun hiring staff, and a director, former Illinois Insurance Commissioner Michael McRaith, has been appointed. The process, however, has taken longer than some hoped as Mr. McRaith did not take up the position of director until June 2011. This raised particular concern within Congress and the insurance industry in relation to the FIO director's role in FSOC discussed below. Also as part of the creation of FIO, Treasury has announced the creation of a Federal Advisory Committee on Insurance to be composed of various stakeholders and experts from the State regulatory system, the insurance industry, academia, and public advocates. The Dodd-Frank Act requires a report to Congress by January 21, 2012, on how to modernize and improve the insurance regulatory system in the United States.[19] The Treasury Department has in the past advocated for additional Federal oversight of insurance[20] and the Dodd-Frank study may provide insight into how FIO will approach this issue.

NRRA/Surplus Lines Insurance

Title V, Subtitle B of the Dodd-Frank Act addresses a relatively narrow set of insurance regulatory issues predating the financial crisis. In the area of nonadmitted (or "surplus lines") insurance, the Act harmonizes, and in some cases reduces, regulation and taxation of this insurance by vesting 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 or agreement, but absent such an agreement their distribution would

[17] 31 U.S.C. §313(r)(2) as added by P.L. 111-203 §502; the law renumbers the current 31 U.S.C. sec. 313 as 31 U.S.C. Sec. 312.
[18] 5 U.S.C. §551 *et seq.*
[19] Eighteen months after the July 21, 2010, date of enactment of the act.
[20] *See, for example,* the 2008 "Treasury Blueprint for a Modernized Financial Regulatory Structure", which proposed an optional Federal charter for insurers as part of an overall reform of the U.S. regulatory structure. Available at *http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf.*

be within the authority of the home State. It also preempts any State laws on surplus lines eligibility that conflict with the NAIC model law unless the States include alternative uniform requirements as part of an agreement on taxes and implements "streamlined" Federal standards allowing a commercial purchaser to access surplus lines insurance. For reinsurance transactions, it vests the home State of the insurer purchasing the reinsurance with the authority over the transaction while vesting the home State of the reinsurer with the sole authority to regulate the solvency of the reinsurer.

The general effective date for the surplus lines provisions of Dodd-Frank was 12 months after the date of enactment or July 21, 2011. If the States wished to enter into a compact or adopt other measures to effectively supersede the provisions specifying that the home States would have the sole right to collect premium taxes before these provisions took effect, the States were required to do so within 330 days from the date of enactment, a deadline that has now passed. NAIC and the National Conference of Insurance Legislators (NCOIL) both developed interstate agreements that would have superseded the Federal provisions. The two models that were developed, however, differed significantly as to the extent of authority that would be ceded by the States to the new body overseeing the agreement. NCOIL's Surplus Lines Insurance Multi-State Compliance Compact (SLIMPACT) is a broader agreement that would address surplus lines regulatory issues and taxes whereas the NAIC's Non-admitted Insurance Multi-State Agreement (NIMA) is more narrowly focused on tax allocation. Each approach has been ratified by some States, but neither has been ratified by a majority. This lack of uniformity was criticized at a July 2011 hearing before the House Financial Services Committee and representatives of the NAIC and NCOIL pledged to address this, possibly through some sort of blending of the two approaches. [21]

Issues Predating the Financial Crisis

Financial Services Industry Convergence

The financial regulatory structure implemented by the Gramm-Leach-Bliley Act (GLBA) was nominally a functional regulatory structure wherein insurers and insurance products would be regulated by insurance regulators, banks and banking products by banking regulators, and securities firms and securities products by securities regulators. Issues arise in such a structure, however, as financial innovation results in, for example, products sold by banks or securities firms taking on insurance characteristics or vice versa. Who decides what product belongs in what category, and thus, who regulates it? While GLBA was in part a response to financial industry convergence, it did not fully resolve this question. The *de facto* outcome has been that whatever charter the producing firm holds has determined which regulator regulates the product. The Dodd-Frank Act may affect this as the FSOC could act as such a referee, particularly for products deemed systemically important, but it is unclear how much of a role FSOC will play in this regard.

Financial product innovation that resulted in mismatched regulation played a central role in the financial crisis. One example of this is the experience with credit default swaps (CDS). Economically, a CDS shares a much greater similarity with an insurance policy than with a more traditional swap, such as an interest rate swap. Because a CDS is structured as a swap, which is a securities product, it generally did not fall under the purview of insurance regulators. This had a huge impact on the usage of CDS and the role that CDS played in the crisis. Were CDS regulated as an insurance product, the regulators would have required that capital be held to back each CDS as it was written, putting an additional cost in the creation of CDS. Because this was not the case, firms could essentially create as many CDS as the market would bear. This stoked the boom in structured financial products, as, for example, CDS were used as raw material to create synthetic collateralized debt obligations, increasing the overall exposure to the housing market and deepening the crash once the bubble burst. Other examples include lending by nonbank institutions backed by securities markets and banklike accounts, such as money market mutual funds, offered by securities firms and outside of the deposit insurance system.

[21] *See,* U.S. Congress, House Committee on Financial Services, Subcommittee on Insurance, Housing and Community Opportunity, "Insurance Oversight: Policy Implications for U.S. Consumers, Businesses and Jobs", 112th Cong., 1st sess., July 28, 2011, particularly the statements by Mr. Clay Jackson and Ms. Letha E. Heaton, available at *http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=252895.*

Multi-State Licensing of Agents and Brokers (NARAB II)

Licensing of insurance agents and brokers is currently a responsibility of the individual States with different States sometimes having differing requirements. An agent or broker serving a client seeking a policy that would cover risks in multiple States is thus required to be licensed in multiple States. This multiplicity of licensure has resulted in complaints from the insurance industry. In 1999, Congress included provisions in the GLBA calling for the creation of a federally backed licensing association, the National Association of Registered Agents and Brokers (NARAB), to supersede multiple State licenses. NARAB was to have come into existence 3 years after the date of enactment if at least 29 States failed to enact the necessary legislation for State uniformity or reciprocity. Following GLBA, the requisite number of States enacted this legislation, and thus the NARAB provisions never came into effect. The issue of insurance producer licensing reciprocity or uniformity continued to be of concern, however, as some continue to see problems in the actions taken by the individual States.[22] In addition, although 47 States were identified by the NAIC as meeting GLBA's requirements, those that have not, California, Florida, and Washington, are not small States, representing together approximately 20 percent of the Nation's population.

Recent Congresses have again seen legislation (H.R. 1112 in the 112th Congress) to create a NARAB, with such legislation generally referred to as "NARAB II." H.R. 1112 would establish 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 differently than in-State producers would be preempted. NARAB would be overseen by a board composed 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 a whole or suspend the effectiveness of any action taken by NARAB. NARAB II legislation has been passed by the House of Representatives in previous Congresses, but has not been acted upon by the Senate. H.R. 1112 has not been acted upon by either chamber in the 112th Congress.

Expansion of the Liability Risk Retention Act

Risk retention groups (RRGs) and risk purchasing groups (RPGs) are alternative insurance entities authorized by Congress in the Liability Risk Retention Act (LRRA).[23] These groups are chartered in single States, but are then authorized by the LRRA to operate throughout the country with minimal oversight by the other 49 States. The goal was to expand insurance supply through a simplification of insurance regulation. Membership in risk retention and purchasing groups is limited to commercial enterprises and governmental bodies, and the risks insured by these groups are limited to liability risks. Although the RRGs and RPGs are a relatively minor part of the insurance marketplace, some believe they have served a meaningful role at various times over the past decades, particularly in serving lines of insurance under stress, such as medical malpractice.[24]

Legislation has been introduced in the House during the last few Congresses (H.R. 2126 in the 112th Congress) to expand the LRRA's preemption of State laws to allow the sale and purchase of property insurance by RRGs and RPGs in addition to liability insurance. Such expansion has been resisted by those, such as the State insurance regulators, who worry that the lessened oversight on these groups, and the lack of coverage by State insurance guaranty funds, may lead to insured parties not receiving the purchased coverage in the case of a loss. In addition to expanding the scope of the law, H.R. 2126 would also place new corporate governance standards on the groups and authorize the director of the Federal Insurance Office to issue a determination as to whether a particular State law or regulation should be preempted by the Act. LRRA expansion legislation has not been acted on by the House, nor introduced in the Senate.

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[22] *See, for example,* the April 16, 2008 testimony by Tom Minkler on behalf of the Independent Insurance Agents and Brokers made before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises at *http://www.house.gov/apps/list/hearing/financialsvcs_dem/minkler041608.pdf.*

[23] 15 U.S.C. Sec. 3901 *et seq. See,* CRS Report RL32176, "The Liability Risk Retention Act: Background, Issues, and Current Legislation", by Baird Webel.

[24] *For example,* "RRGs have had a small but important effect in increasing the availability and affordability of commercial liability insurance for certain groups." U.S. Government Accountability Office, "Risk Retention Groups: Common Regulatory Standards and Greater Member Protections Are Needed", GAO-05-536, August 2005, p. 5.

The McCarran-Ferguson Act's Antitrust Exemption

The 1945 McCarran-Ferguson Act prohibits application of the Federal antitrust laws and similar provisions in the Federal Trade Commission Act, as well as most other Federal statutes, to the "business of insurance" to the extent that such business is regulated by State law—except that the antitrust laws are applicable if it is determined that an insurance practice amounts to a boycott. While this exemption has been limited by courts over the years, [25] this exemption has been seen by some as allowing the insurance industry to undertake collusive practices having negative effects on consumers. Over the years, numerous bills have been introduced to eliminate the exemption either entirely [26] or for particular lines of insurance. [27]

The insurance industry argues that the antitrust exemption allows for information sharing and other cooperation among insurers that result in greater efficiency and overall lower rates for insurance. Small insurers, in particular, depend on the sharing of information in order to accurately assess risks. If McCarran-Ferguson antitrust protection for "the business of insurance" were to be curtailed or abolished, many lawsuits challenging some of these insurer practices as violations of the Federal antitrust laws seem likely. Depending on the outcome of such litigation, major changes in the operation of insurers could result, particularly by small insurers that do not have large pools of information from their own experience. Should additional data be unavailable to small insurers in some way, it would, ironically, likely spur further consolidation in the insurance industry as small insurers may merge in order to gain the competitive advantage of additional information. This outcome, however, is only one of a range of possibilities. It is also possible that many of the cooperative activities that insurers engage in would be found to be permissible under the "State action" doctrine. [28]

Federal Chartering for Insurers

Although proposals for some form of Federal chartering for insurers have existed for decades, interest in the concept was particularly sparked by the Gramm-Leach-Bliley Act in 1999. While GLBA statutorily reaffirmed the primacy of State regulation of insurance, it also unleashed market forces that were already creating more direct competition among banks, securities firms, and insurers. The insurance industry increasingly complained about overlapping and sometimes contradictory State regulatory edicts driving up the cost of compliance and increasing the time necessary to bring new products to market. These complaints existed prior to GLBA, but the insurance industry generally resisted federalization of insurance regulation at the time. Facing a new world of competition, however, the industry split, with larger insurers tending to favor some form of Federal regulation, and smaller insurers tending to favor a continuation of the State regulatory system. Because life insurers tend to compete more directly with banks and securities firms, they have tended to favor some form of Federal charter to a greater extent than have property/casualty insurers.

Some Members of Congress have responded to the changing environment in the financial services industry with a variety of legislative measures. In the 108th Congress, Senator Ernest Hollings introduced S. 1373 to create a mandatory Federal charter for insurance. In the 108th and 109th Congresses, Representative Richard

[25] *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.

[26] The latest was H.R. 1583 in the 111th Congress.

[27] H.R. 1150 and H.R. 1943 in the 112th Congress would address the exemption solely for the health insurance industry.

[28] The State action doctrine was first enunciated by the Supreme Court in 1943 (*Parker v. Brown,* 317 U.S. 341). It is based on the concept of federalism, and is the reason why Federal antitrust laws are not applicable to the States. The doctrine has, over the years, been interpreted, clarified and expanded to the point that it now confers antitrust immunity not only on the States *qua* States (including State agencies and officials who act in furtherance of State-directed activity, but also on those who act pursuant to State-sanctioned, but not necessarily mandated, courses of action). Its essence is captured in the two-part test set out in *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.* (445 U.S. 97 (1980)): first, the challenged restraint must be "clearly articulated and affirmatively expressed as State policy" (*e.g.*, in a legislatively enacted statute); second, the policy must be "actively supervised" and subject to enforcement by the State itself. *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, for a brief analysis of that doctrine as it pertains to the insurance industry.

Baker drafted, but never introduced, the SMART Act[29] that would have left the States as the primary regulators, but harmonized the system through various Federal preemptions. Such a State-centric approach was generally favored by the smaller stakeholders, while larger stakeholders tended to favor an Optional Federal Charter (OFC) for insurance, with OFC legislation being introduced in the 107th, 109th, and 110th Congresses.

OFC legislation can vary widely in the specifics, but the common thread is the creation of a dual regulatory system, inspired by the current banking regulatory system. OFC bills generally would create a Federal insurance regulator that would operate concurrently with the present State system. Insurers would be able to choose whether to take out a Federal charter, which would exempt them from most State insurance regulations, or to continue under a State charter and the 50-State system of insurance regulation. Given the greater uniformity of life insurance products and the greater competition faced by life insurers, some have suggested the possibility of OFC legislation that would apply only to life insurers, but no such bills have been introduced. There were proposals to implement narrow Federal regulation for reinsurance and for financial guaranty insurance in the 111th Congress, but neither were adopted.[30]

The recent financial crisis amplified concerns about the negative aspects of allowing financial institutions to choose their regulators. Perhaps in response to these concerns, the broad Federal charter bill in the 111th Congress, H.R. 1880, added some mandatory aspects to a framework similar to the previous OFC bills. There have been no Federal chartering bills introduced into the 112th Congress.

International Issues

Although banking, insurance, and other financial services sectors do not produce a tangible goods shipped across borders, the trade in such services makes up a large amount of international trade. The United States has generally experienced a surplus in trade in financial services, other than insurance, but in insurance services in the United States has consistently run a deficit with the rest of the world.[31] Consolidations in the insurance industry are creating larger international entities with growing market shares, particularly in the reinsurance market. Some have speculated that the growing "internationalization" of the financial services industry means governments may find it difficult to reform their regulation in isolation. The need for a single voice at the Federal level to represent U.S. insurance interests on the international stage is a frequently heard argument for increased Federal involvement in insurance regulation and the Federal Insurance Office is specifically tasked with developing Federal policy in international insurance matters.

The European Union and Solvency II

The European Union (EU), the United States' biggest trading partner in insurance services, is implementing a comprehensive program to transform the EU into a single market for financial services. Part of this is an updated solvency regime for insurers—known as Solvency II—attempting to more closely match the capital required by regulators to the risks undertaken by insurers. It is

> an ambitious proposal that will completely overhaul the way we ensure the financial soundness of our insurers. We are setting a world-leading standard that requires insurers to focus on managing all the risks they face and enables them to operate much more efficiently.[32]

[29] This Act was the subject of a June 16, 2005, hearing in the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises entitled "SMART Insurance Reform."

[30] During the December 2, 2009, House Financial Services Committee markup of H.R. 2609, a bill to create a Federal Office of Insurance, Representative Dennis Moore offered an amendment (no. 3) that would have created an optional Federal license for reinsurers, while Representatives Ed Royce and Melissa Bean offered an amendment (no. 7) that would have created an optional Federal license for financial guarantee insurers. Both were withdrawn before votes were taken on the amendments. Representative Moore introduced his amendment creating a Federal license for reinsurers as a standalone bill, H.R. 6529, on December 16, 2010.

[31] U.S. exports of noninsurance financial services were $66.4 billion in 2010 *vs.* imports of $13.8 billion. Insurance exports in 2010 totaled $14.6 billion *vs*. imports of $61.8 billion. See the Bureau of Economic Analysis Web site at *http://www.bea.gov/ international/bp__web/simple.cfm?anon=71&table__id=22&area__id=3.*

[32] Charlie McCreevy, "European Union Internal Market and Services Commissioner", quoted in "'Solvency II': EU to take global lead in insurance regulation" available at *http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1060&format=HTML&aged=0&language=EN&guiLanguage=en.* The general EU Web site on Solvency 2 is *http://ec.europa.eu/internal__market/ insurance/solvency/index__en.htm.*

The European Parliament passed Solvency II legislation in 2009 with implementation recently delayed until January 1, 2014. As part of the project, the EU has created a new European Insurance and Occupational Pensions Authority (EIOPA) with the ability develop regulations and rules that are binding at a European level, rather than merely advisory as was the case with its predecessor. If the EU truly creates a more efficient regulatory system, this could improve the competitive standing of EU insurers compared with U.S. insurers. Concerns have also been expressed that the new EU system might result in discrimination against U.S. insurers, particularly if State supervision of U.S. insurers is judged insufficient to allow the same "single passport" access to all EU countries that EU insurers will enjoy. EIOPA has published draft reports on equivalence for Switzerland, Bermuda, and Japan, but has not done so for the United States. There have been suggestions in the past that an EU regulatory change might serve as "a useful tool in international trade negotiations as it could help improve access for European reinsurers to foreign markets," such as the United States.[33] The EU has also cited the overall complexity of the regulatory system in the United States as a barrier to overseas companies operating in the United States.[34]

Reinsurance Collateral

Although U.S. insurers see access to the EU as a significant issue under Solvency II, access to the U.S. market for insurance is also an issue for EU insurers. Of particular concern have been the State regulatory requirements that reinsurance issued by non-U.S. or "alien"[35] reinsurers must be backed by 100 percent collateral deposited in the United States. Alien reinsurers have asked State regulators to reduce this requirement to as low as 50 percent for insurers who meet particular criteria, pointing out, among other arguments, that U.S. reinsurers do not have any collateral requirements in many foreign countries and that the current regulations do not recognize when an alien reinsurer cedes some of the risk back to a U.S. reinsurer. In the past, the NAIC has declined to recommend a collateral reduction, citing fears of unpaid claims from alien reinsurers and an inability to collect judgments in courts overseas. In 2009, the NAIC proposed draft Federal legislation to create a board with the power to enforce national standards for reinsurance collateral, including the reduction of collateral for highly rated reinsurers.[36] In 2010, an NAIC Task Force approved recommendations to reduce required collateral based on the financial strength of the reinsurer involved. This proposal is working its way through the NAIC process and may be approved by the full NAIC by the end of 2011. Some States, such as New York, Florida, and New Jersey, have already begun lowering reinsurance collateral requirements.[37]

PREPARED STATEMENT OF THERESE M. VAUGHAN

CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

SEPTEMBER 14, 2011

Introduction

Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, thank you for the opportunity to testify today. My name is Terri Vaughan. I am the Chief Executive Officer of the National Association of Insurance Commissioners (NAIC). The NAIC is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 States, the District of Columbia, and the five U.S. territories. Through the NAIC, State insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. Our members, working together with the central resources of the NAIC, form the national system of State-based insurance regulation in the U.S.

[33] European Commission, "Commission Proposes a Directive To Create a Real EU-Wide Market for Reinsurance", Internal Market: Financial Services: Insurance: Press Release, *http://europa.eu/rapid/pressReleasesAction.do?reference=IP/04/513&format=PDF&aged=1&language=EN&guiLanguage=en.*

[34] *See, for example,* p. 54 of the European Commission's U.S. Barriers to Trade and Investment Report for 2007, at *http://trade.ec.europa.eu/doclib/docs/2008/april/tradoc_138559.pdf.*

[35] In the United States, the term "foreign" insurer generally denotes an insurer that is chartered in a different State; those insurers from a different country are termed "alien" insurers.

[36] The NAIC proposal can be found on their Web site at *http://www.naic.org/committees_e_reinsurance.htm.*

[37] *See, for example,* "NY DOI Approves Lloyd's Request to Post Lower Collateral", *BestWire,* July 29, 2011.

Our system has a strong track record of protecting consumers and maintaining effective solvency oversight. The insurance sector in the U.S. weathered a devastating financial crisis and remains resilient in coping with equally devastating natural catastrophe losses across the country. Comprehensive data collection and analysis, rigorous hands-on supervision, and transparency for consumers and investors are the hallmarks of the U.S. system.

Over the past few years we have made several enhancements to the regulation of insurance. Some of these refinements were implemented to address, in part, certain aspects of the financial crisis such as new securities lending reporting rules, a reduction of a regulatory reliance on credit ratings, and increased focus on noninsurance affiliates and their potential impact on the insurer and its policyholders. Other changes are being driven by the evolving business of insurance. Today, insurance markets are becoming increasingly global and interconnected, and this trend is likely to continue.

For these reasons, the NAIC's international involvement has been increasingly focused on the supervision of insurers that operate in multiple countries, or internationally active insurance groups (IAIGs). In light of the financial crisis and the evolving insurer business model, insurance regulators recognize it is vital to improve coordination and collaboration to better supervise IAIGs, and we are developing structures and tools to better identify internal and external risks to the insurance sector. These new tools will enable us to better anticipate risks that are evolving beyond our borders and outside our respective jurisdictions. Today, I would like to discuss recent improvements to our State-based system and our efforts abroad.

International Standard Setting

The NAIC participates as a founding member in the International Association of Insurance Supervisors (IAIS), which was established in 1994. The IAIS is the international standards setting body for insurance, similar to the Basel Committee on Bank Supervision (BCBS) setting international bank standards and the International Organization of Securities Commissions (IOSCO) setting international securities standards. State insurance regulators or their NAIC representatives are active members in all of the major IAIS committees and subcommittees. We also worked within the IAIS to ensure that the new Federal Insurance Office would be a voting member of this body. While IAIS activity is nonbinding on its member jurisdictions, the scope and importance of the IAIS work and its potential impact on U.S. insurers has increased significantly since the financial crisis, and subsequently our involvement at the IAIS has increased to ensure that the U.S. regulators' perspective is reflected in its projects.

In particular, we are actively working on revisions to the IAIS Insurance Core Principles (ICPs), which set out the fundamentals to effective insurance supervision. The ICPs are of paramount importance in that they form the basis of the International Monetary Fund's (IMF) Financial Sector Assessment Program (FSAP), which is designed to assess a particular jurisdiction's regulation of financial institutions. Such assessments are conducted periodically on a rolling basis; the United States' system of insurance regulation was most recently assessed in 2010. In that FSAP, the IMF found that U.S. insurance regulators observed or largely observed 25 of the 28 international standards, and noted the overall resilience of the insurance sector through the financial crisis. The IMF stated: "There is generally a high level of observance of the Insurance Core Principles. Aspects of regulatory work such as data collection and analysis in relation to individual insurance companies are world-leading. There are mechanisms to ensure individual States implement solvency requirements effectively." The IAIS is currently revising the ICPs, and we are working to ensure strong U.S. regulator input into the process.

The NAIC is also active in the development of the IAIS Common Framework for the Supervision of Internationally Active Insurance Groups, or "ComFrame." This project aims to make group-wide supervision of IAIGs more effective by creating a multijurisdictional approach that emphasizes robust oversight and supervisory cooperation while maintaining the proper balance between home and host authorities. While the ultimate role of ComFrame remains under discussion and development, the intent is given by its name—a common framework—one that lays out how supervisors around the globe can work together to supervise internationally active insurance groups. ComFrame is neither intended to be a forum to create prescriptive ways to promote a particular means for solvency standards, nor to create additional layers of regulation.

While all regulators have a vested interest in harmonizing regulatory approaches with their international counterparts where appropriate, we cannot abdicate our responsibility for U.S. insurance companies and consumers. We must remember that there are different regulatory systems and approaches around the globe, so regulatory convergence must involve arriving at common outcomes and not necessarily at universal standards or structures. Moreover, global convergence should heavily focus on information sharing and include mechanisms for peer review. Imposing national or regional concepts unilaterally is particularly counterproductive as it undermines the ability to achieve common regulatory goals.

Identification of G–SIFIs

In the aftermath of the financial crisis, regulators in the United States and around the world have been increasingly focused on identifying systemic risks to the financial system. In the United States, the Financial Stability Oversight Council (FSOC) is developing criteria to identify and designate systemically important nonbank financial institutions (SIFIs) for heightened supervision by the Federal Reserve—potentially impacting some insurers. The insurance regulator representative to FSOC is John Huff, Director of Missouri's Department of Insurance, Financial Institutions, and Professional Registration. Director Huff has been an active participant in FSOC discussions since he was selected by his fellow insurance regulators last year. He has been working closely with the new Director of the Federal Insurance Office, Michael McRaith, and he is looking forward to working with insurance expert Roy Woodall if and when he is confirmed by the full Senate. Of critical importance to Director Huff and his fellow regulators is highlighting the distinctions that exist between banking and insurance to ensure that FSOC decisions don't create detrimental unintended consequences for the insurance sector, while ensuring that any potential for systemic risk, however remote, is identified and mitigated.

The U.S. is not alone in wrestling with the challenge of systemic risk. Finance ministers, central banks, and regulators from around the globe convene through the Financial Stability Board (FSB) to address systemic risk issues through the identification of global systemically important financial institutions (G–SIFIs). As part of this work, the FSB has asked the IAIS to develop indicators for identifying global systemically important insurers. U.S. insurance regulators have extensive input into the IAIS process as the NAIC chairs the IAIS Financial Stability Committee work on this issue.

In both the FSOC and FSB efforts, it is critical for members making systemic designations to access unique expertise in particular subject areas. Such knowledge helps ensure that appropriate methodologies are being considered, and gives participants the insights of hands-on regulators with unique expertise in assessing the systemic relevance of certain products or activities.

The U.S., represented by the United States Treasury Department, Federal Reserve Board of Governors, and the Securities and Exchange Commission, is a member of the FSB, which is engaging directly with the IAIS on critical issues including G–SIFI identification. The involvement of insurance regulators is essential as the FSB is a bank-centric organization, yet its decisions have an impact beyond banking. Through the IAIS, we continue to stress that the insurance business model needs to be distinguished from the banking business model when discussing and applying any new regulatory requirements.

Additionally, the Treasury Department coordinates input from the various functional regulators or their representatives on FSB projects and priorities, and we have been active and constructive contributors to those discussions. The FSB has taken on an increasingly active role in attempting to coordinate regulatory developments around the globe. However, some activities have raised questions of coordination, such as how the timing and outcomes of the FSB's process for identifying G–SIFIs relates to domestic processes like FSOC's to identify systemically important financial institutions within our country. I would encourage Federal regulators and legislators alike to be mindful of both the scope and speed of the board's activity, and work to ensure that appropriate deference should be provided to the regulatory authorities of member nations.

Communication, Collaboration, and Cooperation Among Supervisors

Beyond identifying systemic risk, the day-to-day supervision of insurance in the U.S. requires extensive coordination among our regulators. We have a long history of coordination through the NAIC, and have embedded systems of peer review into our processes to promote consistent oversight. Similar efforts to coordinate at the international level are evolving, so U.S. regulators along with their international counterparts are redoubling efforts to strengthen supervision through enhanced coordination.

Insurance regulators are involved in technical exchanges, training programs, and other forms of regular dialogue. We actively pursue necessary bilateral and multilateral information agreements or Memoranda of Understanding that provide the foundation for these regulatory exchanges. U.S. regulator leadership in these efforts help us understand the various supervisory practices and cultures that exist, and better appreciate the global risk trends that may impact domestic insurers and policyholders. This type of increased cooperation has been discussed internationally for some time, particularly with a focus on improved efficiency and teamwork among regulatory systems, but the recent financial crisis has accelerated the current efforts on developing and implementing best practices to eliminate the risk of systemic threats.

Increased international supervisory coordination and collaboration has taken a variety of forms. A key initiative to increase coordination is the IAIS Supervisory Forum, which the NAIC chairs. The objective of this forum is to strengthen insurance supervision and to foster convergence of supervisory practices through exchange of real-world experiences. The work of this group will also contribute to the development and operationalization of ComFrame.

U.S. regulators also participate in supervisory colleges; forums for enhancing supervisory cooperation and coordination among international regulators relating to a specific insurance group. U.S. and international regulators are in the process of developing best practices for participating in these discussions, including guidance on the coordination and communication of information to cross-border and other functional regulators and through international roundtables.

Beyond these formal structures and tools, increased collaboration hinges on establishing trust and relationships among regulators. To help foster such an environment, the NAIC engages in recurring regulator-to-regulator dialogues with representatives from the EU, North America, China, Japan, Switzerland, and other jurisdictions around the world. We also participate in similar international dialogues with our fellow U.S. financial regulators and agencies, such as the Treasury Department, Federal Reserve, and the Securities and Exchange Commission. We provide technical assistance to foreign regulators in the form of training, and have hosted more than 143 foreign insurance regulators from 24 countries in our International Fellows program. Furthermore, we recently provided training to Thai regulators on the importance of data to perform automated financial analysis on the solvency of the insurance industry, and to South Korean regulators to help them identify and prevent insurance fraud. We also have conducted similar training here in the U.S. for Armenian regulators, coordinating with the Treasury Department's Financial Crimes Enforcement Network and the Federal Bureau of Investigation. These efforts promote best practices abroad and are critical as U.S. insurers branch into new markets.

Just last week, a delegation of State insurance regulators, NAIC staff, and a representative of the Federal Insurance Office traveled to Frankfurt, Germany to engage European counterparts on international regulatory issues. The dialogue was especially timely as the European Union (EU) and the U.S. both continue to modernize insurance regulation; Europe through Solvency II, and the United States through our Solvency Modernization Initiative (SMI). Together, the U.S. and the EU oversee more than 70 percent of the global insurance market. Last week's agenda included discussions on regulatory developments, Solvency II implementation and U.S. equivalence, and the process for designating global systemically important financial institutions (G–SIFIs). Both sides agreed that this continued engagement was critical and further agreed to establish joint working groups to resolve various technical issues before the next dialogue in early 2012.

In particular, I would like to highlight our discussions on equivalence. The Solvency II initiative requires an assessment of "third countries" to determine if their levels of solvency supervision are equivalent to Solvency II, notwithstanding that Solvency II is still a few years away from being operational. To the extent that Europe does not find our system of supervision equivalent, it could have negative implications on U.S. insurers doing business in Europe and European insurers doing business in the U.S. Europe is committed to assessing other jurisdictions on an outcomes basis, where they review the overall objective of protecting policyholders and ensuring strong solvency oversight, rather than requiring adoption of Solvency II itself. Although the U.S. insurance regulators do not intend to implement Solvency II in the States, and there are clear differences between the regulatory and legal structure of our markets, we do believe that our system of supervision is at least equivalent to Solvency II on an outcomes basis. The IMF assessment of our system and the performance of our market relative to other sectors during the financial crisis reinforce this view. We strongly encouraged our European colleagues to review our system on an outcomes basis and find our system equivalent to avoid any disruptions in the transatlantic insurance market.

Domestic Improvements to Insurance Regulation

Representatives from the NAIC have frequently testified before Congress on our continuing efforts to improve the State-based system of regulation. While this work was underway well before the financial crisis, that event certainly underscored a need for State insurance regulators to enhance and improve policies and processes in a number of areas.

In June 2008, State insurance regulators commenced the Solvency Modernization Initiative (SMI); a critical self-examination of the U.S. insurance solvency system. While the existing system helped protect the relative stability of the insurance sector during the financial crisis, no regulatory system can remain stagnant in a world of constant change. The SMI project is focused on several major areas: (1) group supervision; (2) capital requirements; (3) governance and risk management; (4) accounting and financial reporting; and (5) reinsurance. Under SMI, we are examining international developments regarding insurance supervision, banking supervision, and international accounting standards in order to consider their use in U.S. insurance regulation. We believe that, ultimately, this open and transparent process will drive changes to our overall regulatory system. We must learn from international developments and collaborate where appropriate, but we cannot abdicate our responsibility for U.S. insurance consumers and companies.

One key area of focus for the SMI project has been enhancing our system of group supervision. Our experience with AIG taught us that we needed to increase our scrutiny of areas outside the regulated insurance company to better understand the risk that exists in other areas of the group.

Traditionally, insurance regulators have mainly focused on ring-fencing the insurance company to protect it from risk that exists in other parts of the group. While we still have an appreciation for the importance of these "walls," we also recognize the need to look through the "windows" to identify risks that could pose a contagion to the insurance company.

In December of last year, the NAIC adopted revisions to the *Insurance Holding Company System Model Act and the Insurance Holding Company System Model Regulation With Reporting Forms and Instructions.* These revisions are intended to provide regulators the ability to better assess the enterprise risk within a holding company system and its impact on an insurer within the group. Ultimately, this enhanced "windows and walls" approach should provide greater and much-needed breadth and scope to solvency regulation while maintaining the highest level of policyholder protection.

We are undertaking a comprehensive review of our risk-based capital requirements. We are also looking at incorporating a review of a firm's group capital assessment as a part of a requirement that firms conduct their "Own Risk and Solvency Assessment" (ORSA).

During the past 2 years, we have made significant changes in the way we assess risk and capital requirements for structured securities. The financial crisis revealed that insurance market participants and regulators overly relied on credit ratings issued by the Nationally Recognized Statistical Rating Organizations (NRSROs). In an effort to reduce our reliance on these rating agencies, the NAIC acted to more closely align the capital requirements for residential mortgage-backed securities (RMBS) and for commercial mortgage-backed securities (CMBS) with appropriate economic expectations. These two asset classes represent over $300 billion in carrying value of invested assets for the U.S. insurance industry.

The NAIC developed alternative methodologies for evaluating CMBS and RMBS investments, and the new process results in a more accurate reflection of the risk of loss for each specific insurer that is then mapped to a risk-based capital factor. At the conclusion of our most recent year of effort in this regard, the NAIC made available projected expected losses on a list of approximately 19,500 residential mortgage-backed securities and 5,200 commercial mortgage-backed securities to insurers, the Federal Reserve and other Federal agencies. While the NAIC continues to use the NRSROs for other asset classes, our Valuation of Securities Task Force, as well as our Rating Agency Working Group, are monitoring these other asset classes to determine whether continued reliance is appropriate.

One concern for insurance regulators during the financial crisis was over securities lending activities by AIG; work that was separate from the noninsurance problems at the AIG Financial Products Division overseas. U.S. insurance regulators had discovered the change in AIG's management of the securities lending program in 2007 during a regular financial examination, and immediately began working with the company to wind down the activity and provide additional public disclosure of the structure and risks facing the program.

In the time since the AIG Securities Lending discovery, insurance regulators have taken a number of actions to ensure transparency in any such activities at insurance companies in the future. We improved the guidance for such activity in 2008, as well as annual financial statement disclosure requirements in order to obtain summary information on the duration of when related collateral is required to be returned to the counterparty. This allows regulators to more readily identify if an insurer's securities lending program could cause excessive liquidity strains under stressed scenarios. Furthermore, the NAIC adopted a new Schedule DL in 2010 to strengthen transparency in securities lending agreements utilized by insurers by requiring detailed disclosure of the program's collateral instruments.

Conclusion

While much work has been done to enhance insurance supervision over the past few years, regulating IAIGs through the creation of common standards and enhanced coordination is an area that regulators here and abroad will continue to focus on to ensure that approaches keep pace with the insurer business model. It is also equally critical that the uniqueness of that model be acknowledged internationally, since regulatory approaches used for other types of financial institutions may not be appropriate for insurance. We continue to refine our system, mindful of and engaged directly in developments abroad. Our goal is to constantly improve our system for the benefit of insurance companies and consumers. We have spent a tremendous amount of time and energy on these issues and will continue to do so in the coming months and years.

Thank you again for the opportunity to testify today. I would be happy to answer any questions.

PREPARED STATEMENT OF MARY A. WEISS

DEAVER PROFESSOR OF RISK, INSURANCE, AND HEALTHCARE MANAGEMENT, TEMPLE UNIVERSITY

SEPTEMBER 14, 2011

My comments for this hearing are mostly directed to emerging issues in insurance regulation, including international issues. The following issues, I believe, are important issues for the insurance industry and insurance regulators:

1. (International) Group Supervision. Most insurance carried out in the U.S. is done by families of insurance companies called groups. Companies within the group are related to each other by common ownership. Recent history has shown that groups can be complex and opaque in nature. In some cases this can hamper insurance regulation, as discussed below.

Many groups are involved in noninsurance activities. [1] These noninsurance activities may be regulated or they may not. Importantly these activities, especially if they are unregulated and involve capital markets, could make a group systemically risky (as was the case for AIG). That is, a convincing case can be made that the insurance activities carried out by insurers do not create systemic risk. However, when insurers drift towards noninsurance activities that involve capital markets, the latter activities can be a source of systemic risk. U.S. insurance regulators at present do not have the authority to supervise these noninsurance activities, and there appears to be no mechanism in place that allows regulators of the insurance and noninsurance activities to work together in maintaining the viability of the total enterprise or even to assess the riskiness of the enterprise as a whole. Even worse, no regulatory authority is present to cooperate with if the noninsurance activities are conducted by a nonregulated entity.

The factors discussed above have an important bearing in determining capital requirements for insurers that are part of a group. For example, it raises the question of whether insurance regulators should put in place capital requirements for noninsurance activities (especially unregulated ones). There are many other questions concerning determination of group capital requirements. For example, there is a question about whether insurers that are part of a group should be allowed to recognize diversification benefits because they operate across different geographic areas and/or in very different lines of business. The latter issue, of course, is one raised by insurers.

Also, some of the products offered by insurers are similar to products offered by other financial institutions. For example, some life insurance products compete with banking products. Therefore care must be taken that regulation of these products are consistent. Regulatory arbitrage can occur if a product of one type of financial institution is considered to be regulated less rigorously than products offered by the

[1] Group and the group holding company are used interchangeably here.

other type of institution. Thus, direct coordination between financial institution regulators is required to prevent regulatory arbitrage of this type from occurring.

Many groups operate internationally. Yet, insurers are actually regulated by national domestic bodies. The wind-up of a perhaps complex insurance group raises questions as to how assets of the group will be distributed among the different countries that the group operates in. This points to the need for direct coordination and cooperation among regulators from different countries. At present, there is some degree of coordination among international insurance regulators when a group experiences financial distress. In this case a "supervisory college" consisting of regulators of companies in the group is convened to deal with the problem. However, these supervisory colleges are in place only so long as the group is in financial distress—they are disbanded when the problem is resolved. Thus supervisory colleges are ad hoc and intermittent. To prevent problems in the first place, coordination among regulators of companies in a group should be ongoing, with regulators in the supervisory college in regular communication with each other.

2. Optional Federal Chartering. A perennial issue that arises is whether insurers should be able to choose to be regulated at the Federal level, leaving the remaining insurers to continue to be regulated at the State level. Arguments exist in favor of this Federal chartering option—many of which are related to efficiency (*e.g.*, streamlined producer and company licensing, speed to market for products, removal of rate regulation). For example, currently an insurer that wants to write insurance in all States must meet the statutory requirements of all of these States. This is cumbersome and time consuming, for U.S. insurers and foreign insurers alike.

Although there are arguments in favor of Federal chartering, I believe there are better reasons not to follow such a route. In my opinion, large insurers would likely opt for Federal chartering, and these insurers could present a powerful lobbying force to the Federal regulator. In fact, the regulator might be prone to regulatory capture, a phenomenon in which the regulator ends up serving the interests of the regulated entities rather than pursuing traditional goals of regulation. One has only to contrast the lobbying power of insurers now—lobbying 50 State regulators—with the lobbying power of insurers if one Federal regulator/agency is in place to see how there could be a problem.

Optional Federal chartering is sometimes compared to the dual system of banking regulation that exists in the U.S. But the cost to multi-State, Federally chartered insurers to switch back to State regulation in multiple States might be larger than it is for banks to switch from Federal to State chartering. Further, it is not clear that Federal regulators would not succumb to the same political pressures of State regulators to provide cross-subsidies to policyholders across and within States (*e.g.,* making insurance affordable by mandating lower insurance prices or limiting risk classification for underwriting purposes). The latter would defeat some of the arguments in favor of optional Federal chartering. Finally there are substantial risks and cost involved with setting up a Federal insurance regulatory agency. For example, Federal policies might be put in place that have unintended consequences and such mistaken policies then would have national effects. Finally, Federal regulation was unable to fend off the most recent financial crisis and may in fact have contributed to it through some deregulation policies preceding the crisis.

Alternatives to optional Federal chartering exist. These might entail minimum Federal standards that States must meet (*e.g.,* about licensing or product approval). Streamlining of insurance regulation might also be achieved by allowing an insurer to choose a primary State for the purpose of rate, policy form, and perhaps other types of regulation. Then the insurer would be allowed to operate in all other States they are licensed in without having to meet regulations such as rate and policy form regulations that are governed by the primary State. Note that the primary State regulations would govern only select aspects of regulation so that solvency regulation or market conduct regulation could still be regulated by each individual State the insurer operates in. [2]

3. Solvency II, the Swiss Solvency Test and U.S. Insurance Regulation. The Swiss Solvency Test (SST) is now in force in Switzerland. Solvency II is slated to go into effect sometime in 2012. Both systems represent a major overhaul of the way insurance will be regulated in Europe. A major aspect of Solvency II concerns capital requirements. An insurer's required capital will be determined by a risk-weighted formula (similar to an RBC approach as used in the U.S.) or on the basis of an internal model created by the insurer which purports to accurately capture

[2] *For further explanation, see,* Scott Harrington, 2006, "Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation", Policy Brief, Networks Financial Institute at Indiana State University.

the riskiness of the insurer's activities. The basic idea is that large insurers will use the model approach while smaller insurers (for whom developing a model is likely to be expensive) would use the risk based formula approach. Obviously, the modeling approach is radically different from the regulatory approach used in the U.S., and I believe it is unlikely that relying on a company's own model to determine its capital requirements will be adopted here.[3]

Nevertheless there are some important aspects of Europe's new regulation framework that could prove to be quite useful in the U.S. For example, under the Swiss Solvency Test, insurers are required to undergo stress tests to see how solvency would be affected by adverse economic or loss development. Stress tests consist of scenarios that would severely affect the insurer. For example, a life insurer might undergo a stress test in which a pandemic is assumed to occur that results in major reinsurer insolvencies and panic in the capital markets.

Also under Solvency II, insurers will be required to provide the regulator with a document entitled the Own Risk Solvency Assessment (ORSA) which details the major risks the insurer faces, among other things. This document is treated confidentially and the use of such a document in U.S. regulation could be quite useful.

The new European insurance regulatory regime also embraces the importance of corporate governance and internal control systems. Under the Swiss Solvency Test, insurers are required to complete two questionnaires that detail the corporate governance and risk management controls within the insurer. These types of questionnaires could be useful in the U.S.

I believe that stress tests, ORSA, and the Swiss Quality Assessment questionnaires are being considered under the Solvency Modernization Initiative (SMI).

4. Leverage, Assets, and Life Insurance. Although insurer assets are generally liquid and of high quality, there are some danger signals with respect to the life insurance industry. Life insurers hold 18.4 percent of their assets in mortgage-backed and other asset-backed securities (MBS and ABS), including pass through securities such as CMOs. Even more startling, the amounts invested in MBS and ABS represent 169.8 percent of life insurer equity (policyholders' surplus). These numbers are relevant because ABS and MBS were especially problematical during the financial crisis. Thus, even minor problems with asset defaults and liquidity demands could significantly threaten the solvency of many life insurers. Somewhat offsetting their asset liquidity risk, life insurers receive a significant amount of net cash from operations, defined as premiums plus investment income net of benefit payments, expenses and taxes. Life insurers' net cash from operations represents 39 percent of equity.

The capital to asset ratios of life insurers was approximately 6.3 percent in 2010, while that for banks was 10.9 percent. Therefore at the present time, banks have about 75 percent more capital relative to assets than life insurers. Excessive leverage is risky because it exposes a firm's equity to slight declines in the value of assets. Therefore, the statutory statements of life insurers make them appear excessively leveraged, especially considering their exposure to mortgage-backed securities.

It is possible that the true leverage ratios of life insurers are much lower than indicated above. This is because statutory accounting is very conservative—overstating liabilities and understating assets. Nevertheless, I believe that leverage might well be a problem for many life insurers.

5. New global accounting standards are being used around the world, and the new insurance solvency systems for Europe rely on market value accounting. These accounting standards are very different from statutory accounting standards used in the U.S. Pressure is likely to develop on regulators to abandon statutory accounting and use accounting standards that are more universally in use. If statutory accounting is continued, this will require firms to continue to maintain two systems of accounting which is cumbersome and expensive.

Much regulation of insurers is underpinned by statutory statements. For example, RBC requirements consist of factors that are applied to statutory accounting values. Other solvency tests, such as ratio analysis (under the FAST system) rely on statutory accounting as well. Thus changing insurance accounting standards would have serious repercussions on how insurers are assessed for regulatory purposes.

6. Passage of the NAIC Reinsurance Modernization Proposal. This proposal entails creation of two new classes of reinsurers in the U.S., national reinsurers and "port of entry" (foreign) reinsurers. Each type of reinsurer would be regulated by only one State (the domiciliary State or the port of entry State). That is, a single

[3] This is not to say that modeling or principles-based regulation does not occur in the U.S. In fact it does exist for certain life insurance products.

State would be the sole regulator of a reinsurer writing assumed business in the U.S. Federal legislation could make this improvement in the regulatory system possible.

Otherwise, reinsurers (both foreign and domestic) must meet the requirements under the NAIC Model Credit for Reinsurance Law. Under the latter, U.S. insurers can take balance sheet credit for reinsurance as long as the reinsurer is "authorized," *i.e.,* licensed in the ceding insurer's State of domicile, accredited in the ceding insurer's State of domicile, or licensed in a State with substantially similar credit for reinsurance laws. Insurers can take credit for unauthorized reinsurance only if the reinsurer posts collateral, in the form of funds held in the U.S. or letters of credit from U.S. banks. The NAIC and several individual U.S. States have begun to liberalize collateralization rules, and the process is ongoing.

PREPARED STATEMENT OF DANIEL SCHWARCZ

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SEPTEMBER 14, 2011

State insurance regulation consists predominantly of relatively strict rules, such as capital requirements and underwriting restrictions. Such rules are often appropriate mechanisms to regulate as complex an industry as insurance. Unfortunately, in their focus on command and control regulation, State insurance regulators have historically ignored an equally vital, and much less intrusive, regulatory strategy: promoting transparency in consumer-oriented property/casualty and life insurance markets.

Currently, most States do a remarkably poor job of promoting transparent insurance markets. This failing occurs at two levels. First, most States do not empower consumers to make informed decisions among competing carriers. For instance, in personal lines markets—such as home, auto, and renters insurance—consumers have no capacity to identify or evaluate the substantial differences in carriers' insurance policies. Consumers cannot acquire policies before, or even during, purchase; instead, they receive them only weeks after the fact. Meanwhile, no disclosures warn consumers to consider differences in coverage, much less enable them to evaluate these differences. Similar deficiencies prevent consumers from comparing carriers' claims-paying practices. Consumers neither receive nor can access reliable measures of how often or how quickly carriers pay claims. Finally, consumers are almost never informed that ostensibly independent agents typically have financial incentives to steer them to particular carriers who may not provide optimal coverage. Given this collective lack of transparency, it is hardly surprising that several large national companies have started to hollow out their coverage and embrace aggressive claims handling strategies.

The failure of State regulators to provide consumers with sufficient information extends to life insurance markets as well. Perhaps the most notable example is that consumers have virtually no means of comparing prices or costs for the cash value life insurance products that different companies offer. When combined with skewed (and nondisclosed) salesperson incentives, this too has produced distressing results. For instance, a substantial majority of life insurance sold in this country is cash value, even though less expensive (and, for insurers, less profitable) term coverage is a better option for the vast majority of individuals.

The second broad transparency failing of State insurance regulators involves the absence of publicly available market information. Unlike the consumer disclosures discussed above—which must be simple, focused, and properly timed—this second form of transparency involves making detailed market information broadly available, typically through the Internet. Most consumers, of course, are unlikely to consult such information. But this form of transparency is nonetheless crucial for markets to operate effectively because it allows market intermediaries—including consumer-oriented magazines, public interest groups, and academics—to police marketplaces, identify problems, and convey relevant information to consumers, newspapers, and lawmakers.

Currently, insurance regulation does a dismal job of making publicly available the information that market intermediaries need to perform this watchdog role. For instance, carriers' terms of coverage are not generally publicly accessible—insurers do not post their policies online and most insurance regulators do not maintain up to date or accessible records on the policies that different companies employ. Company-specific market conduct information—including data on how often claims are paid within specified time periods, how often claims are denied, how often policies are nonrenewed after a claim is filed, and how often policyholders sue for coverage—

is also hidden from public scrutiny and treated as confidential. Virtually no States make available geo-coded, insurer-specific application, premium, exposure, and claims data, similar to that required of lenders by the Home Mortgage Disclosure Act. Product filings with the States and the Interstate Insurance Product Regulation Commission (IIPRC) are not made public before approval, thus precluding public comment. And even companies' annual financial statements are only accessible on the Internet for a fee, in notable contrast to the public availability of companies' SEC filings.[1]

To be sure, the National Association of Insurance Commissioners (NAIC) has started to address some of these issues. But the results to date have ranged from preliminary to inadequate. Its model annuity and life disclosure regulations, for instance, rely on generic buyers' guides and broad standards for insurer disclosure without affirmatively developing tools that consumers need to make cross-company comparisons, such as the mortgage disclosure forms that the Consumer Financial Protection Bureau has developed in recent months. Work in the personal lines context has only recently started after years of consumer pressure. And in many domains, the NAIC has affirmatively rejected transparency. Examples include its refusal to make publicly available data on carriers' market conduct or on the availability and affordability of property insurance in specific geographic areas.

In sum, State insurance regulation has generally failed at a core task of consumer protection regulation—making complex markets comprehensible to consumers and broadly transparent to those who may act on their behalf. This type of transparency is fundamental to fostering competitive and efficient markets. Historically, State insurance regulators have responded promptly to Federal pressure: in the face of such scrutiny, they shored up solvency regulation, coordinated agent licensing, and streamlined product review. The Federal Government should apply similar pressure on State regulators to develop a robust and thoughtful transparency regime. Specifically, Congress should press the new Federal Insurance Office to work with consumer groups to assess transparency in consumer insurance markets. That Office should compare this state of affairs with the transparency standards under development at the Federal level in the context of consumer credit and health insurance. The sharp contrasts that are revealed will hopefully either prompt States to correct these problems or precipitate Federal regulation doing so.

More Detailed Information on Failed Transparency in Insurance Markets

In evaluating the lack of transparency in insurance markets described above, consider first the core product that insurers sell: insurance policies. Unlike virtually any other market, it is virtually impossible for purchasers of personal lines coverage—including homeowners, renters, and auto insurance—to scrutinize this product before they purchase it.[2] Insurers only provide consumers with an actual insurance contract several weeks after they purchase coverage. They do not make sample contracts available to consumers on the Internet or through insurance agents. Marketing materials and other secondary literature from regulators and consumer organizations provide virtually no guidance about how different carriers' policies differ. And most States have essentially zero laws requiring insurers to provide any types of presale disclosure to consumers regarding the scope of their coverage.

This distressing lack of transparency can be traced back to the assumption of regulators that personal lines policies are completely uniform, meaning that disclosure just does not make sense. Historically this assumption was premised on laws that required complete uniformity: most States, for instance, mandated the use of State promulgated fire insurance policies. But these rules gradually faded, in large part because insurers voluntarily adopted uniform policies in new insurance lines, such as homeowners. As often happens, though, market conditions changed. Today, homeowners insurance policies, and likely other personal lines insurance policies, often differ radically with respect to numerous important coverage provisions. In fact, some of the largest insurers in America have substantially degraded the scope of the coverage they provide in their policies. Yet State insurance regulation currently does nothing to provide consumers with the information they need to identify these companies and make their market decisions accordingly.

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[1] Individuals can download five free reports a year if they agree not to use them for commercial purposes.

[2] This analysis is based on my forthcoming article, "Reevaluating Standardized Insurance Policies", 77 *University of Chicago Law Review* (forthcoming 2011), available at *http://ssrn.com/abstract=1687909*.

A second arena in which State insurance regulation fails to promote market transparency involves information on the claims-paying records of carriers.[3] Most States collect extensive market conduct data in various lines of insurance, including private passenger auto, residential property, and life and annuities. These data measure, on a company-specific basis, crucial issues that reflect companies' claims-paying practices, such as such as how often claims are paid within specified time periods, how often claims are denied, how often policies are nonrenewed after a claim is filed, how often consumers complain to the company directly, and how often policyholders sue for coverage.

Although obviously central to evaluating the quality of different insurance products, regulators do not systematically make this information available to the public.[4] Instead, regulators treat it as confidential. In many cases, this claim is legally dubious: at least some of this information occasionally appears in publicly available market conduct exams for specific companies. But the larger issue is why insurance regulators have not worked to alter State laws to the extent that they require this confidentiality, given the importance of this information to assessing the quality of coverage that different carriers provide. In almost all cases, the claim that these data are proprietary is facially implausible: the data reveal how well different companies fulfill their obligations, information which in no sense is the result of insurers' investments in knowledge production.

Yet a third arena in which State insurance regulation fails to promote transparency involves the availability and cost of property/casualty insurance in low-income or minority residential communities.[5] Such insurance is a prerequisite to a wide range of activities, from starting a business to purchasing a home. Moreover, it has long been recognized that certain pricing and marketing practices may disproportionately impact low-income communities. Even if these practices do not involve discriminatory intent, they may constitute a violation of the Fair Housing Act if they have a disparate impact on protected groups and a less discriminatory alternative is available. In response to these concerns, Federal law, through the Home Mortgage Disclosure Act (HMDA), has long required lenders to provide the public with robust information on the availability of home loans. HMDA requires lenders to report and make publicly available geo-coded information regarding home loans, loan applications, interest rates, and the race, gender, and income of loan applicants. This information has promoted richer understanding of credit availability and discrimination, helped identify discriminatory lending practices, and prompted various initiatives to make credit more available in traditionally under-served areas.

By contrast, the vast majority of insurance regulators have repeatedly refused to provide the public with any HMDA-like data regarding the availability of homeowners insurance. One survey found that only four States make insurer-specific, geo-coded data publicly available for homeowners insurance, and no State makes publicly available loss or pricing data for individual insurers. Most State regulators have repeatedly ignored requests to devise a model law that would require such data collection and dissemination. This is particularly troubling because the evidence that is available suggests that homeowners insurance is systematically more expensive and less available in certain low-income, urban areas. Thankfully, the Dodd-Frank Act specifically authorizes the Federal Insurance Office to collect and publish this data.[6]

Insurance regulators have also generally refused to promote transparency with respect to the compensation and incentives of ostensibly independent insurance agents.[7] Insurance agents frequently receive different amounts of compensation for

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[3] I have also discussed this issue in my previous work, including "Regulating Insurance Sales or Selling Insurance Regulation? Against Regulatory Competition in Insurance", 94 *Minnesota Law Review* 1707, 1761 (2010), available at *http://ssrn.com/abstract=1503127*.

[4] The only insurer-specific market-conduct information that regulators do provide to consumers is information about how often consumers complain to insurance departments about their carriers. Although this data is valuable, it is hardly a substitute for the more specific market conduct data described above. Most importantly, only a small and unrepresentative subset of consumers ever complain to State insurance departments. Additionally, consumer complaints concern myriad issues that are disaggregated only in very imprecise ways.

[5] *See, generally,* Gregory D. Squires, "Racial Profiling, Insurance Style: Insurance Redlining and the Uneven Development of Metropolitan Areas", 25 *Journal of Urban Affairs* 391 (2003); Gregory D. Squires and Charis E. Kubrin, "Privileged Places: Race, Uneven Development and the Geography of Opportunity in Urban America", 42 *Urban Studies* 47 (2005).

[6] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, Sec. 502(a) (2010).

[7] To be sure, I have argued before and continue to believe that the regulatory problems created by contingent commissions are particularly resistant to disclosure-based responses. *See,* Daniel Schwarcz, "Differential Compensation and the Race to the Bottom in Consumer Insurance Markets", 15 *Connecticut Insurance Law Journal* 723 (2009), available at *http://ssrn.com/*

placing consumers with different carriers. Often this is a result of "contingent commissions," which are essentially year-end bonuses to agents based on the volume and/or profitability of the business sent to the insurer. Alternatively, some carriers may simply pay higher up-front "premium" commissions. Either way, differential compensation of agents creates obvious incentives for agents to place customers with particular carriers who may not always be optimal for the individual consumer.

Despite this, the vast majority of States do not require independent agents to disclose this potential conflict of interest to their customers, nor do they limit the capacity of these agents to promote their "independence" to consumers. Most States do not currently have any regulations regarding the disclosure of agent compensation. Those that do typically do not require any such disclosure unless the agent received compensation from the customer, which is highly atypical in most consumer transactions. Only a single State, New York, requires that agents disclose prior to sale that "the compensation paid to the insurance producer may vary depending on a number of factors, including (if applicable) the insurance contract and the insurer that the purchaser selects, the volume of business the producer provides to the insurer or the profitability of the insurance contracts that the producer provides to the insurer."[8]

In the life insurance arena, the NAIC has seemingly devoted more attention to promoting transparency, as it has developed Life Insurance and Annuities Disclosure Model Regulations in recent years. Both rules require consumers to be provided with a generic buyers' guide and establish basic standards for the provision of additional information by companies. Although better than nothing, these rules do little to affirmatively empower consumers to choose among the immensely complex products being offered by different companies. To achieve this, regulators must design specific, consumer-tested, required disclosures that combine essential product information into a few basic indices and/or measures. Good examples of such disclosures include the mortgage disclosure forms that the Consumer Financial Protection Bureau recently unveiled as well as the health insurance disclosure form that Health & Human Services recently proposed (and developed in conjunction with the NAIC). If motivated, insurance regulators could easily draft analogous disclosures in the life insurance arena. Indeed, extensive work already exists on how regulators could design and implement disclosures for cash value life insurance policies that would allow consumers to effectively compare the cost and expected rate of returns of different policies.[9]

Standardized, regulator-designed, disclosures have numerous important advantages over the generic buyers' guides and broad standards currently relied upon in life insurance regulation. Most importantly, they recognize the fact that consumers have a limited capacity and willingness to compare complex financial instruments and they affirmatively assist consumers in making decisions. Additionally, because they are standardized and developed by regulators, they can be tested for effectiveness. They give consumers an incentive to invest in learning how to use disclosures, because they are consistent in content and design across companies. And they are relatively easy to police, compared to approaches that give companies discretion to disclose in any manner consistent with broad standards.

In sum, the lack of transparency in consumer-oriented property/casualty and life insurance markets is immensely troubling. To put it bluntly, insurance regulators have failed in a core feature of consumer protection. Transparency is fundamental to the operation of efficient markets: it allows consumers to make decisions consistent with their preferences and forces firms to adjust the products and practices to meet these preferences. Indeed, transparency is ultimately at the heart of recent reforms in the domains of consumer credit and health insurance. And while these reforms have surely been controversial, even their critics have tended to embrace the idea that effective competition requires open and transparent markets.

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abstract=1333291; Daniel Schwarcz, "Beyond Disclosure: The Case for Banning Contingent Commissions", 25 *Yale Law & Policy Review* 289 (2007), available at *http://ssrn.com/abstract=953061*. At the same time, though, effective disclosure-based responses in this domain are clearly better than the *status quo,* wherein ostensibly independent insurance agents market themselves to consumers as trusted, independent advisors while operating under strong incentives to steer customers to particular carriers.

[8] New York Regulation 194, codified at 11 NYCRR Part 30.

[9] *See,* Joseph Belth, "Information Disclosure to the Life Insurance Consumer", 24 *Drake Law Review* 727 (1975); James H. Hunt, "Variable Universal Life Insurance: Is It Worth It Now?" (2007), available at *http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/VariableUniversalLife2007ReportPackage.pdf.*