Statement for the Record

of the

National Association of Mutual Insurance Companies

before the

Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee

House Financial Services Committee

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The National Association of Mutual Insurance Companies ("NAMIC") is pleased to offer comments to the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee on insurance regulatory reform.

Founded in 1895, NAMIC is the largest full-service national trade association serving the property-casualty insurance industry with more than 1,400 member companies in the United States. NAMIC members are small farm mutual companies, state and regional insurance companies, risk retention groups, national writers, reinsurance companies, and international insurance giants. NAMIC members are distinguishable by not only their size, but their diversity in business models and markets. Yet they share a belief that competition and market-oriented regulation is in the best interest of the industry and the customers they serve. It is this goal of open competitive markets that informs and shapes NAMIC's views on insurance regulatory reform.

Over the years the committee has heard extensive testimony on the need for reforms in the insurance regulatory system. Numerous proposals have been advanced, both federal and state based, including federal charters, federal uniformity standards, interstate compacts, and consortiums.

The insurance industry lacks consensus regarding the optimal regulatory structure, as evidenced by the varied approaches to insurance regulatory reform. However, there is general agreement among stakeholders – insurance companies, agents and brokers, regulators, state legislators and consumers – that reform and modernization of the current insurance regulatory system is essential to meet the needs of the 21st century marketplace. There is also broad agreement regarding the principles of sound financial regulation.

Inefficiencies in the insurance marketplace are less the result of the current functional regulatory framework, than the philosophy and execution of the regulatory objectives. Current inefficiencies in the insurance marketplace are driven by excessive rate and form regulation, which hamper competitive pricing, inhibit product and service innovation, and delay product delivery. Free market, competition-based economic structures coupled with a regulatory structure that emphasizes safety and soundness and prompt corrective action should be standard for a modern, vibrant, competitive regulatory structure capable of governing in the modern marketplace.

From a property and casualty insurance industry perspective, the key regulatory problem continues to be an over reliance on outdated and inefficient price and form regulation. To achieve the paramount objective of preventing market failure and encouraging competition, it is imperative that price regulation for all property-casualty insurance lines end. Regulators should facilitate a vibrant marketplace that relies upon competitive forces to set prices. Consistency, while desirable and cost effective, will not in and of itself lessen the marketplace inefficiencies resulting from regulatory models that do not uphold competitive economic principles.

With respect to specific regulatory reforms, NAMIC's conclusion, reached through years of member involvement and research, is that a reformed system of state insurance regulation -

with an appropriate role for congressional oversight and involvement and national standards for non-insurance specific business process issues - is the best structure.

Insurance Regulation

State regulation has for over a century served to address consumer and insurer needs generally well, particularly as it relates to the property-casualty business. The state-based functional regulatory system along with the corresponding application of the McCarran-Ferguson Act limited federal antitrust exemption has promoted and maintained a healthy, vibrant and competitive insurance marketplace.

The state-based insurance regulatory system over the years has proven to be adaptable, accessible, and relatively efficient, with rare insolvencies and no taxpayer bailouts. States have adopted specific programs and policies tailored to the unique needs of consumers within their state. State regulators and legislators consider and respond to marketplace concerns ranging from risks related to weather, specific economic conditions, medical costs, building codes, and consumer preferences. In addition, state regulation is able to respond and adapt to inconsistencies created by various state contract, tort and reparation laws.

Property/casualty insurance is inherently local in nature. The United States has 54 well-defined jurisdictions, each with its own set of laws and courts. The U.S. system of contract law is deeply developed, and with respect to insurance policies is based on more than a century of policy interpretations by state courts. The tort system, which governs many of the types of contingencies at the heart of insurance claims, particularly those covered by liability insurance, is also deeply based in state law including, for example, the law of defamation, professional malpractice, premises liability, state corporation law and products liability. State and local laws determine coverage and other policy terms. Reparation laws affect claims. Local accident and theft rates impact pricing. Geographical and demographic differences among states also have a significant impact on property-casualty coverages. Climate – hurricanes, earthquakes, etc. – differs significantly from state to state.

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

The state insurance regulatory system; however, is not without its shortcomings. State insurance regulation in recent years received justified criticism for overregulation of price and forms, lack of uniformity, and protracted speed-to-market issues. Furthermore, many states still have unnecessary rate regulation that often results in fewer choices and higher rates for consumers. These inefficiencies must be removed to ensure a healthy, effective, competitive marketplace for our modern economy.

While much more reform is still needed, the states have not been blind to the criticism that they need to change with the times, and they have made some significant progress in addressing antiquated rules, such as those involving price controls and company licensing restrictions. The significance of these reforms should not be underestimated as they demonstrate that state regulation can be reformed. Specifically:

- Ten states have adopted flex-band rating systems for property-casualty products to replace the rigid system of price controls.
- Fifteen states have adopted the more flexible use-and-file system.
- Twenty-six states have established no filing requirements, mostly for large commercial risks.
- New Jersey and Massachusetts, both held up as difficult regulatory environments, have enacted some rate modernization. New York has established a regulatory modernization commission to make recommendations for reform.
- Only 16 states still require statutory prior approval. Several of these states, however, are among the largest in the country, accounting for 40.8 percent of the total auto insurance market and 41.4 percent of the total homeowners' insurance market nationwide.
- With respect to insurer licensing, the Uniform Certificate of Authority Application (UCAA) is now used in all insurance jurisdictions.
- A system of electronic filing has been implemented by most states and has
- streamlined the process by which rates and forms are filed by companies.
- Thirty-one states have adopted the interstate compact to serve as a single point of filing for life insurance products.
- The National Conference of Insurance Legislators (NCOIL), the National Conference of State Legislatures (NCSL) and the American Legislative Exchange Council (ALEC) have all endorsed competition as the best regulator of rates. NCOIL has adopted a significant model law that would create a use and file system for personal lines and an informational filing system for commercial lines.
- NCOIL has also adopted a Market Conduct Model Law that will bring significant reform to that area of state regulation.

Despite these steps forward much remains to be done. At the core of the essential reforms must be the adoption of open competition models and the end to price regulation for all property-casualty insurance lines. Open competition models have proven beneficial for consumers. For example, in every state that has enacted competition-based rating systems, the market has improved and consumers have more choices. These benefits must be extended to consumers across the nation and for all lines of insurance.

Additional areas in need of reform include, streamlining agent and company licensing procedures, modernizing the market conduct examination process, establishing effective due process protections for insurers, and increasing speed-to-market for products. Underwriting restrictions preventing insurers from accurately assessing risk must be removed, along with expensive coverage mandates that many consumers do not want. Proper legal protections must also be afforded within the insurance regulatory process.

Options for Reform

Optional Federal Charter

Frustrations with the state regulatory system have led some members of the insurance industry to call for federal intervention in the form of an optional federal charter ("OFC"). Bills to establish a federal charter have been introduced in past Congresses and the subject of much discussion in this Subcommittee. H.R. 3200, the "National Insurance Act of 2007," pending in the 110th Congress would have the federal government assume a direct role in the regulation of insurance by the establishment of an optional federal charter modeled on bank regulation. The legislation embodies the principles of open competition-based regulation by removing direct rate and form regulation and streamlining and centralizing insurance regulation. Proponents argue that regulatory competition promoted by a federal charter option would increase pressure for open competitive markets benefiting insurers and consumers alike.

NAMIC supports the regulatory goals articulated in H.R. 3200, but believes that regulatory reform is best achieved at the state level, without creating a new federal bureaucracy.

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

For example, while proponents of an OFC tout the significant rate deregulation anticipated by the bill, the political and practical reality is that any federal system is likely to more closely resemble the California strict regulatory approach than the Illinois open competition model. Numerous specific concerns arise when considering federal regulation of insurance. Specifically:

- Insurance inherently differs from other financial products and services in that it is a promise of future financial protection making solvency and consumer protection paramount. Federal regulation has proven no better than state regulation in addressing market failures or protecting consumer interests. Unlike state regulatory failures, federal regulatory mistakes can have disastrous economy-wide consequences. The savings and loan debacle of the 1980s that eventually cost taxpayers over $100 billion is the biggest such disaster in recent memory. Similarly, federal regulation of the pension system has failed to prevent recent numerous high profile failures. In contrast, the state guaranty system continues to work well to protect consumers without taxpayer bailouts and state regulators respond to thousands of consumer inquiries each year. In addition an OFC system that establishes a national solvency fund for federally chartered companies or permits insurers operating under different financial regulatory standards to participate in state guaranty funds could raise significant questions regarding the operation, stability and viability of the financial backstop for policyholders and claimants.

- Regulatory competition between state regulators and the federal Office of National Insurance could create an unlevel playing field favoring large, national writers or specific lines of insurance. Despite assurances that all players could choose the regulatory system best matching their business model and consumer needs, the reality is that transaction costs, as well as retooling and retraining expenses, would effectively lock smaller and mid-size insurers into their original choice of regulator. Adoption of an OFC is likely to be accompanied by various "social regulation" provisions that tend to socialize insurance costs by spreading risk indiscriminately among risk classes. Provisions to place restrictions on underwriting or impose broad coverage mandates could undermine the insurance marketplace. By weakening the link between expected loss costs and premiums, underwriting restrictions create cross-subsidies that flow from low-risk insured to high-risk insureds. Similarly coverage mandates could be utilized to inappropriately cross-subsidize risk.

- A federal regulatory system that results in overlapping, dual or conflicting regulation would create regulatory confusion and significantly increase the cost of doing business for all insurers. It is foreseeable that insurers, even those opting for state regulation, would find themselves subject to a panoply of new federal rules and regulations. The health insurance market is a vivid example of the pitfalls and confusion of dual regulation for consumers and insurers. This dual regulatory system must be avoided for the property-casualty industry. A federal regulator also raises concerns regarding accessibility and accountability for both consumers and market participants. With respect to consumers, in 2006, the states combined processed 383,654 consumer complaints and handled an additional 2.5 million consumer inquiries, many involving highly fact specific situations and varied local conditions, laws and regulations. In addition, state regulators interacted countless times with insurers and producers. The likelihood that a federal regulator could provide the same level of response is not high.

- In contrast to other insurance products, the property/casualty business is highly dependent on state and regional differences. Insurance is subject to state and regional differences in legal systems and reparation laws; geographical differences impacting weather patterns and catastrophes; differences in demographics affecting population concentration, driving patterns, and land use; and state and local laws establishing driving rules, building codes, and other local matters. These differences are particularly critical for personal lines property and casualty coverage's (auto, homeowners, personal liability) making "national" products and regulation difficult.

The goal of removing direct rate and form regulation and streamlining and centralizing insurance regulation is laudable; however, NAMIC does not believe that a federal regulatory structure would necessarily provide a greater likelihood of the elimination of unnecessary and arbitrary price and product controls. Congress is no less susceptible to political pressures than state governments and there are numerous examples of federal regulatory excess to justify skepticism that a federal regulator would prove more efficient, effective or market-oriented. NAMIC does not believe that the state system, with its flaws, is so broken

that it cannot be repaired, nor does NAMIC believe there is a national crisis that necessitates building a new federal bureaucracy. Although an OFC is supported by segments of the insurance industry and the Department of the Treasury, a variety of other viable approaches for regulatory reform, including federal standards, domiciliary deference, interstate compacts and model laws and regulations, should be considered.

Federal Standards

While NAMIC opposes an OFC, we believe Congress could play a limited role in achieving specific targeted reforms to achieve national uniformity and consistency. This approach has been adopted by the House in its approval of H.R. 1065, "The Nonadmitted and Reinsurance Reform Act of 2007" which streamlines regulation for nonadmitted insurance and reinsurance carriers and surplus lines companies. The legislation would establish national standards for how states may regulate, collect, and allocate taxes for surplus lines and nonadmitted insurance. The bill would also establish national standards for how states regulate reinsurance – often referred to as insurance for insurance companies. The legislation gives the home state regulator of the insurer primary oversight of multistate surplus lines risk and responsibility for allocating any taxes collected on the coverage to the other involved states. It also makes it easier for sophisticated purchasers to access the surplus lines market. The core reform put in place by the legislation would ensure that only one set of state regulatory rules apply to policies that insure exposures in multiple states – those of the policyholder's home state. The approach embodied in H.R. 1065 allows Congress a meaningful role in modernizing the insurance regulatory system, while leaving the day-to-day regulatory control at the state level. NAMIC supports H.R. 1065 and urges swift Senate action.

A similar method for achieving uniformity is utilized in H.R. 5611, the "National Association of Registered Agents and Brokers Reform Act of 2008" ("NARAB II"). The legislation would establish licensing reciprocity for insurance producers that operate in multiple states. At the same time, it would ensure that states retain the authority to regulate marketplace activity and enforce consumer protection laws. The legislation would establish the National Association of Registered Agents and Brokers ("NARAB") to provide for non-resident insurance agent and broker licensing. H.R. 5611 is a progression from the original NARAB provision that was part of the Gramm-Leach-Bliley legislation enacted in 1999. The legislation would permit producers licensed in good standing in their home states to receive additional state licenses if they satisfy the requirements established for NARAB membership. Producers could remain licensed in the traditional manner, but those operating in multiple jurisdictions could apply for NARAB membership and one-stop non-resident licensing. NARAB II deals only with marketplace entry and would not impact the day-to-day state regulation of insurance. The legislation represents another example of meaningful congressional reform while retaining the state regulatory structure.

As Congress considers insurance regulatory reform proposals, NAMIC urges lawmakers to identify specific areas of reform that lend themselves to national standards. In addition to

nonadmitted and surplus lines regulation and agent and broker licensing, NAMIC encourages Congress to consider federal standards prohibiting states from limiting property-casualty insurers' (1) ability to set prices for insurance products, except where the insurance commissioner can provide credible evidence that a rate would be inadequate to protect against insolvency and (2) use of underwriting variables and techniques, except where the insurance commissioner can provide credible evidence that a challenged variable or technique bears no relationship to the risk of future loss. Targeted federal legislation, such as the proposals outlined, could be more easily achieved and with less federal bureaucracy leading to more expeditious insurance regulatory reform.

Interstate Compacts, Domiciliary Deference and Model Laws

Interstate compacts are contracts between states that allow states to cooperate on multi-state or national issues while retaining state control. Interstate compacts have a deep history dating from their specific mention in the U.S. Constitution. To date there are over 200 interstate compacts and the average state participates in 25 separate contracts. As such, interstate compacts offer one method for resolving differences in state insurance regulation. Thirty-one states have adopted the Interstate Insurance Product Regulation Compact to develop uniform national product standards; establish a central point of filing for these insurance products; and review product filings and make regulatory decisions related to life insurance, annuities, disability income, and long-term care insurance. Interstate compacts have also been suggested for natural disaster risks.

Domiciliary deference vests responsibility with the regulator of an insurer's state of domicile to take the lead role in specified regulatory functions. In financial regulation, states focus on their domestic insurers and rely on the state of domicile to monitor the solvency and financial condition of foreign insurers doing business in their state. States also utilize the concept of domiciliary deference in other examinations, agreeing to forego routine or comprehensive exams and relying on the home state, while retaining the right to examine targeted issues. The concept of domiciliary deference is embodied in H.R.1065 with respect to the treatment of nonadmitted and surplus lines. The concept could be expanded to streamline regulatory processes and avoid redundant examinations and document productions.

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

Treasury Proposals

The recently released Department of the Treasury "Blueprint for Financial Services Reform" makes a number of recommendations for short, intermediate and long-term structural and operational changes affecting all sectors of financial services, including insurance. In

addition to support for adoption of an OFC, the report recommended the immediate creation of an Office of Insurance Oversight ("OIO") within the Department of Treasury. The new office would be charged with the authority to address international regulatory issues and to provide advice and counsel on domestic and international policy issues affecting insurance. NAMIC is concerned that the establishment of an OIO is a prelude to a dual insurance regulatory regime. Permitting federal negotiators to override or dictate standards of regulation affecting market condition and financial solvency could undermine U.S. insurance markets and the state-regulatory structure. An OIO would create regulatory confusion. Advice and counsel on issues affecting the insurance industry is currently available, as evidenced by the involvement of federal officials in a variety of current issues, including terrorism and natural catastrophe risk. Creation of a new bureaucratic entity is not warranted at this time.

Long-term regulatory reforms proposed by Treasury are premised upon of an objectives-based regulatory system keyed to market stability regulation, prudent financial regulation and business conduct regulation. To facilitate this transition, the blueprint calls for the establishment of three distinct regulatory bodies encompassing all sectors of the financial services industry to address the individual specific core objectives.

As Congress reviews Treasury's recommendations for a shift from the current rules-based legal and regulatory system to objectives-based regulation, careful attention must be given to legal and operational issues. Lack of legal certainty could create extreme vulnerability for regulated firms if not properly addressed in conjunction with such a shift in the regulatory paradigm. Whether a particular way of doing business conforms to the objective involved can be a matter of a particular regulator's opinion, and as regulators and circumstances change, so do interpretations. In addition, civil liability concerns must also be addressed if objectives-based regulation is adopted. In the United States, companies are subject to liability in private class actions in both federal and state courts, civil rule enforcement by federal and state regulators, and criminal enforcement by both the U.S. Justice Department and state attorneys general. NAMIC urges regulators and lawmakers to carefully weigh all issues, including ensuring proper legal protection and regulatory transparency and avoiding arbitrary regulator conduct.

In developing regulatory processes to meet consumer and market needs, the financial regulatory structure would also benefit from uniform and consistent acknowledgement and application of fundamental business legal protections, including confidentiality and privilege provisions, due process rights to withhold production, trade secrets, and self-evaluative audits to safeguard the legal and intellectual property rights of financial services entities. In addition, it is imperative that lawmakers and regulators address the complex legal issues arising through the increasing use of third parties. Although regulators often enter into "confidentiality" agreements with these third parties, courts have consistently held that privilege is vitiated when privileged information is provided in such fashion. In addition, the insurer or other financial service entity is not a party to such agreements and as such has little or no remedy if the agreement is deficient or breached.

Although not always in the context of insurance regulatory reform proposals, to successfully achieve the desired goals of effective regulation careful attention must be paid to these issues.

Treasury also recommends enhancing the authority of federal negotiators to address insurance issues. NAMIC supports efforts to ensure the competitiveness of the U.S. insurance market and adequate participation in the U.S. reinsurance market of foreign-based entities. NAMIC supports efforts of state regulators to work with international regulators toward a well functioning marketplace and the international free flow of capital. However, property and casualty insurance is highly dependent on local geographical, demographic and economic conditions, state tort and reparation laws, and other variables. The U.S. system of contract law is deeply developed, and with respect to insurance is based on more than a century of policy interpretations by state courts. The tort system, which governs many of the types of contingencies at the heart of insurance claims, particularly those covered by liability insurance, is also deeply based in state law. Negotiations regarding insurance policy to facilitate international regulatory cooperation cannot override state contract and tort law and insurers cannot have policies that place them in conflict between these state laws and international treaties or negotiations. Standards of regulation affecting market condition and financial solvency of market players also cannot be overridden or dictated by federal negotiators. There are significant differences between insurance and other financial services and products which necessitate specific regulatory treatment. International regulatory cooperation, while vital to U.S. interests, may not take precedence over market solvency and stability and protection of U.S. consumer interests.

Conclusion

NAMIC fully supports the goal of simplification and modernization of the nation's financial regulatory process. We encourage the Subcommittee to fully explore all options for modernizing and reforming the state-based regulatory system. We look forward to working with the committee on proposals to enhance the state-based insurance system for our nation's insurers and policyholders.

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