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NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Statement

of

John T. Hill

President and Chief Operating Officer

Magna Carta Companies

on behalf

of the

National Association of Mutual Insurance Companies

before the

Senate Banking, Housing, and Urban Affairs Committee

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

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

Founded in 1895, NAMIC is the largest full-service national trade association serving the property/casualty insurance industry. NAMIC members are small farm mutual companies, state and regional insurance companies, and large national writers. The breadth of association members gives us an excellent perspective on the relationship between the recent financial crisis and the property/casualty insurance business. Our companies share a belief that competition and market-oriented regulation is in the best interest of the industry and the customers they serve. As mutual insurance companies, it is this goal of competitive markets that informs and shapes our views on insurance regulatory reform.

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

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

As the Committee contemplates reform of the nation's financial services sector, it is essential to consider what is the best structure for all constituents, including consumers, taxpayers, insurance companies, agents, and others affected by the insurance underwriting process. NAMIC's conclusion, reached through years of member involvement and research, is that the best construct is a reformed system of state insurance regulation, in which state officials coordinate and cooperate with other

functional, prudential regulators and state governments and Congress exercise an appropriate oversight role. It is the closeness of these state regulators that is the essential ingredient to understanding unique regional property/casualty insurance markets.

Prudential Insurance Regulation

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

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

The state-based functional regulatory system and the corresponding application of the McCarran-Ferguson Act limited federal antitrust exemption have worked well for decades to promote and maintain a healthy, vibrant, and competitive insurance

marketplace. There are more than 7,000 insurers operating in the United States, the majority of which are relatively small. A number of studies over the years, including those conducted by the U.S. Department of Justice, state insurance departments, and respected economists and academics, have consistently concluded that the insurance industry is very competitive under classic economic tests.

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

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

those covered by liability insurance, is also deeply based in state law including, for example, the law of defamation, professional malpractice, premises liability, state corporation law, and products liability. State and local laws determine coverage and other policy terms. Reparation laws affect claims. Local accident and theft rates impact pricing. Geographical and demographic differences among states also have a significant impact on property/casualty coverages. Climate – hurricanes, earthquakes, etc. – differs significantly from state to state.

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

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

Consumer Protection

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

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

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

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

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

Guaranty Funds

Although solvency and financial integrity are essential in the regulation of all financial services industries, the level and degree of regulation of financial institutions with explicit government guarantees differs from that of financial institutions without the

same governmental financial responsibility. Unlike banking and pension interests, insurance products carry no federal guarantee, but are backed by other insurance companies through the guaranty fund system.

State guaranty associations provide a mechanism for the prompt payment of covered claims of insolvent insurers. All states and territories, with the exception of New York, have created post-assessment guaranty associations. In the event of insurer insolvency, the guaranty associations assess other insurers to obtain funds necessary to pay the claims of the insolvent entity. In the case of New York, the New York Security Fund and certain funds that cover only workers' compensation utilize a pre-assessment mechanism.

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

Each guaranty association has established detailed procedures for handling of assets, filing of claims, and making assessments. With the exception of California, Michigan, New York, and Wisconsin, the guaranty association acts of the states and territories are

based on, and are similar in most respects to, the National Association of Insurance Commissioners (NAIC) Model Act. State legislators and regulators have crafted statutes and regulations regarding the creation and operation of the funds based on the specific needs of policyholders and in coordination with state laws. The funds operate to ensure payment of claims by other industry companies, rather than utilize state or federal financial backstops. The insurance guaranty system and the state regulatory and oversight structure function well for insurers and consumers. The current system avoids catastrophic financial loss to certain claimants and policyholders and maintains market stability, without governmental financial guarantees. As such, regulation and oversight of the guaranty fund system is appropriate at the state level and federal oversight is unnecessary in the context of the industry-funded state-based system.

Risk Regulation in the Property/Casualty Insurance Industry

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

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

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

In addition to more conservative accounting standards, insurers must maintain minimum levels of capital and surplus. In the early 1990s, the NAIC developed a system that prescribes capital requirements corresponding to the level of risk of the company's various activities. The risk-based capital (RBC) formulas apply separate charges for

an insurer‘s asset risk in affiliates, asset risk in other investments, credit risk, underwriting risk, and business risk, and each formula recognizes the correlation between various types of risk. The Risk-Based Capital Model Law also establishes levels of required company and/or regulatory action, ranging from company corrective action to termination of the entity. While the RBC system is intended to prescribe minimum capital levels, more and more, it is also regarded as an early warning system.

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

State solvency regulation also includes model investment laws specifying the types of permitted investments, expectations regarding how insurer portfolios are selected, and limitations on what assets receive regulatory credit. A separate division of the NAIC, the Securities Valuation Office, provides warnings on suspect securities and advice to state financial examiners. States also uniformly impose requirements for professional actuarial review of reserve liabilities, require reporting of audited financial statements, and establish guidelines for selection of auditors.

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

Systemic Risk

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

Some define systemic risk as the probability that the failure of one financial market participant to meet its contractual obligations will cause other participants to default on their obligations leading to a chain of defaults that spreads throughout the entire

financial system and, eventually, to the nonfinancial economy. This conception of systemic risk is likened to the risk of a chain reaction of falling dominoes.

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

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

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

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

Future crises are likely to arise from other types of asset bubbles, or other instances of widespread failure by market participants in evaluating certain types of risk. Past financial crises also suggest that market-oriented systemic risk is of greater concern than risk associated with supposedly systemically significant institutions. For example, the 1987 stock market crash was not precipitated by any particular institution or group of

institutions, nor was it the proximate cause of the failure of any large bank. Instead, it was a market-oriented crisis that was viewed – at the time and since – as an event with potentially systemic consequences that warranted official-sector intervention. In addition to the 1987 stock market crash, examples of such crises might include the widening of interest rate spreads and decline in liquidity following the collapse of Long-Term Capital Management in 1998 and the collapse of the junk bond market in 1989-90.

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

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

Systemic Risk in the Insurance Industry

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

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

- **Leverage**

Very few property/casualty insurers use commercial paper, short-term debt, or other instruments that may be used to leverage their capital structures, a fact that makes them less vulnerable than highly leveraged institutions when financial markets collapse.

Because of their basic business model and strict capital requirements imposed by state regulators, property/casualty insurers are much more heavily capitalized in terms of their asset-to-liabilities ratios than banks and hedge funds. For these reasons alone, the banking system's perennial moral hazard of being "too big to fail" has no equivalent in the insurance industry. This, of course, is a completely different model than the banking world where leverage is a central component of the enterprise.

- **Liquidity**

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

- **Correlation**

Property/casualty insurers use underwriting tools specifically designed to identify and control certain types of correlation, including market concentration, in order to control catastrophe and underwriting exposures. Identifying and managing risks are at the core of insurance and these tools allow insurers to accurately price and underwrite risk. The side benefit of rigorous underwriting is a reduction in systemic risk exposure. It is also important to note the difference between asset-backed securities and other derivative products, where the underlying risk is financial or market (such as credit, price, interest rate, or exchange rate), and property/casualty insurance, where the underlying risk is a real event, such as an automobile accident, fire, or theft. While the former risks are likely to be correlated in that they will be affected by similar cyclical economic or financial factors, the latter are largely individual, non-cyclical idiosyncratic risks. Banking risks are often highly correlated, particularly in economic downturns. Traditional insurance, in contrast, pools uncorrelated idiosyncratic risks, and is not subject to systemic crises in the same way as banks.

- **Connectedness/Sensitivities/Concentration**

Property/casualty insurers manage concentrations of investments and have regulatory limitations on both the type and concentrations of the assets in which they invest. These realities have the effect of reducing the property/casualty insurance industry's connectedness and sensitivity to the actions and conditions of other sectors of the

financial services industry. The one possible exception to this rule is the small subset of monoline financial guaranty insurers that offer specialized products such as bond and mortgage insurance. Because financial guaranty insurance is by definition directly connected to financial products, it is conceivable that these specialty insurers could play a role in propagating systemic risk.

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

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

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

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

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

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

Options for Reform

Single Financial Regulator

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

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

There are also significant differences between property/casualty insurance and other insurance and financial service products that necessitate different specific regulatory treatment. Geographical and demographic differences among states would similarly

pose additional difficulties for a single financial market regulator. NAMIC believes that attempts to establish a single financial regulator would threaten the fundamental underpinnings of the property/casualty marketplace.

Federal Insurance Charter

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

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

- Insurance inherently differs from other financial products and services in that it is a promise of future financial protection, making solvency and consumer protection paramount. Federal regulation has proven no better than state regulation in addressing market failures or protecting consumer interests. Unlike state regulatory failures, federal regulatory mistakes can have disastrous economy-wide consequences. The current high-profile failures of 25 federally

regulated banks in 2008 and 16 more already this year have shown weaknesses in federal solvency regulation. Contrast this with the property/casualty insurance industry which had an excellent solvency record in 2008 in spite of a large drop in investment income and the fourth most expensive natural disaster in US history. The state guaranty system continues to work well to protect consumers without taxpayer bailouts and state regulators respond to thousands of consumer inquiries each year. In addition an optional federal charter (OFC) system that establishes a national solvency fund for federally chartered companies or permits insurers operating under different financial regulatory standards to participate in state guaranty funds could impair the current guaranty system.

- Regulatory competition between state and federal regulators could create an unlevel playing field favoring large national writers or specific lines of insurance. Despite assurances that all players could choose the regulatory system best matching their business model and consumer needs, the reality is that transaction costs as well as retooling and retraining expenses would effectively lock smaller and mid-size insurers into their original choice of regulator.

- As previously noted, the property/casualty insurance business is highly dependent on state and regional differences. These differences are particularly critical for personal lines property/casualty coverages (auto, homeowners, personal liability) making “national” products and regulation difficult.

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

Office of Insurance Information

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

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

NAMIC worked closely with Chairman Kanjorski and the Committee to resolve concerns

related to the scope and authority of the OII, the confidentiality of the data, and the composition of the Advisory Group, and supported passage of the amended legislation.

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

Federal Standards

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

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

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

Interstate Compacts, Domiciliary Deference and Model Laws

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

Domiciliary deference vests responsibility with the regulator of an insurer's state of domicile to take the lead role in specified regulatory functions. In financial regulation, states focus on their domestic insurers and rely on the state of domicile to monitor the solvency and financial condition of foreign insurers doing business in their state. States also utilize the concept of domiciliary deference in other examinations, agreeing to forego routine or comprehensive exams and relying on the home state while retaining

the right to examine targeted issues. The concept could be expanded to streamline regulatory processes and avoid redundant examinations and document productions.

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

Effective Regulation

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

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

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

NAMIC recognizes the interconnectedness of the industry segments within the financial industry and of the U.S. and international financial communities. We acknowledge the

need for greater coordination and cooperation among and between U.S. prudential regulators and foreign regulatory bodies. We believe, however, that it is not necessary to replace the current functional regulatory framework to successfully achieve federal interests in these areas.

NAMIC believes Congress must maintain the state-based insurance regulatory system; however, we recognize that improvements can and should be made. Specifically, NAMIC supports:

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

- **Enhanced international regulatory cooperation and coordination**. Enhanced cooperation and coordination among the various global financial services regulatory bodies is needed. However, such cooperation and coordination should

not come at the cost of abrogation of regulatory authority to foreign jurisdictions or quasi-governmental bodies.

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

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

- **Creation of an Office of Insurance Information**. Legislation introduced by Rep. Paul Kanjorski in the 110th Congress would have also provided greater autonomy to the Department of the Treasury through a newly created Office of

Insurance Information (OII) to engage with foreign jurisdictions on insurance matters. NAMIC supports greater coordination and limited preemptory authority over international insurance issues.

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

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

  Attempting to define and regulate "systemically significant institutions" on the basis of size, business line, or legal classification – such as including all property/casualty insurers – would do little to prevent future financial crises.

> Indeed, a regime of systemic risk regulation that is institution-oriented rather than focused on specific financial products and services could divert attention and resources from where they are most needed, while at the same time producing distortions in insurance markets that would be harmful to consumers.
>
> However, at this time there is no evidence that the property/casualty insurance industry contributes any substantial amount of systemic risk to the global financial system. A new systemic risk regulator should not be tasked with supervising property/casualty insurers that are arbitrarily presumed to be "systemically significant." Instead, any new systemic regulatory system should be given the flexibility to adapt to changing developments in the marketplace, and to anticipate events that could potentially cause a cataclysmic shock to the financial system and the broader economy.

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

Conclusion

NAMIC supports a strong, transparent, market economy. We encourage the Committee to fully explore all options for addressing the various challenges, including systemic risk, confronting the nation's economy. As the Committee and Congress evaluate solutions, NAMIC, on behalf of our member companies and their customers, encourages members to carefully weigh the costs and benefits of proposed regulatory processes. It is critical that any solution address real regulatory gaps, without implementing duplicative and ineffective new regulations where none are needed.

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