

December 12, 2003

The Honorable Richard Baker
U.S. House of Representatives
314 Cannon House Office Building
Washington, D.C. 20515

RE: State Regulatory Modernization Proposals as Federal Solutions

Dear Mr. Chairman:

Pursuant to your request at the conclusion of last month's hearing on insurance regulation, the supporters of a market-based Optional Federal Charter ("OFC") for insurance entities thought you might find it useful if we reiterated the basic principles of our OFC approach and then discussed the shortcomings of competing approaches to regulatory modernization.

The new insurance regulatory paradigm we seek is designed to:

- Empower consumers instead of government officials through market-based regulation;
- Excise the economically-indefensible government price and product controls that stifle consumer choice, innovation and competition, and artificially mask underlying systemic problems;
- Protect consumers by focusing regulatory resources on core functions like financial soundness and stability of the industry;
- Replace 51-jurisdiction inconsistency in regulation with national uniformity and certainty; and
- Create a national regulatory voice on insurance matters.

We are not seeking to be regulated differently than other industries or to avoid necessary regulatory oversight in areas such as corporate governance. In fact, we are simply asking that insurance be regulated like other industries, without the government "command-and-control" apparatus that has been adopted in the name of "consumer protection," but which has prevented consumers from having the strong voice that a market-based system provides.

Our OFC proposal accomplishes these objectives in a way that preserves the state regulatory system for those that wish to continue being regulated by that system and adopts the best aspects of state regulation as part of the proposal.¹

With respect to insurance pricing, the OFC proposal draws on the Illinois market-based approach that you referenced during the hearing. Illinois allowed its rating law to expire over 30 years ago to test the concept of market-driven regulation of insurance premiums. It has never looked back. The Illinois rating model has stood the test of time well and has worked in a way very favorable to consumers in one of the Nation's largest states – a state that also has the third largest city and metropolitan area in the United States (Chicago).

Year after year, Illinois ranks about average or slightly better than average among all states with regard to affordable auto and homeowners insurance premiums. Illinois has achieved this ranking despite the general rule that heavily populated states with high traffic density have much higher auto insurance premiums. Auto insurance premiums are more affordable in Chicago than most large cities and the percentage of drivers in pooled (residual) markets is lower than other states with large urban areas.

Various economic studies have also shown that market regulation of rates in Illinois has brought more stability to insurance premiums than is the case in states with command and control rate regulation - another significant consumer benefit. Rates can rise and fall normally in response to changing loss experience, costs and competition, unlike price control states where rates are held down artificially as costs rise, but eventually need to rise abnormally to avert market crises. And, when loss experience and costs go down, insurers have the confidence to implement rate reductions more frequently. On the other hand, in rigid price control jurisdictions (like California), insurers have less confidence that regulators will approve price increases when necessary to avoid financial distress, thus creating hesitancy to seek rate decreases in less urgent times. Indeed, a comparison of average homeowners' insurance premiums in California and Illinois during the 1990s based on similar insured values demonstrates that premiums in California were consistently 30% higher. For those California homeowners who choose to protect their property from earthquake damage, that price disparity is even greater.

By establishing a market-based optional federal charter, institutions with a business model that would benefit from the advantages a single federal regulatory scheme could provide – uniformity, certainty and efficiency of regulation, and the opportunity to broaden consumer choice by bringing a more diverse group of products to market faster – would be free to elect national supervision. Alternatively, those institutions that believe the state system offers superior regulation would be free to remain state supervised. Our goal is not to dictate which charter institutions must choose, but to make the choice available in the first place. Such a distinction is vitally important given that other

¹ To this end, we have included, as an appendix, an illustrative list of existing regulatory standards from the NAIC and from various state statutes that our current OFC proposal incorporates. While the proposal continues to evolve, the appendix provides examples of the best state regulatory standards our proposal adopts for use in a federal regulatory structure.

approaches to regulatory modernization are less respectful of states' rights, take much longer to implement, or address just one deficiency of the state system instead of all its component parts.

One such approach is the creation of federal standards to be applied by the individual states. This concept could take two forms, neither of which is preferable to optional federal chartering. On the one hand, federal standards could serve as minimum standards for the states, permitting states to add further regulation on top of those standards mandated by the federal government. Under this scenario, federal standards would fail to achieve the uniformity and efficiency of regulation promised by an optional federal charter. In fact, minimum federal standards would only exacerbate the current patchwork of differing laws with which insurers and producers must comply and would increase, rather than decrease, the cost and complexity of regulation by adding another layer of regulation.

On the other hand, federal standards could be mandatory and exclusive. As such, the federal standards would not be an option to state regulation; they would replace it. To the extent a federal standard was created to address a regulatory issue, the role of each of the 51 state insurance regulators would be limited to implementing and enforcing the new federal standard. Instead of creating regulatory alternatives brought about by a market-based optional federal charter and the healthy dynamic such alternatives engender, mandatory federal standards would be more intrusive on states' rights, a result the proponents of optional federal chartering are trying to avoid. Further, directing states to enforce federal standards raises difficult Tenth Amendment issues that would need to be addressed for the enforcement mechanism to be constitutionally viable. In addition, by allowing 51 state regulators to act as "traffic cops" for federal standards, the problem of uneven, non-uniform regulation would persist.

The only conceivable way to reduce these enforcement problems under a federal standards approach would be to make federal law preemptive of certain state regulatory activities. However, this compels all states and insurers to adhere to a single system rather than allowing them to choose the regulatory option that best suits them. For these reasons, the undersigned organizations have concluded that our OFC proposal provides the best vehicle for achieving meaningful insurance regulatory reform without forcing that reform on those that wish to remain in the current state system.

Model laws developed by NCOIL – particularly the NCOIL Property/Casualty Insurance Modernization Act ("NCOIL P&C Modernization Model" or "P&C Model") and the NCOIL Market Conduct Surveillance Model Law ("NCOIL Market Conduct Model" or "Market Conduct Model") – have frequently been mentioned as potential candidates for a federal standards approach. But both models have serious flaws that would render them ineffective if codified at the federal level. The NCOIL P&C Modernization Model contains at least three elements that make it inappropriate for adoption as federal standards.

First, the NCOIL P&C Modernization Model does not address regulation of policy forms.² As such, it does not deal with the critical issue of government product controls opposed by all the undersigned organizations and their members. As we have stressed on multiple occasions, any approach to reform of the dysfunctional state system must focus on eliminating filing/review requirements for insurance. Allowing regulators to dictate which products are offered in the marketplace stifles innovation and creativity, removes incentives for consumers to demand products and services that are responsive to their needs, and distorts the insurance marketplace.

Second, rather than relinquishing government control over prices to consumers in the marketplace, the P&C Model adds another layer of government control by making the level of regulatory authority over rates dependent on a governmental determination as to whether a defined market is “competitive” or “not competitive.” While it is true that the P&C Model presumes that markets are competitive, this presumption is illusory and will not impede states from sub-defining markets to “a geographic area smaller than the statewide market to be tested” and then overcoming the competitiveness presumption by applying a list of subjective factors (such as “[w]hether the total number of companies writing the line of business is sufficient to provide multiple options”). Even if the list of factors in the P&C Model were pared to those considered to be purely objective, state regulators would still have ultimate control over how those factors were applied. In short, “objective” standards in the hands of “subjective” regulators will inevitably become “subjective standards” that may well be worse than the system that exists today. Having the level of rate review triggered upon a market competitiveness determination does nothing to relieve state regulatory incentives to maintain and increase authority over functions that serve no economic purpose and that should be driven by consumers in the market.

In addition, it has been the property and casualty industry’s experience that, once a “non-competitive” determination has been made for any market, it is next to impossible to convince legislators or regulators to rescind that determination. This is due primarily to political expediency – it is easier to artificially cap rates than to relinquish that authority to marketplace forces. The Massachusetts personal auto insurance market provides a good example of this phenomenon. Each year, a determination of market competitiveness is made. Every year, the market is determined to be non-competitive and rates are set by the insurance commissioner. That yearly “non-competitive market”

²The P&C Model does contain a minor exception for “large commercial policyholders” that are exempted from both form and rate regulation. Unfortunately, this exemption may only apply in a very narrow set of situations. The exemption provision is based on threshold criteria left to be established by each state. As a result, the exemptions will be inconsistent across all regulatory jurisdictions and, in most cases, the thresholds will be set at a level that will benefit very few policyholders. In fact, the property and casualty industry’s experience with many states’ handling of these provisions is that they are designed through political compromise not to benefit a significant portion of the policyholder community. For example, a number of states have set their insurance premium threshold criteria at \$500,000; in these states, only the very largest entities qualify for the exemption, while other commercial policyholders remain ineligible to reap the benefits of market-driven regulation.

determination has a chilling, pre-ordained effect on the marketplace and acts to discourage insurers from entering the market.

Third, even in a competitive market, the NCOIL P&C Modernization Model still retains a government price control system that requires personal lines rate filings and authorizes regulatory review of all rates.³ As a result, adoption of the P&C Model does not resolve a fundamental problem with the current state system: a misplaced regulatory focus on controlling rates and a tendency to apply that misplaced control in 51 different ways. In contrast, the OFC proposal places control over insurance prices in the marketplace where consumers have the final say, and shifts regulatory emphasis to ensuring financial stability and overseeing insurer behavior in that marketplace.

With respect to the NCOIL Market Conduct Model, we support the concepts discussed in the draft to date to the extent that they bring uniformity and consistency, and do not result in repetitive examinations by state regulators that simply add burdens and costs. We remain concerned, however, about unresolved issues with the Market Conduct Model such as “domestic deference.” Simply put, domestic deference occurs where the state regulator in the jurisdiction where the insurer is domiciled takes the lead on conducting an examination, and other states where the insurer is doing business defer to the lead state. Such a system, currently used for insurer financial examinations, would greatly reduce the number of duplicative market conduct examinations and would reduce the costs to insurers. Unfortunately, the current struggles at NCOIL and the NAIC on this issue are indicative of the difficulties we face with a system that sometimes views “uniformity” as ceding authority to another. Ultimately, true uniformity and consistency can only be achieved through a single federal regulator applying a single market conduct standard.

It is also unrealistic to believe that we could put in place a series of key federal standards and expect the states to enforce them in a uniform and consistent manner. Two examples provide evidence of this problem. First, when Congress enacted the Terrorism Risk Insurance Act (“TRIA”) in 2002, it, among other things, (a) established a federal quota share program for certain terrorism losses exceeding insurer deductibles, (b) required insurers to make terrorism coverage available on the same terms and conditions as other types of covered losses for the first two years of the program, and (c) set federal conditions for reimbursement while preempting in the first year of the program state “prior approval” laws and waiting periods for terrorism rates and forms covered by TRIA. Despite the clear preemptive language, at least one major state refused to waive its prior approval laws for terrorism exclusions. Other states have misapplied TRIA’s federal standards, wrongly interpreting the “make available” language to require insurers to offer terrorism exclusions and mandating that TRIA policyholder disclosure notices be treated like policy forms.

Second, while the Gramm-Leach-Bliley Act of 1999 (“GLBA”) established federal privacy standards for financial institutions with implementation left to the functional

³ The NCOIL P&C Modernization Model does not require commercial lines insurance rates “in a competitive market” to be filed, but still gives state regulators broad discretion to review those rates.

regulators of those institutions, and the NAIC unanimously adopted a privacy model regulation, states like California, New Mexico, and Vermont have departed from that NAIC model, forcing insurers to comply with varying privacy standards and enforcement mechanisms. In addition, GLBA's registered agent and broker provisions were supposed to provide reciprocity on producer licensing in at least 29 jurisdictions, with the NAIC certifying that it had met the conditions of those provisions. Despite certification, key states are still not in compliance. Even those that have been certified by the NAIC still allow variances – extra requirements like fingerprint and background checks – before a non-resident license is granted.

Moreover, if Congress merely enacts standards with no accompanying federal enforcement mechanism, it is all but inevitable that day-to-day interpretations and other ongoing regulatory matters will either be decided in court or, by default, be brought back to the Financial Services Committee. We believe the only practical means of enforcing these standards would be to assign that task to an existing or new federal insurance regulatory agency, at which point we would be better served by simply creating a federal regulator to administer a federal charter option. This enforcement concern is also the principal drawback to enacting federal standards as a means of assisting the states in implementing an interstate compact to resolve speed-to-market or other regulatory issues.

Lastly, all segments of the insurance industry are acutely concerned with the lack of an insurance regulatory presence in Washington, a situation that federal standards would not address. Indeed, insurance is the only segment of the financial services industry that does not have a single federal regulator to serve as an expert resource on domestic and international insurance issues in which Congress and the Administration are involved, and to provide a national perspective on issues of importance to the industry.

For these reasons, we do not believe that a federal standards approach is the best way to resolve current problems with the state insurance regulatory system – problems that result in diminished consumer protection. We urge you to take a closer look at our OFC proposal as the vehicle for empowering consumers through a federal, market-based regulatory option. As always, we remain at your service and would be happy to answer any further questions you may have.

Sincerely,

The American Bankers Insurance Association
The American Council of Life Insurers
The American Insurance Association
The Financial Services Roundtable

Appendix.

An Illustrative List of State Statutes and Model Laws Used to Develop the Optional Federal Charter Proposal.

The consensus Optional Federal Charter proposal draws on many features of existing state statutes in both the banking and insurance disciplines. These statutes are necessary to describe the basic parameters of the office of the federal regulator, including the powers of the office, the structure of the federal insurance charter and the responsibilities of those entities that elect to be regulated under this structure. For example, below are several areas where individual state statutes or model acts have been incorporated or relied upon to create the appropriate federal provision within the consensus OFC draft:

- Insurance Fraud Provisions – Based upon NAIC Insurance Fraud Prevention Model Act;
- Treatment of U.S. Branches of Non-U.S. Insurers – Based upon NAIC State of Entry Model Act;
- Audit Committee Requirement – Based upon New York Insurance Law;
- General Powers of National Insurance Companies – Based upon Delaware Corporate Law and Model Business Corporation Act;
- Protected Cells Provisions – Based upon NAIC Protected Cell Company Model Act;
- Statutory Accounting Provisions – Based upon NAIC Accounting Practices and Procedures;
- Risk-Based Capital Provisions – Based upon NAIC Risk-Based Capital Rules;
- Valuation of Liabilities – Based upon NAIC Valuation Standards;
- Continuing and Alternative (Nonforfeiture) Benefits – Based upon NAIC Standards;
- Required Actuarial Opinion – Based upon NAIC Model Act & Regulation Standards;
- Reinsurance Credit – Based upon NAIC Credit for Reinsurers Model Act;
- Long-Term Care Rate Regulation – Based upon NAIC Standards;
- Group Insurance Provisions – Based upon NAIC Group Life Insurance Definition and Group Life Insurance Standard Provisions Model Act;

- Insurable Interest Provisions – Based upon Georgia and New York Insurance Law;
- Holding Company Provisions, Acquisition of Control, Mergers and Bulk Transfers – Based upon NAIC Insurance Holding Company System Regulatory Act;
- Domestication of U.S. Branch of a Non-U.S. Insurer – Based upon New York Insurance Law;
- Conversion of Insurers from Stock to Mutual Form – Based upon Wisconsin, California and New York Insurance Law;
- Mutual to Stock Conversions – Based upon California Insurance Law;
- Producer Provisions – Based, in part, on NAIC Producer Licensing Model Act;
- Solvency Provisions – Based upon the Uniform Receivership Law adopted by the Interstate Insurance Receivership Compact Commission in 1998.
- Guaranty Provisions – Based upon the NAIC Model Act.
- Enforcement Provisions – Based upon Federal Deposit Insurance Act, New York Insurance Law and NAIC models;