Testimony of the
National Association of Insurance Commissioners

Before the
Subcommittee on Financial Management, the Budget, and
International Security

Committee on Governmental Affairs
United States Senate

Regarding:
Oversight Hearing on Insurance Brokerage Practices,
Including Potential Conflicts of Interest and the Adequacy
of the Current Regulatory Framework

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Gregory Serio
New York Superintendent of Insurance
Chair, Government Affairs Task Force
National Association of Insurance Commissioners

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Introduction

Good morning, my name is Greg Serio. I am the Superintendent of Insurance in New York. This year I am also serving as Chair of the Government Affairs Task Force of the National Association of Insurance Commissioners (NAIC). I am pleased to be here on behalf of the NAIC and its members to provide the Subcommittee on Financial Management, the Budget, and International Security with an update on actions taken by the nation's state-based system of insurance regulation to supervise brokers, as well as an overview of our efforts to modernize state insurance supervision to meet the demands of the 21st Century.

Today, I would like to make three basic points:

- First, the state system is working well to address known problems and potential conflicts of interest by insurance brokers. The attorneys general in several states are undertaking law enforcement actions and investigations working together with their state insurance departments. At the same time, state insurance commissioners are working collectively through the NAIC to develop and implement a three-prong program to protect consumers by adopting a new model law on broker disclosure of compensation, coordinating multi-state information requests and analyses of certain business practices by brokers and insurers, and launching an online system that will allow anonymous filing of "tips" to alert state regulators about unlawful or unscrupulous business practices.

- Second, insurance is a complex commercial product that is very much different from banking and securities. Consequently, the process for regulating insurance products must also be different. Insurance policies are financial guarantees that are necessarily rooted in the contractual and tort laws of each state to provide protection against unexpected or unavoidable losses that can cripple the lives of individuals, families, and businesses. In doing so, insurance products inevitably touch a host of important and often controversial social issues that are addressed by specific statutory code language in every state. Recent natural disasters, including hurricanes along the eastern coast and fires in California, highlight the advantages of state insurance oversight. State officials are in the best position to respond quickly, and to fashion remedies that are responsive to local conditions. We are directly accountable to consumers who live in our communities, and can more effectively police claims-handling, underwriting, rating, and marketing practices. In addition, residual market mechanisms – which become important as markets harden after catastrophic losses – are more appropriately designed and administered by state officials who are familiar with the insurance carriers and demographics of their region.

- Third, we strongly believe an effective system of national regulation does not mean federal regulation. Involving the federal government will not simplify the complexity of insurance issues, nor diminish their number, nor smooth the process of regulation. Instead, federal intervention in supervising insurance will simply add additional layers of uncertainty, confusion, and cost for policyholders regarding "who is in charge" of regulating claims payments when disasters and personal losses occur. Any federal legislation dealing with insurance regulation carries the risk of undermining state consumer protections through unintended or unnecessary preemption of state laws and regulations. Creating an optional federal charter and its related regulatory apparatus would have a serious negative impact on the state regulatory system, including our efforts to make improvements in areas sought by proponents of a federal charter. Ultimately, a federal regulator would adversely affect state premium taxes and other revenues, which totaled $12.3 billion in 2002.

Two-Tier Action on Broker Issues: Law Enforcement and Regulatory Initiatives

The state response to illegal actions and questionable business practices by brokers and insurers is being handled at two levels. State attorneys general are investigating possible violations of civil and criminal law using their law enforcement powers to obtain information from industry sources by subpoena, file civil lawsuits, and seek criminal indictments and convictions. Due to the very serious consequences associated with charges of illegality and wrongdoing made by law enforcement officials – as well as the severity of potential penalties for persons and firms found guilty – the actions of attorneys general in states such as New York and Connecticut have attracted a great deal of media attention. Complicated business transactions, arcane accounting, and undisclosed compensation arrangements are normally consigned to the business pages of newspapers, but these same practices can become front-page news when allegations of far-reaching criminal fraud and corporate malfeasance affecting billions of dollars are involved.

State insurance regulators are playing a critical role by working jointly with state law enforcement investigations, by developing the facts, and by sharing the information and expertise we have gained through supervising daily aspects of the insurance business. We also recognize that our primary responsibility is to protect the stability of insurance products and markets in our home states by monitoring the solvency of insurers and assuring that consumers are treated fairly when they purchase life, health, and property-casualty insurance for their families, homes, and automobiles. As a result, state regulators routinely monitor aspects of the insurance business that do not attract media attention, but which can have an enormous impact on the two major obligations insurers owe to their customers – issuing sound policies and paying claims on time.

Although the important work done by state regulators to assure that consumers are offered a variety of useful insurance products in a healthy marketplace is not the subject of news headlines, we take pride in the fact that our system has worked very well for over 100 years to provide Americans with confidence that the basic obligations set forth in their insurance policies will be met. Insurance products can be difficult for many people to understand, and they expect state governments to have appropriate market safeguards and an effective local response if problems arise. “No news is good news” for insurance regulators because it means the marketplace is functioning without significant problems and that our corrective efforts, when necessary, are working behind the scenes to keep insurance markets stable.

Everyone wants to see “bad guys” punished for illegal and unscrupulous activities. State insurance regulators are working with our state attorneys general in the pursuit of these investigations. Our primary responsibility is “to protect the innocent” who have bought insurance products to protect them from financial losses or who have been treated unfairly in an insurance transaction. The general rule of financial markets is that ill-informed actions by business institutions, government officials, and consumers can cause a “run on the bank” that undermines or destroys the very products that people want to save. We are committed to obtaining the facts and acting quickly in response to any findings.

Using our authority to issue licenses and supervise the financial condition of insurance providers, state regulators are reviewing industry business practices and implementing changes that will enhance public confidence in insurance markets going forward. As always, our regulatory purpose is to promote stability in insurance markets so that the highest expectation of consumers – getting their insurance claims paid on time – will continue to be the reality they experience. We achieve such stability through solvency monitoring, market conduct examinations, consumer assistance, and rate and form analysis.

Collective Regulatory Action Through the NAIC

State regulators are moving quickly to strengthen the system for supervising the business activities of brokers and other producers. Three weeks ago, the NAIC created a new Executive Task Force on Broker Activities to address alleged violations of insurance laws and regulations. This thirteen-member task force includes most states with ongoing investigations of broker activities, as well as a cross-section of insurance markets in the United States. Task Force members include California, Connecticut, Georgia, Illinois, Maine, Missouri, Montana, New Jersey, New York, Oregon, Pennsylvania, South Carolina, and Texas.

Collective state action through the NAIC on broker issues is important for two reasons. First, the brokers and insurers who are the primary subjects of law enforcement complaints operate across the nation and throughout the world. Business practices in one state may be directly connected to problems being identified in other states. Working together, we are gathering the relevant facts to determine the scope and extent of violations and, where appropriate, to share that information with law enforcement authorities.

Second, state regulators are coordinating their inquiries to insurers and brokerage firms in order to expedite the process of receiving the information regulators need. We also want to avoid duplicative and excessive data requests that could delay the responses from the brokerage and insurance industry. Insurance brokers provide a vital service for many customers, and we will not help those customers if the regulatory process unduly hampers the ability of brokers to function efficiently.

The NAIC's Executive Task Force on Broker Activities is pursuing a three-pronged action plan to coordinate multi-state inquiries, leverage state resources, and engage consumers:

1. <u>Greater Transparency on Broker Compensation</u>: The Task Force has developed a draft model act for broker's disclosure of compensation.

2. <u>Full Inquiry and Coordination</u>: The Task Force has developed and will coordinate implementation of a uniform inquiry "template" for states to use in querying their significant domestic insurers and top brokers.

3. <u>Fraud Reporting</u>: As an immediate means to empower consumers, the NAIC will launch an online fraud reporting mechanism that will allow for anonymous "tips" to report unscrupulous business practices for states to investigate.

Industry Must Do Its Part to Report Bad Business Practices

State insurance departments are not law enforcement agencies, but we do supervise market activities as part of our statutory mandate to assure that insurers are solvent and treat the public fairly. Regulators have an array of administrative powers related to licensing that provides a strong incentive for insurers, brokers, and agents to follow state requirements if they wish to remain in the insurance business. A financial regulatory system – state or federal – cannot function effectively to maintain stable and fair markets if it treats all business participants as potential crooks. The vast majority of insurance industry participants provide sound products that are sold honestly in a highly competitive marketplace. What they need from regulators is clear guidance regarding solvency and market conduct requirements, combined with a system of checks and balances that can spot significant problems before they threaten the ability of an insurer to pay policyholder claims.

State insurance regulators supervise the market conduct of industry participants through a dual system of reviewing basic business operations during periodic examinations and investigating specific complaints. A recent example of a coordinated market conduct review is the investigation of race based premiums by state insurance departments. The broker compensation issues being investigated by state attorneys general are an anomaly because they have not resulted in complaints to state regulators. When consumers have complaints about homeowners, health, automobile, and life insurance, they are not shy about contacting their state insurance departments to let us know. In the current situation, commercial insurance buyers have not made complaints that would trigger state corrective action. Participants in the commercial insurance market argue they should be exempt from state regulatory supervision of their business activities because the commercial market is populated with knowledgeable professionals who are fully able to protect themselves. Some of the most visible participants in the current broker cases are the most vocal supporters of federal legislation that would preempt state authority to regulate rates and sales of insurance.

The NAIC and its members believe industry participants must accept their responsibility for maintaining adequate internal controls and reporting to state regulators
business practices which appear to be harmful, anti-competitive, or unethical. Preventing and correcting market conduct problems requires that regulators and responsible business participants work together toward a common goal of strengthening stability and fairness in the marketplace for all consumers.

State Regulatory Modernization: On Time and On Target

During the current broker investigations, some people have asked whether action or involvement by the federal government is needed. State regulators believe the answer to that question is "no". The state regulatory system is inherently strong when it comes to protecting consumers because we understand local needs and market conditions. However, we recognize a need to make the system more uniform, reciprocal, and efficient. Consequently, state regulators have agreed upon a specific modernization plan that is now being implemented across the nation.

In March 2000, insurance commissioners committed to modernizing the state system by unanimously endorsing an action plan entitled *Statement of Intent – The Future of Insurance Regulation*. This important document sets forth a common vision of our response to the Gramm-Leach-Bliley Act and how a state-based system of national regulation should develop in each area where modernization is needed. In September 2003, state regulators took the next step in the modernization process by setting specific program targets and a common schedule for implementing them through adoption of the *Reinforced Commitment: Insurance Regulatory Action Plan*. This landmark document –

the result of lengthy discussions and negotiations – puts the states on a track to reach all key modernization goals at scheduled dates within the next few years.

Working in our individual states and collectively through the NAIC, we have made tremendous progress in achieving an efficient regulatory system for the business of insurance. Significantly, our specific regulatory program targets were developed with extensive input from industry and consumer representatives who are active in the NAIC's open committee process. We strongly believe our regulatory action plan satisfies <u>every</u> legitimate complaint regarding inefficiency and redundancy in the state system. Even if an alternative federal regulatory system were set up tomorrow, there is no way it could achieve these improvements on a schedule that comes close to the aggressive timetable that state regulators have adopted voluntarily.

Insurance is a Complex Financial Product that Demands Local Regulation

Paying for insurance products is one of the largest consumer expenditures of any kind for most Americans. Figures compiled by the NAIC show that an average family can easily spend a combined total of $4,500 each year for auto, home, life, and health insurance coverage. This substantial expenditure – often required by law or business practice – is typically much higher for families with several members, more than one car, or additional property to insure. Consumers clearly have an enormous financial and emotional stake in making sure insurers keep the promises they make.

Protecting insurance consumers in a world of hybrid institutions and products must start with a basic understanding that insurance is a different business than banking and securities. Banks make loans based upon a straight-forward analysis of a customer's collateral and ability to pay, whereas securities can be bought by anyone having sufficient funds at a price set by open markets. In contrast, insurance is a commercial product that offers consumers a financial guarantee that takes into account each customer's potential claims for losses (depending on variable circumstances), financial situation, place of residence, type of business, "risk management" preparations, or lifestyle choices such as smoking, exercise, education, and travel.

Insurance is thus based upon a series of individual subjective business decisions such as these: Will an insurance policy be offered to a consumer? At what price? What are the policy terms and conditions? Is a claim filed by a policyholder valid? If so, how much should the customer be paid under the policy terms? All of these subjective business decisions add up to one absolute certainty: Insurance products can generate a high level of consumer backlash and customer dissatisfaction that requires a higher level of regulatory resources and responsiveness.

As regulators of insurance, state governments are responsible for making sure the expectations of American consumers – including those who are elderly or low-income – are met regarding financial safety and fair treatment by insurers. Nationwide in 2002, state insurance departments employed more than 13,000 regulatory personnel and spent $947 million to be the watchful eyes and helping hands on insurance problems. We helped consumers collect tens of millions of dollars in claims payments.

The states also maintain a system of financial guaranty funds that cover personal losses of consumers in the event of an insurer insolvency. It is important for Congress to note that the entire state insurance system is authorized, funded, and operated at absolutely <u>no cost</u> to the federal government.

There have been charges from some industry groups that the state regulatory system is inefficient and burdensome, and that a single federal regulator would be better. However, the NAIC and its members do not believe the consumers we serve each day think we are inefficient or burdensome when compared to the agencies and departments of the federal government. During 2002, we handled approximately 4.2 million consumer inquiries and complaints regarding the content of their policies and their treatment by insurance companies and agents. Many of those calls were resolved successfully at little or no cost to the consumer.

Unlike banking and securities, insurance policies are inextricably bound to the separate legal systems of each state. There is no way the federal government could possibly replicate the specific expertise of state legislatures, regulators, and courts to successfully interpret the contractual and tort laws of 50 states and the District of Columbia. Moreover, there is no reason for the federal government to do so when the states have a specific modernization plan and timetable to get the job done.

Congress Must Not Undermine State Modernization Efforts

The NAIC and its members believe Congress must be very careful in considering potential federal legislation to achieve modernization of insurance regulation in the United States. Even well-intended and seemingly benign federal legislation can have a substantial adverse impact on existing state laws and regulations designed to protect insurance consumers. Because federal law preempts conflicting state laws under the United States Constitution, hastily drafted or vague federal laws can easily undermine or negate important state legal protections for American consumers.

When Congress passed the Gramm-Leach-Bliley Act (GLBA) in 1999, it acknowledged once again that states should regulate the business of insurance in the United States, as set forth originally in the McCarran-Ferguson Act. There was a careful statutory balancing of regulatory responsibilities among federal banking and securities agencies and state insurance departments, with the result that federal agencies would not be involved in making regulatory determinations about insurance matters.

Even though Congress tried very hard in GLBA to craft language that would not unnecessarily preempt state laws, there have already been disagreements about the extent to which federally-chartered banks may conduct insurance-related activities without complying with state laws. Under GLBA, no state law may “prevent or significantly interfere” with the ability of a federally-chartered bank to conduct insurance-related business permitted by GLBA. Federally-chartered banks have aggressively asserted their perceived rights under GLBA to conduct non-banking business unhindered by state laws. As a result, the entry of federally-chartered banks into insurance has become a source of uncertainty and dispute despite the best efforts of Congress to avoid this very result.

We fully expect federally-chartered insurers would insist that state laws involving solvency and market conduct cannot "prevent or significantly interfere" with their federally-granted powers to conduct insurance business anywhere in the United States. A federal insurance charter with its associated laws, regulations, and bureaucracy must necessarily parallel every aspect of existing state laws and regulations, meaning potential conflicts between state and federal laws will likely occur across the board. The result would be years of protracted, costly litigation, as well as market and regulatory confusion that will benefit the legal community rather than insurance providers and consumers.

One of the great strengths of state insurance regulation is the fact it is rooted in other state laws that apply when insurable events occur. The NAIC urges Congress to avoid undercutting state authority in considering any federal legislation that would preempt important consumer protections or create a federal insurance charter. Federal laws that appear simple on their face can have devastating consequences for state insurance departments working to protect the public.

The Impact of Federal Chartering on State Regulation Will Not Be "Optional"

Some industry representatives have said a federal charter merely adds an optional choice to the insurance regulatory system in the United States, and that it would not seriously affect the existing state system. State regulators disagree with this assertion. A federal charter may be optional for an insurer choosing it, but the negative impact of federally-regulated insurers will not be optional for consumers, producers, state-chartered insurers, state governments, and local taxpayers who are affected, even though they have little or no say in the choice of a federal charter.

Let's be clear about the impact of a federal insurance regulator upon state regulation and our ability to protect consumers: The federal government is not an equal regulatory partner because it can preempt state laws and regulations. This simple fact contradicts the very foundation of insurance in the United States; because insurance products are uniquely intertwined and dependent upon state law for everything from underwriting standards, to pricing, to claims procedures, to legal resolution of disputes. There is no logical or practical way to divorce insurance regulation from the state laws that give rise to consumer insurance products.

Despite our different sizes, geography, and market needs, states work together through the NAIC as legal equals under the present system. We find solutions as a peer group through extensive discussion and debate, give-and-take and mutual respect, knowing that no single state can force its own will over the valid concerns and objections of other states. Keeping in mind the original purpose of regulation is to protect all consumers, we believe this participatory democracy and state decision-making, based upon the political and business realities of local markets, is a major strength of the state-based system for protecting consumers and regulating insurers and agents.

Ultimately, a federal charter and its regulatory system would result in at least two separate insurance systems operating in each state. One would be the current department of insurance established and operated under state law and government supervision. This system will continue responding directly to state voters and taxpayers, including the statewide election of the insurance commissioner in twelve states.

A second system would be a new federal regulator with zero experience or grounding in the local state laws that control the content of insurance policies, claims procedures, contracts, and legal rights of citizens in tort litigation. Nonetheless, this new federal regulator would undoubtedly have the power to preempt state laws and authorities that disagree with the laws that govern policyholders and claimants of state-chartered insurers. At the very least, this situation will lead to consumer, market and regulatory overlap and confusion. At worst, it will lead to varying levels of consumer protection, perhaps even a “race to the bottom” to lower consumer protection standards, based upon whether an insurer is chartered by federal or state government.

Granting a government charter for an insurer means taking full responsibility for the consequences, including the costs of insolvencies and consumer complaints. The states have fully accepted these responsibilities by covering all facets of insurance licensing, solvency monitoring, market conduct, and handling of insolvent insurers. The NAIC does not believe Congress will have the luxury of granting insurer business licenses without also being drawn into the full range of responsibilities and hard-hitting criticism --- fair and unfair – that go hand-in-hand with a government charter to underwrite and sell insurance. Furthermore, we doubt states will be willing to accept responsibility for the mistakes or inaction of a federal regulator by including federal insurers under state guaranty funds and other important, proven consumer protection laws.

Conclusion

The system of state insurance regulation in the United States has worked well for 125 years. State regulators understand that protecting America’s insurance consumers is our first responsibility. We also understand commercial insurance markets have changed, and that modernization of state insurance standards and procedures is needed to facilitate less costly and less burdensome regulatory compliance for insurers and producers.

The current investigations and law enforcement actions concerning broker practices proves once again that states are the best protectors of consumers and marketplace stability. State insurance regulators are working aggressively to identify and correct business practices that are harmful to policyholders and the public. We expect prompt action at all levels to restore full confidence in the insurance marketplace.

In addition, we respectfully request that Congress, consumers, and insurance industry participants work with us to implement the specific improvements set forth in the NAIC’s *Insurance Regulatory Modernization Action Plan* through the state legislative system.

This is the only practical, workable way to achieve necessary changes quickly in a manner that preserves the state consumer protections consumers demand. The state-based regulatory reform approach far exceeds having an “insurance czar” in Washington, D.C., along with the huge, costly, isolated federal bureaucracy that will accompany it. It also gives citizens in each state control over important aspects of insurance and claims procedures that affect their financial security in the communities where they live.

The NAIC and its member states have fully cooperated over the years with important inquiries by Congress into the adequacy of the state regulatory system. We believe these inquiries have been productive, and have clearly demonstrated why local and regional state regulation of insurance is the very best way to meet the demands of consumers for this unique financial product. We will continue to work with Congress and within state government to improve the national efficiency of state insurance regulation, while at the same time preserving our longstanding proven and successful dedication to protecting American consumers.