Independent Insurance Agents & Brokers of America, Inc.

STATEMENT OF SPENCER M. HOULDIN
ON BEHALF OF THE
INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA

BEFORE THE

U.S. SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS

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Good morning Chairman Dodd, Ranking Member Shelby, and Members of the Committee. My name is Spencer M. Houldin, and I am pleased to be here today on behalf of the Independent Insurance Agents and Brokers of America (IIABA). Thank you for the opportunity to provide our association's perspective on insurance regulatory modernization. I serve as Chairman of the IIABA Government Affairs Committee as well as the Connecticut representative on the IIABA Board of Directors. I am also President of Ericson Insurance, a Connecticut-based independent agency that offers a broad array of insurance products to consumers and commercial clients across the country.

IIABA is the nation's oldest and largest trade association of independent insurance agents and brokers, and we represent a network of more than 300,000 agents, brokers, and employees nationwide. IIABA represents small, medium, and large businesses that offer consumers a choice of policies from a variety of insurance companies. Independent agents and brokers offer a broad range of personal and commercial insurance products. Specifically regarding commercial property-casualty insurance, and some may be surprised to learn this, independent agents and brokers are responsible for over 80% of this market segment.

Introduction

Over the past several months, we have endured and continue to experience a financial crisis that few of us could ever have envisioned. We have seen the federal government take unprecedented action and spend hundreds of billions of dollars in attempts to rectify the problems and right our country's economic ship. And, unfortunately, we all know that our troubles are not over. We must carefully examine the causes of the current crisis, and determine how or if regulatory policy should change to ensure we do not repeat the mistakes of the past. It is a daunting task, and as a small businessman who must conduct business in the regulatory environment of the future, I implore policymakers to act judiciously and make sure that when you act, you get it right. Change for change's sake may result in regulations that do not further protect consumers, help to promote solvency or successfully address systemic threats.

It is too soon to gauge the effectiveness of the substantial federal actions of the past year, but policymakers must remain mindful of the moral hazard implications of such significant federal intervention. We should strive for a system that promotes market discipline and protects taxpayers in the future. Much has gone wrong in the recent past, but there is still much which is very good in the current regulatory framework. I ask you to keep this in mind as you move forward.

For a variety of reasons that I will outline in the course of my testimony, the insurance sector (and the property-casualty industry in particular) is weathering the financial storm with greater success than the banking, securities, and other elements of the financial services world. The insurance arena is certainly not immune from the effects of the current crisis, but I am happy to report that my business and much of the insurance marketplace remains healthy and stable. Accordingly, as you consider how to address this financial crisis in the short-term and begin the process of considering broader reforms to protect against similar problems in the future, I urge the committee to be mindful of the differences between the recent experiences of the insurance industry and the other financial sectors and to be judicious and precise in your actions. While the insurance business would unquestionably benefit from greater efficiency and uniformity in regulation, we should be extremely cautious in the consideration of wholesale changes that could have an unnecessarily disruptive effect on the industry. Unlike other financial services markets, the insurance market, particularly property-casualty, is stable and does not need risky indiscriminate change of its current regulatory system. IIABA also believes that it is critically important to keep in mind how potential regulatory changes could impact small businesses. We want to ensure that there are no unintended consequences to main street businesses from regulatory reform, especially in light of the fact that a lot of attention and discussion of this crisis and reform has centered on large financial institutions.

Some of my industry colleagues believe that now is the time to pursue deregulatory proposals and to establish a new and untested functional federal regulator for the insurance industry. IIABA has long believed that the establishment of an optional federal charter (OFC) system is misguided and will result in regulatory arbitrage, with companies choosing how and where they are regulated thereby pitting one regulatory system against the other in a race to the bottom. Such a proposal, which turns its back on over a century of successful consumer protection and solvency regulation at the state level, seems to make little practical sense in this current market environment. Some industry proponents are trying to use the failure of American International Group (AIG) to promote OFC and its deregulation of the insurance market. While AIG's troubles may strengthen the call for systemic risk oversight at the federal level, we believe that the health of AIG's property-casualty insurance units, which were and are heavily regulated at the state level, point to the stability of the property-casualty marketplace. Improvements can certainly be made to insurance regulation (and are perhaps overdue), but state regulators have done and continue to do a solid job of ensuring that insurance consumers are protected and receive the insurance coverage they need.

Today, I would like to provide IIABA's perspective on the financial services crisis, paying particular attention to the stability of the property-casualty insurance market in comparison to other financial services sectors. Central to the health of this market is the success of state regulation and its strong consumer protections – the primary goal of insurance regulation. I will therefore discuss the dangers of making blanket regulatory changes that could disrupt this system that works well to protect consumers and ensure market stability. With that said, though, no regulatory system is perfect, so I also will discuss methods that can be used to modernize and improve state insurance regulation. I will also provide IIABA's opinions on how best to address the issue of systemic risk and how to provide the insurance market with both a federal and international voice without altering the day-to-day regulation of insurance.

Financial Services Crisis

Healthy Property-Casualty Market

The recent economic crisis has impacted nearly every sector of the financial services industry, from small local financial institutions to the largest financial services conglomerate in the world. Few have been left unscathed, and it is clear that all participants in this broad market, regardless of responsibility, must work together to pull us out of this mess and make sure that we take precautions to prevent this from happening again. While IIABA is committed to helping improve the system, it is worth noting that relative to other segments of the financial services industry, the property-casualty insurance market has remained solid and vibrant. Even though, like most Americans, the property-casualty market has suffered investment losses due to the stock market decline, earlier this month A.M. Best reported that the outlook for the U.S. commercial and personal lines insurance markets remains stable. As we continue to endure almost daily bad news regarding some of our largest and most complex financial institutions, the property-casualty insurance market continues healthy operations and has not been a part of the overall crisis. In fact, while approximately 40 banks have failed since the beginning of 2008, there has not been one property-casualty insurer insolvency during this time. Additionally, since the implementation of the Troubled Assets Relief Program (TARP) late last year, not one property-casualty insurer has sought access to these federal funds. **In short, the property-casualty insurance industry continues to operate without the need for the federal government to step in to provide <u>any</u> type of support.**

Along with being financially sound, it is also widely acknowledged that the property-casualty insurance industry today is intensely competitive and has sufficient capital to pay potential claims. In 2007, there were over 2,700 property-casualty insurance companies operating in the United States. Policy surpluses are at solid levels and credit ratings have remained stable with actually more property-casualty upgrades than downgrades in ratings during the past year. IIABA therefore believes that given the current health of the property-casualty market, policymakers should resist any temptation to enact measures that could unbalance this competitive environment and jeopardize the level of solvency regulation and consumer protection currently being provided.

AIG

While property-casualty insurers are financially healthy, some groups have pointed to the failure of AIG and the federal government's commitment of over $180 billion to this conglomerate to somehow suggest that the insurance industry is unstable and in need of sweeping regulatory restructuring. Others have used the problems of AIG to justify and resuscitate imprudent proposals, such as measures to establish an OFC for the insurance market or to mandate day-to-day federal regulation of insurance. It is important to remember that AIG's property-casualty insurance subsidiaries have been, and continue to be, healthy and stable and were not the cause of its failure.

AIG is a unique institution in the financial services world and an anomaly in the insurance industry. Only approximately 1/3 of its subsidiaries were insurance-related, and it played heavily in exotic investments and made gigantic unhedged bets on credit default swaps (CDSs), which are unregulated at the federal and state level. The catalyst of AIG's downfall was problems with its London-based Financial Products division (the main AIG player in CDSs), the collateral calls on those CDS transactions, and the rush of others to separate themselves from the company once its credit ratings were downgraded. These factors created a liquidity crunch for

AIG and led to the federal government's decision to step in and attempt to save this company. It is true that AIG experienced significant losses with its securities lending operations related to its life insurance subsidiaries. However, these losses became a federal concern because of the larger problems facing the company. Quite simply, AIG is not Exhibit A for a functional federal insurance regulator, because there is no reason to believe that such a federal regulator would have handled AIG's issues in a more effective manner that would have averted its collapse. It certainly does not make the case for an optional federal charter, where AIG could have chosen where it was regulated. In fact, the Office of Thrift Supervision admitted in testimony in front of this Committee just twelve days ago that it was the consolidated supervisor of AIG and, by extension, the operations of AIG's Financial Products division. Clearly then, just the fact that an entity is federally regulated does not mean that it is effectively and responsibly regulated. Despite the fact that AIG's property-casualty insurance subsidiaries were sufficiently capitalized and likely had substantial assets that would have more than covered claim obligations if the overall company had failed, one of the lessons you can take from AIG is that systemic risk oversight may be necessary to prevent this from happening in the future.

State Insurance Regulation Protects Consumers

Policymakers have made it clear that financial services regulatory reform – including a debate over how to address systemic risk – is at the top of the agenda for this year and rightfully so. But as we undertake a review of current regulations in place and consider strengthening existing laws or adding additional ones, we must ensure that we do not simply toss out regulatory systems that work in an effort essentially to wipe the slate clean and start over. Unlike some federal regulators of other financial industries, state regulators have done a commendable job in the area of financial and solvency regulation, which ensures that companies meet their obligations to consumers, and IIABA is concerned that direct federal regulation of insurance would not provide the same level of protection. Insurance regulators' responsibilities have grown in scope and complexity as the industry has evolved, and state regulatory personnel now number approximately 13,000 individuals. Most observers agree that state regulation works effectively to protect consumers, which has been proven once again during this crisis.

State officials also continue to be best-positioned to be responsive to the needs of the local marketplace and local consumers. Unlike most other financial products, which are highly commoditized, the purchaser of an insurance policy enters into a complex contractual relationship with a contingent promise of future performance. Therefore, the consumer will not be able to determine fully the value of the product purchased until after a claim is presented – when it is too late to decide that a different insurer or a different product might have been a better choice. When an insured event does occur, consumers often face many challenging issues and perplexing questions; as a result, they must have quick and efficient resolution of any problems. If one believes that a federal regulator would better handle consumer issues, consider that according to the most recent annual numbers, the Office of the Comptroller of the Currency (OCC) received more than 90,000 calls, compared to just the New York State Insurance Department alone that responded to 200,000 calls (nationally there are over 3,000,000 consumer inquiries and complaints annually).

Unlike banking and securities, insurance policies are inextricably bound to the separate legal systems of each state, and the policies themselves are contracts written and interpreted under the laws of each state. Consequently, the constitutions and statute books of every state are thick with language laying out the rights and responsibilities of insurers, agents, policyholders, and claimants. State courts have more than 100 years of experience interpreting and applying these state laws and judgments. The diversity of underlying state reparations laws, varying consumer needs from one region to another, and differing public expectations about the proper role of insurance regulation require officials who understand these local complexities. What would happen to this body of law if insurance contracts suddenly became subject to federal law? How could federal courts replicate the expertise that state courts have developed? How would federal bureaucrats be able to quickly develop knowledge of regional differences that are embedded in state insurance laws? These are some of the extremely difficult issues that could be posed by direct federal insurance regulation.

Protecting policyholders against excessive insurer insolvency risk is one of the primary goals of state insurance regulation. If insurers do not remain solvent, they cannot meet their obligations to pay claims. State insurance regulation gets very high marks for the financial regulation of insurance underwriters. State regulators protect policyholders' interests by requiring insurers to meet certain financial standards and to act prudently in managing their affairs. The states modernized financial oversight in the 1990's and have a proven track record of solvency regulation. When insolvencies do occur, a state safety net is employed: the state guaranty fund system. If the worst case scenario does occur and an insurer does fail, other companies are well positioned to fill the gap as the marketplace is very competitive with many insurers competing for business. Additionally, it should not be overlooked that the state system has an inherent consumer-protection advantage in that there are multiple regulators overseeing an entity and its products, allowing others to notice and rectify potential regulatory mistakes or gaps. Providing one regulator with all of these responsibilities, consolidating regulatory risk and essentially going against the very nature of insurance of spreading risk, could lead to more substantial problems where errors of that one regulator lead to extensive problems throughout the entire market.

Systemic Risk Oversight

Along with the discussion of AIG and other financial services conglomerates that have been considered “too big to fail” or “too interconnected to fail” is the consideration of risks to the entire financial services system as a whole. While a clear definition of systemic risk has yet to be agreed upon, IIABA believes the crisis has demonstrated a need to have special scrutiny of the limited group of unique entities that engage in services or provide products that could pose systemic risk to the overall financial services market. Federal action therefore is likely necessary to determine and supervise such systemic risk concerns.

Coupled with the stability of the insurance markets and the strength of state regulation, though, is the fact that few, if any, participants in the property-casualty market and few, if any, lines of property-casualty insurance, save for financial guaranty insurance, raise systemic risk issues. Again, the regulatory structure in place at the state level, specifically the state guaranty fund mechanism, and the general nature of the insurance business make it unlikely that a systemic risk to the financial services industry could emanate from property-casualty insurance markets. Therefore, while there may be a need to have some form of limited systemic risk oversight for a certain class of unique financial services entities at the holding company level, such oversight should not displace or interfere with the competent and effective level of functional insurance regulation being provided today. To avoid mission creep, any systemic risk regulator should have carefully defined powers and operate under a tight definition of what entities or activities are systemically significant. Such an entity should have the authority to receive data, analyze risk and at all times work through existing state regulators if problems are identified, but should not engage in day-to-day insurance regulation.

As mentioned above, states already have strong financial and market regulations in place for insurers and effective solvency regulations to protect consumers. IIABA is concerned that the insurance market could be grouped with other financial services industries under a systemic risk umbrella that could include insurer solvency regulation. While IIABA is not in the position to assess whether other financial services industries need more effective solvency regulation at the federal level, insurance solvency regulation, especially for the property-casualty segment, should remain the province of the functional regulators – the states.

In the discussion of systemic risk and the need for more federal insurance expertise, IIABA also believes that consideration should be given to establishing an Office of Insurance Information. This office could fill the void of insurance expertise at the federal level and help solve the problems faced by insurance industry participants in the global economy. This legislation also is an example of the type of federal reforms that are needed for the insurance market – federal legislation that mandates uniformity where needed and when necessary via preemption and national standards without creating a federal regulator.

Targeted Insurance Regulatory Reform

While state regulation continues to protect consumers and provide market stability, IIABA has long promoted the use of targeted measures by the federal government to help reform the state system in limited areas. However, Congress should only modernize the components of the state system that are working inefficiently and no actions should be taken that in any way jeopardize the protection of the insurance consumer. We believe that the best method for addressing the deficiencies in the current system continues to be a pragmatic approach that utilizes targeted legislation to establish greater interstate consistency in key areas and to streamline oversight. By using limited federal legislation on an as-needed basis to overcome the structural impediments to reform at the state level, we can improve rather than dismantle or seriously impair the current state-based system and in the process produce a more efficient and effective regulatory framework. Especially given today's tough economic environment, such an approach would not jeopardize or undermine the knowledge, skills, and experience of state regulators by implanting an unproven new regulatory structure. Unlike other ideas, such as OFC, this approach does not threaten to remove a substantial portion of the insurance industry from local supervision.

The most serious regulatory challenges facing insurance producers (agents and brokers) are the redundant, costly, and sometimes contradictory requirements that arise when seeking licenses on a multi-state basis, and the root cause of these problems is the fact that many states do not issue licenses on a consistent or truly reciprocal basis. State law requires insurance agents and brokers to be licensed in every jurisdiction in which they conduct business, which forces most producers today to comply with varying and inconsistent standards and duplicative licensing processes. These requirements are costly, burdensome, and time consuming, and they hinder the ability of insurance agents and brokers to effectively address the needs of consumers.

To rectify this problem, IIABA strongly supports targeted legislation that would immediately create a National Association of Registered Agents & Brokers (NARAB), as first proposed in the Gramm Leach Bliley Act in 1999, to streamline nonresident insurance agent licensing. This approach would be deferential to states' rights as day-to-day state insurance statutes and regulations, such as laws regarding consumer protection, would not be preempted.

By employing the NARAB framework already passed by Congress and utilizing the experiences and insights obtained over recent years to modernize this concept, Congress can help policyholders by increasing marketplace competition and consumer choice through enabling insurance producers to more quickly and responsively serve the needs of consumers. Such reform would eliminate barriers faced by the increasing number of agents who operate in multiple states, establish licensing reciprocity, and create a one-stop facility for those producers who require nonresident licenses. The NARAB Reform Act, which passed the House last year with broad industry and bipartisan congressional support, incorporates these principles and accomplishes the goal of agency licensing reform, and IIABA strongly supports this legislation.

IIABA also supports targeted legislation to apply single-state regulation and uniform standards to the nonadmitted (surplus lines) and reinsurance marketplaces. As with the admitted market, surplus lines agents and brokers engaging in transactions that involve multi-state risks currently must obtain and maintain general agent or broker licenses and surplus lines licenses in many if not every jurisdiction in which the exposures are located. Some states require that these agents and brokers obtain and maintain corporate licenses as well. This means that a surplus lines broker or agent could potentially be required to obtain and maintain up to 100 separate licenses in order to handle a single multi-state surplus lines transaction. These duplicative licensing requirements cause administrative burdens which impede the ability of agents and brokers to effectively and efficiently service their customers' policies. Perhaps most importantly, these onerous licensing requirements create expenses which ultimately impact policyholders. The Nonadmitted Insurance and Reinsurance Reform Act alleviates the burdens of duplicative licensing requirements by relying on the insured's home state for licensing. IIABA is a strong supporter of this targeted federal legislative reform.

Optional Federal Charter

I am actually quite surprised that, given the economic crisis in which we find ourselves today, I have to address the issue of an optional federal charter for insurance. Most policy leaders seem to be in agreement that regulated entities should not be able to engage in regulatory arbitrage, where one regulator is pitted against another in a race for the regulated institution. An OFC would set up a system that would allow just that scenario to occur – under OFC a company like AIG could have avoided strong regulation by choosing where it was regulated. This clearly would only have exacerbated problems, not solved them. OFC legislation also would deregulate several areas currently regulated at the state level, flying in the face of the nearly universal call today for stronger or more effective regulation of the financial services industry. IIABA therefore continues to oppose this illogical call for a regulatory system that has the potential to negatively impact a market relatively unaffected by the recent crisis.

Most importantly, we oppose OFC because it would worsen the current financial crisis as its theory of regulatory arbitrage has been cited as one of the key reasons why we find ourselves in the current situation. In announcing his seven principles for financial services regulatory reform on February 25th, President Barack Obama said his sixth principle is that "we must make sure our system of regulations covers appropriate institutions and markets, and is comprehensive and free of gaps, and prevents those being regulated from cherry-picking among competing regulators." And just last Thursday, Treasury Secretary Timothy Geithner said one of the problems with the current financial regulatory system is that financial institutions were allowed to choose their regulators and create products in a way so as to avoid regulation. He said it is important to create a new regulatory structure that prevents "this kind of regulatory arbitrage." I can't say it any better than they have, but I will just pose this one question, does anyone really think that allowing AIG to choose where it was regulated, the federal or state level, would have solved their problems?

Creating an industry-friendly optional regulator, as OFC legislation is expected to provide, also is at odds with one of the primary goals of insurance regulation, which, as discussed earlier, is consumer protection. The best characteristics of the current state system from the consumer perspective would be lost if some insurers were able to escape state regulation completely in favor of wholesale federal regulation. As insurance agents and brokers, we serve on the front lines and deal with our customers on a face-to-face basis. Currently, when my customers are having difficulties with claims or policies, it is very easy for me to contact a local official within the state insurance department to remedy any problems. If insurance regulation is shifted to the federal government, I would not be as effective in protecting my customers. I am very concerned that some federal bureaucrat will not be as responsive to a consumer's needs as the local cop, the state insurance regulator.

Even though it is commonly known as "optional," the establishment of a federal insurance charter would not be optional for agents. Independent agents represent multiple companies, and, under this proposal, presumably some insurers would choose state regulation and others would choose federal regulation. In order to field questions and properly represent consumers, independent agents would have to know how to navigate both state and federal systems, making them subject to the federal regulation of insurance – meaning OFC would not in any way be optional for insurance producers. Even more importantly, "optional" federal charter would not be optional for insurance consumers. The insurance company, not the insurance consumer, would make that determination.

Over the past several years, OFC supporters have pointed to the dual banking system as an example of how regulatory competition could work. But this is a comparison that should raise many concerns, not the least of which being the current state of federal financial services regulation. Additionally, there are fundamental differences between banking and insurance. The banking industry has no distribution force like the insurance industry, nothing similar to the claims process exists in the banking industry, and unlike many insurance products, banking products are commoditized and national in scope. However, even as recently as earlier this month, in the face of the failure of several banks and federal government support of numerous others, OFC supporters continue to stress that the insurance industry needs the equivalent of an OCC. But, as we have seen in recent years with the OCC's forceful assertion of preemption, federal regulatory schemes can do grave harm to state consumer protection regulations. IIABA therefore believes it would be unwise to subject insurance consumers to a similar potential fate.

Prior OFC proposals also would create a confusing patchwork of solvency/guaranty regulation, the crux of insurance regulation and consumer protection. This dual structure proposed could have disastrous implications for solvency regulation by largely bifurcating this key regulatory function from guaranty fund protection. The states would not be able to regulate insurers on the front end to keep them from going insolvent, but would be responsible for insurer failures on the back end through the guaranty fund mechanism. With the recent failures in federal financial oversight, this is a tremendous risk to take. In essence, these proposals would create an insurance version of the OCC without the integration of an FDIC into that supervisory system. Such proposals cherry-pick the features from several of these federal banking laws to come up with a model which lacks the consumer protections found in any one of them and ignores the problems it would create for state insurers, guaranty funds, and their citizens. The equally unacceptable alternative would be to attempt to create a new federal guaranty fund mechanism from scratch, and even if this initially was financed by industry, it ultimately would be guaranteed by taxpayers raising a whole host of additional concerns.

Conclusion

It is indisputable that our country, this Congress, and the new Administration have a lot of challenges ahead and difficult decisions to make in working to stabilize our economy and put us back on the road to growth and prosperity. Every participant in the financial services market must pitch in to help get us back on the right track, and IIABA stands ready to assist in any way possible. With the discussion of reforming financial services regulation, IIABA believes that such consideration presents a good opportunity to improve and modernize the state system of insurance regulation. But, as I've mentioned often today and it bears repeating one last time, IIABA believes that, with the possible exception of a properly crafted systemic risk overseer at the federal level, targeted modernization is the prudent course of action for reform of insurance regulation. Therefore, any efforts to use this crisis and the failure of AIG as an opportunity to promote misguided measures that would allow a regulated insurance entity to choose its own regulator should be summarily dismissed as unacceptable in today's financial environment. Additionally, because the foremost goal of insurance regulation is consumer protection, any proposals that have the potential to disrupt the strong consumer protections in place at the state level should be rejected. Even though we have historically opposed measures such as OFC in the best of economic times, it is even more clear in these difficult times that the solution is not to displace effective regulation with an unproven regime harmful to consumers that could have the unfortunate effect of adding to, not solving, our country's financial problems. IIABA again appreciates the opportunity to testify today, and we remain committed to continuing to work to improve state insurance regulation for both consumers and market participants.