UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS
HEARING ON "EXAMINATION AND OVERSIGHT OF THE CONDITION AND REGULATION OF THE INSURANCE INDUSTRY"

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Statement of William H. McCartney
Senior Vice President, Government and Industry Relations
USAA Group

Thank you, Chairman Shelby, Ranking Member Sarbanes, and members of the Committee. My name is Bill McCartney, and I am Senior Vice President, Government and Industry Relations at the United Services Automobile Association (USAA) Group, a national, highly competitive, and fully integrated financial services company headquartered in San Antonio, Texas. USAA and its 22,000 employees provide insurance, banking, and investment products to more than 5 million current and former members of the U.S. military and their families. In fact, USAA's mission, to which we devote our full attention, is "to facilitate the financial security of our members, associates and their families through provision of a full range of highly competitive financial products and services." The company's net worth is greater than $9 billion and USAA owns or manages assets exceeding $79 billion. USAA is known for its financial strength and outstanding service to its members, and is one of only three property-casualty insurance companies in the nation to maintain the highest possible ratings from all three major ratings agencies.

I am here to testify today on behalf of USAA and our property-casualty insurance trade association, the American Insurance Association (AIA), and its 450 members. The Committee is addressing an issue that is vitally important to USAA and to AIA: the outdated and dysfunctional nature of today's state insurance regulatory system. It is the firm belief of USAA and AIA's other member companies that state-based regulation does not allow the insurance industry to meet the needs of Americans or the businesses they run.

As a national diversified financial services institution whose members are mobile and may be ordered to change residences frequently, USAA meets its members' insurance needs while navigating our way through the burdensome, inconsistent, and often overlapping web of insurance regulatory standards. This is not an easy task, due primarily to the trifecta of regulatory failure that largely defines state insurance regulation today: (1) lack of regulatory uniformity; (2) pervasive government price controls; and (3) entrenched government product controls.

I speak about the states' regulatory shortcomings from "inside" experience. From 1987 to 1994, I spent seven years as Nebraska's Director of Insurance and was privileged to serve as President of the National Association of Insurance Commissioners (NAIC) in 1992. I have always believed that the justification for regulatory oversight of insurance rates was to make certain that they are not imperiling an insurer's solvency—the primary and overarching role of insurance regulation. And I used to *believe* that the states could achieve uniformity and consistency of regulation without federal intervention. But, over the course of my 30-year career in insurance, I have come to *know* that the existing regulatory approach at the state level is misguided, that the system of price and product controls empowers regulators, not consumers, that uniformity and consistency are not possible without federal intervention, and that continuing the current system will drive companies out of business and capital out of the United States.

Let me take a few minutes to address these regulatory problem areas. Lack of uniformity and inconsistency are hallmarks of the state insurance regulatory system. The mere existence of different state regulators presents a significant problem for any company serving a national and highly mobile population. This problem is compounded by the fact that, even within each jurisdiction, there are often differing systems for different lines of business, making the process incredibly cumbersome and unresponsive to consumer needs. A limited survey by AIA of state requirements around the country found approximately 350 that dictate how rates are to be filed and reviewed, and approximately 200 that relate to the filing and review of new products. It is illogical to believe that compliance with more than 500 filing and review requirements will lead to efficiency or consistency.

USAA has long had a compact with our active duty members: we will insure their families' special needs wherever they are assigned. As a result, USAA now serves 54 distinct U.S. insurance regulatory jurisdictions: 50 states, the District of Columbia, and 3 U.S. territories. This translates into at least 54 separate regulatory structures to navigate. Each departure from uniformity and consistency means higher compliance and system costs for USAA. And, as a member-owned association, our policyholders absorb every penny in costs we incur responding to each state's different process.

It is also clear that the current system cannot accommodate modern methods of conducting business locally, regionally, nationally, or internationally. Today, USAA members depend heavily on the Internet, telephones, fax machines, and other electronic means to stay in touch with their families and to conduct personal business. USAA is a pioneer in leveraging information technology to provide the best possible customer service at the lowest cost. But the patchwork of shifting and burdensome state laws means our members are unable to manage their insurance products on-line at our website to the degree they can administer their other USAA financial products. It is sometimes a Herculean effort just to ensure that our members are speaking and working with only those insurance member service representatives holding licenses in a specific state – a situation we do not face when servicing brokerage, banking or mutual fund accounts for a member.

The NAIC's efforts, while well-intentioned, can only go so far to produce uniformity and consistency of regulation. The NAIC can draft and adopt models, but it cannot force state legislatures to enact them. Similarly, individual state insurance regulators can push for regulatory modernization in their own respective jurisdictions, but they cannot compel other state insurance regulators to push for similar change.

The history of post-McCarran-Ferguson Act state insurance regulation demonstrates that structural change is not a normal occurrence, but an aberration. The Gramm-Leach-Bliley Act of 1999 (GLBA) provides a great example of the states' resistance to structural change, even where Congress provides a significant push. While GLBA established federal privacy standards for insurance companies with implementation left to the states, 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. Indeed, while Congress recently re-affirmed federal preemption of state restrictions on information sharing among affiliated financial institutions, California has continued to defend Senate Bill 1, which flies in the face of federal law by imposing affiliate-sharing restrictions. This is not only burdensome to insurance companies, but is confusing to consumers who receive multiple privacy notices.

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. For companies like USAA that only write personal lines insurance and distribute insurance products directly, this means that GLBA's best efforts have not only been for naught, but have resulted in additional burdens.

Many states have failed to be effective regulatory stewards of insurance. The McCarran-Ferguson Act is not a federal abdication of regulatory oversight responsibility, it is a delegation. Congress can – and should – act to remedy the lack of uniformity and consistency of insurance regulation that is so evident at the state level.

While non-uniformity is an inherent aspect of state insurance regulation, government price and product controls are not. No other competitive industry in the U.S. is forced to submit their products and the prices charged for those products to a government official for review and approval. This is anathema to the free market environment that forms the backbone of the U.S. economy, including every other competitive industry deemed vital to American citizens, such as food, housing, transportation, and energy. Price and product controls are historical artifacts that have lost their utility and have turned a competitive marketplace into one where insurance prices and products are political pawns. Insurers should not be forced to "beg the government" in order to use their existing products, bring new products to market, or establish prices for those products. Likewise, consumer empowerment in the marketplace should not be replaced by needless regulatory control.

Perpetuation of government price and product controls in insurance has led to a number of problems. First, an entrenched state focus on government price and product controls discourages product innovation and competition, ultimately denying consumers choice. The current regulatory system concentrates on the wrong things. While artificially or arbitrarily repressing prices may be politically popular, it is ultimately economically unwise. Such price controls mask real problems and over a period of time can lead to a crisis, forcing sizable subsidized residual markets and market withdrawals that exacerbate these problems. Government price controls do not work to the benefit of anyone – especially consumers. In states where rigid government price controls are prevalent, insurance premiums are higher, rates are more politicized, consumer choices are restricted, residual markets are larger, and the number of competing insurers is lower. These elements conspire to drive capital from insurance markets in these states, and place a burden on those insurers that remain.

Similar problems arise from suppression of insurance products. Where regulators do not allow a variety of product options and artificially limit the ability of insurers and consumers to structure their insurance needs, insurers are left with a stark choice between insuring or not insuring a consumer, and consumers may therefore be left without coverage. In contrast, allowing insurers and consumers maximum flexibility in the marketplace provides the best opportunity to limit availability problems.

USAA is not immune from the problems attendant to government price and product controls. In an increasing number of our regulatory jurisdictions, USAA is actually prevented from charging rates commensurate with the risks we insure. We have to submit policy and product forms to regulators for lengthy review before using them in the marketplace. In many states, regulatory rate and form approval delays are chronic and increasing. USAA's federally-regulated financial services companies have no similar regulatory obstacles to getting rates and products to market quickly. The emphasis on such controls in insurance slows products from entering the market and inhibits product creativity.

Second, while the property-casualty insurance industry stands out as one of the most heavily regulated sectors of the U.S. economy, it is not just a question of regulation. It's the fact of misguided regulation. If the insurance industry cannot keep pace and cannot provide consumers with real choices, the economy suffers. Insurance provides much-needed security for businesses and individuals to innovate, invest and take on risk. Yet the ability to innovate, invest and take on risk is substantially impeded because insurers labor under the weight of a "government-first, market-second" regulatory system. This system rewards inefficient market behavior, subsidizes high risks and masks underlying problems that lead to rising insurance costs. The bottom line is that consumers ultimately will pay more for less adequate risk protection than would be the case under a more dynamic, market-oriented regulatory system.

Third, because regulatory attention at the state level is misguided and resources misdirected to "front-end" price and product regulation, core functions like financial solvency have taken a backseat. This is both unfortunate and dangerous, as it provides little confidence to insurance consumers that their insurance companies will be around and able to pay claims when they arise. This is a vitally important role for insurance regulators, as financially sound insurers lead to a healthy and vibrant market. But there have been some recent lapses at the state level on that front. It is time to take a hard look at these lapses, and to ask hard questions about whether the state regulatory system has elevated outdated and unnecessary elements of regulation to the detriment of industry financial condition.

Whether the problems are inherent in 50-state oversight or are part of the post-McCarran-Ferguson approach to insurance regulation, the current system is undeniably broken and all stakeholders are suffering as a result. As price and product obstacles increase, insurers find it more difficult to compete and make a reasonable profit in the marketplace. This leads to more competitors withdrawing from the market, taking capital and jobs from that market and leaving fewer choices for consumers. It is no surprise that property-casualty insurance consistently has the lowest return on equity of all the financial services industries. The net result is a parochial regulatory environment that encourages inefficiency and repels investors.

The inability to serve customers because of a troubled regulatory system is of acute concern to USAA, as we have a commitment to provide insurance to members wherever they are located. Our mission doesn't vary with a member's zip code. Unlike other insurers that have the ability to defensively withdraw from markets due to a difficult regulatory environment, USAA's commitment to its members does not make this possible. The current "heavy-handed" regulatory system in many states does not protect consumers, it actually disenfranchises them. Because of the emphasis on price and product controls in these jurisdictions, USAA is forced to devote enormous resources responding to these "pre-market" obstacles rather than developing innovative new products for our members. The system, in fact, discourages innovation because the timeline for approving new products offered nationally can be longer than the shelf-life of the innovation.

The rest of the USAA financial services family does not face these regulatory obstacles. This is confusing and frustrating for our members, who often need to use technology to access our products and services. For example, whenever our members are transferred to another location, they can provide their change of address at our website for all USAA financial services. But, for our property-casualty insurance products, the member's change of address is the beginning, not the end. This is archaic. We should not have a mid-20th century system to handle 21st century needs.

While the focus of this hearing is on the state insurance regulatory environment, USAA and other like-minded companies at AIA have given a lot of thought to solutions to the current problems we are experiencing. After much deliberation, USAA believes that a market-based optional federal charter would be the best route to true regulatory reform. The optional federal charter eliminates the arcane government price and product controls that have been so corrosive to the state regulatory system, empowering consumers through marketplace competition. The optional federal charter also provides for uniform national oversight of federally-licensed insurers.

Equally important, the optional federal charter is just that – a choice. Insurance companies that are comfortable with the current state regulatory system are not forced into the new system, while insurers like USAA that prize uniformity and market freedom may elect to be subject to federal oversight. Similarly, consumers who are comfortable doing business with state-regulated insurers are free to continue to do so. This is not a new regulatory paradigm, but one that is based on the chartering system for U.S. banks.

Our preferred solution also does not place the federal government in unfamiliar regulatory territory. There are numerous examples of federal involvement in property-casualty insurance. One that immediately jumps to mind is terrorism risk insurance, where the Terrorism Risk Insurance Act of 2002 (TRIA) provides a federal-private "shared loss" program for terrorism risk that is administered by the U.S. Treasury. While the TRIA program expires in 2005, insurers, policyholders, regulators, and legislators are currently calling for a two-year extension in order to gather all necessary data about the risk, and for stakeholders to jointly develop and implement a long-term public-private solution for managing terrorism exposure.

Finally, I would be remiss if I did not applaud the House Financial Services Committee for its unyielding efforts to address the problems I've outlined for the Committee today. Over the past few years, the House has conducted 15 hearings on state insurance regulation in a relentless drive to uncover the ills that plague the state regulatory system. While enactment of the optional federal charter is our aim, we support the House process, as well as the market-driven direction of the legislative draft that has been widely circulated. In particular, the draft takes an historic "free market" approach to insurance rates, recognizing the negative legacy of state government price controls. We look forward to continuing to work constructively with both the House and the Senate to ensure that the flaws of state insurance regulation are exposed, and federal legislative solutions found.

Mr. Chairman, thank you for the opportunity to testify and I look forward to answering any questions.