“Examination and Oversight of the Condition and Regulation of the Insurance Industry”

Testimony of

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And

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Chairman Shelby, Senator Sarbanes, Members of the Committee, it is an honor to represent the over one million individuals working in the life insurance industry in America. I am here today not only as Chairman and Chief Executive Officer of Prudential Financial – one of the world's largest diversified life insurance companies – but also as the Chairman of the American Council of Life Insurers (ACLI). With 368 members, the ACLI is the principal trade association representing domestic life insurance companies.

Today I will discuss:

- The function of life insurers in the marketplace and in the economy;
- Our industry's role in helping baby boomers and others provide for their retirement security and financial needs; and
- Why regulatory changes are important to the insurance industry and what the ACLI has done to assess the current regulatory environment and identify areas that are in need of improvement.

Today the life insurance industry competes in a national and even global marketplace. We have entered the 21st century as a much more involved, dynamic partner with American families and businesses, assisting them in protecting and growing their wealth. We provide financial security for Americans in all stages of life with products like life insurance, annuities, disability and long-term care insurance.

These products not only protect a family's finances, but also enable Americans to save money, accumulate wealth for retirement **and** convert it into a lifetime stream of guaranteed retirement income.

No other financial intermediary can do that. The life insurance business is a vital component of the U.S. economy, providing a wide array of essential financial and retirement security products and services to all segments of the American public.

Currently there are over 395 million life insurance policies in force, providing Americans with $17 trillion in financial protection. In addition, Americans have saved $2 trillion toward their retirement by investing through our annuity products. Our long-term commitments and investments have placed us as one of the largest investors in the U.S. economy assisting in economic growth. In managing these obligations, the industry has invested $3.4 trillion in the financial markets, representing nine percent of the total capital. Life insurers are one of the largest holders of long term, fixed rate commercial mortgages in the United States. These long-term, financial commitments are generally ten years and longer in maturity, much longer than commitments made by other industries.

Our most recent numbers show that life insurers invested more than $304 billion in new net funds in the nation's economy. Fifty-seven percent of the industry's assets – or $2 trillion – are held in long-term bonds, mortgages, real estate, and other long-term investments. This includes:

- $417 billion invested in federal, state, and local government bonds, helping to fund urban revitalization, public housing, hospitals, schools, airports, roads, and bridges;
- $251 billion invested in mortgage loans on real estate-financing for homes, family farms, and offices;
- $1.2 trillion invested in long-term U.S. corporate bonds; and
- $791 billion invested in corporate stocks.

Notwithstanding the massive investment we make in the economy, it is the area of long-term savings and retirement security where the life insurance industry may have the greatest positive impact on public policy in the coming years. With 76 million baby-boomers nearing retirement, the U.S. faces a potential retirement crisis. We must confront the fact that the average American nearing retirement has only $47,000 in savings and assets, not including real estate. Industry research indicates that 68 percent of Americans believe they will not be able to save enough for retirement.

Future retirees will have fewer sources of guaranteed income than previous generations. This is due to the decline of traditional defined benefit pension plans and the fact that Social Security, on average, replaces only 42% of earnings. If nothing is done, there is a real possibility that millions of Americans will outlive their retirement assets.

The insurance industry is dedicated and uniquely positioned to help American workers prepare for their financial futures with life insurance, long-term care, retirement and annuity products. Our industry continues to be a prominent resource in helping both large and small employers provide the right qualified retirement or savings plan for their employees. Insurers act as asset managers and/or administrators for defined benefit, 401(k), 403(b), 457 plans and other tax qualified arrangements.

The industry also enables individuals to take control of their own long-term savings through the purchase of annuities. Annuities offer the critically important guarantee of a steady income stream for an individual's lifetime. Although no single savings vehicle by itself can address the retirement savings crisis, the insurance industry is positioned to offer your constituents and all Americans an array of product choices to meet their retirement security needs.

However, for the insurance business to remain viable and serve the needs of the American public effectively, our system of life insurance regulation must become far more efficient and responsive to the needs and circumstances of a 21st century global business.

Life insurers today operate under a patchwork system of state laws and regulations that lack uniformity and is applied and interpreted differently from state to state. The result is a system characterized by delays and unnecessary expenses that hinder companies and disadvantage their customers. We believe it is appropriate, and we are asking for your help, to modernize our regulatory structure to ensure we are able to continue to serve our customers in the most efficient and effective way.

Any solution must ensure:

- greater speed to market for our products;
- uniformity in agent licensing; and
- efficient market conduct examinations.

To achieve that, and in keeping with a policy position adopted by its Board of Directors and embraced by its membership, the ACLI has been addressing regulatory reform on two tracks. Under the first track, the ACLI is working with the states to improve the state-based system of insurance regulation. Under the second, the ACLI is beginning to work with Congress toward a federally oriented solution, which we believe can ultimately best be achieved through an optional federal charter.

Mr. Chairman, the ACLI is ready to work with this Committee to put in place an appropriate federal regulatory option available to insurance companies, agencies, and its producers. It is in the best interests of our industry, your constituents, and our overall economy to do so as quickly as possible. Gramm-Leach-Bliley and an increasingly diversified financial services landscape have intensified this need. With your help, the life insurance industry will be able to help American families and businesses meet their financial needs today and beyond.

On behalf of the member companies of the American Council of Life Insurers, I would like to conclude by thanking you and members of the Committee for the opportunity to express our views on this most important subject.

The Changing Marketplace and

the Importance of Efficient Insurance Regulation

Prepared by ACLI Staff

The marketplace environment in which life insurers and other financial intermediaries compete has changed dramatically in the past several years. Historically, life insurers competed only against other life insurers. Whatever the inefficiencies of insurance regulation, companies experienced them equally.

Today, the situation is radically different. A generation ago, the average life insurer took in almost 90 percent of its premiums from the sale of life insurance, compared to only 13 percent from annuities. Today, those numbers are almost completely reversed, with 70 percent of premium receipts coming from annuities compared to only 30 percent from life insurance. Today, life insurers administer over $1.8 trillion in retirement plan assets, amounting to over 25 percent of the private retirement plan assets under management in the U.S.

The point is that life insurers, as providers of investment and retirement security products, find themselves in direct competition with securities firms, mutual funds, and commercial banks. These non-insurance firms have far more efficient systems of regulation, often with a single, principal federal regulator. Without question, the regulatory efficiencies they enjoy translate into very real marketplace advantages. Our system of insurance regulation now stands as perhaps the single largest barrier to our ability to compete effectively.

Life insurers' inability to bring new products to market in a timely manner is the most serious shortcoming of the current regulatory system. National banks do not need explicit regulatory approval to bring most new products to market on a nationwide basis. Securities firms typically get regulatory approval for new products in several months. By contrast, life insurers must get new products and disclosure statements approved in each state in which the product will be offered, and different jurisdictions often have widely divergent standards, interpretations, and requirements applicable to identical products. With the average shelf life of innovative new life insurance products now less than two years, it is easy to see why the current product approval process is so problematic.

The advent of Gramm-Leach-Bliley and an increasingly diversified financial services landscape has only intensified concerns in this area. For example, there is clear evidence that firms having both insurance and securities operations are allocating capital away from the insurance unit due largely to the inefficiency of the insurance regulatory system. New securities products can be brought to market in a more timely and cost-effective manner than their insurance counterparts. Over the long run, the implications to insurers and their customers of these adverse capital allocation decisions are serious, and they can be expected to worsen as consolidation and cross-industry diversification continue.

Even with respect to products such as whole life insurance, which have no direct analog in the banking or securities businesses, we face competition from other providers of financial services for the consumer's attention and disposable income. Moreover, the costs of regulatory inefficiency are necessarily borne directly or indirectly by the public.

The present state-based system of insurance regulation was instituted at a time when "insurance" was not deemed to be interstate commerce. Today, most life insurers do business in multiple jurisdictions if not nationally or internationally. In short, our system of regulation has failed to keep pace with changes in the marketplace, and there is a very wide gap between where regulation is and where it should be.

For many life insurers, making regulation more efficient is now an urgent priority. Companies no longer believe they have the luxury of being able to wait for years and years while marginal improvements are debated and slowly implemented on a state-by-state basis.

Lack of Uniformity Severely Hampers Multi-State Insurers

A significant impediment for multi-state insurers is the current state-based system's inability to produce, in crucial areas, both uniform standards and consistent application of those standards by the states. I'd like to give you a brief outline of the business and regulatory complexities commonly faced by life insurers under the current system.

Before a company can conduct any activity, it must apply for a license from its "home" or "domestic" state insurance department. A license will be granted if the company meets the domestic state's legal requirements, including capitalization, investment and other financial requirements, for acting as a life insurer. If the company wishes to do business only in its home state, this one license will be sufficient. However, in order to sell products on a multi-state basis, a company must apply for licenses in all the other states in which it seeks to do business. Each additional state may have licensing requirements that deviate from those of the company's home state, and the company will have to comply with all those different requirements notwithstanding the fact that the home state regulator will remain primarily responsible for the insurer's financial oversight.

Once a company is licensed in a state, it can turn its attention to selling policies. To do that, a company must first file each product it wishes to market in a particular state with that state's insurance department and receive the regulator's approval before a product can be sold. A company doing business in all states and the District of Columbia must, for example, file the same policy form 51 different times and wait for 51 different approvals. And this process must be repeated for each product the insurer wishes to offer.

This process is further complicated by the fact that each insurance department may have its own unique "interpretation" of state statutes, even those that are identical to the statues in other jurisdictions. As a result, a company will be required to "tweak" its products in order to comply with each individual department's "interpretation" of what otherwise appeared to be identical law. Since a company has to refile each product after it has been "tweaked," the time lapse from original filing to final approval can very well be double that which was originally expected. And, as a result of the various "tweaks," the product originally filed may no longer be offered to the consumers in one state with the same benefit realized by the consumer in another state.

After a company has received approval to sell its products in a state, it needs a sales force to market those products. Here again we encounter the inefficiencies of the current state system. Each state has its own criteria for granting an agent's license, including differing continuing education requirements once the license is issued. Like companies, insurance agents wishing to work with clients in more than one state must be separately licensed by the insurance departments in each of those states. And, because of the differing state form filing requirements previously noted, persons granted agent licenses by more than one state would not always have the ability to offer all clients the same products.

After this multitude of licenses and approvals has been secured, a company can begin to sell products nationwide. However, the lack of uniformity in standards and application of laws will continue to be a complicated and costly regulatory burden that the company must constantly manage.

Because each state has the authority to approve the products sold to its consumers, and oversee the practices of the companies and agents, each state can also subject a company to market conduct exams. While the NAIC has some "guidelines" for market conduct activity, conformity is optional and there is minimal coordination of these exams among the various states. As a result, a company licensed to do business in all jurisdictions is perpetually having states initiate market conduct examinations just as one or more other states are completing theirs (or, as is frequently the case, forced to deal with multiple jurisdictions conducting examinations simultaneously), with the cost of each exam being borne by the company. And, because these examinations are largely redundant, the benefits derived are often exceeded by the costs incurred.

In sum, these issues result in very real costs in terms of money, time, labor and lost business opportunities attributable to this cumbersome state regulatory system, which places a great competitive burden on individual companies, and on the industry as a whole.

Absence of Insurance "Presence" in Washington

Particularly in the last several years, life insurers have found the absence of an insurance regulatory presence in Washington to be an extremely serious problem. More than at any other time in our history, issues dramatically affecting our business (e.g., life insurance tax policy) are being debated and decided in Congress. Yet, unlike any other segment of the financial services industry, there is no regulator in Washington that can serve as a source of vital information and perspective for Congress and the Administration at both the national and international levels. This lack of insurance regulatory presence was illustrated dramatically in the wake of the events of 9/11/01 when lawmakers had no ready source of information and advice on the immediate and longer-term insurance consequences of those events.

Similarly, Title V of the Gramm-Leach-Bliley Act calls for privacy regulation of the financial services industry by the functional regulators. In the case of insurance, the functional regulators are the state insurance departments, and the result has been a relatively inefficient, multi-state implementation of the federal privacy requirements. And, as federal regulators have now begun to discuss simplification of Gramm-Leach-Bliley privacy notices, insurers are once again disadvantaged. Lacking a national regulator and preemption of state law, revision of the federal notice requirements may leave insurers in the position of having to provide multiple notices to comply with conflicting state and federal requirements.

ACLI Study of Insurance Regulation

By the late 1990s, life insurers had concluded that it was imperative for the industry to address the issue of regulatory reform. In September of 1998, the ACLI Board of Directors instructed the association to undertake a detailed study of life insurance regulation. The objective of this study was to pinpoint those aspects of regulation that are working well and those aspects that are hindering life insurers' ability to compete effectively and thus in need of improvement. This study broke life insurance regulation down into 35 individual elements (e.g., agent and company licensing, policy/contract form approval, solvency monitoring, guaranty associations, nonforfeiture). Individual elements were then rated based on eight factors (uniformity, speed/timing, cost, objective achieved, necessity/relevance, expertise/capacity, sensitivity to industry needs/views, and enforcement/penalties) and assigned one of four overall "scores" based on the eight factors. The overall scores were excellent, good, needs improvement, and unsatisfactory.

This study was completed in November of 1999 and revealed widespread dissatisfaction with the current regulatory system. No element of regulation was rated "excellent," 14 elements were rated "good," and 21 of the 35 elements received negative scores, with 16 rated "needs improvement" and five rated "unsatisfactory."

The study concluded that life insurers generally believe the laws and regulations on the books are necessary and appropriate. However, these laws are seldom uniform across all states and, even where uniform, are frequently subject to divergent applications and interpretations. Having to comply with even uniform laws 50+ times is costly and time consuming. When those laws differ, and when interpretations of identical or similar laws differ significantly state-to-state, an insurer's ability to do business in multiple jurisdictions is severely hindered. Given these considerations, the life insurers do not seek diminished regulation. Rather, they seek a far more efficient and uniform means of administering the laws and regulations to which they are now subject.

A copy of the ACLI report, entitled *"Regulatory Efficiency and Modernization: An Assessment of Current State & Federal Regulation of Life Insurance Companies and an Analysis of Options for Improvement,"* is being made available separately to provide additional background on this issue.

ACLI Policy

Pursuant to a policy position adopted by its Board of Directors and embraced by its membership, the ACLI has been addressing regulatory reform on two tracks. Under the first track, the ACLI is working with the states to improve the state-based system of insurance regulation. Under the second, the ACLI has developed draft legislation providing for an optional federal charter for life insurers.

Track One - Improvements to State Regulation Improving a state-based system of regulation has never really been an "option" for the ACLI: rather, it is a given. While substantial changes to the present system must be made, regulation of insurance by the states will always be a fundamental part of our regulatory environment. From the ACLI's perspective, the yardstick for gauging the success of regulatory reform in the principal areas where change is necessary is quite simple: uniform standards; consistent interpretations of those standards; and a single point of contact for dealing with multiple jurisdictions. Only in this way will insurers doing a national business be able to operate effectively and provide their customers with the products and services they are demanding.

Progress on this track, despite intensive efforts by regulators, state legislators and the life insurance industry, has been disappointing. In its 1999 report, the ACLI found the state system of insurance regulation to be severely deficient in both uniformity and efficiency, to the ultimate detriment of companies and consumers alike. In response, in early 2000 the NAIC adopted its "Statement of Intent," committing the organization and the states to actively work to create "…efficient, market-oriented regulation of the business of insurance." Since that time NAIC efforts on regulatory uniformity and efficiency have centered around 3 high profile issues of critical importance to our industry: product regulation/speed-to-market, market conduct examinations, and producer licensing. In spite of the best intentions of the NAIC and its leadership, a straightforward 2004 report card on these efforts shows only marginal progress over the last 4 years. In the area of market conduct, for example, last week the NAIC adopted a revised version of the National Conference of Insurance Legislators (NCOIL) Market Conduct Surveillance Model Act by a vote of 31 to 20. The Model has been stripped of the critical requirement for domestic deference, substituting Commissioner discretion, undermining the objective of uniformity. In advocating for adoption, NAIC leadership argued that the Model achieved their goal of "uniformity AND diversity."

The single area where the states have had the most success with uniformity is producer licensing. And it must be acknowledged that much of that success is directly related to the requirements found in the NARAB provisions of the Gramm-Leach-Bliley Act. Since GLB was enacted, 46 of 51 jurisdictions have adopted the NAIC Producer Licensing Model Act. However, California, Texas & Florida are among the states which have not enacted the model act, meaning that some of the very largest business states still lack uniformity in this area.

Although this "report card" may seem critical of state efforts, in fairness it does nothing more than illustrate that the very nature of the state regulatory system is not uniform. Under our federalist system individual states have always seen fit to enact their own unique interpretation and enforcement of laws. This is true today with the state system of insurance regulation, and that is the heart of the problem.

It is important to note that this problem of lack of uniformity is not limited to the high profile issues I've discussed. Since 2000, when the NAIC officially recognized the need for greater regulatory uniformity and efficiency, state and NAIC efforts on "second tier" issues have often ignored this need. In the areas of variable contract regulation, accounting rules and annuity sales, just to name a few, state regulators and legislators have continued to go their own way in lieu of more uniform and efficient laws. Neither the life insurance industry nor its consumers can afford the states' commitment to individuality any longer.

Track Two - Optional Federal Charter At the same time the ACLI Board reaffirmed its commitment to improve state regulation, it also directed the association to aggressively pursue an optional federal charter for life insurance companies. To be clear, what we are seeking is modernized regulation: not deregulation. This decision reflects several different perspectives within our membership. A number of companies believe the insurance business is badly in need of a dual regulatory system analogous to that presently found in the commercial banking, thrift, and credit union businesses. Such a system enables institutions to select a state or federal charter based on the particular needs and circumstances of their operations. For example, companies doing business in multiple jurisdictions might be more inclined to opt for a federal charter so that they will have to deal with only a single regulator. On the other hand, companies doing business in a single state might find a state charter to be far more practical and cost-effective. Other companies are skeptical that at the end of the day individual state regulators and state legislators will be able to cede authority to the extent necessary to implement a system of uniform, efficient state regulation.

The ACLI spent approximately a year and a half developing draft legislation providing an optional federal charter for life insurers. This effort involved over 300 ACLI member company representatives and brought to bear their considerable expertise on literally every aspect of life insurance regulation. The American Insurance Association and the American Bankers Insurance Association also developed draft optional federal charter legislation. These three groups have worked closely over the last year and have reached agreement on a consensus draft of a bill providing for a federal charter option for all lines of insurance, insurance agencies and insurance agents.

One of the fundamental values we see in the federal charter option is that it can achieve uniformity of insurance laws, regulations and interpretations the moment it is put in place. Many life insurers believe regulatory modernization is a survival issue, and that the speed with which progressive change takes place is critical. The life insurance regulatory framework is in need of comprehensive overhaul, and we believe the federal charter option is the best course of action for accomplishing that and for providing the states with strong incentive to improve the state-based regulatory system.

A number of arguments have been directed against the federal charter option, but we do not see merit in any of them. For example, it has been suggested that such a system of regulation would give rise to regulatory arbitrage or a so-called "race to the bottom." Nothing could be further from the truth. First and foremost, the ACLI and its member companies are not seeking to migrate to a federal system of insurance regulation that is lax. To the contrary, we are seeking a strong regulator that will administer a comprehensive system of regulation predicated on the "best-of-the-best" drawn wherever possible from existing state statutes or NAIC model laws. More to the point, the notion that adding one more system of regulation on top of the 51 that already exist will somehow give rise to regulatory arbitrage is groundless. Today, companies have the right in virtually all jurisdictions to move to a different state that would have primary responsibility for the company's financial oversight. Consequently, there are 51 opportunities for regulatory arbitrage today. It is inconceivable that Congress would put in place a federal regulatory option that was not at least as strong as the better - if not the best - state system.

Some states have asserted that an optional federal charter would diminish state premium tax revenues. Again, this concern is totally unfounded. As the Committee well knows, with the exception of Government Sponsored Enterprises, all for-profit federally chartered financial institutions such as commercial banks, savings banks and thrifts pay state income taxes. For insurers, this state tax obligation takes the form of a state premium tax. There is no precedent for, nor is there any expectation of, exclusion from this state tax obligation. Indeed, all versions of the optional federal charter legislation expressly provide for the continuation of the states' authority to tax national insurers.

A critical consideration is how consumers would fare under an optional federal charter. Arguments to the contrary notwithstanding, we believe insurance consumers would clearly benefit if an optional federal charter becomes a reality. Strong solvency oversight and strong consumer protections are the cornerstones of any effective insurance regulatory system. The ACLI draft optional federal charter legislation and the consensus version being finalized by the ACLI and other interested groups is built on these cornerstones. In this regard, the draft legislation duplicates the following important aspects of state insurance laws:

- It guarantees that consumers are protected against company insolvencies by extending the current successful state-based guaranty mechanism to national insurers and their policyholders.
- It ensures the financial stability of national insurers by requiring adherence to statutory accounting principles that are more stringent (conservative) than GAAP.
- It duplicates the stringent investment standards currently required under state law.
- It mirrors the strong risk-based capital requirements of state law to ensure companies have adequate liquid assets.
- It duplicates state valuation standards that ensure companies have adequate reserves to pay consumers' claims when they come due.
- It reproduces the requirement that companies submit quarterly financial statements and annual audited financial reports.
- It mirrors the existing nonforfeiture requirements under state law that guaranty all insured receive minimum benefits under their policies.

In addition, consumers who deal with national insurers may very well enjoy significant added protections and benefits over those afforded by the states. For example, consumers will experience uniform and consistent protections nationwide and will enjoy the same availability of products and services in all 50 states. Consumers will also benefit from uniform rules regarding sales and marketing practices of companies and agents, and for the first time consumer issues of national importance will receive direct attention from a federal regulator.

Draft House Regulatory Reform Proposals

It should be noted that hearings have been held in the House, which have highlighted many of the regulatory problems we have described above. As a result, Rep. Richard Baker, the Capital Markets Subcommittee Chairman of the House Committee on Financial Services, has produced draft legislation, entitled the State Modernization and Regulatory Transparency Act (the "SMART Act"), which would address a number of these issues without establishing any federal regulatory role but rather through limited federal preemption.

Two of the most pressing issues for life insurers—speed to market and market conduct examinations—are dealt with in the draft proposal. While we are encouraged that Chairman Baker has elected to lead efforts in the House to reform the insurance regulatory system to make it more streamlined and efficient, dialogue is ongoing and we are hopeful that legislation will be crafted that the ACLI and its member companies can support.

Conclusion

Life insurers today operate under a patchwork system of state laws and regulations that is not uniform and that is applied and interpreted differently from state to state. The result is a system characterized by delays and unnecessary expenses that harm companies and disadvantage their customers. Failure to reform insurance regulation will pose a severe and ever larger competitive burden that could threaten the viability of the life insurance industry and those it serves in an increasingly competitive global economy.

We encourage Congress in the strongest terms to put in place an appropriate federal regulatory option available to insurance companies, insurance agencies, and insurance producers. It is in the best interests of our industry, its customers and our overall economy to do so as expeditiously as possible.