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How Well Has State Regulation of Life Insurance Served the Marketplace?

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Moderator: DWIGHT K. BARTLETT, III
Panelists: LAWRENCE D. CLUFF†
HONORABLE GEORGE M. REIDER, JR.‡
WILLIAM C. WELLER
Recorder: DWIGHT K. BARTLETT, III

Summary: The adequacy of state insurance regulation has come up for discussion and debate over the last several years. The presenters tackle this debate by examining the purpose and intent of the McCarran-Ferguson Act. The strengths and weaknesses of state regulation are presented.

Experts from the regulatory environment and from the insurance industry discuss whether the public interest is best served by 1) the states or the federal government being the primary regulators of insurance or 2) some system of bifurcated regulatory authority shared between the states and the federal government.

Mr. Dwight K. Bartlett, III: I'm a senior health fellow with the AAA and a principal with Bartlett Consulting Services, Inc. in Annapolis, Maryland. We have a very distinguished panel to talk about state and federal insurance regulation. We'll allow a bit of time for some interchange among the panelists since they are going to have somewhat different views on some of these questions. Then we'll open it up to questions from the floor.

All three speakers have very distinguished backgrounds. We're going to start with George M. Reider, Jr. George is the commissioner of insurance in Connecticut and has been in that position since May of 1995. Prior to that, he spent his career at Aetna Life and Casualty in Hartford, beginning there in 1963. He retired as acting vice president of the Property and Casualty Group Claim Operations. George is currently serving as president of the NAIC. I know how demanding that position is, so we're pleased that George could take time out of his incredibly busy schedule to join us for this session. George received his B.S. in Business Administration, Economics from Lebanon Valley College in Annville, Pennsylvania, and he serves on that institution's board of trustees. George has done considerable international travel since he became an officer of the NAIC, representing the NAIC in international discussions of insurance regulation.

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†Dr. Cluff, not a member of the sponsoring organizations is Director of Financial Institutions and Marketing at the U.S. General Accounting Office in Washington, D.C.

‡Mr. Reider, not a member of the sponsoring organizations, is Insurance Commissioner at the State of Connecticut Insurance Department in Hartford, CT.

The next speaker is Lawrence D. Cluff, who is assistant director of financial institutions and market issues for the U.S. General Accounting Office (GAO). Dr. Cluff directs a staff of economists and financial specialists in analyses of issues for Congress relating to the rapidly changing financial sector and its regulation. In this area of insurance, his work has resulted in a series of reports and Congressional testimonies on various aspects of insurance regulation, including how to identify and handle troubled companies, reinsurance, and the role of the NAIC in the regulatory process. Dr. Cluff has been a speaker at numerous conferences and seminars on issues relating to insurance, including conferences sponsored by the NAIC, A.M. Best, Coopers & Lybrand, and the American Bar Association. Before joining the GAO, Dr. Cluff taught at Behrend College in Erie, Pennsylvania. He received his Ph.D. from Pennsylvania State University in 1980.

To give an industry perspective on the problem of the issue of regulation is William Weller. Bill is assistant vice president and chief actuary of the Health Insurance Association of America (HIAA). Previous to joining HIAA, he served as chief actuary of the Blue Cross and Blue Shield Company of Maryland. Bill is a member of the AAA Board of Directors and has been quite active in health insurance matters of the Academy.

I will first set the stage a little bit. We all know, of course, that in 1945 Congress passed the McCarran-Ferguson Act, in effect saying that the federal government would defer to state regulation of the insurance industry to the extent that states properly regulated the industry. Nevertheless, since that pronouncement or policy statement was passed in 1945, clearly the federal government has increasingly intruded into the regulation of the insurance industry. Perhaps the beginning of the breach of that wall was the famous Valic case in which the Supreme Court ruled that variable annuities were, in fact, securities subject to regulation by the SEC as well as regulated as insurance products by states. That Valic decision has been extended to apply to certain general account products that pay excess interest.

More recently, we've had the *Harris Trust v. John Hancock* decision where the Supreme Court said that insurers issuing general account products to pension plans are subject to ERISA fiduciary standards. Certainly that intrusion has been most extensive in the health insurance field. We have the federal government, for example, prescribing the benefit standards for Medigap policies. States simply monitor health insurers for compliance with the federal standards on those Medigap policies. We have the federal government getting into benefit mandates which require that insured as well as noninsured health products that include mental health benefits must be on a parity basis. We have the Health Insurance Affordability and Accountability Act of 1997 in which the federal government, in effect, prescribed certain standards for the small group health insurance market and the individual health insurance market. These items include community rating, guaranteed issue, and guaranteed renewability. So we see this history of increasing intrusion by the federal government into the insurance regulatory field. Is the fact that we have dual regulation a good idea or a bad idea? Should we be pushing for going in just one direction or another, or should we be seeking a combination between the two levels of regulation? That's basically what we're here to discuss. I'm sure George will start us out with a spirited defense of state regulation.

Mr. George M. Reider, Jr.: Dwight and I go back to the time I came aboard four years ago as the insurance commissioner from Connecticut. Dwight was one of the people who I often would turn to for counsel and guidance. Our views have diverged a bit since then, and with all due respect, I do stand in defense of the functional regulation and state insurance regulation. I always have had great respect for Dwight and the actuarial sciences.

I was in the business for 31 years on both the claims side as well as the underwriting side. For three years I was in charge of product development and underwriting for personal lines insurance. At that time, I particularly gained a great appreciation for actuarial science because I found that you can't function without it. And, in the insurance department in Connecticut we have a number of actuaries, one of which is Jack Gies who is with us here, who is responsible for the life side of the actuarial work that we do. Recently, John Purple was hired as our chief actuary. It's the first chief actuary position in the history of the state. We're even in the regulatory side of the house. We're in the numbers game in the best sense of the word.

To say we're in a world of change is an understatement. I think what is most telling is if you go to Connecticut, you'll find that the prior commissioners (and there's quite a long list of those who continue to be retired but active in the state and visit with me) tell me that in my 4-year tenure that I have had more change of controls than all the commissioners in the 128-year history of the department. That's rather telling. It may not be surprising, but it certainly brings home a message. There's hardly a week that goes by that somebody doesn't come in selling his or her life reinsurance operation. Immediately that triggers a Form A filing. We have quite a list of them, which creates a lot of work. It's a major responsibility because we take each and every one of those very seriously. You know that the rumor was that Travelers and Citicorp would be combining into one operation. You don't have to have an actuarial science degree or be a Phi Beta Kappa to realize that that was a very significant undertaking. I think that that has helped trigger the sense of urgency with HR-10 in the Congress.

After this meeting, I was going to return to Connecticut because I do spend a lot of time there as the commissioner; however, we're going to have a meeting in Washington because the Commerce Department is about ready to take up HR-10. Let me just comment on that.

In the summer of 1998, I was invited by Senator Christopher J. Dodd (D-CT) and then Senator Alfonse M. D'Amato (R-NY) of New York to attend meetings with the Banking Association and the regulators in the industry to see if, at that time in the discussions of HR-10, we couldn't come to some agreement. I have great respect for the bankers in this country, and I say that with much sincerity. I also respect the fact that the banks have not always been treated on an even playing field. We all know that, but that has changed dramatically. We saw our largest two agencies in Connecticut combine with the bank. I didn't have one telephone call from anybody; five years ago it would have created tremendous pressure on us. People realize that the world is changing, and the world has to change if we're going to compete; however, I believe that when you deal with the banks, it's not that we need to maintain an even playing field—we want to be in a higher playing field. If similar versions of HR-10 are passed in both the Senate and the House without some modification or some clarity on functional regulation, you're going to have consumers in this country without protection.

During this presentation, you'll hear that there's dual regulation, and that is true. Dwight spoke about that. Some of that is very good and some of it leaves some voids right now in the health insurance arena with the Health Care Financing Administration (HCFA), which we saw last fall. Yet we have a good relationship with HCFA, and we can work down that path. We are working that path, but the fact of the matter is that you're going to have certain marketing procedures and other areas of exposure. If it falls under the federal government, it does not have the organization or structure in place and people will fall through the cracks. If I were on the banking side of the House and I were going to get into insurance and I knew about class actions and all the issues, I'd want to travel hand in hand with the state regulatory authorities. Do we have to change? Indeed we have to change, and we are changing. We must achieve commonality. We

can't have people jumping through 50 hoops; to suggest that that will go away or be pushed down the line is not good.

I think that you're going to see something come out of Congress that does address functional regulation, and that's what we're going to speak about in Washington. It is the first time in the history of the NAIC, I believe, that 50 states will converge at one time to carry a message to the federal government to be careful. We'll be visiting with our senators and our representatives, and we'll be explaining that we're not against HR-10 reform but, simply saying, there are some areas that have to be corrected. If you were in the state of Connecticut and somebody wanted to buy an insurance company today, that company, as a holding company, would have to come to the state insurance department and gain approval. It doesn't matter if it's an insurance company or General Electric. If it were a bank under the new legislation, there's a real question as to whether it would have to get the approval of the state insurance department.

So you can have a major share in the state of Connecticut taken out of the state without approval of the state insurance department. I don't think the citizens of the state of Connecticut are going to like that. They don't even like it when we do it on the procedures we have. If we don't do it that way, we're going to get hung up because you people are not going to give us an even playing field. When any merger or acquisition comes to us, we have six principles we have to follow that are set out in the state law. You interpret them based on the facts, and if you don't do it based on the facts either party has the right to go to the superior court. We've been tested in the superior court three times and have prevailed all three times, but the test is severe. I would give every assurance that banks should be treated just like anybody else, but not when a playing field gets bigger than the one we're on.

The NAIC is an organization of 50 states, the District of Columbia, and 4 territories. There are 10,000 regulators countrywide. There's a budget of $750 million. The NAIC has been in existence since 1871. We have the world's largest insurance financial database and analytical tools. It's just overwhelming to see what information is available. We're the largest publisher of insurance-related information. We develop model laws and regulation, most of which are accepted or adopted by the states. I read in *USA Today* about how viatical settlements are getting a lot of attention. It was suggested that there's no regulation. I can tell you that in the state of Connecticut we do have laws that oversee that, but I would also share with you, talking about life insurance specifically, that there are some real exposures with viatical settlements and some real opportunities for abuse. I believe that has to be tightened. I don't think viatical settlements in principle are wrong, but you have to be very careful that people aren't abused in that arena.

In the life insurance arena, we, in the state of Connecticut, as in most states, adopted the life illustration model. We were one of the states, in fact, that conducted our own investigation of Prudential Life Insurance and its marketing practices that went back to the 1980s. I can tell you that I don't think Prudential or Metropolitan are bad companies. I don't even think all the other companies that had class action suits are bad companies by any stretch. Because I have seen some of the depositions, there can be some bad actors in those situations. I can also tell you if I were advising anybody in life insurance, I'd use three words: *disclosure, disclosure, disclosure*. The NAIC has played a leadership role in that regard. There was some mention made of the fact that it was federally driven. I think one of the positives is the fact that Congressman John Dingell (D-MI) took the industry and the regulators to task for all those insolvencies. There were 45 multistate insolvencies in 1991, but there were 6 in 1998 because we did get accreditation and it worked well. I would admit to the fact that that was in large measure due to Congressman Dingell. It is a good program and it works well, and 49 states are now accredited. The other

state, New York, certainly has high standards. We hope that its accreditation will happen some day as well.

More recently, I was involved in the codification efforts. Some of you are aware that for annual reporting statements in 1991, there were some rules brought into place as to what had to be reported to regulators; however, there wasn't consistency among states. Codification will bring that consistency and a heck of a fight. State legislatures have said that the NAIC is preempting state prerogatives. Other state regulators have said, “Wait a minute, you're going to come in and tell us how to do this?” This compromise in codification was that there will be codification and disclosure effective 2001. Because of Y2K, we extended the compliance date. If you have an in-state company that has no involvement across boundaries, then you can do as you wish. So at least we have that footing. It is a very fascinating thing.

We have an initiative underway now, technology initiatives for 2000, and it has to do with having commonality among the states in how we license agents and companies, and follow the behavior of agents. If you take the federal people (the security people, for example), you’d realize that they do a much better job in monitoring the behavior of an agent or one of their licensed people. With the Metropolitan or the Prudential matter, there were people who acted badly in several states but moved from one state to the other. This new technology will allow us to follow and track that behavior and give better protection to the consumers and better ease for agents to be licensed.

I'll finish with the topic of SERF, which is the electronic rates and form filing. At one of my first meetings, the issue was, “Should we spend the dollars and continue the investment in technology, one of them being the SERF project?” There were those from the industry who said, “No, you can't do that because you'll have proprietary information on this network.” We kept going back to the fact that we live in the age of technology. Consumers and companies had a hard time accepting that. One of them just kept pounding the table saying, “You can't do it.” Everybody is doing it differently at tremendous cost. But I just find it fascinating that there were those who resisted having that technology brought to bear.

The answer was if they are proprietary matters, then we should protect them. We found ways to do it. Today there is a SERF program that's up and running and being expanded across the country. I think it's important today more than ever for everybody to work together. When you're a regulator, there's a wall. There's a line of demarcation, and there's a point of separability of interest where you're not going to agree with the company or the producers. You will have to stand your ground. Most matters are of common interest and not just of interest to the companies and the regulators; it is also of interest to the consumers. On managed care we are planning to gather in Washington, DC within several weeks under the facility of the NAIC and an independent facilitator to bring all the interested parties together and cut through some of the rhetoric. Companies have to be responsible. There are areas of abuse in managed care, but there are a lot of good things that are happening. We can't get to the facts because everybody is telling horror stories.

We’re going to try to sit down and begin to work through that because at the heart of it there are people who are consumers, and they should have the benefit of the best programs. It requires all of us to communicate much more. From the actuarial standpoint, I would just say that you're a big part of the NAIC. As Bill mentioned, he attends each of the sessions that you attend. You're on special and independent committees, both from the regulatory side and within the industry. The actuarial input is extremely valuable.

Dr. Lawrence D. Cluff: In some sense, I feel a bit like a fraud because I feel like Dwight asked me to speak because he thought I would say federal regulation is best. I'm not going to say that. I think we already have a system of dual regulation. It is not like the dual regulation you find in the banking system where there are dual charters. That's another issue. It is under discussion. It may or may not happen. It has been discussed before, but there are lots of pros and cons. The system that we have in place, as Dwight mentioned, really is a dual system. No company in this country other than perhaps the very smallest operates without some constraints imposed on it by federal agencies in one way or another. I'd like to discuss the way Congress oversees the regulation of insurance. The McCarran-Ferguson Act was mentioned.

The McCarran-Ferguson Act has several principal elements. I don't know if any of you have ever actually read it. It's only a few paragraphs. Basically, it says first that regulation of insurance or the business of insurance by the states is in the public interest. I have worked for 20 years in Washington and spent a good part of the last 10 or 15 years looking at financial institutions and regulation, particularly insurance regulation. I think that that is still the sense of most of the people who are in Congress. The second principal element is that no act of Congress, with some specific exceptions primarily having to do with antitrust, shall supersede state laws concerning the business of insurance unless the act specifically declares that it applies to insurance. The significance is that Congress doesn't have to ever repeal McCarran-Ferguson. All it has to do is pass a law that applies to the business of insurance. Congress does that on somewhat of a regular basis, although not as much as some probably would prefer. Federal antitrust regulation is an exception. There is a statement that is not explicit but implicit. If the states do not act as Congress feels is appropriate in the regulation of insurance, then the federal government has the right to step in and do something about it.

Several situations over the past years have illustrated the oversight role played by Congress. One was in the 1950s and 1960s when there were a lot of failures of small, primarily high-risk auto insurers. Senators Thomas Joseph Dodd (D-CT) and Warren Grant Magnuson (D-WA) held hearings on the failures. People who wanted and needed insurance coverage for their cars couldn't get it because their insurer became insolvent. Both Senators introduced legislation calling for a federal guarantee fund to protect people whose insurers became insolvent. The bills were not passed, however, and you all know the result. The result was that by 1972 I believe all the states but one had a property and casualty guarantee fund in place. While it was somewhat later, I believe all the states now have a life guarantee fund as well.

Senator Magnuson in one hearing made a comment that I think is germane. Maybe these hearings might have an effect on the states doing their job, and that is I think the description of the way that many in Congress feel that it exercises oversight of the insurance or of the regulation of insurance.

Mr. Reider mentioned another primary example: the hearings by Congressman Dingell. He started holding hearings, which I was first associated with in 1989. He had held some before that and then held a long series of hearings into the early 1990s looking at insolvencies, the causes of insolvency, reinsurance, the availability of reinsurance, and the accreditation program. There were three annual hearings on the accreditation program. Each time he asked the GAO to look at the accreditation program and report on how it was doing. Those weren't the most fun jobs I've ever had, but I do believe that they did have an effect on how well the accreditation program was adopted and accepted by the states. The GAO raised questions about whether it could be effective, and I think some of those questions were and are legitimate. But I think the fact is that the accreditation program has had a tremendous effect on the quality of insurance. Many of the criticisms that were leveled at insurance regulation in the hearings held by

Congressman Dingell on the variations that existed between the states have led to important changes such as codification and others. In some ways, that was an oversight but certainly effective in its way.

Another example is more recent, and, in fact, it's very recent. In 1998, Congress-man Dingell asked the GAO to look at the issue of year 2000 readiness in the insurance industry and what the insurance regulators were doing to verify and validate that readiness. We briefed Congressman Dingell's staff in March 1999; at the same time, we briefed the special Y2K committee in the Senate. We were asked at that time to put together a statement for the record for a hearing. The report on our work was released by Mr. Dingell recently, and I have copies for anybody who'd like one. Basically we found a number of things as we looked at this issue. I bring these out not just because I did the work, but because I think it illustrates some of the continuing problems that exist in a state system that the state regulators and the NAIC needs to be aware of. We visited 17 states. We chose the 12 largest states in terms of the national share of insurance written by companies domiciled in those states, and we chose 5 other states to give us a sense of what was happening in some of the smaller states as well. We found that there was a wide variation in the approach that states were taking to looking at Y2K preparation of their insurers and a level of oversight activity that those states exercised. We found that, in general, the regulatory oversight of the year 2000 in the insurance industry began considerably later. In many cases, it was much less active than oversight of the banking and securities industries by their regulators.

While both regulators, generally speaking, and other industry observers felt that the insurance industry was not in serious trouble, most of those observations were based on unverified and unvalidated survey responses. I'm not saying they're wrong; the problem was from the perspective of financial markets not liking uncertainty. They do not like uncertainty. Those who need to know what's going to happen or who need some degree of confidence see that there is at least uncertainty in the level of preparation of insurance companies because the regulators have not done their part to assure others of the insurance industry's readiness. We've been asked to do two more updates of this same issue. The first one will be done with an as-of date of July 30. It probably won't be issued. It will be a briefing to Congress and the staff. At that point, they will decide whether or not they want to have a report issued.

The response of insurance regulators, I will say, has been very positive, and there appears to be a genuine desire to do whatever is necessary or at least possible within the remaining time to increase the level of oversight over this issue. Why do I raise this? It's not just because of the issue itself, although it is an important one. It illustrates the most important part of the dual system that I see existing, and that is oversight. While I do not necessarily believe that the federal government should regulate insurance, I think there are issues on both sides of that question. I wouldn't be working where I am if I didn't believe that everybody needs someone looking over their shoulder to help them work better. Every organization becomes involved in handling things in the way that seems to work. There needs to be an outside perspective for everyone to look at whether or not it actually is working and whether or not more needs to be done. The fundamental area of oversight that I stress already exists and is likely to exist to a greater extent in the future.

There are a lot of events currently going on that I believe will lead to a closer and closer association between regulators of financial institutions, including state insurance regulators. There is no longer a place for provincialism, and there's no longer a place for insurance regulators to say, “We’re not like you, leave us alone.” It has never worked before. For instance, when Social Security reform takes place a system of individual accounts is established, and if

those individual accounts are annuitized through the private markets, you can believe that there will be more federal oversight of the annuities market in one way or another. That's because private annuities will then form part of the Social Security underpinning for individual workers in this country. I think it will require the federal government to be more involved.

There have been recent discussions, and we were asked recently to look at this issue. There is currently a surplus in the Social Security Trust Fund of some $50 billion a year. That means about $50 billion more is coming into the Social Security System than is being spent for Social Security. That number will decline until about 2010–2014. At that time it will become zero and then become negative; you'll then start drawing down the trust fund. The trust fund, and I don't have time to go into this, is not really there in one sense. That $50 billion that came in last year was used to buy special-issue Treasury bonds. That means it was given to the Treasury. The Treasury issued a certificate to the Social Security Administration saying, "You own these special-issue bonds that are not available on the market anywhere, and we will pay you some nominal rate of interest. When you need it, we'll give you the money back." Then they proceeded not to borrow the $50 billion from the private sector that they would have borrowed if they hadn't had that $50 billion from Social Security. The money is spent, it's gone, and there's no money there. What is there is an IOU from the Treasury department that says it will borrow it in the future if it is needed. There are some who feel that that's not a great idea and that there are better ways to do it. The Travelers was mentioned. We were in New York recently, and we sat down with a number of companies including Citigroup. In the same room, and I think it was one of the first times that this happened at least for this group of people, we had people representing Solomon Smith Barney and Travelers and Citicorp, the bank. We presented some issues to them, but each company had its own solution. I'm not sure they even understood the other's position very well because I don't think they ever talked before. So there's some integration problems there that may become smoothed out.

I appreciate George's comments about the importance of HR-10 to insurance consumers. In the testimony that the NAIC provided to the Commerce Committee in hearings, one of the things they asked for was federal authority to impose certain changes on the state regulatory system. From the evidence of history, insurance regulation has not worked badly in this country. The record of insolvencies is at least comparable to, if not better than, other financial sectors. Most people who need insurance can find it, and most can find it at a price they can afford. At the same time, if there were a transition to a federal system, there would be huge transition costs both in dollars and in efficiency. However, in this world where financial integration is happening, where distinguishing among financial products is becoming increasingly difficult, and where consumers do not distinguish on the basis of the things that we thought they traditionally distinguished between, both insurance companies and regulators have to expect that the Congress will continue to exercise the oversight role, and probably to a greater extent than it has exercised in the past. Some insurance regulators are not used to GAO or someone looking over their shoulders. We do that every day to federal agencies. It doesn't mean we want to close those agencies down. It doesn't mean that we want to close the state regulatory system down either; however, it is necessary because the goal of oversight and the goal of regulation is to improve the quality of regulation and protect both the customers of financial services and the stability of the markets themselves.

Mr. William C. Weller: My comments are going to be my own and not those necessarily of my employer. I think that an important distinction probably has been made here. I'd just like to note that there are two aspects of regulation. There's a regulatory oversight that Dr. Cluff just talked about. This is when you look at how things are operating and you try to determine whether it is being done well or not. There's accountable regulation, which is getting down to a specific

company, a specific policy form, or a specific rate that's going to be offered to a consumer. I think that's what Commissioner Reider was talking about. When you're talking about a company coming in, you have to look at the management of that company. Decide whether they are capable of doing what they want to do, or are you going to find a big problem in six months? Those are two very different things. As actuaries, I think we tend to deal in accountable regulation more often. I've had some unique experiences working in a trade association in Washington dealing with both the NAIC at many of their meetings as well as with regulatory officials in HCFA on Medicare and various things.

You can see accountable regulation in both, but I think there are some differences. Let's talk about a couple of things in terms of regulatory oversight that I think are very useful. One is from an actuarial point of view, and one is an item that Dr. Cluff had in his notes but didn't cover. That was the issue of antitrust. It was 20 years ago that the Insurance Services Office said, "Here's a standard rate. You can file this policy form with this rate." In many states, that was accepted and there was a great deal of concern about that from an antitrust point of view. They said, "We don't like companies using the same rates," but they didn't say, "You can't use the same experience."

As actuaries, we all understand the value of experience. I found it very useful to note that in the review that I saw in the paper of the UNUM-Provident deal that part of that is a recognition of the value of experience data. The Federal Trade Commission said, "The combined company is supposed to continue to provide to the Society of Actuaries the data that are used for disability income; so there is a recognition that the actuaries need to be able to collect the data from various companies." They can't use the data to produce the same prices, but the data are very important.

From a solvency oversight in regulation, I think that the NAIC, with some push from Congress, has done a great deal in terms of moving toward better solvency regulation. I would note that the NAIC has found that the Academy has been very useful in providing some detail into the risk-based capital formulas concerning liquidity standards. So the actuary is able to provide input before it becomes used, and he or she can work with the insurance department actuaries to review the actual work of the company's actuaries and the reports. There are some areas where regulatory oversight tends to go astray, and this is probably oversight (I shouldn't say regulatory oversight because frequently the oversight that tends to go astray is when Congress doesn't like the current situation). Instead of just talking about it and then giving people a chance to say there are things that we can do to fix it that won't totally disrupt the market, what you end up with is a law that we have to deal with as companies and as regulators, which frequently isn't clear. There may be several years or several decades before we get federal regulations that say what the law meant. As such, it can become very much of a problem. ERISA is a good example of a law that doesn't have a whole lot of good regulations under it. The way in which health insurance carriers and TPAs process claims isn't necessarily the way we want them to do it in the future. Moving to that without a well set-out set of regulations is much more difficult than if we had the kinds of models that the NAIC has developed, which brings up accountable regulation.

With regard to accountable regulation from an industry and an actuarial point of view, we don't want 50 different sets of accountable regulation. We would very much like to have one that is good. By the same token, we're talking about developing accountable regulation that's going to deal with promises that we make 40–80 years into the future, and we don't necessarily know the exact way to do that the first time out of the box. One of the things that we do end up with from both the NAIC and state regulation, from an accountable point of view, is a testing ground for

what works and what doesn't work. As an actuary, I would be very fearful working in an environment where there is only one set of regulations and if you don't get it right the first time, you have to deal with it. That would be one concern that I have.

From an actuarial point of view, accountable regulation deals broadly with three areas. First of all, there's company solvency. The actuaries are involved very much in the opinions with regard to the reserves and cash-flow testing. The Academy, at the behest of the NAIC, is looking at revising the reserving basis through a new standard that may expand on the ability to use more of the assumptions that go into some of the gross premium valuations as opposed to the defined statutory tables. It will add dynamic financial analysis allowing you to look at your future more than your past.

The one thing about company solvency is, and I think this is true of insurance and banks, when it works, very few people hear about it. There are a lot of problems, but you don't hear about them. George hears about them and I'm sure Dr. Cluff hears about some of them, but they don't make the paper unless solvency protection doesn't work. So the fact that you don't hear about it probably means that it is working in more ways than one.

The second area is consumer protection. Training and licensing the product approval process and the claims process are areas that fall under accountable regulation. When we look at the examples of the states that are doing the regulation of insurance companies in the Health Insurance Portability and Accountability Act (HIPAA) versus the places where HCFA is doing the regulation of companies in HIPAA, we find that the states are more effective. It is probably because they've had more experience in doing it as opposed to HCFA, which suddenly found out that it was going to do it but never expected to do it. We received very different results in terms of the way in which they do consumer protection.

The last area is the fair trade practices. Companies and actuaries want consistency. If we see a policy formed by another company, we want to be able to assume that if we do something like that, we can produce the same thing. We want fair trade practices with regard to sales illustrations. This involves an incredible amount of effort on the part of the accountable regulation area. It's not sufficient to just do a broad oversight; you have to stop practices that are bad for all of us.

In terms of accountable regulation, I just don't see the ability of the federal government to do that at this point in time. If there was federal regulation we would lose two things. One is we would lose the ability to test things out in various states without having it applied in all 50 states. The other thing that I think we would lose that a lot of people don't understand is the value of the development of the NAIC models because legislation that becomes an NAIC model act is developed by both insurance regulators and industry people. The Academy provides input. It is not developed by legislators or legislative staff. Once that's done, it can be presented. There are some states that will not follow the NAIC. As soon as the NAIC comes out with something, they want to go off and do something else. That's a problem because there are a few states like that. For the most part, we benefit greatly by having the NAIC process develop those models, and I don't see any way to do that with federal regulation.

Mr. Bartlett: In a few minutes, we'll open this up for questions and comments from the floor, but let's have a little discussion among the panelists first. I'll exercise the moderator's prerogative by posing the first question. I guess this is basically for you, George. Bill referred to the fact that under HIPAA, in effect the federal government mandated certain reforms for small group health insurance and the individual health insurance markets, and it invited states to implement these

reforms. It said that, in effect, if the state did not implement the reforms, the federal government would directly regulate this business. As I understand it, three states defaulted to the federal government: Rhode Island, Missouri, and California. I wonder, if the states are so uniformly enthusiastic about providing or continuing state regulation as far as possible, do you know why these three states decided to default to the federal government in the regulation of these products?

Mr. Reider: Some months ago, there was a longer list of states that had not complied. They had some difficulty getting it done within the time frame of their own legislature. These states want to propose it. Connecticut, for example, wanted to comply. I can recall getting a telephone call within the final days of the legislative session from that state's senator, who was the chairman of the Insurance Committee, telling me that it failed. Somebody put an amendment into it and they didn't want to pass it, so we went back to work and got it passed. So we're down to three states. Connecticut, for example, had one minor change to make, and it was in full compliance. Many of the states were in full compliance with the federal program. So it was really just a matter of being sure. As for the other three states, my understanding was they either felt that they were able to do what the federal government would have had them do, or they ran into a technical difficulty and couldn't get it passed.

Dr. Cluff: Let me just comment on HIPAA. One of the things that I've noticed is that Congress sets out time frames following the act that are very difficult to meet. This applies whether it's the NAIC developing some standards, as it has done for many of the Medigap changes or HIPAA, where it gave the states a number of different options. There was only one legislative session for the states to have gotten through that. In at least one of the states there was a strong difference between some people who wanted to take one option and the insurance industry, which was opposed to the option that those people wanted. Time ran out before there was any compromise.

Clearly the result of that is that someone who never expected to be regulating insurance is now regulating insurance. I was as surprised as anybody. This was, I think, the fourth law that was passed that followed this approach. I think the first one was probably in 1990. It said that there will be some standards. If the states don't do it, then HCFA will take it over. In every other one, all of the states always adopted something within the time frame. There were suddenly several that didn't. HCFA has been scrambling, and companies have experienced problems with dual accountable regulation where the insurance department, which still regulates parts of the policy, wants it done one way and HCFA says, "If you do it that way, we won't approve it under HIPAA." The state is unable to approve new policy forms for the HIPAA market.

Mr. Bartlett: George, did you want to respond to that?

Mr. Reider: I want to make a couple of comments, one pertaining to what the doctor said about federal oversight. When you have 55 different jurisdictions, you're not always going to have people marching lockstep, and sometimes that can be a hindrance. The NAIC is taking very definite steps to try to strengthen that. We will ask Congress for some additional authority so that we can get people more in the same mode on some of the licensing requirements.

The other side of it is if you were to preempt the states, which some would do, there's a cost. We have a great relationship right now with HCFA. We're working very closely with them toward the common interest of the consumers. Remember how terrible the Medicare risk crisis was last year when a number of the companies decided they were pulling out of the Medicare risk market. I can tell you from a state government standpoint, we could have solved that problem

very quickly because what was happening in southeast Connecticut, for example, was two companies pulling out and leaving a void. We were able to have one of the companies remain active, so there is a market. We were successful, but what the people were saying, ironically, was, "We want a managed care product because we get much better coverage for a smaller amount." The companies were saying, "Just allow us to charge $40 or $50 and we'll provide it." The people were saying, "Let that happen; we receive the product." HCFA didn't have the ability to do that because it is under a federal program; they had to wait for legislation first.

So while there may be some disadvantages, I'd also suggest there are advantages. I don't want to get into a heavy discussion on Y2K because we very much appreciate what the GAO has done with their review. I suspect we're not alone. If they had it to do over, many federal, state, and private businesses would have done it a little bit differently. It's like raising my four sons who are all adults now. I'm just about finished being a good parent, but I have to be a good grandparent, which is a much easier task. I suspect with the Y2K situation that we'll all look back on it on January 1, 2000, and say, "This worked a little better," or "If we had just thought of this." But I would say that we saw that as a positive. We're responding quickly, and we were able to point out things that were underway or that maybe weren't clearly defined in the report. I think we're going to all be better for it in the end. We do have to change. We cannot say that we're provincial and that's the way it's going to be. That's not the mode the NAIC is in right now. We're in a mode of saying, "We have to move on with it; we need financial modernization, but we have to do it with functional regulation." The Federal Reserve people out of New York, Boston, and Washington have been to our office on several occasions for lengthy discussions. What's so interesting is while Congress is trying to make decisions about preempting state regulation, here we sit shoulder to shoulder doing a very effective job of regulating the Travelers insurance operation while they regulate the banking arm and the security people regulate the security arm. We think the people who have Travelers insurance are protected as we're currently doing it.

Mr. Bartlett: Larry, will you comment on something? George notes in his remarks that consumer protection, from an insurance regulator point of view, comes down to three words: *disclosure*, *disclosure*, and *disclosure*. Yet we know that for the security salespeople in this country, it is not just disclosure—it's suitability testing. In the insurance industry in the U.K., it's suitability testing. Do you think this is a weakness of state regulation in that it focuses on disclosure and not on suitability?

Dr. Cluff: Suitability is a concern of the insurance regulators as well. I have not looked at the comparison between the suitability requirements for securities and insurance. As insurance products become more like investment products suitability is very important, but most of those products are dually regulated by the insurance and the securities people, so they already have that suitability requirement.

Mr. Bartlett: For variable products, but not for traditional and nonvariable products.

Dr. Cluff: That's true. Some of the issues related to sales practices in the last few years are still being worked out on a regulatory level. I don't know whether suitability is one of the issues that has to be dealt with there or not. Most of those were a little more egregious than just selling an unsuitable product.

Mr. Reider: I hope my comments didn't suggest that we were excluding any other interest. I'm simply saying, Dwight, that if you were the salesperson and you went in there in 1985 and selected the most appropriate product for those people at that time and did everything correctly, evidence shows that they didn't always disclose it in a way that preserved a record. As a result,

some people had to pay some money that otherwise would not have been paid. So I'm just simply saying that if you're going to go in, don't assume that the consumer understands the product. You should spell it out. I think the NAIC's model illustration helps in that regard. But even then there were some guidelines in place, but they weren't used effectively so people came back. The company and some of the salespeople were at a loss to prove it wasn't what the customer said it was. In some instances, it was bad behavior but many times it was not.

Mr. John F. Gies: I'm from the Connecticut Insurance Department. I think the panelists have done a good job of explaining that this is not a tussle for territory but more an issue about how effective regulation can be and what the optimal basis is for proceeding forward with regulation. I'd like to pick up on Dr. Cluff's comment about dual regulation. He split it into federal versus state. I also used that same concept but mostly, as a state regulator, I feel as though our system is almost a self-regulatory system in the sense that the companies themselves are very actively involved in the development of regulation and identification of problems. I forget which of our founding fathers used the following phrase, but he described that the real basis of authority lies in the free will and consent of the governed. In that sense, I think our system has produced a fairly effective regulation or regulatory framework in a state-based arena for insurance. My question is, where then is the impetus for change? Where's the groundswell for changing, in some fashion, the regulatory scheme? On the one hand, I would kind of look at consumers, but they are not fully informed. You could look at their lobbyists. On the other hand, they have their own interest and you can look at the companies who in fact have a large stake in the regulatory apparatus. Where's the groundswell for change? Does anyone have some observations or perceptions on the role of the internationalization of business in influencing change in regulatory structure in the U.S.?

Dr. Cluff: I'm not sure there is a groundswell for change. There are certainly people and companies who are interested in change. Many of those in the early 1990s were most avidly supporting Mr. Dingell's efforts, and some of you will know that he actually did propose a bill for federalizing insurance regulation. I guess I say this at some risk. It was a bad bill and would have been a disaster. I also have to say that a good portion of the bill was written by some companies who were very anxious for there to be federal regulation on terms acceptable to them. I also was fairly deeply involved in the issue of disaster insurance and its federal provision. I know most of you or many of you are life people, but, nonetheless, that bill that was originally presented in Congress a few years ago was a bad bill because it would have given away the store. Frankly, that bill was written by some companies or company-paid people such as lobbyists. Congress doesn't usually have the expertise to write good bills. They look to others to write bills. I'm glad that both of those bills didn't make it because it would have been a disaster for either of those bills to be passed.

So the push and tug of different interests I think is what ultimately gets us to the best outcome. Congress appears gridlocked much of the time and it is, but that may not be bad because when they do something on the spur of the moment, it's often not a good thing. Legislators need the time. There's a bill in Congress right now on disaster insurance, and it is a much narrower bill. I haven't had time to really look at it, although we've recently received a request to look at it. On the surface, it looks like a better bill because it has gone through about four Congresses now where it has been pushed and shoved and prodded and tweaked, so it is better. I don't know whether it's good or not, but it's better.

So that is the kind of process that works. It takes a long time, and it may not be an optimal solution. You just kind of have to take the best. I would say one thing in response to Bill's comments. I believe that the NAIC's process of developing model laws and regulations is a good

one and very useful, and often produces something that's worthwhile. That would be lost if there were a federal system. On the other hand, to some extent, the best federal regulation occurs when the legislative language is fairly general and the regulators are left to interpret the regulation. Securities regulation and bank regulation happen, and they happen reasonably well, although they are not perfect. The process that they go through to get the regulations is a different one from the NAIC's, but it also works. So there are different ways to get to the same end.

Mr. Bartlett: George, in his comments, implied that I had given up on state regulation since I stepped down as Maryland's insurance commissioner. I don't think that's a fair characterization of my views at all. As a matter of fact, I have repeatedly said that there are certain things that the states do exceptionally well, which I don't think the federal government could ever duplicate. One of those things is handling consumer complaints. Frankly, ERISA cripples state regulation in that field, and I just wonder if any of you think there's any prospect whatsoever for a significant ERISA reform which would help that situation.

Mr. Reider: I simply meant to suggest that you have a different perspective on some points than what we may have had, but I do think that's what helped the discussion so I meant that with all due respect.

Mr. Bartlett: You're not going to opine about ERISA reform though.

Mr. Reider: There's quite a discussion now with the federal people talking about patient protection, and the NAIC has got it going across the hurdle. The federal government has oversight of about 50% of the people in this country who have some form of health insurance. What we were kind enough to do was to suggest to the federal government that they should in fact implement certain consumer protections as is happening in the states. For example, in the state of Connecticut, if you have a dispute with your managed care company, you can move through the internal appeal process to an external appeal process for $25. Thirty days later, you'll have a decision from an independent body, and I think the industry now has embraced that as an external appeal. We suggest that the federal government should move in that direction.

Where we do disagree with the federal government is to suggest that they should now mandate what's in each state. Their point is not all states are the same and not all states are going down the path far enough. Our suggestion is that, on our own, we have moved 17 states in the direction of external appeal with more coming on line each and every month.

The other thing I think we're seeing, and Bill you may be able to comment, is a closer working relationship between the federal government and the state people today because the federal people realize there's a void. They don't have, as you say Dwight, the mechanism to handle everyday complaints as a state insurance department does. It's very frustrating. Somebody will call us and be very upset that something's not happening. We say that's the federal government. What we've done in Connecticut and in a number of other states is to tell the consumers that we'll take them down the path and put them in touch with HCFA or the federal people. We'll help them along in the process as much as we can. I believe those are some positive developments.

Mr. Weller: There's certainly always this push and shove when you want to have consistency, and you don't get it with all of the states adopting the same thing. The states do adopt different things and that adds to the administrative expense. At some time, it's possible that that administrative expense may be more than the risk of federal regulation. That's always one of the

questions. Based on the large employer groups that got ERISA, there would be no indication on their part that there would be any value to put up with the state variations that would exist. They would much rather deal with body-part mandates in Congress than to do a wholesale change of ERISA. On the other hand, you have a lot of other products that are new and have unique features. These can have a very different effect from traditional life insurance. Take equity-indexed type of products. Commissioner Reider, with regard to functional regulation, what is the insurance function versus the banking function?

Let me take it down a step if I can since this is an SOA meeting and look at the functional regulation from an actuarial point of view and relate this to some of the products that companies are offering now. There is just not the capability in all of the states to do the actuarial regulatory job that's needed. Unless the NAIC and the states can come up with a way to do that, it seems to me that there's a grave danger down the road. So much of it relies upon the actuarial review and constant monitoring of the asset/liability issues in many of these products. Some states are just not going to be able to do what needs to be done.

Mr. Reider: If you go back 25 or 35 years ago, you had basically 2 life products: whole life and term life. I can remember my father describing those to me and the local agent. Today, you have a whole variety of products out there, so the shelf life of a product today can be 10 months or 11 months or whatever. In the past, that was unheard of. There's a pressure on state insurance regulators today that wasn't there before because companies have products where they're competing with security dealers and banks and others. When they were competing among themselves and the state took 11 months to approve a product, they were on the same ball field. Now they point out to you that that doesn't cut it because they're competing against different companies. I think there is more and more of an awareness on the part of the state regulators and the NAIC that, in a lot of areas, things are becoming much more sophisticated. That does in fact put a heavy burden on us to step up to the plate. You find that a lot of training done in Kansas City and around the country brings regulators in and points out to them treacherous ground and some things we need to get on top of. Again, I'm not against other involvement where it's helpful to the functional regulation. You could conceivably have something that might, in the general sense, be termed an insurance product that has the benefit of other functional regulation because of the very nature of it.

Dr. Cluff: When we did this Y2K work, it was really interesting to go out and talk with the state insurance departments. I will say that they were unfailingly cooperative in every case, but it was clear that some of them simply did not understand the issue and the problem, let alone the solutions that needed to be applied to their companies. This was mostly true of the smaller states rather than the larger states. However, one of the larger states said that its criteria for a company that was likely to be a problem was one that wasn't going to be ready by December 31, 1999, and it did not have a contingency plan. That's from a regulatory perspective, and it is very troubling to me. If you know that a company isn't going to be ready and doesn't have a contingency plan, it's terrifying. If you think it's not going to be ready, whether it has a contingency plan or not, the regulator needs to be in there doing something.

In another state, the chief examiner was talking about what needed to be done and some mention was made of contingency plans. The chief examiner turned to the deputy commissioner and said, “You know, that's a good idea. We should require every company that's not going to be ready in time to have a contingency plan.” I don't say that to make fun of anybody. I say that because it was clear that they didn't understand the problem and, therefore, could not be helping their companies.

The point is that there are some issues where I think a centralized store of expertise or a centralized issuer of regulations and requirements is a clear advantage. There are other cases where you have the time to work through a long process of coming to a mutual agreement of what is appropriate. That's what goes on in the NAIC and that's often a good process. However, in today's world, it's sometimes too slow.

Mr. Reider: We very much appreciated what the GAO had to do and presented to us. We have been faithful, as suggested here, in following it. There were some things being done, and there were some things that weren't clearly understood by those visiting us when the audit was done. I would suggest that if we, as state regulators, went into the federal government and did a review of certain agencies, we might come away with some of the same type of comments.

Dr. Cluff: No doubt, the GAO does it every day.

Mr. Reider: Right. So again, I'm not being defensive because it's a very serious matter. People have to have the cash in the banks when they want it. And when it's an insurance company, the company has to be able to collect the premium because that keeps them solvent. The company has to be able to pay the claims. I tell companies that if they don't pay a claim, it's like not giving a person a paycheck on payday. People just don't accept that very well. So we're deeply concerned and appreciate the situation. We have worked hard, and I think you would acknowledge that the industry has worked hard in a sophisticated manner. We certainly are intensifying it and having meetings.

I would like to remind all of us as we work together that Wayne Gretzky, the great hockey player, didn't go where the puck was; he went where the puck would be. We're all going to be tested to the hilt to be sure we go where the puck's going to be. That's a tricky business, but that's how you win the game.