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

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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 consulting actuary and senior health fellow for the AAA. We have a distinguished panel of three individuals. Glenn Pomeroy, the North Dakota Insurance Commissioner, was unable to come to this meeting, but we have a more than adequate replacement in the form of Merwin U. Stewart, who is the Utah Insurance Commissioner. Commissioner Stewart recently retired as president and chief executive officer of Deseret Mutual Benefit Administrators. In 1970 he was asked to organize and direct Deseret Mutual to provide insurance and retirement benefits for employees of the Church of Jesus Christ of Latter Day Saints and its related organizations. Commissioner Stewart received a B.A. from Brigham Young University in Finance and an M.B.A. from Indiana University. He was the first president of the Utah Health Insurance Association and served on its board for 14 years. Commissioner Stewart's appointment as Insurance Commissioner was made by Governor Michael Leavitt on February 7, 1997.

Our second speaker, Larry Cluff, is assistant director of financial institutions and markets for the U.S. General Accounting Office (GAO). He has been with the GAO since 1979 and supervises a staff of analysts looking at financial institutions. He was very involved in that capacity with the savings and loan problems of a decade or so ago. He has frequently testified before Congress. He has a doctorate from Penn State University.

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Our third speaker, Gary E. Hughes, is with the ACLI and has been there since 1977 after spending four years with the SEC in the divisions of corporate finance and investment management. He headed the Council Securities and Banking Department from 1981 to 1988 and in this capacity represented life insurance companies in the area of federal securities law. Mr. Hughes was appointed General Counsel in 1998. He received his B.A. cum laude from Principia College and his J.D. from the College of William and Mary. He is a member of the Virginia and American Bar Associations. He is also a member of the Board of Governors of the Association of Life Insurance Counsel (ALIC) and past chair of the ALIC securities section.

Before I invite Mr. Stewart to come to the podium, let me just comment a little bit about the history of federal and state regulation. I'm sure you all know that the Congress passed the McCarran-Ferguson Act in 1945, which in effect said that while the Supreme Court the previous year had ruled that the insurance business was interstate commerce subject to federal regulation, the federal government would defer to state regulation to the extent that that state regulation was deemed to be adequate. That was a substantial loophole, and the federal government has exploited that loophole to become increasingly intrusive into the regulation of the insurance business. Examples of that include the VALIC decision of several decades ago in which the Supreme Court ruled that variable insurance products are subject to dual regulation, both by states as insurance products and by the SEC as investment products. More recently we've had the *Harris Trust v. Hancock* Supreme Court decision, which in effect said that general account group annuity products were subject to ERISA federal fiduciary standards. Then we had the Barnett Bank decision, which in effect said that states could not prohibit national banks from entering into the insurance business subject to federal banking rules in that regard.
The federal government has been particularly intrusive in the health insurance area. We have, for example, the rules that were set by Congress several years ago for regulating the Medigap market and setting the standards for policies. That left the states only with the role of compliance monitoring of federal standards for regulating products in the Medigap market. More recently we've had the Health Insurance Portability and Accountability Act of 1996, under which the federal government has set standards for certain segments of the individual health insurance and small group insurance markets. We do see that we now have a dually regulated insurance industry. I'm sure Commissioner Stewart will give us a spirited defense of state regulation, to be followed by Larry Cluff, who will give us an overview from the point of view of a federal monitor of what's going on in both federal and state regulation. That will be followed up by Gary Hughes as a spokesman for the leading trade association in the life insurance field to give us an industry perspective on what's going on.

Mr. Merwin U. Stewart: I'm on the executive committee of the NAIC, and I'm chairperson of the western zone. There are four zones in the NAIC, and the western zone is the largest. It includes 14 states, Guam, and American Samoa, but it has some larger states like Texas, California, and Colorado.

This is a very interesting subject to me. Sometimes I think it is irritating that both the states and the federal government are into insurance regulation. I mean, we're both trying to do the same things, so how should this really be done? More recently I've thought there is some good to this. The good that can come out of it is for a dialogue to happen and for people to discuss the issues involved. There's no question that regulation of interstate commerce is a role for the federal government. There's no question that the federal government has a role in insurance regulation. But there's also no question in my mind that there is a role for state regulation and local control because of the things that are done on a local level.

We talk about the business of insurance as if it only had one aspect to it and that it could be controlled either by the states or by the federal government, yet there are many other aspects to insurance. Some of them work better from the federal level. Some of them work much better from the state level. I could give you a lot of good examples of that, but before I get into that I want to give you an overview of what the NAIC does. Having been in the industry, I was regulated by the insurance department of the state, so I saw one piece of what the insurance department does, and I was aware of the NAIC, but I had no idea what it did. When I became commissioner I discovered that they hold lots of long meetings, and I began to be skeptical about this. I thought, “Well, I’ve got enough work here, back at the ranch. I don’t want to be off at those meetings.”

In the past, conferences were partly work and partly play, rest, and relaxation. When I went to my first NAIC meeting, the actuary had already been there two days, and had been in meetings all day long for two days on technical details such as working out model laws and drafting white papers that are necessary to make insurance and insurance regulation work properly. I then attended the meetings and I didn’t leave the building all day for five days because I was amazed. These people are from insurance departments. They’re actuaries. Industry people have to go to these meetings because they have to watch out for their own interests. Public representatives are there as well. These meetings are open to the public, and there’s a great dialogue going on in every one of these meetings. Issues are being resolved. The whole thrust is to try to find ways of making regulation better, more efficient, less intrusive, and bringing the products of insurance and insurance services to the customer in a better way, giving the customer or the consumer, if you will, a better product through insurance. Insurance affects every person’s life. I think in Utah, as I’ve thought about it, every person is affected by insurance in one way or another, and it’s an important thing. It takes some of the catastrophes of life and evens them out, and through the pooling mechanism it makes life better for people. They can plan better for their own lives through the insurance products. And if it’s properly done, it’s good.

But insurance is different from some other financial services. With banking, for example, when you put $1,000 in a bank, you know you have $1,000 there and what the interest rate is going to be. You borrow some money, and you know what the contract says. You know you have to pay it back. You know what the interest rate is going to be. And if something happens to the bank, you have the FDIC to back it up. What about insurance? You put $1,000 into insurance. How do you know you’re getting full value as a customer? There’s no way you can know that you’ve received fair value from your product unless it’s properly regulated and there are actuaries who are setting aside the reserves that are needed, that the company will be solvent, and that the products are properly priced so that the company can make a reasonable profit and a fair value can go back to the customer. I’ve been a president of an insurance company for many years, and there’s no way that I could have known all of that without the help of our actuaries.

But if you’re from the outside looking in, you may not know these things. The bankers whom I’ve talked to are not aware of the way insurance works. If you were to ask them what actuaries do, most of them wouldn’t even know, so there’s a tendency to take a broad-brush approach and say the business of insurance is simple, and we can do it. We’re bankers, and we’re successful as bankers, or we’re something else. We can do it. They’re just as smart, and they can do it, but we don’t want to rediscover the wheel because a lot of people will be hurt. HR-10 is in Congress as we speak, and it would take away from the states the right to regulate insurance with respect to banks if they choose. If state regulation is restrictive, they have the option of federal regulation, and there is no federal regulation for consumers. There’s no consumer protection and no law in place. As I looked at our laws in the state of Utah, there are from 20 to 30 different consumer protection laws that would be eliminated by HR-10. You create an uneven playing field by giving one segment of the industry the right to opt out of state regulation, which would destroy the whole market. It'll come tumbling down, and the consumers will not be protected until the federal government can come and put in place consumer protections as they exist in state law.

I don't want to get too far into that. I need to tell you about the NAIC and what it's doing. The NAIC includes the commissioners from 50 states, the District of Columbia, and four U.S. territories. It provides assistance to 10,000 state insurance department regulators. Those are the commissioners and their staffs. Departments operate on a combined budget of $750 million. The NAIC has been serving states since 1871. It has the world's largest insurance financial database. It's the largest publisher of insurance-related information in the U.S. It provides a service of producing model laws and regulations for the states to use as they need and/or so choose. Laws, of course, are enacted by the state legislatures. It doesn't enact any laws. It provides information so that laws that relate to a very technical subject such as insurance can be written appropriately at the state level. It produces white papers on key issues such as marketing insurance over the Internet, ERISA, genetic testing, and so on.

State regulation of insurance has allowed markets to develop to serve the particular needs of customers in a state. There's opportunity to address these needs in a different way in different states. State regulation is not about states' rights. It's about what is right for consumers in the state. State regulation allows for local markets to develop innovative, competitively priced products while monitoring the financial viabilities of the companies that sell those products. I know most of the insurance companies that are domiciled in Utah. I know when they're getting in trouble. We, of course, through regulation at the state level, are aware of their financial condition. We're aware of how they're meeting the risk-based capital requirements. That's a very important factor for state regulation.

The NAIC enhances state regulation by bringing a degree of uniformity to the process. It is accomplished in a number of ways. One way is accreditation. The NAIC's accreditation program makes solvency regulation of the insurance industry more effective. The program improves the quality of regulation and increases public confidence in insurance products and services. The accreditation program involves a rigorous review of insurance departments by an independent review team. This helps ensure quality regulation that is both sound and efficient. It involves a full on-site examination and accreditation every five years and requires interim annual reviews to ensure compliance with standards. Today 49 states are accredited, with 32 states having received second round accreditation. In 1991, prior to the effects of the accreditation program, there were more than 45 multistate insolvencies. In 1998 there were six. Of course, there are other factors involved, but the accreditation program has been an important factor in reducing these insolvencies.

Then there is the codification. Codification is a solvency measurement done through financial reporting. The ability to determine financial condition using financial statements is paramount to the protection of policyholders. GAAP is used as a framework and outlines the fundamental concepts on which statutory accounting and reporting is based. A statutory accounting principle statement highlights those areas where GAAP and statutory objectives differ. It provides a foundation for evaluation of alternative accounting treatments. The NAIC adopted the codification project in March 1998, and implementation is scheduled for January 1, 2001.

We've been involved heavily in multistate licensing. While insurance regulation has been good for the insurance industry, the NAIC continues to take steps to make the state regulation more uniform. The State Regulation 2000 Project involves a number of different things. It moves state regulation rapidly into the 21st century with the latest technological advances. There's the accelerated licensure evaluation and review techniques project, which is beginning to be introduced, that will streamline the state's admission process for insurance companies by creating a standard license format and procedure. There's the uniform treatment project, which is designed to allow foreign insurers to file copies of the same application for admission in numerous states. There's the producer database, an electronic database consisting of information relating to insurance agents and brokers. The database links state regulatory licensing systems into one common system, establishing a repository for producer information across the U.S.

There's a producer information network. This system is designed to allow insurers access to the information they need to make sure they do not appoint an untrustworthy individual. We have just completed a pilot project on that in five states. Now all states and companies are invited to participate. We have the system for electronic rate and form filing, which allows companies to submit rates and forms to the various states electronically and far more efficiently. As of this date, there are 27 states that are looking towards an options system for electronic rate and form filing, and 9 of these have implemented these systems. Seven additional states are actively preparing to implement this system. And, finally, the financial database reengineering system, has been developed. This makes it more efficient and less expensive for insurers to meet their statutory obligations to file financial information.

At the NAIC we depend on actuaries, and I won't go through all of the details of how the actuaries help us, but let me say of all of the people that come to our meetings, the actuaries work the hardest. They're there the longest. And they help us on the technical subjects. Most of these things that get put into law need an actuarial look-see to make sure that what we're doing is financially sound. And, as I said in the beginning, I love actuaries. I appreciate the work that they do for these organizations. Banks don't use actuaries, and they don't know too much about what actuaries do in general. We see that in credit insurance. When you pay one dollar for insurance you'd like to get fair value for your money from the product. For credit insurance, without state regulation, 10–20% of the premium dollar would go for insurance claims. It's a product that's sold when you borrow for a car or for something like that, and it's an extra piece of paper that's put in front of you.

The actuaries took a look at this at the NAIC and said the minimum loss ratio for credit insurance should be about 60%. The former commissioner in our state addressed that problem, and he was an actuary himself. He's a good friend of mine, and he's been my actuary. There was heavy lobbying from car dealerships and banks to leave credit insurance alone, but they were able to negotiate a ratcheting up of the loss ratio so that eventually it was hoped that they would get it up to the minimum of 60%. That went into effect last year. It was a delayed implementation. They went up 5% on the loss ratio last year in our state, but they're still down around 20%, which is $0.20 on the dollar for that kind of a product. That's despicable. But with state regulation we'll get it there if the banks don't take it over. If the banks get it, I think it'll stay there.

We have no problem with allowing banks into the insurance field. We just believe that we need an even playing field. We can see the need for state regulation. We see that the federal bills being presented do not provide for the regulation that is needed. We're very concerned and working hard, and we're making some progress. The bill that is in the House of Representatives now has been fixed. The bill that's in the Senate has not been fixed. When the two come together we hope that it'll turn out OK.

Mr. Lawrence D. Cluff: By training and background I'm an economist. I work for an accounting organization, and I'm speaking at a meeting of actuaries. My kids think I have the most boring job in the whole world, but I am glad to be here with you because, quite frankly, on this one I think my kids are wrong. The kinds of things that have been happening in financial services over the past 15 or 20 years have been and continue to be incredibly interesting. The changes that are occurring are important. They will affect all of us in many ways, and I'm grateful that there are organizations like the NAIC that are trying hard to make the legislation come out as good as possible. The ACLI has also had a great deal of input and influence.

Congress writes laws. The problem is that most congressmen and congresswomen don't know a whole lot about very many things except for getting elected. They depend on a lot of other people to wear the rough edges off of bills, and the process through which legislation goes as it moves towards passage is usually a good one. HR-10 or preceding attempts at financial modernization have been rolling downstream for many, many years, and I hope that it is finally getting smooth enough that it might pass this boulder here.

The answer to the question, "How well has state regulation of life insurance served the marketplace?" has already been given by both of the preceding speakers. Dual regulation does exist in insurance today and has existed for some time. What I'd like to focus on is how the oversight process works. As was mentioned, McCarran-Ferguson was passed in the 1940s in response to a Supreme Court decision that said that insurance is, in fact, interstate commerce; therefore, it is properly the responsibility of the federal government to regulate. The federal government was in the middle of World War II. It was still trying to throw off the effects of the Depression and had no interest in assuming another major regulatory burden when there was, in fact, a regulatory system that already existed.

Congress rapidly passed the McCarran-Ferguson Act, which in effect delegated the regulation of insurance to the states. However, you should read the McCarran-Ferguson Act carefully. It's only a few paragraphs, but to the extent that such business, the business of insurance, is not regulated by state law, federal laws can be extended to insurance. It's not particularly clear when you read it how broad that is, but it's been made very broad in this application. And there's kind of a negative checkoff system in the McCarran-Ferguson Act that says no law passed by Congress shall apply to insurance unless it specifically says that it does. What that means is that Congress never has to repeal McCarran-Ferguson. All they have to do is include in a new law that that law applies to the business of insurance, and it does. So McCarran-Ferguson has been very strong in its ability to protect state regulation, but it's kind of a weak read in a sense, when it has to protect the regulation of insurance from federal incursions. It doesn't protect it very well.

I guess my contention is that the system of dual regulation that exists isn't all that bad. There are a lot of people and there is a lot of activity. I've never seen a group of people who work harder than the people who go to NAIC meetings. We visited state insurance departments. There are a lot of dedicated, hard-working people who are looking at insurance regulation at the state level. But a quick look at the history of congressional oversight of state regulation suggests that there has been an important role played by the Congress to date without preempting, at least preempting totally, the state regulation of insurance. A number of situations illustrate that. Through 1950 to 1960 there was a large upsurge of insolvencies, particularly high-risk auto companies. The congressional response, as it often has been, was to hold hearings. Senators Thomas Joseph Dodd and Warren Grant Magnuson both held hearings during the 1960s on solvency regulation and in effect said the states weren't doing their job very well. Both senators introduced legislation calling for a federal guaranty fund to protect policyholders from failed insurers. The bills were not passed. However, by the early 1970s I think every state but one, had a property & casualty guaranty fund. Senator Magnuson remarked in one hearing, and I think this is illustrative of the fact that he understood the role that he played in insurance regulation, that those hearings might have had an effect on the states doing their job. This kind of indirect oversight has been repeated several times.

There was another wave of insolvencies in the 1980s. Many of you may remember some of those insolvencies. Congressman John Dingell (D-MI), who was at that time a very powerful congressman, and still is, although he's in the minority now, held hearings in the Commerce Committee on the House side on state-by-state regulation of insurance. These hearings identified what to him seemed to be a number of weaknesses of state regulation and wide variations in laws and regulations, even in many cases in the most fundamental areas of solvency regulation and other things. Meanwhile, the NAIC under the leadership of Glenn Pomeroy's brother Earl Pomeroy, who is now a congressman himself, introduced the NAIC accreditation program to improve the consistency or uniformity of state solvency regulation. While it's true that Congressman Dingell's hearings may not have been the impetus for the NAIC to establish the accreditation program, I have no doubt as a very interested and involved observer at that time and since, that the oversight provided by Congressman Dingell and the threat of federal regulation contributed heavily to the acceptance by the states of this outside group of people coming in and telling them what their laws had to be. I'm not just talking about the regulators. I'm talking about the legislatures. There's a lot of pride of territoriality in state legislatures, yet there was an incredible degree of acceptance of the NAIC's accreditation standards across the country.

Let me talk about one additional area which, while perhaps not as broad and far-reaching as the solvency hearings that Congressman Dingell held earlier, is also interesting in its illustration of some of the strengths and weaknesses of state regulation. In July 1998, Congressman Dingell requested the GAO to evaluate the readiness of U.S. insurance firms and the activities of insurance regulators in overseeing the insurance industry's Y2K preparations. We did so. We went to the insurance companies domiciled in 17 states that represent about 75% of the total insurance sold in the U.S., and we looked fairly carefully at what those state regulators had been doing to assess and assist the companies that they regulate in preparing for the year 2000. We found a number of interesting things. The first thing we found is that we had a hard time finding out the status of the industry because all the reports that we got from wherever we looked, rating agencies and others, were by and large based on unverified questionnaire information. Many of you work for companies, and I don't know if any of you have been involved in it, but there were a lot of questionnaires sent out. Everybody sent out questionnaires on Y2K. Some of the companies that we talked to set up whole departments to just answer questionnaires. But nobody knew whether the responses to these questionnaires were accurate or if they were a true picture of what was going on.

We felt that the regulators ought to know of these inaccuracies, so we went to see what the regulators had done and what they knew. Basically, what we found out is that while there was some degree of concern, there had been very little action on the part of insurance regulators in many of the states that we visited. We did issue a report entitled, *"Year 2000, State Insurance Regulators Face Challenges in Determining Industry Readiness, U.S. General Accounting Office, April 1999."* The report was dated April 30, 1999 on our initial findings. It wasn't released by Congressman Dingell until around May 17 or 18, 1999. We have been asked by Congressman Dingell to provide him update as of June 30, 1999, and we'll be working with the states and the NAIC to provide an update on what the regulators are doing and what they know about the condition of the companies. I would say we found no evidence that the companies weren't working very hard to become prepared.

There are a number of additional things happening that I can talk about. Let me flip briefly to HR-10. The NAIC has had a lot of influence on one version. There are a number of versions of HR-10. There's the Banking Committee version, the Commerce Committee version, and the Senate version, and they're all different. The NAIC's had a fair amount of influence on the Commerce Committee version. Interestingly enough, Congressman Dingell has, I think, supported their efforts to some extent. In testimony before that committee the NAIC stated the following, and I found this to be very interesting: "The NAIC has clearly heard the demands in Congress and the industry for more uniformity and efficiency in state insurance supervision. Since the NAIC has promoted these same objectives for many years with incomplete success, we now believe it is appropriate to ask Congress for new amendments to HR-10 that will use federal law to let state regulators get the job done." Now, I don't know about you, but that sounds like dual regulation to me, and it also, I think, highlights how weak state regulation has been over the last 10 or 12 years and that is, first, lack of uniformity. Second, there is a lack of resources—particularly those resources with high expertise. There are a number of states that do not have actuaries on staff because actuaries are too expensive, they say. The problem is they charge everything back to the companies. How can you be too expensive? I don't know.

The NAIC has tried to provide uniformity. To a large extent they have succeeded, but they haven't completely succeeded. If they believe that more uniformity is better, then maybe it is time to think about a federal alternative, and I'm not saying that is my particular position because I recognize that there would be a huge cost to moving to a federal regulator and an uncertain possibility of gain. I'm not saying that's the best way to do it, but clearly the partnership that has existed needs to expand if the current system is going to continue. Part of that partnership involves organizations like the GAO. Part of that partnership will mean that state regulators are going to have to expect that federal interests are going to be looking over their shoulders. If I didn't believe, by the way, that that was a good idea, I wouldn't work for whom I work for because that's our job—that is, looking over people's shoulders and making sure that they are doing their jobs the best way they can be done. So state regulators, welcome. We'll be back to see you soon.

Mr. Gary E. Hughes: The title of this segment was, "How Well Has State Regulation of Life Insurance Served the Marketplace?" and I think it's always good to be retrospective about these things. But, I would suggest to you that maybe the prospective question is the more important one right now, and that would be something along the lines of, "How well can the state system of regulation continue to serve the marketplace? I think historically state regulation of insurance has been regarded as quite effective. I have been in the regulatory arena for more than 20 years, and I can think back to not too long ago when the banking and thrift industries, including those components of it that were federally regulated, encountered quite a bit of difficulty. In fact, the thrift piece of that problem cost taxpayers hundreds of billions of dollars. I think if you look at it overall, the state system has up until now done quite well. I don't know whether that's due to luck or skill, but I think most people would say it's done well.

If you were to take a snapshot of regulation today and maybe look forward just a few years, at least within the ranks of the life insurance companies that I represent, you would find a very high degree of frustration and dissatisfaction. I don't think the satisfaction is just on the part of the regulated. In the conversations that we have had with regulators I think to a great extent they are experiencing some frustrations themselves. Indeed, what was just mentioned on the willingness of the NAIC to step up and maybe use Congress a little bit to its advantage to get uniformity on issues such as licensing, does suggest that there has been frustration on the part of the states. Every January the ACLI has what we call an executive roundtable. It's a group composed exclusively of presidents and CEOs. They are the heads of our member life insurance companies. During this meeting they get together in small groups. There's usually a discussion leader. I had the opportunity to sit through a number of those this January. The discussion leader would typically ask, "Why don't we go around the table and each of you indicate what's on your mind? What concerns you?" and it could have been anything. It could have been the stock market. It could have been Social Security reform, taxes, or market conduct. There was a very clear consensus theme, and the theme was regulation. That was the issue that was most on the minds of CEOs. That was their biggest concern. How does regulation effect competition? How does it effect my position in an integrated financial services marketplace? How does it effect product development? How does it effect my timing? How does it effect my cost? How does it effect what I might be doing on an international basis?

As I listened to these people it was clear that as our industry is reshaped, as you have industry consolidation and activities going on across industry lines, whether it's strategic marketing arrangements or actual mergers and acquisitions, regulation is emerging as one of the most critical factors for our business. It's always been important, but I would just suggest to you that today it's even more important than it has been in the past.

The topic du jour these days seems to be state versus federal regulation, and certainly that's what we've been talking about to a great degree. At ACLI we've been bombarded with questions lately. Is the ACLI really going to move toward optional federal chartering? Is the ACLI going to walk away from the state system? At the outset let me just make it clear our board-approved policy position is functional regulation of insurance by the states. That's where we are. That has been the objective of our association as we've been working on HR-10, and our board of directors has not entertained any formal requests to change that policy. However, the level of dissatisfaction on our board is as high as it's ever been. The pressure for significant change to regulation is as high as it's ever been. Is this just large companies doing business on a national or even international basis? No, it's not. There are even small companies, including companies doing business in a single state, that have said that something has to change here. With all of that in mind, our board of directors has asked us to do some serious analysis of the issue of life insurance regulation and to explore ways in which regulation can be improved. One point of clarification here. This is not an issue of deregulation.

I didn't hear any disagreement as Commissioner Stewart ran through all the benefits of insurance regulation currently at the state level. What I am hearing, though, is we can do those things more efficiently, and, indeed, we're going to have to do them more efficiently if we as an industry are going to survive. Again, nobody's policy has changed within ACLI, and I don't think there's any clear consensus that has emerged yet on how these efficiencies might be accomplished. The things that are being considered are what you would imagine. At one end of the spectrum let's redouble our efforts to improve and enhance the current state-based system of regulation. At the other end of the spectrum let's move to something like optional federal chartering. That doesn't dismantle the state system. There would be simply a complementary regulatory system. Somebody had some interesting statistics the other day. They said oftentimes it seems that optional federal chartering is perceived as code for "let's eliminate the state system," and they pointed out that under the dual banking system, which has both state- and federally-chartered institutions, 70% of the banks are state-regulated; 45% of the assets of the banking system fall under state regulation. Those would be the polar ends of the spectrum.

In the middle there's, I think, a pretty wide area of room for interesting ideas—something along the lines that the NAIC brought to the table on licensing. Can you use Congress to achieve uniformity, reciprocity, or whatever is necessary to make state regulation more efficient? It's still a state-based system. The states are still the ones that are in the position of administering and enforcing the laws, but I know when Glenn Pomeroy came to us with this notion of using Congress to get uniformity on regulation he said that we just couldn't get enough state legislatures to act. So maybe you're right. Maybe that is a form of dual regulation, but I think there are ways to say we're not necessarily going to use Congress to regulate. We'll use Congress as a tool to get uniformity and then leave it to the states to regulate. In that middle area I think there's a lot of room for some creative thinking.

I'm not here to advocate any particular change, only to say that from the perspective I come from, which is representing life insurance companies, it's pretty clear to me and our organization that some significant change is essential here. What I think is instructive and perhaps helpful as we have this dialogue, and I agree completely with Commissioner Stewart that it is very important to have this conversation, is that the regulated and regulators alike should be talking about these things because that's how we can work towards some meaningful solutions. But from our perspective what's driving all of this? Why do people feel that some change is essential? Four points, I think, are interesting here.

First, the debate in Congress over financial modernization has without any question highlighted the importance of regulation. HR-10 and the related bills in Congress, in my judgment, are not so much about power as they are about how we're going to regulate diversified financial services. When you have a bank, an insurance firm, and a securities firm all under common ownership with three different functional regulators, how should it work? Is somebody going to be preempted? Can you guard against preemption? Who should do things at the holding company level? Who should do things with the primary institution? All critical questions if the protections and safeguards of regulation are to be in place as they should be.

All the regulators that we have seen want to protect their turf. Now, I don't mean the term *turf* in the usual pejorative sense because *turf* equates with "give me the power to do the things I have to do to be a good regulator," and I think the NAIC and individual states have been no different from the Federal Reserve Board and the Comptroller of the Currency in that regard. I would suggest to you that there is an additional component that federal regulators have embraced that I'm not sure the states have embraced or even can embrace, and that's to some extent, if not championing the issue or the interests of those they regulate, at least taking an interest in providing flexibility and competitive opportunities so that those they regulate can be as competitive as possible and be viable competitors in an integrated financial services arena. Our observation has been that the states have focused exclusively on their ability and authority to regulate, but they have not cared too much about how those they regulate fare in this legislation. I suppose they can accuse us of not caring too much how they fare, although we have tried to be cognizant of the interests of regulators, but some of the things that the Comptroller, the Federal Reserve Board, the Office of Thrift Supervision, and the SEC have done I think highlight the contrast between how federal regulators behave as far as promoting to some extent the interests of those they regulate and how state regulators have approached the issue.

Second, and I think this is one of the most important considerations, is that insurance companies generally don't perceive themselves competing anymore just against other insurance companies. Ten years ago maybe we did. You looked around and asked, "Who's my main competition?" All the other insurance companies. And if that was the case, then the efficiencies or inefficiencies of the state regulatory system weren't that important because whatever costs I

was incurring my competition was incurring. Talk to a CEO today and ask, “Where’s your competition?” and most CEOs of national companies will say, “Well, I’m going head to head with national banks, with mutual funds, and with securities firms.” What we tend to do now in evaluating our own system of regulation is to look over the fence and ask “How’s the other person being regulated?” And as we look over the fence and look at the national bank system, the federal security system, and the federally regulated thrift institutions, we see efficiencies in those systems that we don’t enjoy. We look at state-chartered banks, and we see efficiencies that we don’t enjoy. If you’re a state-chartered bank, and you want to license a subsidiary in all jurisdictions, you get one portal. You go to one state and get your license. You can then do business in all other states. Again, that’s a state-based system that has efficiencies that our system doesn’t have.
The third factor, and I don’t think we should make too much of this but it is important, is that federal bank regulators have been able to capitalize on the difference between simply a state and federal system to the advantage of banks and to the disadvantage or detriment of insurance companies and insurance regulators. Federal banking agencies will make a proclamation that banks can now do an aspect of the insurance business that nobody dreamed was possible under the statute, and courts typically accord judicial deference to the opinion of the federal regulator. On issues of general preemption if there’s a state law and a federal law that conflict, the state law will always be the one that yields to the federal law. Again, this has been a one-way street in favor of the banks, and it has harmed both insurance regulation and insurance competition.

Fourth, as national banks in particular have increased their presence in our business, and to some extent as securities firms have done the same, they are not satisfied with a 50-state regulatory system. They’re used to a single primary regulator. All institutions have more than one regulator, but national banks, for example, have one primary regulator in the Comptroller of the Currency, and they have expressed sharper dissatisfaction with the state system. There are banking groups that are getting ready—I think once HR-10 has been completed or has died—to advocate optional federal chartering for insurance companies and insurance agencies, and I think all of those things taken together prompted our board of directors to take a closer look at this issue of regulation and work with the regulators to conclude how we can make our system more efficient.

For as long as I can remember every year we have said, “Boy, things are changing more now than they ever have.” I think this year I’d say the same thing, but I’d really mean it. The pace of change is incredible. The business I came into more than 20 years ago doesn’t even exist anymore. It doesn’t feel the same. It doesn’t look the same. It doesn’t operate the same. Products and issues may be the same, but it just is a different business. Insurance companies are being forced to adapt and accommodate as they never have before, and I think the same challenge is there for insurance regulation. I, for one, don’t want to see the insurance business be relegated to a product line in somebody else’s industry, yet that is exactly how many out there see the future for us. If you talk to a lot of bankers, they don’t see insurance as an industry. They see it as a subset of their business. I don’t think that has to happen, but I do think that regulation and how the insurance industry is able to adapt and accommodate changing circumstances will be one of the most significant factors in determining how that comes out.

Mr. Bartlett: Commissioner Stewart, state regulation was developed in the 19th century when insurance companies tended to operate on a single state or regional level. Then, as companies tended to go national in the early and middle years of the 20th century, the NAIC helped create an environment where state regulation was not a serious encumbrance to the nationalization of the insurance industry. Now we see, of course, in the latter years of the 20th century an internationalization of the insurance industry.

When I was commissioner in Maryland I did attend conferences of international insurance regulators from other nations. The U.S., as far as I know, is the only nation that regulates its insurance industry at other than the national level. The regulators from other countries tended to look at me as if I were a three-headed monster because every time I spoke I had to modify my comments by saying I could speak authoritatively only for the state of Maryland and not for the other 49 states. What can the NAIC or any other organization do to keep state regulation from being an encumbrance to the internationalization of the insurance industry?

Mr. Stewart: I had a lot of thoughts on that subject. While we're flying at 30,000 feet and looking at internationalization of financial services, we need to remember that the people who use those services live in the same homes they lived in before. They live in the same communities they lived in before. And those services are best provided at the local level. That's where the products are sold. That's where they're used—automobile insurance, home insurance, life insurance, health insurance. This country was set up with balance of powers in many different ways, and one of the balance of powers was that there was a balance between the states and the federal government. The world has had experience with centralization of all services at the federal level, and it hasn't worked in other countries. I've lived in other countries, so I don't mind saying that this country is the best country in the world, and part of that is because of the diversity and the flexibility we have for new ideas and new concepts to develop. If it all has to happen from the central level, I think ultimately we'll be in a very difficult situation.

Am I saying there isn't a role for the federal government in insurance? I am not. I think it's a partnership. I think that it should be done with cooperation. I think that we need to talk about and analyze what works best at the federal level and at the local level. I don't mind oversight. I think we all do better if we have oversight. I was the president of a company for many years, and I'm sure that the people under me wondered if I had oversight, but I had a board of directors and oversight, and I benefited a great deal from that. Then I became chairman of the board, and I found out I still had oversight. I had responsibility to the employers who were over this operation. Oversight is not a problem for me. If you want to encapsulate it into a short phrase, I would say, and Governor Mike Leavitt coined this, "central coordination/local control." That implies central oversight. I would like to see from the central level where we're involved in interstate commerce and where we're not doing quite as well as we might at the state level. I would appreciate guidelines. I would appreciate oversight. I don't mind auditors. Even auditors from the federal level have been very helpful to me in my company over the years. I've always listened to them. I've opened the doors for them. And they have pointed out many things that have been helpful. I think that's good. I think the GAO has done a good service with respect to the Y2K problem, and they have pointed out that the insurance departments in various states have not really tied down as tightly as they should the progress of insurance companies in that regard.

However, there is a lot that has been going on. You know there's a difference between actuaries and accountants. Accountants keep track of things that have already happened. Actuaries look for things that are about to happen. And I am aware of companies, my own included, that have been involved in the Y2K problem since 1987, and they've been working at it because most of those products—annuities and life insurance—are tied to dates. It's pretty much a given that any knowledgeable insurance operation is going to be working on that problem. However, we haven't done as well as we could, and certainly state regulation has a lot of places for improvement, but I can tell you as far as our own state is concerned we're anxious to smooth things out. I believe that we can deliver better products and services through the insurance companies, and we can do it as regulators without the insurance companies. I am working in a cooperative way with the insurance companies to protect the consumers and help them get a better deal, and I think that's a good way to go.

Mr. Cluff: I think Gary was right in that the world is changing, and while it is true that insurance is a product where the consumer interface is very important, for many insurance companies today insurance is only a component of what they do. They're heavily involved on the investment side. They're heavily involved in a lot of financial activities. We completed a job recently on how various kinds of financial institutions measure their capital needs, and I will tell you that the way large financial organizations measure their capital needs boggles the mind in terms of the kinds of expertise and the commitment of resources that they have made to finding out how their capital is being used and how to maximize the use of their capital, what their risks are, how to measure their risks, and how much capital to allocate to various risks. Quite frankly, it requires a lot of expertise to be able to understand what the companies are doing internally. I think one of the problems with state regulation of insurance is that it is difficult to imagine that each of 50 insurance regulators can possibly have enough expertise to understand what the companies are doing on that side of their business. I just don't see how it happens. And yet more and more companies are being required by the competitive forces that Gary mentioned to move into this kind of an operational stance, and that's a concern.

Mr. Richard S. Robertson: I did want to speak a bit on behalf of the AAA. As Commissioner Stewart has indicated, we have been very actively involved in developing public policy with respect to insurance regulation, health plan regulation, and the like, and we appreciate how the NAIC and the commissioners who work with us have accepted our help in developing that policy. We meet regularly with the leadership of the NAIC, we work actively with the various task forces, and we interface at all levels in between.

The Academy, speaking for the actuarial profession, is not directly advocating either state or federal regulation. However, on a number of occasions, and most recently in meeting with several key congressmen and their staffs who are involved in HR-10 and other financial regulation legislation, we've pointed out to them how important it is that any buyer of insurance receive the same kind of protection that now exists under the current regulatory system. We have questioned whether the federal government is prepared to attempt to duplicate that system or, if they did, whether that would be a wise use of resources. That being said, the existing diversity of regulation applicable to national insurance and health plans is a very serious problem. Gary Hughes has pointed out the problems that it causes to the insurance industry. It also causes very serious problems to us as professional actuaries.

We're a small profession. We are very willing and happy to commit resources to work with the NAIC and others to help develop policy, but we don't have the resources to be able to monitor and advise 50 different state legislatures or 50 different insurance commissioners on ways that they are going if they differ from those that are being recommended by the NAIC on a national basis. Similarly, practicing actuaries have a very difficult time trying to identify 50 or 51 different regulatory processes and to comply with each of those separately. And, from a public policy perspective it's difficult to see why a company that is domiciled in Texas should be subject to different financial reporting principles than a company domiciled in New York, or why a Washington state company would present a different financial statement to a Washington state policyholder or a California state policyholder, yet it happens. I think the one message that needs to be carried back to all of the state capitols is that they are regulating a national institution, and they need to take a national perspective in so doing. Obviously, this is not a question but I certainly would welcome any further comments the panelists might have on the subject of diversity.

Mr. Stewart: I agree with those comments 100%. At the state level we really need to be aware of that diversity, and I think most of the commissioners are aware of that. There is a need for uniformity. We're working as fast as we can and as hard as we can, and we're almost there with most of the major issues on uniformity. We're in the process of implementing those across the states. I mentioned those issues, accreditation and the other things that we and the federal government are doing to bring about uniformity, because it is difficult. We want to respect the legislatures in the respective states. We don't want to take away from them what they've been empowered to do, but there are some issues where I think we should be working together with the people at the federal level.

Mr. Cluff: I spent a considerable amount of time in the early 1980s looking at the accreditation program as it developed and had the opportunity of presenting the results of those observations to Congressman Dingell's committee on several occasions. While I would agree that the accreditation program has had a major impact and has caused some states to adopt legislation and regulation that they had not had for many years, which the NAIC had wanted them to have but could not get them to adopt, I would also say the following: It has not led to uniformity or necessarily even consistency. There are a couple of things that the NAIC glosses over in their talk about the success of the accreditation program. The accreditation program doesn't require that states have the NAIC models. It requires that they have the NAIC models or something substantially similar, and that is not defined very carefully.

The second point I would make is that as soon as Congressman Dingell's efforts to keep the accreditation program under a microscope dissolved, there was a backlash. The states and, in some cases, the companies said, "No more, enough, stop. We've had enough. Quit pushing us so hard." And while the NAIC didn't back off completely, they did back off. There's one state that is not accredited. That state happens to be New York, which probably has in many ways some of the toughest regulation in the U.S., as I'm sure some of you have experienced, but their legislature is unwilling to accept the NAIC's models in a couple of areas. They simply said, "Too bad. We don't care. We're not going to do it." There is only so much that an organization like the NAIC, however well-intentioned it is, can do to force uniformity. It has no power. It operates through consensus. While it is true that every organization, including the Congress, operates through consensus, once a majority vote is taken in the Congress it becomes the law of the land. Once a majority vote is taken by the NAIC it becomes a recommendation that people can use if they feel like it, and that's a different kind of way of doing business. I certainly am not advocating federal regulation. I don't want anyone to walk away saying that I think that federal regulation is the only way or the best way to go because there are enormous problems with that, but the problems with the current state system are also enormous and the solutions are not at all obvious.

Mr. Hughes: One comment along the same lines. I think one of the most intriguing questions in the whole debate would be, do the states have the impetus? Does the NAIC and do the individual states have sufficient impetus to change fast enough to put off any serious movement toward something like optional federal chartering or other aspects of federal regulation? I think theoretically everybody in this room could sit down and say, "We know the things that aren't working." We could design efficiencies that would probably address most of the din on all this and make the dissatisfaction go away, but is there sufficient impetus to do that? As I see it, there have been two examples of very forward thinking and action on the part of the NAIC—accreditation and, most recently, licensing. Ask yourself why. What was happening back at the time of accreditation? Well, Larry correctly points out that Congressman Dingell and Senator Howard Metzenbaum were mounting a federal threat. If you don't do it, Congress will do it. And the states stepped up to the plate and acted responsibly. You may disagree totally, but I think our judgment is they acted responsibly and quickly, too.

Why did the NAIC approach us with a way to use Congress to get at least uniformity in the area of licensing? The answer is simple. There's a provision in all of these pieces of legislation that says if the states aren't uniform, a federal entity will be set up to do licensing on a multistate basis for the states and preempt them. Again, not surprisingly, the states showed that with that kind of threat and resulting impetus threat, they could come up with creative, reasonable solutions. I think the larger question is, do the states and does the NAIC have to have that sort of hammer over their head to come up with and achieve the efficiencies that are necessary? And if they can't, what's the answer? I draw a comparison between the NAIC and the Conference of State Bank Supervisors. Those are two state-based regulatory systems. The critical difference is if a state-chartered bank isn't pleased with what the state bank regulators are doing, guess what? They can flip their charter and become a national bank. Now, some people would say, "Well, yes, you've set up a race to the bottom by setting up regulatory competition between two systems." But the fact of the matter is both federal bank regulation and state bank regulation have found additional efficiencies because each system of regulation wants to keep those that it charters. I would hope that in the area of insurance regulation the impetus doesn't have to be something like optional federal chartering, but absent that I would ask the question: What is the real impetus for the states collectively to achieve those efficiencies and to do so in some of our lifetimes?

Mr. Stewart: I mentioned that I thought that oversight is good, and if you put all of the power and all of these regulations and all of our lives in the hands of the federal government, where is the oversight? We rely on the auditors. But let me just point out one thing. We talk about federal regulation as if that is superior and that everything will be perfect. Last year we had in our state two companies that had Medicare Risk contracts. They were providing Medicare under an HMO setting at a reasonable cost, and they were able to include a very nice prescription drug benefit to those people in the Medicare Risk contracts. Those reimbursements from the federal level were set up years ago according to costs that then existed. Utah was receiving a reimbursement that was less than half per capita than what some of the other states were receiving. So, the companies could no longer afford to offer this product in Utah because, cry as we would, try as we would, there was no way we could get quick enough results from the federal level. It was just impossible to get any relief. What happened? Many thousands of people lost that HMO option. They were left only with indemnity coverage. They lost their prescription drug coverage and had to go to a supplement for which they then had to pay additional money; a supplement that is very limited when it comes to somebody who needs a lot of prescription drug coverage. Most of your very expensive things nowadays will run up into thousands of dollars a year for prescription drugs. If you've had a transplant or anything close to that, you get into very high drug expense, and actuaries who work in the health area will know that. These people were left high and dry, and there was nothing that anybody could do about it. Nobody was listening at the federal level. We couldn't get it changed. So, we lost it, and those people lost it. I have a problem with putting everything in the hands of the federal government without a balance of power, and I think that the results will not be as good as they are touted.