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Assistant Secretary David G. Nason Testimony

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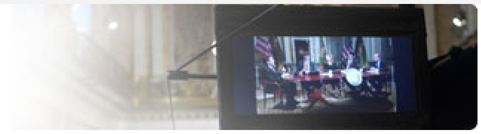
Press Center



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Before the House Committee on Financial Service Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Washington - Thank you, Chairman Kanjorski, Ranking Member Pryce, and Members of the Subcommittee for inviting me to appear before you today to discuss the need for insurance regulatory reform.

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Treasury's Blueprint for Financial Regulatory Reform

On March 31, the Treasury Department ("Treasury") released a report on financial services regulation entitled, "Blueprint for a Modernized Financial Regulatory Structure." The Blueprint reflects a year-long effort in addressing complex, long-term issues and ideas intended to provoke thoughtful discussion as we collectively work toward modernizing all sectors of the financial services industry. The Blueprint is not, and has never been, intended to be a response to recent stress in the credit markets, but rather is a series of Treasury's recommendations to improve our regulatory structure in the future.

The Blueprint presented a conceptual model for an optimal regulatory framework. This structure is an objectives-based regulatory approach, with a distinct regulator focused on one of three objectives--market stability regulation; safety and soundness regulation associated with government guarantees; and business conduct regulation. The regulation of all financial services products, including insurance, is addressed in the optimal regulatory framework.

Treasury's Blueprint also presented a series of "short-term" and "intermediate-term" recommendations that could, in our view, immediately improve and reform the U.S. financial services regulatory structure. Some of our recommendations focus on eliminating some of the duplication inherent in the U.S. regulatory system, but more importantly, they try to modernize the regulatory structure applicable to certain sectors in the financial services industry within the current framework – including insurance.

Today, I will address some of Treasury's recommendations with regard to modernizing insurance regulation in the near-term.

The Need for Insurance Regulatory Modernization

Insurance performs an essential function in our domestic and global economies by providing a mechanism for businesses and citizens to safeguard their assets from a wide variety of risks. Insurance is similar to other financial services in that its cost, safety, and ability to innovate and compete are heavily affected by the substance and structure of its system of regulation.

Unlike banks and other financial institutions that are regulated primarily at the federal level or on a dual federal/state basis, insurance companies in the United States are regulated almost entirely by the states. The constitutional and statutory allocation of regulatory power between the federal government and the states has a complex evolution.

For over 135 years, states have regulated insurance with little direct federal involvement. In 1869, the U.S. Supreme Court concluded that the issuance of an insurance policy was not interstate commerce, and therefore outside the constitutionally permitted scope of the federal government's legislative and regulatory authority (Paul v. Virginia). In 1944, some 76 years later, the Court reversed itself holding that insurance was indeed subject to federal regulation and federal antitrust law (United States v. South-Eastern Underwriters Association). In 1945, before any assumption of federal regulatory authority over insurance, Congress passed the McCarran-Ferguson Act, which "returned" the regulatory jurisdiction over the business of insurance back to the states, and generally exempted the business of insurance from most federal laws unless they specifically relate to the business of insurance. While a state-based regulatory system for insurance may have been appropriate over some portion of U.S. history, changes in the insurance marketplace have increasingly put strains on the system.

Much like other financial services, over time the business of providing insurance has developed a more national focus even within the state-based regulatory structure. The inherent nature of a state-based regulatory system makes the process of developing national products cumbersome and more costly, thereby directly impacting the competitiveness of U.S. insurers.

There are a number of inherent inefficiencies associated with the state-based insurance regulatory system. Economic inefficiency appears to have resulted both from the substance of regulation (such as price controls), and also from its structure (multiple non-uniform regulatory regimes). Even with the efforts of the National Association of Insurance Commissioners (NAIC) to foster greater uniformity through the development of model laws and other coordination efforts, the ultimate authority still rests with individual states. For insurers operating on a national basis, this means not only being subject to licensing requirements and regulatory examinations in all states where the insurer operates, but also operating under different laws and regulations in each state.

In addition to a more national focus today, the insurance marketplace also operates globally with many significant foreign participants. A state-based regulatory system creates increasing tensions in such a global marketplace, both in the ability of U.S.-based firms to compete abroad and in the allowance of greater participation of foreign firms in U.S. markets. In particular, foreign government officials have continued to raise issues associated with having at least 50 different insurance regulators, which makes coordination on international insurance issues difficult for foreign regulators and companies. The NAIC has attempted to fill this void by working closely with international regulators on a number of projects. The NAIC itself is not a regulator but facilitates communications among the states on international regulatory issues. In the end, whatever the NAIC accomplishes in the international arena, given the NAIC's structure as a coordinating body and the inherent nature of the state-based system, it will be increasingly difficult for the United States to speak effectively with one voice on some international insurance regulatory issues.

A number of countries are pushing forward with regulatory systems seeking more uniform, efficient and stronger insurance sectors, in order to underpin more and better products for their consumers with less risk to the financial system. In particular, the European Union is working on its Solvency II project to forge one insurance market for all of its member states. The interaction between the U.S. regulatory system and its foreign counterparts in these types of discussions will likely impact the ability of U.S. firms to conduct business abroad and the flow of capital to the United States.

Treasury believes the fundamental question is whether our current state-based system of insurance regulation is up to the task of meeting the challenges of today's evolving and increasingly global insurance market. In other words, is the state-by-state regulatory approach, as chosen by the Congress in 1945, and as it exists today, still the most effective and efficient system for regulating an evolving insurance marketplace?

A number of reform proposals have been considered over the years to modernize the U.S. system of insurance regulation: total federal preemption; dual federal/state systems under an optional federal charter (OFC) approach; mandating national standards on the state-based system; and harmonizing and making more uniform regulation among the states. In Treasury's view, the establishment of a dual federal/state system with an OFC provides the best opportunity for the establishment of a modern and comprehensive system of insurance regulation.

Optional Federal Charter

The establishment of an OFC structure would provide insurance market participants with the choice of being regulated at the national level or continuing to be regulated by the states. Such a structure is broadly consistent with the current regulatory structure that applies to banks and other insured depository institutions. An OFC insurance regulatory structure should enhance competition among insurers in national and international markets, increase efficiency, promote more rapid technological change, encourage product innovation, reduce regulatory costs, and, importantly, provide high quality consumer protection.

Treasury believes that an OFC structure should provide for a system of federal chartering, licensing, regulation, and supervision for insurers and insurance producers (i.e., agents and brokers). It should also provide that the current state-based regulation of insurance would continue for those insurers not electing to be regulated at the national level. States would not have jurisdiction over those electing to be federally regulated. However, insurers holding an OFC could still be subject to some continued compliance with other state laws, such as state tax laws, compulsory coverage for workers' compensation, and individual auto insurance, as well as the requirements to participate in state mandatory residual risk mechanisms and guarantee funds.

The establishment of an OFC should incorporate a number of fundamental regulatory concepts. For example, the OFC should ensure safety and soundness, enhance competition in national and international markets, increase efficiency in a number of ways, including the elimination of price controls, promote more rapid technological change, encourage product innovation, reduce regulatory costs, and provide consumer protection.

Treasury also recommends the establishment of the Office of National Insurance (ONI) within Treasury to regulate those engaged in the business of insurance pursuant to an OFC. The Commissioner of National Insurance would head the ONI and would have specified regulatory, supervisory, enforcement, corrective action, and rehabilitative powers to oversee the organization, incorporation, operation, regulation, and supervision of national insurers and national agencies. The ONI could be required to integrate current portions of the state-designed body of regulation into the new national system, which would limit major disruptions to the marketplace.

There are currently pending bills in both the House (H.R. 3200) and Senate (S. 40) entitled the "National Insurance Act of 2007" that would create an OFC and establish an ONI. These bills contain many of the core concepts surrounding the establishment of an OFC structure. We look forward to evaluating further the specific provisions of these bills.

Office of Insurance Oversight (OIO)

While Treasury believes an OFC offers the best opportunity to develop a modern and comprehensive system of insurance regulation in the near term, we acknowledge that the OFC debate in the Congress is ongoing. At the same time, however, Treasury believes that some aspects of the insurance segment and its regulatory regime require immediate attention. In particular, Treasury recommends that the Congress establish an Office of Insurance Oversight (OIO) within Treasury. The OIO through its insurance oversight would be able to focus immediately on key areas of federal interest in the insurance sector.

The OIO should be established to accomplish two main purposes. First, the OIO should exercise newly granted statutory authority to address international regulatory issues, such as reinsurance collateral. Therefore, the OIO would become the lead regulatory voice in the promotion of international insurance regulatory policy for the United States (in consultation with the NAIC), and it would be granted the authority to recognize international regulatory bodies for specific insurance purposes. The OIO would also have authority to ensure that the NAIC and state insurance regulators achieved the uniform implementation of the declared U.S. international insurance policy goals. Second, the OIO would serve as an advisor to the Secretary of the Treasury on major domestic and international policy issues. Once the Congress does enact significant insurance regulatory reform establishing an OFC, the OIO could be incorporated into the OFC framework.

Conclusion

We appreciate the efforts of the Chairman and Members of the Subcommittee in evaluating issues associated with modernizing insurance regulation.

We look forward to continuing to work with the Congress toward finding an appropriate balance as proposals for dual federal/state regulation of insurance are considered. Thank you.

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