THE EFFECTIVENESS OF STATE REGULATION: WHY SOME CONSUMERS CAN'T GET INSURANCE

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

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CONTENTS

THE EFFECTIVENESS OF STATE REGULATION: WHY SOME CONSUMERS CAN'T GET INSURANCE

Thursday, April 10, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:09 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Shays, Kelly, Ney, Biggert, Miller of California, Tiberi, Garrett, Kanjorski, Meeks, Inslee, Lucas of Kentucky, Clay, Baca, Matheson, Miller of North Carolina, Emanuel and Scott.

Chairman BAKER. [Presiding.] We would like to call this meeting of the Capital Markets Subcommittee to order and welcome all of those in the hearing room.

Today's hearing is to focus on the causes and factors that relate to the availability of insurance for the myriad reasons consumers need to have access to insurance.

It appears that the regulatory environment is a direct contributor to not only availability but as to affordability of the insurance product marketplace.

In reviewing many of the witnesses' comments today for the hearing, it appears that there is almost a direct relationship between the sophistication of the regulatory environment and the availability of product. And it is not a good relationship. It seems the more stringent the regulatory constraints, the fewer the number of providers, the lesser the number of consumer choices, and the more expensive those choices become.

However, it is a certainty that a regulatory system is warranted, but it seems as though some States have adopted systems which are more conducive to a free market environment that does in fact aid the consumers directly.

It is my hope that in the course of today's hearing to understand more fully the current regulatory system, how improvements might be offered and how we can assure availability of insurance product to any and all who may need those services.

At this time I would like to recognize Mr. Kanjorski for his opening statement.

Mr. KANJORSKI. Mr. Chairman, we meet today to examine how different forms of State regulation in the personal property and casualty marketplace affect the availability of insurance, the affordability of policies and the profitability of the industry. This hearing also represents the first time in the 108th Congress that our subcommittee has met to consider insurance issues.

Before we hear from our experts, I believe it is important to make some observations about the insurance industry. Insurance, as my colleagues already know, is a product that transfers risk from an individual or business to an insurance company. Every single American family also has a need for some form of property and casualty insurance, especially products like auto and homeowners insurance.

Additionally, according to the National Association of Insurance Commissioners, more than 3,200 property and casualty companies helped to meet the insurance needs of American families and businesses in 2000. A.M. Best also reports that insurers underwrote $163 billion in personal line premiums in 2001, slightly more than half of the total property and casualty industry.

In addition, the largest lines of the personal property and casualty marketplace are auto and homeowners insurance. The insurance industry underwrote nearly $128 billion in net premiums in 2001 for private passenger auto insurance, up from $113 billion in 1997.

The net premiums for homeowners insurance also grew in the same timeframe from $26.9 billion to more than $35 billion. Furthermore, insurance differs from most other products in that insurers must price and sell their policies before knowing the full cost of the coverage. As a result, insurers often pay out more in claims than they collect in premiums.

For example, in 2001, insurers paid out $1.16 for every dollar earned in premiums. One of our witnesses today will also make the point that property and casualty insurers paid $22 billion more in claims and expenses than they collected in premiums in 2002.

To compensate for these balance sheet shortfalls, insurance companies have increasingly relied on income from their investments. Fortunately, the net investment income of property and casualty insurance companies has trended upwards since 1980, and this income stream has helped insurers to offset their annual underwriting losses.

In particularly good years on Wall Street, some have suggested that the investment income may have also helped to keep premiums artificially low. I would like our experts today to address this point.

As you know, Mr. Chairman, the McCarran-Ferguson Act also authorizes the States to regulate the insurance business, and Congress recently reaffirmed this system in approving the Gramm-Leach-Bliley Act. As a result, each State currently has its own set of statutes and rules governing the insurance marketplace. Traditionally, the States have highly regulated the personal property and casualty insurance industry with rate controls and pre-approval of new products.

In recent years, however, many States have begun to experiment with their regulatory models. In an effort to promote greater competition in the marketplace, some States have even decided to exempt the industry from long-standing anti-trust protections.

From my perspective, promoting competition through fair and effective regulation should ultimately result in better and more affordable insurance products for many customers.

The States, in my view, must also continue to work proactively to modernize their systems for regulating the insurance marketplace.

Absent continued advances in these state insurance regulatory efforts, the Congress may need to consider altering the statutory arrangements through the creation of an optional Federal chartering system or the promotion of greater uniformity in insurance regulation.

In closing, Mr. Chairman, I want to commend you for bringing these matters to our attention. I believe it is important that we learn more about the views of the parties testifying before us today and, if necessary, work to further reform and improve the legal structures governing our nation's insurance system.

I yield back.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 51 in the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman. I want to thank you for holding this hearing this morning. It is an important issue that is of great concern to this committee and to consumers all across the country.

I strongly believe that Americans deserve to have affordable insurance. And today, the insurance market faces a perfect storm—growing losses, lower investment returns, and inefficient regulation coupled with price controls that have left many States in a crisis.

It is the responsibilities of these States and their insurance commissioners to promote competitive climate in which consumer choice can be achieved.

Unfortunately, some States have chosen to adopt heavily priced regulated models, that have driven insurers out of the market and stifled competition. When States determine what prices insurers are allowed to charge, whether it is in the form capping premiums, or imposing price controls, we have seen this over-regulation place a tremendous strain on the system.

Last Congress, I held a hearing in the Oversight and Investigations Subcommittee on the effects of state over-regulation of automobile insurance. In the hearing, we touched on the competition based reforms that South Carolina and Illinois enacted, two States that are represented here on today's panel.

As a result of their reforms, both of these States currently have numerous automobile insurance companies providing consumers with real choices at competitive prices. The answer to high auto insurance rates is clear—more competition is more effective than just more regulation.

I am very happy that when it comes to auto insurance we have also gotten it right in my home State of New York. But I am concerned that the price controls in the nearby State of New Jersey may have a negative impact on other out of state consumers.

So today we are going to hear from witnesses that I hope will talk more and lead us more in the direction of understanding what needs to be done to make sure that price controls and over regulation does not pull the entire insurance market.

I thank the witnesses for appearing today, and I look forward to their testimony.

[The prepared statement of Hon. Sue W. Kelly can be found on page 53 in the appendix.]

Chairman BAKER. Thank you, Ms. Kelly.

Mr. Baca?

Mr. BACA. Thank you very much, Mr. Chairman. Thank you for hosting this hearing. I am going to be short and brief.

I look forward to getting the information that should be available in terms of availability of insurance affordability and then look at home it might impact and what changes may need to be done as it affects not only our customers, but our consumers, but also the industry as well.

I look forward to the hearing, and hopefully it can be productive, and look at changes that need to be done as we deal with the free market environment, look at reform for competitive prices as well.

Thank you.

Chairman BAKER. I thank the gentleman for his statement.

Mr. Miller?

Mr. GARY MILLER OF CALIFORNIA. Thank you. I applaud you for holding this hearing. This is an issue of tremendous importance to me. And specifically with the State of California, I mean, if you look at what is going on nationally, there just seems to be a lack of uniformity of laws. I mean, it is become very difficult or insurance companies to even do business. The inability to provide new products in a timely fashion with the insurance industry is very obvious compared to security firms that can generally provide new opportunity within 90 days in banks, can virtually do it immediately.

I mean, the process has become a logistical and administrative nightmare in most States. Dual banking systems has proved to be highly successful of an approach. I am not sure that it not be the same success if we looked at a dual system for insurance. One would be a Federal charter.

Many States have just created the absolute shortage of opportunity for consumers. I know if you are a business person, you try to get liability. There is more exclusion with a liability policy than there are inclusions today. And much of that is caused by the state's process and what they require.

You cannot mandate a business to lose money. And in many States, that is just about what they are doing to the insurance companies. They require them to provide such an extensive list of coverages instead of allowing them to be competitive and offering it based on what the market demands. And many States, you have seen insurance companies, the larger ones, just pull out of that state or stop writing new policies. And it is not because business people do not want to provide a product.

It is because businesses will not be mandated to lose money. And in being involved in areas that States mandate that they should not otherwise be involved in.

And in closing, Mr. Chairman, I—this is of tremendous interest to me. I have—if you had asked me 10 years ago I would never have thought of the concept of a Federal charter. The more I watch what is going into the industry today, and what impact is being placed upon consumers, the more I am becoming to believe that a Federal charter might be a very viable option, and I would like to hear if anything, reasons why I am absolutely wrong. And I believe we have individual States that will try to make that presentation. And I look forward to hearing it. I yield back.

Thank you.

Chairman BAKER. I thank the gentleman for his statement.

Mr. Inslee?

Mr. INSLEE. Thank you.

I just want to make a comment, and it may not be exactly on the topic we have had here today. But I think it is important to make today.

I was reading in Mr. Hartwig's statement that the 1990s and these opening few years of the new millennium have been very difficult for insurers. Natural disasters of unprecedented frequency and ferocity cost the industry nearly $110 billion between 1990 and 2002, while September 11th terrorist attacks produced the largest insured losses in the United States in world history, amounting to $40 billion.

The reason I note that today is many, many scientists believe that the rate of natural disasters that your industry will be exposed to in the coming century, that rate will increase both as to frequency and ferocity due to global warming. And changing very, very systemic ways are climate systems.

And I am very concerned that your industry is going to be exposed to that over the next century in part because the U.S. Congress is failing abjectly in dealing with this threat that is going to expose your industry to losses no matter who your charter is in. And you know it does not matter who your charter is in, if these hurricanes become more severe, you are going to have significant losses. And I just want to appraise you today that the U.S. House has before it an energy bill. And the energy bill that will pass will do absolutely nothing effectively to deal with this threat of global warming.

And I am just advising you of that, because even if we fix charter problems, whatever they may be, it is not going to solve this problem of you being exposed to these enormous losses.

So I will look forward to your comments about that particular aspect about what light you can shed on that and your concern in this regard.

And look forward to your testimony. Thank you.

Chairman BAKER. I thank the gentleman. I would like to call on Ms. Biggert at this time to make a particular introduction.

Mrs. BIGGERT. Thank you very much, Mr. Chairman.

I am absolutely delighted to introduce to the committee today a good friend and long-time adviser to me in my work in the Illinois legislature and in Congress.

He is Nat Shapo, who served for four years as the Director of Insurance for the State of Illinois. As the Insurance Director, Mr. Shapo consulted with Congress and Federal bank regulators on the

Gramm-Leach-Bliley Act and helped draft the National Association of Insurance Commissioners or NAIC statement of intent for the future of insurance regulation.

Mr. Shapo has been a leader in the insurance regulation field. He was twice elected to a national office at the NAIC—as Secretary-Treasurer and Vice President—and twice served as chair of the NAIC mid-western zone.

As a NAIC official, Nat was responsible for inviting me to visit New Orleans for the first time in my life to address a NAIC annual meeting. "Come to New Orleans," he said. "You will love the big easy."

Well, I came; it poured. It poured some more and the hotel swimming pool overflowed into the ballroom during the hurricane and I never left the hotel once to see the city.

So—but I digress.

I will try to put all parochial interests and personal bias aside and objectively state that Illinois has one of if not the most efficient insurance systems in the country. I believe that Mr. Shapo's experience will be most helpful for the committee. He will be sorely missed as director of insurance, but he will continue to share his expertise as a partner in the insurance regulatory group for the law firm of Ssonnenschien's Chicago office.

So thank you very much, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Biggert. I would observe that your personal experience with the city of New Orleans in the rain is not uncommon. In fact, some have observed about many Louisiana elected officials there seem to be either under water or under indictment. So it is——

[Laughter.]

——but we would like to invite you back for another attempt to enjoy our hospitality, I assure you.

Mr. Garrett, did you wish to make an introduction at this time, sir?

Mr. GARRETT. Yes, I would. Thank you.

First of all, Mr. Chairman, let me just say thank you for having this hearing. You know, as someone who has in the state legislature for a number of years in New Jersey and has had the opportunity to chair the banking insurance committee for a number of years in New Jersey, the auto insurance was one topic that we grappled with for a long time. We just could never get our hands around and get the political will to get the job done. But I appreciate the chance now to see how some other States are and maybe we can get things moving in the right direction.

But I am pleased at this point to introduce a gentleman who I know for some time, John Marchioni, who is now I see the Vice President and Director of Government Affairs with Selective Insurance Group. That is in my district. That is in my home county of Sussex County, New Jersey. And that is actually my old employer, with Selective Insurance for a number of years back.

Now John brings to this panel and to this hearing today, I guess you could say just about all sides of the equation. He like I and like other past or current residents of New Jersey bring a consumer side and know exactly what it is like to have to pay a bill or a high premium for auto insurance in the state. So we have that perspective there. And then if you go back in his career, where I first met him, he had the opportunity to serve as a staff with an assemblyman when I was in the state legislature, Assemblyman Jerry Zecker. There were only a couple of us in the entire state legislature who had a background in insurance. I had it and the other assemblyman did, being an agent. And so John had the opportunity to work with the legislature in his office from the legislative, the public side as far as tackling the issue.

Following that, he went on to bigger and better things, and worked with the Commerce and Industry Association up in Bergen County, New Jersey. So he got to work on the private sector, the commercial side, and again to see what the problems were there. And to try to lobby and work for changes.

Well, and finally now, it brings us to where he is today, and that is with my old employer, Selective Risk, the private industry, the insurance company itself.

You know, Selective always has the policy, I remember over the years of saying they were going to be an insurance company that did not proactively lobby, if you will, for changes in insurance regulation. They would just simply say, we will take whatever the government dishes out and we will try to make a buck at it and do the best we can.

And a number of industries tried to do that—companies did that as well. But I think you will see over time that in New Jersey, because of the over-regulation, all of the companies have realized that now it is come to the point that we have to do something to get out of this deadlock that we are in.

So I am pleased that he is able to represent all perspectives, but the one that he is most educated in comes from the private sector as well. And I presume that the testimony that we will hear from him and the others is that more competition is part of the answer. Less regulation is part of the answer. And at the end of the day that we have to achieve some sort of solution to this problem for our state and the rest as well.

So thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

If there are no further opening statements by members at this time, I would like to recognize our first witness here this morning.

Welcome Dr. Robert Hartwig, Senior Vice President and Chief Economist for the Insurance Information Institute. Welcome Dr. Hartwig.

STATEMENT OF ROBERT P. HARTWIG, SENIOR VICE PRESIDENT & CHIEF ECONOMIST, INSURANCE INFORMATION INSTITUTE

Mr. HARTWIG. Thank you, Mr. Chairman and members of the committee. The committee asked me to testify today regarding the overall economic performance of the property casualty insurance industry, the industry's rate of return, and to contrast that performance to other industries.

As we just heard from Mr. Inslee, the 1990s and these opening years of the new millennium have indeed been very difficult for insurers. Natural disasters, terrorist attacks and tort costs have all taken their toll.

Insurers are also subject to an extraordinarily complex array of rules and regulations that significantly impair an insurer's ability to earn an adequate rate return and to attract and retain the capital needed to cope with these problems.

Earning an adequate rate of return is a core concern for all heavily regulated industries. From 1988 through 2002, profitability in the property casualty insurance industry displayed in exhibit one under performed the Fortune 500 by an average 5.3 percentage points.

Return on equity is essentially the rate of return to investors who put their own money into the business. Exhibit one clearly indicates that investors in most years would have done better by investing in other industries or a broadly diversified portfolio of stocks such as the S&P 500. The performance gap is even more striking when the high relative risk of investing in property casualty insurers is taken into account.

The inevitable consequence of repeatedly disappointing investors is the diminished ability to attract or retain capital, shrinking capacity on a global scale, rating agency downgrades and a loss of investor confidence as manifested by falling share prices.

Underwriting losses over this same period are displayed in exhibit two, which represent the amount by which losses and associated expenses exceed premium income, were also enormous, totally nearly $350 billion. Focusing on insurers more recent performance reveals that the period from 1999 through 2002 witnessed four of the six largest underwriting losses in the history of the industry.

Last year's $22 billion underwriting loss, while a marked improvement from the terrorism impacted $52 billion loss in 2001, indicates a continued drain on the industry's capital.

In the final analysis, it is investor money that is lost. Investors observing these losses and low rates of return will be unlikely to invest in the P&C insurance industry unless they have a reasonable expectation that financial performance will improve in the near future.

Not surprisingly, the three most heavily regulated lines of insurance, auto, homeowners, and workers compensation produced below average returns in recent years and generated some of the largest losses. These three products alone account for roughly 60 percent of all premiums earned by insurers. Consequently, when underlying losses or loss trends shift adversely, pushing costs up sharply, insurance costs that sell heavily regulated insurance products are guaranteed to lose money.

Deliberate suppression of rates, delays in the rate approval process and delays in the approval of new forms and products invariably cost insurers billions of dollars in unnecessary losses each year, leading to reduced availability for customers.

Presently the availability of property-causalty insurance is shrinking and prices are rising as a result. A sharp drop in the pool of capital available to underwrite insurance is a principle factor fueling the rising cost of insurance today.

Capital held by U.S. domiciled property-casualty companies has plunged by nearly 20 percent or $63 billion since mid-1999. Foreign capital which is critical to the U.S. insurance market, is also shrinking.

Globally, capacity fell by an estimated 25 percent or $230 billion over the past two years.

Over the past year, industry critics have attempted to lay blame for higher insurance prices on so-called reckless investment strategies by insurers. While earnings from investments declined as they have for all investors, the P&C insurance industry still generates significant cash flow from its investment portfolio, an estimated $39.5 billion in 2002 alone.

Investment earnings are simply returning to their pre-bubble levels. Two-thirds of the industry's invested assets are in fact in the form of bonds. About only 20 percent is held in the form of common stock.

The decline in investment gains over the past several years merely reflects downward trends in interest rates which now stand at 40-year lows as well as fewer opportunities to realize capital gains on the stock portfolio.

Critics of the P&C insurance industry have also asserted that recent increases in the cost of insurance are unjustified and that insurers are simply gouging consumers.

The rate of return and underwriting loss figures discussed earlier clearly suggest otherwise. Moreover, the cost of auto, home and commercial coverages remains very reasonable by historical standards.

The cost of homeowners' insurance, for example, relative to the cost of the home itself, has decreased or remained stable every year since 1994. Likewise, the cost of managing risk for businesses relative to revenues is roughly the same today as it was a decade ago.

Thank you.

[The prepared statement of Robert P. Hartwig can be found on page 64 in the appendix.]

Chairman BAKER. Thank you very much.

A particular pleasure for me to introduce our next witness. I am pleased that he was able to accept out invitation.

Mr. Dan Juneau, President of the Louisiana Association of Business and Industry, an organization back home which has been particularly progressive in addressing the issues of government regulation. And I might add that Mr. Juneau has been particularly aggressive as President of that aggressive organization in helping to assist Louisiana government in making appropriate changes to its regulatory environment.

So Dan, it is good to have you here. Welcome.

STATEMENT OF DAN JUNEAU, PRESIDENT, LOUISIANA ASSOCIATION OF BUSINESS & INDUSTRY

Mr. JUNEAU. Thank you, Mr. Chairman, and warm wishes from your home district back home.

My organization is a combination of state chamber of commerce, state manufacturers association. We have 3,500 members in all, all sizes, all different types of business classifications. We are represented in every parish in Louisiana that corresponds to your counties.

I am not an insurance expert. I am simply a mirror, Mr. Chairman. I am a mirror of the concerns of the business community in the State of Louisiana about this subject and about this topic.

Every year I enjoy doing something very much. Right before our legislative session starts, and it just started in Louisiana, I get to take the month before that and go all across the State of Louisiana meeting with almost every chamber of commerce of any size in discussing the issues that are coming up in the session and hearing from those small business people.

And this year I think I got the strongest message that I have ever received from the business community in Louisiana. And it was about the affordability and the availability of insurance in our state.

Mr. Chairman, I remember two faces in particular who came up and talked to me after some of my presentations. One of them was a small businessman in Louisiana who sells tractors and tractor parts. And he was telling me that last year his property and casualty insurance was $145,000 for his premium. This year when he finally found a writer, it was $560,000, a 385 percent increase in his premium.

I remember another gentleman from south Louisiana who owns a wrecker service, obviously a small business person. And at that time his carrier still could not get him a quote for his liability insurance in the state.

The insurance crisis is hitting hard in Louisiana. Huge cost increases are inhibiting growth, profitability and employment levels and bringing some businesses to the edge of closure.

It is our opinion that the most critical ingredient of that problem in our state is the declining number of carriers writing policies. Give you a little example of what I mean by that.

Let's look at homeowners insurance in the State of Louisiana. Prior to 1992, that is when Hurricane Andrew hit in our state, 120 carriers were writing home owner's policies in Louisiana. Today, only 19 are writing them. And when you get to I-10 and south of that in the coastal areas, there is less than that.

Only six carriers are writing new home owner policies in our state, a real, real crisis. And commercial lines, the market is tightening for commercial auto insurance very greatly. My residential contractor members tell me that only A-rated carrier is writing them in the state. Many of our oil industry service companies say they also have only one or two carriers writing. You certainly are not going to get a bargain when that few people are writing new policies.

Our automobile dealers are down to two carriers who will write them and are facing such a crisis that they are looking to self insure, which is a very risky venture in this type of marketplace.

Interestingly, the crisis in Louisiana, has lead to the formation of a unique coalition. It is the group called the coalition to ensure Louisiana. It is composed of retailers, bankers, automobile dealers, oil field contractors, independent oilmen and representatives of the insurance industry, which these business groups often disagreed with quite—you know, quite often when it came to insurance.

But they realized that more competition is absolutely critical to stabilizing our market and eventually bringing prices down in the State of Louisiana.

So what needs to be done in our state to do that? Our organization and the coalition of others are pursuing reforms in the current session of our legislature to do several things. First of all, and I think one of the most important problems we have is our structure of regulation. We have an insurance rating commission in Louisiana. Most States allow some form of free market pricing.

In Louisiana, there has to be prior approval from our insurance rating commission for any increase to go into effect. The commission consists of an elected commissioner who chairs the commission and commission members who are appointed, who are political appointees of the governor or our state. That is not a very good system for regulation in our opinion.

Carriers are often delayed and denied when attempting to get rate increases. In the year 2001 legislation passed in our state house that would have actually moved to a more free market approach and reformed the regulatory system. Unfortunately, that legislation was vetoed. And when that happened, many more carriers started leaving the state after that veto.

Legislation has been introduced in this session to allow increases or decreases of up to 10 percent without prior approval of the insurance rating commission. It is a step we believe towards the free market approach that is needed.

Another problem in Louisiana is our residual market, our market of last resort for numerous lines of insurance. Carriers writing in Louisiana in the voluntary market are assigned policies from this residual market pool. It is a very unprofitable book of business. This is the policies that nobody wanted to write to begin with.

The losses in that book of business are not generally alleviated by greatly increasing the premiums on those people getting that insurance. It has been primarily by—or often cases by assessments on the carriers. So what this has led to in Louisiana is carriers trying to shuck their voluntary book of business because of that growing assessment that is being placed on them coming out of that residual market.

This is something that is absolutely going to have to be cleared up we think if we are going to get more carriers to write in Louisiana.

We are a direct action state. Only two States, Wisconsin and Louisiana, allow a lawsuit to be filed directly against an insurance company. When that happens, obviously the presence of insurance is known. And in Louisiana, through the discovery process, you get to very quickly find out what the policy limits are. This often results in higher awards we believe, since the amount of insurance present is overshadowed by the merits—overshadows the merits of the lawsuit in hand.

We also have a collateral source rule. Some States have a ban on plaintiffs getting multiple recoveries from various insurance sources when they file a lawsuit. In Louisiana, there is no such ban. Most States allow collateral payments, medical insurance, workers comp, disability et cetera, to be introduced into evidence at our trial. We do not allow that also in Louisiana.

Jury trial threshold also is another problem that is being worked on in Louisiana. Most States give defendants an unfettered right to a trial by jury. Louisiana limits a defendants right to a jury trial to suits involving $50,000 or more.

So in conclusion, Mr. Chairman, our organization is working with the coalition and others to enact reforms to return competition to the insurance marketplace in Louisiana. High premiums and reduced coverages are negatively impacting jobs and economic development. And we believe that competition fostered by free market principles is the key to recovery.

High premiums are one thing, but when insurance companies refuse to take your money, you know you have a problem.

And that is a problem we are facing in Louisiana today.

Thank you.

[The prepared statement of Dan Juneau can be found on page 77 in the appendix.]

Chairman BAKER. Thank you, Dan. We appreciate your participation here today.

Our next witness is the Director of the South Carolina Department of Insurance, the Honorable Ernest Csiszar. Welcome, sir.

Did I get that right?

STATEMENT OF HON. ERNST CSISZAR, DIRECTOR, SOUTH CAROLINA DEPARTMENT OF INSURANCE

Mr. CSISZAR. Absolutely, Mr. Chairman.

Chairman BAKER. Okay, thank you.

Mr. CSISZAR. Thank you, Mr. Chairman, distinguished members of the subcommittee. I am the Director of the South Carolina Department of Insurance and this is clearly a topic that is dear to my heart. So I welcome the opportunity to appear before this committee and share what I hope you will agree is a success story.

I can quite affirmatively state here today that our consumers, particularly when it comes to personal lines, are not experiencing an availability problem. I can also state categorically that 5 or 10 years ago that was not the case. And if I were to look to the one cause of how this change came about, that cause I can only attribute to the fact that South Carolina moved from what was a very stringent intrusive regulatory, prior approval type of process to what I can only describe as a more market driven competition driven, if you will, approach to the entire regulatory process.

In South Carolina, we have on the automobile side, we passed reform legislation in 1997 which through a transition period of two, two-and-a-half years, is now entirely in place. We have significant, as I will share with you in a moment, significant numbers of companies have come into the state, in the hundreds in the thousands. And they continue to come into the state to write insurance.

In our commercial lines, we have deregulated that process. There are no—there is no rate review. There are no policy review, no product review, if you will. There are DEEMER provisions in place. And there are no restrictions on premium or anything. So we have deregulated in essence, the commercial market. And this is particularly beneficial when you have small business owners who are looking for the right kinds of coverages.

I can also say that as a next step this year, hopefully within the next week, we will be introducing legislation in South Carolina that will deregulate the homeowners' market. We are slightly—we have a slightly different situation there from the automobile side, not the least because we have hurricane exposures and earthquake exposures in South Carolina. So we are going about it a little differently, but the ultimate aim I can only describe as is to implement the type of market-drive regulatory process that Illinois now has in place.

So these are the three prongs on which we are proceeding. And again, I attribute the fact that we do not have an availability problem in our personal lines or our commercial line largely because of this market-driven process.

Now to give you a little bit of history of where we were, and I will try to be brief on this because it is a rather sordid history. We in South Carolina had a rate making process that was driven by politics. The actuaries had nothing to do with the process really. Supply and demand did not have anything to do with it. IT was driven by politics.

And the end result was that it was rate suppression. And not only was their rate suppression, there was what I would call a peanut buttering of rates. So that the good driver really did not get much credit for driving well, and the poor driver really did not get punished for being a very poor driver. The end result is that quite apart from the rate suppression there was also the wrong signal being sent to the consumers. Why improve your behavior, your driving behavior is you are not going to get much credit for.

We had a residual facility. It was called the South Carolina Reinsurance Facility, and I can tell you from personal experience, that you can always judge how well a market works by looking at the residual market and seeing how many are covered through the residual market.

In South Carolina's case there residual market which was designed to be the market of last resort, became the market of first resort. It had the lowest premium in essence, and those premiums were never raised because of politics once again.

So the end result was that we had over 40 percent, actually close to 43 percent at one point, at one point 2 million policies going through our reinsurance facility at an annual deficit of over $200 million. It varied of course from year to year, but at its highest, it was $200 million.

That deficit was recovered by a recoupment fee. Who paid for that? Well, everyone paid for that. The good driver paid for that, and the lousy drivers paid for that as well.

And again, the wrong signals to the market.

We—in 1997, finally things came to a head. And through a bipartisan effort, this was not the Democrats or not the Republicans. This was truly a bipartisan effort—South Carolina passed automobile reform legislation.

We did away with a mandate to write. We did away with the preapproval process by way of implementing a flex rating type of system at plus or minus 7 percent. We did away with what were rather stringent underwriting restrictions. That actually probably chaffed more than the rate restrictions, a fact that you really could not underwrite a bad risk appropriately, or a good risk for that matter.

So we did away with the entire scheme, if you will. We replaced the reinsurance facility with a joint underwriting facility which is not an assigned risk facility. And I can only tell you that the true measure of successes in this is that having gone from 1.2 million policies at one point in the facility, we now have less than 350 policies. I repeat that—350 policies in the residual pool.

It is proof that the private market works if you let the private market work. So we are very much in favor of a market-drive type of regulatory system.

Now to give you some indications on the rates, certainly we have improved. If you look at averages, for instance, we look at—we have improved. But quite frankly, the averages do not tell us a lot. I would rather see a scheme where a rate of $500 premium is averaged out with a $3,500 premium than have two premiums at $2,000 each because again, the signal to the market here is important in terms of improved driving.

We are still a lousy state when it comes to fatalities for instance. We still have too many DUI fatalities. The only way you can send a signal to the market or to the driver is by charging them an appropriate rate. So this is where I think where the prime accomplishment really comes in when you look at the rate differentials.

We have now in our market, we have attracted and we actively go out to recruit companies. We have, I believe, the number is somewhere around 170, 180 companies and I cannot keep track of it, actually because every week we have new companies coming in. And by the way, when they come in to write automobile insurance, many of them also write homeowners insurance.

And that is a welcome mark in South Carolina, where we always deal with capacity constraints along the coast because of hurricane exposures.

So it brings success in other markets as well, I think.

We certainly are—complaints, we do not hear about rates. The best way I can describe it, Mr. Chairman, is the Chairman of our Insurance Committee in the House probably put it best. His name is Harry Cato and he said to me quite recently said, "You know, for the first time in years," 10 years I think he used, "I can go to the barber on Saturday and get a haircut and not have to listen to bitch and moaning about automobile rates and homeowners rates.

So that is probably the best indication that something good has happened here. As I said, we are replicated this on commercial lines, and we are about to replicate it on the homeowners line.

I will conclude on this point, and the point very simply is that the market indeed does work, and South Carolina is a good example of it.

Thank you.

[The prepared statement of Hon. Ernst Csiszar can be found on page 56 in the appendix.]

Chairman BAKER. Thank you, sir.

And I need to get that barber's number when we are done here today.

[Laughter.]

Our next witness is Mr. John Marchioni who is Vice Chairman of the New Jersey Coalition for Auto Insurance Competition.

Welcome, sir.

STATEMENT OF JOHN MARCHIONI, VICE CHAIRMAN, NEW JERSEY COALITION FOR AUTO INSURANCE COMPETITION

Mr. MARCHIONI. Thank you. Good morning, Mr. Chairman, and distinguished members of the committee.

My name is John Marchioni, and I am Vice President and Director of Government Affairs and compliance for Selective Insurance Group, a New Jersey-based property and casualty insurer.

This morning I am testifying in my role as Vice Chairman of the Coalition for Auto Insurance Competition, a coalition consisting of insurance companies, insurance trade associations, business groups and over 20,000 consumers who are rallying to the cause of restoring competition to New Jersey's auto insurance marketplace.

New Jersey residents face an auto insurance availability crisis of unprecedented proportions. During the past decade, over 20 insurers have left New Jersey, seven companies having left or filed plans to leave within the last year alone.

When State Farm, the state's largest carrier completes its withdrawal, five of the six largest writers in the nation will not be going business in New Jersey.

As we speak, over 4,000 motorists each month receive notice that their insurer is leaving the state having to scramble for coverage. One million drivers could ultimately be impacted if significant reforms are not achieved.

The disaster that is facing drivers in New Jersey is neither a natural disaster or an accident. It is a disaster of the state's own making. It is the result of a politicized auto insurance regulatory system.

New Jersey operates arguably the most strictly regulated system in the nation and consumers are paying a heavy price.

Virtually every aspect of the auto insurance business is controlled by statute and or regulation. The state dictates how much coverage must be provided and who companies must insure.

They control the prices, they determine whether an insurer can come into the state, and when an insurer can leave.

And if a company can successfully manage to navigate this complex regulatory scheme and earn a profit, the state tells you how much you may keep and how much you must return.

However, unlike the state's cap on profits, the amount of losses an insurer can be forced to absorb is unlimited. The result of this regulator morass is that insurers have headed for the exits. There are a third fewer carriers in New Jersey than in neighboring States, despite having a population with one of the highest per capita incomes in the nation.

As carriers leave, consumers lose coverage.

Numerous newspapers reports document that replacement coverage is increasingly hard to come by because many of the remaining insurers simply do not have the capacity nor the capital to take on additional business.

New capital has not been invested in the state because many insurers do not want to do business in this highly politicized overly burdensome regulatory climate.

Adding to this lack in capitalization is the fact that the majority of the state's largest insurers, including four of the top five, write their business in single state subsidiaries in an attempt to insulate their parent company from this turbulent market.

That is the bad news. The good news is that progress has been made towards reversing this decades-old problem. To solve the capacity and availability crisis, additional capital must be invested by the private sector in New Jersey's auto insurance market. The private sector, however, is unlikely to do that until the many regulatory barriers to competition are dismantled. Reforms must give existing insurers confidence they can generate a competitive rate of return and attract additional insurers to the market place.

Insurers must know that regulatory decisions will be made fairly and will not be the result of political manipulation. Fortunately, the legislation that is moving in Trenton goes a long way towards restoring competition to the state's auto insurance system.

By restoring a competitive insurance market, New Jersey drivers will reap the benefit through increased availability and choices.

Senate bill 63 has passed the state senate and we anticipate the state assembly will take it up in May. Called the New Jersey Auto Insurance Competition Choice Act, it is backed by Governor McGreevy and a bipartisan group of legislators in both houses.

While not a panacea, we believe it will ease the availability crisis and if fully implemented lead to long-term stability in this troubled market. S. 63 phases out the take all comers law, expedites the rate setting process, eases the excess profits law and streamlines withdrawal restrictions.

Again, this bill is not a panacea, but it is an important and positive first step. It is only a first step because after the bill is enacted the administration must fully implement the various regulatory components of this reform package.

New Jersey has a checkered past in this regard as well. It took four years to implement an expedited rating law passed by the legislature in 1997. The redrawing of a 50-year old territorial rate map dictated by statute in 1998 has still not been implemented.

If S.63 becomes law, the administration must act quickly and they have committed to doing so on the regulatory changes called for on expedited and prior approval rating, withdrawal, excess profits, and territorial rating.

The current reform effort could be a significant step to move New Jersey into the mainstream of state insurance regulation. It took decades to create this dysfunctional system, so dramatic results are not likely to occur over night.

Assuming S.63 is signed into law, the required regulatory changes are swiftly enacted and the reforms are allowed to take root without political interference, New Jersey could become a more attractive market for insurers, and the ultimate beneficiaries will be the state's consumers.

Thank you, Mr. Chairman, and that concludes my remarks.

[The prepared statement of John Marchioni can be found on page 83 in the appendix.]

Chairman BAKER. Thank you very much, sir.

Our next witness is Mr. Nathaniel Shapo, who is a Partner in Sconnenschein Nath and Rosenthal and former Director of the Illinois Department of Insurance.

Welcome, sir.

STATEMENT OF NATHANIEL SHAPO, PARTNER, SONNENSCHEIN NATH & ROSENTHAL, FORMER DIRECTOR, ILLINOIS DEPARTMENT OF INSURANCE

Mr. SHAPO. Thank you, Mr. Chairman and good morning to you. It is a pleasure to see you again. I enjoyed working with you when I was at the NAIC. It is a great opportunity to be here today before you and our Ranking Member, Kanjorski and Representative Biggert who was very kind in her introduction of me earlier.

Mr. Chairman, in Illinois, the government does not regulate the price of insurance. Rather supply and demand and the anti-trust laws do. This is sufficient and consumers are well protected.

Since insurance is not a monopolist product, it is strange that this model is viewed as an usual approach. Well settled public policy holds that in a market with many sellers, supply and demand and the anti-trust laws, true competition, should regulate price.

Insurance is such a non-monopolistic product. It is sold by hundreds of carriers who aggressively challenge consumers to compare their prices against their competitors. Consumers routinely shop for coverage and price through conversations with agents, calls to toll-free numbers, and by surfing the Internet.

If I described any other business this way, one would be surprised at the notion that price controls were necessary or appropriate.

Yet government rate regulation is commonly used in insurance to keep prices down. Price controls, which were put on the table to deal with unique but now completely absolute conditions in the market have not gone away. State rate regulation has historical, legal and policy roots not in ensuring affordability, but in ensuring solvency.

The purpose of price controls was to facilitate the propping up not the suppression of rates.

Because in the 1800s and the early 1900s insurers were prone to severe underpricing and insolvency, for decades they were encouraged not to compete but rather to cooperate on prices. Rating bureaus produced recommended rates and States having encouraged the practice, regulated the resulting anti-competitive prices through prior approval requirements as they usually do with monopolies.

In fact, 89 years ago, the Supreme Court invalidating the constitutionality of insurance price controls in the case of German Alliance v. Lewis, explicitly cited the quote, the monopolistic character, unquote of the insurance marketplace as the basis for its decision.

Since prices were not regulated by what the court called quote, the higgling of the market, unquote, that is to say competition, they should be regulated by the state.

The cooperative rate making allowed by the Supreme Court was essentially encouraged by Congress in the McCarran—Ferguson Act, which provides an anti-trust exemption for insurers if States occupied the field with rate regulation. But the market has changed dramatically since Congress passed McCarran in 1945. Solvency regulation has drastically improved beyond the point of needing to rely on a rate regulation. Bureaus no longer produce rates and companies develop their prices independently.

Monopolistic practices have been replaced by competition. But the create regulation used to control the monopolistic market endures as a tool not to protect solvency, but affordability.

Studies show however, that prior approval of insurance rates does not in the long run produce prices lower than competition. Furthermore, since price controls deter supply, they often spur availability crisis characterized by large residual markets as Director Csiszar just testified.

In Illinois, competition benefits insurance consumers as it does throughout the rest of the economy. Illinois has the highest number of carriers writing homeowners policies in the country. This ample supply produces a marketplace which by statistical analysis is competitive and non-concentrated. The residual market is infinitesimal. The uninsured rate is below the national average. And rates are or below national norms, 27th highest in auto and 39th in homeowners.

In short, consumers are well protected. They are protected in the following ways. First, rates are regulated. They are regulated by supply and demand. They are also regulated by the anti-trust laws because since the state does not regulate rates, McCarran's anti-trust exemption does not apply.

Furthermore, Illinois has added an additional safeguard, the Cost Containment Act, which requires the Department to collect data from insurers, analyze that information using recognized statistical indexes and report to the legislature to confirm the competitiveness of the market.

The Department does not proactively regulate rates because empowered consumers can and do utilize supply and demand by shopping for price.

Consumers cannot protect themselves in all aspects of their transactions though, so Illinois funnels its scarce regulatory resources toward vigorous solvency, market conduct, policy forum and consumer complaints regulation. The market cannot regulate these activities itself, so the government must. For instance, since consumers cannot be expected to understand the balance sheet of the company, the Department actively regulates solvency.

Illinois' success in solvency and market conduct regulation is renowned. It originated many of the model laws at the heart of the National Association of Insurance Commissioners' accreditation program. And it is had three winners, the most of any State of the NAIC's Robert Denine award, the association's highest honor for professional regulators.

Insurance is infused with the public good. As Chairman Oxley said, it is the glue that holds our economy together. For that reason, insurance is and should be a heavily regulated industry.

I think that Illinois's experience indicates that as one would expect in a market with many competitors, proactive government regulation is best focused on areas where unlike with respect to price, only the state can protect consumers.

I believe Illinois' experience demonstrates that the same rules for price regulation that apply throughout the economy should also be considered by policy makers in this vital but no longer unique insurance marketplace.

I have used up my time, and I thank you for your indulgence, Mr. Chairman.

[The prepared statement of Nathaniel Shapo can be found on page 90 in the appendix.]

Chairman BAKER. Thank you, Mr. Shapo.

It is rare in this committee's jurisdiction where we have an issue that the resolution of it seems to be so clear cut. I want to thank each of you for your testimony and for the rather dramatic differences in your presentation between those who have relied on the competitive model and those who are struggling to reform the regulatory model.

It—at least for me and others may have differing opinions, it is dramatically clear what would be in the consumer's best interest. And I had intended to spend more time in trying to heighten those differences to make the public case stronger, but I do not think given your testimony, that is really necessary.

Rather, I will jump ahead a little bit. As you all know we have been discussing in this committee now for almost two years the advisability of some national system to help expedite the competitive model adoption.

And let me add a quick caveat, I see and will constantly maintain support for the state regulatory model as to consumer affairs and to the capital adequacy of the companies which may be domiciled within your state. So there will always be a strong need for a state regulatory model in that regard. But with particular focus on the question of product availability, and the need now to go to 50 differing state systems to apply for permission, given the impact of your testimony and where less regulatory inhibition has resulted in more product availability at lower cost, am I making a leap that is inappropriate to assume that if companies—let's just take for example, were able to get licensed in five or six States, to sell a particular product in a particular line, then it would be automatically acceptable for them to move into all other States.

Or is there value in having a 50 stop review in order to be able to sell your product on a national scale, which also lends to the question is there an advantage in having a company have the access to a national market to enable them to even further reduce price? As I am interpreting your comments, it seems as though when you got rate makers out of the way, and let the market work, prices came down because the competition would undercut you and take more of the market if you did not.

It is just really an open question to the panel. Somebody help me here. Mr. Csiszar, your testimony was great. Anybody who can go from 1.2 million policies, to 350 needs to be heard.

Mr. CSISZAR. I think—let me add one—just one word of caution for perspective. There—it is not entirely always the case of the competitive model versus the regulatory model and that one works and the other one does not work. I mean, I use our neighbor to our north for instance, North Carolina, which very much is in the mode of applying a regulatory model, but has a very stable and a very good market.

I think there is a lot of difference in how the model is actually applied. It is the—the model itself is probably a neutral tool whether it is the competitive or the regulatory model. It is how you go applying it and the intrusiveness of it and the minutia that you get into.

So I think it is—there is that gray area as to markets in which there is a regulatory model that actually does work. Now having said that, clearly in South Carolina's case, we felt that in order to change things and to change them for the better, we had to move away from that regulatory model entirely.

And it was not so much a philosophical discussion. It was a very, very practical decision that was made. We had drivers who were upset by their recoupment fee that they were being charged and the politicians heard about it.

From the standpoint of how this fits into a national kind of market, I think—I am a state regulator and I am a believer in State regulation. Truly, truly am. And I think there is a difference first of all between the life market and the property and casualty market.

I think on the property and causality market, there is less of a national market, less of a national market than there is on the life side, looking just at South Carolina for instance. I have Charleston that sits on a earthquake fault. Nowhere else in the state do we have that problem.

We have a coast that has hurricane exposures. We have an inland part that has hail and tornado, but does not have hurricane exposure. We have of course, our own individual torte laws state by state.

So I think there are enough state differences to warrant a state-based system. Does that mean the system should remain as is in terms of applying in 50 States? No. I agree with you. It has to be modernized. And I think the NAIC is making an effort and a good effort in that respect. Is it as fast as some of us would like to see it? Probably not, but on the other hand, we are making progress in that respect.

So I think that—I think that the hearings like this help. They clearly help because they bring out best practices, I think. And if we take a best practices approach to a state by state approach, I think it can be made to work.

Chairman BAKER. I will come back to that. I do not want to go beyond my allotted time. We will just wait for another round to come back and investigate that more.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

I am wondering whether the panel is avoiding the other side of the question, because you all sounded so uniformly satisfied that we can get to a very stable insurance market without any problems. There must be some problem out there.

I am trying to think of one of them. One could be if this model has worked so well, for instance in South Carolina, how has it applied to the health insurance industry? Do you have steady and uninterrupted markets for health insurance down there? Very competitive?

Mr. CSISZAR. I wish I could say that. No, we do not.

Mr. KANJORSKI. Why?

Mr. CSISZAR. In large part because we also have the Federal government to deal with. Give you an example. We have a small group market that I would describe as highly dysfunctional at this point. We have very few companies left writing in that—one to 15 employees kind of market.

Mr. KANJORSKI. What does the Federal government do to affect the health insurance marketplace?

Mr. CSISZAR. The HIPAA, the HIPAA imposes guaranteed issue and reissue requirements. And when you talk to our companies, we have had over 100 companies exit our state on this small group health insurance policy. And when we speak to them and when we to an exit interview each time, what we get back is, "No, it is not the state mandates. No it is not the rate bands that States impose on us. It is the guaranteed issue and reissue mandated by HIPAA. That is the real problem with it."

So you have got this mix of state and Federal in the health insurance side that you really do not see prevailing the property and causality or the life side.

Mr. KANJORSKI. In the auto, property and causality industry, you can refuse coverage at will on the part of the company?

Mr. CSISZAR. That is correct, and you have the residual market to go to if you are refused. Now if——

Mr. KANJORSKI. Why don't you just adopt that regulatory system on the health side?

Mr. CSISZAR. Because we cannot. It is a Federal law that——

Mr. KANJORSKI. Okay.

Mr. CSISZAR. ——states——

Mr. KANJORSKI. But if we did, you do not think that going to the residual market would bankrupt the state?

I mean, if everybody is losing money in health insurance coverage and they pull out of the state and say go to the state fund to get covered, how can the state cover the costs? They are obviously not leaving because they could make money. They are leaving because they could lose money and are losing money generally.

Mr. CSISZAR. Right, right.

Mr. KANJORSKI. So, they want to extricate themselves from the loss of the market, and put it on the residual market. Can the state support that burden?

Mr. CSISZAR. The way we—the way we resolved that on the property and casualty side is to make sure that the rate charged at the residual level, is in fact an adequate rate, an actuarially sound rate.

I think if you were to do that on the health side, you would at least have a partial solution to it. We do not do it on the health side. And we cannot do it on the health side right now, again because we also have Federal mandates out there.

Mr. KANJORSKI. A lot of the reform that has been talked about here, particularly in auto insurance, is a capping of recovery elements, going after multi-policies and everything else.

That is not a form of regulation and control in the reverse? You are lessening the opportunity for the victim or for the individual that is injured to seek out a recovery, and obtain a potential recovery. You are getting into a very controlled area, one policy to go against, whatever the limits of that policy are, that is your cap.

Mr. JUNEAU. Well, my understanding of insurance is it is there to make the insured party whole. And you know, I guess maybe you could say that is form of a cap. I just think it is a logical if someone is—if you allow multiple recoveries from various different policies maybe owned by the individual or owned by other people who are the employer or whatever else, and those multiple recoveries have to have an impact in cost not just in one line of insurance but in other lines as well.

I mean, again, I thought the purpose was to make the party whole, not to stack up many, many layers of recoveries.

Mr. KANJORSKI. Well, when they are recovering, they are not recovering above and beyond their damages. They are just recovering from several sources to contribute for the payment of proved lost damages.

Mr. JUNEAU. Not in my state.

Mr. KANJORSKI. Are they not?

Mr. JUNEAU. In my state, they can very easily recover beyond their level of damages.

Mr. KANJORSKI. Well, that would be in the particular facts of a case, and of course we cannot go into that.

How do we protect consumers? I am open to a competitive market, except I worry about how we protect individual people without weight in the marketplace to be assured that they can get coverage and that they do not get taken advantage of?

In your markets, if I have a home on the same street as another person, and ABC company underwrites a neighbor's policy for $200,000 casualty insurance at X number of dollars, and I have a home within that rate, can I go to that company and get a guarantee that I am going to pay the same price? Or is there a differential?

Mr. MARCHIONI. If I can just respond to that. I think clearly in a healthy and competitive marketplace, one of the primary roles for a regulator is to ensure that consumers have appropriate and adequate information as to what is available to them out there.

So I think when you have sophisticated buyers that are capable of doing that by themselves——

Mr. KANJORSKI. Well, I am not talking about sophisticated buyers. I am talking about unsophisticated buyers.

Mr. MARCHIONI. And I think it is appropriate for regulators and I believe most of them do, post rate comparisons and do a lot of the leg work in terms of the price of the product.

Mr. KANJORSKI. So, you do it by rate comparison, but am I not guaranteed if I live next to my neighbor to get the same price from the same company as he got?

Mr. MARCHIONI. Well, that is where the various or the individual loss characteristics of a particular risk come into play. I think the base rates would be no different, but the risk characteristics of that given exposure would come into play in determining whether that rate would differentiate.

Mr. KANJORSKI. Well, that is nothing to worry about. In other words, there is no guarantee that I am going to get it. It depends on how it is rated out by the company. It is a one-on-one negotiation between the insured and the insurer.

We had the same situation when we deregulated the telecommunications industry. There was a bonanza in savings for huge companies. They were able to go in and negotiate telephone service prices with major providers down to darn near nothing, but unsophisticated buyers have literally been rapped over the last several years.

I mean there are some people still paying 20 cents a minute for long distance when you could probably in the competitive field get it for a nickel.

Mr. MARCHIONI. Well, and the response to that is when you look at the competitive market places, those regulators whop are not spending the vast majority of their time pouring over rate filings, could really focus their attention on unfair business practices and market conduct examination processes to do the back end regulation that provides the consumer protection that I think it is—that you are looking to. And I think it is absolutely appropriate.

But again, if the regulator is forced to spend their time handling prior approval of rate and forms, they probably do not have adequate staffing or resources to dedicate to the business practice review that it is that they are responsible for.

Mr. KANJORSKI. So, you want to get them out of the regulation business and get them out of the competition business, but get them into the policing business that they comply with good practices?

Is that what happens in Illinois?

Mr. SHAPO. Yes, sir. That is what I was trying to get at in my testimony is that there are certainly aspects to the business where consumers cannot protect themselves. And that is what the department of insurance should be for.

You cannot expect a consumer to understand the balance sheet of a company whether it is financially stable or not. That is what our financial examiners are for.

You cannot expect a consumer to understand the ins and outs of claims practices. That is what market conduct examiners would be for to deal with that on a global method. And individual consumer complaints as well, thousands and thousands a year.

The department would serve as an ombudsman to help consumers and that would include perhaps a case where a consumer felt they were not getting the same price and the same coverage offered to them by a company of someone of the same risk characteristics.

But I think when you are talking about say, telecom, I think the insurance business is different. Insurance is just a—has no monopolistic characteristics at this point and it has not for decades. You would expect that that bargaining going back and forth between the consumer and the company particularly because it is being driven on a global scale by millions would produce the right results.

Mr. KANJORSKI. All of your testimony is so compelling. I have got to ask this last question. If you have such great things happen in places like Illinois and South Carolina, how is it that some insurers came up to the Congress and asked for catastrophic insurance coverage to cover hurricanes? If you are so able to price out and cover these catastrophic occurrences, why did they come up and ask the Congress to underwrite those losses when they occur?

No, no, no, I am not talking about terrorism insurance. I am talking about when they came up here and noted that in the State of Florida, all of the insurance companies were leaving because they had such huge losses after Hugo, was it? Hurricane Hugo or whatever it was. They were leaving Florida unless the Federal government stepped in and became the reinsurer of the high-risk factor.

If the private market is working so well, we should not be involved in it.

Mr. CSISZAR. I would agree with you that the government should not be involved in it from that standpoint.

And in Florida, as it turns out, I do not think—I do not think the Federal government ever became the market of last resort other——

Mr. KANJORSKI. No——

Mr. CSISZAR. ——than the floor insurance program.

Mr. KANJORSKI. Only because some of us had faith in the private market and kept the Congress from passing a stupid act.

[Laughter.]

And the private market has——

Mr. CSISZAR. I commend you for that.

[Laughter.]

Mr. KANJORSKI. ——provided insurance.

I take that responsibility for my side of the aisle rather than my colleagues——

Chairman BAKER. And I comment my colleague for his defense of free enterprise.

[Laughter.]

Ms. Kelly?

Mrs. KELLY. Thanks.

I have a question for Mr. Shapiro—I mean, Shapo. I am sorry. Did I pronounce that right?

Mr. SHAPO. Shapo.

Mrs. KELLY. Shapo. I will get there. Mr. Shapo, if New Jersey and Louisiana impose price controls on insurance, does not that force the insurance companies to raise prices in the other parts of the country to make up for the shortfall until they can get out of places like New Jersey and Louisiana?

Mr. SHAPO. I think it essentially has that effect, Representative. Some of the—some States will have laws that on paper prohibit that kind of subsidy, but when you are talking about a national company, the fact of the mater is that company has got to back up the risk in each state with appropriate amounts of surplus. And that the surplus used there is surplus ultimately comes out of the hides of policyholders in other States.

And in fact, as you alluded to, this—the dynamics there can be so bad that companies will have to in order to prevent that from happening, and in order to do the responsible thing to their owners and policy holders, throughout the county, they will in essence have to quarantine the risk by doing business in a tough state through a subsidiary a single state subsidiary. And the dynamics there are that that subsidiary is not as well capitalized. It cannot take on as much risk. And it eventually will face the risk of insolvency if capital is not able to earn an adequate rate of return.

And then of course, that company will have to take steps to withdraw from the market.

Mrs. KELLY. So basically, if I understand it putting it down into a very simple formula, what is happening is that it is forcing in the short run, those States are really forcing out of state consumers to subsidize the risk.

Is that right?

Mr. SHAPO. I believe it has that effect in the end, because the surplus; the capital that will have to come in to support the risk because premiums are not adequately supporting the risk, more capital will have to come in from out of state. And that is surplus that is coming out the hide of other consumers. So yes, consumers in other States will end up subsidizing consumers in States where companies cannot earn an adequate rate of return.

Mrs. KELLY. Thank you. Mr. Csiszar, since we are discussing the effectiveness of State regulation, I want to touch on something that is rather close to my heart and that is NARAB. It is a section of the Gramm-Leach-Bliley bill. We tried to hit at the heart of burdensome, inefficient over regulation with an NARAB section in that bill. And I wonder if you are familiar enough with the issue, if you could give me your thoughts on where NARAB is now. And whether or not we can help you in any way get some effective control there with NARAB.

Mr. CSISZAR. I think you will find that there has been good progress with NARAB in so far as implementation is concerned. I know in South Carolina, for instance, we are one of the States that passed the Uniform Model Producer Act.

I think what you will find is a couple of things, and let's be very fair and practical about this, States are to some extent passing them with some individual variation. So the entire uniformity that perhaps was anticipated is not quite there. But it is being passed and overall, I think a majority of States—I would have to check—but it is close to—38 States. I thought the number was 38—38 States have passed it.

Some of the larger States are balking at it and I think again where you can help us is by making your voices heard that those States are also included in this NARAB process.

We have not quite reached a reciprocity stage or we have reached a reciprocity stage but we have not reach a uniformity state I should say.

So we are a good way a long the way, but not quite there yet. Even thought we have fulfilled I think the letter of the law, if you will.

Mrs. KELLY. Thank you very much.

I yield back the balance of my time.

Chairman BAKER. Thank you, Ms. Kelly.

Mr. Scott?

Mr. SCOTT. Yes. Mr. Shapo, you testified that the Illinois model of regulation could serve as a successful model for other States, that it could produce a healthy market and provide necessary consumer protections in virtually any state in America.

In your opinion, is there any reason why we could not make the Illinois law the national model? Do you believe it is time for us to give that serious consideration?

Mr. SHAPO. Whether Congress should mandate that?

Mr. SCOTT. Right. Make the Illinois law national law?

Mr. SHAPO. Through congressional action?

Mr. SCOTT. Yes, yes.

Mr. SHAPO. My belief is that there is nothing about insurance as I just described at length in my testimony, that would make it so that this product could not be regulated in that competitive fashion to the benefit of consumers essentially in any state.

My view while I was Commissioner, and it remains so today, is that this state system is—deserves the opportunity to work and without creating a Federal regulator. And I think—Representative Kelly talked about NARAB before. And I think Congress is right to be trying to think of methods by which it can bring about change and use its authority to help the States help themselves.

I mean, you have a classic collective action problem in insurance regulation. And that is—and Congress was of course formed to help the States deal with their collective action problems by being a national instrument for facilitating interstate commerce.

At some point I think that Federal preemption is the only way for States to help themselves. And in fact can help the state system—can save the state system. You can have limited Federal preemption as Mr. Scott is suggesting, that allows—that does not create a Federal regulator but certainly simply puts certain mandates on the States.

And I think that depending on how urgent the problem Congress thinks it is, that if the States have not been able to do it themselves, individually through the NAIC or through an NARAB type model, that at some point the most severe problems in the regulatory system particularly those that impede capital investment and that impede the globalization of the business for the benefit of consumers, I think that that that reluctantly I think that may be necessary at some point.

And again, I think eventually that becomes a benefit to the state system because it allows you to keep the state system in place while not creating a Federal regulator by simply smoothing out the rough edges through congressional mandate.

Mr. SCOTT. It just seems to me that in listening the testimony that New Jersey and Louisiana are suffering in large measure because they are not doing some of the things that Illinois and South Carolina are doing.

Let me go to South Carolina for a moment. Mr. Csiszar is it?

Sorry about that. Hope I did not do your name too bad.

You testified that by moving from a strict prior approval process to a more open market process, that you have been better able to focus on what is essential to insurance regulation. Could you tell us how this reallocation of resources better protects the consumer?

Mr. CSISZAR. It does it in a number of ways. And some are really a byproduct. Let me start with the byproduct. The byproduct is that is also allows the legislature to focus more on what is essential for instance. When you look at the cost structure of insurance, by in large the cost structure, yes, there are expenses. But it is made up of claims.

And it is a fact that you have poor drivers, or you have accidents and so forth.

In our case, it is allowed our legislature to really focus on DUI laws for instance, seat belt laws, helmet laws, things that we did not have, even highway safety—the dividers on a highway.

And that is where the true impact on the cost structure, I think, can be had.

So one benefit comes from the legislative focus. In the case of our Department, we are doing very much what Nat described a moment ago. We are focusing very much on the financial side, the solvency side of things. And we are focusing very much on the market conduct side to avoid the kinds of problems that Mr. Kanjorski, for instance mentioned.

The market conduct side has become much much more active than we ever were I think within the last few years.

We focus on discrimination, the redlining. You know, these are things that in the past we talked about. We just did not have the resources to do them with. So it is a different process, and I think a more effective process.

Mr. SCOTT. If I may—because I just want to go over to Louisiana for a second.

Chairman BAKER. Take all of the time you need.

Mr. SCOTT. Thank you. I wanted to just talk because there is this dichotomy. It is like they are doing what is right, and maybe if you all did some of these it might solve some of that problem. But and each state is unique. And in my State of Georgia has its concerns on this issue as well.

I want to talk to you about the negative effect of price controls on availability. You testified that the problem in Louisiana comes down to one critical point, that insurance carriers continue to leave your market. And as the insurers disappear, the availability shrinks. Could you please explain how the State of Louisiana's use of price controls have caused the insurer flight in Louisiana.

Mr. JUNEAU. Well, if they cannot get the premium increases that they deem necessary to price their product in our marketplace, they are faced with a choice of just continuing to face losses which you know—I am not an insurance expert, but Representative Kelly was talking about if they are losing money in Louisiana do they have to make it up somewhere else. And I guess to the extent that they can, they try to do that.

But they either have to continue to build losses in to their operations or they try to not write as much as possible. They really increase their underwriting standards. They judge risk much more carefully in a state where they are operating like that, which means they chose not to write policies to a lot of people. Or if when it comes down to the final analysis, they leave. We have had a lot of them that have left, particularly in automobile insurance, property and casualty. Some of the health lines in Louisiana, these carriers have just up and left.

You know, are there ancillary things that impact that? Yes. I will mention some that exist in our law. But I do think that the primary thing to focus on in Louisiana to begin to change the situation is our regulatory scheme that we have in the state. I mean, when you politically appointed people and an elected commissioner sitting on the commission and they are looking at will people look badly upon them if they grant a 10 or 15 percent rate increase?

The tendency of them is to not—to deny or delay. They will just keep telling the people well come back or we will give you 2 percent, but you cannot—it sounds like bargaining in a bazaar somewhere sometimes. You know, the people come in with their book with their actuarial data and they put it down and they say, “Here is what our costs are and we would like to recoup those costs and make a reasonable profit.”

So I do think that the structure that we have, the prior approval structure has lead to the out-migration of a lot of those carriers in the State of Louisiana.

Mr. SCOTT. Could you tell the committee how severe is this insurance crisis? What impact is it having on jobs? Or does it, and economic development in Louisiana?

Chairman BAKER. And that would have to be the gentleman’s last question, please.

Mr. JUNEAU. Yes, sir. I will mention a couple of anecdotal things in my testimony of companies facing some severe problems. This is rampant through the State. But basically, when you are faced—there are two main problems. When you are faced with a sizable increase and I mean a really sizable increase in your liability insurance as a company, it affects your profitability. It affects your ability to expand. It affects your ability to hire people. It affects your ability to buy machinery and equipment that you need in your business. And those have repercussions that operate throughout the business.

The other main thing is that if your coverages are reduced, if exclusions are put in your policy, if you simply cannot get it and have to go bare, then one instance where you have a loss or a claim can really put you out of business. And some companies have just stopped doing certain operations because of fear of liability exposure because either they could not get the insurance or they got it at very reduced coverages which increase their exposure. And so they stopped certain types of operations.

Mr. SCOTT. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Scott. Just on a personal note, my homeowner’s insurance carrier withdrew last November. And I had to scramble around in December, and try to find that. For all of the agents, I have coverage in effect.

[Laughter.]

But it happens to everybody.

Mr. Gary Miller?

Mr. GARY MILLER OF CALIFORNIA. Thank you, Mr. Chairman.

You talked about liability insurance, and often on the Housing Subcommittee, we debate the impact of government and the regulatory process and how that impacts affordable housing.

And I know specifically in California, liability insurance for builders is almost impossible any more. And if you do buy a policy, it does not cover attached product which by in large is entry level in most areas. It includes also subsidies and it goes on and on to where when you get through with the policy, there is very little that in fact it does cover.

And that puts a builder in a very difficult situation because without adequate coverage, lenders are not going to provide loans, because they know they are going to be liable. And it goes on and on to subcontractors.

And State regulation has been criticized as imposing enormous cost and restricting rather than facilitating competition.

Is it Mr. Shapo? I did that correctly?

I know that in Chicago like Los Angeles, is a large densely populated city. Yet insurance is much easier to achieve in Chicago than it is in Los Angeles. Could you address that?

Mr. SHAPO. Well, I can address the Chicago part of that probably easier than——

Mr. GARY MILLER OF CALIFORNIA. Please.

Mr. SHAPO. ——the Los Angeles part.

Illinois is a State that—it is a large State. It has urban and rural. It has all kinds of different weather problems. It has hail, ice, tornadoes, et cetera. So I think it serves as a example to virtually any state because of its very conditions. And it is comparable to any state's—any other state's large cities.

And the—what we—what we found is by focusing on encouraging capital it benefits the consumers because in the first place you avoid the availability crisis that you get. Often what will happen is the price controls and trying to keep prices down will simply in the end cause a major availability crisis. And by focusing on availability in Illinois, going the opposite way. In the first place you have the availability, the residual markets are tiny. They are virtually non-existent which means that people can find coverage through the regular insured market.

And in the second place, it has the effect in the end of keeping rates affordable. So by focusing more on availability up front, you end up avoiding the crisis, where people cannot get coverage. And you end up producing more like the price controls we are trying to get which is affordable coverage.

Mr. GARY MILLER OF CALIFORNIA. There has been discussion about NARAB and a lack of uniformity in application. Would somebody contrast the benefit of NARAB versus a possible Federal charter as it applies to opportunity and price?

Mr. CSISZAR. I wonder if you could clarify that question, because I am a bit confused.

Mr. GARY MILLER OF CALIFORNIA. Well, NARAB was intended to serve a specific purpose. And yet applications not uniform from state to state, which is somewhat self-defeating in and of itself, you are looking at various States that over regulate the industry. And in the industry is fleeing those States. And you look at some insurance companies that might provide some sort of a policy for builders for improvements of a subdivision or whatever, that if you apply that over 30 States, every state is different. One state allows a third party insurer, and another state does not allow a third party insurer.

And many of these companies are smaller companies that provide that type of an insurance. And it is becoming increasingly difficult in this country, except for a few States obviously, to acquire insurance and for business people to acquire liability policies which is in some fashion hampering the economy from growing as it should.

If we had a, let's say reasonable applied Federal charter, that was similar to what we have for banks. You know, a bank can go from state to state, can get a business. Yet there are state laws that apply that banks fall with under. But it does not take you two years to have an a new approach applied equally throughout the United States if it can do something that did that much more rapidly and was much more consistent, and somewhat eliminated much of this paperwork process they are having to go through from state to state. It is almost like an industry in and of itself filling out forms.

If we had a reasonable Federal charter, compared to something like NARAB that is not being implemented uniformly, do think there would be a benefit to that?

Mr. SHAPO. Mr. Representative, could I suggest as a matter of public policy, that there is at least one step in between NARAB and a Federal charter.

Mr. GARY MILLER OF CALIFORNIA. I am talking about the option of Federal charter, not a mandatory——

Mr. SHAPO. Understand.

Mr. GARY MILLER OF CALIFORNIA. It can go either way.

Mr. SHAPO. I understand, but I would suggest——

Mr. GARY MILLER OF CALIFORNIA. What would that step be?

Mr. SHAPO. I would like to suggest that there is at least one step in between which——

Mr. GARY MILLER OF CALIFORNIA. Such as?

Mr. SHAPO. ——is just pure Federal mandates and preemption, which is—the step that you did not get to in NARAB because the States achieve the hurdle of——

Mr. GARY MILLER OF CALIFORNIA. So an absolute Federal mandate rather than an optional Federal mandate be applied rather than an optional Federal charter or allowing state option?

Mr. SHAPO. Well, what I was going to suggest in terms of if you are assessing policy options, that there is at least one policy option between NARAB and the optional Federal charter, which is limited Federal preemption, but pure Federal preemption in certain cases but that is preemption of certain state practices, without creating a Federal regulator.

So instead of going, hopping all of the way to creating a Federal regulator and allowing that as an option, you could go, you could stop, make one stop before that and say, and in certain areas where we have discussed and believe it is necessary, we would have limited preemption. We would tell the States that you simply cannot do X or you simply cannot do Y. We are not going to Federalize the implementation of the regulation, but we are going to tell the States that because of the collective action problem and because we have not been able to fix it either the States voluntarily or through an NARAB type of approach, you just simply tell the States you cannot—you cannot apply this type of a law or so forth.

Mr. GARY MILLER OF CALIFORNIA. Well, quickly, in closing, is there agreement on this panel with that approach?

Mr. CSISZAR. Clearly that is an option that you have. I would add one other thing to it as you move—since you had bought up the Federal charter. My fear with respect to even an optional Federal charter would not be that no, you are not going to cure some of these problems. Clearly you would cure some of the problems if you go with the Federal charter.

But you are introducing other risks. By that I mean a new Federal bureaucracy for instance. I am an immigrant to this country, and I have had the distinct pleasure of dealing both with the IRS and the INS.

Mr. GARY MILLER OF CALIFORNIA. Are you not lucky.

[Laughter.]

Mr. CSISZAR. And quite frankly, my fear would be that you are—by the way, the IRS is downright customer friendly by comparison.

Mr. GARY MILLER OF CALIFORNIA. Well, the chairman will never approach that direction of even complimenting the IRS or these other agencies.

[Laughter.]

So thank you, Mr. Chairman, for your patience on that.

Chairman BAKER. Certainly. I think the gentleman's point as I was generally understanding it was that produce uniformity is a distinctly different issue from consumer advocacy, and that the 50-state consumer advocacy approach is something I believe everybody is in defense of. It is simply trying to figure out how to get product across state lines with the least amount of encumbrance.

Mr. Brad Miller?

Mr. BRAD MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman. I am not entirely used to the idea that I should come into a committee meeting an hour and 15 minutes late and immediately begin to ask questions. But let me do it nonetheless.

There was just one set of questions that did not appear to be answered, and I suppose the best person to direct it to would be Mr. Csiszar?

Yes. How much regulation—I know the bulk of the testimony and questions have been about rate regulation. But how much regulation is there of policy forms in South Carolina and other States that you may know about?

Mr. CSISZAR. Again, we were in a situation where everything was prior approval five, 10 years ago. And we have within the last few years moved away from that. We are now on the commercial side. For instance, we are no longer reviewing policy forms, just property and casualty.

On the life side, we used to review everything from a very simple whole life policy, to the most sophisticated indexed annuity that you might find. What we are doing now is we are exempting clients from review when there clearly is no plain vanilla kind of policies for instance, where there is no need to review. So we have a selective review process on the life side based on the sophistication of the product, a judgment on how sophisticated the product really is or how complex. Maybe sophistication is not the word. Complexity in a better word, how complex the product is. Whereas, on the commercial side, it is an open market entirely in South Carolina.

Let me make one exception to that, our malpractice, medical malpractice forms for instance are still regulated on that side, as is our credit products. I apologize. We do make those two exceptions.

Mr. BRAD MILLER OF NORTH CAROLINA. Well, basic coverage is like automobile liability and homeowners. Is there a standard form that applies to every insurer offering that?

Mr. CSISZAR. We have standard forms of course. And there are minimum mandated coverages for instance, for automobile. There are different—right now as I said we are still on the personal line side. We are still reviewing products to make sure that the consumer actually gets the appropriate coverages.

Mr. BRAD MILLER OF NORTH CAROLINA. Okay. And are you familiar with other States? Is that the case in——

Mr. CSISZAR. Other States I think with rate exceptions are also prior approval. I think Colorado might be an exception. Nat, you might remember. I do not think they review products. But I think most States have the prior approval process in place.

Mr. BRAD MILLER OF NORTH CAROLINA. Okay. Mr. Juneau, are you familiar with Louisiana in that respect?

Mr. JUNEAU. I am not an expert on insurance and all of that in Louisiana. I represent a trade association, so a business association, a state chamber of commerce in Louisiana. So I mean, I do not know that I could help——

Chairman BAKER. Let me jump in to help Mr. Juneau a little bit. Yes, there is significant prior approval. We have one of the longest delay times from application——

Mr. BRAD MILLER OF NORTH CAROLINA. You are talking about——

Chairman BAKER. ——to the entry into market for new product, typically averaging 180 days, but it can go up to a year.

Mr. BRAD MILLER OF NORTH CAROLINA. Well, then that—can I continue to address my question about Louisiana to the chair?

[Laughter.]

Mr. JUNEAU. I think he still votes there.

[Laughter.]

Mr. BRAD MILLER OF NORTH CAROLINA. Are there standard form policies basically every insurer in the State offering automobile liability insurance has the same standard form?

Chairman BAKER. Yes, yes.

Mr. BRAD MILLER OF NORTH CAROLINA. And the same is true of homeowners?

Chairman BAKER. Correct for a minimum policy. There are minimum levels, and there is standardization.

Mr. BRAD MILLER OF NORTH CAROLINA. All right, and as to the forms that allow insurers to giveth or taketh away, are those standardized as well?

Chairman BAKER. Yes.

Mr. BRAD MILLER OF NORTH CAROLINA. Thank you.

Chairman BAKER. The gentleman has no further questions. Mr. Garrett?

Mr. GARRETT. Thank you.

You know, New Jersey is proud to be number one in a number of things, in a number of different areas. I think the length of time, we exceed yours as far as approval. So besides having the highest rates in the nation, we also take the longest times to approve them—the forms.

It seems a consensus of this panel is that the regulatory side is part of the equation as far as where the reform is necessary. And a question from a member from the other side of the aisle that is still here that raised an interesting—and the answer that we got from it—raised an interesting question. It is done a little different here, but this was brought up. And that was if things are working along the way, they are in a couple of States where they are, without the intrusiveness of excessive regulation, the question was raised, "Well, then how come it is not working in the health side?" And the answer was, "Well, that is because the Federal government got its finger into it and started messing things up."

So would it help for those States that have made the conscious decisions to allow their local citizens decide what level of coverage you have which varies from state to state. And that will be my follow up question in the insurance on the auto side, how does that differ?

Would it help for those States to have on the health side of the equation to have exemptions or waivers from the Federal preemption on the health side to give the States the opportunity where they so chose to run on the health systems and provide their consumer with the exact type of health coverage that they want to have?

Mr. CSISZAR. My answer to that would be a resounding yes that clearly there is room, if nothing else, for States to opt out of some of these. There ought to be some room for States to opt out of some of the Federal mandates particularly when it comes to for instance small group health where you have a particular group of employees. You do not have any cancer problems. Well, why do you need cancer coverage for instance?

So there ought to be some room to opt out of the Federal mandates. And it would be helpful. Overall, I think the health insurance is a classic example of being over regulated whether it is the privacy issue which we are now going through, whether its the rate making issue. Believe me, I do not blame entirely the Federal government for this. We have done our fair share at the state side.

We have rate bands in place. We have state-based mandates in place. Some very onerous ones, fertility mandates for instance, very onerous mandates.

And so we have also done our fair share. But ultimately I can tell you at least from my experience as I talk to companies exiting these lines of business, the uniform reply that we get that "Yes, there are problems. These state-based things are problems, but the real, real problem lies with HIPAA and the guaranteed issue." That is the answer we are getting.

Mr. GARRETT. Maybe it is because, and I speak as a former state legislator who is now in Congress, maybe it is because we have so many former state legislators who saw the attributes of regulating on the state level, that now that we are here we say, "We just cannot give up this idea of passing mandates on the States." Maybe this is where this comes from.

But I would be glad to explore that possibility of seeing what we can do in that area.

The question along that lien then is, is it possible though for why we see such a divergence of costs and why we see such a divergence of success in these areas, in part due to what the citizens or the legislature in the States have opted to say, "This is what we want for our insurers."

Now in New Jersey we have some reform, and then you can comment in a moment if you would as to what reform is not being done, but you would like to see. And maybe some of the other States that are represented here could say it is in part that you are not requiring mandatory coverages that other States such as New Jersey is requiring?

If New Jersey wants to start, if John wants to start.

Mr. MARCHIONI. In terms of the mandates and the coverage levels that are dictated by individual state legislatures, that is really a public policy issue that state legislative bodies should be making along with the insurance departments. The issue here is whether or not the market who serves that product has the ability to adequately price the product. From a public policy standpoint, a state legislature decides that certain levels of first party medical benefits and certain minimum levels of liability coverage are what should be provided as a minimum to every consumer in the state.

That is fine. But the private market has got to be able to price that product. And the problem you run into is when we dictate very high levels of mandatory coverages, it generates a very high cost product, which then attracts political interest amongst the voters and them obviously amongst the legislature which leads to price controls.

So it becomes at the start they are separate issues, but then they become intertwined once the cost of the product rises to the level in fact the mandatory benefit is too high.

Mr. SHAPO. Also, representative I think that is as matter of public policy, that is what some of us are testifying is that the desires as you described it, for the legislature to quite appropriately say, "This is what we want for our consumers here," that what ends up happening is that these methods that are used to try to get there end up having the opposite effect.

And that by saying, we want lower prices for our consumers, what you are—using the tool of heavy rate regulation and rate roll backs and things like that, what happens in the end is that the goal of trying to get more affordable or available coverage for consumers, the result is quite the opposite. By focusing so much on price, you end up withering supply. Capital does not come into the market. So then you have an availability crisis, and then in the end rates have not gone down.

Chairman BAKER. Thank you, Mr. Garrett.

Mr. Clay?

Mr. CLAY. Thank you Chairman Baker.

Dr. Hartwig, if reforms are not enacted to address this availability crisis, and the States continue to impose artificially low rates while losses continue rising, will things get better or worse for consumers? Is this a cyclical or long term problem for consumers?

Mr. HARTWIG. What we have today here for consumers under the current regulatory environment is a long term problem. It is not something that is going to go away on its own. It is not cyclical. It is here to stay.

Now we have heard testimony from New Jersey, for example. This is a problem that has lasted at least a quarter century. That is far more than cyclical.

In the end what is going to happen is that you have a situation where more capital will drain from the system over time. Invariably that means there will be less insurance available. What insurance is available will be available on more restrictive terms and at higher costs. That is precisely what is happening today. And to the extent that there is any acceleration in the exiting of that capital from the industry, or there are more stresses put on this industry, say from another terrorist attack, or from anything like this, you have a situation where you have an acceleration in terms of the pricing and a decrease in availability.

Mr. CLAY. Well, does that force us to mandate less coverage? I mean, if that is the way you are going with the argument.

Mr. HARTWIG. I think that what we are looking at or what we need is an environment where customers determine what they need in terms of how much coverage and what types of coverage they want. It is that way on the commercial side in a number of sectors. It is not that way in the personal lines side in very many States today.

And so I think we can allow customers who are today are more knowledgeable than ever by the way, in terms of finding out not only about the price, but what is included in a product. There is more information available. We can allow them to take some of that into their own hands as they do when they buy just about any other product out there today.

Mr. CLAY. Thank you.

Mr. Juneau, you testified that you believe competition is the best regulator of rates. Why do you believe this?

Mr. JUNEAU. Well, from our experience right now in Louisiana, when you have so few carriers available to write to businesses in the various lines, I mean there is no shopping. There is not bargaining. There is no playing one company against the other. You are just kind of over a barrel. The companies that remain and are writing, you know, it is just a very, very difficult situation.

There is no impetus to bring prices down. I mean, quite often the regulatory scheme does not allow them to raise their prices very fast, so they simply continue to disappear. They continue to simply not write certain types of insurance so you have to simply exclude a lot of different coverages that you need in running your business.

And just to me, it has been a picture of a real failure of the market to work in the State of Louisiana. The gentleman next to me talks about the companies that are moving into South Carolina to write, and when they do they often write in more than one line of insurance. I do not know any lien of insurance in Louisiana in which we have companies in to write.

I know about every lien of insurance and we have companies leaving the state. Part of it may be some things in our law which I touched on, but part of it is the fact that they think that we have a very strange regime for regulating the market. And like I said before, when actuarily they go before a commission and state, "Here is what we raised in premiums, here is what our costs are. Here is the book, look at the book. Check and see what the loses are. We need premium increases to continue to write." And they are told come back in—you know, next month. Of come back in three months, or we will give you 3 percent, but not 145 percent.

It is just not a market they want to write in, sir.

Mr. CLAY. Okay, thank you. Mr. Csiszar, you talked about how you all had been able to confront redlining in your state. Can you elaborate for me? How do you actually focus on that issue? What measures do you take to discourage that? And when you do find incidents of redlining, what measures do you take against those companies?

Mr. CSISZAR. Interestingly enough, when the other reform legislation passed, one of the objections by consumer groups to that legislation had to do with the fact that the legislation specifically permitted zip code rating. And the argument was that that only calls for redlining.

Well, as it turns out when companies rate by zip code as most of them do, that is one of the best ways to determine whether any redlining is going on. Because you have the data siting in front of you. And my point very simply was that I can now devote resources to that issue. And we have had cases that we have actively investigated for redlining. I can now devote the resources to that to me which is more important than the rate making process when I have 200 companies competing with each other to write the business.

We have a very active consumer outreach program now which we did not have before. We make sure we go out into communities. Churches—I have got one man on staff who just goes out into the low country in South Carolina, for instance and speaks to groups and informs them of how insurance works. Goes to high schools, for instance, Rotarian clubs. These are things that we just did not do before because we were shuffling all of this paper around. You know, it is become like a—my actuary, by the way who is sitting behind me, some years back said to me, "You know when we moved to this system, it is like a breath of fresh air." And it really is.

Mr. CLAY. You have become more proactive with the——

Mr. CSISZAR. Yes.

Mr. CLAY. ——with consumers. When you find an incident of redlining, I guess a number of variables and factors come into play? Do you look at an insurer's driving record and say it is impeccable, do you then make a determination that that is redlining?

Mr. CSISZAR. Oh, yes. Actually if there is no redlining if nothing else, we have a very active consumer assistance program. We pull them out of that company and find another company to write for him.

Now we are still going to pursue the redlining issue as a matter of discrimination as an issue of law, but we are not going to let them sit with that company. We are going to place them with another company.

Chairman BAKER. Thank you, Mr. Clay.

I want to try again to see if I can get agreement as to the observation I was making earlier to distinguish access of product from consumer advocacy.

Mr. Csiszar, you just made a very persuasive argument that in South Carolina, that when once relieved of the product approval and paper shuffling responsibilities, it released the ability of your employees to go out and actually help consumers proactively.

That is exactly what I am contemplating if we were to act on a national basis to have every state's insurance regulatory aimed at helping and informing consumers while getting out of the product approval process.

That is a very simplistic explanation, but the current system of 50 state approval processes, rate setting systems, form setting requirements, counter-signatory requirements serves no consumer interest.

I mean, there is nothing inherent to that process which automatically insures that a homeowner in south Louisiana is going to get property and casualty insurance.

But if you take the barriers down and let all of the folks roam where they may, I would suspect that there would be people to come to me and offer a myriad of products where frankly I have few choices today. When some one told me the final four was in New Orleans, I thought, my God, that is the end of the insurance world.

You know, I did not know what they were talking about.

[Laughter.]

If you take the fences down and let people offer product on terms and conditions as they seem fit, what is it that i hear and not to characterize any particular person, but among the NAIC membership, is the concern about that national structure? If we are not building a 13 story building on K Street, if we are merely talking about the way in which product get to the market?

Can you respond to that, because I hear concerns that we are moving too far too fast if we contemplate that methodology?

Do you want to respond? All right.

Mr. CSISZAR. I will give you my first cynical response.

[Laughter.]

Rates and forms are a way of exercising power, and if nothing else you are touching upon a power base that has been traditionally the territory of commissioners. And that is just the reality whether we like to hear that or not. That is just the fact.

I will tell you my own personal view, and I will speak as director of South Carolina here. That I think it is excellent or insurance commissioner to hear what you have to say on this topic, because there is no doubt in my mind that change is needed.

Even where we are in South Carolina, we have got a long way to go still. While insurance is somewhat of a unique product in a sense that you pay now and have to wait for the benefits to see them later.

There is a regulatory process that is needed. No one is talking about taking a libertarian approach here and doing away entirely with regulation. No, there is clear room for regulation.

And it needs to be changed. So I would welcome, I welcome your interest in this and your pursing this issue because I come out of an investment banking environment for instance. We did not have these problems. What we went after was disclosure and transparency, for instance.

Well, there is a lot of need for transparency in this industry still. These are the things that we really ought to be pursuing.

But it is not a uniform view amongst commissioners at this point.

Chairman BAKER. Oh, I—that is clearly understood.

I thank you, sir, for your comment.

Mr. Shapo, assuming that you may generally agree with the gentleman's comments, how long is it—I have been asking this question now for a decade—how long do we set the clock and ask States through the NAIC structure to adopt some not just reciprocity, but real uniformity at least with regard to product? Or is it advisable to help by having the Congress say do it by such and such a date certain or a Federal action is taken?

What is your response to that?

Mr. SHAPO. My chair just got very warm.

[Laughter.]

The—I think as policy makers, you have to gauge yourself just how tough to get at what point. But clearly, I believe that—I will say it again. This is the active collective action problem with the States. And it is up to a certain point to the extent that deviations are allowed and not specifically preempted, they will exist. That will always happen.

I mean, to the States, I think virtually every state insurance department in the country does a good solid job of regulating insurance. They know their jobs. They do it well. They have experience and so forth.

But if the test is not, are they competent and trustworthy to their job, if their test is will they have the right policies and or uniform policies, the States at some level are ultimately going to fail that test.

I mean, it is just impossible with 51 equally sovereign actors to expect them all to achieve uniformity on their own. So I think that to the extent that I do not want to get into the business of publicly offering advice on this, that the thing to do is to very directly state the goal that you want and say these are the options on the table, a NARAB type of approach which is preemption, but it is preemption that could be preempted. Right, the NAIC preempted the NARAB preemption by reaching the goal, the 29 jurisdiction goal which allowed several key States to not join up.

So you could say, well, there is another step down the road which could be just an outright preemption saying you can prior approve or if you prior approve, you have to have a DEEMER or whatever would be. And you could say that that is the next option, and the option after that is the mother lode, you know the 13 story building in K Street. And I think you directly lay out those options and you pick, you know, a reasonable timetable probably in consultation with the key players, including NAIC officers on it. And then you just publicly state these are the goals. And at some point those last two, a direct Federal mandate that cannot be preempted by States and or a Federal charter. Those we will actively pursue those. And I plan to sponsor those on a certain date.

And you know, I think that the date on the first one of those, the plain mandate probably should not be too far in the future. I mean, my experience as a public administrator, as a public policy maker was that you need to in order to get people to do things, you have to have the hammer, you know, visible. It cannot be little dot on the horizon.

Chairman BAKER. Well, I hope folks can at least hear footsteps. I mean, they do not need to see us, but they at least need to hear us. I mean, we have been talking about this for so long.

Mr. Kanjorski?

Mr. KANJORSKI. You know, we have been talking for about two hours, and I am starting to conclude that I have not really heard anybody. When you really think about what we are arguing here, we are saying we want to provide coverage for the business community and the consumer community. We are obviously not discussing that you are being inhibited or that the insurance industry is being inhibited from cutting their rates. Is that what I am supposed to gather from today? Or am I correct that what you are really all talking about is there has to be an increase in rates? We are all talking about how we go about doing that, whether we get to do away with rate regulation or policy content control. More money has to flow into the insurance industry to give the coverage that is requested to meet the claims that are out there and underwritten.

Is that not about the simplest way to summarize what we are talking about?

Mr. HARTWIG. I think so, sir, and it is definitely the case that the issue of changing rates in the insurance industry is not symmetrical. No one stops you from lowering them very frequently. But you are very frequently prevented from raising them.

Mr. KANJORSKI. Right.

Mr. HARTWIG. And that creates a problem——

Mr. KANJORSKI. That is what we are talking about then. The insurance industry needs higher rates, and how are we going to do it and how will you make it look nice.

I am not opposed to an efficient insurance marketplace. I want to go to Louisiana's problem because it is a problem. I have been sort of an obstacle in Congress to providing catastrophic insurance. You raise the question, Mr. Juneau, that you are losing companies in the southern part of Louisiana. That fact does not surprise me and it does not necessarily mean it is because of rate regulation or content regulation, or product regulation.

Louisiana is subject to hurricanes. Under every forecast I have heard, it is reasonable to assume within the next 20 or 30 years, a class-one hurricane is going to hit New Orleans and cause great decimation. There is not any property and casualty company that wants to be insuring that risk without some protective cover from the Federal government or the ability to spread that risk loss across the country to a very large base.

But I do not care what kind of a product it is, you know what the rates are, the risk of writing casualty insurance in New Orleans in Miami Beach—I will not single out only Louisiana is higher. We have identified about 13 major population centers in the United States that are at extreme risk for higher losses of property and causality insurance. In a way, everybody is trying to find a way to allow these communities to continue to exist at the same insurance rates they are paying now. Continued growth however, means greater exposure to be picked up in the case of a loss.

I think that if Hurrican Andrew had come 25 miles north of where it hit and if it came today the insured losses would be $75 billion. That point has always been my argument. Why should the guy in Idaho underwrite someone who wants to build a building on Miami Beach? Part of the risk of building a building in Miami Beach or New Orleans is the fact that you have got a chance, a much higher chance, of catastrophic loss. The marketplace should reflect that risk with higher costs in that particular marketplace.

I am in favor of that principle. Unfortunately, I do not think you are going to get an awful lot of economic development started in a higher risk area because your rates are going to be extraordinary compared to all of the rest of the country.

If you are sitting on top of a volcano or if you are sitting on top of a fault in California, you have got a problem. All of us are trying to find some way to subsidize or ameliorate that problem. If we go to a real free market economy model and we say the rates should reflect the exposure, the potential exposed loss that is going to come through natural circumstances, you are not going to have a very positive economic development future in southern Louisiana or in Florida or in California along the coastline.

It is just not going to happen. I, for one, representing the State of Pennsylvania say, "Hey, why should we give a rate guarantee or underwriting advantage regardless of how you do it, whether it is through the Federal government of whether you spread it the base across the country, the rate, why should we encourage capital to flow artificially by being subsidized by other areas of the country or by the Federal government to go into higher risk areas?

Clearly, if you are going to spend $10 million on a building, and if you build in Kokomo, Indiana, your appreciation is likely not going to be that great. If you put it in Miami Beach however, it is going to appreciate significantly over the next five or 10 years. So if you can just meet the period of time where the loss does not occur, the exposure does not occur, your investment is going to appreciate a great deal.

But the reason it is appreciating a great deal is because they are getting an artificially low insurance rate to cover the potential loss or cost that is there.

Maybe your argument should be, let's let the marketplace handle that. I am for that. But it is going to be very disadvantageous to some of the high growth areas of this country if they adopt that policy. I am, however, for it as long as we can find, I think, a uniform product.

I think Mr. Miller brought that point up and that is very important. I mean, I do not want to read that insurance policy or hire an insurance lawyer to figure out what I am covered for and what I am not covered for, as we discussed up here on the dias when some of you were talking. I cannot think of many people other than business people, executives specifically hired to study insurance policies, that spend the time reading their policies. They call up their insurance companies and say, "I am buying an automobile, give me automobile coverage."

Assume you get a good policy from the company. I could not tell you what it excludes or includes. I only find that out after they do not want to pay for the damages that I have had after an accident or after something happens. That is when I read my policy, and find out what they do not cover and what I thought they did.

The homeowners policy has the same problem.

Now as far as I am concerned, if we can get some balance either on the state level or across the country for a uniform product that people do not have to hire a Philadelphia insurance lawyer to interpret their policy every time they file a claim, and if we go to the natural market driven rate, I am of the opinion that we may favor some of the more disadvantaged economic areas of the country that have been subsidizing the economic growth areas of the country for a long time, particularly in the private market through insurance by having companies go in there and suffer huge losses in Florida and Louisiana and having to pick up those losses in other States or get out of the business.

Now the one other thing that bothers me is that I feel someone could interfere with the insurance business. Let me ask you this. I like the idea that we have small insurance companies. I am not sure that if we get into this market-driven system we are not just putting such favoritism to huge, well capitalized companies and eventually forcing the smaller companies out of business that just cannot write because they have such a limited base or pool to write on.

What is the panel's thinking on that point? Are we going to materially shrink the number of companies that are engaged in the business?

Mr. HARTWIG. I might start first here. Already in virtually in every state and those that are competitive of course, like Illinois, and like South Carolina, you have the presence of major insurers who have a significant market share. But for decades you have had them competing with very small insurance companies who might only write within that state or within that region. They might only write a single line within a single state.

The obituary of small insurance companies has been written many, many times and always prematurely. And so these companies have been able to demonstrate their ability to compete with large insurance companies in the current environment and I would expect that to be the case under any regulatory scheme.

Mr. KANJORSKI. In Illinois we changed the system. Will they be able to continue to exist, we are not going to disadvantage small companies?

Mr. HARTWIG. What I am saying is that yes, small companies now compete with large companies under all regulatory schemes today.

Mr. KANJORSKI. Yes.

Mr. SHAPO. In Illinois, Representative, we have the highest number of companies competing in the homeowner's market. So I think it would have the opposite effect. I think it enables small companies to be able to compete it. And I think that makes sense if the regulatory system is very burdensome, probably a larger company with more surplus would be able to afford the—those transactional costs than a smaller company would.

And if I could make one quick comment on when you said earlier as kind of a bottom line, when you were talking about rates being too low or too high, I think it is—I do not think we can say that it is just what this is all about is the insurance company needing higher rates. I think what we are saying is that insurance companies need to be able to raise and lower rates quickly. And in accordance with market driven decisions, as opposed to driven by regulatory considerations and a long delay. And that has to do with not only raising but also lowering rates.

And it is also not just——

Mr. KANJORSKI. Well, that is true in a measured area, but as the doctor said, the industry is undercapitalized. It has to attract more capital.

Mr. SHAPO. Right.

Mr. KANJORSKI. That means more profit. That means higher rates.

Mr. SHAPO. Well, but it also means that companies need to be able that they can charge higher rates when they need to.

I think what is happening in a lot of States, with the tighter regulatory systems, because companies are concerned that their capital will be subject to government capture, they do not invest it in the first place. Not necessarily because they might need a higher rate right away but because conditions might change and the industry needs to be able to charge the right premium to deal with those changing conditions. If they cannot do that, they will not subject their capital to government capture, and that is why they would be undercapitalized.

Mr. MARCHIONI. If I could just respond to your original question. I think you could probably make a pretty strong argument that the strict rate regulatory environments are more difficult on the small comapnies than would be a competitive rating market. And the reason I say that is when you have a competitive rating law when a small company realizes they need to make an adjustment either in their pricing structure or their underwriting structure, they can do that rather quickly.

Whereas, in a prior approval system, when we used the example of a state where it takes 18 months to get a prior approval filing done, if a small company realizes they need to make an adjustment and it takes then 18 months to get there, that 18 months may put them out of business.

So I think—you know, you could probably make a pretty strong argument that just the opposite would apply if in fact we were to go to a competitive rating law on a national basis.

Mr. CSISZAR. If I could just pick up on that point that Nat picked up on a moment ago on a point that you made, Mr. Kanjorski, is that what it really means is higher rates fro some and lower rates for others. On average of course, I think we are talking about an increase in rate. The other comment that I would make on some of the subsidizing that you were mentioning that make on currently. I mean when you look at one of the most dysfunctional programs when it comes to subsiding, is the Federal flood insurance program.

Mr. KANJORSKI. Yes, I was going to raise that with you.

Mr. CSISZAR. Yes. Where people are rebuilding in that same flooded location through——

Mr. KANJORSKI. So, you agree with many members of Congress that South Carolina's people have got to start paying the real rates for damages, and South Carolina has a responsibility to exercise zoning and control development laws along that coast.

Mr. CSISZAR. And enforcing building codes. Yes, indeed, I do.

Mr. KANJORSKI. Well, why have you not just on a state basis pursued that policy?

We do not have to enact anything up here for you to say, "Whoa, citizens of South Carolina, the rich northerners are coming down from the Cold Belt. Stop building your million-dollar homes on areas we know are going to flood every 10 years."

Mr. CSISZAR. Well, there is always the question of political will, I suppose.

Mr. KANJORSKI. You mean South Carolina does not have the political will?

Mr. CSISZAR. Well, our commissioner previously did not. He had political ambitions.

[Laughter.]

Chairman BAKER. Nothing further, Mr. Kanjorski?

I want to express my appreciation to all of our witnesses. This has been, I think, a particularly informative hearing for the committee. We obviously are not poised to take any immediate action but your recommendations are certainly helpful in dictating the course of these discussions.

And it is my hope that we can find some manner of mechanism to facilitate increased affordability and accessibility to insurance products for more Americans. It is clear that the current system from a national perspective at least, is in a difficult state and that some modifications are in order.

Exactly what those modifications might look like are yet to be determined, but we do appreciate your comments and observations in this effort to bring about reform.

We have votes pending on the floor so our meeting is now adjourned.

Thank you very much.

[Whereupon, at 12:18 p.m., the subcommittee was adjourned.]

A P P E N D I X

April 10, 2003

OPENING STATEMENT OF
CHAIRMAN MIKE OXLEY
COMMITTEE ON FINANCIAL SERVICES
Hearing: "The Effectiveness of State Regulation: Why Some Consumers Can't Get Insurance"
April 10, 2003

I am very pleased that Chairman Baker is holding this hearing today to review a problem that has reached crisis proportions in some States: the increasing difficulty consumers face in finding available insurance for their homes and cars.

It is becoming increasingly clear that this consumer crisis is being caused in part by the archaic system of insurance price controls imposed by some States. Time and time again, politicians have been seduced by the illusory short term benefit of price controls: an immediate reduction in premiums. But in the long term, price controls hurt consumers by depleting insurer capital and forcing insurers out of the market. Less insurance capacity means less choice and less availability for consumers.

When wrong-headed regulation drives out competition and leaves consumers without coverage, it's time to examine whether the means is achieving an appropriate end. Pushing insurance companies out of the State undermines competitive pricing and eliminates the right of consumers' to take advantage of the benefits of a strong and highly competitive industry.

But it doesn't have to be this way. The great State of Ohio with a relatively free market competitive system, has some of the lowest homeowners and auto insurance rates in the country. Ohio consumers enjoy the 3rd lowest homeowners' rates and the 15th lowest auto rates. Similarly, Illinois has successfully used free market competition for 30 years and South Carolina opened its automobile market to more competition and free market pricing in the late 1990's to the benefit of its consumers.

In contrast, Louisiana and New Jersey are two States that have unsuccessfully tried to artificially manipulate the insurance marketplace. New Jersey currently utilizes a broad array of anti-competitive tools including: price controls, lock-in laws, take-all-comers requirements, and excess profit laws. Louisiana is nearly as bad, employing a highly politicized rating commission to dictate insurance rates. Consumers in both States are now suffering from a severe insurance shortage.

Louisiana and New Jersey should not be reluctant to adopt the proven models used successfully in Illinois and now South Carolina. Louisiana squandered such an opportunity two years ago when the governor vetoed a regulatory modernization bill. I hope they give it another shot. New Jersey may have an opportunity in the near future: the N.J. legislature is currently considering bipartisan regulatory reform. While the bill is not a panacea, it is a step in the right direction.

I would like to thank Chairman Baker for holding this hearing to determine what is – and is not – working to ensure a competitive insurance market that safeguards consumers.

STATEMENT OF THE HONORABLE WM. LACY CLAY
Before the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"The Effectiveness of State Regulation: Why Some Consumers Can't Get Insurance"

April 10, 2003

Good morning Mr. Chairman, Ranking Member Kanjorski and Members of the Committee.

Mr. Chairman we are facing a crisis of monumental and unprecedented proportions, in some states, because of the unavailability of personal insurance for customers and unavailability of insurance coverage for businesses. The severity of the crisis differs in various states, however, the problem is one that the nation as a whole faces.

There are several factors that have caused this crisis. Among them are the flight of capital from the insurance investment market as investors seek more lucrative and stable investments; state and local government regulations that some companies claim are too restricting; the events of September 11, 2001; and natural disasters.

We have homeowners and automobile owners in some states that have limited selections of companies from which to purchase their needed personal lines of insurance. We have businesses that have problems with coverage either being unavailable or too expensive to purchase. States are losing jobs as companies have to scale back costs. As the job losses occur, the economies falter. Despite the assessment of the blame, we have a crisis that has to be addressed and remedied.

We cannot simplify the problem and say that we will stop states from regulating the industry and have a national preemption of state laws that regulate the industry in their respective states. I served in State government for 17 years and know that regulation is needed at that level as the needs of the individual states differ and have different influences. Local officials are familiar with the particular idiosyncrasies of their states and cities and can prescribe solutions better than a federal blanket regulation. The States do have the responsibility to be reasonable in their regulations. The insurance industry has to be able to make a profit and through doing so attract investors to the industry. We have to find a common ground from which to solve this national crisis.

Mr. Chairman, I am eager to hear the testimony of the panel and have questions that need to be answered. Additionally, I ask unanimous consent to submit my statement to the record.

OPENING STATEMENT OF LUIS V. GUTIERREZ SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES "THE EFFECTIVENESS OF STATE REGULATION: WHY SOME CONSUMERS CAN'T GET INSURANCE" APRIL 10, 2003

Dramatic improvements in insurance regulation are needed to promote beneficial competition and to protect consumers.

The auto insurance industry also must do more to fight fraud. Insured motorists spend an exorbitant amount of money each year on fraudulent claims and they continue to pay far too much for far too little coverage. This practice needs to stop.

I hope that today's hearing will serve as an opportunity to address this issue and to discuss the lack of availability of affordable insurance for consumers.

Before I conclude, I would like to bring up an issue of great importance to me. This issue is the process of insurance scoring and how it impacts the availability of insurance products. Currently, 90 percent of property insurers use credit scoring as a determining factor in their approval process and as a means to derive rates.

However, according to Consumer Reports, 70 percent of credit reports contain factual errors and 29 percent have at least one major miscalculation that could greatly tarnish an individual's ability to obtain reasonable insurance rates or cause them to be completely denied coverage.

The increased emphasis placed on the use of insurance scores in the underwriting process is particularly troubling given that no one has been able to identify the exact causal relationship between credit characteristics and insurance loss ratio relativities.

To further compound on these issues, the Florida Task Force on the Use of Credit Reports in Underwriting Automobile and Homeowners Insurance concluded that the use of credit reports has a negative impact on young people, minorities and people with low-incomes.

This is why I recently introduced H.R. 1473, the Insurance Credit Score Disclosure and Reporting Act. Through the enactment of this bill, insurance companies who utilize insurance "scoring" in underwriting decisions, including policy renewals, would be required to provide much-needed disclosures to consumers including the use of insurance scores and the explanation of the scoring criteria used by insurers to determine risk.
My bill would also require insurance companies to disclose the weight of each criterion and how

an applicant scored in each area. It would further prohibit any adverse actions to be taken against an individual based on little or no credit history, unusually high bills created by medical emergencies and other special circumstances.

We have a responsibility to help consumers understand that paying a credit card bill or loan late could negatively impact their ability to obtain adequate coverage and affordable rates on automobile or homeowners insurance.

This common sense legislation would provide the needed transparency that will help protect consumers against discriminatory practices and will provide them with the necessary tools to improve their situation.

While shedding light on insurance scoring practices, this bill would also greatly enhance the availability and affordability of insurance products and services to consumers and small businesses of all economic circumstances and in all geographic areas.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE EFFECTIVENESS OF STATE REGULATION: WHY SOME CONSUMERS CANNOT OBTAIN INSURANCE

THURSDAY, APRIL 10, 2003

Mr. Chairman, we meet today to examine how different forms of state regulation in the personal property and casualty marketplace affect the availability of insurance, the affordability of policies, and the profitability of the industry. This hearing also represents the first time in the 108^{th} Congress that our Subcommittee has met to consider insurance issues.

Before we hear from our experts, I believe that it is important to make some observations about the insurance industry. Insurance, as my colleagues already know, is a product that transfers risk from an individual or business to an insurance company. Every single American family also has a need for some form of property and casualty insurance, especially products like auto and homeowners insurance. Additionally, according to the National Association of Insurance Commissioners, more than 3,200 property and casualty companies helped to meet the insurance needs of American families and businesses in 2000.

A.M. Best also reports that insurers underwrote $163 billion in personal line premiums in 2001, slightly more than half of the total property and casualty industry. In addition, the largest lines of personal property and casualty marketplace are auto and homeowners insurance. The insurance industry underwrote nearly $128 billion in net premiums in 2001 for private passenger auto insurance, up from $113.6 billion in 1997. The net premiums for homeowners insurance also grew in the same time frame from $26.9 billion to more than $35 billion.

Furthermore, insurance differs from most other products in that insurers must price and sell their policies before knowing the full cost of the coverage. As a result, insurers often pay out more in claims than they collect in premiums. For example, in 2001 insurers paid out $1.16 for every dollar in earned premium according to A.M. Best. One of our witnesses today will also make the point that property and casualty insurers paid $22 billion more in claims and expenses than they collected in premiums in 2002.

To compensate for these balance-sheet shortfalls, insurance companies have increasingly relied on income from their investments. Fortunately, the net investment income of property and casualty insurance companies has trended upward since 1980, and this income stream has helped insurers to offset their annual underwriting losses. In particularly good years on Wall Street, some have suggested that this investment income may have also helped to keep premiums artificially low. I would like our experts today to address this point.

As you know, Mr. Chairman, the McCarran-Ferguson Act also authorized the states to regulate the insurance business, and the Congress recently reaffirmed this system in approving the Gramm-Leach-Bliley Act. As a result, each state currently has its own set of statutes and rules governing the insurance marketplace. Traditionally, the states have highly regulated the personal property and casualty insurance industry with rate controls and pre-approval of new products. In recent years, however, many states have begun to experiment with their regulatory models. In an effort to promote greater competition in the insurance marketplace, some states have even decided to exempt the industry from long-standing anti-trust protections.

From my perspective, promoting competition through fair and effective regulation should ultimately result in better and more affordable insurance products for consumers. The states, in my view, must also continue to work proactively to modernize their systems for regulating the insurance marketplace. Absent continued advances in these state insurance regulatory efforts, the Congress may need to consider altering these statutory arrangements through the creation of an optional federal chartering system or the promotion of greater uniformity in insurance regulation across state lines.

In closing, Mr. Chairman, I want to commend you for bringing these matters to our attention. I believe it important that we learn more about the views of the parties testifying before us today and, if necessary, work to further refine and improve the legal structures governing our nation's insurance system. I yield back the balance of my time.

Statement Congresswoman Sue Kelly
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing: "The Effectiveness of State Regulation: Why Some Consumers Can't Get Insurance"
April 10, 2003

Good morning, and thank you, Chairman Baker, for holding this important hearing on insurance availability – an issue that is of great concern to this Committee and consumers across the country.

I strongly believe all Americans deserve access to affordable insurance. Today, the insurance market faces a perfect storm: growing losses, lower investment returns and inefficient regulation coupled with price controls have left many States in a crisis. And it is the responsibility of these States and their insurance commissioners to promote a competitive climate in which consumer choice can be achieved.

Unfortunately, some States have chosen to adopt heavily price-regulated models that have driven insurers out of the market and stifled competition. When States determine what prices insurers are allowed to charge – whether it is in the form of capping premiums or imposing price controls – we have seen this overregulation place a tremendous strain on the system.

Last Congress, I held a hearing in the Oversight and Investigations Subcommittee on the effects of state over-regulation of auto insurance on consumer choice. In the hearing, we touched on the competition-based reforms that South Carolina and Illinois enacted – two states represented on today's panel. As a result of their reforms, both of these States currently have numerous auto insurance companies providing consumers with real choices at competitive prices. The answer to high auto insurance rates is clear: more competition is more effective than just regulation.

I am pleased that when it comes to auto insurance we also have gotten this right in my home state of New York. But I am concerned that price controls in nearby states, like New Jersey, may also have a negative impact on other out-of-state consumers.

Today, we will hear from a number of witnesses from diverse states with unique experiences. But the common themes we will hear are that excessive regulation and price-regulated insurance models create extremely harmful conditions to consumer choice and overall availability.

I thank the witnesses for appearing before the subcommittee and look forward to hearing their testimony.

COMMITTEE ON TRANSPORTATION
AND INFRASTRUCTURE
CHAIRMAN, SUBCOMMITTEE ON
ECONOMIC DEVELOPMENT, PUBLIC BUILDINGS
AND EMERGENCY MANAGEMENT

COMMITTEE ON
GOVERNMENT REFORM

COMMITTEE ON
FINANCIAL SERVICES
VICE CHAIRMAN, SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT

COMMITTEE ON
STANDARDS OF OFFICIAL
CONDUCT

Steven C. LaTourette
Congress of the United States
14th District, Ohio

April 10, 2003

Mr. Chairman, thank you for the opportunity to participate in this hearing today on an issue that affects countless Americans and many individuals in my district in Northeast Ohio. There's no question that portions of the American insurance industry are in trouble and that availability of personal lines of property-casualty insurance is declining, and consumers are being forced to shoulder much of the burden.

For homeowners and automobile drivers in particular – as this hearing will address – rising construction, maintenance, and purchase costs for consumers have led to skyrocketing rates and insurers becoming increasingly selective in their policy writing. As a result, people are finding unexpected roadblocks to buying a home, being forced into contracts with ridiculously high rates, and are more frequently choosing to pay out-of-pocket for things that could normally be covered by their policies. To me, this is completely contrary to the very reason insurance exists: Why should I, as a consumer, choose to increase my deductible, pay for a repair to my car or home that could easily be covered by my policy, *and* continue to send premium payments to the insurance company? What's the point? What is my money paying for? The definition of "insurance" is the coverage by contract whereby one party undertakes to indemnify or guarantee another against loss. But if my insurer drops my policy, be it after one year or 30 years of being a loyal customer, because I have a string of bad luck that's no fault of my own, then there's a fundamental flaw in the system that is distinctly anti-consumer.

All of that said, there's no question that a struggling U.S. economy combined with rising costs of medical claims, automobile and home repair, and varied degrees of state regulation have made it a difficult environment for insurers to operate in. I read one particularly striking example in a piece by Dr. Hartwig (whose testimony I look forward to hearing today) stating that homeowners insurers over the past decade paid out $1.18 in losses and expenses for every one dollar they earned in premiums. Combine that with a litigious society anxious for big settlements in mold claims, and increasing amounts of catastrophe-related losses that cost consumers and insurers billions of dollars each year, and it becomes obvious that there's a growing crisis that needs to be addressed.

Since there's no federal insurance regulator, we have before us today representatives from several state insurance commissions, demonstrating how legislation and regulation can both support – and cripple – an industry. While the folks from the Ohio Department of Insurance in my home state aren't here today, I'm happy to report that they're on the right end of that spectrum and continue to do a remarkable job for the residents of Ohio.

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Historically, Ohio has one of the best insurance markets for consumers:

- Currently there are some 300 property and casualty policy writers in Ohio, and the State ranks 3rd in the nation for the best homeowner's insurance premiums and 15th in automobile premiums, better than any other state with large urban centers.
- There are over 166,000 licensed agents doing business in Ohio, and the State ranks 7th in the nation in the number of life insurance companies located in the state, and is home to 2 of the top 5 auto insurers – Progressive (which is located in my district) and Nationwide.
- Ohio is also leading the way to modernize rate and form filing review without compromising important consumer protections. The Ohio Department of Insurance was among the first in the nation to begin development of an electronic rate and form filing system which speeds up the review and approval time, protects consumers, and allows businesses to get their products to the market faster.

Thank you, Mr. Chairman. I look forward to hearing the testimony of all the witnesses, and hopefully today some questions will get answered.

Outline of Testimony Before the
Congress of the United States of America
House of Representatives Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

April 10, 2003
10:00 a.m.

Ernst N. Csiszar
Director of Insurance
State of South Carolina

The Effectiveness of State Regulation: Why Some Consumers Cannot Obtain Insurance

I. Introduction

Mr. Chairman, ranking member Kanjorski, members of the Subcommittee,

Good morning, my name is Ernie Csiszar, and I am the Director of Insurance for the State of South Carolina. Thank you for the opportunity to speak to you today on the topic of the effectiveness of state regulation and why some consumers cannot obtain insurance. Let me state at the outset that in South Carolina our consumers are able to obtain insurance.

In addition to the traditional issues of insurer solvency and market conduct, insurance availability and affordability have become guiding general principles of insurance regulation. A variety of factors contribute to insurance availability and affordability within the market, perhaps not the least of which is the regulatory environment itself.

As you are aware, there are a variety of rate regulatory structures in effect in this country. These structures range from state-made rates and rating bureau adherence to an open market system relying on the anti-trust laws. Different lines of property and casualty coverage may be accorded varying levels of regulatory oversight. However, most processes are generally categorized as either "prior approval" or "competitive." While the regulatory processes may differ by state, the same principles guide every state's rate regulation: that the rates be adequate (to maintain insurer solvency), but not excessive (too high) or unfairly discriminatory (unfairly discriminating between members of the same class).

I am here today to discuss the affordability and availability of insurance within the property and casualty insurance market in South Carolina, with particular emphasis on how state regulation can affect affordability and availability. In this respect, I will discuss South Carolina's experiences and our efforts to modernize insurance regulation.

Property and casualty markets tend to exhibit unique local characteristics. Let me highlight some characteristics of South Carolina as an example. South Carolina's terrain is as varied as any you might find. We have beaches in one part of the state, low-lying areas in some parts of the state, and mountains in others. Our state is exposed to natural disasters such as hail, hurricanes, tornados, and flooding. The City of Charleston is on an earthquake fault. This makes for a very challenging property market.

Traditionally, South Carolina has regulated its property and casualty market by use of a prior approval system with significant restrictions on the ratemaking process. This is where change is taking place. Issues of insurance availability and affordability as well as rate subsidization in the mid-1990's initiated a change in the regulatory philosophy of the South Carolina Department of Insurance and the lawmakers in our state. By moving from a strict prior approval process to a more open market approach, we are better able to focus on what is essential to insurance regulation.

II. History of Rate Regulation

Prior approval developed as a method of preventing insurer insolvency. Early rate regulation emerged as a result of insolvencies triggered by catastrophes and overly zealous forms of competition. Insolvent insurers cannot compensate their policyholders. Rate regulation, in general, developed from the recognition that the health of the insurance industry was dependent upon quality of information, analysis, and accurate underwriting performed by insurers. Rate bureaus were created to collect and segregate data to make class plans and to prevent insolvency. Insurers were required to adhere to bureau filed rates and rating systems.

Three factors have influenced the direction of rate regulation activities since the late 1960's. First, some states, believing competition would do a better job of arriving at prices that more accurately reflect underlying costs of insurance, moved in the direction of reliance on competition among insurers to better control rising prices.[1] Second, in the mid-1980's, federal price deregulation occurred in airlines, trucking, railroads and financial services. As a result, some states adopted laws based on a model competitive rating law adopted by the National Association of Insurance Commissioners (NAIC) in 1980.[2] For example, states moved to rely on competition in workers' compensation prices. By the late 1990's, most workers' compensation premium was collected relying on competitive pricing.[3] However, two developments converged to produce a movement back in the direction of prior approval rate regulation.[4] In 1986-87, there was a spike and shortage in municipal and other general liability insurance. Moreover, there was an upsurge in auto insurance premiums driven by substantial increases in liability, repair costs and fraud related costs.[5] The result was Proposition 103 in California. Voters opted

[1] *See, e.g.,* Philip R. O'Connor, Ph.D. and Eugene Esposito, J.D., *Modernizing Insurance Rate Regulation: Tacking to the Winds of Change,* A Report Delivered to the National Conference of Insurance Legislators Property and Casualty Committee Hearing on Proposals for Personal Lines Deregulation March 2001).
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.*

to replace California's competitive rating law with a prior approval system.[6] Third, the deregulation of rates and policy contract forms for larger commercial insurance risks has had a significant impact on regulatory rate policy.[7]

III. South Carolina's Efforts to Modernize Insurance Rate Regulation

A. South Carolina's Move toward the Competitive Rating Model

The State of South Carolina is moving toward a competitive approach to rate regulation in our personal and commercial lines property and casualty insurance markets. These changes will not only affect rates, but will, in the future, affect policy forms as well. I say moving, because the process is evolving and not yet complete. We are pursuing this approach to rate regulation in our property and casualty insurance markets because we think it is the right way to address any availability and affordability issues. The successful reform of our automobile insurance market has made this an easier process.

B. Reforming the Automobile Insurance Delivery System in South Carolina

For years, neither actuarial methodology nor supply and demand had much to do with automobile insurance ratemaking in South Carolina. Politics drove that ratemaking process within our state. Politically, there was never an opportune time to raise insurance prices. This resulted in significant rate suppression. In the short term, rate suppression kept the costs of insurance down. However, in the longer term, insurers were leaving the market because they were unable to secure an adequate rate for their product. Hence, the level of competition within the market decreased.

Rate suppression, as well as frequent legislative changes designed to address short-term ills of one form or another, also sent the wrong signals to the market. These provided incentives to consumers to continue to engage in risky behavior (e.g., speeding), because the insurance premiums they paid were artificially low for some and did not accurately reflect their insurance risk. Consequently, in this system, good-risk drivers were subsidizing the insurance of bad-risk drivers.[8]

To put things in perspective, here is some history. In 1974, South Carolina enacted S.C. Act No. 1177, which imposed numerous mandates on automobile insurers writing in South Carolina including a mandate-to-write, risk classifications and territorial plans. This mandate-to-write required insurers to provide insurance coverage to all who applied irrespective of risk. In 1980, South Carolina had approximately 159 insurers writing within the state, but almost half had left the market by 1996. Concomitantly, the

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[6] *Id.*
[7] *Id.*
[8] A bad-risk driver is a driver with multiple driving violations. A good risk driver is a driver without multiple driving violation or insurance points.

number of insurers writing homeowners insurance decreased from 175 in 1980 to about 117 in 1996-97.

The regulatory system in most states is comprised of a voluntary market and a residual market. The residual market is generally established as a market of last resort for consumers who are unable to secure insurance coverage within the voluntary market. Act 1177 created the South Carolina Reinsurance Facility[9] as South Carolina's residual market mechanism. The size of the residual market is an indication of how well a system is working. It is generally agreed, that in a properly functioning market, the residual market should not exceed 5%.

However, South Carolina's market of last resort soon became the primary writer of private passenger automobile insurance coverage in this state. At one point, the South Carolina Reinsurance Facility had over 40% of all drivers. More importantly, the rates charged by the Facility were not adequate. Consequently, the South Carolina Reinsurance Facility was losing money. It had an annual deficit that reached as high as $200 million at one point.[10]

In 1988, the state instituted a recoupment fee to recover losses of the South Carolina Reinsurance Facility.[11] Each South Carolina driver had to pay a proportionate share in recoupment fees to recover the losses. Consequently, good-risk drivers complained that they were subsidizing the insurance premiums of the bad-risk drivers. There were no incentives for bad-risk drivers to reduce or alter their risk-taking behavior. The automobile insurance delivery system became a tremendous political issue, and issues of automobile insurance availability and affordability dominated the discussions at the state house for over a decade.

It is important to note that the automobile insurance market that existed in South Carolina in the mid-1990's was ***not*** the one South Carolina regulators or legislators intended to create 20 years earlier. It emerged as a result of unintended consequences. A number of factors are responsible for its evolution, including politics and unrealistic public expectations that speeding tickets, at-fault accidents and driving under the influence should have little or no impact on one's insurance rates. Corrective changes were piecemeal and lacked focus. The need for change was evident.

Even though insurers and state regulators have a responsibility to attempt to provide consumers with insurance products that are stable from an insurer solvency perspective and at the same time available and affordable, consumers must also share in this responsibility. If consumers fail to avail themselves of the opportunity to learn how their actions can influence the industry and continue to participate in risky behavior,

[9] The South Carolina Reinsurance Facility was an unincorporated, nonprofit legal entity that replaced the assigned risk plan in 1974. Under a reinsurance facility system, companies are required to accept all customers. Following the sale of an insurance policy, the company may cede the policy and its premium to a joint risk pool of all insurance companies. Facility policies are serviced by the companies to whom the drivers originally applied. Losses and profits are apportioned among the insurance companies.
[10] Martin F. Grace, *et al.*, *Auto Insurance Reform: Salvation in South Carolina*, Brookings Institute (2001).
[11] *Id.*

problems will continue to exist in these areas. It is only when all three groups work together that the desired results can be obtained.

The change came in 1997 following the release of an audit report by the South Carolina Legislative Audit Council which concluded that the automobile insurance delivery system in South Carolina needed to be reformed.[12] As a result of that report and consumer outrage in 1997, the General Assembly enacted legislation that radically reformed the automobile insurance delivery system in South Carolina. Act 154:

- Eliminated the mandate-to-write private passenger automobile insurance.
- Created a modified prior approval or flex rating system that allowed insurers to file and use rates once a year that were +/-7% or less; all other rate change requests were subject to prior approval.
- Eliminated the Uniform Classification and Territorial Plans and permitted insurers to file individual classification and territorial plans; these plans were subject to the prior approval of the Department.
- Eliminated the recoupment fee for good-risk drivers by March 1, 2003.
- Instituted stiff penalties for companies engaging in unfair discrimination.
- Replaced the South Carolina Reinsurance Facility with a joint underwriting association for four years. The joint underwriting association was then converted into an assigned risk plan.
- Instituted stiffer penalties for driving uninsured in South Carolina and created a mechanism for better enforcement of the compulsory insurance laws.

These changes were based on the competitive rating model. This new automobile insurance delivery system went into effect on March 1, 1999. It has been in effect for a little over four years now. Let me share with you some statistics.

- The number of insurers in our market increased from 78 in 1996 to 165 as of March 1, 2003.
- The information that we have on automobile insurance rates in our system suggests the following:
    - South Carolina's ranking according to the NAIC Average Premium Expenditures Report has improved.
    - Consumers are able to find competitive rates within the voluntary market.

[12] Report, South Carolina Legislative Audit Council, *The South Carolina Reinsurance Facility* (1997). The 1997 Legislative Audit Council Report recommended that the General Assembly consider amending the auto insurance laws of this state to: (1) give insurance companies increased flexibility in setting insurance premium rates; (2) allow insurance companies to refuse to sell insurance to any driver for reasons other than race, ethnicity, or other related unfairly discriminatory factors; (3) replace the South Carolina Reinsurance Facility with a joint underwriting association and then an assigned risk plan; (4) eliminate the recoupment fees; and (5) eliminate the designated insurance agents system in South Carolina.

- o Our residual market has decreased from over 600,000 policies in 1999 to approximately 340 policies as of March 1, 2003 in all residual market mechanisms.[13]

- No insurer has more than 25% market share.[14]
- Consumer complaints about having to pay recoupment fees have decreased significantly. We believe consumers now have a better understanding of how their behavior can affect the cost of their insurance coverage.
- The number of insurers writing private passenger automobile insurance coverage continues to increase.
- The Department, industry, legislators and consumer groups work cooperatively to craft insurance-related legislative initiatives for the market.

One of the keys to the success of these reforms was providing an adequate transition period to avoid market disruption. These changes were phased in over roughly a two year period.

South Carolina still regulates many aspects of our automobile insurance market. However, our approach to regulatory oversight has changed:

- This Department monitors markets and competition more closely than it has in the past.
- We encourage consumers to shop around for insurance coverage and provide market assistance.
- We actively recruit companies to address availability issues that may arise in segments of the market.
- We are in the process of drafting legislation to institute a fraud section within the Department of Insurance to complement the insurance fraud efforts of the South Carolina Attorney General's Office.

These are all indications to us that the market is functioning as it should. The changes are significant and positive for a primarily rural state that ranks high in automobile fatalities.[15]

In order for any regulatory system to work properly, enforcement must become a priority. South Carolina has long had a high number of uninsured motorists. The evidence suggests that number dropped after 1999 with the adoption of several preventative measures and stricter enforcement of financial responsibility requirements. This remains

[13] There are no policies in the South Carolina Reinsurance Facility; 330 policies in the South Carolina Associated Auto Insurers Plan, which is in run-off, and 7 policies in the assigned risk plan. These figures are as of March 1, 2003.

[14] This information was obtained from the South Carolina Market Share Report reflecting business written in 2001. The amounts listed are developed from the amounts reported on the insurers' 2001 South Carolina Fee and Tax Returns and verified with the annual amounts reported on the Business Page of their 2001 Annual Statements.

[15] Statistics indicate that South Carolina ranks 12th nationally in automobile fatalities and 2nd nationally in DUI fatalities. This information was provided by the National Highway Traffic Safety Administration of the United States Department of Transportation.

an issue, though, and the state continues to improve its efforts to detect and prosecute uninsured motorists.

C. *Modernization of Commercial Lines Regulation*

Like a number of other states, South Carolina re-engineered its commercial lines market. In 2000, we eliminated prior approval requirements for commercial policies with a threshold of $50,000 in premium. In 2002, we removed that threshold. Not all commercial lines were included within this process. Medical malpractice and credit-related insurance products remain subject to prior approval.

The regulatory changes were implemented in accordance with our desire to increase competitiveness. We also created an Alternative Risk Transfer Services Division to address availability and affordability issues within commercial lines of insurance.

South Carolina's law eliminates the requirement that commercial policies and rates marketed to large commercial entities be approved by the Department of Insurance prior to issuance. These policies can be filed on a "deemer" basis.[16]

The response to the change in our commercial lines market has been very positive. This market has stabilized as a result of this effort, and we are contemplating instituting a file and use system for all commercial policy forms. We believe this move will encourage more companies to enter and write in the South Carolina commercial lines property and casualty market by allowing them to get their products to market in a timely fashion.

D. *South Carolina's Homeowners Insurance Market*

According to the Insurance Information Institute, the high number of catastrophes, high costs of home repairs, the aging of the United States homes and the emergence of mold claims are pushing homeowners rates upward. In South Carolina, we have had some experience with this. Hurricane Hugo cost the industry $4 billion in 1989. Increasing population growth and increasing property values in an area subject to catastrophes makes us anticipate a future capacity problem in the coastal areas of the state.

Even though we have seen the entry of more insurance companies as a result of automobile insurance reform, we anticipate needing significantly more capacity than currently exists. We are currently considering introducing a competitive model to the South Carolina property and casualty homeowners insurance market in an attempt to improve insurance affordability and availability. The Department plans to introduce a bill based on a National Conference of Insurance Legislators (NCOIL) model similar to what is being done in Illinois (where the Director will certify the

[16] This means the regulator would have a certain period of time within which to act on the filing or the filing would automatically be deemed approved.

competitiveness/stability of the market). Due to its comprehensive nature, it will be implemented in phases, like our automobile insurance delivery reform efforts, to prevent market disruption. The reforms will include flex-rating for homeowners and a gradual transition to the NCOIL model.

IV. <u>Conclusion</u>

As Director of Insurance for the State of South Carolina, I am an ardent supporter of state insurance regulation. Notwithstanding, my colleagues and I understand that the property and casualty insurance marketplace in 2003 differs significantly from the market 10, 20 or 30 years ago. My colleagues and I understand that fair, effective and efficient regulation is good for the consumer and the industry. Availability, affordability, fair competition, a knowledgeable consumer, quality customer service and solvency are our objectives. This is what we are accomplishing in South Carolina. Too many changes have occurred within the financial services market to continue to regulate the business of insurance as we did forty years ago. In recognition, the NAIC is re-engineering many regulatory processes.

Our experience suggests that, much like Illinois, the competitive rating model works. The automobile insurance climate in South Carolina has improved. Consumer complaints have decreased. There are more insurers operating. The market is more competitive. Insurance premiums more closely reflect the claims experience of the insured. Now, instead of focusing on the insurance premiums, our General Assembly spends time on bills dealing with the true "cost drivers" of insurance:

- DUI;
- Drivers Training;
- Guard Rails;
- Uninsured Motorists;
- Mandatory Seatbelts; and
- Motorcycle Helmets.

Consumers are offered far more choice than ever. No insurer has more than 25 % of the market. This is markedly different from our market five years ago. Most importantly, our consumers appear to understand the power and importance of shopping around for the best coverage and the best rates.

South Carolina and Illinois are good examples of how competitive rating models, when accompanied by appropriate regulatory oversight and market monitoring, work efficiently. With appropriate solvency and market conduct regulation, competition can be used as an effective regulatory tool to ensure that rates as well as forms comply with the applicable law.

I thank you very much for your time and for the opportunity to share South Carolina's experiences with you.

TESTIMONY AS DELIVERED

BY

ROBERT P. HARTWIG, PH.D., CPCU

SENIOR VICE PRESIDENT & CHIEF ECONOMIST

INSURANCE INFORMATION INSTITUTE

NEW YORK, NEW YORK

BEFORE THE HOUSE FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS,

INSURANCE AND GOVERNMENT SPONSORED

ENTERPRISES

APRIL 10, 2003

Thank you, Mr. Chairman, and members of the Committee.

The Committee has asked me to testify today regarding the overall economic performance of the property/casualty insurance industry, the industry's rate of return and to contrast that performance to other industries.

The 1990s and these opening few years of the new millennium have been very difficult for insurers. Natural disasters of unprecedented frequency and ferocity cost the industry nearly $110 billion between 1990 and 2002 while the September 11 terrorist attacks produced the largest insured losses in United States and world history, amounting to some $40 billion. Tort costs paid by insurers amount to nearly $130 billion per year.[1] Insurers are also subject to an extraordinarily complex array of rules and regulations that significantly impair an insurer's ability to earn an adequate rate of return and attract or retain capital needed to cope with these problems.

Earning an adequate rate of return is a core concern of all heavily regulated industries. From 1988 through 2002, profitability in the property/casualty insurance industry (as measured by return on equity) underperformed the Fortune 500 by an average of 5.3 percentage points (Exhibit 1). Return on equity essentially reflects the rate of return to investors who put their money into the business. Exhibit 1 clearly indicates that investors in most years would have done much better by investing in other industries or a broadly diversified portfolio of stocks, such as is represented by the Fortune 500 or S&P 500. The performance gap is even more striking when the high relative risk of investing in property/casualty insurers is taken into account. Indeed, the industry's estimated 4.4 percent rate of return last year was even less than the 4.6 percent that investors earned *risk free* on 10-year U.S. Treasury securities. The inevitable consequence of repeatedly disappointing investors is a diminished ability to attract and retain capital, shrinking capacity on a global scale, ratings agency downgrades and a loss of investor confidence as manifested by falling share prices. All three are presently coming to pass in the p/c insurance industry.

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[1] Tillinghast Towers-Perrin estimate for 2000.

Underwriting losses over this same period, which represent the amount by which losses and associated expenses exceed premium income, were also enormous, totaling nearly $350 billion (Exhibit 2). Focusing on insurers' more recent performance reveals that the period from 1999 through 2002 witnessed four of the six largest underwriting losses in the history of the U.S. property/casualty insurance industry. Last year's $22 billion underwriting loss—while a marked improvement from the terrorism-impacted $52 billion loss in 2001—indicates a continued drain on the industry's capital. In the final analysis, it is investor money that is lost. Investors observing these losses and associated low rates of return will be unlikely to invest in the property/casualty insurance industry unless they have a reasonable expectation that financial performance will improve in the near future.

Not surprisingly, the three most heavily regulated lines of insurance—auto insurance, homeowners insurance and workers compensation—have produced below average returns in recent years (Exhibit 3) and generated some of the largest losses. These three products alone account for roughly 60 percent of all premiums earned by insurers. Consequently, when underlying loss trends shift adversely, pushing costs up sharply, insurance companies that sell heavily regulated insurance products are *guaranteed* to lose money. Deliberate suppression of rates, delays in the rate approval process (another form of rate suppression) and delays in the approval of new forms, invariably cost insurers billions of dollars in unnecessary losses each year, leading to reduced availability for consumers.

Why This Matters to Consumers

Presently the availability of property/casualty insurance coverage is shrinking and prices are rising as a result. A sharp drop in the pool of capital available to underwrite insurance is a principal factor fueling increases in the cost of insurance today. Capital held by U.S. domiciled property/casualty insurers has plunged by nearly 20 percent or $63 billion since mid-1999 (Exhibit 4). Foreign capital, which is critical to the U.S. insurance market, is also shrinking. Globally, capacity fell by an estimated 25 percent or $230 billion from between 2000 and 2002 (Exhibit 5). Because such a large proportion of foreign insurers' capital is actually allocated to back-up policies written in the United States, current and prospective investors outside the U.S. are less likely to supply capital unless they are reasonably assured that losses will narrow and rates of return rise in the near future.

Investment Environment

Over the past year industry critics have attempted to lay blame for higher insurance prices on "reckless" investment strategies by insurers. While earnings from investments have declined for insurers over the past several years, as they have for all investors, the property/casualty insurance industry still generates significant cash flow from its investment portfolio—an estimated $39.5 billion in 2002 alone (Exhibit 6). Investment earnings are simply returning to their pre-bubble levels. Two-thirds of the industry's invested assets are in the form of bonds, while only about 20 percent of the industry's portfolio is invested in common stock. The decline in investment gain over the past several years merely reflects the downward trend in interest rates—which now stand at 40-year lows—as well as fewer opportunities to realize capital gains on the stock portfolio.

The Legend of the Price Gouging Insurer

Critics of the property/casualty insurance industry have also asserted that recent increases in the cost of insurance are unjustified and that insurers are simply "gouging" consumers. The rate-of-return and underwriting loss figures discussed earlier clearly suggest otherwise. Moreover, the cost of auto, home and commercial coverages remains very reasonable by historical standards. The cost of homeowners insurance, for example, relative to the cost of the home itself has decreased or remained stable every year since 1994 (Exhibit 7). Likewise, the cost of risk to businesses, which is driven primarily by insurance expenditures, relative to revenues is roughly the same today as it was a decade ago (Exhibit 8).

Thank you.

EXHIBITS

TESTIMONY AS DELIVERED

BY

ROBERT P. HARTWIG, PH.D., CPCU

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INSURANCE INFORMATION INSTITUTE

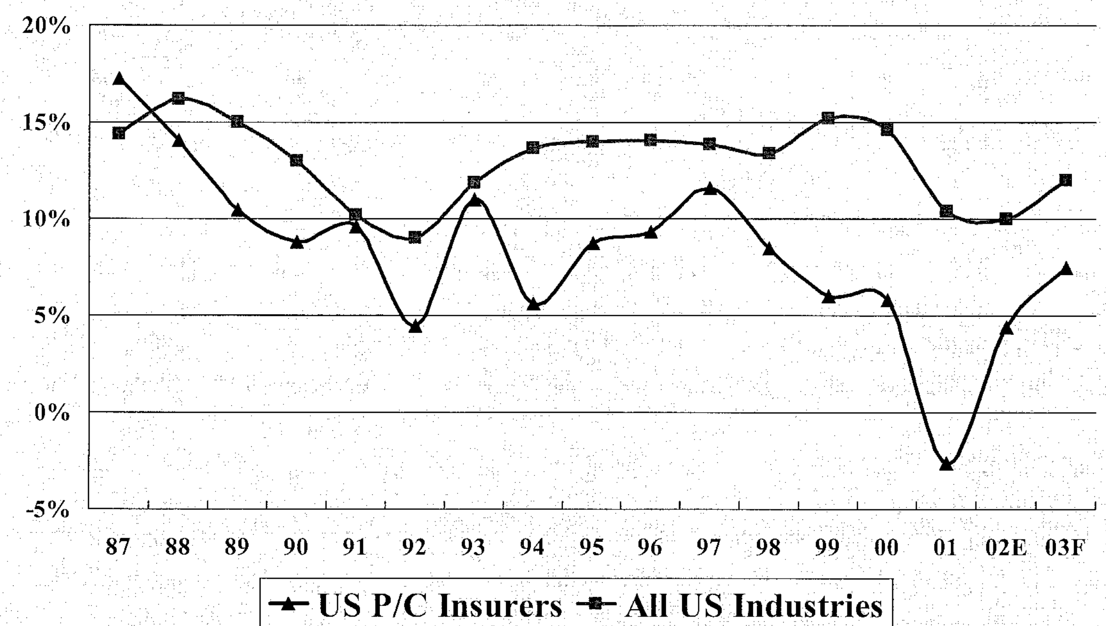
NEW YORK, NEW YORK

BEFORE THE HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE ANG GOVERNMENT SPONSORED ENTERPRISES

APRIL 10, 2003

Exhibit 1.

ROE: P/C vs. All Industries: 1987–2003F



Source: Insurance Information Institute; *Fortune*

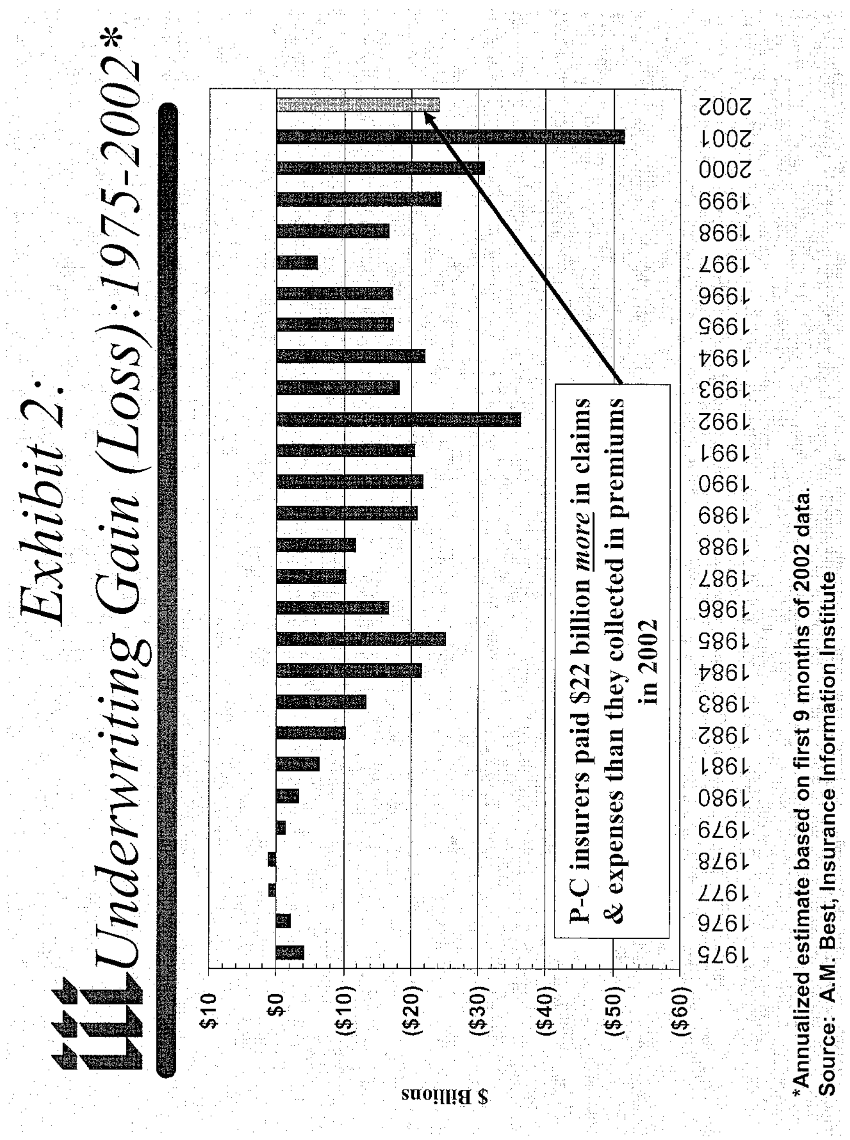
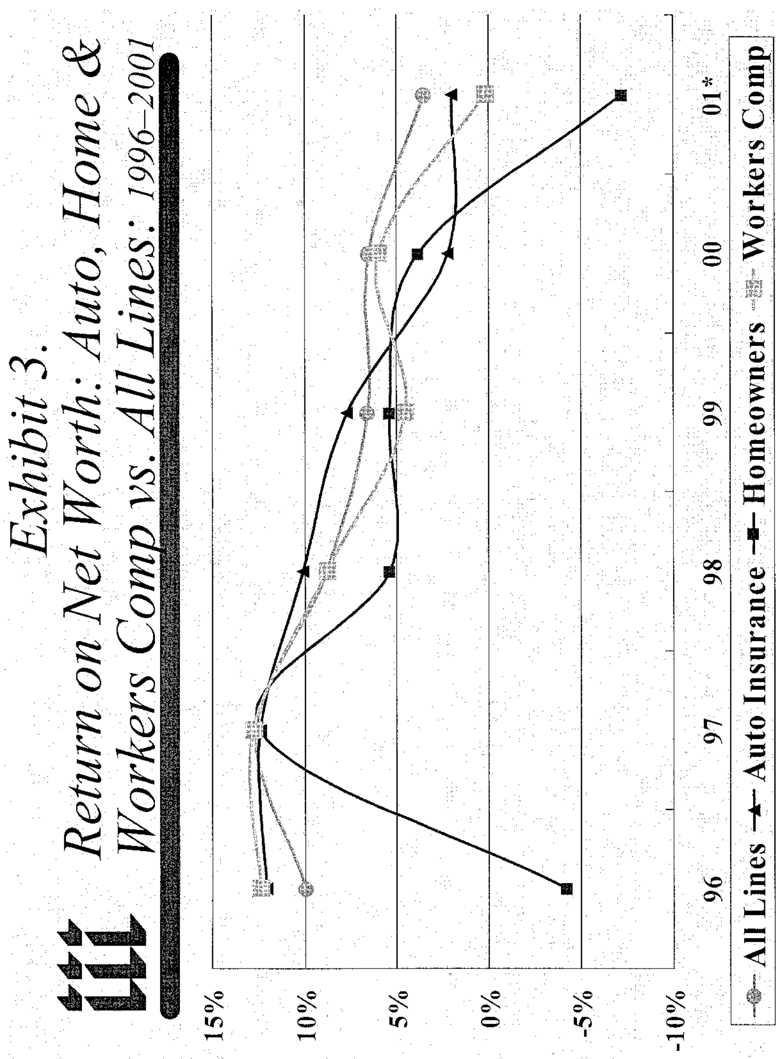


Exhibit 2:
Underwriting Gain (Loss):1975-2002*
$ Billions
$10
$0
($10)
($20)
($30)
($40)
($50)
($60)
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
P-C insurers paid $22 billion *more* in claims & expenses than they collected in premiums in 2002
*Annualized estimate based on first 9 months of 2002 data.
Source: A.M. Best, Insurance Information Institute

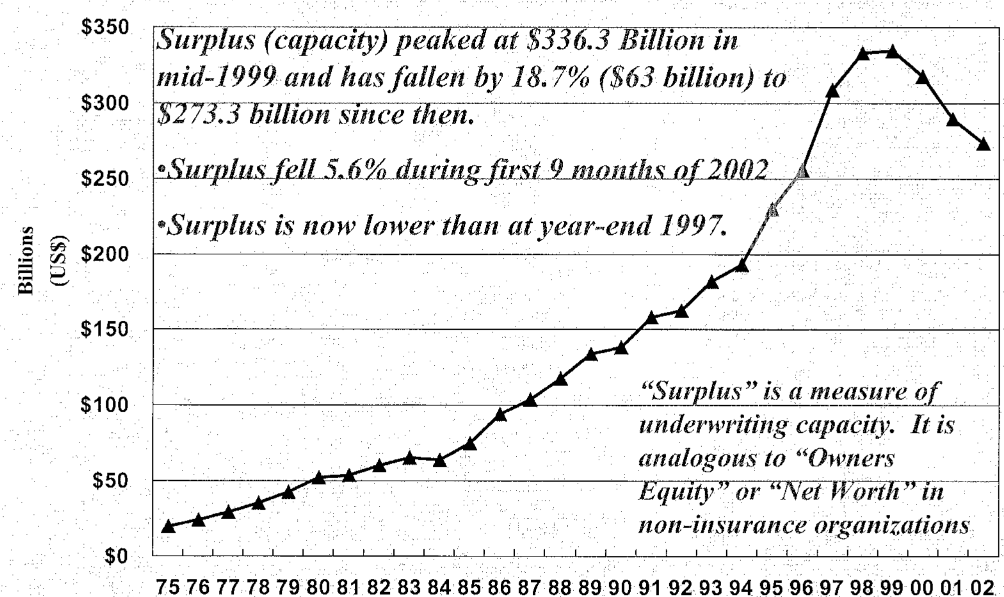


*All Lines 2001 figure is adjusted to remove the impact of 9/11 terrorist attacks.

Source: National Association of Insurance Commissioners, Insurance Information Institute.

Exhibit 4.

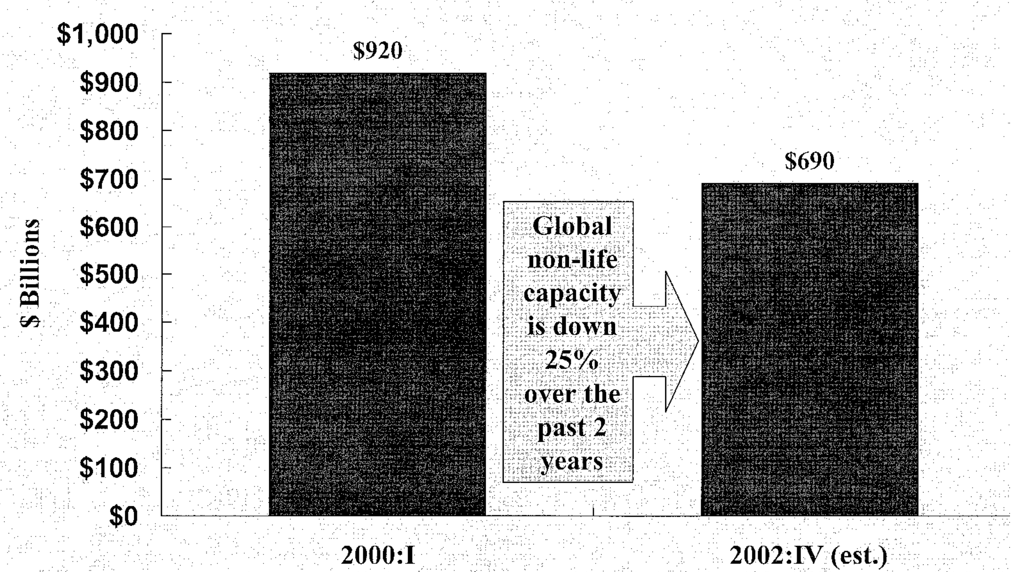
Policyholder Surplus: 1975-2002*



*As of September 30, 2002

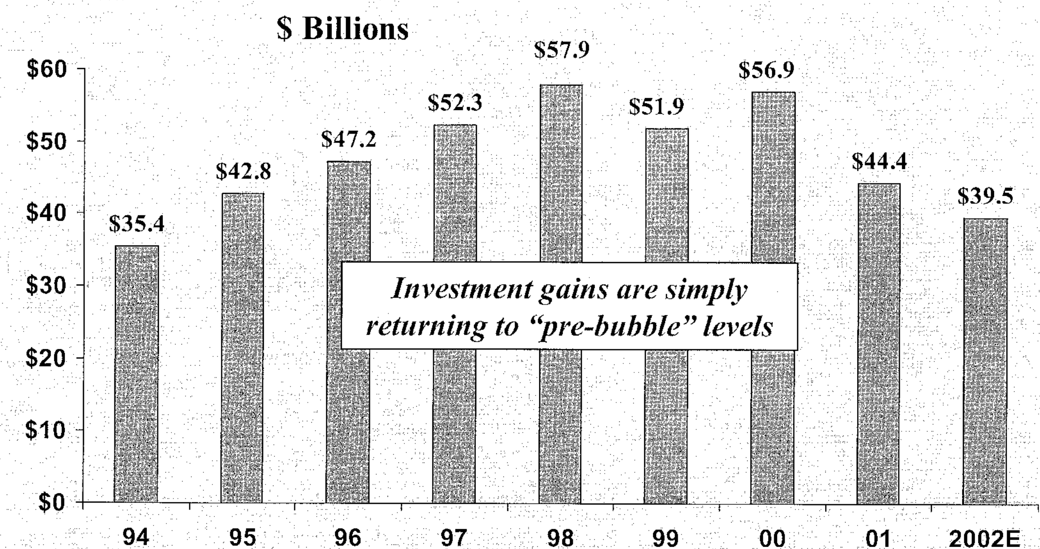
Source: A.M. Best, Insurance Information Institute

Exhibit 5.
Global P/C Insurance Capacity is Falling Dramatically



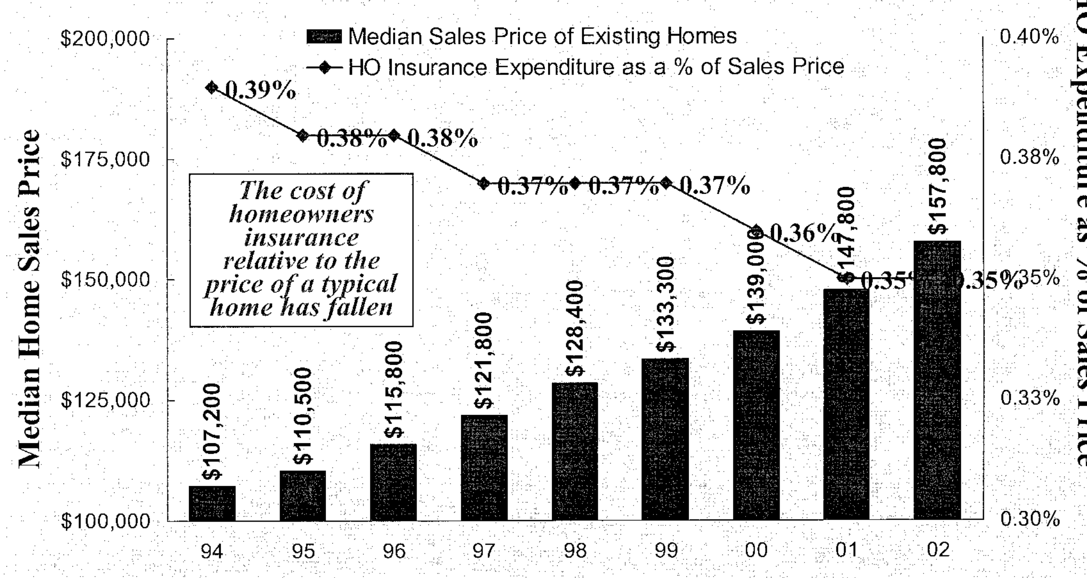
Sources: Insurance Information Institute, Swiss Re

Exhibit 6.
Property/Casualty Insurance Industry Investment Gain*



*Investment gains consists primarily of interest, stock dividends and realized capital gains and losses.
Source: Insurance Services Office; Insurance Information Institute estimate annualized as of 9/30/02.

Exhibit 7. Homeowners Insurance Expenditure as a % of Median Home Price



Source: Insurance Information Institute calculations based on data from National Association of Realtors, NAIC.

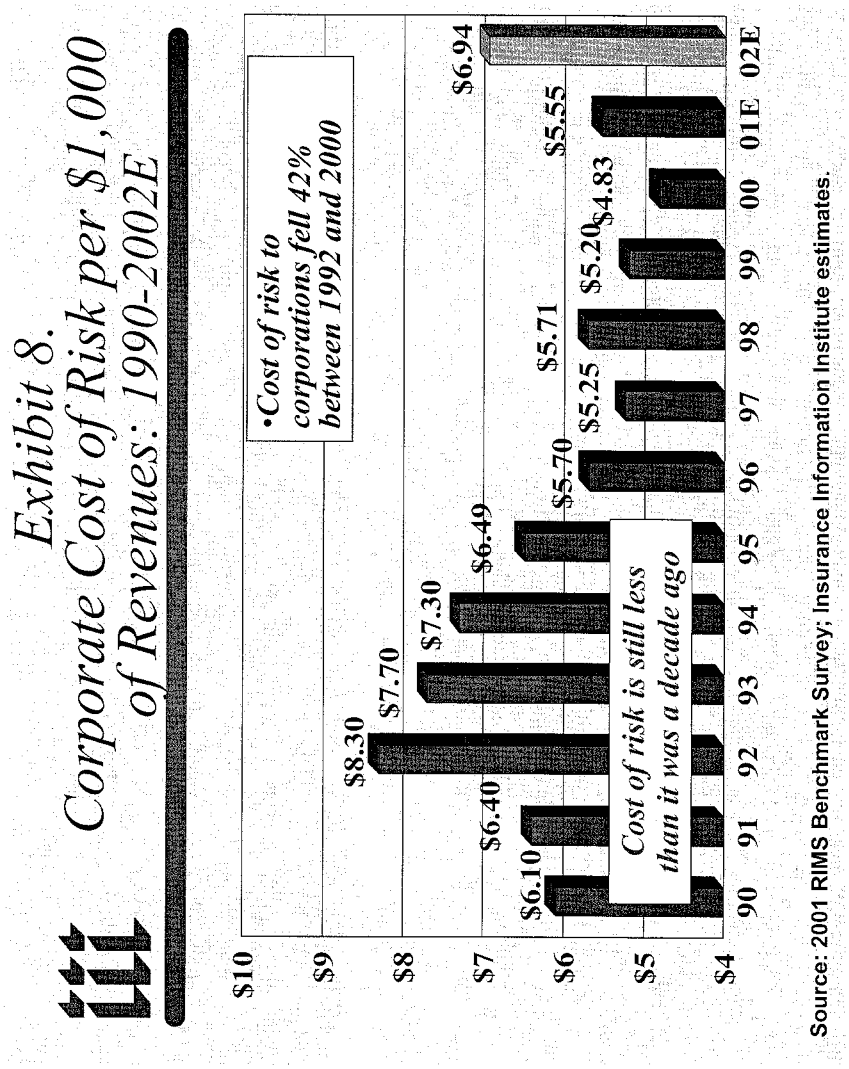


Exhibit 8.
Corporate Cost of Risk per $1,000 of Revenues: 1990-2002E
$10
$9
$8
$7
$6
$5
$4
$6.10
$6.40
$8.30
$7.70
$7.30
$6.49
$5.70
$5.25
$5.71
$5.20
$4.83
$5.55
$6.94
90
91
92
93
94
95
96
97
98
99
00
01E
02E
•Cost of risk to corporations fell 42% between 1992 and 2000
Cost of risk is still less than it was a decade ago
Source: 2001 RIMS Benchmark Survey; Insurance Information Institute estimates.

**TESTIMONY BY DANIEL L. JUNEAU, PRESIDENT
LOUISIANA ASSOCIATION OF BUSINESS & INDUSTRY**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES
Why Some Consumers Can't Get Insurance**

April 10, 2003 -- 10:00 a.m. -- Room 2128 of Rayburn House Office Bldg.

Mr. Chairman and Distinguished Members of the Committee:

I am Dan Juneau, President of the Louisiana Association of Business and Industry. My organization is a combination of a state manufacturers association and a state chamber of commerce. We have 3,500 businesses in our membership and they are located throughout the state and in every business sector.

Every year at this time, just prior to the beginning of our state legislative session, I make a speaking tour around the state, addressing business groups. This gives me an excellent opportunity to hear directly from business owners—particularly small business representatives—about the challenges they are facing.

Never in the last 10 years of making those appearances has one issue dominated the concerns of business men and women in Louisiana. That issue is the availability and affordability of the insurance necessary to run their businesses.

Louisiana is not alone in facing insurance problems. Fallout from September 11, 2001, problems with reinsurance, stock and bond market losses and other factors have complicated businesses' ability to get insurance—and led to skyrocketing premiums.

I can only speak for Louisiana, but I can tell you that the insurance crisis is having a definite impact on jobs and economic development in the Bayou State.

There are many symptoms of the problem in Louisiana, but all of those telltale signs come back to one critical ingredient: Insurance carriers continue to leave the Louisiana marketplace. As the carriers disappear, availability shrinks and competition—the best regulator of rates—erodes.

Although not a commercial line of insurance, the condition of the homeowners market in Louisiana is indicative of what is going on in the industry as a whole. In 1992, prior to Hurricane Andrew, there were 120 carriers writing homeowners insurance in Louisiana. Today, there are only 19 carriers writing any measurable degree of the market (less in South Louisiana due to hurricane exposure). Less than a half dozen carriers are writing any new policies—which creates a particular hardship on new homeowners.

The commercial auto and commercial property and casualty markets are a disaster in Louisiana. Residential general contractors tell me that only one "A" rated carrier is writing policies for them in Louisiana. My oil marketing members—the wholesalers who sell gasoline to retailers—tell me they too have only one carrier left who will write them insurance.

Louisiana's oilfield contractors—the small businesses who service our domestic oil and gas industry—are having an extremely difficult time finding insurance, and if they do, it is often prohibitively expensive. Auto dealers are down to two carriers that will write them. Their situation is so critical that they are taking steps to self-insure—a risky move in the current market.

The absolute crisis in commercial insurance in Louisiana has led to a marriage of interests I never expected to see. Retailers, oilfield companies, realtors, bankers and other industry groups have formed an alliance with the insurance industry to fight for reforms needed to lure more carriers back into the State of Louisiana. This alliance is called The Coalition to Insure Louisiana. These are groups that have often fought in the past on insurance issues, but now they are banding together in an attempt to bring order to chaos.

While elements such as the overall business cycle and potential risks from terrorism can't be overcome by regulation, at either the state or federal level, there are reforms that can help to bring carriers back to Louisiana. My organization and the Coalition to Insure Louisiana are working toward enacting those reforms. Here is a short synopsis of some of them:

<u>Insurance Rating Commission:</u>

Most states allow some form of free market pricing for insurance policies. State regulatory agencies only become involved if their actuaries identify faulty data for the rate increases. In Louisiana, we have an Insurance Rating Commission that is comprised of political appointees named by the governor. There is no basic free market approach to pricing in our system. Legislation was passed in 2001 that would have trimmed the powers of the Commission and installed more of a free market approach. Unfortunately, that legislation was vetoed. Legislation has been introduced in the current legislative session that would move closer to a free market approach by allowing carriers to implement increases or decreases in rates of up to 10 percent without first getting prior approval of our Commission.

FAIR Plan Reform

Louisiana has a market of last resort known as the "FAIR Plan." Carriers writing any premiums at all in the state are forced to write policies in this assigned risk pool. Significant losses in the pool have led to large assessments levied against the carriers, which in turn leads to them minimizing their market share. This aspect of the market place must be reformed before more carriers are forced out of the state by the high assessments.

Direct Action Statute

Louisiana is one of only two states (Wisconsin is the other) that allows plaintiffs to sue an insurance carrier directly. The existence of insurance is known up front, and policy limits are determined in the discovery process. This knowledge leads to higher awards than would be granted if the lawsuits were judged on their merits and not on how much insurance was available.

Collateral Source Rule

Some states ban "multiple recovery" in suits where numerous avenues (medical insurance, workers' comp, general liability insurance, automobile insurance and disability payments) are available to make a plaintiff whole. A majority of states allow the presence of those collateral sources into evidence before the trier of fact. Louisiana has an absolute ban against even the mentioning of recovery.

Jury Trial Thresholds

In most states, defendants have an absolute right to a jury trial. In Louisiana, there is a threshold of $50,000 that must be met before the defendant is allowed the right of having a jury trial.

My organization and others representing the business community will be working hard in the current legislative session to enact reforms that will assist in bringing insurance carriers back into Louisiana. High insurance premiums are affecting jobs and profits throughout the state. High premiums are one thing, but when insurance companies refuse to take your money, you know you have a problem.

Thank you for allowing me to testify before you today.

STATEMENT OF JOHN MARCHIONI
VICE CHAIRMAN, COALITION FOR AUTO INSURNCE COMPETITION
TO THE
U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS
APRIL 10, 2003

Good morning Mr. Chairman and distinguished members of the Committee. My name is John Marchioni and I am Vice President and Director of Government Affairs and Compliance for Selective Insurance Group, Inc., based in New Jersey. I am testifying today in my capacity as Vice Chairman of the Coalition for Auto Insurance Competition. The Coalition consists of insurance companies, insurance trade associations, business groups and over 20,000 individual consumers who are rallying to the cause of restoring choice and competition to New Jersey's auto insurance market place.

New Jersey residents face an auto insurance availability crisis of unprecedented proportion. During the past decade, over 20 auto insurers have left New Jersey. Seven companies left or filed plans to leave just last year. When State Farm, the state's largest carrier, completes its withdrawal, five of the six largest auto insurers in the nation won't be doing business in New Jersey. As we speak, over 4,000 motorists each month receive notice that their insurer is

withdrawing from the state, leaving them to scramble for coverage. Over one million drivers could ultimately be impacted if significant reforms are not enacted.

The disaster that is facing auto insurance consumers in New Jersey is not a natural disaster. It is not an accident, something that couldn't have been anticipated. It is a disaster of the state's own making. The current market condition is the direct result of an over-politicized auto insurance regulatory system. New Jersey operates arguably the most strictly regulated system in the nation and consumers are paying a heavy price. Virtually every aspect of the auto insurance business is controlled by statute and/or regulation. The state dictates how much coverage must be provided. They determine who must be covered. They control the prices. They determine when an insurer may come into the state and they determine when an insurer may leave. And if a company can successfully manage to navigate this complex regulatory scheme in New Jersey and earn a profit, the state tells you how much of that profit you may keep and how much you must return. However, unlike the state's strict cap on profits, the amount of losses an insurer can be forced to absorb is unlimited.

The predictable result of this regulatory morass is that insurers have headed for the exits. (The attached exhibit lists those companies that have left the state in the past 20 years.) We have a third fewer carriers in New Jersey than surrounding states, despite having a population with one of the highest per capita incomes in the nation. As carriers leave, consumers lose coverage. Numerous newspapers reports document that replacement coverage is increasingly hard to come by because many of the remaining insurers simply do not have the capital to take on additional insureds. New capital has not been invested in the

state because many insurers do not want to do business in this highly politicized, overly burdensome regulatory climate. Adding to this lack of capitalization is the fact that the majority of the state's largest insurers, including 4 of the top 5, write their business in single-state subsidiaries in an attempt to insulate their parent company from this turbulent market.

That's the bad news. The good news is that progress has been made toward reversing this decades old problem.

In order to solve the current capacity and availability crisis, it is imperative that additional capital be invested by the private sector in the New Jersey auto insurance market. The private sector, however, is unlikely to take that step until the numerous regulatory barriers to competition are dismantled. Reforms need to be enacted that will give existing insurers confidence they can generate a competitive rate of return and attract additional insurers to enter the marketplace. Insurers must know that regulatory decisions will be made in a fair and predictable fashion and are not the result of political manipulation. Fortunately, there is legislation moving in Trenton that goes a long way toward restoring competition to New Jersey's auto insurance system. By restoring a competitive auto insurance market in New Jersey, consumers will reap the benefit through increased availability and choice.

Senate Bill No.63 has passed the State Senate and we anticipate the Assembly will consider it in May. Called the New Jersey Auto Insurance Competition and Choice Act, it has the backing of Governor James McGreevey and a bipartisan group of legislators in both houses.

While it is not a panacea, we believe it will ease the current availability crisis and, if fully implemented, lead to greater long-term stability in this troubled market.

Here are the four major provisions of the bill.

Take All Comers

Current law requires insurers to offer coverage to all applicants with fewer than 9 motor vehicle points on their driving record. S-63 phases out the take-all-comers law over a 5-year period. During the phase-out, insurers would be granted relief from take-all-comers when their growth exceeds a set percentage in a given geographic territory.

Rate Approval

New Jersey would retain its current prior approval system for rate filings in excess of 7%. The state's current "expedited rating law" would be amended to accept filings of up to 7%, as opposed to the current maximum of 3%. This "expedited" process is a prior approval system with shorter response times for the regulator. New Jersey's prior approval system has been known for delays of up to 18 months, with outcomes driven more by politics than by actuarial science. While S-63 represents a positive change to the rate approval process, it falls far short of the desired system – a competitive rating law.

Excess Profits

New Jersey is among a small group of states that have an excess profits law. New Jersey's law, however, is clearly the most restrictive. S-63 contains some modest improvements in the

excess profits rule. The bill extends the excess profits calculation period from three to seven years. While this extension is a positive step, additional change in either statute or regulation is necessary to allow insurers the opportunity to earn a more appropriate rate of return. Without these additional changes, national and regional carriers will be reluctant to move their capital to New Jersey from states where a more reasonable rate of return is achievable.

Withdrawal

New Jersey's withdrawal rules are perhaps the single most significant barrier to entry of new carriers. For good reason, the state's withdrawal scheme is referred to as the "lock-in law." The clear purpose of this withdrawal system at the time it was adopted was to make withdrawal as difficult and arduous as possible so that companies would not leave. It has not served its purpose. Companies continue to leave at a rapid pace, some buying their way out, others risking the possibility of surrendering their licenses for other lines of business. S-63 makes some improvement in the system by allowing insurers, after an informational filing and 1-year advance notice to policyholders, to nonrenew their business at a uniform rate over a 3-year period. The Commissioner would have the authority to suspend this system when insurers representing more than 25% of the market have filed to withdraw. These changes are delayed until 2007, in recognition of current market conditions.

There are other provisions in the bill that reflect Governor McGreevey's priorities, including a low cost policy option for low income families and additional consumer information programs, but the four areas outlined above the major provisions that we

believe will begin to move New Jersey toward a more competitive insurance market. Again, this bill is not a panacea, but it is a positive first step.

It is only a first step in that the administration, after the bill is enacted, will need to fully implement the various regulatory components of the reform package. New Jersey has a checkered past in this regard, as well. It took four years to implement the Expedited Rating Law, enacted in 1997. The re-drawing of the 50-year old territorial rate maps, as called for in the 1998 reforms, has still not been accomplished. If S-63 becomes law, the administration must act quickly to follow through on the regulatory changes called for on expedited and prior approval rating, excess profits, withdrawal, and territorial rating.

The current reform effort could be a significant step in moving New Jersey closer to the mainstream of state insurance regulatory schemes. It took decades to create this highly dysfunctional system, so dramatic results are not likely to occur overnight. However, assuming S-63 is signed into law, the required regulatory changes are swiftly enacted, and the reforms are allowed to take root without political interference, New Jersey could become a more attractive market for insurers. The ultimate beneficiaries would be the state's consumers.

Thank you, Mr. Chairman. That concludes my testimony.

New Jersey Auto Insurance Market Withdrawals

The following insurers have withdrawn from New Jersey's auto insurance market:

INSURER	YEAR	INSURER	YEAR
GEICO	1976	St. Paul	1993
UNIGARD	1976	Preferred Risk Mutual	1994
SAFECO	1977	Atlantic Employers (CIGNA)	1994
Worcester Mutual	1978	Property & Casualty Co. of MCA	1994
Peerless	1978	Home Insurance Companies	1994
National Grange	1979	Motors Insurance Company	1994
Nationwide	1981	UMUS	1995
Security of Hartford	1981	American Hardware	1996
Progressive	1983	Royal Insurance Company	1997
State-Wide	1990	Home State Insurance Co. (1)	1997
Crum & Forster	1990	Lumbermens Group (Kemper)	1997
John Hancock	1990	Maryland Casualty	1997
Horace Mann	1991	NCIC (2)	1998
Commercial Union	1992	Bayside Casualty Insurance Co.	1998
Interboro Mutual	1992	Provident Washington	2001
Reliance	1992	GSA	2001
Wausau	1992	Ohio Casualty	2002
		Great American	2002
		Harleysville	2002
		Twin City	2002
		Robert Plan Companies (3)	2002
		AIG (4)	2004*
		State Farm (5)	2006*
		Central Mutual (6)	Pending
		Merchants (6)	Pending

(1) Taken over by Department of Banking & Insurance, company declared insolvent
(2) Company allowed to dissolve by order of the Department of Banking & Insurance
(3) Solvent runoff of business by order of the Department of Banking & Insurance
(4) Department has given AIG the ability to proceed with Plan of Withdrawal after December 2003
(5) State Farm, under the Market Stabilization Order issued in June 2002, may begin non-renewing policies for the purposes of withdrawal after January 2006
(6) Filed a Plan of orderly Withdrawal, December 2002

Source: Insurance Council of NJ, with information from NJDOBI

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Competition and Vigorous, Effective Insurance Regulation

Testimony of Nathaniel S. Shapo

House Financial Services Committee

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Honorable Richard H. Baker, Chairman

April 10, 2003

Introduction

Good morning, Mr. Chairman, and thank you for the opportunity to appear before your committee on this important topic. My name is Nat Shapo. I am a partner in the national law firm of Sonnenschein Nath & Rosenthal, based in our Chicago office. I am also a Lecturer in Law and a member of the Visiting Committee at the University of Chicago Law School. I was formerly the Director of the Illinois Department of Insurance from January, 1999 to January, 2003. The views I express today are my own based on my years of experience as a regulator.

As Director, I observed and formed strong opinions about the best way to regulate insurance prices in personal automobile and homeowners lines. Insurance consumers, like those of any other competitively marketed and sold product, are best served by government policies which complement rather than inhibit the laws of supply and demand. Competition produces better results than government price controls. Insurance consumers can and will protect themselves by shopping for the coverage they need at prices they can afford when government does not inhibit their opportunity to do so. Insurance companies must be vigorously regulated by the states in areas where consumers cannot adequately protect themselves, such as solvency, market conduct, policy forms, and consumer complaints. Scarce government resources are best directed toward these tasks, not the regulation of price, which is best done by the marketplace.

My testimony today will address:

- how and why the practice of government regulation of insurance rates developed;
- why government rate regulation as practiced today is badly mismatched to the purpose for which it was created;
- how Illinois has protected consumers and successfully built a thriving market in personal auto and homeowners insurance, characterized by available and affordable coverage, through market-based regulation of rates; and
- why the Illinois model is a proven example for encouraging capital investment in today's modern, global marketplace, where the enormous financial pressure caused by today's hardening conditions will only be exacerbated by punitive rate regulatory policies.

Government Price Controls Were Designed to Keep Prices Up, Not Down

Hundreds of sellers compete for buyers in the modern insurance marketplace, making this business naturally susceptible to regulation by the law of supply and demand. However, insurance is nonetheless broadly subject to government price controls, which are a vestige of a different time and a different market with different needs.

Government regulation of insurance prices was designed to ensure solvency, not affordability, by preventing rates from being too low rather than too high. Many states established rate regulation in the early 1900s to facilitate pricing cooperation between insurance companies because sellers routinely underpriced, failed to properly reserve for catastrophic losses, and frequently became insolvent following large fires and earthquakes. Policymakers determined that price competition was harmful to consumers; that the formation of collusive, anti-competitive rating bureaus were beneficial and should be encouraged; and that states, having encouraged monopolistic practices, should regulate the resulting rates for both adequacy (to assure solvency) and excessiveness (to assure that the sanction of monopoly did not enable price gouging). Price controls were then and are now anathema to consumer protection in a **competitive** market. Insurance presented an unusual case, though, because governments wanted to thwart competition by creating monopolistic conditions in the name of a greater consumer protection – solvency.

The practice of state rate regulation was facilitated and encouraged by Congress in the McCarran-Ferguson Act of 1945. Congress passed McCarran because in 1944, the Supreme Court, in U.S. v. Southeastern Underwriters, reversed a long-held position and found that insurance was interstate commerce and thus subject to Congressional oversight. The Court made this ruling in order to allow the Justice Department to regulate the collusive practices of insurance cartels, which, absent antitrust oversight, had gone beyond just common ratemaking by employing extreme and unacceptably coercive tactics. The Court's decision threw the viability of rating bureaus and the state regulatory system itself into legal question. McCarran was designed to address both concerns. First, it assured the integrity of state regulation by delegating oversight over the interstate commerce of insurance to the states through "reverse preemption," whereby state law trumps federal law unless the federal law is specific to insurance. McCarran, in its brevity, also establishes the first specific federal insurance policy. It exempts insurers from the Sherman, Clayton, and Federal Trade Commission Acts, subject to two provisos: boycott, coercion, and intimidation are never acceptable, and the antitrust exemption only applies to the extent that the states regulate the field. The states, seeking to ensure solvency by facilitating the bureau system, quickly mooted the federal antitrust laws by occupying the field of rate regulation with prior approval rating statutes.

Competition Replaces Monopoly; Price Controls Become Obsolete, Misused, and Ineffective

Since McCarran, states have developed more sophisticated financial regulatory practices, which replaced artificial propping up of rates as the preferred method of ensuring solvency. By the 1970s, bureau ratemaking practices were prohibited and the monopolistic insurance marketplace was transformed by competition.

Today's insurance marketplace is highly competitive. Consumers shop for price and coverage by meeting with independent agents, calling toll-free numbers, and surfing the Internet. Companies specifically challenge each other's prices through advertising in all media. Yet government regulation of prices, rooted in the anti-competitive practices enabled by Congress, endures, even though the market is no longer collusive. The purpose of government rate regulation has changed, though: prices controls are used today to ensure affordability and availability of coverage to consumers by suppressing rates. The irony is unavoidable: bedrock American economic policy uses **competition** to ensure affordability and availability, but today states often use a practice designed to **impede** competition, price controls, as a means to that same end.

Numerous expert academic studies, including several gathered in a 2002 book, published by AEI-Brookings, entitled Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency, demonstrate that government rate regulation does not deliver the promised benefits of decreased costs and increased accessibility. Prior approval regulatory systems in the end do not yield lower rates than competition and instead impair availability. In prior approval markets, carriers, fearing government capture of their capital, do not enter, do not compete fully and aggressively, and/or prepare and execute withdrawal plans. As a result, with less supply, prior approval states have larger residual markets and are therefore less stable and more volatile. This is precisely what one would expect where government artificially shackles what would otherwise be a competitive market.

The Illinois Model: Competition Produces Affordability and Accessibility

Government rate regulation hinders the most ruthless regulator of prices, the law of supply and demand, by reducing incentives for capital investment and distorting supply. The "Illinois model," by contrast, produces abundant supply and empowers consumers to effectively shop for the coverage they need at prices they can afford. Illinois has no law empowering its insurance commissioner to review and challenge prices charged by sellers of automobile and homeowners insurance. Prices are not unregulated, however, and consumers are not left unprotected. As in the rest of the economy, supply and demand vigorously regulate Illinois insurance prices. This protection is guaranteed as in other industries by the antitrust laws; since the state has not occupied the field with rate regulation, McCarran-Ferguson's antitrust exemption for insurers does not apply. Illinois law also supplies an additional safeguard to ensure the benefits of competition: a Cost Containment Act which requires the Department of Insurance to collect and statistically analyze extensive data from insurers, and to confirm to the legislature every year that the marketplace is measurably competitive.

By encouraging ample capital investment and supply in the marketplace, competition has protected Illinois consumers by producing coverage that is demonstrably available and affordable. The number of carriers writing homeowners insurance in Illinois is the highest in the country. Herfindahl/Hirschman Index analyses of the marketplace show that the market is extremely competitive and not concentrated. The residual market is infinitesimal (.03 percent in auto and .22 percent in homeowners). The uninsured rate is below the national average. And rates are at or below the national norm (the 27th highest in auto and 39th highest in homeowners nationally, according to Insurance Information Institute statistics).

The Illinois Model: Vigorous Government Regulation Where Consumers Need It

Illinois' decision to regulate prices with the competitive tools of supply and demand, the antitrust laws, and the Cost Containment Act produces tangible benefits to consumers both by producing fair prices and by freeing the Department of Insurance to regulate the aspects of the business where consumers need government protection. Consumers in Illinois can and do protect themselves with respect to prices by shopping for the best deal. But consumers cannot fully fend for themselves in their insurance transactions, so the Illinois Department proactively regulates solvency, market conduct, forms, and consumer complaints. Consumers are at an information and resource disadvantage vis a vis their insurance carriers in these areas; unlike with rates, where they can easily shop and compare prices for themselves, adequate protection requires active government oversight of these aspects of the business.

Illinois excels at solvency and market conduct regulation. Many of the model laws and practices at the heart of the National Association of Insurance Commissioners' (NAIC) financial accreditation program originated in Illinois, and Illinois routinely participates on the largest multi-state market conduct exams. The department also acts as an ombudsman on thousands of consumer complaints a year and reviews forms on a file and use basis to ensure that they comply with state law, including provisions which prohibit unfair discrimination based on race and other protected classes as well as general prohibitions against unfair or deceptive acts or practices. Illinois routinely receives "A" level grades from consumer groups' reviews of its insurance regulatory practices, and the Department has produced three winners, the most of any state, of the NAIC's Robert Dineen Award, the association's highest honor for professional regulators.

In your invitation letter to me, you asked me to "describe the Illinois model of insurance regulation." If you step back to consider the model I have described, it is somewhat bizarre that I have been invited to testify about a unique regulatory system where the prices in a competitive marketplace are primarily regulated by supply and demand and not the government. If this were any other competitively sold product, the "Illinois model" would be the rule, not the exception, for it is well-settled public policy in the United States that the market and the antitrust laws produce the best affordability and availability for consumers.

Illinois as a Successful Model for Other States

I believe that the "Illinois model" of regulating the automobile and homeowners' insurance markets could produce a healthy market and provide necessary consumer protections in virtually any state in America. New Jersey and South Carolina's recent experiences vividly demonstrate that sellers must be enticed by the normal incentives found in successful markets so that supply will grow to adequately meet demand. Capital will flow to wherever there are enough consumers to justify investment – as long as sellers can compete for business without having their assets subject to government capture.

Illinois is a major state with many if not all of the difficult characteristics faced by policymakers overseeing today's insurance markets. It has urban areas and rural areas; tornadoes and icestorms; large jury verdicts and high medical costs. Just as there is nothing unusual about insurance which makes it impervious to the beneficial effects of supply and demand on prices, there is nothing about Illinois to suggest that its success with competitive rating practices should not work in other places. New Jersey's failures with burdensome regulatory policies and South Carolina's success with competition merely reinforce what Illinois has demonstrated for decades: the regulation of a healthy marketplace that benefits consumers begins with a commitment to simple and otherwise widely followed economic and regulatory principles.

Insurance is Not Uniquely Immune to the Laws of Economics

Insurance is a product infused with the public good. As Chairman Oxley says, it is the glue that holds our economy together. That is why insurance is -- and should be -- a heavily regulated business. However, there is no convincing legal or policy justification for the widespread practice of government rate regulation in today's competitive insurance market. Various, unconvincing justifications are given for this highly unorthodox but widespread form of price controls. Some suggest that, because insurance is a virtual necessity and often required by the government, the state has an obligation to ensure affordable prices through rate suppression. This position, however, has no basis in history, economics, or public policy. As I previously discussed, insurance rate regulation was not created for this purpose. Rather, insurance was sold for centuries without price controls before governments began to prop rates up to ensure solvency; thus, the "necessity rationale" is not supported by the historical record. In addition, many other products at least as essential as insurance are not subject to price controls. The products which insurance is purchased to protect, cars and homes, are by definition as necessary as the insurance which covers them, yet their prices -- which are substantially higher than insurance prices -- are not regulated. Food is more essential to life than insurance, but the state does not control its cost. Moreover, the government places many mandates on its citizens which require substantial purchases in privately sold products, but it only regulates the prices of insurance. (It should also be noted that only auto insurance is commonly required by government; homeowners insurance is required by lenders, not the states.) Most importantly, however, insurance is simply not immune to the laws of economics. Price controls, which are anathema in non-monopolistic markets as harmful to the public good, provide no better consumer protection in the highly competitive insurance marketplace than they would in any other similar venue.

Conclusion

This is a very trying time in the property/casualty insurance marketplace. A confluence of factors – including but not limited to declining investment portfolios, a spike in claims severity, and fears of catastrophic terrorism losses – have put enormous pressure on underwriting and rating practices. In my view, policymakers must respond to this hard market as they would in any other industry, by enabling rather than impeding the law of supply and demand. The global insurance marketplace needs capital in order to adequately serve its consumers. The price controls of a long obsolete, anti-competitive marketplace are antithetical both to the needs of today's consumers and to American public policy. Congress intended, the Supreme Court asserted in U.S. v. Southeastern Underwriters, "to make of ours … a competitive business economy." State rate regulation, as practiced today, confounds this fundamental goal. Its price controls are an unjustified anomaly and a harmful obstacle to integrating insurance regulation into the natural flow of our economy.

As I understand it, this Financial Services Committee was formed in part to recognize and facilitate the transformation of the financial services marketplace already occurring through globalization and the passage of the Gramm-Leach-Bliley Act. I therefore commend to you, Mister Chairman, the Illinois model of insurance product regulation as a modern, efficient approach commensurate with the needs of a competitive marketplace, and the consumers therein.