OVER-REGULATION OF AUTOMOBILE INSURANCE: A LACK OF CONSUMER CHOICE

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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OVER-REGULATION OF AUTOMOBILE INSURANCE: A LACK OF CONSUMER CHOICE

WEDNESDAY, AUGUST 1, 2001

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2220, Rayburn House Office Building, Hon. Sue W. Kelly, [chairwoman of the subcommittee] presiding.

Present: Chairwoman Kelly; Representatives Tiberi, Inslee, Schakowsky, Moore, Capuano, Crowley, and Clay.

Also present: Representative Ferguson.

Chairwoman KELLY. First of all, I want to welcome all of you. This hearing on the Subcommittee on Oversight and Investigations is going to come to order. Without objection, all Members' opening statements will be made part of the record.

This afternoon, we are holding a hearing on the effects of State over-regulation of automobile insurance on consumer choice. State insurance commissioners bear a responsibility to promote a competitive climate in which consumers can choose from a number of stable and solvent companies at competitive prices. When that climate is not maintained, there are going to be warning signs.

Unfortunately, the alarm bells are sounding in New Jersey and Massachusetts. It is apparent from the exodus of companies from New Jersey and the refusal of many insurance companies to do business in Massachusetts that the regulatory climate for automobile insurance in those States has turned into an oppressive one.

In New Jersey, over one-half of the 15 largest auto insurers in the country have either already left or will leave in the near future. Over one million people in New Jersey will lose their automobile insurance with a dwindling supply of alternative companies willing to do business in that State.

Massachusetts might be in even worse shape, with two-thirds of those same 15 largest insurers either writing little or no business or refusing to do business at all in the State. Why are the people of Massachusetts denied the right to do business with the insurer of their choice? Why do they continue to tolerate a system that has driven two-thirds of the largest, most competitive providers out of the State?

Meanwhile, in free-market States such as Illinois and South Carolina, there are numerous auto insurance companies providing consumers with real choices at competitive prices without subsidizing risky drivers with bad records. For instance, in South Carolina, the number of insurers accessible to consumers has doubled since the State eliminated artificial price controls. It is that contrast that we are here to examine today.

I would note that the New York insurance superintendent has been watching the events in these States very carefully, especially across the border in New Jersey, and has drawn the right conclusion. If there is a problem with high auto insurance rates, the answer is more competition and sound fraud enforcement, not just regulation. That is why New York is pursuing a package of real reform to catch and prevent insurance fraud, bar drivers who won't pay their insurance from recovering damages, and allowing more choices and incentives for lower cost repairs. That sounds like reform, and that will bring real results for New York's drivers.

I have a recent op-ed, written by the New York Insurance Superintendent, Greg Serio, that I believe sets out a strong case for the reforms that they are working on in New York. I am going to ask unanimous consent to have it made part of the record.

Hearing no objection, so ordered.

[The information can be found on page 30 in the appendix.]

Chairwoman KELLY. Before us today, we are honored to have a distinguished panel of auto insurance experts to share their thoughts and observations with us on these issues. I thank all of you for taking the time out of your day to be here and to share your thoughts with us. We need to take a look at how the regulations in these States are being affected by the State's regulation and the consumers' needs, and I look forward to discussing those issues with you.

I also want to inform Members of my subcommittee and their staff, it is my intention to strictly enforce the 5-minute rule, and I would appreciate their cooperation in notifying their Member if their Member decides to appear.

We have been joined today by my friend from New Jersey, Mr. Ferguson. He is a Member of the Financial Services Committee, but he is not a Member of this subcommittee. I would ask unanimous consent to allow him to participate as if he was a Member of this subcommittee.

Hearing no objection, so ordered.

In addition, we have received a statement from the Alliance of American Insurers, and I am going to ask unanimous consent to have that made part of the record.

Hearing no objection, so ordered.

[The prepared statement of the Alliance of American Insurers can be found on page 125 in the appendix.]

Chairwoman KELLY. I am now going to go to the panel, and I want to inform the panel that I am not only pleased to have you here today, but I am also going to ask you to remember that we have your written statements, therefore, I will ask you to hold your remarks within the 5 minutes.

I would first like to go to Mr. Ferguson, who has an opening statement, I believe.

[The prepared statement of Hon. Sue W. Kelly can be found on page 28 in the appendix.]

Mr. FERGUSON. I do have a brief opening statement.

Chairwoman KELLY. Thank you.

Mr. FERGUSON. First of all, I thank the chair for your graciousness in hosting me here today. As a Member of the Full Committee who certainly has an interest not only in this topic, but also in today's proceedings, in particular, since we are talking about, one of the States we are talking about is my home State. I do have a brief statement, and I appreciate the opportunity to be with you here today.

Certainly, I know today is not a beat-up session on New Jersey or Massachusetts, as much as it is a learning process, looking at some of the things that perhaps we can improve upon and certainly maybe some things that are not going well in some of our States.

Automobile insurance in my home State of New Jersey, as we know, is in dire need of reform. New Jersey has been overburdened with strict regulations resulting in a reduction of competition and choice between insurance companies with equitable rates. I appreciate my presence here today and the chair for having me here today to attend the hearing and to focus on this lack of consumer choice in New Jersey and some of the announced withdrawals of four auto insurers in our State within the last year.

Specifically, I am interested in discussing with our panel the challenging regulatory climate in New Jersey and the benefits of a much more competitive market found in States like Illinois and South Carolina. The State of New Jersey auto insurance market has been criticized for being both politicized and over-regulated, and also we have been criticized for enacting laws within our State in the last few years which have crippled the market.

Recently, two of the top five automobile insurers announced that they were being forced to withdraw from the New Jersey market, citing the burdensome regulatory system, exceedingly delayed decisions by our State commissioner and restrictions on rate adjustments.

In addition, in 1999, the State Commission required a 15-percent rate reduction to policyholders, forcing insurers to provide the cut before enacting many of the reforms that would have enabled insurers to adjust their rates without increased market volatility. Some insurers have not been able to reduce by 15 percent the rate reductions within the strict State regulations and have chosen to exit the State, rather than to try and work with the State Commission.

Today, New Jerseyans have seen a loss of consumer choice and an increase in rates without relief from some of the regulatory burdens, leaving potentially a million drivers uninsured. It is my hope that today's witnesses will touch upon this research and the analyses that they have done within the State and to provide some suggested solutions to the growing number of uninsured drivers in my home State.

I thank the chair for your graciousness again for having me here. I yield back.

[The prepared statement of Hon. Mike Ferguson can be found on page 38 in the appendix.]

Chairwoman KELLY. Thank you very much. We are delighted to have you here.

I am going to move now to the panel, since there are no more opening statements, and we have before us Mr. Robert Litan, the Vice President and Director of Economic Studies for the Brookings Institution.

Mr. Litan, I apologize for the fact that we haven't got a long enough table there. You are really kind of hanging on by your fingernails, but thank you for hanging on and for being here.

Mr. Litan worked in two capacities for the Clinton Administration. He was the Associate Director for the Office of Budget and Management and the Deputy Assistant Attorney General for the Antitrust Division of the Department of Justice. I am going to introduce you as you speak, if you don't mind. I am not going to introduce the whole panel now. In the interest of time, I would like to go on with you first, Mr. Litan.

As I said before, we have your written statements. Without objection, they will be entered as a part of the record. So, if you would be willing to try to stay within the timeframe, that would be appreciated. I just want to explain the lighting system. There is a box here with the lights. The green light means you have 5 minutes, the amber light means you have 1 minute left, and when the red light comes, it means that you might just hear me tapping. That means summarize it quickly.

Thank you. It is an important issue. I don't mean to make light of the issue, but the thing is that we need to hear from you. So I want to hear from you all, and then we will have some questions.

So, Mr. Litan, will you please proceed.

STATEMENT OF ROBERT E. LITAN, VICE PRESIDENT AND DIRECTOR, ECONOMIC STUDIES, BROOKINGS INSTITUTION

Mr. LITAN. Thank you very much, Madam Chairwoman. It sounds like you have already summarized my testimony.

[Laughter.]

Mr. LITAN. But what I am going to do here today is summarize very briefly the major findings of a study that will be released by the AEI-Brookings Joint Center, which I codirect. This study was directed by Professor David Cummins of the University of Pennsylvania. Here are a few key points that are worth noting:

Number one, academic scholars, including those who participated in our study, overwhelmingly agree that auto insurance rates should not be regulated. Insurance is not a natural monopoly, but instead, over 100 firms typically compete in most states. Like other firms in our economy, insurers ought to be free to compete subject to the antitrust laws.

Two, the AEI-Brookings study looked at three States where auto rates have been regulated: Massachusetts, New Jersey and California. The findings for Massachusetts and New Jersey are similar. In both States, rates have been held down which looks like a good deal for consumers, but is not, on closer inspection. Artificially low rates discourage entry into the business and discourage existing insurers from staying, as has been pointed out. In Massachusetts, for example, in 1982 all top ten auto insurers in the State were national firms, but by 1998, only three were national. In New Jersey, five of the Nation's top ten auto insurers do not do business in the

State. The net result is that regulation deprives consumers of choice.

Binding regulation also punishes good drivers by forcing them to subsidize bad ones. In Massachusetts, for example, some high-risk drivers receive subsidies as high as 60 percent, requiring some low-risk drivers to pay 11-percent higher premiums. In South Carolina, where rates were recently deregulated in 1999, 42 percent of consumers were forced to buy in the so-called residual or involuntary market in 1992, requiring significant subsidies from other drivers. And by 1999, this State residual market facility had a cumulative deficit of over $2 billion—then South Carolina deregulated. But the point is that subsidizing high-risk drivers makes absolutely no economic sense, as it can lead to higher accident rates and loss costs.

California has been an exception to these patterns, but only because Proposition 103 turns out not to have been that binding. Claims costs for insured vehicles in the State, unlike energy costs, actually fell after 1988, so insurers were not forced to abandon California, as they were in New Jersey and Massachusetts. In addition, the most controversial part of Proposition 103, the 20-percent rollback, was never fully implemented, for constitutional reasons.

What about States that have deregulated? Well, let us look to South Carolina. As I said, it deregulated in 1999, and guess what? Insurers came flooding back to the State, doubling in number. Meanwhile, South Carolina's residual market has almost disappeared simply because insurers can now charge according to risk. What about Illinois? As has been mentioned, there has been deregulation there for over 3 decades. The result, almost no residual market. Meanwhile, Illinois consumers have roughly twice the number of auto insurers to choose from than is true in New Jersey.

One of my Brookings' colleagues, Cliff Winston, has documented that in other industries, where prices and entry have been deregulated, efficiency and productivity have dramatically improved. Professor Cummins, who led our study, has documented significant inefficiencies in the insurance industry that could be rooted out if the forces of competition were simply unleashed.

So is there any role left for regulation? Yes, there is: To ensure solvency, number one; to protect consumers from unscrupulous practices, number two; and, finally, to help standardize forms for personal lines and small businesses so that customers can easily compare prices.

State insurance officials should not have to spend their scarce dollars on collecting rate data and, in some cases, approving them.

Thank you, and I look forward to your questions, and I beat the time clock.

[The prepared statement of Robert E. Litan can be found on page 39 in the appendix.]

Chairwoman KELLY. You did, indeed. Thank you very much, Mr. Litan.

Next, we move to Mr. David Snyder, the Assistant General Counsel for the American Insurance Association. Mr. Snyder previously served in the Pennsylvania Department of Insurance and has been employed by several major insurers.

Mr. Snyder, thank you very much for appearing today.

STATEMENT OF DAVID F. SNYDER, ASSISTANT GENERAL COUNSEL, AMERICAN INSURANCE ASSOCIATION

Mr. SNYDER. Thank you very much for the opportunity to be here, distinguished Chairwoman Kelly and members of the subcommittee.

The association which I represent is composed of member insurers that not just provide auto insurance in the U.S., but do so around the globe. The lessons and experience they have can be applied to the subject of your hearing today. And thank you for holding this hearing, because the issue of State auto insurance regulation is an issue that is important to consumers, public officials, and insurers.

Most States currently have the extraordinary authority to fix prices on personal auto insurance, something they don't have for virtually every other product, including absolute essentials such as food, housing, and even the automobiles being insured. The damage that can be done with this far-reaching power is now evident in States such as New Jersey, which is experiencing the exit of companies that insure 20 percent of the market and Massachusetts, where consumer choices are very limited, both due to the regulatory system's denial of needed rates.

State rate regulation harms consumers, when the underlying costs paid by auto insurance are declining, by retarding the market's lowering of its prices, as happened in California. But when the costs of providing insurance are perennially high or rising, costs such as auto repair, increased litigation, increased medical costs, rate suppression can cause severe market dislocations and shortages, as now being felt in New Jersey.

State rate regulation hurts consumers because they have fewer choices. It hurts insurers because they have less capital than they need to operate in the market and even harms the public officials administering the system by forcing them to make political decisions on issues they know should be left to the private economic marketplace.

But State rate regulation has additional negative impacts. It is often used to mandate hidden subsidies that are not cost-based. This obviously harms the consumers who are paying those subsidies, but it also harms the subsidized parties, because it hides from them and the public the preventable causes of higher-than-necessary losses, such as too lenient supervision of beginning drivers, a newly emerging pattern of fraudulent behavior or hazardous intersections in congested areas. This, in turn, results in delaying effective measures to prevent accidents, deaths, and injuries, such as graduated licensing laws, antifraud measures, and more effective enforcement of the traffic laws.

If particular subsidies are desirable, they should be applied through legislation above-board, not, as so often is the case, through back-door methods, because the regulator can hold hostage through the rate-approval process a company's entire financial ability to function in the State.

Finally, rate regulation of the kind embodied in most U.S. State laws is contrary to international best practices. As more countries establish their insurance markets, competition for global insurance capital will intensify. Regulatory systems which assure solvency, but leave pricing to the market, will emerge as the most capable of attracting capital.

The U.S. should not be left behind in the global competition because of a legacy of State price control systems. So, regardless of your viewpoint, whether as consumers, as public officials or as insurers, rate regulation, as embodied in most State laws, is inherently capable of abuse. And when abused or even used as envisioned, it ultimately harms the very people who are intended as its beneficiaries.

Thank you, and I would be pleased to answer any questions you may have.

[The prepared statement of David F. Snyder can be found on page 46 in the appendix.]

Chairwoman KELLY. Thank you. You, too, went in under the wire. Thank you very much, Mr. Snyder.

Next, we have Mr. Tom Ahart. Did I pronounce that correctly?

Mr. AHART. Ahart.

Chairwoman KELLY. Ahart, pretty good. President of the Ahart, Frinzi & Smith Insurance firm located in New Jersey, who is testifying on behalf of the Independent Insurance Agents of America. Mr. Ahart is a chartered property casualty underwriter, an accredited adviser of insurance in New Jersey.

Mr. Ahart, thank you very much for being here, and we look forward to your testimony.

STATEMENT OF THOMAS B. AHART, CPCU, AAI, PRESIDENT, AHART, FRINZI & SMITH INSURANCE, ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA

Mr. AHART. Thank you very much. Good afternoon, Chairwoman Kelly and members of the subcommittee.

As mentioned, I do own an insurance agency in New Jersey. It is a second-generation insurance agency started by my father in 1950. We currently have half of our business in personal lines, and I also am an auto insurance buyer in New Jersey, including three young drivers. So I do have firsthand knowledge.

[Laughter.]

Mr. AHART. Also, I will be president of the Independent Insurance Agents of America in October.

Chairwoman KELLY. Congratulations.

Mr. AHART. Thank you. Well, maybe, right.

[Laughter.]

Mr. AHART. One crucial theme you will hear the IIAA say repeatedly is our desire to identify mechanisms that can be used to help foster uniformity of the existing State insurance regulatory systems. At the same time, we recognize that in many respects insurance remains an inherently local business. And any system of insurance regulation must be flexible enough to accommodate differing local, State and regional needs.

The current problems related to the over-regulation of auto insurance rates in many States implicate both the potential benefits of greater uniformity and the need to accommodate different local contexts. Rates that will be viewed as adequate will, of course, vary from State-to-State with the specific conditions of the respective marketplaces.

In many States, however, dozens of auto insurance carriers have withdrawn from the insurance markets over the course of the last 2 decades because of excessive efforts to account for such conditions have resulted in approved rates that have been grossly inadequate. In a competitive economy such as ours, insurance companies cannot be required to lose money. In some States, however, the only effective alternative for them, with respect to auto insurance, has been to abandon the marketplace completely. And in New Jersey, in order to leave the auto marketplace, you need to turn in your license and leave in all lines. And even though they are making money in other lines, it still is paying some of them to leave New Jersey completely, just because of the loss in auto insurance.

Consumers suffer because their insurance markets are underserved and because drivers with better driving records and those that live in lower exposure areas subsidize other drivers. Consumers also suffer, because even in times when approved rates are more than adequate, insurers are reluctant to reduce prices for fear that they will not be able to raise them again if cost inflation accelerates. Insurance agents also suffer because of the lack of markets and fewer products to sell. The challenges any reform effort in this context must overcome are thus significant.

I would now like to spend a few moments discussing in more detail the rate regulatory environment in two States in which it is particularly onerous, my home State of New Jersey and Massachusetts.

In New Jersey, new carriers may change premiums without affirmative approval of the insurance commissioner. We have a prior approval law, and it generally takes at least 6 to 12 months for the commissioner to make an initial ruling. The commissioner has not, however, granted a significant rate increase request in recent memory, and the last several commissioners have refused to grant any increases at all during an election year. The futile process is coupled with two particularly burdensome regulatory requirements:

First, although insurance companies are not guaranteed any profits, they are prohibited from earning more than 6 percent in profits from their sales of auto insurance over any 3-year period. This excess profits law is very difficult for companies to make any kind of rate of return.

Second, carriers are required to take all comers, meaning they are required to insure any licensed New Jersey driver that has less than eight points that applies for coverage. Because of the difficulty in raising rates under the State's procedures, drivers with good driving records inevitably subsidize those with poor records.

In Massachusetts, the maximum auto insurance rates for all carriers are established globally. In August of each year, briefs are filed by both industry and Government representatives, and a full trial-type hearing is then held that can last 3 to 4 months, during which they have testimony and all kind of different presentations. At the conclusion of these proceedings, the insurance commissioner unilaterally sets the rates that will apply during the next year.

In summary, auto insurance needs to be more uniform, while respecting the differences within each State. We need to allow the free marketplace to work by enhancing competition. At the same time, we need to remove politics from the rate-making system.

In New Jersey, commercial lines has been deregulated for a period of time, and the commercial marketplace has blossomed. Years of company insolvencies and higher premiums have proved to be wrong in commercial lines. Likewise, States like Illinois and South Carolina, who have had similar problems like New Jersey and Massachusetts, have changed to make their laws more competitive and their marketplace more competitive, and at the same time their premiums have been reduced.

So, with that, I thank you for the opportunity to present our testimony and look forward to any questions you may have.

[The prepared statement of Thomas B. Ahart can be found on page 55 in the appendix.]

Chairwoman KELLY. Thank you very much, Mr. Ahart.

Next, we have Mr. Robert Hunter, the Director of Insurance for the Consumer Federation of America. Mr. Hunter served as the Federal Insurance Administrator under both Presidents Ford and Carter. Mr. Hunter, we are pleased to have you here today. Thank you for testifying.

STATEMENT OF J. ROBERT HUNTER, DIRECTOR OF INSURANCE, CONSUMER FEDERATION OF AMERICA

Mr. HUNTER. Thank you, Madam Chairwoman.

Consumers agree that there needs to be more uniformity and more efficiency in the regulation of rates and forms. And, in fact, we participated in a process of developing methods for more efficient, timely and effective review of rates and forms through the National Association of Insurance Commissioners over the last year, including the CARFRA and Improvements to State-Based Systems Initiatives. We have even proposed ways which will shorten the time regulation takes to no more, in any State, than 30 to 45 days.

The assumption, however, that over-regulation of auto insurance as a major consumer problem in America is not right. The real problem that we face as consumers is market conduct abuses that are not caught by the State regulatory regimes in any State, much less in one or two States. So you have vanishing premiums, you remember, with Prudential and MetLife and insurers like that. You have State Farm putting on parts that were found by courts to be fraudulent and in breach of contract. You have race-based premiums now recently being caught and red-lining in minority communities that courts have ruled against.

These are the issues that are very important to consumers. They really abuse consumers, and these are the ones that have national implications. The States have done a poor job in policing these practices.

There is no groundswell from consumers for faster products or less review of rates and forms. I have never, out of 27,000 calls I have received in my career that I have estimated, had a consumer say, you know, we need less look at the insurance companies or, you know, I can't find some product that I am looking for that some company wants to get to market.

Some of the new ideas that insurance companies come up with have potential to downright harm consumers. Congress right now is looking at the possibility of controlling use of the human genome by health insurers, for example. That is a potential problem. Credit scoring is now being used in auto insurance by 93 percent, according to Conning and Company in a study that just came out today. Some insurers, they say, give more weight to the type of credit card you own or other elements of your credit history than to your driving record when establishing auto insurance prices.

When I was Texas Insurance Commissioner, I first heard of the use of credit scoring when a woman told me she was being surcharged for her insurance because she had declared bankruptcy 7 years earlier. I asked what kind of insurance it was, and she said "auto insurance," and I almost fell over, because I couldn't understand the connection between the fact that she had filed bankruptcy a few years ago and her driving ability. But I really got mad when she told me she never went bankrupt, that she, as a single mother, got a second job, pulled herself out and withdrew the bankruptcy, but it was still being used to up-rate her by the insurance company. I think Government needs to look at those kinds of things and see if those are proper to use.

Progressive Insurance Company in Texas is now using Global Positioning Satellites to follow cars around so that they track where you are, where you are going, what time you drive, and so on in cars they insure. I think Government needs to look at that. That is an incredible invasion of privacy, in my view.

Regarding New Jersey and Massachusetts, these two States, over the last 5 years, had rates of return, New Jersey of 8.3 percent, compared to 10.8 in the Nation, and in Massachusetts, 8 percent. They are slightly below the national average, but there is no crisis of profitability in these States. The traffic density in New Jersey is 2.67 times the national average, and in Massachusetts, it is 2.19 times the national average, and therefore their rates are going to be high, and particularly in New Jersey, where you have one of the richest benefit systems in the entire country, Mr. Ferguson. It is very rich. That obviously costs money.

Can companies succeed in New Jersey? Absolutely. New Jersey Manufacturers is a classic example, and Plymouth Rock in Massachusetts is another example of a very successful company competing in that State. The market share in New Jersey of New Jersey Manufacturers has gone from 9.8 percent in 1994 to 12.7 percent in 1999. They have the lowest complaint ratio in the State. They have paid dividends to policyholders every year since 1918—$1.4 billion in dividends in the last 10 years alone to policyholders. Therefore, you can succeed in New Jersey. You have to be efficient. Maybe why companies are withdrawing is they are not competitive.

Consumers have looked at California's auto insurance regulatory system, and we find California to be the best practices in the country.

I would conclude here because I see the red light is on.

[The prepared statement of J. Robert Hunter can be found on page 62 in the appendix.]

Chairwoman KELLY. Thank you very much, Mr. Hunter.

Finally, we are going to hear from Mr. Robert Zeman. He is the Vice President and the Assistant General Counsel for the National Association of Independent Insurers. Mr. Zeman directs the State

Government relations activities for the NAII. Mr. Zeman, we appreciate having you here today and look forward to your testimony.

STATEMENT OF ROBERT L. ZEMAN, VICE PRESIDENT AND ASSISTANT GENERAL COUNSEL, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

Mr. ZEMAN. Thank you. Good afternoon, Madam Chairwoman, Members of the subcommittee.

NAII represents over 690 property/casualty insurance companies. We are the largest property casualty trade association. Our perspective on this issue is that, indeed, some States have excessive regulation and that impedes the ability of consumers to have a wide array of choices in the marketplace. The good news, however, is that other States do take a more competitive approach, with clear benefits for consumers, more choices for consumers, and these competitive States provide the road map for State-based reform that can be accomplished in the more troubling States.

Yes, in the view of our members, New Jersey is a State where excessive regulation has restricted competition, and thus had a negative impact on consumers. We recently conducted a specific analysis of the problems in the automobile insurance regulatory system in New Jersey, and the results confirmed the concerns that have been expressed by our members for some time and the points that have been made by other panelists today.

New Jersey has a highly politicized and volatile regulatory system that makes it very difficult for insurance companies to compete, contrary to Mr. Hunter's assertion. The culmination of these regulatory factors and restrictions has hurt the marketplace and hurt New Jersey's consumers, and it is clearly evidenced by the companies that have made their independent decisions to withdraw from the State.

Other witnesses have given details about the problems in New Jersey, and they are detailed in our written statement. But first and foremost, would be the onerous rate regulatory system that was outlined by the agent representative. Other problems include restrictions on rate adjustments in the involuntary, as well as the voluntary market, and all of this is of critical importance to our members.

The results of our analysis were confirmed by an independent study conducted by Professor John Worrall of Rutgers University. And basically he concluded that all of the problems in New Jersey have indeed resulted in fewer firms writing business in the State and fewer choices for consumers. And the 1999 rate rollback was mentioned, where the rollback was implemented, but the cost-saving measures were never really fully implemented.

Now, some of the reforms recently implemented in New Jersey at least have elements of steps in the right direction, but major additional reform is needed, and the details of our suggested reforms are in our statement.

Now, in Massachusetts as well, as you have heard, we see similar problems. There is unequivocal evidence in the marketplace that the strict regulatory environment, the strict regulation of rates, and forms, and underwriting has led directly to a decrease in the choices available to consumers. And by law, as was noted, the commissioner actually sets the rates in Massachusetts. That is a result of the legislative system that is in place. It is that legislative, regulatory structure which needs to be reformed. All of this has a tremendous adverse impact on consumers in Massachusetts.

But as I said at the outset, there is good news in other States, and a few of them have been mentioned, but you need to be aware that there are actually several States out there that take a more competitive approach, and a wide array of academic studies, our own surveys and our own studies with our members have confirmed the same thing; that in the States with the more competitive environments, consumers have a better choice. They have more choices in terms of coverages and insurers from which they can get coverages. There is less subsidies, there is more accurate pricing. These are all clear benefits for consumers in the more competitive environments.

It is most important to note that some States like Illinois, where I come from, and Wisconsin, have used the more competitive system for years. But the best news of all was mentioned regarding South Carolina, which went from a restrictive regulatory environment to a more competitive approach. And very quickly the number of companies doing business there doubled, rates fell, the residual market population fell. There are a number of solid indicators of the progress that was made in South Carolina, and it gives us hope for other States.

Some Insurance Departments across the country are implementing operational reforms that have been proposed by the National Association of Insurance Commissioners. But in addition to those operational efficiencies, we need better public policy, legislative changes in the more restrictive States. We are also pleased that the National Conference of Insurance Legislators just produced a model bill which would help truly enhance competition, but that model, or elements of it, must be enacted by the States.

NAII has continued to believe, and we will continue to support State regulation, we believe the State-based system can work. We totally reject any assertion by Mr. Hunter or anyone else that the California system is better for consumers. Their study was completely flawed, ignoring the fact that the reduction in premiums have been due to a reduction in losses. The prior approval system in California has hurt consumers. Other academics have said that if not for the prior approval system in California, rates probably would have gone lower. But, because of the prior approval system, companies, even when they saw loss costs going down, felt somewhat reluctant, perhaps, to increase rates or to lower rates as far as they could for fear of inability to raise them down the road.

Proposition 103 has been a bad deal for consumers in California. Clearly, when you look at the total landscape across the country, the total academic evidence, the experience of our members countrywide is that in the more competitive States there are better choices for consumers, less subsidies, and those States provide the road map for State-based reform.

I have gone over time—my apologies.

[The prepared statement of Robert L. Zeman can be found on page 103 in the appendix.]

Chairwoman KELLY. I have been clocking exactly the number of seconds. You are not that far over, but thank you very much.

I appreciate the testimony of all of you today. I have a few questions.

I, first of all, want to say, Mr. Snyder, for a tired Congresswoman, it was nice to read your testimony. You sure summed it up and made it easy for me to read, and I thank you very much. I appreciate that.

We have been joined now by several other members. I am going to start the questioning here. I just want to welcome the people who have come in—Ms. Schakowsky, Mr. Moore, Mr. Clay.

I am going to just ask one question, and I would like an answer from all of you. New York insurance costs have been rising, in large part because of $1 billion in fraud that is committed annually. But instead of imposing price controls, the governor is fighting the fraud head on. New York is cutting the reporting and processing time for medical claims. It is letting consumers pick preapproved doctors and repair shops in exchange for lower rates. It is barring uninsured drivers from filing claims, raising the penalties for fraud and making the attorney general a special prosecutor for insurance fraud.

Do you think this is a better approach to reducing the costs and increasing the choices for the consumers, instead of imposing a sort of a stop-gap price control that is only going to probably worsen the problems in the long run?

I would be glad to have any of you answer this. I would like to hear especially from you, Mr. Litan.

Mr. LITAN. There is an old saying in economics that if you have a problem, you want to have a solution that directly attacks it, and you have outlined that if the problem is fraud, you attack it directly, not indirectly.

Now, Mr. Hunter raised in his testimony some legitimate points about market misconduct. He said, and I think it is true that if you look across the country, insurance departments have scarce resources. Many of them are underfunded. They have difficulties getting revenue from their State legislatures. But wouldn't it make a lot more sense to get them out of the business of doing rate regulation, which as I said makes no economic sense, and use those resources to attack the market misconduct, which includes, by the way, not just misconduct by insurance companies, but also misconduct by insured, fraudulent claims?

So I think it makes all of the sense in the world to attack the problem directly.

Chairwoman KELLY. Does anyone else want to—Mr. Hunter, would you like to speak?

Mr. HUNTER. Yes. Well, you know, New York has been, for decades, viewed as the State to look to by the rest of the country kind of for leadership in a lot of issues. That is probably why they have prior approval for their auto insurance.

Chairwoman KELLY. So you think New York is a pretty good State?

Mr. HUNTER. It is a very good State on regulation, I mean, historically, anyway. I don't know how currently, but actually it does have prior approval of auto insurance rates. So, if the PIP rates are going up because of fraud, they still have to come forward to the Department and say we want to raise the rate and get the approval of the Department, and I think that is appropriate. And I do think that the direct attack on the PIP fraud is the right approach in any State that has a problem with fraud in PIP.

Chairwoman KELLY. Apparently, I have just been advised by counsel. New York has flex rating, not prior approval, for private passengers.

Mr. HUNTER. That is not true.

Chairwoman KELLY. Well, that is what we have here.

Mr. ZEMAN. They have flex rating for private passenger automobiles.

Chairwoman KELLY. We do have flex rating in New York.

Mr. SNYDER. Madam Chairwoman.

Chairwoman KELLY. Yes?

Mr. SNYDER. If I might add further to the comments, New York is at a juncture at this point, a very important juncture. It has a fundamentally good no-fault system of reparations benefits, but a growing fraud problem has exerted significant cost pressures all across the system and has resulted in, for example, a residual market plan growing alarmingly over the past few years.

The State administration, as I understand it, is proposing really a twofold approach: The first is to address the underlying fraud problems by something called Regulation 68, which would require prompt notification of claims, among other factors, and would increase penalties and increase resources to fight the fraud that is broken out there. That is clearly something that needs to be done.

The second thing is, the Administration is proposing the continuation of important free-market elements that have been added to the New York system, without which the market could very well go the way New Jersey has. That includes the flex rating process—the idea that, at least for some slight amount of rate increase, it is something the companies can get when they really need it. If that is not continued by the legislature, and there is opposition in the legislature, it could well be that we would have the same kinds of problems in New York State that we do elsewhere. So, the Administration is trying to address both the maintenance of the private enterprise elements in what is otherwise a very strict regulatory system and to address the underlying problems.

Thank you.

Chairwoman KELLY. Thank you very much.

Mr. Zeman, you have something you would like to say?

Mr. ZEMAN. Just briefly. I agree with what Mr. Snyder has said. From our indications, clearly, fraud is the major problem in New York right now. And, clearly, the package that you outlined before the State legislature is clearly directed at that problem and can go a long way toward resolving issues in New York. New York does have flex rating now. It does sunset frequently. And down the road in New York, New York might want to look at either making that permanent or considering additional, more competitive regulatory systems.

But, clearly, for now, you are absolutely right, Madam Chairwoman, the package that is oriented toward fraud in the legislature would be a major step toward reform, for the benefit of consumers.

Chairwoman KELLY. Thank you very much.

I wanted to say that, according to the State Rate and Form Law Guide of the American Insurance Association, they say that New York does have private passenger flex rating.

Mr. HUNTER. That may be correct. I may have been thinking back a couple of years.

Chairwoman KELLY. Your comment, Mr. Zeman, is about the sunset problems with it.

Mr. ZEMAN. Yes.

Chairwoman KELLY. Something that we may need to discuss with our New York colleagues in the State Assembly and Senate.

In the meantime, I am going to turn now to Mr. Clay. We welcome you, Mr. Clay, and thank you very much for being here.

Mr. CLAY. Thank you very much. Just a few questions.

Mr. Snyder, you testified that over-regulation by States such as New Jersey and Massachusetts not only penalizes good drivers to subsidize bad ones, but also forces citizens in the rest of the country to subsidize high-risk drivers in those States. Can you elaborate how this negative subsidization occurs.

Mr. SNYDER. Yes, sir, I can.

Problems in the auto market in New Jersey can be spread to all other lines of property and casualty insurance, through something that is phrased a "lock-in law." In other words, in order to exit from the auto market, you have to give up the ability to do all other lines of property and casualty business. So you start with a spot problem in automobile insurance, and pretty soon you have a problem that affects homeowners and commercial property and casualty insurance.

Then, if the company involved is part of a larger national company, the shortfalls in New Jersey have to be made up from somewhere, and they are made up from capital that has been contributed to the company by policyholders in other States. So you have even an interstate subsidy issue going on with respect to New Jersey.

Mr. CLAY. OK. Along those same lines, say in States where there is no regulation—I represent Missouri—and you know rates vary according to zip codes and other factors, do you ever take into consideration drivers' records, good drivers, no claims ever filed? Do you ever take that into consideration when you set premiums and rates?

Mr. SNYDER. The driving experience of the drivers?

Mr. CLAY. Yes.

Mr. SNYDER. It is one of the many factors, one of the principal factors that are used—the driving experience also. The conditions under which the driving occurs, is it driving to and from work, which are the highest accident times. All of those factors are considered, as is the make and model of the motor vehicle, because we know there is very different loss and theft experience with respect to motor vehicles. So there are many, many factors that are used to determine as accurate a rate as possible. There is a strong market incentive for that, to be as accurate as possible in rating.

Mr. CLAY. Just to be clear, you are advocating today against over-regulation by the States of New Jersey and Massachusetts, correct?

Mr. SNYDER. That is correct.

Mr. CLAY. You don't think there should be Rate Commissions and all of that?

Mr. SNYDER. We think there is a proper role for regulation, principally in the solvency area, because that is ultimately the promise that the insurance company makes, that it is going to be there when you have a claim. We also believe that regulations should be pro-competitive.

Mr. CLAY. Yes.

Mr. SNYDER. And, unfortunately, rate regulation, which was well-intended, can have a very, very adverse impact on consumers, generally, in terms of creating shortages that didn't have to exist.

Mr. CLAY. What factors prompted the New Jersey and Massachusetts statutes?

Mr. SNYDER. Both States are high-cost states. They are perennially high-cost States. They have prior approval systems of regulation. In fact, in Massachusetts, it goes beyond that to the State directly, doing what it calls fixing and establishing the rates. Once a determination is made that the market isn't competitive, and that is routinely made, despite evidence to the contrary.

So, when you get the combination of high costs and a rate approval system, a rate regulatory system that gives the State the authority to set prices, you have a very volatile situation with the results that you have got in Massachusetts and New Jersey, which means that ultimately consumers aren't benefited because shortages are unnecessarily created.

Mr. CLAY. Mr. Litan, let me ask you, you know, some States, I guess most States now, mandate auto insurance. Do you know of any associations who oppose that initiative in any State? Most of them don't, do they?

Mr. LITAN. Most States do mandate auto insurance.

Mr. CLAY. Yes, right.

Mr. LITAN. Yes.

Mr. CLAY. But do you know of any insurance associations that ever opposed mandating auto insurance?

Mr. LITAN. Some people are shaking their heads. I don't, but there are other people here——

Mr. CLAY. Mr. Snyder, would you answer?

Mr. SNYDER. Yes, sir. We have traditionally opposed mandatory insurance, but recognize that it has some appeal, and we have tried to work within the system accordingly. But we do, as a policy position, oppose mandatory insurance.

Mr. CLAY. I see.

Mr. ZEMAN. And the same for our organization. For the record, we have opposed it. It is another example of over-regulation.

The States, when they mandate, they don't always mandate just the fact that you have insurance, but having a specific amount that allegedly is right for everyone. We think it should be a matter of consumer choice, a matter of consumers selecting the right benefit levels for themselves.

Mr. CLAY. Mr. Zeman, let me ask you about choices, and premiums, and pricing for insurance. I represent an urban area in Missouri, and the rates vary so widely throughout my State. Now, I realize that there are factors that set your rates, but let us take, for instance, a 70-year-old retired woman parks her car in a garage, never had a moving violation, never an accident, and never filed a claim, but she pays the same rate as, say, a younger driver who has had moving violations, who has filed claims.

What causes that?

Mr. ZEMAN. First of all, I would like to know more details about whatever this case is. But, second, Missouri, we generally hear, has a positive environment. There are a number of companies doing business there and giving consumers other opportunities and other choices. So, if any individual feels that he or she is not paying the right amount of premium, one thing that we recommend is they shop around to other companies. The companies, as Mr. Snyder and others indicated, use a number of factors to determine insurance rates. It is not a one-size-fits-all, and that needs to be considered as well.

Mr. CLAY. OK.

Mr. HUNTER. Mr. Clay, actuarially, the older person typically does pay less than the younger person, and people with accidents, everything else being equal, do pay more than people that don't have accidents.

Mr. CLAY. Except for in Missouri. See, I am a consumer in Missouri, and I shop around for my auto insurance. As a member of the State legislature, I was able to use an address in the State capital, which is in a rural setting. Legally, I can do that. And my premiums were a lot less than what I pay now in the City of St. Louis because that is now my legal residence. I don't have any moving violations. I haven't filed any claims. I have a garage, park my car in it.

Mr. HUNTER. The other factor is territory. They do charge differential rates based upon where you live, and the cities do pay more. There is no question.

Mr. CLAY. Based upon zip codes or what factors are related there?

Mr. HUNTER. Some companies do use zip codes.

Mr. HUNTER. It depends on the State, but some companies use zip codes and some companies don't, but there is definitely a territorial aspect to the rating.

Mr. ZEMAN. Different companies definitely use different rating plans. And you know what? It is another example of competition and how companies find different market niches, and ultimately we think that benefits consumers.

Mr. CLAY. And now I heard Mr. Hunter say that you don't have a crisis of profitability.

Chairwoman KELLY. Mr. Clay, I am sorry, but you have gone well over your 5-minute limit.

Mr. CLAY. Perhaps someone on this side would like to share their 5 minutes with me.

Chairwoman KELLY. Perhaps they would.

Mr. CLAY. Perhaps.

[Laughter.]

Chairwoman KELLY. Perhaps they would, but right now I am asking you—I am saying that everyone——

Mr. CLAY. OK. I will stop now, and perhaps they can get back around to me.

Thank you, gentlemen.

Chairwoman KELLY. Thank you. Yes, if we want, we can have a second round. Thank you.

We will move now to Ms. Schakowsky.

Ms. SCHAKOWSKY. Thank you, Madam Chairwoman.

I have to tell you that as a person who self-identifies as a consumer advocate, I always find it somewhat difficult to swallow when industry people come in and tell us what is really good for the consumer, and then the person representing the consumer advocacy organization is opposed, in general, to the proposals. What is a consumer to do? How are we to understand what is really in our interest?

My background is, as I say, dealing with consumer organizations and then in the State legislature, where we dealt with problems in Illinois, by the way, of insurance red-lining, various kinds of discrimination, particularly based on neighborhood. And I have to tell you that in all of my experience, never once has a consumer come to me and said, "I am so sick of all of these regulations. I am really wanting to see this industry more deregulated."

So, perhaps, and I do apologize for coming in late, but I am trying to understand how exactly the consumer—well, let me ask a threshold question. Why are we here? Are you seeking national actin on auto insurance regulation; are any of you? Mr. Snyder, what do you hope to get from us?

Mr. SNYDER. Madam Congresswoman, I think the first thing is that as the Congress looks at insurance issues, and particularly the Financial Services Committee, more than had been the case in the past, it is important to understand the functioning of it, so that important decisions that you will have to make in the future you can make on the basis of that information.

Ms. SCHAKOWSKY. And what might we be looking at, in terms of auto insurance? Just single that——

Mr. SNYDER. We are looking at a record of——

Ms. SCHAKOWSKY. No, for potential action in the future.

Mr. SNYDER. We support an approach that would return the auto insurance market and all other property and casualty markets to a free enterprise model, rather than a model in which the State or Federal Government or anyone else has the authority to fix prices, has the authority to make all kinds of market-based determinations that ultimately, in the end, results in unnecessary shortages, and disruption. And New Jersey is a classic example, absolute chaos in the market that benefits no one.

Ms. SCHAKOWSKY. So we are focusing just on rates here.

Mr. SNYDER. We are focusing on rate regulation and over-regulation, in general, by the States today.

Ms. SCHAKOWSKY. Yes, Mr. Zeman.

Mr. ZEMAN. If I may, one of the reasons why you don't hear consumers in Illinois complaining is because we hold Illinois up as the model for other States.

Ms. SCHAKOWSKY. Oh, I know, I know, I know. But we do have a good deal of regulation. We do have a good deal of regulation.

Mr. ZEMAN. That is true. It is true. Illinois is not without regulation.

Ms. SCHAKOWSKY. And we are not without regulation.

Mr. ZEMAN. That is right.

Ms. SCHAKOWSKY. And, in fact, some of us would like to think that there ought to be a little bit more regulation. So what I am not hearing is we love it, because the insurance industry is so great, and in fact we would like a little less regulation to make it even better. This has never come up in conversation.

Mr. Hunter, did you want to comment?

Mr. ZEMAN. Can I add one more?

Mr. HUNTER. I just wanted to say that the reason the insurance companies want hearings like this is to pressurize the States to try to deregulate and take away consumer protections.

Ms. SCHAKOWSKY. And what would those be?

Mr. HUNTER. They are pushing very hard. The National Association of Insurance Commissioners has moved very fast to try to simplify regulation, to try to make it quicker, to make it more effective, and to even promise that in any State, even with the toughest regulation, that within 30 to 45 days, there will be a final answer on any filing. They have done all of that. That is not enough for the insurers. Now they want to deregulate auto insurance. The insurance companies came back to the NAIC and started pressurizing them late last year, early this year. They are starting to look at it again, and that is what is going on.

Ms. SCHAKOWSKY. Well, you heard Mr. Snyder's summary of why this is bad for consumers, why the current regulatory system is bad for consumers. Can you summarize then why you disagree with that.

Mr. HUNTER. Well, every State has a slightly different regulatory regime. No State has no regulation. Even Illinois has regulation of forms, for example. You can't put a policy out in Illinois without getting approval. So every State has a slightly different regime. The legislatures of the State make their mind up, and quite frequently it has to do with how much urbanization there is, and there has been red-lining in a lot of the big cities.

Ms. SCHAKOWSKY. Including mine.

Mr. HUNTER. There have been serious problems. And so the States, over the years, have moved to tougher regulation in those situations. In the more rural areas, they have not moved that tough. That is historic.

Now, in my testimony I put forth that California has the best system in the country because it combines both regulation, as a backstop, with real competition; that is, they apply the antitrust laws, they get rid of the antigroup, and antirebate laws. They allow the companies to really fight and have to operate at arm's length, unlike in most States where there is an antitrust exemption, even with no regulation.

So I think, if you want to look to a best-practices model, look at California. Since Proposition 103, the rates have fallen by 12 percent; whereas, the typical State has gone up by 37 percent. The assigned risk plan has almost disappeared, the uninsured motorist has fallen about in half, and the insurance companies made the most profits. The biggest complaint, as you have heard again today is, “Oh, we made too much money in California. It is terrible for consumers.” Well, we like it that way, when rates are falling, and they are making money.

Chairwoman KELLY. Thank you very much, Ms. Schakowsky. I am sorry you are over time here.

We are going to move to Mr. Moore.

Mr. MOORE. Thank you, Madam Chairwomanperson. I appreciate the testimony of the witnesses here.

Mr. Snyder, if I understood your testimony, basically, it was that the insurance companies would like less regulation, more competition or opportunity for the market to work. Is that essentially correct?

Mr. SNYDER. That is correct.

Mr. MOORE. What do you say to Mr. Hunter and what he just said and some of his concerns about consumers and the way that insurance companies affect consumers?

Mr. SNYDER. Well, let me start by saying this: There are probably a million consumers in New Jersey right now that are wondering how effective their regulatory system really is as they are cast out into a market without some of the very players that are major players in virtually every other State. And it is the insurance regulatory system, with its element of price control, which is truly extraordinary in this day and age, for any product anywhere in the United States, indeed, anywhere in the world, for the Government to be able to directly set prices, as it can in virtually every State. When that authority is exercised in an environment with otherwise high costs, significant market shortages can occur which, in turn, benefits no one, certainly consumers most of all.

So the issue today is, as this subcommittee looks at the largest line of property and casualty insurance, almost $120 billion is this line of insurance in the United States. So it is appropriate for this subcommittee to look at its dynamics and its regulatory system and what is the best way to deliver those products to consumers. It needs to look at the different models that are out there.

Now, Mr. Hunter mentioned California. Fortunately, for the drafters of Prop 103, it was put in place at a time in which other factors were dramatically driving down costs. The Supreme Court there reversed what is called a third-party bad-faith doctrine, which allows two actions to be brought in every automobile accident case. That reversal dramatically cut costs. In addition, highway safety measures and antifraud measures occurred at the time when Prop 103 came in, in California.

Now, because those costs were going down, the rate regulator didn’t need to force the premiums down because they were going down on their own. In fact, the evidence seems to be that the premiums would have gone down even more dramatically if the companies functioned under a system where if they needed to adjust to market conditions by raising rates, they could do that. Compare that with the absolute disaster in New Jersey and Massachusetts, where there are few national players, where consumers do not have the choices they do elsewhere.

Mr. MOORE. Thank you, Mr. Snyder.

Mr. SNYDER. That is how we prevent that kind of thing from happening. It is what we are focusing on.

Mr. MOORE. Mr. Zeman, I believe you testified that levels of insurance should not be mandated; is that correct, sir?

Mr. ZEMAN. That is the position of our association, that it should be up to each individual and their family to make the choice as to what level is right for them.

Mr. MOORE. Should there be minimum levels of insurance by people who drive cars?

Mr. ZEMAN. That largely reflects what many States have right now—you know, a minimum level. In some States, it varies from State-to-State.

Mr. MOORE. Do you agree with that, that there should be minimum levels and that States should be able to set minimum levels?

Mr. ZEMAN. Again, actually, our position is that it is bad public policy for the States to mandate the purchase of insurance and mandate the specific levels as well. There have been tremendous problems in enforcing this, since compulsory was tried back in the 1920s.

Mr. MOORE. So you are saying or your association would be taking the position that people could drive automobiles without any insurance if they chose to do that?

Mr. ZEMAN. No. Well, our position is that people should be adequately insured, and that includes making sure they have underinsured motorist coverage to protect themselves if they are hit by an uninsured motorist.

Mr. MOORE. Well, how do you do——

Mr. ZEMAN. We do recognize that the vast majority of States have adopted compulsory provisions, so we work with our members in helping them implement in those States.

Mr. MOORE. But you disagree with a requirement or a mandate for minimum levels of insurance?

Mr. ZEMAN. Philosophically, yes, because of the mandate.

Mr. MOORE. We are talking about the real world here. I am not talking philosophy.

Mr. ZEMAN. Once again, the position of our members is that the specific levels should not be mandated by the States.

Mr. MOORE. Not even a minimum level.

Mr. ZEMAN. Not even a minimum level.

Chairwoman KELLY. Thank you very much. Mr. Moore, have you finished? Do you want one more question?

Mr. MOORE. I think my time is up.

Chairwoman KELLY. Just about.

Mr. MOORE. Thank you very much.

Chairwoman KELLY. OK. Thank you.

I turn now to Mr. Capuano. Oh, I am sorry. We have Mr. Tiberi. Mr. Tiberi, do you have questions?

Mr. TIBERI. Yes, but I will defer to the——

Chairwoman KELLY. I will take you first.

You two can fight it out over there, just let us go.

[Laughter.]

Mr. TIBERI. Thank you, Madam Chairwoman. I apologize. I was at a markup actually.

Just a couple of observations and then maybe a question, an open-ended question to everyone on the subcommittee.

First, Mr. Hunter, you mentioned about State legislatures making the law. I am from Ohio, and we have a court that likes to make the law in Ohio. So I would take exception to your statement, specifically with respect to auto insurance, by the way.

We had, in Ohio, a few years back, a bill that was introduced dealing with no fault insurance. And through testimony in the Insurance Committee, both positive and negative, it became clear that, at least from Ohio's perspective, no fault would have a detrimental effect to consumers, ultimately, Ohio, because of a lack of competition because insurers wouldn't be writing there, at least in Ohio, which I think is considered a competitive State for the industry.

There are two Ohio companies that are large companies, national companies, that do not write in either Massachusetts or New Jersey. I don't know if anyone here is an expert at least on what would the reasons be that a national company not write in New Jersey and Massachusetts.

Mr. AHART. As an agent in New Jersey, we have had quite a few national companies not participate in New Jersey, and it is pretty simple. It is just because they don't believe they can make money in New Jersey.

Mr. TIBERI. And companies that are writing in New Jersey, what reason is it that they continue to write there?

Mr. AHART. Some of them have large books of other lines of business other than auto, and some are making money in auto insurance. You know, efficiency clearly is a key to that, but the simple fact is, again, there wouldn't be so many leaving if they could actually make money. And the fact is that so many are leaving right now, it is really starting to put a burden on a lot of the others that can't even absorb the 25-percent market share that is going to be missing once those companies leave.

Mr. TIBERI. In Ohio, with this most recent court decision, there have been several companies that have already pulled out of writing in Ohio. Are there other States where an example could be used or either a legislature or the court has regulated, has gone farther, in terms of regulating the industry, where there has been a significant pullout of carriers? Can anyone point to that?

Mr. HUNTER. Not really. Usually, there are threats, but they usually don't follow through. There were threats, for example, as Proposition 103 was being debated, that if that happens, we are going to pull out, but they didn't. In fact, 17-percent more company groups are writing now in California than before.

Mr. LITAN. But we discussed earlier in the testimony the flip side, and that is South Carolina deregulated, it went the other direction, and the number of insurers doubled within the space of a little more than a year.

Mr. HUNTER. I might comment on that too.

The numbers of insurers doubled, and I have done a little bit of research. I only got the testimony notice yesterday, but I made a couple of phone calls. The doubling of companies in South Carolina is almost exclusively within groups that are already in the State, when they have added very high-cost, nonstandard companies, which I have great difficulty finding a great consumer benefit out of this sudden inrushing of very high-priced companies into South Carolina.

Mr. ZEMAN. If I may, rates have fallen for consumers in South Carolina—let me finish, please—and the residual market population has gone down as well. So there are a number of factors, indisputable, that the South Carolina deregulation has been a success story.

Mr. HUNTER. Unfortunately, as I pointed out in my testimony, the South Carolina data that you are relying on is wrong. The NAIC left the recoupment charges out of the data.

Mr. ZEMAN. Once again, Mr. Hunter, you are talking about rates, and I stand by what I said about rates, in terms of the companies there and the residual market population has decreased—no dispute there.

Mr. LITAN. It went from, roughly, a million people in the assigned market to only about 50,000 today.

Mr. HUNTER. There was no assigned market in South Carolina.

Mr. LITAN. Residual market.

Mr. TIBERI. I know my time is about to expire. Can I ask the other two witnesses who haven't spoken yet if they have any clue?

Mr. SNYDER. Thank you very much, Congressman. I think the issue here is to apply the lessons in every other product and market to insurance, and it really functions according to the same rules.

What occurs in States where costs are high, and in Ohio, you are right, there were some very adverse court decisions, but the legislature dealt with that, and that law was signed yesterday.

But in States where those costs continue to rise unaddressed, and there is price regulation which is imposed on insurance companies, just as if it were imposed on food producers or anyone else, the result would be to create scarcity in the market. Because a company, when unable by Government fiat to earn what it needs to cover its costs, will try to reduce the number of products that it is selling in that market.

And we have that case in both Massachusetts and New Jersey, where major national writers, including writers which are based in your State, as you mentioned, are simply unable to do business because of the economics imposed upon them through Government regulation.

The fundamental point today is apply the same lessons that we know from every other product to insurance, and you will find that it will function the same way. Reduce or eliminate the price regulation, allow the prices to go where they need to, work with insurance companies, and consumer groups, and highway safety groups, and law enforcement to continue to address the underlying problems, deal with those court cases that are completely outliers, and you'll have a very, very positive system, one that costs less for consumers and one in which consumers have a maximum amount of choice. And they are being denied that because of the over-regulation principally resulting from rate regulation.

Now, let me add one other thing. This does not imply that abuses that insurers may engage in cannot be addressed by the Government. Clearly, the antidiscrimination laws, clearly, other laws continue to apply to insurance companies. Laws that apply to businesses, generally, would apply to insurance companies. And we have said that if optional Federal chartering is adopted, we are willing to give up totally with the antitrust exemption, but let us leave that aside.

The reality is that the abuses can be addressed, but the automobile insurance market can be made healthy again and be assured to be healthy in every State if we simply apply the lessons to that product that we do to every other product.

Thank you.

Chairwoman KELLY. Thank you very much.

We are going to go to Mr. Capuano.

Mr. CAPUANO. Thank you, Madam Chairwoman.

I am from Massachusetts, gentlemen.

First of all, I would echo Ms. Schakowsky's question, why are you here? The Massachusetts legislature is in session, they are working on their budget. Go tell them. Why are you telling us? I mean, I appreciate it.

Chairwoman KELLY. Because I am running this hearing, Mr. Capuano.

[Laughter.]

Mr. CAPUANO. Fair enough. That is a fair answer.

Mr. LITAN. They asked us to come.

Mr. CAPUANO. That is a good answer.

[Laughter.]

Mr. CAPUANO. Well, thank you very much. It was very interesting.

[Laughter.]

Mr. CAPUANO. I guess I want to make one statement, because in some of the stuff I was reading before I got here, I noticed there were some quotes from some executives from Liberty Mutual that may be pulling out of the auto insurance business in Massachusetts. And just as a footnote, last I knew, Liberty Mutual was adamantly opposed to Federal charters. Now, they may have changed their tune since in the last week or two, but as of 2 weeks ago, they were adamantly opposed to it. Now, they may or may not be part of the industry, and I know that that will be a discussion.

But just as another footnote, a subfootnote to that, if and when you get Federal charters, please recognize that there will be many of us who will then try to hold you to other Federal laws that you don't want to be held to—many little things like fair housing standards when the insurance comes to us. Another argument for another day, but you can't just get Federal charters without getting Federal requirements as well, at least—you might be able to, but not from me.

[Laughter.]

Mr. CAPUANO. The third comment I want to make is when I hear deregulation, lately, I get a little nervous. It didn't work so well in energy. It didn't work so well in airlines. Every day I read the paper, I went to a hearing just yesterday, it is not working so great in the stock market right now. We have got analysts who are getting questioned. Deregulation is not the panacea of business. And as we all know, there is regulation in the insurance industry. Even in those States who have allegedly "deregulated," they still have regulation.

I guess the other point I want to make is, for those of you who don't know, Massachusetts has had three governors now who have each been vehement proponents of little or no Government regulation on anything, and it is the governor in Massachusetts who appoints the rate setters. So, if there is a rating problem in Massachusetts, the first stop you should make is to the governor of Massachusetts, the last three of whom have run on antiregulation. So, if there is a problem, see them.

I also want to make another comment. Very clearly, I don't like the Massachusetts auto insurance system. It is terrible. It is horrendous. It is archaic. It does subsidize bad drivers at the expense of good drivers. Being a good driver, I am one of them. It is also, in my opinion, incredibly discriminatory. I believe, in my heart, that it is unconstitutional because of rating territories. In Massachusetts, I don't know other States, rating territories almost uniformly conform to where racial minorities and economically deprived people live. It is almost a perfect overlap. That is discrimination, gentlemen, in my opinion. An argument for another day in a State court, more than likely.

All that being said, the fact that companies have withdrawn from Massachusetts, you are right, and again I agree with you. The Massachusetts system needs to be overhauled. There are ways to do it that don't jeopardize some of the fundamental concerns we have in consumer fairness, minimum coverage, because I would respectfully disagree that I believe strongly in minimum coverage requirements because I know plenty of people, personally, who without that minimum coverage would be in serious trouble today.

All of that being said, though, I am glad you came, and I am glad the chairlady asked you to come, and I am glad you respected her wishes.

[Laughter.]

Mr. CAPUANO. I would respectfully request, unless you want to come and ask for a Federal charter, which if you do, fine, I will tell you right now, I am going to start talking about other things as well. I don't have any opposition to Federal charter, but you are not going to just get on a silver platter, I hope, just the Federal charter without the Federal requirements. And for me, when it comes to auto insurance, we will talk a lot about auto insurance discrimination when it comes to my constituents and whatever Federal plan there will be.

But other than that, I do thank you for coming today, and enlightening me and educating me a little bit anyway.

Chairwoman KELLY. Thank you very much, Mr. Capuano.

There is a vote on the floor. We have all had a period of time in which to ask some questions of you.

I am going to enter into the record the State Rate and Form Law Guide that I mentioned earlier from the American Insurance Association, making that a part of the record. And hearing no objection, so ordered.

[The State Rate and Form Law Guide can be found on page 32 in the appendix.]

Chairwoman KELLY. I, also, want to say that there are no more questions. I am sure there are questions, but since we have a vote on the floor, I know that these additional questions members may want to submit to you in writing.

So, without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

With that, I want to say thank you very much, gentlemen. This was a very interesting hearing. I appreciate your being here. It, obviously, is something that we need to continue to explore until we come up with some right or at least illuminating answers on the topic.

The panel is excused with our great thanks and appreciation for your time. The hearing is adjourned.

[Whereupon, at 3:20 p.m., the hearing was adjourned.]

A P P E N D I X

August 1, 2001

Statement of Chairwoman Sue Kelly
House Committee on Financial Services
Subcommittee on Oversight and Investigations
Over-regulation of Automobile Insurance: A Lack of Consumer Choice

August 1, 2001

This afternoon we are holding a hearing on the effects of state over-regulation of auto insurance on consumer choice. State insurance commissioners bear a responsibility to promote a competitive climate in which consumers can choose from a number of stable and solvent companies at competitive prices. When that climate is not maintained, there are going to be warning signs.

Unfortunately, the alarm bells are sounding in New Jersey and Massachusetts. It is apparent from the exodus of companies from New Jersey and the refusal of many insurance companies to do business in Massachusetts that the regulatory climate for auto insurance in those states has turned oppressive. In New Jersey, over one-half of the 15 largest auto insurers in the country have either already left or will leave in the near future. Over one million people in New Jersey will lose their automobile insurance, with a dwindling supply of alternative companies willing to do business in the state.

Massachusetts might be in worse shape, with two-thirds of those same 15 largest insurers either writing little or no business or refusing to do business at all in the state. Why are the people of Massachusetts denied the right to do business with the insurer of their choice? Why do they continue to tolerate a system that has driven two-thirds of the largest, most competitive providers out of the state?

Meanwhile, in free market states such as Illinois and South Carolina, there are numerous auto insurance companies providing consumers with real choices at competitive prices without subsidizing risky drivers with bad records. For instance, in South Carolina, the number of insurers accessible to consumers has doubled since the state eliminated artificial price controls. It is that contrast that we will examine today.

I would note that the New York Insurance Superintendent has been watching the events in these states carefully, especially across the border in New Jersey, and drawn the right conclusion. If there is a problem with high auto insurance rates, the answer is more competition and sound fraud enforcement, not just more regulation. That's why New York is pursuing a package of real reform to catch and prevent insurance fraud, bar drivers who won't pay their insurance from recovering damages, and allow more choices and incentives for lower-cost repairs. That sounds like reform that will bring real results for New York's drivers. I have a recent op-ed written by the New York Insurance Superintendent, Greg Serio, that I believe sets out a strong case for the reforms they are working on in New York. I'm going to ask unanimous consent to have made part of the record – hearing no objection so ordered.

Before us today we are honored to have a distinguished panel of auto insurance experts to share their thoughts and observations with us on these issues. I thank you all for taking the time out of your busy schedules to help us understand how the regulation in these states is affecting consumers and look forward to discussing these issues with you.

Opinion

Jersey Way Wrong Way On Insurance

By GREGORY V. SERIO

Daily headlines chronicle the exodus of automobile insurers from New Jersey because of what the insurance companies say is an unduly restrictive regulatory environment.

Here in New York, many say the dire situation in New Jersey is a precursor to disaster in our own automobile insurance marketplace.

But we New Yorkers can avoid this problem if we do not choose the New Jersey way, as some in the Assembly are advocating.

In 1998, New Jersey passed a major auto insurance law change that forced insurers to adopt across-the-board price cuts of 15%. Drivers now are witnessing the results of this government-knows-best mandated rate reduction: State Farm, American International Group and Newark Insurance have announced that they intend to stop writing new automobile coverage in New Jersey. Analysts warn that the departures of these insurers will reduce competition, which ultimately will translate into higher costs for drivers.

We in New York should not rely upon such a shortsighted remedy, particularly when it causes the very market disruption we are trying to avoid: widespread withdrawal of automobile insurers from the market. Unfortunately, some members of the Assembly want us to follow New Jersey's path.

The New York State Insurance Department has introduced a sweeping legislative and regulatory reform package that can ensure a strong auto insurance marketplace. It focuses on the root causes of the problem — automobile insurance fraud and abuses in no-fault insurance claims.

New York's drivers pay an estimated $1 billion a year in a so-called fraud tax — that is, the costs of insurance fraud and abuse that are passed on through increased premiums. The Insurance Department's package would repeal this tax by weeding out fraud, lowering premiums for all New York drivers.

It would do this by barring damage recoveries to those who own or operate uninsured vehicles and by establishing new categories of crime. For example, the package would make acting as a runner — a person who, for a fee, arranges for someone to unlawfully obtain insurance benefits — a felony.

In addition, the package proposes structural changes in the no-fault auto insurance system, closing loopholes that have been exploited as opportunities for fraud and abuse. The package is the only plan that would control rates by reducing unnecessary claim costs while providing more consumer rights and options to reduce auto insurance premiums.

For the first time, New Yorkers would have real options to lower their insurance rates. Consumers could, for example, agree to have their vehicles repaired by designated repair shops in return for reduced premiums. Insurers would be required to lower rates to reflect the savings attributed to the use of such shops.

Three years after New Jersey drivers were promised reduced auto insurance rates, they are being rewarded with fewer choices as auto insurers flee the state.

I urge the Legislature to act on the only plan that can reduce premiums and put a brake on fraud and abuse. We can do it the right way or the New Jersey way. The choice is clear.

Serio is superintendent of the New York State Insurance Department

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State Rate and Form Law Guide

2001

STATE RATING SYSTEMS

Automobile

(1) State-Made Rates
Massachusetts *(noncompetitive market)*

(2) Strict Prior Approval
Delaware
Nevada
New Hampshire
New York *(under certain circumstances)*
Oklahoma *(if rate change exceeds 15%)*

(3) Prior Approval With Express Deemer
Alabama
Alaska
Arkansas
California
Colorado *(assigned risk)*
Connecticut *(personal lines in a noncompetitive market and residual rates)*
District of Columbia
Florida
Georgia *(private passenger)*
Hawaii
Iowa *(in a noncompetitive market)*
Kansas
Kentucky *(in a noncompetitive market, or if rate change exceeds 25% within 12 months, or if residual market rate)*
Louisiana
Maryland *(noncompetitive market)*
Michigan *(excluding private passenger in a competitive market)*
Mississippi
Missouri *(commercial casualty if rate change exceeds 25% annually)*
Nebraska
New Jersey *(private passenger)*
New Mexico
North Carolina *(private passenger)*
North Dakota
Ohio *(commercial casualty in a noncompetitive market)*

(3) Prior Approval With Express Deemer (cont.)

Oklahoma
Oregon *(commercial liability markets specified by regulator subject to flex band)*
Pennsylvania
Puerto Rico
Rhode Island
South Carolina
South Dakota *(if closer supervision is necessary)*
Tennessee *(personal coverage)*
Vermont *(in a noncompetitive market)*
Virginia *(AIP and uninsured coverage)*
Washington *(personal coverage)*
West Virginia
Wyoming *(in a noncompetitive market)*

(4) File and Use

Arizona *(in a noncompetitive market and assigned risks)*
Colorado
Connecticut *(in a competitive market)*
Georgia *(other than private passenger)*
Indiana
Maine
Maryland
Michigan *(private passenger in a competitive market)*
Minnesota
Montana
New York *(flex rating)*
North Carolina *(commercial)*
Ohio *(commercial in a competitive market and all other auto)*
Oklahoma *(Automatic Rate Revisions)*
Oregon
South Dakota
Utah *(in a noncompetitive market)*
Virginia *(in a competitive market file on or before effective date; in a noncompetitive market file 60 days before effective date)*
Virgin Islands

(5) Use and File

Arizona *(in a competitive market)*
Florida

(5) Use and File (cont.)

Idaho
Illinois *(private passenger, taxicab and motorcycle rates)*
Iowa *(in a competitive market)*
Kentucky *(in a competitive market)*
Missouri
New Jersey *(commercial lines)*
Tennessee *(commercial)*
Utah *(in a competitive market)*
Vermont *(in a competitive market)*
Washington *(commercial P/C)*
Wisconsin

(6) Rate Filing Only

None

(7) Flex Rating

Kentucky
Missouri *(commercial casualty)*
New York *(private passenger)*
Oklahoma (*Automatic Rate Revisions and Reductions*)
South Carolina
Texas *(DOI sets benchmark and flex band)*

(8) No Filing

Illinois *(commercial)*
Wyoming *(in a competitive market)*

Note: see individual state pages for filing exemptions.

prepared, not delivered, inserted in the record

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Oversight and Investigations
August 1, 2001

"Over-regulation of Automobile Insurance: A Lack of Consumer Choice"

I am very pleased that Chairwoman Kelly is holding this hearing today to examine the effect of over-regulation of automobile insurance on consumer choice. Consumers deserve the right to do business with the insurance companies of their choice. Unfortunately, in States such as New Jersey and Massachusetts where insurers have fled in droves, consumers are being denied this right.

In June, New Jersey's largest automobile insurer, State Farm, announced that it was withdrawing from the New Jersey market due to the "highly politicized and over-regulated" environment. Following closely on State Farm's heels was AIG which described the New Jersey business climate as "untenable."

As a result of these decisions, in excess of **one million** New Jersey drivers will lose their coverage. That is more than **one out of every five** drivers in New Jersey who will need to obtain new insurance policies at potentially higher rates.

Regulation becomes a real problem when it goes from protecting consumers to harming consumers. How can you rationalize to the one million New Jersey consumers losing their automobile insurance that price controls are intended to help them? 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.

Massachusetts may be in even worse shape. Two-thirds of the top 15 national auto insurance companies write minimal or no private passenger automobile insurance in the State.

Why are consumers in Massachusetts denied the same range of choices as consumers in other States? And why are Massachusetts and New Jersey afraid to adopt the models used successfully in Illinois and now South

Carolina, which have opened up their insurance markets to more competition and free market pricing?

South Carolina recently moved from "command and control" regulation to a more market-oriented approach. In just two years, South Carolina has doubled the number of insurers doing business in the State. As the Committee heard in an earlier hearing this year, Illinois' consumers have been able to purchase automobile insurance from a large number of companies at reasonable prices for the last thirty years. These States should be looked to as examples.

I would like to thank Chairwoman Kelly for holding this hearing, and I yield back the balance of my time.

###

Congressman Mike Ferguson
Subcommittee on Oversight and Investigations
"Over-regulation of Auto Insurance: A Lack of Consumer Choice"
August 1, 2001

I'd like to thank the Chairwoman, and members of the Subcommittee on Oversight and Investigations for allowing me to participate in this hearing.

Automobile insurance in my state of New Jersey is in dire need of reform. New Jerseyans have been overburdened with strict regulations resulting in reduction of competition and choice between insurance companies with equitable rates. I appreciate the ability to attend this hearing that will focus on the lack of consumer choice in New Jersey, and the announced withdrawals of four auto insurers in our state within the last year. Specifically, I am interested in discussing with the witnesses the negative regulatory climate in New Jersey and the benefits of a much more competitive market found in states like Illinois and South Carolina.

The state of New Jersey auto insurance market has been criticized for being both politicized and over-regulated, and for enacting laws within the last few years that have crippled the market. Recently, two of the top five automobile insurers announced that they were being forced to withdraw from the New Jersey market citing a burdensome regulatory system, exceedingly delayed decisions by the state commissioner, and restrictions on rate adjustments. In addition, in 1999, the state commission required a 15% rate reduction to policyholders, forcing insurers to provide the cut before enacting many reforms that would have enabled insurers to adjust rates without increased market volatility. Insurers have never been able to reduce by 15% the rate reductions within the strict state regulations, and have chosen to exit the state than try to work with the state commission.

Today, New Jerseyans have seen a loss of consumer choice, and an increase in rates without relief from regulatory burdens, leaving potentially one million drivers uninsured. It is my hope that today's witnesses will touch upon the research and analyses they have done within the state and provide suggested solutions to the growing number of uninsured drivers in my home state.

Testimony of Robert E. Litan[1]

before the

Subcommittee on Oversight and Investigations

of the

House Committee on Financial Services

August 1, 2001

I am pleased to appear before you today to discuss state regulation of auto insurance. As it turns out, the AEI-Brookings Joint Center on Regulatory Studies will release a major study of this subject in several months that was overseen by Professor J. David Cummins of the University of Pennsylvania.[2] If the Subcommittee holds further hearings on this subject, I encourage it to seek testimony from Professor Cummins and others who participated in the study. In their absence, I will report some of its main findings.

Background and Summary of Testimony

The auto insurance industry currently collects about $120 billion in annual premiums, accounting for roughly 40 percent of overall property-casualty insurance premiums. As the Subcommittee is well aware, approximately half of the states have some form of prior approval over auto insurance rates.

[1] Vice President and Director of Economic Studies at the Brookings Institution and co-director of the AEI-Brookings Joint Center on Regulatory Studies. A summary of my professional background is provided as an attachment, as required by rules of the House.
[2] For another summary of the study's findings, see the Joint Center's web site: http://www.aei.brookings.org/events/010118/summary.asp. The complete study -- J. David Cummins, ed., Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency (AEI-Brookings Joint Center, 2001) -- also contains analyses of property-casualty markets and regulation in other countries, and regulation of commercial lines forms.

The AEI-Brookings insurance study contains both a statistical analysis of insurance in all states as well as case studies of insurance regulation and deregulation in selected states, all authored by leading scholars in the insurance field.

The bottom line of all this analysis is very simple to state. Auto insurance is a competitive industry. It certainly is not characterized by monopoly, the traditional basis for price and entry regulation. Nor is the product so complicated that it requires government to set rates to protect consumers. Indeed, because it is what I would call a "plain vanilla" financial product – in large part because insurance policies have been standardized through forms regulation -- consumers are easily able to use the Internet to shop for auto (and other types of) insurance.[3] In facilitating price comparisons, the Net is making and will continue to make auto insurance – and the financial services industry more broadly – even more competitive.

In short, from an economic perspective, there is no basis for regulating rates. Furthermore, there is no evidence from either the AEI-Brookings study or in the academic literature of which I am aware indicating that either prices or profits in states that rely on markets to set rates – rather than regulation – are excessive.

Experience Under Rate Regulation

What about the states that do regulate insurance? As part of the AEI-Brookings study, Professor John Worrall of Rutgers University examined the experience of New Jersey, while Professors Sharon Tennyson of Cornell and Mary Weiss and Laureen Regan of Temple University studied Massachusetts. In both of these states auto insurance rates are heavily regulated. The authors of these state case studies reached similar conclusions.

[3] Not all lines of insurance, however, benefit from forms regulation. One of the conclusions from the AEI-Brookings study is that the regulation of forms for commercial insurance sold to medium and large companies – or sophisticated customers who often purchase insurance in a negotiated setting -- slows innovation in that segment of insurance.

In both states, rates have been suppressed below levels that would obtain in a freely competitive environment. On the surface, this may look like a good deal for consumers, but closer study reveals deeper problems. For one thing, rate suppression not only discourages entry by new insurers, but encourages existing insurers to leave – which in fact has occurred in both New Jersey and Massachusetts. Meanwhile, many more of those insurers who remain operate only in a single state (either as standalone companies or subsidiaries of national firms that are formed to limit financial exposures to the parent companies). In Massachusetts, for example, in 1982 all top ten auto insurers in the state were national firms, but in 1998 this was true for only 3 of the top 10. A similar pattern has existed in New Jersey: five of the nation's top 10 auto insurers do not do business in the state. The net result from restrictive rate regulation is less choice for consumers among less diversified firms.[4]

Less choice in regulated states manifests itself in another way as well. In his statistical analysis of insurance rates across states, Professor Scott Harrington of the University of South Carolina confirms that insurers in regulated states are less willing to voluntarily underwrite insurance, leaving a significantly higher fraction of consumers to buy their insurance in residual markets (where most states assign policy holders to insurers based on their shares in the primary or voluntary market). Again, Massachusetts illustrates the problem: roughly half of the state's drivers were forced to buy insurance in the residual market during the 1980s (reaching a high of 72 percent in 1989). The Massachusetts case study authors report improvements in the 1990s

[4] Professor Cummins has documented elsewhere (with colleagues) that the replacement of national firms with smaller regional and single-state firms drives up the average costs of providing insurance (since there are economies of scale in insurance). Smaller insurers also tend to have higher insolvency probabilities than larger firms. See J. David Cummins, Martin F. Grace and Richard D. Phillips, "Regulatory Solvency Prediction in Property-Liability Insurance: Risk-Based Capital, Audit Ratios, and Cash Flow Simulation", Journal of Risk and Insurance, 1999, Vol. 66., pp. 417-458.

due to some reforms, but also observe that declining claims costs also made helpful contributions (as they did elsewhere, as I discuss later).

Furthermore, regulated rates are often distorted by political pressures in order to subsidize certain classes of drivers. The AEI-Brookings study found evidence that not only does regulation often suppress average rates, but distorts rates between different classes of drivers – keeping rates for high-risk drivers artificially low, while raising rates for lower-risk drivers. This cross-subsidization is accomplished directly through limits on rates in certain classifications or by channeling subsidies to higher risk drivers by keeping rates low in the residual market. The Massachusetts case study, for example, found that some high risk drivers receive subsidies as high as 60 percent, requiring some lower risk drivers to pay 11 percent more in premiums than they would pay in a competitive environment. Similarly, the authors of the South Carolina case study discussed shortly report that the residual market in that state ballooned under regulation to 42 percent of consumers in 1992, requiring significant subsidies from drivers in the voluntary market. By 1999, the state residual market facility had a cumulative deficit of $2.4 billion. Subsidizing high-risk drivers is hardly a desirable social or economic policy because it can lead to higher accident rates and loss costs (due to more ownership and driving by higher risk drivers).

What about the experience in California, which adopted one of the nation's best known regulatory regimes under Proposition 103 enacted in 1988? Professors Dwight Jaffee of University of California at Berkeley and Thomas Russell of Santa Clara University conclude that the harmful effects of regulation found by the authors of the Massachusetts and New Jersey case studies – exit of insurers, rising residual market shares, and rate suppression – did not occur in California. The major reason for this different result, however, is that in both absolute and relative terms, claims costs in California – especially liability costs -- fell dramatically after Proposition 103 was implemented.[5] Why did costs fall? Jaffee and Russell conclude that one reason was that Proposition 103 mandated a 20% "good driver" discount. But the more important factors, taken together, were more aggressive enforcement of seat belt and drunk driving laws, [6]as well as the elimination in 1988 of third party lawsuits in the state against insurers for bad faith.[7] Phillip O'Connor, former Insurance Commissioner of Illinois, has also recently testified to the fact that the most publicized part of Proposition 103 – the 20 percent rate rollback – was never fully implemented (because of adverse court rulings).[8]

In short, the California experience demonstrates that rate regulation need not produce deleterious results if other good things happen at the same time and if the regulatory regime is not that binding. But if there are upward pressures on costs, then almost by definition, rate regulation will result in rate suppression and the various negative consequences that flow from that outcome.

Experience Under Deregulation

In 1999, South Carolina substantially deregulated auto insurance rates (under legislation enacted in 1997) and began phasing out its subsidies. Professors Robert Klein of Georgia State University and his colleagues Martin Grace and Richard Phillips examined the limited data available since then and found some striking results. Before deregulation, South Carolina had an average of 59 insurers serving consumers, compared to almost 200 insurers in other Southeastern

[5] Notably, between 1990 and 1998, the number of collisions per insured car fell by 51 percent in the state, far more than the 15 percent decline in the U.S. as a whole.
[6] The authors point to the fact that California seat belt usage rate is now 89 percent, 20 percentage points higher than the national average of 69 percent.
[7] The elimination of third party bad faith lawsuits resulted from the California Supreme Court's decision in *Moradi-Shalal v. Fireman's Fund.*
[8] Testimony of Philip R. O'Connor before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Committee, June 21, 2001.

states. After deregulation, the number of insurers serving South Carolina roughly doubled. At the same time, the residual market facility in South Carolina has virtually disappeared – down to about 50,000 consumers, from a high of one million -- because insurers now can charge rates based on risk in the voluntary market. Overall premiums have fallen, in part because claims costs have fallen (a result which may have been influenced by the increased use of risk based pricing).

Auto insurance has been deregulated in Illinois for over three decades (and indeed, the state is the only one in the nation without a rating law of any kind).[9] In his study of this experience for the AEI-Brookings study, Professor Stephen D'Arcy of the University of Illinois finds that premiums in Illinois are in line with losses, that they change more frequently and in smaller increments than they do than in regulated states (as one would expect in a competitive market), and that the residual market barely exists in the state (at less than 1 percent of the market). Meanwhile, Illinois consumers have roughly twice the number of auto insurers (129) to choose from than those in New Jersey (67), where rates are tightly regulated. In sum, the Illinois experience is consistent with that of other states that have so-called competitive rating laws – laws that do not require prior approval – and the state accomplishes this result without having to divert scarce regulatory resources into monitoring rates (but can focus on solvency and market misconduct instead).

The experience from other industries where prices and entry have been deregulated also demonstrates that deregulation, by unleashing the forces of competition, helps drive out inefficiencies and thus leads to higher productivity and lower costs.[10] In fact, there is evidence of significant inefficiency in the insurance industry. In another recent study, Professor Cummins

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[9] Even states that do not require prior approval typically allow the insurance commissioner to disapprove filed rates or to require varying levels of documentation of rates.

[10] See Clifford D. Winston, "Economic Deregulation: Days of Reckoning for Microeconomists," Journal of Economic Literature, 1993, Vol. 31, pp. 1263-1289.

and colleagues estimated that on average property-liability insurance firms could reduce their expenses by an extraordinary 32 percent if they were all highly efficient.[11] Rate deregulation in the states where it still exists would help unleash competitive forces that would help realize these cost savings.

Conclusion

The economic case for eliminating rate regulation in auto insurance is overwhelming and compelling. Virtually all economists who have studied the industry over the last several decades have reached this conclusion. The obvious policy implication: auto insurance – indeed, all lines of insurance – should be governed by the market, just like other industries in our economy. Moreover, like other industries, insurance ought to be subject to the antitrust laws.

There are several roles for regulation, however: to monitor insurer solvency (so that consumers will be paid when covered events occur), to protect consumers from unscrupulous practices, and to help standardize forms for personal lines and to small businesses (so that consumers can easily compare prices). Eliminating rate regulation would free up resources within insurance departments to pursue each of these functions (especially solvency and misconduct regulation) more vigorously.

[11] See J. David Cummins, Mary A. Weiss, and Hongmin Zi, "Organizational Form and Efficiency: An Analysis of Stock and Mutual Property-Liability Insurers," Management Science, 1999, Vol. 45, pp. 1254-1269.

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**TESTIMONY OF DAVID F. SNYDER
ON BEHALF OF THE
AMERICAN INSURANCE ASSOCIATION**

BEFORE THE

**SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES**

ON

OVERREGULATION OF AUTO INSURANCE BY STATES

AUGUST 1, 2001

I am David F. Snyder, Assistant General Counsel of the American Insurance Association (AIA), responsible for motor vehicle insurance, transportation and international trade issues. I have previously served in the Pennsylvania Department of Insurance and have been employed by several major personal lines insurers. I am also a Chartered Property and Casualty Underwriter. On behalf of AIA, I am pleased to be able to share our experience with State auto insurance regulatory systems.

Personal automobile insurance is the largest line of property and casualty insurance in the United States, amounting to more than $118 billion in annual premiums. AIA member companies write personal automobile insurance in all U.S. jurisdictions and, because they also write insurance globally, have experience under every kind of insurance regulatory system.

State auto insurance regulation has assumed gargantuan proportions, in terms of expense, intrusiveness, market disruption and avoidable shortages. At the core of this regulatory structure is rate regulation, in reality the governmental power to control prices, that is authorized in some form in all but one or two of our States. The most far-reaching version of rate regulation, prior approval, is embedded in the laws of more than one half of the States. See the attached chart.

When the underlying costs of the insurance product are stable as a result of positive trends in crashes, injuries, thefts, damage and legal, medical and repair bills, the regulatory system is largely invisible and seemingly benign. But as the recent history in New Jersey and Massachusetts demonstrates, when underlying costs rise or remain high, rate regulation leads to rate suppression. Insurer responses to rate suppression lead to more regulation and the public ultimately suffers from avoidable shortages.

RECENT HISTORY IN NEW JERSEY AND MASSACHUSETTS DEMONSTRATES THE FATAL FLAWS IN RATE REGULATION AND OTHER GOVERNMENT INTRUSION INTO THE AUTO INSURANCE MARKETPLACE.

New Jersey and Massachusetts have much in common. Both are in the top five most expensive auto insurance States. Both have a tradition of rate suppression, and systematic controls over every other element of personal auto insurance. And both have a severe shortage of insurance written by national insurers, resulting in an extreme scarcity of choices for consumers.

New Jersey, first in the nation in average auto insurance premiums, is in the midst of a market crisis. Nearly one million policyholders will have to look elsewhere for coverage because insurers writing nearly 20% of the market, including the nation's largest, have indicated they will leave. These latest developments are occurring in a system in which more than one third of the national auto insurers were already bypassing the State. Even before the latest exits, New Jersey had only 67 companies writing person auto insurance in 1999, much lower than the national average.

Coupled with the refusal by public officials to prior approve obviously needed rate increases, New Jersey forces insurers to write un-profitable high risk business at a loss, through "take-all-comers" provisions, mandatory assignment of under-priced policies and territorial rate caps. As a final control mechanism, New Jersey has a law requiring the forfeiture of all licenses by a company wishing to exit the auto insurance market. Despite this severe penalty, increasing numbers of insurers are willing to incur the loss. The ultimate victim is the public, because not only are there growing shortages in the auto insurance market but the shortages may even spread to other lines of personal and commercial insurance.

Massachusetts, ranks 5th in average auto insurance premiums and has even fewer national insurers writing in its market, less than one third of the top 15 national writers. Massachusetts routinely "fixes" insurance rates for all insurers, controls rating factors and heavily regulates underwriting and market withdrawal, similar to New Jersey. The resulting absence in consumer choice is also similar, with only 47 companies writing personal auto insurance in 1999.

South Carolina had a similar history of rate suppression and accompanying controls over other market actions. But, in contrast to New Jersey and Massachusetts, it has begun to dismantle its counterproductive regulatory system. South Carolina had 76 insurers actively writing auto insurance in 1999, up from prior years.

RATE REGULATION SKEWS PRICES AND LEADS TO RATE SUPPRESSION WHERE UNDERLYING COSTS ARE HIGH OR RISING.

When underlying costs are stable or declining, the rate approval system seems benign. Yet, it still has an anti-consumer, albeit less visible, impact.

Without rate regulation, companies would respond rapidly to changing circumstances by cutting prices and expanding underwriting, because the companies would be able in the future to change their prices to meet any upward trends in the costs of providing the product.

But with rate regulation, the suspicion, often quite justified, will persist that while reducing rates is easy, raising them to meet changing conditions will not be easy or even allowed at all. The natural reaction will be to be more cautious about lowering rates. Will the positive cost trends continue? If they don't, how fast can we respond by raising prices to match rising costs and have them approved? Asking these inevitable questions could have been responsible for the surprisingly high level of profits in California since the Prop.103 prior approval rating system replaced the State's competitive rating system.

Rate regulation, by suppressing rates in response to the political outcry resulting from higher costs, has its most damaging impact on the market at precisely the time when more capital is most needed in the market to cover the rising costs of providing the product. When, for example, litigation, medical costs or repair bills are rising, constituents will put the most pressure on public officials to suppress prices, something they can't do in most other markets but can and may for personal auto insurance because they have the authority to do so under insurance rating laws. Market decisions then become political decisions.

New Jersey is the most obvious example of the politicization of rate approval. The State's underlying costs are very high and because the State's law permits it, public officials have repeatedly bent to political pressure to suppress rates, and continue to do so.

For example, after a $ 3 billion deficit was created because of rate suppression in New Jersey's residual market, or JUA, the State replaced the JUA with a mandatory depopulation program and a short term involuntary market facility called the Market Transition Facility (MTF) which the Insurance Commissioner was instructed to run on a break even basis. Instead, by suppressing rates, he quickly created a new $1.2 billion deficit. Here is what one court found, even while applying its normally deferential standard of review applicable to the insurance regulator:

> ...it was becoming obvious that MTF was accumulating huge deficits. .... The Commissioner did not adjust MTF rates in response to an avalanche of actuarial evidence that the facility was operating unsoundly ....The Commissioner decided that the indicated rate need was 12.2%, plus .4%.............He did not, however, adopt any part of the 12.6% rate need he found. Since premiums were MTF's only

> revenue source, the Commissioner's responsibility was to predict MTF's rate needs to operate on a break-even basis, and to meet them with rate increases. Increases, however, would disappoint popular hopes that the FAIR Act would reduce high auto premiums. 256 N.J. Super 158 at 168-171 (1992)

Although directed to a specific commissioner acting at a particular point in the long history of rate suppression in New Jersey, the judge's comments graphically illustrate the unavoidable danger and inevitable consequences of rate regulation in situations of high or rising insurance costs.

RATE SUPPRESSION LEADS TO THE ABSENCE OF CONSUMER CHOICE.

Any player in a market when its costs of providing a product rise beyond its control, which is usually the case in auto insurance because it pays for litigation, medical, weather related and auto repair costs, will try to increase its prices. When the regulatory system refuses to allow raising needed capital to meet rising costs, the next reasonable response is to reduce the numbers of loss producing products being sold.

Insurers reduce their numbers in several ways. In response to rate suppression, they may tighten their underwriting criteria to decline risks they might otherwise write if they could charge adequate prices and compete more fiercely for the better risks. This is what some consumer advocates refer to as "selection competition", actually a reaction to rate suppression.

Increasing selectivity is heightened and aggravated if there is inadequate capital as a result of rate suppression. Insurers next will cancel or non-renew existing policyholders using more stringent criteria, again seeking to maintain only their lowest risk customers.

As a result, many consumers may find themselves without insurance or relegated to the high priced residual market plans--customers who before were being written by voluntary insurers. They pay more and have fewer, sometimes many fewer, choices of insurers who will write them. For most people, this result is worse than moderately higher premiums so long as they can be written by the same agent or company or may shop among many choices.

The regulatory response to these insurer actions, made necessary by rate suppression, is often even more regulation. This will take the form of limiting the allowable grounds for rejecting, canceling or non-renewing, mandatory writing of "good drivers", and mandatory assignment of high risk drivers. New

Jersey and Massachusetts did all of these things, resulting in major insurers exercising the only action left open to them--to pull out of the market entirely, resulting in severe market disruptions and chaos affecting millions of citizens.

Even before the current regulation driven crisis, New Jersey lacked 6 of the top 15 national auto insurers, including GEICO, Nationwide and Farmers and a major regional insurer, Erie. Now, the nation's largest auto insurer, State Farm, with over 800,000 policies in New Jersey and 17.6% market share has announced it will pull out. Three other companies are taking similar actions, affecting the security of more than 1 million insureds. For insureds, the absence of choice, or what is termed "unavailability", may be even worse than higher rates.

In Massachusetts, the government "fixes and establishes" the prices that may be charged and mandates a standard policy form. Its residual market had grown to such threatening proportions that many national insurers declined to participate in its market. Massachusetts now lacks 10 of the top 15 national auto insurers. While regulators have recently tried to find some competitive wiggle room in a government dominated regulatory system, the annual determination of non-competitiveness is still routinely issued, resulting in the government directly setting auto insurance prices.

As of 1999, Massachusetts had only 47 insurers writing personal auto insurance and New Jersey had 67, well below national averages. Meanwhile, South Carolina had 76, up dramatically following several years of regulatory modernization. Illinois, without rate approval, had 126.

California imposed prior approval rate regulation, mandatory writing of good drivers and other regulation through Prop.103 in 1988. Since then, however, the overturning of the third party bad faith doctrine, judicial decisions, safety and antifraud efforts have combined to dramatically reduce underlying costs. For example, California bodily injury liability loss costs *declined* 26.3% from 1987 (narrowing the difference between Ca. and countrywide from double to 20%), compared to a countrywide *increase* of 29.75% and *increases* of 65.4% in New Jersey (now more than 90% over the countrywide average) and 14.8% in Massachusetts (now more than 80% above the countrywide average loss cost).

Because of declining underlying costs, the true potential of California rate regulation has not been felt in terms of constricting the market. It is quite possible, however, that the Prop.103 regulation has contributed to higher than expected premiums and profits for insurers because it dampened downward movement in rates reflecting the decrease in costs. If underlying costs in California rise significantly, the apparatus is there to suppress rates and constrict the market, following the path of New Jersey and Massachusetts.

There is virtually no doubt that rate regulation in high or rising cost States, when combined with controls on underwriting leads inevitably to something worse than higher premiums--the increasing inability to buy the product because there are fewer providers.

RATE REGULTION LEADS TO THE CREATION OF UNFAIR AND UNWARRANTED SUBSIDIES.

Auto insurance covers the vehicle and its drivers for damage to persons and property. To reflect the cost of producing the product for each risk, as opposed to over all rate levels considered above, many factors are used to predict future risk exposure. The most rational and fairest insurance price is the one that most accurately predicts the combination of risk exposures that the car and the drivers pose versus the risk posed by other cars and their drivers. Rate suppression often separates pricing from risk and results in lower risk drivers subsidizing higher risk drivers.

In the July 23, 2001 issue of the independent Auto Insurance Report, at page 6, is this commentary:

> In 2000, we believe that the Garden State has set an all-time record for disparity between the liability loss ratio and the physical damage loss ratio...This is truly an imbalanced market. Is it possible that insurers are really bad at adding and subtracting in New Jersey? No. But it is true that regulators in New Jersey gleefully require insurers to charge too little on liability, and too much on physical damage. ....This is a consistent problem that has been in place for many years, and is now coming to a head. Insurers would gladly fix the imbalance, but regulators won't let them.

In Massachusetts, subsidies for some policyholders reach nearly $2000 annually. High risk drivers, such as inexperienced drivers, are subsidized under this system.

The subsidies go from low risk to high risk drivers, from one type of coverage to another, from one line of insurance to another and finally from one State to another. There is no doubt in New Jersey that better risks are subsidizing worse risks, that physical damage coverages are subsidizing liability coverages, that commercial insurance (through the "lock-in law") is subsidizing personal auto insurance and that the rest of the country is subsidizing New Jersey.

When these subsidies are created, they obviously harm the subsidizers and the credibility of the system, but they also harm the subsidized parties, because the poor driving behavior or other remediable causes of loss are hidden and tolerated rather than identified and remedied.

RATE SUPPRESSION HARMS THE SUBSIDIZED PARTIES AS WELL AS THE PARTIES PROVIDING THE SUBSIDIES.

Because true costs are hidden from the public, remedies to underlying conditions are often delayed or avoided altogether. Rate suppression masks problems such as the high incidence of accidents among young drivers. When their true costs are known, it helps focus attention on preventative strategies such as graduated licensing programs.

As discussed earlier, rate suppression also harms higher risk motorists the most, because being more expensive to insure, capital shortages will result in rejection or non-renewal of them first. So these people will earlier feel the harm of tightening selection competition as a result of over-regulation.

RATE SUPPRESSION WILL INCREASINGLY LIMIT THE ATTRACTIVENESS OF THE U.S. MARKET IN THE GLOBAL INSURANCE MARKETPLACE.

Until now, because of tradition and political stability a few countries, namely the U.S., Japan and some European nations had a lock on global insurance capital. That increasingly will no longer be the case. Nation after nation, including former enemies of the U.S. and places where private insurance didn't exist 10 years ago, are creating markets and regulatory systems more modern and more market driven than exist in many of our Sates. Newly emerging insurance markets with market based regulatory systems extend from Viet Nam to Azerbaijan to Jordan, and include China and India. As their political stability and rule of law strengthen and become institutionalized, these nations will begin competing for finite insurance capital. That capital will go to countries which have both stability and fundamental market freedoms and away from places where rate suppression and governmental control are the rule.

The globalization will soon be felt around the world when the decision to commit capital is not just between the States of Georgia and Illinois but also between the Republic of Georgia (without rate suppression) and the State of Georgia (with rate suppression). We all have an interest in the U.S. being able to compete effectively in the world market for the insurance we want and need. To do so will require less, not more, regulation.

CONCLUSION

Rate regulation may seem benign when costs are low. Even then, it may retard the reduction of rates to rapidly reflect declines in underlying costs, as shown by the California experience. But when underlying auto insurance costs are high or rising, as has long been the case in New Jersey and Massachusetts, rate regulation leads to rate suppression. Not only are overall prices politically set but subsidies are created which harm both the policyholders who are subsidizing and those being subsidized. Justifiable insurer reactions to reduce their exposure to losses are blocked by additional controls over their underwriting. Ultimately, consumers suffer with a reduction in market capacity and choice. South Carolina, on the other hand, offers an example of where dismantling price and underwriting regulations can result in a stronger, more competitive market and many more choices for consumers.

Independent Insurance Agent®

Independent Insurance Agents of America

Incorporated

TESTIMONY OF:

THOMAS AHART
AHART, FRINZI & SMITH INSURANCE
On Behalf of the

INDEPENDENT INSURANCE AGENTS OF AMERICA
BEFORE THE HOUSE SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS

AUGUST 1, 2001

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STATEMENT OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
FINANCIAL SERVICES COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

August 1, 2001

Good afternoon Chairwoman Kelly and Members of the Subcommittee. My name is Tom Ahart, and I am pleased to have the opportunity to give you the views of the Independent Insurance Agents of America (IIAA) on some of the problems we have experienced related to state regulatory oversight of the rates charged for automobile insurance in the personal lines market. I am President of the Ahart, Frinzi & Smith Insurance Agency in Phillipsburg, New Jersey. I also am a member of the IIAA Executive Committee, and I will become President of the IIAA in October of this year.

IIAA is the nation's oldest and largest national trade association of independent insurance agents, and we represent a network of more than 300,000 agents and agency employees nationwide. IIAA members are small businesses that offer customers a choice of policies from a variety of insurance companies. Independent agents offer all lines of insurance – property, casualty, life, health, employee benefit plans, and retirement products.

Introduction

At the outset, Chairwoman Kelly, I must note that IIAA welcomes this Committee's efforts to analyze and assess the challenges that face our state-based system of insurance regulation. It is our expectation that this will be the second of a series of hearings, and we hope we will have the opportunity to present our views at each and every stage of your deliberations on these crucial questions.

If given this opportunity, one overarching theme that you will hear from us repeatedly is our desire to modernize and harmonize existing state insurance regulatory systems and to make regulatory requirements more uniform across state boundaries. At the same time, we recognize that, in many respects, insurance remains an inherently local business and that any system of insurance regulation must be flexible enough to accommodate differing local, state and regional needs and circumstances.

Last month, Chairman Baker's Subcommittee held a hearing examining the manner in which states currently oversee and approve insurance products, and the hearing brought to light many of the inefficiencies, idiosyncrasies, flaws, delays, and redundancies associated with the existing system of oversight and review. Many of these same problems are evident in the regulation of personal lines automobile insurance rates, an area of regulation that is in many cases wrought with inconsistent state requirements and excessive government interference.

A recent study on property-liability insurance price deregulation, published in April of this year by the American Enterprise Institute-Brookings Institution Joint Center for Regulatory Studies, describes the current state of regulation in this area:

> Automobile insurance prices are currently regulated in forty-nine States. In thirty-one States, the regulation is of the *prior approval* variety, meaning that insurers must file rates with the state insurance commissioner and have them approved before they can be used in the market. In the other States, insurers can change prices without prior approval, usually with the proviso that they file the rates with the insurance commissioner, who can subsequently disapprove the rates. Only Illinois does not allow disapproval.

Extensive rate regulation in States like New Jersey and Massachusetts is motivated by the political desire to minimize insurance rates. According to the AEI-Brookings study, however, "[s]tate regulation of the $120 Billion annual auto insurance market does not significantly decrease prices for consumers" but instead "generally reduces the availability of coverage and increases price volatility." Moreover, as the authors of the AEI-Brookings study conclude, "there is no evidence that prices or profits in States that rely on markets to set rates are excessive or that insurers behave collusively."

At the same time, as the AEI-Brookings study also recognizes, rate regulation "often results in rate suppression, meaning that the total amount of premiums collected in a State is less than would be collected under competition, resulting in a decline in the market value of insurer equity." Indeed, in Massachusetts and New Jersey, dozens of automobile insurance carriers have withdrawn from the automobile insurance markets over the course of the last two decades because the approved rates for automobile insurance coverage in these States have been grossly inadequate. In a competitive economy such as ours, insurance companies cannot be required to lose money. In Massachusetts and New Jersey, however, the only effective alternative with respect to automobile insurance is to abandon the market completely.

In the short term, such over-regulation presents a tremendous opportunity for independent insurance agents because, in times of market turmoil, we protect consumer interests by ensuring that their automobile insurance coverage is placed with a qualified carrier that intends to continue offering personal lines automobile insurance products in these States. Independent agents are situated uniquely, because we have the authority and expertise to move a customer's coverage from a withdrawing insurer to the best available alternative coverage package quickly, as soon as the initial insurer's plans to withdraw become evident.

In the long term, however, consumers suffer because these insurance markets are under-served and because drivers with better driving records and those that live in lower exposure areas subsidize other drivers throughout a more heavily regulated State. As the AEI-Brookings study notes, rate regulatory systems like those in New Jersey and Massachusetts "subsidize[] high-cost drivers [those likely to have the most accidents], sending adverse incentive signals and increasing accident costs." According to the authors of the study, such regulation thus "creates material economic inefficiencies in order to provide subsidies to the drivers who impose the highest costs on state automobile insurance systems." As the study also recognizes, consumers also suffer when the insurance market is strong overall because "[i]nsurers are reluctant to reduce prices in regulated states, even when premiums are high relative to expected costs, out of concern that they will not be able to raise premiums again if cost inflation accelerates." In addition, insurance agents suffer in the long term because there are fewer products to offer to their customers.

At the same time, rates that will be viewed as adequate vary from State to State with the specific conditions of their respective marketplaces. For example, because the automobile theft rate in Topeka pales in comparison to the theft rate in Newark, and because the population density in New Jersey greatly exceeds the population density of Kansas, the insurance costs in those two locales vary significantly.

The challenges that any reform effort in this context must overcome are thus significant. My testimony today will focus primarily on the problems that we are facing in two States in which the rate regulatory environment is particularly onerous -- my home State of New Jersey and the Commonwealth of Massachusetts. In both of these States, the intrusion and excessive intervention of regulators into the setting of personal lines automobile insurance rates effectively means that pricing is not responsive either to market conditions or to the circumstances of individual drivers in any way. This has resulted in the mass exodus of many carriers from the personal lines automobile insurance marketplace in both States. In Illinois and South Carolina, in contrast, reforms to the personal lines automobile insurance rate oversight process have resulted in the entry of dozens of new carriers into each marketplace and in the reduction of insurance costs for many drivers.

New Jersey

For well over twenty years, New Jersey drivers have paid the highest auto insurance premiums in the country. State officials were hopeful that a series of statutory reforms enacted in 1998 – including a provision that mandated a 15 percent across-the-board rate reduction – would ease automobile insurance premium levels.

The centerpiece of New Jersey's automobile insurance rate regulation is its requirement that no carrier may change the premiums on the automobile insurance policies it offers without affirmative approval of the change by the New Jersey Commissioner of Insurance. After a request is filed, it generally takes at least 6 to 12 months for the Commissioner to make an initial ruling. The Commissioner has not, however, granted a significant rate increase request in recent memory, and the last several Commissioners refused to grant any increases at all during an election year. Moreover, although a carrier that has been denied a requested rate increase can appeal that decision to an administrative law judge, the decision of the judge is non-binding, and no rate change denial ever has been overturned on appeal to the New Jersey Supreme Court.

This onerous process is coupled with two regulatory requirements that have proven to be particularly burdensome. First, although insurance carriers are not guaranteed any profits, they are prohibited from earning more than 6 percent in profits from their sales of automobile insurance policies over any three-year period. If a carrier does earn more than that percentage in profits, it is required to return the "excess" profits to its insureds. There is no allowance or make-up if the carrier lost money prior to the start of the three-year period in which it performed well.[1]

Second, carriers are required to "take all comers," meaning that they are required to insure any licensed New Jersey driver that applies for coverage. Because of the difficulty in raising rates under the State's procedures, drivers with good driving records inevitably subsidize those without paying higher premiums to make up for the shortfall.

While automobile insurance rate reform always has been a high-profile issue in New Jersey, it was not until the State's 1997 elections that state leaders witnessed widespread voter discontent. In the weeks and months preceding the election that fall, polling data showed that residents were unhappy with their leaders' inability to reduce automobile insurance premiums.

Not surprisingly, the 1998 session was the most serious attempt to reform the automobile insurance system in many years. Attempts at auto insurance reform, however, were nothing new for New Jersey. In the early 1970s, the State implemented a verbal threshold, no-fault mechanism to help reduce the costs associated with excessive litigation. With the no-fault option (which is accepted by 88 percent of New Jersey motorists), medical payments are made regardless of fault and the need for litigation is reduced. Victims can sue for pain and suffering damages if they suffer a "serious" bodily injury or a certain specified injury. This verbal threshold was intended to limit the right to sue to cases involving serious injuries, such as dismemberment, loss of bodily function, and similar severe damages. Instead of stabilizing the cost of liability claims, however, costs increased 34% from 1989 to 1996 while the average state premium increased only three percent.

After joint legislative hearings on the issue were held in 1998, separate versions of the automobile insurance reform legislation made their way through the State Senate and Assembly. The process was complicated and controversial from the start, and one insurance industry observer suggested that the movement of the bill resembled a "ping-pong match" between the two chambers and the governor. Eventually, after a conditional veto from the governor, a legislative package reforming the existing no-fault system was agreed to and signed into law.

The centerpiece of the new law is a mandatory 15 percent reduction in automobile insurance premiums. For the average consumer, the 15 percent required rollback will mean an annual savings of about $165 to $180.

In order to justify the 15 percent savings, the 1998 law included numerous provisions intended to reduce current costs. Most notably, the law attempted to tighten "no fault" rules to limit pain and

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1 In contrast, insurance laws in the following seventeen (17) States dictate that insurance departments cannot find insurance rates excessive if the insurance market is a competitive one: Arkansas, Connecticut, Delaware Georgia, Idaho, Illinois, Indiana, Kentucky, Michigan, Missouri, Montana, Nevada, Oklahoma, Oregon, Vermont, Virginia and Wyoming. In addition, insurance laws in the following five (5) States dictate that rates are "presumed" not to be excessive if there is a reasonable degree of competition: Arizona, Kansas, Minnesota, New Mexico and Wisconsin.

suffering lawsuits. The law also purported to repeal the State's territorial rate requirements. This provision, however, has not been implemented even though it was scheduled to go into effect by January 1, 2000, when the 27 existing territories were required to have been redrawn. Even under the repeal, the insurance commissioner retains the ability to deny rate increases that affect urban drivers in a "significantly disproportionate" manner, a term that has never been defined.

Although the 1998 law contained some favorable cost saving reforms, the industry consensus is that these do not come close to realizing the 15% reductions in premiums that the law required. Indeed, the 15% rollback appeared to be based on an arbitrary figure, with no connection to the law's likely impact. Independent studies have been conducted that support this contention by suggesting that the resulting cost savings are unlikely to exceed 3-5 percent.

At the time, independent agents in the New Jersey were hopeful that the new law would help build upon the gradual improvements made to the New Jersey automobile insurance market over recent years. At the same time, we recognized that we would play an essential role in the implementation of the law, as consumers would turn to us for advice, guidance, and clarification about their policies and the impact of the new law. We also recognized that, even under the best case scenario, many drivers would assume that their insurance costs would automatically drop by 15%, but they all would not receive such a reduction.

Unfortunately, enactment of the 1998 reforms has not resulted in the "best case scenario" but has instead led to the departure of carriers who formerly counted among their insureds over 25 percent of all New Jersey drivers. The reasons for this mass exodus are at once numerous and hard to pinpoint. The uncertain rate environment, the shear expense of participating in the rate-making process, the virtual impossibility of obtaining adequate rate increases, and the "take all comers" requirements all appear to have contributed to the reluctance of carriers to continue their participation in the New Jersey automobile insurance marketplace. In addition, the number of carriers abandoning the New Jersey automobile insurance market might have been *greater* if withdrawing insurers were not required to give up their licenses to offer all types of property-casualty insurance within the State if they choose to withdraw from the personal lines automobile insurance segment.

Massachusetts

Although the rate-setting process in Massachusetts is quite different than that in New Jersey, the outcome has been largely the same.

In Massachusetts, the maximum automobile insurance rates for all carriers are established globally in an annual adjudicative proceeding. In August of each year, the Massachusetts Automobile Insurers Bureau files a single petition on behalf of all carriers offering automobile insurance coverage in the State to establish rates that will apply to all such carriers. In early September of each year, the State Ratings Bureau and the Massachusetts Attorney General file papers challenging the requested rates on behalf of Massachusetts drivers. A full trial-type hearing is then held over the course of the next several months during which all parties make presentations, present testimony and cross-examine each others' witnesses. At the conclusion of these proceedings, the Insurance Commissioner sets the rates.

Although carriers can and do deviate from these rates by offering discounts to safe drivers and through group marketing arrangements, the system – like New Jersey's – still fosters incredible rate uncertainty and results in good drivers subsidizing the rates of bad drivers and experienced drivers subsidizing less experienced drivers. Many carriers responded by fleeing the Massachusetts automobile insurance market in the mid-1980s, and, to the detriment of both consumers and insurance agents, there have been essentially no returnees or new entrants in the intervening two decades. As in New Jersey, the number of carriers withdrawing from this market might have been even greater if such carriers were not also required to give up their ability to offer any type of property-casualty insurance in Massachusetts if they withdraw from the automobile insurance segment.

South Carolina

Until recently, the automobile insurance market in South Carolina resembled that of New Jersey and Massachusetts. Mandatory pre-approval of all rate changes and a "take all comers" requirement resulted in a continual erosion of the number of carriers serving that market and imposed higher insurance costs on many South Carolina drivers.

All of that changed in March 1999, when South Carolina's new rate deregulation law went into effect. Under that new law, carriers may increase or decrease automobile insurance rates in any given year by up to 7 percent without any prior approval whatsoever, and they may amend their rates by a greater percentage under a much more liberalized and predictable "file and use" system. These "flex rating" and "file and use" regulations allow carriers to begin using their proposed rates as soon as they are filed with the state insurance department, and they generally give the Insurance Commissioner only a limited window of time during which to challenge usage of the proposed rates.

Within two years, South Carolina drivers were paying on average $80 less per year for their automobile insurance policies, and South Carolina had dropped from 26th in the nation in automobile insurance rates to 38th. The ability to underwrite each driver individually (and thus to provide non-standard coverages to non-standard drivers), the new pricing certainty, and the elimination of the uncertainty of the rate approval process have helped contribute to the entry of over 100 new carriers into the South Carolina automobile insurance market and generate the resulting declines in the price paid for automobile insurance.

Illinois

At one time, Illinois had a very highly regulated automobile insurance market and, like New Jersey and Massachusetts, it experienced very high rates and the departure of a significant number of carriers. In the mid-1970s, Illinois completely deregulated its automobile insurance rate approval structure and adopted a free-market pricing system. Despite the fact that Illinois is a highly industrialized State with a large urban center, the premiums Illinois drivers pay for automobile insurance are consistently ranked in the middle among all the States, and the Illinois automobile insurance market is served by as many automobile insurance carriers as any other State.

* * *

Thank you for giving me the opportunity to express IIAA's views. We look forward to working with the Subcommittee on this issue and I will be happy to take any questions you may have for me.

Consumer Federation of America

THE PROBLEM IS NOT "OVERREGULATION" OR "LACK OF CONSUMER CHOICE"

INSURERS' MARKETPLACE ABUSES ARE THE BIGGEST PROBLEM INSURANCE CONSUMERS FACE

By J. Robert Hunter[1]
Director of Insurance

Before the Subcommittee on Oversight and Investigations
Of the U.S. House of Representatives
Committee on Financial Services

August 1, 2001

Madame Chair, I appreciate your invitation to testify before you today.

THE PRIMARY INSURANCE REGULATORY PROBLEM IS INEFFECTIVE MARKET CONDUCT REGULATION

The title of this hearing assumes a problem and then searches for facts to justify the assumption. But the assumption – that "overregulation" of auto insurance is a major consumer problem in America – is simply wrong.

The insurance companies have tried to turn a few anecdotes about long review times for policy forms or rates by a couple of states into a major attack on state regulation. Many of their "examples" of delay are caused by the insurers themselves where the state asks reasonable questions about a filing and the insurer takes months to respond. Or because state regulators do not want to simply disapprove a bad filing without giving the insurer making the filing an opportunity to fix the harmful provisions in the filing.

We agree that the review of insurance rates and forms by state insurance departments can be more efficient and uniform. But the state regulators – through their own activities and the activities of the National Association of Insurance Commissioners – have moved

[1] Mr. Hunter served as Federal Insurance Administrator under Presidents Ford and Carter and as Texas Insurance Commissioner. His CV is attached to this testimony as Appendix B. Neither he, nor CFA, have received any grants or contracts since October 1, 1999 from the federal government related to the subject of this testimony. Birny Birnbaum, Executive Director of the Center for Economic Justice, assisted Mr. Hunter in the preparation of this testimony.

strongly to redress these problems. Consumers have participated in this process of developing methods for more efficient, timely and effective review of rate and form filings – including the CARFRA and Improvements to State Based Systems initiatives. We have proposed many ways to shorten the time regulation takes – changes which will shrink the process to no more than 30 - 45 days.

However, the industry proposition that auto insurance regulation is too slow or too tough is not accurate. To say it is a major problem to America's insurance consumers is preposterous. It is time that we compare the cost to consumers of a delay in a filing or tough regulation in one or two states to the cost to consumers of ineffective market conduct regulation throughout the nation, which has allowed inappropriate aftermarket parts to be put onto damaged cars in breach of the insurance contract (as an Illinois jury found State Farm was doing[2]), vanishing premiums and other market conduct abuses[3], race-based premiums and redlining of minority communities.

The biggest problem for consumers today is not "overregulation," but the state's failure to prevent, and protect consumers from, insurers' market conduct abuses. Moving to "open competition," "market-based regulation," or whatever this week's euphemism for deregulation insurers are using – will worsen an already bad situation by allowing even more bad insurance products into the marketplace.

The states have done a poor job in policing the on-the-ground practices of insurers. This is much more crucial to consumers than any possibility of a little delay in getting some unspecified insurance "product" to market. And, while state regulators have moved aggressively to respond to insurers' concerns about speed and uniformity of rate and form filing processes (and even deregulation of commercial lines), the needed improvements in market conduct regulation are still in the discussion stages.

While there is clearly room for improving the efficiency, uniformity and speed of insurance regulation, the greatest need is to improve the effectiveness of regulation. Just because insurers are complaining about regulation does not mean that there is a problem for consumers out there. The facts show clearly that consumers have been harmed far more by ineffective regulation – allowing bad products into the market or failing to stop market conduct abuses – than by slow product approvals.

Where is the groundswell of consumers clamoring for new products getting to market faster? I talk to consumers every day – to about 25 a week. I've done this for over 20 years, so I estimate I have fielded over 27,000 calls in my career. I have never had a complaint about a problem getting some new product from a consumer (I've had complaints about getting an existing product, especially from low income and minority consumers). Take auto insurance or homeowners insurance consumers. Are they clamoring for the reductions in coverage insurers want to push through in several states?

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2 The judge went even further; he saw the actions of State Farm as fraudulent. The verdict of over $1 billion was upheld by the appeals court and is now headed to the Illinois Supreme Court.

3 The nation's largest life insurers such as MetLife and Prudential perpetrated these abuses. They had to pay billions to the abused policyholders.

Are they clamoring for greater use of credit scoring in determining eligibility and premiums? Of course not. Consumers want their states to carefully consider such moves that insurers might propose.

Take credit scoring: Some insurers give more weight to the type of credit card you own or other elements of your credit history than to your driving record. This makes no sense, Madame Chair.

When I was Texas Insurance Commissioner, I first heard of the use of credit scoring when a woman approached me after a meeting and told me she was being surcharged for her insurance because she had declared bankruptcy several years earlier. I asked what kind of insurance it was. She said, "auto insurance." I could have fallen over from shock. What does the fact that she was earlier in financial trouble have to do with her ability to drive today?

But my shock turned to outrage when she told me that she never became bankrupt – that she, a single mother, had taken a second job and pulled herself out of debt and withdrew her request for bankruptcy. Here she was, an American heroine, pulling herself up by her bootstraps, only to get slapped around by an insurance system that makes no logical sense.

I thus proposed a regulation in Texas that would require that a classification had to be logical, explainable to a person as risk related, as well as justified by statistical analysis.

I can report to this Subcommittee that the NAIC has taken seriously the problems with state regulation and is working diligently to address efficiency and uniformity issues. The industry, however, is pushing deregulation and giving lip service to making existing regulation more efficient. For example, it is clear that the weakest aspect of state insurance regulation is market conduct examination -- state regulators are often the last to discover or acknowledge serious market conduct problems. Reporters or trial lawyers uncover the abuses and the states then have to catch up. What is the industry's top priority on this issue? Minimum resources for the state to do their job better? No. Their top priority is a self-critical privilege to shield themselves from liability for their unfair practices.

There are three aspects of product regulation that require separate analysis -- review of forms (products), overall rate levels and risk classification schemes. In our view, the order of importance is forms, risk classification and overall rates. You must be aware of the distinction between overall rate levels and the risk classification system that determines how much different types of consumers are charged for the same product. When insurers talk about getting products to market and "market" regulation of prices, they are asking for carte blanche on risk classification. They are saying, in effect, let us have the freedom to use the human genome to rate or deny risks. Obviously, this is an area where open competition has great potential to harm consumers and leads to the use of inappropriate rating factors. While, under certain circumstances (not in place today), some insurance markets can be competitive for purposes of overall rate level competition, there can never be a beneficially competitive market for risk classification or forms.

NEW JERSEY AND MASSACHUSETTS

In response to your expressed concern with the auto insurance regulatory regimes in New Jersey and Massachusetts, I undertook some analysis of these systems.

The industry vastly overstates the problem of rate suppression in these jurisdictions. From 1995 to 1999, the return on net worth in the nation for auto insurance averaged 10.8%[4]. The return in New Jersey was 8.3% and in Massachusetts was 8.0%. Hardly a crisis in profitability.

The average auto insurance rate in the nation was $683.27[5]. In New Jersey, the average was $1,033.88 and in Massachusetts it was $889.24. While this appears high, the traffic density in New Jersey is 2.67 times the national average and in Massachusetts it is 2.19 times the national average. These are states that, by their nature, will have high rates.

CFA took a look at a factor that many in the industry argue drives auto insurance prices[6] more that most others, traffic density, viz.:

TABLE 1

STATE	1999 Ave. Expenditure	1998 Traffic Density
Alabama	612.45	0.87
Alaska	750.85	0.53
Arizona	788.56	1.25
Arkansas	596.90	0.44
California	659.35	2.57
Colorado	743.85	0.69
Connecticut	824.16	2.11
Delaware	862.67	2.13
Dist. of Col.	988.02	3.46
Florida	761.83	1.77
Georgia	660.52	1.27
Hawaii	734.90	2.82
Idaho	492.78	0.43
Illinois	646.06	1.09
Indiana	581.98	1.1
Iowa	466.20	0.38
Kansas	542.01	0.3
Kentucky	609.66	0.94
Louisiana	813.03	0.99
Maine	514.38	0.89
Maryland	756.63	2.38
Massachusetts	889.24	2.19
Michigan	705.92	1.15
Minnesota	687.91	0.56
Mississippi	655.34	0.69

[4] Report on Profitability By Line By State in 1999, National Association of insurance Commissioners.
[5] State Average Expenditures and Premiums, National Association of Insurance Commissioners, May 2001.
[6] And use for their pricing models throughout the nation.

Missouri	605.11	0.78
Montana	511.23	0.2
Nebraska	527.01	0.28
Nevada	821.19	0.73
New Hampshire	697.85	1.14
New Jersey	1033.88	2.67
New Mexico	644.15	0.55
New York	942.96	1.63
North Carolina	546.56	1.29
North Dakota	468.80	0.13
Ohio	577.89	1.34
Oklahoma	576.26	0.56
Oregon	621.29	0.73
Pennsylvania	692.66	1.25
Rhode Island	833.61	1.96
South Carolina	575.31	0.98
South Dakota	484.11	0.14
Tennessee	582.29	1.07
Texas	696.24	1.03
Utah	615.48	0.77
Vermont	560.42	0.69
Virginia	566.62	1.51
Washington	697.45	0.96
West Virginia	684.12	0.78
Wisconsin	545.25	0.75
Wyoming	490.56	0.42
Countrywide (Simple Average of above)	665.56	
Countrywide	683.27	1

Source: Expenditures: State Average Expenditures and Premiums
for Personal Automobile Insurance, National Association
of Insurance Commissioners, 1995 and 2000 Editions
Density: FHA Highway Statistics, 1998 related to national density (reported by NAIC in Auto Insurance Database.

Regressing density against expenditure, we see a very strong correlation of about 73% between the two data sets.[7] It is not surprising that New Jersey and Massachusetts have high average expenditures[8]. New Jersey also has one of the richest benefit regimes in the country, which adds to its expected cost.

Further, in the time period 1989 to 1999, average expenditures in the nation rose by 37.2% in the typical state. In New Jersey, the expenditure rose by only 5.2% and in Massachusetts by 22.1%.

These data do not seem to indicate a situation where insurance companies should be considering pulling out, unless the motivation is political.

[7] Regression shows R-square of over 50% -- impressive for one variable. The coefficient of traffic density is statistically highly significant -- 99.9999%. The coefficient is also substantial --the intercept is 518 and the impact of the traffic density factor is from $20 to $400 (ND v. DC) on total average premium.

[8] New Jersey's average expenditure of $1,033.88 is more than the regression would imply ($867.69). So too Massachusetts' average expenditure of $889.24 is more than the regression would imply ($804.93). Other factors, such as these states' high benefit provisions are likely involved in this difference.

Take State Farm as an example. It threatens pulling out of New Jersey. The basis is the state's refusal to accept a 16.8% rate increase. Yet in the rest of the nation, in order to maintain its declining market share, State Farm is willing to price at an average 18% below cost. State Farm's rate cuts have gotten to the point where competitors are publicly complaining.[9] Warren Buffet complains that State Farm's price cutting is unfair, because, "it's costs are clearly increasing right along with those of the rest of the industry. Consequently, State Farm had an underwriting loss last year from auto insurance...of 18% of premiums."

Consumers do not fault State Farm for its acts to hold down rates. For years, we have maintained that the insurer was overcapitalized and should do this. We applaud its efforts to hold on to share. The point I want to make to you today, Madame Chair, is that even if State Farm is losing some money in a state, that is not critical to its success. Indeed it is their strategy to keep their market share.

So, what's going on in New Jersey? Can companies succeed in this state? The answer is a resounding "Yes."

Consider New Jersey Manufacturers Insurance Company (NJM). Its market share in the state has grown from 9.8% in 1994 to 12.7% in 1999.[10] It has the lowest complaint ratio of "all major personal lines auto insurance carriers in the state." It has paid dividends to policyholders in every year since 1918. Over the last 10 years dividends to policyholders have totaled $1.4 billion. In auto insurance, their dividend last year was 15% of premium. Its overhead expense costs are 9.2% of net premiums, compared to the industry average cost of 27.5%. NJM is the second most efficient company among the top 100 insurers in the nation.[11]

It is thus very clear that being an auto insurer in New Jersey is very good business for an efficient competitor like NJM.

A threat to pull out of a state can have very fast results in the state (such as getting approval of a questionable price increase). It can also have national political ramifications, particularly when the industry is pushing a deregulation agenda.

SOUTH CAROLINA

It is too soon to be sure what is the result of the recent change in law in South Carolina. One of the reasons it is difficult to determine is the fact that the reported drop in premiums in the state is not accurate. The reason is that the data used by the NAIC in making the calculations of expenditures and rates in South Carolina exclude the previously recorded recoupment charges, which must be included if an accurate result is to be obtained.

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[9] State Farm: Behind the Veil, Best's Review, July 2001. Share dropped from 21.6% in 1995 to 18.9% in 1999. Page 64.

[10] From NJM's website, www.njm.com

[11] Id.

A rough estimate of the impact of recoupment is this: The NAIC report shows the average South Carolina expenditure as $575.31 which would place the state in 38th position nationally. Last year, South Carolina was in 26th place. If we make the adjustment for the premiums that have been excluded, the South Carolina average expenditure becomes $614.24, which places South Carolina in 30th position.

This does not take into account that there is still $100,000,000 of recoupment shortfall. Since the recoupment has been limited, part of the South Carolina reduction is forced through that cap. In addition, we are aware of a substantial amount of rate increase that were approved in 1999 and 2000, which indicates the South Carolina position is expected to deteriorate in the near future.

Whatever the reason, the NAIC numbers are inaccurate for comparing South Carolina with the rest of the nation. These numbers paint a picture of the "success" of South Carolina auto deregulation that is completely inaccurate and misleading at best. It is the result of a lack of any analytical checking of the NAIC numbers prior to their release.

CALIFORNIA

The NAIC has begun a review of personal lines regulation. That led consumer groups to undertake a major review of regulatory regimes throughout the nation to determine which system works best for consumers.

The standards we used to measure the excellence of regulation were based upon our principles and standards set forth above. They include that the law:

- Make regulation easily understood by, responsive to, accountable to and inspire confidence from the public and regulated entities.
- Promote beneficial competition towards the end of fair profits for regulated entities and fair treatment of consumers.
- Make public policy the primary determinant of risk classification schemes.
- Provide for public involvement in the regulatory process, including institutionalized consumer participation in review of forms, manuals and rates.
- Provide the regulator, regulated entities and the public with the tools to identify market problems and harmful competition such as redlining.
- Prevent harmful products from coming to market, deter regulated entities from unfair and harmful practices, stop harmful practices from continuing and provide restitution to consumers injured by harmful and unfair practices of regulated entities.
- Promote loss prevention and loss mitigation as the most important way for insurers to manage exposure.

By these measures, one state, California, stands out as the state with the statutory provisions that most meet these standards. The people of California put most of these provisions into place by the 1998 enactment of Proposition 103. We particularly like the Proposition's powerful combination of increased competition through repeal of the state antitrust exemption, repeal of the anti-rebate law, repeal of the anti-group law and so on, coupled with strong prior approval regulatory back up. This combination works to give the consumers of California the best system in the nation.

We tested California's performance since Prop 103 became effective to determine if these best provisions really produced the expected positive results for consumers and for the insurers as well. Among our findings were:

- Auto insurance rates went down in California by 11.8% while nationally, in the typical state, rates were rising by almost 37.2%.
- California has enjoyed the lowest rate change of any state in the nation since the adoption of Proposition 103.
- The savings enjoyed by Californians total nearly $30 billion.
- Rate rollbacks totaling $1.3 billion were paid to consumers.
- Loss costs were controlled by the strong incentives for driver safety built into the initiative. "Clean" drivers received a 20% discount. They also gained the right to buy insurance from the company of their choice.
- Insurer expenses were reduced by the system of disallowing excess expenses and fines, coupled with increased competitive pressure.
- In 1989 8.4% of the insureds in California were in the Assigned Risk Plan. In 1999, the percentage had fallen to 0.3%. This represents an astounding drop in the Assigned Risk Plan of 96%.
- From 1989 to 1997, the uninsured motorist population declined 38%.
- There was entry and exit consistent with a competitive industry. The number of insurer groups competing in the state increased by 17%.
- Proposition 103 produced excellent profits for insurers: the highest in the nation.
- Proposition 103 encouraged a national movement by insurers to fight fraud, push for safety and cut costs.

CFA has presented this study to the NAIC and has forwarded it to each of the 50 state insurance commissioners. It is available on the CFA web page at www.consumerfed.org.

As you think about Proposition 103's achievements, don't forget to compare it to other major regulatory changes in recent years. In California alone there have been three major changes. First, Prop 103 moved insurance from deregulation to regulation and real competition. Two other regulatory changes in California went from regulation to deregulation: Electricity, about which I will not comment, and workers compensation insurance. It is now in crisis with 8 of the 12 top writers in solvency trouble.

CALIFORNIA V. ILLINOIS

Using the regressions based on traffic density shown earlier in this testimony, the anticipated auto insurance expenditure for Illinois[12] with its traffic density of 1.09 of the national average would be $661 (the actual experienced expenditure was $646, so Illinois

[12] The state the insurers like to put forth as the model for regulation.

was a bit below the anticipated expenditure – perhaps due to the regulatory efforts of the state). California has a traffic density of 2.57, which implies an expenditure of $855. California drivers actually expended $659, fully 23% below the expected level. The fact is the California regulatory approach has done much more to hold auto insurance rates down than the Illinois approach that the insurance companies favor.

THE RATIONALE AND RECORD OF INSURANCE REGULATION

We suggest that the rationale behind insurance regulation is to promote beneficial competition and prevent destructive or harmful competition in various areas.

Insolvency: One of the reasons for regulation is to prevent competition that routinely causes insurers to go out of business and leave consumers unable to collect on claims. Insolvency regulation has historically been a primary focus of insurance regulation. After several insolvencies in the 1980s, state regulators and the NAIC enacted risk-based capital standards and implemented the accreditation program to help prevent and identify future insolvencies. The 1990s experienced far fewer insolvencies and state regulation appears to be doing a good job, though the strong securities markets have helped shore up companies' retained earnings, called "surplus." Some changes were made in the guaranty fund system but there are still some significant gaps in the protection for consumers.

Unfair and Deceptive Policies and Practices: Insurance policies, unlike other consumer products or services, are complex legal contracts that promise to make certain payments under certain conditions and at some point in the future. Whereas a consumer can easily research the price, quality and features of a television, the consumer has very limited ability to do so on insurance policies. Because of the complicated legal nature of insurance policies, the consumer relies on the representations of the seller/agent to a far greater extent than for other products. Regulation exists to prevent competition that causes unfair and deceptive policies, sales and claims practices. An example of competition that is adverse to consumers in this area is what we term "fine-print" competition, where insurers compete for profits by deceptive policy provisions that reduce coverage.

Unfortunately, states have not fared as well in controlling unfair and deceptive policies and practices. Rather than acting as the instigator of enforcement actions, states more often have *reacted* after lawsuits or news stories brought bad practices to light. For example, the common perception among regulators that "fly-by-night" companies were the ones to fear was shattered by widespread allegations of misleading and deceptive practices by household names such as MetLife, John Hancock, and Prudential. Though it is true that state regulators eventually took action, e.g., coordinated massive settlements, the allegations were first raised in private litigation.

One of the problems insurance departments face is a lack of resources for market conduct regulation. Consumer Federation of America's (CFA) recent survey indicates it would take five to seven years for states to complete market conduct exams on all of their domestic companies, over 50 years for all companies. Only 15 of the jurisdictions meet the standard of devoting 10% of premium taxes to regulation. This means that states making up 75% of the country's population have inadequate resources. It is not surprising that many of the industry's bad practices fall through the cracks. 15 states perform no market conduct exams at all.

So things go through this porous sieve, e.g.:

- Though banned in rating over three decades ago, life insurance companies have used race in rating older policies since that time.
- States now are investigating alleged unfair claims practices (the use of bogus medical reasons to deny claims for injuries) of State Farm after the television news show *Dateline* aired a story about several lawsuits against the insurer.

While the industry and some regulators criticize it, litigation has been a better market conduct enforcement tool in many instances than state regulation. Mindless deregulation, which will allow more bad products to reach consumers will surely be a bonanza to the trial bar.

Insurance Availability: Some insurance is mandated by law or required for other activities (e.g., mortgage). In a normally competitive market, insurers compete on the basis of selection of consumers. Selection competition leads to availability problems and redlining.[13] Regulation exists to limit destructive selection competition.

Lawsuits brought by fair housing groups and the Department of Housing and Urban Development (HUD) reveal availability and unfair discrimination exist but demonstrate a lack of oversight and attention by many of the states. NAIC had ample opportunity after its own studies indicated a problem to move in the direction of protecting consumers but retreated when the industry threatened to cut off database funding, a primary source of NAIC funds.

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[13] The industry's reliance on selection competition can have negative impacts on consumers. Insurance is a risk spreading mechanism. Insurance aggregates consumers' premiums into a common fund from which claims are paid. Insurance is a contractual social arrangement, subject to regulation by the states.

The fact of the common fund in which wealth is shifted from those without losses (claims) to those with losses (claims) is why the contribution of insurance companies to the Gross National Product of the United States is measured as premiums less losses for the property/casualty lines of insurance. The U.S. government recognizes that the losses are paid from a common fund and thus are a shift in dollars from consumers without claims to those with claims, not a "product" of the insurance companies.

Competition among insurers should be focused where it has positive effects, e.g., creating efficiencies, lowering overhead. But rather than competing on the basis of the expense and profit components of rates, the industry has relied more on selection competition, which merely pushes claims from insurer to insurer or back on the person or the state. States have failed to control against the worst ravages of selection competition (e.g. redlining).

Some of the vices of selection competition that need to be addressed include zip code or other territorial selection; the potential for genetic profile selection; income (or more precisely credit report) selection; selection based on employment. Targeted marketing based solely on information such as income, habits, preferences, etc. leaves consumers in need of insurance out, perhaps unfairly. The data being collected by the web and otherwise can be used to profile for selection.

The industry has been adamantly opposed to disclosure of zip code data and underwriting guidelines. Such disclosure would promote competition and benefit consumers but states, for the most part, have refused to require such disclosure, apparently agreeing with the industry that such information is "trade secret" despite the absence of legal support for such position. In addition, though insurance companies want to compete with banks that come under Community Reinvestment Act ("CRA") requirements of data disclosure and addressing needs of underserved communities, they refuse to acknowledge a similar responsibility to communities.

Reverse Competition: In certain lines of insurance, insurers market their policies to a third party, e.g., creditors or auto dealers, who, in turn, sell the insurance to consumers on behalf of the insurer for commission and other compensation, often not disclosed to the consumer. Absent regulation, reverse competition leads to higher, not lower prices for consumers because the higher the price the higher the compensation for third party sellers.

Every few years, consumer groups issue reports on the millions of dollars overcharged for consumer credit insurance. Despite the overwhelming evidence that insurers do not meet targeted loss ratios in most states, most states have not acted to protect consumers by lowering rates.

Low value life insurance and industrial life insurance, markets characterized by overpriced and inappropriately sold policies and a lack of competition, demonstrate the need for standards that ensure value and honest disclosure. Insurers rely on consumers' lack of sophistication to sell these overpriced policies. With some exceptions, states have not enacted standards that ensure value or provide timely, accurate disclosure. Consumers continue to pay far too much for very little coverage.

Information for Consumers: True competition can only exist when purchasers are fully aware of the costs and benefits of the products and services they purchase. Because of the nature of the policies and pricing, consumers have had relatively little information about the quality and comparative cost of insurance policies. Regulation is needed to ensure consumers have access to information necessary to make informed insurance purchase decisions and to compare prices. Some states have, according to studies by CFA, done fairly well at getting good information out to consumers but all too often the marketplace and insurance regulators have failed to ensure adequate disclosure. Their failure affects the pocketbooks of consumers, who cannot compare adequately on the basis of price.

For decades, consumer advocates pressed for more meaningful disclosure for life insurance, including rate of return disclosure. Then the widespread misleading and abusive practices by insurance companies and agents of the mid-90s prompted state regulators, through the NAIC, to develop model illustration laws and other laws to address the problems. Regulators voiced strong concern and promised tough action to correct the abuses. While early drafts held promise and included some cost-comparison requirements, the industry successfully lobbied against the pro-consumer provisions. The disclosure model that NAIC adopted is inadequate for consumers to understand the structure and actual costs of policies or to comparison-shop.

While information and outreach efforts of states have improved, states and the NAIC have a long way to go. Few, if any, states provide information to consumers about their rights vis-a-vis their insurance policies. The NAIC's website does not focus on consumers, although there is a move that has just begun to make it more so. CFA's studies on consumer outreach reveal gaps in information. For example: 22 states have no auto insurance price guide; 34 states have no homeowners insurance price guide; and only 6 states have comprehensive health price guides. No state has a life insurance price guide. In a majority of the states, consumers do not have access to complaint ratio information for auto, homeowners, health or life insurance.

States have done somewhat better in getting information up on web pages. However, many offer no price information or complaint ratio information. Further, the states have not set up electronic rate filings as a way to assist private price vendors get quote service data updates automatically, despite repeated requests from consumers for such a system. The NAIC has a national complaint database that consumers have asked be released for years but it still languishes in the computers, not helping consumers determine which companies offer good service. Fortunately, at the NAIC meeting recently concluded in New Orleans, the NAIC voted to make this data public by the end of the year.

Are the reasons for insurance regulation still valid in the wake of the GLB law? We believe that the reasons for regulation are as relevant, or in some instances even more relevant, today than five or ten years ago:

- Advances in technology allow insurers to pursue selection competition to an extent unimaginable ten years ago and give insurers access to detailed data about customers.
- Advances in technology allow insurers to reach consumers in ways not possible ten years ago.
- Insurance is being used as a tool to fund a greater share of a person's future income, e.g., annuities.
- Competition from other financial firms for the same customers can serve as an incentive for misleading and deceptive practices and market segmentation, leaving some consumers without access to the best policies and rates.
- Combination of insurer and lender functions under one corporation will lead to even greater incentives to sell inappropriate add-on insurance – or to inappropriately fund insurance policies through high cost loans – making some products subject to abuse.

As consumers are faced with these changes, it is more important than ever that insurance laws be updated and the consumer protection bar raised.

IS THE NAIC MOVING IN THE RIGHT DIRECTION FOR CONSUMERS?

We strongly agree that dramatic improvements in insurance regulation are needed. Although the NAIC declares that the primary purpose of regulation is to protect insurance consumers, it is unfortunately clear that the NAIC approach is leading toward mindless deregulation (without the application of antitrust laws or informed consumers) of the kind sought by the insurance industry.

We can tell you with certainty that consumers, who have been the victims of vanishing premiums, churning, race-based pricing, creaming, and consumer credit insurance policies that pay pennies in claims per dollar in premium, are NOT clamoring for such policies to be brought to market with even less regulatory oversight than in the past. We think smarter, more efficient regulation benefits both consumers and insurers and leads to more beneficial competition.

We question the entire premise behind less front-end regulation coupled with more back-end (market conduct) regulation. The track record of market conduct regulation has been extremely poor. As noted above, insurance regulators rarely are the first to identify major problems in the marketplace.

From an efficiency and consumer protection perspective, it makes no sense to lessen efforts to prevent the introduction of unfair and inappropriate policies in the marketplace. It takes far less effort to prevent an inappropriate insurance policy or market practice from being introduced than to examine the practice, stop a company from doing it and providing proper restitution to consumers after the fact. The deregulation pushed by the industry will surely be a class-action attorney's dream come true.

The unique nature of insurance policies and insurance companies requires more extensive front-end regulation than other consumer commodities. And while insurance markets can be structured to promote beneficial price competition, deregulation does not lead to, let alone guarantee, such beneficial price competition.

We think front-end regulation should be designed to prevent market conduct problems from occurring instead of inviting those problems to occur. We think front-end regulation should be designed to promote beneficial competition – price competition, loss mitigation efforts – and to deter destructive competition – selection competition, unfair sales and claims settlement practice. Simply stated, strong, smart, efficient and consistent front-end regulation is critical for meaningful consumer protection and absolutely necessary to any meaningful modernization of insurance regulation.

Principles and standards for insurance regulation have been developed by consumers to serve as the measure for consumers of NAIC's (or a federal bill's) commitment to consumer protection in the reinvention process. The consumer representatives presented the principles and standards to the NAIC in September of 2000. These standards, which we apply to any proposal at NAIC, a state, or here in Congress, are set forth as Appendix A.

RECOMMENDATIONS TO CONGRESS

1. Congress should hold hearings on the more important issue to consumers of how to strengthen the ineffective state market conduct regulation.

2. We request that you carefully consider all proposals that come before you to see that the principles and standards we have set out for consumer protection are part of any Congressional action you take.

3. Please reject any system that gives the regulated an option to go back and forth between regulators, playing them off against each other to lower protections. Any optional system must contain minimum standards for both regulatory regimes, high standards based upon the above principles.

4. We recommend that you look to California for a model personal lines regulatory system that works best for consumers and gives excellent profits to insurers as well.

APPENDIX A

Consumer Principles and Standards for Insurance Regulation

1. Consumers should have access to timely and meaningful information of the costs, terms, risks and benefits of insurance policies.

- Meaningful disclosure prior to sale tailored for particular policies and written at the education level of average consumer sufficient to educate and enable consumers to assess particular policy and its value should be required for all insurance; should be standardized by line to facilitate comparison shopping; should include comparative prices, terms, conditions, limitations, exclusions, loss ratio expected, commissions/fees and information on seller (service and solvency); should address non-English speaking or ESL populations.
- Insurance departments should identify, based on inquiries and market conduct exams, populations that may need directed education efforts, e.g., seniors, low-income, low education.
- Disclosure should be made appropriate for medium in which product is sold, e.g., in person, by telephone, on-line.
- Loss ratios should be disclosed in such a way that consumers can compare them for similar policies in the market, e.g., a scale based on insurer filings developed by insurance regulators or independent third party.
- Non-term life insurance policies, e.g., those that build cash values, should include rate of return disclosure. This would provide consumers with a tool, analogous to the APR required in loan contracts, with which they could compare competing cash value policies. It would also help them in deciding whether to buy cash value policies.
- Free look period with meaningful state guidelines to assess appropriateness of policy and value based on standards the state creates from data for similar policies.
- Comparative data on insurers' complaint records, length of time to settle claims by size of claim, solvency information, and coverage ratings (e.g., policies should be ranked based on actuarial value so a consumer knows if comparing apples to apples) should be available to the public.
- Significant changes at renewal must be clearly presented as warnings to consumers, e.g., changes in deductibles for wind loss.
- Information on claims policy and filing process should be readily available to all consumers and included in policy information.
- Sellers should determine and consumers should be informed of whether insurance coverage replaces or supplements already existing coverage to protect against over-insuring, e.g., life and credit.
- Consumer Bill of Rights, tailored for each line, should accompany every policy.
- Consumer feedback to the insurance department should be sought after every transaction (e.g., after policy sale, renewal, termination, claim denial). Insurer should give consumer notice of feedback procedure at end of transaction, e.g., form on-line or toll-free telephone number.

2. Insurance policies should be designed to promote competition, facilitate comparison-shopping and provide meaningful and needed protection against loss.

- Disclosure requirements above apply here as well and should be included in design of policy and in the policy form approval process.
- Policies must be transparent and standardized so that true price competition can prevail. Components of the insurance policy must be clear to the consumer, e.g., the actual current and future cost, including commissions and penalties.
- Suitability or appropriateness rules should be in place and strictly enforced, particularly for investment/cash value policies. Companies must have clear standards for determining suitability and compliance mechanism. For example, sellers of variable life insurers are required to find that the sales that their representatives make are suitable for the buyers. Such a requirement should apply to all life insurance policies, particularly when replacement of a policy is at issue.
- "Junk" policies, including those that do not meet a minimum loss ratio, should be identified and prohibited. Low-value policies should be clearly identified and subject to a set of strictly enforced standards that ensure minimum value for consumers.
- Where policies are subject to reverse competition, special protections are needed against tie-ins, overpricing, e.g., action to limit credit insurance rates.

3. All consumers should have access to adequate coverage and not be subject to unfair discrimination.

- Where coverage is mandated by the state or required as part of another transaction/purchase by the private market, e.g., mortgage, regulatory intervention is appropriate to assure reasonable affordability and guarantee availability.
- Market reforms in the area of health insurance should include guaranteed issue and community rating and where needed, subsidies to assure health care is affordable for all.
- Information sufficient to allow public determination of unfair discrimination must be available. Zip code data, rating classifications and underwriting guidelines, for example, should be reported to regulatory authority for review and made public.
- Regulatory entities should conduct ongoing, aggressive market conduct reviews to assess whether unfair discrimination is present and to punish and remedy it if found, e.g., redlining reviews (analysis of market shares by census tracts or zip codes, analysis of questionable rating criteria such as credit rating), reviews of pricing methods, reviews of all forms of underwriting instructions, including oral instructions to producers.
- Insurance companies should be required to invest in communities and market and sell policies to prevent or remedy availability problems in communities.
- Clear anti-discrimination standards must be enforced so that underwriting and pricing are not unfairly discriminatory. Prohibited criteria should include race, national origin, gender, marital status, sexual preference, income, language, religion, credit history, domestic violence, and, as feasible, age and disabilities. Underwriting and

rating classes should be demonstrably related to risk and backed by a public, credible statistical analysis that proves the risk-related result.

4. All consumers should reap the benefits of technological changes in the marketplace that decrease prices and promote efficiency and convenience.

- Rules should be in place to protect against redlining and other forms of unfair discrimination via certain technologies, e.g., if companies only offer better rates, etc. online.
- Regulators should take steps to certify that online sellers of insurance are genuine, licensed entities and tailor consumer protection, UTPA, etc. to the technology to ensure consumers are protected to the same degree regardless of how and where they purchase policies.
- Regulators should develop rules/principles for e-commerce (or use those developed for other financial firms if appropriate and applicable)
- In order to keep pace with changes and determine whether any specific regulatory action is needed, regulators should assess whether and to what extent technological changes are decreasing costs and what, if any, harm or benefits accrue to consumers.
- A regulatory entity, on its own or through delegation to independent third party, should become the portal through which consumers go to find acceptable sites on the web. The standards for linking to acceptable insurer sites via the entity and the records of the insurers should be public; the sites should be verified/reviewed frequently and the data from the reviews also made public.

5. Consumers should have control over whether their personal information is shared with affiliates or third parties.

- Personal financial information should not be disclosed for other than the purpose for which it is given unless the consumer provides prior written or other form of verifiable consent.
- Consumers should have access to the information held by the insurance company to make sure it is timely, accurate and complete. They should be periodically notified how they can obtain such information and how to correct errors.
- Consumers should not be denied policies or services because they refuse to share information (unless information needed to complete transaction).
- Consumers should have meaningful and timely notice of the company's privacy policy and their rights and how the company plans to use, collect and or disclose information about the consumer.
- Insurance companies should have clear set of standards for maintaining security of information and have methods to ensure compliance.
- Health information is particularly sensitive and, in addition to a strong opt-in, requires particularly tight control and use only by persons who need to see the information for the purpose for which the consumer has agreed to sharing of the data.
- Protections should not be denied to beneficiaries and claimants because a policy is purchased by a commercial entity rather than by an individual (e.g., a worker should get privacy protection under workers' compensation).

6. Consumers should have access to a meaningful redress mechanism when they suffer losses from fraud, deceptive practices or other violations; wrongdoers should be held accountable directly to consumers.

- Aggrieved consumers must have the ability to hold insurers directly accountable for losses suffered due to their actions. Unfair trade practices acts should provide private cause of action.
- Alternative Dispute Resolution clauses should be permitted and enforceable in consumer insurance contracts only if the ADR process is: 1) contractually mandated with non-binding results, 2) at the option of the insured/beneficiary with binding results, or 3) at the option of the insured/beneficiary with non-binding results.
- Bad faith causes of action must be available to consumers.
- When regulators engage in settlements on behalf of consumers, there should be an external, consumer advisory committee or other mechanism to assess fairness of settlement and any redress mechanism developed should be independent, fair and neutral decision-maker.
- Private attorney general provisions should be included in insurance laws.
- There should be an independent agency that has as its mission to investigate and enforce deceptive and fraudulent practices by insurers, e.g., the reauthorization of FTC.

7. Consumers should enjoy a regulatory structure that is accountable to the public, promotes competition, remedies market failures and abusive practices, preserves the financial soundness of the industry and protects policyholders' funds, and is responsive to the needs of consumers.

- Insurance regulators must have clear mission statement that includes as a primary goal the protection of consumers:
- The mission statement must declare basic fundamentals by line of insurance (such as whether the state relies on rate regulation or competition for pricing). Whichever approach is used, the statement must explain how it is accomplished. For instance, if competition is used, the state must post the review of competition (e.g., market shares, concentration by zone, etc.) to show that the market for the line is workably competitive, apply anti-trust laws, allow groups to form for the sole purpose of buying insurance, allow rebates so agents will compete, assure that price information is available from an independent source, etc. If regulation is used, the process must be described, including access to proposed rates and other proposals for the public, intervention opportunities, etc.
- Consumer bills of rights should be crafted for each line of insurance and consumers should have easily accessible information about their rights.
- Insurance departments should support strong patient bill of rights.
- Focus on online monitoring and certification to protect against fraudulent companies.
- A department or division within regulatory body should be established for education and outreach to consumers, including providing:

- Interactive websites to collect from and disseminate information to consumers, including information about complaints, complaint ratios and consumer rights with regard to policies and claims.
- Access to information sources should be user friendly.
- Counseling services to assist consumers, e.g., with health insurance purchases, claims, etc. where needed should be established.
- Consumers should have access to a national, publicly available database on complaints against companies/sellers, i.e., the NAIC database.
- To promote efficiency, centralized electronic filing and use of centralized filing data for information on rates for organizations making rate information available to consumers, e.g., help develop the information brokering business.
- Regulatory system should be subject to sunshine laws that require all regulatory actions to take place in public unless clearly warranted and specified criteria apply. Any insurer claim of trade secret status of data supplied to regulatory entity must be subject to judicial review with burden of proof on insurer.
- Strong conflict of interest, code of ethics and anti-revolving door statutes are essential to protect the public.
- Election of insurance commissioners must be accompanied by a prohibition against industry financial support in such elections.
- Adequate and enforceable standards for training and education of sellers should be in place.
- The regulatory role should in no way, directly or indirectly, be delegated to the industry or its organizations.
- The guaranty fund system should be prefunded, national fund that protects policyholders against loss due to insolvency. It is recognized that a phase-in program is essential to implement this recommendation.
- Solvency regulation/investment rules should promote a safe and sound insurance system and protect policyholder funds, e.g., rapid response to insolvency to protect against loss of assets/value.
- Laws and regulations should be up to date with and applicable to e-commerce.
- Antitrust laws should apply to the industry.
- A priority for insurance regulators should be to coordinate with other financial regulators to ensure consumer protection laws are in place and adequately enforced regardless of corporate structure or ownership of insurance entity. Insurance regulators should err on side of providing consumer protection even if regulatory jurisdiction is at issue. This should be stated mission/goal of recent changes brought about by GLB law.
- Obtain information/complaints about insurance sellers from other agencies and include in databases.
- A national system of "Consumer Alerts" should be established by the regulators, e.g., companies directed to inform consumers of significant trends of abuse such as race-based rates or life insurance churning.
- Market conduct exams should have standards that ensure compliance with consumer protection laws and be responsive to consumer complaints; exam standards should include agent licensing, training and sales/replacement activity; companies should be

held responsible for training agents and monitoring agents with ultimate review/authority with regulator. Market conduct standards should be part of an accreditation process.

- The regulatory structure must ensure accountability to the public it serves. For example, if consumers in state X have been harmed by an entity that is regulated by state Y, consumers would not be able to hold their regulators/legislators accountable to their needs and interests. To help ensure accountability, a national consumer advocate office with the ability to represent consumers before each insurance department is needed when national approaches to insurance regulation or "one-stop" approval processes are implemented.
- Insurance regulator should have standards in place to ensure mergers and acquisitions by insurance companies of other insurers or financial firms, or changes in status of insurance companies (e.g., demutualization, non-profit to for-profit), meet the needs of consumers and communities.
- Penalties for violations must be updated to ensure they serve as incentives against violating consumer protections and should be indexed to inflation.

8. Consumers should be adequately represented in the regulatory process.

- Consumers should have representation before regulatory entities that is independent, external to regulatory structure and should be empowered to represent consumers before any administrative or legislative bodies. To the extent that there is national treatment of companies or "one-stop" (OS) approval, there must be a national consumer advocate's office created to represent the consumers of all states before the national treatment state, the OS state or any other approving entity.
- Insurance departments should support public counsel or other external, independent consumer representation mechanisms before legislative, regulatory and NAIC bodies.
- Regulatory entities should have well-established structure for ongoing dialogue with and meaningful input from consumers in the state, e.g., consumer advisory committee. This is particularly true to ensure needs of certain populations in state and needs of changing technology are met.

APPENDIX B

J. ROBERT HUNTER
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Arlington, VA 22207

Summary

Consulting actuary with nearly 40 years of experience with the insurance industry, primarily engaged in analysis of major public policy issues relating to regulatory and consumer issues.

Academic Education

B.Sc. in Physics, Clarkson University, Potsdam, N.Y., 1958.

Professional Qualifications and Professional Association Activities

Casualty Actuarial Society. Fellow (by examination).
American Academy of Actuaries. Member

Experience and Employment

Present

Self-employed consulting actuary.

Also serve as *pro-bono* Director of Insurance for the Consumer Federation of America (CFA). (See "*Pro Bono* Activities," below.)

Employment in the Private Insurance Industry.

1959-1960. **Atlantic Mutual Insurance Companies.** Underwriter, working on several lines of insurance, including commercial property/casualty insurance.

1960-1966. **National Bureau of Casualty Underwriters (NBCU)** (a forerunner organization of the Insurance Services Office (ISO)). I ran their state rate-filing unit, and later became an automobile rate making supervisor in the actuarial department. Duties included: analysis of claims experience for rate making; presentation of the rate requests to the appropriate Bureau committees for action;

and presentation of the adopted rate levels to state officials, sometimes in hearings.

1966-1970. **Mutual Insurance Rating Bureau (MIRB) and the Mutual Insurance Advisory Association (MIAA).** I was an Associate Actuary, engaged in activities similar to those in which I was engaged at NBCU, but for all lines of property/casualty insurance (including liability insurance). As an officer of MIRB and MIAA, I dealt directly with the General Manager and was responsible for much of the research undertaken at these organizations.

MIRB/MIAA were forerunner organizations to the Automobile Insurance Plans Service Office ("AIPSO"), the organization charged with servicing and helping run, for the insurance industry, the residual market mechanisms (usually assigned risk plans) for automobile insurance in the U.S.

1970-1980. **Federal Insurance Administration, U. S. Department of Housing and Urban Development**, under HUD Secretary George Romney.

I served in a number of positions, including Chief Actuary, Deputy Federal Insurance Administrator, Acting Federal Insurance Administrator, and Federal Insurance Administrator.

During my ten-year stint in federal insurance regulation (1970-1980), I was involved with insurance-related public policy issues of the highest order. I testified before Congress on many occasions on the programs of the Federal Insurance Administration, as well as on insurance issues generally (such as the purported medical malpractice insurance "crisis" of the mid nineteen-seventies, the costing of health insurance, no-fault auto insurance proposals, and many other issues). I also served on federal inter-agency task forces dealing with products liability insurance, medical malpractice insurance, risk retention group formation, workers' compensation insurance, and other issues.

I was responsible for actuarial and public policy advice to HUD regarding statutory programs (*e.g.* flood insurance, the Riot Reinsurance/FAIR Plan, and Urban Crime Insurance) and many other matters as requested by the White House and other federal agencies. Some examples:

- Administered the FIA's Riot Reinsurance/FAIR Plan program. ("FAIR Plans" are the residual market for fire (homeowners and business properties) insurance. These were usually Joint Underwriting types of organizations.) In my work administering this program, we made many examinations of FAIR Plans, including reviewing claims practices. I participated in writing a book-length overall analysis of the public interest issues involved in residual market insurance (Fair Plan and automobile assigned risk plan) entitled *Full Insurance Availability* (HUD 1974).

- Administered the FIA's flood insurance program, which included both homeowner and business insurance. I monitored claims-paying approaches of the insurance companies that serviced the flood insurance program.

- Wrote the actuarial regulations for President Nixon's temporary 1972 wage- and price-freezing directives as well as for other phases of that program, and helped run some insurance rate cases for the Price Commission.

- Worked with the U.S. Department of Transportation on its landmark no-fault automobile insurance study.

- Worked with the U.S. Department of Labor on workers' compensation insurance matters.

- Worked with the U.S. Federal Trade Commission on life insurance matters.

- Worked with the White House on national health insurance proposals.

I received the HUD Secretary's Award for Excellence by Secretary Carla Hills for the work I performed from 1971-1977.

State Insurance Regulation

1993-94 **Insurance Commissioner of the State of Texas,** appointed by Governor Ann Richards. In charge of the day-to-day operations of the Texas Department of Insurance (TDI). Made all executive decisions on insurance policy matters that arose during my tenure, including rate making, statistical collection, loss prevention, solvency monitoring, residual market issues, enforcement, examination, claims practices, complaint resolution, consumer information dissemination and myriad other matters attendant to running a major government agency such as TDI.

I also undertook a major reorganization of TDI, cutting the staff from 1,100 to about 900 and greatly decentralizing the authority to the remaining staff. TDI became a much more effective and efficient organization during my brief tenure.

As Texas Insurance Commissioner, I was a member of the National Association of Insurance Commissioners (NAIC). Served on the Executive Committee of the NAIC and as Vice-Chair of the Western Zone of the NAIC and member of the Life Insurance Committee. Served on several advisory groups to the NAIC, including the Advisory Committee to the Task Force on Profitability and Investment Income, the Market Conduct Advisory Committee, the Nuclear Insurance Advisory Committee and as co-chair of the Technical Resource Group to the Statistical Task Force.

(Since leaving the insurance regulation field I have served as a "funded" consumer representative to the NAIC (i.e. NAIC paid travel expenses to facilitate my attendance at their meetings).)

Private Actuarial and Public Policy Consulting

1980-1993 Conducted my own actuarial and insurance public policy consulting practice, voluntarily limiting my clients to *government agencies* and *consumers of insurance* to avoid even the appearance of any conflict of interest *vis-à-vis* my work on consumer matters. (Clients are named below under "Public Policy Research and Testimony".)

1994-to date Actuarial and insurance public policy consulting practice; resumed *pro-bono* activities as Director of Insurance for the Consumer Federation of America.

Extensive consulting work on a variety of insurance issues for state agencies, including:

Ratemaking and profitability matters (early 1980s) and disciplinary actions related to market conduct abuses for the Florida Department of Insurance.

Pricing and public policy issues related to tort reform measures for the New York, Maine and California legislatures.

Medical malpractice insurance for the Governor of Puerto Rico

Workers' compensation insurance rate making for the Attorney General of Oklahoma, the Attorney General of Virginia, the Public Advocate of Maine, the Public Advocate of Florida and the Governor of Puerto Rico.

Private passenger automobile insurance as a member of the Governor's Task Force in the State of New Jersey.

Private passenger automobile insurance *rate making* for the Public Advocate of New Jersey, the Public Advocate of South Carolina, the Attorney General of Connecticut, the Attorney General of Massachusetts, the Attorney General of Virginia, the Attorney General of California, the Office of Public Insurance Counsel in Texas and the Departments of Insurance in California, Georgia, New Jersey, North Carolina, and Texas.

Insurance implications of hurricanes as a member of the consulting team for the Academic Task Force in the State of Florida following Hurricane Andrew in 1992.

Antitrust and reinsurance as a member of the Governor's Subcommittee on Antitrust and Reinsurance in Virginia.

Public Policy Research and Testimony

Testified as an actuarial expert on behalf of clients (such as those listed below); on behalf of the private insurance industry when I was employed there during the nineteen-sixties; on behalf of consumer organizations such as NICO, CFA, Consumer's Union (publisher of *Consumer Reports*), Common Cause, and others; on behalf of the States of California, Florida, Massachusetts, New Jersey, New York, North Carolina, Oklahoma, South Carolina and others; and on behalf of the federal government from the 1980s to the early 1990s.

Testified or performed research for federal agencies, including:

U.S. Department of Labor (on Workers' Compensation rate making)

U.S. Department of Health and Human Services (on Medical Malpractice)

U.S. Environmental Protection Agency (on insurance aspects of hazardous waste)

U.S. General Accounting Office (on federal tax policy and rate issues)

The U.S. Congress's Office of Technology Assessment on several issues.

Testified frequently before committees of both the U.S. House of Representatives and the U.S. Senate, as Federal Insurance Administrator, as President of NICO, as Texas Insurance Commissioner, and as Director of Insurance at CFA.

Testified before every state legislature in one forum or another.

News Media Writing and Interviews

Articles published in *The New York Times*, *The Washington Post*, *The Los Angeles Times*, the *Dallas Morning News*, *USA Today*, *The Wall Street Journal*, and other leading newspapers.

Quoted extensively in the insurance industry press and the general media.

Interviews on numerous TV programs, including "Larry King Live," "60 Minutes," "This Week With David Brinkley," "The Today Show," "Good Morning America," "CBS Morning News," "CBS Evening News," "NBC Evening News," "Fox News," "Donahue," and "Oprah Winfrey."

Frequent appearances on radio shows—both news programs (*e.g.* National Public Radio's "All Things Considered") and talk shows (*e.g.* Larry King).

Publications

Published Articles and Papers

2001 J. Robert Hunter, *Why not the Best? The Most Effective Auto Insurance Regulation in the Nation,* (Consumer Federation of America, June 2001). Analyses the state regulatory regimes for auto insurance and concludes that California's system, adopted by a vote of the people of the state in 1988, constitutes the finest regulatory system in the country.

1998 J. Robert Hunter, *America's Disastrous Disaster "System"* (Consumer Federation of America, 1998). Analyzes critically the current approach to handling disasters in this nation and proposes an alternative system that would end taxpayer subsidy of anticipated levels of damage, move the cost of high risk to those who live in high risk areas, and minimize death and damage due to unwise construction practices.

1995 J. Robert Hunter, *Product Liability Insurance Experience, 1984-1993* (1995)

1995 J. Robert Hunter, *Medical Malpractice Insurance Experience, 1984-1993* (1995)

1995 J. Robert Hunter, *Auto Insurance—Progress Through Reform But More To Be Done* (1995)

1994 J. Robert Hunter, "Insuring Against Natural Disaster," *Journal of Insurance Regulation* (1994).

1993 J. Robert Hunter, "Rate Suppression, A Critique", *Journal of Insurance Regulation* (1993).

1985 J. Robert Hunter and Professor Raymond Hill (Princeton University), *Workers' Compensation Insurance Rate making: Regulation of Profit Margins and Investment Income.* (Written under contract for the U.S. Department of Labor.)

1983 J. Robert Hunter, "Study of Feasibility of Risk Retention Groups for Hazardous Waste Facilities," in the *Journal of the Chartered Property Casualty Underwriters' Society*. Addressed the possible use of risk retention groups to ease the tight market for environmental coverage. (Written under contract for the Environmental Protection Agency.)

1983 J. Robert Hunter and Dr. John W. Wilson, *Investment Income and Profitability in Property/Casualty Insurance Rate Making* (1983). Paper was instrumental in convincing the NAIC to adopt "total return rate making procedures" as the preferred rate regulatory model.

Reports

2000 J. Robert Hunter, *Study of State Insurance Departments, Part III: Internet Web Page Grades.* (CFA) This report gave the internet site of the Florida Department of Insurance a grade of "A," which resulted in a DOI press release publicizing the Department's good grade: "Insurance Department Gets 'A' For Consumer-Friendly Web Site, " viewable at http://www.doi.state.fl.us/consumers/alerts/press/2000/pr032400.htm.

2000 J. Robert Hunter, *1988, 1993, and 1998 Changes in State Insurance Department Resources.* (CFA)

1999 *Consumer Information Available From State Insurance Departments.* (CFA)

1999 *Insurance Department Grades for Consumer Complaint Information.* (CFA)

1986 J. Robert Hunter, *Insurance in California: Profitability, Competition and Equity in Selling and Pricing Private Passenger Automobile Insurance and the Crisis in Day Care and Municipal Liability Insurance.* Commissioned by the California legislature. The principal document used by the drafters of Proposition 103 as a blueprint for casualty insurance reform in California.

1984 Series of reports on the interrelationship of gender and miles driven in setting auto insurance rates.

1981 J. Robert Hunter, *Gas Prices and Auto Rates: Insurance Implications of the Dynamic Changes in America's Driving Habits.*

1980 J. Robert Hunter, *Taking the Bite Out of Insurance: Investment Income in Rate Making*. Led to a major NAIC study of this issue.

Pro Bono Activities

1980-93 I created an insurance consumer organization, the National Insurance Consumer Organization, which I served *pro-bono*. NICO was the first national organization dedicated to looking at all kinds of insurance (except pensions) from a consumer perspective. It undertook research and advocacy on behalf of consumers, and became the leading voice for consumers on insurance issues.

NICO published information advising consumers how to buy insurance of all types, fielded complaints from consumers, developed a computerized service to help consumers understand cash value life insurance products and otherwise dealt on a daily basis with the needs and concerns of insurance consumers, including their understanding of insurance contracts.

1995 to date Serve *pro-bono* as Director of Insurance for the Consumer Federation of America (CFA), 1424 16th Street, NW, Suite 604, Washington, DC 20036.

CFA is a federation of some 240 consumer advocacy groups with a combined membership of more than 50 million Americans.

Consumer Federation of America

CONSUMER RESPONSE TO INSURER COMMENTS ON CFA'S AUTO INSURANCE REGULATION REPORT

Background:

In June, 2001, CFA released its report on insurance regulation in America, "Why Not the Best? The Most Effective Auto Insurance Regulation in the Nation."[1] This report was undertaken by CFA in response to the National Association of Insurance Commissioners announcement in March 2001 that they would be studying personal lines regulation to determine best practices.

The initial CFA study found that California's auto insurance regulatory system, established by the people of California when they enacted Proposition 103 in 1988, was the best system in the nation, producing a reduction of 11.8% in auto insurance expenditures over the 1989 to 1999 period. The national change in a typical state was an increase of 37.2%. California's average expenditure, which was 33% above the national average prior to the passage of Prop. 103 is now 5% below the nation. Californians have saved at least $25 billion due to the incentives and requirements of Proposition 103. The assigned risk plan has declined by 96% and the uninsured motorist population has fallen by almost 40%.

And the profits for the insurers in California were the highest in the nation during the period as well.

You would think that the insurance companies would applaud such wonderful results benefiting both consumers and insurers, but you would be wrong. The insurance industry and its consultants, while confirming all of the key findings of the report as to better results in California today than under the previous open competition system of California, argue that it was despite Proposition 103, not because of it, that wonderful things occurred.

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[1] Available on CFA's web page at www.consumerfed.org

Not bothering much with detailed analysis, the insurers and their consultants have made a series of claims that they say shows that Proposition 103 has not contributed much to the good results observed in California – and nowhere else – since its enactment.

Should We Believe the Industry when it Claims that Prop. 103 is ineffective?

The industry has not had a good track record in analyzing Proposition 103. During the 1988 campaign regarding the Proposition, the industry claimed:

Industry Claim: "Prop 103 could make it impossible for 40% of Californians to find auto insurance, drive 35 companies out of business and another 40 to the brink of financial collapse, and create chaos for California drivers. Don't let New Jersey happen here." (Advertisement of Californians Against Unfair Rate Increases, "A Coalition of Independent Agents and Insurers")

CFA Comment: More Californians are insured in the voluntary market than ever before. There has been an increase in company groups writing auto insurance in the state of 17%. No insurers went insolvent due to Prop. 103.

Industry Claim: Prop 103 is "a New Jersey-style, State run Auto Insurance Bureaucracy for California" "Keep Big Government out of the Auto Insurance Business..." The measure "destroys California's free market approach to auto insurance...mandates massive and costly government intervention." (Id.)

CFA Comment: Prop. 103 did not create a state run auto system in California. Indeed, Prop. 103 increased private insurer competition.

Industry claim: Prop 103 does "nothing to reduce the costs driving up auto insurance." (Id.)

CFA Comment: Prop. 103's good driver provisions caused a huge drop in loss costs in the state as drivers avoided accidents and tickets to gain the 20% discount and maintain the right to get insurance from the company of their choice.

Industry claim: USAA says that it anticipates "a massive withdrawal of insurance companies from California" and that it has "concerns for assuring the financial stability of the Association." "...it may not be possible for any auto insurer to pay dividends in the future." (USAA letter to policyholders)

CFA Comment: Prop. 103 did not cause a massive withdrawal of companies from the state...and USAA has continued to pay dividends there.

Industry claim: Farmers Insurance says that Prop 103 "does nothing to address the real problems of fraud, uninsured motorists and runaway accident litigation. This initiative...could ultimately destroy our insurance system, rather than to help reform it." (Farmer's letter to policyholders)

CFA Comment: Prop. 103 did destroy the awful "open competition" system that existed before it, and the positive results are powerful and compelling. The previous system had resulted in the excesses that Prop. 103 removed. It also caused the industry to address fraud, as law enforcement in California have commented, it sharply reduced the uninsured motorist problem in the state and litigation has been reduced under Prop. 103.

Industry claim: Southern California Physicians Insurance Exchange said, "...Nader's purpose in Prop 103 is to force the insurance companies out and put the state in the insurance business." (Letter to policyholders)

CFA Comment: There is no evidence that this was Mr. Nader's intent and the Proposition's effects since passage are exactly opposite to this claim.

Industry claims: State Farm says that Prop 103 does not "provide for a reduction in the costs that make up the rates" but adds "costs by imposing a maze of bureaucratic regulation and judicial review procedures." (Letter to policyholders)
The Automobile Club of Southern California says that Prop 103 "only treat(s) the symptoms and not the underlying causes of today's auto insurance crisis" and that it does "nothing to stabilize rates for the long term." (Letter to policyholders)

CFA Comment: Under the Proposition, California auto insurance costs are down and rates have thus fallen sharply.

<u>Why does the Industry Fear the Truth about Prop. 103?</u>

After the Proposition passed, the insurers engaged in a scorched earth strategy ranging from lawsuit to hyperbole, the intent of which was to discredit the workings of the

Proposition and intimidate other states from considering similar law changes. They do not want to credit Proposition 103 with any success because it undermines their long-term strategy to discredit the Proposition. It also upsets their current push to put in place what they call a "modern" regulatory system, which is nothing more than the discredited system that Prop. 103 replaced, the "open competition" system.

Why should we believe the industry now when it denies the great benefits of Proposition 103 to the people of California? They fought against it before it passed, spending $85 million in their unsuccessful attempt to head it off. They fought it every step of the way after passage, filing lawsuit after lawsuit. And, year-after-year, they misrepresented the successes of Proposition 103 throughout the nation, in an unfortunately successful attempt to hold off other states from following California's brilliant lead.

We should not believe the industry any more today than in 1988 when they made their clearly wrong statements about what Proposition 103 would do and in their lawsuits and hyperbole since. Again they attack the Proposition, without substantial analysis, claiming that it did not produce the very results they admit have occurred.

Materials Reviewed in this Analysis:

The materials we have reviewed put out by the industry are as follows:

- June 8, 2001 – State Farm Insurance Company – Letter to CFA
- June 14, 2001 – Personal Insurance Federation of California – Letter to CFA
- June 21, 2001 – National Association of Mutual Insurance Companies – Testimony before the House of Representatives
- June 21, 2001 – National Association of Independent Insurers and Alliance of American Insurers – Testimony before the House of Representatives
- June 21, 2001 – Phillip O'Connor – Testimony before the House of Representatives
- June 29, 2001 – American Insurance Association – Press Release and letter to CFA
- July 16, 2001 – Association of California Insurance Companies – letter to CFA

Analysis:

Here are the arguments we have seen that the industry/consultants have made, followed by our comment.

ISSUE 1: Profits will be higher under regulation because insurers will be "fearful of being trapped in rates lowered to reflect falling loss costs." (O'Connor, P.9) NAII and NAMIC say a similar thing.

CFA Response: This issue was fully covered in the original report at pages 43 and 44. We pointed out that consumer groups noted the high profits and a series of requests made for hearings on the matter, as called for under the terms of Proposition 103, were rejected by Commissioner Quackenbush who was later forced to resign. It can hardly be the fault of the Proposition that a shamed commissioner, while taking monies from insurers, refused to do his duty under the law.

ISSUE 2: "Dramatic drop-off in auto insurance loss costs" not from Prop. 103 but from other factors: (O'Connor P.13)

- Prop. 103 "may well have had some positive effects" on giving incentive to drivers to drive safely. (O'Connor P.14)
- But more important were seat belt laws, drunk driving enforcement, and the California Supreme Court's Moradi decision. (O'Connor P.15)

O'Connor claims that the physical damage loss costs have risen while liability loss costs have fallen, which he says belies the claim that the 20% good driver discount has helped hold down loss costs, albeit the discount "may be helpful." (O'Connor P.15) NAII/AAI say Moradi, mandatory seat belt law and improved drunk driver laws were what why California auto "decline in rates." NAMIC credits Moradi, seat belt laws, no pay, no play, and anti-fraud efforts. AIA credits stronger drunk driving laws, seatbelts, airbags and no pay/play. AIA says CFA report "completely ignores" Moradi.

CFA Response: The Moradi decision was fully analyzed in our report on pages 44 and 45. We concluded that this decision had, at most, a modest effect. O'Connor does not give any credit to the fact that states with laws similar to Moradi had greater rate increases than the nation generally. Moreover, he does not address the fact that we showed that, even if the other state data are ignored, Proposition 103 contributed at least 62% of the savings realized by California consumers since 1989.

Seat belt law impacts were also fully discussed in the original CFA report at pages 45-47. Although many commentators say that greater seat belt use deserves more credit for the California results than Proposition 103, none shows any data to prove it. Indeed, in our analysis, we showed that the seat belt use in California had risen by 34% over the 1989-1998 period but that the national increase was 54%. If anything, all other influences equal, insurance prices in California would have risen relative to the nation on the change in seat belt usage over the test period. Instead, they dropped.

Drunk driver laws are credited by some as a reason insurance prices have dropped in California. This claim is made with no analysis. We can find no research that shows that California has been tougher in enforcing drunk driver laws than elsewhere in the nation. The national efforts of Mothers Against Drunk Driving (MADD) have been effective in Washington and across the country.

The "no pay, no play" law limits the legal rights of uninsured motorists who are innocent victims of a car accident to obtain compensation for pain and suffering. The law was enacted in 1996 and upheld as constitutional by state Supreme Court in 1997. There are several other cases, some still ongoing. Obviously, the law could have no pre-1996 effect. And, given the finding of constitutionality was not until 1997, little, if any, before the end of 1997.

Our review of the change in motor vehicle lawsuits in California over the time since Proposition 103 was passed would indicate that the no pay no play law had little, if any, influence on lawsuits. It would no doubt discourage lawsuits brought by innocent uninsured motorists. But how many would that be? Uninsureds, who tend to be poor, were very unlikely to actually go to a lawyer prior to this law's passage. The poor do not use the courts as frequently as the more affluent.

Consider these data:

YEAR	NUMBER OF MOTOR VEHICLE CIVIL FILINGS	YEAR-TO-YEAR PERCENT CHANGE
1989/90	82,886	
1990/1	80,208	-3.2
1991/2	70,687	-11.9
1992/3	55,495	-21.5
1993/4	49,513	-10.8
1994/5	47,554	-4.0
1995/6	47,841	0.6
1996/7	43,947	-8.1
1997/8	42,252	-3.9
1998/9	44,576	5.5

Source: 2000 Court Statistics Report,
Judicial Council of California, Page 46

The average annual decline in the number of lawsuits filed in the period 1989/90 to 1995/6 was 8.5% per year. For the period after no pay, no play, the number of filed suits dropped at an annual rate of 2.2%.

There is simply no evidence of a major shift in California lawsuits due to the 1996 no pay, no play law.

Anti-fraud efforts are credited by some as a reason insurance prices have dropped in California. This claim is made with no analysis. While Proposition 103 is recognized by law enforcement as a catalyst for improved anti-fraud and safety efforts by the industry in California (as noted in our original report at page28) it also kicked off national efforts by the industry which had similar effects across the nation. For instance, most insurers started Special Investigative Units (SIU) units shortly after Proposition 103 was passed. These units had national effects, not local. There is absolutely no evidence that anti-fraud efforts saved more in California than elsewhere.

The use of airbags is credited by some as a reason insurance prices have dropped in California. This claim is made with no analysis. We can find no research that shows that California has greater use of airbags than the nation. The insurers/consultants presented no evidence.

O'Connor says that physical damage premiums rising in California while liability premiums fell from 1989 to 1999 show that the good driver protections of Proposition 103 do not do much good. He conveniently leaves out the fact that, while California liability premiums improved relative to the nation by 40%, Comprehensive premiums improved relative to the nation by 39% and Collision premiums improved by 17%. So the physical damage premiums did have positive impact too, by 62% of the impact of liability premiums, as the original CFA report makes clear.

<u>ISSUE 3:</u> Prop. 103 was not fully implemented. The 20% rollback was far short of full application, premium and loss data have not been collected by ZIP Code, territorial rating has not been banned, the courts have prevented independent lawsuits against rates already approved by the commissioner, permanent ratemaking rules have not yet been adopted, the comprehensive buyer's guide has not been developed. (O'Connor P.15) AIA also claims that lack of full implementation means limited impact on auto insurance results. The Association of California Insurance Companies (ACIC) claims that the $1.3 billion in rollbacks are "possible" but faults CFA for having a different number ($125 million) also in the report.

CFA Response: This is an amazing argument from an industry that used lawsuits, lobbying, media, corruption of one commissioner and every other means to delay and deny full application of Proposition 103 for the benefit of the people of California.

In fact, $1.3 billion in rollbacks were paid (per the Department of Insurance web page as we reported in footnote 4 in our original study), a total of over $25 billion has been saved for California's consumers, some of the ZIP Code data are now available to the public, consumer information systems are up in the state both at the Department of Insurance and privately, territorial rating has been modified to have less impact (in a process known as "sequential analysis") although not as much as the statute contemplated and the interim ratemaking rules are state-of-the-art rules which CFA believes all states should emulate.

The fact that the strong, pro-consumer results we reported were achieved even though the industry had to be brought kicking and screaming into this most modern of regulatory systems, is great tribute to the brilliance and power of the Proposition.

As to ACIC's claim that we also had a lower, different number for the rollbacks in the report, it is clear from the report that the $125 million was the rollbacks paid at the time the Calfarm decision was handed down by the California Supreme Court, not the ultimate rollback, which is $1.3 billion. Ultimate full implementation of the few parts of the

Proposition that have not been implemented will bring further benefits to California's consumers.

ISSUE 4: ACIC claims that Prop.103 did not require the insurers "to open their books to justify rate increases."

CFA Response: This is really an unbelievable claim by ACIC. Prior to Prop. 103, California had a "no-file" law where the insurers did not even have to send in a copy of a rate filing. After Prop. 103, all rate changes must be filed with the Commissioner for approval prior to use. Further, the California regulations are the state-of-the art regulations in the nation, the best there are, requiring the most thorough support data for rate filings in the country.

ISSUE 5: Several of the trade groups claim that consumers fare better under the deregulation system they prefer, Illinois (albeit they often do not disclose that Illinois does regulate forms and is in the midst of attempting to regulate credit scoring -- part of rate establishment). AIA for example points out that California average expenditure is $659.35, $13.29 more than Illinois' $646.06

CFA Response: No analysis is made of the claim that Illinois must be doing better in regulating than California because of this $13 "savings." So, CFA took a look at a factor that many in the industry argue drives auto insurance prices[2] more that most others, traffic density, viz.:

TABLE 1

STATE	1999 Ave. Expenditure	1998 Traffic Density
Alabama	612.45	0.87
Alaska	750.85	0.53
Arizona	788.56	1.25
Arkansas	596.90	0.44
California	659.35	2.57
Colorado	743.85	0.69
Connecticut	824.16	2.11
Delaware	862.67	2.13
Dist. of Col.	988.02	3.46
Florida	761.83	1.77
Georgia	660.52	1.27
Hawaii	734.90	2.82
Idaho	492.78	0.43

[2] And use for their pricing models throughout the nation.

Illinois	646.06	1.09
Indiana	581.98	1.1
Iowa	466.20	0.38
Kansas	542.01	0.3
Kentucky	609.66	0.94
Louisiana	813.03	0.99
Maine	514.38	0.89
Maryland	756.63	2.38
Massachusetts	889.24	2.19
Michigan	705.92	1.15
Minnesota	687.91	0.56
Mississippi	655.34	0.69
Missouri	605.11	0.78
Montana	511.23	0.2
Nebraska	527.01	0.28
Nevada	821.19	0.73
New Hampshire	697.85	1.14
New Jersey	1033.88	2.67
New Mexico	644.15	0.55
New York	942.96	1.63
North Carolina	546.56	1.29
North Dakota	468.80	0.13
Ohio	577.89	1.34
Oklahoma	576.26	0.56
Oregon	621.29	0.73
Pennsylvania	692.66	1.25
Rhode Island	833.61	1.96
South Carolina	575.31	0.98
South Dakota	484.11	0.14
Tennessee	582.29	1.07
Texas	696.24	1.03
Utah	615.48	0.77
Vermont	560.42	0.69
Virginia	566.62	1.51
Washington	697.45	0.96
West Virginia	684.12	0.78
Wisconsin	545.25	0.75
Wyoming	490.56	0.42
Countrywide	665.56	
(Simple Average of above)		
Countrywide	683.27	1

Source: Expenditures: State Average Expenditures and Premiums for Personal Automobile Insurance, National Association of Insurance Commissioners, 1995 and 2000 Editions
Density: FHA Highway Statistics, 1998 related to national density (reported by NAIC in Auto Insurance Database.

Regressing density against expenditure, we see a very strong correlation of about 73% between the two data sets.[3]

Using the regressions, the anticipated auto insurance expenditure for Illinois with its traffic density of 1.09 of the national average would be $661 (the actual experienced expenditure was $646, so Illinois was a bit below the anticipated expenditure – perhaps due to the regulatory efforts of the state). California has a traffic density of 2.57, which implies an expenditure of $855. California drivers actually expended $659, fully 23% below the expected level. The fact is the California regulatory approach has done much more to hold auto insurance rates down than the Illinois approach.

ISSUE 6: ACIC claims that insurers were not provided with financial incentives for efficient performance under Proposition 103.

CFA Response: The regulations implementing Prop. 103 make it clear that insurers with inefficient expense levels can not pass through these inefficiencies but insurers with low costs can make a higher profit as a result, and did. Further, Prop. 103 regs required identification of certain expenses (such as fines and bad faith lawsuit verdicts) and disallowed these costs. These innovations were done first in California under Prop. 103.

ISSUE 7: ACIC claims that the consumer intervention program is "a euphemism for 'personal injury lawyer' because plaintiff lawyers are the major source of funding for the so-called consumer groups that routinely appear at Department of Insurance proceedings. Prop. 103 created job security for lawyers who sue insurance companies for a living, plain and simple...."

CFA Response: ACIC, of course, offers no evidence for these claims, because there is none. Indeed, the results are the opposite.

Other items of interest in the industry responses:

The industry responses do accept all of the CFA report's findings related to the excellent, pro-consumer results under Proposition 103 such as:

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[3] Regression shows R-square of over 50% -- impressive for one variable. The coefficient of density is highly significant -- 99.9999%. The coefficient is also substantial --the intercept is 518 and the impact of the traffic density factor is from $20 to $400 (ND v. DC) on total average premium.

- Auto insurance expenditures *fell* 11.8% from 1989 to 1999 in California while *rising* 37.2% in the typical state. California's performance was the best in the nation.
- California auto insurer profits for the period were the highest in the nation.
- The assigned risk plan dropped in size by 96%.
- The UM population fell by 38%.
- A 17% rise in company groups competing in the California market occurred.

Indeed, insurers reported that these were correct findings and differed with each other and with our report only on why these results were achieved.

They also had some positive things to say about the market in California, such as:

- NAMIC says "auto insurance rates have fallen and complaint volume at the California Department of Insurance is low."
- Nicole Mahrt, spokeswoman for the American Insurance Association, said consumers knew that better auto insurance products were available at a better rate than even the low-cost auto policies specifically designed for the poor. (Press release responding to the failure of low cost auto policies to take off in California, June 2001) California's healthy and competitive auto insurance market has given consumers access to mainstream policies, she said.

Conclusion:

Data that became available from the NAIC after CFA released the earlier report shows that the pro-consumer results achieved by Proposition 103 have continued for another year. The savings for California drivers are significant: 11.8% from 1989 to 1999. The people of California are now paying 5% less than the nation whereas under the failed open competition system in effect prior to the Passage of Proposition 103, the California rates were over 33% higher than the nation.

Yet the same industry advocates who told us the world would end if Prop. 103 became law, who spent $85 million to try to defeat it, who filed lawsuit after lawsuit to delay and confuse the results of the Proposition and who consistently bad-mouthed the effects of the Proposition over the last decade, now ask us to believe that the initiative was a failure. The industry agrees that the California auto rates have dropped by 12% since Prop. 103 passed, compared with an almost 40% increase in the typical state, that their profits were great, that the UM population has declined by almost 40%, and that the assigned risk population has all but disappeared. What they ask us to believe is that Prop. 103 had nothing at all to with all of this and that these positive things happened in spite of the Proposition. They offer no analysis to support their view, merely conclusions that comport neatly with their decade-long hype. In fact, the only thing they seem willing to concede is that the Proposition caused their profits to be high, too high they complain, because, of course, achieving high profits greatly upsets them.

The remarkably weak industry/consultant arguments against Proposition 103 makes us even more certain that Proposition 103 is the best practices model that NAIC should adopt as the personal lines regulatory model for the nation.

TESTIMONY OF
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

BEFORE
U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON OVERSIGHT & INVESTIGATIONS

AUGUST 1, 2001

TESTIMONY BY ROBERT L. ZEMAN
VICE PRESIDENT AND ASSISTANT GENERAL COUNSEL
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

I am pleased to present the following statement on behalf of the National Association of Independent Insurers (NAII). We represent over 690 property/casualty insurance companies, and our members write approximately thirty-nine percent of the U.S. property/casualty insurance market. We want to commend the members of this subcommittee for holding this important hearing. Our overall perspective on this issue is that in some states excessive regulation does indeed impede the ability of consumers to have a wide array of choices in the insurance marketplace. The good news, however, is that other states take a more competitive approach with clear benefits for consumers, and they provide a road map for state-based reform.

THE "OVERREGULATION" ISSUE

Support for the ability to compete in a competitive marketplace has been the hallmark of NAII since its inception just following enactment of the McCarran Act. We are hearing from our members, however, unprecedented levels of concern regarding excessive regulation of rates and forms in some states and how it is hurting competition. There is significant diversity across the states as to how property/casualty rates and forms are regulated. In many states the regulatory framework balances the forces of competition with effective solvency and market conduct regulation. Competition serves as the best regulator of pricing and products. It is clear that some states do a better job than others of facilitating a competitive marketplace, which leads us to the subject of today's hearing.

In some jurisdictions, excessive regulation has hindered competition, not only driving insurers out of the marketplace, but hurting consumers as well by limiting consumer choice, creating more cross subsidies, and increasing residual market populations. Clearly there is growing consensus on this point as evidenced by this very proceeding, comments we hear from our members, academic studies, and our Association's own analyses.

THE NEW JERSEY EXPERIENCE

NAII members believe New Jersey is in fact a state where excessive regulation has restricted competition and thus had a negative impact on consumers. For many years NAII has been involved in industry-wide analyses of the problems in the New Jersey regulatory system and various attempts toward reform of it. As part of that continuing effort we recently conducted a specific analysis of the automobile insurance regulatory structure in particular, and the results confirmed and fleshed out in further detail the impediments to competition that currently exist in the state. New Jersey motorists pay the most in the country for their automobile insurance in part because they live in a high cost, very urbanized state and are exposed to the greatest amount of traffic density in the nation. They also incur the highest overall loss costs due to very expensive healthcare fees and the second most generous no-fault benefit package available in the country. These factors in large part account for why auto insurance costs more in New Jersey than in other states. However, it is the highly politicized and volatile regulatory system that makes it much more difficult for insurance companies to compete and operate in the marketplace. New Jersey's personal automobile insurance ten-year profitability results are among the worst in the country. The culmination of these regulatory factors and the impediments to competition they create have caused a number of insurers to exit the state over the years.

For three decades, the automobile insurance marketplace in New Jersey has been marked with significant problems resulting from adverse regulatory and legislative actions. Causes of the major problems over the years have included the following:

1. A no-fault law which provides significantly high medical benefits, yet still allows recovery for pain and suffering on a fault basis.
2. Severe limitations on the ability of insurers to terminate unprofitable business by way of cancellation/non-renewal.
3. Laws that restrict an insurer's ability to freely withdraw from the market and impose limits on the profits an insurer can earn in the state, both of which discourage new entrants and investment of new capital into New Jersey's auto insurance marketplace.
4. Unreasonable regulations and restrictions on rate adjustments in both the voluntary and residual markets.

That last point is of critical importance to our members. Under New Jersey law, companies are required to have rates approved through one of the most stringent and detailed rate regulatory systems in the nation. Contrary to a statute that says the commissioner needs to render a decision within 120 days from the time a hearing is requested, some rate filings have not received a final notice of action until a year or more after the filing was made.

The results of our analysis were confirmed by a study conducted by Professor John Worrall of Rutgers University whose findings were part of a Brookings Institution conference early this year. In his view, New Jersey is a state where it is incredibly difficult to get rate relief. The law has changed in the last two years, but rate regulation has not: 29 of 32 rate filings were rejected, and three others got partial approval. Other requests for rate increases are pending.

Professor Worrall also concluded that the state probably has fewer firms writing business and less competition than it would under different regulatory schemes. The law and its administration have subjected drivers and insurers to unnecessary costs and burdened them with needless administration. It has limited the choices that would enable families with different resource levels to make insurance selections that are in their own best interests.

In NAII's analysis, we listed other specific factors that have contributed to the restraints on competition in New Jersey. These include:

1. Creation of a joint underwriting association (JUA) that later became the largest insolvent provider of automobile insurance in the country. By 1990 the JUA deficit had grown to $3.1 billion. (Since that time the JUA has been eliminated and replaced with an assigned risk plan.)
2. An excess profits law that uses a questionable formula for determining excess profits and that is not needed if the competitive market were allowed to function properly.
3. Regulations that give the commission the authority to order an insurer planning to withdraw to continue renewing policies for up to six years from the time the withdrawal plan is approved.
4. Provisions that require insurers to surrender their licenses to sell all other lines of insurance if they abandon the state's auto insurance market.
5. Restrictions on rating that create further subsidizations through restrictions on territorial rating. Insurers cannot charge a rate in one rating territory that is "significantly disproportionate" to rates charged under a prior territorial rate

restriction law. Under that law, insureds cannot be charged more than 2.5 times the territorial base rate, nor more than 1.35 times the statewide average base rate.

6. A 1999 requirement that insurers provide an overall 15% reduction to their policyholders for rates renewed on or after March 22, 1999. Insurers were required to provide the rate cut before many of the cost reductions in the Act were implemented. Many of the reforms still have not been effectuated to this date. Part of that same reform law was aimed at fighting fraud, reducing over-utilization of PIP medical expense benefits and tightening the verbal threshold. These reforms, while positive, have not generated nearly the 15% rate reduction mandated by the law. There remains a great deal of uncertainly as to whether or not the change in the verbal threshold will result in any cost savings. The bottom line is that in the two plus years since the Act took effect, the cost savings that were supposed to be generated have not approached the 15% premium reduction.

NEW JERSEY: PROPOSALS FOR IMPROVEMENT

Some of the reforms recently implemented are a step in the right direction. Clearly, however, additional reform is needed to return New Jersey to a more competitive marketplace. This can be accomplished within the current state-based regulatory system, but substantial change in this state's regulatory structure and culture would be required, including but not limited to the following:

1. Repeal of the prior approval rating law and replacement with a more competitive use-and-file statute.

2. Complete repeal of state-mandated territorial restrictions. In essence these restrictions unfairly force some drivers to subsidize other drivers. Bad drivers and good drivers alike should be required to pay premiums commensurate with the risk they present.
3. Repeal of the take-all-comers law that requires auto insurers to extend coverage to all eligible applicants, even if the applicant does not meet the insurer's own underwriting criteria.
4. Repeal of restrictions on non-renewing bad drivers.
5. Further reform of the no-fault system.
6. Repeal of withdrawal law, which creates a process that can take up to six years to leave the New Jersey market.
7. Repeal of the excess profits law.
8. More consumer choice on benefit levels.

MASSACHUSETTS

As in New Jersey, in Massachusetts the insurance industry experiences excessive regulation of rates, forms and underwriting that has led to a decrease in choices available to consumers. By law, the insurance commissioner in Massachusetts actually sets the mandated rates that must be utilized by all insurers, and only limited deviations are allowed. This is done on an annual basis after the commissioner has made the necessary legal determination as to whether to use the rate-setting process. Under current law, the insurance commissioner has until December 15 to provide an auto insurance rate decision. Insurers then have until January 1 to convert the new mandated rates into premium computations for individual policy renewals in January. Because this window is so small, many insurers are forced to issue estimated bills, with final bills being sent out later.

This onerous form of rate regulation, among the most extreme in the nation, severely limits the ability of insurers to react to market forces. The stringent anti-competitive regulatory system has had a chilling effect on competition. The number of companies offering personal automobile insurance in Massachusetts is one of the lowest in the country, with only 60 insurers offering personal automobile insurance coverage. In the 1980s, many of the larger national companies departed the state because of the extremes of the system and because of their high levels of losses.

Another significant related problem in Massachusetts lies in the tight regulation of the residual market. Any agent writing business through the residual market, known as the Commonwealth Automobile Reinsurers, has the ultimate right by statute to a contract with a carrier and to place any business with that carrier, with very few permissible underwriting criteria. Excessive regulation in the residual market, coupled with the same problem in the voluntary market, has left consumers in Massachusetts with fewer carriers from which they can choose.

There is further limitation of choice for Massachusetts consumers because the statutes also prescribe the precise form of coverage that must be made available to all, with the only variations being in the limits that insurers can offer to different customers. Carriers that want to include other coverages or offer other variations, even at lower rates are effectively precluded from doing so.

As in New Jersey the road to real solutions and more choices for consumers lies in a more competitive-based system, which would require comprehensive reform. Desirable legislative changes would include a rating law with an approach grounded in competition such as a file-and-use law.

GOOD NEWS – BENEFITS FOR CONSUMERS IN MORE COMPETITIVE STATES

In contrast with New Jersey and Massachusetts, a number of other states around the country including but not limited to Illinois have more competitive-oriented regulatory systems, and the benefits for consumers as well as insurers are clear. There is a growing body of academic studies regarding more restrictive versus more competitive rating laws, and these studies conclude the benefits for consumers in states with competitive systems are very real. Examples of some of the latest academic evidence indicate:

1. "There is little or no evidence that prior approval on average has a material effect on average rates. ... Prior approval regulation is, however, reliably associated with lower availability of coverage. It is positively and significantly related to residual marketshares, even when states with reinsurance facilities or related residual market mechanisms and the largest residual marketshares are excluded from the comparison. Prior approval regulation also is reliably associated with greater volatility in loss ratios and expenditure growth rates after controlling for the influence of a number of other variables that could affect volatility." (*From An Econometric Analysis of Insurance Rate Regulation,* Scott Harrington)

2. "The Illinois experience suggests that rate regulation for automobile insurance is unnecessary. Illinois has functioned without a rating law since 1971. Auto insurance is widely available from a large number of competitors. Rate changes are frequent, modest and appear to follow claim experience. Loss ratios and the size of the uninsured and residual market are in line with that in states that have

competitive rating laws. Thirty years of experience suggests that the automobile insurance market functions without regulation." (*Insurance Price Deregulation: The Illinois Experience*, by Steven D'Arcy)

3. "From the mid-seventies through 1998, South Carolina intensively regulated auto insurance. Rate levels and rate structures were restricted, insurers underwriting discretion was limited and large cross-subsidies were channeled through its residual market. Contrary to political expectations, but consistent with economic theory, these regulatory measures worsened market conditions. ... South Carolina's prior approval system was replaced by flex rating and restrictions on risk-based pricing and underwriting were substantially eased. The Reinsurance Facility and its large subsidies are being phased out and replaced temporarily by a JUA and ultimately by an assigned risk plan that will be required to charge adequate rates. ... With most of the reforms becoming effective in 1999, it is too soon to determine their ultimate outcome, but the early prognosis is positive. The number of insurers writing auto insurance has doubled with the implementation of the reforms. Many insurers have implemented more refined risk classification and pricing structures, as well as alternative policy options for consumers. It also appears that overall rate levels have continued to fall, possibly reflecting declining claims costs, as well as the easing of restrictions of risk-based pricing. Most importantly, the Facility is depopulating rapidly." (*Auto Insurance Reform: Salvation in South Carolina*, by Martin F. Grace et al)

The conclusions of these and other academic scholars are consistent with the results of our Association's own surveys and analyses. We want to emphasize, as pointed out above, that the success of more competitive systems is far from limited to Illinois. Other states such as Wisconsin have had more competitive systems for years and consumers have enjoyed the benefits of competition. It is also essential to note that more recently jurisdictions such as South Carolina have helped consumers through adoption of reforms that have facilitated a more competitive environment. The point is there is compelling evidence that states can indeed make the transition from a more restrictive environment to a more competitive system, bringing with the changes substantial benefits for consumers, including greater availability and less subsidization.

In addition to reform of rate regulation, some states have taken specific positive action regarding reform of form filing requirements for certain risks. These include Arizona, Colorado, Michigan and Minnesota. States that have evolved their regulatory system to recognize the role played by competition show that state regulation works.

THE SOLUTION, PART I:

Last year the National Association of Insurance Commissioners (NAIC) produced a number of practical and operational suggestions that, if immediately adopted by individual insurance departments, would help speed the process of rate and product approval in the states. Those suggestions include elimination of desk-drawer rules, use of clear checklists regarding what must be in a filing, and specific timeframes for action by insurance departments on proposed rate and form changes. In our discussions with state regulatory officials as well as our members, we have seen that many states are beginning to move toward more efficient regulatory practices. Unfortunately, while there are some positive changes being made in some states on process and procedure, the need to deal with mindset and regulatory culture remains in several others. Changing this culture and mindset will take time. We urge Congress to give the states the opportunity to do just that. It is up to individual insurance departments to effectuate these operational efficiencies.

But we also hope that regulators will work with state public policymakers, as we are, to ultimately effectuate the public policy changes needed to assure that consumers are not denied the benefits of a more competitive environment.

THE SOLUTION, PART II: STATE LEGISLATION TOWARD MORE COMPETITIVE ENVIRONMENTS

While our organization supports competition, we do not call for elimination of all regulation. We suggest that states adopt laws that rely upon competition among insurers to determine insurance rates but also provide for regulatory intervention and consumer protection if a market is found not to be competitive. This also allows regulatory resources to be concentrated on solvency and market conduct.

There is some recent good news to report on the legislative front. Several states during their 2001 legislative sessions considered proposals for reform of the rate and/or form approval process. While there have been few enactments to date this year, it is good to see the states are indeed dealing with the issue.

We are also heartened by the very recent adoption by the National Conference of Insurance Legislators (NCOIL) of a model law that can truly help enhance competition and eliminate unnecessary and excessive regulation, for the benefit of consumers. The NCOIL model takes a use-and-file approach for personal automobile insurance. There would still, however, be a prohibition on rates that are inadequate or unfairly discriminatory. Moreover, if a market is found not competitive, the insurance regulator would then have greater control over rate changes. We believe the NCOIL approach protects the consumer through a combination of competitive market forces and specific regulatory oversight. Of course, now the major challenge is to win adoption of competitive legislation along the lines of this model and the successful statutes in place in states like South Carolina, Illinois and Wisconsin. We hope that through additional discussion in state legislative forums such as NCOIL and NCSL, as well as the NAIC, more legislators and regulators will understand the need for competitive-based reforms. These reforms must be tailored to fit the nuances of each state.

CONCLUSION

NAII has long believed that state regulation of insurance is the most desirable means through which to achieve a competitive insurance marketplace for the benefit of the industry, regulators and consumers. A competitive marketplace insures consumers the lowest price, most diverse products, best service, and greatest number of insurance providers from which to select. Some states have indeed shown that state regulation can work in a manner that promotes a competitive environment. In order to achieve this goal, the regulatory structures and principles followed in other states such as New Jersey and Massachusetts must change. Regulatory and legislative impediments that restrict market competition in these states and others must be eliminated.

NAII supports state regulation of insurance and opposes continued federal encroachment in the regulation in the business of insurance. As the debate over insurance regulation and reform continues, our organization will of course continue to examine other regulatory options as they are proposed. NAII recognizes that support within the industry for state regulation is dependent in large part on the states instituting meaningful reforms to modernize regulation for the benefit of consumers. NAII strongly urges Congress to give the states ample opportunity to improve the state regulatory system, to meet the concerns that have been expressed regarding states including New Jersey and Massachusetts. NAII is deeply committed to working with the NAIC, individual insurance commissioners, state legislators and all other interested parties on improvements to the state regulatory system. Thank you again for the opportunity to testify.

NATIONAL ASSOCIATION OF INDEPENDENT INSURERS ANALYSIS OF STATE PRIVATE PASSENGER AUTO INSURANCE REGULATED MARKETS

Introduction

Each state has its own approach to regulating the property/casualty insurance business. The subtle differences between state regulation allows local policy makers to adjust regulatory needs to the nuances of the local market, including tort systems, population density, traffic and highway conditions, building codes and a host of other state-specific laws. Most state insurance departments have achieved with relative success a competitive market, enabling companies to operate in such a way that consumers benefit from fair insurance rates and greater product availability. A few states, including New Jersey, have enacted laws and regulations that make it difficult, if not impossible, for companies to operate effectively. This analysis focuses primarily on the condition of the New Jersey private passenger automobile insurance environment. The report also examines the South Carolina market, which was experiencing problems similar to those in New Jersey, but has recently improved market conditions thanks to changes in its regulatory system.

Highlights of this analysis include:

- On average, New Jersey motorists pay the most for their auto insurance because they live in a high-cost, very urbanized state and are exposed to the greatest amount of traffic density in the nation. They also incur the highest overall loss cost due to expensive health care fees and the second most generous no-fault benefit package available in the country. Moreover, there has been an increase in attorney utilization by New Jersey claimants, whereas claimants in other states have reduced their level of representation.
- The above variables coupled with a highly politicized and volatile regulatory system stifle competition and make it difficult for insurance companies to operate effectively in the state. New Jersey's personal auto insurance ten-year profitability results are among the worst compared to other states. These factors have caused a number of insurers to exit the state over the years.
- On the other hand, in light of recent auto insurance reform in South Carolina, favorable results are now being observed. These include rapid entry of new insurance companies into the state, a decline in average auto expenditures, and a drop in the auto residual market.

Although insurance regulation in New Jersey and several other states is in great need of reform, the majority of states have allowed free market forces to work well. Insurance consumers in most other states receive the benefits commonly associated with competitive markets, that is, insurance products and services available from alternative sources at the lowest possible prices.

New Jersey

For three decades, the personal auto insurance marketplace in New Jersey has been marked with significant problems resulting from adverse regulatory and legislative actions. Causes of the major problems over the years have included the following:

- a no-fault law which provides significantly high medical benefits,[1] yet maintains easy access to the courts for claims for pain and suffering;
- unreasonable regulations and restrictions on rate increases in both the voluntary and residual markets;
- severe limitations on the ability of insurers to terminate unprofitable business by way of cancellation and nonrenewal; and
- severe limitations on an insurer's ability to select the risks it will write in the state.

To allow for the current examination of each company's rates and practices, companies operating in New Jersey have been subject to some of the most stringent and detailed requirements in the nation. Companies are required to have their rates approved by the commissioner prior to their use, often after long and drawn out procedures lasting many months, if not years. As part of the prior approval procedure, many rate proposals are rigidly examined and challenged. Contrary to statute that says that the commissioner needs to render a decision within 120 days from the time a hearing is requested, some rate filings have not received a final notice by the commissioner until a year or more after the filing was made.[2] Often, the final rate changes are less than what was originally requested, in spite of supporting information.

Several specific legislative, regulatory and judicial actions affecting the New Jersey personal auto insurance market over the years are listed below. It is no wonder that this state has warranted such an unfavorable reputation in terms of the ability of insurers to do business here.

- The creation of a joint underwriting association (JUA) that was the largest *insolvent* provider of auto insurance in the country.[3] In 1986, the deficit was estimated to be $750 million, growing to $3.1 billion by 1990.[4] The JUA has since been eliminated.
- An "excess profits" law, that requires policyholder refunds if profits exceed a specified amount, but that prevents insurers from increasing surplus in a way needed to support the state's growing population.
- The enactment of the Fair Auto Insurance Reform Act in 1990, which allows "stranger" agents to place business with any insurance company. Under the "take-all-comers" law in the state, companies must accept the driver, regardless of how risky

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[1] Until 1990, the level of medical benefits offered in New Jersey was unlimited.

[2] John D. Worrall, *Private Passenger Auto Insurance in New Jersey: A Three Decade Advert for Reform*, April 15, 2001

[3] Report, "The New Jersey Automobile Full Insurance Underwriting Association: Recommended Solutions," submitted to New Jersey Governor Thomas H. Kean, September 1986.

[4] A subsequent JUA-related action includes a 1990 proposal by Governor Jim Florio requiring insurers to pay $1.4 billion to help satisfy the $3.1 billion deficit in the state's JUA.

the individual is. The Act also imposed $150 million in premium taxes over a two-year period and annual assessments of $160 million over a seven-year period on insurers doing business in the state.

- The New Jersey Superior Court Appellate Division's decision to uphold a FAIR Act provision requiring insurers to surrender their licenses to sell all other lines of insurance if they abandon the state auto market.
- Regulations that give the commissioner the authority to order an insurer planning to withdraw to continue renewing policies for up to six years from the time the withdrawal plan is approved.
- A provision resulting in a subsidization in rates, whereby policyholders living in the suburban and rural areas of New Jersey are required to pay more to offset reductions given to their counterparts living in urban areas.
- The establishment of auto insurance Urban Enterprise Zones in 1997, requiring more insurers to write business in the cities.

Loss Experience

In order that insurance rates not be inadequate or excessive, they need to be actuarially sound, i.e., based on costs. In New Jersey, this condition is virtually impossible, as the level of regulation has been so oppressive that cost-based pricing simply cannot exist. For over a decade, the state has had the highest average premium in the nation, being 50%-60% higher than the countrywide norm. This should not be surprising, as New Jersey auto insurance policyholders:

- incur the highest overall auto insurance loss cost in the nation;[5]
- are exposed to the greatest number of vehicles per highway mile (ranked the highest in the nation,[6] the traffic density in New Jersey is about 780 motor vehicles per square mile);
- continue to hire more attorneys when the level of representation has gone down countrywide; the increased level of attorney involvement in New Jersey has contributed to higher insurance costs (68% of New Jersey auto insurance claimants hired an attorney in 1997, up from 61% five years earlier);[7]
- incur very high hospital room charges (the 1999 average hospital inpatient service charges per admission in New Jersey are about 50% greater than the countrywide norm);[8] and
- receive the second highest level of personal injury no-fault benefits ($250,000) in the nation (second only to Michigan).

Since 1996, the state's bodily injury liability loss cost has gone up more than 20%[9] (see Figure 1). If losses continue to rise and rates become more and more inadequate, insurers

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[5] *Fast Track Monitoring System, @1st Qtr. 2001*, quarterly report prepared jointly by the National Association of Independent Insurers and Insurance Services Office, Inc.

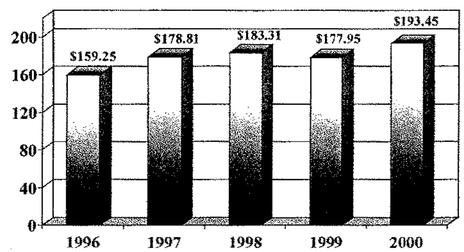
[6] The ranking of states excludes the District of Columbia; the source of this information is the Federal Highway Administration and the Bureau of the Census.

[7] Insurance Research Council, *Injuries in Auto Accidents: An Analysis of Auto Insurance Claims, 1999*

[8] Mutual of Omaha Insurance Company, *Current Trends in Health Care Costs and Utilization*

will not be able to sustain their operations in the state. It is no wonder that State Farm Indemnity Company, American International Insurance Company of New Jersey and other companies have made recent announcements to withdraw.

Figure 1
New Jersey
Bodily Injury Liability Loss Cost

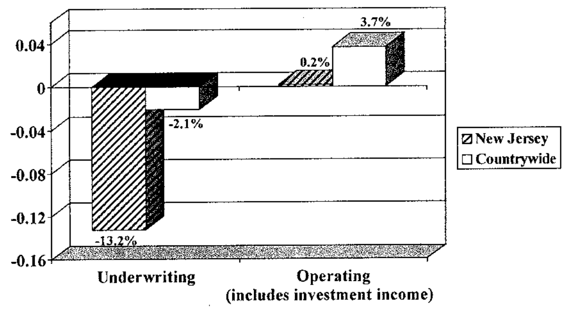


Source: Fast Track Monitoring System

Profitability
The deteriorating economics of New Jersey's underwriting can also be demonstrated by examining profit figures. Over the years, the state's private passenger auto insurance companies have fared poorly in terms of profitability, both on an underwriting basis and after investment income is taken into account. While the industry has realized a profit during some years, it does not come close to making up for the overall losses incurred by insurers in this state. Below in Figure 2 is an illustration comparing the ten-year average profitability results, from 1990-1999, for New Jersey and countrywide from both the underwriting and investment operations.

[9] *Fast Track Monitoring System, @1st Qtr. 2001*

Figure 2
New Jersey vs. Countrywide
Personal Auto Profitability
(as a % of earned premium)
1990-1999 Combined



Source: National Association of Insurance Commissioners, Profitability by Line By State, (liability and physical damage combined)

During the ten-year span, private passenger auto writers in New Jersey accrued a total underwriting loss of 13.2% of earned premium, or $5.3 billion.[10] This figure reflects both liability and physical damage coverages. While underwriting results nationally have resulted in a loss, too, the percentage is not as low as in New Jersey. And after investment income is included, New Jersey auto insurers barely broke even over the past decade, while companies writing in the entire United States made only a small operating profit.

Competition in New Jersey
Sales concentration ratios for the leading firms are traditionally used as an appropriate measurement of market power. Theoretically, if one or a few firms control unreasonably large shares of the market, prices and availability might be unduly influenced by the actions of the leading firms. The aggregate market share of the top four auto insurance companies in New Jersey jumped fifteen points from 1998 to 2000 (from 33.5% to 48.2%); similarly, the aggregate market share of the top eight insurers increased 10 points over the same period (from 50.5% to 60.8%).[11] Such growth indicates that the largest writers are having greater influence on the market and there is a tendency toward less competition among the total number of auto insurance companies in the state.

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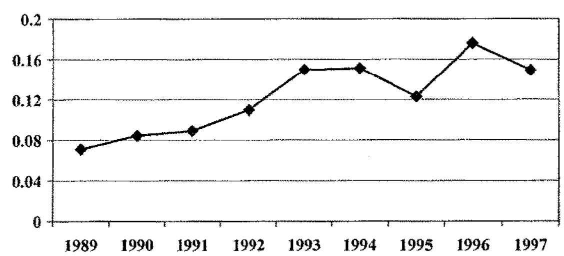
[10] National Association of Insurance Commissioners, *Profitability By Line By State*
[11] National Association of Insurance Commissioners database, Thomson Financial Insurance Solutions

This is also seen to be the case in Massachusetts, another state with onerous regulations. Here, the law requires the state commissioner to set the auto insurance rates. Like New Jersey, Massachusetts is high cost and very urbanized, which contributes to the high price paid by policyholders. This state, too, has a poorly structured regulatory system that has discouraged new companies from entering the market. The number of companies offering personal auto insurance in Massachusetts is one of the lowest in the country, much lower than elsewhere. Only 60 insurers offer personal auto insurance here;[12] given the state's number of drivers, this quantity is remarkably low and very disconcerting.

Uninsured Motorist Population

1997 auto insurance reform legislation in New Jersey established urban enterprise zones to alleviate the problem of uninsured motorists in the state (i.e., primarily in the inner cities). Having had one of the lowest uninsured driver populations in the nation at one time, New Jersey has in recent years been faced with an ongoing problem of drivers without liability coverage. In 1989, its share of uninsured motorists was only 7.1%; latest data for 1997 show that this level has more than doubled to 14.9%, rising to nearly 18.0% in 1996.[13] It is too soon to tell whether the creation of urban enterprise zones is a long-term solution to the problem.

Figure 3
New Jersey
Estimated Uninsured Motorist Population



Source: Insurance Research Council

South Carolina

South Carolina had a regulatory structure that, like New Jersey's current structure, proved difficult for insurers. That has changed. In 1999, South Carolina auto insurance reform measures became effective pursuant to a 1997 enactment; one of these changes was a

[12] Ibid.

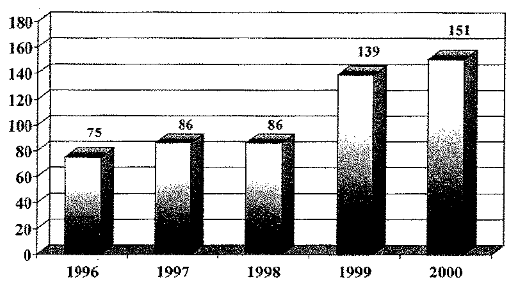
[13] Insurance Research Council, *Uninsured Motorists, 2000*

conversion in the rating law from a prior approval system to a flex-rating system.[14] Other favorable changes included elimination of restrictions on territorial rating differentials and significant residual market reform. Some favorable observations have resulted since the change in law; these include the following:

- On average, South Carolina motorists paid 12.2% less for auto insurance in 1999 compared to the previous year. In 1998, the average annual auto insurance expenditure in this state was $655.33, while in 1999, the amount dropped to $573.31.[15]

- The number of private passenger auto insurers has more than doubled, resulting in a more competitive market for consumers. In 1996, there were 75 auto writers in South Carolina; four years later, this figure has now surpassed 150 (see Figure 4).[16]

Figure 4
Number of Companies
Writing Personal Automobile
in South Carolina



Source: National Association of Insurance Commissioners

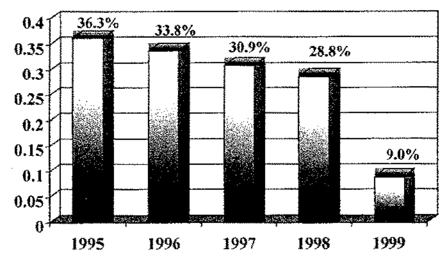
- The South Carolina personal auto industry concentration index is now in the unconcentrated range, indicating improved competition among insurers. This index is based on market shares of all the writers and is used to measure the level of competition in the market.
- According to the Center for Risk Management and Insurance Research Department at Georgia State University, new insurers in the South Carolina market are opting to

[14] Under a flex-rating system, companies may file and use their new rates without waiting for approval from the commissioner if increases or decreases fall within a specified band. Rate changes outside the band still require prior approval.
[15] National Association of Insurance Commissioners, *State Average Expenditures & Premiums for Personal Automotive Insurance*
[16] National Association of Insurance Commissioners database, Thomson Financial Insurance Solutions

write homeowners insurance because of the economics involved in marketing multiple personal lines insurance products. This has a highly beneficial effect for South Carolina residents as the state has a high hurricane risk.[17]

- Before auto reform was enacted, South Carolina's residual market share was mostly in the 30%-40% range. Following the change in the rating law, the level of policies in the residual market plunged to 9.0%.[18]

Figure 5
South Carolina
Residual Market Share
Private Passenger Automobile



Source: South Carolina Department of Insurance

- From 1998 to 1999 (effective year of reform) the number of vehicles insured in the residual market dropped 70 percent while those in the voluntary market increased 36 percent, clearly showing the absorption of risk by the South Carolina voluntary auto insurance market.[19]

The National Association of Independent Insurers is a trade association of more than 690 property/casualty insurance companies. NAII members represent approximately 45% of the personal auto market in the nation.

[17] *Auto Insurance Reform: Salvation in South Carolina,* Center for Risk Management and Insurance Research, Georgia State University, January 15, 2001, Martin Grace, Robert Klein & Richard Phillips
[18] South Carolina Department of Insurance
[19] AIPSO, *AIPSO Circular,* Circular Number BOD 01-05 RMC 01-10, May 15, 2001

STATEMENT

OF

ALLIANCE OF AMERICAN INSURERS

BEFORE

HOUSE FINANCE SERVICES COMMITTEE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

**HEARING ON OVER-REGULATION OF AUTOMOBILE INSURANCE:
A LACK OF CONSUMER CHOICE**

WASHINGTON, D.C.

AUGUST 1, 2001

The Alliance of American Insurers (Alliance) is a national property and casualty insurance trade association whose membership is composed of more than 320 member companies. Our membership writes all lines of property and casualty insurance coverage including a significant amount of personal automobile insurance. We thank the subcommittee for the opportunity to discuss the issue of over-regulation of automobile insurance and the impact this over-regulation has on consumers.

We understand the focus of this hearing will be automobile insurance regulation in several states ---- New Jersey and Massachusetts in particular--- contrasted with Illinois' competition regulatory structure. This hearing will raise some very important issues for discussion. It must be remembered however that each state has its own unique regulatory scheme and philosophy. The Alliance believes that working within the state legislative and regulatory system is the best approach to resolving many, if not all, of the issues raised in this hearing. There is no "one-size-fits-all" answer. For purposes of this statement, we will focus, in detail, on New Jersey while briefly discussing other states.

Our comments highlight the complexity of one line of coverage in one state. They serve as a case study of the premise that in the property and casualty industry each state has unique characteristics and that modernization within this context means the states must move toward market based approaches while rethinking regulatory philosophy. However, this does not mean "black letter law" uniformity across the nation is the only solution. Rather it illustrates the need for action on both the operational efficiencies of the regulatory system and public policy.

New Jersey

No subject has caused more controversy over the past two decades than the New Jersey automobile insurance law. Beginning with the passage of no-fault under the Cahill administration in 1972 to the passage of the Automobile Insurance Cost Reduction Act in 1998, the law has been subject to nearly constant revision. The primary emphasis of most of the legislative activity has been the enactment of a body of law that would bring stability to the automobile insurance market as a functioning economic entity. As it stands, the New Jersey automobile insurance market is one of the most complex in the nation. To understand its complexity, one must understand its evolution.

New Jersey instituted a compulsory no-fault system for car insurance in 1972. The law provided unlimited payment for hospital and medical expenses and a minimum of $5,200 per year for lost wages. Lawsuits were not allowed for pain and suffering unless medical expenses reached $200.

By the late 1970s, it became apparent that the lawsuit threshold amount of $200 was too low, when compared with the very rich first party benefit coverage. The system was "no-fault" in name only

In 1985, after years of effort, the legislature modified the no-fault law, eliminating the \$200 threshold and substituting the nation's first dual threshold. Because of substantial opposition by the New Jersey Bar Association and other attorneys' organizations, it was difficult to secure passage of a verbal threshold to limit the number of lawsuits for pain and suffering.

Instead, the legislature passed a law that established an elective threshold of a choice between a so-called "zero" threshold (no tort limitation) and a verbal threshold. A number of other elective options were set forth so that persons could modify their coverage to reduce premiums.

A mechanism had to be established, called the Risk Exchange, to reconcile claims payments among companies for the dual threshold option. Because failure to elect one threshold or another resulted in the assignment of a zero threshold, nearly 75 percent of the population, omitting to make any decision at all, retained the zero threshold and thus received no savings from the law. The system continued to be essentially a fault based system.

The Joint Underwriting Association (JUA) law was enacted in 1982 to address criticisms directed at the Assigned Risk Plan, which, in the view of some, "stigmatized" drivers who were insured in the Plan. It was a take-all-comers residual market mechanism to which changes were made in 1986. These were initiated by the Commissioner of Insurance and included such things as providing for the appointment of computer companies to service the JUA business as an alternative to insurers, the modification of certain rates, the reduction of some of the commissions payable on JUA business, and the imposition of a very unpopular surcharge program for JUA drivers, called the "DIP" (Driver Improvement Program) plan.

Because of delays in implementation, computer companies did not come on line until several years later. The fundamental rate insufficiency of the JUA still existed, however, and the deficit continued to grow. Finally, the Department of Insurance was forced to levy the Residual Market Equalization Charge (RMEC), which within a year amounted to \$220 per car. The imposition of the RMEC was absolutely essential to the JUA's ongoing ability to pay claims.

By 1988, it was clear that the automobile insurance system needed further adjustment. The following major changes were made:

1. The no-fault law was amended to make the verbal threshold the basic threshold; that is, if individuals did not make an affirmative election, they would have been assigned the verbal threshold. That portion of the premium which represented tort costs in the system was reduced approximately 35 percent for these insureds.

The legislature determined to retain unlimited medical benefits and compulsory insurance. It provided for the promulgation of a medical fee schedule to contain medical expenses, and established a mandatory $250 medical expense deductible and mandatory 15 percent expense co-pay for expenses up to $5,000.

2 The JUA's structure was substantially changed The JUA was no longer to charge the same rates as the rates in the voluntary market, but rather was changed to become self-sustaining after a transitional period of four years. Rates were raised 10 percent each year, so that there would be sufficient time for depopulation. This not only was to meet the goal of making the JUA self-sustaining, but was also meant to provide more cash to the JUA in the short term to lessen the necessity of increasing RMEC, which was paid by drivers in both the voluntary and residual markets. The RMEC was to remain in place until after the JUA deficit was paid off. After a four-year period, the JUA would truly be the insurer of last resort for drivers with poor driving records, and its rate would have been 35 to 40 percent higher than voluntary market rates.

3. The law contained a number of provisions to encourage the depopulation of the JUA by insurers writing in the voluntary market. Quotas were to be established which provided that 10 percent of the drivers in the JUA were to be taken out each year for four years. After four years, to the extent that more than 10 percent remained in the JUA, the Commissioner of Insurance could then assign persons to insurers.

One of the most persistent complaints by the industry was that the Department was so slow in approving rate increases that it was impossible to insure any risk but one with an absolutely clean record. As a response to this, the legislature enacted a flex-rating provision, which established a yearly rate increase amount linked to the Consumer Price Index (CPI), which insurers could use without waiting for prior approval.

4. The legislature amended the law that forbade insurers to cancel insureds' policies for any reason except non-payment of premium; the amendment permitted insurers to cancel up to two percent of their insureds per year. This was to make them more willing to write new business and take risks out of the JUA. In addition, companies were permitted to establish non-standard rates in the voluntary market. This had never been permitted in New Jersey but was in use in many other states. Non-standard rates are a higher level of rate generally, charged to certain categories of drivers with higher loss experience.

Historically, one of the problems in New Jersey was that the voluntary market rate level was generally viewed as inadequate to support the higher rated classes and territories. In other states, young drivers, for example, are often written in the non-standard market until an insurer has a sense of the driver's potential as a good risk or a bad risk; henceforth, they are either placed in the voluntary market as a standard risk or they are retained in the non-standard market until their driving record improves.

The 1988 law had three major purposes. First, it changed the purpose of the JUA; the JUA was no longer to be a market-rate level mechanism but rather a true market of last resort for drivers whose records were so poor that they could not secure coverage elsewhere.

Second, the law was aimed at creating a more competitive voluntary market in New Jersey so that premiums would reflect true market forces of supply and demand and reflect the true cost of doing business rather than be subject to the artificial restraints than they had in the past.

Third, the law attempted to restore some balance to the no-fault system and reduce system-wide costs by making the verbal threshold the basic threshold and the zero threshold the optional threshold. This resulted in about 80 percent of drivers having their bodily injury rates reduced.

In 1990, one of the first acts of the Florio administration was to make substantial changes to the automobile insurance system. The so-called FAIR Act was extremely comprehensive in scope.

Some of the most significant provisions of the FAIR Act are as follows:

1. The no-fault law was retained, but unlimited medical benefits were eliminated and a cap of $250,000 was placed on medical expense benefits. At the option of the insured, other health insurance coverage could be used instead of PIP medical benefits; thus, the cost of this coverage was shifted in some cases to employers. Initially, the bill provided that insurers had to offer coverage in excess of $250,000, but this provision was eliminated; some carriers offer up to $1 million but others offer only $250,000. In addition, a medical fee schedule was to be promulgated by the Commissioner of Insurance; health care providers were permitted to charge no more than that provided in the schedule. This provision was included because the Department of Insurance had never established the fee schedule provided for in the 1988 law.

2. The JUA was to cease writing policies as of October 1, 1990, and the RMEC was not to be collected on any policy after April 1, 1991. At the time of its shutdown, the JUA still was obligated to pay an estimated $3 billion in outstanding claims. As its premium income would cease completely in 1991 and the income from RMEC would also cease at that time, it was necessary to find new funds to meet the JUA's obligations.

An Automobile Insurance Guaranty Association was established to pay the obligations of the Association.

3. To write residual market vehicles, a new residual market mechanism was created, known as the "Market Transition Facility" (MTF). It went into business on October 1, 1990 as the JUA went out of business, using the same rate structure

as the JUA. At the same time, the residual market was to be depopulated in accordance with a series of orders by the Commissioner.

4. The MTF issued policies until October 1, 1992. In the meantime, as of April 1, 1992, insurers in the voluntary market were required to write all drivers characterized as "eligible" by statute or regulation. This is the so-called "take-all-comers" provision. Persons not eligible are those convicted of driving while intoxicated, those convicted of a crime of the first, second or third degree, those convicted of theft or fraud, and those who have poor driving records, as established by the Commissioner by regulation. This has been determined to be drivers with nine "eligibility" points or more.

5. After October 1, 1992, an Assigned Risk Plan took the place of the MTF as the residual market mechanism. No more than 10 percent of the drivers were to be in the Plan. Risks would be assigned to insurers on the basis of the insurer's market share. The Commissioner would approve the rates for the Plan. The degree to which there was to be a subsidy between the residual and the voluntary markets would thus be in the hands of the Department of Insurance.

6. There were certain safeguards for insurers who might be rendered fiscally unsafe or unsound as a result of the operation of the law, including the "take-all-comers" provision and the Assigned Risk Plan. If certain financial tests were met, the Commissioner could relieve them of their obligations under the law.

On May 19, 1998, the Automobile Insurance Cost Reduction Act was signed into law. It is tempting to ignore New Jersey's 1998 auto insurance reforms and concentrate only on the "rate rollback." More accurately, the New Jersey reforms centered on mandated cost reductions tied to mandated changes in the no-fault law.

New Jersey's new law promised a 15 percent savings on a revision of the state's lawsuit threshold to limit lawsuits for pain and suffering and several other deep cost-cutting reforms which, after delay, are finally being implemented. Under the new verbal threshold law, the requirement for pain and suffering lawsuits is that injuries must be to a body part or organ, not just tissue, and must be permanent.

Also under the new law in New Jersey, consumers can buy less PIP coverage than the $250,00 formerly required – as low as $15,000. Costs were further reduced by a new PIP arbitration system that utilizes peer review and by providing treatment and testing in accordance with commonly accepted medical protocols.

The new law also requires that physicians certify the seriousness of the plaintiff's condition in every complaint in a pain and suffering lawsuit brought under the revised lawsuit threshold. A fraudulent filing of a certificate is punishable by imprisonment and revocation of a physician's professional license.

The new law also permits multi-car households to significantly cut their comprehensive and collision premiums by specifically naming those drivers who will be permitted to use certain vehicles. Under the "named driver exclusion" a youthful driver could be assigned to a car that is less expensive to insure. Before this change, the highest risk driver in a household was assigned to the most expensive car in the household for purposes of setting rates.

The New Jersey reform measure, in addition, provided for the availability of a new basic policy to allow people to meet the state's mandatory insurance requirement at an estimated cost of $350 - $400. The basic policy consists of $15,000 in PIP coverage and $5,000 in property damage liability. Catastrophe medical expenses (brain, spinal cord, etc.) are covered up to $250,000, as is trauma care center coverage. Drivers have an option of purchasing $10,000 of B.I. liability and comprehensive and collision with a standard $500 deductible. Regular FR limits in New Jersey are 15/30/5.

But the key to the New Jersey rate reductions is the medical protocols. They establish explicit standards against which to measure reimbursement of medical treatment and diagnostic tests. These measures are the reason for a reduction in PIP-related premiums of 25 percent or roughly $250 million a year.

These strict new protocols establish care paths that are typical courses of treatment to be followed and establish checkpoints at which treatment is reviewed to determine if it is necessary and proper. They are designed to eliminate abuses in "over-utilization" of PIP benefits and eliminate reimbursement for unnecessary medical treatment and testing. This is the strong medicine that accounts for most of the New Jersey savings.

New Jersey also has a strong "no pay-no play" law that prohibits uninsured drivers from suing for pain and suffering in an accident.

In general, the history of no-fault in New Jersey shows a record of experimentation, change, and adjustment designed to create an insurance system which strikes a balance between the needs of the insuring public and the need to eliminate unnecessary costs in order to provide a product which is affordable and readily available. The state has been a laboratory for experimentation and change.

On the matter of costs, the National Association of Insurance Commissioners (NAIC) annual premium ranking, which has received much publicity about who is number one, has at best been an imperfect barometer of who pays how much for car insurance in the United States.

The NAIC report simply takes premium and divides it by the number of insured cars to come up with a so-called average. Well, the fact of the matter is that drivers do not pay average premiums and there are no "average drivers." Driver's pay a premium for car insurance based on accident frequency of the rating territory, where the person garages the car, age, driving record, type of vehicle driven, and use of the car insured. The NAIC method in effect presupposes a one-territory state where **everybody** pays the same price regardless of accident involvement or driving history. Try selling that to the people of New Jersey or any other state. Auto insurance premiums vary throughout New Jersey. People in the suburbs pay less than those in the city, rural areas less than urban, and so on.

Changes in the rating law and the Administrative Procedures Act, plus a return to flex rating in the state can partially address what is wrong. The medical protocols and medical fee schedule, when fully implemented, will help sort out other existing problems and partially address cost drivers.

One final note. If there had been an intractable federal system in place in New Jersey in recent years, the state would have been precluded from its experimentation with no fault and would have been forced to comply with strictures that, in our view, would have been a disaster. Instead, we have a system that has shown it can be fixed, and the Alliance is working on changes to do just that.

Also note that New York in looking to reform its no-fault system and is considering adoption of elements enacted in New Jersey in 1998, particularly the medical protocols and changes in the verbal threshold definition.

Massachusetts

Despite being a medium sized market, the number of insurers writing in Massachusetts is significantly lower than in other states, both in the Northeast and nation wide. Far fewer direct writers provide insurance in the state than in others and their market share has decreased while it has increased in other states. The state's residual market is one of the nation's largest. Prior to the adoption of the current regulatory scheme in 1974, the residual market share was similar to other states. Loss costs and premiums are high in the state. We believe much of this can be attributed to a regulatory structure that creates "cross subsidies" and a low tort threshold that provides incentives for fraud.

One area deserves special mention. Earlier this year, a respected national publication, Auto Insurance Report, using data from the NAIC, released its annual review of company profitability for personal auto insurance on a state-by-state basis. In 1999 Massachusetts ranked 47th in the nation, down from 40th in 1998. This survey does not include the impact of the most recent rate decrease. Since 1994, auto insurance rates in the state have decreased 24% while costs for auto parts and medical have significantly increased. When this is coupled with the fact that Massachusetts's drivers have the highest accident rate in the country, an environment problematic for auto insurance is created. These are problems that the state and the industry must address, but they are not insurmountable. By working together we believe that many, if not all, can be resolved.

Illinois

The Illinois personal automobile market, when contrasted with that of New Jersey and Massachusetts, is an excellent example of the benefits to consumers of a highly competitive marketplace. Illinois has effectively functioned without a rating law since 1971. The state ranks 5th in population but currently ranks 25th in average automobile expenditures. Auto insurance is widely available from a large number of competing insurers. Rate changes are frequent, modest and follow claims experience. Loss ratios and the size of uninsured and residual market are in line with states that have competitive rating laws.

Earlier this year, the Capital Markets, Insurance, and Government Sponsored Enterprises subcommittee held a hearing on "speed to market" issues. The Illinois experience was discussed in a comprehensive manner. We urge the subcommittee to review the transcript of that hearing. After review of the thirty year Illinois experience, one can only conclude that the auto insurance market can function effectively and efficiently without extensive regulation.

South Carolina

From the mid-seventies through 1998, South Carolina had one of the most tightly regulated insurance markets in the nation. Its system was noted for strict rate regulation that resulted in large cross subsidies to "bad risk" drivers at the expense of "low risk" and "medium risk" drivers. At one point the states residual market insured more than forty percent of the states automobiles.

In 1997, the state legislature passed reforms that significantly deregulated the insurance market. Restrictions on rates and underwriting were reduced and the residual market mechanism changed. The cross subsidy was eliminated. While it is still early in the evaluation of these reforms, there are encouraging signs. The number of insurers writing automobile coverage has doubled. The number of vehicles insured by the residual market has declined rapidly. It appears that the consumer has benefited significantly.

South Carolina is a prime example of what can happen when insurers, regulators, and the legislature work together to resolve problems within a particular state.

Conclusion

There are states whose regulatory regime and philosophy have created difficulties. New Jersey has often been cited as a worst-case example, yet reforms have taken place that we believe can work to the benefit of the consumer. Whether or not these changes will be sufficient when fully implemented, only time and experience will tell. The Alliance believes that South Carolina can now be cited as examples of what can be achieved as the industry, public policy makers and consumers work together to achieve needed reforms.

Reforms need not be "black letter law" uniformity across the nation. To do so would ignore the unique characteristics and needs of each state. Rather, the regulatory philosophy must be reviewed in an effort to increase efficiencies within the system. Meaningful cooperative activity among regulators, state legislators, consumers, and the insurance industry provides the best means of fostering competition and provide for the insurance needs of the consumer. Such cooperative efforts make the states an effective laboratory in devising regulatory environments that meet the special needs of their citizens. There is no "one-size-fits-all" answer to how best increase competition and benefit the consumer.

However, there is a significant and urgent need for the states to focus on the premise that modernization is imperative and harmonization is needed. Frustration with the current system, be it auto insurance or the system as a whole, will only increase if the leadership of the NAIC does not continue to press for the changes that are needed to modernize the regulatory system. These changes must balance the policies and priorities in such a way to end the parochial--- and sometimes trivial--- overly complex and meaningless rules and regulations. A movement from a "front end" rigid prior approval to a "back end" regulatory system is needed.

We continue to believe that state insurance regulation, despite its problems, is the best public policy choice. The Alliance is committed to working with public policy makers and consumers to resolve insurance and regulatory problems as they arise. As this subcommittee moves forward in its endeavors, we will continue to assist the committee in a constructive and positive way.