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ON BEHALF OF THE

NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

AT THE HEARING ON

INSURANCE REGULATION REFORM

BEFORE THE SENATE BANKING, HOUSING,

AND URBAN AFFAIRS COMMITTEE

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Good morning Chairman Shelby, Ranking Member Sarbanes and Members of the Committee. My name is Bob Wadsworth, and I am pleased to testify today on behalf of the National Association of Mutual Insurance Companies regarding insurance regulation reform. Founded in 1895, NAMIC is the nation's largest property and casualty insurance company trade association, with more than 1,400 members underwriting more than 40 percent of the property-casualty insurance premium written in the United States.

I am the Chairman and Chief Executive Officer of Preferred Mutual Insurance Company, a multi-state writer located in New Berlin, New York. Preferred Mutual writes more than $197 million in premium across four states. I also currently serve as Chairman of NAMIC.

NAMIC appreciates the opportunity to testify at this important hearing. It comes at a critical time in insurance regulation. The present system of state regulation is too slow and cumbersome and often denies consumers the benefits of competition. Consumers and insurers have a shared interest in a modernized system of regulation that will facilitate the bringing of new products to market in a timely fashion and assure that they are competitively priced.

The question is how best to achieve these goals. NAMIC believes that reform at the state level is more likely to produce better results than federal involvement in insurance regulation. Let me explain why NAMIC takes this position, as opposed to some other trade associations, including some property-casualty trade associations.

NAMIC and the Role of Mutual Insurers

The great majority of our members are mutual insurers, companies that do not have shareholders, but are controlled by and operated for policyholders. The first successful insurance company formed in the American colonies was actually a mutual: The Philadelphia Contributionship for the Insurance of Houses from Loss by Fire. It was created in 1752 after Benjamin Franklin and a group of prominent Philadelphia citizens came together to help insure their properties from fire loss. The company is still in business today and is a NAMIC member.

In those early days before America declared its independence from British rule, most insurance companies followed the Contributionship model; that is, groups of neighbors typically formed entities to help each other avoid the certain financial ruin that would befall them if their properties were destroyed by fire. The other predominate type of insurance company is the stock company, which is owned by its shareholders.

NAMIC members account for 47 percent of the homeowners market, 39 percent of the automobile market, 34 percent of the workers' compensation market, and 32 percent of the commercial property and liability market.

The History of Insurance Regulation

Since the beginning of the property-casualty insurance business, it has been regulated at the state level. In 1944, the U.S. Supreme Court in the *South Eastern Underwriters* case found that insurance was a business in interstate commerce that could be regulated by the federal government. The Congress responded by enacting the McCarran-Ferguson Act in 1945 which declared that "[T]he business of insurance, and every person engaged therein, shall be subject to the laws of the several States." The only exception to this rule is where the Congress enacts legislation that "specifically relates to the business of insurance." Since 1945, with few exceptions, insurance has been regulated at the state level.

NAMIC believes that state regulation has generally served both consumers and insurers well over the years, particularly with respect to the property-casualty business. Unlike the life insurance business, the property-casualty insurance is primarily a state-based business. While some of our products cover interstate activities, most of our products that directly affect your constituents—auto, farm, and homeowners insurance—are single state products. As such, we believe the states have the best understanding of the products and the people for whom they provide protection.

Weaknesses of State Regulation

While the state regulatory structure has worked well for years, it has not always kept up with changing times. Insurers, large and small alike, need several changes in the regulatory structure in and among the states if they are to provide customers with the products they need at the lowest possible prices.

First and foremost among needed changes is an end to price regulation of all lines of property-casualty insurance. Only one state, Illinois, allows personal automobile and homeowners insurers to set prices through what is known as "open competition." While some other states have made notable progress in this area, particularly on the commercial side, the fact remains that auto insurance is the only product in America with multiple sellers whose price is regulated by the government rather than by the marketplace. We trust people to make decisions that can have a far greater impact on their lives—such as their health plans and retirement investments—without government control as to the prices that can be charged. We understand the political sensitivity to permitting property-casualty insurers to compete on the basis of price, but we submit that it is an historical anachronism that is at odds with the faith we place in individuals and a free marketplace throughout the American economy.

A brief review of state experience with different approaches to pricing is instructive. The experience in Illinois, an open competition state since 1969, shows the benefits of unregulated prices—stable rates and low residual markets because the Illinois market attracts the largest share of all private passenger auto and homeowner insurers in the nation. Other examples abound. South Carolina has adopted a flex-rating system for personal lines and has seen prices fall and new insurers enter the market. The recent

reforms in New Jersey, once cited as the poster child for overregulation, have produced similar results. In nearly every state that has adopted market-based rating schemes, the market has improved.

On the other hand, almost every state that has availability or affordability problems suffers from overregulation and price controls. Massachusetts, a strict prior approval state, now has only18 insurers selling private passenger auto insurance; Illinois has hundreds. Far too often, policymakers in these troubled jurisdictions react by placing a tighter regulatory grip on the market, which usually leads more insurers to leave the state, thus exacerbating availability and affordability problems.

California, in contrast, is often cited as a success by proponents of strict rate regulation. A careful analysis of the California situation, however, demonstrates that rate regulation ultimately works against consumers, just as federal restrictions on the rate of interest banks could offer on deposits into the 1980s harmed bank customers. California aggressively regulates pricing, especially for auto insurance. Its recent rate experience is better than that of most states, meaning that premiums there are relatively low compared to similarly situated states. Supporters of rate regulation attribute this to Proposition 103, a ballot initiative passed in 1988 that mandated auto insurance rate rollbacks and established a prior approval system of rate regulation. In reality, California's relatively low auto insurance rates are almost entirely the result of that state's Supreme Court overturning its own previous decision to permit individuals to file so-called third-party bad faith suits against the at-fault driver's auto insurer.

This decision was handed down in 1988, the same year that Proposition 103, calling for strict regulation of the industry, was adopted. The highly respected RAND Institute for Civil Justice found that the third party bad faith claims permitted before the 1988 decision increased bodily injury liability premiums by 32 (low estimate) to 53 (high estimate) percent. Thus, when these suits were barred there was a dramatic reduction in the cost of bodily injury liability claims. However, because of the difficulties of changing rates in the strict prior approval regime of Prop 103, insurers did not lower premiums commensurately, resulting in increased insurer profits. Thus, it is a reasonable conclusion that the result of the restrictive Prop 103 ratemaking system has been *higher*, not lower, rates for California insureds than they would have experienced had Prop 103 not been adopted.

While insurance price controls are the most troublesome feature of state insurance regulation, there are many others that deserve attention. These include the lack of uniformity among states with respect to routine matters such as producer licensing and form filing; underwriting restrictions that prevent insurers from accurately assessing risk; blanket coverage mandates that force insurers to provide coverage for particular risks they may not wish to cover, and for which consumers may not be willing to pay; and arbitrary and redundant "market conduct examinations" that cost insurers enormous sums that could otherwise be used to pay claims

Because of these and other problems, some very large insurance companies, including some of our members, are now asking for a federal regulator that would pre-empt the states' ability to regulate all insurers.

The Strengths of State-Based Regulation

Notwithstanding the misguided laws and regulations that plague insurance markets in many states, the decentralized system of state-based insurance regulation has inherent virtues that would be lacking in a national insurance regulatory system. State insurance regulation has the capacity to adapt to local market conditions, to the benefit of consumers and companies, and affords states the opportunity to experiment and learn from each other.

A state insurance commissioner is able to develop expertise in issues that are particularly relevant to his or her state. Unlike banking and life insurance, property-casualty insurance is highly sensitive to local risk factors such as weather conditions, tort law, medical costs, and building codes. Many state building codes are tailored to the risk found in that state. In the Midwest, the focus is on damage from hail and tornados, while codes in coastal regions focus on preventing loss from hurricanes. In other states, seismic concerns dictate the type of construction. All these factors are considered by insurers in assessing risk and pricing insurance products. State insurance regulation is able to take account of these state and regional variations in ways that federal regulation would not.

Insurance consumers directly benefit from state regulators' familiarity with the unique circumstances of their particular states. Over time, each state's insurance department has accumulated a level of "institutional knowledge" specific to that state. Historically, state regulators have drawn upon that knowledge to develop consumer assistance programs tailored to local needs and concerns. Compared to a federal regulator, state regulators have a greater incentive to deal fairly and responsibly with consumers. Twelve state insurance departments are headed by commissioners who are directly elected by their states' voters; the others serve at the pleasure of governors who also must answer to voters. A federal regulator, by contrast, would be far less accountable to consumers in particular states, and would thus have less motivation to be responsive to their needs.

Is There a Need for Federal Regulation?

NAMIC believes that the answer to this question lies in both an examination of how the states are responding to the problems outlined in the previous section and the likely outcome of federal legislation.

State Reforms

States have not been oblivious to the criticisms leveled against them. They have made significant progress in addressing antiquated rules such as those involving price controls

and company licensing restrictions. The results in recent years have been encouraging. On the matter of price regulation,

- Nine states have adopted flex-band rating systems for property-casualty products to replace the rigid system of price controls.

- 14 states have adopted the more flexible use and file system.

- 24 states have established no filing requirements, mostly for large commercial risks.

- Only 16 states still require statutory prior approval. Several of these states, however, are among the largest in the country, accounting for 40.8 percent of the total auto insurance market and 41.4 percent of the total homeowners insurance market nationwide.

- With respect to insurer licensing, the Uniform Certificate of Authority Application (UCAA) is now used in all insurance jurisdictions.

- A system of electronic filing has been implemented by most states and has streamlined the process by which rates and forms are filed by companies.

- 27 states have now adopted the Life Insurance Interstate Compact, which allows the compact to now function and serve as a single point of filing for life insurance products.

- The National Conference of Insurance Legislators (NCOIL), the National Conference of State Legislatures (NCSL) and the American Legislative Exchange Council (ALEC) have all endorsed competition as the best regulator of rates. NCOIL has adopted a significant model law that would create a use and file system for personal lines and an informational filing system for commercial lines.

- NCOIL has also adopted a Market Conduct Model Law that would bring significant reform to that area of state regulation.

The Risks of Federal Regulation

There are many options that federal policy makers can take, from broader approaches such as a complete federal takeover or an optional federal charter to the narrower approaches pursued by the House Financial Services Committee in its different SMART bill drafts and in H.R. 5637, the Nonadmitted and Reinsurance Reform Act .

The Sununu-Johnson bill (S. 2509), titled the "National Insurance Act of 2006," would establish an optional federal charter modeled on bank regulation. In essence, the bill

would allow every insurer to choose whether to be regulated by the states or by a new federal regulatory system to be administered by an Office of National Insurance. NAMIC is deeply concerned that the optional federal charter proposal could lead to negative outcomes that would far outweigh any potential benefits, and that many of those benefits will not be realized.

In theory, an optional federal charter might increase competition among multi-state insurers by streamlining and centralizing insurance regulation. It might exempt federally chartered insurers from notoriously inefficient and archaic rate regulation, which serves mainly to force low-risk policyholders to subsidize high-risk policyholders. In theory, it might promote regulatory competition between federal and state regulators, with each striving to create regulatory regimes that provide the greatest benefit to insurers and consumers alike.

The problem, as we see it, is that in practice, optional federal chartering might achieve few or none of these results, and that the potential risks are too great. Here are our greatest concerns:

The "big mistake." Federal regulation has proven no better than state regulation at addressing market failures or protecting consumer interests and, unlike state regulatory failures, federal regulatory mistakes can have disastrous economy-wide consequences. The savings and loan debacle of the 1980s that ended up costing taxpayers over $100 billion is the biggest such disaster in recent memory. When a state regulator makes a mistake, the damage is localized and can more easily be "fixed." Proponents of an optional federal charter for insurance argue that congressional action could bring a system resembling that found in Illinois to the entire country. But it is entirely possible that the system that eventually emerges will instead resemble the highly regulated states. The fallout from a strict national regulatory climate could do serious harm to large sectors of the economy.

Negative charter competition. S. 2509 is modeled on the dual banking system, with a federal analogue to the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS). That model is at best problematic. During the 1980s and 1990s, the OCC promulgated rules, regulations and orders expanding bank powers and limiting the applicability of state consumer protection laws (including those relating to predatory or sub-prime lending), thereby encouraging state-chartered banks to migrate to federal charters. As the OCC is funded by the fees it charges the national banks it regulates, it had every reason to encourage state chartered banks to flip their charters and build the OCC's regulatory empire, at the expense of both consumers and taxpayers.

This was not a one-way street. State thrift supervisors also competed with the OTS for savings and loan charters and many of the most costly S & L failures were by state-chartered thrifts that had even broader powers than federal S & Ls and were subject to very little supervision by their state regulators.

Social regulation. NAMIC is also concerned that while proponents of federal regulation may design a "perfect system," they can neither anticipate nor prevent the imposition of disastrous social regulation in exchange for the new regulatory structure.

While NAMIC favors price competition, we are not so naive as to believe that the same political dynamic that makes it so difficult to achieve price competition in the states will not recur during the debate on S. 2509 and its successors. Just as political expediency occasionally leads state office-holders and candidates to call for insurance price controls and rate rollbacks, we can easily imagine situations in which their federal counterparts would be tempted to do the same. What we are likely to be left with, then, is no pricing freedom and more social regulation.

"Social regulation," as we use that term, encompasses any number of measures that tend to socialize insurance costs by spreading risk indiscriminately among risk classes. In particular, regulations that restrict insurers' underwriting freedom often have this effect. It is important to note that accurately assessing and classifying the risk of loss associated with particular individuals and properties is the *sine qua non* of the property-casualty insurance business. Without risk-based underwriting, the insurance enterprise cannot operate.

As Bob Litan of Brookings explained in a recent article,

> Individuals or firms with higher risks of claims . . . should pay higher premiums. If this were not the case—that is, if insurers required higher-risk customers to subsidize lower-risk customers—then insurers who provided coverage only to low-risk policyholders could underprice their competitors and capture just these customers, driving out their competitors in the process.

Government restrictions on underwriting freedom ostensibly guard against unfair business practices and ensure that insurance will be available to meet market demand. In many instances, however, the effect of these regulatory interventions is to create dysfunctional market conditions that lead to problems such as adverse selection and cross-subsidies. Adverse selection occurs when low-risk insureds purchase less coverage, and high-risk insureds purchase more coverage, than they would if the price of insurance more closely reflected the expected loss for each group. Government-imposed underwriting restrictions foster adverse selection by depriving insurers of the ability to distinguish between individuals who have a low probability of experiencing and those with a high probability of experiencing a loss.

By weakening the link between expected loss costs and premiums, underwriting restrictions create cross-subsidies that flow from low-risk insureds to high-risk insureds. S. 2509's promise of rate deregulation for federally-chartered insurers will mean little if federal regulators impose underwriting restrictions that impair the ability of insurers to charge premiums based on risk. There is nothing in S. 2509 to prevent this, and we find no reason to be optimistic that a federal insurance regulator

would voluntarily refrain from eventually restricting underwriting freedom. Indeed, even without explicit insurance regulatory authority, the federal government has attempted on various occasions to restrict the use of certain underwriting variables. In the 1990s, for instance, the Department of Housing and Urban Development launched a campaign to prevent insurers from using the age and value of a home to assess the risk of loss associated with residential properties. More recently, some Members of Congress have proposed placing limitations on insurers' freedom to underwrite and price life insurance based on foreign travel, despite the obvious risks in countries wracked by war, pestilence, uncontrollable viruses or natural disasters.

Such regulatory interference in the marketplace could ultimately make coverage less available and affordable for most consumers. We prefer that the states continue to work together to achieve greater regulatory uniformity.

The potential for dual regulation. Proponents of an optional federal charter argue that the legislation would simply create an alternative regulatory scheme for those who seek it. We believe that it could well result in dual regulation for insurers as it has for banks. Current banking law gives banks the choice of being regulated under either a federal or state charter, but all banks are subject to some regulation by the Federal Deposit Insurance Corporation (FDIC), regardless of their charter. It is certainly within the realm of reality that in order for an Optional Federal Charter to work, Congress would eventually be forced to replace the state guaranty funds with a federal insurance fund similar to the FDIC. If this occurs, insurers choosing to remain under state regulatory jurisdiction could nevertheless find themselves subject to a vast array of federal rules, but would not enjoy the benefits of uniformity. Over time, the multi-state writers would effectively be forced into the federal system, leaving smaller companies with the states—in effect, creating adverse selection in regulation.

One must look only as far as the health insurance system to see the potential pitfalls of dual regulation. As you know, health insurance is regulated by both state and federal law. This redundant regulatory scheme is partially responsible for the increasing costs of health insurance. It also has created a situation in which consumers seeking assistance from regulators are often caught between state and federal agencies, depending on the problem at hand. The added costs of dual health insurance regulation are eventually passed on to consumers, as are all regulatory costs. Under an optional federal charter for property-casualty insurance, consumers will likely suffer the same confusion that exists under the health insurance regulatory structure: Which problem falls under which jurisdiction? Whom do they call for help? What agency deals with what problem? Uncertainties that currently befuddle health insurance consumers could easily recur under a dual property-casualty regulatory system.

The illusion of "choice." In theory, an optional federal charter could promote regulatory competition between state governments and the federal government. Such competition would provide strong motivation for further state reforms, and would

deter the federal insurance regulator as well as state regulators from undertaking excessively burdensome market interventions.

But regulatory competition will work only if most insurers can switch charters at relatively low cost. In fact, the largely fixed costs of adopting a federal charter are likely to be quite high, and switching back to a state charter could be even more expensive. As a practical matter, thousands of small to medium sized insurers would find themselves trapped in the regulatory system they initially chose because they would be unable to absorb the costs associated with switching between regulatory regimes. The result would be an unlevel playing field on which only the largest insurers would have the financial wherewithal to choose the regulatory regime that happened to be most hospitable at any given time. Moreover, the inability of most insurers to switch readily between state and federal regulation would undermine the regulatory competition that supporters envision.

In sum, an optional system would not necessarily result in the optimal system, particularly over time. As with the banking system, it would generally mean that the large insurers would opt for the federal system and the small ones would be left in the state system and may be subject to dual regulation. Perhaps the goals of S. 2509 could be better met by using the Congress' powers to improve the state systems instead. We offer one such approach in the next section of the testimony.

If Not OFC, What Can Be Done?

As I indicated earlier, the "shotgun" approach to insurance regulatory reform embodied in the optional federal charter proposal would bring uncertain benefits while potentially creating a variety of negative consequences. I have also indicated that government rate regulation and restrictions on underwriting freedom pose the greatest impediments to the creation of healthy, competitive property-casualty insurance markets. If Congress wishes to eliminate these defects, it may do so without establishing a federal insurance regulatory authority or by mandating an extensive overhaul of the state-based system of insurance regulation. Instead, it might consider a simple piece of legislation that would do just two things:

1. Prohibit states from limiting property-casualty insurers' ability to set prices for insurance products, except where the insurance commissioner can provide credible evidence that a rate would be inadequate to protect against insolvency.
2. Prohibit states from limiting or restricting the use of underwriting variables and techniques, except where the insurance commissioner can provide credible evidence that a challenged variable or technique bears no relationship to the risk of future loss.

Conclusion

In conclusion, NAMIC believes that the states have not acted as rapidly and as thoroughly to modernize insurance regulation as we believe is necessary, but we are

encouraged that they have picked up the pace of reform and are headed in the right direction. The states need more time and perhaps a federal prod to complete the job. Given this recent progress and the risks associated with creating an entirely new federal regulatory structure, NAMIC is convinced that reform at the state level is the best and safest course for consumers and insurers alike.