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SECURA INSURANCE COMPANIES
APPLETON, WISCONSIN

ON BEHALF OF THE

NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

AT THE HEARING ON

THE NEED FOR INSURANCE REGULATORY REFORM

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS,
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Good afternoon Chairman Kanjorski, Ranking Member Pryce and Members of the Subcommittee. My name is John Bykowski, and I am testifying today on behalf of the National Association of Mutual Insurance Companies. 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 President and Chief Executive Officer of Secura Insurance Companies located in Appleton, Wisconsin. Our company began in 1900 as a farm company, and has grown steadily so that today, we write about $330 million in personal, commercial and farm products through 400 independent agencies in 13 states. I also currently serve as Chairman of NAMIC.

We appreciate the opportunity to testify before you today on the need for insurance regulatory reform. NAMIC supports a *reformed* system of state regulation. While we agree with some of the criticisms you will hear today, ultimately, NAMIC believes reform at the state level is more likely to produce better results than further federal involvement in insurance regulation.

Let me explain why NAMIC and a majority of property-casualty companies take this position.

NAMIC and the Role of Mutual Insurers

Most NAMIC members are mutual insurers that are controlled by and operated for the benefit of their policyholders. The first successful insurance company in America was formed in 1752 by Benjamin Franklin and some of his Philadelphia neighbors to help insure their properties against fire loss. The Philadelphia Contributionship for the Insurance of Houses from Loss by Fire is still in business today and is a NAMIC member.

In those early days, most insurance companies followed the Contributionship model of neighbors forming entities to help each other avoid certain financial ruin if their properties were destroyed by fire. The other predominate type of insurance company is the stock company, which is owned by its shareholders.

Today, 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

States regulated the property-casualty insurance business until 1944, when the U.S. Supreme Court in the *South Eastern Underwriters* case declared that insurance was a form of interstate commerce and it could be regulated by the federal government. Instead of creating a federal insurance bureaucracy, the Congress responded the next year by

enacting the McCarran-Ferguson Act 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 would occur where the Congress enacted legislation that "specifically relates to the business of insurance." Since 1945, few exceptions have occurred with the result that insurance has been regulated at the state level.

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

Weaknesses of Current Regulation

NAMIC believes the state regulation must adapt to keep pace with today's global insurance market. Large and small insurers alike need to see changes in the state regulatory structure if they are to continue to provide customers with the products they need at the lowest possible prices.

The cornerstone of reform must be an end to price regulation for all property-casualty insurance lines. While several states have enacted reforms in recent years, more must be done. In every state that has enacted competitive based rating systems, the market has improved and consumers have more choices.

While some states allow pricing freedom for commercial insurance products, the fact remains that personal insurance lines are the only products in America with multiple sellers (there are approximately 2,700 licensed property-casualty companies) whose price is regulated by the government rather than by the marketplace.

This seems paradoxical to us when you consider that we trust people to make far greater decisions affecting their lives—such as their health plans and retirement investments—and yet government wants to control insurance prices. We understand the political sensitivity involved, but we would suggest that this is an historical anachronism at odds with the faith we place in individuals and the free marketplace in other parts of the American economy. I also would note that in Wisconsin, we had a total of 816 property-casualty companies operating in 2006, of which 183 were domiciled in the state.

A brief review of different state approaches to pricing may be instructive here. Since 1969, Illinois has had deregulated competition-based pricing for both personal and commercial lines. As a result, Illinois has experienced stable rates and few entrants in its residual market because it has attracted the largest share of private passenger auto and homeowner insurers in the nation. A few years ago, South Carolina and Louisiana adopted a flex-rating system for personal lines and the states have seen their auto prices fall and new insurers enter the market. In both instances, the markets improved as a result of adopting more market-based rating schemes.

At the other end of the spectrum, 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.

While insurance price controls are the most troublesome feature of state insurance regulation, other examples also deserve attention. These include a lack of uniformity among states with respect to producer licensing laws, form filing procedures, underwriting restrictions preventing insurers from accurately assessing risk, expensive and otherwise unwanted coverage mandates, and arbitrary and redundant "market conduct examinations" that cost insurers enormous sums that could otherwise be used to pay claims

As a result of these and other problems, some large and international insurance companies believe a better option for them would be a federal regulator that would pre-empt the states' ability to regulate all insurers.

The Strengths of State-Based Regulation

Notwithstanding the need to improve state-based regulation, NAMIC believes 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 can develop expertise on issues particularly relevant to his or her state. Unlike banking or 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 fashioned to the risk found in that state. In the Midwest, these codes focus on damage from hail and tornados, while in coastal regions, the codes focus on preventing loss from hurricanes. In other states, seismic concerns dictate the building codes. Insurers must consider all of these factors in assessing risk and pricing insurance products. State insurance regulation can take account of these state and regional variations in ways the federal regulation cannot.

Insurance consumers directly benefit from a state regulators' familiarity with the unique circumstances of his or her state. Over time, state insurance departments accumulate a level of "institutional knowledge" that has helped regulators 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. Eleven 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 the answer to this question lies in both an examination of how the states are responding to the problems outlined above and the likely outcome of federal legislation.

State Reforms

States have not been oblivious to the criticism that they need to change with the times, and they have made some significant progress in addressing antiquated rules such as those involving price controls and company licensing restrictions. On the matter of price regulation, specifically:

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

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

- Twenty-six 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.

- Thirty 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 will bring significant reform to that area of state regulation.

The Risks of Federal Regulation

One of the bills introduced in the 110th Congress would have the federal government assume a more active role in the regulation of the insurance industry. H.R. 3200, titled the "National Insurance Act of 2007," would establish an optional federal charter modeled on bank regulation. In essence, the bill would allow an insurer to choose between being regulated by the states or by a new federal regulatory system to be administered by an Office of National Insurance.

While the drafters of the OFC bill are proposing significant rate deregulation, which is our goal as well, the political and practical reality of the final product is much more likely to look like the burdensome California style regulatory system than it would an Illinois system.

NAMIC believes effective regulatory modernization can be accomplished without creating a new federal bureaucracy. While, an OFC seeks to:

- increase competition among multi-state insurers by streamlining and centralizing insurance regulation;

- exempt federally chartered insurers from notoriously inefficient and archaic rate regulation, which serves mainly to force low-risk policyholders to subsidize high-risk policyholders; and

- 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 is that in practice, an OFC would achieve few or none of these results, and that the potential risks are too great. Here are our greatest concerns:

- Federal regulation has proven no better than state regulation in 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. Similarly, federal regulation of the pension system has failed to prevent recent numerous high profile failures.

- Under H.R. 3200, there could be a negative charter competition between the Office of National Insurance and state regulators. NAMIC is concerned an OFC would create an un-level playing field, with only larger companies choosing to be federally regulated. Proponents argue that all players in the market would be free to choose the regulator that best meets their business model and consumer needs,

including shifting seamlessly between state and federal regulation. In reality, transaction costs, as well as retraining and retooling costs, would be significant and could effectively lock smaller and medium sized insurers into their original choice of regulator and providing only an illusion of choice for many producers or insurers.

- Disastrous social regulation in exchange for the new regulatory structure (under H.R. 3200). Social regulation encompasses any number of measures that tend to socialize insurance costs by spreading risk indiscriminately among risk classes. Without risk-based underwriting, the insurance enterprise cannot operate. By weakening the link between expected loss costs and premiums, underwriting restrictions create cross-subsidies that flow from low-risk insured to high-risk insureds. 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 federal regulation. 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.

- Proponents of an optional federal charter argue that the legislation would simply create an alternative regulatory scheme for those who seek it. NAMIC believes that it could well result in dual regulation for insurers as it has for banks. A dual regulatory system would ultimately increase costs for insurers and policyholders and create the potential for regulatory confusion. In addition, insurers choosing to remain under state regulatory jurisdiction are likely to find themselves subject to a vast array of federal rules, but would not enjoy the benefits of uniformity. 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 is a regulatory scheme that we do not want to occur in the property-casualty industry. 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.

Additionally, we believe a federal regulator would be less sensitive to both company and consumer concerns. Consumers and smaller companies like mine would not receive the same level of response they now receive from their state regulators. In 2006, the states combined processed 383,654 consumer complaints and handled an additional 2.5 million consumer inquiries. Is a Washington DC federal bureaucrat on a 1-800 number going to be as sensitive to consumer and company complaints as a local regulator? For small and regional companies like mine, I worry that my voice

will be muted in DC, as we might have problems reaching the right federal regulator if we had an issue. Right now, in my home state of Wisconsin, I have on numerous occasions picked up the phone and called my insurance commissioner on regulatory issues that impacted my company and our policyholders. And the Wisconsin insurance commissioner can do the same with me. The Commissioner has visited my company on numerous occasions to discuss insurance regulatory matters. Do you think this would be possible under a federally regulated model?

Finally, I also would note that in contrast to other insurance products, the property/casualty business is highly dependent on state and regional differences. Insurance is subject to state and regional differences in legal systems and reparation laws: geographical differences impacting weather patterns and catastrophes; differences in demographics affecting population concentration, driving patterns, and land use; and state and local laws establishing driving rules, building codes, among numerous state differences. These differences are particularly critical for personal lines property and casualty coverage's (auto, homeowners, personal liability) making a "national" products and regulation difficult.

The McCarran Repeal Effort

While I recognize that the following bill does not come under the jurisdiction of the Financial Services Committee, I nevertheless wanted to inform you that NAMIC is deeply concerned about H.R. 1081, the Insurance Industry Competition Act of 2007, which, if enacted, would repeal the very limited antitrust exemption found in the McCarran-Ferguson Act.

Proponents of H.R. 1081 and its Senate counterpart, S. 618, have argued that repealing McCarran would improve property insurance availability, affordability and claims handling, especially in disaster-prone regions.

NAMIC believes that repealing McCarran would have the opposite effect. For insurers, repealing McCarran would mean that companies like mine would no longer be able to access credible loss cost data. This, in turn, would cause companies like mine to exit insurance markets due to increased costs of estimating losses, thereby leaving consumers with fewer choices and less competitive markets.

Earlier this year, NAMIC commissioned Dr. Lawrence S. Powell, the Whitbeck-Beyer chair of Insurance and Financial Services at the University of Arkansas-Little Rock, to examine McCarran and to see what the consequences would be if it were repealed. Powell's research, which is titled, "The Assault on the McCarran-Ferguson Act and the Politics of Insurance in the Post-Katrina Era," was made public two weeks ago.

His paper concludes that repealing McCarran is not good public policy because: insurance markets are competitive; the limited antitrust exemption does not harm consumers; repealing McCarran would ultimately harm consumers; and the best way to

provide for affordability and availability of insurance products was through state regulatory reforms.

If Not OFC, or McCarran Repeal, 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. The same would be true for repealing McCarran.

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.

While NAMIC strongly opposes an OFC, we do believe that Congress could potentially play a limited role in achieving some targeted reforms that the states have not yet acted on, such as a "targeted federal tools" approach. And, indeed, the House already has taken a positive step in that regard by passing H.R. 1065, which streamlines regulation for nonadmitted insurance and reinsurance carriers. If this is an approach that Congress wishes to follow, here are two issues that members may wish to consider:

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; and,
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 not enough states have acted as rapidly or as thoroughly in creating insurance regulatory reforms, but states have picked up the pace in recent years and appear headed in the right direction. States need more time and perhaps a federal prod along the lines of a federal tools approach. In no case, however, should Congressional action take the form of creating an optional federal charter or repealing McCarran.

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 most appropriate course for consumers and insurers alike.