

Nathaniel S. Shapo
312-876-7418
nshapo@sonnenschein.com

8000 Sears Tower
233 South Wacker Drive
Chicago, IL 60606
312.876.8000
312.876.7934 fax
www.sonnenschein.com

Chicago
Kansas City
Los Angeles
New York
San Francisco
St. Louis
Washington, D.C.
West Palm Beach

Testimony of Nathaniel S. Shapo

House Financial Services Committee
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises

April 10, 2003

Introduction

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

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

My testimony today will address:

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

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

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

Government regulation of insurance prices was designed to ensure solvency, not affordability, by preventing rates from being too low rather than too high. Many states established rate regulation in the early 1900s to facilitate pricing cooperation between insurance companies because sellers routinely underpriced, failed to properly reserve for catastrophic losses, and frequently became insolvent following large fires and earthquakes. Policymakers determined that price competition

was harmful to consumers; that the formation of collusive, anti-competitive rating bureaus were beneficial and should be encouraged; and that states, having encouraged monopolistic practices, should regulate the resulting rates for both adequacy (to assure solvency) and excessiveness (to assure that the sanction of monopoly did not enable price gouging). Price controls were then and are now anathema to consumer protection in a **competitive** market. Insurance presented an unusual case, though, because governments wanted to thwart competition by creating monopolistic conditions in the name of a greater consumer protection – solvency.

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

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

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

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

Numerous expert academic studies, including several gathered in a 2002 book, published by AEI-Brookings, entitled Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency, demonstrate that government rate regulation does not deliver the promised benefits of decreased costs and increased accessibility. Prior approval regulatory systems

in the end do not yield lower rates than competition and instead impair availability. In prior approval markets, carriers, fearing government capture of their capital, do not enter, do not compete fully and aggressively, and/or prepare and execute withdrawal plans. As a result, with less supply, prior approval states have larger residual markets and are therefore less stable and more volatile. This is precisely what one would expect where government artificially shackles what would otherwise be a competitive market.

The Illinois Model: Competition Produces Affordability and Accessibility

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

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

The Illinois Model: Vigorous Government Regulation Where Consumers Need It

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

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

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

Illinois as a Successful Model for Other States

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

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

Insurance is Not Uniquely Immune to the Laws of Economics

Insurance is a product infused with the public good. As Chairman Oxley says, it is the glue that holds our economy together. That is why insurance is -- and should be -- a heavily regulated business. However, there is no convincing legal or policy justification for the widespread practice of government rate regulation in today's competitive insurance market. Various, unconvincing

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

Conclusion

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

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