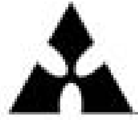
American Insurance Association

TESTIMONY
OF
ROBERT C. GOWDY
CEO OF BEACONONE INSURANCE GROUP

ON BEHALF OF
THE AMERICAN INSURANCE ASSOCIATION

ON INSURANCE PRODUCT APPROVAL THE NEED FOR MODERNIZATION

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT-SPONSORED ENTERPRISES
U.S. HOUSE OF REPRESENTATIVES

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Thank you Mr. Chairman, my name is Robert Gowdy, and I am the President and CEO of OneBeacon Insurance Group located in Boston, Massachusetts. I am here today on behalf of the American Insurance Association, which represents over 370 major property-casualty insurers. Before I begin, I would like to thank you for the opportunity to testify before this panel.

Over the past two decades, most sectors of the financial services industry have undergone regulatory reform to facilitate speed to market for the innovative new products that have reshaped our financial landscape. Regulatory modernization also has accelerated competition among financial firms, thus reducing prices while expanding options, service, and quality for consumers. Against the backdrop of increasing reliance on marketplace dynamics, the property/casualty insurance industry stands out as one of the most heavily regulated sectors of our economy with respect to both price and product controls—commonly referred to in the insurance context as rate and form regulation.

Speed to market reform will benefit the insurance mechanism as a whole and, in particular, the individuals, families, and businesses who rely on property/casualty insurance products for short- and long-term financial security. AIA has been working closely with the National Association of Insurance Commissioners ("NAIC"), and individual state legislators and regulators, to promote speed to market in individual state systems. We commend the Subcommittee's focus on this topic as part of your broader examination of insurance regulation in the post-Gramm-Leach-Bliley era.

Compelling Forces At Work In the U.S. and Global Economy

The insurance regulatory system that is now in place is largely the result of the McCarran-Ferguson Act, enacted in 1945. In the last fifty years, and most dramatically in the last decade, the entire U.S. economy has undergone radical restructuring. Yet, the insurance regulatory system is largely unchanged. For the past twenty years, the NAIC and individual state regulators have debated insurance regulatory reform. NAIC reports have been written, model laws have been approved and amended, and incremental improvements have been made in a number of states. But, these changes are not enough to propel the insurance regulatory system into the 21st century. Indeed, a number of recent developments have accelerated the need for significant regulatory reform to facilitate speed to market for property-casualty insurance:

- ***Financial Services Modernization:*** Improved technology, the internet, global trends, and the 1999 passage of the Gramm-Leach-Bliley Act will bring companies and products offered by the banking, securities, and insurance industries closer together, while at the same time increasing competition among these industries. Excessive levels of regulation place property-casualty insurance at a competitive disadvantage compared to banking and securities, industries that operate with a minimum of price and product regulation, particularly as financial institutions, and financial products, converge under Gramm-Leach-Bliley.

- ***The Global Economy:*** Modern telecommunications, ease of travel, the internet, and liberalization of trade have made insurance and financial service markets truly global. This trend will only accelerate. An important strategic issue for the competitiveness of the U.S. in world trade is that a number of leading nations, particularly members of the European Union and Canada, have comprehensively deregulated their insurance markets. Viewed against the backdrop of freer insurance markets abroad, U.S. property-casualty insurers are often severely restrained in their ability to innovate and quickly adapt to changing consumer interests and economic trends. In addition, while working to open up opportunities for American insurers abroad, state regulators, trade negotiators, and policymakers need to be aware of how complex and over-regulated the U.S. insurance market appears to foreign insurers hoping to do business here. To serve as an example for further liberalization of regulatory systems abroad, the U.S. needs to free its own insurance markets from unnecessary and counter-productive regulation.

- ***The Internet and E-Commerce:*** The internet is helping to expand the amount of information available to consumers about insurance beyond resources available just a few years ago. An increasing number of property-casualty insurers are building web sites to deliver quotes and planning a major push to market insurance over the internet. There also are several comprehensive insurance web sites that allow consumers to shop and receive quotes from dozens of companies in one location. On the regulatory front, the NAIC is working to improve the ability of consumers to navigate its own web site, as well as developing "best practices" for state insurance departments to use in enhancing their own web sites. The availability of education, information, and shopping opportunities through the internet will allow insurance markets to work better than ever before, thus further obviating the need for restrictive rate and form regulation.

  The technological revolution also has created the need for new risk management products for business and personal use. While these products can be developed

by insurers at "Internet speed," the regulatory approvals needed to bring a product to market often operate at the speed of an ancient mainframe.

When Insurers Are Allowed to Compete Aggressively, Consumers Benefit

While pervasive rate and form regulation characterize the insurance regulatory environment in most states, a few jurisdictions have adopted a market-based approach, with very positive results, including more market insurers competing for business and, all other factors (e.g., traffic density, claiming behavior, attorney involvement) being equal, lower insurance prices. A recent study by University of South Carolina Professor Scott Harrington classified the states into three basic groups—(1) states with little or no price regulation, (2) states with moderate price regulation, and (3) states with very stringent price regulation.[1] Summarizing the results of this study:

- Fourteen states with competitive or minimal pricing oversight had the lowest annual auto insurance prices, averaging $585.
- Ten states with a medium level of price regulation averaged $648 annually.
- The twenty-seven states with very stringent price controls were the most expensive states for auto insurance consumers, with annual expenditures averaging $695. This came to $110, or 19%, higher on an annual basis than the 14 states with minimal or no price regulations. The states with stringent price controls include several that long have had among the most expensive auto insurance costs in the nation—New Jersey, Hawaii, Rhode Island, Massachusetts and Delaware.
- Furthermore, states with competitive rating systems attracted more insurers into the market, creating more competition and choice for consumers. By contrast, numerous insurers have withdrawn from the

[1] Harrington, Scott, "*Insurance Deregulation and the Public Interest*," AEI-Brookings Joint Center for Regulatory Studies, January 2000. In the study, University of South Carolina's Professor Harrington divided the 50 states and Washington D.C. into the three categories of no prior approval, (14 states), conditional prior approval, (10 states), and prior approval of rates required (27 states) and calculates average auto insurance premiums for 1996 for the three groups. Note: Washington D.C., which was one of the 27 counted as having strict prior approval has moved toward a more competitive rating system, and is considering further deregulation. Early results from deregulation of auto insurance rates in Washington D.C. as of year end 1999, indicated several new carriers entering the market, an 84 percent decline in the number of policies written by the residual market from 1997 to 1999, and a decrease in auto insurance premiums.

- heavily regulated markets in Massachusetts and New Jersey, despite significant exit barriers that have been imposed by those states.

Specific Examples of Consumer Benefits From Regulatory Reform

Illinois has had a competitive rating law since 1978, one that does not require any sort of rate review or approval from the state. It is one of the best examples of consumer benefits flowing from rate reform. Illinois has a large urban population, typically one factor leading to higher auto insurance prices due to higher traffic density. Because of population and traffic density, the presence of a large metropolis, and other factors affecting losses, Illinois would normally be expected to rank among the top 10 states for auto insurance costs. However, Illinois perennially ranks in the middle (24th-26th) among states for auto insurance prices, and competition has been a key factor. There are significantly more auto insurers competing in Illinois than similar urbanized states such as New Jersey or Massachusetts that have implemented strict price controls.

South Carolina is a more recent example of the benefits of regulatory reform for consumers. In a well-intentioned, yet flawed effort to make insurance more affordable for low to moderate income drivers and reduce uninsured motorists, South Carolina adopted restrictive rate regulation in 1974, coupled with creation of a "reinsurance facility" to insure riskier drivers. The market became so over-regulated that, by the mid-1990s, the reinsurance facility insured over 40% of South Carolina drivers, meaning that four in ten auto insurance consumers were unable to select their insurer of choice. Losses were high, and most insurers were operating at a loss, causing a number of companies to exit the South Carolina market. Rates began to increase significantly due to the burden of the reinsurance facility. In 1997, legislation was passed to deregulate the market and phase out the reinsurance facility. The results have already been dramatic for consumers—the number of insurers doing business in the state doubled over a one-year period, and good drivers generally have seen rate decreases of 20% or more.

On the business side of insurance, Michigan is a positive example of the benefits of deregulation. A number of years ago, Michigan deregulated pricing and form regulation for commercial lines insurance policies (e.g., commercial auto, commercial multiperil, liability, property, umbrella, and other specific policies). This allows commercial insurers to bring new products serving the Michigan economy to the marketplace much sooner than is the case in most other states. Each year the Michigan Insurance Department does a study of the commercial insurance market as a precaution to assure that the market is fully competitive with regard to products available, numbers of competitors, and pricing. There have been no reported problems with commercial insurance markets in Michigan, and each year the market is declared fully competitive using traditional economic measures.

Problems Associated with Restrictive Regimes

In a study presented earlier this year at an AEI/Brookings symposium on insurance regulation, Professor Scott Harrington conducted an econometric analysis of the impact of rate regulation on auto insurance consumers and insurers during the quarter century spanning 1972-98.[2] His findings further discredit the merits of restrictive rate regulation. Specifically, Professor Harrington found that prior approval rate regulation was strongly associated with reduced coverage availability and increased volatility for both insurers and consumers. Insurers saw more volatility in loss experience, while consumers saw more volatility in pricing because insurers were unable to process small increments of either price increases or decreases based on loss experience. When rate adjustments finally were approved by prior approval states, they were significantly larger than in states with less rate regulation, bringing ‘sticker shock’ to consumers.

Professor Harrington also found that prior approval regulation is “persistently and reliably associated” with larger residual markets (i.e., state-created facilities that provide insurance for individuals or businesses which no private insurer is willing to underwrite because the regulated price is inadequate given the risk involved). Residual markets are supposed to be markets of last resort for very high risk drivers, businesses, and properties. A large residual market means that average and sometimes even good risks are perceived as high risk given the premium that insurers are permitted to charge in a restrictive rate regulatory environment. Most insurance consumers prefer being served by a private company and its representatives. Consumers placed in a residual insurance market have few, if any, pricing or product options and no competitors vying for their business. Claim and other services are often provided by a vendor who has no vested interest in the customer.

In addition, rate regulatory restrictions often force some policyholders (e.g., safer drivers or employers, or homeowners who live away from coastal hurricane zones) to subsidize others who pose more risk to the system as a whole. By encouraging riskier activities, such subsidies drive up total system costs and may result in an unfair redistribution of income.

On the product side, one of the most significant indirect costs of insurance rate and form regulation is the excessive time delay that insurers experience in trying to gain approvals for new products in 50 states. Time delay for product approvals varies tremendously by state. A few states (e.g., Michigan and Minnesota on commercial forms) essentially have no time delay because they allow free market forces and informed consumers to regulate the content, scope, and pricing of new products. However, in the other states, the average delays for all product filings exceed seven

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[2] Harrington, Scott E., Professor, Darla Moore School of Business, University of South Carolina, “An Econometric Analysis of Insurance Rate Regulation,” prepared for the AEI-Brookings Conference on Insurance Regulation, January 18, 2001.

months, with delays in some lines of insurance in a few states averaging close to a year. The variations in the amount of time it takes to launch a new product or change a rate in all 50 states adds additional complexity and costs. Because there is so much uncertainty and variation in the amount of time states take to process new products and rate changes, insurers rarely, if ever, can count on being able to launch new and innovative products in an orderly and planned fashion throughout the U.S. According to a study by Professor Richard Butler of Brigham Young University, the loss of consumer welfare due to lengthy delays in product approvals and launch, amounts to an average countrywide hidden tax for new products of about 9%.[3]

Moreover, business customers using alternative risk transfer markets (e.g. self-insurance, captive insurers, risk retention groups, etc.) do not have to deal with the complexities and delays of the varied multi-state approval system. In contrast, insurers operating in traditional markets are at a cost disadvantage and consumers lose out by having to pay higher prices and having fewer choices. According to Professor Butler, the shift from traditional commercial insurance to alternative markets over the last 20 years, caused in part by this hidden tax and dysfunctional form regulation, represents an annual loss of $18.6 billion in traditional commercial insurance premiums. Moreover, because a sizeable portion of the alternative risk market is offshore, economic output, jobs, and premium (as well as other) taxes are lost to the states and the U.S. Treasury.

SUMMARY

Comprehensive regulatory reform of property-casualty insurance will bring insurance consumers numerous benefits. Here are some examples, based on evidence from states that have substantially reformed their insurance regulatory systems:

- Consumers should realize savings in insurance costs as the market becomes more efficient, competitive, and the costs of unnecessary regulation are squeezed out of the system.
- Consumers are likely to have more product options, particularly with respect to innovative personal and commercial lines coverages.
- The availability of insurance also should increase in areas that sometimes experience shortages of carriers, including areas subject to natural disasters. Although prices may rise in such areas to adequately cover the true risk, product options like deductibles and discounts for loss mitigation also would increase.

[3] Butler, Richard J., Professor, Department of Economics Brigham Young University, "Form Regulation in Commercial Insurance," prepared for the AEI-Brookings Joint Conference on Insurance Regulation, January 18, 2001.

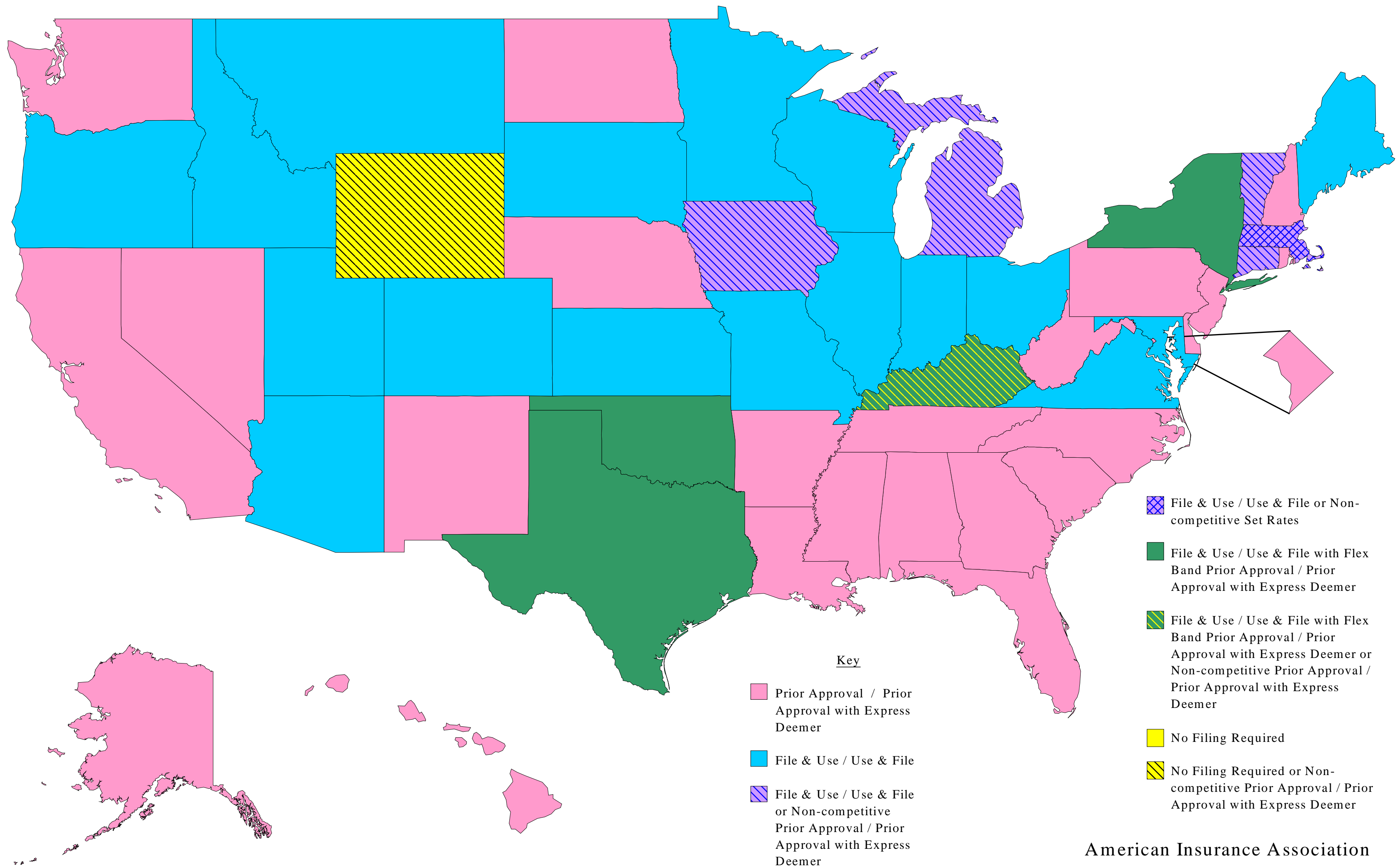
- Market-based systems will reduce subsidies that lower-risk consumers often provide to those with higher risk characteristics (e.g., development in hazardous areas, high risk drivers).

- Insurance markets will better keep up with fast-paced change in the economy and the financial needs of individuals, businesses and families.

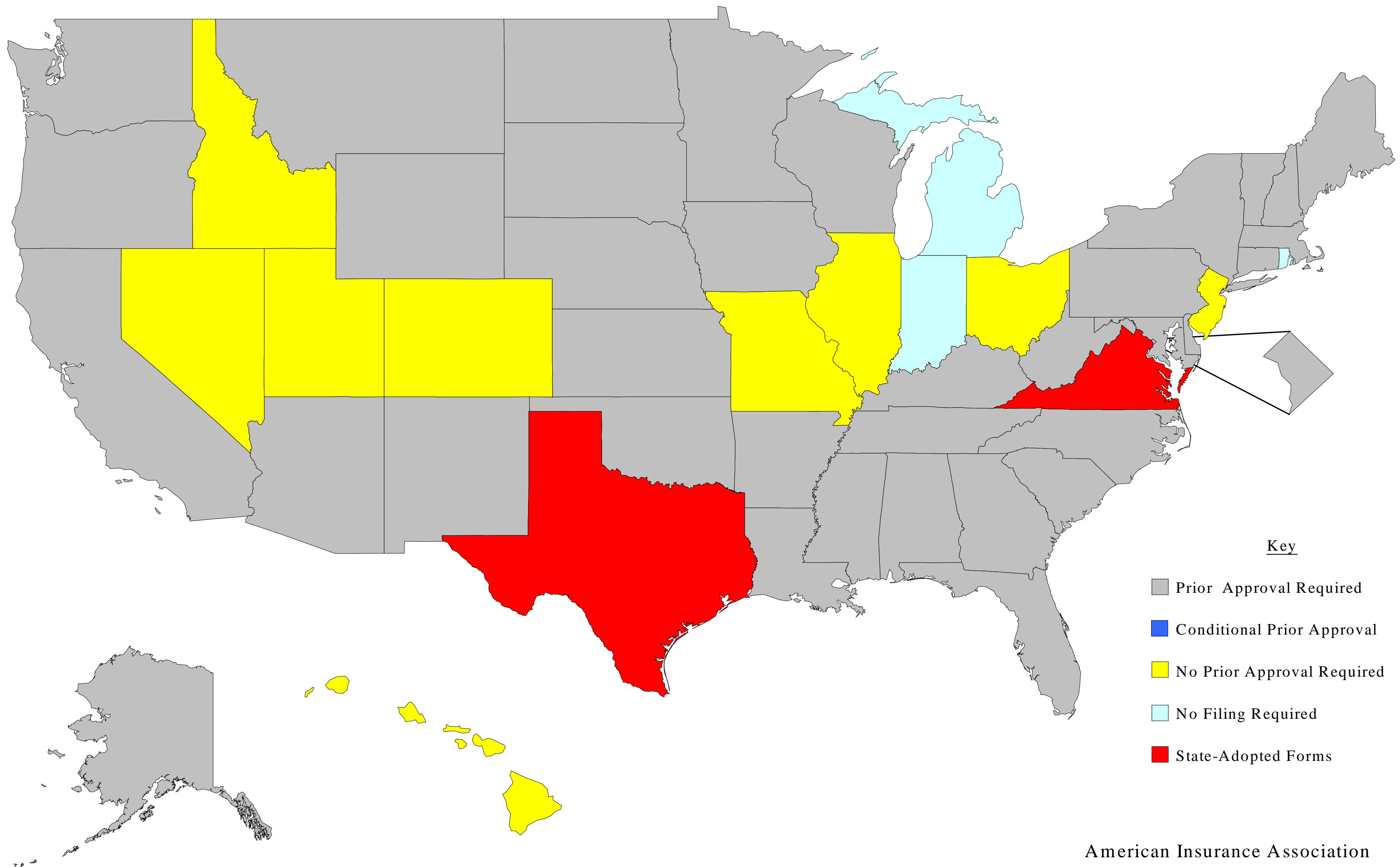
- Finally, insurance deregulation will benefit consumers, state insurance markets, the national economy, and taxpayers in a more general way by creating a more competitive insurance industry that can adequately service U.S. business and compete in a global economy.

Financial services modernization, the global economy, foreign trade liberalization, E-Commerce, and better informed consumers are combining to create an urgent need for comprehensive insurance regulatory reform to assure a healthy, consumer-oriented U.S. property-casualty insurance industry for the 21st century. We appreciate the Subcommittee's attention to this important issue.

Property-Casualty Insurance Industry State Regulatory Structure
Personal Auto Lines Rate Filing Systems



Property-Casualty Insurance Industry State Regulatory Structure
Personal Auto Lines Form Filing Systems



Property-Casualty Insurance Industry State Regulatory Structure
Homeowners' Lines Form Filing Systems