TESTIMONY OF PHILIP R. O'CONNOR, PH.D

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE & GOVERNMENT SPONSORED ENTERPRISES
OF THE
FINANCIAL SERVICES COMMITTEE
OF THE U.S. HOUSE OF REPRESENTATIVES

JUNE 21, 2001

My name is Philip R. O'Connor and I am President of PROactive Strategies, Inc. of Chicago, a consulting firm engaged in research and public policy development in financial and network industries. In addition, I am engaged in the marketing of competitive electric power at the retail level in Northern Illinois as Illinois Market President of AES NewEnergy, Inc. an Illinois licensed Alternative Retail Electric Supplier. From mid-1977 through mid-1982 I served in the Illinois Department of Insurance, first as deputy director for research and urban affairs and then for three years as Director of Insurance.

During my time as Illinois Director of Insurance I had the opportunity to administer an approach to full open competition in property-liability insurance rates, including auto and homeowners. That system, with reliance on the antitrust laws, competition and professional regulation of solvency and market conduct has operated extraordinarily well for thirty years and is a model that other states ought to consider as a replacement for outmoded prior approval regulation.

I appreciate the Subcommittee's invitation to testify and to assist the Subcommittee in its review of conditions in the insurance markets and in the regulation of insurance.

THE NEED FOR A REVIEW OF INSURANCE RATE REGULATION

Approximately half the states have laws that subject property-liability insurance rates, especially rates for personal lines such as auto and homeowners, to some form of prior approval. In the main these laws were enacted in the states at the end of World War II in an effort to substantially maintain the *status quo ante* that existed prior to the wartime decision of the U.S. Supreme Court that insurance was engaged in interstate commerce. Most of the remaining states have laws that presume the existence of a competitive market. In these states, rates may take effect without prior approval but on the basis, in most states, that rates can be reviewed after a finding of a non-competitive market. These competitive pricing laws mainly took effect in the years since the mid-1960s. Some states have moved from prior approval to open competition while several have moved in the other direction.

Much has changed since the late 1940s when our economy was simpler and the notion of a globalized economy had not emerged. Four winds of change have so altered conditions that policymakers should carefully reconsider whether the basic motif of property-liability insurance rate regulation established in the late-1940s should be adhered to.

1) **Computerization and the Internet** have created an environment of "total information" that has accelerated decision making and has broken the near-monopoly on information that large business enterprises may have previously enjoyed.

2) **Globalization** of the economy has made real the formerly theoretical "infinite" mobility of capital. Investment will seek the most favorable environment for growth and return. Many insurers have become global and multi-national enterprises whose capital cannot be considered captive to any given territorial market.

3) **Consumer Power** has never been greater since the purchasing power of the individual family and business has increased dramatically. And in insurance, assuming that regulatory barriers are modest, entry is relatively easy. Therefore consumers can

easily switch their allegiance from one insurer to another. A relatively small number of well-informed, sophisticated consumers can act as leaders having a significant impact on purchasing trends.

4) **Financial Convergence**, abetted by such reform measures as Gramm-Leach-Bliley, is producing more choices of financial products and greater diversity in distribution networks. In addition, most consumers use financial services that are far more complex than auto or homeowners insurance but which are not price regulated.

The mismatch between the market place in 2001 and the insurance rate regulatory framework created in the late-1940s should be reconciled.

THE PAPER: *MODERINZING INSURANCE RATE REGULATION*

In addition to this statement, I have recently co-authored a paper for delivery to the National Conference of Insurance Legislators (NCOIL) in March of this year. That paper, *Modernizing Insurance Rate Regulation: Tacking to the Winds of Change*, presents a review of the varied experiences and conditions in six states. The paper is informed by what we have learned from thirty years of academic and regulator initiated research about the role and effects of the various forms of regulation of property-liability insurance rates by the states. Overall, these six states (Illinois, South Carolina, New Jersey, Massachusetts, California and Texas), each chosen for its salience as an important regulatory example, lend credence to several significant views widely held among academic observers of the insurance regulatory scene.

First, systems that rely on prior approval of insurance rates rather than upon competition to set rate levels create substantial opportunities for market intervention that yields unintended consequences that are not consistent with the interest of consumers seeking to buy insurance coverage. **Second**, heavily regulated systems appear to offer no off-setting benefits for consumers in return for the greater likelihood of other adverse results of rate regulation. **Third**, problems in the insurance market, especially in the personal lines such as auto and homeowners, are not likely to be solved through heavy-handed price regulation and are more likely to be extended and exacerbated by such measures. Market forces appear to do a far better job than regulation of attracting capital to cover consumer risks and to bring rates in line with the actual cost of providing protection against loss.

THIRTY YEARS OF EXPERIENCE AND RESEARCH

These conclusions are in line with thirty years of experience and research that tell us that prior approval states:

- Tend not to keep rates lower than do competitive states;
- In 1999 the 10 most costly auto insurance states had some form of prior approval at that time;
- Have higher exit and lower entry rates of insurance companies;
- Tend to have residual markets (provider of last resort pools) with larger market shares;
- Have more volatile loss ratios as a group than do competitive states;
- As a group have the same long-run average loss ratios as do competitive states;
- Tend to create large cross-subsidies within the voluntary market;
- Tend to create large subsidy flows to the residual markets;
- Send less accurate price signals to consumers about risk and losses;
- Allocate regulatory resources to an unproductive regulatory ritual;
- Tend to make price changes political rather than economic events.

SIX STATES TELL US ABOUT RATE REGULATION

Illinois tells us that operating without any rate regulation at all for property-liability insurance, but relying instead on an antitrust model with aggressive solvency oversight, market conduct exams, consumer complaint resolution and prohibitions on unfair practices such as the use of race or religion in underwriting, produces results so reliable and stable that auto insurance and homeowners insurance rates have disappeared as political and legislative issues over the past three decades. Illinois has consistently been right in the middle of all states in the annual NAIC report on auto insurance rates in the states.

South Carolina tells us that after years of auto insurance market deterioration induced by heavy-handed regulation, a modest movement toward a reliance on price competition can attract new providers and move the market back toward a more normalized condition. Since the insurance reforms of 1997, the market share of the Auto Facility (residual market mechanism), which was 43% and 1 million cars 1992, has fallen by 95% to about 50,000. Loss ratios in the Auto Facility are now comparable to those in the voluntary market. In the 16 years prior to reform, the number of auto insurers operating in the states declined by over 50%. Since the 1997 reforms, more than 100 insurers have entered the state, more than off-setting the 16 year decline.

New Jersey and Massachusetts tell us that state regulation that prescribes auto insurance risk classifications, severely limits rate differentials across territories and imposes long delays on regulatory filings, yields a never-ending set of political controversies, dissatisfied consumers and insurers lined up to leave the market and high prices. Over the past twenty years, the number of auto insurers in Massachusetts has declined by one-half and in New Jersey by one-third. And, in many cases, the insurers operating in these two states are set up as single state insurers in order to limit the exposure of parent companies to adverse regulatory action. New Jersey consistently has the highest auto rates in the country and Massachusetts is always a close runner-up.

California tells us that rate freezes and mandated reductions stimulated by a reaction to temporary, severe market conditions are more likely, over time, to prop rates up above levels that would have prevailed if insurers were not fearful of being trapped in rates lowered to reflect falling loss costs.

Texas tells us that when consumers of insurance products have the choice within the same market of regulated or competitive prices, significant market share will gravitate toward competitive set prices rather than regulated prices. Due to a historical quirk in state insurance laws, larger national insurers have been able to acquire the county mutual insurance companies in Texas. These county mutuals are not subject to rate regulation for homeowners insurance. Homeowners insurance sold by conventional insurers are subject to prior approval rate regulation.

Today, roughly two-thirds of the homeowners market has migrated to the competitively priced market place. Similarly, about one-fourth of the auto insurance market has migrated from regulated rates to competitive rates for coverage sold through "Lloyds" and reciprocal insurance companies that are not rate regulated.

THE ILLINOIS MODEL

The Illinois model is worth focusing on, both because it is not well known outside the state and because it is so simple and successful. After thirty years of operation, the Illinois antitrust pricing model is no longer an experiment or an interesting oddity. It should be seriously considered a model for modernizing insurance rate regulation.

- Illinois has operated since 1971 without a law that subjects property-liability rates to regulatory review or action by reason of excessiveness or inadequacy. This condition came about by accident when, following a two-year experiment with a competitive rating law in place of prior approval, the Illinois General Assembly could not agree on certain features in a revised law. A drafting error prevented the re-imposition of the old prior approval law. As a consequence, Illinois had no rate law and therefore insurers were subject to the antitrust laws in the absence of state regulation pursuant to McCarran-Ferguson. This has been called the "Penicillin Scenario" because it had to have happened by accident since no one would have had the insight or courage to advocate the Illinois model as a policy in 1971. Illinois continues to regulate rates in credit insurance, a line that is characterized by the potential of "reverse competition."

- Residual market mechanisms (the auto assigned risk program and the FAIR plan) are subject to prior approval rate regulation by the Director of Insurance. These plans have far less than one percent of the insured market share (auto .1% and FAIR Plan .4%).
- Insurers are permitted to participate in the joint development of trended (forecasted) loss cost data through licensed advisory organizations.
- In 1982 the Illinois General Assembly, with the support of business and labor and over the opposition of some elements of the insurance industry, made Illinois the first state to move to competition and away from prior approval for workers compensation rates. Many other states have since followed suit. The workers compensation residual market has remained subject to prior approval and has a low population.

- Illinois law still prohibits any different rate to be charged to a consumer by reason of race, color, religion or national origin, nor can auto insurance applications be rejected solely by reason of physical handicap and the law provides for the Director of Insurance and the Attorney General to pursue other unfair competitive practices that the law has not specifically defined.
- For purposes of setting auto liability rates auto insurers may not subdivide a municipality (Chicago).
- The General Assembly has provided for specific, targeted discounts associated with such public policy objectives as encouraging the installation of auto anti-theft devices and senior citizen driver training.
- There are various limitations and disclosure requirements with respect to cancellations and non-renewals of auto and dwelling fire and homeowners policies, information about eligibility for the auto assigned risk plan and FAIR Plan and how to contact the Insurance Department to file a complaint. Premium refund standards are set by law.
- The Illinois Insurance Department requires insurers to individually file illustrative rates for auto and homeowners insurance and personal

lines cancellation, non-renewal and new policy counts by ZIP Code in order to help in the monitoring of competitive developments.

- The Illinois Department also conduct an annual, in-depth review of market conditions and the availability and affordability of personal and commercial property-liability insurance pursuant to Illinois Insurance Cost Containment Act of 1986.

Researcher after researcher has looked at Illinois and Illinois has repeatedly been compared to other states in terms of important outcomes. Illinois consistently fares well. Prices are always right in the middle of all states, residual market populations have been perennially low, over-the-phone price quotes are readily available, the state has the largest number of licensed personal lines insurers, and political controversy is rare and suggestions for a return to prior approval have not been seriously made in many years.

CALIFORNIA AND PROPOSITION 103

In 1988, California voters reacted to a major run-up in auto insurance rates in the mid- to late 1980s by replacing the competitive pricing regime that had existed since 1947 with a prior approval regime for all property-liability insurance other than workers compensation that also sought to roll back rates across the board by 20% relative to 1987 rate levels. Significant litigation and lengthy regulatory proceedings followed and actual implementation of many Prop 103 provisions has been absent or incomplete, including the rate rollbacks.

There is widespread agreement that since 1989 there has been a dramatic drop-off in auto insurance loss costs. After several years of rapidly escalating rates, by 1988, average auto expenditure per insured auto in California were among the ten highest in the country. By 1999, the average expenditure had fallen to the median, with California being slightly more expensive that Illinois. The controversy about California, now as in 1988, is whether prior approval rate regulation as represented by Prop 103 is a help, a non-event or a hindrance for consumer interests.

Recently, Robert Hunter, a former Texas Commissioner of Insurance, authored a paper for the Consumer Federation of America (CFA) that attributes the fall in auto insurance loss costs in California since 1989 to Prop 103. His conclusions are in contrast to my own and those of others, who attribute the decade-long reduction in auto loss costs to other factors more directly associated with accidents, claims and litigation. Further, there is disagreement over the meaning of the agreed-upon fact that since 1989, the average return on capital for insurance operations in California for auto liability insurance has been twice the national average: 14.8% versus 7.25%.

Mr. Hunter's CFA paper has a number of problems that may have led to conclusions that are likely well off the mark. The critical element of the CFA paper is the belief that Prop 103 has, in some way, incented drivers in California to operate their vehicles more safely and incented insurers to improve their claims practices and anti-fraud efforts. Prop 103 may well have had some positive effects in this regard. However, the simpler and more direct hypothesis is that other factors are more at play. These include California's first-mover status in primary enforcement of seat-belt laws, stronger drunk driving enforcement and the California Supreme Court's Moradi decision, just before the passage of Prop 103, that put a stop to future third party bad faith lawsuits, a problem that had burgeoned in the decade prior.

There are several elements of the CFA report that should cause the reader to be skeptical of its conclusions.

- While early in the CFA report Prop 103 is cited as containing nearly all of the features that would characterize an ideal system, in the latter pages of the CFA report one finds that many of the major features were never implemented fully or at all, having either been invalidated by the courts or downplayed by the Insurance Department.

- The 20% rate rollback mandate fell far short of full application since the courts found that the Fifth Amendment to the U.S. Constitution stood in the way of confiscatory state action.
- Premium and loss data have not been collected by ZIP Code.
- Territorial rating has not been banned as Prop 103 advocates intended and is as important as ever for insurer rate setting.
- The courts have prevented independent lawsuits against rates already approved by the Insurance Commissioner.
- Permanent rate making rules have not yet been adopted.
- The expected Insurance Department comprehensive buyer's guide for comparison shopping has not been developed.

- The linchpin belief in the report that a 20% good driver discount in Prop 103 has, itself, been a key factor in driving down auto loss costs is belied by the fact that while liability loss costs have fallen, physical damage losses have risen. This dynamic suggests that something happening in the liability side of the equation. We cannot easily conclude that California drivers have found a way to have accidents that hurt cars but not people. While the good driver discount may be helpful, it is far more likely that the main force in reducing liability costs has been the 180 degree turnaround in the opportunity for third party bad faith lawsuits that occurred with the 1988 California Supreme Court Moradi decision.

- The CFA report takes the position that since a number of other states have “Moradi” type laws but have seen their loss costs rise nonetheless, the Moradi decision does not distinguish California. The flaw in the analysis is that the Moradi laws in the other state were “preventive” measures undertaken before third party lawsuits were able to get off the ground to any degree while in California, the Moradi decision was “remedial,” coming after nearly a decade of rapidly expanding court dockets. Other states recognized that the potential for third party bad faith lawsuits often prompted insurers to settle third party claims at levels higher than would otherwise have been the case. Thus, in California, the Moradi decision correlates with the point in time at which loss costs began to fall while in the other states, the loss cost increases at-tributable to this phenomenon were largely avoided.
- The CFA report tends to use statistical information in ways that should alert the reader to a heighten level of skepticism. A good

example is the attempt to establish a picture of unfairness in territorial rating by citing a 66% difference in liability insurance rates in central Los Angeles, a part of LA, compared to the average statewide premium outside the full City of Los Angeles. The CFA report on pages 16-17 reports that 93.5% of insured cars in central LA and 95.4% of insured cars elsewhere in California outside LA were claim free between 1982 and 1984, a difference of 1.9%. The report suggests that the 66% higher rate compared to statewide averages outside LA evidenced “redlining.” The problem is that the 1.9% absolute difference in accident rate translates into a 41% higher accident rate in central LA than in the rest of the state outside LA (.019/.046=.41). The overall higher costs of medical care in LA and the propensity for litigation in LA could easily account for the additional portion of the rate difference.

- The CFA, which one would expect to decry as a systemic failure a ten-year sustained auto liability profit level double the national average (14.8% versus 7.25%), instead attributes the situation to a personal failure by the Insurance Commissioner to respond to CFA’s entreaties for reduced profit levels. The CFA report does not seem to grasp the irony in its trumpeting as the best regulatory system in the country, a regime that yields such a result. Prop 103 seems to have frozen rates at extraordinarily high levels in 1989 and then operated to discourage voluntary rate reductions as loss costs fell. The prospect of being unable to raise rates if costs rose again must certainly have been considered by any rational insurance company management.

REGULATORY RESOURCE ALLOCATION

In the more than half-century since McCarran-Ferguson and the follow-on rate regulation legislation in the states, the entire structure and environment of the insurance industry has changed significantly. However, we have never really undertaken a comprehensive review of the framework of regulation established after World War II. In effect, many states continue to make regulatory resource allocations on the basis of a regulatory model that has not been seriously changed since that time. In many states substantial direct and indirect regulatory effort and funds are expended in order to regulate property-liability rates when there is little, if any research that suggests any benefit from doing so. And, there is much research to the contrary.

The states are on the front line of insurance regulation and the states have made major improvements in the past thirty years in solvency oversight and in the protection of consumers from unfair market conduct. Yet, much more could be done, especially if the resources devoted to the futile and unproductive exercise of rate regulation. An improved allocation of regulatory resources would include:

- Better pay for insurance department financial and actuarial examiners so states can compete for talent with private industry;
- Making insurance department consumer complaint management systems meet the best standards of private industry for high levels of consumer interaction and satisfaction;
- Increased anti-fraud prevention, detection and prosecution to limit auto and workers compensation fraud as well as the looting of insurance companies and the sale of fraudulent insurance products.
- Upgrading of the technological capacity of insurance regulators on a continuing basis so that regulators can be as technologically up-to-date as are insurers; and
- Investment in leveraging the Internet to help personal lines consumers shop and compare prices, services, products and financial strength.

Rate regulation seems to be an anachronism that sucks up resources for no good reason.

CHOICES FOR CONGRESS

Both the Illinois and California models deserve close attention and consideration. The terms and conditions and the results of the Illinois system seem clear and simple enough and have been in operation for thirty years (and nearly twenty years for workers compensation), weathering several underwriting cycles in all line of insurance. The California situation is far less clear. While current conditions can be compared empirically to those in 1988, the reasons for the change in conditions are subject to widely varying interpretations. These range from the belief that Prop 103 has largely been a non-event due to the ingrained competitive culture in the California insurance market and regulatory agency to the belief that Prop 103 itself has been the main reason for falling loss costs, even if profit levels are abnormally high.

The ultimate question, of course, is whether Congress wishes to maintain a system in which each state determines with total freedom where it will fit between the vast terrain between the Illinois model at one end and the New Jersey and Massachusetts model at the other. Or, should Congress provide guidance or requirements within which the states would address regulation of property-liability rates.