Testimony
Robert Restrepo
President, Chairman, and CEO
State Auto Insurance Companies
On behalf of
Property Casualty Insurers Association of America (PCI)

The Federal Insurance Office's Report on Modernizing Insurance Regulation

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Committee on Financial Services
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Thank you Mr. Chairman and Ranking Member for inviting PCI to testify today.

My name is Bob Restrepo, President, Chairman and CEO of State Auto Insurance Companies and Chairman of PCI. State Auto was founded in 1921 and today is an A rated insurer with 2,500 employees countrywide providing a broad range of protection to consumers for their home, auto and business needs. PCI is composed of more than 1,000 member companies, representing the broadest cross section of insurers of any national trade association. PCI members write more than $195 billion in annual premium and 39 percent of the nation's property casualty insurance, epitomizing the diversity and strength of the U.S. and global insurance markets.

I am going to provide a different overview of the current insurance regulatory system from the FIO report. I will talk about some areas where PCI and State Auto agree with the report on the need for reform and some recommendations that might bear reconsideration. Then, I will end with some questions and thoughts about how Congress might want to follow-up.

Framing the Current Regulatory System and the Right Questions for Improvement

The U.S. has the largest and most diverse insurance market in the world, with a 150 year track record of comprehensive state regulation protecting consumers. The insurance sector has been stable throughout the last several financial crises, and despite a confluence in the last decade of record storms, market contractions and regulatory changes has had no major recent insolvencies, has achieved record levels of capitalization, and our residual markets for consumers and businesses are at or near historic lows suggesting that overall private sector insurance availability is better than ever for consumers. The more local focus of our state-based insurance regulatory system has allowed property and casualty insurance markets to be more responsive to the particular local needs and realities of insurance customers and the companies that serve them.

State regulation is, however, far from perfect. The FIO report does a good job of itemizing the numerous current controversies in insurance regulation that the states are working on. For example, while the states have clearly performed well in protecting consumers through solvency regulation they could do better in allowing open competition in rating without prior approval, coordinating market conduct exams, and streamlining commercial forms approvals.

But we would fundamentally disagree with FIO's conclusion that "The need for uniformity and the realities of globally active, diversified financial firms compel the conclusion that federal involvement of some kind in insurance regulation is necessary" or that a "hybrid" federal-state approach would be preferable. PCI previously provided to the Committee during the Dodd-Frank Act debates a statistical analysis comparing federally regulated banking and thrift insolvencies to insurance failures, and in fact state regulation compared quite favorably. Federal involvement is neither inherently uniform, as evidenced in the banking sector, nor have most foreign jurisdictions with federal regulation implemented more sophisticated consumer protections.

The better question is perhaps not whether federal involvement is necessary, but rather what are the best standards for good regulation and good regulators and where can the current system be improved. PCI's mission, which State Auto supports, is to promote and protect the viability of a competitive private insurance market for the benefit of consumers and insurers and we have analyzed each of FIO's recommendation through this filter.

FIO Recommendations that Could Improve the Market

State price controls on insurance rates including prior approval requirements pose a constant threat to the marketplace and are virtually unknown in other sophisticated insurance markets. Recent experience in New Jersey auto insurance and Florida property insurance are classic examples of how politicized rate regulatory systems can create market failures, artificial scarcities, less competition and higher prices over the long term. Academic and economic observers are almost unanimous in their criticism of rate regulation, yet it continues to be practiced in most states. Classic economic theory suggests that rate regulation should be reserved for oversight of monopolistic markets, but the insurance industry has very low market concentration with thousands of companies vigorously competing to offer consumers the best products and prices. FIO accurately cites studies finding that rate regulation reduces availability and affordability and cites the success in Director McRaith's home state of Illinois in allowing free-market private competition for consumers. PCI and State Auto agree with FIO's analysis on rate regulation and suggest promoting the model laws, for example, those of the National Conference of Insurance Legislators, to eliminate prior approval rate requirements.

Market conduct is another area where the states have made some improvements but, as FIO accurately reports, more progress is needed. States often pursue duplicative exams or investigations the benefits of which are unlikely to exceed the costs, sometimes using outside examiners with inconsistent quality and expense controls. While the NAIC has a group working on the issue, we would encourage them to provide a timeline for improvements similar to that followed vigorously for qualified jurisdictions under the NAIC's amendments to the Credit for Reinsurance Model Law. The NAIC could also set up a task force to develop standards and protocols for outside examiners.

Commercial lines regulation, especially product approval, should be modernized. Insurers should be able to respond more quickly to the needs of their commercial customers, especially those that are large and sophisticated. The inability to do so costs commonly regulated insurers billions annually in loss of business compared to less regulated alternative risk transfer mechanisms. We have provided the NAIC with a list of reforms and they are now surveying the states but more progress is needed in this area.

There are other recommendations of the report that we hope will encourage action, including pursuing further uniformity for surplus lines, Congressional enactment of NARAB II for insurance agent licensing, and improved loss mitigation to help reduce natural catastrophe risk.

FIO's Recommendations that Could Harm the Market

The FIO report makes several recommendations that do not meet PCI's test of promoting and protecting the viability of a competitive private insurance market for the benefit of consumers and insurers.

While FIO supports free market rates, the report suggests that federal standards may be appropriate for governing the risk factors that are used to set rates. In fact, every single state currently prohibits unfair discrimination by insurers and regulators are constantly studying and evolving their regulations with significant success in maximizing insurance availability and affordability while bringing last-resort residual markets to all-time lows. The few states that have experimented with limiting the ability of insurers to consider consumer risk factors other than for protected classes have not only impaired their markets but have limited the ability of consumers to take advantage of modern technology such as vehicle telematics, which can be used to price coverage based on individual driving behavior. Governments often seek to manipulate insurance markets for socially driven cross-subsidies, but we suggest that FIO could seek to encourage the states to reduce barriers to new rating technologies more quickly.

The report also makes a number of recommendations pressing state regulators to adopt best practices, standards, and principles that are developed by international bodies. PCI welcomes more international coordination, mutual recognition and, where appropriate, harmonization. However, we do not support the current push for a one-size-fits-all bank-like global regulatory system. The U.S. system is very focused on protecting insurance consumers and has had considerable success.

A number of international standards are developed based on a different mission or market structure than those applicable in the U.S., for example shifting focus to protecting investors or employers, or the need to set a higher bar against failures because of the absence of the safety net of guaranty funds. Imposing the same regulatory standards and trip wires on every country when the underlying regulatory missions and systems are fundamentally different is not always in the best interests of American consumers. Indeed, adopting a single global set of standards could even give rise to systemic risk that does not exist in the current environment of diverse business models. This Committee has previously encouraged the representatives of the state and federal government to work together and coordinate our insurance voice internationally. We believe that this goal is more important than ever.

Additional Considerations

PCI's board will shortly act on a more comprehensive and detailed response to each of the recommendations in the FIO report that we will provide to Congress, but a more fundamental question is, given the very limited resources of the FIO office and its carefully defined role under Dodd-Frank: what fundamental strategic purpose should it serve?

Assisting the Secretary in administering the Terrorism Risk Insurance Act (TRIA) is clearly a statutory priority. FIO is working on a separate report on TRIA and the terrorism insurance market as part of Treasury's involvement in the President's Working Group on Financial Markets, but is there additional guidance FIO can provide as TRIA reauthorization legislation is being considered by the Committee?

The Dodd-Frank Act directs FIO to consult with the States and coordinate Federal efforts on international prudential matters. With the expanding number of “voices” representing the U.S. in international regulatory discussions, are there additional opportunities for FIO to serve a coordinating role to bring together the NAIC and state regulators, state legislators, the Treasury, the Fed and the FSOC’s independent insurance expert to hammer out joint positions? Can we get a united position for our marketplace or have we just added multiple federal voices to the multiple state voices? The failure to advocate a single U.S. message weakens our negotiating power in a highly competitive regulatory negotiating scrum with differing country interests.

FIO has done a good job at outreach to the industry on a number of issues. But the international regulatory discussions are increasingly going far beyond the parameters in the Dodd-Frank Act and are increasingly being held behind closed doors by non-U.S. and non-insurance actors without individual accountability for global policymaking. Are there opportunities for FIO to press for more transparency and public discussion of the Financial Stability Board and International Association of Insurance Supervisors where critical decisions are made without due process rights or legal protections, for example with respect to designations of systemically important insurers? And what involvement should Congress have in the U.S. involvement in setting new standards the NAIC is being pressured to adopt that go well beyond the Dodd-Frank Act?

Finally, are there opportunities for FIO to insist on more rigorous deliberation, including cost benefit analyses, in international standard setting discussions? Too often, we have seen costly new mandates emerge from closed door meetings with no proof that the additional compliance costs will be a net benefit for either insurers or consumers in terms of competition and cost. Instead there is often only a stated assumption that centralization of regulation is inherently good and regulators need to adopt global standards and then work out the details as they go along. Increasing regulatory costs are driving particularly smaller insurers out of business and worsening coverage availability and affordability for consumers.

Conclusion

The U.S. property and casualty insurance market is financially strong, competitive, characterized by diverse business models and comprehensively regulated. In this context, the FIO report’s specific recommendations deserve serious consideration and should be judged according to their effects on the market. The states can certainly make improvements towards free-market pricing, better market conduct examination coordination and commercial streamlining, although hopefully not undermine the ability of the marketplace to use appropriate risk factors or impose suboptimal bank-like global standards where they do not benefit private competition for consumers and insurers. Ultimately, Congress and FIO will have to decide strategic priorities given limited available resources. We suggest promotion of free market pricing and coordination of U.S.-international policymaking should be key drivers. PCI and State Auto appreciate your interest and look forward to working with you and FIO in this endeavor.