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

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Ernst N. Csiszar
Director of Insurance
State of South Carolina

The Effectiveness of State Regulation: Why Some Consumers Cannot Obtain Insurance

I. Introduction

Mr. Chairman, ranking member Kanjorski, members of the Subcommittee,

Good morning, my name is Ernie Csiszar, and I am the Director of Insurance for the State of South Carolina. Thank you for the opportunity to speak to you today on the topic of the effectiveness of state regulation and why some consumers cannot obtain insurance. Let me state at the outset that in South Carolina our consumers are able to obtain insurance.

In addition to the traditional issues of insurer solvency and market conduct, insurance availability and affordability have become guiding general principles of insurance regulation. A variety of factors contribute to insurance availability and affordability within the market, perhaps not the least of which is the regulatory environment itself.

As you are aware, there are a variety of rate regulatory structures in effect in this country. These structures range from state-made rates and rating bureau adherence to an open market system relying on the anti-trust laws. Different lines of property and casualty coverage may be accorded varying levels of regulatory oversight. However, most processes are generally categorized as either “prior approval” or “competitive.” While the regulatory processes may differ by state, the same principles guide every state’s rate regulation: that the rates be adequate (to maintain insurer solvency), but not excessive (too high) or unfairly discriminatory (unfairly discriminating between members of the same class).

I am here today to discuss the affordability and availability of insurance within the property and casualty insurance market in South Carolina, with particular emphasis on how state regulation can affect affordability and availability. In this respect, I will discuss South Carolina’s experiences and our efforts to modernize insurance regulation.

Property and casualty markets tend to exhibit unique local characteristics. Let me highlight some characteristics of South Carolina as an example. South Carolina's terrain is as varied as any you might find. We have beaches in one part of the state, low-lying areas in some parts of the state, and mountains in others. Our state is exposed to natural disasters such as hail, hurricanes, tornados, and flooding. The City of Charleston is on an earthquake fault. This makes for a very challenging property market.

Traditionally, South Carolina has regulated its property and casualty market by use of a prior approval system with significant restrictions on the ratemaking process. This is where change is taking place. Issues of insurance availability and affordability as well as rate subsidization in the mid-1990's initiated a change in the regulatory philosophy of the South Carolina Department of Insurance and the lawmakers in our state. By moving from a strict prior approval process to a more open market approach, we are better able to focus on what is essential to insurance regulation.

II. History of Rate Regulation

Prior approval developed as a method of preventing insurer insolvency. Early rate regulation emerged as a result of insolvencies triggered by catastrophes and overly zealous forms of competition. Insolvent insurers cannot compensate their policyholders. Rate regulation, in general, developed from the recognition that the health of the insurance industry was dependent upon quality of information, analysis, and accurate underwriting performed by insurers. Rate bureaus were created to collect and segregate data to make class plans and to prevent insolvency. Insurers were required to adhere to bureau filed rates and rating systems.

Three factors have influenced the direction of rate regulation activities since the late 1960's. First, some states, believing competition would do a better job of arriving at prices that more accurately reflect underlying costs of insurance, moved in the direction of reliance on competition among insurers to better control rising prices.¹ Second, in the mid-1980's, federal price deregulation occurred in airlines, trucking, railroads and financial services. As a result, some states adopted laws based on a model competitive rating law adopted by the National Association of Insurance Commissioners (NAIC) in 1980.² For example, states moved to rely on competition in workers' compensation prices. By the late 1990's, most workers' compensation premium was collected relying on competitive pricing.³ However, two developments converged to produce a movement back in the direction of prior approval rate regulation.⁴ In 1986-87, there was a spike and shortage in municipal and other general liability insurance. Moreover, there was an upsurge in auto insurance premiums driven by substantial increases in liability, repair costs and fraud related costs.⁵ The result was Proposition 103 in California. Voters opted

¹ See, e.g., Philip R. O'Connor, Ph.D. and Eugene Esposito, J.D., *Modernizing Insurance Rate Regulation: Tacking to the Winds of Change*, A Report Delivered to the National Conference of Insurance Legislators Property and Casualty Committee Hearing on Proposals for Personal Lines Deregulation March 2001).

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ *Id.*

to replace California's competitive rating law with a prior approval system.⁶ Third, the deregulation of rates and policy contract forms for larger commercial insurance risks has had a significant impact on regulatory rate policy.⁷

III. South Carolina's Efforts to Modernize Insurance Rate Regulation

A. South Carolina's Move toward the Competitive Rating Model

The State of South Carolina is moving toward a competitive approach to rate regulation in our personal and commercial lines property and casualty insurance markets. These changes will not only affect rates, but will, in the future, affect policy forms as well. I say moving, because the process is evolving and not yet complete. We are pursuing this approach to rate regulation in our property and casualty insurance markets because we think it is the right way to address any availability and affordability issues. The successful reform of our automobile insurance market has made this an easier process.

B. Reforming the Automobile Insurance Delivery System in South Carolina

For years, neither actuarial methodology nor supply and demand had much to do with automobile insurance ratemaking in South Carolina. Politics drove that ratemaking process within our state. Politically, there was never an opportune time to raise insurance prices. This resulted in significant rate suppression. In the short term, rate suppression kept the costs of insurance down. However, in the longer term, insurers were leaving the market because they were unable to secure an adequate rate for their product. Hence, the level of competition within the market decreased.

Rate suppression, as well as frequent legislative changes designed to address short-term ills of one form or another, also sent the wrong signals to the market. These provided incentives to consumers to continue to engage in risky behavior (e.g., speeding), because the insurance premiums they paid were artificially low for some and did not accurately reflect their insurance risk. Consequently, in this system, good-risk drivers were subsidizing the insurance of bad-risk drivers.⁸

To put things in perspective, here is some history. In 1974, South Carolina enacted S.C. Act No. 1177, which imposed numerous mandates on automobile insurers writing in South Carolina including a mandate-to-write, risk classifications and territorial plans. This mandate-to-write required insurers to provide insurance coverage to all who applied irrespective of risk. In 1980, South Carolina had approximately 159 insurers writing within the state, but almost half had left the market by 1996. Concomitantly, the

⁶ *Id.*

⁷ *Id.*

⁸ A bad-risk driver is a driver with multiple driving violations. A good risk driver is a driver without multiple driving violation or insurance points.

number of insurers writing homeowners insurance decreased from 175 in 1980 to about 117 in 1996-97.

The regulatory system in most states is comprised of a voluntary market and a residual market. The residual market is generally established as a market of last resort for consumers who are unable to secure insurance coverage within the voluntary market. Act 1177 created the South Carolina Reinsurance Facility⁹ as South Carolina's residual market mechanism. The size of the residual market is an indication of how well a system is working. It is generally agreed, that in a properly functioning market, the residual market should not exceed 5%.

However, South Carolina's market of last resort soon became the primary writer of private passenger automobile insurance coverage in this state. At one point, the South Carolina Reinsurance Facility had over 40% of all drivers. More importantly, the rates charged by the Facility were not adequate. Consequently, the South Carolina Reinsurance Facility was losing money. It had an annual deficit that reached as high as \$200 million at one point.¹⁰

In 1988, the state instituted a recoupment fee to recover losses of the South Carolina Reinsurance Facility.¹¹ Each South Carolina driver had to pay a proportionate share in recoupment fees to recover the losses. Consequently, good-risk drivers complained that they were subsidizing the insurance premiums of the bad-risk drivers. There were no incentives for bad-risk drivers to reduce or alter their risk-taking behavior. The automobile insurance delivery system became a tremendous political issue, and issues of automobile insurance availability and affordability dominated the discussions at the state house for over a decade.

It is important to note that the automobile insurance market that existed in South Carolina in the mid-1990's was *not* the one South Carolina regulators or legislators intended to create 20 years earlier. It emerged as a result of unintended consequences. A number of factors are responsible for its evolution, including politics and unrealistic public expectations that speeding tickets, at-fault accidents and driving under the influence should have little or no impact on one's insurance rates. Corrective changes were piecemeal and lacked focus. The need for change was evident.

Even though insurers and state regulators have a responsibility to attempt to provide consumers with insurance products that are stable from an insurer solvency perspective and at the same time available and affordable, consumers must also share in this responsibility. If consumers fail to avail themselves of the opportunity to learn how their actions can influence the industry and continue to participate in risky behavior,

⁹ The South Carolina Reinsurance Facility was an unincorporated, nonprofit legal entity that replaced the assigned risk plan in 1974. Under a reinsurance facility system, companies are required to accept all customers. Following the sale of an insurance policy, the company may cede the policy and its premium to a joint risk pool of all insurance companies. Facility policies are serviced by the companies to whom the drivers originally applied. Losses and profits are apportioned among the insurance companies.

¹⁰ Martin F. Grace, *et al.*, *Auto Insurance Reform: Salvation in South Carolina*, Brookings Institute (2001).

¹¹ *Id.*

problems will continue to exist in these areas. It is only when all three groups work together that the desired results can be obtained.

The change came in 1997 following the release of an audit report by the South Carolina Legislative Audit Council which concluded that the automobile insurance delivery system in South Carolina needed to be reformed.¹² As a result of that report and consumer outrage in 1997, the General Assembly enacted legislation that radically reformed the automobile insurance delivery system in South Carolina. Act 154:

- Eliminated the mandate-to-write private passenger automobile insurance.
- Created a modified prior approval or flex rating system that allowed insurers to file and use rates once a year that were +/-7% or less; all other rate change requests were subject to prior approval.
- Eliminated the Uniform Classification and Territorial Plans and permitted insurers to file individual classification and territorial plans; these plans were subject to the prior approval of the Department.
- Eliminated the recoupment fee for good-risk drivers by March 1, 2003.
- Instituted stiff penalties for companies engaging in unfair discrimination.
- Replaced the South Carolina Reinsurance Facility with a joint underwriting association for four years. The joint underwriting association was then converted into an assigned risk plan.
- Instituted stiffer penalties for driving uninsured in South Carolina and created a mechanism for better enforcement of the compulsory insurance laws.

These changes were based on the competitive rating model. This new automobile insurance delivery system went into effect on March 1, 1999. It has been in effect for a little over four years now. Let me share with you some statistics.

- The number of insurers in our market increased from 78 in 1996 to 165 as of March 1, 2003.
- The information that we have on automobile insurance rates in our system suggests the following:
 - South Carolina's ranking according to the NAIC Average Premium Expenditures Report has improved.
 - Consumers are able to find competitive rates within the voluntary market.

¹² Report, South Carolina Legislative Audit Council, *The South Carolina Reinsurance Facility* (1997). The 1997 Legislative Audit Council Report recommended that the General Assembly consider amending the auto insurance laws of this state to: (1) give insurance companies increased flexibility in setting insurance premium rates; (2) allow insurance companies to refuse to sell insurance to any driver for reasons other than race, ethnicity, or other related unfairly discriminatory factors; (3) replace the South Carolina Reinsurance Facility with a joint underwriting association and then an assigned risk plan; (4) eliminate the recoupment fees; and (5) eliminate the designated insurance agents system in South Carolina.

- Our residual market has decreased from over 600,000 policies in 1999 to approximately 340 policies as of March 1, 2003 in all residual market mechanisms.¹³
- No insurer has more than 25% market share.¹⁴
- Consumer complaints about having to pay recoupment fees have decreased significantly. We believe consumers now have a better understanding of how their behavior can affect the cost of their insurance coverage.
- The number of insurers writing private passenger automobile insurance coverage continues to increase.
- The Department, industry, legislators and consumer groups work cooperatively to craft insurance-related legislative initiatives for the market.

One of the keys to the success of these reforms was providing an adequate transition period to avoid market disruption. These changes were phased in over roughly a two year period.

South Carolina still regulates many aspects of our automobile insurance market. However, our approach to regulatory oversight has changed:

- This Department monitors markets and competition more closely than it has in the past.
- We encourage consumers to shop around for insurance coverage and provide market assistance.
- We actively recruit companies to address availability issues that may arise in segments of the market.
- We are in the process of drafting legislation to institute a fraud section within the Department of Insurance to complement the insurance fraud efforts of the South Carolina Attorney General's Office.

These are all indications to us that the market is functioning as it should. The changes are significant and positive for a primarily rural state that ranks high in automobile fatalities.¹⁵

In order for any regulatory system to work properly, enforcement must become a priority. South Carolina has long had a high number of uninsured motorists. The evidence suggests that number dropped after 1999 with the adoption of several preventative measures and stricter enforcement of financial responsibility requirements. This remains

¹³ There are no policies in the South Carolina Reinsurance Facility; 330 policies in the South Carolina Associated Auto Insurers Plan, which is in run-off, and 7 policies in the assigned risk plan. These figures are as of March 1, 2003.

¹⁴ This information was obtained from the South Carolina Market Share Report reflecting business written in 2001. The amounts listed are developed from the amounts reported on the insurers' 2001 South Carolina Fee and Tax Returns and verified with the annual amounts reported on the Business Page of their 2001 Annual Statements.

¹⁵ Statistics indicate that South Carolina ranks 12th nationally in automobile fatalities and 2nd nationally in DUI fatalities. This information was provided by the National Highway Traffic Safety Administration of the United States Department of Transportation.

an issue, though, and the state continues to improve its efforts to detect and prosecute uninsured motorists.

C. Modernization of Commercial Lines Regulation

Like a number of other states, South Carolina re-engineered its commercial lines market. In 2000, we eliminated prior approval requirements for commercial policies with a threshold of \$50,000 in premium. In 2002, we removed that threshold. Not all commercial lines were included within this process. Medical malpractice and credit-related insurance products remain subject to prior approval.

The regulatory changes were implemented in accordance with our desire to increase competitiveness. We also created an Alternative Risk Transfer Services Division to address availability and affordability issues within commercial lines of insurance.

South Carolina's law eliminates the requirement that commercial policies and rates marketed to large commercial entities be approved by the Department of Insurance prior to issuance. These policies can be filed on a "deemer" basis.¹⁶

The response to the change in our commercial lines market has been very positive. This market has stabilized as a result of this effort, and we are contemplating instituting a file and use system for all commercial policy forms. We believe this move will encourage more companies to enter and write in the South Carolina commercial lines property and casualty market by allowing them to get their products to market in a timely fashion.

D. South Carolina's Homeowners Insurance Market

According to the Insurance Information Institute, the high number of catastrophes, high costs of home repairs, the aging of the United States homes and the emergence of mold claims are pushing homeowners rates upward. In South Carolina, we have had some experience with this. Hurricane Hugo cost the industry \$4 billion in 1989. Increasing population growth and increasing property values in an area subject to catastrophes makes us anticipate a future capacity problem in the coastal areas of the state.

Even though we have seen the entry of more insurance companies as a result of automobile insurance reform, we anticipate needing significantly more capacity than currently exists. We are currently considering introducing a competitive model to the South Carolina property and casualty homeowners insurance market in an attempt to improve insurance affordability and availability. The Department plans to introduce a bill based on a National Conference of Insurance Legislators (NCOIL) model similar to what is being done in Illinois (where the Director will certify the

¹⁶ This means the regulator would have a certain period of time within which to act on the filing or the filing would automatically be deemed approved.

competitiveness/stability of the market). Due to its comprehensive nature, it will be implemented in phases, like our automobile insurance delivery reform efforts, to prevent market disruption. The reforms will include flex-rating for homeowners and a gradual transition to the NCOIL model.

IV. Conclusion

As Director of Insurance for the State of South Carolina, I am an ardent supporter of state insurance regulation. Notwithstanding, my colleagues and I understand that the property and casualty insurance marketplace in 2003 differs significantly from the market 10, 20 or 30 years ago. My colleagues and I understand that fair, effective and efficient regulation is good for the consumer and the industry. Availability, affordability, fair competition, a knowledgeable consumer, quality customer service and solvency are our objectives. This is what we are accomplishing in South Carolina. Too many changes have occurred within the financial services market to continue to regulate the business of insurance as we did forty years ago. In recognition, the NAIC is re-engineering many regulatory processes.

Our experience suggests that, much like Illinois, the competitive rating model works. The automobile insurance climate in South Carolina has improved. Consumer complaints have decreased. There are more insurers operating. The market is more competitive. Insurance premiums more closely reflect the claims experience of the insured. Now, instead of focusing on the insurance premiums, our General Assembly spends time on bills dealing with the true “cost drivers” of insurance:

- DUI;
- Drivers Training;
- Guard Rails;
- Uninsured Motorists;
- Mandatory Seatbelts; and
- Motorcycle Helmets.

Consumers are offered far more choice than ever. No insurer has more than 25 % of the market. This is markedly different from our market five years ago. Most importantly, our consumers appear to understand the power and importance of shopping around for the best coverage and the best rates.

South Carolina and Illinois are good examples of how competitive rating models, when accompanied by appropriate regulatory oversight and market monitoring, work efficiently. With appropriate solvency and market conduct regulation, competition can be used as an effective regulatory tool to ensure that rates as well as forms comply with the applicable law.

I thank you very much for your time and for the opportunity to share South Carolina’s experiences with you.