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TESTIMONY OF DAVID F. SNYDER
ON BEHALF OF THE
AMERICAN INSURANCE ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

ON

OVERREGULATION OF AUTO INSURANCE BY STATES

AUGUST 1, 2001

I am David F. Snyder, Assistant General Counsel of the American Insurance Association (AIA), responsible for motor vehicle insurance, transportation and international trade issues. I have previously served in the Pennsylvania Department of Insurance and have been employed by several major personal lines insurers. I am also a Chartered Property and Casualty Underwriter. On behalf of AIA, I am pleased to be able to share our experience with State auto insurance regulatory systems.

Personal automobile insurance is the largest line of property and casualty insurance in the United States, amounting to more than $118 billion in annual premiums. AIA member companies write personal automobile insurance in all U.S. jurisdictions and, because they also write insurance globally, have experience under every kind of insurance regulatory system.

State auto insurance regulation has assumed gargantuan proportions, in terms of expense, intrusiveness, market disruption and avoidable shortages. At the core of this regulatory structure is rate regulation, in reality the governmental power to control prices, that is authorized in some form in all but one or two of our States. The most far-reaching version of rate regulation, prior approval, is embedded in the laws of more than one half of the States. See the attached chart.

When the underlying costs of the insurance product are stable as a result of positive trends in crashes, injuries, thefts, damage and legal, medical and repair bills, the regulatory system is largely invisible and seemingly benign. But as the recent history in New Jersey and Massachusetts demonstrates, when underlying costs rise or remain high, rate regulation leads to rate suppression. Insurer responses to rate suppression lead to more regulation and the public ultimately suffers from avoidable shortages.

RECENT HISTORY IN NEW JERSEY AND MASSACHUSETTS DEMONSTRATES THE FATAL FLAWS IN RATE REGULATION AND OTHER GOVERNMENT INTRUSION INTO THE AUTO INSURANCE MARKETPLACE.

New Jersey and Massachusetts have much in common. Both are in the top five most expensive auto insurance States. Both have a tradition of rate suppression, and systematic controls over every other element of personal auto insurance. And both have a severe shortage of insurance written by national insurers, resulting in an extreme scarcity of choices for consumers.

New Jersey, first in the nation in average auto insurance premiums, is in the midst of a market crisis. Nearly one million policyholders will have to look elsewhere for coverage because insurers writing nearly 20% of the market, including the nation's largest, have indicated they will leave. These latest developments are occurring in a system in which more than one third of the national auto insurers were already bypassing the State. Even before the latest exits, New Jersey had only 67 companies writing person auto insurance in 1999, much lower than the national average.

Coupled with the refusal by public officials to prior approve obviously needed rate increases, New Jersey forces insurers to write un-profitable high risk business at a loss, through "take-all-comers" provisions, mandatory assignment of under-priced policies and territorial rate caps. As a final control mechanism, New Jersey has a law requiring the forfeiture of all licenses by a company wishing to exit the auto insurance market. Despite this severe penalty, increasing numbers of insurers are willing to incur the loss. The ultimate victim is the public, because not only are there growing shortages in the auto insurance market but the shortages may even spread to other lines of personal and commercial insurance.

Massachusetts, ranks 5th in average auto insurance premiums and has even fewer national insurers writing in its market, less than one third of the top 15 national writers. Massachusetts routinely "fixes" insurance rates for all insurers, controls rating factors and heavily regulates underwriting and market withdrawal, similar to New Jersey. The resulting absence in consumer choice is also similar, with only 47 companies writing personal auto insurance in 1999.

South Carolina had a similar history of rate suppression and accompanying controls over other market actions. But, in contrast to New Jersey and Massachusetts, it has begun to dismantle its counterproductive regulatory system. South Carolina had 76 insurers actively writing auto insurance in 1999, up from prior years.

RATE REGULATION SKEWS PRICES AND LEADS TO RATE SUPPRESSION WHERE UNDERLYING COSTS ARE HIGH OR RISING.

When underlying costs are stable or declining, the rate approval system seems benign. Yet, it still has an anti-consumer, albeit less visible, impact.

Without rate regulation, companies would respond rapidly to changing circumstances by cutting prices and expanding underwriting, because the companies would be able in the future to change their prices to meet any upward trends in the costs of providing the product.

But with rate regulation, the suspicion, often quite justified, will persist that while reducing rates is easy, raising them to meet changing conditions will not be easy or even allowed at all. The natural reaction will be to be more cautious about lowering rates. Will the positive cost trends continue? If they don't, how fast can we respond by raising prices to match rising costs and have them approved? Asking these inevitable questions could have been responsible for the surprisingly high level of profits in California since the Prop.103 prior approval rating system replaced the State's competitive rating system.

Rate regulation, by suppressing rates in response to the political outcry resulting from higher costs, has its most damaging impact on the market at precisely the time when more capital is most needed in the market to cover the rising costs of providing the product. When, for example, litigation, medical costs or repair bills are rising, constituents will put the most pressure on public officials to suppress prices, something they can't do in most other markets but can and may for personal auto insurance because they have the authority to do so under insurance rating laws. Market decisions then become political decisions.

New Jersey is the most obvious example of the politicization of rate approval. The State's underlying costs are very high and because the State's law permits it, public officials have repeatedly bent to political pressure to suppress rates, and continue to do so.

For example, after a $ 3 billion deficit was created because of rate suppression in New Jersey's residual market, or JUA, the State replaced the JUA with a mandatory depopulation program and a short term involuntary market facility called the Market Transition Facility (MTF) which the Insurance Commissioner was instructed to run on a break even basis. Instead, by suppressing rates, he quickly created a new $1.2 billion deficit. Here is what one court found, even while applying its normally deferential standard of review applicable to the insurance regulator:

> …it was becoming obvious that MTF was accumulating huge deficits. …...... The Commissioner did not adjust MTF rates in response to an avalanche of actuarial evidence that the facility was operating unsoundly ....The Commissioner decided that the indicated rate need was 12.2%, plus .4%............He did not, however, adopt any part of the 12.6% rate need he found. Since premiums were MTF's only

> revenue source, the Commissioner's responsibility was to predict MTF's rate needs to operate on a break-even basis, and to meet them with rate increases. Increases, however, would disappoint popular hopes that the FAIR Act would reduce high auto premiums. 256 N.J. Super 158 at 168-171 (1992)

Although directed to a specific commissioner acting at a particular point in the long history of rate suppression in New Jersey, the judge's comments graphically illustrate the unavoidable danger and inevitable consequences of rate regulation in situations of high or rising insurance costs.

RATE SUPPRESSION LEADS TO THE ABSENCE OF CONSUMER CHOICE.

Any player in a market when its costs of providing a product rise beyond its control, which is usually the case in auto insurance because it pays for litigation, medical, weather related and auto repair costs, will try to increase its prices. When the regulatory system refuses to allow raising needed capital to meet rising costs, the next reasonable response is to reduce the numbers of loss producing products being sold.

Insurers reduce their numbers in several ways. In response to rate suppression, they may tighten their underwriting criteria to decline risks they might otherwise write if they could charge adequate prices and compete more fiercely for the better risks. This is what some consumer advocates refer to as "selection competition", actually a reaction to rate suppression.

Increasing selectivity is heightened and aggravated if there is inadequate capital as a result of rate suppression. Insurers next will cancel or non-renew existing policyholders using more stringent criteria, again seeking to maintain only their lowest risk customers.

As a result, many consumers may find themselves without insurance or relegated to the high priced residual market plans--customers who before were being written by voluntary insurers. They pay more and have fewer, sometimes many fewer, choices of insurers who will write them. For most people, this result is worse than moderately higher premiums so long as they can be written by the same agent or company or may shop among many choices.

The regulatory response to these insurer actions, made necessary by rate suppression, is often even more regulation. This will take the form of limiting the allowable grounds for rejecting, canceling or non-renewing, mandatory writing of "good drivers", and mandatory assignment of high risk drivers. New

Jersey and Massachusetts did all of these things, resulting in major insurers exercising the only action left open to them--to pull out of the market entirely, resulting in severe market disruptions and chaos affecting millions of citizens.

Even before the current regulation driven crisis, New Jersey lacked 6 of the top 15 national auto insurers, including GEICO, Nationwide and Farmers and a major regional insurer, Erie. Now, the nation's largest auto insurer, State Farm, with over 800,000 policies in New Jersey and 17.6% market share has announced it will pull out. Three other companies are taking similar actions, affecting the security of more than 1 million insureds. For insureds, the absence of choice, or what is termed "unavailability", may be even worse than higher rates.

In Massachusetts, the government "fixes and establishes" the prices that may be charged and mandates a standard policy form. Its residual market had grown to such threatening proportions that many national insurers declined to participate in its market. Massachusetts now lacks 10 of the top 15 national auto insurers. While regulators have recently tried to find some competitive wiggle room in a government dominated regulatory system, the annual determination of non-competitiveness is still routinely issued, resulting in the government directly setting auto insurance prices.

As of 1999, Massachusetts had only 47 insurers writing personal auto insurance and New Jersey had 67, well below national averages. Meanwhile, South Carolina had 76, up dramatically following several years of regulatory modernization. Illinois, without rate approval, had 126.

California imposed prior approval rate regulation, mandatory writing of good drivers and other regulation through Prop.103 in 1988. Since then, however, the overturning of the third party bad faith doctrine, judicial decisions, safety and antifraud efforts have combined to dramatically reduce underlying costs. For example, California bodily injury liability loss costs *declined* 26.3% from 1987 (narrowing the difference between Ca. and countrywide from double to 20%), compared to a countrywide *increase* of 29.75% and *increases* of 65.4% in New Jersey (now more than 90% over the countrywide average) and 14.8% in Massachusetts (now more than 80% above the countrywide average loss cost).

Because of declining underlying costs, the true potential of California rate regulation has not been felt in terms of constricting the market. It is quite possible, however, that the Prop.103 regulation has contributed to higher than expected premiums and profits for insurers because it dampened downward movement in rates reflecting the decrease in costs. If underlying costs in California rise significantly, the apparatus is there to suppress rates and constrict the market, following the path of New Jersey and Massachusetts.

There is virtually no doubt that rate regulation in high or rising cost States, when combined with controls on underwriting leads inevitably to something worse than higher premiums--the increasing inability to buy the product because there are fewer providers.

RATE REGULTION LEADS TO THE CREATION OF UNFAIR AND UNWARRANTED SUBSIDIES.

Auto insurance covers the vehicle and its drivers for damage to persons and property. To reflect the cost of producing the product for each risk, as opposed to over all rate levels considered above, many factors are used to predict future risk exposure. The most rational and fairest insurance price is the one that most accurately predicts the combination of risk exposures that the car and the drivers pose versus the risk posed by other cars and their drivers. Rate suppression often separates pricing from risk and results in lower risk drivers subsidizing higher risk drivers.

In the July 23, 2001 issue of the independent <u>Auto Insurance Report</u>, at page 6, is this commentary:

> In 2000, we believe that the Garden State has set an all-time record for disparity between the liability loss ratio and the physical damage loss ratio…This is truly an imbalanced market. Is it possible that insurers are really bad at adding and subtracting in New Jersey? No. But it is true that regulators in New Jersey gleefully require insurers to charge too little on liability, and too much on physical damage. ......…This is a consistent problem that has been in place for many years, and is now coming to a head. Insurers would gladly fix the imbalance, but regulators won't let them.

In Massachusetts, subsidies for some policyholders reach nearly $2000 annually. High risk drivers, such as inexperienced drivers, are subsidized under this system.

The subsidies go from low risk to high risk drivers, from one type of coverage to another, from one line of insurance to another and finally from one State to another. There is no doubt in New Jersey that better risks are subsidizing worse risks, that physical damage coverages are subsidizing liability coverages, that commercial insurance (through the "lock-in law") is subsidizing personal auto insurance and that the rest of the country is subsidizing New Jersey.

When these subsidies are created, they obviously harm the subsidizers and the credibility of the system, but they also harm the subsidized parties, because the poor driving behavior or other remediable causes of loss are hidden and tolerated rather than identified and remedied.

RATE SUPPRESSION HARMS THE SUBSIDIZED PARTIES AS WELL AS THE PARTIES PROVIDING THE SUBSIDIES.

Because true costs are hidden from the public, remedies to underlying conditions are often delayed or avoided altogether. Rate suppression masks problems such as the high incidence of accidents among young drivers. When their true costs are known, it helps focus attention on preventative strategies such as graduated licensing programs.

As discussed earlier, rate suppression also harms higher risk motorists the most, because being more expensive to insure, capital shortages will result in rejection or non-renewal of them first. So these people will earlier feel the harm of tightening selection competition as a result of over-regulation.

RATE SUPPRESSION WILL INCREASINGLY LIMIT THE ATTRACTIVENESS OF THE U.S. MARKET IN THE GLOBAL INSURANCE MARKETPLACE.

Until now, because of tradition and political stability a few countries, namely the U.S., Japan and some European nations had a lock on global insurance capital. That increasingly will no longer be the case. Nation after nation, including former enemies of the U.S. and places where private insurance didn't exist 10 years ago, are creating markets and regulatory systems more modern and more market driven than exist in many of our Sates. Newly emerging insurance markets with market based regulatory systems extend from Viet Nam to Azerbaijan to Jordan, and include China and India. As their political stability and rule of law strengthen and become institutionalized, these nations will begin competing for finite insurance capital. That capital will go to countries which have both stability and fundamental market freedoms and away from places where rate suppression and governmental control are the rule.

The globalization will soon be felt around the world when the decision to commit capital is not just between the States of Georgia and Illinois but also between the Republic of Georgia (without rate suppression) and the State of Georgia (with rate suppression). We all have an interest in the U.S. being able to compete effectively in the world market for the insurance we want and need. To do so will require less, not more, regulation.

CONCLUSION

Rate regulation may seem benign when costs are low. Even then, it may retard the reduction of rates to rapidly reflect declines in underlying costs, as shown by the California experience. But when underlying auto insurance costs are high or rising, as has long been the case in New Jersey and Massachusetts, rate regulation leads to rate suppression. Not only are over-all prices politically set but subsidies are created which harm both the policyholders who are subsidizing and those being subsidized. Justifiable insurer reactions to reduce their exposure to losses are blocked by additional controls over their underwriting. Ultimately, consumers suffer with a reduction in market capacity and choice. South Carolina, on the other hand, offers an example of where dismantling price and underwriting regulations can result in a stronger, more competitive market and many more choices for consumers.