TESTIMONY OF PHILIP R. O'CONNOR, Ph.D.
TO THE UNITED STATES HOUSE COMMITTEE
ON FINANCIAL SERVICES
MARCH 31, 2004

Thank you Mr. Chairman and Members of the Committee for your invitation to appear today. My name is Philip R. O'Connor and I served from 1979 to 1982 as Illinois Director of Insurance and prior to that as deputy director for research and urban affairs. For three years I served as Chairman of the Illinois Commerce Commission, our state's utility regulatory agency. Since 1986 have been in private consulting as well as in the energy business in which I am currently engaged. I have attached a brief resume to my testimony.

I testified previously on June 21, 2001to Mr. Baker's Subcommittee on Capital Markets, Insurance and Government Sponsored Entities during the earlier stages of your oversight inquiries into insurance regulation.

60 Years since the Southeastern Underwriters Decision

In just two months, we will be commemorating the sixtieth anniversaries of the momentous events of the first week of June 1944. Allied Forces liberated Rome and carried out the long awaited D-Day landings on the coast of France. In that same week there was a far less noticed event but one that has also had long lasting significance. In the 1944 *Southeastern Underwriters* case, the United States Supreme Court determined that insurance was indeed interstate commerce and subject to Congressional regulation under the Constitution's "commerce clause." Insurance was, therefore, subject to the antitrust laws.

After that decision, Congress promptly delegated the job of insurance regulation to the states and granted a rather expansive exemption from much of the Federal anti-trust laws to the extent that a state regulated aspects of insurance. We should be clear. There is no issue of states' rights here since the Supreme Court dispensed with that question 60 years ago. It is, rather, a question of how can we do the best job for consumers in assuring the availability, integrity and solidity of the insurance promise.

A great deal has changed in the larger world as well as in the world of insurance and insurance regulation in the past sixty years. This Committee is right on target in reviewing how the states are handling this important delegation of authority and whether Congress should take on a greater role in setting standards for the regulation of insurance.

The Committee has identified two central themes for today's hearing, whether competitive insurance markets better serve consumers and whether certain state based reforms can effectively promote nationwide standards in regulation.   I will be suggesting that the evidence is clear that competitive insurance markets are far superior for consumers and as for rate regulation, it is time to consider at the national level active promotion of the Illinois Model that relies on antitrust principle in insurance pricing.

30 Years of Progress in State Regulation….But There Are also Shortfalls

Over the past three decades, the states have dramatically improved the quality of regulation in a number of areas. In cooperation with one another through the National Association of Insurance Commissioners (NAIC), the states have made considerable progress in achieving substantial professional conformity and harmonization of standards and performance in such areas as financial and solvency oversight, investment regulation and operation of guaranty funds to protect consumers in the event of liquidations. I am pleased to note that Illinois has been an innovator and a leader in these areas of reform.

Not as successful, however, have been efforts to better harmonize the process for policy forms oversight and product innovation, underwriting regulation, allowing for more efficient distribution and marketing and applying consistent standards and efficient methods in market conduct examinations. In the important arena of rate setting, about half the states continue to put their faith in outmoded prior approval rate regulation regimes. Prior approval methods have remained largely unchanged since World War II when Congress delegated regulatory power to the states.

Quite sensibly, the Committee is paying attention to the areas in which there remains significant disparity among the states. And the relevant question is whether these disparities are warranted in the regulation of an industry that must be considered today to be far more “interstate commerce” than ever before.

Insurance Rate Regulation since McCarran-Ferguson

In its delegation of insurance regulatory authority to the states with the passage of the McCarran-Ferguson Act in 1945[1], Congress was engaged in accommodating much of the *status quo ante* and the applicability of the antitrust laws. There was a common expectation that the states would exercise control over rates, in great part for the traditional purpose of setting rates that would be designed to maintain levels sufficient to minimize the risk of insolvency due to inadequate pricing. By 1947, most states responded by enacting rating laws based on a model NAIC law that licensed industry data organizations (rating bureaus) but made sure to insert the state as the entity that approved rates and assured their use. Previously, the rating bureaus in many states had enforced rate adherence.

By the mid-1960s, a number of states had taken the path blazed by California in 1947 or relying on competitive pricing rather than prior approval. These states were trying to address a serious shortage in the auto insurance markets that were being exacerbated by increasingly adverse prior approval rate decisions. The Illinois experiment of reliance on antitrust principles emerged from that era. Eventually, in 1981, the NAIC adopted an alternative competitive rating law for consideration by the states.

Heading into the decade of the 90s, California voters, in reaction to a tort driven run-up in auto insurance rates, adopted Proposition 103 that instituted prior approval to replace its trailblazing 1947 competitive rating law. While Prop 103 was dramatic and has been portrayed as somehow revolutionary, court decisions and regulations promulgated since passage have made the

[1] U.S. Code Section 101 et seq. (1945)

California system a fairly traditional prior approval system with a bias toward reliance on competitive forces.[2]

Today, rate regulatory regimes run the gamut. There are rates that are basically "state made", prior approval of rates with extensive proceedings, prior approval with light handed oversight, "flex-rating" systems that review rate changes exceeding certain thresholds, competitive pricing with residual review mechanisms and the Illinois Model. In all cases, insurers are able to participate to one extent or another in loss data collection and analysis by state-licensed organizations.

Competitive Rating is Superior to Prior Approval Regulation

It is rate regulation that we find some of the deepest disagreements about regulatory policy. In my opinion, however, the experience and the research of the past thirty years actually leave little room for substantive disagreement. In my view, the verdict is in. Classic prior approval rate regulation offers no protection for consumers. If anything, it perpetuates a costly illusion that government price regulation can magically lower prices below competitive market levels while at the same time stimulating an adequate supply of coverage for a growing economy and the protection of business and family assets.

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[2] In my June 21, 2001 written testimony to the Subcommittee I devoted considerable space to a review of the report of the Consumer Federation of America authored by Robert Hunter contending that Proposition 103 represented a significantly new and different approach to rate regulation and had produced substantial beneficial results. I concluded that in the end the system produced by Prop 103 was neither all that new and different nor has it produced significant benefits. The available independent academic research largely coincides with my conclusions. See "Regulation of Automobile Insurance in California" in *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency*, J. David Cummins (Editor), Brookings-AEI Joint Center, May 2002.

I believe that, for the most part, those states that stay with prior approval systems do so largely out of habit and inertia. It is no longer seriously contended that state rate regulation provides any particular assistance to solvency oversight, an original objective of rate regulation. Over the past 60 years there have been substantial advances in state financial regulation and in actuarial techniques and massive expansion of loss data bases. Some states, however, have found themselves in such deep trouble with the results of historically over-regulating their markets that they now have genuine difficulty making the hard decisions to take a new course. Finally, a few have made decisions to revert to prior approval in some form.

Virtually every bit of reputable academic and governmental research conducted over the past thirty years either concludes that reliance on competitive pricing in insurance produces appreciable tangible consumer benefits or, at the very least, prior approval produces no discernible benefits for consumers. The minimal support for price regulation in the literature is to be found mainly in polemical papers from one advocacy organization or another. The essence of the story is that we have a level of consensus rare in the social sciences and studies of government policy.

In 2001 my testimony included a summary of a report I had co-authored for delivery to the National Conference of Insurance Legislators (NCOIL).[3] There were some basic conclusions in that report that go directly to the heart of the Committee's theme of whether consumers are better served by

[3] *Modernizing Insurance Rate Regulation: Tacking to the Winds of Change*, by Philip R. O'Connor, Ph.D. and Eugene P. Esposito, J.D., PROactive Strategies, Inc., April 2001. (Available on request from Phil_OConnor@earthlink.net)

competitive markets. There is a strong basis for believing that those conclusions remain unaltered today.

- Prior approval states show no evidence of being able to keep rates lower than in competitive states;
- Among the dozen most costly auto insurance states, prior approval rate regulation is the pre-dominant regime[4];
- Prior approval states tend to have higher exit and lower entry rates of insurance companies, with some states such as Massachusetts and New Jersey having lost over half of the auto insurance companies operating in those states between 1980 and 1999 and others losing about one-third of their homeowners insurers (see charts attached to this testimony);
- Prior approval states tend to have auto insurance residual markets (provider of last resort pools) with larger market shares than do competitive states (see the charts attached to my testimony);
- Prior approval states tend to have more volatile loss ratios than do competitive states, suggesting larger and more erratic price swings;
- Prior approval states do not, as a group, have long-run average loss ratios much different than do competitive states, indicating that consumers do not get more of their insurance dollar back in claims payments;
- Prior approval states tend to create large cross-subsidies within the voluntary market as a result of more intervention in risk classification;

[4] See the Facts and Statistics section of the Insurance Information Institute's website for the most recent state comparison of auto insurance rates at http://www.iii.org/media/facts/statsbyissue/auto/

- Prior approval states tend to have larger subsidy flows to the residual markets;
- Consumers receive less accurate and less timely price signals about risk whereas in prior approval states consumers are more likely to see market conditions manifested in shortages of coverage;
- Prior approval states allocate regulatory resources to an unproductive regulatory ritual;
- In prior approval states, price changes tend to be political events rather than normal economic events.

The Illinois Model: Reliance on Antitrust Principles in Pricing

My own research work, beginning when I was research director at the Illinois Insurance Department in the late 1970s, has been oriented toward comparative studies of the performance of different rate regulatory regimes across the states and over time. As a result of my research and as a former insurance regulator in Illinois, I have become increasingly convinced that what has often been called the Illinois experiment has evolved into a proven model that Congress and other states should carefully consider for widespread adoption.

Since 1971, Illinois has operated without a law regulating property and casualty insurance rate, with the exception of workers compensation and medical malpractice. In those two lines, the law provides that rates in a competitive market are deemed not to be excessive and there is residual authority for the Director if the market is found non-competitive. Illinois was the first state to implement the conversion from classic prior approval in workers compensation in 1983.

The Illinois Model, in effect, accepts the applicability of Federal anti-trust laws to most property and casualty insurance pricing in the state. Certain important areas of common activity such as loss data collection and analysis can be conducted in concert under state oversight but pricing is an individual insurance company responsibility.

The Illinois Model is simple and requires minimal regulatory resources. It creates a climate that attracts the largest share of operating P&C companies (see the charts attached to my testimony) of any state in the nation and has been the key reason that periods of inadequate supply in any line of coverage have tended to be short. Repeated surveys comparing homeowners and auto insurance rates across states consistently finds Illinois right in the middle.[5] One indicator of the success of the Illinois model is that political controversy about insurance rates has been fairly rare over the years, especially in contrast to a variety of prior approval states where the controversy never seems to end. Neither house of the Illinois General Assembly has ever passed a bill to impose rate regulation in any form since 1969.

Interestingly, the Illinois Model was not so much an experiment as it was a happy accident. In 1971, the General Assembly was unable to agree on re-enactment of or changes to a two-year trial run of a competitive rating law to replace the classic prior approval law. To the surprise of everyone, it seems,

[5] See the Facts and Statistics section of the Insurance Information Institute's website for the most recent state comparison of auto insurance rates at http://www.iii.org/media/facts/statsbyissue/auto/

the lack of a trigger re-imposing the old law left Illinois with no P&C rating law at all. At first, when the roof did not fall in, there was little motive to act. As the years went on, partly during the time I was Director, we all began to figure out that what we were originally embarrassed by, was actually becoming a badge of honor. The Illinois Model was the result of a "penicillin scenario."

The key specific elements of the Illinois Model are:

- Property-liability rates, other than for workers compensation and medical malpractice, are not subject to regulatory review or action by reason of excessiveness or inadequacy. Work comp and med mal rates are deemed not excessive as long as the Director has not made a finding of a noncompetitive market.
- Illinois law prohibits unfair discrimination. No rate can 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. 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 such as encouraging the installation of auto anti-theft devices and senior citizen driver training.
- Insurers are permitted to participate in the joint development of trended (forecasted) loss cost data for all lines, including workers compensation, through licensed advisory organizations.
- 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.
- Residual market mechanisms (the auto assigned risk program, the FAIR plan for fire, homeowners and renters and workers comp assigned risk) are subject to prior approval rate regulation by the Director of Insurance. Rates are set with attention to avoiding under-pricing that would encourage excessive use of the plans. These plans in Illinois have small market shares: auto 0.03%, FAIR Plan 0.25% and work comp between 8 and 9% in the hard market of 2003).
- 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.

- Illinois continues to regulate rates in credit insurance, a line that is characterized by the potential of "reverse competition."
- The Illinois Insurance Department also conducts 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.

Researchers have repeatedly compared Illinois to other states in terms of important outcomes and Illinois consistently fares well. Auto and homeowners insurance 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 in personal lines, the state has the largest number of licensed personal lines insurers and the Illinois Insurance Department has been able to devote resources to professionalizing its capabilities.

The Illinois Model Could Work Well across the Country

After more than thirty years of operation, the Illinois Model is ripe for export and possibly even for adoption at the national level. The Illinois Model is an approach to P&C insurance rates that could be easily and confidently applied to all states. The Illinois Model does not require the creation of a new bureaucracy or the development of any complicated rules or standards. Transaction and compliance costs for regulated companies and consumers do not increase and are likely to decrease. In contrast, of course, application of a prior approval approach to all states would create new bureaucracies, require voluminous new rules and increase compliance costs.

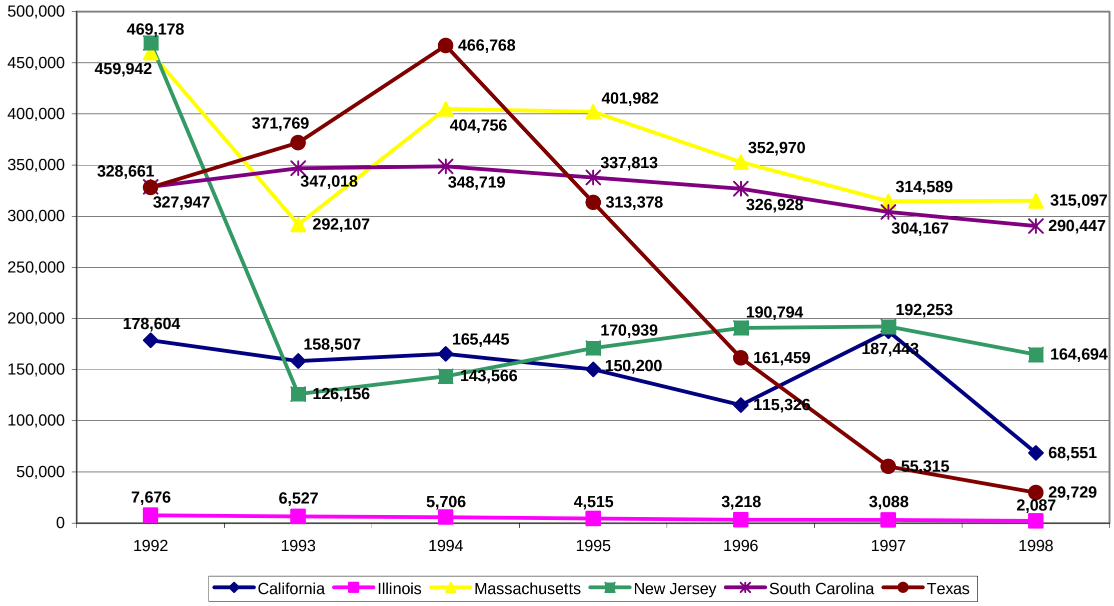
More important, however, the Illinois Model would be highly likely to deliver consumer benefits. Indeed, if every state were to address rate regulation by way of a reliance on competition and anti-trust principles, those states with competitive rating laws in operation would see little change, while those states with extreme prior approval systems that produce chronic shortages of insurers and insurance would see more normal markets develop. Consumers would have more options to meet their needs and insurers likely see a lower cost of capital, all things being equal, to the extent that regulatory risk in pricing was largely eliminated.

For Congress, the interesting question to consider is that while the Illinois Model has proven itself, not even Illinois adopted its approach consciously and directly. As explained, the Illinois Model was serendipitous. It may well be that for other states to take the steps necessary to install the Illinois Model, there will need to be serious encouragement to do so or perhaps even Federal legislation that would help states effectuate the change.

Residual Market Private Passenger Liability Premium 1992-98 (000 omitted)

[Source AIPSO Facts 1999]

Figure: 1



Private Passenger Automobile 1980-2001
Six State % of U.S. Companies Available To Sell Auto Insurance
[Source: A.M. Bset Executive Data Service]