Testimony of
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Arkansas Insurance Commissioner
And
Member of the National Association of Insurance Commissioners

Before the
Senate Committee on Commerce, Science and Transportation

Regarding:
Oversight of the Property and Casualty Insurance Industry

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Chairman Inouye, Vice Chairman Stevens, Senator Pryor and members of the Committee, thank you for the opportunity to testify here today on the role of insurance commissioners in regulating the property and casualty insurance, the financial health of the property and casualty insurance industry, and its market activities such as pricing, underwriting and settling claims.

My name is Julie Bowman. I am the Insurance Commissioner for the State of Arkansas and an active member of the National Association of Insurance Commissioners (NAIC). Related to the topic matter of today's hearing, I serve as Vice Chair of the NAIC's Market Regulation and Consumer Affairs Committee and am a member of the Workers' Compensation Task Force, the Speed to Market Task Force, the Operational Efficiencies Working Group.

Today I would like to provide my perspective to help you understand how insurance regulators protect consumers and my views on the health of the property and casualty insurance industry and their market activities.

- First, the most important job of an insurance commissioner is to protect insurance consumers. This is accomplished by maintaining strong, cooperative regulatory oversight of insurer solvency and monitoring insurer marketing activities so that a healthy competitive marketplace exists to serve consumers.

- Second, there is misunderstanding about what constitutes an insurance market and how insurers go about serving the markets that they choose to serve.

- Third, in spite of paying for record levels of catastrophes in 2004 and 2005, the financial health of the property and casualty insurance industry has never been better.

- Finally, I will comment on insurer pricing, rate regulation, and insurer practices related to claim settlement and underwriting. In particular I would like to explore

some myths that are promoted by some who hope that you would do away with state-based insurance regulation or at least offer them a choice of regulatory frameworks.

Insurance Regulation and Consumer Protection

The most important job of an insurance commissioner is to protect insurance consumers. This is accomplished by maintaining strong, cooperative regulatory oversight of insurer solvency and monitoring insurer marketing activities so that a healthy competitive marketplace exists to serve consumers.

In its simplest form, insurance regulation is about two things. The primary job of an insurance regulator is to make sure that insurance companies remain solvent so that they can pay claims as they become due and to make sure that insurers treat their customers and claimants fairly. An insolvent insurer does not have the resources to pay its claims and therefore, is of no use to either its policyholders or those with claims against them. A recalcitrant insurer that fails to comply with state consumer protection laws and regulations also can be a problem if it fails to deliver the expected insurance benefits to consumers at times when they are needed the most.

The goal of financial regulation is protecting consumers against excessive insurer insolvency risk. Insurance regulators protect the public interest by requiring insurers to meet certain financial standards and taking remedial action when needed. Congress has chosen to leave the regulation of insurers to the states under the terms specified in the McCarran-Ferguson Act, and state legislatures have created regulatory frameworks in state law to address financial regulation. A typical state would have capital adequacy standards that would include minimum capital and surplus requirements to protect policyholders and claimants against unexpected increases in liabilities and decreases in the value of assets held by insurers. In addition, states also use a risk-based capital test that more specifically measures the risks each insurer assumes. Risk-based capital is intended to provide capital adequacy standards that are related to risk, that raise the safety net for insurers, that are uniform among states and that provide for regulatory action when actual capital falls below the standard.

States also have enacted legislation that regulates the reserves that an insurer is obligated to set aside for future claims payments. One of the uncertainties for property and

casualty insurers is to determine the reserves needed for claims that have already occurred, but not yet paid. Regulators review insurer financial statements and actuarial opinions to assess whether insurers are establishing adequate reserves for unpaid losses.

There are investment restrictions specified in state laws. State laws take a conservative approach to insurer investments with most states limiting the amount of investments an insurer can make in non-investment grade assets. State regulators work collectively through the NAIC's Securities Valuation Office (SVO) to monitor the assets held by insurers. The SVO assigns a credit rating to assets that are not otherwise rated by a rating agency such as Standard & Poors or AM Best. This function helps state examiners with their evaluation of the assets that an insurer holds as part of a financial examination.

These regulatory requirements are of little value if there is no mechanism in place to monitor insurers' compliance with the requirements. The purpose of solvency monitoring is to ensure that insurance companies are meeting regulatory standards and to alert regulators if action is needed to protect policyholders' interests. State regulators have established a vast solvency monitoring system that encompasses a range of regulatory activities, including financial reporting, early-warning systems, financial analysis and onsite insurer examinations. Annual and quarterly financial statements filed by insurers serve as the principle source of information to assess insurer financial position. Insurers generally are examined every three years. States coordinate the financial examinations through the NAIC association-wide or zone exams process to avoid duplicative or redundant examinations of the same insurer.

State insurance regulators have developed a certification program for insurance departments. The goal of the certification process is to ensure that a state's solvency regulation meets certain minimum requirements so that other jurisdictions can have a degree of confidence in the state's financial oversight of its domestic insurers. Adopted in 1990, the NAIC's Financial Regulation Standards and Accreditation Program establishes standards that states must meet to become accredited. Each insurance department's financial regulatory framework and monitoring program is reviewed by an independent review team that assesses the department's compliance. A compliance review will look at three areas: laws and regulations; regulatory practices and procedures; and organizational and personnel practices. States that pass the review are recognized as accredited states.

Market regulation deals with insurer pricing, product development and market practices. If insurers are able to use their market power to raise prices above competitive levels, then regulators can improve market performance by setting a price ceiling at the competitive price level. This rarely happens as the competitive structure of most markets prevents insurers from acquiring significant market power.

Market regulation also encompasses review of contractual language before it is sold to consumers. This basic consumer protection helps both the insurer and the policyholder by having an expert state employee review the insurance contract before the transaction with the policyholder. Property and casualty insurance contracts are based in state laws and regulations. State regulators with expertise in the state's civil justice system and requirements enacted by the state legislature review the contract for statutory compliance.

Another form of market regulation is the market analysis and market conduct examination process. Market analysis is about the collection of data and review of it to determine if insurers are treating policyholders and claimants fairly. Market conduct examinations are called if the regulator suspects that an insurer is failing in this duty. Some market conduct exams are done without suspicion of wrong doing. In this type of exam, a regulator would review a sampling of claims files to see that statutory timeliness requirements are met and that the insurer provided the claimant with a reasonable settlement in accordance with the policy provisions.

Insurance Markets

While the rest of the world thinks of the United States as having the largest insurance market, it is not a single marketplace but rather a combination of a smaller markets that, when aggregated, yield a $1.35 trillion "marketplace." In comparison, the insurance market in Japan is roughly $475 billion and the UK is $300 billion. The largest state market is California with $124 billion in written premiums. Only Japan, the UK, France Germany and Italy have larger markets than California. Following California is New York with $116 billion, Florida with $92 billion and Texas with $82 billion. Of the top ten jurisdictions in the world, four are the states previously mentioned. My state, Arkansas, has $8.6 billion, slightly less than Poland and Mexico, but larger than the insurance markets in Argentina, Turkey, Israel and Thailand.

One could assume that each state has a single marketplace, but even that comparison is inaccurate. For example, in Arkansas, we do not spend much time worrying about hurricanes. I know my fellow commissioners in the Gulf States spend a great deal of time thinking about them and how to finance the devastating losses that they cause. Our property insurance writers are more concerned with tornados, lightning and hail. We also have some earthquake risk as we are exposed to the New Madrid Fault. Although you might view Arkansas as a small state from an insurance perspective, we have two distinct insurance markets when it comes to personal lines polices such as auto insurance and homeowners insurance. Little Rock is an urban area with different market dynamics than the rural areas of the state. As I mentioned earlier, the Eastern part of our state has earthquake exposure that is different from the Western portions of the state.

Since insurance markets are different, insurers approach them in different ways. Citizens in Western Arkansas have no difficulty obtaining earthquake coverage, while the Eastern residents, particularly those living near the fault line, have recently experienced some availability problems and the prices for the coverage, when offered, have risen sharply. In most the country, for most lines of business, insurance is a voluntary offering by a private enterprise with the intent that the insurance sold will generate sufficient revenues to pay all claims and expenses with a little bit left over to provide a profit for the owners. Sometimes the public misperceives that they have a right to obtain insurance.

We do have some obligation to make sure that our citizens can obtain the essential insurance coverages that they need. Most state governments require that citizens buy auto insurance if they wish to operate a motor vehicle. Banks and other lending institutions generally require the purchase of property insurance as a condition for obtaining a loan. Thus, it is in the public's interest for government to take steps to see that all citizens are served by making available auto insurance and property insurance to those that need it. When the private sector chooses not to serve a market, the states generally have stepped in and created a residual market to meet that pressing need. A variety of types of residual market mechanisms are available in the states, including FAIR plans, catastrophe funds, assigned risk plans and joint underwriting associations.

Nationwide, the property and casualty insurance market for individuals and businesses is healthy and competitive. It has been well recorded that, despite record catastrophic losses, the industry is also enjoying record profits. However, there are some coastal

regions of the country where the insurance market is in crisis, due largely to insurers' reluctance to provide insurance in areas of perceived high risk and, subsequently, the reinsurance costs associated with those areas. It is important for you to know that insurance costs are not going up directly to recoup the losses of 2004 and 2005. They are going up because the losses of 2004 and 2005 have demonstrated a level of risk potential for the future that has insurers rethinking what their prospective losses will be going forward. When an insurer suffers a 1-in-500 year event in consecutive years, it rightly begins to question the validity of its models and risk management assumptions, and adjusts its future expected losses accordingly. At the same time, reinsurers are drawing those same conclusions, which add to the overall price increase.

In terms of what areas of the country are suffering an insurance crisis, another important distinction is the difference between coastal states and coastal regions within those states. Most coastal states, perhaps with the exception of Florida, have a relatively healthy property and casualty market in the vast majority of the state. Even in Florida the auto insurance market is performing well; however, the property insurance market is troubled. In Alabama, only 2 of the 67 counties are having insurance issues, and even within those counties, the problems are limited largely to within just a few miles of the coast. In Mississippi, 6 of its 82 counties are directly experiencing problems. Louisiana, which took the brunt of hurricane Katrina, only has experienced troubles in the 24 of its total 62 coastal parishes. These trouble spots are somewhat limited, but they comprise the bulk of the cases we have all heard about on the news, where insurance costs are skyrocketing, building has come to a standstill, and mortgage defaults are on the rise.

In some areas of the country however, the lack of availability and affordability is impacting the entire state – as is the case in Florida and South Carolina. The Florida market has been battered by 8 storms in 2 years resulting in $38 billion in losses, and the impact spans virtually the entire state. For those living in Florida's high-risk areas, the real tragedy occurred after the storms as policyholders experienced displacement, shortages in building supplies, shortages in homebuilding labor, rising insurance premiums, mortgage defaults, and the unavailability of private insurance. Even today, one can sea blue tarps covering homes that have not been repaired fully from the prior hurricane seasons.

Although the voluntary market recapitalized by infusing approximately $1 billion of new capital into the private market, this situation is not self-sustaining. There are a far greater number of insurance companies exiting the homeowners insurance market than there are new companies entering. Even for those companies staying in the market, there has been a significant retrenchment. Companies are enforcing stricter underwriting standards to limit their exposure in certain high-risk areas or limiting types of property they select to insure.

South Carolina has been at the forefront of regulatory modernization and is considered a model regulatory environment by many insurers. The state also adopted the 2003 International Building Codes and has not had a direct hit from a major hurricane (e.g., Category 3 or better) in nearly two decades. Yet, South Carolina is experiencing many of the same problems that the gulf coast states are experiencing. Shortly after hurricane Katrina, admitted carriers were seeking to increase rates by 100 to 200 percent, decreasing coverage by requiring 5 to 10 percent deductibles, non-renewing long-term policyholders and discontinuing writing new business in certain areas. Surplus lines carriers were increasing rates even more – by as much as 300-400 percent. Condominiums were particularly hard hit as insurers recognized the risk concentration they presented. One development saw its premium increased from $126,000 to $879,000 and it took 5 different insurers to piece together the coverage. Many condominium owners in South Carolina are retirees and senior citizens on fixed incomes so, again, this problem is having a disparate impact on a large segment of the population who do not have many options.

South Carolina has implemented many of the measures the insurance industry says need to be in place to create the kind of free-market environment that would enable the private sector to handle this problem, and yet, the state is seeing only scattered relief from the lack of available and affordable property insurance. In South Carolina's coastal counties, the number of policies written by admitted insurers has only increased 3 percent, while population has grown 9 percent, building permit activity has increased 27 percent, and property values have increased 28 percent since 2000. Like other coastal states, South Carolina also has a wind pool to pick up policies that the private market won't cover. From 2001 through the third quarter of 2006, the written premiums for the Wind Pool increased 88 percent for residential lines and 448 percent for commercial lines. In the

past several months, however, there are indications that the coastal property insurance market may be improving. Insurers are not reporting the same problems acquiring reinsurance as they did in 2006. Other insurers and producers have indicated that capacity within the reinsurance market has increased and that reinsurers are looking at deploying that increased capacity in the coastal property insurance market in South Carolina and other southeastern states. Additionally, the Wind Pool has reported that it is losing some of the condominiums that it insured in 2006. These condominiums are canceling coverage with the Wind Pool because they are finding better coverage and/or better rates elsewhere. Recently, the Wind Pool indicated that it has had some days with negative written premium. All are indications that there is more capacity within the market.

Outside of Florida, those markets are absorbing the impact of recent catastrophic events, but in areas that were hit hardest, insurers are responding as if the next big catastrophe is certain to be a hurricane that hits the exact same region in the gulf coast, and pricing coverage accordingly. This begs the question, what happens if the next catastrophe is an earthquake in the Midwest or a massive Nor'easter in New England? Will those policyholders see a doubling and tripling of their rates because insurers are not adequately hedging their risk, and we as a nation are not doing the pre-event building, planning, and mitigation steps that limit those losses? Clearly, people who build and buy homes or operate businesses directly in harms way, whether that is on a coastline or a fault line, should pay insurance costs that reflect that risk, but they should not be the scapegoats for insurers, reinsurers, risk modelers, regulators, and legislators who fail to learn the lessons of 2004 and 2005.

Financial Health of the Property and Casualty Industry

Let me first caution that the figures I am providing are preliminary and might change slightly as more information arrives in regulators' offices. Annual financial statements are due March first of each year. There are some insurers who ask for and are granted filing extensions. When the filings are received, they undergo a thorough evaluation with many checks and balances known as "crosschecks" that are applied to assure that the data submitted is complete and as accurate as it can be. This process takes time.

It is safe to say that 2006 was a very good year for the U.S. property and casualty insurance industry. There were no hurricanes that made landfall in 2006 and other catastrophe losses were low. The lack of major catastrophes combined with favorable market pricing conditions led to a record year for insurers. The industry posted an underwriting gain of over $34 billion and it achieved its lowest combined ratio in years, estimated to be 92.6 percent. The combined ratio is a way to determine if insurers made money on their insurance operations with 100 percent combined ratio being a break-even point. Thus a combined ratio below 100 percent means that the underwriting part of the business was profitable. In addition to making money on underwriting, insurers also make money on their investments. Between underwriting results and investment results, the property and casualty industry's policyholders' surplus grew to almost $480 billion.

Rate Regulation and Insurer Practices

You likely will hear from industry representatives that rate regulation causes them to be less competitive than they might be otherwise. They generally refer to rate regulation as price control. This is an inaccurate term. The process in almost all states for virtually all insurance products written by property and casualty insurers starts with the insurance company actuaries preparing a rate change proposal and providing it to insurer management. Management considers the input from their actuaries and from their marketing people and decides whether a rate filing will be submitted and, if so, how much will be charged. The rate filing is then prepared and submitted to the state regulator. In some cases, it must be approved by the regulator, but for many states and many lines of business, it does not. For example, in Arkansas, for personal lines products and small commercial lines products an insurer would file the rates and be able to use them within 20 days as long as the markets are competitive. Prior approval would be required only if I were to find that a particular market is noncompetitive. Insurers who write large commercial risks would not even be required to make a filing.

Insurers often maintain that price controls make them noncompetitive. I think you will agree that the financial performance of the property and casualty industry in recent years makes that statement ring hollow. I expect that some witnesses will agree with these statements and suggest that insurance regulators should do more to lower prices.

Insurance is a cyclical business. In some years, insurers make a decent return and, in other years, competitive forces lead them to lower prices and they lose money. Catastrophes can affect the bottom line. It is a regulators job to balance the competing interests of all parties to the insurance contract. Insolvent insurers do not pay claims so insurance regulators must be sure that insurers are charging adequate rates. Consumers want to pay low prices for quality insurance products. Thus the insurance regulator must assure that rates are not excessive and that the insurance contract delivers reasonable benefits that comply with state laws and regulations. Insurance consumers want their insurers to treat them fairly with regard to price and claim settlement. Thus the insurance commissioner is charged with making sure that rates are not unfairly discriminatory. I say "unfairly discriminatory" because rates are, by nature, discriminatory. Insurers assess the risks that each consumer presents and have a rating system that uses a variety of risk classification factors to determine the price that a person or family will pay. Each state has an Unfair Trade Practices Act and many have Unfair Claim Settlement Practices Regulations that govern insurer conduct in the marketplace.

The invitation letter to this hearing inquires about claims and policy writing practices of insurers. Insurance is a business of contracts. Each insurance policy is a contract between the policyholder and the insurer to perform certain activities if certain unintended events occur. The requirements for the coverage provisions of insurance contracts are based in state law and regulation. It may be that if a state has enacted a law or regulation, it is because some insurer at some time disadvantaged a policyholder or claimant who complained about the treatment to a state legislator who drafted a law to fix the problem. Thus, not all insurance contract provisions have a law in place that specifies how that contract is to be drafted. Since actions of insurers are local, it also safe to say that no two states have exactly the same laws on the books.

Recent news events related to the 2004 and 2005 hurricane seasons have shown a spotlight on insurance contracts. The most common problem was consumer dissatisfaction with claim settlements related to whether it was wind or water that caused a particular loss. This problem arose because the coastal consumer cannot go to a single insurer and obtain all of the coverages he or she needs. The National Flood Insurance Program (NFIP) was created in the 1960s because insurers no longer wanted to provide coverage for floods. The storm surge in hurricanes is considered to be a flood by the

insurance industry and the NFIP. To be fully covered in a coastal county, a family might need to purchase three separate insurance policies: a homeowners policy from a private insurer that covers all perils except for wind and flood, a wind policy from a state-based wind pool and a flood policy from the NFIP. The problem for the consumer arises when there is debate about which of the perils caused a particular loss. In other words, did the wind knock down the house before the storm surge washed all the wreckage away or did the house withstand the wind only to be washed away by the storm surge? When all that remains of the house is a pile of rubble, it is difficult for claims adjusters to determine which peril was responsible for the damages. Having multiple adjusters assessing a single loss only compounds the problem.

A companion problem is the fact that the homeowners policy, the wind policy and the flood policy all have different coverage limits and the details of what is covered differ in each policy. Thus, it is possible for a well-meaning homeowner to try to do the right thing by purchasing three insurance contracts and end up with a shortfall at claim settlement time.

Much has been made of the anti-concurrent cause language in a standard property insurance policy. This provision is a direct result of the bifurcated insurance system we have, and was developed by the insurance industry to protect insurance companies from having to pay for losses (in this case, flood losses) which are excluded from coverage and for which they did not collect a premium. It is a provision that frankly had not been tested at the magnitude of a storm like Hurricane Katrina where wind and water losses were so wide spread. Some have suggested that this provision allows companies to avoid paying their obligations of coverage when flood damage is present. This is <u>not</u> the intent of that language, and the vast majority of companies do not distort the provision to shirk their obligations. In Mississippi, for example, where this issue has become the subject of much debate, Commissioner Dale issued a bulletin immediately following hurricane Katrina to all property and casualty insurers instructing them that the burden of proof for determining the cause of loss is on the insurers, not the policyholders. Furthermore, Commissioner Dale advised companies that when there was doubt as to whether damage was caused directly by flood or wind, the insurers were to err in favor of covering the insured.

Despite this, there have been serious allegations that some companies or adjusters have wrongly denied claims while misconstruing this provision, and they are now being forced to defend that contention to their insurance department or in the courts. The fact that insurers feel compelled to structure their policies to create legal barriers to segregate various perils (with the cost to defend these legal barriers often factored into rates), and those barriers add confusion and uncertainty for policyholder who are now challenging those barriers in courts. It is worth considering a system that offers consumers an all-perils policy that covers wind and water and eliminates the need for this provision along with any possible distortion or manipulation of its intent.

Our role as insurance commissioners is to foster an industry that prepares people before and then provides for them after some of the worst possible events that they may endure in their lifetime. Thank you for taking the time to hold this hearing, for inviting me here today to participate, and for your continued interest and leadership on this crucial issue. I am pleased to answer any questions that you may have.