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# FACT SHEET

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## **Insurance Regulation and Solvency: The Role of Government**

The government's role in insurance regulation originated for several important reasons, both of which the insurance industry strongly supports. The first purpose was to help guarantee the solvency of insurers, thereby protecting their customers. The second was to monitor how insurance companies conduct themselves in the market place, and ensure proper and ethical business conduct.

In the early days of insurance regulation, the emphasis was on accurate underwriting and rate adequacy. It was widely recognized that insolvent insurers are unable to compensate policyholders. Over time, however, the role of the regulator in some states shifted to that of "guaranteeing" affordability of insurance. While this type of regulation may appear to be consumer-friendly, history and experience have demonstrated that it has the opposite effect.

The price of insurance, like the price of any other product, is a factor of cost. Insurance regulators can control the price of insurance, but have no control over the prices of the things insurance pays for: medical costs; the price of construction materials; home values; labor costs; the price of automobile parts. That is why, no matter how well-intended, artificial price controls do not work in the long run. Businesses cannot price their product below cost for any extended period of time and expect to stay in business. When this economic reality is ignored, new companies have no incentive to enter the market and some companies will start to leave. This puts upward pressure on prices—the exact opposite effect from that intended by those who advocate price controls.

To further complicate matters, insurance rating is prospective. The premiums collected today are not used to pay for losses which have already happened. Instead, the premiums paid today go to help pay for the losses that will occur in the future. Price controls tend to be retrospective. That is, prices are typically suppressed after it's deemed that insurers have made what appear to be "excessive" profits. This has the unfortunate effect of

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essentially forcing insurers to operate from “paycheck to paycheck,” existing on only enough revenue to operate and not accumulating the cash reserves necessary to respond to future claims.

New Jersey and South Carolina are both examples of states where heavy-handed regulation and stringent attempts to control prices did not work. Thirty years of attempts to “fix” auto insurance in New Jersey did nothing to change the fact that New Jersey’s auto insurance rates are among the highest in the country. Instead of lower prices, New Jersey consumers were left with fewer and fewer choices as insurers fled the state. It wasn’t until New Jersey passed legislation to improve competition and reduce heavy-handed regulation that companies re-entered the market. Companies like GEICO and Progressive, that weren’t in New Jersey five years ago, are now selling auto insurance there.

In the late 1990s, South Carolina was considered one of the most restrictive rate regulated states in the country suffering from a significant problem with the availability of insurance. In 1997, the legislature passed a measure which would allow insurers to vigorously compete for price without government intervention. The number of auto insurers doing business in the state quickly doubled, rates stabilized and, in some cases, declined. Based on the success of that market-based experiment with auto insurance, South Carolina extended the law to include homeowners insurance with great success for consumers.

Each of these states continues to vigorously regulate issues relating to insurer solvency and the manner in which they conduct themselves in the market place.

In 2003, the Texas Legislature passed insurance reforms that modernized insurance regulation in Texas and created the framework for a competitive environment for insurers. Their intent was to create an atmosphere where competition, not the heavy hand of regulation, was the key to stabilizing rates, encouraging more companies to enter the Texas market and offer abundant choices for consumers.

As part of the reforms passed by the Legislature, Texas adopted a “file and use” system of regulation. Under “file and use,” insurance companies are required to file rates but are then permitted to use the rates without waiting for approval. The Insurance Commissioner retains the authority to review and disapprove rates.

The responsibility for implementing the objective of the legislature is now the job of the Texas Department of Insurance. The fate of a consumer-friendly, intensely competitive system where insurers can offer inducements in the form of price and service rests in the hands of Texas regulators.

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The auto insurance market in Texas has operated under a file and use system and the results have been quite positive. Overall rates have declined, competition for price and service prevails and consumers have choices in what they purchase and at what price.

The same is true about workers' compensation insurance where rates are determined by strong market forces and vigorously competitive market-driven rates. The ultimate beneficiaries are employees covered by workers' compensation and the employers who purchase it. This insurance product also falls under a file and use system.

The foundation of insurance regulation from the beginning was to monitor the financial strength of insurers and their business behavior in the marketplace. Hopefully, as Texas transitions to a market-based and competitive environment, where insurers can vigorously compete to offer the best combination of value, service and products, regulators will center their attention where they can truly benefit consumers: on company solvency and market conduct.

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