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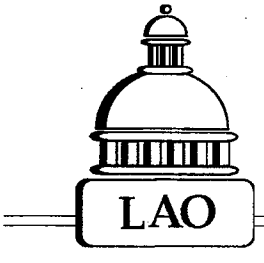
The 1990-91 Budget:
Perspectives and Issues

Proposition 103-- One Year Later



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Proposition 103--One Year Later

What Has Been Done to Implement Proposition 103 During the Last Year and What Issues Are Still Outstanding?

Summary

On November 8, 1988, California voters approved Proposition 103, which called for 20 percent rate rollbacks and ongoing regulation of the insurance industry. Our review of the past year's activities by the department suggests that considerable time will pass before the regulatory process has been fully developed and implemented. The department has proceeded slowly; thus, there are many elements of the regulatory approach that have not yet been developed and numerous issues remain to be resolved. In effect, while much activity has occurred over the past year, we are in essentially the same place as when the initiative passed.

One of the stated purposes of Proposition 103 is to encourage a competitive insurance marketplace. Our analysis suggests that many competitive elements already are present. Thus, it is not clear that California's high insurance premiums are due to a noncompetitive industry. This suggests that the insurance industry may not require a very intrusive regulatory approach in order to adequately safeguard the public against noncompetitive behavior and performance, including excessive premium rates. Our analysis also indicates that, in setting the level of allowable premium rate increases, it is very important that this process be based on sound assessments of a company's current and projected financial position and of investment market conditions.

In addition, we recommend that the Legislature review the statutes establishing the California Automobile Assigned Risk Plan in order to clarify the plan's purpose so that actions by the Insurance Commissioner are consistent with legislative intent. Finally, we recommend that the Legislature continue its review of factors that affect the underlying cost of insurance claims, since we believe there are significant opportunities for gaining control over insurance costs.

Almost 14 months ago, California voters approved Proposition 103, which required insurance premium rate rollbacks, ongoing regulation of rates for all property/casualty insurance companies, and changes in the way individual premiums are set for automobile insurance. Last year we examined Proposition 103 (please see "Insurance Reform," *The 1989-90 Budget: Perspectives and Issues,* page 289) in order to assess the effects of the initiative on the automobile insurance market. We concluded then that:

- The full effects of Proposition 103 on buyers of insurance (prices and availability) and sellers of insurance (profitability and regulatory environment) would be known *only after* the measure is fully implemented.
- The insurance industry exhibits many characteristics of a competitive industry and we were unaware of evidence of persistently high or "excessive" profits on an industry-wide basis.
- Costs of insurance claims are a key factor in explaining increasing premiums.

During the last year, a number of events related to the implementation of the initiative have occurred, most involving the Department of Insurance and its Commissioner. However, for many reasons the full implications of Proposition 103 *still are not yet known.* (For a discussion of the budget implications of delays by the department, please see our *Analysis of the 1990-91 Budget Bill,* pages 238-40.) Given the far-reaching implications for insurance buyers and sellers of these implementation activities, in this analysis we update where things currently stand and identify the key issues that are being dealt with. Our analysis again focuses on automobile insurance since that remains the segment receiving the greatest amount of attention.

First, we discuss the status of the 20 percent rollbacks specified in the proposition. Second, we examine the implications of the Commissioner's regulations governing "rating methodology"--the way insurance companies price insurance to groups of drivers. Third, we review the issues under consideration during the "generic" rulemaking hearings currently underway. (The purpose of these hearings is to determine the appropriate overall level of revenues that insurance companies should be permitted to realize.) Finally, we examine two issues not directly addressed by Proposition 103 but that have an important impact on the overall level of automobile insurance rates--the assigned risk plan and factors affecting the cost of claims.

BACKGROUND

Figure 1 provides a summary of the major provisions of Proposition 103, taking into account the Supreme Court's May 1989 decision regarding the initiative. While the court upheld most of the provisions of Proposition 103, it modified the measure in several important ways. The most significant change was the determination that companies are entitled to a fair and reasonable profit. Additionally, the court ruled that during the period from November 8, 1988 through November 7, 1989, companies could change premiums upon filing a notice with the Department of Insurance (this is known as a "file and use" system). Finally, the court ruled unconstitutional the creation of a nonprofit consumer advocacy corporation.

Figure 2 provides a chronology of the significant events associated with the implementation of the initiative since its passage. Several areas of activity are especially noteworthy: (1) the Supreme Court decision (referenced above), (2) the 20 percent rollbacks, (3) the Commissioner's rating methodology regulations, (4) consolidated hearings that deal with generic issues, and (5) the assigned risk plan premium rate increase decision.

Supreme Court Decision. The court's finding that companies are entitled to a fair and reasonable return is particularly important because it overturned the "substantially threatened with insolvency" standard found in the initiative. The court found that the solvency standard was "confiscatory" in accordance with a long chain of U.S.Supreme Court rulings regarding the right of companies subject to regulation to earn "normal" profits. (The term "normal" profits essentially means that companies should be allowed to both cover their costs and also have a profit margin left over equivalent to what could be earned elsewhere in the economy.) While this ruling applied specifically to the rollbacks, it also has applicability to future "prior approval" rate filings. Thus, determination of appropriate profit levels is one of the key decisions driving the implementation proceedings discussed below.

20 Percent Rollbacks. Proposition 103 requires insurance companies to reduce their premiums by 20 percent. Once the court upheld this provision, the Commissioner issued regulations specifying the data required from companies in order to request exemptions from the rollbacks. The resulting exemption requests, which virtually all insurance companies filed by the June 5, 1989 deadline, were then reviewed by the department. Based on that review, the Commissioner ordered hearings for seven of the largest insurers to determine whether they should be required to roll back rates. These hearings were originally expected to be the primary forum for developing the basic regulations that

Figure 1

Provisions of Proposition 103 as Upheld by the California Supreme Court[a]

Category	Key Provisions
Rate Changes:	
Initial rollback	❒ 20% below rates in effect on November 8, 1987 for all policies written or renewed after November 8, 1988, subject to a "fair and reasonable" return on investment standard
Additional changes	❒ "File and use" rates until November 8, 1989 ❒ Additional 20% reduction in auto insurance rates for all "good drivers" beginning November 8, 1989
Rate Regulation:	
Filing and justification	❒ Effective November 8, 1989, "prior review" and approval of all rate changes ❒ Justification for all rate changes
Basis for rates	❒ Rates must reflect investment earnings ❒ No consideration given to "competitive conditions"
Factors for Establishing Rate Classes	❒ Primary consideration given to driving record, miles driven, and years of driving experience, in that order ❒ Secondary consideration given to other factors as determined by the Commissioner
Antitrust	❒ Removes current exemption from antitrust and unfair business practice laws
Consumer Assistance	❒ Requires Department of Insurance to provide comparative rate information for consumers upon request
Other Features	❒ Permits sale of insurance by state-chartered banks ❒ Permits discounts and rebates by insurance agents ❒ Requires election of Insurance Commissioner ❒ Increases gross premiums tax and regulatory assessments to offset administrative costs and state revenue losses due to insurance rate reductions (the court declined to rule on the

[a] These provisions generally apply to all lines of insurance covered by Proposition 103 (including auto, fire and liability).

Figure 2

Major Milestones in the Implementation of Proposition 103

1988	
November 8	***Initiative Passed*** Proposition 103 approved by voters.
December 7	***Rollbacks Put on Hold*** Except for the rollbacks, the state Supreme Court allows Proposition 103 to take effect pending formal review.
1989	
May 4	***Supreme Court Upholds Proposition 103*** The court, however, rules that rollbacks can be exempted if companies are denied a reasonable return and that companies can use a "file and use" process for rate increases until November 8, 1989.
June 5	***Rollback Exemption Filings Deadline*** Deadline for filing rollback exemption petitions. Virtually all companies file for partial or total exemptions.
June 19-23	***Implementation Hearings*** The Commissioner holds public hearings on general implementation issues.
August 1	***Rollback Exemption Decision*** The Commissioner announces the 11.2 percent profit rate standard, accepts many exemption requests, and rejects exemption requests of 7 large insurers.
August 14-18	***Rating Methodology Hearings*** The Commissioner holds a series of public hearings to help determine the methods by which insurers could set individual premium rates.
October 2	***Interim Rate Increase Freeze*** The Commissioner imposes a six-month rate freeze in response to almost 500 "file-and-use" requests and to provide time to develop prior approval and rating methodology regulations.
November	***Generic Issues Consolidated Hearing (GICH), Rating Methodology Phase*** The Commissioner initiates a series of hearings to determine generic regulations for rating methodology.
December 5	***Rating Methodology Rules*** The Commissioner releases emergency regulations governing rating methodology. Key provisions required reduced emphasis on territory in setting individual rates and imposed a cap on future rate increases.
December 18	***Assigned Risk Pool Decision*** The Commissioner denies the assigned risk pool rate increase request because it does not consider the new rating methodology rules and insurance affordability.
December-Present	***GICH, General Regulation Phase*** The Commissioner initiates a series of hearings to determine generic regulations for rollbacks and prior approval regulation process.

would govern the industry under Proposition 103. However, the hearings have never been held.

Rating Methodology Decision. During the time that the department was reviewing the rollback exemption requests, it was also attempting to write the regulations that would govern the way insurers developed individual rates for automobile insurance (referred to as the "rating methodology"). Proposition 103 mandates specific individual characteristics that must be given precedence in the development of rates. The weighting of the mandatory factors is quite different from that used by the insurance industry prior to enactment of the initiative. The regulations were announced by the Commissioner in December of 1989 following hearings in August and November of 1989.

Generic Rulemaking Proceedings. There are two main elements to the department's new regulatory program: (1) the rollbacks and (2) the "prior approval" regulatory program mandated to begin in November of 1989. Under prior approval, insurance companies must obtain approval of proposed rates *before* they can use them. As we indicated above, the Commissioner attempted to use the seven-company rollback hearings as a way to develop the regulations that would be needed to administer the prior approval regulatory program. Once it became clear that this approach to the development of regulations would not work, the Commissioner called for a set of hearings that began in December 1989. These hearings--called the generic issues consolidated hearings (GICH)--are expected to provide the data and concepts needed to develop the basic regulatory structure to be used by the department. The hearings are expected to last into the spring of 1990.

Assigned Risk Pool Ratefiling. California, like most states, has provisions for the use of a pooling arrangement to allocate "bad" risk and otherwise uninsurable drivers among automobile insurers. The California arrangement is known as the California Automobile Assigned Risk Plan (CAARP) and is managed by the insurance industry. The CAARP's rates have long been determined using a form of prior approval regulation. In recent years, the CAARP rate increase requests have been large and the Commissioner (as well as her predecessor) has systematically authorized smaller increases than have been requested. Holding down CAARP rates relative to rate increases in the regular market has resulted in both increasing enrollments, and increasing deficits in the plan. While Proposition 103 does not directly address the CAARP, there are issues (related to the role and purpose of CAARP) raised by a December 1989 CAARP rate increase decision that affect the regulation of insurance companies pursuant to Proposition 103.

WHAT IS HAPPENING WITH THE 20 PERCENT RATE ROLLBACKS?

Under the provisions of Proposition 103 as enacted by the voters, insurance companies were required to reduce rates to a level 20 percent below the rates in effect on November 8, 1987 unless the company was *substantially threatened with insolvency.* As noted earlier, the Supreme Court ruled that the threat of insolvency was too strict a standard and replaced it with the *fair and reasonable return* standard common to other regulated industries. As noted earlier, this standard means that a company is entitled to a "normal" profit rate.

Exemption Filings

Once the court upheld the central provisions of Proposition 103, implementation of the initiative began. Within a week after the court ruling, the Commissioner released regulations specifying: (1) how insurance companies were to file for exemptions from the rollbacks and (2) the information and data needed in order to support an exemption filing. About 450 insurance companies--virtually the entire industry--filed a total of more than 4,000 individual line-of-business (such as automobile, homeowners, commercial liability) exemption requests. These requests were examined by the department and the Commissioner's initial rulings were announced August 1.

At the same time, the Commissioner announced the profitability standard the department would use for evaluating the exemption filings. The department adopted a profit rate of 11.2 percent as the basis for determining whether company profits were excessive. Using that standard, the Commissioner agreed with a significant number of the exemption requests, withheld on many others, and found that seven of the largest insurers (including State Farm, Allstate, USAA and California State Automobile Association) would be subject to rollbacks of varying amounts. Rollbacks were ordered for a number of insurance lines--including automobile insurance. The largest percentage-of-premium rollbacks, however, generally were ordered for earthquake, homeowners, and inland marine insurance. Only relatively small rollbacks (less than 6 percent) were ordered for private passenger automobile insurance (with one exception, USAA, which was ordered to reduce rates by about 16 percent). Each of the seven companies that was ordered to roll back rates petitioned for a hearing.

Rollback Hearings

The purpose of the hearing process was to determine whether the department's analysis of and conclusions regarding the exemption filing was justified. The usual practice in regulatory agencies is to have an *already established* set of basic regulations to govern the industry. Rather than issue these regulations *prior to* beginning the rollback hearings, however, the Commissioner chose to use the individual company hearings *themselves* as the forum for developing basic regulations. Among the basic issues that the hearings needed to resolve were: (1) the methods for calculating both actual and allowable profits, (2) the method for allocating owners' equity (insurance regulators and companies call this "surplus") between lines of business, and (3) the general regulatory approach (discussed below).

The Commissioner's approach to developing regulations quickly became bogged down by challenges from the companies. These challenges delayed the start of the hearings (in fact, these hearings have not yet been rescheduled) and led the Commissioner to propose a set of consolidated hearings to produce a set of generic regulations to govern both the rollbacks and future prior approval regulation. The generic issues consolidated hearings which resulted from this decision are discussed later.

Summary Regarding Rollbacks

Virtually all insurers filed for exemptions from the rollbacks for automobile insurance (and many other lines, as well). The Commissioner ordered rollbacks for a number of the largest insurers, which then requested hearings. These hearings were to be the forum for developing basic regulations governing the industry. Problems with this approach, however, put the rollbacks "on hold" indefinitely.

WHAT ARE THE IMPLICATIONS OF THE RATING METHODOLOGY REGULATIONS?

In December of 1989 the Commissioner released regulations on the subject of "rating methodology." This section discusses the possible effects of those regulations.

Why Is Rating Methodology Important?

Rating methodology refers to the techniques used by insurance companies to determine premium rates for individual policyholders. Because development of truly unique rates for each individual would be too costly and because probabilities of claims occurring must be used, insurance companies typically assign

each policyholder to a group of individuals that exhibit similar degrees of risk for incurring claims costs. This process is important to the financial viability of a company. Therefore, companies use statistical techniques, usually under the direction of an experienced actuary, to evaluate various individual characteristics that would allow the company to determine a driver's approximate degree of risk.

Among the characteristics reviewed are: driving records, number of years of driving, use of vehicle, miles driven, geographic location of drivers, and automobile characteristics (such as make and model of vehicle, engine size, safety features, and company experience with the vehicle). The companies assign weights to each significant factor, which are then used in calculating actual premiums. In the past, the most significant weight (up to 50 percent) was given to "territory" (that is, where a person lives based on groups of zip codes). However, there has been disagreement about the proper relative weighing between territory and other factors.

What Are the Regulations Proposed by the Commissioner?

The rating methodology regulations describe both the mandatory and the optional factors insurers can use, and the relative weighting of these factors. The regulations also provided a cap on rate increases.

Mandated Factors Given Precedence. Proposition 103 identified three factors that must be considered *before* any optional factors could be used when developing premiums. These *mandated* factors are (1) driving record (including both traffic violations and at-fault accidents), (2) number of miles driven annually, and (3) number of years of driving experience. The Commissioner ruled that the second factor (miles driven) could have no more weight than the first factor (driving record), and that the third factor (years of driving experience) could have no more weight than the second factor.

Optional Factors Specified. The Commissioner banned the use of territory, gender, age, sex and certain other factors when making individual rates. In their place, the Commissioner identified 22 optional factors that could be used by companies to help set premiums *after* the mandated factors are considered. All of these optional factors affect the cost of paying a claim (such as cost of repairs, theft rates, litigation rates, average medical costs in an area, and vehicle characteristics--including safety features). Additionally, some factors are also territory-related (such as population density and vehicle density). Before any optional factor is used, however, companies must show that it bears a

substantial relationship to the risk of loss. Significantly, the Commissioner also ruled that the *combined* weight of *all* of the optional factors could have no more weight than the third most important mandated factor listed above. This effectively limits the total weight of *all* optional factors to less than 25 percent.

Cap on Rate Increases. As we discuss below, it is likely that any given individual's premium rates under the Proposition 103 rating methodology will be different from what they are now. Arguing that Proposition 103 called for lower--not higher--rates, the Commissioner ruled that no rate could be increased in any year by more than the California Consumer Price Index (CCPI).

How Will These Regulations Affect the Price of Auto Insurance?

The rating methodology is the basis for all individual premium rates. Substantially changing the existing rating methodology is likely to have significant effects on the rates some individuals pay. We have identified two such effects: (1) potentially substantial cross-subsidies between different groups of insurers (due to the reduced weighting of the optional factors), and (2) overall limitation of premium increases to less-than-actual increases in the cost of providing coverage.

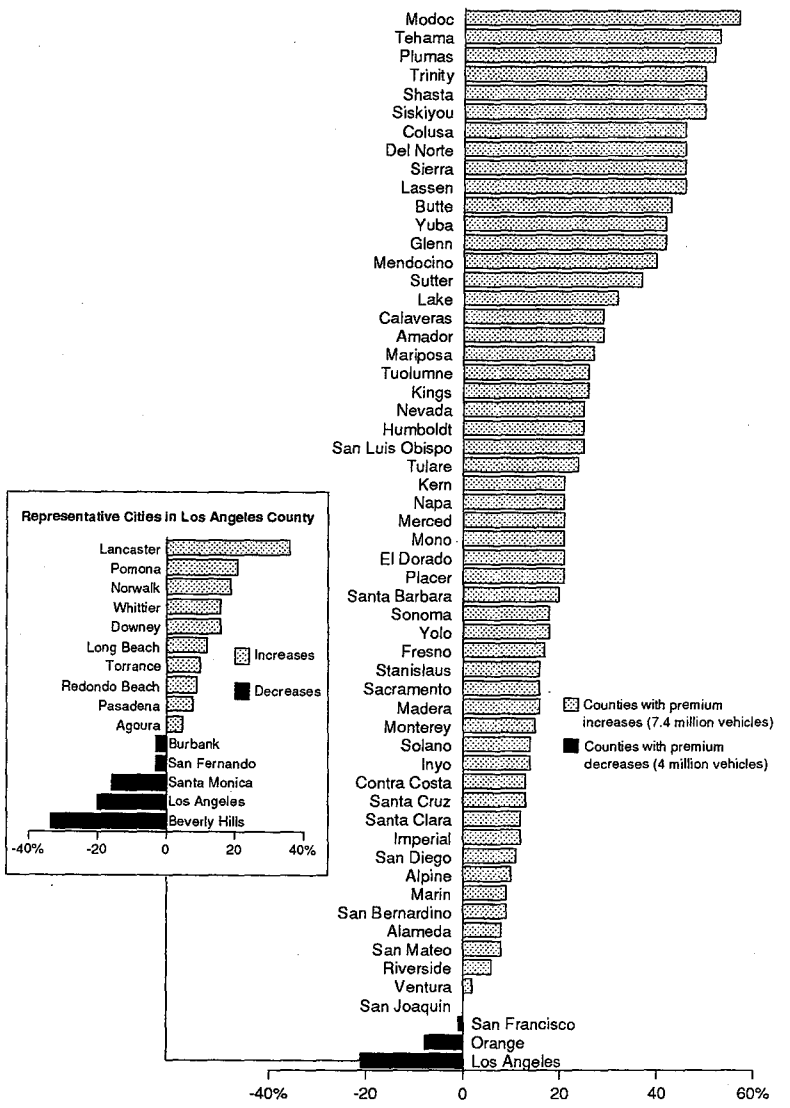
Cross-Subsidies. Cross-subsidies occur when one group of consumers is charged a premium that exceeds the cost of providing coverage to that group, while another group of consumers is charged a premium that is below the cost of providing that group's coverage. The group that pays insurance premiums that are in excess of the cost of providing coverage, in effect, helps to pay for (that is, subsidize) the below-cost coverage provided to the other group.

There is wide agreement among actuaries that territory (as a surrogate for certain of the optional factors discussed above) should have a greater weight than is allowed by Proposition 103. The greater the difference between the true weight of the optional factors and the allowed weight, the greater the extent of the cross-subsidy between consumers.

Figure 3 shows the department's rough estimate of county-by-county average premium changes that would result by reducing the importance of territory as a rating factor under the proposed regulations. We must caution the reader that it is impossible to predict the precise impact of the proposed changes for any given policyholder. Nonetheless, the figure provides an indication of the *general magnitude* of the premium changes. It indicates that drivers in all but three counties would experience premium increases and that the increases would be *quite large* in

Figure 3

Automobile Insurance Average Premium Changes Due to Reduced Effect of Territory [a]



[a] This estimate applies to liability coverages and assumes that the weight of territory as a rating factor is reduced to 24.7 percent.

Source: California Department of Insurance 1987 Premium Data.

some counties (primarily rural counties). The figure also provides a breakout of premium changes for selected locations within Los Angeles County. It shows that even within the county that would, on average, benefit the most from the change in methodology, there are still many drivers who would experience premium increases.

CCPI Cap. The CCPI cap was imposed by the Commissioner primarily to limit premium increases in counties adversely affected by the new rating methodology. A cap on premium increases could, however, threaten an insurance company's profitability in several ways:

- In response to the changes in rating methodology, companies probably would need to increase premiums in some parts of the state by many times the CCPI (which in the current year is expected to be in the range of 4 to 5 percent) in order to compensate for mandated decreases in premiums elsewhere if they were to maintain their current level of profitability.
- Many of the underlying costs of providing insurance are increasing more rapidly than the CCPI. If the cap prevented companies from recovering these increasing costs in future rate proceedings (using the prior approval process specified in Proposition 103), then company profits would decline, potentially resulting in some firms withdrawing from the market.

Summary Regarding the Rating Methodology

Proposition 103 required changes in the way individual rates are set. Except for the rate cap, the Commissioner's regulations follow the basic requirements mandated by the initiative. These regulations do, however, result in potentially significant subsidies to certain buyers of insurance at the expense of other buyers of insurance. Additionally, the rate cap could make it difficult for insurers to earn a "fair and reasonable" profit without challenging the legality of the cap.

WHAT ARE THE KEY REGULATORY ISSUES STILL TO BE RESOLVED?

As we indicated above, the Commissioner originally attempted to develop regulations for the industry using individual company rollback hearings. It quickly became apparent that this process would not work, so the Commissioner next proposed a separate set of hearings (announced in October of 1989) to determine generic rules for regulating the industry. The first phase of the GICH ended with the promulgation of the rating methodology regulations discussed above. The second phase,

currently underway, is expected to end in March of 1990 and to result in regulations governing both the rollbacks and future prior approval rate filings. This section presents an overview of the more fundamental issues that must be resolved before regulation can begin.

What Regulatory Approach Should Be Taken?

The first step in developing a regulatory process is establishing the kind of oversight of insurance companies to be exercised by the department. This issue must be resolved before the other issues under consideration during the GICH can be addressed. Since regulation generally is used to approximate the results one would expect to find in a competitive market, the choice of regulatory approach should be guided by (1) the degree to which the industry is already subject to competitive forces, (2) the extent to which "excessive" profits exist, and (3) the degree to which the initiative allows competitive forces to be considered in regulatory proceedings.

Degree of Competition. Last year (please see *The 1989-90 Budget: Perspectives and Issues,* pages 293-294) we examined the insurance industry and found that competitive elements are present. Specifically, we found that there are many companies selling insurance and there is significant freedom of "entry and exit" in the industry. Additionally, a survey of industry studies (produced by academics, consultants, and government agencies) indicates that most experts agree that the insurance industry generally exhibits competitive characteristics.

Profitability. In last year's review we also examined a number of automobile insurance profitability studies. We found that these studies do not support the view that the industry has been earning excessive profits. This industry has a history of volatile profitability, and in any given year some companies could be earning larger profits than would be normal for the long-run. However, over time, the industry as a whole appears to exhibit competitive performance. During the past year, we examined additional studies and have been unable to find evidence of persistent excess profits. The department's review of rollback exemption filings (discussed above) provides additional support to the view that automobile insurance profits have not been excessive.

Consideration of Competition. While the evidence suggests that competitive elements are present, the Commissioner may be prevented from considering these elements in the regulatory program. One of the *stated* purposes of Proposition 103 is "...to encourage a competitive insurance marketplace...." Else-

where in the initiative, however, the Commissioner is instructed to give "...no consideration to the degree of competition..." when approving insurance rates. If, in fact, the industry is competitive and the Commissioner must ignore that fact, an inappropriate type of regulatory oversight could result.

What Ratemaking Approach Is Appropriate? Some participants in the GICH argue that insurance companies require very close scrutiny during rate review because the industry has been exempt from antitrust oversight for many years (the initiative removed these exemptions). The regulatory approach proposed by this group would include: (1) a formal public utility rate-of-return ratemaking proceeding (perhaps some variation of the way in which the California Public Utilities Commission--CPUC--regulates electric or gas utilities), (2) a close and detailed review of all company records, and (3) so-called "social" regulation (use of the regulatory process to achieve specified public policy goals such as income redistribution, caps on certain expenses or "good service incentives").

Other participants in the GICH argue that insurance companies exist within a basically competitive environment, thus requiring relatively less intrusive oversight by the department (such as the way the CPUC regulates the trucking industry). The regulatory approach proposed by this group would give the department much more discretion about the intensity of individual company reviews. In essence, this approach would include more emphasis on general policies to guide reviews and the use of bands of rate flexibility within which companies could set their premiums without in-depth review.

There are many regulatory approaches that would fit within these two relative extremes. It is not clear at this time, however, what regulatory approach the Commissioner will choose.

As we noted last year, regulation of the insurance industry, like any industry, should proceed from a neutral perspective and focus on the underlying economic realities of the industry. *In our view, the available evidence on the competitive forces in the industry suggests that a less intrusive regulatory approach is warranted.*

How Will Profits Be Measured?

The court ruled that insurance companies are entitled to a fair and reasonable return. This requirement establishes the importance of profit calculation in the regulatory process since the regulator must know both the standard to be used to determine *allowed* profits and the method for calculating *actual* company profits. There are many technical factors that must be resolved in

order that these calculations are performed in a manner that is consistent with good economic analysis. The principal issues are:

- ***How to Measure Profits?*** In prior-approval ratemaking, profits must be determined so the regulator can determine whether proposed premiums are too high or too low to allow firms to earn an adequate rate of return. Several major issues need to be resolved before actual regulation can proceed in an appropriate manner. These include determination of: (1) the appropriate accounting standards to use in measuring profits, (2) rules for allocating "owner's equity" and overhead costs between lines of insurance when computing their profitability, and (3) the appropriate time frame for calculating profit rates (for example, should the focus be on past or projected future profits).
- ***How to Establish the Level of Allowable Profits?*** In order to determine whether an individual company is earning a fair and reasonable return, the regulator also must define a standard (so-called *allowable* profits) against which to compare a company's actual profits. Some of the issues yet to be resolved include: (1) whether different standards should be used for rollback and for future rate proceedings, (2) whether allowable profits should be an industry average versus company or line-of-business averages, and (3) what an adequate profit return is in order for an insurance company to remain economically viable over time.

What Is a Fair and Reasonable Profit Rate? A fair and reasonable profit rate is that which is sufficient to attract needed financial capital to an industry and keep it there. Stated another way, it would be the profit rate that would make investors earn as much by investing in an insurance company as they would in other industries having a similar degree of risk. This suggests that proper regulation of the insurance industry requires ongoing adjustments of the allowable profit rate because economic forces change from year to year and would affect investment decisions. Additionally, since premiums in regulatory proceedings are set for the *coming* year, it is important that allowable profits take into account future (that is, prospective) profits, rather than simply on how companies have performed in the past.

As noted earlier, the Commissioner adopted an *allowed* profit rate of 11.2 percent for use during the department's reviews of the rollback exemption filings. This profit rate was arrived at by taking a 15-year average of industry-wide return on equity--including all investment income.

The department's decision to use return on equity as a measure of allowable profits is appropriate. It is not clear to us, however, whether the department's approach in arriving at the 11.2 percent figure gives:

- Adequate consideration to the longer-run profitability requirements of the industry;
- The proper recognition to future economic conditions; and
- Proper consideration to differences in the riskiness of individual lines-of-business.

The department's methodology in arriving at this standard currently is under review as part of the GICH.

How Will Reserves, Surplus, and Expenses Be Measured?

Once the regulatory approach and a method for measuring profits are determined, another set of issues must be resolved. These issues generally relate to the treatment of certain critical accounting variables such as loss reserves, surplus, and expenses.

Loss Reserves and Surplus. Loss reserves (funds set aside to pay claims) and surplus (under regulatory accounting rules surplus is roughly equivalent to owners' equity) represent large pots of money which, some parties allege, could be subject to manipulation by the companies to the detriment of policyholders. Specifically, these parties contend that insurance companies frequently place more funds into loss reserves and surplus than is required on actuarial grounds. If true, the premiums paid by consumers would be higher than they otherwise would be while reserves and surplus are being built up. On the other hand, regulators (and good business practice) require companies to set aside an appropriate level of funds to assure that monies are available to pay off all claims. Specifically, unduly holding down the size of reserves and surplus could increase the danger that a company might be unable to pay off claims in a timely fashion or might not be able to survive a large catastrophe.

Allocation of Surplus. Accounting issues have been raised regarding the *allocation* of surplus among the lines-of-business for the purposes of determining the profitability of individual lines. Companies typically do not organize their accounting records in a way that directly allows for a line-of-business division of the surplus; consequently, some method must be devised for doing the allocation. Since surplus is treated as backing for premiums written (much the same way as banks hold loan reserves), a natural method for allocating surplus among lines

would be to use the degree of risk faced by each line-of-business. This kind of allocation, however, is apparently very difficult to accomplish. Hence, some other method for allocating the surplus must be devised.

The department proposes to use so called "premium-to-surplus norms" to allocate surplus among lines-of-business. A premium-to-surplus norm represents the number of dollars of premiums a company can write for each dollar of surplus held. Some parties have proposed the use of premium-to-surplus ratios that were developed by regulators as "rules-of-thumb" to trigger closer examination of companies during solvency reviews. Hence, these norms represent the limit beyond which a company is thought to become sufficiently risky to merit closer evaluation. While this approach has some surface appeal because the norms are easy to use, the department has provided little analytical support for the use of these norms. There are at least two problems with their use:

- Norms, in effect, establish a standard for the "correct" level of surplus and make no allowance for operating differences between companies.
- Companies that choose to hold "extra" surplus (to reduce their exposure to large unanticipated losses) would be disadvantaged by having to accept a lower profit rate. This is because regulators would not permit premium increases large enough to maintain this excess.

Should Companies Be Held to Efficiency Standards? Some participants in the GICH argue that expenses also should be evaluated using industry norms. Thus, all companies would, in effect, be reviewed based on the behavior of the "average" or, alternatively, the lowest-cost (the most efficient) company. Use of norms or "efficiency standards" are proposed as a way to force less efficient (higher cost) companies to improve their performance. Other participants argue that each company must be reviewed based on its individual choices regarding the level of expenses it incurs. This view is based on the notion that companies in the industry are diverse in many ways, and thus face different costs. Hence, norms could reduce incentives to innovate by forcing all companies to become more alike.

Should Certain Expenses Be Excluded or Capped? Some participants argue that certain expense items should be capped or excluded when setting rates and computing profits. These items include political contributions, executive salaries, image advertising, and bad faith judgments. Other participants argue that the department does not need to cap or exclude any expense categories because the market would exert discipline over management to contain these, and all other, costs. In January of this

year, the Commissioner announced her intent to use such caps and exclusions.

Summary Regarding the Key Regulatory Issues

There are many generic issues yet to be resolved before Proposition 103 can be implemented fully. The previous discussion touched on only the more important and, perhaps, contentious issues. The GICH process is only the beginning. Once the Commissioner issues her generic regulations sometime in spring 1990, she must then apply them to individual company rollback and prior approval rate filings. It is not yet clear how difficult it will be to make the generic rules workable in the context of everyday company regulation. Most observers expect challenges both to the generic regulations and to their application to individual companies. Resolving those challenges likely will take some time.

OTHER KEY ISSUES RELATED TO PROPOSITION 103

While we have focused above on the implementation of Proposition 103 during the last year, there are two closely related insurance issues that are deserving of the Legislature's attention. These include:

- The role of the California Automobile Assigned Risk Plan (CAARP).
- How to gain control over the rising cost that companies incur in order to provide insurance.

What Is the Purpose of CAARP?

We recommend that the Legislature review the statutes establishing the California Automobile Assigned Risk Plan to clarify the Legislature's intent whether (1) the CAARP was established as a self-supporting pool, (2) its purpose is to insure only bad drivers, and (3) it is to subsidize insurance to low-income drivers.

CAARP Deficits Are Large and Growing. As described earlier, the CAARP was established to provide insurance for "bad" drivers (that is, drivers with extremely poor driving records). In recent years the number of policyholders insured through CAARP has been growing rapidly because of the plan's relatively low rates. As recently as 1986 the CAARP provided insurance coverage for about 423,000 drivers (approximately 3 percent of all insured drivers in California). The department estimates that at the end of 1989 about 1.2 million drivers were

in CAARP (more than *10* percent of all insured drivers), and it further estimates that the enrollment could reach about 1.5 million by the end of 1990. In recent years, the relatively low rates have caused the plan to change so that many, perhaps most, of the drivers currently insured through the CAARP would be considered "good" drivers under Proposition 103 (that is, no more than one moving violation during the previous three years). As mentioned above, these drivers appear to be choosing the CAARP, in part, because: (1) it offers *lower* premiums for basic coverage than does the regular market and (2) insurers providing regular coverage are reluctant to serve some of these customers. Currently, this practice is limited primarily to Los Angeles County but could become a concern in other urban areas in the future.

The CAARP administrators estimate, and department staff concur, that in 1989 the expected cost of claims and expenses associated with settling those claims from the CAARP policies *exceeded* premium revenues by at least $600 million. The department staff estimate that the deficit could reach $1 billion in 1990 given present trends. The funds needed to cover these deficits come from the premiums paid by drivers purchasing insurance in the regular market. In effect, the regular market is subsidizing insurance coverage for both the good and bad drivers in CAARP. Those subsidized drivers, however, are not necessarily low-income individuals.

1989 CAARP Rate Proceeding. In February 1989 the CAARP administrators filed a request for an approximately 112 percent increase in the average assigned risk pool premium. Actuarial estimates done by the industry and confirmed by department actuaries indicate that this increase in average rates is required in order for the plan to cover its costs. The request was then set for hearings which focused on a number of issues including:

- Whether concerns about the ability of drivers to afford insurance should affect the CAARP premiums, and
- Whether passing the CAARP deficits through to non-CAARP policyholders would establish "unfairly discriminatory" premium rates for the regular market (because of the cross-subsidies).

On December 4, 1989, the presiding Administrative Law Judge (ALJ) found that the CAARP rate increase request was justified because disallowing the request would result in a subsidy of CAARP policyholders by non-CAARP policyholders (the regular market). This subsidy would violate provisions of Proposition 103 which mandate that voluntary market premiums

cannot be unfairly discriminatory. Thus, the ALJ concluded that the current CAARP rate structure is inadequate and the premium increase is justified.

The Commissioner, in her decision filed December 18, 1989, disagreed with the ALJ (whose findings are advisory only) and denied the CAARP rate request on the grounds that it did not adequately take into consideration affordability concerns raised during the hearings. Additionally, she found that the CAARP administrators did not adequately justify their premium increase request since they failed to consider changes in rating methodology mandated by Proposition 103. The deficits identified in the premium increase request could be partially offset by these changes. The Commissioner ordered the CAARP administrators to submit a rating plan within 60 days that includes two rate tiers: (1) a lower, subsidized tier for low-income drivers and (2) a second, nonsubsidized tier for other CAARP policyholders. The decision, however, did not address whether lower-income bad drivers should be subsidized.

Summary Regarding CAARP. Proposition 103 does not directly address the CAARP. The relationship between the initiative and the CAARP ratefiling became more explicit, however, when parties to the proceeding raised issues regarding the purpose of the CAARP and its use as a means to redistribute the cost of insurance among policyholders. Nevertheless, significant questions remain regarding (1) whether the CAARP was established as a self-supporting pool, (2) whether its purpose was to insure only bad drivers, and (3) whether it is to subsidize insurance to low-income drivers. Because CAARP was created by statute, these are basic policy issues which the Legislature can address.

Therefore, we recommend that the Legislature review the statutes establishing the CAARP and enact whatever changes are appropriate to clarify the Legislature's intent regarding the above issues. This would provide the necessary guidance to the Commissioner in regulating the CAARP.

How Can the Cost Side of Insurance Be Addressed?

Proposition 103 primarily focuses on: (1) improving competition (such as requiring the department to provide comparative premium quotes, subjecting companies to antitrust statutes, and removing some restrictions on who can sell insurance policies), and (2) regulating premiums charged by insurance companies. The costs of providing coverage and paying claims is not directly addressed by the initiative. Yet, as we concluded last year, these costs play an important role in the high and rapidly increasing cost of insurance in California.

There are many factors that make up the cost of insurance. These include repair costs, medical costs, theft, fraud, type of car insured, legal fees, wage loss, pain and suffering, selling expenses and operating expenses. Individual companies can directly affect some of these cost components. Other cost components are not so easily controlled by either insurance companies or drivers.

Because there are many factors that affect insurance costs, a variety of different approaches must be pursued to control costs. The following are most often identified as ways to gain some control over insurance costs.

Double Payments. Currently, individuals involved in an auto-related personal injury lawsuit may receive awards which include medical costs even though they have already received payment from their medical or disability insurer. This is because under the "collateral source rule," juries must ignore such payments when determining awards. The problem is that the medical or disability insurer has no direct way of knowing about the lawsuit award (the second payment). One way of addressing the problem of double payments is to require notification of medical and other insurance companies of these awards. They could then recover their costs by placing a lien on the award. This kind of insurance coordination currently exists for workers' compensation insurance. Eliminating double payments could reduce the incentive for individuals to bring suit hoping to profit from an award by pocketing that part of the payment representing economic damages already paid by other insurers. Department staff feel it is a significant cause of litigation in some areas of the state. It is difficult to estimate the extra costs due to double payments. However, one actuarial consulting firm estimated in a recent study that double recoveries could have increased the cost of automobile insurance in California by between $176 million and $374 million in 1989.

Fraud. Insurance fraud (including faked accidents, faked injuries, false repair cost estimates and other false statements) is often mentioned as a significant factor affecting the cost of insurance. Many kinds of fraud are difficult and costly to investigate and prosecute; therefore, it is often cheaper to pay suspect claims than to pursue them. Chapter 1609, Statutes of 1988 (SB 2344, Lockyer) established a surcharge on insurance *policies* that would be used by local prosecutors and the department to investigate and prosecute fraud cases. Chapter 1119, Statutes of 1989 (SB 1103, Robbins) increased the surcharge and applied it to insured *vehicles,* in order to double the amount of money available for fraud investigations and prosecutions. This increased attention by investigators and prosecutors should help to reduce

the incidence of these crimes, thereby helping to reduce premium costs.

Theft Prevention and Stolen Vehicle Tracking Equipment. Some insurance companies give premium discounts for the use of theft prevention equipment (in fact, some companies make the use of this equipment a condition of coverage for certain high-theft-rate vehicles). Technology currently exists that may make it feasible for police to track stolen vehicles, though installing and operating the equipment is costly. Greater use of these devices and greater incentives for the use of theft prevention devices could help reduce the cost of comprehensive insurance coverage if this equipment proves to be cost effective.

No Fault Insurance. No fault insurance removes the need to determine fault before insurance claims are paid to injured parties. The U.S. Department of Transportation reviewed no fault plans and concluded that *well-designed* plans *could* help to limit the rate of growth in costs. They concluded, however, that even with good plans it is unlikely that insurance costs would decrease in absolute terms since reduced litigation costs would be offset by larger average payments to injured parties. Clearly, these plans would trade more frequent and higher average payouts to injured parties for the loss of the right of a party to bring personal injury suits (except for very serious injury or for death). No fault plans sometimes are criticized for reducing economic incentives to be a good driver. While this could occur, insurance companies could take account of accidents by increasing premiums for the parties cited in accidents. Thus, some incentive to avoid accidents would continue to be reflected in insurance premiums.

As far as we know, there is no strong empirical record for or against the ability of no fault to control auto insurance costs. Given the cost constraining potential of a well-designed and implemented plan, however, no fault deserves more in-depth study to determine if an economically beneficial plan can be devised.

Improved Information. One of the basic requirements of competitive markets is that consumers must have enough comparative product information to make informed decisions. Better decisionmaking and more effective shopping could put pressure on insurance companies to be more efficient and innovative, thus holding premium costs below what they otherwise would be. Proposition 103 mandates that the department make available to the public an extensive comparative premium data base. (This data base is expected to be available later in 1990.) This data base should help consumers become more effective shoppers.

Another area in which the information available to consumers might be improved is in reporting of complaints. Many consumers base insurance purchase decisions on service provided by insurers. Currently, it is difficult for consumers to obtain information about the behavior and service quality of insurance companies at the time they make purchase decisions. Improved monitoring and frequent, periodic reporting of complaints received by the department (cross-referenced by company, by type of complaint and by manner resolved) could provide important information to: (1) consumers, when shopping for insurance; (2) consumer groups, when evaluating companies; and (3) the Attorney General and local prosecutors, for use during consumer protection investigations. Regular reporting also could encourage companies, brokers and agents to improve their performance.

SUMMARY AND CONCLUSIONS

Our analysis of the past year's effort by the department to implement Proposition 103 suggests that considerable time will pass before the regulatory process has been fully developed and implemented. The department has proceeded slowly in developing the basic regulations needed to govern the industry. Thus, there are many procedures needed to regulate the industry that have not yet been developed. In effect, while much activity can be identified over the past year, the public is in essentially the same place as when the initiative passed. The GICH process, however, offers some expectation that basic regulations ultimately will be formulated.

As we discussed above, one of the stated purposes of Proposition 103 is to encourage a competitive insurance marketplace. Our analysis of the industry suggests that competitive elements are present in this industry and that it is not clear that California's high insurance rates are due to a noncompetitive insurance industry. Consequently, we feel that the insurance industry may not require a very intrusive regulatory approach in order to adequately guard against noncompetitive performance. Whatever approach is used should take account of a company's current and projected financial position.

With regard to issues related to Proposition 103, we recommend that the Legislature review the statutes establishing CAARP to clarify the Legislature's intent regarding the plan's purpose. In addition, we recommend that the Legislature continue to review the factors that affect the costs of insurance.

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