Consumer Federation of America

State Automobile Insurance Regulation: A National Quality Assessment and In-Depth Review of California's Uniquely Effective Regulatory System

By J. Robert Hunter
Director of Insurance

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PART ONE: NATIONAL ASSESSMENT OF STATE INSURANCE REGULATION

A. EXECUTIVE SUMMARY

In response to the advocacy of the insurance industry, Congress has considered several significant pieces of legislation in recent years to weaken state insurance regulation and replace it with looser federal oversight. One prominent proposal would allow insurers to *choose* whether to be regulated at the state or federal level, known as an optional federal charter. Another would have blocked the states from regulating insurance rates. In an attempt to staunch the political support for federal deregulatory measures, the National Association of Insurance Commissioners (NAIC) has urged states to adopt a number of steps in the last decade to reduce consumer protections for automobile and homeowner's insurance. Meanwhile, industry-sponsored academics have generated a spate of reports that seek to discredit rate regulation in particular as anti-consumer and to offer economic arguments for deregulation.

To provide an objective analysis of the impact of regulation on consumers, the Consumer Federation of America (CFA) undertook a study of automobile insurance regulation in all 50 states and the District of Columbia. The report focused on auto insurance since nationally it represents 74.6 percent of the property/casualty insurance market known as "personal lines." The rest of personal lines is made up largely of homeowner's insurance, which we decided not to analyze because the homeowner's line of insurance, which is also high-volume, has been troubled with huge hurricane losses, which distorts results over the time period studied.

The report tests several factors related to insurance regulation that are most important to consumers. First, the report analyzes how rate regulatory systems perform in holding down prices. The report also assesses how regulatory systems enhance or impede vigorous competition by many market participants. Finally, the report evaluates how the systems worked regarding insurer profits.

The six rate regulatory systems in use in the country were evaluated. The systems, ranked from most to least stringent are:

1. State Set – Only in use in Massachusetts. The state establishes allowable rates.
2. Prior Approval (PA) – Used in 15 states. Requires that the regulator agree to rate changes prior to their use. In North Carolina, the North Carolina Rate Bureau files rates for the entire industry, but insurers are allowed to deviate from those prices if they file notice with the state.
3. File and Use (F&U) – Used in 23 states. Insurers must file their prices with the state prior to use, but can start charging these rates without state approval. A state can later disapprove a rate but usually cannot require refunds if a rate is deemed to be excessive.
4. Use and File (U&F) – Used in eight states. Insurers must file their prices with the state, but only after they use them in the market, A state can later disapprove a rate but usually cannot require refunds if a rate is deemed to be excessive.

5. Flexible (FLEX) – Used in two states. Insurers can put prices into use without state oversight if the rate change is within a particular range. Outside of this allowable range, Prior Approval of rate changes is required.
6. Competitive (COMP) – Used in two states. No state review of rates is made. Rates are not required to be filed with the state.

The report evaluates these questions in every state (state detail is found in the National Findings section of the report, starting at page 9. A summary of the report's findings is as follows:

PRIVATE PASSENGER AUTO INSURANCE

Column 1	Column 2	Column 3	Column 4	Column 5
Regulatory System	Number of States Using the System	1989/2005 Change in Expenditure	1997/2005 Return on Net Worth	HHI Index
State Set	1	52.8%	6.4%	1371
Prior Approval	15	54.0%	8.6%	984
F&U	23	68.1%	9.0%	1016
U&F	8	70.0%	9.7%	935
FLEX	2	70.8%	7.0%	12192
COMP	2	73.9%	9.6%	1111

Column 1 shows the regulatory status, ranked from strongest to weakest.
Column 2 shows the number of states using each system today.
Column 3 shows the change in auto insurance price from 1989 to 2005.
Column 4 shows insurer profits.
Column 5 shows the HHI index -- lower score indicates lower concentration and greater competition.

B. ANALYSIS

First, we tested which states deliver the lowest rate increases for consumers.

As the summary table above shows in column 3, the weaker the regulatory system, the greater the price increase paid by consumers for auto insurance over the last 16 years. States that set rates and required Prior Approval of rates had lower rate increases. The five states with the lowest rate of change were:

EXPENDITURE CHANGE BY STATE

STATE	1989 Average Expenditure	2005 Average Expenditure	1989 to 2005 Percent Change	Predominant Rating Law
California	$747.97	$844.50	12.9%	PA
New Jersey	$982.93	$1,183.54	20.4%	PA
Hawaii	$673.36	$842.78	25.2%	PA
New Hampshire	$609.13	$791.71	30.0%	F&U
Pennsylvania	$646.03	$849.14	31.4%	PA
Countrywide	$551.95	$829.17	50.2%	

(Note: For full detail for all states see Spreadsheet 1 in data section below.)

The report also determined price increases according to the type of regulation in place in each state (See Spreadsheet 2 in data section below).

Second, we tested to see if there was a difference in insurer profits for each regulatory system.

Column 5 in the summary table above shows that profits are relatively unaffected by regulatory systems, with a slight trend toward higher profits in states with less regulation. Below are the states in which auto insurance profits between 1997 and 2006 were within a two percent range of the national average profit of 8.1 percent:

STATE	Predominant Rating Law	1997 to 2006 Profitability Personal Auto
California	PA	10.1%
Wisconsin	U&F	10.0%
Wyoming	COMP	10.0%
Iowa	F&U	9.9%
New York	PA	9.9%
Indiana	F&U	9.6%
Maryland	F&U	9.5%
Alabama	PA	9.1%
Illinois	COMP	9.1%
New Jersey	PA	9.1%
Nebraska	F&U	8.9%
Oklahoma	U&F	8.9%
Colorado	F&U	8.4%
North Dakota	PA	8.2%
Georgia	PA	8.1%
Washington	PA	8.1%
Missouri	U&F	8.0%
Texas	FLEX	7.8%
Arkansas	F&U	7.3%
Pennsylvania	PA	7.3%

North Carolina	PA	7.1%
Tennessee	PA	7.1%
Massachusetts	State Set	6.4%
Alaska	FLEX	6.2%

(Note: For full detail for all states see Spreadsheet 3 in data section below.)

The five highest profit states were:

STATE	Predominant Rating Law	1997 to 2006 Profitability Personal Auto
Hawaii	PA	19.1%
Dist. of Columbia	F&U	14.9%
Connecticut	PA	13.2%
New Hampshire	F&U	12.3%
Vermont	U&F	12.3%

The five lowest profit states were:

Florida	F&U	4.7%
Nevada	PA	4.0%
Mississippi	PA	3.7%
Michigan	F&U	2.3%
Louisiana	F&U	0.8%

(Note: Three of these states – Florida, Louisiana and Mississippi – suffered severe hurricane activity in the period studied.)

Third, we examined whether other factors were important in holding down price or increasing profit for insurers in the states.

We assessed seatbelt laws in use, whether states had laws allowing legal action against insurers based on the Unfair Trade (or Insurance) Practices Act, the size of the residual market (assigned risk plan) in each state, the percentage of motorists not insured, thefts per thousand people, disposable income per capita, auto repair costs and the type of legal regime in place for automobile accidents (tort vs. no-fault). These state-by-state comparisons are contained in Spreadsheets 4, 5 and 6 in the data section below.

In reviewing the regulatory systems of the states, we found that the most comprehensive regulatory requirements with express standards for evaluating insurer rates and expenses were the regulations of California. California is also the only state that funds consumer participation in the rate-setting process if an intervening consumer or consumer group makes a "substantial contribution" to a rate hearing. Three other states (Florida, South Carolina and Texas) had consumer advocates with the authority to intervene in a rate hearing on behalf of consumers. In Massachusetts, the attorney general can intervene in the ratemaking process.

Fourth, we evaluated the level of competition in the marketplace.

Column 6 of the summary table (in previous section) shows no clear trend in competition, as regulation gets weaker or stronger.

We used the test usually employed to measure competitiveness in a market, the Herfindahl-Hirshman Index (HHI), which calculates market concentration.[1] The closer a market is to being a monopoly, the higher the HHI index. The U.S. Department of Justice considers a market with a score of less than 1,000 to be a competitive marketplace, a result of 1,000-1,800 to be a moderately concentrated marketplace and 1,800 or greater to indicate a highly concentrated marketplace.

The five states with the lowest (i.e., most competitive) HHI Indices were:

STATE	HHI	REGULATORY STATUS
Maine	603	F&U
Vermont	643	U&F
Connecticut	653	PA
California	716	PA
New Hampshire	748	F&U

(Note: For full detail for all states see Spreadsheet 7 in the data section below.)

Only one state, California, fully applies its antitrust laws to the insurance industry, while two others, New Jersey and Texas, partially apply state antitrust laws. California is also the only state to require that an insurer group quote the lowest price available from any of its companies when an insurance applicant asks for price information.

Fifth, we examined the availability of insurance.

Only four states, California, Massachusetts, New Hampshire and North Carolina require insurers to take all good drivers who apply for insurance. In these states, a good driving record gives a consumer the right to obtain insurance from a licensed insurance company. This is actually a pro-competitive step that these states have taken, since all but 11 of the 51 states we studied require that consumers purchase auto insurance as a condition of obtaining a license to drive.[2] Because of these mandatory insurance laws the demand of auto insurance is inelastic. A mandate on an insurer requiring that coverage be made available to good drivers balances this supply-demand situation. Such a requirement also helps ensure that rates are set fairly because insurers can't use tools such as credit scoring to unjustifiably refuse coverage to good drivers.

Our review of populations of assigned risk and uninsured motorists by state are found in Spreadsheet 6 in the data section below.

Sixth, we reviewed the measures that states use to assure that rates are fair.

[1] The HHI is calculated by squaring the market share of each firm competing in a market and totaling the resulting figures.

[2] See spreadsheet 6 in the data section below.

Auto insurance prices can vary tremendously, based on the factors used by insurers to determine these rates. Some rating factors, like driving record, make a lot of sense in that the classification is based on a logical predicate: people who have driven poorly in the recent past will continue to drive poorly in the future. Moreover, data analysis confirms that this hypothesis is correct. Other rating factors, like credit scoring, do not have a logical or legitimate thesis underlying their use and are only supported by data analysis that claims a correlation to a policyholder's driving record.

Our review shows that several states have taken steps to control or prohibit the use of unfair procedures to develop rate classifications, like credit scoring. For example, Maryland has banned its use for home insurance, but not for auto insurance. Hawaii and California have banned its use for auto insurance. Other states have put some restrictions, usually modest ones, on the use of credit scoring for underwriting and pricing insurance.

However, only California has a comprehensive system to assure that rate classifications are fair. In that state, three auto classes are mandatory and must have the greatest impact on automobile insurance rates, with the first factor having the greatest impact of the three, and the third factor the least impact. These classification categories are: (1) driving record, (2) miles driven, and (3) years of experience. Insurers can also propose other classes for approval. Credit scoring has not been approved for use in California. If another class is approved (and several have been) the class must have less impact on insurance rates than the third mandatory factor. Thus, unfair systems, even if they are approved, will have a limited impact on an individual's final auto insurance price. For example, the impact of territory – where a consumer lives – has been greatly reduced under these rules.

C. METHODOLOGY FOR NATIONAL ANALYSIS

I. Price Change by State and by Regulatory Status

We reviewed the changes in auto insurance premiums paid by consumers over the period 1989 to 2005, by state, identifying the type of regulation used in each state. These data are displayed in Spreadsheet 1 of this section of the report. We also determined how the price changes varied among the states, based upon the type of regulation in place in each state. These data are displayed in Spreadsheet 2 of this section of the report.

II. Auto Insurance Profits over Last Decade by State and Regulatory System

We reviewed the profitability of auto insurance from 1997 to 2006 for each state and also for each of the regulatory systems in use in all states. These data are found in Spreadsheet 3 of this section of the report.

III. Review of Other Possible Rating Factors by State

We also reviewed several other factors by state, including seatbelt laws in use, whether a law prohibiting the bad-faith settlement of claims by insurers was in place, the size of the residual market (assigned risk plan), the percentage of motorists not insured, thefts per thousand

people, disposable income per capita, auto repair costs, and the type of legal regime for automobile accidents (tort vs. no-fault). These factors are displayed by state in Spreadsheets 4 (Seatbelt Law), 5 (restrictions on private rights of action) and 6 (all the other factors) in this section of the report.

IV. The Competitiveness of Each State's Auto Insurance System

We used the test that is commonly used to measure competitiveness in a market, the Herfindahl-Hirshman Index (HHI), which calculates market concentration.[3] The closer a market is to being a monopoly, the higher the HHI index score. The U.S. Department of Justice considers a market with a score of less than 1,000 to be a competitive marketplace, a result of 1,000-1,800 to be a moderately concentrated marketplace and a score of 1,800 or greater to indicate a highly concentrated marketplace. The HHI data are displayed in Spreadsheet 7 of this section of the report.

[3] The HHI is calculated by squaring the market share of each firm competing in a market and totaling the resulting figures.

D. NATIONAL FINDINGS: Spreadsheets 1 through 7

Spreadsheet 1: State Ranking by Size of Rate Increase from 1989 to 2005

EXPENDITURE CHANGE BY STATE

STATE	1989 Ave. Expenditure	2005 Ave. Expenditure	1989 to 2005 Percent Change	1989 Prem Rank (1 = highest)	2005 Prem Rank (1 = highest)	1989 State Prem as % of Nationwide	2005 State Prem as % of Nationwide
California	$747.97	$844.50	12.9%	3	18	135.5%	101.8%
New Jersey	$982.93	$1,183.54	20.4%	1	2	178.1%	142.7%
Hawaii	$673.36	$842.78	25.2%	7	19	122.0%	101.6%
New Hampshire	$609.13	$791.71	30.0%	12	22	110.4%	95.5%
Pennsylvania	$646.03	$849.14	31.4%	10	16	117.0%	102.4%
Connecticut	$740.02	$990.52	33.9%	4	9	134.1%	119.5%
Rhode Island	$725.82	$1,059.13	45.9%	6	7	131.5%	127.7%
Maryland	$646.18	$944.73	46.2%	9	12	117.1%	113.9%
Illinois	$505.32	$742.65	47.0%	21	28	91.6%	89.6%
Georgia	$531.01	$783.69	47.6%	19	24	96.2%	94.5%
Maine	$434.84	$643.50	48.0%	32	42	78.8%	77.6%
Dist. Of Columbia	$796.72	$1,181.77	48.3%	2	1	144.3%	142.5%
Ohio	$447.73	$668.93	49.4%	27	39	81.1%	80.7%
South Carolina	$494.25	$752.56	52.3%	23	25	89.5%	90.8%
Massachusetts	$728.39	$1,112.73	52.8%	5	4	132.0%	134.2%
Indiana	$426.29	$657.35	54.2%	35	41	77.2%	79.3%
North Carolina	$388.00	$602.20	55.2%	40	46	70.3%	72.6%
Tennessee	$423.26	$658.60	55.6%	37	40	76.7%	79.4%
Wisconsin	$392.46	$615.33	56.8%	39	45	71.1%	74.2%
Oregon	$466.29	$736.67	58.0%	25	29	84.5%	88.8%
Alabama	$426.30	$678.01	59.0%	34	37	77.2%	81.8%
Arizona	$581.42	$926.33	59.3%	14	14	105.3%	111.7%
Virginia	$437.87	$697.86	59.4%	30	33	79.3%	84.2%
Missouri	$430.05	$685.49	59.4%	33	35	77.9%	82.7%
Colorado	$515.31	$827.47	60.6%	20	21	93.4%	99.8%
New Mexico	$443.76	$727.35	63.9%	28	30	80.4%	87.7%
Vermont	$423.43	$698.74	65.0%	36	32	76.7%	84.3%

Idaho	$348.31	$582.99	67.4%	44	48	63.1%	70.3%
Nevada	$586.60	$982.56	67.5%	13	10	106.3%	118.5%
New York	$665.07	$1,122.45	68.8%	8	3	120.5%	135.4%
Mississippi	$440.80	$744.84	69.0%	29	27	79.9%	89.8%
Michigan	$550.84	$930.79	69.0%	18	13	99.8%	112.3%
Oklahoma	$399.19	$677.53	69.7%	38	38	72.3%	81.7%
Texas	$497.35	$844.87	69.9%	22	17	90.1%	101.9%
Washington	$490.50	$840.17	71.3%	24	20	88.9%	101.3%
Alaska	$560.27	$961.72	71.7%	17	11	101.5%	116.0%
Minnesota	$460.41	$791.47	71.9%	26	23	83.4%	95.5%
Kansas	$340.76	$590.29	73.2%	45	47	61.7%	71.2%
Florida	$610.21	$1,063.36	74.3%	11	6	110.6%	128.2%
Iowa	$315.02	$555.04	76.2%	48	50	57.1%	66.9%
Delaware	$574.04	$1,027.65	79.0%	15	8	104.0%	123.9%
Utah	$385.44	$705.56	83.1%	41	31	69.8%	85.1%
Louisiana	$571.96	$1,076.09	88.1%	16	5	103.6%	129.8%
Arkansas	$364.68	$693.31	90.1%	43	34	66.1%	83.6%
North Dakota	$283.11	$554.30	95.8%	50	51	51.3%	66.8%
West Virginia	$437.09	$856.53	96.0%	31	15	79.2%	103.3%
Kentucky	$375.71	$749.62	99.5%	42	26	68.1%	90.4%
Wyoming	$318.28	$639.05	100.8%	47	43	57.7%	77.1%
Montana	$336.04	$685.01	103.8%	46	36	60.9%	82.6%
South Dakota	$273.51	$565.23	106.7%	51	49	49.6%	68.2%
Nebraska	$284.86	$620.60	117.9%	49	44	51.6%	74.8%
Nation	$551.95	$829.17	50.2%				

Source: NAIC Auto Database Report 2004/2005 and previous editions.

Spreadsheet 2: Review of States 1989 to 2005 Price Changes by Regulatory Status

PERSONAL AUTO RATE LAWS

STATE	1989 Ave. Expenditure	2005 Ave. Expenditure	1989 to 2005 Percent Change	Predominant Rating Law	Prior Approval	FLEX	U & F	F & U	COMP	State Set
Alabama	$426.30	$678.01	59.0%	PA	59.0%					
Alaska	$560.27	$961.72	71.7%	FLEX		71.7%				
Arizona	$581.42	$926.33	59.3%	U&F			59.3%			
Arkansas	$364.68	$693.31	90.1%	F&U				90.1%		
California	$747.97	$844.50	12.9%	PA	12.9%					
Colorado	$515.31	$827.47	60.6%	F&U				60.6%		
Connecticut	$740.02	$990.52	33.9%	PA	33.9%					
Delaware	$574.04	$1,027.65	79.0%	F&U				79.0%		
Dist. of Colum.	$796.72	$1,187.77	49.1%	F&U				49.1%		
Florida	$610.21	$1,063.36	74.3%	F&U				74.3%		
Georgia	$531.01	$783.69	47.6%	PA	47.6%					
Hawaii	$673.36	$842.78	25.2%	PA	25.2%					
Idaho	$348.31	$582.99	67.4%	U&F			67.4%			
Illinois	$505.32	$742.65	47.0%	COMP					47.0%	
Indiana	$426.29	$657.35	54.2%	F&U				54.2%		
Iowa	$315.02	$555.04	76.2%	F&U				76.2%		
Kansas	$340.76	$590.29	73.2%	F&U				73.2%		
Kentucky	$375.71	$749.62	99.5%	U&F			99.5%			
Louisiana	$571.96	$1,076.09	88.1%	F&U				88.1%		
Maine	$434.84	$643.50	48.0%	F&U				48.0%		
Maryland	$646.18	$944.73	46.2%	F&U				46.2%		
Massachusetts	$728.39	$1,112.73	52.8%	State Set						52.8%
Michigan	$550.84	$930.79	69.0%	F&U				69.0%		
Minnesota	$460.41	$791.47	71.9%	F&U				71.9%		
Mississippi	$440.80	$744.84	69.0%	PA	69.0%					
Missouri	$430.05	$685.49	59.4%	U&F			59.4%			
Montana	$336.04	$685.01	103.8%	F&U				103.8%		
Nebraska	$284.86	$620.60	117.9%	F&U				117.9%		
Nevada	$586.60	$982.56	67.5%	PA	67.5%					

New Hampshire	$609.13	$791.71	30.0%	F&U				30.0%		
New Jersey	$982.93	$1,183.54	20.4%	PA	20.4%					
New Mexico	$443.76	$727.35	63.9%	F&U				63.9%		
New York	$665.07	$1,122.45	68.8%	PA	68.8%					
North Carolina	$388.00	$602.20	55.2%	PA	55.2%					
North Dakota	$283.11	$554.30	95.8%	PA	95.8%					
Ohio	$447.73	$668.93	49.4%	F&U				49.4%		
Oklahoma	$399.19	$677.53	69.7%	U&F			69.7%			
Oregon	$466.29	$736.67	58.0%	F&U				58.0%		
Pennsylvania	$646.03	$849.14	31.4%	PA	31.4%					
Rhode Island	$725.82	$1,059.13	45.9%	F&U				45.9%		
South Carolina	$494.25	$752.56	52.3%	F&U				52.3%		
South Dakota	$273.51	$565.23	106.7%	F&U				106.7%		
Tennessee	$423.26	$658.60	55.6%	PA	55.6%					
Texas	$497.35	$844.87	69.9%	FLEX		69.9%				
Utah	$385.44	$705.56	83.1%	U&F			83.1%			
Vermont	$423.43	$698.74	65.0%	U&F			65.0%			
Virginia	$437.87	$697.86	59.4%	F&U				59.4%		
Washington	$490.50	$840.17	71.3%	PA	71.3%					
West Virginia	$437.09	$856.53	96.0%	PA	96.0%					
Wisconsin	$392.46	$615.33	56.8%	U&F			56.8%			
Wyoming	$318.28	$639.05	100.8%	COMP					100.8%	
Nation	$551.95	$829.17	50.2%		54.0%	70.8%	70.0%	68.1%	73.9%	52.8%

Data from NAIC Auto Insurance Database Reports

Information on state rating laws from Insurance Information Institute website visited on 2/16/08.

PA = Prior Approval

U&F = Use and File

F&U = File and Use

FLEX = Flexible rating

COMP = No rating law

Spreadsheet 3: Auto Insurance Profit by Regulatory Status of States

STATE	Predominant Rating Law	1997 to 2006 Profitability Personal Auto
Alabama	PA	9.1%
Alaska	FLEX	6.2%
Arizona	U&F	10.4%
Arkansas	F&U	7.3%
California	PA	10.1%
Colorado	F&U	8.4%
Connecticut	PA	13.2%
Delaware	F&U	5.9%
Dist. of Columbia	F&U	14.9%
Florida	F&U	4.7%
Georgia	PA	8.1%
Hawaii	PA	19.1%
Idaho	U&F	11.8%
Illinois	COMP	9.1%
Indiana	F&U	9.6%
Iowa	F&U	9.9%
Kansas	F&U	11.3%
Kentucky	U&F	5.6%
Louisiana	F&U	0.8%
Maine	F&U	12.0%
Maryland	F&U	9.5%
Massachusetts	State Set	6.4%
Michigan	F&U	2.3%
Minnesota	F&U	10.7%
Mississippi	PA	3.7%
Missouri	U&F	8.0%
Montana	F&U	5.5%
Nebraska	F&U	8.9%
Nevada	PA	4.0%
New Hampshire	F&U	12.3%
New Jersey	PA	9.1%
New Mexico	F&U	12.0%
New York	PA	9.9%
North Carolina	PA	7.1%
North Dakota	PA	8.2%
Ohio	F&U	11.1%
Oklahoma	U&F	8.9%
Oregon	F&U	10.6%
Pennsylvania	PA	7.3%
Rhode Island	F&U	11.3%
South Carolina	F&U	5.2%
South Dakota	F&U	11.9%
Tennessee	PA	7.1%
Texas	FLEX	7.8%

Utah	U&F	10.6%
Vermont	U&F	12.3%
Virginia	F&U	10.7%
Washington	PA	8.1%
West Virginia	PA	4.9%
Wisconsin	U&F	10.0%
Wyoming	COMP	10.0%
Nation		8.1%

Data from NAIC Profitability Reports
Information on state rating laws from Insurance Information Institute
website visited on 2/16/08.
PA = Prior Approval
U&F = Use and File
F&U = File and Use
FLEX = Flexible rating
COMP = No rating law
Prior Approval in 15 states with average profit of 8.6% in 97 to 06 period
FLEX rating in 2 states with an average profit of 7.0% in 97-06
State Set in one state with profit of 6.4% in 97-06
Competition in two states with average profit of 9.6% in 97-06
Use and File in 8 states with an average profit of 9.7% in 97-06
File and Use in 23 states with an average profit of 9.0% in 97-06
Since the FLEX plan is recent in TX and Alaska, and the sample is small, I believe the data are unreliable.
Since the State Set rate involves only one state, I draw no conclusions.
Illinois and Wyoming have long-term competitive systems and higher profits than the other systems.
Of the three systems that are used by several states each, the profits are lowest in Prior Approval states, with Use and File and File and Use delivering higher profits than Prior Approval.

Spreadsheet 4: State Price Changes by Seatbelt Law Quality

STATE	1989 Ave. Expenditure	2005 Ave. Expenditure	1989 to 2005 Rate Change	Seatbelt Law Quality
Alabama	$426.30	$678.01	59.0%	FAIR
Alaska	$560.27	$961.72	71.7%	GOOD
Arizona	$581.42	$926.33	59.3%	MARGINAL
Arkansas	$364.68	$693.31	90.1%	MARGINAL
California	$747.97	$844.50	12.9%	GOOD
Colorado	$515.31	$827.47	60.6%	MARGINAL
Connecticut	$740.02	$990.52	33.9%	FAIR
Delaware	$574.04	$1,027.65	79.0%	GOOD
Dist. of Colum.	$796.72	$1,187.77	49.1%	GOOD
Florida	$610.21	$1,063.36	74.3%	MARGINAL
Georgia	$531.01	$783.69	47.6%	FAIR
Hawaii	$673.36	$842.78	25.2%	FAIR
Idaho	$348.31	$582.99	67.4%	MARGINAL
Illinois	$505.32	$742.65	47.0%	FAIR
Indiana	$426.29	$657.35	54.2%	GOOD

Iowa	$315.02	$555.04	76.2%	FAIR
Kansas	$340.76	$590.29	73.2%	MARGINAL
Kentucky	$375.71	$749.62	99.5%	GOOD
Louisiana	$571.96	$1,076.09	88.1%	FAIR
Maine	$434.84	$643.50	48.0%	GOOD
Maryland	$646.18	$944.73	46.2%	FAIR
Massachusetts	$728.39	$1,112.73	52.8%	MARGINAL
Michigan	$550.84	$930.79	69.0%	FAIR
Minnesota	$460.41	$791.47	71.9%	MARGINAL
Mississippi	$440.80	$744.84	69.0%	FAIR
Missouri	$430.05	$685.49	59.4%	MARGINAL
Montana	$336.04	$685.01	103.8%	MARGINAL
Nebraska	$284.86	$620.60	117.9%	MARGINAL
Nevada	$586.60	$982.56	67.5%	MARGINAL
New Hampshire	$609.13	$791.71	30.0%	POOR
New Jersey	$982.93	$1,183.54	20.4%	FAIR
New Mexico	$443.76	$727.35	63.9%	GOOD
New York	$665.07	$1,122.45	68.8%	FAIR
North Carolina	$388.00	$602.20	55.2%	GOOD
North Dakota	$283.11	$554.30	95.8%	MARGINAL
Ohio	$447.73	$668.93	49.4%	MARGINAL
Oklahoma	$399.19	$677.53	69.7%	FAIR
Oregon	$466.29	$736.67	58.0%	GOOD
Pennsylvania	$646.03	$849.14	31.4%	MARGINAL
Rhode Island	$725.82	$1,059.13	45.9%	MARGINAL
South Carolina	$494.25	$752.56	52.3%	FAIR
South Dakota	$273.51	$565.23	106.7%	MARGINAL
Tennessee	$423.26	$658.60	55.6%	FAIR
Texas	$497.35	$844.87	69.9%	FAIR
Utah	$385.44	$705.56	83.1%	MARGINAL
Vermont	$423.43	$698.74	65.0%	MARGINAL
Virginia	$437.87	$697.86	59.4%	MARGINAL
Washington	$490.50	$840.17	71.3%	GOOD
West Virginia	$437.09	$856.53	96.0%	MARGINAL
Wisconsin	$392.46	$615.33	56.8%	MARGINAL
Wyoming	$318.28	$639.05	100.8%	MARGINAL

Seatbelt law quality as determined by the Insurance Institute on
Highway Safety, "How State Laws Measure Up."
Rates from NAIC Auto Insurance Database Report 204/2005 and previous editions.

There are 11 states with a good IIHS rating.
These states have an average rate of $816.23.
They also have an average 89/06 rate increase of 60.2%.
There are 16 states with a fair IIHS rating.
These states have an average rate of $845.54.
They had a 56.1% increase in the 89/05 period.
There are 23 states with a marginal IIHS rating.
These states have an average rate of $759.63.
They had a 73.4% increase in the 89/05 period.
There is only one state with a poor rating with a rate of $791.71.
It had a 30.0% increase in the 89/05 period.
The fact that the states with better seat belt laws have higher rates than those with bad laws is interesting, but not conclusive, as more rural states have lower legal protection in this area. The rate changes show a mixed pattern. Based on this data, it is not possible to conclude that strong seatbelt laws lead to smaller increases in rates.

Spreadsheet 5: State Price Change by Laws Restricting Private Rights of Action against Insurance Companies

STATE	1989 Ave. Expenditure	2005 Ave. Expenditure	1989 to 2005 Rate Change	State has "Moradi" Type Law	Rate Change/ Moradi State
Alabama	$426.30	$678.01	59.0%		
Alaska	$560.27	$961.72	71.7%	YES	71.7%
Arizona	$581.42	$926.33	59.3%		
Arkansas	$364.68	$693.31	90.1%		
California	$747.97	$844.50	12.9%	YES	12.9%
Colorado	$515.31	$827.47	60.6%	YES	60.6%
Connecticut	$740.02	$990.52	33.9%		
Delaware	$574.04	$1,027.65	79.0%	YES	79.0%
Dist. of Colum.	$796.72	$1,187.77	49.1%		
Florida	$610.21	$1,063.36	74.3%		
Georgia	$531.01	$783.69	47.6%		
Hawaii	$673.36	$842.78	25.2%		
Idaho	$348.31	$582.99	67.4%	YES	67.4%
Illinois	$505.32	$742.65	47.0%	YES	47.0%
Indiana	$426.29	$657.35	54.2%	YES	54.2%
Iowa	$315.02	$555.04	76.2%	YES	76.2%
Kansas	$340.76	$590.29	73.2%	YES	73.2%
Kentucky	$375.71	$749.62	99.5%		
Louisiana	$571.96	$1,076.09	88.1%	YES	88.1%
Maine	$434.84	$643.50	48.0%		
Maryland	$646.18	$944.73	46.2%	YES	46.2%
Massachusetts	$728.39	$1,112.73	52.8%		
Michigan	$550.84	$930.79	69.0%	YES	69.0%
Minnesota	$460.41	$791.47	71.9%		
Mississippi	$440.80	$744.84	69.0%	YES	69.0%
Missouri	$430.05	$685.49	59.4%	YES	59.4%
Montana	$336.04	$685.01	103.8%		

Nebraska	$284.86	$620.60	117.9%		
Nevada	$586.60	$982.56	67.5%	YES	67.5%
New Hampshire	$609.13	$791.71	30.0%		
New Jersey	$982.93	$1,183.54	20.4%		
New Mexico	$443.76	$727.35	63.9%	YES	63.9%
New York	$665.07	$1,122.45	68.8%	YES	68.8%
North Carolina	$388.00	$602.20	55.2%	YES	55.2%
North Dakota	$283.11	$554.30	95.8%	YES	95.8%
Ohio	$447.73	$668.93	49.4%		
Oklahoma	$399.19	$677.53	69.7%		
Oregon	$466.29	$736.67	58.0%	YES	58.0%
Pennsylvania	$646.03	$849.14	31.4%	YES	31.4%
Rhode Island	$725.82	$1,059.13	45.9%		
South Carolina	$494.25	$752.56	52.3%	YES	52.3%
South Dakota	$273.51	$565.23	106.7%	YES	106.7%
Tennessee	$423.26	$658.60	55.6%		
Texas	$497.35	$844.87	69.9%		
Utah	$385.44	$705.56	83.1%	YES	83.1%
Vermont	$423.43	$698.74	65.0%		
Virginia	$437.87	$697.86	59.4%		
Washington	$490.50	$840.17	71.3%		
West Virginia	$437.09	$856.53	96.0%		
Wisconsin	$392.46	$615.33	56.8%	YES	56.8%
Wyoming	$318.28	$639.05	100.8%	YES	100.8%
Simple Ave.			64.3%		65.9%

Source: NAIC Auto Database Report 2004/2005 and earlier editions.

Spreadsheet 6: State-by-State Review of Miscellaneous Factors that Might Impact Auto Insurance Prices

STATE	Uninsured Drivers 2004	Residual Market 2005	Legal Regime	Compulsory Insurance?	Thefts per 1,000 Vehicles	Disposable Income per Capita	Auto Repair Costs - 2004 (average)
Alabama	25%	0.0%	Tort	Yes	3	$26,851	$2,258
Alaska	15%	0.3%	Tort	Yes	3	$32,151	$2,720
Arizona	22%	0.0%	Tort	Yes	14	$26,899	$2,316
Arkansas	14%	0.0%	Add-on	Yes	3	$24,072	$2,454
California	25%	0.1%	Tort	Yes	8	$32,010	$2,297
Colorado	15%	0.0%	Tort	Yes	12	$33,124	$2,404
Connecticut	12%	0.1%	Tort	Yes	4	$39,727	$2,433
Delaware	12%	0.0%	No-fault	Yes	3	$32,356	$2,269
Dist. of Colum.	21%	1.0%	No-fault	Yes	35	$48,432	$2,224
Florida	19%	0.0%	No-fault	Yes	5	$30,416	$2,397
Georgia	10%	0.0%	Tort	Yes	6	$27,704	$2,223
Hawaii	13%	0.7%	No-fault	Yes	9	$30,487	$1,872
Idaho	9%	0.0%	Tort	No	2	$25,586	$2,337
Illinois	16%	0.0%	Tort	Yes	4	$31,973	$2,110
Indiana	16%	0.0%	Tort	No	4	$27,896	$2,189
Iowa	12%	0.0%	Tort	No	2	$28,722	$2,236
Kansas	13%	0.1%	No-fault	Yes	4	$29,560	$2,235

Kentucky	12%	0.0%	No-fault	Yes	3	$25,303	$2,347
Louisiana	10%	0.0%	Add-on	Yes	5	$22,529	$2,178
Maine	4%	0.0%	Tort	Yes	1	$27,468	$1,966
Maryland	12%	4.0%	Add-on	Yes	9	$36,179	$1,799
Massachusetts	6%	8.0%	No-fault	Yes	4	$37,395	$1,992
Michigan	17%	0.1%	No-fault	Yes	6	$29,275	$2,201
Minnesota	10%	0.0%	No-fault	Yes	3	$32,637	$2,277
Mississippi	26%	0.0%	Tort	No	4	$22,985	$2,138
Missouri	12%	0.0%	Tort	Yes	5	$28,001	$2,277
Montana	12%	0.1%	Tort	Yes	2	$25,985	$2,588
Nebraska	8%	0.0%	Tort	Yes	3	$29,635	$2,159
Nevada	17%	0.0%	Tort	No	17	$31,468	$2,134
New Hampshire	9%	0.6%	Tort	No	2	$33,928	$2,092
New Jersey	9%	3.0%	No-fault	Yes	5	$38,019	$2,563
New Mexico	24%	0.0%	Tort	Yes	5	$25,380	$2,468
New York	7%	2.3%	No-fault	Yes	4	$33,876	$2,468
North Carolina	8%	23.3%	Tort	Yes	4	$27,548	$1,937
North Dakota	9%	0.0%	No-fault	Yes	1	$28,542	$2,082
Ohio	15%	0.0%	Tort	No	4	$28,057	$2,171
Oklahoma	15%	0.0%	Tort	Yes	4	$26,978	$2,360
Oregon	12%	0.0%	Tort	Yes	6	$28,256	$2,039
Pennsylvania	10%	0.6%	No-fault	Yes	3	$30,851	$2,170
Rhode Island	14%	4.8%	Tort	Yes	5	$31,040	$2,818
South Carolina	10%	0.0%	Tort	Yes	5	$25,413	$2,112
South Dakota	9%	0.0%	Add-on	Yes	1	$30,148	$2,316
Tennessee	21%	0.0%	Tort	No	5	$28,409	$2,244
Texas	16%	0.1%	Tort	No	5	$29,738	$2,175
Utah	9%	0.0%	No-fault	Yes	4	$24,571	$1,925
Vermont	6%	0.7%	Tort	Yes	1	$29,206	$2,142
Virginia	10%	0.3%	Add-on	No	3	$32,578	$1,796
Washington	18%	0.0%	Add-on	Yes	8	$31,637	$2,041
West Virginia	10%	0.0%	Tort	Yes	3	$23,620	$2,279
Wisconsin	14%	0.0%	Add-on	No	2	$29,375	$2,296
Wyoming	11%	0.0%	Tort	Yes	1	$33,495	$2,552
Nation	15%	1.3%			5	$29,404	$2,233

Sources: Uninsured motorists from Insurance Research Council, "IRC Estimates More Than 14 Percent of Drivers are Uninsured" June, 2006.
Residual market data from "AIPSO Facts, 2006/2007" from Automobile Insurance Plans Service Office.
Tort law: NAIC Auto Insurance Database report 2004/2005 -- (2004 data).
Compulsory law: NAIC Auto Insurance Database report 2004/2005 -- (2004 data).
Theft Data from 2004 from Federal Bureau of Investigation and Federal Highway Administration.
Disposable Income from Bureau of Economic Analysis – (2005 data).
Auto Repair Costs from Automatic Data Processing, Inc. and Audatex.

We also examined state laws regarding driving while intoxicated. California and all but seven of the other states have tough laws, with suspension. All states have a 0.08 BAC Threshold. Because of the overwhelming similarity of the laws, we chose not to show those data in this spreadsheet.

Spreadsheet 7: Test of Competitiveness of Auto Insurance Market by State

STATE	HHI	REGULATORY STATUS
ME	603	F&U
VT	643	U&F
CT	653	PA
CA	716	PA
NH	748	F&U
WA	803	PA
RI	805	F&U
IN	809	F&U
ND	816	PA
OH	821	F&U
AZ	830	U&F
NV	831	PA
NJ	840	PA
ID	855	U&F
IA	881	F&U
SD	941	F&U
MT	945	F&U
NE	959	F&U
CO	973	F&U
OR	976	F&U
MI	982	F&U
VA	982	F&U
NC	984	PA
GA	987	PA
KY	991	U&F
NY	993	PA
PA	993	PA
MN	1000	F&U
UT	1009	U&F
WY	1014	COMP
OK	1016	U&F
FL	1022	F&U
KS	1029	F&U
TX	1035	FLEX
NM	1036	F&U
AR	1049	F&U
WI	1064	U&F
MO	1068	U&F
TN	1069	PA
MD	1121	F&U
SC	1163	F&U
HI	1182	PA
AL	1206	PA
IL	1208	COMP
MS	1217	PA

DE	1282	F&U
MA	1371	STATE SET
WV	1474	PA
LA	1511	F&U
AK	1548	FLEX
DC	1740	F&U

Based on market share information tabulated from annual reports, 2005.

Type of Regulation	Average HHI
FLEX (2)	1292
STATE SET (1)	1371
PA (15)	984
F&U (23)	1016
U&F (8)	935
COMP (2)	1111

E. CONCLUSIONS

I. Stronger Regulation Leads to Lower Rates for Automobile Insurance Consumers.

We evaluated four significant factors in each state and for each regulatory system.

The first test examined the ability of a rating system to hold down rate increases. It was very clear in the results that the more stringent the regulatory regime, the lower the price increases that were observed. State Set prices rose the least, rates in Prior Approval states the next slowest, etc. Rates in states that had a "Competitive" regulatory system performed most poorly in holding prices down over the long term. In evaluating the three regulatory systems that are used by more than two states, the Prior Approval system had the lowest rate increases, followed by states with a File and Use system and those with a Use and File regime.

The second test examined the profits of the insurers in each state by regulatory system. It is not good for consumers if insurer profits are either too high or too low. Consistently low profits could lead to bankruptcy and volatility in the market, which is very disruptive to policyholders. Extremely high profits usually mean that insurers are charging too much for coverage. We found that profits do rise somewhat as regulation weakens, which is to be expected. Over the long term, profits in states with Prior Approval regimes are just under those in states that employ a File and Use system, and a point less than profits in states that have a Use and File process. All three systems produced profits in the reasonable range.

The last test was a test of competitiveness. The State Set system had an HHI score indicating the greatest concentration and least competition. States with Prior Approval, File and Use, and Use and File systems scored in a relatively narrow range around the 1,000 HHI breaking point between markets that are deemed to be competitive and those that are moderately concentrated. The states with the least regulation (FLEX and COMP) have moderately concentrated competitive market structures on average while states with prior approval have competitive markets on average.

We also ran data by state on several other key factors that could affect insurance rates, including seatbelt laws, bad faith claims settlement laws, uninsured motorist population, size of the residual market, the legal regime in use for auto claims, thefts per 1,000 vehicles, disposable income, repair costs and other factors, as shown in the spreadsheets immediately above.

Overall, the Prior Approval system of regulation works best for consumers overall. This system is best at holding prices down, yet allowing reasonable insurer profit and maintaining a competitive market. It is also clear that the worst regulatory regime for consumers is the so-called "Competitive" system, which does not hold down prices, allows somewhat higher profits than other regimes and results in less competitive markets.

II. California Stands Out from All Other States in Having the Best Regulatory System for Protecting Consumers.

In our review of the findings cited above, we found that one state passed virtually every test for good performance, with the exception of a high uninsured motorist population and profit levels for insurers that are somewhat high. We found the following results for California:

- Ranked first among all states in holding down rate increases;
- Ranked fourth in market competitiveness as measured by the HHI;
- The only state to totally repeal its antitrust exemption for automobile insurers;
- Has a low residual market population e.g. low level of participation in higher cost assigned risk plans;
- Among the eleven states with the highest ranking from the Insurance Institute for Highway Safety for strong seat belt laws;
- One of only four states to guarantee insurance to a good driver from the insurer the driver chooses;
- The only state to require that a person's driving record is the most important factor in determining insurance rates;
- One of only three states to ban the use of credit scoring; and
- The only state that funds consumer participation in the ratemaking process if they make a substantial contribution.

On the negative side, California's uninsured motorist population is high – the third highest in the nation according to the industry organization, the Automobile Insurance Plans Services Office, and about 20th in the nation according to the California Department of Insurance estimate. Profits for insurers over the last 15 years have also been too high.

On balance, California is clearly the best state in the nation for consumers buying auto insurance. We therefore studied the California system in-depth.

PART TWO: REVIEW OF CALIFORNIA'S REGULATORY SYSTEM

A. EXECUTIVE SUMMARY

The balance of the report is focused on the successes and failures of California's regulatory system, so that the public and policymakers can understand the details of the system that works better than any other in the nation to protect consumers.

In 1988, the people of California voted to change its automobile insurance regulatory system. Proposition 103 replaced a regulatory structure that placed virtually no restrictions on how insurers determined rates or what they charged, similar to the system in use in Illinois today. Proposition 103, by contrast, took a number of steps to encourage vigorous competition, including repealing the state anti-trust exemption, improving policyholder access to key information, and allowing groups to form to purchase insurance. However, it also required insurers to meet the toughest requirements in the nation for the Prior Approval of insurance rates.

I. Regulatory Standards of Excellence

The study examines a variety of criteria to determine how well our best performing state, California, met the following regulatory standards of excellence:

- Regulations that are easily understood by, responsive and accountable to, and inspire confidence from the public and regulated companies and individuals.
- Beneficial competition that results in fair profits for regulated companies, reasonable rates for ratepayers and the equitable treatment of consumers.
- Elimination of the many problems associated with using certain criteria – sometimes unjustifiably – to choose whether to insure some policyholders and not others, and at what cost (known as "selection competition"[4]) and a prohibition on the use of risk classification factors that are not equitable or appropriate.
- Broad and vigorous public involvement in the regulatory process, including institutionalized consumer participation in the review of insurance rates, forms, and underwriting guidelines.
- Key information is provided to regulators, regulated entities and consumers to allow them to identify market problems and harmful competition.
- Reduction and elimination of harmful products, and unfair and deceptive practices in the marketplace, as well as the provision of meaningful restitution to consumers harmed by these products and practices.
- Promotion of loss prevention and loss mitigation as the most important way for insurers to manage risk and ensure safety and soundness.

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[4] Insurance Commissioner Benjamin R. Schenck of New York said of selection competition: "In insurance there is one form of competition that seldom exists in other products or services. That is selection competition – the ability of an insurer to affect its success, not by the price or quality of its products, but by selecting its customers in a fashion that will give it an advantage over its rivals…Selection competition should have few admirers. It is capable of denying to some people the opportunity to buy insurance at all in a day when many forms of insurance have become legal and practical necessities." Convention of Casualty and Surety Agents, White Sulfur Springs, West Virginia, October 9, 1972.

II. Proposition 103 Best Meets the Standards of Excellence

Overall, California stands out as having the "best practices"[5] in the nation as measured against these standards as a result of the remarkably effective provisions of Proposition 103, the insurance reform initiative approved by California voters in 1988.

Consumer Impact

Under Proposition 103's rate rollback requirement, refunds totaling $1.43 billion[6] were paid to consumers between 1989 and 2002. However, these refunds pale in significance to the significantly lower premiums overall that Proposition 103 has achieved. Consider the following table of personal automobile insurance rate changes over the period since the passage of Proposition 103 and its implementation in 1989, after the first wave of legal challenges to the measure by the insurance industry failed, and the temporary judicial stay of its implementation was lifted.[7]

AVERAGE AUTO INSURANCE PREMIUMS PER POLICYHOLDER

TABLE 1

Average Expenditure	1989 Premium	1989 Rank	2005 Premium	2005 Rank	1989-2005 % Change
California	$747.97	3	$844.50	18	+12.9%
Countrywide	$551.95		$829.17		+50.2%
Total Premium					
California	$875.60	3	$969.11	17	+10.7%
Countrywide	$635.58		$948.97		+49.3%
Liability Premium					
California	$519.39	2	$487.04	20	-6.2%
Countrywide	$339.82		$496.73		+46.2%
Collision Premium					
California	$235.53		$365.31	7	+55.1%

[5] Producing the best outcomes for consumers, as well as good results for insurers.

[6] California Department of Insurance, 2006 Annual Report of the Insurance Commissioner.

[7] State Average Expenditures & Premiums for Personal Auto Insurance, NAIC, 1993 and 2006 Editions. Expenditure equals total written premium divided by total number of cars insured. It measures what consumers actually spend on insurance for each insured vehicle. Total premium, on the other hand, is the sum of the premiums for liability, collision and comprehensive and represents the average cost for a driver buying all coverages.

		9		
Countrywide	$197.33	$308.96		+56.6%
Comprehensive Premium				
California	$120.68	$116.76	44	-3.2%
		9		
Countrywide	$98.44	$143.28		+45.6%

During the twenty years after Proposition 103 was adopted, rates increased by only 12.9 percent in California but by over 50 percent nationally. California has enjoyed the lowest rate of increase of any state in the nation since the adoption of Proposition 103.[8]

Prior to the passage of Proposition 103, auto insurance prices in California rose faster than the national average. Since then, premiums have increased at a much slower rate than the national average at under six-tenths of a percent a year compared to over 2.1 percent a year nationally. Using a savings test analysis that assumes that, in the absence of Proposition 103, California auto insurance rates would have merely kept pace with the national rate of change, the actual savings realized by consumers was $61.8 billion.[9]

How has Proposition 103 achieved such remarkable results for consumers? First, it achieves all of the regulatory standards of excellence cited above. Unlike the deregulatory measures adopted by some states and promoted by the industry in Congress and before the NAIC, Proposition 103 fully incorporated a comprehensive set of proposals to spur vigorous competition. For example, it prohibited anti-competitive behavior by requiring insurers to comply with antitrust standards, allowed banks to sell insurance well before Congress permitted it in the rest of the country, allowed group sales of insurance well before other states did, and encouraged agents to compete by offering rebates.

Further, unlike the half-hearted regulatory efforts adopted in most states that purport to require the approval of insurance rates by regulators prior to their use by insurers (so-called "Prior Approval" systems), Proposition 103 required full regulatory oversight of all property/casualty rates, including auto, home and business insurance, to ensure that competition is sufficient to keep rates reasonable. California's present rate review and approval regulations are state-of-the-art – far and away the best in the nation.[10] They require insurers to specify how

[8] See spreadsheet, "Personal Auto Expenditure Ranked by Least to Most Change in the 1989 to 2005 Period," in Part 1, Spreadsheet 1. After Proposition 103 was implemented in 1989, auto rate changes in California held steady or declined relative to the nation until 2001. From 2001 to 2006, the rate changes tracked the nation during a period of unchecked excess profits, which are being addressed currently (See page 95 for a fuller discussion of this situation).

[9] See "Estimate of Savings from Proposition 103" Appendix 4, Spreadsheet 13.

[10] To enforce Proposition 103, the Insurance Commissioner, which the measure made an elective position, adopted strong Prior Approval ratemaking regulations in 1991 that established the ratemaking formulae that determine whether rates are excessive or inadequate. In 2007, the Commissioner adopted amendments to the formulae to include specific values and methodologies for the ratemaking components. See discussion of Prior Approval regulations on page 56.

they have developed their rates in a completely transparent manner. The regulations disallow the use of excessive costs in calculating rates, such as unjustifiable expenses, fines, excessive executive salaries and costs incurred as punishment for treating customers with bad faith. The regulations specify standards that must be used to test the assumptions that insurers make in setting rates. Insurers are required to provide data that assists other insurers becoming more competitive in the way they set rates, which helps to lower costs for consumers. The regulations also prohibit the use of unfair pricing systems by reducing the variation in rates between various regions of the state and by excluding credit scoring from use.

An important adjunct to the regulatory framework established by Proposition 103 is its mechanism for public scrutiny and participation in the process of reviewing and approving rates. Proposition 103 grants consumers the right to challenge improper rates and practices before the Department of Insurance as well as the courts.

A key factor reducing insurer costs and consumer rates for automobile insurance is the strong financial incentives that the law provides consumers to drive more safely. "Clean" drivers are required to receive a 20 percent discount. They also have the right to buy insurance from the company of their choice through Proposition 103's "Good Driver Protections."

Proposition 103 was a "shot across the bow" of insurance companies that had very little incentive to lower costs or rates or, for that matter, fight fraud. Prior to Proposition 103, the industry saw itself largely as a "pass-through" operation. Indeed, the ratemaking methods allowed by regulators created a perverse incentive for insurance companies to keep costs and rate high. As long as their projections of future claims and costs (called "trend") increased, their profit rose, since the ratemaking method previously in use set allowable profit as a percent of costs. This "cost-plus-percentage-of-cost" operating style was achievable because full competition between insurers was not present. Many insurers used the same trend data, coordinating their efforts to project costs into the future through industry-funded agencies known as "advisory organizations," such as the Insurance Services Office (ISO).[11] At the time Proposition 103 was adopted, these advisory organizations developed full final rates, including overhead and other expenses and a profit level that insurers could adopt for use. Insurers did not have an incentive to combat fraud aggressively or to lower rates for safer cars.

Proposition 103 reversed this ratemaking trend, not just in California but also throughout the nation. The regulations ended the "cost-plus" system, requiring insurers to aggressively trim waste and prosecute fraud.

Proposition 103 had a salutary affect nationwide as well. Fearing that the requirements of Proposition 103 would be adopted by other states (especially the Proposition's mandate that all property/casualty rates be rolled back by one year and reduced by an additional twenty percent overall), insurers stopped passing through as much of the excessive and unjustified costs in most states. Advisory organizations stopped the practice of setting full final rates and, instead, just established the part of the rate to cover losses and the expenses of settling claims (although they continued the anti-competitive joint trending efforts outside of California). They joined with

[11] Such anti-competitive collaboration, normally unlawful, is allowed because the McCarran-Ferguson Act passed by Congress in 1945 exempts collusion in pricing by insurance companies from federal antitrust scrutiny.

consumer groups to form the Coalition Against Insurance Fraud and the Advocates for Highway and Auto Safety.[12]

In addition to premium savings that California consumers have realized, Proposition 103 has achieved many other benefits for ratepayers. The law regulates the use of rating factors used to discriminate prices between different driver characteristics for fairness (thus, credit scoring is not used in California and the use of territorial distinctions have been moderated). It requires greater disclosure and transparency, such as availability of detailed loss data and customer service statistics by ZIP code to determine if "redlining" is present. There is greater public scrutiny of rate filings by insurers, and procedures that allow consumer groups to be reimbursed if they make a "substantial contribution" to a rate proceeding in challenging an insurer's rate setting methods or other practices.

Industry Impact

Proposition 103 can also be considered a success when factors often cited by the insurance industry as important are evaluated, including profit levels, the number of competitors throughout the state and the relatively small number of consumers covered by the "residual" (i.e., the assigned risk plan for auto insurance) rather than the traditional marketplace.

Insurers claim that a key reason that rate regulation is not effective is that the size of the residual market for personal automobile coverage will become too large.[13] Their argument is that regulation keeps rates too low, which discourages insurance companies from offering coverage to certain kinds of consumers. Simply looking at the size of the residual market size does not prove much of anything about competition in the marketplace, unless the size of the non-standard and uninsured markets are also examined since all of those markets together would be the best indicator of the vitality of the "normal" or "voluntary" market in a jurisdiction.

The size of the residual market in California shows that the situation is far better under Proposition 103 than before it took effect. In 1989, 8.4 percent of insured drivers in California were in the California Automobile Assigned Risk Plan (CAARP). By 2006, this percentage had fallen to 0.1 percent, which represents an astounding decline in enrollment of 99 percent.[14]

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[12] To be sure, the insurance industry did not allow Proposition 103 to take effect without a fight. Insurance companies and their trade associations also filed more than eighty lawsuits and used other means to forestall 103's implementation for as long as possible, both to delay its implementation and to lead other states into believing that Proposition 103 was not working.

[13] A "residual market" is a mechanism for insuring those persons that the normal ("voluntary") market will not cover. The most usual mechanism is the assigned risk plan, where a person not able to get normal insurance applies for coverage and is randomly sent to an insurance company. The share of the normal market is the basis for the number of assignments a company receives. California uses this mechanism, as do most states. Other mechanisms include Joint Underwriting Associations (where all insurance companies share the risk of a pooled policy), State Funds and Reinsurance Facilities. In this latter system, the consumer can go to the company of his/her choice and the insurer must write the policy. The company is free to cede (send) the risk to a pool that reinsures the risk but the contract remains with the insurer, just as in the normal market. Strictly speaking, this facility approach is not "residual," since insurers have incentives to cede more than poor risks to the facility.

[14] AIPSO Facts 2006/2007, AIPSO. Some of the drop may be due to the sharp increase in CAARP rates during the period, but to the extent that's so, the uninsured motorist population would be expected to sharply rise, which it did not.

The California Insurance Department reports that the number of uninsured motorists (UM) have dropped from 29.87 percent in 1995 to 14.43 percent in 2004, a drop of 52 percent.[15] On the other hand, in a different study, the number of uninsured motorists in California in 1989 was 23.2 percent, which increased to 25 percent in 2005, the most recent year for which the data is available from the Insurance Research Counsel. This represents an increase of 7.8 percent in the uninsured population, which probably reflects an influx of lower income unlicensed drivers into the state, rather than a decline in the affordability of insurance (as rates have been relatively flat in California, rising less than the rate of inflation, since Proposition 103 was adopted). In 1993, California law was amended to prohibit the state from providing drivers licenses to undocumented immigrants and California is home to about a third of the nation's illegal immigrants.[16] Nationally, the number of uninsured from 1989 to 2005 dropped by 8 percent, from 16.3 to 15 percent.[17] At worst, even given the influx of lower income drivers into the state, the UM population in California has remained stable under Proposition 103, and probably has declined.

We were unable to find data on the non-standard market shares in California and nationwide.

Insurers also cite the number of insurance companies entering and exiting the marketplace as evidence of the quality of competition in a state's marketplace. Again, this is not a particularly valid test. A large number of new high-cost "non-standard" insurers might enter a state because the state does not properly regulate excessive or unjustified rates. Such a development would not be positive for consumers.[18]

However, Proposition 103 has performed well even by this flawed measurement. According to an academic analysis of post-Proposition 103 California,[19] and California Department of Insurance market share reports, insurers entered and exited the state consistent with "a competitive industry." A few companies left the state but the number of insurer groups competing in the state increased.

One test of a marketplace's competitiveness is the Herfindahl-Hirshman Index (HHI), which calculates market concentration.[20] The closer a market is to being a monopoly, the higher the HHI index. The U.S. Department of Justice considers a market with a score of less than 1,000 to be a competitive marketplace, a result of 1,000-1,800 to be a moderately concentrated marketplace and 1,800 or greater to indicate a highly concentrated marketplace.

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[15] CDI's Statistical Analysis Division, April 1, 2008 report.

[16] Driver's Licenses for Undocumented Aliens, Institute of Governmental Studies, University of California, http://igs.berkeley.edu/library/htImmigrantDriverLicenses.html

[17] Uninsured Motorists, Insurance Research Council, 2000 Edition.

[18] For example, in South Carolina in recent years, many new high-cost insurers that are "running mates" of companies already competing in the state have started selling coverage, causing average rates to rise somewhat more than nationally since 1989 (50.2% in nation vs. 52.3% in South Carolina).

[19] The Regulation of Automobile Insurance in California, Jaffee and Russell, 2001.

[20] It is calculated by squaring the market share of each firm competing in a market and totaling the resulting figures.

Insurers often identify Illinois as the most "competitive" state because of its total lack of rate regulation. The HHI for Illinois personal auto insurance is 1,208, which means that it is moderately concentrated under standards.[21] The California HHI is 716, which indicates that it is highly competitive. In fact, California is the fourth most competitive state in the nation for auto insurance by this widely used standard, while the insurance industry's favorite regulatory state, Illinois, is 44th.[22]

Insurers often complain that rate regulation improperly suppresses rates and stifles their profits. However, the data show that excellent results for consumers under Proposition 103 did not come at the expense of insurer profits. Insurers have enjoyed automobile insurance profits in California that are considerably higher than in the nation overall.

CALIFORNIA AND NATIONAL AUTO INSURER PROFITS

TABLE 2

	1989 - 2005 Return on Net Worth	
	California	Countrywide
Personal Auto Liability	12.9%	7.5%
Personal Auto Physical Damage	15.8%	16.3%
Personal Auto Total	13.5%	9.9%
Homeowners	7.4%	-1.2%
All P/C Lines	13.9%	6.5%

These data suggest that insurer profits in California over the long term have been too high because regulators have done too little to use the tools they have under Proposition 103 to ensure that rates are as low as they should be.[23] This problem is being redressed by the amendments to the Prior Approval regulations approved by the Insurance Commissioner in 2007, which include strict profitability standards and a uniform state measure for excessive or inadequate rates, and by strong actions begun in 2007 by the California Insurance Department to order needed rate reductions.[24]

The unprecedented premium savings obtained by California consumers under Proposition 103, and the panoply of protections that has made the California insurance marketplace a fair and honest place, occurred despite continuous litigation by insurers, and a scandal in the Department of Insurance in connection with Insurance Commissioner Chuck Quackenbush, who refused to enforce the law fully for six years (1994-2000) by resisting unjustified rate increases. Mr. Quackenbush resigned in disgrace in 2000 after legislative and law enforcement investigations found that he had set up nonprofit organizations to collect large contributions from insurers that were under investigation by the Department. The "contributions" were accepted in lieu of requiring insurers to pay fines for unfair claims practices after the Northridge earthquake. After

[21] See "Test of Competitiveness of Auto Insurance Market by State" Spreadsheet 7.

[22] Ibid.

[23] As Spreadsheet 3 shows, the profit over the last decade is more reasonable, being only 2 percent over the national average.

[24] See page 96, section titled 2007-present (Insurance Commissioner Poizner), for a fuller discussion of the recent rate reductions being ordered.

he was forced to resign, a retired appellate judge was appointed interim commissioner; he served from the end of 2000 through 2002, and oversaw a departmental reorganization that was aimed at salvaging a debilitated bureaucracy rather than saving consumers money through regulation. The Department's rate regulation division was severely neglected during this period. Insurer rates, and thus profits, increased sharply between 2001 and 2003, when scores of unchecked rate increases went into effect. Only after the election of a new Commissioner did rate oversight again begin in earnest, which led to lower rates and more appropriate profit margins. By 2004, rate decreases were the norm as major insurers in California responded to stronger oversight and the intervention of consumer groups intervened, challenging the rates of numerous insurance companies as excessive. Excessive profits should be tempered as future commissioners exercise their full powers under Proposition 103.

III. Congress and the States Should Take Heed

As the following in-depth review of the California system demonstrates, Proposition 103 has been an enormous success from both a consumer and an industry perspective. As the National Association of Insurance Commissioners (NAIC) considers the future of personal lines regulation, it should take steps to emulate California's unparalleled achievements under Proposition 103. As Congress considers an optional federal charter that would allow insurers to offer coverage in California but be (poorly, if at all) regulated in Washington D.C., it should carefully consider the negative consequences of overriding the will of the voters of the nation's largest state and undermining the most effective system of insurance regulation in the country.

The question that should be posed to the nation's insurance commissioners and to Congress is, "Why not adopt a system that is demonstrably the best for consumers and works well for insurers too?" Instead of running headlong toward deregulation under slogans such as "modernization" or "speed-to-market," the NAIC should adopt California's standards for a quality regulatory system and also move toward full competition, by taking steps such as repealing the insurance industry's unjust exemption from state anti-trust laws. Consumer protection requires thoughtful, efficient and effective regulation. Mindless deregulation of the current flawed regulatory systems, as proposed by the insurance industry, would represent an abdication of state and Congressional responsibilities to consumers.

B. EVALUATION OF THE SUCCESSES AND FAILURES OF PROPOSITION 103

I. Overview

In the balance of this report, we focus on how California achieved such excellence in regulation. We explain the major provisions of Proposition 103 and provide a history of industry efforts to undermine its effectiveness. We then review the successes and failures of Proposition 103. Finally, we respond to concerns raised by insurance companies and academics regarding blemishes in Proposition 103, although we are unaware of any serious challenge to its effectiveness.

In Appendix 2, we compare the provisions of California law to the principles of consumer protection developed by consumer organizations in "Reinventing State Insurance

Regulation for the Benefit of Consumers – A Time for Change." That paper, which was presented to the NAIC in September of 2000, outlined why insurance consumer protections must be strengthened at the beginning of the 21st Century.

II. California Has Bucked the Trend Toward Reduced Consumer Protections at the State and Federal Level

The extraordinary improvements in automobile insurance regulation in California under Proposition 103 stand in stark contrast to the regulatory environment in many other states and at the federal level. Over the past decade in particular, the insurance industry has launched an unremitting and quite successful campaign to undermine key state consumer protections, an effort that has also caused states to respond weakly, if at all, to insurance problems facing their residents.

Insurance Deregulation Takes Root at the State Level

In late 1999, Congress passed the Gramm-Leach-Bliley Act (GLBA), allowing federally-chartered banks to sell insurance products. Soon after, insurance trade associations began considering a federal role in insurance regulation, driven by the fear that insurance companies would be at a competitive disadvantage if banks could get insurance or similar products approved for sale more quickly and more cheaply.

Fear of federal insurance regulation has also prompted the National Association of Insurance Commissioners (NAIC) to adopt proposals to weaken insurance regulation and consumer protections, such as the deregulation of property/casualty insurance rates for insurance purchased by small businesses. The NAIC is currently considering adoption of a similar proposal for personal lines of insurance (like auto coverage) that would severely reduce consumer protections. Some states have already rolled back consumer protections for automobile insurance, including New Jersey, Texas, Louisiana, South Carolina and New Hampshire.

Reflecting the industry's press for deregulation, the NAIC and many states have failed to act in response to a number of serious problems facing consumers that have arisen in the insurance marketplace in recent years. For example, the NAIC has failed to call for the repeal of state antitrust exemptions for insurance, refusing to follow the example set by California under Proposition 103. It has also failed to curtail or end the use of inappropriate underwriting and rating criteria that often results in unjustifiably high auto insurance rates for low and moderate income consumers and minorities, such as credit scoring and prior insurance limits that Proposition 103 has blocked from use. During this period, the NAIC and many states have ignored, rejected or postponed consideration of almost all of the detailed regulatory principles and proposals offered by consumer organizations. This inaction has exposed consumers, particularly individual and small commercial consumers, to the risk of abusive insurer practices.

The Federal "Whipsaw" Strategy

For the insurance industry, promoting an increased federal role in insurance "regulation" has two huge benefits. First, the legislation that has been promoted by the industry and

introduced by their allies in Congress would, if enacted, dramatically undercut the stronger aspects of state regulation, such as the comprehensive rate regulation contained in Proposition 103. Secondly, the mere possibility of an increased federal role – even if it never occurs – has already succeeded in pressuring the NAIC and some states into gutting consumer protections over the last decade, as described above. Insurers have repeatedly warned states that the only way to preserve their control over insurance regulation is to weaken consumer protections.[25]

Insurers were assisted in their state deregulatory effort by a series of hearings in the U.S. House of Representatives under the previous Congressional leadership. Rather than focusing on the need for improved consumer protection, the hearings served as a platform for a few Representatives to issue ominous statements calling on the states to further deregulate insurance oversight, "or else."[26] This strategy of "whipsawing" state regulators to lower standards benefits all elements of the insurance industry, even those that do not support any federal regulatory approach.

Optional Federal Charter Legislation

[25] The clearest attempt to inappropriately pressure the NAIC occurred at their spring 2001 meeting in Nashville. There, speaking on behalf of the entire industry, Paul Mattera of Liberty Mutual Insurance Company told the NAIC that political support among insurance companies was growing on a daily basis for federal regulation and that the NAIC's huge effort in 2000 to deregulate and speed product approval was too little, too late. He called for an immediate step-up of deregulation and measurable "victories" of deregulation to stem the tide. In a July 9, 2001, *Wall Street Journal* article by Chris Oster, Mattera admitted his intent was to get a "headline or two to get people refocused." His remarks were so offensive that I went up to several top commissioners immediately afterward and said that Materra's speech was the most embarrassing thing I had witnessed in 40 years of attending NAIC meetings. I was particularly embarrassed since no insurance commissioner challenged Mattera and many commissioners at the meeting had almost begged the industry to grant them more time to deliver whatever the industry wanted.

Jane Bryant Quinn, in her speech to the NAIC on October 3, 2000, said: "Now the industry is pressing state regulators to be even more hands-off with the threat that otherwise they'll go to the feds."

Larry Forrester, President of the National Association of Mutual Insurance Companies (NAMIC), wrote an article in the *National Underwriter* of June 4, 2000. In it he said, "…how long will Congress and our own industry watch and wait while our competitors continue to operate in a more uniform and less burdensome regulatory environment? Momentum for federal regulation appears to be building in Washington and state officials should be as aware of it as any of the rest of us who have lobbyists in the nation's capital…NAIC's ideas for speed to market, complete with deadlines for action, are especially important. Congress and the industry will be watching closely…The long knives for state regulation are already out…"

In a press release entitled "Alliance Advocates Simplification of Personal Lines Regulation at NCOIL Meeting; Sees it as Key to Fighting Federal Control," dated March 2, 2001, John Lobert, Senior VP of the Alliance of American Insurers, said, "Absent prompt and rapid progress (in deregulation) … others in the financial services industry – including insurers – will aggressively pursue federal regulation of our business…"

At the NAIC meeting of June 2006, Neil Alldredge of the National Association of Mutual Insurance Companies pointed out that "states are making progress with rate deregulation reforms. In the past four years, 16 states have enacted various price deregulation reforms…(but) change is not happening quickly enough…He concluded that the U.S. Congress is interested in insurance regulatory modernization and the insurance industry will continue to educate Congress about the slow pace of change in the states (Minutes of the NAIC/Industry Liaison Committee, June 10, 2006)."

[26] For a more complete description of these hearings, see (CFA testimony, "The Property/Casualty Insurance Business in 2007: Profits, Problems and Quality of Consumer Protections," before the Committee on Commerce, Science and Transportation, April 11, 2007
http://www.consumerfed.org/pdfs/Insurance_Regulation_Senate_Commerce_Testimony041107.pdf

In recent years, bills have been drafted by trade associations like the American Bankers Association and the American Council of Life Insurers that would allow insurers to choose whether to be regulated at the federal or state level. These proposals grant the federal regulator little, if any, authority to regulate price or products, regardless of how non-competitive the market for a particular line of insurance might be. (This year, the bill has been re-introduced in the House as H.R. 3200 by Representatives Bean and Royce and in the Senate as S. 40 by Senators Johnson and Sununu. Treasury Secretary Paulson also called for the creation of an optional federal charter for insurance in a "Blueprint for Financial Regulatory Reform" made public in March 2008.) The bills and proposals also offer little improvement in consumer protection or consumer information systems to address the major problems cited above.

Creating an optional federal charter for insurance that allows the regulated company, at its sole discretion, to pick its regulator is a prescription for regulatory arbitrage that can only undermine needed consumer protections in states like California. Indeed, in meetings with CFA, the industry drafters of such proposals have openly stated that this is their goal. If such a proposal were adopted, there is little doubt that many states would move quickly to further weaken consumer protections in order to retain regulatory authority (not to mention the significant income from insurer assessments) over the large national insurance companies that would otherwise choose weak federal oversight.

The SMART Act

The State Modernization and Regulatory Transformation (SMART) Act was proposed by former House Financial Services Chairman Michael Oxley and Representative Richard Baker as a discussion draft in 2005. Rather than increase insurance consumer protections for individuals and small businesses while spurring states to increase the uniformity of insurance regulation, this sweeping proposal would have overridden important state consumer protection laws, sanctioned anticompetitive practices by insurance companies and incited state regulators into a competition to further weaken insurance oversight. For example, it would have preempted state regulation of insurance rates, such as Proposition 103. The proposal would not have required a single new consumer protection. It would immediately, upon effectiveness, gut all rate regulatory consumer protections – even in the wake of a catastrophe (unlike the OFC which would do that more slowly, as states competed for insurers via lower regulatory standards).

III. Methodology

Proposals at the federal and state level to deregulate personal lines of property/casualty insurance prompted CFA to look at the various state regulatory models to see which states have experienced the slowest price increases. As discussed in Part 1 of this report, we determined that Prior Approval was the best system in use today to protect consumers and that California's system was the best Prior Approval system in the nation.

California best met a series of tests we used as standards for excellence in regulation:

- Regulations that are easily understood by, responsive and accountable to, and inspire confidence from the public and regulated companies and individuals.

- Beneficial competition that results in fair profits for regulated companies, reasonable rates for ratepayers and the equitable treatment of consumers.
- Elimination of the many problems associated with using certain criteria – sometimes unjustifiably – to choose whether to insure some policy holders and not others, and at what cost ("selection competition"[27]), and a prohibition on the use of risk classification factors that are not equitable or appropriate.
- Broad and vigorous public involvement in the regulatory process, including institutionalized consumer participation in the review of insurance rates, forms, and underwriting guidelines.
- Key information provided to regulators, regulated entities and consumers that allow them to identify market problems and harmful competition.
- Reduction and elimination of harmful products, unfair and deceptive practices in the marketplace, as well as the provision of meaningful restitution to consumers harmed by these products and practices.
- Promotion of loss prevention and loss mitigation as the most important way for insurers to manage risk and ensure safety and soundness.

Once we determined that California best met these standards, we evaluated rate and cost information to test if these factors led to positive outcomes for the public. We then analyzed and commented on the most methodologically sound critiques of Proposition 103 available in recent academic literature.

IV. Key Findings

This study concludes that by almost any measure, Proposition 103 in California represents the best practices for insurance regulation in the nation. We call upon the NAIC to adopt Proposition 103 as the model for regulating personal lines of insurance throughout the nation.

The provisions of Proposition 103 meet each of the standards of excellence explained above. This study finds that it has achieved the following:

- It has promoted vigorous and fair competition among automobile insurers in California. It eliminated the state's antitrust exemption, allowed banks to sell insurance, permitted insurance groups to form that were previously prohibited, spurred competition among agents by eliminating prohibitions against rebating part of their commission to consumers, and it vastly improved consumer information.
- It has put an end to destructive competition that adversely affected insurance consumers. For example, it outlawed "selection competition" by guaranteeing significant rate savings to good drivers and imposed fairness standards on the way insurers use "classifications" – based for example on credit scoring – to develop insurance rates.
- It has promoted efficient competition, not just by spurring a high level of competition, but by also ensuring that ratepayers do not have to pay for inappropriate or wasteful insurer expenses such as fines, excessive salaries, and bad-faith lawsuit costs.

[27] See footnote 2 for an explanation of selection competition.

- It has promoted driver and automobile safety by requiring insurers to give the most weight in the development of rates to driving record and to offer a 20 percent discount to good drivers as well as allowing drivers with good accident and ticket histories to receive auto coverage from the insurance company of their choice.
- It has the fairest, most transparent and most comprehensive system for the Prior Approval of rates and forms in the nation.
- It has opened the books of the insurance companies to public scrutiny and made significantly more information about how insurers develop rates and coverage available to consumers.
- It has made it possible for consumers to play an active, informed role in the regulatory process through advocates for consumers who are entitled to receive compensation if they intervene in a rate case and make a "substantial contribution."
- It has made data, such as access to insurance services by ZIP code, available to the public and regulators for their review of how well insurers serve all of the markets of the state.

These provisions of the law have produced outstanding results such as lower prices, fewer assigned risks, safer driving, lower insurer expenses and reasonable (at times bordering on excessive) profits for insurance companies.

C. BACKGROUND OF PROPOSITION 103

On November 8, 1988, the people of California adopted an insurance reform initiative, Proposition 103 (attached, Appendix 1) by a narrow 51 to 49 percent margin. This was a remarkable victory for consumers, especially considering that the insurance industry spent $63.8 million opposing reform, while the grassroots campaign for Proposition 103, led by consumer advocates, spent only $2.9 million, less than 5 percent as much.

I. Proposition 103's Key Elements

Proposition 103 enacted a series of measures designed to reform the insurance marketplace and industry practices, and to provide far greater protections to policyholders. The key elements were:

1. Immediate rate relief to offset excessive rate increases in business, auto and other lines of insurance.

2. Reforms to encourage competition in the insurance marketplace.

3. Rate regulation to limit rate instability and unjust premiums, and to require insurers to focus on efficiency and loss prevention.

4. Provisions to promote fairness in insurance pricing and eliminate unjust and discriminatory practices.

5. Provisions to encourage public participation and accountability in insurance matters.

1. Short Term Premium Relief, The Insurance Rate Freeze & Rollback

Proposition 103 reduced all automobile, homeowner, business and most other property/casualty insurance rates and premiums to the levels in effect on November 8, 1987, then required that they be reduced a further 20 percent. During the period of the freeze/rollback (November 8, 1988 through November 8, 1989), insurers were to be prohibited from raising rates or premiums. However, the initiative was drafted to allow an insurer to obtain increases from the Insurance Commissioner, if the freeze "substantially threatened" the company's solvency.

The rollback and reduction were intended to:

- Protect consumers by offsetting possible rate increases during the campaign year prior to the election.
- Establish a lower baseline premium from which rate increase requests would be reviewed under the Prior Approval system. In effect, the rollback reduced rates, which had reached excessive levels because of the absence of either regulation or effective competition.
- Ease the transition to the new system established by Proposition 103 by providing the Insurance Commissioner with a full year from Election Day to develop the regulations needed to implement the Prior Approval system.

The California Supreme Court upheld the rollback against a constitutional challenge by insurers, but ruled that the test for exemptions -- "substantially threatened with insolvency" -- violated the insurers' constitutional rights. The Court provided a different standard (see discussion of "The CalFarm Case," below).

2. Enhanced Beneficial Competition

Prior to the passage of 103, insurance companies were exempted by state law from California's consumer protection statutes. These exemptions artificially blocked competition in the insurance marketplace, resulting in higher-than-necessary insurance rates.

Antitrust Exemption

Proposition 103 repealed the insurance industry's exemption from the state's antitrust laws. In 1945 the insurance industry had won an exemption from California's antitrust laws; similar exemptions remain on the books federally and in almost every other state (Texas and New Jersey reduced their exemptions in the wake of Proposition 103). Under the exemption, insurer-operated "rating bureaus" were permitted to distribute proposed pricing data, including projected losses, expenses, profits and overhead charges among carriers. The rates always were based on costs incurred by the least efficient members of the cartel.

In addition to repealing the exemption, Proposition 103 prohibited the operation of "rating" and "advisory" organizations. Proposition 103 does allow insurers to exchange historical claims data. This permits insurers, particularly new or small carriers, to obtain information that

will enable them to develop their own projections and prices. Such information must also be provided to the Insurance Commissioner and to the public. Additionally, Proposition 103 permits insurers to participate in joint pooling arrangements established by the Insurance Commissioner or by law, which assures access to insurance for certain customers, such as day care centers, etc.

Discounting Agents' Commissions

Proposition 103 repealed the statutory prohibition against competition among insurance agents and brokers known as the "anti-rebate law." Every other state (except Florida) had a similar law. Under the "anti-rebate law," agents and brokers were prohibited from reducing their own commissions in order to offer consumers a discounted premium (in the same way that "fair trade" laws had prohibited retail competition on products decades earlier). Agents who violated the law were subject to penalties and the loss of their license. Consumers paid higher prices because of the anti-rebate laws. Moreover, such laws reward the inefficiency of some agents because they are shielded from competition by agents who are efficient, and are willing to cut prices in an attempt to gain market share.

Bank Sales of Insurance

Proposition 103 repealed the statutory prohibition on the sale of insurance by financial institutions. The ban on bank sales of insurance limited the number of providers in the market and thus reduced price competition.[28]

Expanded Group Insurance

Prior to Proposition 103, state laws deprived consumers of the ability to join together to negotiate discounted insurance plans. Proposition 103 expanded the definition of acceptable groups in order to permit consumers to unite to negotiate the policies and coverage they need, using their joint bargaining power in the marketplace just as large businesses do.

Enhanced Transparency: Consumer Comparison Shopping Service

A chief tenet of insurance reform is full disclosure of information. A consumer must be well informed on price, service and insurer solvency if the marketplace is to operate efficiently. While the insurers' statutory exemptions permitted them to exchange information with each other, consumers in the past had little access to data that would enable them to effectively shop for insurance. Proposition 103 requires the California Commissioner to provide consumers with a current rate comparison survey for all personal lines of insurance. Every admitted insurer selling private passenger automobile insurance policies must provide consumers with a cost estimate of its lowest priced personal auto policy at the insured limits the consumer requests, for which the consumer is eligible. Recent enhancements to California's insurance law added rules requiring all insurers to maintain either a toll-free telephone or an internet web site where consumers can obtain a cost estimate, or be referred to an insurance agent or broker who will provide the estimate. Insurer information regarding the toll-free telephone number or web site must be provided to the California Department of Insurance. The Commissioner has made this

[28] Congress allowed bank sales nationally under legislation adopted in 1999 (i.e., the Gramm-Leach-Bliley Act).

information available on the Department's Internet Web site and through its consumer toll-free telephone line (800) 927-4357. No other state requires this much consumer information, and, particularly, none have the important requirement that each insurer group offer the lowest quote available for all companies in the group.

3. Effective and Efficient Rate Regulation

Prior to Proposition 103, California had no meaningful regulation of insurance rates; there was no requirement that rates even be filed with the Commissioner, much less be reviewed or justified. Imagine the situation: through antitrust exemption, insurers could collude to set rates jointly, but the commissioner could not regulate (or even know about) insurer prices. This was a prescription for the pricing abuse and inefficiency that occurred.

As a result, insurers could pass through all costs to consumers, no matter how unjustified. They explained that their rates were "mirrors of society" and they passed through nearly every penny, plus a percentage profit factor. This cost-plus-percentage-of-cost approach gave insurers a perverse incentive; the larger the costs, the bigger the profit the percentage add-on would produce.

Imagine yourself on the board of directors of a stock insurance company when your actuary appears to present next year's rate analysis:

"We could go along as usual, increasing prices ten percent based on past cost increases and allow the costs to meet that expectation or we could hold the line or even reduce rates if we take on our agents by establishing more reasonable commissions, lay off our excess layers of middle management, fight GM to produce safer cars, lobby for safer roads and fight fraud more extensively. For our trouble, all this additional work will hold our profit flat rather than creating the increase in profit of 10 percent we can enjoy if we do nothing to hold the line."

How would you vote?

Proposition 103 mandates that insurance companies open their books and justify rate increases (and decreases). The Insurance Commissioner must approve proposed rate changes after a process in which the public may participate.

The "Prior Approval" regulatory system established by Proposition 103 promotes insurer efficiency and loss prevention by ending the insurers' ability to unilaterally pass through all expenses and claims costs, accompanied by that percentage of cost markup for profit, overhead and expense costs. Instead, Proposition 103 established a system that gives extra rewards for efficient performance so that, for the first time, insurers had an incentive to eliminate waste, cut unneeded expenses, weed out fraud and engage in loss prevention practices.

4. Enhanced Fairness

Excessive premiums were but one of the complaints that motivated the call for reform in California. Many motorists opposed the insurers' risk classification systems, which categorized

policyholders by geography or even on such non-risk related criteria as whether they had prior insurance coverage in order to determine the basic premiums each policyholder would pay.

Insurers allocate risk among policyholders by grouping each consumer into a pool composed of individuals with similar characteristics. Insurers traditionally set base premiums by giving first and primary emphasis to territories – clusters of ZIP codes – in a model known as "territorial rating." The unfairness of this approach is obvious: within any particular ZIP code – urban or rural – there are many drivers who have never had an accident at all. Yet their rates constantly increase – because under the territorial rating system, the vast majority of good drivers are forced to subsidize the rates of a few bad drivers located in the same ZIP code. The same unfairness relates to use of age, gender and marital status as classifiers. Rather than using the individual's driving record for pricing, the insurers used these non-risk related, non-causal factors to price. As an example, using age as a major rating factor rewards older drivers rather than safer drivers. This "guilty until proven older" concept is unfair to every excellent young driver.

A 1986 study prepared for the California legislature by the National Insurance Consumer Organization (NICO) demonstrated the defects of territorial rating. Of the 4.9 million cars insured in California between 1982 and 1984, 95.4 percent had no claims. In central Los Angeles, 93.5 percent of the cars avoided claims. The difference in the number of claims is to be expected given population density and reliance on automobiles in Los Angeles. However, the difference in claims between L.A. and the rest of California does not explain why accident-free L.A drivers paid on average 66 percent more for property damage insurance than did the average accident free driver outside L.A.[29]

On a related point, insurers often effectively evaded selling coverage to consumers in particular locations simply by refusing to write insurance in those areas, or by more subtle methods, such as failing to establish offices or agencies in those regions. This practice, known as "redlining," is a particular problem in congested urban areas.

Finally, many policyholders complained of other arbitrary practices, such as the abrupt cancellation of policies or non-renewals. Proposition 103 terminated these abusive and unjustified practices.

Emphasis on Driving Safety Record

Proposition 103 minimizes the use of discriminatory territorial rating, under which insurance companies determine automobile insurance premium by looking primarily at a customer's ZIP code. Proposition 103 requires that auto insurance premiums be based primarily upon a motorist's driving record, the number of miles he or she drives each year, and the consumer's years of driving experience, weighting those factors in that order. Only after primary weight is given to these factors can the commissioner allow other factors to have any effect. By substituting the driver's own record as the primary determinant of his or her auto premiums,

[29] Insurance in California: A 1986 Status Report for the Assembly," National Insurance Consumer Organization, October, 1986, Sec. IV, p. 14-16

Proposition 103 gives drivers a strong incentive to keep their rates low by driving safely, thus restoring logic and "fairness" to the system.

The commissioner may approve additional rating factors, but only after full public hearings, and only upon proof that the factors are substantially related to risk of loss, i.e., that they are shown by statistical analysis to hold predictive power once the first three "mandatory" factors are applied to determine the majority of the premium. Such additional factors approved by the commissioner will have relatively little impact on rates, as Proposition 103 specifies that they must be accorded lower weight compared to the three chief factors.

The Unruh Civil Rights Act as well as other provisions of the California law made applicable by Proposition 103, were applied to effectively prohibit rate classifications that include race, language, color, religion, national origin and ancestry (see below).

20 Percent Good Driver Discount

Proposition 103 further required that insurers provide a 20 percent discount for good driving to all qualifying consumers – individuals with a virtually clean driving record (one moving violation is permitted) for the preceding three years. This adds a further incentive for drivers to maintain a clear auto safety record.

Elimination of Harmful Competition, such as Selection Competition (Redlining)

Proposition 103 specifies that any good driver has the right to purchase a Good Driver auto insurance policy from the insurer of his or her choice. The absence of prior insurance coverage cannot disqualify an otherwise good driver. By providing all "good drivers" with this statutory right to a policy, the measure effectively eliminates redlining and allows for classifications that are fairer in that insurers cannot choose to write coverage for certain drivers, if they don't like a class.

Arbitrary Cancellations

A common experience of California policyholders prior to Proposition 103 was the abrupt cancellation or non-renewal of an automobile insurance policy immediately after the first claim was filed. Proposition 103 prohibits cancellation or non-renewal except under one of the following conditions: (1) non-payment of premium; (2) fraud or material misrepresentation affecting the policy or the insured party; (3) a substantial increase in the *hazard* insured against.

Application of Other State Laws

As noted above, prior to the passage of Proposition 103, insurance companies were exempt from the application of many state laws, including the state's civil rights and consumer protection statutes. Proposition 103 made these laws applicable to the insurance industry. By making California's consumer protection, civil rights and other laws applicable to the insurance industry, Proposition 103 makes available to consumers a panoply of remedies for improper actions that were previously specifically inapplicable to the insurance industry.

5. Public Participation and Accountability

It is essential that consumers' interests be represented in the often-complex regulatory system, and that government regulators be accountable to the public.

"Capture" of regulators by regulated entities – the fox guarding the chicken coop – is common, and, even if only a perception rather than a reality, it corrupts the public trust. The opportunity for individual citizens to enforce reforms and challenge insurer actions, and the democratic accountability of those administering insurance reform, are critical to its success.

Proposition 103 established a series of measures designed to foster participation and accountability; by specifying such measures, the voters could be assured that the specific purposes and goals of Proposition 103 would be implemented in the most pro-consumer fashion.

Elected Insurance Commissioner

In all but 12 states, the Insurance Commissioner is an appointee (usually by the governor). Often, the individual is a former insurance industry executive (as was true in California prior to Proposition 103), and the appointment is a form of political patronage. All too often in America's insurance regulatory history, the only people lobbying the governor when the appointment of an insurance commissioner was being considered were insurers. As a result, state insurance agencies have frequently been criticized for a pro-industry bias that harms consumers. In pre-103 California, independent studies repeatedly criticized the Department of Insurance for its inaction in the insurance crisis, its failure to respond to consumer complaints and its incompetent enforcement of the Insurance Code.

Proposition 103 required that the Insurance Commissioner be elected, beginning in November 1990. Entrusting the responsibility to implement Proposition 103 to an elected official had several virtues. An elected commissioner is subject to public, rather than political, supervision: only the voters may pass judgment on the commissioner's performance, providing the commissioner with the independence and incentive necessary to establish good public policy. A commissioner who fails to protect the public will not be re-elected to office. This will protect against efforts by insurance companies to install their own candidate for the job. This is not to say that bad commissioners cannot be elected. The scandal surrounding California Insurance Commissioner Chuck Quackenbush, who was forced out of office in 2000, is a stark lesson in what happens when the news media, lawmakers and voters fail to pay close attention to the conduct of state regulators. (The Quackenbush scandal is discussed in detail below). Appointment does make the commissioner more beholden to the Governor than to the people. Since it therefore takes two people (the governor and the commissioner) to be politically willing to stand up to the powerful insurance lobby, the election process offers a somewhat better opportunity for consumer interests to be fairly represented. Obviously, election of an insurance commissioner should be coupled with campaign finance reform. It is notable that in the wake of the Quackenbush scandal, no candidate who accepted any insurance industry campaign contributions has been elected to the post.

Funded Consumer Intervention

It is a basic tenet of due process that each party to a proceeding has the right to be fully represented. Such participation is critical in the context of insurance regulation, since insurance premiums represent more than 10 percent of the average American family's annual disposable income and is a necessity for consumers and businesses.

As presented to the voters, Proposition 103 set forth three avenues for consumer participation in establishing a fair insurance system. First, it provided individual consumers with the right to seek redress from the Department of Insurance or the courts if insurance companies fail to comply with their responsibilities to the policyholder. If the Department of Insurance fails to respond effectively to a consumer's complaint, consumers will not be "locked out" of the courts with no remedy.

Second, recognizing the cost and complexity of regulatory participation, Proposition 103 encouraged non-profit consumer advocacy groups to intervene in the expanded regulatory process to protect the interests of the public. Citizen groups that make a "substantial contribution" to a rate hearing or other matter before the Department of Insurance, or to an insurance matter which goes before a court, are entitled to receive reasonable advocacy fees and reimbursement of expenses for such costs as expert witnesses. Assessments collected from insurers are used to fund this program, except that when the matter involves a single company or insurer group, as in a rate hearing, the statue requires the company itself to reimburse the intervening consumer or citizen group. A March 8, 2008 Los Angeles Superior Court decision upheld Department of Insurance regulations that require companies to reimburse citizen groups that substantially contribute to the outcome of a proposed rate change, whether or not the proposal reaches the formal hearing process.[30] The reimbursement system enables citizen groups to monitor the Department of Insurance on a stable – and professional – basis. Numerous citizen groups have utilized this system to monitor implementation of Proposition 103.

Finally, Proposition 103 contained an additional mechanism to guarantee effective consumer representation. Insurance consumers were to be given the opportunity to establish and join a democratically created and controlled advocacy organization. A staff of advocates, funded by voluntary contributions and grants, would represent consumers on insurance matters before the Insurance Commissioner, the courts, and the state legislature. In order to enable the advocacy organization to obtain the support of consumers, Proposition 103 required insurers to enclose special notices with their premium bills, informing their customers of the opportunity to participate in the program. (Insurers would be reimbursed for any additional expenses caused by insertion of the notice). However, the California Supreme Court excised this provision of Proposition 103, as discussed in the next section.

II. The *CalFarm* Case

The morning after the voters approved Proposition 103, thirteen separate lawsuits were filed in state and federal courts by numerous insurance companies challenging the constitutionality of the new law and its compliance with state statutes governing the subject

[30] *ACIC, et al v. Poizner, et al*. Los Angeles Superior Court BS109154

matter of initiatives. These cases were consolidated into one before the California Supreme Court. On November 10, 1988, in the face of a shutdown of operations by nearly all carriers in the state, and threatened withdrawals by many insurance companies, the Supreme Court granted a stay of the entire initiative.

One month later, in December of 1988, the Court lifted the stay on all provisions of the measure with the exception of the rate rollback and the formation of the consumer advocacy group.

On May, 4, 1989, the California Supreme Court unanimously upheld the initiative, including the rate rollback, but ruled that the "substantially threatened with insolvency" standard might be interpreted so severely by the Commissioner that it would force insurers to obtain an "inadequate return" on their investment. The Court said, "[t]he risk that the rate set by the statute is confiscatory as to some insurers from its inception is high enough to require an adequate method for obtaining individualized relief." CalFarm Insurance Company v. Deukmejian (1989) 48 Cal.3rd 805 ("Calfarm"). The Court therefore substituted a "fair rate of return" standard, leaving it to the commissioner through the exemption process established by Proposition 103 to determine whether the rate rollback would deprive each insurer of a fair rate of return. The Court further ruled that insurers would be allowed to maintain their existing rate levels pending completion of the exemption process, noting that when rollbacks were ordered they would be retroactive and accompanied by interest.

The Court also excised the provision of Proposition 103 that required the insurance commissioner to establish a citizen funded insurance consumer advocacy group with access to insurer mailings. The Court ruled that this provision violated a provision of the California Constitution, which states that no initiative may "name" or "identify" a "private corporation."

The constitutional "fair return" requirement is familiar to regulators throughout the nation. It has become the focal point of most of the subsequent litigation brought by insurers against the implementation of Proposition 103.

449 insurance companies licensed to operate in California filed 4,089 specific line of insurance requests for exemptions from the rollback, claiming they would be deprived of a fair rate of return if forced to comply. The remaining 230 insurers either issued rebates, totaling about $125 million, or had maintained rates that complied with the rollback levels.

III. History of the Post-*CalFarm* Implementation of Proposition 103

Appendix 3 contains a brief history of the actions of the five insurance commissioners (Gillespie, Garamendi, Quackenbush, Low, and Poizner) in implementing Proposition 103. To say that there have been ups and downs in regulation over this time period would be a great understatement. This history is presented to show that the forces unleashed by Proposition 103 have been effective in holding down insurance prices with both pro-consumer and pro-industry commissioners at the helm.

D. FINDINGS

Proposition 103's components did, as the above review of the law's provisions demonstrates, meet the standards for regulatory excellence we set forth earlier in this paper. The question is, "How did Proposition 103 perform in the years since its passage?" As the following list shows, Proposition 103 has produced results that are unmatched throughout the nation.

Under Proposition 103, these remarkable results occurred between 1989 and 2005, unless specified otherwise:

- Auto insurance rates went up in California by only 12.9 percent, while nationally, rates rose by over 50 percent.
- California has enjoyed the lowest rate increase of any state in the nation since the adoption of Proposition 103.
- Rate rollbacks totaling $1.43 billion were paid to consumers.
- Loss costs passed on to ratepayers were controlled by the strong incentives for driver safety built into the initiative. "Clean" drivers received a 20 percent discount. They also gained the right to buy insurance from the company of their choice.
- Insurer expenses passed on to ratepayers were reduced by disallowing excess expenses and fines. Fewer insurer expenses were also passed through because of increased competitive pressure.
- In 1989, 8.4 percent of the insured drivers in California were in the Assigned Risk Plan. In 2005, the percentage had fallen to 0.1 percent. This represents an astounding drop in enrollment in the Assigned Risk Plan of 99 percent.
- There was entry and exit by insurers into the California market consistent with a competitive industry. The number of insurer groups competing in the state increased and the HHI index of 716 indicated a highly competitive market.
- Proposition 103 produced excellent profits for insurers, the fifth highest in the nation.
- Proposition 103 encouraged a national movement by insurers to fight fraud, push for automobile and highway safety and to cut costs – partly in order to head off the adoption of similar laws in other states.

One key measure of Proposition 103's effectiveness has been its ability to hold down costs and premium charges while maintaining reasonable profits for insurance companies. As to holding down costs, the following table of expenditure changes ranked from lowest to highest shows that, since 1989, California has had the smallest increase in auto insurance prices.

EXPENDITURE CHANGE BY STATE

STATE	1989 Average Expenditure	2005 Average Expenditure	1989 to 2005 Percent Change
California	$747.97	$844.50	12.9%
New Jersey	$982.93	$1,183.54	20.4%
Hawaii	$673.36	$842.78	25.2%
New Hampshire	$609.13	$791.71	30.0%

Pennsylvania	$646.03	$849.14	31.4%
Connecticut	$740.02	$990.52	33.9%
Rhode Island	$725.82	$1,059.13	45.9%
Maryland	$646.18	$944.73	46.2%
Illinois	$505.32	$742.65	47.0%
Georgia	$531.01	$783.69	47.6%
Maine	$434.84	$643.50	48.0%
Dist. of Colum.	$796.72	$1,187.77	49.1%
Ohio	$447.73	$668.93	49.4%
South Carolina	$494.25	$752.56	52.3%
Massachusetts	$728.39	$1,112.73	52.8%
Indiana	$426.29	$657.35	54.2%
North Carolina	$388.00	$602.20	55.2%
Tennessee	$423.26	$658.60	55.6%
Wisconsin	$392.46	$615.33	56.8%
Oregon	$466.29	$736.67	58.0%
Alabama	$426.30	$678.01	59.0%
Arizona	$581.42	$926.33	59.3%
Virginia	$437.87	$697.86	59.4%
Missouri	$430.05	$685.49	59.4%
Colorado	$515.31	$827.47	60.6%
New Mexico	$443.76	$727.35	63.9%
Vermont	$423.43	$698.74	65.0%
Idaho	$348.31	$582.99	67.4%
Nevada	$586.60	$982.56	67.5%
New York	$665.07	$1,122.45	68.8%
Mississippi	$440.80	$744.84	69.0%
Michigan	$550.84	$930.79	69.0%
Oklahoma	$399.19	$677.53	69.7%
Texas	$497.35	$844.87	69.9%
Washington	$490.50	$840.17	71.3%
Alaska	$560.27	$961.72	71.7%
Minnesota	$460.41	$791.47	71.9%
Kansas	$340.76	$590.29	73.2%
Florida	$610.21	$1,063.36	74.3%
Iowa	$315.02	$555.04	76.2%
Delaware	$574.04	$1,027.65	79.0%
Utah	$385.44	$705.56	83.1%
Louisiana	$571.96	$1,076.09	88.1%
Arkansas	$364.68	$693.31	90.1%
North Dakota	$283.11	$554.30	95.8%
West Virginia	$437.09	$856.53	96.0%
Kentucky	$375.71	$749.62	99.5%
Wyoming	$318.28	$639.05	100.8%
Montana	$336.04	$685.01	103.8%
South Dakota	$273.51	$565.23	106.7%

Nebraska	$284.86	$620.60	117.9%
Countrywide	$551.95	$829.17	50.2%

Source: NAIC Auto Database Reports for several years.

Prior to the passage of Proposition 103, auto insurance prices in California rose faster than the national averages. Since then, the rate of change has been much slower, under six-tenths of a percent a year, compared to over 2.1 percent annually for the nation. Using a savings test that assumes that California auto rates would have merely kept pace with the national rate of change, the actual savings realized by consumers under Proposition 103's rate measures was $61.8 billion.[31]

From the consumer perspective, this is a very favorable finding for insurance regulation in California. In order to determine how favorable, we looked at other information such as insurer profitability.

1989/2005 RETURN ON NET WORTH

	California	Nation
Personal Auto Liability	12.90%	7.50%
Personal Auto Physical Damage	15.80%	16.30%
Personal Auto Total	13.50%	9.90%
Homeowners	7.40%	-15.40%
All P/C Lines	13.90%	6.50%

Note: National data includes California.

The profits are so high that some cite them as a failure of Proposition 103. We cover this issue below.

I. Findings Relative to Proposition 103's Impact on Premiums in California

Benefits

- Between 1989 and 2002, insurance companies operating in California issued over $1.43 billion in premium refunds to more than seven million policyholders under Proposition 103's rollback mandate.

[31] See "Estimate of Savings from Proposition 103" Appendix 4, Spreadsheet 13.

- Beyond the rollbacks, California consumers have saved an additional $61.8 billion since 1988 under Proposition 103, in rate change savings for auto insurance alone.[32]

- California's auto insurance premiums rose by only 12.9 percent from 1989 to 2005. California saw the lowest rate of increase during this period. Nationally, rates rose by 50.2 percent during this time.

- California declined from the state with the third fastest growing auto premiums in 1989 to the slowest premium growth state in the nation through 2005.

- California declined from the state with the 3rd most expensive auto premiums in the nation in 1989, to number 18 in 2005.

- Insurance companies that fulfilled their rollback obligation were permitted rate increases when justified, based on criteria developed by the Insurance Department. The rollback was put in place by Proposition 103 to assure that "baseline" rates were not excessive at the start of the new regulatory approach. The regulations for considering rate increase proposals following the rollback were also stringent. This enabled insurance companies to be profitable and to react to changing conditions yet assured the public that rates were fair and adequate.

Problems

Insurers were determined to exhaust all legal avenues in order to delay payment of the rate rollbacks. Although unsuccessful in their attempts to have the rate rollback requirement invalidated, this was also part of the insurer strategy to discredit Proposition 103 in order to discourage similar reforms in other states.

- Insurers lobbied state lawmakers to repeal or amend certain provisions of Proposition 103, despite a state law banning hostile amendments to voter approved measures.[33] In each case, if not defeated in the legislature, the amendments were invalidated in legal challenges that often reached the California Supreme Court. These failed attempts to undermine Proposition 103 included legislation to achieve the following:
  - Exempt three lines of insurance from Proposition 103's rollback requirement.[34]
  - Permit insurance advisory organizations to resume distribution to insurers of data on projected losses for price-setting purposes, part of an Insurance Services Office (ISO)-sponsored plan.[35]
  - Allow illegal practices including surcharges on drivers who have a gap in coverage or no prior insurance, and allowing insurance agents to "double-dip" by charging customers a broker fee on top of the agent commissions they receive from the insurer.

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[32] Ibid

[33] Proposition 103 section 8(b) forbade legislative amendments to the initiative that did not further the purposes of Prop 103: "The provisions of this act shall not be amended by the Legislature except to further its purposes by a statute passed in each house by roll call vote entered in the journal, two-thirds of the membership concurring, or by a statute that becomes effective only when approved by the electorate."

[34] *See* Amwest Surety Ins. Co. v. Wilson, 906 P.2d 1112 (Cal. 1995)

[35] § 1855.5.

- Insurers' battle against Proposition 103 necessarily extended to the regulatory realm where much of the commissioner's rate oversight ability rests. The failure of successive commissioners to fully enforce the prohibition on "excessive" and "inadequate" rates permitted insurers' profits to exceed reasonable levels in some instances.[36] Amendments to the Prior Approval regulations that were adopted in 2007 imposed specific requirements (such as the allowable rate of return) and methodologies on the ratemaking process that enhance regulatory oversight of rates.

- Rate oversight became lax under the 2000-2002 interim commissioner. Between 2001 and 2003, 83 rate increases and only 5 decreases were approved for California's top 50 auto insurers. The 2004 to 2006 period saw the opposite trend as rate oversight got back on track: the Department approved 25 rate decreases and just 1 increase. These decreases included successive 5 percent and 7 percent reductions by the second largest insurer in California, the AAA-affiliated Interinsurance Exchange of Southern California ("Auto Club"), and two reductions totaling 11.9 percent by the state's largest insurer, State Farm.[37] Recently, the Department has ordered a 15.9 percent auto rate reduction for Allstate of about $120 per vehicle annually, totaling nearly $250 million statewide. The Auto Club also "settled a Proposition 103-related lawsuit with a pledge to issue $22.5 million in refunds to about 120,000 (auto insurance) customers."[38]

- Had Proposition 103's "Prior Approval" regulatory requirements been properly enforced, Californians would have saved an estimated additional $8 billion over the time Proposition 103 has been in effect.[39]

- Without first seeking action by the California Department of Insurance, a group of lawyers filed a lawsuit in 1998 against major insurers and Insurance Commissioner Quackenbush, charging that the Commissioner had approved excessive rates and requested damages. The case was dismissed by the San Francisco Superior Court on the principle of law that such complaints should first be brought to the administrative agency with expertise in the issue, in this case, the Department of Insurance, for its review. The plaintiffs appealed. The appellate court in San Francisco went beyond the lower court ruling, and held that once the insurance department has approved or failed to disapprove a proposed insurance rate, those rates may not be subsequently challenged in a lawsuit (Walker v. Allstate Indemnity Co. 2000; 92Cal.Rptr.2d132). The decision effectively negated sections 1861.05, 1861.09 and 1861.10 of Proposition 103, which specifically allows consumers to challenge, and seek judicial review of, any rate in effect in violation of Proposition 103's requirements. In litigation challenging any misconduct, insurers routinely assert a Walker defense, arguing that so long

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[36] See Appendix 3.

[37] Rate Filing Approvals by Year, 2000-2006, California Department of Insurance. Private Passenger auto liability/physical damage rate approvals, excluding specialty insurance programs such as motorcycle, motor home, etc.

[38] Auto Insurers' Rate Cuts a Result of Prop. 103, Union Tribune, March 19, 2008.

[39] Arguably, profits over the time period were of the order of 3 to 4 percent too high on a premium basis. This produces a rough estimate of roughly $8 billion in overcharges. The California Insurance Department has moved to toughen the regulations to end excess profits.

as the rate, rule or practice was part of a filing not disapproved by the Commissioner, it cannot be subsequently challenged.

- Several insurers have sought variances from the newly amended Prior Approval regulations that would allow companies to charge higher rates than Proposition 103 rules allow. The requests are under scrutiny in several pending rate proceedings, and many have already been rejected.

II. Findings Relative to Proposition 103's Impact on Insurer Operations

Benefits

- Proposition 103 impelled insurers to engage in major cost cutting programs. Ending the "pass-through" mentality of insurance companies, in which even unjustifiable insurer expenses were allowed to be passed on to ratepayers, was one of the most important achievements of the new law. The freeze on rates, imposed to encourage compliance with Proposition 103's rate rollback requirement, forced insurers to "tighten their belts" significantly in order to maintain profit levels. Insurers are now more engaged in fighting fraud, promoting automobile and driver safety, reducing unnecessary expenses and otherwise working to hold down costs.

- Regulatory controls have encouraged insurers to actively pursue anti-fraud programs. Two years after Proposition 103 passed, the Los Angeles District Attorney noted that, "until coming under pressure to lower rates under Proposition 103, [insurance] carriers simply settled claims and passed the cost to consumers in the form of higher premiums. 'That has begun to change,' he said. 'Insurance companies are getting serious about fraud.'"[40] A trade publication observed that "low expense ratios [are] a common factor among many of [the] auto insurers that posted underwriting profits. They have avoided expense-hungry products, out-sourced functions or eliminated the middle man from their operations."[41]

- Proposition 103 also renewed insurer efforts to prevent losses. It directly prompted the insurance industry to work with consumer groups in 1989 and 1990 to establish the Advocates for Auto and Highway Safety and the Coalition Against Insurance Fraud. In fact, the establishment of ongoing, institutionalized efforts to hold down loss costs throughout the nation, and particularly in California, is an important legacy of Proposition 103 that has helped insurers maintain profits. (See below for discussion of whether Proposition 103 has allowed excess profits.)

- In January 2007, California Insurance Commissioner John Garamendi amended the regulatory ratemaking formula to establish specific requirements and methodologies to be used in the Prior Approval rate setting process. These standards built on what was already the most rigorous and systematic rate regulation regime in the nation under Prop 103. The 2007 rules, which took effect in April of that year, set specific numerical or methodological

[40] Lois Timnick, *51 to Face Charges in Auto Insurance Fraud Roundup*, L.A. TIMES, Oct. 18, 1990, at B4.
[41] Richard Yingling, *Rebuilding Crumbling Loyalties*, BEST'S REV., Sept. 1, 1990, at 57, 59.

constraints on the ratemaking process to ensure that rates are not excessive or inadequate. The standards include the following:

- **Limit on Rate of Return.** Under Proposition 103, insurance rates must be based on data that project a rate of return that is based upon an average of returns on various government bonds plus an additional 6 percent. As of February 2008, the maximum rate of return that an insurer could build into its rate is 9.39 percent.

- **Efficiency Standard.** Expense efficiency standards are determined by line and distribution based on an average of the last three years of industry-wide expense data expressed as a ratio of allowable underwriting expenses to earned premiums. The standard "represents the fixed and variable cost for a reasonably efficient insurer to provide insurance and to render good service to its customers." For example, the current efficiency standard for auto liability insurance sold by captive agents (such as State Farm and Allstate) is approximately 32%, meaning that for every $100 of premium charged to policyholders, an allowance is given to insurance companies of about $32 to cover the cost of commissions to agents, other acquisition costs (e.g., advertising, etc.), general expenses (e.g., rent, salaries, etc.), premium taxes and fees paid to the State of California and for the expenses of adjusting and settling claims other than defense and cost containment expenses.

- **Company Specific Trend.** Loss and premium trends are to be based on an insurer's company-specific most recent twelve quarters of data.

- **Surplus Limits.** Leverage factors are established by the Commissioner to ensure that this component factor which is used to derive the profit provision allowed to insurance companies in the rate calculation is reasonable. The factors are based on national industry-wide ratios of premium to the average year-beginning and year-end surplus for each insurance line using data reported in Best's Aggregates and Averages. Currently, for auto insurance, the leverage factor (earned premium divided by surplus) is about 1.33.

With these values and methodologies in place, a new round of rate decreases has begun. The first publicly challenged rate filing that was subject to a hearing under these rules resulted in a savings of nearly a quarter of a billion dollars for Allstate auto insurance customers. In October 2006, Allstate filed a new rate structure and requested that the overall rate remain unchanged for its auto line. Under the Prior Approval regulations in effect at the time, it was evident that some decrease was needed. During the hearing process the amended rules became effective and, despite Allstate's requests for only an 8 percent rate reduction, the new rules required a much more substantial rate cut. At the end of the hearing process, it was determined that Allstate must reduce auto insurance rates by 15.9 percent, or approximately $245 million.

<u>Problems</u>

- Under Proposition 103, California regulators have not cracked down on some claims payment abuses. Insurers throughout the country appear to have reduced their payouts and

maximized their profits by turning their claims operations into "profit centers" by using computer programs and other techniques designed to routinely underpay policyholder claims without adequately examining the validity of each individual claim. For instance, many insurers use programs such as "Colossus," sold by Computer Sciences Corporation (CSC).[42] CSC sales literature has touted Colossus as "the most powerful cost savings tool" and also suggested that the program will immediately reduce the size of bodily injury claims by up to 20 percent. As reported in a recent book, "…any insurer who buys a license to use Colossus is able to calibrate the amount of 'savings' it wants Colossus to generate…If Colossus does not generate sufficient 'savings' to meet the insurer's needs or goals, the insurer simply goes back and 'adjusts' the benchmark values until Colossus produces the desired results."[43] In a settlement of a class-action lawsuit, Farmers Insurance Company has agreed to stop using Colossus on uninsured and underinsured motorist claims, where a duty of good faith is required, and has agreed to pay class members cash benefits.[44] Other lawsuits have been filed against most of America's leading insurers for the use of these computerized claims settlement products.[45] The use of these programs severs the promise of good faith that insurers owe to their policyholders. Any increase in profits that results cannot be considered to be legitimate. Moreover, the introduction of these systems could explain part of the decline in benefits that policyholders have been receiving as a percentage of premiums paid in recent years.

- No other problems that we have identified regarding insurer operations have been significant. Minor changes have been made to accommodate specific concerns by insurers. For example, the industry successfully sought state legislation to tighten the timelines for departmental review of rate change applications.[46]

III. Findings Relative to Proposition 103's Impact on Competition and the Marketplace

Benefits

- Under Proposition 103, California's antitrust laws are fully applied to insurance to prevent monopolistic pricing. Indeed, the application of the antitrust laws protected Californians against industry misconduct in the aftermath of Proposition 103's approval by the electorate. Immediately after the passage of Proposition 103, most insurers in the state ceased selling new policies to exert pressure upon the California Supreme Court to rule favorably on the industry's request to invalidate the ballot measure. The state Attorney General subsequently found the boycott to be a violation of the antitrust laws made applicable by the measure, although he declined to prosecute.[47] The California Attorney General issued specific antitrust

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[42] Other programs are also available that promise similar savings to insurers, such as ISO's "Claims Outcome Advisor." These systems relate to bodily injury claims but other systems, such as Exactimate, "help" insurers control claims costs on property claims.

[43] "From Good Hands to Boxing Gloves – How Allstate Changed Casualty Insurance in America," Trial Guides, 2006, Berardinelli, Freeman and DeShaw, pages 131, 133, 135.

[44] Bad Faith Class Actions, Whitten, Reggie, PowerPoint Presentation, November 9, 2006.

[45] Ibid.

[46] Insurance Code §1861.05 was amended in 1992 and 1993. §1861.055 was added by statute in 1990.

[47] *See* E. Scott Reckard, *Insurers' Pullout Blamed on Conspiracy*, THE ORANGE COUNTY REG., Jan. 3, 1991, at A3.

guidelines applicable to the industry in 1990. The threat of antitrust prosecution has made insurers more competitive and discouraged industry collusion in rate setting.

- Within four years of Proposition 103's passage, 133 banks obtained approval to sell insurance, increasing competition in the marketplace. Proposition 103 led the way to national change when, in 1999, Congress adopted the Gramm-Leach-Bliley Act allowing banks to sell insurance across the nation, although consumer groups did express serious concerns about the absence of regulatory oversight under this legislation.

- The number of insurer groups offering automobile coverage in California has increased since Proposition 103 took effect, strengthening competition. Despite repeated threats that many insurers would leave the state if Proposition 103 became law, no major auto insurance company closed its California operations after the passage of the Initiative.[48] One early analysis concluded that more insurance companies had applied to do business in California after the passage of Proposition 103 (85) than had withdrawn (3), or had requested permission to withdraw, as of July 1990 (25). While the number of individual insurance companies writing auto insurance in California has dropped from 265 to 193 since 1989, this is not the relevant yardstick by which to measure competition, since the industry has consolidated in recent years. The proper measure of competitive activity is the number of insurance corporate groups writing coverage in the state, which has risen from 94 to 99.[49]

- By the standards of the Herfindahl-Hirshman Index, California's score of 716 makes it the 4th most competitive market in the nation.[50]

Problems

- Proposition 103 permitted insurance agents and brokers to cut their commissions in order to discount the price of a policy. Such discounting is common in negotiations over commercial insurance policies, but was prohibited by law in consumer sales prior to Proposition 103. Unfortunately, insurance companies, under pressure from trade associations representing agents, have sought to discourage such competition among their sales force by terminating individual agents who engage in "rebating."[51] Consequently, few consumers are aware of their ability to request a discount.

- California was one of the first states to require a computerized buyer's guide to insurance policies, again leading the nation under Proposition 103. California's Department of Insurance Premium Comparison website[52] provided more information than was available

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[48] Jay Angoff, Editorial, *Quit California? Don't Bet on It*, L.A. TIMES, Dec. 1, 1988, at § II, at 7.

[49] The Regulation of Automobile Insurance in California, Jaffee and Russell, 2001.

[50] See "HHI Data by State" Part 1, Spreadsheet 7.

[51] In 1994, an administrative law judge ruled that it did not violate the antitrust laws for an insurance company to terminate an insurance broker who engaged in such competition, so long as the company's action was not the product of pressure from other brokers. *See In re* Prudential Ins. Co., OAH Nos. L-60175, L-60174, L-60173, L-60172, L- 60171, Case Nos. UPA 0053-AP, UPA 0054-AP, UPA 0055-AP, UPA 0056-AP, UPA 0057-AP (Cal. Dep't of Ins. 1993). UPDATE?

[52] http://www.insurance.ca.gov/0100-consumers/0010-buying-insurance/0080-compare-premiums/index.cfm

through other departments around the country. Visitors received estimated premium quotes for auto, home, long-term care and Medigap insurance for more than 50 companies. However, the quotes were based on a few, basic classifications that allow some generic comparison shopping and do not yet provide the robust, actual price comparison based on the consumer's profile that Proposition 103 anticipated. However, a system that provides more personalized price information began in 2005. Every admitted insurer selling private passenger automobile insurance policies must provide consumers with a cost estimate of its lowest priced personal auto policy at the limits the consumer requests and for which the consumer is eligible. Insurers must provide a toll-free telephone and/or an internet web site where consumers can obtain a cost estimate or be referred to an insurance agent or broker who will provide the estimate. Insurer information regarding the toll-free telephone number and/or web site must be provided to the California Department of Insurance. The Commissioner has made this information available on the Department's internet web site and consumer toll-free telephone line: (800) 927-4357. No other state requires this much consumer information, including the vital information that the insurer group offer the lowest price.

- Proposition 103 empowered consumers to more easily negotiate group insurance purchases, and several group policies have been negotiated under the expanded definition. Significant research at NAIC and elsewhere into group policies has shown real savings for consumers through the efficient delivery of auto insurance by this method. Many states have moved to allow group policies, following Proposition 103's lead in this area. There is a critical need for public education and awareness about group insurance options to assure that consumers can take advantage of these choices. The issue of improved consumer education about insurance options has moved to the national stage since 1992, with California and others launching various efforts. For example, the NAIC developed a national complaint database, which allow much better information about insurers' service track record to be created and publicized. However, more needs to be done to help consumers deal with the complexities of buying insurance. Too much "junk" insurance that is unnecessary or overpriced is still sold in California and around the country, not to mention overpriced policies from companies that offer poor service.

IV. Findings Relative to Insurer Accountability and Public Participation

Benefits

- Proposition 103 encourages non-profit consumer advocacy groups to intervene in the regulatory process to represent and protect the interests of the public. Insurance Commissioner John Garamendi established "state of the art" regulations to encourage consumer representation in insurance matters. Subsequently, Insurance Commissioner Quackenbush sought to discourage such representation by delaying or denying payment of attorneys' and expert witness fees to consumer representatives. Commissioners Garamendi and Poizner, who succeeded Quackenbush, did not follow this pattern.[53]

[53] A handful of citizen organizations routinely intervene in California's insurance regulatory proceedings. Since the enactment of Prop 103 through June 30, 2007, insurance companies have paid $10,365,374 to citizen and consumer group intervenors and their experts.

- Consumers fought an ongoing battle with insurers attempting to undermine Proposition 103's provisions permitting ratepayers to challenge insurers' illegal conduct in court (particularly in the event that a recalcitrant insurance commissioner fails to enforce the law). Consumers won a victory in 2004 in the Second District Court of Appeals with Donabedian v. Mercury Insurance. The court rejected insurers' arguments that only the insurance commissioner can remedy overcharges and other violations of Proposition 103, and upheld the public's right to enforce Proposition 103 under the state's Unfair Competition Law.[54] Insurance Commissioner Garamendi argued for plaintiffs in the case, with a friend of the court brief that argued the Department "simply lacks the resources to pursue every allegation."

- California remains the best state for consumer intervention in ratemaking cases in the nation. Auto rate challenges by consumer representatives saved motorists $450 million between 2003 and 2008 (and another $600 million in the homeowners and medical malpractice lines). Several pending rate challenges should be finalized this year, with hundreds of millions in savings expected for drivers and homeowners.

- The elected insurance commissioner position has provided crucial public accountability, although the three individuals elected to the position since 1990 conducted themselves in starkly different ways. As noted above, Insurance Commissioner Garamendi largely championed consumers' interests under Proposition 103 and in other insurance matters. Insurance Commissioner Quackenbush abused his authority in office and resigned in disgrace. Current Insurance Commissioner Poizner has aligned himself with consumers, while maintaining a relationship with the insurance industry. There are two lessons to be learned from the track record of the elected commissioners in California so far. First, commissioners who are elected with large quantities of campaign contributions from insurance companies are more likely to ignore consumer concerns.[55] Second, Commissioner Quackenbush was ultimately held accountable because he was elected to the position. An appointed regulator operates at the pleasure of the governor. Corruption involving industry campaign donations to the appointing official is far more difficult to uncover. The Quackenbush scandal confirms that the best way to make insurance regulation accountable to the public is to make the regulator directly accountable to the public.

- Under Proposition 103's mandate of broad public disclosure, California consumers have far more access to information about insurance companies than was available prior to 1988, or is readily available in most states to this day. For example, under Proposition 103 regulations, the state must disclose to the public the data it collects from insurance companies to determine whether insurers are engaged in redlining by discriminating against consumers

[54] B&P §17200, et al.

[55] Chuck Quackenbush accepted more than $8 million in campaign contributions from insurers and funneled millions more into nonprofit organizations controlled by his associates prior to resigning in disgrace. Steve Poizner won his post after pledging to take no money from the insurance industry, and a campaign highlighting the hundreds of thousands of dollars in industry contributions taken by his opponent. Similarly, Poizner's predecessor John Garamendi refused industry contributions, winning a primary election in part by distinguishing himself from a candidate who chose to accept industry money.

based on their race, income, or the ZIP code where they live. The public has full access to rate filing documents and most other formal filings made with the Department.

Problems

- In upholding the constitutionality of Proposition 103, in May 1989 the California Supreme Court eliminated from the initiative an important mechanism to guarantee effective consumer representation. Under § 1861.10(c), insurance consumers were to be given the opportunity to establish and join a democratically created and controlled advocacy organization that would represent consumers on insurance matters before the insurance commissioner, the courts, and the state legislature. The California Supreme Court excised this provision of Proposition 103, ruling that section 1861.10(c) violated Article II, Section 12 of the California Constitution, which prohibits an initiative from "naming or identifying" a private corporation. *Calfarm Ins. Co. v. Deukmejian*, 48 Cal. 3d 805, 832 (1989). A later effort in the California Legislature to create such an advocacy group was blocked by insurance industry lobbyists. Meanwhile, Texas, following 103's lead, enacted the Office of Public Insurance Council, which was a well-funded consumer group that was nonetheless subject to the pressure that insurers could generate on the governor regarding the group's budget and priorities. The nation still lacks a model of independent consumer advocacy with sufficient funding to be effective. The National Association of Insurance Commissioners (NAIC) has consistently refused to take up the issue.[56]

V. Findings Relative to Proposition 103's Impact on Fairness

Benefits

- To ensure that qualified drivers can obtain insurance regardless of where they live, the measure specifies that any good driver, as defined by law, has the right to purchase an auto insurance policy from the insurer of his or her choice. Moreover, under Proposition 103, the absence of prior insurance coverage cannot be used by the insurer to disqualify or penalize motorists applying for insurance. These provisions, intended to reduce the residual market pool, are in effect and successful. In 1989, 8.4 percent of insured drivers in California were in the California Automobile Assigned Risk Plan (CAARP). In 2005, the percentage had fallen to 0.1 percent. The decline nationally from 1989 to 1998 was 7.1 to 1.3 percent.[57] This represents an astounding drop in participation in the California Assigned Risk Plan of 99 percent.

- Proposition 103's prohibition on arbitrary cancellations and non-renewals is in effect. In 1990, the California Supreme Court ruled that this provision of Proposition 103 does not prevent an insurance company from terminating its policyholders as part of a plan to cease doing business in the state.[58] Indeed, Proposition 103 contained a specific provision

[56] After the adoption of Proposition 103, the NAIC finally agreed to fund the travel expenses of about a dozen consumer advocates to attend their meetings. However, the NAIC does not provide reimbursement for the time spent by these advocates on NAIC related matters, which significantly limits their ability to participate.
[57] AIPSO Facts 2006/2007, AIPSO.
[58] Travelers Indem. Co. v. Gillespie, 50 Cal. 3d 82 (1990)

intended to protect California policyholders against a boycott or market withdrawal by insurance companies. Under section 1861.11 of the California Insurance Code, the insurance commissioner is empowered to establish a "joint underwriting authority" in which all insurance companies selling any form of insurance in California must participate to provide coverage in the event of a shortage in any specific line of insurance. The California Department of Insurance has not utilized this provision. An exception in the statutory prohibition against non-renewals – for a "substantial increase in the hazard insured against" – has created an opportunity for insurers to evade the law. Regulations defining this exception and limiting non-renewals were promulgated in 1994 and amended in 1998.[59]

- Proposition 103 requires that premiums be based primarily on driving record, miles driven and experience, characteristics that are within the control of the motorist. This minimized the impact of discriminatory rating factors – including territory (where a driver lives), gender, marital status and education – that have allowed insurers to charge certain communities more but avoid the charge of redlining. Insurers attacked this provision of Proposition 103 with particular force, and implementation was repeatedly delayed through legislative, legal and regulatory channels.

- The insurance industry argued that eliminating territory as the primary determinant of premiums would result in substantial premium increases for good drivers. In 1994, Insurance Commissioner Garamendi published a detailed statistical analysis that refuted the industry's predictions, and rebutted the industry's contention that territorial rating was consistent with the provisions of Proposition103.[60] However, Garamendi left office before implementing the change in law. In 1996, Insurance Commissioner Quackenbush issued new regulations[61] containing a loophole that allowed insurers to continue to use territorial rating. An independent review of the rating plans filed by three major insurance companies confirmed that the regulations violated Proposition 103.[62] Two lawsuits were subsequently filed to compel the Insurance Commissioner to properly enforce the statute[63] but the 1st District Court of Appeal, in a decision issued December 29, 2000, upheld the Quackenbush regulations on the grounds that they preserve a substantial relationship between rating factors like territory and the risk of loss. The Court acknowledged that the regulations do not ensure that rates would be determined primarily by driving safety record and miles driven as

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[59] CCR Title §10,2632-19.

[60] *See* Office of Policy Research, California Dep't of Ins., Impact Analysis of Weighting Auto Rating Factors to Comply With Proposition 103 (1994). *See id*. at 4.

[61] *See* CAL. CODE REGS. tit. 10, § 2632.1 (1997).

[62] Virtually all insurance companies in the state were found to be misinterpreting the regulations in order to continue to base premiums on territory, in violation of Proposition 103. *See* Kenneth Reich, *Loophole Seen Gutting New Car Insurance Plan*, L.A. TIMES, Oct. 4, 1997, at A1. An industry trade journal noted that Insurance Commissioner Quackenbush had improperly approved the rating plans: "[T]he commissioner has been misleading the public and the media by proclaiming that under his new rules territory is no longer the dominant factor in setting auto insurance rates." *California Class Plan Ruling Should Be in Quackenbush's Hands; What Will He Do?* AUTO INS. REP., Nov. 17, 1997, at 1, 3.

[63] *See* Proposition 103 Enforcement Project v. Quackenbush and Spanish Speaking Citizens' Found., Inc. v. Quackenbush, consolidated case No. 796071-6 (Alameda Super. Ct. filed Mar. 25, 1998).

Proposition 103 requires. However, the court left the ultimate determination of the statute's requirements to the insurance commissioner.[64]

- Interim Commissioner Harry Low did not review the issue, but in 2003, Insurance Commissioner John Garamendi revisited the territory regulations he did not complete in his first term of office. New regulations were adopted in July of 2006 that required insurers to begin a transition to compliance with the rule in August of 2006. Several insurance trade associations filed suit to block the regulations but were rejected in a series of court decisions in 2006 and 2007. During that period, most companies began the process of restructuring the rating and classification system to prioritize driving record over territory and concurrently lowered rates for most of their customers. The 2006 regulation requires that all companies complete the transition by August 2008. Twenty years after the voters rejected using where a driver lives, instead of how he or she drives, as the basis for insurance rates, this last key provision of Proposition 103 will finally be implemented.

Problems

- A number of insurers routinely violate provisions mentioned above that are meant to ensure that drivers who qualify can obtain affordable insurance no matter where they live.[65] In recent years, several lawsuits were filed against insurers for surcharging customers who had no prior insurance or had a lapse in coverage. Prop 103 expressly forbids such a surcharge.[66] In response to the suits, insurers sponsored California legislation (SB 841) in 2003 to amend Proposition 103 in order to allow this practice. Though enacted, California courts invalidated the law in 2005 as an illegal amendment to Prop 103.

- Since the repeal of SB 841, several of the lawsuits have been resolved. In one case, the insurance affiliate of the Auto Club (AAA) of Southern California refunded $22.5 million to about 190,000 current and prior policyholders. The practice of surcharging drivers without prior insurance appears to have ceased in California.

VI. Findings Relative to the National Impact of Proposition 103

Benefits

- Proposition 103 has spurred insurance reform activity in over 40 states. Over 1,000 Proposition 103-style reforms were introduced in state legislatures in several sessions in the years immediately following the introduction of Proposition 103 in California. Numerous states enacted rate rollbacks or other significant Proposition 103-type reforms, including Texas, Pennsylvania and New Jersey. Antitrust exemptions were partially removed in New

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[64] Spanish Speaking Citizens' Foundation Inc. vs. Low, (2000) 103 Cal, Rptr, 2d 75.

[65] *See* Vlae Kershner, *Agents Say Insurers Forcing Them to Skirt Prop. 103*, S.F. CHRON., Feb. 5, 1990, at A1; Scott Ard, *Farmers Sued for Denying Coverage*, THE DAILY REV. (Alameda County, Cal.), Mar. 3, 1990, at 1; Vlae Kershner & David A. Sylvester, *Survey Shows Biggest Insurers Sidestep 103*, S.F. CHRON., Feb. 8, 1990, at A1.

[66] CA Insurance Code §1861.02 (c): The absence of prior automobile insurance coverage, in and of itself, shall not be a criterion for determining eligibility for a Good Driver Discount policy, or generally for automobile rates, premiums, or insurability.

Jersey and Texas. Auto rates were frozen in South Carolina, Florida and Georgia. Proposition 103 positively affected insurance regulation throughout the nation in many other areas, including information systems, allowing banks to sell insurance, safety efforts, fighting fraud, and restricting (but not ending) the ability of insurers to pass-through excessive costs to ratepayers.[67] However, the industry effectively weathered the Proposition 103 "earthquake" nationally through court action, public relations efforts and a "full-court" lobbying effort to undermine reform efforts in most states.

- Shortly after Proposition 103 passed, the Insurance Services Office, an industry-controlled organization that distributes proposed rates to insurance companies, agreed to cease this most anti-competitive of its practices. It announced that it would end the filing of "final rates" with states, instead filing only prospective loss costs that did not include insurer expenses or profits. The National Council on Workers Compensation Insurance later did the same thing. This practice is less anti-competitive than setting full rates, but it still results in collusive prospective ratemaking, particularly in regard to joint trending. The joint use among insurers of loss trend data is particularly objectionable since insurers use the same predictions of future costs to develop the loss portion, which is the largest component of their rates. This encourages the perverse "pass-through" mentality of insurers. In California, happily, ISO and the other rate bureaus can't file prospective loss costs. This is a great advance and one of the key reasons competition has increased and prices have moderated in the state.

- After the adoption of Proposition 103, insurers worked nationally to reduce overhead costs and offer more efficient rates. They trimmed commissions and opted to use less wasteful, direct marketing methods. However, as the pressure for reform has eased and pressure to deregulate insurance pricing has gained strength, insurer expenses have started to creep up on a national basis. Personal automobile underwriting expenses dropped from 22.8 percent in 1989, to 21.8 percent in 1996, but rose to 24.0 percent by 2006, according to A. M. Best and Company.[68] It seems likely that insurers have incorporated additional, unnecessary costs into rates as the pressure for regulatory reform has lessened and efforts by insurers to reduce consumer protections at both the state and federal level have increased. As insurers have enjoyed four years of unprecedented profits nationally from 2004 through 2007, they have had little incentive to cut costs.

- Major insurers have joined with consumer groups to create the "Advocates for Auto and Highway Safety" and the "Coalition Against Insurance Fraud." Both the Coalition and the Advocates remain very active in public policy matters to improve automobile and road safety and to stop insurer and consumer fraud.

- In Congress, Proposition 103 inspired a serious effort in the early 1990s to repeal or amend the insurance industry's federal antitrust exemption. However, the industry managed to hold off reform with an enormous lobbying effort, but not before elements of the industry broke ranks to support the repeal or amendment of the McCarran-Ferguson Act's antitrust

[67] One key problem in other states is the continued exemption from state anti-trust law and the joint insurer use of trend factors made by rating organizations.
[68] Aggregates and Averages, A. M. Best and Co., 2007 edition.

exemption. Both the Chairman and Ranking Member of the U.S. Senate Judiciary Committee now support rolling back or eliminating this protectionist law.

Problems

- Like the magician who diverts your attention in order to perform sleight-of-hand, the insurance industry was very successful in promoting the idea that if Proposition 103's rate rollbacks were not implemented immediately, Proposition 103 was a failure. Then, in a clever maneuver, the same insurers that established that as the test of Proposition 103's success proceeded to file lawsuits and did everything in their power to delay the rate reductions in California. In many instances, industry lobbyists in other states simply asserted that 103 had been ruled unconstitutional by California courts.[69] This ploy was quite successful and held off reforms elsewhere, to the great detriment of consumers around the nation. The industry's propaganda effort was supplemented with a more sophisticated and fierce lobbying and public relations strategy, which included temporarily holding down costs, and forming coalitions with consumer groups.[70] As a result of these efforts, it managed to stop most of the reforms proposed across the nation. Most states, if they did anything, only managed to pass weaker imitations of some of the aspects of Proposition 103.

- Fears of more public anger about insurance rates and practices tempered the insurance industry's ability to raise rates nationally soon after the passage of Proposition 103. Such fear has long passed, spurring four years of record profits through 2007.[71] Meanwhile, insurers have received much bad publicity in the last few years for poor treatment of homeowners in the wake of Hurricane Katrina and other natural disasters and for sharply increasing rates and coverage cutbacks along the Atlantic and Gulf Coasts. As a result, insurance is once again a major concern for the public, opening the door for reforms.

- In the last few years, insurers have launched a major effort to reduce state consumer protections and weaken regulation across the nation. As stated above, they have pressed for deregulation at the NAIC and on a state-by-state basis. The effort is powered by the industry's threat to seek federal action to create a federal optional charter (or other federal intervention) that would allow no regulation of rates or forms. This effort has convinced the

[69] Insurers filed lawsuits challenging the Proposition's constitutionality as well as other aspects of the Proposition, demanded administrative hearings and engaged in massive public relations efforts to discredit Proposition 103 nationally. For example, Roger Schmeltzer, Vice President of the National Association of Mutual Insurance Companies told the NAIC that, "Taken alone it (Proposition 103) threatens the health of California companies and puts millions of consumers at risk. The evidence against Proposition 103 is unimpeachable." He went on to say that if Proposition 103 was adopted in other states, it would "…create New Jersey scenarios all over the country, forcing companies out of the marketplace, thereby denying consumers the choices they deserve." Battle Over Prop 103 Continues, National Underwriter, August 22, 2001. New Jersey had a problem of insurers exiting because of alleged price suppression, a problem that California was promised when insurers argued against Proposition in the 1988 election cycle, but which never materialized.

[70] The creation of the Advocates for Auto and Highway Safety and the Coalition Against Insurance Fraud are two prominent examples of this effort.

[71] Property/Casualty Insurance in 2008: Overpriced Insurance and Underpaid Claims Result in Unjustified Profits, Padded Reserves, and Excessive Capitalization, CFA and other consumer groups, January, 2008, at http://www.consumerfed.org/pdfs/2008Insurance_White_Paper.pdf

NAIC and some states to abandon some important regulatory measures for consumers.[72] When the American Council of Life Insurers (ACLI) published its federal charter bill, one of the leaders of the NAIC deregulation effort (Commissioner Fitzgerald of Michigan, the co-chair of the one-stop rubber stamp approval process he is pushing at NAIC) said, "It's important to recognize that everything the ACLI has asked for is being worked on and developed by state regulators…We have been specifically responsive to concerns raised by the industry."[73]

VII. Other Tests of the Effectiveness of Proposition 103

Insurers maintain that strong Proposition 103-style regulation is ineffective because it pushes too many consumers into the personal automobile coverage residual market (in California, the Assigned Risk Plan) instead of allowing them to purchase coverage from mainstream insurers. Although it is not the case that a small residual market size proves much, the requirements in Proposition 103 have passed this insurer-administered test with flying colors. In 1989, 8.4 percent of insured drivers in California were in the Assigned Risk Plan. By 2005, this number had fallen to 0.1 percent, a decline of 99 percent!

A large residual market is not necessarily bad for consumers. For example, in a state like North Carolina, an insured driver has the right to seek insurance from a company he or she chooses. The insurance company has a right to send the applicant to a reinsurance facility if the company has any concerns regarding the applicant. There is no penalty if the company cedes the risk to this reinsurance entity. Since about half of all applicants in any particular class are "worse than average," one would expect that up to 50 percent of the people would end up in the reinsurance plan. The existence of up to half of the market in a plan in this circumstance is not a problem if rates are affordable and appropriately regulated.

A better test of whether consumers are being well served is to assess the size of the residual market, the non-standard market,[74] and the uninsured motorist market to determine how many drivers might be receiving high-priced or no coverage. However, we have been unable to find data on the market share for non-standard insurers in California and nationwide. The number of uninsured motorists has either dropped significantly (according to Department of Insurance data) or increased marginally (according to insurance industry data) in California from 1989 to 2005, in either case a good result considering the influx of unlicensed drivers in the state.

Insurers also evaluate the number of companies entering and exiting a state's market when testing the effectiveness of regulation. Again, this is not a particularly good test of competitiveness. Companies might exit a state because of mergers taking place in a competitive

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[72] See CFA testimony, "The Property/Casualty Insurance Business in 2007: Profits. Problems and Quality of Consumer Protections," before the Committee on Commerce, Science and Transportation, April 11, 2007, at http://www.consumerfed.org/pdfs/Insurance_Regulation_Senate_Commerce_Testimony041107.pdf

[73] ACLI Proposal Could Undermine Efforts of State Regulators, Michigan Commissioner Says, Bestwire, A. M. Best, April 20, 2001.

[74] This market includes high-priced companies that move into non-competitive areas of the state, such as cities. It is particularly offensive to deem a reinsurance facility as "bad" for consumers in urban areas when these facilities are eliminating from the market of these high-priced, "scavenger" companies through competition.

market. Many entrants into a state may mean that high-cost, so-called "non-standard" insurers are entering the market because of weak regulation.

In California, the number of individual companies offering auto insurance has dropped from 265 to 193 since 1989, but the number of groups of companies writing coverage rose from 94 in 1989 to 99 in 2006.[75] For example, Allstate Insurance Group contains five companies, including Allstate Indemnity Company and Allstate Property & Casualty Insurance Company. The number of groups in the marketplace is the real measure of competitiveness, since members of a group do not compete with each other in any real way.

Another problem with the measure is that it does not distinguish between markets with a number of participants that have significant market share, and markets where one or two companies are dominant. A much better test of market competitiveness is the Herfindahl-Hirshman Index (HHI), which finds that the California market is a very competitive 716 for automobile insurance. (For home insurance the HHI is 1082, a score that is deemed by the U. S. Justice Department to be moderately concentrated, just missing the "competitive" designation of below 1,000.) California is the fourth most competitive state in the nation in auto insurance, much more competitive than, for example, Illinois, which has an HHI of 1,208, making it the 44th most competitive state in the nation.[76]

There are many other real consumer benefits from the passage of Proposition 103, including the regulation of rating factors, availability of detailed loss data by ZIP code, and consumer participation in the process. Proposition 103 appears to have discouraged insurers from participating in normal cyclical behavior.[77] The insurance cycle is the rise and fall of insurer profits over time, from "hard market" periods of steep price rises after low profits to periods of low price increases, known as "soft markets." Insurers have tried for decades to minimize this cyclical behavior but have largely failed. Profits also seem to be a little less affected by the insurance business cycle over time in California than in the rest of the nation as the following graph shows:

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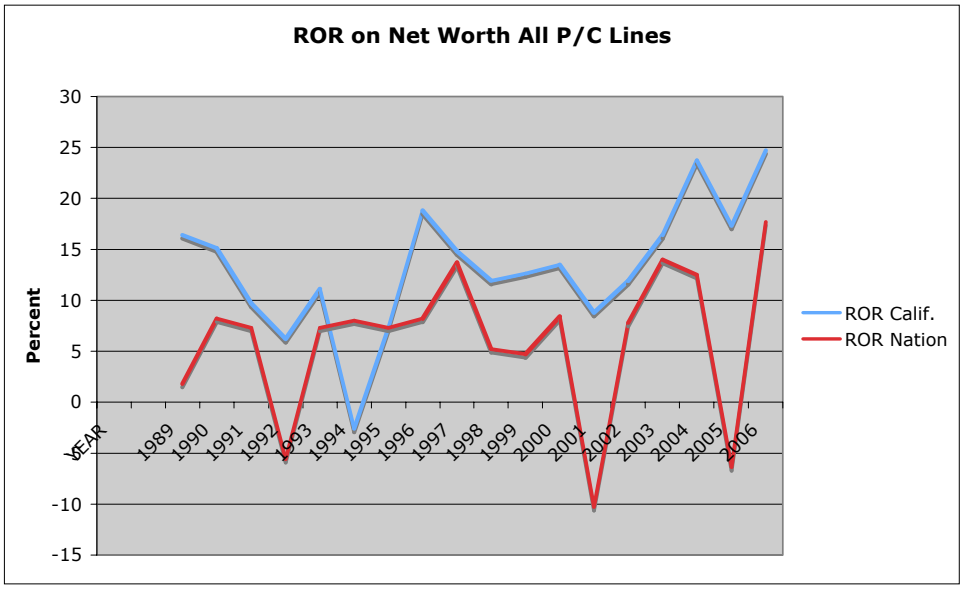
[75] The Regulation of Automobile Insurance in California, Jaffee and Russell, 2001, CA DOI P&C Market Share Report for 2006.

[76] See "HHI Data by State" Part 1, Spreadsheet 7.

[77] "The last soft market was driven purely by the need for cash to invest. . .We all know we can't do the dumb things we did last time. . . . We will not see a repeat of 1985-86" Mark A. Hofmann & Christine Woolsey, Marketplace Not What It Used To Be: Insurers, BUS. INS., July 13, 1992, at 5. Another executive has observed: "I don't think you1ll see a 1985-1986 repeat. There are too many regulatory restraints put in place to preclude it. A lot of regulations addressed our own stupidity. We made the bed and now we have to lie in it." Mark A. Hofmann & Christine Woolsey, Insurers Say Expectation of Price Turn Pushed Back, BUS. INS., Jan. 10, 1994, at 1, 14. And a senior official with the Insurance Services Office, an industry trade group, warned: "As an industry, nothing will disrupt our relations with customers faster, not to mention regulators and public-policy makers, than an abrupt recovery from our current underwriting down cycle. . . . Remember the fallout from the last recovery: California1s Proposition 103 and other price-suppression laws, threats to the industry on the antitrust front, and virulent consumer hostility." Not Like 1985's: ISO Official Predicts Next Upturn in Cycle to be Gradual, INS. WK., Oct. 19, 1992, at 15, 15. But the cycle did repeat itself, with a strong hard market existing in the 2000 to 2003 time period that resulted in a string of record property/casualty insurance profits in 2004 to 2006. We are now. Once again, in a soft market in 2008.



Note: 1992's low ROR in the nation is the effect of Hurricane Andrew and 1994's low figure in California was the result of the Northridge Earthquake.

VIII. Why did Proposition 103 Achieve so Much Compared to Other Regulatory Approaches?

What is it about Proposition 103 that has led to vigorous competition, low rates and a very healthy return for insurers? First, unlike the anti-competitive version of deregulation put into place in many states and advocated today for national implementation by insurers, Proposition 103 contains provisions that spur full competition and penalize collusive behavior by insurers. For instance, it imposes antitrust law on the industry, allows banks to sell insurance, allows group sales, and allows agent competition through rebating.

However, Proposition 103 did not just rely on competition to right the insurance marketplace in California. It incorporated full regulatory oversight to assure that competition is effective and sufficient to do the job. California regulations are the state-of-the-art – far and away the best in the nation for consumers. They are fully transparent to insurers and the public. They disallow excessive costs such as undue expenses, fines, punitive damages in bad-faith lawsuits, excessive executive salary costs, etc.

Proposition 103 also built strong incentives for safety into the initiative. "Clean" drivers gain a 20 percent rate discount. They also receive the right to buy insurance from the company of their choice through Proposition 103's "Good Driver Protections." These requirements that emphasize safety are very similar to the "Bonus-Malus Plan" in the European Union, which has been shown to improve driving behavior.[78]

Further, Proposition 103 was a warning to insurers that they cold no longer pass on unreasonable expenses to ratepayers to increase profits. Before Proposition 103, insurers had

[78] See Bonus-Malus Systems: The European Approach to Merit Rating, Lemaire, North American Actuarial Journal, Society of Actuaries, 1989.

every incentive to allow costs to rise by an industry-wide "trend," particularly when the trend was agreed to at cartel-like rating bureaus. This "cost-plus-percentage-of-cost" ratemaking approach was achievable because full competition was not present. Many insurers used the same trends and tried to achieve them. Insurers did not fight fraud seriously, nor was automobile or driver safety a paramount concern.

After Proposition 103, insurers not only lowered rates in California, but, fearing that other states might require rate reductions of 20 percent, they stopped passing through many unjustified costs to ratepayers throughout the nation. Insurers also joined with consumer groups to form the Coalition Against Insurance Fraud and Advocates for Highway and Auto Safety. Insurers also used multiple lawsuits and other strategies to delay full implementation of Proposition 103 for as long as possible, in an effort to convince other states into thinking that Proposition 103 was not working.

IX. Comparing Proposition 103 to California's Deregulation of Worker's Compensation Insurance

The movement toward the anti-competitive deregulation of the insurance industry in states other than California – as reflected in a number of proposals adopted by the NAIC – has been fueled by think tanks, academics, economists and other "scholars" sponsored by insurance companies and other business interests. These parties have conveniently ignored discussing the failures that have occurred in the insurance market because of unfettered deregulation. At the same time that Proposition 103's balanced regulation has protected California consumers for twenty years, the state has experienced a deregulation disaster because of the state legislature's repeal in 1993 of oversight of workers' compensation insurance rates. Insurers proceeded to try to undercut their competitors with rates too low to cover the risks they were insuring in a race for premium dollars in California's then-golden economy. Their reckless underwriting practices in turn led to dozens of insolvencies. Premiums initially plummeted, then began to skyrocket and were more than double the national average by 2003.[79] More than half of California's businesses were forced to buy policies with the State Compensation Insurance Fund, California's quasi-public insurer of last resort. The crisis hit a breaking point in 2003 and 2004, but reform legislation ignored the lack of oversight that allowed the industry to spiral out of control in the first place. Successive changes lowered compensation to injured workers. The unregulated industry did very well in the following years, saving money but passing on a fraction of those savings to employers. While employers continued to pay for overpriced policies, Insurers reported loss ratios from 2005 through 2007 that never rose above 55 percent, the lowest point in a decade.[80]

X. Review of Industry Objections to Proposition 103

Despite the positive impact that Proposition 103 has had on insurance rates and competition, which has been widely documented, the insurance industry and its partisans continue to criticize it.

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[79] Los Angeles Times. "Hitch in Workers' Comp Reform," Jerry Hirsch and Marc Lifsher, Apr. 5, 2004.

[80] Workers Compensation Insurance Rating Bureau of California, Summary of Sep. 30, 2007 Insurer Experience.

Excessive Profits

Insurers argue that Proposition 103 allowed them to reap excessive profits. Insurers claim that they would have lowered rates even more than they were required to if they had been free to adjust rates upward without regulatory approval. They could have sharply lowered rates, they say, because they would have been able to compensate for unexpectedly low returns later (if rates were too low) by increasing rates more than Proposition 103 would allow. In other words, the insurance industry and its partisans argue that Proposition 103 didn't work because insurers failed to reduce their rates as much as they should have, given their profits.

It is true that insurers did not lower their rates as much as they should have, but not because of Proposition 103. Rates did not drop because an insurance commissioner whom insurers helped elect, Chuck Quackenbush, refused to enforce Proposition 103's rate requirements.

Recognizing that rates and profits were too high, consumer groups asked for hearings to require further rate reductions under the terms of the Proposition. Proposition 103 allows consumer representatives not only to request rate hearings but to receive reimbursement for attorneys and expert witnesses who must be retained, if they make a "substantial contribution" to the process. Commissioner Quackenbush generally refused to investigate rates, much less limit insurer profits. Indeed, it later became clear that some of the same companies that benefited from the Commissioner's refusal to use his regulatory powers under Proposition 103 had provided money to various funds he had established in exchange for favors.

Following Quackenbush's resignation, his successor also neglected rate regulation as he re-organized the insurance department. Proposition 103's rate requirements only began to be fully enforced during the terms of Commissioners Garamendi and Poizner, and premiums and profits began to decline.

It is the height of hypocrisy for insurance companies to criticize Proposition 103 for high profits that they enjoyed while resisting its enforcement. In fact, Proposition 103 forced insurers to reduce rates after the measure passed and forbade increases by prohibiting excessive and unjustified expenses. This, in turn, compelled insurers to trim waste and inefficiency dramatically in order to obtain higher profits.[81] There is little doubt that, absent 103's regulatory protections, insurers would have raised, rather than lowered, rates in California, as they did throughout the rest of the nation.

Nothing in Proposition 103 itself prevented insurers from lowering rates to levels that would produce reasonable profits, as expenses and loss costs fell. Indeed, the claim that fear of restrictions on rate increases somehow prevented insurers from lowering rates when justified is belied by the significant rate reductions that occurred in California in 1999 and 2000. Thus, when insurers wanted to compete, they could and they did lower rates. However, for many years the insurers chose not to lower rates, and instead were allowed by the state regulator to reap windfall profits.

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[81] See The Regulation of Automobile Insurance in California, Jaffee and Russell, 2001.

As we discuss elsewhere in the report,[82] the excessive prices have been aggressively tackled in 2006 through 2008.

Role of Change in California Bad-faith Claims Handling Law

The insurance industry and its partisans assert that the lower insurer costs in California, which in part helped to fuel lower premiums, are not the result of, or at best only partly the result of, Proposition 103. They argue that a 1988 California Supreme Court ruling, [83] which prohibited some lawsuits against insurance companies for refusing to pay claims properly, is responsible for the dramatic post-Proposition 103 premium rate savings.

This argument is contradicted by declining rates for comprehensive auto insurance coverage under Proposition 103. Lawsuits for bad faith are in no way related to comprehensive claims

Appendix 4, spreadsheet 8 reveals that Comprehensive premiums have declined in California by 3.2 percent since 1989 but increased nationally by 45.6 percent, meaning that rates in California were 66.5 percent lower. Collision premiums rose less in California (55.1 percent) than nationally (56.6 percent), a difference of one percent during the same period. Liability premiums decreased by 6.2 percent in California and increased by 46.2 percent nationally, a difference of 55.8 percent less.

These data imply that the primary cause of the liability rate savings and most of the physical damage savings are due to Proposition 103.

Research comparing California and other states also contradicts the industry's argument that the limited change to California's "bad-faith" law was responsible for the dramatic premium savings after Proposition 103. In states with Moradi-style laws, which held that the Unfair Claims Practices Act did not allow direct legal actions against the insurer, rates rose *faster* from 1989 through 2005 than in states without such a law in place.[84] Meanwhile, as noted, California's rates went up less than any other state.

Proposition 213's Change in California Tort Liability

Insurers also like to credit the enactment of Proposition 213 in November 1996 with keeping premiums low. The "no pay, no play" initiative was sponsored by then-Commissioner Quackenbush and derived from insurance industry arguments that lawsuits brought by uninsured motorists were unfairly driving up premiums. The law banned uninsured drivers who are injured in an accident from collecting non-economic damages in court. Four states in addition to California – Alaska, Michigan, Louisiana and New Jersey – enacted similar laws to limit

82 See page 96, section titled 2007-present (Insurance Commissioner Poizner)
83 Moradi-Shalal v. Fireman's Fund Insurance Cos., 46 Cal. Rptr. ii6 (1988).
84 See spreadsheet showing Personal Auto Insurance Expenditure Change in the 1989 to 2005 Period by Moradi Law Status as of 2001, in Appendix 4, spreadsheet 6.

uninsured drivers' recovery after an accident.[85] If the industry's claim is correct, liability premiums in each state should have fallen relative to countrywide premiums.

In fact, California premiums dropped in relation to countrywide premiums, while premiums in Michigan and Louisiana increased. Measured from the date each state's "no pay, no play" law was enacted, California liability premiums fell 1.1 percent while rates nationwide rose 12.7 percent. Michigan premiums increased 39.7 percent as rates nationally increased by just 13.1 percent. In Louisiana, rates increased 38.7 percent during a period in which the national increase was only 23.4 percent.[86] No definite conclusions can be drawn with 2005 premium data for New Jersey and Alaska because the law in those states only went into effect in 2004. There is, therefore, no evidence that "no pay, no play" laws lower premiums after their enactment.

Seat Belt Usage in California

Some have argued that greater use of seat belts in California relative to the nation is responsible for California's remarkable rate savings after the passage of Proposition 103. It is true that seatbelt use is higher in California than nationally: 93 percent versus 82 percent. However, during the 1989 to 2005 period seat belt usage in California actually increased more slowly than nationwide. Data show that from 1989 to 2005, seatbelt use increased by 40.5 percent in California and by 78.3 percent nationally.[87] If anything, changes in seatbelt use during this period would have caused California rates to *rise* relative to the nation.

As the attached spreadsheet shows,[88] there are 11 states with a good Insurance Institute for Highway Safety (IIHS) rating regarding the strength of seatbelt laws. These states had an average auto insurance expenditure of $816.23 in 2005. They also had an average rate increase of 60.2 percent between 1989 and 2005. There are 16 states with a fair IIHS rating. These states have an average rate of $845.54, with a 56.1 percent increase during the same period. There are 23 states with a marginal IIHS rating, which had an average rate of $759.63 and a 73.4 percent increase. Only one state had a poor rating, with a rate of $791.71 and a 30.0 percent increase.

The fact that the states with better seat belt laws have higher rates than those with bad laws is interesting, but not conclusive, as more rural states (with typically lower rates) have lower legal protection in this area. The rate changes show a mixed pattern. Based on the seatbelt data cited here, it is not possible to conclude that lower rates in California since 1988 are the result of a strong seat belt law and high usage.

Other Possible Factors

We also assessed other possible factors that might help California achieve such low rates.[89] For example, we looked at the legal regime by state, as well as laws that require the

[85] Insurance Information Institute. http://www.iii.org/media/hottopics/insurance/compulsory/
[86] See "By No Pay, No Play Law Status" Appendix 4, spreadsheet 7.
[87] See "By growth in use of seatbelts" Appendix 4, spreadsheet 5.
[88] See "By Seatbelt Law Status" Appendix 4, spreadsheet 4.
[89] See "By Miscellaneous Factors such as uninsured motorists, residual market population, legal regime in state, compulsory law status, theft data, disposable income and average auto repair costs" Appendix 4, spreadsheet 9.

purchase of automobile insurance. We also examined the number of thefts, disposable income, average auto repair costs and drunk driving laws by state. All of these factors appear to not be significant in keeping rates down in California, compared to the rest the nation. The tort regime is used by most states, including California, as are compulsory insurance laws. Thefts are higher in California than nationwide, but that should increase rates, not lower them. California's disposable income is higher than in the nation, which should also lead to higher rates. Repair costs are similar in California and nationwide and should not influence rates. California and all but seven other states have tough drunk driver laws, with a 0.08 blood alcohol content limit and mandatory license suspension.

Studies Critiquing Proposition 103

While most of the claims in these reports have already been addressed elsewhere in this Report, we will briefly cover them again in the context of these criticisms.

1. "The Regulation of Automobile Insurance in California," Dwight M. Jaffee and Thomas Russell, April 2001.

The Jaffee/Russell findings include:

- We find no evidence of the 'traditional' adverse consequences (of regulation) from the Proposition, such as firm exit, an expanding assigned risk pool, or declining industry profit rates."

- "We find the Proposition may have had a positive effect by (a) encouraging safer driving (through incentives created by the safe driver discount for insurance premiums) or by (b) causing firms to control fraud and dissipative expenses…by limiting their ability to pass such costs on to their consumers."

- "We find the Proposition may have had a detrimental effect on auto insurance premiums by increasing (insurer) profit margins."

- "Taken together, these findings suggest that drivers in California have little to regret from the passage of Proposition 103 and the regulatory regime it introduced."

The report noted a sharp drop "in absolute and relative terms" in California auto insurance premiums, but indicated that, based on "back of the envelope calculations," half of the savings came from the "relative decline in collisions with injuries and fatalities to greater seat belt use," 14.5 percent were due to the Moradi case, which held that the Unfair Claims Practices Act did not allow direct legal action against an insurer.[90]

This report's findings on Proposition 103's effect on California consumers are very positive overall. The only "problems" it cites were high profits for insurers and the possibility

[90] Moradi-Shalal v. Fireman's Fund Insurance Cos., 46 Cal. Rptr. ii6 (1988).

that rough calculations imply that "only" 35.5 percent of the drop in premiums in California can be attributed to Proposition 103.

The first problem is easily explained. As discussed above, Proposition 103 would have prevented excess profits had the Insurance Commissioner enforced the law and held hearings on rates and profits, as requested repeatedly by consumer groups. The fact that the Commissioner refused to use his clear authority under Proposition 103 to lower rates because of a clear conflict-of-interest can hardly be blamed on the Proposition.

The second problem is also discussed above. The Jaffee/Russell report ignores the fact that premiums for comprehensive coverage were much cheaper in California than nationwide. Arguments that the Moradi case and higher seatbelt usage were the primary causes of lower rates do not explain the huge savings relative to the nation that Californians have enjoyed for coverage of comprehensive damage.

As to liability coverage, data comparing state laws regarding liability coverage with rate changes suggests that the safety impact of seat belts after Proposition 103 was adopted was not a factor that lowered rates in California. Indeed the greater increase in use of seatbelts nationally after Proposition 103 would imply a greater effect to lower rates in the nation than in California.[91] The key question in examining the impact of seatbelt usage on insurance premiums during this period is whether usage in California increased relative to the rest of the nation. As the table below demonstrates, usage in California was higher when Proposition 103 took effect and, therefore, increased more slowly than nationwide afterward.

	1989	2005	% Change
California	66.5%	93.4%	+40.5%
Country	46.0%	82.0%	+78.3%

Thus, if seatbelt usage was the dominant factor affecting rates during this time, California rates should have increased more than nationally. Lower costs resulting from high seatbelt usage in California in 1989 would already have been incorporated into the rates that were being charged at that time. For example, if one state had 100 percent seatbelt use over a period of time and usage in another state increased from 25 to 50 percent, auto insurance rates in the second state would fall relative to those in the first, all other factors being equal. In other words, seatbelt use did not significantly contribute to the remarkable rate reductions in California between 1989 and 2005.

States with Moradi-type laws had rate increases over the last decade of 65.9 percent on average, while states overall had increases averaging 64.3 percent.[92] This means that legal changes as a result of the Moradi case is very unlikely to significantly contribute to rate savings in California after Proposition 103 took effect.

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[91] See "By growth in use of seatbelts" Appendix 4, Spreadsheet 9.

[92] See the attached spreadsheet displaying personal auto expenditure change in the 1989 to 2005 period by 'Moradi' Law Status in Part 1, Spreadsheet 5.

It is also clear that the simple imposition of a requirement that insurers receive Prior Approval of rate increases from the state would not have had as significant an impact in California as Proposition 103 did. The spreadsheet attached[93] shows that Prior Approval states have had price increases at about the same rate as "File and Use" states that only require insurers to notify them of rate increases before they take effect. Both types of states had smaller rate increases than "Use and File" states that only require insurers to notify them after rate increases are in place.

Ranked in order of high to low profit over the 1989 to 2006 period:

- "Competitive" systems exist in two states with an average profit of 10.1 percent.
- Use and File exists in eight states with an average profit of 9.6 percent.
- File and Use exists in 24 states with an average profit of 9.1 percent.
- Prior Approval exists in 14 states with an average profit of 8.9 percent.
- State Set rates exists in one state with a profit of 8.6 percent.
- "FLEX" rating exists in two states with an average profit of 7.8 percent.

It is interesting to note that, with the exception of the FLEX rating data, profit rises as regulation decreases. However, data on one or two states does not allow for meaningful conclusions. A further problem with comparing states that require prior rate approval with so-called "competitive" states is that both systems are deeply flawed. Prior Approval in this country is weakly enforced in many jurisdictions. Regulators are often understaffed, under funded and have close relationships with industry representatives.[94] Competition is not vigorous in most states while industry collusion, in the form of antitrust exemptions, anti-group insurance laws, and the joint of rating trend factors undercut the claim of competition.

As stated above, California insurance regulation produces unique results because it relies on both vigorous competition and strong regulation.

2. "Modernizing Insurance Regulation – Tacking To The Winds Of Change," by Philip R. O'Connor and Eugene P. Esposito, April 2001 (funded by State Farm and Allstate insurance companies)

After criticizing states that require Prior Approval of rates for increasing the number of drivers in the "residual" market populations, and driving insurers out-of-state, O'Connor and Esposito can find no such effects in California. Data presented in the study show how well Proposition 103 has performed. The study reports the following:

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[93] See attached spreadsheet, "Review of States 1989-2005 Price Change by Regulatory Status" in Part 1, Spreadsheet 2.

[94] Half of the nation's insurance commissioners worked first in the insurance industry, while half work for insurers after leaving their position, per Issues and Needed Improvements in State Regulation of the Insurance Business, GAO, 1978, updated by NICO in 1988 and by CFA in 1995. Resource inadequacy documented in State Insurance Department Resources – 1988, 1993, 1998, CFA, August 2000.

- A sharp drop in insurance costs and premiums.

- A significant decline in the size of the residual market, falling to 0.8 percent of the personal auto insurance market in 1998. The size of the market fell by more than half to 0.3 percent in 1999, after the report was released and is 0.1 percent today.

- California had a high percentage of all the insurance companies in the nation: 23 percent of all auto insurance companies and 18 percent of homeowners' insurance companies.

- High auto insurance profits: 14.8 percent in California in the decade ending 1998 versus 7.3 percent nationally.

Unable to criticize Proposition 103 for the "usual" reasons that insurers oppose strong regulation, the authors state that the "single most startling point after more than a decade of Prop 103 rate regulation is that average auto liability profit levels for insurers in California appear to have been considerably higher than the average in the other 49 states…" They point out that profits in California were about 50 percent above what they consider to be fair.

Like Jaffee, O'Connor never mentions the fact that industry-supported Commissioner Quackenbush refused to act under the clear provisions of 103 to lower rates and profits, despite repeated requests from consumer organizations. (See discussion above). The authors also claim that the Moradi decision has significantly lowered rates since Proposition 103 took effect. "It is most likely that this [Moradi] decision reining in the tort system along with other developments…contributed to significantly lower costs since passage of Prop 103." As stated above, there is no evidence that the Moradi case lowered rates significantly.

The authors also credit increased seat belt use in California as a factor in lowering rates. As mentioned above, all factors being equal, seatbelt usage in California during the period after Proposition 103 took effect should have produced higher, not lower rates in California relative to the nation, but the opposite occurred.

The authors also applaud the deregulation of Workers' Compensation in California, even though, at the time the report was written there were well known concerns that "a wave of insolvencies has led officials to warn of a looming crisis."[95]

E. RECOMMENDATIONS

As the findings of this study make clear, the insurance regulatory structure in place in many states has failed consumers in a number of ways. In particular, many states do a poor job of ensuring that insurance rates are fair, that rates are adequately reviewed by the regulator, that competition is vigorous, and that consumers are adequately involved in the rate-making process. This report also provides considerable evidence that the deregulatory proposals being promoted

[95] "Deregulation is Taking Toll on Workers' Compensation," Ellis, Los Angeles Times, April 16, 2001.

by the insurance industry at the state and federal level, especially the elimination of rate regulation, fail to protect consumers and ensure fair rates.

It is time for a sea change in the way that insurance is regulated on behalf of consumers. State and federal policymakers need to throw out the failed deregulatory measures offered by the insurance industry and rely on regulatory models that demonstrably protect consumers and spur vigorous competition. As this study demonstrates, Proposition 103 represents the single most effective regulatory structure in place right now. By combining close regulation of how rates are set with opportunities for vigorous competition and fair returns for insurers, Proposition 103 has established a 20-year track record of success for California consumers.

1. State policymakers should use twenty years of experience to their advantage by implementing comprehensive regulatory changes modeled after Proposition 103. In particular, state policymakers should adopt regulatory changes that achieve the following:

   - Sets key ratemaking standards, such as reasonable rates of return, restrictions on the amount of overhead costs that can be passed on to consumers, and guidelines for projecting future rate increases;
   - Establishes a state rate-making model that the regulator must use to evaluate the rate requests of insurers;
   - Prevents excessive or unjustified expenses from being passed on to consumers, such as fines, penalties for bad faith behavior, and excessive executive salaries;
   - Requires that driving record is the most important factor in setting rates for drivers, followed by miles driven and years of experience;
   - Balances supply and demand by requiring insurers to offer coverage to good drivers who are compelled by the state to purchase it;
   - Repeals the state anti-trust exemption; and
   - Involves consumers actively in the rate-setting process by funding consumer participation.

2. The National Association of Insurance Commissioners should stop flirting with the idea of adopting a proposal to deregulate auto insurance. Since 2000, the NAIC has been considering a proposal offered by insurers that would favor so-called "competition" systems that involve little or no regulatory control of prices. This proposal moves in the opposite direction of the findings of this report, which shows that tight but fair regulation of insurance rates and classifications leads to lower and more equitable rates for consumers. The Proposition 103 regulatory model also increases competition substantially by prohibiting insurers from colluding to set rates or partial rates, though such procedures as joint "trending".

3. New York and other states should not weaken rate regulation of auto insurance, whether in the guise of "principles-based" regulation or in other forms. The insurance superintendent in New York has offered a proposal to overhaul insurance regulation by adopting a "principals-based" approach designed to require insurers and regulators to comply with broad regulatory principles, not just specific rules. It is unclear whether this proposal would override the regulation of rates and classifications, although some

insurance interests clearly hope that it will. Given the findings of this study, New York and many other states need to consider tightening, not weakening, the regulation of rates, forms, and classifications, whether such goals are embedded in broad principles or specific rules.

4. Congress should reject proposals to weaken oversight of insurance in the few remaining states that do it well, whether through the adoption of an "optional federal charter" or through other means. Optional federal charter proposals introduced in Congress grant the federal regulator little, if any, authority to regulate price or products, regardless of how non-competitive the market for a particular line of insurance might be. The proposals also offer little improvement in consumer protection or consumer information systems to address the major problems cited in this report. Instead, these proposals allow regulated insurers, at their sole discretion, to choose whether they are overseen at the federal or state level. If such a proposal were adopted, there is little doubt that many states would move quickly to further weaken consumer protections in order to retain regulatory authority (not to mention the significant income from insurer assessments) over the large national insurance companies that would otherwise choose weak federal oversight. Consumers in California and other states with meaningful consumer protections would be harmed as a result.

If Congress is serious about improving the quality of insurance regulation for consumers, it should consider mandating that states meet minimum standards of regulation similar to those required by Proposition 103. In the alternative, Congress could consider a full federal takeover of insurance regulation, but such a dramatic shift in the manner in which insurance has been overseen for the last 60 years must mandate the highest regulatory and enforcement standards. Under no circumstances, should proposals to establish uniform federal insurance regulation be used as an excuse to undermine the handful of states that still provide strong consumer protections to their residents.

APPENDIX 1

Text of Proposition 103[96]

On November 8, 1988, Californians passed the Insurance Rate Reduction and Reform Act, better known as Proposition 103. What follows below is the complete, original text of the ballot initiative.

NOTE: Changes made by the state Legislature and the Courts are noted in different text (shaded for additions **BOLD CAPS** *for deletions). For the complete text noting the repeal of then-existing laws (Section 7), please consult the 1988 California General Election Voter Information Pamphlet or the California Insurance Code at your local law library.*

Insurance Rate Reduction and Reform Act

Section 1. Findings and Declaration.
The People of California find and declare as follows:

Enormous increases in the cost of insurance have made it both unaffordable and unavailable to millions of Californians.

The existing laws inadequately protect consumers and allow insurance companies to charge excessive, unjustified and arbitrary rates.

Therefore, the People of California declare that insurance reform is necessary. First, property-casualty insurance rates shall be immediately rolled back to what they were on November 8, 1987, and reduced no less than an additional 20%. Second, automobile insurance rates shall be determined primarily by a driver's safety record and mileage driven. Third, insurance rates shall be maintained at fair levels by requiring insurers to justify all future increases. Finally, the state Insurance Commissioner shall be elected. Insurance companies shall pay a fee to cover the costs of administering these new laws so that this reform will cost taxpayers nothing.

Section 2: Purpose.
The purpose of this chapter is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians.

Section 3: Reduction and Control of Insurance Rates.
Article 10, commencing with Section 1861.01 is added to Chapter 9 of Part 2 of Division 1 of the Insurance Code to read:

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[96] Downloaded from the web page of the Foundation for Taxpayer and Consumer Rights at http://www.consumerwatchdog.org/insurance/articles/?storyId=17589 on May 25, 2001. A change was made to alter colored text to shaded or bold test so that black and white printing would be feasible.

Insurance Rate Rollback
1861.01. (a) For any coverage for a policy for automobile and any other form of insurance subject to this chapter issued or renewed on or after November 8, 1988, every insurer shall reduce its charges to levels which are at least 20% less than the charges for the same coverage which were in effect on November 8, 1987.

(b) Between November 8, 1988, and November 8, 1989, rates and premiums reduced pursuant to subdivision (a) may be only increased if the commissioner finds, after a hearing, that an insurer is substantially threatened with insolvency. [**The California Supreme Court unanimously upheld the rollback in May of 1989 but struck down the "substantially threatened with insolvency" standard.** ***The court substituted a "fair rate of return" constitutional standard, leaving it to the Commissioner to determine on a company-by-company basis, through the individual rollback exemption hearings, whether the rate rollback would deprive an insurer of a fair rate of return***.]

(c) Commencing November 8, 1989, insurance rates subject to this chapter must be approved by the commissioner prior to their use.

(d) For those who apply for an automobile insurance policy for the first time on or after November 8, 1988, the rate shall be 20% less than the rate which was in effect on November 8, 1987, for similarly situated risks.

(e) Any separate affiliate of an insurer, established on or after November 8, 1987, shall be subject to the provisions of this section and shall reduce its charges to levels which are at least 20% less than the insurer's charges in effect on that date.

Automobile Rates & Good Driver Discount Plan
1861.02. (a) Rates and premiums for an automobile insurance policy, as described in subdivision (a) of Section 660, shall be determined by application of the following factors in decreasing order of importance:

(1) The insured's driving safety record.
(2) The number of miles he or she drives annually.
(3) The number of years of driving experience the insured has had.
(4) Those other factors that the commissioner may adopt by regulation and that have a substantial relationship to the risk of loss. The regulations shall set forth the respective weight to be given each factor in determining automobile rates and premiums. Notwithstanding any other provision of law, the use of any criterion without approval shall constitute unfair discrimination.

[Insurance Code Section 1861.02(b) was amended by the state Legislature. Amendments are noted in shaded text, deletions in BOLD CAPS.]

(b) (1) EVERY PERSON WHO (A) HAS BEEN LICENSED TO DRIVE A MOTOR VEHICLE FOR THE PREVIOUS THREE YEARS AND (B) HAS HAD, DURING THAT PERIOD, NOT MORE THAN ONE CONVICTION FOR A MOVING VIOLATION WHICH HAS NOT EVENTUALLY BEEN DISMISSED Every person who meets the criteria of Section 1861.025

shall be qualified to purchase a Good Driver Discount policy from the insurer of his or her choice. An insurer shall not refuse to offer and sell a Good Driver Discount policy to any person who meets the standards of this subdivision.

(2) The rate charged for a Good Driver Discount policy shall comply with subdivision (a) and shall be at least 20% below the rate the insured would otherwise have been charged for the same coverage. Rates for Good Driver Discount policies shall be approved pursuant to this article.

(3) (A) This subdivision shall not prevent a reciprocal insurer, organized prior to November 8, 1988, by a motor club holding a certificate of authority under Chapter 2 (commencing with Section 12160) of Part 5 of Division 2, and which requires membership in the motor club as a condition precedent to applying for insurance from requiring membership in the motor club as a condition precedent to obtaining insurance described in this subdivision.

(B) This subdivision shall not prevent an insurer which requires membership in a specified voluntary, nonprofit organization, which was in existence prior to November 8, 1988, as a condition precedent to applying for insurance issued to or through those membership groups, including franchise groups, from requiring such membership as a condition to applying for the coverage offered to members of the group, provided that it or an affiliate also offers and sells coverage to those who are not members of those membership groups.

(C) However, all of the following conditions shall be applicable to the insurance authorized by subparagraphs (A) and (B):

(i) Membership, if conditioned, is conditioned only on timely payment of membership dues and other bona fide criteria not based upon driving record or insurance, provided that membership in a motor club may not be based on residence in any area within the state.
(ii) Membership dues are paid solely for and in consideration of the membership and membership benefits and bear a reasonable relationship to the benefits provided. The amount of the dues shall not depend on whether the member purchases insurance offered by the membership organization. None of those membership dues or any portion thereof shall be transferred by the membership organization to the insurer, or any affiliate of the insurer, attorney-in-fact, subsidiary, or holding company thereof, provided that this provision shall not prevent any bona fide transaction between the membership organization and those entities.
(iii) Membership provides bona fide services or benefits in addition to the right to apply for insurance. Those services shall be reasonably available to all members within each class of membership.
Any insurer that violates clause (i), (ii), or (iii) shall be subject to the penalties set forth in Section 1861.14.

(c) The absence of prior automobile insurance coverage, in and of itself, shall not be a criterion for determining eligibility for a Good Driver Discount policy, or generally for automobile rates, premiums, or insurability.

[Insurance Code Section 1861.02(d), noted in shaded text below, was added to the Insurance Code by the state Legislature. It was NOT part of the original text of Proposition 103.]

(d) An insurer may refuse to sell a Good Driver Discount policy insuring a motorcycle unless all named insurers have been licensed to drive a motorcycle for the previous three years.

(D)(e) This section shall become operative on November 8, 1989. The commissioner shall adopt regulations implementing this section and insurers may submit applications pursuant to this article which comply with **SUCH** those regulations prior to that date, provided that no such application shall be approved prior to that date.

[Insurance Code Section 1861.025, noted in shaded text below, was added to the Insurance Code by the state Legislature. It was NOT part of the original text of Proposition 103.]

1861.025. A person is qualified to purchase a Good Driver Discount policy if he or she meets all of the following criteria:

(a) He or she has been licensed to drive a motor vehicle for the previous three years.

(b) During the previous three years, he or she has not done any of the following:
(1) Had more than one violation point count determined as provided by subdivision (a), (b), (c), (d), (e), (g), or (h) of Section 12810 of the Vehicle Code, but subject to the following modifications:

A. For the purposes of this section, the driver of a motor vehicle involved in an accident for which he or she was principally at fault that resulted only in damage to property shall receive one violation point count, in addition to any other violation points which may be imposed for this accident.

B. If, under Section 488 or 488.5 an insurer is prohibited from increasing the premium on a policy on account of a violation, that violation shall not be included in determining the point count of the person.

C. If a violation is required to be reported under Section 1816 of the Vehicle Code, or under Section 784 of the Welfare and Institutions Code, or any other provision requiring the reporting of a violation by a minor, the violation shall be included for the purposes of this section in determining the point count in the same manner as is applicable to adult violations.

(2) Had more than one dismissal pursuant to Section 1803.5 of the Vehicle Code that was not made confidential pursuant to Section 1808.7 of the Vehicle Code, in the 36-month period for violations that would have resulted in the imposition of more than one violation point count under paragraph (1) if the complaint had not been dismissed.

(3) Was the driver of a motor vehicle involved in an accident that resulted in bodily injury or in the death of any person and was principally at fault. The commissioner shall adopt regulations

setting guidelines to be used by insurers for the their determination of fault for the purposes of this paragraph and paragraph (1) of subdivision (b).

(c) During the period commencing on January 1, 1999, or the date 10 years prior to the date of application for the issuance or renewal of the Good Driver Discount policy, whichever is later, and ending on the date of the application for the issuance or renewal of the Good Driver Discount policy, he or she has not been convicted of a violation of Section 23140, 23152, or 23153 of the Vehicle Code, a felony violation of Section 23550 or 23566, or former Section 23175 or, a violation of Section 191.5 or subdivision (a) of Section 192.5 of the Penal Code.

(d) Any person who claims that he or she meets the criteria of subdivisions (a), (b), and (c) based entirely or partially on a driver's license and driving experience acquired anywhere other than in the United States or Canada is rebuttably presumed to be qualified to purchase a Good Driver Discount policy if he or she has been licensed to drive in the United States or Canada for at least the previous 18 months and meets the criteria of subdivisions (a), (b), and (c) for that period.

Prohibition on Unfair Insurance Practices
1861.03 (a) The business of insurance shall be subject to the laws of California applicable to any other business, including, but not limited to, the Unruh Civil Rights Act (Sections 51 through 53, inclusive, of the Civil Code), and the antitrust and unfair business practices laws (Parts 2 (commencing with Section 16600) and 3 (commencing with Section 17500) of Division 7 of the Business and Professions Code).

[Insurance Code Section 1861.03(b) was amended by the state Legislature. Additions are noted in shaded text, deletions in BOLD CAPS.]

(b) Nothing in this section shall be construed to prohibit (1) any agreement to collect, compile and disseminate historical data on paid claims or reserves for reported claims, provided such data is contemporaneously transmitted to the commissioner, **OR** (2) participation in any joint arrangement established by statute or the commissioner to assure availability of insurance**.** , (3) any agent or broker, representing one or more insurers, from obtaining from any insurer it represents information relative to the premium for any policy or risk to be underwritten by that insurer, (4) any agent or broker from disclosing to an insurer it represents any quoted rate or charge offered by another insurer represented by that agent or broker for the purpose of negotiating a lower rate, charge, or term from the insurer to whom the disclosure is made, or (5) any agents, brokers, or insurers from utilizing or participating with multiple insurers or reinsurers for underwriting a single risk or group of risks.

(c) (1) Notwithstanding any other provision of law, a notice of cancellation or non-renewal of a policy for automobile insurance shall be effective only if it is based on one or more of the following reasons:

(A) non-payment of premium;
(B) fraud or material misrepresentation affecting the policy or insured;
(C) a substantial increase in the hazard insured against.

[Insurance Code Section 1861.03(c)(2), noted in shaded text below, was added to the Insurance Code by the state Legislature. It was NOT part of the original text of Proposition 103.]

(2) This subdivision shall not prevent a reciprocal insurer, organized prior to November 8, 1988, by a motor club holding a certificate of authority under Chapter 2 (commencing with Section 12160) of Part 5 of Division 2, and which requires membership in the motor club as a condition precedent to applying for insurance, from issuing an effective notice of nonrenewal based solely on the failure of the insured to maintain membership in the motor club. This subdivision shall also not prevent an insurer which issues private passenger automobile coverage to members of groups that were in existence prior to November 8, 1988, whether membership, franchise, or otherwise, and to those who are not members of groups from issuing an effective notice of nonrenewal for coverage provided to the insured as a member of the group based solely on the failure of the insured to maintain that membership if (i) the insurer offers to renew the coverage to the insured on a nongroup basis, or (ii) to transfer the coverage to an affiliated insurer. The rates charged by the insurer or affiliated insurer shall have been adopted pursuant to this article. However, all of the following conditions shall be applicable to that insurance:

(A) Membership, if conditioned, is conditioned only on timely payment of membership dues and other bona fide criteria not based upon driving record or insurance, provided that membership in a motor club may not be based on residence in any area within the state.

(B) Membership dues are paid solely for and in consideration of the membership and membership benefits and bear a reasonable relationship to the benefits provided. The amount of the dues shall not depend on whether the member purchases insurance offered by the membership organization. None of those membership dues or any portion thereof shall be transferred by the membership organization to the insurer, or any affiliate of the insurer, attorney-in-fact, subsidiary, or holding company thereof, provided that this provision shall not prevent any bona fide transaction between the membership organization and those entities.

(C) Membership provides bona fide services or benefits in addition to the right to apply for insurance. Those services shall be reasonably available to all members within each class of membership.

Any insurer that violates subparagraphs (A), (B), or (C) shall be subject to the penalties set forth in Section 1861.14.

Full Disclosure of Insurance Information

1861.04. (a) Upon request, and for a reasonable fee to cover costs, the commissioner shall provide consumers with a comparison of the rate in effect for each personal line of insurance for every insurer.

[Insurance Code Section 1861.05(c) was amended by the state Legislature. Additions are noted in shaded text.]

Approval of Insurance Rates

1861.05. (a) No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter. In considering whether a rate is excessive, inadequate or unfairly discriminatory, no consideration shall be given to the degree of competition and the commissioner shall consider whether the rate mathematically reflects the insurance company's investment income.

(b) Every insurer which desires to change any rate shall file a complete rate application with the commissioner. A complete rate application shall include all data referred to in Sections 1857.7, 1857.9, 1857.15, and 1864 and such other information as the commissioner may require. The applicant shall have the burden of proving that the requested rate change is justified and meets the requirements of this article.

(c) The commissioner shall notify the public of any application by an insurer for a rate change. The application shall be deemed approved sixty days after public notice unless (1) a consumer or his or her representative requests a hearing within forty-five days of public notice and the commissioner grants the hearing, or determines not to grant the hearing and issues written findings in support of that decision, or (2) the commissioner on his or her own motion determines to hold a hearing, or (3) the proposed rate adjustment exceeds 7% of the then applicable rate for personal lines or 15% for commercial lines, in which case the commissioner must hold a hearing upon a timely request. In any event, a rate change application shall be deemed approved 180 days after the rate application is received by the commissioner (A) unless that application has been disapproved by a final order of the commissioner subsequent to a hearing, or (B) extraordinary circumstances exist. For purposes of this section, "received" means the date delivered to the department.

(d) For purposes of this section, extraordinary circumstances include the following:

(1) Rate change application hearings commenced during the 180-day period provided by subdivision (c). If a hearing is commenced during the 180-day period, the rate change application shall be deemed approved upon expiration of the 180-day period or 60 days after the close of the record of the hearing, whichever is later, unless disapproved prior to that date.

(2) Rate change applications that are not approved or disapproved within the 180-day period provided by subdivision (c) as a result of a judicial proceeding directly involving the application and initiated by the applicant or an intervenor. During the pendency of the judicial proceedings, the 180-day period is tolled, except that in no event shall the commissioner have less than 30 days after conclusion of the judicial proceedings to approve or disapprove the application. Notwithstanding any other provision of law, nothing shall preclude the commissioner from disapproving an application
without a hearing if a stay is in effect barring the commissioner from holding a hearing within the 180-day period.

(3) The hearing has been continued pursuant to Section 11524 of the Government Code. The 180-day period provided by subdivision (c) shall be tolled during any period in which a hearing is continued pursuant to Section 11524 of the Government Code. A continuance pursuant to Section 11524 of the Government Code shall be decided on a case by case basis. If the hearing is

commenced or continued during the 180-day period, the rate change application shall be deemed approved upon the expiration of the 180-day period or 100 days after the case is submitted, whichever is later, unless disapproved prior to that date.

[Insurance Code Section 1861.055, noted in shaded text below, was added to the Insurance Code by the state Legislature. It was NOT part of the original text of Proposition 103.]

1861.055. (a) The commissioner shall adopt regulations governing hearings required by subdivision (c) of Section 1861.05 on or before 120 days after the enactment of this section. Those regulations shall, at the minimum, include timelines for scheduling and commencing hearings, and procedures to prevent delays in commencing or continuing hearings without good cause.

(b) The sole remedy for failure by the commissioner to adopt the regulations required by subdivision (a) within the prescribed period or to abide by those regulations once adopted shall be a writ of mandate by any aggrieved party in a court of competent jurisdiction to compel the commissioner to adopt those regulations, or commence or resume hearings.

(c) Nothing in this section shall preclude the commissioner from commencing hearings required by subdivision (c) of Section 1861.05 prior to adopting the regulations required by this section.

(d) The administrative law judge shall render a decision within 30 days of the closing of the record in the proceeding.

1861.06. Public notice required by this article shall be made through distribution to the news media and to any member of the public who requests placement on a mailing list for that purpose.

1861.07. All information provided to the commissioner pursuant to this article shall be available for public inspection, and the provisions of Section 6254(d) of the Government Code and Section 1857.9 of the Insurance Code shall not apply thereto.

[Insurance Code Section 1861.08 was amended by the state Legislature. Additions are noted in shaded text, deletions in BOLD CAPS.]

1861.08. Hearings shall be conducted pursuant to Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code, except that:

(a) Hearings shall be conducted by administrative law judges for purposes of Sections 11512 and 11517, chosen under Section 11502 or appointed by the commissioner.

(b) Hearings are commenced by a filing of a notice in lieu of Sections 11503 and 11504.

(c) The commissioner shall adopt, amend or reject a decision only under Section **11517 (C) AND (E)**11518.5 and subdivisions (b), (c), and (e) of Section 11517 and solely on the basis of the record**;** as provided in Section 11425.50 of the Government Code.

(d) **SECTION 11513.5 SHALL APPLY TO THE COMMISSIONER;** Notwithstanding Section 11501, Section 11430.30 and subdivision (b) of Section 11430.70 shall not apply in these hearings.
(e) **D**Discovery shall be liberally construed and disputes determined by the administrative law judge. as provided in Section 11507.7 of the Government Code.

1861.09. Judicial review shall be in accordance with Section 1858.6. For purposes of judicial review, a decision to hold a hearing is not a final order or decision; however, a decision not to hold a hearing is final.

Consumer Participation
1861.10. (a) Any person may initiate or intervene in any proceeding permitted or established pursuant to this chapter, challenge any action of the commissioner under this article, and enforce any provision of this article.

(b) The commissioner or a court shall award reasonable advocacy and witness fees and expenses to any person who demonstrates that (1) the person represents the interests of consumers, and, (2) that he or she has made a substantial contribution to the adoption of any order, regulation or decision by the commissioner or a court. Where such advocacy occurs in response to a rate application, the award shall be paid by the applicant.

[The California Supreme Court invalidated Section 1861.10(c) of Proposition 103 in May 1989. The section is in BOLD CAPS below.]

(C) (1) THE COMMISSIONER SHALL REQUIRE EVERY INSURER TO ENCLOSE NOTICES IN EVERY POLICY OR RENEWAL PREMIUM BILL INFORMING POLICYHOLDERS OF THE OPPORTUNITY TO JOIN AN INDEPENDENT, NON-PROFIT CORPORATION WHICH SHALL ADVOCATE THE INTERESTS OF INSURANCE CONSUMERS IN ANY FORUM. THIS ORGANIZATION SHALL BE ESTABLISHED BY AN INTERIM BOARD OF PUBLIC MEMBERS DESIGNATED BY THE COMMISSIONER AND OPERATED BY INDIVIDUALS WHO ARE DEMOCRATICALLY ELECTED FROM ITS MEMBERSHIP. THE CORPORATION SHALL PROPORTIONATELY REIMBURSE INSURERS FOR ANY ADDITIONAL COSTS INCURRED BY INSERTION OF THE ENCLOSURE, EXCEPT NO POSTAGE SHALL BE CHARGED FOR ANY ENCLOSURE WEIGHING LESS THAN 1/3 OF AN OUNCE. (2) THE COMMISSIONER SHALL BY REGULATION DETERMINE THE CONTENT OF THE ENCLOSURES AND OTHER PROCEDURES NECESSARY FOR IMPLEMENTATION OF THIS PROVISION. THE LEGISLATURE SHALL MAKE NO APPROPRIATION FOR THIS SUBDIVISION.

Emergency Authority
1861.11. In the event that the commissioner finds that (a) insurers have substantially withdrawn from any insurance market covered by this article, including insurance described by Section 660, and (b) a market assistance plan would not be sufficient to make insurance available, the

commissioner shall establish a joint underwriting authority in the manner set forth by Section 11891, without the prior creation of a market assistance plan.

Group Insurance Plans
1861.12. Any insurer may issue any insurance coverage on a group plan, without restriction as to the purpose of the group, occupation or type of group. Group insurance rates shall not be considered to be unfairly discriminatory, if they are averaged broadly among persons insured under the group plan.

Application
1861.13. This article shall apply to all insurance on risks or on operations in this state, except those listed in Section 1851.

Enforcement & Penalties
1861.14. Violations of this article shall be subject to the penalties set forth in Section 1859.1. In addition to the other penalties provided in this chapter, the commissioner may suspend or revoke, in whole or in part, the certificate of authority of any insurer which fails to comply with the provisions of this article.

Section 4. Elected Commissioner
Section 12900 is added to the Insurance Code to read:

(a) The commissioner shall be elected by the people in the same time, place and manner as the Governor not to exceed two four-year terms.

Section 5. Insurance Company Filing Fees
Section 12979 is added to the Insurance Code to read:

Notwithstanding the provisions of Section 12978, the commissioner shall establish a schedule of filing fees to be paid by insurers to cover any administrative or operational costs arising from the provisions of Article 10 (commencing with Section 1861.01) of Chapter 9 of Part 2 of Division 1.

Section 6. Transitional Adjustment of Gross Premiums Tax
Section 12202.1 is added to the Revenue & Taxation Code to read:

Notwithstanding the rate specified by Section 12202, the gross premiums tax rate paid by insurers for any premiums collected between November 8, 1988 and January 1, 1991 shall be adjusted by the Board of Equalization in January of each year so that the gross premium tax revenues collected for each prior calendar year shall be sufficient to compensate for changes in such revenues, if any, including changes in anticipated revenues, arising from this act. In calculating the necessary adjustment, the Board of Equalization shall consider the growth in premiums in the most recent three year period, and the impact of general economic factors including, but not limited to, the inflation and interest rates.

Section 7. Repeal of Existing Law
Sections 1643, 1850, 1850.1, 1850.2, 1850.3, 1852, 1853, 1853.6, 1853.7, 1857.5, 12900, Article 3 (commencing with Section 1854) of Chapter 9 of Part 2 of Division 1, and Article 5 (commencing with Section 750) of Chapter 1 of Part 2 of Division 1, of the Insurance Code are repealed.

Section 8. Technical Matters
(a) This act shall be liberally construed and applied in order to fully promote its underlying purposes.

(b) The provisions of this act shall not be amended by the Legislature except to further its purposes by a statute passed in each house by roll call vote entered in the journal, two-thirds of the membership concurring, or by a statute that becomes effective only when approved by the electorate.

(c) If any provision of this act or the application thereof to any person or circumstances is held invalid, that invalidity shall not affect other provisions or applications of the act which can be given effect without the invalid provision or application, and to this end the provisions of this act are severable.

APPENDIX 2

**Consumer Principles and Standards for Insurance Regulation –
How Proposition 103 Meets Consumer White Paper Proposals
Presented to the NAIC in 2000**

All references are to the California Insurance Code unless otherwise noted.

I. Consumers should have access to timely and meaningful information of the costs, terms, risks and benefits of insurance policies.

- Meaningful disclosure prior to sale tailored for particular policies and written at the education level of average consumer sufficient to educate and enable consumers to assess particular policy and its value should be required for all insurance; should be standardized by line to facilitate comparison shopping; should include comparative prices, terms, conditions, limitations, exclusions, loss ratio expected, commissions/fees and information on seller (service and solvency); should address non-English speaking or ESL populations.

  Proposition 103 mandates that the Department of Insurance provide consumers with the ability to "comparison shop" for the best automobile or homeowner insurance policy. The Department must provide, upon request and for a reasonable fee, a statement comparing the rates in effect for each insurer. §1861.04.
- Insurance departments should identify, based on inquiries and market conduct exams, populations that may need directed education efforts, e.g., seniors, low-income, low education.
- Disclosure should be made appropriate for medium in which product is sold, e.g., in person, by telephone, on-line.
- Loss ratios should be disclosed in such a way that consumers can compare them for similar policies in the market, e.g., a scale based on insurer filings developed by insurance regulators or independent third party.
- Non-term life insurance policies, e.g., those that build cash values, should include rate of return disclosure. This would provide consumers with a tool, analogous to the APR required in loan contracts, with which they could compare competing cash value policies. It would also help them in deciding whether to buy cash value policies.
- Free look period with meaningful state guidelines to assess appropriateness of policy and value based on standards the state creates from data for similar policies.
- Comparative data on insurers' complaint records, length of time to settle claims by size of claim, solvency information, and coverage ratings (e.g., policies should be ranked based on actuarial value so a consumer knows if comparing apples to apples) should be available to the public.
- Significant changes at renewal must be clearly presented as warnings to consumers, e.g., changes in deductibles for wind loss.
- Information on claims policy and filing process should be readily available to all consumers and included in policy information.

- Sellers should determine and consumers should be informed of whether insurance coverage replaces or supplements already existing coverage to protect against over-insuring, e.g., life and credit.
- Consumer Bill of Rights, tailored for each line, should accompany every policy.
- Consumer feedback to the insurance department should be sought after every transaction (e.g., after policy sale, renewal, termination, claim denial). Insurer should give consumer notice of feedback procedure at end of transaction, e.g., form on-line or toll-free telephone number.

  Proposition 103 provides consumers or their representatives with the right to challenge insurance industry rates and practices. Consumer representatives must be reimbursed for their substantial contribution to agency or judicial proceedings. §1861.10
  Proposition 103 requires all information submitted to the Department of Insurance for regulatory purposes be made available to the public. §1861.07

II. Insurance policies should be designed to promote competition, facilitate comparison-shopping and provide meaningful and needed protection against loss.

- *Disclosure requirements above apply here as well and should be included in design of policy and in the policy form approval process.*
- *Policies must be transparent and standardized so that true price competition can prevail. Components of the insurance policy must be clear to the consumer, e.g., the actual current and future cost, including commissions and penalties.*
- *Suitability or appropriateness rules should be in place and strictly enforced, particularly for investment/cash value policies. Companies must have clear standards for determining suitability and compliance mechanism. For example, sellers of variable life insurers are required to find that the sales that their representatives make are suitable for the buyers. Such a requirement should apply to all life insurance policies, particularly when replacement of a policy is at issue.*
- *"Junk" policies, including those that do not meet a minimum loss ratio, should be identified and prohibited. Low-value policies should be clearly identified and subject to a set of strictly enforced standards that ensure minimum value for consumers.*
- *Where policies are subject to reverse competition, special protections are needed against tie-ins, overpricing, e.g., action to limit credit insurance rates.*

III. All consumers should have access to adequate coverage and not be subject to unfair discrimination.

- Where coverage is mandated by the state or required as part of another transaction/purchase by the private market, e.g., mortgage, regulatory intervention is appropriate to assure reasonable affordability and guarantee availability.

  Auto insurance is mandatory in California. Proposition 103 requires all auto insurance rates be priced fairly based on proper expense and profit levels.
  Proposition 103 requires that insurers offer qualified drivers a 20% Good Driver Discount. §1861.02(b).
  Proposition 103 forbids insurers from denying or penalizing applicants who have not been previously insured. §1861.02(c)

- Market reforms in the area of health insurance should include guaranteed issue and community rating and where needed, subsidies to assure health care is affordable for all.
- Information sufficient to allow public determination of unfair discrimination must be available. ZIP code data, rating classifications and underwriting guidelines, for example, should be reported to regulatory authority for review and made public.

  Proposition 103 requires all information submitted to the Department of Insurance for regulatory purposes be made available to the public. §1861.07
- Regulatory entities should conduct ongoing, aggressive market conduct reviews to assess whether unfair discrimination is present and to punish and remedy it if found, e.g., redlining reviews (analysis of market shares by census tracts or ZIP codes, analysis of questionable rating criteria such as credit rating), reviews of pricing methods, reviews of all forms of underwriting instructions, including oral instructions to producers.

  Proposition 103 requires insurers to base auto insurance premiums primarily upon driving safety record, annual miles driven and years of driving experience, rather than upon factors outside of the motorist's control, such as ZIP code. §1861.02
- Insurance companies should be required to invest in communities and market and sell policies to prevent or remedy availability problems in communities.
- Clear anti-discrimination standards must be enforced so that underwriting and pricing are not unfairly discriminatory. Prohibited criteria should include race, national origin, gender, marital status, sexual preference, income, language, religion, credit history, domestic violence, and, as feasible, age and disabilities. Underwriting and rating classes should be demonstrably related to risk and backed by a public, credible statistical analysis that proves the risk-related result.

  Proposition 103 requires insurers to base auto insurance premiums primarily upon driving safety record, annual miles driven and years of driving experience, rather than upon factors outside of the motorist's control, such as ZIP code. Other rating factors can be used only if demonstrated to have a "substantial relationship to the risk of loss" §1861.02(a).

  Proposition 103 also makes the state's civil rights and consumer protection laws applicable to the insurance industry. §1861.03

IV. **All consumers should reap the benefits of technological changes in the marketplace that decrease prices and promote efficiency and convenience**.

- Rules should be in place to protect against redlining and other forms of unfair discrimination via certain technologies, e.g., if companies only offer better rates, etc. online.
- Regulators should take steps to certify that online sellers of insurance are genuine, licensed entities and tailor consumer protection, UTPA, etc. to the technology to ensure consumers are protected to the same degree regardless of how and where they purchase policies.
- Regulators should develop rules/principles for e-commerce (or use those developed for other financial firms if appropriate and applicable)
- In order to keep pace with changes and determine whether any specific regulatory action is needed, regulators should assess whether and to what extent technological changes are decreasing costs and what, if any, harm or benefits accrue to consumers.
- A regulatory entity, on its own or through delegation to independent third party, should become the portal through which consumers go to find acceptable sites on the web. The

standards for linking to acceptable insurer sites via the entity and the records of the insurers should be public; the sites should be verified/reviewed frequently and the data from the reviews also made public.

V. Consumers should have control over whether their personal information is shared with affiliates or third parties.

- Personal financial information should not be disclosed for other than the purpose for which it is given unless the consumer provides prior written or other form of verifiable consent.
- Consumers should have access to the information held by the insurance company to make sure it is timely, accurate and complete. They should be periodically notified how they can obtain such information and how to correct errors.
- Consumers should not be denied policies or services because they refuse to share information (unless information needed to complete transaction).
- Consumers should have meaningful and timely notice of the company's privacy policy and their rights and how the company plans to use, collect and or disclose information about the consumer.
- Insurance companies should have clear set of standards for maintaining security of information and have methods to ensure compliance.
- Health information is particularly sensitive and, in addition to a strong opt-in, requires particularly tight control and use only by persons who need to see the information for the purpose for which the consumer has agreed to sharing of the data.
- Protections should not be denied to beneficiaries and claimants because a policy is purchased by a commercial entity rather than by an individual (e.g., a worker should get privacy protection under workers' compensation).

VI. Consumers should have access to a meaningful redress mechanism when they suffer losses from fraud, deceptive practices or other violations; wrongdoers should be held accountable directly to consumers.

- Aggrieved consumers must have the ability to hold insurers directly accountable for losses suffered due to their actions. UTPAs should provide private cause of action.
  Proposition 103 makes state consumer protection laws applicable to the insurance industry. §1861.03.
  Consumers may challenge improper actions by insurers in the courts. §1861.09.
  Proposition 103 provides consumers or their representatives with the right to challenge insurance industry rates and practices. §1861.05.
  Consumer representatives must be reimbursed for their substantial contribution to agency or judicial proceedings. §1861.10.
- Alternative Dispute Resolution clauses should be permitted and enforceable in consumer insurance contracts only if the ADR process is: 1) contractually mandated with non-binding results, 2) at the option of the insured/beneficiary with binding results, or 3) at the option of the insured/beneficiary with non-binding results.
- Bad faith causes of action must be available to consumers.

- When regulators engage in settlements on behalf of consumers, there should be an external, consumer advisory committee or other mechanism to assess fairness of settlement and any redress mechanism developed should be independent, fair and neutral decision-maker.
- Private attorney general provisions should be included in insurance laws.
- There should be an independent agency that has as its mission to investigate and enforce deceptive and fraudulent practices by insurers, e.g., the reauthorization of FTC.

7. Consumers should enjoy a regulatory structure that is accountable to the public, promotes competition, remedies market failures and abusive practices, preserves the financial soundness of the industry and protects policyholders' funds, and is responsive to the needs of consumers.

- Insurance regulators must have clear mission statement that includes as a primary goal the protection of consumers:

  Proposition 103 specifies that the mission of the Insurance Commissioner and the Insurance Department is the protection of consumers. (Preamble, Purposes Clauses).
- The mission statement must declare basic fundamentals by line of insurance (such as whether the state relies on rate regulation or competition for pricing). Whichever approach is used, the statement must explain how it is accomplished. For instance, if competition is used, the state must post the review of competition (e.g., market shares, concentration by zone, etc.) to show that the market for the line is workably competitive, apply anti-trust laws, allow groups to form for the sole purpose of buying insurance, allow rebates so agents will compete, assure that price information is available from an independent source, etc. If regulation is used, the process must be described, including access to proposed rates and other proposals for the public, intervention opportunities, etc.

  Proposition 103 applies the antitrust laws, allows group insurance, rebating and requires full disclosure of information. §§1861.03, 1861.12, Sec. 5 (repealers).
- Consumer bills of rights should be crafted for each line of insurance and consumers should have easily accessible information about their rights.
- Insurance departments should support strong patient bill of rights.
- Focus on online monitoring and certification to protect against fraudulent companies.
- A department or division within regulatory body should be established for education and outreach to consumers, including providing:
- Interactive websites to collect from and disseminate information to consumers, including information about complaints, complaint ratios and consumer rights with regard to policies and claims.
- Access to information sources should be user friendly.
- Counseling services to assist consumers, e.g., with health insurance purchases, claims, etc. where needed should be established.
- Consumers should have access to a national, publicly available database on complaints against companies/sellers, i.e., the NAIC database.
- To promote efficiency, centralized electronic filing and use of centralized filing data for information on rates for organizations making rate information available to consumers, e.g., help develop the information brokering business.
- Regulatory system should be subject to sunshine laws that require all regulatory actions to take place in public unless clearly warranted and specified criteria apply. Any insurer claim

of trade secret status of data supplied to regulatory entity must be subject to judicial review with burden of proof on insurer.

Proposition 103 requires all information submitted to the Department of Insurance for regulatory purposes be made available to the public. §1861.07. Judicial review is provided. §1861.09.

- Strong conflict of interest, code of ethics and anti-revolving door statutes are essential to protect the public.
- Election of insurance commissioners must be accompanied by a prohibition against industry financial support in such elections.
- Adequate and enforceable standards for training and education of sellers should be in place.
- The regulatory role should in no way, directly or indirectly, be delegated to the industry or its organizations.
- The guaranty fund system should be prefunded, national fund that protects policyholders against loss due to insolvency. It is recognized that a phase-in program is essential to implement this recommendation.
- Solvency regulation/investment rules should promote a safe and sound insurance system and protect policyholder funds, e.g., rapid response to insolvency to protect against loss of assets/value.
- Laws and regulations should be up to date with and applicable to e-commerce.
- Antitrust laws should apply to the industry.

  Proposition 103 applies the antitrust laws. §1861.03
- A priority for insurance regulators should be to coordinate with other financial regulators to ensure consumer protection laws are in place and adequately enforced regardless of corporate structure or ownership of insurance entity. Insurance regulators should err on side of providing consumer protection even if regulatory jurisdiction is at issue. This should be stated mission/goal of recent changes brought about by GLB law.
- Obtain information/complaints about insurance sellers from other agencies and include in databases.
- A national system of "Consumer Alerts" should be established by the regulators, e.g., companies directed to inform consumers of significant trends of abuse such as race-based rates or life insurance churning.
- Market conduct exams should have standards that ensure compliance with consumer protection laws and be responsive to consumer complaints; exam standards should include agent licensing, training and sales/replacement activity; companies should be held responsible for training agents and monitoring agents with ultimate review/authority with regulator. Market conduct standards should be part of an accreditation process.
- The regulatory structure must ensure accountability to the public it serves. For example, if consumers in state X have been harmed by an entity that is regulated by state Y, consumers would not be able to hold their regulators/legislators accountable to their needs and interests. To help ensure accountability, a national consumer advocate office with the ability to represent consumers before each insurance department is needed when national approaches to insurance regulation or "one-stop" approval processes are implemented.

  Proposition 103 has a fully accountable regulatory process with full opportunity for consumer participation. The insurance commissioner is elected by vote of the people. §§ 1861.05, 1861.09, 1861.10, Govt. Code §12900.

- Insurance regulator should have standards in place to ensure mergers and acquisitions by insurance companies of other insurers or financial firms, or changes in status of insurance companies (e.g., demutualization, non-profit to for-profit), meet the needs of consumers and communities.
- Penalties for violations must be updated to ensure they serve as incentives against violating consumer protections and should be indexed to inflation.

8. Consumers should be adequately represented in the regulatory process.

- Consumers should have representation before regulatory entities that is independent, external to regulatory structure and should be empowered to represent consumers before any administrative or legislative bodies. To the extent that there is national treatment of companies or "one-stop" (OS) approval, there must be a national consumer advocate's office created to represent the consumers of all states before the national treatment state, the OS state or any other approving entity.

  Proposition 103 provides full opportunity for consumer intervention and participation. Consumers may challenge improper actions by insurers in the courts. §1861.09. Proposition 103 provides consumers or their representatives with the right to challenge insurance industry rates and practices. §1861.05. Consumer representatives must be reimbursed for their substantial contribution to agency or judicial proceedings. §1861.10.
- Insurance departments should support public counsel or other external, independent consumer representation mechanisms before legislative, regulatory and NAIC bodies.
- Regulatory entities should have well-established structure for ongoing dialogue with and meaningful input from consumers in the state, e.g., consumer advisory committee. This is particularly true to ensure needs of certain populations in state and needs of changing technology are met.

APPENDIX 3

HISTORY OF PROPOSITION 103 IMPLEMENTATION UNDER FOUR VERY DIFFERENT COMMISSIONERS

1988 – 1990 (Insurance Commissioner Gillespie)

California's final appointed insurance commissioner was Roxani Gillespie, who was in office when Proposition 103 was approved by voters. Gillespie had opposed the measure and, apparently under the belief that the Supreme Court would invalidate it, refused to implement its requirements until the CalFarm decision was issued. Commissioner Gillespie subsequently began a series of informal informational hearings and public announcements; however, no progress was made toward the two time-sensitive reforms: (1) the issuance of rollback orders, which was to be completed before November 8, 1989 so that insurers would be able to seek rate increases under the measure's Prior Approval system thereafter; and (2) the development of a new rating system to replace territorial rating.

In October 1989, Commissioner Gillespie froze insurance rates pending completion of the rollback process. She lifted this freeze prior to the end of her term. On December 13, 1990, shortly before she left office, 60 insurers were granted price increases.

The combination of Commissioner Gillespie's inability -- or, as some consumer advocates argued, her unwillingness -- to implement the Proposition, and the decision by insurers to challenge in the courts all efforts to implement the measure, effectively precluded implementation of the rollback and classification portions of Proposition 103's reforms during the balance of Gillespie's tenure, although many of the Proposition's reforms -- such as removal of antitrust exemption, anti-rebate and anti-group laws did become effective even absent Commissioner action.

1990-1994 (Insurance Commissioner Garamendi)

The state's first elected insurance commissioner won the post on November 6, 1990. John Garamendi, formerly a state Senator, took office on January 7, 1991.

As his first act in office, Commissioner Garamendi immediately placed a freeze all property-casualty insurance rates, which he announced would not be lifted for any insurer until that insurer had complied with a rollback order from the Commissioner and all related litigation had been concluded. Commissioner Garamendi subsequently withdrew most of the rollback and other regulations proposed by Commissioner Gillespie and issued stringent new regulations that established normative standards for insurer profitability and efficiency. The regulations

specified a formula that determined the amount, if any, each insurer would pay under the rollback requirement.[97] The regulations:

- Capped the rate of return.

- Established ceilings for executive salaries, and set an overall limit on expenses equal to the industry average, rewarding insurers that operate more efficiently with a higher rate of return. Expenses in excess of that amount were to be excluded from the rate base.

- Prohibited insurers from engaging in bookkeeping practices that inflate their claims losses, and limited the amounts insurers could set aside as surplus and reserves.

- Forbade insurers from passing through to consumers the costs of the industry's lobbying, political contributions, institutional advertising, the unsuccessful defense of discrimination cases, bad faith damage awards and fines or penalties.

With revisions to reflect a greater rate of return than would govern the rollback requirement, the regulations were intended to be used to govern the process of approval for rate increase requests once an insurer satisfied its rollback obligation.

Insurers challenged the rollback formula as confiscatory. However, in August 1994, the California Supreme Court unanimously upheld the regulations as constitutional.[98]

Commissioner Garamendi's tenure reflected a massive change in the mission and role of the commissioner and the Department of Insurance. Forced to begin from scratch, his implementation of Proposition 103 proceeded carefully but efficiently. However, litigation by insurers, as well as hostile actions against reform by state lawmakers and then-Governor Pete Wilson contributed to delays in full enforcement by Garamendi of Proposition 103.

1994-2000 (Insurance Commissioner Quackenbush)

State legislator Chuck Quackenbush's tenure as commissioner was plagued with criticism from its inception. As a candidate, Quackenbush said, "You can't take company money from [the insurance industry]. You regulate them. The conflict there is difficult to explain to the voters."[99] He went on to accept over $2.5 million from the industry for his 1994 campaign and took over $6 million from the industry before being forced from office in 2000 amidst a major scandal.

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[97] Findings and Determinations of the Insurance Commissioner, State of California, *In the Matter of Determination of Exposure Basis, Reserve-Strengthening, Executive Compensation and Efficiency Standards for 1989 Rate Calculations*, File No. RCD-1 (August 14, 1991); Findings and Determinations of the Insurance Commissioner, State of California, *In the Matter of Determination of Rate of Return, Leverage Factors and Projected Yield for 1989 Rate Calculations*, File No. RCD-2 (August 14, 1991).

[98] *Twentieth Century Insurance Co. v. Garamendi*, 8 Cal.4th 216 (1994). The U.S. Supreme Court refused the insurance industry's final appeal. *Century-National Ins. Co. v. Quackenbush*, 513 U.S. 1153 (February 21, 1995) (*cert. denied*); *State Farm Mutual Automobile Insurance Co. v. Quackenbush*, 513 U.S. 1153 (February 21, 1995) (*cert. denied*).

[99] "Insurance Industry's Really in This Race; Betting on Quackenbush for State Commissioner," The San Diego Union-Tribune, James P. Sweeney, October 30, 1994.

After four years of a pro-consumer insurance commissioner, the insurance industry was determined to install an industry-friendly commissioner. Insurance industry interests provided 73% of Quackenbush's campaign war chest in 1994.

Quackenbush and Proposition 103 Refunds

Even after the courts ruled against industry challenges, Quackenbush negotiated numerous deals with insurers — many of whom had contributed to his campaign – to substantially reduce the Proposition 103 refunds ordered by his predecessor Commissioner John Garamendi.

In one instance, 20th Century Insurance Company's Proposition 103 rollback obligation was cut from $120 million to $46 million due to purported fiscal problems arising from the company's Northridge Earthquake losses. However, 20th Century was able to afford a $5,000 campaign contribution to Quackenbush's election campaign, a month after he had won office. In 1996, Quackenbush granted 20th Century the opportunity to re-enter the homeowner and earthquake insurance market. The insurer also contributed $100,000 to Quackenbush's Proposition 213 initiative that year.

Quackenbush and Earthquake Insurance under 103 Rules

Quackenbush came under fire for failing to address widespread complaints concerning insurers' mishandling of Northridge earthquake claims. In 1996, legislation sponsored by Quackenbush at the behest of the insurance industry established a new state agency, the California Earthquake Authority, which assumed responsibility for providing earthquake insurance coverage, effectively providing the insurance industry with a potential $39 billion dollar bailout in the event of a catastrophic earthquake. Homeowners purchasing CEA policies were forced to pay about twice as much for only about half the coverage available prior to the CEA. In February 1998, after a hotly contested hearing held pursuant to Proposition 103, an administrative law judge found that the rates charged by the CEA were illegal and ordered the Authority to recalculate the rates.

Quackenbush and Insurance Rate Increases Under 103 Rules

While California was the only state in the nation to experience consistent rate reductions in the post-103 period, data assembled by independent experts confirmed that insurers were reaping excessive profits and that rates should be reduced even further. In 1996, California consumer organizations petitioned Quackenbush to conduct hearings on industry profits and to order rate reductions. Quackenbush refused to investigate, much less limit, the insurers' profits. In February 1998, Quackenbush quashed a study on excessive auto insurance rates and profits by a task force subcommittee he himself had previously appointed.

Quackenbush failed to complete and issue Garamendi-era regulations governing rate change requests under 103's Prior Approval process, choosing to allow companies to set rates without clear standards.

Quackenbush approved an average of nearly one rate increase request for every day he was in office — 1,002 rate increases through March 18, 1998 (1,172 days in office). This included 122 increase approvals for personal earthquake insurance (32 of them for 100% or more!). One of these was a 100% increase for Allstate, which contributed $266,502 to his campaign committees since 1994.

There are many other anti-consumer activities by Commissioner Quackenbush that could be listed here. Since most are not directly related to the Proposition, we will resist the temptation to cite them all. However, we will cover the large scandal, which led to the resignation in disgrace of the Commissioner. We do so because the insurers involved include some of the largest auto insurers, which may give insight into why there was inaction by the Commissioner on excess profits for these insurers during his term.

The Quackenbush/Northridge Earthquake Scandal

In March 2000, the Los Angeles Times exposed what would become the largest political scandal in recent California history. Based on information provided by a Department of Insurance whistleblower, the Los Angeles Times reported that Insurance Commissioner Chuck Quackenbush had shielded the state's largest insurance company, State Farm, and two other companies from $3.37 billion in fines – the largest ever assessed against insurance companies in the United States – in exchange for $10.75 million in contributions to non-profit organizations and to his own political committees.

Responding to homeowner complaints concerning the claims handling practices of insurance companies in the aftermath of the Northridge earthquake, Department of Insurance staff had conducted a series of secret investigations into the conduct of insurers. They recommended that State Farm, 20th Century (now 21st Century) and Allstate pay $3.7 billion in fines and restitution. Initially, Quackenbush claimed that the recommended payment was merely a negotiating tactic. Quackenbush told legislators that the $12 million in tax-deductible donations ultimately made by five insurance companies to non-profit entities set up and controlled by Quackenbush in lieu of the penalties, was an appropriate "settlement" of his agency's investigation of the insurers' conduct. For their part, the insurers repeatedly insisted they did nothing wrong after Northridge, but agreed to the relatively modest donations out of charity. They pointed to the settlement agreements Quackenbush signed with the insurers in exchange for the payments to the non-profit entities. The agreements largely exonerated the insurers of misconduct, concluding that the companies, faced with "an extraordinary circumstance" (a big earthquake), handled their policyholders' claims "in good faith."

Company	**Disposition Recommended by DOI Staff**	**Disposition by Quackenbush**	**Actual Expenditure by Company**

State Farm	$2.38 Billion in fines; $114.7 Million to a policyholder fund	Final Order finds State Farm acted in good faith in Northridge claims	$2,000,000 to foundation. $5,000 “costs” to DOI.
Allstate	$172 Million in fines; $73.7 Million to a policyholder fund	Northridge created "extraordinary circumstances" for Allstate	$2,000,000 to foundation
20th Century	$819 Million in fines; $44.2 Million to a policyholder fund	Allowed to resume selling homeowners insurance; MCE found "alleged deficiencies in claims files reviewed"	$6,550,000 to foundation. $200,000 for “public education” $100,000 fine
Farmer's	Unknown	Unknown	$1,000,000 to foundation $2,500 “costs” to DOI
Fireman's Fund	Unknown	Unknown	$550,000 to foundation

But public disclosure of the secret internal reports – known as “Market Conduct Examinations (MCEs)” – belied Quackenbush’s assertion that his settlements were fair. Executive Summaries of the MCEs indicated that the Department, in fact, conducted full-scale investigations between November 26, 1997 and November 18, 1998 into the companies' behavior. According to the reports, the insurance companies routinely low-balled their policyholders, delayed or denied payment of reasonable claims and frequently misled their policyholders concerning whether their claims were even covered. For example:

- State Farm did not properly explain policyholder's benefits, misled policyholders or misrepresented settlement in 37% of the 825 files reviewed**.** State investigators found an average of 3.5 violations of state law in 47% of the State Farm claims files they reviewed. So pervasive was State Farm’s claims infractions that investigators recommended the company be ordered to review every claim – auto, homeowner or business — it had handled in the preceding five years, and make any necessary repayments.
- 75% of 20th Century's files included citations, and 20th Century offered unacceptably low settlements in 32% of the 431 files reviewed and**;**
- Allstate reduced settlements based on unnecessary or excessive depreciation of property value in 16% of the 808 files reviewed.

Subsequent investigations revealed that the foundations established by Quackenbush were used as “slush funds” to benefit Quackenbush’s political efforts, members of his family and friends:

- $3 million were spent on “educational” television ads featuring Quackenbush.
- $500,000 donation made to Sacramento Urban League shortly after Quackenbush joined the Board of Directors of the organization.
- $263,000 donation to a football camp attended by Quackenbush's children.

An extensive legislative inquiry was undertaken, while state and federal law enforcement agencies began their own investigations. When it appeared certain that Quackenbush would be impeached for misconduct in office, he resigned on June 28, 2000 and moved to Hawaii. Several individuals involved with the Quackenbush foundations were indicted and went to jail.

In the aftermath of the scandal, California consumer groups concluded that current state claims handling laws were insufficient to protect the public against abuse by insurance companies, which earn huge profits by investing our premiums and therefore have a powerful incentive to delay or deny claims. They called on California lawmakers to enact new laws that protect consumers by requiring insurance companies to pay all legitimate claims fully and fairly. Additionally, the groups called for a ban on insurance industry campaign contributions to the elected commissioner.

2000- 2002 (Insurance Commissioner Low)

On July 31, 2000, California Governor Gray Davis appointed retired appellate justice Harry Low to fill the vacancy created by Quackenbush's resignation. Low was considered an individual of high integrity, but consumer groups raised questions concerning his role as a private arbitrator and whether Low had the ability and temperament to be a zealous advocate for consumers.

In the ensuing years, Low took a low profile and described his principal goal as restoring the credibility and integrity of the Department of Insurance. However, in critical litigation to enforce Proposition 103's prohibition on unfair rating practices (discussed below), Low sided with the insurance industry in support of a court decision which upheld Quackenbush regulations that approved the continued use of territorial rating in violation of the express provisions of Proposition 103. Low subsequently stated he would revisit Quackenbush's regulations. Further, Commissioner Low did not actively pursue excessive rate proposals by insurers and allowed more than 80 rate increases among the top 50 auto insurers.

2003-2006 (Insurance Commissioner Garamendi)

Californians voted to return John Garamendi to head the Department of Insurance and he, in essence, picked up where he had left off in 1994. During his tenure, the rate regulation division stepped up its enforcement of Proposition 103's rate oversight responsibilities and approved about eight auto rate decreases for every increase. In 2006, Garamendi approved new rules finally mandating Proposition 103's requirement that insurers base premiums primarily on driving safety record rather than motorists' ZIP codes. He also updated the Prior Approval regulations to ensure more vigorous restraints on excess profits and rates. Not satisfied to simply allow insurers to file decreases at their own speed, Commissioner Garamendi ordered several companies to justify homeowners insurance rates as well, and subsequently ordered rate cuts averaging about 20 percent among major insurers. He also ordered all auto insurers to file new rate plans by summer of 2008 in conjunction with companies' obligations to comply with the new rules limiting the use of ZIP code in premium setting. Insurers that began to comply in 2006 announced a series of rate reductions at the same time.

2007-present (Insurance Commissioner Poizner)

Steve Poizner campaigned for the insurance commissioner's post as a consumer advocate who would maintain Proposition 103's rules protecting policyholders from excessive and arbitrary rates. He refused insurance industry campaign contributions while his main opponent did not, sustaining a trend that has made industry contributions poison to commissioner candidates since Quackenbush's resignation. Commissioner Poizner took office on January 8, 2007. In 2008 he signed a decision requiring Allstate to lower auto rates by 15.9%, creating a savings of nearly a quarter billion dollars for that company's policyholders. At the date of publication of this report he has only been in office for about 15 months and a further assessment will be necessary after more time in office.

APPENDIX 4

SPREADSHEETS 8 THROUGH 13 – CALIFORNIA POST-PROPOSITION 103 (1989[100] TO 2005) DATA

SPREADSHEET 8: Premium Changes Since Proposition 103

	AVERAGE EXPENDITURE		AVERAGE PREMIUM		AVERAGE PREMIUM LIABILITY	
YEAR	CALIFORNIA	COUNTRYWIDE	CALIFORNIA	COUNTRYWIDE	CALIFORNIA	COUNTRYWIDE
1989	$747.97	$551.95	$875.60	$635.58	$519.39	$339.82
1990	$751.32	$571.69	$872.33	$658.83	$501.34	$354.61
1991	$783.18	$596.91	$897.32	$686.79	$533.93	$377.15
1992	$766.11	$616.18	$887.30	$711.97	$518.30	$395.54
1993	$802.63	$637.72	$892.80	$730.39	$523.21	$412.70
1994	$789.54	$650.73	$874.84	$740.38	$502.76	$420.23
1995	$803.19	$668.27	$886.76	$757.56	$514.53	$428.51
1996	$799.04	$691.32	$878.95	$780.11	$511.14	$438.00
1997	$773.32	$707.39	$871.36	$798.91	$504.00	$441.28
1998	$717.98	$704.32	$823.10	$797.23	$452.23	$426.21
1999	$665.65	$685.09	$771.46	$785.49	$404.33	$405.43
2000	$666.94	$689.27	$766.90	$788.50	$397.28	$401.19
2001	$722.79	$725.57	$812.90	$824.31	$427.78	$420.46
2002	$778.00	$780.77	$887.37	$887.87	$460.33	$456.84
2003	$837.30	$824.49	$957.82	$941.31	$493.10	$487.93
2004	$846.30	$839.55	$971.66	$961.42	$492.20	$500.09
2005	$844.50	$829.17	$969.11	$948.97	$487.04	$496.73
89/05 % CHANGE	12.9%	50.2%	10.7%	49.3%	-6.2%	46.2%
$$ CHANGE	$96.53	$277.22	$93.51	$313.39	-$32.35	$156.91
CA RANK						
1989	3		3		2	
2005	18		17		20	

	AVERAGE PREMIUM COLLISION		AVERAGE PREMIUM COMPREHENSIVE	
YEAR	CALIFORNIA	COUNTRYWIDE	CALIFORNIA	COUNTRYWIDE
1989	$235.53	$197.33	$120.68	$98.44
1990	$245.19	$202.34	$125.80	$101.88
1991	$238.78	$207.30	$124.61	$103.63
1992	$243.98	$207.34	$125.02	$109.09
1993	$234.83	$205.78	$134.76	$111.91
1994	$241.68	$206.60	$130.41	$113.55
1995	$240.93	$213.32	$131.30	$115.74
1996	$238.64	$222.40	$128.91	$119.01
1997	$246.33	$235.40	$121.04	$122.23

[100] Proposition 103 was enacted in November 1998 but did not take full effect until lawsuits were completed. The major lawsuit, CalFarm, was decided in May 1989 and the first rate action, the freeze, was in October of 1989. Thus, 1989 is the proper base year for measuring Proposition 103's achievements.

1998	$249.97	$245.28	$120.90	$125.74
1999	$234.81	$249.53	$113.67	$130.53
2000	$244.80	$255.80	$110.44	$131.51
2001	$280.30	$270.73	$104.82	$133.12
2002	$318.65	$292.81	$108.36	$138.22
2003	$349.77	$308.26	$114.95	$145.12
2004	$363.60	$214.43	$115.87	$146.90
2005	$365.31	$308.96	$116.76	$143.28
89/05				
% CHANGE	55.1%	56.6%	-3.2%	45.6%
$$ CHANGE	$129.78	$111.63	-$3.92	$44.84
CA RANK				
1989	9		9	
2005	7		44	

Source: NAIC Auto Insurance Database Report 2004/2005 and previous editions.

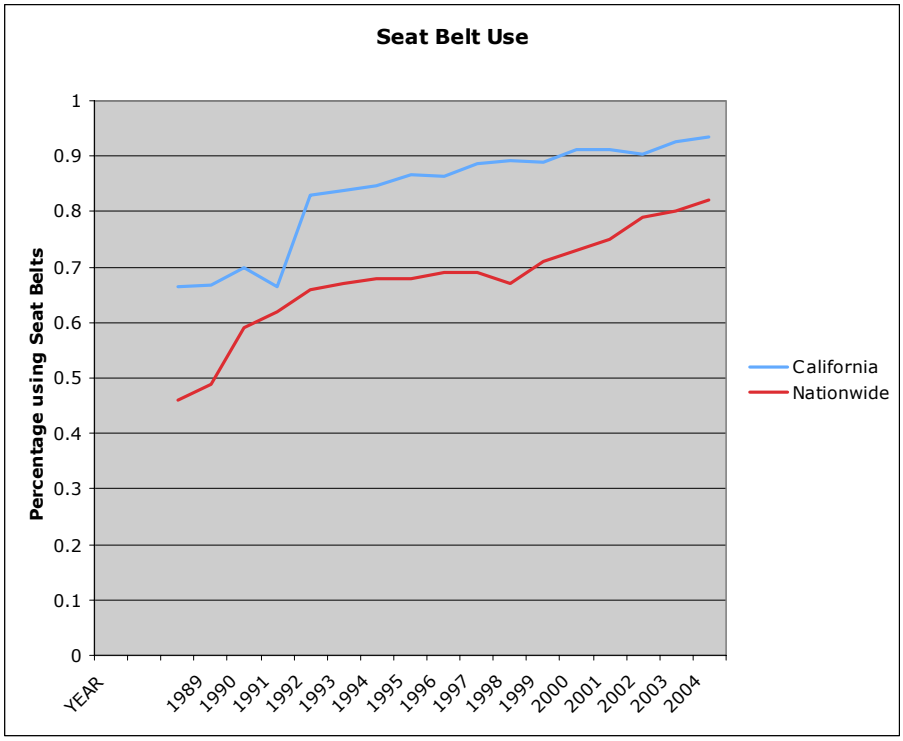
SPREADSHEET 9: By Growth in Use of Seatbelts

SEAT BELT USE

YEAR	California	Nationwide
1989	66.5%	46.0%
1990	66.7%	49.0%
1991	69.9%	59.0%
1992	66.5%	62.0%
1993	82.9%	66.0%
1994	83.8%	67.0%
1995	84.7%	68.0%
1996	86.6%	68.0%
1997	86.4%	69.0%
1998	88.6%	69.0%
1999	89.3%	67.0%
2000	88.9%	71.0%
2001	91.1%	73.0%
2002	91.1%	75.0%
2003	90.4%	79.0%
2004	92.5%	80.0%
2005	93.4%	82.0%
89/05		
% Change	40.5%	78.3%

* These numbers are from surveying drivers only. Normally, surveys include both drivers and passengers.

"California, a primary enforcement state, currently reports 91% usage -- the highest in the country. After the passage of a mandatory seatbelt law in 1986, California's usage rate went from 26% to approximately 45%. By 1992, California's usage had increased to 71%. With the passage of the primary enforcement law in 1993, California's usage rate jumped to 83%, steadily climbing to the current rate." Seatbelts: Current Issues, Gantz and Henkle, October, 2002.
http://www.preventioninstitute.org/traffic_seatbelt.html
Also NHTSA reports for recent CA and USA figures.



SPREADSHEET 10: By No Pay, No Play Law Status

Liability Premium Change Relative to Effective Date of "No Pay, No Play" Laws

(eff Mar 96)	1996 Avg. Liability Premium	2005 Avg. Liability Premium	1996 to 2005 Liab. % Change	1996 Prem (Liab.) Rank (1 = highest)	2005 Prem (Liab.) Rank (1 = highest)
Michigan	$348.49	$486.90	39.7%	32	21
Countrywide	$439.05	$496.73	13.1%		

(eff Jan 97)	1997 Avg. Liability Premium	2005 Avg. Liability Premium	1997 to 2005 Liab. % Change	1997 Prem (Liab.) Rank (1 = highest)	2005 Prem (Liab.) Rank (1 = highest)
California	$492.31	$487.04	-1.1%	14	19
Countrywide	$440.66	$496.73	12.7%		

(eff Sep 98)	1999 Avg. Liability Premium	2005 Avg. Liability Premium	1999 to 2005 Percent Change	1999 Prem (Liab) Rank (1 = highest)	2005 Prem (Liab.) Rank (1 = highest)
Louisiana	$479.68	$665.25	38.7%	10	7
Countrywide	$402.38	$496.73	23.4%		

(eff Feb 04)	2004 Avg. Liability Premium	2005 Avg. Liability Premium	2004 to 2005 Percent Change	2004 Prem (Liab.) Rank (1 = highest)	2005 Prem (Liab.) Rank (1 = highest)
New Jersey	$759.56	$750.81	-1.2%	1	3
Countrywide	$500.09	$496.73	-0.7%		

(eff Oct. 04)	2004 Avg. Liability Premium	2005 Avg. Liability Premium	2004 to 2005 Percent Change	2004 Prem (Liab.) Rank (1 = highest)	2005 Prem (Liab.) Rank (1 = highest)
Alaska	$600.28	$595.95	-0.7%	11	9
Countrywide	$500.09	$496.73	-0.7%		

SPREADSHEET 11: California and Countrywide Profits by Year 1989-2006 (1999-2006 on following page)

CALIFORNIA PROFITS BY LINE (1989 TO 2006)
RETURNS ON NET WORTH

PROPOSITION 103
LINES OF BUSINESS

CALIFORNIA DATA

	1989	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
PVT PASS AUTO LIABILITY	5.3%	3.6%	13.2%	17.7%	16.4%	15.5%	20.3%	21.0%	21.6%	14.5%
PVT PASS AUTO PHYS DGE	23.4%	27.2%	27.7%	32.6%	24.5%	20.4%	14.1%	14.4%	11.6%	6.9%
PVT PASS AUTP TOTAL	9.6%	9.0%	16.5%	21.2%	18.4%	16.7%	18.7%	19.3%	18.9%	12.4%
COMM AUTO LIABILITY	-2.0%	8.2%	9.3%	12.1%	12.4%	8.0%	12.3%	9.3%	14.0%	8.0%
COMM AUTO PHYS DGE	29.0%	30.8%	35.6%	30.5%	34.9%	27.5%	14.2%	11.1%	11.7%	12.9%
COMM AUTO TOTAL	4.8%	12.8%	14.0%	15.2%	15.4%	10.5%	12.7%	9.6%	13.6%	8.9%
HOMEOWNERS M/P	19.8%	-1.5%	-46.0%	-3.7%	-13.8%	-1.6%	-5.4%	18.3%	17.1%	12.5%
FARMOWNERS M/P	23.2%	18.9%	16.6%	2.5%	5.6%	14.4%	1.3%	18.6%	1.0%	6.0%
COMMERCIAL M/P	15.9%	11.0%	2.7%	-11.5%	5.9%	-14.6%	0.6%	4.5%	8.6%	2.9%
FIRE	14.8%	19.2%	6.5%	8.7%	6.5%	14.7%	42.1%	34.0%	29.7%	28.6%
ALLIED LINES	19.2%	32.8%	8.5%	-4.1%	30.5%	-24.5%	-1.3%	26.0%	10.3%	4.8%
INLAND MARINE	28.1%	24.0%	24.8%	30.5%	38.8%	-58.5%	13.0%	42.4%	28.1%	25.5%
MEDICAL MALPRACTICE	29.2%	25.6%	37.7%	15.9%	15.1%	15.0%	-3.5%	11.6%	13.8%	13.8%
OTHER LIABILITY	-0.8%	-1.2%	5.3%	-13.1%	-11.3%	2.4%	-5.5%	4.0%	6.4%	3.1%
SIMPLE AVERAGE	16.4%	15.1%	8.7%	6.2%	11.1%	-2.6%	7.3%	18.8%	14.8%	11.9%

COUNTRYWIDE DATA

PVT PASS AUTO LIABILITY	0.5%	-0.7%	4.5%	9.4%	10.1%	9.0%	11.6%	13.4%	13.1%	10.5%
PVT PASS AUTO PHYS DGE	16.0%	20.3%	28.8%	29.6%	27.6%	19.1%	11.5%	6.8%	10.2%	9.0%
PVT PASS AUTO TOTAL	4.7%	4.8%	10.6%	14.3%	14.2%	11.4%	11.6%	12.1%	12.4%	10.1%
COMM AUTO LIABILITY	3.5%	8.8%	9.3%	12.8%	12.8%	8.2%	9.1%	7.4%	8.2%	4.3%
COMM AUTO PHYS DGE	29.1%	27.7%	13.1%	28.5%	41.8%	27.9%	13.0%	5.0%	4.4%	2.0%
COMM AUTO TOTAL	8.4%	12.2%	12.5%	15.2%	15.7%	10.1%	9.7%	7.0%	7.6%	3.9%
HOMEOWNERS M/P	-9.6%	-0.9%	-6.6%	-54.3%	2.5%	-1.7%	3.7%	-4.2%	12.4%	5.4%
FARMOWNERS M/P	-2.7%	-1.6%	-3.3%	3.1%	0.5%	5.4%	2.6%	-9.6%	6.4%	-4.0%
COMMERCIAL M/P	8.3%	10.9%	8.0%	-5.6%	7.9%	3.7%	7.5%	5.2%	8.9%	3.5%
FIRE	8.9%	22.1%	14.3%	-2.3%	20.7%	18.6%	14.4%	18.3%	21.8%	11.0%
ALLIED LINES	-49.1%	-7.1%	-8.8%	-63.6%	-23.2%	2.3%	-17.9%	6.7%	19.6%	-12.9%
INLAND MARINE	18.7%	15.1%	20.5%	13.2%	12.8%	10.5%	25.9%	25.1%	23.5%	17.5%
MEDICAL MALPRACTICE	22.4%	17.4%	15.9%	15.5%	15.3%	13.7%	12.7%	12.6%	12.6%	7.6%
OTHER LIABILITY	8.3%	9.5%	10.3%	8.3%	6.4%	6.3%	2.6%	8.6%	12.1%	9.7%

SIMPLE AVERAGE	1.8%	8.2%	7.3%	-5.6%	7.3%	8.0%	7.3%	8.2%	13.7%	5.2%

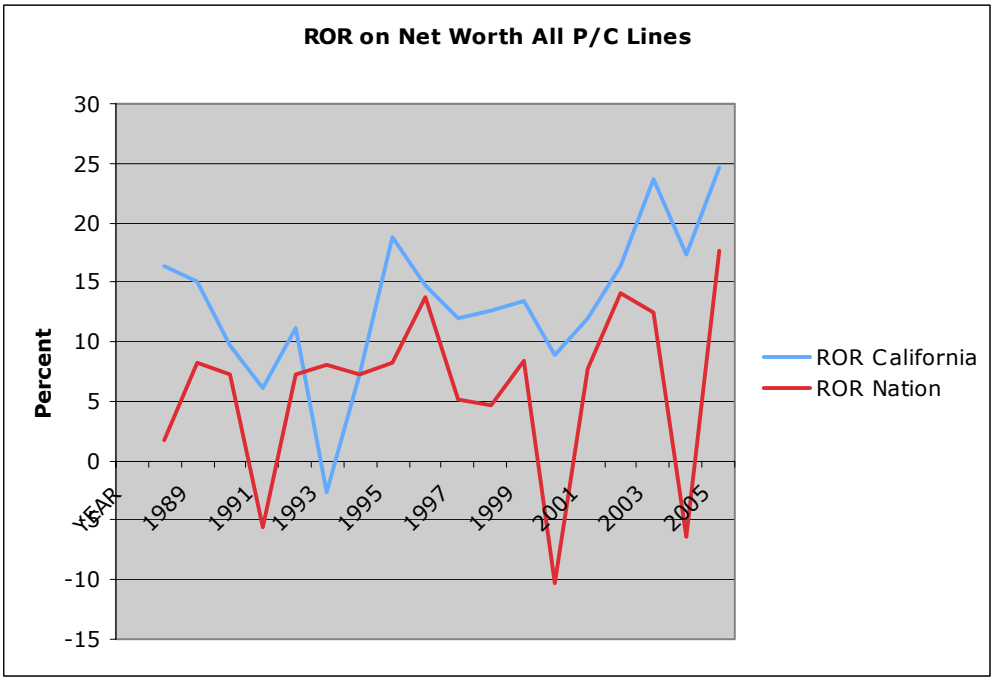
CALIFORNIA DATA	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**SIMPLE AVERAGE 1989 TO 2006**
PVT PASS AUTO LIABILITY	10.0%	1.4%	3.5%	3.8%	9.1%	14.9%	14.1%	13.8%	12.9%
PVT PASS AUTO PHYS DGE	7.6%	-1.9%	-2.0%	3.0%	13.3%	18.2%	14.4%	13.3%	15.8%
PVT PASS AUTP TOTAL	9.3%	0.4%	1.6%	3.5%	10.6%	16.1%	14.2%	13.6%	13.5%
COMM AUTO LIABILITY	3.1%	5.8%	2.2%	4.3%	3.7%	12.8%	16.2%	17.6%	9.3%
COMM AUTO PHYS DGE	5.0%	6.9%	13.1%	11.0%	19.8%	24.7%	20.2%	15.8%	20.9%
COMM AUTO TOTAL	3.5%	6.0%	4.4%	5.7%	6.9%	15.0%	17.0%	17.3%	11.4%
HOMEOWNERS M/P	15.9%	13.9%	3.4%	6.1%	-5.4%	33.3%	31.9%	30.4%	7.4%
FARMOWNERS M/P	-0.9%	13.0%	11.2%	13.9%	4.1%	18.6%	22.1%	19.2%	12.3%
COMMERCIAL M/P	10.3%	5.0%	2.3%	-0.2%	10.3%	17.4%	16.8%	15.9%	6.1%
FIRE	17.8%	31.1%	-3.6%	39.9%	40.9%	37.3%	27.5%	38.9%	25.6%
ALLIED LINES	29.0%	17.9%	27.5%	42.0%	44.6%	41.5%	-4.9%	37.6%	19.8%
INLAND MARINE	26.4%	30.3%	33.1%	24.4%	37.7%	40.3%	24.3%	37.7%	26.5%
MEDICAL MALPRACTICE	8.8%	13.7%	4.0%	1.1%	12.0%	18.5%	19.9%	25.7%	16.3%
OTHER LIABILITY	5.7%	3.5%	4.5%	-17.2%	2.2%	-0.9%	3.8%	10.3%	0.1%
SIMPLE AVERAGE	12.6%	13.5%	8.8%	11.9%	16.4%	23.7%	17.3%	24.7%	13.9%
COUNTRYWIDE DATA									
PVT PASS AUTO LIABILITY	7.0%	2.1%	0.6%	0.6%	6.3%	9.4%	9.1%	10.5%	7.5%
PVT PASS AUTO PHYS DGE	9.4%	2.5%	5.3%	11.7%	16.4%	21.9%	15.3%	16.1%	16.3%
PVT PASS AUTO TOTAL	7.7%	2.2%	2.0%	4.1%	9.4%	13.3%	11.0%	12.1%	9.9%
COMM AUTO LIABILITY	0.5%	1.6%	-0.3%	1.2%	7.2%	12.1%	12.8%	13.6%	7.8%
COMM AUTO PHYS DGE	-1.4%	1.1%	6.7%	13.5%	23.3%	22.6%	18.0%	16.2%	17.2%
COMM AUTO TOTAL	0.1%	1.5%	1.0%	3.5%	10.1%	14.0%	13.7%	14.0%	9.4%
HOMEOWNERS M/P	5.4%	3.8%	-7.2%	1.4%	9.7%	3.7%	-2.8%	18.5%	-1.2%
FARMOWNERS M/P	2.0%	5.8%	-3.6%	2.0%	9.5%	13.0%	14.6%	9.3%	2.9%
COMMERCIAL M/P	1.6%	6.7%	-5.5%	7.4%	11.2%	8.8%	5.7%	15.6%	6.5%
FIRE	7.7%	16.4%	-40.7%	37.6%	34.8%	35.6%	9.1%	29.6%	16.3%
ALLIED LINES	-2.3%	11.5%	-55.2%	14.2%	26.8%	-2.1%	-123.6%	23.0%	-15.4%
INLAND MARINE	11.8%	22.0%	7.9%	25.4%	27.4%	26.9%	-11.4%	26.3%	18.8%
MEDICAL MALPRACTICE	5.1%	5.4%	-4.7%	-7.4%	-0.1%	9.9%	13.5%	16.5%	10.8%
OTHER LIABILITY	8.0%	8.9%	2.8%	-10.3%	1.6%	1.8%	6.4%	12.4%	6.7%
SIMPLE AVERAGE	4.7%	8.4%	-10.3%	7.8%	14.0%	12.5%	-6.4%	17.7%	6.5%

SOURCE: NAIC REPORTS ON PROFITABILITY BY LINE BY STATE, VARIOUS YEARS

SPREADSHEET 12: Review of the Cycle in California vs. Nation since Proposition 103 was Adopted

YEAR	ROR California	ROR Nation
1989	16.4	1.8
1990	15.1	8.2
1991	9.7	7.3
1992	6.2	-5.6
1993	11.1	7.3
1994	-2.6	8
1995	7.3	7.3
1996	18.8	8.2
1997	14.8	13.7
1998	11.9	5.2
1999	12.6	4.7
2000	13.5	8.4
2001	8.8	-10.3
2002	11.9	7.8
2003	16.4	14
2004	23.7	12.5
2005	17.3	-6.4
2006	24.7	17.7

From NAIC Profitability Reports.



SPREADSHEET 13: Estimate of Savings from Proposition 103

YEAR	California Ave Expen	California Year to Year Change	California Cumulative Change	Nationwide Ave Expen	Nationwide Year to Year Change	Nationwide Cumulative Change	Savings in Year	Personal Auto Earned Prems in California (millions)	CA Premiums had Rates Followed National Trend	Savings
1989	$747.97	NA	NA	$551.95	NA	NA	NA	NA	NA	NA
1990	$751.32	0.4%	0.4%	$571.69	3.6%	3.6%	-3.0%	$11,700	$12,064	$364
1991	$783.18	4.2%	4.7%	$596.91	4.4%	8.1%	-3.2%	$11,740	$12,126	$386
1992	$766.11	-2.2%	2.4%	$616.18	3.2%	11.6%	-8.3%	$11,451	$12,481	$1,030
1993	$802.63	4.8%	7.3%	$637.72	3.5%	15.5%	-7.1%	$11,324	$12,193	$869
1994	$789.54	-1.6%	5.6%	$650.73	2.0%	17.9%	-10.5%	$11,474	$12,815	$1,341
1995	$803.19	1.7%	7.4%	$668.27	2.7%	21.1%	-11.3%	$11,877	$13,391	$1,514
1996	$799.04	-0.5%	6.8%	$691.32	3.4%	25.3%	-14.7%	$12,119	$14,209	$2,090
1997	$773.32	-3.2%	3.4%	$707.39	2.3%	28.2%	-19.3%	$13,266	$16,445	$3,179
1998	$717.98	-7.2%	-4.0%	$704.32	-0.4%	27.6%	-24.8%	$13,418	$17,837	$4,419
1999	$665.65	-7.3%	-11.0%	$685.09	-2.7%	24.1%	-28.3%	$13,206	$18,419	$5,213
2000	$666.94	0.2%	-10.8%	$689.27	0.6%	24.9%	-28.6%	$13,513	$18,925	$5,412
2001	$722.79	8.4%	-3.4%	$725.57	5.3%	31.5%	-26.5%	$14,439	$19,642	$5,203
2002	$778.00	7.6%	4.0%	$780.77	7.6%	41.5%	-26.5%	$15,992	$21,749	$5,757
2003	$837.30	7.6%	11.9%	$824.49	5.6%	49.4%	-25.1%	$17,872	$23,849	$5,977
2004	$846.30	1.1%	13.1%	$839.55	1.8%	52.1%	-25.6%	$18,726	$25,174	$6,448
2005	$844.50	-0.2%	12.9%	$829.17	-1.2%	50.2%	-24.8%	$19,088	$25,397	$6,309
2006							-24.8%	$19,307	$25,674	$6,367
								TOTAL SAVINGS		$61,877

Savings assume that California rates would have gone up at national levels, year-by-year. Actually, California personal auto insurance prices were climbing faster than national in the years running up to Proposition 103's enactment. 2006 savings assumed at 2005 level.

APPENDIX 5

BRIEF DISCUSSION OF THE 13 SPREADSHEETS USED TO ANALYZE CALIFORNIA'S SYSTEM AGAINST THE NATION

A) THE PRICE COMPARISONS (2 SPREADSHEETS)

Premium Changes Since Proposition 103

Spreadsheet 8 (Part 2) shows that California's average personal auto insurance expenditure went up 12.9% from 1989 to 2005, while the national average went up 50.2%. Average total premium figures were 10.7% and 49.3%. Liability: -6.2% vs. 55.1%. Collision: 55.1% v. 56.6% Comprehensive: -3.2% vs. 45.6%.

State Ranking by Size of Rate Increase from 1989 to 2005

Spreadsheet 1 (Part 1) shows that California's average personal auto insurance expenditure went up 12.9% from 1989 to 2005, while the national average went up 50.2%. This breaks down the data by state. California has the best record in the nation. Rank fell from third most expensive in 1989 to 18th in 2005 and the California relationship with the countrywide averages fell from 135.5% (i.e., CA 35.5% higher than the national average) in 1989 to 101.8% (1.8% higher).

B) TESTING IF SOMETHING OTHER THAN 103 WAS THE REASON FOR EXCELLENCE (6 SPREADSHEETS)

State Price Changes by Seatbelt Law Quality

Spreadsheet 4 (Part 1) shows that there are 11 states with a good IIHS rating. These states have an average rate of $816.23. They also have an average 1989 to 2005 rate increase of 60.2%.
There are 16 states with a fair IIHS rating. These states have an average rate of $845.54. They had a 56.1% increase in the 89/05 period.
There are 23 states with a marginal IIHS rating. These states have an average rate of $759.63. They had a 73.4% increase in the 89/05 period.
There is only one state with a poor rating with a rate of $791.71. It had a 30.0% increase in the 89/05 period.

The fact that the states with better seat belt laws have higher rates than those with bad laws is interesting but not conclusive as more rural states have lower legal protection in this area. The rate changes show a mixed pattern.

Based on the seatbelt data studied in this spreadsheet, it is not possible to conclude that California's good experience on rate changes since 1988 is because of the seat belt law in the state.

By Growth in Use of Seatbelts

Spreadsheet 9 (Part 2) reviews California vs. Countrywide growth of use of seatbelts. There is greater growth nationally than in California so the impact on rates over time should be less in California than the nation (i.e., less growth in California implies that seatbelts do not explain the low rate changes in California).

State Price Change by Laws Restricting Private Rights of Action against Insurance Companies

Spreadsheet 5 (Part 1): Taking the simple average of the states with Moradi laws shows no real difference between rate changes between them and the national average.

By No Pay, No Play Law Status

Spreadsheet 10 (Part 2): Latest data for four states with No Pay No play laws showing that the law does not lower auto liability price changes vis-à-vis the nation in other states, so is not likely a major cause of rate relief in California either.

Review of States 1989 to 2005 Price Changes by Regulatory Status

Spreadsheet 2 (Part 1) shows that, as regulator system toughens, personal auto insurance rate changes tend to be moderated.

Prior Approval	FLEX	Use and File	File and Use	Competitive	State Set
54.0%	70.8%	70.0%	68.1%	73.9%	52.8%

As you see, the rate change over the 1989 to 2005 period was highest in competitive states (2 states) and FLEX states (2) and lowest in the single State Set state (but these were both a small sample and should not be given too much weight). But it is instructive that the least control did result in the highest average price change and the strictest the lowest. In the states with many samples, Prior Approval clearly was the most successful from the consumer perspective, easily beating Use and File and File and Use.

This adds credibility to the idea that Prop 103, being the toughest Prior Approval regime, was the cause of the lowest rate change in the nation over the test period.

State-by-State Review of Miscellaneous Factors that Might Impact Auto Insurance Prices

Spreadsheet 6 (Part 1) tested other factors to see if California had any particular thing that might impact rates downward. It appears not. The uninsured motorist percentage in California is the same as nationally. California's residual market percentage is trivial, and should not impact pricing. The legal regime, tort, is typical of most states and thus should not be a major rate

driver when compared to the nation. Almost all states have compulsory insurance, again signifying little rate impact in California vis-à-vis the nation. If anything, California's high theft rate should cause comprehensive insurance costs to rise compared to national costs…they fell. And California has a higher than average disposable income per-capita and that should make rates go up, not down, compared to the nation.

C) PROFITABILITY DATA (2 SPREADSHEETS)

Auto Insurance Profit by Regulatory Status of States

Spreadsheet 3 (Part 1) shows these profits over the 1989 to 2006 period by regulatory status.

Prior Approval in 14 states with average profit of 8.9% (8.6% in 97 to 06 period)
FLEX rating in 2 states with an average profit of 7.8% (7.0% in 97-06)
State Set in one state with profit of 8.6% (6.4% in 97-06)
Competition in two states with average profit of 10.1% (9.6% in 97-06)
Use and File in 8 states with an average profit of 9.6% (9.7% in 97-06)
File and Use in 24 states with an average profit of 9.1% (9.0% in 97-06)

Since the FLEX plan is recent in Texas and Alaska, and the two-state sample is small, we believe the data are unreliable for that sample. Since the State Set Rate is only one state, we draw no conclusions from those data. Illinois and Wyoming have long-term competitive systems and higher profits than the other systems. Of the three systems with several states, the profits are lowest in Prior Approval states, with Use and File and File and Use delivering higher profits than Prior Approval. Related to Prior Approval profits, the profits in File and Use jurisdictions is just 2% higher, Use and File states are 8% higher and no-file or competitive states are 11% higher. The relationships between the Prior Approval, competitive, File and Use and Use and File states are consistent when reviewed over the entire time frame or over just the 1997 to 2006 period.

California and Countrywide Profits by Year

Spreadsheet 11 (Part 2) shows the California and countrywide profits by year from 1989 to 2006. For all lines, California profits were 13.9 percent vs. 6.5 percent nationally. For personal auto, the profits averaged 13.5 percent in California and 9.9 percent nationally.

D) COMPETITION TESTS (2 SPREADSHEETS)

Test of Competitiveness of Auto Insurance Market by State

Spreadsheet 7 (Part 1) shows that the HHI index for California is competitive at 716.

	Average HHI
FLEX (2 States)	1292
STATE SET (1 State)	1371

Prior Approval (15 States)	984
File & Use (23 States)	1016
Use & File (8 States)	935
Competitive, no file (2 States)	1111

The U.S. Department of Justice considers a market with a result of less than 1,000 to be a competitive marketplace; a result of 1,000-1,800 to be a moderately concentrated marketplace; and a result of 1,800 or greater to be a highly concentrated marketplace.

California has one of the most competitive market concentrations in the nation (4th). Illinois, cited by insurers as their favorite system, is a moderately concentrated state based on the HHI figures. Illinois is the 44th ranked state.

We believe that using just HHI to measure competition is not sufficient to fully understand the competitive status of a state. A state could have a lot of non-standard carriers that are offering insurance at prices that are too high, for instance. Also, there are insurers with a license in some states that do not actually offer insurance or write only insignificant amounts. But this is a measure that insurers trumpet. So we add it here.

Review of the Cycle in California vs. Nation since Proposition 103 was Adopted

Spreadsheet 12 (Part 2) shows that, since the advent of Proposition 103, the cycle appears to be retarded in California for all Property/Casualty insurance lines, but not for personal auto alone.

E) SAVINGS (1 SPREADSHEET)

Estimate of Savings from Proposition 103

Spreadsheet 13 (Part 2) is a calculation of the savings from Proposition 103 over the years. The method used was to assume that the California rates would have gone up by the same level as the nation, year-by-year (prior to the introduction of Proposition 103, the rates rose faster than the nation). The estimate of the savings is $61.8 billion.