



REPORT OF THE WORKING GROUP TO REVIEW THE NATIONAL CONFERENCE OF INSURANCE LEGISLATORS (NCOIL) PROPERTY-CASUALTY INSURANCE MODERNIZATION ACT

Pursuant to H.C.R. No. 83 (2005)
REQUESTING THE INSURANCE DIVISION OF THE DEPARTMENT OF
COMMERCE AND CONSUMER AFFAIRS TO CONDUCT A REVIEW OF THE
NCOIL PROPERTY-CASUALTY INSURANCE MODERNIZATION ACT AS
AMENDED ON NOVEMBER 21, 2003

Prepared by the

INSURANCE DIVISION
DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS
STATE OF HAWAII

December 2005

**REPORT BY THE WORKING GROUP TO REVIEW THE NATIONAL
CONFERENCE OF INSURANCE LEGISLATORS (NCOIL) PROPERTY-
CASUALTY INSURANCE MODERNIZATION ACT
PURSUANT TO H.C.R. NO. 83 (2005)**

H.C.R. No. 83 (2005) requested the Insurance Division to conduct a review of the NCOIL Property-Casualty Modernization Act as amended on November 21, 2003 (Modernization Act). The Concurrent Resolution requested the Insurance Commissioner to convene a Working Group ("Working Group") consisting of the Director of Commerce and Consumer Affairs, Director of Business, Economic Development, and Tourism, and representatives of the Hawaii Insurers Council, State Farm Insurance Company, and Consumer Lawyers of Hawaii. The Concurrent Resolution requested the Insurance Commissioner to submit the Working Group's findings to the Legislature no later than 20 days before the convening of the Regular Session of 2006.

The members of the Working Group are:

1. J.P. Schmidt, Chair
2. Lawrence M. Reifurth on behalf of Mark E. Recktenwald (Director of Commerce and Consumer Affairs), Member
3. Pearl Imada Iboshi on behalf of Theodore E. Liu (Director of Business, Economic Development, and Tourism), Member
4. Alison Powers (Hawaii Insurers Council or HIC), Member
5. Martin Erwin (State Farm Insurance Company), Member
6. Robert S. Toyofuku (Consumer Lawyers of Hawaii), Member

FINDINGS

The Working Group held public meetings on August 15, 2005, September 12, 2005, October 3, 2005, November 10, 2005, and December 12, 2005.

The Modernization Act establishes a use and file rate regulatory system for personal lines of insurance, a no-file system for commercial lines, and allows policies sold to large, sophisticated commercial insurance providers to be exempt from rate and regulatory requirements. The purpose of the Modernization Act is to create a more competitive and less onerous regulatory system. Under a regulatory system based on the Modernization Act, an insurer would be able to

develop rates, start using them, and then file the rates with the Insurance Division for personal lines.

The Working Group also considered the NCOIL Property-Casualty Flex-rating Regulatory Improvement Model Act (Flex Band Act), which would allow a limited file and use system. Under a flex-rating or flex-band system, the insurer could change rates within a certain percentage (such as no more than 10 percent) and use the rates without the prior approval of the insurance regulator.

Hawaii is a prior approval state. In other words, property and casualty insurers are not allowed to change their rates or forms without the prior approval of the Insurance Commissioner.

The Working Group found that no state has adopted the Modernization Act in its entirety. Illinois does not regulate rates, and thus the market operates in a manner similar to the system set up by the Modernization Act. Illinois has a competitive marketplace. The experience in Illinois illustrates that rate deregulation does not necessarily lead to insurance companies arbitrarily raising rates and charging rates that are not actuarially justified.

According to NAIC's preliminary report on 2003, Illinois ranks #24 for average annual automobile expenditures compared to other states. Hawaii is rated #23, \$13.41 per year higher. It should be noted, however, that comparing rates in this manner is not necessarily an effective way of determining what rate modernization would do to rates, as the cost of insurance is related in large part to the legal system, required coverages, and number and severity of claims.

Alaska, South Carolina, and Louisiana have adopted modified versions of the Flex Band Act. Alaska enacted a flex-rating system that took effect on November 2, 2005. Under Alaska's new law, a company wishing to make a rate change of 10 percent could file the change and begin using the new rate immediately. Proposed rate changes of more than 10 percent would require an evaluation by the state Department of Insurance.

South Carolina's property and casualty insurance personal lines flex-rating law took effect July 29, 2004, and mirrors South Carolina's system established for automobile rates in 1999. This law allows property and casualty insurance carriers to increase or decrease rates within a seven percent band without prior approval from the South Carolina Department of Insurance. Companies may institute a rate increase or decrease if the Department of Insurance does not respond within 30 days. Rate changes outside the seven percent band must still go through the prior approval process.

Louisiana's flex-rating law took effect January 1, 2004. This law allows property and casualty insurers to make annual rate changes of plus or minus 10 percent without having to go before the Louisiana Insurance Rating Commission.

The Working Group was unable to find any conclusive reports on the effectiveness of a use and file rating system patterned after the Modernization Act since no state has adopted it. The flex-rating law in Alaska has only been in effect for a short time, and it is premature to draw conclusions as to its effectiveness. South Carolina and Louisiana adopted flex-rating laws as part of more general reform packages. No comprehensive studies are yet available that measure the effectiveness of flex rating as part of the total package.

However, some say the bulk of new carriers in South Carolina were substandard insurers because new rating factors were allowed as a result of the reform. Premiums in South Carolina in 2003, however, are 26 percent higher than in 1999, when the law was enacted. This is an expected result. Before flex rating, 43 percent of all drivers were insured by the government-run auto facility, which had a \$2.4 billion deficit at the time. Price increases were necessary to return this dysfunctional market to equilibrium. Louisiana's flex-rating law is also credited, in part, with bringing in more companies and lowering premiums.

The Working Group notes that in all three states that enacted a flex-band law, the auto insurance markets were in distress. Some indications of distress include insurers exiting the market, high premiums, unavailability of insurance, and a growing assigned risk plan. None of these conditions currently exist in Hawaii. In addition, there were major legislative changes enacted in all three states at approximately the same time that they enacted flex-band legislation. There is no evidence that if these states were to enact only a flex-band law that competition would increase and premiums would be lowered.

Advocates for a use and file model such as the Modernization Act told the Working Group that such a model may result in greater competition in the insurance marketplace. Consequently, this would lead to lower premiums and more choices for Hawaii's consumers. Use and file advocates stated that prior approval regulations are not necessary because of the aggressive competition that already exists in Hawaii's property and casualty insurance market. However, no studies were found that analyzed the impact of a file and use or flex-band system on a small, fragile, but healthy marketplace like Hawaii. The Working Group also notes that for auto insurance, Hawaii had a file and use system before 1988. In 1988, the existing prior approval system was enacted, at least in part in response to the insolvencies of Financial Services Insurance Co., Ltd. (FSIC) and United Independent Insurance Agencies (UIIA).

The Working Group received comments from several organizations that stated that while they support the Modernization Act, it may be too big a jump from Hawaii's existing prior approval system. GEICO Direct, Progressive Casualty Insurance Company, State Farm Insurance Companies, Property Casualty Insurers Association of America (PCI), and National Association of Mutual Insurance Companies supported either the Modernization Act or a flex-rating system.

Some members of the group questioned the need for change if the system is not broken and were not convinced that changing the current system would increase competition. In analyzing Hawaii's market for motor vehicle insurance, the Working Group agreed that Hawaii has enjoyed the deepest premium reductions over the past ten years of all the states. During this same period, insurers have also experienced the highest return on equity of all the states. During this ten-year period, there have been significant statutory changes in Hawaii, albeit none were rating changes.

Motor vehicle insurance companies in Hawaii have been making record profits over the past ten years, particularly from 1994-2003. Eight insurers already have an 83.5 percent market share and 14 insurers have about a 99.5 percent market share. Prior to 1994, an average of eight non-life insurers entered Hawaii's market each year. From 1994 onward, that number doubled to 16.

Because of the small marketplace in Hawaii with major companies covering the majority of the auto market, concerns were raised as to whether a new system would significantly increase competition in the motor vehicle insurance market or whether it would result in significant reductions in insurance premiums. At the same time, other members suggested that changes to the system may encourage the establishment of new insurers targeting new niche markets, which would ultimately benefit Hawaii's consumers.

There was discussion that the current system is working well, the motor vehicle insurance market is stable, and any change to a file and use system may cause some instability in this market. Nevertheless, this did not preclude the Working Group from considering alternative means to improve competition, strengthen the marketplace, and better meet the needs of Hawaii's consumers.

HIC comprises 75 percent of the personal motor vehicle insurance business in Hawaii and is divided on the merits of the Modernization Act and Flex Band Act. While some HIC members strongly believe that a rating law change would increase speed to market, others strongly believe that a rating law change alone may not increase speed to market, may not increase competition, and may not reduce premiums in a vibrant marketplace.

Although there was evidence and testimony on each side of the various issues, a majority of the Working Group found that a flex-band rate approval system may be beneficial in Hawaii in increasing competition, encouraging more insurance companies to do business in Hawaii, lowering administrative costs and premiums, and providing a more efficient regulatory system. The Working Group found that adoption of the Flex Band Act would eliminate some valuable anti-discrimination protections for consumers. As a result, the Working Group determined that a better approach would be to explicitly retain Hawaii's anti-discriminatory protections, limit flex-band legislation to the process for rate approval, and limit it to motor vehicle insurance.

RECOMMENDATIONS

Based on these findings, the Working Group finds, by a 3-1-1 vote, that while it supports less rate regulation in principle, the Modernization Act and the Flex Band Act incorporate unnecessary risk at this point, and recommends the adoption of a flex-band rating model allowing for rate increases or decreases of 10 percent applicable to only motor vehicle insurance.

**SUPPLEMENTAL STATEMENT TO THE REPORT BY THE WORKING
GROUP TO REVIEW THE NATIONAL CONFERENCE OF INSURANCE
LEGISLATORS (NCOIL) PROPERTY-CASUALTY INSURANCE
MODERNIZATION ACT
PURSUANT TO H.C.R. NO. 83 (2005)**

This is a supplemental statement to the report as submitted pursuant to H.C.R. No. 83 (2005), and this statement is being submitted on behalf of the Consumer Lawyers of Hawaii (CLH), a member of the Working Group.

CLH does not object to all of the specific Findings that are contained in the report. However, CLH feels that it is necessary to submit this supplemental statement to clearly indicate its opposition to the recommendation by three out of the five members of the Working Group that a flex-band system be adopted. The reasons CLH voted in the negative on the motion to recommend a flex band system follows.

1. CLH feels that the prior approval system of rate making is a better system to protect consumers.

2. The prior approval system has been working well since its adoption in 1988 and especially during the past ten years. The data indicates that the auto insurers in Hawaii have had the highest profit percentage compared with all other states in the nation. The findings also support the fact that the data also shows that the auto insurance premiums in Hawaii have had a substantial reduction over the past ten years under this system. Specifically, the findings indicate that the Working Group agreed that Hawaii has enjoyed the deepest premium reductions and experienced the highest return on equity of all of the states.

3. CLH does not believe that adoption of a flex-band system will significantly increase competition which is the primary factor raised by certain proponents of adopting the flex band system. Current data indicates that seven insurers have about 83.5% of the auto insurance market and of these seven insurers, four companies are considered to be the top in the nation in terms of market share and two others are considered to be in the top ten in the nation in terms of market share. CLH raised the issue in discussion that it seems unlikely that there will be significant greater competition with the result of significantly reducing auto insurance premiums for consumers. Further, the Findings state that since 1994, 16 non-life insurers entered the Hawaii market each year, and during discussions HIC stated that currently there are two auto insurers interested in entering the Hawaii market.

4. CLH expressed concern that adopting a flex-band system could destabilize the market place in auto insurance. There is not sufficient evidence and history to support the assumption that the flex-band system would be better than the current prior approval system in terms of lower premiums for consumers, higher profits for insurers, or significantly more competition.

5. The report does reflect that the Hawaii Insurers Council (HIC) could not vote for or against the motion to recommend a flex-band or NCOIL model because its members are divided on the merits of either system. This is another major factor why CLH voted "no" on the motion to recommend the flex band system.

6. During the discussions by the Working Group, and especially during the discussion at the last meeting on December 12, 2005, some comments were made by different members of the Group, some of which are generally reflected in the report, which also contributed to CLH casting a no vote. These comments included statements that indicated that either none of the studies were convincing, or that there seems to be inadequate evidence but that a flex-band system may be beneficial, or at least the flex-band system would be a controlled experiment.

The final vote on the motion to recommend a flex-band rating model, after several amendments to the motion, was as follows: three in favor - State Farm Insurance Company, Department of Commerce and Consumer Affairs, and the Department of Business, Economic Development, and Tourism; one against - Consumer Lawyers of Hawaii; and one abstained - Hawaii Insurers Council whose reasons are stated in the Findings.