BY THE COMPTROLLER GENERAL 11628

Report To The Congress

OF THE UNITED STATES

Issues And Needed Improvements In State Regulation Of The Insurance Business (Executive Summary)

This report reviews the resources and activities of all State insurance departments in the United States today and evaluates some of them. It is not an all-inclusive evaluation of State insurance regulation because some States perform certain functions better than others; nor does it review the regulation of all lines of insurance. The report covers the following generally applicable issues:

--background and purposes of insurance regulation;

--workload and resources of departments;

--departments' financial examination procedures;

--consumer protection and trade practices regulation;

--automobile insurance price regulation;

--automobile insurance risk classification;

--insurance availability; and

--organization of insurance regulation.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To The President of The Senate and the
Speaker of the House of Representatives

This report assesses the effectiveness of the regulation of insurance by State insurance departments and discusses a number of insurance regulatory issues.

Primarily concentrating on automobile insurance, the report finds a number of regulatory shortcomings in that most insurance departments do not have systematic procedures to determine whether consumers are being treated properly with respect to such matters as claims payments, rate-setting, and protection from unfair discrimination.

This report responds to growing Congressional interest in the effectiveness of the States in regulating the business of insurance pursuant to the McCarran-Ferguson Act. Although we make no specific recommendation with respect to a Federal response to the cited shortcomings, we believe that the information and analysis in this report will prove useful to the Congress in evaluating the alternatives before it.

We are also sending this report today to the Governors and congressional delegations of the States in which we did fieldwork, and the chairman of cognizant congressional committees.

Elmer B. Staats
Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

ISSUES AND NEEDED
IMPROVEMENTS IN STATE
REGULATION OF THE
INSURANCE BUSINESS
(EXECUTIVE SUMMARY)

D I G E S T

There are serious shortcomings in State laws and regulatory activities with respect to protecting the interests of insurance consumers in the United States. In particular, most State insurance departments do not have systematic procedures to determine whether insurance consumers are being treated properly with respect to such matters as claims payments, rate-setting, and protection from unfair discrimination.

The States have primacy in regulating insurance due to the McCarran-Ferguson Act. The Congress passed the Act in 1944 to reaffirm States' primacy in order to secure adequate regulation of the business of insurance after a Supreme Court decision to the contrary.

Critics in the Congress and elsewhere have since charged that State insurance departments have not adequately protected insurance consumers. GAO examined the resources and activities of the State insurance departments through a questionnaire to all States and fieldwork in a sample of 17 States. Its review covered some regulatory activities with regard to all lines of insurance with the primary focus on regulatory issues involving automobile insurance, particularly price regulation, risk classification, and insurance availability.

Each State has an insurance regulatory agency whose responsibilities include licensing companies and insurance agents, maintaining a system of financial and trade practice regulation, and ensuring that rates are not excessive, inadequate, or unfairly discriminatory.

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common use of consumer complaints in enforcement activities is to target companies for special market conduct examinations, but this was done systematically in less than half the States in which GAO did fieldwork. Most States do not maintain a system whereby complaints are coded, analyzed, and used in the examination process.

GAO also reviewed a number of market conduct examination reports and found deficiencies in all of them. The most serious was a lack of explicit standards in evaluating insurance companies. Although all States had unfair trade practices laws, none of the market conduct examinations explained what the minimum standards were or even if such standards were used in assessing company performance. The most common cause of consumer complaints against insurers is the handling of claims. None of the insurance departments GAO examined monitored claims handling performance on a routine basis. Moreover, claims handling was reviewed by departments solely from the perspective of insurance company records, only one State included consumer comments or complaints as part of its review process. (See ch. 4.)

PRICE REGULATION

GAO examined two major issues concerning the regulation of automobile insurance rates.

--How thoroughly do the insurance departments review rate requests?

--Is price regulation of automobile insurance necessary?

GAO found: (See ch. 5.)

--The degree of scrutiny given important premium increase requests varies among the States. Among those GAO examined, only Texas and Massachusetts conducted an original actuarial analysis enabling them to independently recommend the appropriate level of insurance rates.

the use of age, sex, and marital status. Critics have charged that these categories are not as accurate, on an individual basis, as claimed by insurers and yield pricing differences that are inequitable.

Although GAO does not conclude that the classification plans now used either are or are not unfairly discriminatory, there are serious questions which have been properly raised about the propriety of these plans and the resulting price differentials. Similarly, while losses do differ by territory, questions have been raised about whether, in many areas the current territorial boundaries are the optimum way of grouping risks. GAO found: (See ch. 6.)

--Most insurance departments have not analyzed the actuarial basis of personal classification plans.

--Most insurance departments have not determined whether loss experience justifies territorial boundaries.

INSURANCE AVAILABILITY

Community groups and some Government agencies have charged that insurance companies engage in redlining--the arbitrary refusal to insure based on geographic location. Without attempting to reach a conclusion on the merits of these charges, GAO found that only a minority of the urbanized States have conducted studies to determine if redlining was a problem in their States.

Every State has an assigned risk plan or other means of providing insurance for those who are otherwise unable to obtain insurance. Although insurance is available, consumers in many States are affected adversely by being denied coverage in the voluntary market because coverage in assigned risk plans is limited and premiums are considerably higher. Moreover, in some States, many of the people whose

A good deal of uniformity in regulation is provided by the National Association of Insurance Commissioners. None of the insurance company officials interviewed believed that having to comply with different regulations in different States imposed significant costs, and they viewed any problems created by multiple jurisdictions as residing only in a few problem States. (See ch. 8.)

In many regulatory settings, it is important that regulators be impartial and responsive to broad public interests. Nonetheless, a common and longstanding criticism of insurance departments is that they are overly reponsive to the insurance industry at the expense of its consumers.

GAO found that insurance regulation is not characterized by an arms-length relationship between the regulators and the regulated. While the extent of the "revolving door" problem may be overstated by critics of State regulation, about half of the State insurance commissioners were previously employed by the insurance industry and roughly the same proportion joined the industry after leaving office. The meetings of the National Association of Insurance Commissioners are numerically dominated by insurance industry representatives. Its model laws and regulations were drafted with advisory committees composed entirely of insurance company representatives.

Most insurance commissioners commenting on the matter objected to GAO's findings that insurance regulation is not characterized by an arms-length relationship between the regulators and the regulated. GAO did not conclude that most commissioners are "revolving door" appointments or that there is anything necessarily wrong with industry employment before or after department service. However, there is still a substantial imbalance in the meetings of the NAIC.

Several insurance departments partially disagreed with GAO's findings of various shortcomings. They stated that although there are

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ABBREVIATIONS

ICC Interstate Commerce Commission

NAIC National Association of Insurance Commissioners

ISO Insurance Service Organization

FIA Federal Insurance Administration

CHAPTER 1

INTRODUCTION

In the McCarran-Ferguson Act, which gives the States the primary responsibility for regulating the business of insurance, the Congress declared that "the continued regulation and taxation by the several States of the business of insurance is in the public interest." In reporting out the bill, the House Committee on the Judiciary stated that enactment would secure more adequate regulation of the business of insurance. Therefore, the current division of responsibility for insurance regulation is predicated on the assumed adequacy of State regulation. This study examines the nature and effectiveness of the regulation of the business of insurance.

Critics of State regulation do not believe that this giant national industry is effectively regulated at the State level. They charge that most State insurance departments do not adequately protect consumers because State insurance regulatory departments are

--dominated by "revolving door" commissioners who come from insurance companies and return to the industry,

--inadequately staffed and funded,

--protective of companies and agents rather than the public, and

--failing to address major consumer protection issues.

State regulators, on the other hand, maintain that State regulations do, indeed, serve the public. They argue that State insurance departments already have expert personnel in 50 States, that State regulation is closer to the people than any Federal regulation can be, and that State regulation affords beneficial diversity and innovation.

SCOPE

The purpose of this study is to provide an overview of the resources and activities of all State insurance departments and to provide an intensive evaluation of a smaller number of States. It is not possible in this report to provide a universal evaluation of the adequacy of State insurance regulation because some States perform certain functions better than other States, and we did not review

In general, our criteria for conducting this review were based on the existing regulatory responsibilities of the States.1/ Much of this report assesses the extent to which the States are discharging their statutory mandates; it applies almost exclusively to the regulation of personal lines insurance, rather than the less regulated commercial lines.

METHODOLOGICAL APPROACH

We conducted this study in two phases. First, a comprehensive questionnaire was sent out to insurance departments in the 50 States and the District of Columbia. Forty-five of the 51 questionnaires were returned.

Second, staff members from GAO regional offices did fieldwork, ranging from 1 to 3 weeks, in the insurance departments of the following 17 States: Arizona, California, Connecticut, Indiana, Illinois, Kansas, Massachusetts, Michigan, New Jersey, New York, North Carolina, Ohio, South Carolina, Texas, Virginia, Washington, and Wisconsin. The fieldwork supplemented some of the issues covered on the questionnaire. The bulk of the fieldwork, however, focused on the regulation of automobile insurance. Wherever appropriate, we have combined the questionnaire and fieldwork results. Results that originate from the fieldwork are referred to as "fieldwork States" or "fieldwork results".

We also used data supplied by A. M. Best and Company to analyze the economic effects of insurance rate regulation.

1/Statements pertaining to State laws are based on information supplied by the States and on other secondary sources, except for cases and laws directly quoted.

insurance companies. 1/ In response, the Congress passed the McCarran-Ferguson Act in 1945. The Act declared that, "* * * the continued regulation and taxation by the several States of the business of insurance is in the public interest * * *." Basically, the Act exempted the insurance business from the Federal antitrust laws (the Sherman Act, the Clayton Act, and the Federal Trade Commission Act), as long as insurance was regulated by State law. The antitrust exemption is not complete, however. Still proscribed under the Sherman Act are any acts of or agreements to boycott, coerce, or intimidate. Although there has been some narrowing of the McCarran exemption, 2/ the States still have primary responsibility for regulating insurance, and the States are deemed to be regulating insurance by the existence of relevant laws and an insurance department to enforce those laws. 3/

RATIONALE FOR INSURANCE REGULATION

Although the business of insurance has been regulated for five centuries, a review of the justifications for regulation provides a basis for evaluating whether particular regulatory actions are effective or even necessary.

One basic rationale for regulating insurance is the need for Government to correct flaws in the marketplace (market failures). The business of insurance is characterized by several market failures, summarized in the following sections.

The future service aspect of insurance

Insurance customers pay a small, regular, predetermined fee (an insurance premium) for the promise that they will be compensated if certain unpredictable, enumerated events occur in the future. The insurance marketplace can function only if there is reasonable assurance that the company will be able to

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1/U.S. Congress, House Committee on the Judiciary, Report No. 143, February 13, 1945.

2/St. Paul Fire & Marine Insurance Co., et al. v. Barry, 98 S. Ct 2923; Group Life and Health Insurance Co. v. Royal Drug Co., 77 U.S.L.W. 4203 (Supreme Court).

3/Ohio AFL CIO v. Insurance Rating Board 451 F2d 1178. FTC v. National Casualty Co., 357 U.S. 563.

for themselves. Not being able to choose limits the consumer impact on the market and reduces the competitive incentive to improve product quality and to lower prices. Thus, regulatory intervention is necessary to produce the effect usually made by knowledgeable consumers.

The existence of externalities

An externality is normally an undesirable impact on a third party caused by a transaction between two other parties. In insurance, externalities are caused by the lack of transactions. In most other markets it makes no difference to the consumer if others purchase the product, but in the case of liability insurance it makes a great deal of difference whether other consumers have purchased insurance. In a fault-finding tort system, if Consumer Jones causes an accident that severely injures Consumer Smith, Smith is harmed again if Jones does not have assets to compensate Smith or liability insurance to furnish those assets. Insurance markets which, for whatever reasons, suffer from availability or affordability problems, produce externalities in that the majority of consumers who have insurance might be negatively affected by the minority who do not.

Social policy reasons for insurance regulation

In one sense, all regulation of insurance is premised on a broad social policy objective--that there be a mechanism whereby risk can be shared so that people can have a greater measure of security in their personal and business lives. Through the years, other social policy objectives have evolved. These include prohibitions on unfair discrimination in insurance, restrictions on unfair trade practices, and procedures for providing necessary insurance coverage to those who would be denied it in a free market.

A major social policy reason for regulation is that some types of insurance are essential. Insurance is either required by law, as in the case of automobile insurance in most States, or is required as a condition of obtaining mortgages and other forms of credit.

More recently, some regulators and consumer groups have focused on the relationship between insurance and other social problems such as racial discrimination and urban decay. Critics have also asserted that the currently used risk

1. licensing insurance companies and agents;

2. examining companies' financial condition and claims practices;

3. implementing the statutory standards that rates shall not be excessive, inadequate, or unfairly discriminatory and that health products must meet standards requiring benefits to be reasonable in relation to premium;

4. administering a complaint handling office;

5. enforcing unfair trade practice laws;

6. regulating residual market mechanisms designed to provide insurance for risks rejected by the voluntary insurance market;

7. applying for a court order for liquidation, rehabilitation, or conservation of companies because of insolvency or other reasons.

The States undertake these functions with considerable differences in resources, organization, and regulatory activities.

This appears to represent a considerable increase over earlier years when compared to a median of $281,900 (in 1977 dollars) found by the O'Mahoney report in 1957.

The increased expenditures, however, only slightly exceeded the general growth of State government expenditures and are only slightly more than the growth of insurance premium volume. In summary, the insurance department budgets of the States are roughly the same now (in proportion to State government budgets and to insurance premium volume) as they were 20 years ago.

The size of departments varies greatly among the States and correlates highly with the size of population and the amount of insurance business. However, even between some States of the same size, there are some substantial differences in the amount of resources States commit to insurance regulation. Table 1 shows the absolute size of department budgets and the size of staff by State. In order to compare State budgets relative to the size of States, table 2 shows department budget per million dollars premium volume and per domestic insurance company.

Although some regulators claim that the system of State regulation is less costly than any Federal system would be, the total amount spent on insurance regulation is a sum almost as much as the combined total 1978 budgets of the Securities and Exchange Commission and the Federal Trade Commission--the two Federal agencies that are somewhat parallel to insurance departments in that they have broad jurisdiction over financial and trade practice matters. Comparison can also be made to the Interstate Commerce Commission (ICC), whose regulatory responsibility over the interstate surface transportation industry is similar to that exercised by insurance departments over the insurance industry. In 1978 the ICC's budget was $65 million.

While the mission of these Federal agencies is, of course, different from that of State insurance departments, enough similarities exist to suggest that expenditures on State regulation are not insignificant.

Insurance departments collect substantial revenues for the States, primarily in the form of premium taxes, but little of those collections are spent on regulation. Insurance department budgets average less than 5 percent of the

Table 2

State Insurance Department Budget as a
Proportion of State Budget and State Premium Volume

State	Dept. budget per million dollars premium volume	Dept. budget per number of domestic companies
Alabama	870	22,667
Alaska	2,302	134,000
Arizona	931	2,657
Arkansas	1,189	25,158
California	861	67,291
Colorado	789	14,403
Connecticut	634	25,151
Delaware	N/A	
Florida	2,171	43,848
Georgia	N/A	
Hawaii	716	
Idaho	1,211	30,206
Illinois	630	10,831
Indiana	536	13,437
Iowa	1,033	7,722
Kansas	1,698	35,417
Kentucky	N/A	37,763
Louisiana	539	10,603
Maine	N/A	
Maryland	1,038	42,142
Massachusetts	1,424	66,239
Michigan	959	41,855
Minnesota	583	6,489
Mississippi	N/A	
Missouri	410	9,758
Montana	1,052	47,854
Nebraska	1,429	11,649
Nevada	2,025	289,504
New Hampshire	2,509	34,500
New Jersey	863	72,539
New Mexico	1,026	37,000
New York	1,764	60,453
North Carolina	913	25,316
North Dakota	1,119	6,835
Ohio	442	12,609
Oklahoma	N/A	
Oregon	2,629	185,609
Pennsylvania	960	20,294
Rhode Island	1,039	19,067
South Carolina	2,355	44,488
South Dakota	699	3,304
Tennessee	902	27,290

CHAPTER 4

SURVEILLANCE OF COMPANIES:

FINANCIAL AND TRADE PRACTICE REGULATION

Insurance departments are responsible for making sure that insurance companies comply with the law. Traditionally, the primary focus of departmental surveillance has been to examine the financial condition of insurance companies. More recently, there has been increased attention to other consumer protection requirements, and many States now conduct market conduct examinations. However, financial examination personnel still make up about 25 percent of insurance department staff, and examinations are mainly financial in nature.

FINANCIAL REGULATION

Although primary responsibility for the examination of companies rests with the State in which the insurance company is domiciled, all the insurance departments have an interest in the financial health of the companies that operate in nearly all the States. Uniformity of financial reporting and coordination of the examination process is furnished by the NAIC, and these services were the most frequently mentioned by insurance departments as examples of assistance provided by the NAIC.

A 1974 study of financial regulation conducted for the NAIC by McKinsey & Co. found a number of deficiencies in the financial regulation process. The NAIC adopted many of the McKinsey recommendations, which included revising the association's examiners' handbook. Our survey, however, found that apart from increased use of the NAIC early warning system to detect potential financial problems, most State insurance departments have not instituted the changes recommended by the NAIC-sponsored study. In particular, most States do not have examiners who specialize in either of the two major fields of insurance, property-casualty and life and health, and few States have the capacity to perform computerized audits. Moreover, most insurance departments continue to assess companies for each examination performed, despite NAIC's earlier recommendation to the contrary.

Although there is evidence that the examination process itself is not closely related to the number of insolvencies, it should be noted that the number of insolvencies in the period we studied was roughly equivalent to the rate of insol-

Complaint information can be useful in alerting consumers to potential problem companies. However, our fieldwork, data indicate that while many States prepare complaint ratios for each company (the ratio of complaints to premium volume), very few States publicize these ratios or make them widely available to consumers.

The handling of citizen complaints by insurance departments has an importance that goes beyond the resolution of individual grievances. The receipt of complaints from the public can be a department's most direct source of information about problems encountered in insurance transactions.

For complaints to be useful to agencies and the public, they must be handled in a systematic way. Systematic procedures should include a consistent complaint classification procedure, statistical reporting mechanisms, and mechanisms to ensure that complaints from the public are fed into the system of regulatory enforcement and decisionmaking.

Most State insurance departments do not have systematic complaint-handling systems. The most common use of complaints in insurance department enforcement activities is to target companies for special market conduct examinations, but this was done systematically in less than half the States in which we did fieldwork. It appears that most States do not maintain a system whereby complaints are coded, analyzed, and fed into the examination process.

Another potential use of complaint data is to trade information among insurance departments to assist in licensing and enforcement activities. This activity, however, is not universally undertaken. Only half of the departments responding to our questionnaire reported that they always checked the complaint records of the domicile State when an out-of-State insurer seeks a license to do business.

Market conduct examinations

Insurance department examinations of such consumer matters as claims handling, advertising, underwriting, and other trade practices are known as market conduct examinations. Most States perform special separate market conduct examinations (as contrasted with examining market conduct only during financial examinations).

While systematic complaint handling procedures have great utility, an effective market conduct examination process is

CHAPTER 5

PRICE REGULATION OF AUTOMOBILE INSURANCE

In all States except Illinois, automobile insurance rates are subject to active or passive Government regulation. The general requirement is that rates be neither excessive, inadequate, nor unfairly discriminatory. Although the original purpose of insurance rate regulation was to prevent rates from being too low, rate regulation now is intended to prevent excessive rates.

Most States operate under a prior approval system, which means that changes in rates must be approved by the insurance departments or the department has an opportunity to disapprove rates for a specified period of time. A smaller number of States have a competitive rating system whereby insurers simply establish premiums without having to obtain regulatory approval. Even in most prior approval States, however, there is competition among insurers, as many companies offer rates that are below the legally allowed maximums.

THE PROCESS OF RATE REGULATION AND MONITORING COMPETITION

There is wide variety in the way in which States review insurance rate filings and the scrutiny which those filings receive, but the review process in all the States we visited appeared adequate to meet statutory requirements. Taking all lines of insurance together, rate filings are generally approved without modification, but major private passenger rate filings are generally challenged and the requested increase is reduced by a small amount in most States.

With the exception of Massachusetts and Texas, no State performs an independent actuarial analysis, based on loss data, of what rates should be. Rather, department rate analysts or actuaries only review the calculations of insurance companies or rating bureaus. In both Texas and Massachusetts, the rates recommended by the State insurance departtment were seen, in retrospect, to more accurately reflect actual loss experience than the rates recommended by the can obtain financing for the purchase of an automobile. The necessity for insurance probably makes the demand for the the product somewhat inelastic. Third, there are legally sanctioned practices and regulations that may restrict competition. For example, most States allow an initial 60-day free underwriting period during which an insurer may cancel a new policy for any reason. To the extent that consumers are aware of this situation, the free cancellation period would discourage them from switching companies and thus would decrease competitive pressures.

Finally, unlike other industries, insurance companies compete not only by seeking customers they want, but by rejecting customers they view as high risks (or whose loss expectancy is perceived as being too great for the rates they are permitted to charge). Thus, while companies may solicit business in most areas and for most potential customers, there will be other areas and customers who are shut out of the market by these same competitive forces.

The effects of price regulation on automobile insurance costs

On the average, there is little difference in automobile insurance price, as measured by loss ratios, between States that regulate insurance rates and those that do not. Indeed, liability insurance is a slightly better value in open competition States, while physical damage insurance is somewhat more expensive in those States. (See table 3.) These physical damage ratios are probably more reliable than the liability ratios because the existence of and changes in no-fault laws over the 5 years we used may distort the liability ratios and because liability pay-outs take longer and are less predictable than physical damage. However, even this relationship is small and not statistically significant.

years 1973-1977 for the country as a whole, there is no consistent difference in variation between rate regulated States and open competition States. Of course, there may be substantially greater variation in a few price regulated States than in open competition States as some previous studies have shown. However, for the country as a whole, price regulation does not appear to force companies into feast-or-famine cycles, nor do rates in competitive rating States fluctuate wildly without regulatory control.

Analysis of insurance cost differences among the States

Having determined that there are only small cost differences among the States based on type of rate regulation law, there still remains the question of what factors are related to observed cost differences between the States. To see whether the regulatory system makes any difference in the cost of insurance, we used appropriate statistical analyses to determine the relationship, if any, between regulatory variables, market structure, and the cost of insurance, using the adjusted loss ratio as the proxy for the price of insurance. Because there is relatively little variation among the States, the analysis is limited and the results are meant to be suggestive not conclusive.

We found a small relationship between insurance department resources and market structure on the one hand, and the cost of insurance on the other. Insurance costs tended to be lower in States with proportionately larger insurance departments, and in States in which the direct writers (companies such as Allstate and State Farm who file their own rates and generally employ their own exclusive agents) have a larger share of the market. But the most striking finding is that one State, New Jersey, accounts for 26 percent of the variance in liability loss ratios among the States.

The cost of liability insurance in New Jersey is substantially lower than the national average and this accounted for more of the differences in the cost of insurance among all the States than any other factor we tested. Adding the budget per capita increased the amount of variance explained to 41 percent. By excluding the case of New Jersey from the analysis, 21 percent of the difference in insurance cost is accounted for by the per capita insurance department budget.

In summary, while type of regulatory law is not related to the cost of insurance, one State whose regulatory system apparently causes substantially higher loss ratios accounts for the largest single amount of the difference among the

Another market failure is the existence of externalities--an insurance market in which insurance is not sufficiently available or affordable. When price regulation creates prices that are artificially low, insurance becomes less available in the voluntary market. However, in such circumstances price regulation may create a problem of availability rather than solve it.

In general, consumers would be better served if insurance departments devoted fewer resources to price regulation and more resources to regulation designed to allow competitive forces to work most effectively. For the most part, the market is competitively structured. While there are limitations on competition in insurance, such as lack of consumer information and the risk selection process, the regulation of base insurance rates is an indirect and apparently ineffectual way of dealing with market failures in the automobile insurance market. Ironically, in lines of insurance where there is no effective competition, such as title insurance, there is little exercise of regulatory authority. In short, insurance lines that do not need price regulation are regulated, while insurance lines that might be usefully regulated are not.

Even though the market structure does not justify base price regulation, the problem of consumer knowledge does require regulatory intervention. Consumers now have little or no information on which to judge the quality of insurance policies. Government intervention should not be in the form of direct regulation, however. Rather, insurance departments can pursue the less intrusive strategy of collecting and disseminating (or requiring the dissemination of) information that would provide consumers with a better basis of knowledge for purchasing insurance. Such information might include annual price comparisons by territory for several widely purchased insurance coverages, complaint ratios (e.g., number of complaints per million dollars premium volume or per thousand policies), and requiring readable or standardized policy information _prior_ to purchase so that consumers can compare policies.

In summary, we believe that base insurance rates in the voluntary private passenger automobile insurance market need not be regulated if there is much greater regulatory action to provide consumers with enough information to make the competitive market work efficiently. However, as discussed in the following chapter, regulation may be necessary to prevent the use of rate differences that constitute unfair discrimination.

THE ISSUES OF RISK CLASSIFICATION

The automobile risk classification system is controversial because it leads to very large differences in the price paid for insurance. The underlying question is whether these differences are appropriate, since unfair discrimination in the pricing of insurance is prohibited. The criteria of what is appropriate revolve around the issues of public acceptability, predictability, equity, and competition. Two documents in particular have been at the center of the debate. The first is the report of SRI International (formerly called the Stanford Research Institute), which describes and evaluates alternative classification systems and and regulations. 1/ Although this study was commissioned by various insurance industry groups, its findings have been cited by critics as well as supporters of current industry practices. The second is the Opinion, Findings and Decision on 1978 Automobile Insurance Rates issued by James M. Stone, while he was Commissioner of Insurance in Massachusetts. 2/ Stone's decision prohibits the use of age (except for a senior citizen discount), sex, or marital status in classifying risks and articulates the rationale behind that prohibition.

Public acceptability

Some categories, such as race, might produce different potentials for loss, but these are not used because they violate public acceptability and public policy. Critics of the classification system claim that age, sex, and marital status are similarly unsuitable because they represent a socially reprehensible form of discrimination. Insurers argue that discrimination, defined as differentiating among risks, is basic to insurance, and that the public accepts the proposition that higher risk groups should pay more. Critics claim, however, that it is unfair to penalize individuals simply because they share certain characteristics with others who, taken as a group, have a high loss

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1/Stanford Research Institute, The Role of Risk Classification in Property and Casualty Insurance: A Study of the Risk Assessment Process, May 1976.

2/Commonwealth of Massachusetts, Division of Insurance, Opinion, Findings and Decision on 1978 Automobile Insurance Rates, December 28, 1977. The Division also published Automobile Risk Classification; Equity and Accuracy (1978) which contains the technical papers that supported Commissioner Stone's decision.

groups would "subsidize" higher risk groups by paying higher premiums than under the current system. Some companies have prepared exhibits showing how the lower prices groups would fare if the classification plans eliminated age, sex, and marital status.

Critics of the classification system argue that this notion of subsidy is conceptually wrong in several respects. First, all insurance may be seen as a subsidy--those who have no loss subsidize those who do. The purpose of insurance is to spread loss. Given the fact that all drivers within a class or territory are not at the average loss expectancy for that class, it is not fair for good drivers in a higher risk class to be forced to share claims costs only with other drivers in that class. Under the current system it is unclear who is subsidizing whom.

Young males who are skilled and responsible drivers must share the cost of loss only with other young drivers who, as a group, have disproportionately high losses. Critics of the system argue that there is no inherent reason why these good drivers should have the exclusive burden of bearing the loss cost of other young drivers. The only thing held in common between them is age--not a controllable attribute. Thus, according to this viewpoint, flattening the rates would not be a subsidy but rather a more equitable way of spreading the cost of losses.

There is also an important equity question in determining the relative price that different categories should be charged. In that the groups are not homogeneous and the group charged the highest rates is even less homogeneous, is it fair to have substantial differences in rates that are based on imperfect information and categories that are administratively convenient but not controllable by the insured? Critics of the current system argue that even if age or a similar factor such as years of driving experience is kept as a category, it is doubly inequitable to the low risk driver who is grouped in the high risk class to be charged substantially more in premiums. In other words, in that certain individuals will inevitably be subject to errors in pricing, should the errors be the type that improperly overcharge a small number of drivers several hundred dollars annually, or should they be the type that overcharge a large number of drivers 10 to 20 dollars?

TERRITORIAL RATING

Rating territories have been established by insurers to reflect the fact that more accidents occur in certain geographic areas than in others. Therefore, base insurance rates differ according to territory. Many of the same issues regarding personal classifications also apply to the question of territorial rating, such as the charge that territories are not optimally predictive of individual loss, and consequently territorial rating is inequitable.

Some issues, however, are specific to territorial rating. Two issues in particular are frequently raised. First, it is alleged that territorial rating is a manifestation of racial discrimination and that territories composed mainly of minority groups are not accidents of geography. Second, is the special problem of central cities, which are charged higher premiums as a result of higher losses within their boundaries. Losses are greater in central cities partly because of heavier traffic congestion. Critics maintain that the congestion is caused mainly by suburban cars coming into the city, and thus the higher rates reflect the driving habits of suburban residents. It is unfair, critics claim, to assess only urban residents for losses that are due to congestion caused by others.

Beyond questions of fairness and social policy, there is the issue of actuarial accuracy. Territorial boundaries of long standing are primarily an issue in urban areas, and critics question whether the boundaries are even justified from an actuarial standpoint. That is, do existing territories constitute a reliable and nondiscriminatory way of grouping risks?

In those States where territorial rating is an issue, the controversy involves allegations of unfair discrimination by insurers. To respond to these allegations, insurance departments must collect data to determine the extent and nature of these problems in their States. We examined the information the States collect on territorial rating practices and the analyses utilized by insurance departments.

For each territory, all departments receive insurance company or rating bureau loss costs, loss ratio, and loss ratio in relation to the State average. These data indicate whether rates for particular territories should be raised or lowered. We determined that the level of rates for territories as units is monitored. The more fundamental issue is

Out of our 17 fieldwork States, 11 have not done an actuarial or other statistical review to see if loss data justify existing territorial boundaries. While the 17 States data on the loss ratios by territory, they do not review, for example, whether the territories are internally homogeneous. The insurance departments do not know if there are areas within territories that have a markedly better or worse loss experience than the territory as a whole; nor do they know if areas are more similar to other territories than the territory of which they are a part. In four States, California, Connecticut, North Carolina, and South Carolina, the composition of territories is under review or has been challenged by the insurance department. In Massachusetts, the department grouped all the cities and towns on the basis of their actual claims experience.

Even if insurance departments were to attempt to analyze territorial and classification plans more rigorously, there is an important potential limitation on their ability to collect data--a limitation in the insurance laws of most States. An NAIC model law adopted by most States provides that insurance companies cannot be required to record or report loss experience on a classification basis that is inconsistent with the company's own classification system. Thus, if a department wanted to monitor the validity of territories, it would be limited to data collected in the aggregate for such territory. This limitation would make it impossible to determine the variation within territories. While only one State we visited reported that this was a hindrance, few States made any attempt to require justification of territorial boundaries.

SUMMARY AND CONCLUSIONS

We did not evaluate the validity of personal classification plans or the integrity of territories in any State. Based on an examination of existing evaluations of the systems, we conclude that serious questions remain as to whether the price differentials in widely used classification systems conform with the prohibition against unfair discrimination--particularly with regard to territorial rating. The allegations about the lack of predictability and homogeneity in existing classes and territories are sufficiently well supported to warrant greater regulatory scrutiny.

We are, however, able to present conclusions about the adequacy of State regulation of classification schemes. Few departments have undertaken their own evaluations of whether the classification plans currently used in their States

CHAPTER 7

INSURANCE AVAILABILITY

Insurance is essential to personal security and community growth, but according to the Federal Insurance Administration (FIA) and other knowledgeable observers, there is a serious problem of insurance availability in personal lines insurance in urban areas. This chapter examines the response of State insurance departments to the issue of insurance availability, with a particular focus on automobile insurance.

REDLINING

The most conspicuous availability problem is "redlining." The Federal Insurance Administration defines redlining as the "arbitrary refusal by the industry to insure certain risks because of their location." The impact of redlining was noted by the FIA:

> "Insurance redlining today denies many urban property owners access to a voluntary insurance market. The practice is not based on any sound underwriting standards but rather on highly subjective criteria that would appear to result from unfounded generalizations or preconceptions about urban property risks. The effect of this practice is that many property owners are denied access to insurance at affordable prices." 1/

The regulatory response to allegations of redlining bear directly on the mandate of insurance departments to prohibit unfair discrimination in the sale of insurance.

Because of the negative connotations of the term "redlining," the definition itself is controversial. One issue is whether the refusal to write insurance in an area is a correct manifestation of sound underwriting and actuarial principles, or whether it is purely arbitrary. Another issue is what constitutes refusal to insure. Among the practices designated as redlining by a report of State advisory

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1/U.S. Department of Housing and Urban Development Office of the Federal Insurance Administration, Insurance Crisis in Urban America, 1978, p. 44.

Table 4

State Insurance Department Studies on Redlining, 1974-1978

States Responding That They Have Conducted Studies of Redlining

Urban (75% of population in SMSAs)	Nonurban (less than 75% in SMSAs)
Arizona	Alaska
California	Indiana
Colorado	Kentucky
a/Illinois	Missouri
Maryland	Montana
a/Massachusetts	Nebraska
Nevada	West Virginia
a/Pennsylvania	a/Wisconsin

States Responding That They Have Not Conducted Studies of Redlining

Urban	Nonurban
Florida	Alabama
Hawaii	Arkansas
Michigan	Delaware
New Jersey	Idaho
New York	Iowa
Ohio	Kansas
Rhode Island	Louisiana
Texas	Minnesota
Utah	New Hampshire
District of Columbia	New Mexico
	North Carolina
	North Dakota
	Oregon
	South Carolina
	South Dakota
	Tennessee
	Vermont
	Virginia
	Washington

States Not Responding to GAO Questionnaire

Urban	Nonurban
Connecticut	Mississippi
Georgia	Oklahoma
Maine	Wyoming

a/States that submitted copies of reported study to us.

AUTOMOBILE INSURANCE AVAILABILITY

The problems of availability in automobile insurance differ from property insurance. All States have some sort of residual market plan to sell automobile insurance to people who cannot obtain insurance in what is known as the voluntary market--individual insurance companies offering coverage voluntarily. The most common residual market plan is the automobile insurance plan, better known as the assigned risk plan, which exists in 43 States, but there are other types as well. Seven States have either a joint underwriting association or a reinsurance facility. While differing in administrative approach, these plans are similar in that the involuntary market is pooled and shared proportionately among all the companies writing auto insurance in the State. Maryland is the only State in which the involuntary market plan is administered by the State government.

Despite the universal existence of auto residual market plans, there may still be an availability problem because the concept of availability is a slippery one. There is no commonly accepted definition of availability. Most regulators and industry sources regard availability from the consumer's perspective as solved by residual market plans. They consider the residual market as consisting only of drivers who are forced into the assigned risk plan because they cannot obtain insurance in the voluntary market. Others have told us that the residual market is larger, consisting not only of the assigned risk plan, but also of those paying higher nonstandard rates to high risk companies and those who are uninsured. By this point of view, the extent of the availability problem cannot be measured solely by the size of a State's assigned risk plan.

The extent of availability

The various measures of availability are shown in table 6, which lists a relatively straightforward indicator of availability--the percentage of cars in the automobile insurance plan--and two additional indicators: the estimated percentage of uninsured cars in each State and the proportion of premium volume accounted for by "nonstandard" or high risk companies.

Adequacy and affordability of coverage

The assigned risk plan is not a complete substitute for voluntary market coverage in all the States because the amount and type of coverage may be limited. In recent years, however, assigned risk plan coverages have been expanded to bring them closer to those available in the voluntary market. 1/ By the end of 1977, only six States did not have optional liability coverage of at least 25/50/10. Only six States did not have comprehensive and collision coverage offered through the automobile insurance plan. 2/ In those States where coverage is limited, motorists generally must turn to the substandard or high-risk companies for coverage.

Although the automobile residual market plans are designed to provide coverage to everyone, they are not necessarily designed to offer coverage at the same rates. In 8 of the 17 fieldwork States the residual market plan rate was at least 25 percent higher than the voluntary market. These rates may be seen on table 7.

Despite higher rates in most residual market plans, it should be noted that the plans are generally not self-sustaining, and in most of the States the plans lose money. For example, there were residual market plan underwriting losses in 38 States in 1976, ranging from $0.38 per car in Nevada to $543.22 per car in North Dakota with a median loss of $45.35. 3/ Thus, the losses are not spread evenly. In 1976, 95 percent of the total underwriting loss was concentrated in 10 States: New Jersey, Massachusetts, New York, Florida, South Carolina, North Carolina, California, Pennsylvania, Michigan, and Virginia. These losses are made up by insurance companies' voluntary market business, and in this sense the voluntary market "subsidizes" the residual market.

Taken as a group, assigned risk plan drivers compile a worse record than those in the voluntary market. However, not all the individuals in the group have bad driving records or should be considered high risks. One issue is the number

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1/Finley Lee, Servicing the Shared Automobile Market, National Industry Committee on Automobile Insurance Plans, 1977, p. 21.

2/AIPSO Insurance Facts 1978, pp. 124-144.

3/National Industry Committee on Automobile Insurance Plans, Circular NIC 78-47.

of "clean risks" placed in residual market plans. A clean risk is generally defined as someone who has had no accidents or moving violations for the previous 3 years. 1/ The question is whether people who as individuals are good drivers are being consigned to the automobile insurance plan because of various factors beyond their control. In general, as the automobile insurance business climate is regarded as poor by insurers, the percentage of cars in the assigned risk plan increases. Most of the fieldwork States had no information, beyond rough estimates, of the number of clean risks in the automobile insurance plan.

In conjunction with the Automobile Insurance Plans Service Organization, the Virginia Insurance Department participated in a comprehensive study of the composition of Virginia's automobile insurance plan. The study concluded that there were, in fact, very few truly clean risks in the plan. There is no basis, however, to assume that the conclusions have applicability beyond Virginia, which does not have any appreciable availability problem.

CONSUMER RIGHTS

Individuals who are rejected from the voluntary market may obtain insurance in the automobile insurance plan, but in many States they suffer adverse consequences. Therefore, we examined insurance department policies and consumer rights with regard to nonrenewals, cancellations, and other denials of coverage in the voluntary market.

Protection against adverse underwriting decisions

The laws of all 17 fieldwork States protect consumers against cancellation during the policy period by specifying narrow grounds on which insurance may be cancelled. Typically, the only grounds for cancellation are nonpayment of premium and suspension or revocation of driver's license. A few States have provisions allowing cancellation for drunk driving convictions, conviction for car theft, fraud or misrepresentation in the policy application. None of these States had cancellation provisions that impaired legitimate consumer rights, once the policy has been in force for 2 or 3 months. The big exception is the initial period of the

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1/It should be noted that clean risks are not necessarily considered by insurers to be good risks because the lack of previous accidents is not considered to be highly predictive of future losses.

We found that as of the fall of 1978, not only are individuals not told why their applications are rejected, but State insurance departments also do not ascertain why individuals are rejected from voluntary market companies. None of the States in which we did fieldwork knew why individuals are placed in the assigned risk plan. 1/

In the States in which we did fieldwork, we checked to see if each State required insurance companies or agents to tell consumers why they had been rejected from the standard-rate voluntary market. In Massachusetts, North Carolina, and South Carolina, companies must accept all risks and then cede those they do not want to a reinsurance facility. Consumers do not even know they have been ceded because there is no direct rejection of the consumer by the company. The question of consumer rights to information is relevant in the other 14 States, however. Of these, only three, California, Wisconsin, and Virginia, require insurance companies to provide the reasons for rejection, and then only on written request by the consumer. The remaining 11 have no requirement.

The protection provided by State law is somewhat better in requiring the reasons behind cancellations and nonrenewals. Nearly all States require companies to give the reason for cancellation. A survey of the law of all States shows that 16 jurisdictions require that the reason for cancellation be provided together with the cancellation notice. Twenty-eight States have the less satisfactory requirement that the reasons for cancellation be given upon the request of the insured.

Fewer States protect consumers' rights with regard to nonrenewal. Fifteen States require that the reasons accompany the notice of nonrenewal. Fourteen States require that the reasons for nonrenewal be given at the request of the insured. The remaining 21 States and the District of Columbia have no statute stipulating that the reasons for nonrenewal be disclosed.

Particularly because the denial of insurance may make it more difficult to get insurance in the future, consumers should be informed of the reasons behind that denial. Nor is it sufficient to wait for a written request from the

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1/The Virginia department has participated in a recently completed study of the composition of its assigned risk plan.

CHAPTER 8

ORGANIZATIONAL ISSUES

The business of insurance is under a unique regulatory system. It is the only major interstate financial industry regulated primarily by the States. Moreover, because of the McCarran-Ferguson Act, the Federal Government is precluded from exercising antitrust and trade practice jurisdiction that would normally apply to businesses in interstate commerce.

Although there apparently was little question in the Congress about the desirability of the continued primacy of State regulation when the McCarran-Ferguson Act was passed, questions have been raised in the Congress and by consumer groups about the adequacy of State regulation, and suggestions have been made that Federal regulation or standards would be preferable in some areas. However, both the industry and the State regulators have opposed any expansion of Federal regulatory activity over the business of insurance. Their claim that State regulation is superior is a central part of the current discussion of many insurance issues.

THE CLAIMED ADVANTAGES OF STATE REGULATION

The continuation of the almost exclusive role of the States in regulating insurance is an underlying goal shared by State regulators and the insurance industry. Several reasons are advanced as arguments for the superiority of State regulation versus Federal regulation. The purported advantages of State regulation and some of the findings of this report that are relevant to the debate follow.

The virtue of Federalism

The decentralization of governmental authority as manifested in the system of insurance regulation is a fundamental value of our system of government. As a question of political philosophy, this issue is not necessarily appropriate for analysis by GAO. It is for the Congress to determine whether the circumstances of insurance regulation continue to be such that the value of decentralization of government authority outweighs other policy goals.

Many insurance problems, however, are not congruent with State boundaries and State insurance departments have no special advantages in dealing with them. Moreover, many departments do not have sufficient information to deal with local manifestations of such national issues as redlining and other discrimination problems. Most insurance departments also may not have the information needed to address the problems of particular segments of the population. We found this to be true with regard to supplemental health insurance aimed at the elderly.

Providing uniformity in a system of multiple jurisdictions

Although in a decentralized system, insurance companies must deal with many jurisdictions, none of the company officials we interviewed believed that having to comply with different regulations in different States imposed significant costs. Company officials stated that problems of diversity were not due to a lack of uniformity, but were due to a few problem States.

Where uniformity is necessary, regulators and industry officials have stated that it is provided by the National Association of Insurance Commissioners (NAIC). The NAIC consists of the heads of the insurance departments of the 50 States, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands. While the NAIC has no legal regulatory authority, it is an inherent and significant part of the system by which the business of insurance is regulated. The primary functions of the NAIC are to

--draft model laws and regulations for voluntary adoption by the States;

--gather and distribute information on regulatory matters, such as license revocations and securities valuations;

--maintain computerized financial data aimed at early detection of insurer insolvency; and

--conduct studies of nationally significant insurance issues.

Despite its important functions, the NAIC is not a large organization. Executive and administrative functions are performed by a relatively small staff in the central office

Independence of the NAIC

Some critics have alleged that the NAIC is, on balance, oriented more toward the welfare of the insurance industry than its consumers, and that it is heavily dependent on the industry. One manifestation of this dependence is the alleged industry domination of the various committees and task forces that study insurance issues and help formulate NAIC model laws and regulations. Until 1977, these advisory committees were officially known as "industry advisory committees," and, apparently, were composed exclusively of insurance industry representatives. The NAIC Central Office reported that it did not maintain a list of advisory committees, but we did obtain information on the composition of a number of committees convened since an NAIC rules change providing for voluntary consumer representation on advisory committees. Most committees still had no consumer representatives, and the others were almost exclusively composed of industry members. Moreover, nearly the entire body of NAIC model regulations and statutes were developed under a system with no consumer participation in the process by which the advisory committees worked with the regulators in developing those model laws.

Industry representatives also are numerically dominant at NAIC meetings and provide "hospitality suites," meals, and other entertainment to insurance commissioners.

We do not conclude that the insurance regulatory system is completely dominated by the insurance industry, but the system in general is not characterized by an arms-length relationship between the regulators and the regulated.

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CHAPTER 9

COMMENTS FROM THE STATE INSURANCE DEPARTMENTS

We sent copies of an earlier draft of this report to the insurance commissioners in all the States in which we did fieldwork and to the National Association of Insurance Commissioners (NAIC). The NAIC told us that they would be unable to comment in the time we requested, but would do so later. We received comments from California, Connecticut, Illinois, Indiana, Kansas, New Jersey, and Ohio.

Most insurance commissioners commenting on the matter objected to our findings that insurance regulation is not characterized by an arms length relationship between the regulators and the regulated. This issue is discussed in chapter 8.

Several insurance departments partially disagreed with our finding of various shortcomings. They stated that, although there are shortcomings, many of the issues we raised are new and the insurance departments are responding to problems in a timely fashion. A detailed discussion of specific department comments is included in our full report.

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in Milwaukee. The organization's budget is also modest; for fiscal year 1978 the budget was $842,790--an amount that was exceeded by most State insurance departments.

Most States rely on the NAIC for financial reporting and valuation services and many other States cited the information-clearinghouse role of the NAIC as valuable. We found, however, that the NAIC had little of the information that we sought on the resources and activities of State insurance departments.

INDEPENDENCE OF INSURANCE REGULATORS

In any regulatory setting, it is important that regulators be impartial and responsive to broad public interests. Nonetheless, one of the most common and longstanding criticisms of insurance departments, as well as other regulatory agencies, is that they are overly responsive to the very industries that they regulate, even to the extent of being "captured" by them. It was not the purpose of this report to examine in great depth the question of regulatory independence from industry. Rather, we reviewed two issues of regulatory independence which are meant to suggest broader complexities.

The revolving door

Critics have charged that a major manifestation of industry dominance of insurance departments is the "revolving door" phenomenon whereby insurance regulators come from the ranks of the insurance industry and then return to the industry after short terms of service.

In about half the States the commissioner who was in office in 1978 was previously employed in the insurance industry, but over one-third of the commissioners had previous insurance department experience. In only nine States did the commissioner have only an insurance industry background. Our data on employment after leaving office is more limited, but slightly less than half of the commissioners for whom we have information joined the insurance industry after leaving office

In responding to our report several insurance commissioners objected that our discussion of the "revolving door" issue impugns the integrity of commissioners who have been employed in the insurance industry. We did not conclude that most commissioners are "revolving door" appointments or that there is anything necessarily wrong with industry employment before or after department service.

State regulation already exists

Experienced personnel are currently administering a regulatory system in all 50 States. We did not evaluate the costs or other problems associated with the transfer of regulatory authority to the Federal Government. We note, however, that there is nothing inconsistent about the advantages of State regulation and various proposals to institute Federal standards that could be enforced by the States.

Pluralism and innovation

Plural regulatory authority provides the opportunity for innovation that can be tried on a State-by-State basis. This benefit is realized in insurance regulation, although there is no way of knowing whether greater innovation would be possible (or desirable) under a centralized system. Examples of recent innovations include the prohibition of age, sex, and marital status as rating factors in Massachusetts and North Carolina; the California Insurance Commissioner's efforts to obtain an agent commission rate that was more equitable to consumers in the assigned risk plan; and the efforts of the former Wisconsin Insurance Commissioner to institute higher standards for supplemental health insurance and to develop meaningful life insurance cost disclosure requirements.

It should be mentioned, however, that rigid regulatory systems in some States have retarded innovations in insurance products and marketing techniques such as homeowners' policies and auto insurance discounts for good students.

Threat of Federal regulation

It has been suggested that the perceived threat of Federal regulation prompts State regulators to do a better job. This may be true, but it is not clear who benefits from this situation. There is also evidence that the threat of Federal action has created an impetus to promulgate regulations favored by the insurance industry in order to preempt Federal Trade Commission action which is not favored by the industry.

Responsiveness to local needs

Considerable evidence shows that State insurance departments responded to the unique insurance needs within their States, especially in the areas of medical malpractice and commercial liability insurance.

consumer--a requirement that places the burden of action upon the consumer. Since insurers presumably have specific reasons for denial of insurance to particular individuals, they should not incur any substantial burden by being required to state those reasons to the individual at the time the decision is communicated.

Another major problem of consumer information is the relationship between the residual market plan and the substandard market. In seven of the fieldwork States, the rate in the substandard market was at least 20 percent higher than the automobile insurance plan rate. Since the automobile insurance plans are designed for those who are refused coverage in the voluntary market at standard rates, it is difficult to understand why consumers would pay far more when they can get adequate coverage for lower rates in the assigned risk plan.

It has been suggested that this occurs because some insurance agents place consumers with the higher-priced, nonstandard companies in order to obtain higher commissions or simply because they have had more experience with those companies. Most insurance departments in the fieldwork States do not make sure that consumers rejected from the voluntary market are fully informed about the alternative automobile insurance plan. A simple remedy would be to require that such information accompany the notification of rejection from the voluntary market.

SUMMARY AND CONCLUSIONS

Despite the many allegations of redlining and other unfair discriminatory practices, most insurance departments have not investigated the problem nor do they collect the data necessary to monitor insurance availability.

Availability, measured as the proportion of cars in the residual market, is not a problem in most States. However, the large proportion of drivers in the substandard market and the large number uninsured may indicate a very real availability problem in terms of getting insurance at standard rates in the voluntary market. At a minimum level, all drivers can get some coverage in a market of last resort. While it may be argued that genuinely high risk drivers should be consigned to the assigned risk plan or substandard market, the problem is that State insurance departments do not determine why individuals are denied voluntary market coverage or whether such denials constitute unfair discrimination. Moreover, most States do not have laws or department programs to inform consumers about adverse underwriting decisions and what alternatives are available to them.

policy during which 43 States allow a free underwriting period when an insurance company may cancel a policy for any reason. The unrestricted period is 60 days in 38 States, up to 90 days in 3 States, and 2 States have no laws protecting consumers against cancellation at any time. This practice is defended on the grounds that insurance companies must be able to defend themselves against misrepresentation on applications and that they cannot be automatically bound by their agents. While this situation is very convenient for insurance companies, there is little justification for such an open-ended grant of arbitrary discretion to insurers. Hawaii, Massachusetts, New Hampshire, North Carolina, and South Carolina are the only States that do not allow a free underwriting period. The present provisions in most States allowing cancellation for nonpayment and revocation of license could be augmented with a provision allowing cancellation for misrepresentation by the insurance applicant. Even if companies have good reasons for not wanting to be bound by their agents, a 60-day unrestricted free cancellation period without restriction is far too long and seriously jeopardizes consumers. By contrast, the District of Columbia allows only only a 30-day free underwriting period. 1/

The provisions governing nonrenewal are generally less restrictive than those governing cancellation, and insurers are allowed a wider latitude of reasons for nonrenewal. All States and the District of Columbia require advance notice of nonrenewal, ranging from 10 to 60 days, with 30 days being the typical notice required.

Consumers' right to be informed

Denial of first-time application for coverage, nonrenewals, and cancellations are adverse underwriting decisions. In many cases, these adverse decisions are based on broad marketing decisions and may represent an insurer's desire to retrench. However, adverse underwriting decisions may also be based on a perception that the individual is an undesirable risk. When that happens, the adverse underwriting decision is analogous to other adverse financial decisions such as the denial of credit. The Federal Privacy Protection Study Commission recommended that consumers should be informed of the reasons behind these adverse decisions.

1/National figures from Alliance of American Insurers, Compendium of Insurance Charts, Chart dated January 1978.

Table 7

Rate Comparison for 1978 Standard Performance Compact Car

State	Adult male, pleasure use ISO	Automobile insurance plan	Sub-standard a/	Eighteen year old, commuting to work ISO	Automobile insurance plan	Sub-standard a/
Arizona (Phoenix)	382	721 b/	669	1,356	$2,235 b/	1,098
California (Los Angeles)	429	503	813c/	1,523	962	1,446 c/
Connecticut (Hartford)	450	440	N/A	-	N/A	N/A
Illinois (Central Chicago)	684 Aetna	742	810	2,428	2,547	2,261
Indiana (Indian apolis)	355	465 b/	1,0007 c/	1,189	874	2,405
Kansas (Wichita)	268	324	648 c/	951	709	1,230 c/
Massachusetts	-	-	-	-	-	-
Michigan (Detroit)	466	815 b/	1,007 c/	1,654	2,521 b/	2,344
New Jersey (Newark)	651	700 b/	No substandard	2,311	N/A	N/A
New York (Brooklyn)	700	1,225 b/	861	2,485	2,379	2,389
North Carolina (Charlotte)						
liability	79	87	-	87	96	None
P.D.	98	-	540	98	None	540
Ohio (Cleveland)	599	864 b/	1,235 c/	2,126	2,503	2,485
South Carolina (Charleston)	234	234	None	830	830	-
Texas (Harris County)	-	140	662 c/	-	384 b/	1,407
Virginia (Richmond)	300	510 b/	298	-	1,271	758
Washington (Seattle)	323	405 b/	602 c/	1,065	1,067	1,085
Wisconsin (Milwaukee)	-	293	292	-	844	672

a/Mean rate of two leading substandard insurers in the State.

b/AIP Rate exceeds voluntary by at least 25 percent.

c/Substandard exceeds AIP by at least 20 percent.

Source: ISO and data provided by State insurance departments.

Table 6

Measures of
Insurance Availability

State	Percent of cars In AIP a/ 1977	Percent of cars Uninsured a/ 1976		Percent of premium volume in nonstandard companies 1977
Alabama	.48	32.2		10.3
Alaska	3.3	23.9		17.3
Arizona	.1	12.0	(27-33%) b/	14.4
Arkansas	.6	3.8		10.5
California	2.4	16.8	(20-30%) b/	11.1
Colorado	.1	9.3		15.1
Connecticut	4.6	20.2	(7.9%) b/	0.8
Delaware	7.3	.8		3.1
D.C.	2.0	37.8		16.4
Florida	9.3	17.4		7.9
Georgia	3.9	9.9		14.0
Hawaii	2.1	5.8		14.6
Idaho	.1	21.9		9.8
Illinois	.7	11.8	(10%) b/	10.0
Indiana	.1	8.6	(8-9%) b/	6.1
Iowa	.1	1.9		8.4
Kansas	2.1	0	(5%) b/	8.7
Kentucky	.9	15.2		9.6
Louisiana	4.4	27.4		7.2
Maine	2.4	15.9		5.2
Maryland	5.7	9.5		7.7
Massachusetts	18.8	13.4		0.1
Michigan	2.7	10.2	(4-5%) b/	7.1
Minnesota	.7	2.4		8.0
Mississippi	2.0	23.3		7.2
Missouri	1.0	2.1		6.9
Montana	.1	3.6		12.3
Nebraska	.1	3.4		8.8
Nevada	.2	12.4		22.3
New Hampshire	8.3	10.1		0.1
New Jersey	18.7	16.4		0.8
New Mexico	.1	19.1		11.5
New York	9.4	15.0	(6-12%) b/	1.1
North Carolina	16.2	3.6		1.0
North Dakota	.2	0		11.6
Ohio	.1	26.3	(15%) b/	7.3
Oklahoma	.2	7.6		12.6
Oregon	.3	12.8		15.2
Pennsylvania	4.2	24.5		2.9
Rhode Island	4.0	26.8		0.8
South Carolina	N/A	8.9	(10-15%) b/	1.0
South Dakota	.1	0		9.6
Tennessee	2.3	18.5		8.3
Texas	3.1	22.2	(29%) b/	16.4
Utah	.03	2.4		12.2
Vermont	2.0	14.8		5.6
Virginia	7.2	12.5		6.7
Washington	1.7	9.2	(9-11%) b/	13.5
West Virginia	1.0	.5		9.4
Wisconsin	.2	7.3		9.0
Wyoming	.2	5.6		12.1
U.S.A.	4.07			8.4

Source: Insurance Information Institute, Automobile Insurance Plan Service Office

a/Based on the difference between automobile registration and automobiles insured.

b/1978 estimates of insurance departments.

Table 5

Insurance Department Data Collection
Relevant to Discrimination

Data category	Number of departments: Collecting data	Not collecting	No response	Number of departments: Plan to collect	Do not plan to collect	No response
New policies	6	32	8	7	30	9
Policies in force	9	30	7	7	29	10
Cancellations	5	33	8	7	30	9
Nonrenewals	5	33	8	7	30	9
Loss data	14	24	8	10	23	13

Source: GAO questionnaire.

whether unfair geographic discrimination exists in the sale of insurance.

UNDERWRITING PRACTICES

Underwriting is an insurance company's way of determining the acceptability of risks. Unlike classification categories, which are based on objective criteria, underwriting is a subjective process.

Questions have been raised about the propriety of certain underwriting practices published in the industry's underwriting manuals. For example, some underwriting manuals note that objectionable occupations include antique dealer, automobile dealer, bartender, contractor, fashion designer, loan shark, painter, and waiter and waitress.

The States have very limited authority over underwriting guidelines. Only 12 of 43 (28 percent) States responding to our questionnaire item on underwriting reported that they had the authority to forbid the use of particular guidelines. Based on the practice in the fieldwork States, it appears that few State insurance departments review or even collect the underwriting guidelines used by insurance companies in their States. Generally, departments collect only some manuals or portions of manuals.

committees to the U.S. Civil Rights Commission are the following: Selective placement of agents to reduce business in certain areas, terminating agents and failure to renew their business, pricing insurance at such high levels that for all practical purposes it is unavailable, informally or formally instructing agents to avoid certain areas, and varying underwriting practices solely by zip code. 1/

Response of State insurance departments to allegations of redlining

Our focus was on the response of State insurance departments to these problems--specifically whether State insurance departments were investigating the likelihood of unfair discrimination in the sale of property and casualty insurance.

Sixteen States (36 percent) responding to our questionnaire reported that they had conducted studies of allegedly unfair territorial discrimination practices in the availability of property or liability insurance over the past 5 years. Territorial discrimination is an issue primarily in urban States, particularly in older central city areas. While a higher proportion of urban States 2/ than nonurban States conducted studies, less than half of the urban States (44 percent) had conducted studies of alleged redlining. We requested copies of such studies, but only four States submitted them. The States by category are listed in table 4.

To find out if redlining exists, data must be collected according to some geographic unit. Such data collection should include policies in force, new policies being written, and cancellations and refusals by the insurer to renew existing policies, as well as information on losses by neighborhoods within existing rating territories. If loss data by neighborhood showed marked discrepancies within territories, this would cast doubt on the validity of territorial boundaries. As seen in table 5 less than 20 percent of the States collect anything on a geographic basis other than loss data. In brief, most States do not systematically collect data or conduct special studies that would be useful in determining

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1/Illinois, Indiana, Michigan, Minnesota, Ohio, and Wisconsin Advisory Committees to the U.S. Commission on Civil Rights, Insurance Redlining: Fact Not Fiction, 1979.

2/States where 75 percent of the population reside in Standard Metropolitan Statistical Areas over 200,000.

conform to the prohibition against unfair discrimination. Despite serious questions that have been raised about the accuracy and fairness of these plans, most State insurance departments have unquestioningly accepted pricing systems that are convenient for insurance companies rather than effectively protecting the legal rights of citizens.

While it can be argued that classification plans, being national in statistical underpinning, should be addressed by the States jointly through the NAIC (which has continued to delay action recommended by its own task force and subcommittee), no such requirement is present in the case of rating territories within each State. Again with few exceptions, State insurance departments have not assured the validity of rating territories despite the fact that in most cases the existing territorial boundaries were established long ago and by a process about which no one has much information. While State insurance departments may be justified in awaiting the results of further study before acting on the issue of personal classification, they can only assure the rights of their citizens by reviewing the validity of territorial rating within their boundaries.

whether the composition of territories is reviewed by departments to see if territorial boundaries are justified by patterns of losses within each territory. In the fieldwork States, we reviewed whether insurance departments determine if loss experience justifies the territorial boundaries used in automobile insurance.

There is no standard or authoritative criterion used by State regulators to justify territorial boundaries. Nevertheless, by deduction from the statutory standard that rates shall not be unfairly discriminatory, several criteria can be suggested. The prohibition against unfair discrimination means that persons with the same risk characteristics shall not be charged different rates by an insurer. The question with regard to territories is whether the residents of a rating territory, who are being charged the same base rates by each insurer, do indeed have the same risk probability. The most basic criterion, therefore, is whether each territory is relatively coherent and internally homogeneous. Indeed, this standard of homogeneity was put forward by the Commissioner of Insurance in Connecticut in a thorough review of territories in that State. Although a territory can never be entirely homogeneous, areas within territories should not deviate substantially from the territorial average, nor should they be more similar to other territories (with other rates) than they are to the areas in their own territory.

In statistical terms, there should be more variance of loss experience between territories than within them. Moreover, the degree of variation within the territories should be similar. If some territories in a State have substantially greater internal variation than other territories, this situation would indicate that many insureds in those higher-variation territories have risk probabilities that are significantly different from the average for the territory. Those insureds are therefore being consistently overcharged or undercharged, since the rate would be based on the average loss experience for the territory.

In reviewing State action on territorial rating, we did not impose any particular criterion or methodology as a standard against which to assess State insurance department actions. Instead, we reviewed whether the States use any analytical technique to determine if currently used territorial rating plans satisfy the statutory criterion that insurance rates are not unfairly discriminatory.

Regulation of classification plans

The prohibition against unfairly discriminatory rates gives all States some authority over the relative rates in classification plans. Beyond that general grant of authority, the specific authority over categories used in classification plans is quite limited, although few States require prior approval of classification plans. The only criterion for approving classification plans in most States is that the classifications be statistically justified on a group basis.

The issue on which we focused was whether State insurance departments perform actuarial or other evaluations to determine if relativities and classes within a State are justified.

The relativities assigned to classes are based on national data, not on State data. The actual base premiums within a State are based on State-wide loss data. Normally, the rate review performed by the insurance departments covers only base rates, adjusted for each territory. So, if a particular State has loss data for young drivers that are different than national trends, this difference would not be reflected in data submitted by the industry to the insurance commissioner, nor is such data required to be submitted.

In the fieldwork States, we found that no State periodically or routinely performs an independent actuarial analysis of personal classification relativities used by insurance companies. Three States did report, however, that they reviewed changes in classification plans or plans that departed from the ones used by most insurance companies. Most States that we examined either did not review classification plans at all, or reviewed them incidentally to reviewing rate filings. Only two fieldwork States, Massachusetts and New Jersey, have done comprehensive studies of the actuarial basis of classification plans. South Carolina, Texas, and Massachusetts have mandated their own classification plans and so the question of whether they review the plans of the insurance companies is not relevant to them. The NAIC has been actively involved in this issue as well. Although an NAIC task force originally recommended in 1978 that age, sex, and marital status be prohibited as rating factors, the NAIC recommended in December 1978 and in June 1979 that the issue be studied further.

Additionally, several State legislatures, including New York and Ohio, have held hearings on the classification issue.

experience. The critics claim that more controllable factors, particularly driving record should be the basis of rates Thus, the issue of social fairness relates directly to two other issues--how predictive the current system is and what are the predictive capabilities of merit rating.

Predictability

The classification system is not meant to be perfectly predictive in the sense of foretelling exactly who will have accidents, but experience has shown that certain groups (e.g., young males) have many more accidents per number of insureds than other groups (e.g., middle aged drivers). The issue of predictability relates to the differences between groups and individuals within those groups. Critics point out that the rating groups are not homogeneous and there is great overlap between the loss experience of groups. Insurance companies reply that there may be better than average risks in the higher risk groups, but that it is impossible to identify them and that the rating system is highly predictive for the groups in the aggregate. Insurers argue that rating by driving record would be far less accurate than the current system. The evidence on this point, however, appears to be unclear, since different insurers have drawn different conclusions on this point depending on what indicators of driving record are used.

Apart from the fact that the categories are not homogeneous, the current classification system may not even be accurate because loss experience is viewed only in terms of groups. The current rate differentials are based only on countrywide data, but are applied uniformly to all territories. However, an NAIC task force reported in 1976 that the current differential between younger drivers and adult drivers was too great in the higher cost urban territories. 1/

Equity and subsidy

Defenders of the classification system argue that it is both fair and economically sound for groups to pay premiums based on the expected losses of their own group. To spread the cost more broadly by eliminating certain classification categories would involve cross subsidies--i.e., lower risk

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1/NAIC (D1) Subcommittee Task Force on Private Passenger Classifications, Report, June 1976 NAIC Meeting.

CHAPTER 6

THE REGULATION OF RISK CLASSIFICATION

Consumers purchasing insurance from the same company pay markedly different prices for the same level of coverage. In the case of automobile insurance, price differences are based on such factors as the use of the car; the age, sex, and marital status of the principal driver; and where the car is garaged. This process is known as risk classification, and it is one of the most controversial issues of insurance regulation. While there is little dispute that insurance companies should be able to charge more for demonstrably higher individual risks (and charge less for demonstrably lower risks), there is great controversy as to where the lines should be drawn between risk classes and, more particularly, whether certain classes of risk should be used at all.

Classification relativities are expressed as a factor by which the base rate for particular insurance coverage in a specific territory is multiplied. Other factors, such as type of automobile and driving record, may be added into the multiplying factor. For example, an unmarried 18-year-old male who is the principal driver of a car used for pleasure is assigned a relativity factor of 2.50 by one classification plan. If the base rate for 25/50/10 coverage in a particular location is $100, the 18-year-old male would pay 2.5 x $100, or $250 for insurance. (The actuarial data from which the relativities are calculated are based on national data for the Insurance Services Office (ISO) 1/ and for most direct writers.)

The number of classes used varies considerably by insurers, but nearly all companies use similar rating factors based on age, use of car, and driving record for older drivers. For younger drivers, the added factors of sex, marital status, and completion of a driver training course also determine the price. Some companies also give a good student discount to younger drivers in school.

1/ISO is the national rating bureau which pools loss data of its member companies and calculates and publishes combined loss information and advisory rates.

States in the cost of insurance. And, States with proportionately larger budgets have somewhat lower rates than other States.

REGULATION AND MARKET FAILURES IN THE AUTOMOBILE INSURANCE INDUSTRY

The fact that price regulation makes little difference in most States does not necessarily mean that it is not justified--only that it does not yield average prices that are much different from what they would be under open competition systems.

The automobile insurance market is characterized by several market failures: the need to guarantee future solvency, the externality problem, and the lack of consumer information. The question is whether price regulation is the appropriate regulatory response to these market failures.

Apart from solvency regulations, rate regulation has been the States' primary response to the various market failures associated with personal lines insurance. The assumption is that if the State directly regulates rates to assure that they are neither excessive nor inadequate, the consumer is relieved of the need to evaluate insurance companies or the value of policies.

Rate regulation, however, is not a complete substitute for other actions that can correct market failures that may hamper competition in the insurance market. In most prior approval States, companies are free to offer rates uniformly below State-mandated maximum rates, and many companies do so. Consumers may choose on the basis of price if they are aware of price differences, but generally they lack information on the relative value of insurance policies. As noted in chapter 4, most insurance departments do not adequately monitor the market conduct of insurance companies nor do they provide consumers with sufficient information to overcome the market failure of lack of consumer information. In competitive rating States, there also is no systematic effort to deal with these market failures. While consumer sensitivity to price is assumed and some States monitor market conditions, open competition States do not deal with problems of consumer knowledge any better than price regulated States.

While price regulation emerged to safeguard company solvency, the function of assuring solvency is now done primarily through direct financial requirements and examination. Price regulation, as currently implemented, bears little relationship to assuring company solvency.

Table 3

Mean Industry Adjusted Loss Ratios

Year and line of loss ratio	Competitive rating	Rate regulated
Combined 5-year industry loss ratio	65.6	66.4
5-year industry loss ratio - liability	64.9	64.3
5-year industry loss ratio - physical damage	66.2	68.5
Industry liability loss ratio:		
1977	62.1	64.3
1976	67.5	67.5
1975	70.4	68.2
1974	62.7	61.0
1973	62.2	60.3
Inaustry physical damage loss ratio:		
1977	59.8	63.9
1976	70.5	74.5
1975	76.3	79.5
1974	63.8	64.9
1973	60.7	59.8

Source: Calculations based on data from A. M. Best Co., Inc.

It has been thought that because it is more difficult to adjust to market changes and loss trends in prior approval States, there would be wider swings in the underwriting cycle in those States. Previous studies focusing on a few selected States found greater variation in losses between years in States that regulate insurance prices. However, using the standard deviation 1/ of the mean underwriting ratio for the

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1/The standard deviation is a statistic that summarizes the variation in a series of numbers. The greater the standard deviation, the greater the variation of the series of numbers around their average (arithmetical mean).

insurance companies. Indeed, even adopting the reductions in rate requests made by the department staff, insurance rates in Texas and Massachusetts were comparatively higher than the national average (adjusting for losses). 1/

Even in competitive rating States, insurance departments have a mandate that rates be neither excessive nor inadequate. Although competition is presumed to assure the reasonableness of rates, the departments still have administrative responsibilities to monitor rates--or at least to monitor the competition that is regarded as the prerequisite to reasonable rates. All the open competition States we visited monitored some aspect of insurance cost and competition. Only one, Virginia, has a documented system that monitors competition by periodically reviewing a variety of economic indicators of the health of competition.

THE ECONOMICS OF PRICE REGULATION

More fundamental than the procedures of rate regulation is the question of the need for regulation and the ultimate effects of price regulation. Our study examines (1) whether the private passenger automobile industry is characterized by an economic structure that requires price regulation; (2) what the price effects of rate regulation are; and (3) whether market failures justify insurance rate regulation.

Competition--opportunities and limitations

In terms of such factors as number of firms, degree of concentration, and barriers to entry, the automobile insurance market is competitively structured on a State-wide basis. However, there are limitations that may affect the degree of competition that is actually present. First is the problem of consumer information. Lack of information about the differences in quality among companies makes it difficult for consumers to compare policies. Second, insurance is compulsory in 25 States and physical damage insurance is effectively required everywhere so that consumers

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1/Comparative insurance prices in this and other sections of the chapter are measured by adjusted loss ratio, a widely accepted measure of insurance value. The loss ratio is the ratio of claims to premiums and represents the percentage of the insurance dollar that is returned to consumers as claims. Thus, the higher the loss ratio the lower is the price of insurance.

is also needed to guarantee that policyholders and claimants are fairly treated. The primary purpose of market conduct examinations is to identify those insurers engaging in unfair trade or business practices and to develop the basic information needed for appropriate regulatory action.

We found serious deficiencies in many of the market conduct examination reports. The most serious problem was the lack of explicit standards in evaluating companies. The NAIC Handbook for Examiners recommends that examination results be compared to minimum qualitative standards in order to determine relative company performance. Although all States have unfair trade practices laws, none of the market conduct examination reports we reviewed explained what the minimum qualitative standards were, or even identified if such standards were used to assess company performance. Therefore, it was impossible to tell from the examination reports whether errors and violations by companies were in the range of acceptable behavior or whether they constituted a pattern of widespread unfair business practices.

The review of claims handling also needs improvement. Although claims handling is reviewed during the market conduct examinations, in nearly all States the market conduct examinations did not present guidelines against which to measure claims handling performance. Moreover, claims handling was reviewed solely from the companies' perspective; only one State we visited included consumer input as part of the review process. Finally, none of the fieldwork States routinely monitor claims handling performance. Consequently, departments are unable to compare how insurance companies handle their claims.

In general, we found that State insurance departments do not have systematic procedures to monitor the performance of insurance companies. And, without systematic information these insurance departments cannot regulate as effectively as they should.

vencies during the period covered by the NAIC/McKinsey study. This suggests that the record of the past 5 years has not improved over the preceding decade. Moreover, in Illinois, which has more property-casualty companies domiciled than any other State, the insurance department has expressed concern that property-casualty insurers in that State are in some danger because they maintain inadequate loss reserves.

TRADE PRACTICE REGULATION

Because of the McCarran-Ferguson Act, consumers must look to State insurance departments to protect their interests in insurance transactions. We reviewed insurance department trade practice regulation, particularly with regard to complaint handling and market conduct examination procedures, and found that this aspect of regulation is seriously in need of improvement. Because the procedures of most departments are not systematic, the departments and the public are deprived of information that would be useful in evaluating insurance company performance.

Enforcement actions

There was substantial variation in the number of formal complaints by insurance departments against insurance companies and agents. The largest category of formal complaints was failure of agents to remit premiums to insurance companies. The next most numerous category was unfair or deceptive sales practices and failure to pay claims. Most departments reported that they more often used informal rather than formal procedures.

The ultimate penalty of suspension or revocation of license was rarely a result of enforcement actions. For the 3-year period from 1975 to 1977, there was an average of six revocations or suspensions of insurance company licenses in each State.

Handling complaints

For the most part, the insurance departments we reviewed were highly responsive to individual complaints, and most departments follow up on individual complaints at least to the extent of getting a response from the insurance company or agency. Most departments considered most complaints valid and reported that the majority were resolved in favor of the consumer. However, nearly all departments lack direct authority to order companies to pay disputed claims where there are factual questions at issue.

Table 2 - Continued

State	Dept. budget per million dollars premium volume	Dept. budget per number of domestic companies
Texas	1,729	31,162
Utah	1,828	49,237
Vermont	1,079	13,894
Virginia	943	34,173
Washington	1,257	49,450
West Virginia	716	21,056
Wisconsin	911	7,764
Wyoming	N/A	
District of Columbia	1,349	29,110

amount of premium taxes collected. However, premium taxes are primarily for the purpose of raising general State revenues and are not intended to be allocated specifically to regulation. Other revenues, which are more directly related to regulation, such as licensing fees, approximately equal the expenditures of State insurance departments.

Personnel

Insurance departments have several personnel resource problems.

- --The level of professional training represented on department staffs is rather low, particularly in actuarial science.

- --Nearly all States reported the need for additional staff. The greatest needs are in the areas of trade practice regulation and rate and policy form regulation.

- --Departments spend very little to upgrade the skills of their staffs.

- --Salary levels are low in relation to the salaries qualified professionals can earn elsewhere.

- --Although the senior staff have had many years of experience, the length of service of insurance commissioners has been declining and is now only an average of 3 years.

Table 1

Total Budget and Staff by State 1978

State	Budget	Staff	State	Budget	Staff
Alabama	$ 1,360,000	60	Nebraska	1,211,458	62
Alaska	670,000	19	Nevada	868,511	37
Arizona	1,116,000	61	New Hampshire	966,008	35
Arkansas	981,175	52	New Jersey	3,554,434	218
California	10,497,357	384	New Mexico	518,000	32
Colorado	965,000	56	New York	16,806,000	689
Connecticut	1,156,926	73	North Carolina	2,000,000	130
Delaware	2,674,700	20	North Dakota	321,258	16
Florida	9,779,406	456	Ohio	2,345,337	93
Georgia	b/2,468,100		Oklahoma	b/761,200	
Hawaii	290,084	16	Oregon	3,155,357	64
Idaho	483,300	21	Pennsylvania	5,317,000	232
Illinois	4,300,000	218	Rhode Island	438,538	26
Indiana	1,437,708	79	South Carolina	2,758,230	103
Iowa	1,536,612	69	South Dakota	218,051	14
Kansas	1,947,961	130	Tennessee	1,773,880	93
Kentucky	b/1,850,400		Texas	11,467,643	606
Louisiana	1,113,258	58	Utah	837,033	34
Maine	b/510,600		Vermont	236,200	15
Maryland	1,969,957	123	Virginia	2,084,525	85
Massachusetts	4,371,796	235	Washington	1,978,000	85
Michigan	4,352,901	165	West Virginia	463,235	28
Minnesota	1,258,786	63	Wisconsin	1,902,220	78
Mississippi	b/937,400		Wyoming	b/185,700	
Missouri	995,287	82	District of Columbia	677,300	24
Montana	382,831	19			
			Total	122,252,663	

Source: GAO questionnaire.

a/Data not provided or inaccurate. Budget estimated at 0.122 percent of the State budget.

b/For these States that did not respond to our questionnaire and for Kentucky who responded, but did not report budget data, we have estimated budget figures as 0.122 percent of the State budget which was the average percentage of those States that did report data to us. Connecticut also did not complete a questionnaire, but we obtained actual budget figures. The correlation between State government outlays and insurance department budget is 0.795.

CHAPTER 3

OVERVIEW OF STATE INSURANCE DEPARTMENTS:

GREAT VARIATION IN RESOURCES AND ACTIVITIES

Every State and the District of Columbia have an insurance regulatory department or bureau, most of which are separate administrative entities. In nearly all the States, the insurance department is headed by a single insurance commissioner, who is most often appointed by the governor.

INSURANCE DEPARTMENT WORKLOAD

We collected data on several aspects of insurance departments' workload, including company and agent licensing applications, rate filings, examinations, and policy form filings. For some activities such as rate filings, there were wide differences among the States that were not proportional to population. Other aspects of workload (complaint processing for example) were proportional to premium volume and to State population. We make several comparisons to the findings of the comprehensive survey (widely known as the O'Mahoney Report) of State insurance regulation conducted in 1957 by the Senate Judiciary Committee. 1/

Approximately 900 property and casualty insurance companies are licensed in nearly all States. Insurance departments have a measure of regulatory responsibility over the conduct of all those insurers--in-State (domestic) and out-of-State (foreign)--but their primary responsibility is over the domestic insurers.

INSURANCE DEPARTMENT RESOURCES

The total amount spent in 1977 by all State insurance departments was about $122,000,000--far more than the $16,906,000 spent in 1957. Even accounting for inflation, the 1957 figure represents only $36,217,338 when restated in 1977 dollars. In 1978, the median insurance department budget was $1,360,000.

1/U.S. Senate, Committee on the Judiciary, Subcommittee on Antitrust and Monopoly, The Insurance Industry: Aviation, Ocean Marine and State Regulation, 86th Congress, 2d sess. (1960); The Insurance Industry: Insurance: Rates, Rating Organizations and State Rate Regulation, 87th Congress, 1st sess. (1961).

classification systems result in substantial rate differences, which are not only inequitable but interfere with other important social goals such as incentives for preventing losses. 1/

THE PURPOSES OF INSURANCE REGULATION

Although early regulation developed to produce revenue and to protect domestic insurers against competition from foreign and alien insurers, the primary stated purpose of modern insurance regulation is to protect the public. Protection of the public involves three main goals. The first is to assure the solidity and solvency of insurance companies. So that the insurance system can provide security against future loss, the financial health of companies must be monitored, and policyholders and third party claimants must be protected against loss due to an insolvency. The second goal is that rates be neither excessive nor inadequate. Premiums paid by the insurance buyer should not be more than the worth of the coverage, and the rates charged by the company should be enough to keep the company financially solid. There is a subsidiary to this second goal--insurance should not be unfairly discriminatory. Individual insureds with the same risk exposure should be charged the same rate by an individual company. Finally, there should be a market available to those who need insurance and can reasonably qualify for it. 2/

Although the specific laws, resources, and regulatory philosophies vary among the States, there is considerable consistency in the basic functions of the insurance departments found in every State and the District of Columbia. According to the National Association of Insurance Commissioners (NAIC), the basic functions undertaken by State insurance departments are: 3/

1/See chapter 6.

2/C.A. Kulp and John Hall, Casualty Insurance, 4th ed., (New York: Ronald Press, 1968) p. 959. c.f. Spencer Kimball, "The Purposes of Insurance Regulation: A Preliminary Inquiry Into the Theory of Insurance Law," 45 Minnesota Law Review 471 (1961).

3/Jon Hanson, "An Overview--State Insurance Regulation," 31 CLU Journal, pp. 20-31 (April 1977).

pay for the future loss--in other words, the company must remain solvent. The interests of industry, consumers, and society in a risk-sharing system of assured solvency are so compelling that a government regulatory system is justified.

Lack of adequate consumer knowledge

The future solvency of an insurance firm is crucial to consumers. Most consumers cannot be expected to have enough information to evaluate the financial condition of a company, thus governmental regulation of certain financial matters is required. There are two other reasons why consumers do not have the information necessary to evaluate the quality and price of insurance. First, it is difficult for a layman to compare the monetary value of insurance policies. For example, the lack of a meaningful system of price disclosure in life insurance makes it impossible for consumers to compare the value of whole life policies. 1/ When policies offer diferent types and amounts of coverage, as is the case with supplemental health insurance, it is extremely difficult to judge the value of the policy. Even when the policy form is more standardized, as with automobile and homeowners insurance, it is hard for consumers to understand what they are buying because the laws of most States permit the policies to be written in obtuse legal language. Even assuming awareness, the consumer would be hard pressed to compare the value of dissimilar policies at different prices because the information necessary to make these comparisons is not available.

Another barrier to full consumer knowledge is the uncertainty of the quality of the service specified by the policy. All the consumer is buying is the promise of compensation for certain specified events. Unlike other products and services, the consumer cannot see or evaluate that promise until after the purchase.

Although there is evidence that insurance consumers are sensitive to price differences, their sensitivity does not imply awareness of quality differences. When sufficient information is not available to compare products and prices, or when consumers are not able to judge product quality before purchase, they are unable to choose the best product

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1/U.S. Federal Trade Commission, Life Insurance Cost Disclosure, Staff Report to The Federal Trade Commission (July 1979) pp. 70-81.

CHAPTER 2

BACKGROUND OF INSURANCE REGULATION

DEVELOPMENT OF STATE REGULATION OF INSURANCE

State regulation of insurance began when State legislatures granted charters to new companies. The sole regulatory requirements of the charters were periodic reports and public disclosure of the financial condition of the company. Not until 1851, beginning with New Hampshire, did the States start to create separate administrative entities to regulate insurance. In 1859, New York became the first State to create a separate administrative agency headed by a single superintendent who was vested with broad licensing and investigative powers.

Insurance regulation thus developed under the jurisdiction of the States. State jurisdiction was reaffirmed by the landmark decision of Paul v. Virginia (1868) in which the U.S. Supreme Court upheld a Virginia statute requiring the licensing of foreign companies and their local agents. The Court held that "issuing a policy of insurance is not a transaction of commerce" and therefore the insurance business would not come under the commerce clause of the United States Constitution. 1/

That doctrine prevailed until 1944 when the Supreme Court issued another major decision (U.S. v. South-Eastern Underwriters Association). 2/ Overturning the Paul v. Virginia precedent, the Court held that

> "No commercial enterprise of any kind which conducts its activities across State lines has been held to be wholly beyond the regulatory power of Congress under the Commerce Clause. We cannot make an exception of the business of insurance." 3/

The Court's decision threw the industry and State regulators into turmoil. In addition to casting doubt on the legality of private rating bureaus, the decision also cast doubt on the States' power to tax and otherwise regulate the

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1/8 Wall. 168, 183.

2/322 U.S. 533 (1944).

3/Ibid., 552-553

all lines of insurance. We have, however, reviewed the following general issues:

--The background and purposes of insurance regulation.

--The workload and resources of departments, including overall quantitative measures of workload and the division of resources between regulatory functions, such as budgets, quantity and qualifications of personnel, and the identified needs of departments.

--Departments' financial examination procedures.

--Consumer protection and trade practices regulation, including the extent and thoroughness of the departments' surveillance of insurance company trade practices, complaint handling procedures, and the monitoring of claims handling.

We focused our study on the regulatory issues surrounding automobile insurance because of its economic importance and because of congressional interest in the controversies generated by this line of insurance. With regard to automobile insurance, we reviewed three main controversies:

--Price Regulation. States have differing systems of regulating insurance premiums, ranging from no regulation of rates to State-made rates. We assess the procedures by which States monitor insurance rates and review the various effects of different systems of price regulation.

--Risk Classification. Classifying risks by geographical territory, age, sex, and marital status has become a major issue. We review the controversy and assess the extent to which the States have evaluated whether these risk plans constitute unfair discrimination.

--Insurance Availability. It is alleged that unfair discrimination makes automobile and property insurance unavailable to various groups. We reviewed State programs designed to improve insurance availability and monitor whether there is unfair discrimination.

shortcomings, many of the issues GAO raised are new and the insurance departments are responding to problems in a timely fashion. (See ch. 9.)

Although GAO makes no specific recommendation with respect to a Federal response to the cited shortcomings, GAO believes that the information and analysis in this report will prove useful to the Congress in evaluating the alternatives before it.

applications for insurance are rejected are not necessarily high risks. The protection of consumer interests in obtaining insurance needs improvement; specifically:

--While consumers are protected against arbitrary cancellation during most of the policy period, most State laws allow a "free look" period of 60 days during which an insurer can cancel coverage for any reason.

--In most States consumers do not have a right to be told why their application for insurance was rejected.

--None of the departments GAO examined routinely determined why individuals are placed in the assigned risk plan, and most did not know the number of clean risks in the plan.

--In some States, so-called substandard companies insure individuals (who otherwise would go to the assigned risk plan) at rates considerably in excess of those charged by the assigned risk plan, a situation that may indicate a serious problem of availability and consumer information. (See ch. 7.)

REGULATORY ORGANIZATION AND INDEPENDENCE

A number of advantages are claimed for State regulation of insurance. These include Federalism, innovation that can be tried on a State-by-State basis, increased effectiveness spurred by the threat of Federal intervention, and more responsiveness to local needs. GAO found evidence that affirms, as well as evidence that contradicts, all of these points. In particular, even though the system emphasizes localism, many insurance problems are national, and there would be economies of scale in performing some functions centrally.

Viewed retrospectively, the staff recommendations in the two States more accurately reflected actual loss experience than the rates recommended by insurance companies.

--Viewed on a statewide basis, the automobile insurance industry is structured to facilitate competition. However, there are limits to what competition can achieve due to a lack of consumer information, legal impediiments, selective underwriting, and other factors.

--There is little difference in the price of automobile insurance (measured by the loss ratio) between States that regulate insurance rates and those that do not.

--Using appropriate statistical analysis, GAO found that what differences exist are primarily accounted for by one State with relatively low insurance costs and, secondarily, by the relative size of the staff and budget of State insurance departments.

Insurance rates in the voluntary private passenger automobile insurance market need not be regulated if there is appropriate regulatory action to lessen the current limitations on competition. Specifically, much greater regulatory action is needed to provide consumers with enough information to enable the automobile insurance market to fulfill its competitive potential. In these circumstances, regulation of base insurance rates would be unnecessary, but regulation to prevent unfair discriminatory pricing would still be appropriate. (See ch. 5.)

AUTOMOBILE RISK CLASSIFICATION

Insurance companies base their automobile insurance premiums on the loss experience of the group to which the policyholder belongs. Since the 1950s, policyholders have been grouped according to age, sex, marital status, and the location where the automobile is garaged. Recently, some States have banned

INSURANCE DEPARTMENT RESOURCES

There is variety in the resources of the various State insurance departments. Some States spend far more than others with about the same population and amount of insurance business. In general, the number of individuals on insurance department staffs with relevant professional training is small, departments spend little to upgrade staff skills, and salary levels are low in relation to the salaries of similar professionals elsewhere. (See ch. 3.)

FINANCIAL AND TRADE PRACTICE REGULATION

Insurance departments are responsible for monitoring the compliance of insurance companies with legal requirements by direct examination and other means. Traditionally, their primary focus was the financial condition of the companies. More recently, there has been increased attention to other consumer protection requirements, and many States now perform market conduct examinations.

An earlier study of financial regulation sponsored by the National Association of Insurance Commissioners (NAIC) found a number of deficiencies in the process of financial regulation. The NAIC adopted many of the study recommendations, and revised its examination handbook. However, apart from increased use of the NAIC's "early warning system" to detect potential financial problems, most State insurance departments have not instituted the changes recommended by the NAIC-sponsored study 5 years ago. Most States do not have specialized examiners and few States have the capacity to do computerized audits. (See ch. 4.)

State insurance departments are also responsible for receiving and responding to complaints about insurance companies and agents. All departments examined by GAO were responsive to individual complaints, although the authority of departments to order corrective action is very limited. Moreover, most departments do not effectively utilize consumer complaints in other regulatory activities. The most

This is the Executive Summary of the GAO report "Issues and Needed Improvements in State Regulation of the Insurance Business." For a copy of the full report, please request report number PAD-79-72. Instructions for ordering GAO reports are printed on the inside back cover of this document.