PCI Property Casualty Insurers Association of America
Shaping the Future of American Insurance

ANALYSIS OF PROPERTY/CASUALTY INSURANCE RATE REGULATORY LAWS

Executive Summary

During the past 35 years, much in-depth research has been conducted to examine the different rate regulatory approaches; all studies conclude that the public benefits more under a system that allows greater rate competition than one that requires state approval. Less restrictive, or more market-oriented, rating laws rely on competitive forces to ensure that insurance rates are consistent with underlying costs. Insurers can react quickly to changing loss trends and implement rate increases or decreases in a timely fashion, hence keeping the market stable and strong. These types of laws operate to curtail excess profits, improve insurance availability, remove rate regulation from political volatility, and increase regulatory efficiency. Companies are also able to accept a wider range of insurance applicants.

On the other hand, prior approval laws assume that the state must intervene to ensure a proper balance between adequate and excessive rates; this may be difficult, if not impossible, to maintain as political pressures to provide low cost insurance may lead to rate levels that are insufficient to cover losses and expenses. Not only is there greater price inequity among policyholders in this type of environment, but added regulatory costs are created and passed on to consumers. Another concern is the additional underwriting risk that companies face due to the time lag from the review process; such delays make companies hesitant to lower rates for fear they will not be able to increase them when later needed.

Currently, 38 states and the District of Columbia have less restrictive rating laws in place, which take on different forms, i.e., flex-rating, file-and-use, use-and-file, no-file or no rating law. While most of these states have operated this way for many years, 11 states (Alaska, Connecticut, Georgia, Massachusetts, Nebraska, New Mexico, New York, North Dakota, Oklahoma, Rhode Island, and Texas) modernized their personal auto and/or homeowners insurance rate regulatory systems within the last decade.[1] Other states are considering similar changes, particularly toward flex-rating and file-and-use laws. Arguably the most prominent among these states is Massachusetts, which at one time had the most restrictive and least competitive auto insurance market in the nation.[2]

Indeed, the nation's insurance rate regulatory framework is trending toward greater rate modernization and away from more rigid and restrictive supervision. Even New Jersey, which is still a prior approval state, passed significant auto insurance reform in 2003.[3] The National Conference of Insurance Legislators and American Legislative Exchange Council, both comprising insurance lawmakers throughout the country, have also adopted property casualty model laws designed to eliminate prior approval systems; they advocate open competition instead.

[1] Louisiana also converted to a personal auto flex-rating system on January 1, 2004,[1] but reverted to a "modified prior approval" for political reasons when the Louisiana Insurance Rating Commission was abolished in January 2008. Under the modified system, rates are on file for 45 days before becoming effective.

[2] Effective April 1, 2008, Massachusetts personal auto rates are no longer set by the state and instead are determined by companies under a "managed competition" file-and-use system.

[3] New Jersey auto reforms (June 2003) include rate filings to be approved more quickly.

Assembly committee: Commerce and Labor
Exhibit: L Page 1 of 18 Date: 2/23/11
Submitted by: Jeanette Belz

Experience in certain states (e.g., Massachusetts, New Jersey and Florida) shows that rigid market and price controls have had detrimental effects on the public. In contrast, two benefits resulting from some states' move to greater rate competition are: (1) an increased number of insurers, offering consumers more choice in companies and products; and (2) the ability for insurers to better price their products, creating cost savings in the form of lower rate increases or even rate decreases.

New York is one state that has had a history of rotations in its personal auto rate regulatory law (the current law is flex-rating, effective on January 1, 2009). As such, it provides a good model to evaluate the impact of converting from one rating law to another. When the New York Department of Insurance twice examined an open competition vs. prior approval environment more than three decades ago,[4] it concluded the following:

"There are good reasons to believe that the return (to prior approval) would tend to make existing problems worse, bring back old problems, and limit the resources available to cope with other compelling needs. With regard to the cost of insurance, there is no evidence to suggest that prior approval would reduce the cost of insurance to the consumer. Indeed, if anything, it would tend to have the opposite effect. The return of prior approval would be particularly troublesome in the area of product availability."

"In general, insurers under prior approval would be likely to become less willing to write insurance than they are now because they would no longer be confident of their future ability to implement price changes, up or down, in accordance with changing experience. In addition, a reduction in the variety of prices available in the market would reduce the alternatives that are open to many consumers."

"A review of the particular alternatives (to the competitive rating law), especially a return to prior approval (in New York), indicates that these problems would be made worse, not better, by the alternative approaches."

When New York converted from prior approval to a flex-rating law beginning in 1995, drivers in this state saw benefits. Specifically, auto insurance rates stabilized or reduced immediately thereafter and the number of insurers increased by 28 percent during its six-year flex period, providing greater coverage options from which to select. But when the state reverted to prior approval in 2001, policyholders saw larger increases in their premiums as well as a decline in their choice of auto insurers. Since New York's latest rate regulatory change took place less than two years ago, there are insufficient data to determine the latest impact.

Finally, it should be noted that competition-based systems do not cost the public more money. Rather, the group of states with these types of laws has lower insurance prices than the group of prior approval states. Insurance carriers also do not arbitrarily file for large unwarranted rate revisions when they have greater rate flexibility. Rate increases after states modernized their laws were found to be quite low; many were, in fact, decreases. Furthermore, insurers operating in an environment with greater rate competition do not make more profit. Although profit levels are not impacted by the type of rate regulatory law, they do tend to be more stable under a less stringent rating system.

[4] State of New York Insurance Department, *Competition in Property and Liability Insurance in New York State,* 1973, and *The Open Rating Law and Property-Liability Insurance: An Evaluation of Insurance Price Regulation*, 1977

Introduction

A primary objective of insurance regulation is to ensure that carriers are financially sound and the market is sufficient so consumers can receive the most efficient flow of services at the lowest possible prices. Today, all states have insurance departments created to oversee rates charged by insurance companies, among other functions.

Every state subjects insurance ratemaking to a specified type of statutory regulatory control for at least one line of business. Although the type of control varies by state and by line of business, the purpose of all rating laws is to ensure that rates are not excessive, inadequate or unfairly discriminatory. These three principles of rate regulation are explicitly stated in the All-Industry model statutes adopted by the National Association of Insurance Commissioners (NAIC) in 1945.

In general, rate regulatory systems range from state-made rates to open competition; state laws are sometimes said to fall under one of two broad categories: those that are "prior approval" or those that are "more market-oriented" or "competition-based." Further variations exist in each of these categories (for brief descriptions of these rating laws, see Appendix I). It should not be assumed that competition among insurers does not exist in states having prior approval laws. All rating laws, regardless of the level of price controls, strive for the same goal, that is, to have the lowest possible insurance prices for consumers. However, these laws differ in two important ways: (1) the focus of the regulator's attention; and (2) the timing of rate filings.

Political pressures that often co-exist with prior approval regulation may lead to artificially lower rates that are not sufficient to cover related losses and expenses. Consequently, prices in states with prior approval laws usually result in higher loss ratios and higher rate changes. Furthermore, increased insurance availability is discouraged and additional regulatory costs are imposed under these more rigid controls; such costs ultimately are passed on to consumers.

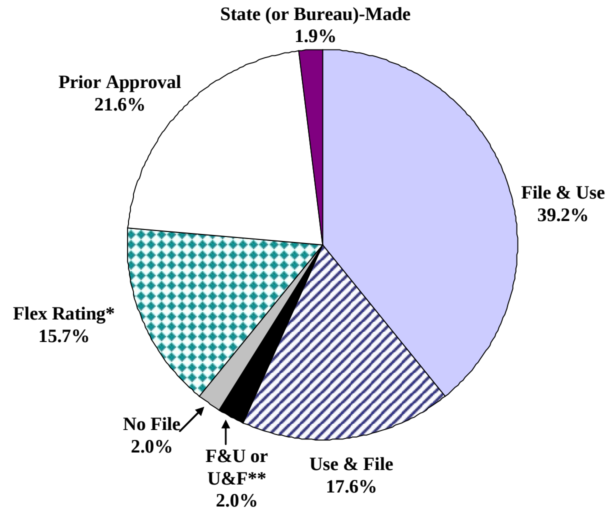
On the other hand, more market-oriented rating laws rely on competitive forces to keep insurance rates consistent with underlying costs; in this way, prices are fair for everyone as rates more accurately reflect insured risks. This approach is a more efficient way of setting insurance rates because it is self-adjusting. If insurers set rates too high or too low, the market adjusts to drive rates to the competitive level. Greater rate competition has the ability to stabilize the market by smoothing any fluctuations in rate adjustments. Moreover, innovation will be stimulated, thus making a wider variety of product, price, and service combinations available to consumers.

Consumers in states with more rate competition generally pay less for their insurance coverage than their counterparts in prior approval states. This is due to the lack of political influences and delays in having to wait for state approval. As a result, the premiums that are implemented will more likely be able to cover necessary losses and expenses, which in turn produce more favorable underwriting gains. Insurers therefore do not need to raise their rates as often under this type of system, and they are more willing to provide rate decreases as well, when warranted, to the benefit of their customers.

Less stringent rating laws by no means imply that regulators have given up oversight of insurance companies. There are other ways, such as licensing requirements, solvency regulation, market conduct surveillance and monitoring consumer complaints by which state insurance departments can devote more of their resources to ensure fair, nondiscriminatory markets.[5]

The vast majority of states' rate regulatory laws now embody some form of competition-based rating. For personal auto business, 30 states representing 58.8 percent of all U.S. jurisdictions have a use-and-file, file-and-use, or no-file system (Illinois has no rating law, as it does not allow for disapproval of rates; it is classified with the use-and-file states since companies must make informational filings). Eight other states or 15.7 percent have a flex-rating law,[6] while the remaining 25.5 percent still operate under a more restrictive prior approval law (in this group of 13 states, one[7] of them still uses rates developed by the state rate bureau) (Figure 1).

Figure 1
Distribution of States
by Personal Auto Rate Regulatory Law



***Pennsylvania is included in the flex-rating group, even though flex applies to rate decreases only.**
**** Insurers have the option of selecting either file-and-use or use-and-file in Florida.**

The movement away from prior approval rating laws toward more modernized rate-filing regimes has also been driven in part by state legislators. Both the National Conference of Insurance Legislators (NCOIL) and the American Legislative Exchange Council (ALEC) have adopted model laws designed to eliminate prior approval laws in jurisdictions where they exist. (For additional information on the NCOIL and ALEC model laws, see Appendix II.)

[5] Among its many duties, the New York Department of Insurance (DOI) oversees insurer and producer activities to protect consumer interests, ensures that policies comply with state law, and resolves any disputes between consumers and insurers. Using financial statements regularly submitted by insurers, the DOI evaluates their accounting procedures and conducts periodic examinations to ensure their financial soundness.

[6] Although Pennsylvania's flex-rating law applies only to auto rate decreases, it has been placed into this category in this analysis.

[7] North Carolina utilizes a mandatory bureau rating system, whereby insurers are required to become members of a rating organization in order to write given lines of insurance.

National Trend Toward Greater Rate Competition

Thirty-nine jurisdictions now allow for some or all personal auto[8] rates to be adjusted without prior approval by the insurance commissioner. These jurisdictions are:

Alaska	Illinois	Missouri	Pennsylvania
Arkansas	Indiana	Montana	Rhode Island
Arizona	Iowa	Nebraska	South Carolina
Colorado	Kansas	New Hampshire	South Dakota
Connecticut	Kentucky	New Mexico	Texas
District of Columbia	Maine	New York	Utah
Florida	Maryland	North Dakota	Vermont
Georgia	Massachusetts	Ohio	Virginia
Idaho	Michigan	Oklahoma	Wisconsin
	Minnesota	Oregon	Wyoming

Within the last few years, Alaska, Connecticut, Georgia, Massachusetts, Nebraska, New Mexico, New York, North Dakota, Oklahoma, Rhode Island and Texas have been the latest to make changes toward greater rate competition in personal auto. Louisiana had also converted to flex-rating in 2004, but for political reasons went to a "modified" prior approval system[9] when the Insurance Rating Commission dissolved in 2008.

Positive changes for consumers have been observed in some states that have amended their rating laws. Two of the more common benefits seen are:

- more insurers entering the state, allowing consumers more choices in companies and products; and
- lower rate increases and rate decreases that benefit insured drivers.

History of New York Experience During Flex-Rating and Prior Approval

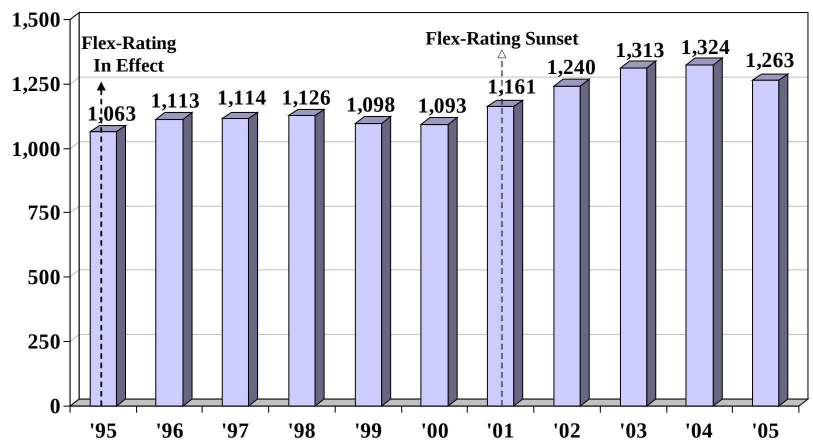
New York first transitioned from prior approval to flex-rating in 1995 and then reverted to prior approval in 2001. With a 2007 annual average premium of $1,179, this state is now ranked 4th highest in the nation. After New York's flex-rating law went into effect in mid-1995, its average premium remained the same for two years. During its flex-rating period (1996-2000), insured drivers paid an annual average of $1,109 for liability and physical damage premiums.[10] The average premium had been stable or declining; dropping from a level of $1,113 in 1996 to $1,093 in 2000, the premium fell 1.8 percent overall. After flex-rating sunset, the average premium rose 13 percent in just two years, from $1,161 in 2001 to $1,313 in 2003 (Figure 2).

[8] The type of rating law varies according to the product line. Personal auto is fairly representative of the way rates are regulated in other lines, even though there are variations in some states with respect to auto and homeowners (or commercial auto, medical malpractice, etc.).

[9] Under Louisiana's modified prior approval system, rates are on file for 45 days before becoming effective.

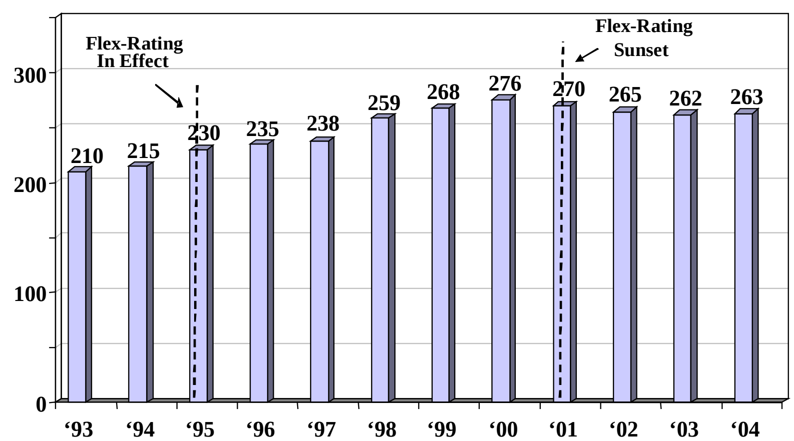
[10] The average of $1,109 is the arithmetic mean of the premiums during the five years 1996-2000. Source: NAIC *Auto Insurance Database Report, 2006/2007*, 2009 edition

Figure 2
Trend in New York Average Auto Premium
Before and After Flex Sunset



In addition, when the New York regulatory system changed to a less restrictive rating law in 1995, the number of insurance carriers grew 7 percent (from 215 companies in 1995 to 230 companies in 1995). The level continued to grow, accelerating to 276 companies five years later. However, after the law sunset in 2001, there was an immediate reduction, whereby the number of writers dropped steadily (Figure 3).

Figure 3
New York
Growth in Personal Auto Insurers
After Flex-Rating Went into Effect



It is believed that insurance companies are encouraged to write business when a more competitive rate regulatory system is adopted. Those that do not write in a state with this type of environment are now more willing to enter the market under these conditions. But when a regulatory system reverts to one with less freedom, such as prior approval, companies no longer want to operate there and, hence, they withdraw from the market. As one noted economist asserts: "persistent rate suppression should produce reductions in product quality or exit by insurers."[11] This is clearly the case observed in New York's earlier transitions from prior approval to flex-rating and back to prior approval.

Effective January 1, 2009, New York once again converted to a flex-rating system. It is too soon to tell what the positive effects of flex-rating are.

Less Restrictive Rating Systems Do Not Cost Consumers More Money

It is sometimes presumed that companies will seize the opportunity to implement large rate increases under a system with greater price freedom, knowing that these rates will not need regulatory approval. This is clearly not the case, as insured drivers in states that went to greater rate competition saw immediate cost benefits.

Six leading auto insurance companies implemented rate reductions (one as large as 10 percent) or no rate change at all following South Carolina's regulatory modernization. In a March 2004 letter, Dean Kruger, the former chief actuary at the insurance department, wrote, "the assumption used under the prior approval law was that requiring insurers to lower requested rate increases saves money for consumers. If such an assumption were accurate, then premiums should have increased during the implementation. In fact, they dropped and this indicates that the competitive marketplace is the more effective in controlling rate levels."

These sentiments were echoed by former Louisiana insurance commissioner, J. Robert Wooley, who claimed that policyholders benefited when his state converted to greater rate competition: "Insurers aren't as reluctant to reduce rates when business is good because they know they can also raise rates without incurring a political battle." After the change, State Farm Mutual Auto Ins. Co. policyholders received an average $20 rate reduction, or an overall cost savings of $19.3 million.[12]

Even Massachusetts – once considered the most heavily regulated state in the country – has eased its rigid rules pertaining to auto insurance rates. In response to the regulatory change, effective April 1, 2008, companies filed rate reductions for their policyholders, some up to 25 percent. Innovative product features in the form of additional discounts and new endorsements (e.g., accident forgiveness and sliding-scale deductibles) were also implemented.

In states where insurers are allowed to operate more competitively, their policyholders generally have more affordable insurance.[13] Prior approval systems inevitably cause low-risk consumers to pay inflated (and unfair) rates because they are forced to subsidize high-risk consumers who often are not charged a rate commensurate with their level of risk. This in turn leads to both adverse selection (i.e., higher-risk drivers buying more insurance or choosing lower deductibles) and moral hazard (i.e., drivers having less incentive to mitigate their risk or avoid high-risk behavior), which result in higher claim costs.

As discussed earlier, insurers in a more market-oriented system can respond to competitive market conditions and determine appropriate rate level changes more quickly. Rather than costing consumers

[11] Scott E. Harrington, "Rate Suppression," *The Journal of Risk and Insurance*, June 1992

[12] *The Baton Rouge Advocate*, January 21, 2005

[13] While insurance prices are influenced by rating laws, the primary driver of rates should be insured costs.

more money, these less restrictive laws would help them save money through lower rate increases or rate decreases.

Using the latest NAIC data (Table 1), personal auto insurance rate levels are 8.3 percent lower for the group of states with fewer controls than the group of states with more controls ($878.08 – more market-oriented vs. $957.96 – prior approval).[14]

Table 1 **Personal Auto** **Average Annual Insurance Premiums – 2007**		
Type of Rating Law	Liability & Physical Damage Premium	Premium Differential
Prior Approval	$957.96	--
More Market-Oriented	$878.08	8.3 percent less
State classifications are made reflecting their status in 2007. *Source: NAIC Auto Insurance Database Report, 2006/2007, 2009 edition*		

Impact of Rate Regulatory Laws on Insurer Profitability

Questions have also been raised regarding the impact of rate regulatory laws on insurer profitability. It should be noted that the type of rating law does not affect the level of profits made by insurance companies. According to the NAIC, there is no statistical difference in profitability between those states with greater price restrictions and those with fewer restrictions.[15] While other factors – such as unforeseen losses, operating efficiency and price competition – have a more significant impact on an insurer's financial performance than does the type of rate regulation, more market-oriented systems lead to efficient allocation of resources, thus eliminating excessive rates and profits.[16]

Although the magnitude of profitability is not affected by the type of rate regulatory law, research conducted by different individuals and groups finds that regulatory systems with more price controls increase the variability of underwriting profits.[17] In other words, insurers face greater underwriting uncertainty in states that require prior approval of rates, while profitability tends to be more consistent in states that do not require approval (Figure 4).

---

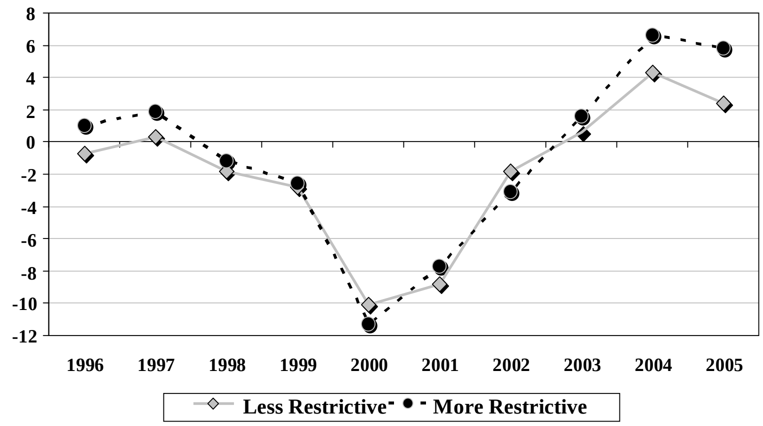
[14] NAIC, *2004/2005 Auto Insurance Database Report*, 2007

[15] NAIC, *Monitoring Competition: A Means of Regulating the Property and Liability Insurance Business*, May 1974

[16] Emilio Palermo, "The False Face of Prior Approval," *Best's Review: Property/Casualty*, July 1991

[17] Sharon Tennyson, "The Effect of Rate Regulation on Underwriting Cycles," *CPCU Journal*, March 1991; Orin S. Kramer, *Rate Suppression and Its Consequences: The Private Passenger Auto and Workers' Compensation Experience*, 1991; and Virginia Insurance Bureau, *Competition in the Property and Casualty Industry*, January 1978

Figure 4
Personal Auto Underwriting Profits
(as a percent of earned premiums)



While the 10-year trends in profitability for both more restrictive systems and less restrictive systems are seen to almost parallel one another, the difference between the maximum and minimum underwriting profit levels in the former group of states is 3.5 points larger than in the latter group of states [17.9 points – more restrictive rating vs. 14.4 points – less restrictive rating; these are the differences between the 2000 (minimum) and 2004 (maximum) returns for both groups].[18]

One reason for greater stability in profit levels among the group of more market-oriented rating states is that insurers have the opportunity to change rates more quickly in accordance with varying loss experience. Since companies are able to price their policies more accurately in this type of environment, they feel more comfortable in reducing rates if warranted because they realize that they can increase them later if needed. This was observed in states, such as Louisiana, South Carolina and Texas, all which moved toward greater rate modernization.

Academic and Governmental Literature on Rate Regulatory Laws

The subject of insurance rate regulation has been one of great interest over the last 35 years. Regulators and other government officials, academicians, and economists who have examined the different regulatory approaches all conclude that a more market-oriented rating law provides additional benefits to consumers. Some findings are cited below (for a comprehensive bibliography of different studies and presentations on this issue, see Appendix III).

- "A review of the particular alternatives, especially a return to prior approval, indicates that these problems would be made worse, not better, by the alternative approaches."[19]

- "If consumers in competitive rate states fare as well or better than they did in 'non-competitive' rate states, there appears to be no empirical economic justification for the regulation of automobile

[18] NAIC, *Profitability By Line By State*, 2005 edition
[19] State of New York Insurance Department, *The Open Rating Law and Property-Liability Insurance: An Evaluation of Insurance Price Regulation*, 1977

insurance rates by regulatory authorities, especially when considering the costs of regulating rates."[20]

- "…prior approval regulation of rates entails direct and indirect costs and serves no useful purpose in modern, competitively structured insurance markets. Rather, the insurance-buying public would benefit from deregulation of rates."[21]

- Supreme Court Justice Hugo L. Black opined that the philosophy of a less regulated market….
  "rests on the premise that the unrestrained interactions of competitive forces will yield the best allocation of our economic resources, and lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic, political and social institutions."[22]

The ***Property Casualty Insurers Association of America (PCI)*** *is a national trade association consisting of more than 1,000 insurers of all sizes and types that write 40 percent of the auto, homeowners, business and workers compensation insurance. PCI members represent 39.5 percent of the total personal auto and homeowners markets throughout the country.*

[20] Robert C. Witt and Harry Miller, "Is Auto Insurance Rate Regulation Necessary?" *Best's Review, Vol. 81, No. 8*, Dec. 1980
[21] Scott E. Harrington, AEI-Brookings Joint Center for Regulatory Studies; *Insurance Deregulation and the Public Interest*, 2000
[22] *Northern Pacific R. Co. vs. United States 356 U.S. 1 (1958)*

APPENDIX I

SUMMARY OF INSURANCE RATE REGULATORY LAWS

Historically, property/casualty insurance rate regulatory laws were enacted to protect price-fixing cartels from prosecution under the federal anti-trust laws. Under the McCarran-Ferguson Act of 1944, the insurance industry's rate-fixing activities are exempt from anti-trust laws to the extent that they are regulated by the states.

This appendix briefly discusses seven variations of insurance rate regulatory control; they are: (1) state- or bureau-made; (2) prior approval; (3) flex-rating; (4) file-and-use; (5) use-and-file; (6) no file; and (7) no rating law. These laws can vary by line of business. In addition, further differences in the filing of rates (and forms) can and do exist, depending on specific provisions and insurance department practices.

(1) State- or Bureau-Made

Under this regulatory system, rates are set by a state agency or rating bureau. Currently in Massachusetts, the insurance commissioner establishes personal auto insurance rates after he or she finds an "absence of competition." Effective in April 2008, however, rates will be determined by each company through "managed competition" and are still subject to insurance department disapproval.

North Carolina utilizes a mandatory bureau rating system, whereby insurers are required to become members of a rating organization in order to write given lines of insurance. Rates used by the rating organization must undergo the prior approval process. Insurers are usually allowed to deviate upward or downward from rates set by the rating bureau, subject to some constraints, including prior approval.

(2) Prior Approval

In prior approval states, rates, rules and rating plans must be filed with the regulatory authority, who must then approve or disapprove the filing before it can go into effect. The system essentially relies on the regulator's judgment and the existing political climate. Many prior approval laws have a "deemer" provision which allows companies to use rates if they are not approved or disapproved within a certain time period. In other words, rates are "deemed" approved.

(3) Flex-Rating

In an attempt to provide price stability for the public, "flexible rating" (flex-rating) combines the principles of prior approval and file-and-use or use-and-file rating (see below); under this system, various bands of rate level increases or decreases are established for designated lines. Flex-bands define the percent ranges in which revisions for these markets may take effect without prior approval. That is, rate revisions within a designated percentage flex band may be used without approval, while those outside the band must be authorized by the regulator. Percentages range from 5 percent to 25 percent, but more are within 5 to 10 percent.

Flex-rating provides insurers flexibility to determine appropriate rate level changes, allowing companies leeway to respond to competitive market conditions. The proper administration of this plan would enable the regulator to assess at an early stage whether rates are reasonable, inadequate or excessive.

(4) File-and-Use

Under "file-and-use" laws, rates must be filed with the regulatory authority no later than the proposed effective date. Rating laws of this type generally do not state what happens once the effective date has elapsed. Rates can be put into use without advance approval of the regulator in most cases, but in some instances, a waiting period is imposed before the rates can be used. Moreover, rates are subject to review and possible disapproval after they have taken effect (this type of statute is also sometimes referred to as a "subsequent disapproval" law). If filings are made by a rating organization on behalf of insurers, rates must be adhered to by the insurer unless the insurer files for a deviation.

(5) **Use-and-File**

Under a "use-and-file" law, rates become effective on the filer's chosen effective date and may be used prior to filing with the regulator. Copies of the filing must be submitted to the regulatory agency within a specified time pursuant to the applicable law. They are typically filed for information purposes only. Rates are subject to review and possible disapproval after they have taken effect.

(6) No File

States with "no file" laws make no requirement that rates be filed or affirmatively approved by the commissioner. Rates are subject to review and possible disapproval after they have taken effect.

(7) No Rating Law

Illinois is the only state that does not have a rate regulatory law for most lines of business, applicable to voluntary risks.[23] It is said to operate in an "open competition" environment. Although rates are not directly controlled by the regulator, they are still subject to the provisions of the state antitrust laws.

[23] Rates for the residual market are regulated in Illinois, and filings must be submitted to the insurance department 10 days after first use.

APPENDIX II

EFFORTS BY STATE LEGISLATOR ORGANIZATIONS TO MODERNIZE INSURANCE RATE REGULATION

In 2001, the National Conference of Insurance Legislators (NCOIL) adopted the "Property/Casualty Insurance Modernization Act," which establishes a use-and-file rate regulatory system for personal lines of insurance, and a no-file system for commercial lines. The model exempts policies sold to large, sophisticated commercial insurance buyers from all forms of rate regulation. In 2004, NCOIL adopted a second model bill aimed squarely at reforming prior approval laws – the "Property/Casualty Flex-Rating Regulatory Improvement Act." As its title implies, this measure establishes a flex-rating system, under which an insurer's rate filing takes effect immediately upon the filing date, provided that the filing entails an overall statewide rate increase or decrease of no more than 12 percent in the aggregate for all coverages that are subject to the filing.

Both NCOIL models contain language noting that they are "intended for consideration in jurisdictions with a more restrictive rate-filing and review system than outlined in the bill" – an obvious reference to prior approval laws. The 2004 NCOIL model act further advises that "states may also wish to consider implementing a competitive rating law, such as the National Conference of Insurance Legislators Property/Casualty Insurance Modernization Act."

The American Legislative Exchange Council (ALEC) adopted its "Property/Casualty Insurance Modernization Act" in 2004. Like the NCOIL model act of the same name, the ALEC model establishes a use-and-file rate regulatory system for personal lines of insurance, a no-file system for commercial lines, and allows policies sold to large, sophisticated commercial insurance providers to be exempt from all rate and regulatory requirements. The bill's summary pointedly notes that its purpose is to "create a more competitive and less onerous regulatory environment in the property/casualty insurance industry." The ALEC model leaves no doubt that it is aimed squarely at prior approval rating laws, noting, like the NCOIL model bills, that it is "intended for consideration in insurance regulatory jurisdictions with a more restrictive rate filing and review system than outlined in the bill."

NCOIL's membership consists of legislators representing 36 states; most serve as chairmen or members of the committees responsible for insurance regulation in their respective state capitols. ALEC is the nation's largest nonpartisan individual membership association of state legislators, with more than 2,400 members nationwide. The NCOIL and ALEC model laws reflect a broad national consensus among lawmakers that overly restrictive rating laws distort insurance markets and harm consumers.

The fact that these two diverse, nonpartisan organizations of state legislators from across the country have endorsed measures that promote varying degrees of rating freedom constitutes a forceful repudiation of prior approval insurance rate-filing systems. If Colorado were to replace its current file-and-use system with a retrograde prior approval regime, it would be defying the accumulated wisdom of most of the country's insurance lawmakers.

APPENDIX III

SUMMARY OF STUDIES EXAMINING THE PERFORMANCE OF INSURANCE RATE REGULATORY LAWS

The following is a list of studies conducted over the last 35 years examining the performance of different property/casualty insurance rate regulatory laws. These analyses were performed by academicians, economists and government agencies. Compared to prior approval laws, all conclude that less restrictive rating laws provide greater benefits in the form of price stability, more product availability and consumer choices, lower regulatory costs, improved efficiency, and a more stable market to the insurance-buying public.

1. **The Impact of Rate Regulation on Claims: Evidence from Massachusetts Automobile Insurance,** Richard A. Derrig and Sharon Tennyson *(Preliminary draft presented at the American Risk and Insurance Association Annual Meeting, Quebec City, August 5-8, 2007)* http://www.aria.org/meetings/ARIA_2007_Program.pdf

   This study analyzed the relationship between price subsidies and insurance cost growth comparing annual state level data on loss costs per car for Massachusetts compared to those in other states during the time period 1972-1998. The analysis showed that the rate regulation/control used by Massachusetts resulted in liability loss cost levels 43 percent over that in the remainder of the U.S. market with the same demographics and liability coverages during 1978-1995, when premiums were fixed by the state. This may be attributed to efficiency losses from the class and price cross-subsidy providing restrictions that resulted in excessive cost growth through the over-purchase and over-use of the insurance system by high-risk insureds.

2. **Efficiency Consequences of Rate Regulation in Insurance Markets – Policy Brief**, Sharon Tennyson, *Networks Financial Institute at Indiana State University* (March 2007) 2007 PB-03

   This study critically examines the arguments for rate regulation and discusses the consequences of this regulation for the insurance marketplace. It discusses the consequences of rate regulation for insurance market outcomes making use of both economic theory and empirical evidence from academic studies of regulated insurance markets. The paper concludes that insurance rate regulation entails high costs for society and for insurance consumers, and that alternative policies for meeting regulatory objectives should be considered. Rate regulation distorts market functioning in many ways. Regulatory attempts to reduce prices by holding down insurer profits have been shown to adversely affect insurance availability and to distort market structure. Regulatory pricing that is substantially below risk-based premiums for some consumers has been shown to lead to larger residual markets and to higher average insurance costs for all.

3. **Effects of Prior Approval Rate Regulation in Auto Insurance, in., Deregulating Property-Liability Insurance**, J. David Cummins, ed. *(Washington, D.C.: AEI-Brookings Joint Center for Regulatory Studies)* (2002) 285-314

   The main results, which confirm and extend those of several previous studies, suggest that on average, prior approval regulation had little or no effect on the relationship between rate levels and claim costs over time; however, it did reduce coverage availability and increased volatility for both insurers and consumers. This finding is consistent with an inability of rate regulation to reduce average rates materially and persistently in competitively structured markets without significantly reducing product quality or ultimately causing widespread exit by insurers. Prior approval regulation is reliably associated with lower availability of coverage, nevertheless.

4. **Auto Insurance Reform: Salvation in South Carolina**, M.F. Grace, R.W. Klein, and R.D. Phillips, 2002, *in J. D. Cummins, ed. Deregulating Property-Liability Insurance. (Washington, D.C.: Brookings Institution Press)* (2002) 148-194

   From the mid-1970s through 1998, South Carolina intensively regulated auto insurance. Rate levels and rate structures were restricted, insurers' underwriting discretion was limited and large cross subsidies were channeled through its residual market. After several earlier attempts failed, the legislature was successful in enacting a comprehensive regulatory reform package that became effective in 1999. South Carolina's prior approval system was replaced by flex-rating and restrictions on risk-based pricing and underwriting were substantially eased. The number of insurers writing auto insurance has doubled with the implementation of the reforms. Many insurers have implemented more refined risk classification and pricing structures, as well as alternative policy options for consumers. It also appears that overall rate levels have continued to fall.

5. **Deregulating Property-Casualty Insurance Pricing: The Case of Workers' Compensation**, A. Barkume and J. Ruser, *Journal of Law and Economics* (2001) 44: 37-64

   Property and casualty lines of insurance have traditionally been subject to more regulatory price control than most goods in the U.S. economy. However, beginning in the 1970s, some states began to deregulate these lines of insurance, either dropping mandatory pricing in concert by means of rating bureaus or, additionally, dropping regulatory prior approval of premiums. This paper assesses the impact of rate deregulation in workers' compensation insurance. Besides examining the impact of deregulation on price, effects on injury rates were examined, as rate regulation may have reduced incentives for workplace safety by restricting price differences across risk classes. It was found that eliminating both rating bureau pricing and prior approval reduced long-run premiums by 13.7 percent and reduced injury rates at most by 8.2 percent. In contrast, eliminating rate bureau pricing only had small effects.

6. **Insurance Price Deregulation: The Illinois Experience**, Stephen P. D'Arcy, *Presented at the Insurance Rate Regulation Conference Brookings Institution* (January 2001 Revised: May 14, 2001)

   Illinois has functioned without a rating law since 1971, and experience in this state suggests that rate regulation for automobile insurance is unnecessary. Auto insurance is widely available from a large number of competitors. Rate changes are frequent, modest and appear to follow claim experience. Loss ratios and the size of the uninsured and residual markets, as well as insolvency assessments, are in line with those in states with less restrictive systems. Thirty-five years of experience suggests that the auto insurance market functions effectively with no rate regulation.

7. **Proactive Strategies, Meeting the Market: Re-Engineering State Regulation of Commercial Insurance**, Philip R. O'Connor and Eugene P. Esposito (January 1999)

   Traditional rate regulation and burdensome policy form regulation are imposing unnecessary transaction costs because they ignore the actual balance of information in the modern risk protection insurance market. This report recommends that states adopt a "new paradigm" for commercial insurance regulation offering consumer benefits that flow from vigorous price competition and flexibility in product offerings.

8. **Does Rate Regulation Alter Underwriting Risk?**, *Journal of Insurance Issues*, Michael M. Barth and William R. Feldhaus (Spring 1999) Vol. XXII, No. 1

   This research shows that underwriting results are more stable, and thus underwriting risk is lower, in those states that insurers perceive to have less restrictive regulatory environments.

9. **The Effect of Open Competition Law on Insurance Price in Property and Casualty Insurance**, *Journal of Business and Behavioral Science*, (Fall 1997) Vol. 3, No. 1

   The study addresses the insurance price regulation issue in auto and homeowners insurance, and makes an attempt to find whether insurance rates in Illinois are lower and less volatile than in other states where rates are regulated. The analysis of premiums and loss ratios indicates that Illinois policyholders do not pay higher premiums than residents in other comparable states. Auto and homeowners premiums are lower in Illinois than in other states. The loss ratio of all lines does not seem to indicate higher premiums in Illinois. The open competition law in Illinois can deserve partial credit for lower premiums in the state.

10. **Rate Suppression, Rate-of-Return Regulation, and Solvency**, Orin S. Kramer, *Journal of Insurance Regulation* (1992) 10 J. Ins. Reg. 523

    The article concentrates on efforts at rate suppression and rate-of-return regulation in private passenger auto and workers' compensation lines of insurance. The author measures the quantitative effects of rate suppression on insurer finances and concludes that rate suppression increases in solvency risks, produces price inequities among insureds, increases residual markets, increases premiums in the voluntary market, and restricts the availability of insurance coverage.

11. **Auto Insurance in Michigan: Regulation. No-fault, and Affordability**, Scott E. Harrington, *Journal of Insurance Regulation 10* (1991) pp. 144-183

    The report evaluates the private passenger auto insurance market in Michigan. The analysis suggests that additional restrictions on underwriting and rate classification should be avoided. Instead, consideration should be given to allowing more discretion in underwriting and classification to provide insurers and policyholders with better incentives for controlling claim costs. The analysis also suggests that the state's no-fault system could be improved by allowing policyholders significant choice in the selection of personal injury protection levels and by taking steps to ensure that tort liability for non-economic loss is restricted to serious injuries.

12. **Price and Availability Tradeoffs of Automobile Insurance Regulation**, Henry Grabowski, W. Kip Viscusi, and William N. Evans, *The Journal of Risk and Insurance* Vol. 56, No. 2 (June 1989) pp. 275-299

    This study provides an early analysis of auto insurance regulation and deregulation efforts. The analysis focuses on a thirty-state sample from 1974 through 1981 and on the experience of eleven deregulated states. The states that undertook deregulation over the past two decades experienced reduced unit prices and decreases in the size of the involuntary market.

13. **The Impact of Rate Regulation on Automobile Insurance Loss Ratios: Some New Empirical Evidence**, Scott Harrington, *Journal of Insurance Regulation* (1984) 3:182-202

The objective of the paper was to provide further evidence of the impact of prior approval regulation on auto insurance loss ratios. The overall result of the studies suggests that average loss ratios were significantly higher in prior approval states than in more market-oriented rating states.

14. **Benefits and Costs of Insurance Deregulation**, Irwin M. Stelzer and Geraldine Alpert, National Economic Research Associates, Inc., *presented at the National Conference on Insurance Deregulation, University of Wisconsin* (October 1981)

    This presentation discusses the primary benefits of deregulation as bringing rates more closely in line with costs, leading to a more efficient allocation of resources. There is reason to believe that, in the long run, competition will reduce costs, and hence rates, by forcing insurers to be more efficient than they must be when protected by regulation. The following consequences will result: (1) reduced cross-subsidization, resulting in consumers' purchasing decisions being based on the true costs of insuring them; (2) greater availability of coverage; (3) increased consumer choices; and (4) more rational risk classifications, since insurers will compete for the business of low-risk members of any class, hence driving down rates.

15. **Issues and Needed Improvements in State Regulation of the Insurance Business: Report to the Congress by the Comptroller General of the United States**, U.S. General Accounting Office (October 9, 1979)

    In general, price regulation does not force companies into feast or famine cycles, nor do rates in less restrictive environments fluctuate wildly without regulatory control. The auto insurance industry is competitively structured and price regulation is not warranted in the voluntary market. State intervention should not be in the form of direct regulation. Rather, insurance departments can pursue the less intrusive strategy of collecting and disseminating of information that would provide consumers with a better basis of knowledge in purchasing insurance.

16. **The Pricing and Marketing of Insurance. A Report to the Task Group on Antitrust Immunities**, U.S. Department of Justice (January 1977)

    The DOJ concluded that rigid state rate regulation in insurance, characteristic of a number of state systems, has fostered greater adherence to bureau rates, discouraged rate reductions, contributed to instability in insurance company operations, established various forms of cross-subsidization between good and bad risks, imposed unnecessary restrictions on the collective merchandising and the direct writing of insurance, and aggravated the availability problem in which marginal or high risks have difficulty obtaining coverage in the open market at the prevailing rates.

    Unrestricted price competition can provide an effective substitute for rate regulation as a means of achieving reasonable prices and maximum efficiency in the sale and distribution of insurance. The experience of the same insurers under certain open competition and prior approval systems suggests that competition fosters greater independent pricing, operating stability, and flexibility in the pricing structure. A highly competitive system suggests that it provides a more effective mechanism for accomplishing one of the basic insurance goals, that is, generally available coverage at a price reasonably related to cost.

17. **The Open Rating Law and Property-Liability Insurance: An Evaluation of Insurance Price Regulation**, State of New York Insurance Department (1977)

    The department believes that a total return to prior approval would be retrogressive, impairing its operational efficiency and stifling the marketplace. The public interest would best be served by returning the auto line to open competitive rate regulation. In addition, the changing populations of the various residual markets do not appear to bear any direct relationship to the type of rating law applicable to that line of business. The contention that prior approval of rates is essential to control prices and that open competition would cause rates to skyrocket is not borne out by the findings of this study. The type of rating law neither contributes to nor mitigates the underlying costs of insurance losses. Competitive pricing in the marketplace does, however, appear to provide a greater incentive to improve efficiency and reduce expenses.

18. **Competition Under the California Rating Law and Its Effect on Private Passenger Automobile and Homeowners Insurance**, California Department of Insurance (1974)

    Competition in the California market for private passenger auto and homeowners insurance has been effective and has benefited consumers: (a) on average, rates were generally within reasonable ranges, as judged by usually accepted standards for loss costs and expenses; (b) the state's loss ratios and loss ratio trends were not out of line with nationwide loss ratios and loss ratio trends; (c) rate levels generally responded promptly to changes in market conditions; (d) there was a large number of financially sound insurers significantly active in the California market; (e) there was a high degree of insurer independence from bureau rates; (f) the state insurance market grew substantially; and (g) the voluntary market was doing a good job of absorbing the bulk of insured automobiles and dwellings.

19. **Competition in Property and Liability Insurance in New York State**, State of New York Insurance Department (1973)

    After examining the possibility of reverting from open competition to prior approval, it was found that prior approval would not do anything to help the problems which currently exist in the system. Instead, there are good reasons to believe the return would make existing problems worse, bring back old problems, and limit the resources available to cope with other compelling needs. Moreover, there is no evidence to suggest that prior approval would reduce the cost of insurance to the consumer; if anything, it would tend to have the opposite effect. A return to prior approval would be particularly troublesome in the area of product availability. In general, insurers under prior approval would likely become less willing to write insurance than they are now because they would no longer be confident of their future ability to implement price changes, up or down, in accordance with changing experience. In addition, a reduction in the variety of prices available in the market would reduce the alternatives that are open to many consumers.