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THE TROUBLESOME LEGACY OF PROP 103

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EXECUTIVE SUMMARY

In 1988, California voters approved Proposition 103 by a slim margin, 51 percent to 48 percent. Over the more than a quarter-century since its passage, implementation of the measure has dramatically changed the course of the state's regulatory structure and that of the entire U.S. property-casualty insurance industry.

Both Prop 103's authors and its latter-day defenders claim the law and its regulatory progeny have been effective in controlling rising insurance rates, saving Californians billions of dollars in the process. They repeatedly have sought to protect it from amendment and repeal, even seeking to have its scope broadened. They have battled at the ballot box, in the Legislature and in courts to defend their achievement and maintain the new status quo. Yet, per dollar of premium,

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California's auto insurance rates remain among the highest in the nation.^{1,2}

This paper examines not the superficial claims that Prop 103 has produced consumer savings for Californians, but instead compares the efficiency and competitiveness of California's property-casualty market using data gathered from publicly available rate-filing outlets like the National Association of Insurance Commissioners' System for Electronic Rate and Form Filing (SERFF).

1. According to the National Association of Insurance Commissioners, California's ranked 22nd in terms of how much residents spend on personal auto insurance in 2012. However, that number is misleading, because California's mandatory liability minimums, which most drivers select, are among the lowest in the nation. In an apples-to-apples comparison, conducted by Quadrant Information Services, quoted premiums for equivalent policies and equivalent drivers ranked California seventh-highest in the nation.

2. Fred Meier, "Survey: Louisiana car insurance costs most, Maine least," *USA Today*, March 18, 2013. <http://www.usatoday.com/story/money/cars/driveon/2013/03/18/50-states-most-least-expensive-car-insurance/1996691/>

Specifically, our research examines how California compares to a diverse group of five states (Illinois, Nebraska, New York, Louisiana and Washington), chosen both for their varying sizes and because each takes different approaches to the rate approval process and to the means for selecting an insurance commissioner.

To understand which system is most effective at encouraging competition, we examined the number of filings made in each state; the speed-to-market of those rate filings; and the impact of a unique feature of the Prop 103 system – rate intervenors.

Our results suggest that Californians are paying more and getting less for their system of insurance regulation than any of the other states examined. California’s insurance department is larger and more costly even than New York’s, which has the additional responsibility of regulating significant parts of Wall Street. Its speed-to-market is slower than other prior-approval states – like Washington and Louisiana. Most problematically, California enjoys fewer rate filings on both an objective and adjusted basis than the other states – in some cases, by orders of magnitude.^{3 4} This is a telling metric of an insurance market’s present and future health.

The California system discourages competition because it is slower, less predictable and more punitive than other states. Lengthy form review cycles tend to mean that California consumers are slow to receive new products, even though the state’s market—as the nation’s largest and most diverse—should make it among the first.

Prop 103 purports to promote consumer protection through state intervention in the rate-making and underwriting processes. But while consumer protection is a value shared by all, there are varying means to achieve it. A functioning rate-making system that encourages competition would lead to a more reliable form of consumer rating protection: market competition.

INTRODUCTION

The birth of insurance

Insurance is a system to manage, transfer and pool risk. The earliest forms predate both the bible and the Roman Empire. Even Hammurabi’s Code in 1772 BCE recognized the practice of “bottomry,” in which a payment would be taken on the value of a seagoing vessel as it undertook a voyage. In the

3. The state of affairs is even worse than it appears. California’s number of filings is inflated by a wave of filings compelled by Auto Rating Factor regulations promulgated in 2008.

4. *Insurance Journal*, “California Aims to Improve Insurance Rate Approval Process,” May 5, 2008. <http://www.insurancejournal.com/magazines/features/2008/05/05/156244.htm>

event that a ship did not arrive safely, the payment would not be returned. The insurance industry may not be primeval, but it is pretty close.

The rise of maritime trade in the Middle Ages necessitated that business interests guarantee the value of the increasingly specialized cargo they carried. In exchange for a fee, early insurers provided sailors and those with a financial stake in the vessel or its cargo with a guarantee in the event of loss.⁵

But it was not until the 17th century CE that insurance emerged in the form that would be recognized in the modern context. From 1645 to 1665, the French mathematician Blaise Pascal contributed to the development of probabilistic calculus, laying the foundation for actuarial science.⁶ In 1666, only one year after a plague that killed one-third of its residents, London suffered the Great Fire, which claimed more than 14,000 buildings and left the heart of the British Empire in ruin.⁷

The following year, underwriters from the maritime sector redirected their attention to insuring structures fixed to land by organizing local firefighting units. Thus, the first true property-casualty insurance policies began. In 1736 South Carolina, the first insurance company in the Americas was founded. This new enterprise gained renown. Even the likes of Benjamin Franklin saw fit to begin his own insurance firm.⁸

Insurance regulation before pre-Prop 103

The first U.S. insurance regulation was passed by the Commonwealth of Massachusetts in the early 19th century.⁹ By midcentury, New Hampshire became the first state to appoint an insurance commissioner and, later, New York founded the nation’s first insurance department.¹⁰

The states’ reflex to regulate grew as firms undertook to sell more complex products and sought to diversify beyond single lines of insurance. That it was the states, and not the federal government, that moved first to regulate insurance proved transformative. In an era of more limited federal

5. Eliyahu Ashtor, “Levant Trade in the Middle Ages,” Princeton University Press, p. 374, 1984.

6. Pascal died in 1662, but his work *Traité du triangle arithmétique* (Treatise on the Arithmetical Triangle) was not published until 1665. The work led directly to Jacob Bernoulli’s “law of large numbers.”

7. Barry Klein, “The Great Fire of London,” Ultimate Insurance Links, June 2001. <http://www.irmi.com/expert/articles/2001/klein06.aspx>

8. The Philadelphia Contributionship, “Company History,” <http://www.contributionship.com/history/index.html>

9. Susan Randall, “Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners,” *Florida State University Law Review*, Vol 26:625, 1999. <http://archive.law.fsu.edu/journals/lawreview/downloads/263/rand.pdf>

10. Ibid.

power under the U.S. Constitution, the states asserted regulatory authority that persists today.

State authority to regulate insurance matters was affirmed by the U.S. Supreme Court in *Paul v. Virginia* in 1869.¹¹ The *Paul* decision held that issuing an insurance policy was not “commerce” as defined by the Constitution and thus fell beyond the scope of federal regulation. However, in 1944, *Paul* was overturned and the prospect of federal regulation of insurance returned.¹²

But instead of opting to create a new system of federal regulation, Congress passed the McCarran-Ferguson Act of 1945.¹³ That measure exempted insurers from some elements of federal antitrust regulation, subject to regulation by the states. In doing so, the act virtually mandated that insurance regulation remain a state-regulated activity.

California took its first crack at insurance regulation in 1868, a year before *Paul*, but it was not until 1929 that the state founded a separate Division of Insurance, organized within the Department of Investment.¹⁴ That body mirrored closely in form the modern Department of Insurance, with a focus on licensing insurers doing business in California. In 1941, insurance regulation was spun off from the Department of Investment,¹⁵ and with autonomy came a name change.¹⁶ So was born the California Department of Insurance.¹⁷

Shortly after Congress passed McCarran-Ferguson, the California Legislature acted to immunize insurers within the state from the Sherman Antitrust Act (and various other antitrust laws) by defining the CDI’s authority through the McBride-Grunsky Insurance Regulation Act.¹⁸ Under McBride-Grunsky, all insurance companies operating in the state, regardless of their line of business, were required to register with the CDI. Additionally, authority over rate-making and regulation accrued to the department, though only rate manuals were required to be filed. The law also provided for a relatively laissez-faire approach to rate filing; its provisions allowed for open competition.

11. U.S. Supreme Court, *Paul v. Virginia*, 75 U.S. 7 Wall. 168, 1869. <https://supreme.justia.com/cases/federal/us/75/168/case.html>

12. U.S. Supreme Court, *United States v. South-Eastern Underwriters*, 322 U.S. 533, 1944. <https://supreme.justia.com/cases/federal/us/322/533/>

13. McCarran-Ferguson Act, 15 U.S. Code § 6701 - Operation of State law, March 9, 1945. <https://www.law.cornell.edu/uscode/text/15/6701>

14. Online Archive of California, “Inventory of the Dept. of Insurance Records, Agency History” <http://www.oac.cdlib.org/findaid/ark:/13030/tf9c6006j2/admin/#bioghist-1.7.3>

15. *Ibid.*

16. *Ibid.*

17. *Ibid.*

18. Cal. Ins. Code §1850-1860.3.

California’s regulatory structure remained stable under the McBride-Grunsky framework until 1988, the year that voters approved Proposition 103.

Modern approaches to rate-regulation

Of the 50 states, 49 regulate insurance prices.¹⁹ When California abandoned its open-rating system of rate filing in favor of Prop 103, it marked a significant change in the way that rates were dammed, channeled and released in the state. But there are many approaches to rate regulation beyond just these two systems. Insurance rate regulation in the United States generally falls into one of five categories. According to the Insurance Information Institute,²⁰ from most to least onerous they are:

- **Prior approval:** Rates must be filed with and approved by the state insurance department before they can be used. Approval can be by means of a deemer provision, which indicates approval if rates are not denied within a specified number of days.
- **Modified prior approval:** Rate revisions involving changes in expense ratio or rate relativity require prior approval. Rate revisions based on experience only are subject to “file and use” laws.
- **Flex-rating:** Prior approval of rates is required only if they exceed a certain percentage above (and sometimes below) the previously filed rates.
- **File and use:** Rates must be filed with the state insurance department before their use. Specific approval is not required, but the department retains the right of subsequent disapproval.
- **Use and file:** Rates must be filed with the state insurance department within a specified period after they have been placed into use.

These systems are subject to change and, in practice, the designations can be misleading. For instance, though Texas is technically a file-and-use state, in practice, the insurance department has been known to require insurers to refund premiums collected using rates not already approved. In Alaska, the Legislature gave the insurance department the ability to institute a flex-band. However, in practice, the department still operates on a prior-approval basis. In some cases, a “benevolent” regulator can mask dysfunctions in an otherwise overly onerous rating system. In California, the reverse has come to pass.

19. Illinois requires insurers to file rates, but the state does not have the power to disapprove them.

20. Insurance Information Institute, “Regulatory Modernization,” April 2015. <http://www.iii.org/issue-update/regulation-modernization>

PROPOSITION 103

The genesis of Proposition 103

California's average auto-insurance premiums increased dramatically in the 1980s.²¹ For consumers, the cause of this trend was an open question. Self-styled “consumer advocates” – many of them current or former trial attorneys – presented one explanation, while insurers presented another.

Consumer advocate Harvey Rosenfield, who ultimately would be Prop 103's author, maintained that premiums were increasing as a result of greed and profligacy on the part of insurers. Writing about the initiative's genesis, Rosenfield reflected that:

“Central to the consumer analysis is the understanding that the insurance industry is no longer strictly a mechanism for risk sharing, as it once was many years ago. Rather, the insurance industry has become a financial institution devoted primarily to maximizing profits; premiums are simply the funds used to fuel the profit engine.”²²

Insurers maintained that high premiums were the result of California's never-ending tort war. A 1979 California Supreme Court ruling in the matter of *Royal Globe Insurance Company v. Superior Court*²³ allowed third parties, not part of the insurance contract, to bring actions for bad faith directly against insurers. Third-party suits allow accident victims, with the involvement of personal injury lawyers, to sue not only the responsible party, but also that person's insurance company, for punitive damages.

This ruling arguably encouraged litigious behavior, as costly insurance-related lawsuits multiplied. Between 1980 and 1987, the number of auto liability claim filings in California's Superior Courts increased by 82 percent and their severity grew by a factor of four.²⁴ A pattern of predictable and inevitable rate increases corresponded closely to the uptick in litigation.

In response to the premium increases, five competing referenda were filed – three by the insurers and two by different

branches of the plaintiff's bar.^{25 26} The initiatives sought to constrain cost drivers in different ways. The three insurer-backed measures sought to reform the tort system, to do away with third-party bad faith claims and to introduce a no-fault auto insurance system to restrict third-party tort liability in exchange for reimbursement without proof of fault. The trial bar proposals each sought to increase regulation of the insurance industry, but to different degrees.²⁷

Ultimately, after a costly battle – in which the insurers spent tens of millions of dollars – Prop 103 was the only one of the five initiatives to pass. Though Prop 103 was defeated in 50 of the 58 California counties, it was ratified by 51.2 percent of the voters.²⁸

Two days after its passage, the California Supreme Court suspended the initiative's implementation. After a month, much of the initiative was allowed to go into effect, with the exception of a mandatory 20 percent rate rollback provision that was held unconstitutional and rewritten by the court. Some speculated at the time that the promised rollback likely was a major motivator of many who voted yes.²⁹

Prop 103 and the California Department of Insurance

Prop 103 is the framework under which property-casualty insurers operate in California and is, thus, the rulebook that defines the CDI's property-casualty rate regulatory functions. Because it supplanted large portions of the CDI's previous enabling statute, changes to the code made by Prop 103 were incorporated by reference to the existing functions of the department.³⁰ Thus, while much of the power and scope of the CDI's authority has changed, its legacy functions have stayed the same.

The CDI still carries out its four legacy functions: 1) overseeing the administrative direction of the department itself; 2) licensing, regulating and examining insurers; 3) enforcing the California Insurance Code and adopting regulations

21. W.K. Viscusi, et al, “The Performance of the 1980s California Insurance and Liability Reforms,” *Risk Management and Insurance Review*, 2008, p. 18. http://law.vanderbilt.edu/files/archive/201_The-Performance-of-the-1980s-California-Insurance-and-Liability-Reforms.pdf

22. Harvey Rosenfield, “Proposition 103: The Consumer's Viewpoint,” *The Society of CPCU*, 1991. <http://www.harveyrosenfield.com/uploads/pdfs/opeds/CPCU%20article.pdf>

23. California Supreme Court, *Royal Globe Ins. Co. v. Superior Court*, 23 Cal.3d 880, 1979. <http://scocal.stanford.edu/opinion/royal-globe-ins-co-v-superior-court-30520>

24. David Appel, “Revisiting the Lingering Myths about Proposition 103,” September 2014. <https://www.heartland.org/sites/default/files/appelfinalrpt.pdf>

25. Prop 100 – by the California Trial Lawyers; Prop 101 – by Coastal Insurance Company; Prop 103 – By Voter Revolt; Prop 104 – by a collection of insurers (no-fault); Prop 105 – by a collection of insurers (legal fee limit).

26. Dwight Jaffe, et al., “The Causes and Consequences of Rate Regulation in the Auto Insurance Industry,” chapter in “The Economics of Property-Casualty Insurance,” The University of Chicago Press, p. 34.

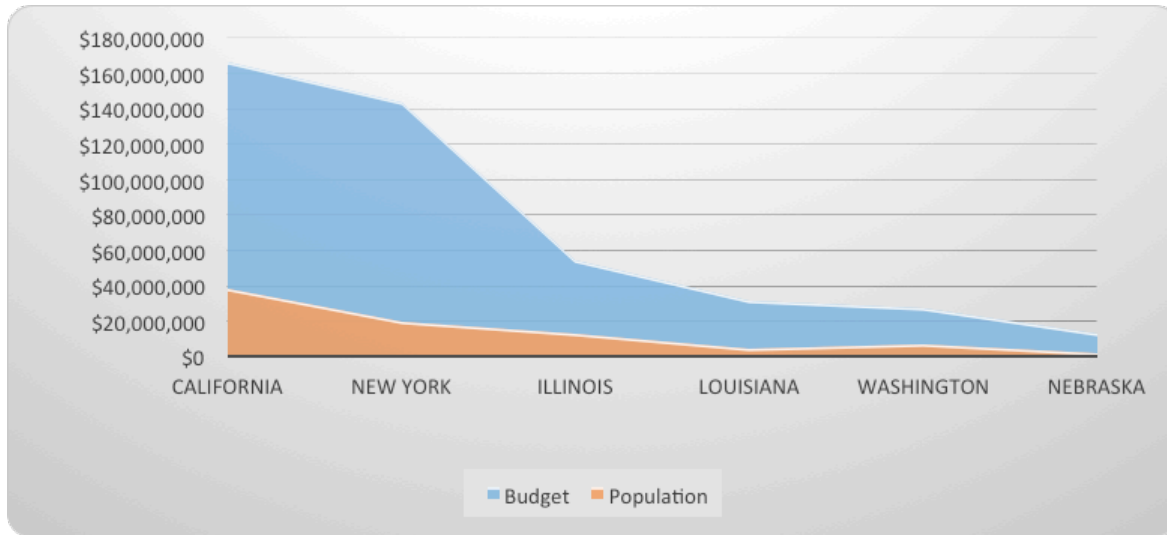
27. Proposition 103 ballot arguments. <http://www.consumerwatchdog.org/resources/1988BallotPamphlet.pdf>

28. Scott Harrington, “Canut's Revenge: Prop 103 and the Incompetent Consumer,” The Manhattan Institute, February 1989. http://www.manhattan-institute.org/html/cjm_13.htm

29. One wonders if the initiative would have passed at all if the rollback provision had not been included. Stephen Barnett expressed that supposition in a *Los Angeles Times* op-ed of May 16, 1989, titled: “Is this the will of the people? On Prop. 103 Justices Were Good at Politics, Bad at Law.”

30. Cal. Ins. Code §12906

FIGURE I: POPULATION VS. INSURANCE DEPARTMENT BUDGET, 2013



SOURCES: U.S. Census Bureau, NAIC

necessary to implement enforcement actions; and 4) acting as a resource to the public when they have questions and complaints about the industry.

Prop 103 resulted in the added three significant responsibilities: 1) instituting a system of “prior approval” of rates; 2) providing for private intervention in the CDI rate-hearing process; and 3) reporting to a newly created elected, rather than appointed, insurance commissioner. Since the Office of Insurance Commissioner became a statewide elected post, there have been six commissioners and eight elections.³¹ Currently, the office is held by former Assemblyman Dave Jones, D-Sacramento. Jones took office in 2010 and is in his second term.

To accommodate its new role, the CDI has expanded the personnel it employs. The CDI is the largest state insurance department in the country, both by budget and by number of employees. Before John Garamendi became the first elected regulator following Prop 103, the CDI had approximately 600 employees. As of budget year 2013, CDI employees numbered more than 1,300.³²

Along with an increase in staff, the CDI’s budget also has grown. Since Prop 103’s passage, the CDI’s budget has grown by \$130 million to total annual funding of roughly \$237

million.³³ The cost to implement Prop 103’s provisions are financed from the CDI’s Insurance Fund,³⁴ which in turn comes almost entirely from fees and assessments on insurance companies. Ultimately, those costs are passed along to consumers, insurance company employees and (for those companies that have stock-based structures), company shareholders.³⁵

How Prop 103 functions

How Prop 103 functions and how Prop 103 was intended to function are distinct issues. Of the ballot argument for Prop 103’s 11 paragraphs, only two describe the mechanisms that the initiative sought to put in place.³⁶ Nonetheless, these offer a baseline of what its authors hoped to accomplish.

“(Prop 103) alone reduces all of your automobile, home and business insurance premiums to November 1987 prices. Then, it alone cuts them another 20 percent.... Proposition 103 will also end the insurers’ exemption from the antimonopoly laws, allow people to elect the Insurance Commissioner, require a special 20 percent discount for good drivers, and stop unfair price increases in the future. It specifies that a

31. John Garamendi from Jan. 7, 1991 to Jan. 2, 1995; Chuck Quackenbush from Jan. 2, 1995 to July 10, 2000; J. Clark Kelso from July 10, 2000 to Sept. 17, 2000; Harry W. Low from Sept. 18, 2000 to Jan. 6, 2003; John Garamendi from Jan. 6, 2003 to Jan. 8, 2007; Steve Poizner from Jan. 8, 2007 to Jan. 3, 2011; Dave Jones from Jan. 3, 2011 to present.

32. National Association of Insurance Commissioners, “2014 Insurance Department Resources Report, Volume 1,” Page 29.

33. Ibid at 3

34. Cal. Ins. Code §1861

35. State of California Manual of State Funds, “Insurance Fund,” Department of Finance, August 2012. http://www.dof.ca.gov/accounting/manual_of_state_funds/index/documents/0217.pdf

36. The pamphlet’s “Rebuttal to Argument against Proposition 103” is more substantive, but also more misleading: “103 is the only initiative that will immediately cut everyone’s premiums by 20%.”

permanent, independent consumer watchdog system will champion the interest of insurance consumers.”³⁷

As the statement provides, Prop 103 affects auto, home and business insurance, but the complete list of impacted lines is far longer: dwelling fire, earthquake, personal umbrella, commercial aircraft, commercial auto, boiler and machinery, burglary and theft, commercial earthquake, farm owners, commercial fire, glass, inland marine, medical malpractice, special multiperil, miscellaneous multiperil, professional liability, other liability, commercial umbrella, some fidelity lines and coverage under the United States Longshoremen’s & Harbor Workers’ Compensation Act.³⁸ This proliferation of lines goes far beyond the initiative’s stated intent.

Prop 103 applies California antitrust law to insurers, effectively ending the industry’s limited exemption within the state. It also has been responsible for creating a “good driver discount,” though nearly all drivers receive it, thanks to relaxed requirements for the program.

The “stop unfair price increases in the future” part of the ballot statement is short, but also perhaps the most significant language. A vital part of Prop 103’s intended function was to introduce a new system for rate approval, whereby the CDI determines whether a rate is appropriate. In practice, its process is exceedingly complex, since “fairness” is a subjective matter.

Under the current regime, when an insurer wants to change a rate to reflect developments in the market, the CDI requires them to submit specific information to justify the request. The insurance commissioner must decide whether the rate change request is “excessive, inadequate or unfairly discriminatory”³⁹ by applying requirements articulated in the California Insurance Code and the California Code of Regulations.

The factors considered include a company’s past and prospective loss experience, in addition to administrative expenses related to marketing products and conducting loss adjustments. Additionally, the commissioner may consider investment income, repair cost trends, medical cost trends, the adequacy of the insurer’s loss reserves, the cost of reinsurance and other relevant dynamics. Ultimately, if the commissioner concludes that a request is not “most actuarially sound,” the CDI can require a rate reduction or reject a rate filing completely.⁴⁰

37. Proposition 103 ballot arguments.

38. California Department of Insurance, “Information Sheet: Proposition 103 Intervenor Process,” <http://www.insurance.ca.gov/01-consumers/150-other-prog/01-intervenor/info.cfm>

39. Cal. Ins. Code §1861.137(b)

40. California Department of Insurance, “Prior Approval Rate Filing Instructions,”

The process is unpredictable and frequently takes months. Whether consumers are protected from “unfair” prices is unclear.⁴¹ Similar ambiguity surrounds the perhaps too literally described “consumer watchdog system” of independent rate review.

A unique characteristic of Prop 103 was its inclusion of outside parties in the rate-approval process. Known as “intervenor,” these individuals or groups may choose to participate in “proceedings.” This initially was an undefined term that has, by regulation, changed from when a rate filing goes to hearing to the entire pre-hearing negotiation process, regardless whether a hearing ultimately is held. For their efforts, intervenors are reimbursed by CDI through individual insurance companies.⁴² Though any group or individual may intervene, Consumer Watchdog is the most frequent and highest-compensated intervenor.⁴³

There are other important parts of the California regulatory apparatus that have been changed by Prop 103, but the imposition of a new rating system, in combination with a role for private intervenors, are the most significant for the purposes of the body of research to follow.

The academic verdict on Prop 103

The Prop 103 fight attracted attention nationally. Academics interested in the impact of rate regulation in legal and economic terms turned their attention to California to evaluate how the experiment would unfold. There have been distinct periods of analysis, corresponding to three major periods of Prop 103’s history, but a common thread runs through them all. Each analysis has sought to evaluate the success of Prop 103 based on its ability to “hold down” or reduce rates. Since all of the studies recognize that, objectively, auto insurance rates went down after the passage of Prop 103, the thorny question they seek to resolve is one of cause and effect.

The question is complicated. Roughly coinciding with passage of Prop 103, the *Royal Globe* decision was overturned. The California Supreme Court decided in 1988’s *Moradi Shalal v. Fireman’s Fund*⁴⁴ that the third-party liability pro- pounded by *Royal Globe* was problematic, both as a legal and policy matter. In the absence of third-party liability, in the

June 2, 2011. http://www.insurance.ca.gov/0250-insurers/0800-rate-filings/0200-prior-approval-factors/upload/Rate_Filing_Instructions.pdf

41. Kingsdale, Jon. “Potential Impact of a 2014 Ballot Initiative on Implementation of Covered California and Health Insurance Reform in California”. Wakely Consulting Group. May, 2014.

42. Information Sheet: Proposition 103 Intervenor Process.

43. California Department of Insurance. “Informational Report on the CDI Intervenor Program.” <http://www.insurance.ca.gov/01-consumers/150-other-prog/01-intervenor/report-on-intervenor-program.cfm>

44. *Moradi-Shalal v. Fireman’s Fund Ins. Companies*. 46 Cal. 3d 287. (1988). <http://sco-cal.stanford.edu/opinion/moradi-shalal-v-firemans-fund-ins-companies-28538>

10 years following Royal Globe's repeal, the number of third party bad faith actions related to auto claims fell from 91,000 to 42,000.⁴⁵

Presumably, if Prop 103's regulatory requirements were the actual cause of the rate decrease, then it has been a success. At the same time, if it was not the cause of the decrease, and if instead any number of other factors lowered rates, then it has not been a success. Some maintain that non-Prop 103 factors have led to lower rates: fewer auto lawsuits; safer cars; stronger drunken driving laws; more effective anti-fraud measures; a demographic shift by baby boomers into the safest driving years; and limits on noneconomic damages for uninsured drivers. Others contend that only in concert with the rate review process set out by Prop 103 could those factors be responsible for premium decreases.

The three major periods of Prop 103 analysis were:

The near-term aftermath: During this period, portions of Prop 103 were not yet in effect, due to ongoing litigation that eventually led to the abrogation of certain provisions. The insurer suits challenging Prop 103's required 20 percent rate rollback as unconstitutional had been resolved, but other suits implicating the cost savings of Prop 103 were left in doubt. No hard data was yet available concerning the rating effect of Prop 103, so scholars primarily examined the legal and market impact of the initiative and attempted to predict its future.

One study of note, which evaluated various potential outcomes, was conducted by Stephen Sugarman of the University of California at Berkeley School of Law.⁴⁶ Sugarman was a critic of Prop 103 during the 1988 campaign cycle and remained skeptical after the initiative became law. In his report, he documented in great detail the administrative wrangling surrounding the rate rollback provision and concluded that the Supreme Court's rewritten rule would be unlikely to render meaningful rebates.⁴⁷ We also learn from Sugarman that Prop 103's supporters actually chose to boycott the first rate-approval hearings until an elected commissioner could fill the post. In their absence, he speculated that prior-approval processes and standards would not be too onerous for insurers.

45. Kissell, Chris. "Why are Car Insurance Rates Falling?" Citing Pete Moraga of the Insurance Information Network. Aug. 2011. <http://www.consumerwatchdog.org/story/why-are-car-insurance-rates-falling>.

46. Sugarman, Stephen. "California's Insurance Regulation Revolution: The First Two Years of Proposition 103." 27 *San Diego L. Rev.* 683. Jan. 1990. <http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1634&context=facpubs>

47. He was right. Virtually no rebate ever was disbursed based upon the Supreme Court's standard.

Ultimately, Sugarman concluded that:

Proposition 103 could wind up leaving Californians with little more than a larger bureaucracy in the Department of Insurance...yet, even if Proposition 103 ultimately fails to achieve its proponents' goals, perhaps there is now sufficient pressure to contain insurance prices that new legislators (or possibly yet another initiative) will make more fundamental changes.⁴⁸

Supplementing Sugarman's analysis was a study in the University of Connecticut's *Journal of Financial Economics* that concluded Prop 103 led directly to a 6.91 percent fall in the valuations of publicly traded insurers affected by the law.⁴⁹ Thus, the early academic appraisal of Prop 103 can be said to lean negative, in the sense that it emphasized the initiative's disruption and costs.

Midterm aftermath: The last of the preliminary rounds of Prop 103 challenges was completed in 1995. A second round of examinations of Prop 103 would emerge in the early 2000s, when a collection of major academic studies were published in connection with a conference jointly sponsored by the Brookings Institution and the American Enterprise Institute.⁵⁰

The first, by Dwight Jaffee from Cal-Berkeley, found that Prop 103 did not have the expected cataclysmic impact on the state's insurance market. Firms by and large did not leave the state. Consequently, premiums did not increase as a result of product scarcity.⁵¹ But Jaffee's analysis concluded that Prop 103's impact on rates, to the extent that it could be separated from a background of sharply falling costs, was minimal. In fact, Jaffee found that "the Proposition may have had a detrimental effect on auto insurance premiums by increasing profit margins."⁵² As a result, Jaffee concluded, quite controversially, that increased regulatory control is not related to problematic market outcomes.

Harvard University economist W. Kip Viscusi's study focused on insurer profitability. Rather than the market's expected decline in profitability, California insurers instead

48. Sugarman at 714.

49. Fields, Joseph. Et al. "Wealth effects of regulatory reform: The reaction to California's Proposition 103." *Journal of Financial Economics*. Dec. 1990. <http://www.science-direct.com/science/article/pii/0304405X90900544>

50. Cummins, J. David. "Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency." *AEI-Brookings Joint Center for Regulatory Studies*. 2001. <http://citeseerx.ist.psu.edu/viewdoc/download;jsessionid=C8633513654C92323EADDEC7395E8503B?doi=10.1.1.138.6248&rep=rep1&type=pdf>

51. Dwight Jaffee, et al., "Regulation of Automobile Insurance in California," AEI-Brookings Joint Center, p. 195. 2001. <http://citeseerx.ist.psu.edu/viewdoc/download;jsessionid=C8633513654C92323EADDEC7395E8503B?doi=10.1.1.138.6248&rep=rep1&type=pdf>

52. *Ibid* at 233.

experienced an improvement relative to those in the rest of the country.⁵³ That point complicated the narratives of the various insurance trade associations, who appeared to be arguing against their economic interests.

Building on Jaffee's findings, Consumer Federation of America Director of Insurance J. Robert Hunter published a 2001 study that served as a response to ongoing NAIC discussions about the potential for deregulating various property-casualty lines.⁵⁴ The report's key qualitative finding was that Prop 103, "by any measure...represents far and away the best practices for regulation in the nation."⁵⁵ The basis for that conclusion was that rates in California fell after the passage of Prop 103, and Hunter pointed to the regulatory tools created by the initiative as responsible for that change.

On behalf of a collection of insurance trade associations, David Appel published a review of the CFA report in December 2001.⁵⁶ Appel's report, unsurprisingly, took issue with the Hunter report and found that Prop 103, instead of holding down auto insurance rates, had in fact subjected Californians to an opportunity cost of \$10 billion.⁵⁷

The dialogue offered contrasting visions of the role that a regulator should play. While the Hunter report favored outcomes that emphasized perceived fairness enforced by an independent regulatory authority, the Appel report stressed the costs associated with the pursuit of such normative objectives by a centralized authority. Both used Prop 103's outcomes, and not an evaluation of its technical operation, to make their respective cases.

Contemporary perspectives: Led by Hunter, the CFA took another look at Prop 103 in 2013,⁵⁸ coming to much the same conclusion as its predecessors. After noting that some claims-payment abuses continued to occur under the Prop 103 system, the 2013 report found that "[no] other problems that we have identified regarding insurer operations have been significant."⁵⁹

53. Viscusi.

54. J. Robert Hunter, "Why not the best?" Consumer Federation of America, June 2001. <http://www.consumerfed.org/pdfs/WHYNOTTHEBEST.pdf>

55. *Ibid* at 10.

56. David Appel, "Analysis of the Consumer Federation of America Report 'Why not the best,'" Milliman USA, December 2001. <https://www.heartland.org/sites/default/files/polpaperappelcfa.pdf>

57. *Ibid* at 48.

58. Hunter, Robert. "What Works: A Review of Auto Insurance Regulation in America." Consumer Federation of America. Nov. 2013. http://www.consumerfed.org/pdfs/whatworks-report_nov2013_hunter-feltner-heller.pdf

59. Hunter, Robert. "State Automobile Insurance Regulation: A National Quality Assessment and In-Depth Review of California's Uniquely Effective Regulatory System." *Consumer Federation of America*. April, 2008. http://www.consumerwatchdog.org/resources/state_auto_insurance_report.pdf

But Brian Sullivan, editor of the trade publication *Auto Insurance Report*, responded to Hunter's 2013 report with a piece asserting that, while Prop 103 undoubtedly was successful in making it very difficult for insurers to raise rates, over the long term, it's also made it very difficult to lower insurance rates.⁶⁰

"What the authors of Prop. 103 could not have seen was that California claims costs were about to plummet. At first they plummeted both in total numbers and relative to the rest of the nation, either because of Moradi-Shalal or some other unforeseen force. Then, as the impact of this unique one-time event faded, California claims costs continued to fall along with claims costs in the rest of the nation. Poorly equipped to handle this change, California's regulatory structure has made matters worse for consumers. The rules not only make it hard to increase prices, they also unwittingly make it hard to reduce prices."⁶¹

There is no single academic consensus on the value of Prop 103. Despite hard work to identify the causes of California's late 1980s premium decline, they remain in dispute and the debates are unlikely to be resolved. Moreover, the cost of Prop 103 cannot be derived simply by comparing insurer profits and consumer premiums between California and other states. Even if Prop 103 were found responsible for California's decline in auto insurance rates, another regulatory approach might have been even more effective.

The counterfactual that none of the reports ultimately address directly is how California's auto insurance market would have developed under a different regulatory system. In an effective system of insurance regulation, rates reflect underlying costs.

Rate decreases are appropriate as a response to falling costs and rate increases are appropriate in response to rising costs. If rates cuts are ordered where cost drivers do not indicate they are appropriate, premiums will be left below what the market can properly sustain. Even if Prop 103 was singularly responsible for forcing rates down, it may have forced them down for the wrong reasons. Suppressing rates robs the market of important price signals about underlying costs trends, and it is those trends that public policy ultimately must address.

This study looks at how Prop 103 actually has functioned. By examining the quantity of auto-insurance rate filings and how quickly they come to market, it's possible to evaluate the

60. Sullivan, Brian. "What Doesn't Work: CFA is wrong; Prop 103 has been a disaster." *The Auto Insurance Report*. Dec. 2013. <http://pifc.force.com/library/servlet/fileField?id=0BEI000000TNR6>

61. Sullivan at 5.

TABLE I: 2013 COMPARISON OF REPRESENTATIVE INSURANCE DEPARTMENTS

| State | CA | IL | LA | NY | NE | WA |
|-------------------------------|----------------|--------------|-------------------------|-----------------------------|--------------|----------------|
| Filing method | Prior approval | Use and file | Modified prior approval | Prior approval/ flex rating | File and use | Prior approval |
| Intervenor? | Yes | No | No | No | No | No |
| Commissioner | Elected | Appointed | Elected | Appointed | Appointed | Elected |
| Dept. staff | 1,325 | 234 | 249 | 814 ¹ | 103 | 230 |
| Dept. budget (\$M) | 166.2 | 53.9 | 31.1 | 143.6 | 12.9 | 27.0 |
| Insurance groups ² | 74 | 89 | 44 | 51 | 55 | 51 |
| Auto rate rank ^{3,4} | 7 | 37 | 1 | 33 | 32 | 43 |
| Population (M) ⁵ | 38.3 | 12.9 | 4.6 | 19.7 | 1.9 | 7.0 |

SOURCES: SNL Financial, NAIC, QIS, U.S. Census Bureau

1. This number is somewhere misleading because, as of late 2011, responsibility for the regulation of insurance was merged into the Department of Financial Services, which is charged with regulating state-chartered depository institutions, securities firms and other providers of financial services. The number of employees dedicated to oversight of the property and casualty insurance market is substantially smaller.
2. Only groups with at least 0.1% of the state's market have been included, because it is unlikely that groups below that threshold are responsible for more than *de minimis* product filings.
3. Quadrant Information Services uses a different methodology than the NAIC to account for different liability minimums between states. Instead of simply dividing total premiums written by number of policies, QIS examines the quoted cost of identical policies. This method provides a picture of what a premium dollar actually buys. In this case, based on full coverage for a single, 40-year-old male who commutes 12 miles to work each day, with policy limits of 100/300/50 and a \$500 deductible on collision and comprehensive coverage, UM coverage, a clean driving record and good credit.
4. Gregg Whitaker, "Average Car Insurance Rates by State 2013 - Find the Cheapest Insurance Rates," June 2013. <http://www.prweb.com/releases/average-car-insurance/rates-2013/prweb10860824.htm>
5. U.S. Census Bureau, American Fact Finder, <http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkml>

impact that Prop 103 has on California's market and posit how that market would perform under a different regulatory framework.

COMPARING THE STATES

Above is a comparison of how the six representative states chosen for this analysis (California, Illinois, Louisiana, New York, Nebraska and Washington) differ in filing method used; intervenor status; selection of insurance commissioner; insurance department staffing; insurance department budget; number of large insurance groups⁶² operating within the state; where the state's auto-insurance premiums rank nationwide; and the state's population. Using data collected from the National Association of Insurance Commissioners and a number of other sources, the differences between the departments of insurance becomes clear.

California's department is massive, as one would expect. Its staff and budget are the largest not only of this collection of states, but also nationally. In fact, taken alone, California's insurance market is the eighth-largest in the world. It is odd then that, though it is the largest in so many terms, it has fewer insurance groups competing in its market than Illinois. California's size conceals a more complicated picture of the regulatory control the CDI exercises over the market. To understand that picture, it is necessary to examine how the markets function.

As a practical matter, this is challenging, due in part to the number of products offered across the various states and the differences among them. Though Prop 103 applies to many lines of property-casualty insurance, to avoid "apples to oranges" comparisons, this analysis is confined only to private-passenger auto insurance. As a historical matter, private-passenger auto insurance was central to the changes inspired by Prop 103. For many voters, it was the basis on which they voted for a wholesale regulatory change. We evaluate this particular line to discover the sorts of outcomes each state achieves through their respective system.

Frequency of rate filings

Companies that are able to file rates fluidly are more likely to file. Thus, they also are more likely to compete aggressively with other firms to ensure their rates are viable. Competition very often leads to lower rates or improvements in service. Thus, markets in which insurers more frequently file rates are better situated to serve consumers.

Among the states examined, the difference in the number of rate filings was dramatic in both absolute and adjusted terms. California insurers made roughly half as many private-passenger auto rate filings in 2013 as insurers in New York and roughly one-third as many as insurers in Illinois. In Louisiana, Nebraska and Washington, though fewer rate filings were made in 2013, the rate at which insurers filed for changes was higher than California insurers.

62. Insurance groups are distinct from insurance companies in that groups are consist of separate affiliated statutory companies who answer to the controlling entity atop the group.

TABLE 2: 2013 PERSONAL-AUTO RATE FILINGS

| State | Total filings | Avg. per/group |
|-------|---------------|----------------|
| CA | 135 | 1.82 |
| IL | 304 | 3.41 |
| LA | 102 | 2.31 |
| NY | 206 | 4.03 |
| NE | 104 | 1.89 |
| WA | 166 | 3.25 |

SOURCES: NAIC System for Electronic Rate and Form Filing, CDI Web Access to Rate and Form Filings

The relatively paltry number of filings in California are even worse than they appear, as the state already requires repetitive, involuntary filings. Under regulations added to Prop 103 in 2007, insurers must refile previously approved rates at least every three years.^{63,64} (Colorado, not examined in this analysis, requires annual rate filings). The rationale for the requirement is that, over time, changes in loss costs could render filed rates excessive and thus fall out of compliance with California Insurance Code Section 1861.5.⁶⁵ In other words, this measure is intended as a prophylactic step to ensure that rates do not become unreasonable. While the regulation does not explicitly prescribe a specific required frequency of rate applications, in practice, the CDI requires rates to be refiled on a triennial basis.

The result is that at least some portion of California's already-low number of filings would not have been made were insurers not compelled to do so. The number of voluntary insurer-initiated filings is lower than reflected in Table 2.

Rather than foster a market with frequent filings and aggressive competition, California has adopted a system wherein companies wait until they are forced to file.

Average speed-to-market of rate filings

Insurers gather data constantly to reflect changing trends in the claim frequency and severity of covered activities. With that information, companies evaluate whether the rates they charge reflect their actuaries' evolving view of risk.

Consumers benefit when rate changes can occur quickly. They obviously can enjoy the boon of lower rates sooner. Moreover, while rates may increase, such changes guarantee consumers are informed on a timely basis about the risks

63. Refiling of approved rates: "As a means to determine whether a rate previously approved remains in compliance with the statutory standard set forth in California Insurance Code Section 1861.05(a), for an insurer operating with a rate approved three years ago or longer in the homeowners multiple peril and private passenger auto liability and physical damage lines, the Commissioner may require an insurer to file a rate application. Nothing in this section shall be construed to specify how often an insurer may make a rate application filing."

64. 10 California Code of Regulations §2644.50.

65. California Department of Insurance, "Initial Statement of Reasons, RH05042747." <http://www20.insurance.ca.gov/pdf/REG/85969.pdf>

inherent in their activities. They thus can act to mitigate those risks or, alternatively, shop for a better rate. Lower regulatory barriers to rate filings means consumers have access to the most up-to-date pricing information.

TABLE 3: 2013 PERSONAL-AUTO RATES FILINGS AND TIME TO RESOLUTION

| State | Number of filings | Avg. days to resolution |
|-------|-------------------|-------------------------|
| CA | 135 | 139.05 |
| IL | 304 | 12.43 |
| LA | 102 | 32.55 |
| NY | 206 | 57.60 |
| NE | 104 | 25.74 |
| WA | 166 | 55.26 |

SOURCES: NAIC System for Electronic Rate and Form Filing, CDI Web Access to Rate and Form Filings

The speed with which an insurance department renders judgments on a proposed rate is a crucial factor in determining whether or not the insurer will move forward with that product. The NAIC has recognized the need to improve products' speed-to-market, forming a task force to study ways for departments to modernize their rate-approval procedures.⁶⁶ Yet while some obstacles to timely rate approval can be addressed through better filing systems (like SERFF), others are structural and demand more fundamental reform.

An exhaustive analysis of the speed-to-market of Prop 103 lines of insurance in California was completed in May 2014 in contemplation of that November's ballot on Proposition 45, a measure to introduce prior approval to the health insurance market.⁶⁷ Undertaken by Jon Kingsdale of the Wakely Consulting Group, the study examined property-casualty applications filed between 2005 and 2011 to determine how quickly the average application moved from filing to resolution.⁶⁸ Accounting for all Prop 103 lines of business, not just personal auto, the average time was 138 days, or roughly four and one-half months.

66. National Association of Insurance Commissioners, Speed to Market Task Force, http://www.naic.org/committees_ex_speed_to_market_tf.htm

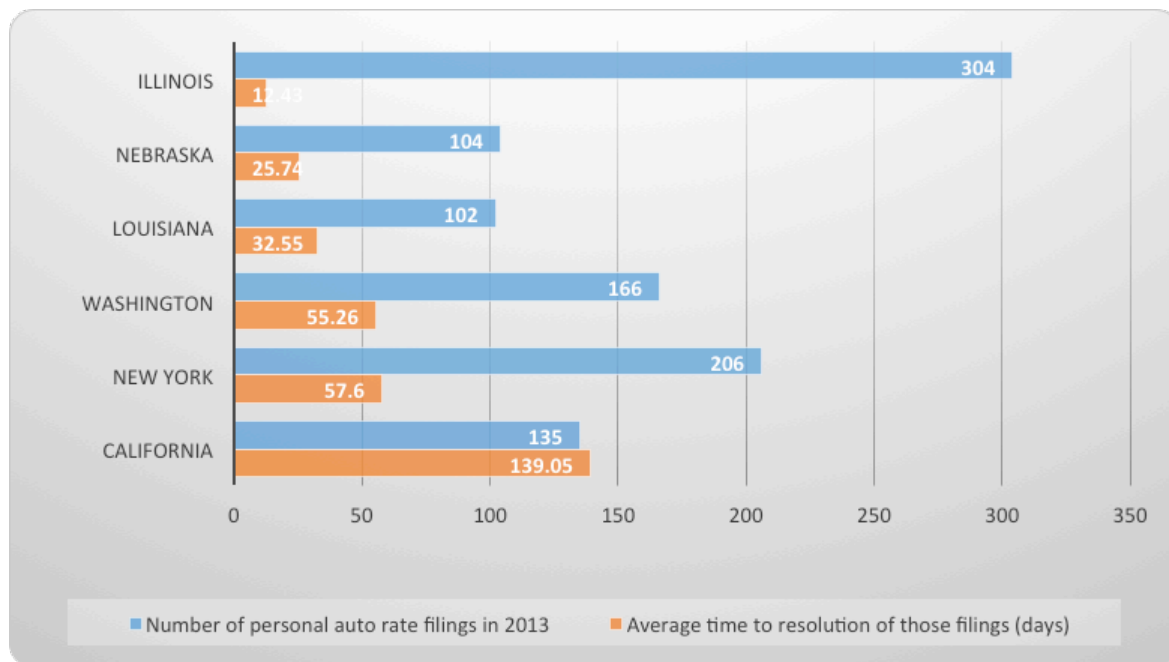
67. Kingsdale.

68. The CDI drafted a response to the Kingsdale study on June 18, 2014, in which the department claimed the report "grossly inflates the percentage of rate filings with intervenors." The CDI dismissed Kingsdale's methodology of analyzing petitions separately according to company, as opposed to by group, and asserted the report picked a timeframe unrepresentative of more recent trends. By the CDI's own admission, Kingsdale's approach was "technically accurate" -- each company did file separately.

The Kingsdale report also was forced to choose a filing cutoff date in 2011 because of the CDI's own delay in disposing of filings, the last of which from that period was not completed until July 2013. The CDI's assertion that Kingsdale should have examined data from 2012 likely would have been impossible.

The CDI asserted there were 47,795 personal-lines rate filings between 2005 and 2011, rather than the 1,523 filings counted by the consulting firm Perr & Knight. Clearly, a methodological distinction separates these two approaches. From analysis of WARFF results, it appears the CDI included every filing, while Perr & Knight's methodology was limited to filings susceptible to intervention.

FIGURE 2: NUMBER OF PERSONAL-AUTO RATE FILINGS VS. AVG. TIME TO RESOLUTION



SOURCES: NAIC System for Electronic Rate and Form Filing, CDI Web Access to Rate and Form Filings

As seen in Table 3, our own analysis – using SERFF and the CDI’s equivalent Web Access to Rate and Form Filings – demonstrates that California takes far longer to act on rate filings than the other representative states. The comparison is particularly stark when one considers that California experiences these delays despite receiving fewer filings than much-smaller states, illustrated in Figure 1.

This data shows that California is far slower to act than other states in our sample, even when compared to a state like Washington, which has a similar prior-approval system. The slow pace of rate approvals almost certainly contributes to insurers’ reluctance to file. But as detailed in the next section, California’s intervenor system also plays a role.

California’s unique intervenor system

California is currently the only state that permits private third-party intervenors to engage in the property-casualty rate filing process.⁶⁹ New Jersey, the only other state to have adopted a similar policy, let its system for intervention expire.⁷⁰ The process was presented to the voters as a safeguard to prevent insurers from charging unreasonable rates. This implicitly assumes the CDI’s system of prior approval, in which the department charged with conducting rigorous

evaluations of rate filings, fails to prevent unreasonable rates. Given the CDI’s history of onerous rate evaluations, the public intervenor’s role today is, at best, redundant and, at worst, both costly and structurally burdensome.

In addition to examining the time for rate filings to reach resolution, the Kingsdale report also took pains to examine the impact intervenors have on how quickly rate filings are resolved. Where a typical filing took 138 days to resolution, filings in which an intervenor took part were resolved, on average, in 343 days – just short of a full calendar year.⁷¹

Only a relatively small percentage of rate filings – about 5.6 percent of those filed between 2005 and 2011 – attract an intervenor,⁷² but these interventions vary widely in the impact they have on the system as a whole. Building on the tables provided by the Kingsdale report, we noticed that a full 50 percent (43 of 86) of the interventions were made against California’s five largest insurance groups.⁷³ In fact, as illustrated in Figure 3, we estimate that California’s five largest insurance groups are nearly twice as likely to face intervention as other insurance groups in the state.

There were 1,523 filings made during the period studied by the Kingsdale report. Out of 257 admitted insurance groups

69. Judy Dugan, et al., “Health Reform and Insurance Regulation: Can’t Have One without the Other,” p. 25 May 2011. <http://www.consumerwatchdog.org/resources/cwraterregulation.pdf>

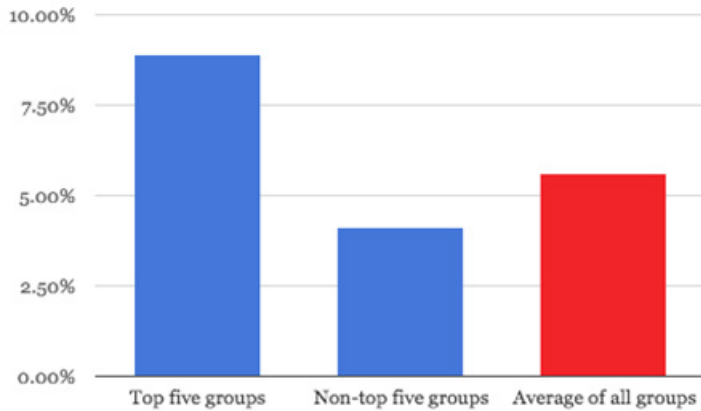
70. New Jersey Department of Banking and Insurance, “Rate Intervenor Rules,” <http://www.state.nj.us/dobi/ad071001.htm>

71. Kingsdale at 5.

72. Ibid.

73. State Farm, 13 interventions; Farmers, 15; Liberty Mutual, 4; Berkshire Hathaway, 0; Allstate, 11.

FIGURE 3: LIKELIHOOD OF RATE INTERVENTION IN CALIFORNIA



SOURCES: CDI Web Access to Rate and Form Filings

selling property-casualty insurance in the state – all Prop 103 lines, not just personal auto – the top five groups represent 31.6431 percent of total written property-casualty premium.⁷⁴ If filings occurred roughly according to written premium market share of those five groups,⁷⁵ they would be expected to make about 482 of the filings (31.6 percent). That means the top five groups would face an intervenor 8.92 percent of the time, whereas those not among the top five groups would face an intervenor 4.13 percent of the time.

Large insurance groups set trends that smaller players follow. The filings of the top five groups often are subsequently replicated by smaller players in the market in what are called “me too” filings. As a result, intervening against an insurer from one of the top five groups magnifies the impact of the intervention and retards adoption of market-responsive rates for players across the market. What’s more, it belies claims that the relatively small number of interventions means they do not have significant impact on the market. When they happen, intervenors act strategically to make them count.

While intervenors like Consumer Watchdog claim that intervenors have been responsible for huge savings to consumers, the structure of the process is indicative of a different motivation. While consumers, insurance companies and the CDI benefit from a speedy and efficient rate-approval process, intervenors do not. The longer the process takes, the more hours they are able to bill. Their expenses are paid for by the insurers against whom they intervene, who then pass along those costs to policyholders.

74. California Department of Insurance, “2013 California P&C Market Share Report,” June 2014. <http://www.insurance.ca.gov/01-consumers/120-company/04-mrkt-share/2013/upload/GrpMktShr2013WP.pdf>

75. This is an assumption, which ensures the final result can be only an educated guess. Given the margin of difference in intervention rates, we have high confidence in the conclusion that the top five insurance groups are meaningfully more likely to face intervention.

Perhaps this delay would be understandable were it not so unnecessary. The participation of intervenors is redundant of the CDI’s reviews. The significant growth of CDI, costly and burdensome as it has been, has virtually guaranteed the expertise needed to ensure the Prop 103 rate-making process is properly carried out.

The most notable result of the intervenor process is that it compels rate filings to become rate negotiations. There is an opportunity cost associated with the filings that are not made specifically because of the potential for extended and costly intervention. The intervenor process thus is better conceived of as an “intervenor tax.”

INTERPRETING THE DATA

Comparing how insurers behave under the Prop 103 system versus their behavior in other states allows us to take the pulse of California’s property-casualty market. More active markets are, generally speaking, more sensitive to changing circumstances. A regulatory system that encourages more market activity will also be one that shields consumers from languishing with outdated products and prices. Toward this end, many states employ different rate-approval strategies to ensure a balance between market oversight and activity.

From the data presented above, we can draw core conclusions about Prop 103:

1. It discourages rate filings; and,
2. It slows the rate-approval process.

California enjoys fewer rate filings, in real and adjusted terms, than should be expected in a jurisdiction of its size. It experiences the slowest speed-to-market of any of the states examined, by orders of magnitude. As a result, it has fewer insurance groups than a state like Illinois, with a population less than half its size. It also has the most expensive administrative apparatus in the nation and auto-insurance rates that are higher than 86 percent of other states. In spite of dubious claims of savings afforded to California's policyholders by Prop 103,⁷⁶ the relative inefficiency of the system bares out that authentic savings will only be realized when structural reforms are contemplated.

The crux of the problem is Prop 103's challenging rate-approval process in an area of business which, by the CDI's own admission, is "very complex."⁷⁷ Unlike in other states, insurers in California submit rate filings under a cloud of uncertainty about how the department will respond. The cloud is made thicker by an intervenor system that duplicates the CDI review and obstructs speedy resolution, to the point that rate-approval times double. As a result, Prop 103 likely has encouraged insurers to file rates that are higher than they otherwise would, as it forces them to anticipate a negotiation process. Insurers hope to land at a final rate that is feasible for their business model. In the process, they encourage intervenors to claim credit for consumer savings.

California insurers likely forego making some number of filings, as the system is so difficult to navigate effectively. The opportunity costs are the necessary rate adjustments that are never made and the potential product innovations that are foregone. Slow product approval timelines further lead to product-innovations coming to market in California more slowly than elsewhere—if they come at all.

Prop 103 has served to rob consumers of premium decreases they would have received in other states. This is particularly problematic given that the state requires drivers to carry insurance. When it comes to a product required by law, Californians should expect they are receiving the best system money can buy. As is made clear through this analysis, Prop 103 does not come close to satisfying that expectation.

California is alone in maintaining a right of private intervention in rate-filing proceedings. Its system does not align with the NAIC's model approach to rate regulation. Under the

76. In the response to the Wakely report, the CDI claimed: "During Commissioner Jones' tenure alone, the implementation of rate regulation for property and casualty insurance has resulted in \$1.673 billion in savings for California consumers and businesses." The CDI draws this statistic from the various Consumer Federation of America reports authored by J. Robert Hunter. Those reports measure the difference between insurers' first offer in rate filings and the final rate. Since first offers are made in anticipation of protracted negotiations, it is misleading to claim that differential as a savings produced solely as the result of the law.

77. California Department of Insurance, "Response to Wakely Consulting Group Report," June 18, 2014. <http://www.insurance.ca.gov/0400-news/0200-studies-reports/upload/CDIRespToWakelyRpt.pdf>

Prop 103 model, in fact, insurer profits initially increased, as California's average auto-insurance premiums muddle along among the middle tier of the nation's rankings. California's unique position among states, as a market that cannot be ignored, may be the lone factor marginally offsetting Prop 103's stultifying effects.

There are superior alternative regulatory systems that rely on private agency, not government intervention, to keep premiums low.

POLICY RECOMMENDATIONS

The Illinois experience and the case for liberalization

Of the states in our sample, Illinois enjoys more rate filings than any other. This can be attributed to its very low speed-to-market lag, the absence of private intervenors and the presence of an appointed insurance commissioner. In regulatory terms, California is nearly the opposite of Illinois.

But until early 1969, Illinois' rate-approval regime was one of the nation's more onerous.⁷⁸ The shift away from strict regulatory price controls to open rating has served both the state and its policyholders well. Undoubtedly, the practical hurdles – statutory and political alike – that confront efforts to liberalize California's approach to rate regulation are daunting. But insurers and regulators alike have much to learn from the Illinois approach.

The liberalization of Illinois' rate-approval process came not as a result of any proactive step by the state Legislature, but rather as the result of the previous legislation's sunset.⁷⁹ Even after Illinois' rate-regulation law expired, insurers still were required to file their rates with the Department of Insurance. Illinois also still regulates insurers' solvency and conducts market examinations, roles which are more important and properly within the scope of a regulator's expertise.⁸⁰

Illinois' renewed focus on its mission to ensure insurance markets are subject to appropriate prudential oversight has allowed insurers to seek appropriate prices via competition. The results, according to a study associated with the Brookings-AEI report, are conclusive. Between 1990 and 1999, Illinois' loss ratios and rate levels were less variable than other

78. Stephen D'Arcy, "Insurance Price Deregulation: The Illinois Experience," *AEI-Brookings Joint Center for Regulatory Studies*, p. 248, 2001. <http://citeseerx.ist.psu.edu/viewdoc/download?sessionid=C8633513654C92323EADEC7395E8503B?doi=10.1.138.6248&rep=rep1&type=pdf>

79. Illinois moved away from prior approval in 1969 and embraced an open-competition law in 1970. In 1971, that law's sunset provision led to its expiration. The Legislature, unable to strike an accord on a replacement, did not furnish a replacement. Today, Illinois remains without a rate-regulation law.

80. Illinois Department of Insurance, "Annual Report to the Governor, 2013," p.3. <http://insurance.illinois.gov/Reports/AnnRept/2013AnnualRptToGovernor.pdf>

states; its number of insurers was the highest in the nation; its premium levels were lower than comparable areas; and its rate of uninsured drivers and the size of its residual market both were lower than anticipated.⁸¹

In fact, during the 1990s, Illinois saw not only more rate filings than states with more restrictive regulatory environments, but it also saw smaller rate changes between those filings.⁸² In other words, states that make it easier to change rates are less likely to experience rate shocks. As our research demonstrates, with the benefit of non-proprietary data, that trend continues to this day.

The Illinois experience is indicative of the value of regulatory liberalization, but it is not the only evidence of such a need. A broad-based recent examination of the U.S. system of rate regulation, not targeted at the Illinois system or Prop 103 specifically, compared the various systems employed across the states. The review, by Angelo Borselli, surveyed the U.S. system from a European perspective.⁸³

Borselli's analysis dates to the recent financial crisis, and came to the notably contentious conclusion that U.S. insurance regulation stymies the market while simultaneously failing to monitor solvency effectively. His observations are startling in their rebuke of prior approval systems.

“...in prior approval systems insurers may experience delays or denials in getting approval for rate increases. There could also be political pressure on insurance commissioners to keep rates low. A commissioner might grant approval for a rate increase lower than that requested by the insurer, either to attain the rate increase over a longer period of time or not at all... Because of the time and expense to meet the rate-filing requirements, insurance companies may have less-than-optimal opportunity to adjust their rates to changes in the market. While deregulating might result in higher rate volatility, it would permit insurance companies to set appropriate rates in response to changes in market conditions.”⁸⁴

That trade-off, between market volatility and rate appropriateness, underscores the difficulty of placing authority to regulate rates in the hands of an elected official. In a study of voting patterns related to Prop 103, Dwight Jaffee, who has expressed sympathy for the initiative, found that:

“Voting in favor of price regulation is positively correlated with the level of insurance premium. This result is consistent both with the view that voting behavior is based on self-interest and with the view that the increased demand for regulation is driven by concerns that the large disparity in premiums across counties is unfair.”⁸⁵

Put another way, the combination of the structure of democratic politics and the intricacies of insurance pricing guarantees an electoral focus on retaliatory populism; driving down rates is the best avenue to be elected to the CDI's highest-ranking post. When that political regulator has control over the process of rate evaluation, the negative results described by Borselli are compounded.

On rate evaluation, the standard by which most states judge the propriety of a filed change is whether it is “actuarially sound.” Prop 103 offers a different standard: “most actuarially sound.”⁸⁶ The supposition behind that standard is that, from a band of actuarial data, a singular point can be reached. The phrase is foreign to the actuarial profession. It's not present either in the field-defining “Actuarial Standards of Practice” or in a national survey conducted on the application of actuarial soundness.⁸⁷

The “most actuarially sound” standard allows the CDI to reject a rate even if it passes all actuarial tests of reasonableness. Effectively, the department may substitute its own judgment of what rate would be “most sound” based on the outcome they would like to see achieved. This has become a particularly effective tool when employed as part of the rate-negotiation process. At bottom, Prop 103 has codified in statute the recognition that it is OK to depart from actuarial science to achieve social goals at the expense of the vast majority of premium payers.

The best thing that California could do to improve its insurance marketplace would be to reform its approach to rate approval with the goal of emulating Illinois. Short of that, it has other, more realizable avenues of reform.

Rationalizing the power of intervenors

As has been demonstrated, intervenors slow rate filings from coming to market. In fact, intervention prompts a minimum 45-day hold on filings.⁸⁸ That wait alone would be a relatively

81. Ibid, 261-281.

82. Ibid, 268.

83. Angelo Borselli, “Insurance Rates Regulation in Comparison with Open Competition,” *Connecticut Insurance Law Journal*, Vol. 18.1, May 2012. <http://insurancejournal.org/wp-content/uploads/2012/04/Borselli.pdf>

84. Borselli, 154.

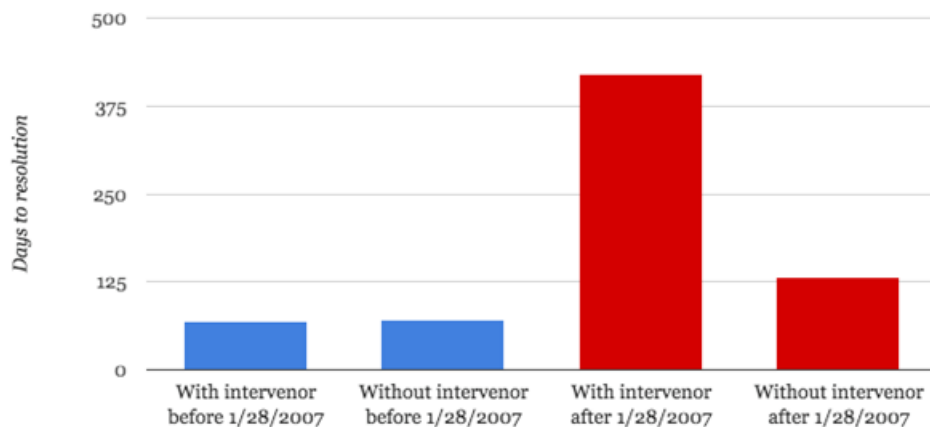
85. Dwight Jaffee, “The Causes and Consequences of Rate Regulation in the Auto Insurance Industry,” *National Bureau of Economic Research*, September 1995. <http://www.nber.org/papers/w5245.pdf>

86. Cal. Ins. Code §2642.8.

87. Shawna Ackerman, “Actuarial Soundness,” American Academy of Actuaries, May 2012. http://www.actuary.org/files/Actuarial_Soundness_Special_Report_5.10.12.pdf

88. Cal. Ins. Code §1861.05(c)

FIGURE 4: AVG. RESOLUTION TIME FOR CALIFORNIA RATE FILINGS



SOURCES: Kingsdale, CDI Web Access to Rate and Form Filings

lengthy approval timeline for other states. At 45 days, California has not even begun its rate review in earnest.

Since intervenors strategically chose their targets, they have an outsized impact on the speed and number of rate filings made. But the deleterious impact of intervenors is felt in other ways. When it comes to intervening in a legal proceeding, the CDI has crafted a system that would be utterly unrecognizable to a civil jurist.

In the California civil-justice system, the California Code of Civil Procedure defines in its preliminary provisions a proceeding as an adversarial action. Specifically:

An action is an ordinary proceeding in a court of justice by which one party prosecutes another for the declaration, enforcement or protection of a right, the redress or prevention of a wrong, or the punishment of a public offense.⁸⁹

The California Insurance Code sets forth that “[a]ny person may initiate or intervene in any proceeding permitted or established pursuant to this chapter.” That would suggest the statute refers to intervention in adversarial circumstances, like a rate hearing, and not mere rate filings.⁹⁰ Rate filings do not have the indicia of an adversarial action.

However, the CDI has chosen to include rate filings in the definition of “a proceeding.”⁹¹ Defining proceeding this way further delays the approval process by allowing intervenors to intercede in the earliest stages of the process, which could

appropriately be handled by the department alone. This is compounded by the precedent of a September 2003 order by former Insurance Commissioner John Garamendi that a rate application that is subject to intervention cannot be withdrawn.⁹² The CDI also has promulgated regulations to permit so-called “intervenor as of right” to intervene in proceedings, regardless of what value they may bring.

Together, these two factors have combined to create a no-lose scenario for intervenors, who are compensated for their intervention based on no initial threshold for relevance and with the benefit of initiating their involvement at the earliest possible stage of a rate filing. Since Jan. 28, 2007 – when the revised definition of “proceeding” was filed with the Office of the Secretary of State –⁹³ the average time from filing to resolution has increased from 72 to 132 days in cases where there is no intervenor, and from 68 to 420 days in cases where there is.

Garamendi and his successor, former Insurance Commissioner Steve Poizner, sought to address a genuine problem. Intervenors who had spent time working on filings could not be compensated in cases where the filing was withdrawn, as there would then be no “proceeding.” To correct this genuine problem, both commissioners sought to overcome the most obvious obstacle: the definition of proceeding.

However reasonable their motives, the fix has been disproportionately burdensome on the process. Not only has it slowed rate approvals dramatically, it has made it even harder for companies to commit to a rate change by rendering them unable to respond to informal guidance from the CDI.

89. Code of Civil Procedure, Preliminary Provisions, 22. <http://www.leginfo.ca.gov/cgi-bin/displaycode?section=ccp&group=00001-01000&file=2-33>

90. Cal. Ins. Code §1861.10(a)

91. *Association of California Insurance Companies v. Poizner*, No. B208402, Dec. 30, 2009. http://www.consumerwatchdog.org/resources/CtApp_ACIC_v_Poizner.pdf

92. *In re the Rate Application of American Healthcare Indemnity Co. et al.*, File No. PA-02025379, Aug. 22, 2003.

93. *Association of California Insurance Companies v. Poizner*, No. B208402, Dec. 30, 2009.

Public participation is important, but the manner of participation has run amok.

By returning the definition of “proceeding” to that in the California Code of Civil Procedure and requiring that intervenors must bring a genuinely novel position to a rate hearing, the speed with which rate filings are resolved could be improved and a significant barrier to market participation could begin to be addressed.

Changing Prop 103

As an initiative, Prop 103 may be modified only by further popular initiative or by a two-thirds vote of the Legislature. Even with a two-thirds vote, legislative amendments are required to “further the purposes” of Prop 103.⁹⁴ Several attempts to change Prop 103 have languished in court because of a failure to further the initiative’s purposes.

Prop 103 lays out with great specificity which rating factors insurers may use to develop auto-insurance rates, divided between 16 optional factors and three mandatory ones. Additional rating factors may be adopted via regulation by the insurance commissioner, so long as those factors have a “substantial relationship to the risk of loss.”⁹⁵

An example demonstrating the challenge of drafting legislation that passes the “in furtherance” test involves persistency. Actuaries long have asserted that customer “persistency” – that is, how long a customer has maintained insurance without interruption – is predictive. However, subsection (c) of Prop 103’s Section 1861.02 prevents insurers from charging increased rates on the basis of a lack of prior coverage. The rationale was that, even if predictive of the risk of loss, allowing insurers to consider this factor would hinder the goal of reducing the number of uninsured drivers.

Former Insurance Commissioner Chuck Quackenbush in the late 1990s promulgated a regulation that allowed insurers to use persistency as an optional rating factor, in spite of the prohibition articulated in Section 1861.02, so long as they did not “punish” customers for not having insurance. Rather, there were allowed reward those who did have continuous coverage.

Lacking a clear definition of persistency, some insurers chose to interpret it as the number of years of continuous coverage the insured enjoyed with a single company, while others interpreted persistency to entail continuous coverage with any insurer. In 2002, former Insurance Commissioner Harry Low sought to clarify the definition by promulgating

a regulation making clear that only the length of time that a driver had been with a single company (or an affiliate) counted toward the discount. This meant that persistency was not “portable” for the customer and thus constrained company-to-company movement of insurance buyers. It made it difficult for companies to lure customers from other insurers.

Some insurers were unhappy about the elimination of “portable persistency” discounts, so they went to the Legislature to seek a remedy. S.B. 841 of 2003, which ensconced portable persistency discounts in statute, was drafted and passed based on Section 1862.02’s prohibition against making rates on the basis of a lack of previous coverage. The bill’s sponsors ensured that it included intent language making clear that the bill “further the purpose of Proposition 103 to encourage competition among carriers so that coverage overall will be priced competitively.”⁹⁶

Alas, upon challenge, the California Court of Appeal struck down the bill.⁹⁷ The court ruled that the thinking behind 1861.02(c) was that, between rating factors, cost distribution is a zero-sum game. For example, previously uninsured drivers will face higher rates if insured drivers are offered portable persistency discounts, because one factor will need to be adjusted to cover the cost of the other.⁹⁸ By adjusting the rate, the previously uninsured will be made to subsidize the persistently insured. For this reason, S.B. 841 was found not to “further” Prop 103’s purpose – which, ultimately, the court decided is to expand access to auto insurance.

Given the difficulties and impediments to scrapping Prop 103, it is more important to make it work for the public. That means looking to other states for clues about elements of the California system that are obviously dysfunctional. Changes that can pass an “in furtherance” test must be the highest priority.

CONCLUSIONS

Prop 103 was passed at a time when insurance cost drivers were ebbing from a high tide. Relative to the rest of the nation, California insurer profits rose in the first decade following the passage of Prop 103. While those profits have diminished, largely a result of the adoption of a rate-of-return template, the current system continues to allow sizable portions of the insurance industry to profit without significant competition. By contrast, Prop 103 does little to protect consumers from insurance rates that are higher than they would other

94. Text of Proposition 103. Section 8. Technical Matters. <http://www.consumerwatchdog.org/feature/text-proposition-103>

95. Cal. Ins. Code §1861.02(e)

96. Senate Bill 841 (Perata), 2003. http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb_0801-0850/sb_841_bill_20030802_chaptered.html

97. *The Foundation for Taxpayer and Consumer Rights v. Garamendi*, No. B176461, September 2005. <http://caselaw.findlaw.com/ca-court-of-appeal/1360219.html>

98. For an interesting discussion on how rating factors are weighed, i.e.: “pumping” and “tempering,” see *Spanish Speaking Citizens’ v. Low*.

wise be in a more dynamic market and under a more flexible regulatory system.

The authors of Prop 103 wrote their ballot initiative on the assumption that underlying auto-insurance costs would continue to rise and that the system should limit these inexorable increases.⁹⁹ Instead, underlying costs began to fall, as the liability system changed, crime declined, norms against unsafe driving behavior took hold and new technologies helped drivers avoid crashes.

The CDI claims the purpose of the prior-approval process is to “ensure that rates are not inadequate, excessive or unfairly discriminatory.”¹⁰⁰ Yet the very structure of Prop 103 is to force rates to be in excess of what they could be under another system. A system intended to limit rate increases has largely served to limit rate decreases and increase insurer profits.

Many major California insurers file for rate changes only when required to do so by law, thanks in large part to intervenors that can engage too early in the process and in an unrecognizably unfettered fashion. As a result, insurer savings rarely are passed on to consumers. The difficultly implicit in lowering rates hurts everyone. Under Prop 103, the CDI is not content to let competition limit rate increases. Instead, to see their own political goals achieved, administrative litigation is the preferred avenue.

While Prop 103 has increased the regulatory bureaucracy and associated costs of doing business in California, it has done nothing to reduce insurance fraud or insurance rates. Just as troubling, instead of saving Californians money, it has dramatically expanded the regulatory purview of the CDI at immense cost to the taxpayer and premium-payer alike.

Notes on methodology

Much care went into capturing an “apples-to-apples” analysis of rate filings between the states, although this was difficult. For the year 2013, not all of the states employed the same rate-filing system. As a result, compiling an accurate total of filings for each state required ensuring that counted filings were of the same type. For the purposes of establishing a baseline, because California was still using its “WARFF” system in 2013 and not the “SERFF” system that it uses now, we used WARFF to define the scope of our search criteria.

Across all states, we compared rate filings; both rate and form filings; and rate and variance filings. We chose these filings because they are readily comparable between the filing plat-

forms and are directly susceptible to the impact of Prop 103’s requirements. Class plans were omitted because they are a separate threshold requirement that is independent of other prior-approval rate submissions and, insofar as they are relevant, are redundant of “new program” filings.¹⁰¹

There was a discrepancy between the CDI’s master list of public notices of rate filings and the number of search results rendered using WARFF. Fewer results were reflected on the 2013 master list.¹⁰² To err on the side of caution, this paper uses the WARFF search results for the purposes of comparison. To replicate the results of our WARFF search, enter the following search terms:

Line Type: Personal – Line Code: Auto Liab/Phys
Damage – Type of Filing: Both Rate and Form; Rate;
Rate and Variance; New Program – Public Notice
Date: 01/01/2013 – 12/31/2013.

Because California’s system of classification differs from other filing search platforms, we were forced to review filings individually to ensure they corresponded to the filings reflected in the WARFF search. For instance, using Washington’s filing search with similar search criteria to California’s yields filings that do not bear directly on rates (e.g., symbol changes). Thus, while the unfiltered result from Washington is 231 filings during the period in question, the number of comparable filings during that period is 166. In Illinois, the unfiltered result of a similar search yields 621 filings, though only 304 are comparable to the WARFF results.

Necessarily, this process required the use of subjective judgment in discriminating between relevant and irrelevant data. As a result, the findings of this research are better understood as indicative of larger trends. What’s more, since it is California’s system that is at issue in this study, we employed the principle of charity and, in close cases, opted to be more inclusive in our consideration of California filings and more discriminating about including filings from other states.

99. Sullivan at 5.

100. California Department of Insurance Response to Wakely Consulting Group Report at 2.

101. According to the CDI, “Class Plan (Rev. 11/10/09) - is used to file changes in any Private Passenger Automobile rating factors or introduce a new Private Passenger Automobile program...” Since filings changing rating factors alone are beyond the scope of our analysis in other states and California maintains a separate “new program” filings, class plan filings have not been included in this analysis.

102. California Department of Insurance. “Public Notices of Rate Filings.” <http://www.insurance.ca.gov/0250-insurers/0800-rate-filings/0100-rate-filing-lists/public-notices/index.cfm>

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