California's Proposition 103: An Overview and Analysis

An Honors Thesis (ID 499)

by

Teresa K. Holmes

Thesis Director

[Signature]

Ball State University

Muncie, Indiana

December 1989

Expected date of graduation: December 1989
Comments by the Author

I became interested in Proposition 103 while doing summer work for Great American Insurance Company. In fact, during my very first day at work a special meeting was held to distribute work assignments for the California rate rollback exemption filings. For the next three weeks, all current actuarial projects were dropped and efforts were directed toward completing the California exemption proposals. Consequently, the importance of Prop 103 became very clear to me. Not only is Prop 103 threatening to California property-casualty insurers, but it is also important to the entire insurance industry due to the possibility of similar measures spreading to other states and other lines of insurance.

At this time, I will warn the reader that Proposition 103 is an extremely current topic; consequently, the present status of each of its controversial provisions is constantly changing. For updated information, I highly recommend National Underwriter magazine (specifically articles written by Alfred G. Haggerty) from which much of my informational data was gained.

In conclusion, I wish to extend a special thanks to Great American Insurance Company for aiding me in my initial research and understanding of Proposition 103. I would also like to thank Dr. John Beekman for his support and suggestions on this project.
# Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td></td>
</tr>
<tr>
<td>History of Proposition 103</td>
<td>1</td>
</tr>
<tr>
<td>Prop 103 Legislative and Judicial Battles</td>
<td>4</td>
</tr>
<tr>
<td>Implementation of the Prop 103 Supreme Court Decision</td>
<td>6</td>
</tr>
<tr>
<td>Detailed Analysis of Proposition 103</td>
<td>9</td>
</tr>
<tr>
<td>Twenty Percent Rate Rollback</td>
<td>9</td>
</tr>
<tr>
<td>Territorial Rating and Other Rating Factors</td>
<td>11</td>
</tr>
<tr>
<td>Rebating</td>
<td>14</td>
</tr>
<tr>
<td>Antitrust Laws</td>
<td>15</td>
</tr>
<tr>
<td>Overview of Other Prop 103 Provisions</td>
<td>16</td>
</tr>
<tr>
<td>Costs of Prop 103 VS. Benefits</td>
<td>17</td>
</tr>
<tr>
<td>Overall Importance of Proposition 103</td>
<td>18</td>
</tr>
<tr>
<td>Impact of Prop 103 on Other States</td>
<td>19</td>
</tr>
<tr>
<td>In the Future</td>
<td>22</td>
</tr>
<tr>
<td>Future of Proposition 103</td>
<td>22</td>
</tr>
<tr>
<td>Another Alternative for Auto Insurance</td>
<td>24</td>
</tr>
</tbody>
</table>
As we approach the 1990's, insurance rates continue to rise to even greater heights. Many groups including both consumers and the insurance industry itself are looking for remedies to this serious problem. California has created its so-called remedy in the legislative passage of Proposition 103.

**History of Proposition 103**

Although this type of measure might have been initiated in any state, California certainly sets a perfect stage. It has the "third-highest auto premiums in the country [and] is the last big state to legislate prior rate approval." [9] Proposition 103 may also be considered a postponed side effect of Proposition 51 which was passed by California voters in 1986.

Proposition 51 was a law that "did away with joint-and-several liability - the 'deep pocket doctrine' - and restricted defendants' civil liability for non-economic damages, such as pain and suffering, to their relative proportion of fault." [57] Although the proposition was billed as a way to make commercial coverage more available and affordable, those opposed to it came to the conclusion that the measure was an attempt by the insurance industry to limit damage awards and make up for lost investment income. California consumers falsely understood Proposition 51 to be an initial solution to the Golden State's insurance problem. Obviously, these consumers were disappointed with the reality of the measure. This disappointment and anger eventually led to combined efforts which specifically addressed the state's current auto insurance crisis. [57]

During the end of 1987 and the beginning of 1988, a free-for-all filing occurred for initiatives geared to diminish the problems with automobile insurance availability and affordability in California. In all, seven initiatives were filed. The Association of California Insurance Companies filed for the establishment of a no-fault system of insurance and limited contingency fees for attorneys representing automobile accident victims while various consumer groups and trial lawyers included definite rate rollbacks in their initiatives. Also, Consumers Union and the Center for Public Interest Law proposed a state-run auto insurance plan which would cover each registered vehicle in California at a cost of about $300 each. [57]

Six of these initiatives were then circulated in search of the 372,198 valid signatures required to place them on the November 1988 ballot. The California Trial Lawyers Association's proposal (the seventh initiative) was dropped in support of the Insurance
Consumer Action Network's initiative. [16] Four of the six initiatives received the required signatures and were then placed on the ballot. These initiatives were Proposition 100 backed by the Insurance Consumer Action Network and California trial lawyers, Proposition 101 sponsored by state Assemblyman Richard Polanco, Proposition 103 known as the Voters Revolt Initiative and backed by several consumer groups and consumer advocate Ralph Nader, and Proposition 104 backed by the insurance industry. [39]

**Proposition 100**

Proposition 100 was supported by the Insurance Consumer Action Network and California trial lawyers. It would have required a 20 percent rate reduction for good drivers and prior approval of rate changes in excess of 7.5 percent for personal lines and 15 percent for commercial lines. It would have prohibited: territorial rating for auto insurance, no-fault auto insurance, and any change in the attorney contingency fee system without two-thirds approval of the Legislature. Additionally, Proposition 100 would have repealed insurer's anti-trust exemption and California's anti-rebate law, established a consumer advocate in the Department of Insurance, and allowed banks to both underwrite and sell insurance. [39]

**Proposition 101**

Proposition 101 was sponsored by state Assemblyman Richard Polanco. It would have reduced premiums by 50 percent for both bodily injury and uninsured motorist insurance. In exchange, it would have limited general damages and non-economic damages each to 25 percent of the economic damages except in cases of serious and permanent injury. Additionally, attorney's fees would also be limited to 25 percent of economic damages for most automobile cases. [39]

**Proposition 103 “The Voters Revolt Initiative”**

Proposition 103, created by Harvey Rosenfield, was supported by various consumer groups and consumer advocate Ralph Nader. It called for a 20 percent reduction of the rates in effect as of November 1987 followed by a one year rate freeze. It also requested prior approval of rates with investment income included in the consideration of these rates and a 20 percent good driver discount. Rates would be based mainly on the driver's driving record, number of miles
driven, and driving experience, therefore, saying 'goodbye' to age, gender, and territory of residence as primary rating factors. Finally, under this proposition, banks would be allowed to sell insurance; the office of insurance commissioner would become an elected position; the anti-rebate law would be repealed; and insurer's antitrust exemption would be eliminated. [39]

**Proposition 104**

Proposition 104, geared mainly toward no-fault insurance, was supported by the insurance industry. It would have reduced the average statewide rate for bodily injury liability and uninsured motorist insurance by 20 percent for 2 years and would have prohibited insurers from raising rates or from canceling or non-renewing policies in respect to claims made for no-fault benefits. In turn, a no-fault system would have been established. Under this system, accident victims could not have sued unless they suffered serious and permanent injuries; their damages exceeded no-fault limits; or the accident was caused by a convicted drunk driver. However, drivers would have had to purchase minimum coverage of $10,000 in medical expenses, and $15,000 in lost wages. Proposition 104 would have also limited attorney's contingency fees in auto cases to 33.3 percent of the first $50,000 of an award, 25 percent of the next $50,000, and 15 percent of the remaining amount for awards over $100,000. Finally, the proposition would have reaffirmed California's anti-rebate law, and barred banks from selling insurance. [39]

Each of these proposals placed the interests of its supporters first which obviously created several interesting debates. The insurance industry advertised its no-fault Proposition 104 to be "the only proposal which seeks to reduce the legal costs of auto insurance." [32] Its opponents, however, felt that the public may have been misled about the cost-savings involved in no-fault auto insurance and disapproved of the $57 million spent by the industry for its campaign. [20] Prop 104 would have set specific limits on attorneys' contingency fees; therefore, the proposition was also strongly opposed by trial lawyers.

Of the other three proposals, Proposition 103 was the most controversial because it called for a rate reduction without lessening the industry's outflow of insurance dollars. As reported by California's insurance commissioner, Roxani Gillespie, Proposition 103 could drive 35 insurers to insolvency in two years. [38] Also, Prop 103 called for discontinuing the use of
territorial rating as a primary rating factor. The controversy of this requirement was justified by Gillespie's estimate that if auto insurers could not consider territory in setting rates, two-thirds of California's insured vehicles would be assessed with an average 22 percent increase while one-third would be pleased by a decrease of about 36 percent. [25]

Finally, these heated disputes led to a poll by the California Field Poll. In the survey, half of a group of 889 registered voters were told who was sponsoring the initiatives and half were not. Proposition 104 was typically disapproved of; however, it was disliked even more by those knowing that it was sponsored by the insurance industry. This supports the industry's ever present image problem. In contrast, Proposition 100, whose supporters included the California Trial Lawyers Association, was favored by 85 percent when sponsorship was not disclosed and slipped only 7 percent among those to whom it was disclosed. Both Proposition 101 and Proposition 103 fell in the middle range; however, the rating for Prop 103 jumped 16 percent when voters were told that it was supported by Ralph Nader in addition to several consumer groups. [19]

By this time, California was aware that regardless of the election day results, lawsuits would develop if any of the proposals were approved by voters. A poll by the Insurance Initiative Campaign Committee indicated, however, that all proposals might be turned down due to the confusion of the voting public. [22] Instead, on November 8, 1988, the voting public stunned insurers by narrowly approving Proposition 103 by a 51 - 49 margin.

Prop 103 Legislative and Judicial Battles

At 9 a.m. the day after Election Day, the first lawsuit was filed with the California Supreme Court by State Farm, Allstate, Fireman's Fund, Cal Farm, and the Association of California Insurance Companies. The suit challenged Proposition 103 on constitutional grounds and alleged that "the initiative violates the due process clause because it doesn't consider loss costs and sets arbitrary rollback rates." [20] The filing of this lawsuit as well as three others resulted in a stay of all provisions of Prop 103. This stay was challenged by Attorney General John Van de Kamp. He stated that "Consumers are entitled to have the law they enacted for their own protection implemented without delay." [41] After the written arguments of both sides were reviewed, the court decided to hear the industry's suit challenging the constitutionality of Prop 103 on the grounds that the proposition would force those
companies to sell insurance at a total loss of about $4 billion in the first year alone. The provisions of Prop 103 that were challenged by this lawsuit included: the rollback, reduction, and freeze of rates; limitations on nonrenewal of auto insurance policies that would apply retroactively to existing policies; and the creation of a private corporation to represent consumers. Other sections of the proposition not directly included in the suit, however, were allowed to go into effect. These included: restrictions on policy cancellations and nonrenewals, prior approval of rates, elimination of the insurer's antitrust exemption, approval of banks to sell insurance, repeal of anti-rebate laws, limited use of territories as rating factors, and the position of California insurance commissioner being an elected rather than appointed position. [13]

In addition to this major lawsuit, many legislative actions were concurrently being initiated in response to several insurance companies' post Election Day reactions. As many as 70 insurers announced their withdrawals from California following the election. Although a survey determined that 94.3 percent of the private passenger auto insurers were renewing old policies and 80.8 percent were writing new policies, California legislators still felt that large penalties should be imposed against companies refusing to continue to sell insurance. [41] This led to the introduction of a bill (SB 103) that would make insurers subject to a fine if they drop 5 or more percent of their auto policies expiring during any 30 day period. The fine would be equal to 50 percent of the previous year's private passenger auto premium multiplied by the percentage of nonrenewals for that 30 day period. [26] This bill, introduced by State Senator Alan Robbins, was passed by the California Senate and approved by a state Assembly Committee. [54]

Additional legislative action was taken in response to a situation specifically involving State Farm and SAFECO. State Farm, itself, was no longer considering new applicants; instead, its affiliates, whose rates were 20 to 60 percent higher, were accepting those applicants. SAFECO, on the other hand, was accused of changing its underwriting standards because many of its new customers were only offered a policy with 25 percent higher rates designed specifically for high-risk drivers. In response to these two situations, Senate President Pro Tem David Roberti proposed "a bill that would make it illegal for insurers to change underwriting standards or place applicants with affiliated companies which charge
higher rates for the same risk." [17] The bill initially fell 3 votes short, but Roberti promised to bring it back for another vote. [26]

A third bill inspired by Proposition 103 was introduced by Assemblyman Patrick Johnston. This bill proposed a rate freeze at November 7, 1988 levels for all lines of insurance affected by Prop 103 until the constitutionality of the proposition was decided. Johnston introduced the bill in response to widespread reports that the stay on Prop 103 created a loophole for uncontrolled rate increases. Commissioner Gillespie disputed this accusation by responding that rate increases of more than 10 percent must be accompanied by supporting data, and lesser increases must be justified upon request as stated by the existing laws. [13]

**Ruling on Constitutionality of Prop 103**

Finally, after 6 months of legal disputes and legislative battles, the California Supreme Court ruled on the constitutionality of Proposition 103's controversial provisions. Basically, almost all of the proposition was upheld including the 20 percent rate rollback followed by a one-year rate freeze at those levels. Additionally upheld was the provision that auto insurance policies can be canceled or nonrenewed only in cases of unpaid premiums, fraud, or substantial increase in the hazard insured against. Although the outcome favored those in support of Prop 103, a small portion of the ruling was positive for the insurance industry. [14] This included the holding that the creation of a consumer advocacy corporation is unconstitutional. Also, the insolvency standard for exemption from rate rollbacks was held unconstitutional. Instead, the standard of a "fair and reasonable" rate of return was substituted. [43]

**Implementation of the Prop 103 Supreme Court Decision**

In regard to this court decision, Commissioner Roxani Gillespie proposed that a "fair and reasonable" rate of return would be decided on a case-by-case basis for each insurer who submitted an application for exemption from the 20 percent rate rollback. The 16 page filing application, necessary for each line or subline of insurance, required the inclusion of a detailed computation of investment income allocated to California and how it is considered in the rate level. It also required exhibits such as: (1) a Rate Level History; (2) Earned Premium Adjustment; (3) Incurred Loss; (4) Loss Development Factors; and (5) Annual Trend Factors
and Trending Methodology. In addition to the application, all filings were required to include: (1) Calculations showing the applicants rate of return expressed as both a percentage of equity and earned premium for the Proposition 103-mandated premium level as well as the premium level applied for; (2) statements of the applicant's justification as to why the mandated premium level results in an unfair rate of return and why the premium level applied for results in a "fair and reasonable" rate of return. [10] (For detailed Rate Filing Documents Requirements see California Department of Insurance, Information Packet, Proposition 103, May 11, 1989)

All insurers writing any class of insurance affected by Proposition 103's rollback provision were required to submit a statement to the commissioner by June 16, 1989. This statement would verify the insurer's response to the mandated rollback. If the insurer was not applying for exemption, the statement would submit that the insurer had rolled back its premiums retroactive to the effective date of Proposition 103 (November 9, 1988). Otherwise, the statement would verify that the insurer had applied for exemption prior to June 3, the effective date of the Supreme Court Decision, and was currently using the rate level applied for. [10] Overall, 230 companies accepted the prescribed rollbacks while 445 property/casualty companies combined for approximately 4000 applications for rollback exemptions. [2]

The next step in the implementation of Prop 103 was the review of each exemption application by the California Department of Insurance. Although this process was run by Commissioner Gillespie, California Attorney General John Van de Kamp voiced his opinion by calling for the insurance commissioner to reject all of the petitions for exemptions. [44] (The Attorney General's reasoning will be discussed later in the analysis section of this paper.) Gillespie, however, rejected this advice and continued to let the department's specially assembled team of 70 financial and rate examiners review and decide upon each application. As a result of this review process, 180 auto insurers were eventually exempted from Proposition 103 rollbacks, and public hearings were called for the cases where requests for exemptions were determined to be invalid. Commissioner Gillespie stated, "Basically, we are calling companies to hearings on their exemption request if they made a profit of more than 11.2 percent." The commissioner determined the 11.2 percent threshold by averaging the rate of return for all U.S. property-casualty insurers for the past 15 years. [34]
As a result of that 11.2 percent benchmark, a total of 47 insurers representing approximately 47 percent of California's property and casualty market were scheduled for rate hearings. Thirteen of these 47 are major insurers with the sum of their indicated rollbacks equaling more than $415 million. These thirteen are Allstate, California State Automobile Association, Progressive Casualty, SAFECO, State Farm Fire & Casualty, 20th Century, United Services Automobile Association, Fireman's Fund, United States Fidelity & Guaranty, Government Employees Insurance Company, United Pacific, Calfarm, and Century-National. They represent the first group of insurers to have "company specific" hearings. They also represent some of the most efficient insurers; therefore, as stated by Commissioner Gillespie, "the rest of the industry should take heed, because this may lead us to very demanding standards of efficiency." [29]

An additional three companies who met the exemption guidelines were also scheduled for hearings due to requests by intervenors, including Attorney General Van de Kamp. These three companies, State Farm Mutual, Farmers (Los Angeles), and the Automobile Club of Southern California, write nearly 40 percent of California's private passenger automobile insurance. [29]

With all 50 hearings set, one would think that the supporters of insurance reform would be at least temporarily satisfied with the implementation of Proposition 103. Obviously, this assumption is wrong, because on September 7, 1989, Harvey Rosenfield's Voter Revolt, along with two other insurance reform groups, filed a suit charging California Insurance Commissioner Roxani Gillespie with failing to lawfully implement Proposition 103. The suit asks the court to order Gillespie to stop using 11.2 percent as the standard for the fair rate of return, because that standard was established with "no public notice or comment and in avoidance of the state's Administrative Procedure Act's protections, safeguards and mandatory legal review." [28] The suit also accuses Gillespie of failing to start the process of adopting the regulatory factors which insurers must use for rating and underwriting decisions beginning November 8, 1989. [28]

In turn, this lawsuit filed by insurance reform groups did trigger some larger steps of action taken by Commissioner Gillespie. Her first step was a six-month rate freeze on private passenger auto rates announced on October 2. The following day she issued an emergency
order requiring insurers to discontinue territorial rating without any increases to offset required rate decreases. The two announcements together put Commissioner Gillespie in another unfavorable position; however, this time it was the insurers who were threatening to sue. [40]

Combined efforts eventually led to an agreement with consumer groups, insurers, and the state attorney general which maintains the six-month rate freeze while lifting the ban on territorial rating. Actually, negotiations will be held to determine any additionally necessary rating factors such as territories. Commissioner Gillespie called the agreement, "a milestone in implementing Proposition 103." [40] The agreement also seemed to set a more productive atmosphere for the public hearings to determine rating factors, fair rate of return, and other related questions. These hearings were to be held prior to the "company specific" hearings. [Note: The status of territorial rating has changed since this section was written. This change will be discussed in the final section of the paper.]

**Detailed Analysis of Proposition 103**

To further understand Proposition 103 as a whole, one must understand the controversy associated with several of its major provisions. This section will focus on provisions that may cause large impacts on either consumers or insurers. The section will also discuss the implementation costs of Prop 103 versus the benefits likely to be gained from it. During this section it is important to remember that although focus may be placed upon private passenger auto insurance, Prop 103 provisions apply to nearly all lines of property-casualty insurance.

**Twenty Percent Rate Rollback**

Of all the Proposition 103 provisions, the 20 percent rate rollback must be the one most well known by both insurers and consumers. It is also one of the most disputed provisions of the proposition. As stated earlier, the initial wording of Prop 103 which included the insolvency standard would have deprived California insurers of more than $4 billion in premiums during the first year. From a consumer standpoint, this fact alone may not seem unfair if all of the insurers are maintaining a high rate of return. However, with the additional information that approximately 35 insurers would become insolvent within two years, even consumers should see that the original wording of the proposition was unfair. In addition to
simply being unfair, the California Supreme Court ruled that the insolvency standard for exemption from the 20 percent rate rollback was unconstitutional. The court instead substituted the standard of a “fair and reasonable” rate of return.

**What is a “fair and reasonable” rate of return?**

One possible way to answer this question is by applying the standard business school approach to returns. This approach calculates the required rate of return for investments by summing a risk-free rate, plus the market risk, added to the specific risk of the enterprise if it is typically riskier than the general market. The risk-free return is best represented by government bonds which are currently between 9 and 10 percent. The market premium is generally between 2 and 4 percent, and since property-casualty insurance is typically riskier than the general market due to catastrophes, the insurance cycle, and unexpected lawsuit expenses, an additional risk premium of 6 to 8 percent should be added. In total this brings the fair rate of return to between 17 and 22 percent. [45]

Another possible answer was presented by Commissioner Gillespie who suggested 11.2 percent as a benchmark because it represented the industry’s average rate of return for the last 15 years. Before presenting this suggestion, Gillespie spoke to the California Public Utilities Commission and learned that the state’s utilities were allowed a 15 percent return on their investment. [24] This coincides with Business Week magazine’s statement that the average rate of return for other similar industries is 15 percent. [6]

According to consumer advocate Ralph Nader, 10 to 15 percent would be a “fair and reasonable” rate of return for property-casualty insurers as long as they demonstrate proper reserving practices. Harvey Rosenfield, author of Proposition 103 and chairman of Voter Revolt, disagreed with Nader by saying that no specific percentage should be set. Instead, he felt that regulators should focus on differentiating between well run companies and “wasteful, slothful” ones. [31] Obviously, Mr. Rosenfield’s opinion played a large role in the establishment of the previously mentioned lawsuit filed against Commissioner Gillespie for using the 11.2 percent figure. In addition to this opinion, Rosenfield did feel that insurers were deliberately inflating loss reserves to disguise their profits. These charges were rejected by the California insurance department which found the reserves of the companies in question to be
reasonable. [5] It is important to note that if loss reserves are inadequate, companies may not be able to cover all claims if a catastrophe occurs.

Attorney General John Van de Kamp agreed with Harvey Rosenfield's proposal that no single preset figure is an appropriate standard for judging all companies' return on equity. In fact, Van de Kamp initially called on Commissioner Gillespie to reject all exemption applications after having his own team of legal and actuarial experts review the exemption requests. Van de Kamp supported his opinion by claiming that insurance companies spend too many dollars on overhead and expenses such as insurance initiatives. The attorney general additionally offered the following methodology for calculating fair rate rollbacks: (1) exclude expenses that provide no benefit to customers such as political contributions, (2) impose a ceiling on recoupable expenses so that companies cannot pass on unreasonable overhead and salary expenses to their customers, (3) calculate projected claims using historical data in addition to the company predictions, (4) when calculating a company's earnings take into account all sources of income including investment income, and (5) allow for profit only on the investment that is actually needed to support the company's insurance operations. [44]

Finally, from an actuarial point of view, any mandatory rate rollback insults the actuarial profession which has devoted tremendous time and energy to developing sound principles of insurance pricing. Prior approval of rates may be a good idea because it provides a control system for the insurance industry, but if consumers and legislators begin dictating rates, the industry will not survive. Also, in deciding upon a fair rollback or increase for each company, all effects of the proposition should be considered. Both the 20 percent good driver discount and any changes in rating factors such as territorial rating need to be considered in judging a company's forecasted rate of return. Possibly some or all of Attorney General Van de Kamp's suggestions may need to be implemented; however, consumers must still remember that insurers have the right to earn a "fair and reasonable" rate of return.

**Territorial Rating and other Rating Factors**

Specifically, Proposition 103 requires that automobile insurance rates be based in decreasing order of importance on the insured's driving safety record, miles driven annually, and years of experience. This list leaves out several important factors which are currently
used as top rating factors. These factors include age, marital status, gender, vehicle make and model, and geographic location. The possible use of these factors, specifically geographic location, continues to be questionable.

On October 3, Commissioner Gillespie placed a ban on the use of territorial rating which stated that no increases were allowed to offset required rate decreases. Obviously, the commissioner was pressured into making the order because she herself described the complete elimination of territorial rating as 'wrong' and publicly vowed to fight against it as long as she held the office of insurance commissioner. After a period of negotiations between consumers, insurers, and the attorney general, this ban was lifted. The participating parties agreed to continue to negotiate in hopes of producing a rating system using the three factors dictated by Prop 103 in addition to any factors added during the negotiations. [40] (Again, the status of territorial rating has changed since this section of the paper was written. This change will be discussed in the final section of the paper.)

How useful are the three required rating factors?

These factors - driving safety record, annual mileage, and number of years of driving experience are generally useful in determining risk; however, they are not as valuable at predicting future loss potential as the more traditional factors. The reasoning behind this statement is that collision and comprehensive coverage cannot be adequately priced without knowing the vehicle make and model. Additionally, a person’s driving record (the first factor) is an insufficient indicator of future accidents unless it is tempered by other, more valid rating criteria. More specifically, a 1984 study by the All-Industry Research Advisory Council revealed that only 58 percent of California accidents with vehicle damage of $500 or more appeared on the state’s motor vehicle reports. [50] Also, one must understand that most people have too few accidents to establish their own probability of risk.

In considering the usefulness of the second and third factors, the ability to verify the factors becomes important. Although the second factor, annual mileage, can be related to a driver’s probability of risk, it is not a good rating criterion because it is difficult to verify. Years of driving experience is a reliable indicator of loss potential because it is both easily verified and can be related to the probability of risk of an insured. This third factor, however,
is still secondary to age as a useful rating criterion according to the National Association of Independent Insurers. [50]

**How important is territorial rating?**

Territorial rating has proven to be a statistically sound rating factor according to actuaries. To eliminate territories or place artificial restrictions on their use would distort the automobile pricing system. The cost of providing insurance coverage would be unfairly distributed because those who represent less of a risk would be placed in the same category with those who have a greater probability of loss. More specifically, car owners in suburban and rural areas would be subsidizing the city drivers.

According to Commissioner Gillespie, if territorial rating is eliminated in California, private passenger auto insurance would increase on 7.35 million vehicles in 55 counties and decrease on 3.97 million vehicles in three counties. [37] Consequently, this provision of Proposition 103 would be unjust to 65 percent of California automobile policyholders. It is easy to show the unfairness involved in the elimination of territorial rating by comparing the average amount of loss per insured vehicle in Los Angeles Metropolitan South with the comparable rate in Inyo County. This Los Angeles territory has the highest average incurred loss in California at $606.19 per vehicle; whereas, Inyo County has the lowest at $145 per vehicle. [50] Clearly, elimination of territorial rating is not in the best interest of California consumers unless they live in Los Angeles or another large metropolitan area.

**What other rating factors are important?**

The National Association of Independent Insurers (NAII) suggested that the highest possible weight be given to vehicle make and model for pricing collision and comprehensive coverage. They claim that extensive analyses of physical damage losses have shown that certain types of cars have had average losses significantly higher or lower than the average car in their group. More specifically, "some cars are more easily damaged, more expensive to repair and more tempting to thieves than other cars." [50]

A second important rating factor is gender. According to the National Safety Council, male drivers have a 30 percent higher accident frequency per mile than female drivers. This rating criterion as well as two other highly favored factors, age and marital status, have
previously been combined to put unmarried males under the age of 25 in the highest premium group. NAII data confirms the use of age as a valid rating factor. They have found that the amount of loss per insured car incurred by young drivers is 86 percent higher than that incurred by adult drivers. Drivers under the age of 25 are not only involved in a higher percentage of accidents, but their average claim costs are also higher. Finally, marital status as well as age often reveals a level of maturity and responsibility that is not indicated by years of driving experience. [50]

From an actuarial standpoint, rates should be determined using all factors that are statistically proven to influence incurred losses for a particular group of automobiles. If valid factors are omitted from a pricing model, many consumers may be unjustly paying higher rates that will eventually be used to subsidize other groups of insureds who represent greater risk. Consequently, it is important that age, marital status, gender, vehicle make and model, and geographic location be added to the proposed rating system. Consumers, insurers, and legislators must find a more valid way to reduce premiums across the board which will in turn reduce premiums in the troubled metropolitan areas.

**Rebating**

One small, yet important provision included in Proposition 103 is the repeal of California's anti-rebating laws which have been in place for approximately 80 years. The repeal of these laws allows for rebating of commissions by both agents and brokers. Although rebating has no direct effect on insurance companies, it is of importance to both consumers and agents.

**Is rebating beneficial to either agents or consumers?**

Rebating is obviously not monetarily beneficial for agents; however, it is additionally unfavorable because it creates bookkeeping and public relations difficulties for agents who use it. Any agent who rebates must either pay taxes on his entire commission including the rebated portion or file form 1099 with the Internal Revenue Service therefore transferring tax responsibilities for that rebated portion to his client. [23] Rebating may also "produce considerable job dissatisfaction and turnover among agents who feel they are less able to serve
the customer correctly and are unfairly perceived as being manipulative and underhanded" according to Drs. Lawrence Crosby and Kenneth Evans, researchers at Arizona State University. [53] Finally, the number of new agents who are able to prosper in the insurance industry may decrease if long-term successful agents decide to offer rebates. [23]

Rebating may have negative effects on consumers as well as agents. For example, consumers may fail to obtain the best policy or most qualified agent because they are pursuing a large, one-time price discount. This pursuit might also lead to delaying the purchase of insurance despite the financial risk of being underinsured. [53] Rebating may additionally hurt consumers by diminishing the incentive of employers to maintain a safe work place. Since rebates are unrelated to the insured’s experience, companies might be receiving large rebates regardless of unsafe working conditions. [46] All of these factors become important when comparing the single benefit of a one-time monetary gain against the adverse effects of rebating.

**Is mass rebating likely?**

Many agents believe that most consumers are not even aware of rebating or that Proposition 103 makes it legal in California. They additionally believe that California will follow Florida’s example by creating such strict anti-discriminatory regulations that rebating will be extremely limited. As it stands, agents of reciprocal companies are unable to offer rebates while all other agents can. This in itself may be judged as discriminatory which in turn will require changes in the current wording of this Prop 103 provision. Last, but not least, agents themselves will be hesitant to rebate due to the extra bookkeeping and public relations involved in addition to the obvious monetary loss that rebating represents. When combined, these factors suggest that mass rebating will probably not occur which may be a lucky conclusion considering the downfalls discussed in the previous section.

**Antitrust Laws**

As a result of Proposition 103, insurance companies that practice in California are no longer exempt from the state's antitrust laws. The purpose of excluding insurers from exemption is to reduce the potential of anti-competitive activities such as interdependent pricing. One major difficulty with the provision is that the antitrust "guidelines warn that
insurers should not be aware of pricing data compiled by competitors, while Proposition 103 requires data to support rates." [42] This brings about the question: How can companies price their products at competitive rates if they are not aware of the pricing data which they are to compete against? Another problem with the provision results from the limitations placed on agents and brokers. According to the Professional Insurance Agents of California, "The notion that an agent or broker incurs criminal liability for disseminating insurers' underwriting and pricing information ignores the benefits of the broker's efforts to 'shop around' for the best coverage at the best price for the client." [8] A third problem with the provision lies with the elimination of standardized insurance forms. Standardized forms not only reduce insurance coverage disputes, but they also allow agents and brokers to provide accurate and reliable counseling to their clients. These three points show that although the elimination of insurance companies from antitrust exemption was proposed to protect consumers, the provision additionally has many negative side effects.

**Overview of Other Prop 103 Provisions**

The provisions discussed in this section are not as controversial as the previous ones; however, they are still important because they are indisputably beneficial to consumers.

**Good Driver Discount**

Previously within this paper, the good driver discount provision had been described as an additional 20 percent discount for drivers who have had no more than one conviction for a moving violation during the last three years. However, the provision also states that a person with a valid driver's license who fits the above criterion "shall be qualified to purchase a Good Driver's Discount policy from the insurer of his or her choice. An insurer shall not refuse to offer and sell a Good Driver Discount policy to any person who meets the standards of this subdivision." [35] To consumers, this provision means not only more affordable premiums, but also, more available policies. To insurers, it simply represents another unfair provision of Proposition 103.

**Rate Comparisons**

Consumers will be allowed to request a comparison of the rates in effect for each personal
line of insurance for every insurer. This comparison will be provided by the insurance commissioner for a reasonable fee to cover costs. [36] The benefit of this provision to consumers is obvious. They will be able to see all of the rates and make more informed decisions. One drawback, however, is the fact that coverage may significantly vary from company to company due to the Prop 103 repeal of insurers' exemption from the antitrust laws. This means that rates will be less likely to form a one to one correspondence between companies, and decisions based upon these rates will be less valid.

**Consumer Participation**

This provision states that "persons representing the interest of consumers who make a substantial contribution to rate hearings or other proceedings will receive reasonable advocacy and witness fees and expenses. In the case of rate hearings, the award shall be paid by the insurer." [36] Obviously, this is beneficial to consumers because more key people will be willing to represent them at the rate hearings. It is ironic, however, to note that insurers will be paying these people to testify against the insurers' own companies.

**Costs of Prop 103 VS. Benefits**

From the very beginning California's insurance reform movement has been expensive. Approximately $76 million was raised to wage the auto insurance initiative war which ended in the passage of Proposition 103. The Prop 103 campaign, itself, cost only about $2.2 million; however, the proposition's major cost has resulted from it implementation stage. [20] The increase in the California Department of Insurance budget for 1988 due to Prop 103 was $1.8 million which represented 5.4 percent of the original base budget. This additional amount was to fund: 66 new staff positions, an upgraded telecommunications system to provide greater access to the Department by telephone, phase one of a micro-based computer system, and relocation of the Los Angeles office to accommodate the new staff. The increase in the 1989 budget due to Prop 103 was $24.1 million representing a 68 percent increase over the originally allocated budget. The extra money was to fund: 178 new staff positions, expansion of the Fraud Bureau, phase two of the micro-based computer system, and a $3 million contingency reserve for unforeseen expenses. Both increases listed in this paragraph represent a direct cost
to consumers through taxes. [10] (For additional budget information see California Department of Insurance, Information Packet, Proposition 103, May 11, 1989)

The direct monetary benefit of Prop 103 to consumers is basically equal to the proposition’s cost to insurers which cannot be established until the rate rollback hearings are concluded. Keep in mind that insurers are allowed to receive a fair rate of return; however, the 11.2 percent benchmark suggested by Commissioner Gillespie is currently being challenged by various consumer groups. Also note that the cost of preparing and filing rate rollback exemption proposals incurred by the insurance companies will eventually be added into the companies’ expenses. Consequently, premium dollars will be indirectly paying for these Prop 103 expenses.

The important question in this situation becomes: Will the final rate rollbacks be sufficiently greater than the total cost of Prop 103? The true answer to this question may not be available for years; however, a reasonable prediction is that the margin between the cost of Prop 103 versus its benefits will never be large enough to solve the insurance crisis in California. That crisis can be solved only if consumers and insurers begin to work together instead of against each other.

**Overall Importance of Proposition 103**

Although the analysis section of this paper has not covered every single provision of Proposition 103 or every single point of view, it has given an important overview of the proposition’s impact on the two groups most influenced by Prop 103, consumers and insurers.

**Consumers**

To consumers, Proposition 103 represents a long awaited victory in the fight against ever rising insurance premiums. Unfortunately, they fail to see the entire picture. As pointed out several times within this paper, many of Prop 103’s provisions may not be as beneficial to consumers as they may seem. For example, under the territorial rating provision, 65 percent of California policyholders would receive increases in their private passenger auto rates. This brings about the point that insurance consumers need to be more educated. Luckily, the controversy surrounding Prop 103 has been extremely publicized, and consumers are slowly becoming more informed about the insurance industry. As their understanding increases,
hopefully consumers will be able to work with insurance companies to find effective ways of not only reducing rates, but also lowering the costs of providing insurance.

**Insurers**

To insurance companies, Proposition 103 represents an unfair, unconstitutional means of reducing insurance premiums. The proposition at various points has not only threatened their solvency, but it has also threatened actuarial principles that have taken years to develop. Insurers realize that solutions must be found, and they are willing to combine efforts with consumers, regulators, and legislators to find these solutions. They are not, however, willing to sit back and have the industry destroyed by people who have little or no expertise in ratemaking or other insurance principles.

**Impact of Prop 103 on Other States**

Proposition 103 has prompted two types of reactions from other states. Several are following California's lead by initiating insurance reform movements. Others, however, are taking actions to guarantee that companies do not increase premiums in states with less regulations in order to offset losses in states such as California.

The second group includes states who already have acceptable premiums such as Iowa and Washington. Washington is specifically stating that proposed auto insurance rates for their state must be based primarily on a company's claims experience within the state. If nationwide data is used, it must exclude California claims experience. Iowaans, who are currently paying the lowest average auto premiums in the United States are additionally concerned with the possible jeopardy of the financial solvency of the companies who write in both Iowa and California. Consequently, they are preparing to implement protective measures so that Iowans do not unjustly suffer from Proposition 103 or other measures similar to it.

**Insurance Reform Movements**

The initial fear of insurance companies is becoming a reality as Proposition 103 type initiatives spread to other states. David Gates, president of the National Association of Insurance Commissioners, stated that "labeling auto insurance companies as 'bad entities' and mandating auto rate rollbacks cannot help but be enticing on a national level."
Obviously, his statement must hold some truth because as many as 30 states are seeking to implement reforms similar to California's Prop 103. [7] These reforms are being advocated by Ralph Nader as well as consumer organizations such as Citizen Action who has specifically targeted fourteen states. This section will overview four specific states who have taken steps to pass reforms like Prop 103.

**Indiana**

The Indiana General Assembly has been considering a bill which imitates nearly all provisions included in Proposition 103. This bill, HB 1298, would mandate a 20 percent rate rollback followed by a one year rate freeze. During this period only companies facing insolvency would be allowed to increase their rates. (Keep in mind that an identical insolvency standard was ruled unconstitutional by the California Supreme Court.) After the rate freeze is lifted, prior approval would be necessary for all rate changes. Rates would be based upon the insured's safety record, annual number of miles driven, the number of years of driving experience, and any other factors adopted by the commissioner. A 20 percent good driver discount would be required for drivers who have committed only one moving violation within the last three years. Finally, the bill would allow agents and brokers to offer rebates, make the office of insurance commissioner an elected position, and repeal the state's antitrust exemption for insurers. Obviously, California's Proposition 103 has been the inspiration for this Indiana bill. [52]

**Illinois**

Although the president of Illinois Insurance Information Service maintains that "Illinois' auto rates and those for other lines are lower than any comparable state," the Illinois Public Action Council (IPAC) is encouraging consumer support of insurance reforms for the state. The IPAC claims that auto insurance premiums have risen more six times more than insurers' direct losses since 1985. In response to this claim and other claims with similar arguments, three bills were to be reviewed by the Illinois House of Representatives. The first bill, HB 2147, was proposed to abolish the industry's exemption from antitrust laws; however, it was eventually rejected. This action has made the IPAC feel that it is pointless to request a vote on the remaining two bills. These bills are (1) HB 2144 which calls for a 15
percent rate rollback followed by a one year rate freeze and an elected state insurance commissioner and  (2) HB 2148 which requires state approval of rates fluctuating more than 15 percent (flex-rating). Apparently, the lack of a true insurance crisis in Illinois has made this type of consumer driven insurance reform a more difficult task in that state. [47, 55]

Nevada

Nevada's insurance reform movement might possibly become even more controversial than California's. This is because the insolvency standard for exemption from the state's 15 percent rate rollback has been upheld by a federal judge in Nevada. (An appeal is to be filed in the 9th circuit court of appeals in San Francisco.) In determining whether an insurer is substantially threatened with insolvency, the law requires the commissioner to consider the profitability of not only auto insurance, but also all other lines of insurance transacted by the insurer. This requirement in addition to another provision which prohibits cancellation or nonrenewal of policies to avoid the rollback may lead to losses of up to $35 million in private passenger auto insurance lines. David Snyder of the American Insurance Association in Washington, D.C. assessed the situation by saying, "This sends a serious signal to all private enterprise in the United States, that regardless of economic reality, regardless of losses, the government can come in and lower prices." [49] Mr. Snyder's statement is strong, but in regard to the present status of Nevada's reform movement, the statement seems to be valid. [4, 48, 49]

South Carolina

South Carolina has implemented a more conservative insurance reform measure than the other states which have been discussed. The General Assembly passed a bill which mandates a five percent rollback on renewals after September 5, 1989. This five percent is expected to equal the effects of South Carolina's new mandatory seat belt law. [56] Consequently, the required decrease in rates is offset by a decrease in expected losses. This is an example of reducing insurance costs across the board because premiums can be reduced without threatening the insurance pricing system.

Other provisions of this bill include an increase in the mandatory safe driver discount to 20 percent from the previous 15 percent and a minimum policy term of 60 days except for
nonpayment of premium or disposal of the vehicle. These provisions are also conservative in nature compared to reform movements of other states. For example, the South Carolina good driver discount represents a 5 percent increase instead of the 20 percent increase proposed in other states. (ie. an increase from zero to 20 percent) It is additionally more reasonable because it is not tied to a 20 percent rate rollback. The minimum policy term is also very reasonable in comparison to the Prop 103 nonrenewal and cancellation provision. Overall, South Carolina's insurance reform measure seems to have made small, yet important steps towards responding to consumer needs while still maintaining a solvent insurance industry.

After considering all four states, it is easy to see that California's insurance reform movement has had a tremendous impact on all of the states. Indiana and Illinois, both targeted states of Citizen Action, are basically trying to imitate Proposition 103. Nevada is also imitating California's historic proposition; however, it is facing additional controversy due to the fact that the proposed insolvency standard for its rate rollback provision has initially been upheld. Finally, South Carolina, who has taken the most conservative approach to insurance reform, seems to have followed all sides of Proposition 103 and has come to accept the fact that insurance premiums can be justly lowered only if the cost of providing insurance is lessened.

In the Future

The concluding sections of this paper are geared toward predicting the future of Prop 103 and examining another possible alternative to California's auto insurance crisis.

Future of Proposition 103

Proposition 103 was approved by voters on November 8, 1988. Due to the enormous number of lawsuits and hearings that have plagued the proposition, no rate rollbacks have been officially and irreversibly mandated by the California Department of Insurance at this time. In fact, complete implementation of Prop 103 may not happen for many years. Consequently, one can only make reasonable predictions about the future of this historical
proposition. This section will specifically consider the future of the various Prop 103 provisions examined earlier in the paper.

**Twenty Percent Rate Rollback**

The rate rollback provision will most likely be the last to be settled because it is dependent upon the results of other Prop 103 provisions such as regulation of rating factors and the 20 percent good driver discount. Also, this provision tends to generate the most lawsuits due to the immense positive or negative effects that it represents respectively to either consumers or insurers. Consequently, the most probable prediction at this time for the future of the rate rollback provision is that lawsuits, producing no real answers, will continue to plague the provision until a separate, less controversial method of reducing insurance rates is developed. At that time the “20 percent rate rollback/fair and reasonable rate of return” issue will simply become an issue of the past.

**Territorial Rating and Other Rating Factors**

Assuming the 20 percent rate rollback provision is the most controversial of all Proposition 103 provisions, regulation of territorial rating and other rating factors is definitely in a close second place. In fact, the most recent “blow” to insurance companies as a result of Prop 103 came on December 5, when Commissioner Gillespie announced the new Proposition 103-inspired auto rate regulations which include the elimination of territorial rating for auto insurance. The regulations also place a cap on the rate increases which will result for rural and suburban drivers. To clarify these new regulations it is important to understand that although territorial rating is eliminated, insurers can continue to use “valid elements” of territorial rating such as population density, vehicle density, and accident frequency to establish rates as long as credible data is provided to prove the validity of these factors. [15] Consequently, rate increases for rural and suburban drivers should be relatively small. As for the future of territorial rating, one can reasonably predict that insurance companies will use every element of territorial rating that is proven by their data. Insurers may additionally fight the mandated rate cap in the future if it prevents them from receiving their “fair and reasonable” rate of return.
In regard to other rating factors, the auto rate regulations specifically eliminate the use of age, gender, and marital status in ratemaking. They also state that the three Prop 103 mandated factors must be given as much weight as any optional factor that is additionally approved. Together these requirements resemble another possible lawsuit. Even Commissioner Gillespie admitted that "the use of mandated factors skews the actual relationship of the premium to the risk, and if Prop 103 requirements are followed, some people will have to pay more for insurance than the actual risk of loss would normally warrant." [15]

Other Prop 103 Provisions

The probable future of the remaining provisions are as follows: (1) The existence of rebating should be reasonably limited due to factors discussed earlier in the paper (See Rebating). (2) Antitrust laws will ban rating organizations, but they will probably be applied loosely so that insurers may continue to share historical data. This insures that adequate data will be available for ratemaking purposes. (3) The California Department of Insurance will probably enforce the mandatory sale of the Good Driver Discount policies; however, wording for the policy will likely be revised to exclude controversial applicants. (4) Consumer requests for rate comparisons will continue to be honored by the Department of Insurance. (5) Persons representing the interest of consumers at rate hearings will be subsidized for their expenses as required by Prop 103. Note that the final two predictions suggest that the interest of consumers will be protected in the future.

Another Alternative for Auto Insurance

As proposed throughout this paper, Proposition 103 is not the ultimate solution for California's auto insurance crisis; however, it has stimulated further examination of other solutions. This final section will overview one specific alternative to the mandated rate rollback of Prop 103. Ironically, the principles behind this alternative are very similar to those included in Proposition 104 which was defeated by voters at the same time Proposition 103 was approved.
No-Frills, No-Fault Insurance

To reduce the cost of insurance, it is necessary to reduce the cost of claims. Consequently, "suing for big bucks" must be limited. California is currently considering a no-fault auto insurance bill specifically for that purpose. According to David Snyder of the American Insurance Association, "the currently pending no-frills, no-fault bill, AB 354, could provide auto coverage at under $200 per year for every Californian - something Prop 103 can never do." [3]

Basically, the no-frills policy would pay up to $15,000 for injuries to one person and no more than $30,000 total for injuries to all persons involved in a single accident. It would additionally prohibit suits for pain or suffering except where injuries are "substantial or permanent." The policy would provide no collision or comprehensive coverage for the insured's own vehicle; however, property damage and additional liability coverage would be available for those willing to pay extra. The specific price of the policy, $160, was calculated by assuming that basic bodily injury liability coverage of $15,000/$30,000 costs approximately $400. This amount is reduced by 50 percent due to the elimination of pain and suffering suits. The final $40 difference is attributable to the no-fault provision. [18]

Although this bill is supported by Consumers Union as well as the Association of California Insurance Companies, it is still bitterly opposed by the California Association of Trial Lawyers who have blocked no-fault in California repeatedly over the past 20 years. The bill is additionally opposed by Harvey Rosenfield, author of Proposition 103. Rosenfield believes that voters have already spoken on the issue of no-fault insurance by rejecting the previous Proposition 104. Consumers Union, however, was quick to defend the current bill by saying "AB 354 is 'significantly better for consumers' than the system proposed in Prop. 104, which provided only $10,000 in health care coverage, $15,000 in lost wages and virtually eliminated suits for pain and suffering." Under AB 354 maximum benefits would be $50,000 per person for health care plus $2000 compensation per month up to 36 months for wage loss. [21]

From an actuarial point of view, no-frills, no-fault insurance is undeniably preferable to Proposition 103. Unlike Prop 103, AB 354 is a mathematically sound solution that will preserve the principles of insurance pricing while concurrently lowering automobile premiums. This fact, as well as others, should be brought to the attention of consumers.
Hopefully, in the future actuaries will also become educators by developing explanation of insurance pricing principles that can be understood by the average consumer, and hopefully, the barrier between consumers and insurers can be 'broken down' so that consumers will be more willing to listen and learn.
Bibliography


