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UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

STATEMENT OF HARRY S. HAVENS, DIRECTOR  
PROGRAM ANALYSIS DIVISION  
U.S. GENERAL ACCOUNTING OFFICE

BEFORE THE  
SUBCOMMITTEE ON ANTITRUST, MONOPOLY, AND BUSINESS RIGHTS  
COMMITTEE ON THE JUDICIARY  
UNITED STATES SENATE

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ON  
[ISSUES AND NEEDED IMPROVEMENTS IN STATE REGULATION  
OF THE INSURANCE BUSINESS]



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Mr. Chairman:

We are pleased to be here to discuss GAO's study of the regulation of the insurance business by State insurance departments. In our study we reviewed the background, purposes, and need for insurance regulation; the resources and workloads of State insurance departments; and State insurance department surveillance of the financial condition and trade practices of insurance companies. We also conducted a more detailed analysis of the regulatory issues surrounding automobile insurance, such as risk classification, unfair discrimination, price regulation, and insurance availability.

Our study is based on data obtained from a questionnaire sent to all State insurance departments, fieldwork in the insurance departments of 17 States, and insurance industry sources.

This morning I would like to summarize our findings in four related areas:

- the regulation of automobile insurance risk classification,
- insurance availability,
- trade practice regulation, and
- the appropriate degree and extent of regulation of the price of automobile insurance.

## RISK CLASSIFICATION

### Personal risk classes

The price which a person pays for automobile insurance depends on age, sex, marital status, place of residence and other factors. This risk classification system produces widely differing prices for the same coverage for different people. Questions have been raised about the fairness of this system, and especially about its reliability as a predictor of risk for a particular individual. While we have not tried to judge the propriety of these groupings, and the resulting price differences, we believe that the questions about them warrant careful consideration by the State insurance departments.

In most States the authority to examine classification plans is based on the requirement that insurance rates be neither inadequate, excessive, nor unfairly discriminatory. The only criterion for approving classifications in most States is that the classifications be statistically justified--that is, that they reasonably reflect loss experience.

Relative rates with respect to age, sex, and marital status are based on the analysis of national data. A youthful male driver, for example, is charged twice as much as an older driver all over the country. None of the State insurance departments we visited conducts a regular independent actuarial analysis of these personal classification relativities to establish whether they are valid in its State. The State departments do not normally

collect and analyze the information necessary to make these judgments on either a statewide basis or with respect to specific parts of their States. However, in two States which we visited, Massachusetts and New Jersey, the insurance departments undertook special comprehensive studies of the actuarial basis of classification plans. Massachusetts prohibited the use of age, sex, and marital status as rating factors, and New Jersey is still conducting a series of hearings on the issue.

#### Rates based on territory

Similar problems exist with the system of territorial rating. Different geographic areas have greater losses than other areas and insurers have established territorial rates to reflect these differences. For example, automobile insurance premiums are much higher in urban areas than in suburban and rural areas. However, higher losses in urban areas are the result, in part, of congestion caused by suburban commuters. The question has been raised as to whether it is fair to charge central city residents for losses caused (at least in part) by others. Furthermore, these territorial rating plans may also discriminate against minorities because urban areas usually have higher concentrations of minorities.

While insurance departments receive data on losses in each territory, most departments do not have sufficient information to evaluate whether or not the territorial boundaries used by insurance companies are fairly and accurately drawn. We reviewed

whether the State insurance departments evaluate territorial rating plans to see if the plans satisfy their own statutory criterion that insurance rates are not unfairly discriminatory. Out of our 17 fieldwork States, 11 have not done so.

### INSURANCE AVAILABILITY

#### Redlining: geographic discrimination

It has also been claimed that insurance companies engage in redlining--the arbitrary denial of insurance to everyone living in a particular neighborhood. Community groups and others have complained that State regulators have not been diligent in preventing redlining and other forms of improper discrimination that make insurance unavailable in certain areas. In addition to outright refusals to insure, geographic discrimination can include such practices as: selective placement of agents to reduce business in some areas, terminating agents and not renewing their book of business, pricing insurance at unaffordable levels, and instructing agents to avoid certain areas. We reviewed what the State insurance departments were doing in response to these problems.

We found that most States do not either systematically collect data or conduct special studies to determine if redlining exists. Only 36 percent of the States responding to our questionnaire reported that they had conducted studies of territorial

discrimination over the past 5 years. While redlining is an issue primarily in urban areas, less than half of the urbanized States reported that they had conducted studies of alleged redlining.

To determine if redlining exists, it is necessary to collect data on a geographic basis. Such data should include current insurance policies, new policies being written, cancellations, and nonrenewals. It is also important to examine data on losses by neighborhoods within existing rating territories because marked discrepancies within territories would cast doubt on the validity of territorial boundaries. Yet, not even a fifth of the States collect anything other than loss data, and that data is gathered on a territory-wide basis.

Underwriting: a subjective practice

Underwriting practices also affect availability. While classification categories, such as territorial ratings, are based on explicit and objective categories, underwriting is more subjective, and may lead to consumers' being denied essential insurance because of unsubstantiated judgments. Questions have been raised about the propriety of certain underwriting guidelines. For example, some underwriting manuals list as "objectionable" such occupations as painter, automobile dealer, and waiter.

Only 26 percent of those responding to our questionnaire reported that they had the authority to forbid the use of

particular guidelines. Few State departments even review or collect underwriting guidelines used by insurance companies. Generally, departments collect only some manuals or portions of manuals.

Furthermore, most States provide only limited protection to consumers who have had adverse underwriting decisions. Individuals who are rejected for standard automobile insurance can usually obtain insurance through assigned risk plans, but they often suffer adverse consequences such as limited coverage and higher prices. In about half the States for which we obtained rates, the cost of the assigned risk plan was at least 25 percent higher than the suggested rating bureau rate. In almost one third of the States, consumers denied standard rate policies were purchasing insurance issued by the so-called substandard companies--whose rates were at least 20 percent higher than those of the assigned risk plans. We are not suggesting that these rates should be lower or higher. We do believe, however, that it is important for insurance departments to protect consumers against unwarranted denials of coverage, establish whether consumers are being unfairly discriminated against, and ensure that consumers are fully informed about these matters.

Most States do not require that consumers be informed as to why they were denied insurance coverage. Only three States out of 17 where we did fieldwork require insurance companies

to provide the reasons for a rejection. Even in these cases, an explanation is required only if the individual makes a written request. Furthermore, none of the departments in which we did fieldwork knew why individuals are placed in assigned risk plans, although Virginia has recently participated in a study of the composition of the assigned risk plan.

Nearly all States protect consumers against arbitrary cancellation once a policy has been in force 60 days. However, 43 States allow a free underwriting period--usually 60 days--during which an insurance company can cancel a policy for any reason.

The protection provided policyholders by States is somewhat better with respect to cancellations and nonrenewals. Nearly all States require companies to give the reasons for cancellation. With respect to nonrenewal, however, only 15 States require that the reasons accompany the notice. Fourteen States require that the reasons be given at the request of the insured. The remaining 21 States and the District of Columbia have no statutory requirement to explain a nonrenewal.

**TRADE PRACTICE REGULATION:**  
**LACK OF SYSTEMATIC PROCEDURES**

Risk classification and insurance availability were among several issues we reviewed where insurance departments lacked sufficient information to regulate effectively. While we did not examine all the data collection and analysis activities of

State insurance departments, we found deficiencies in every one that we reviewed. There was also a lack of systematic procedures for handling consumer complaints and trade practice surveillance in most of the departments in our sample.

We examined whether insurance departments were responsive to consumer complaints, and whether departments were able to find out whether particular companies or trade practices were creating problems for consumers.

Most of the departments we visited followed up on consumer complaints, but have only limited authority to do anything about them. Most State insurance departments do not have systematic complaint handling procedures whereby complaints are coded, analyzed, and used in the examination and regulation of insurance companies. Complaints could reveal a pattern of abuses by insurers or agents, but such information is generally not developed.

Most insurance departments have been responsive to the recommendation of the National Association of Insurance Commissioners that, in addition to financial examinations, they should undertake market conduct examinations. Such examinations look at claims handling, advertising, underwriting, and other matters in order to identify insurers engaging in unfair business practices. However, based on the examination reports that we reviewed, the market conduct examination process needs considerable improvement.

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For example, the National Association of Insurance Commissioners Handbook for Examiners recommends that examination results be compared to minimum qualitative standards to determine relative company performance. However, none of the market conduct examination reports we reviewed explained what the standards were or identified if such standards were used to assess company performance. Without set guidelines, it is impossible to tell whether actions by companies constitute a serious pattern of unfair practices or only an acceptable number of innocent mistakes.

The procedures used to monitor insurance company claims handling also need substantial improvement. None of the departments we visited monitors claims handling on a continuous or periodic basis other than in examinations--normally every 3 years. Moreover, these reviews only include the company's perspective and not the consumer's. The examinations in most cases showed no evidence of having contacted policyholders or complainants. Only one of the 17 fieldwork States, Wisconsin, regularly contacts a sample of policyholders and claimants as part of its examination process.

In short, the insurance regulatory process needs more and better information, and more systematic procedures, to assure that consumers receive adequate protection.

## PRICE REGULATION OF AUTOMOBILE INSURANCE

Less regulation, however, may be a viable option with regard to the price of automobile insurance. In all States except Illinois, automobile insurance rates are subject to active or passive State regulation. The general requirement is that rates not be excessive, inadequate, or unfairly discriminatory. Approximately two-thirds of the States require prior approval of all changes in rates. The rest have a competitive rating system whereby insurers establish premiums without the need for prior approval.

We found great variety in the procedures and thoroughness with which the insurance departments review the rate filings of insurance companies. One common denominator, however, is that few States perform an original actuarial analysis of what rates should be. Rather, analysts review the calculations of insurance companies or rating bureaus. We found that in the two States, in our sample, that do their own original actuarial work, Texas and Massachusetts, the rates developed by the State staffs have proved, in retrospect, more accurate than those developed by the insurance company rating bureaus.

More fundamental than the procedures of rate regulation are the issues of the effects of price regulation and whether it is needed. On average, we found almost no difference in automobile insurance cost between States that have prior approval price regulation and those that do not. It should be emphasized

that these findings are stated in averages and are based on the relationship between premiums and claims payments for each State as a whole. Rate regulation in a few States has resulted in rates that are lower than they otherwise would be and the prohibition of certain rating factors in, for example, Massachusetts, has resulted in rates that are considerably lower for younger drivers.

Although there are imperfections in the market for automobile insurance, we believe that it may not be necessary for the government to regulate the base price of automobile insurance, except in assigned risk plans. As I noted earlier, however, differentials between various classes of risks, and the validity of the classifications themselves need greater attention by the States.

#### Regulation to enhance competition

In general we believe that consumers could be better served if insurance departments devoted fewer resources to price regulation and more resources to regulation designed to allow competitive forces to work more effectively. Although the automobile insurance market is competitively structured in terms of such indicators as number of firms, concentration ratios, and ease of entry, several factors nonetheless inhibit competition.

One major problem is that consumers simply do not have enough information to bring about as much competition as possible

between insurers. While many insurance departments issue buyer's guides, very few compare specific premium rates for similar policies. The policies themselves are often written in obscure legal language and are difficult to understand. Only a few States require readable policies. And, by not widely disseminating information on claims handling and complaints against insurers, departments do not enable consumers to evaluate differences in quality among companies. The free underwriting period may also inhibit competition in that consumers may be hesitant to switch companies if they have no assurance against cancellation by the new company.

Insurance departments should do more to disseminate information about comparative insurance prices and indicators of the quality of companies. Such information might include price comparisons, by territory, for several widely purchased insurance coverages, insurance company loss and expense ratios, and easily understandable policy information. These measures would enable consumers to compare policies before purchasing insurance.

While we believe that competition can more efficiently achieve the lowest possible base prices, we also realize that regulation may be necessary to prevent the use of unfairly discriminatory rate differences.

## BETTER REGULATION IS NEEDED

We have not attempted to conduct a comprehensive evaluation of all facets of insurance regulation. Based on the work we did, however, we conclude that a number of problems in insurance regulation need to be remedied. Many alternatives are available to that end: reform by the States themselves, a stand-by Federal role through the amendment of the McCarran-Ferguson Act that would allow regulation by Federal agencies in specific areas, the establishment of specific Federal standards through legislation, or the repeal of the McCarran-Ferguson Act and active Federal regulation. We hope our report will assist the Congress in evaluating these alternatives.

This concludes my prepared remarks. We will be nappy to answer any questions.