Proposition 103: The Consumer's Viewpoint

by Harvey Rosenfield, J.D.

Unlike virtually every other private industry in the United States, the insurance industry's relationship with the consumer of insurance is often an involuntary one. At the very least, insurance is a matter of economic survival for businesses, homeowners, municipal entities, and other consumers. And in many states, motorists are compelled to become consumers of insurance by law.

This critical distinction is the basis for understanding the consumer viewpoint toward insurance reform—a viewpoint manifested by Proposition 103 and its progeny across the United States. In a free marketplace, when the relationship between the seller and the buyer becomes unsatisfactory, buyers have the option of looking elsewhere—or not buying at all. In the insurance system, unhappy consumers do not have the luxury of refusing its purchase. Instead, as in the provision of essential services such as police, fire, water, gas, and telephone, consumers first look to the government to protect them in their contractual relationships with private insurance firms. If that proves unsatisfactory, consumers will ask the government to take a more active role in providing the product they need.

This article will review the movement for insurance reform in the United States today. First, we will analyze how the insurance industry jeopardized and finally ruptured its relationship with consumers, leading to Proposition 103-style efforts in California and elsewhere.

Second, the article will describe the theoretical basis for Proposition 103's component reforms, and provide an update on their implementation in California.

Third, we will examine the insurance industry's response to Proposition 103, to determine whether insurers are effectively healing the breach, or instead are merely widening it.

Finally, the analysis will conclude with a discussion of the next phase of the insurance reform movement, one which may involve even more profound change than that enacted by Proposition 103.

The Origin of Insurance Reform in the 1980s

In the first major insurance "crisis" of the last two decades, during the mid-1970s, the insurance industry managed both to provoke the crisis through dramatic rate increases, and then control the solution through restrictions in the tort laws.

The second "crisis," that of the mid-1980s, followed an identical track for more than two years. Rapid rate increases in business, non-profit, governmental, and finally auto insurance stirred up a predictable public outcry; insurers effectively directed the frustration of these consumers toward the tort system, and, throughout the United States, "tort reform" became one of the most hotly debated public policy matters.

In California in 1986, for example, the insurance industry backed a broad coalition of business and municipal entities in their campaign to pass a restriction of the legal doctrine of joint and several liability. The promise of a 15 percent reduction in business liability insurance rates led to the passage of the measure, despite strong opposition from consumer and trial lawyer organizations.

The insurance industry and its partners in the venture were quite explicit that Proposition 51[1] was merely a stalking horse for a far broader assault on the civil justice system, to be conducted in the legislature or, if necessary, at the next election in 1988.

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Unlike the experience of the 1970s, however, consumer organizations were far more sophisticated in their analysis of the industry's actions, and in response to the attack on the tort system, were prepared to offer their own explanation of the "crisis," and their own solution.

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.

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Rates, in turn, are a function of conditions in the financial marketplace. Indeed, the industry has its own "cycle": in times of high interest rates, insurer investments produce an excellent return. Under such conditions, the industry reduces rates, and frequently underwrites poor risks, to attract capital for investment.

When interest rates are low and investment yields are correspondingly reduced, the industry increases insurance premiums to maintain high profit levels and to offset the results of imprudent business judgement. The rate "crises" of the last two decades correspond exactly to the troughs in this financial cycle.

The recognition of the insurance industry as merely another form of profit-oriented financial institution illuminated a profound contradiction in the industry's fundamental purpose and responsibility. Though insurers are in the business of compensating for loss, as profit-making ventures they have nothing to gain—in fact, have a great deal to lose—if accidents or claims decrease.

Put another way, insurers operate on a "cost-plus" basis: accident costs are passed through to consumers, along with a very considerable markup for profit and profits hidden in the form of bloated overhead, surplus and reserves. Thus, the more accidents and claims, the more justification for higher rates, which, in turn, means more funds for investment and hence higher profits. The present system of insurance perversely rewards the very events insurance is designed to protect against.

Viewed in this light, it is little wonder that the annual budget of the Insurance Institute for Highway Safety, the industry's national safety research organization, is approximately one-tenth the amount of money the insurance industry spent in California in 1988 trying to defeat Prop 103.

Consumer advocates throughout the United States responded to the industry in the mid-80s by educating news media and elected officials about the industry cycle and the inherent conflict in its basic purpose. As they did so, they were bolstered by reports of massive increases in profits, reflecting the dramatic rate increases of the previous years.

In California, where state law shielded the industry from both competition and regulation, neither the free market nor government supervision were permitted to moderate the severe impact of the insurance cycle.

Moreover, the industry's "tort reform" propaganda became increasingly less credible as the industry refused to provide empirical data which would justify their assertions that the civil justice system, rather than insurer greed, was responsible for rate increases.

During 1987, a non-profit group now known as Voter Revolt organized a coalition of hundreds of other organizations representing millions of Californians in support of a statewide legislative campaign to push for modest regulation of the insurance industry and a repeal of the industry's exemption from the antitrust laws.

But the insurance industry's powerful Sacramento lobby refused to acknowledge the need for any reform and successfully blocked the consumer proposals, setting the stage for Proposition 103. The announcement of the Voter Revolt initiative in November 1987 broke a fragile, opportunistic "truce" between the insurance industry and the California Trial Lawyers Association designed to prevent any ballot measures addressing either insurance or tort issues, and led to the domino-like filing of six other insurance-related initiatives. Five initiatives ultimately gained enough signatures to be placed on the November 1988 ballot.

Insurers backed three of the propositions, which would have enacted various tort restrictions and no fault auto insurance. The industry initiatives were defeated by margins of between 3 to 1 and 8 to 1, despite over $80 million in campaign expenditures. The state's trial bar backed a fourth initiative with $14 million; it was a more detailed but less dramatic version of Proposition 103. Only 103 received voter approval in 1988, largely due to an unprecedented door-to-door grassroots campaign led by consumer advocate Ralph Nader.

Since 1988, legislators and citizens in forty-four states have begun serious consideration of insurance reforms inspired by Prop 103; rate rollbacks and strengthening of insurance regulation have become law in Nevada, New Jersey, South Carolina, and Pennsylvania. Insurers continue to challenge the laws in court.

Proposition 103: Theory and Practice

Proposition 103 addressed the industry cycle and the cost-plus nature of the industry through a series of reforms designed to alter the industry and its environment:

1. **Immediate rate relief to offset excessive rate increases through establishing a baseline for measuring appropriate rates.**
2. **Reforms to stimulate competition and establish a free market for insurance.**
3. **Provisions to eliminate unjust, discriminatory practices.**
4. **Disclosure and rate regulation to orient the industry to efficiency and loss prevention.**
5. **Provisions to guarantee full democratic accountability to the public in the implementation of the initiative.**

Short Term Relief: The Insurance Rate Freeze and Rollback

In order to protect consumers during the transition to the new system established by 103, and to offset the "last ditch" rate increases during the campaign year prior to the election, the initiative froze all automobile and other property-casualty insurance rates at 80 percent of November 8, 1987 levels for one year.

The right of a fair rate of return is well-established in constitutional jurisprudence, as is the corollary requirement that not every enterprise is entitled to earn a rate of return—only those which operate reasonably and efficiently.

The 20 percent rollback avoids "locking in" the excessive rates of the past four or five years, during which time rates skyrocketed while the Consumer Price Index rose only a few points each year. For example, between 1985 and 1986, automobile premiums in California increased by 22 percent, while automobile claims payments by insurance companies increased less than 9 percent, and the inflation index increased only a few points each year.[2]

During the period of the freeze/rollback (11/8/88 through 11/8/89), insurers were prohibited from raising rates. However, the initiative was drafted to allow an insurer to obtain increases from the insurance commissioner, if the freeze "substantially threatened" the company's solvency.

Because an estimated $5 billion in refunds would be mandated by the rollback, this provision of 103 became the centerpiece of the insurance industry's legal challenge to the initiative, filed two days after the election. In May 1989, the California Supreme Court upheld the rollback but ruled that the "insolvency" test for exemptions infringed on the insurers' right to a "fair rate of return."[3]

The right of a fair rate of return is well-established in constitutional jurisprudence, as is the corollary requirement that not every enterprise is entitled to earn a rate of return —only those which operate reasonably and efficiently (see, for example, *Aetna Insurance Co. v. Hyde* (1928) 275 U.S. 440, 446-47; *Troy Hills Village v. Township Council* (1975) 68 N.J. 604). Nevertheless, virtually every one of the more than 600 insurance companies operating in California filed requests for exemptions from the rollback, claiming they would be deprived of a fair rate of return if forced to comply.

The California Insurance Commissioner subsequently commenced a series of generic hearings to determine a standard methodology for analyzing the profitability of the industry, leading to company-specific rollback exemption decisions.

A comprehensive study released in May 1990, conducted by Robert Hunter of the National Insurance Consumers' Organization, showed that the top 14 auto insurance companies operating in California could reduce rates an average of 19.4 percent without infringing their constitutional right to a "fair rate of return"—if the Commissioner adopted a formula for analyzing the profitability of the insurance companies which caps profits, including investment income, at 11.2 percent annually; establishes expense ceilings and rewards insurer efficiency; prohibits insurers' from engaging in phony bookkeeping practices that inflate their losses; limits surplus and reserve funds; and forbids them from passing through to consumers the costs of the industry's lobbying, political activities and bad faith judgements.[4]

In June, Commissioner Gillespie issued a decision which accepted the consumer rollback formula in part; however, she refused to curb the insurance industry's expenses, a key form of hidden profit. The industry's bloated overhead, the result of years of insulation from both competition and regulation, eats up an average of 35 cents of every premium dollar Californians pay for auto insurance. This omission will likely cut the 103 rollback in half.

In response, Allstate and 60 other insurers have sued in the California courts to invalidate Commissioner Gillespie's regulations, claiming they are not supported by the hearing record and are unconstitutional. In the meantime, rates remain frozen. However, numerous public complaints indicate many insurers are not complying with the rate freeze; some are unlawfully placing insureds with sub-standard affiliates in order to increase premiums.

Long Term Relief: Competition/Regulation/ Fairness/Accountability

Competition

Prior to 103, insurance companies were exempted by law from the consumer protection statutes which are applicable to every other business in California. These exemptions have artificially blocked competition in the insurance marketplace for most consumers, permitting companies to essentially fix prices among themselves, and resulted in higher rates. The Voter Revolt initiative repeals these unjust exemptions, and adds other pro-competition reforms:

- Proposition 103 repeals the insurance industry's exemption from the antitrust laws. The insurance industry won an exemption from California's antitrust laws in 1946; similar exemptions remain on the books of every other state and in federal law as well. Proposition 103 repealed the exemption, prohibited the operation of "rating" and "advisory" organizations set up by the industry to circulate critical pricing and policy information to all insurance companies.
  However, 103 does permit insurers to exchange historical data—as opposed to projections—about claims. This enables insurers—particularly brand new or small companies—to obtain useful information that will assist them in developing their own projections and prices. All such information must also be provided to the insurance commissioner and to the public. Proposition 103 also permits insurers to continue to participate in special joint pooling arrangements—as long as they are established by the insurance commissioner or by law - to make more insurance available to certain kinds of customers, such as day care centers, automobile drivers, etc.

The California Attorney General has issued a series of antitrust guidelines concerning the enforcement of this provision of 103.[5]

- Proposition 103 repeals the prohibition against competition among insurance agents and brokers, the so-called "anti-rebate law" also on the books of many other states. Under the "anti-rebate law," all agents and brokers were permitted to enter into agreements with insurance companies under which they promise to charge the same commission. It also prohibited agents and brokers from reducing their own commissions in order to offer consumers a lower price, and contains a variety of artificial limitations on contractual relationships between insurers, claims repair facilities, even between an insurance agent and his or her heirs. Those who violated these laws are subject to stiff penalties and loss of their license.

Such blatantly anti-competitive arrangements would normally be a clear violation of the antitrust laws. Consumers pay higher prices and receive poor service because of these provisions. Moreover, the system rewards the inefficiency of some agents because it shields them from competition by agents who are willing to work harder to satisfy their customers.

To date, few California agents have reduced their commissions; since few consumers are aware of their rights under this provision of 103, there has been little public pressure on agents or brokers.

- Proposition 103 repeals the prohibition on the sale of insurance by financial institutions. This will enlarge the marketplace for insurance and hence lead to lower prices. The application of general consumer protection laws will ensure that financial institutions do not attempt to coercively tie the sale of insurance to other financial products or services they provide. In California, two of the state's largest banks have announced plans to enter the insurance business.
- Proposition103 expands the definition of group insurance. Today, most consumers are denied the ability to join together to negotiate special insurance plans—again, because of anti-competitive restrictions by the legislature and the Department of Insurance. 103 permits consumers to join together to negotiate the kind of policies and coverage they want, using their bargaining power in the marketplace just as large businesses do today.
- Proposition 103 mandates increased information for consumers. It is a basic tenet of economics that consumers must be well-informed if the marketplace is to operate efficiently. While the insurers' antitrust exemption permitted them to exchange price and other information with each other, consumers in the past had almost no access to information which would enable them to effectively comparison shop. Indeed, a 1987 study by the California Public Interest Research Group[6] documented the often insurmountable obstacles consumers confront when shopping for insurance. Proposition103 requires the California Commissioner to provide consumers with a current rate comparison survey for all personal lines of insurance. Consumers are to be charged a modest fee to cover the cost of this system. This provision of 103 remains unimplemented.

It is difficult to estimate the cost savings which the imposition of marketplace competition will generate. But there is every reason to believe that substantial long term savings will occur. Commissions and related selling expenditures amount to between 15 and 30 percent of each year's premiums, according to a federal study; a 1977 study by the U.S. Department of Justice estimated savings of 6 percent to 7 percent annually for insurance consumers merely by eliminating "anti-rebate" laws.

Regulation

Government regulation of the rates, practices and policies of insurance companies is as essential as regulation of other products or services which bear a special legal, semi-governmental responsibility.

There is no basis for the simplistic argument, often made by insurers, that the repeal of the industry's antitrust exemption obviates the need for rate regulation. At best, the insurance marketplace will operate imperfectly; there can never be a truly competitive market in insurance because there are so many variations on the product.

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Moreover, regulation and competition are not mutually exclusive. Proposition 103 seeks to establish a highly-competitive insurance market that rewards efficient and service- oriented companies with higher profits. But 103 also establishes boundaries to the marketplace beyond which insurers cannot venture; governmental supervision is necessary to ensure that the industry respects the boundaries.

Indeed, it is through regulation of rates that consumers can impose a new mission upon the insurance industry, forcing its attention to loss prevention and away from profit maximization through rate escalation.

- Proposition103 requires that the companies open their books and fully justify rate increases (or decreases) before they go into effect. According to a 1986 study by the U.S. General Accounting Office[7], rates are higher in states without such prior approval systems. Insurers which wish to raise their rates will be required to provide comprehensive data in justification of their requests, including a complete breakdown of their financial transactions and investment income. Such a system of financial disclosure and rate setting is essential to the debate concerning "tort reform." Under Prop 103, policy-makers and the public will obtain the information they need to determine whether the insurance industry is operating effectively, and whether other reforms are necessary. In particular, this system will provide data which will illuminate whether specific changes in the legal system are required to keep rates low and improve compensation to those involved in mishaps.
- 103 promotes insurer efficiency, loss prevention. By ending the insurers' ability to unilaterally pass-through all claims costs accompanied by self-governed profit, overhead and expense costs, Proposition 103 for the first time provides insurers with an incentive to eliminate waste, cut unneeded expenses, weed out fraud and engage in loss prevention practices.

- Under the 103 regulatory regime, efficiency is rewarded with higher profits; inefficiency with a lower rate of return. The norms by which insurer profits, expenses, surplus, reserves, accounting practices and other behavior are to be measured have been developed through the rollback methodology hearings. These will then be utilized under the prior approval system to dramatically re-orient the mission of the insurance industry.

Properly administered, the prior approval system will disengage the "cost-plus" approach, substituting a rate structure which encourages both insurers and consumers to engage in loss prevention. Insurers should be rewarded for research and programs which lead to reduced losses and claims; consumers, in turn, should be rewarded with lower premiums for their individual efforts, such as installation of anti-theft or anti-fraud devices, air bags, and driving record.

Fairness

Insurance is, by definition, a discriminatory enterprise, in the sense that in order to allocate risk, insurers must group each consumer into a larger pool composed of individuals with similar characteristics. To a degree not well understood by the insurers themselves, the business of insurance depends on the consumer's tacit acceptance of the industry's classification system and the consumer's sense of trust in the fairness of that system.

Particularly in the area of auto insurance, insurers have rightfully lost the consumer's sense of trust in the fairness of such classification systems. Despite substantial advances in computer technology, insurers continue to utilize imperfect, imprecise methods of setting premiums; consumers demand that their rates bear a closer relationship to the risk they pose as motorists.

- Proposition 103 prohibits the use of territorial rating, under which insurance companies determine automobile insurance premium by looking primarily at a customer's zip code.

Basing insurance rates upon a consumer's zip code is, of course, arbitrary, and is far from the most accurate criterion upon which to assess the risk a person poses. Though computer technology has dramatically increased the sophistication of risk analysis, insurers continue to utilize a simplistic surrogate, zip code, rather than more precise technical factors. But within any particular zip code—urban or rural—there are many drivers who have never had an accident at all. Yet their rates constantly increase—because under the territorial rating system, the vast majority of good drivers are forced to subsidize the rates of a few bad drivers located in the same zip code.

Proposition 103 requires that auto insurance premiums be based primarily upon a motorist's driving record, the number of miles he or she drives each year, and the consumer's years of driving experience. By substituting the driver's own record as the primary determinant of his or her auto premiums, Proposition 103 gives drivers a strong incentive to keep their rates low by driving safely, thus restoring "fairness" to the system.

The commissioner can approve other factors—but only after full public hearings, and only upon proof that the factors are substantially related to risk of loss, i.e., that they are shown by statistical analysis to hold predictive power once the first three "mandatory" factors are applied. Such additional factors approved by the commissioner will have relatively little impact on rates, as the initiative specifies that they must be accorded much lower status compared to the three chief factors.

Insurance companies focused their anti-103 political campaign on this provision of the initiative, arguing—with some success—to rural voters that 103 would "eliminate" territorial rating and cause rate increases for every non—urban motorist. Of course, 103 does not prohibit the use of geographic variables in setting rates; it merely substitutes a set of criteria—strongly supported, according to polls, by rural as well as urban drivers— which will determine most of the premium.

There are, to be sure, differences in the likelihood of accidents between urban and rural areas. But these differences do not account for the great differences in price between the two regions. A 1986 study prepared for the California State Assembly by the National Insurance Consumers Organization (NICO)[8] illustrates the fallacy of the zip code-based system of territorial rating. Of the 4.9 million cars insured in California between 1982 and 1984, 95.4 percent had no claims. In central Los Angeles, 93.5 percent of the cars avoided claims. The 41 percent difference in the claim frequency is to be expected, given the population density and reliance on automobiles in Los Angeles. However, it is clear that most California drivers, including the overwhelming majority of urban L.A. drivers, are good drivers—in contrast to the industry's arguments. Moreover, the difference in claims frequency between L.A. and the rest of California does not explain why *accident-free* L.A. drivers pay on the average 66 percent more for property-damage insurance than did the average no-accident driver in outside L.A., according to the study. Differences in the cost of car repairs between L.A. and rural areas do not account for the astounding contrast in premiums.

By permitting other factors to be utilized only after justification, 103 mandates that insurers investigate, publish and obtain government approval for the empirical basis of their classifications.

This provision of Proposition 103 is currently stayed, pending judicial review of regulations issued by the California Insurance Commissioner intended to implement the section. Commissioner Gillespie's regulations contained several flaws which impermissibly rewrite this provision of 103; they are expected to be overturned on appeal. Insurers, on the other hand, contend 103 cannot lawfully alter insurance classifications to substitute the "mandatory" factors for other factors which the industry argues hold more predictive power (i.e., territory). There is no basis in law for this argument, however.

- Proposition 103 prohibits red-lining, the failure of insurers to service particular population areas. Of course, this widespread form of insurer discrimination is integrally related to the grossly imprecise and unfair classification process that occurs under the territorial rating system.

Proposition 103's emphasis on driving record and individual driving habits establishes a new theoretical system for establishing rates. But merely reforming the theory is not enough to force insurers to end red-lining and sell their product to inner-city residents or other "undesirable risks."

Thus, 103 specifies that any good driver, as defined in the initiative, has the right to purchase an auto insurance policy from the insurer of his or her choice. The absence of prior insurance coverage cannot disqualify an otherwise good driver.

Though this provision of Proposition 103 is in effect, many insurers are refusing to comply with the provision, according to testimony by insurance agents and consumers.

- Proposition103 requires that insurers must grant a 20 percent Good Driver Discount to all qualifying consumers—individuals with a virtually clean driving record (one moving violation is permitted) for the preceding three years. Estimates are that the vast majority of all California drivers will qualify for this rate. This adds a further incentive for drivers to maintain a clear auto safety record.

Public Accountability

Ultimately, reform of the insurance industry can succeed only if the consumer's faith in the insurance system has been restored. Proposition 103 recognizes that it is essential to enable consumers to participate effectively in the reform process, by themselves or through professional representation.

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Similarly, both industry and government regulators must be accountable to the public for the process to obtain public confidence. "Capture" of the regulators by the regulated—the fox guarding the chicken coop— is so common, and so corrupting of public faith, that the democratic accountability of those administering insurance reform is critical to its success.

- Proposition 103 establishes two avenues for consumer participation in establishing a fair insurance system.

First, it provides individual consumers with the absolute right to go to the Department of Insurance or the courts should insurance companies fail to comply with their responsibilities to the individual. If the Department of Insurance fails to respond effectively to a consumer's complaint, consumers will not be "locked out" of the courts with no remedy.

Second, 103 encourages non-profit consumer advocacy groups to intervene in the expanded regulatory process to protect the interests of the public. Citizen groups which make a "substantial contribution" to a rate hearing or other matter before the Department of Insurance, or to an insurance matter which goes before a court, will be entitled to receive reasonable advocacy fees and reimbursement of expenses for such costs as expert witnesses. Assessments collected from insurers will be used to fund this program. The reimbursement system will enable citizen groups to monitor the Department of Insurance on a stable—and professional —basis.

Proposition 103 contained an additional mechanism to guarantee effective consumer representation. Insurance consumers were given the opportunity to establish and join a democratically-created and controlled advocacy organization. A staff of advocates, funded by voluntary contributions and grants, would represent consumers on insurance matters before the Insurance Commissioner, the courts, and the state legislature. In order to enable the advocacy organization to obtain the support of consumers, insurers would be required to enclose special notices with their premium bills, informing their customers of the opportunity to participate in the program. (Insurers would be reimbursed for any additional expenses caused by insertion of the notice).

Similar consumer representation systems have been in effect at the state Public Utilities Commission with strong success. Funded citizen intervention programs have protected against unnecessary or duplicative proceedings, while providing consumers with significant, skilled representation. Requiring utility companies to inform consumers of the existence of such programs has ensured that consumers can be represented with sufficient resources to be effective and professional.

However, the California Supreme Court struck this provision of Proposition 103, ruling that it violated a state constitutional prohibition on "naming or identifying" a private corporation by initiative. Not surprisingly, the insurance lobby has managed to block subsequent efforts in the state legislature to create such an advocacy group.

Insurers often fear and strongly oppose the institution of such advocacy mechanisms. Such opposition is both cynical and bewildering. It is a basic tenet of democracy and government that each party to a proceeding has the right to be fully represented.

Moreover, presuming their claims and rate applications are meritorious, insurers should welcome the presence of professionals representing consumers in rate hearings and other matters. The two-party judicial process leads to openness, constructive change, reform and consumer acceptance.

Many insurers—like their counterparts in other industries—view mechanisms for funding consumer intervention as likely to result in uncontrolled, ceaseless regulatory conflict. That view is false, since even the best-funded citizen groups rarely are able to contest any but the most important cases. Ironically, it is the absence of such groups which can be troublesome for insurers. A vacuum is created that is often filled by individual citizens, with few or no resources and little training. These individuals have a more difficult time participating in proceedings effectively, and the proceedings themselves are forced to move more slowly in order to accommodate the individuals.

- Proposition 103 requires that the Insurance Commissioner be elected, beginning in November 1990. In the majority of states, the Insurance Commissioner is a political appointee with no direct accountability to the public. It is no surprise then, that the state insurance agencies have frequently been criticized for poor enforcement and a pro-industry bias. In California, independent studies had repeatedly criticized the Department of Insurance for its inaction in the insurance crisis, failure to respond to consumer complaints and incompetent enforcement of the Insurance Code.

The benefits of an elected commissioner are easy to understand. An elected commissioner is subject to public, rather than political, supervision. Only the voters may pass judgement on the ommissioner's performance, providing the commissioner with the independence—and incentive—necessary to establish good public policy. Finally, voters will have an easy way to evaluate the insurance commissioner —by the fairness of rates and practices of insurers. A commissioner who fails to protect the public will not be re-elected to office. This will protect against efforts by the insurance industry to "install" their own candidate for the job.

- Proposition 103 gives consumers enforcement powers inherent in other statutes. By making California's consumer protection, civil rights and other laws applicable to the insurance industry, 103 makes available to the consumers a panoply of remedies for improper action that were previously unavailable.

The Industry Response to Reform

Two years later, the insurance industry response to Proposition 103 must be characterized as poor at best.

In California, insurers have sought to block or delay through court action every major provision of Proposition 103 and every regulation issued pursuant to 103 by the Insurance Commissioner. Not one company in California has broken ranks to secure a competitive advantage by voluntarily granting consumers the rollbacks, and advertising that fact, or by implementing 103's reform of territorial rating. As a result, voter hostility to the insurance industry in California is greater than it was on Election Day, 1988.

Elsewhere throughout the nation, the industry seems to be divided between two disappointing responses.

The first is to treat insurance reform efforts as declared war, the only appropriate response being full nuclear retaliation. This might be called the "California response," since it approximates the stance adopted by most insurers operating in California. It reflects a determination to discourage the Prop 103 clones underway in other states by refusing to accept any reform that implies that rates were ever excessive—even by one dollar—or that there are any other defects in the industry which must be corrected.

Partisans of this approach seem to comprise the largest insurers, such as State Farm, which appear to view any one state's laws as subject to its own independent inclinations. It is best exemplified by the views of a former executive of the National Association of Independent Insurers, John Crosby, who compared consumer advocates to Hitler and seemed to advocate a jihad against them.[9] This view got much applause during an industry convention in 1989, though Crosby later departed his position under a cloud of controversy as reports of his statement circulated among consumer groups and elected officials through the national press.[10]

The second industry response is to acknowledge its defeat—but with a tendency to view it as a massive failure of public relations, as if the industry simply hadn't spent enough money trying to defeat 103 in California. Proponents of this approach will admit the need for "reform," simply because the polls tell them it is going to happen —but never 103-style reforms.

Characteristic of this response is the call for close "cooperation" between consumer advocates and insurance companies, which is manifested by conferences, committees and joint appearances. For example, a "Coalition for Consumer Health and Safety" was announced by the leader of the Consumer Federation of America in 1989; industry leaders joined with the CFA in a press conference to issue a product safety "reform agenda." Other than the high visibility insurers won, nothing else besides the press release survived the event.

More promising is the Advocates for Highway and Auto Safety, a new industry-funded group designed to lobby for mutually-agreed upon proposals such as auto safety. The group is governed by a panel which includes several Washington, D.C.-based consumer leaders. However, with an anticipated budget of $1.5 million, such a step, though clearly a boon to the campaign for safer cars, must be viewed as a relatively inexpensive way for the industry to obtain credibility and good public relations.

A more disturbing use of industry resources is evident in its role in creating and funding Project New Start, a so-called citizen group which has been advocating industry-supported no fault laws in many states. Established with insurance industry support shortly after 103 passed, Project New Start claims it is independent but insurers have sponsored the organization through solicitations and other means.

Whether industry-sponsored efforts will amount to more than public relations remains to be seen. Obviously, if such cooperation can bear any fruit, it is worth exploring. But such cooperation poses a danger to consumer groups, particularly those outside Washington, who may be distracted from the more fundamental and more necessary reforms, such as tougher regulation and enhanced accountability.

There is a significant danger for the industry too, because this strategy threatens to lull the industry into believing that such efforts, though important in their own right, can substitute for the needed structural changes. And, of course, these kinds of activities can be used by the industry to protect itself against such changes.

Not one industry leader has discussed or even acknowledged the role of the industry cycle and insurers' cash needs in rapid rate increases. None have evidenced any sign of recognition of the profoundly conflicting responsibilities of the industry to maximize shareholder return and, at the same time, deter losses, much less proffered a sophisticated strategy for resolving the contradiction. And, of course, the industry's lobbyists continue to fight all looming reform efforts at the state and federal levels.

Without leadership which can honestly accept the need for reform, and cooperatively implement such measures, the industry will continue to face the same and even greater demands from consumers.

Post-Proposition 103 Reforms

The Consumer Agenda

Both insurance officials and consumer advocates might agree that Proposition 103 is the beginning, rather than the end, of insurance reform in our nation. However, insurers must recognize that Proposition 103's disclosure, regulatory, accountability and fairness provisions are prerequisites to policy-maker and public support for further reforms.

There are four key issues which await action; they cannot be resolved without the prior, full implementation of 103:

1. **Auto insurance policies for low-income drivers**

A society which requires motorists to obtain insurance must provide an alternative for those, particularly the working poor, who cannot afford a policy no matter how effectively Prop 103 style reforms are implemented. Uninsured motorists pose a danger to themselves and force rates up for insured motorists. A "lifeline" policy to make sure that the truly needy can obtain full insurance protection for themselves, their families and others is a top priority. It can be subsidized through uninsured motorist premium reductions.

2. Loss prevention

Though Proposition 103 provides new incentives for insurers to engage in loss prevention practices, further legislation will be required to establish auto, highway safety, manufacturing and other standards that will encourage safety and reward loss prevention in the rate base and revenue stream.

3. Health care reform

Health care costs have skyrocketed—and will continue to do so—until a comprehensive solution to America's health care crisis is found. The relationship between liability insurance premiums and health care costs is obvious. Part of the solution must be to control costs; another is to afford basic health care to every citizen. Like the auto and liability insurance crisis of the 1980s, health insurance is increasingly unavailable and unaffordable." Over 5.2 million Californians have no health insurance coverage.[11] Rates for the rest of us will skyrocket 20 percent in 1990—more than four times the cost of living.

4. Civil justice reforms

Reforms to improve and enhance the rights of citizens to seek justice in the courts involve eliminating unnecessary or frivolous litigation and enabling consumers to obtain compensation inexpensively without the assistance of an attorney in minor auto accident cases.

The Industry Agenda

Unfortunately, the insurance industry persists in its strategy of the mid-1980's of proposing legislation which restricts victims' compensation rather than excessive profits, waste and inefficiency within the industry. Hence, the industry's priority reform continues to be "no fault."

Most "no fault" programs guarantee that all motorists, regardless of their culpability, are covered for basic medical losses. While that is a worthy goal, it is an extremely expensive proposition, both in terms of the sacrifices it demands of innocent victims and the higher premiums it demands of consumers.

One of the most unfortunate consequences of "no fault" is its impact on insurance rates. A 1985 U.S. Department of Transportation study of "no fault" systems in other states is a useful reference for both sides in the reform debate.[13] The study shows that "no-fault" provides compensation to more people than does liability insurance. But more compensation paid out means more premiums must be paid in. And that, of course, means higher insurance rates. Not surprisingly, the DOT study found that premiums in no-fault states, including those considered by DOT to be among those with the "best" "no fault" laws, were on average higher than premiums in non-"no fault" states.

The DOT and other studies suggest that "no fault" systems will lower transaction costs—the costs of settling auto accident compensation disputes. There is little disagreement that motorists should not have to hire an attorney and endure years of litigation in order to obtain full compensation for their injuries.

However, the efficiency gains achieved by no-fault systems are primarily a consequence not of the elimination of fault, but rather of the introduction of alternative dispute resolution mechanisms to determine damages. Fault is usually obvious in auto accident cases and is not generally the subject of litigation. Most often, it is the amount of damages that are disputed. And, all too often, victims are forced into court in order to obtain full compensation from an insurance carrier. These kinds of disputes will continue, regardless of whether or not we have no-fault, so long as insurance companies and policyholders have divergent aims and responsibilities.

Moreover, no-fault systems introduce a few inefficiencies of their own, such as the possibility of litigation over whether injuries fall below or above the threshold.

Finally, "no fault" fundamentally contradicts Proposition 103's emphasis upon the consumer as master of his or her insurance policy. Under "no fault" laws, the innocent victim is in effect blamed for the accident by having his or her insurance rates raised, since "no fault" by definition does not permit any discrimination between at fault and innocent drivers. Proposition 103, by contrast, requires insurers to base automobile premiums primarily upon individual characteristics such as a driver's safety record. This provides each motorist the opportunity and incentive to reduce his or her insurance rates by maintaining a safe driving record.

This analysis is not to say that the broader compensation provided by "no-fault" systems would not justify higher premiums; or that a "no fault" system could not be constructed which respects a victims' legal rights. Rather, it is simply to note that the primary concern of most consumers is to obtain lower rates, not greater compensation, and it is clear that "no fault" does not lower rates.

Moreover, there is simply no way to evaluate the virtues of this or any other proposal for fundamental reform of the industry without first having the empirical data which Proposition 103, when fully implemented and enforced, will require the insurance companies to provide. Standard "prior approval" systems, combined with basic regulatory enforcement powers, will permit the insurance commissioner, policy-makers and the public to obtain the data needed to evaluate the industry's claims concerning the legal system and compensation of accident victims. Without specific data on the industry's claims and compensation practices, its expense-reduction, fraud and loss prevention programs, and the effect of compensation restrictions on consumers and taxpayer programs, there is no basis for the supposition that "no fault" or any other tort restriction will benefit anyone but the insurance industry.

Alternatives to Proposition 103

In California, consumers have begun to contemplate the prospect that compliance with the fundamental reforms of Proposition 103 will not be forthcoming, at least in sufficient time to address the pocketbook crisis that motivated the initiative's passage nearly two years ago.

Insurers may believe that through obstruction and delay, consumers will cease struggling for 103. But as long as consumers must purchase insurance, there will be a growing demand for implementation of rate regulation and other 103 reforms to lower rates.

"The centerpiece of the CAP plan is the California Non-Profit Insurance Fund, a publicly-controlled corporation which will replace the private insurance companies."

Voter Revolt has drafted a new initiative intended to encourage insurers to cooperate in the implementation of 103, or, if that fails, to establish an alternative mechanism for providing auto insurance coverage.

The "Proposition 103 Enforcement Act" requires that (1) auto insurance rates be reduced, on the average, to the reasonable levels specified by Proposition 103, and (2) the number of uninsured motorists be reduced to no more than 15 percent of all licensed drivers, by November of 1993. If these standards of marketplace fairness and stability have not been met, a comprehensive, publicly-controlled auto insurance system—the California Auto Plan— will be established, with operation commencing one year later. The centerpiece of the CAP plan is the California Non-Profit Insurance Fund, a publicly-controlled corporation which will replace the private insurance companies.

Note that the private insurance companies are not required by the initiative to sell insurance at the 103 rollback level. The proposal simply states that if the companies will not—or, as they argue, cannot—reduce rates to the appropriate, reasonable levels specified by 103, the California Auto Plan system will take effect to provide a stable, reliable, law-abiding insurance system.

Coverage

The California Non-Profit Insurance Fund will provide automobile insurance for every licensed private passenger vehicle in California. The amount of coverage to be provided will be not less than that required by California mandatory insurance laws. Private insurance companies will be permitted to sell automobile and other motor vehicle insurance only for coverages in excess of amounts sold by the fund. All motorists will be required to buy the minimum insurance required by existing law from the Fund in order to register their automobiles.

Rates and Prices

The fund will operate on a non-profit basis—insurance premiums will be no higher than needed to pay claims and expenses. It will be prohibited from making a profit. All expenses are sharply limited, all income from investment of premiums temporarily held by the fund (which must be invested in California if possible) will be used to reduce rates.

The fund will reduce rates by controlling health care and car repair costs, and actively working to prevent losses by promoting safer driving habits and safer automobile design. While 103's rate reductions and other reforms provide incentives for private insurance companies to do the same, few companies have taken any action on these matters.

Loss adjustment, administration and other functions will be contracted out on a competitive basis to ensure efficient, low cost delivery of insurance services.

Sales

The fund will be able to sell insurance directly and/or through agents or any other means convenient for consumers. Policyholders will be able to buy policies on an installment basis.

Regulation

The fund will comply with 103's civil rights, regulatory and accountability protections; the elected insurance commissioner will set all rates charged by the fund.

Claims

The fund will be required to pay all legitimate claims promptly. One of the advantages of a publicly-controlled insurance system is that since the fund will have no financial incentive to delay or deny payment of legitimate claims, it will be possible to resolve claims disputes using less formal and time-consuming procedures than are employed in most courtrooms.

To simplify and ensure prompt resolution of minor accident disputes, and to clear the backlogged courts so they can process more important cases, a new, independent auto claims resolution system will be established, called "Auto Claims Administrative Court." The system will be modeled after the existing small claims courts. Attorneys will not be permitted, except to represent themselves. However, a Consumer Assistance Office will be established to provide basic assistance with Auto Claims Court procedures, all of which will be oriented toward lay people, rather than lawyers, and will be much more flexible.

Wrongdoers will be held responsible for the damage they cause and victims will be entitled to full compensation for their injuries, as is presently the case.

The new system will operate for cases up to $15,000, and will be voluntary. Victims will still be able to choose to hire a lawyer and proceed through the civil courts if they wish. But the initiative provides strong incentives for using the new, streamlined system.

The Auto Claims Administrative Court is appropriate only because the fund would entirely replace the private auto insurers, who have a profit motive to delay and deny legitimate claims. The new, publicly controlled company will not resist legitimate claims and will quickly provide full compensation; hence, it is justifiable to allow claimants to resolve disputes informally. It would be irresponsible to advocate such changes in victims' civil justice protections outside the context of a publicly-controlled company.

Finally, the initiative requires that all insurers—not just auto insurers—settle cases in good faith.

Fraud

To address abuses of the present system that can contribute to higher rates, the initiative will severely punish medical professionals, attorneys, car repair facilities and others who fabricate or inflate insurance claims of any kind. Professionals will lose their license to practice and be subject to fines and incarceration for violations.

Consumer Representation

A permanent citizen watchdog organization shall be established to advise and monitor the Fund and to protect consumer interests on all insurance matters.

Conclusion

The insurance industry enters the new decade challenged by the forces of change, reflected in Proposition 103 and similar efforts underway in many other states to restructure the marketplace to make it more competitive, make rates responsive to public needs, and make regulators more accountable to the voters. Change is inevitable; cooperation, not further confrontation, is the most effective and appropriate response the industry can make. The penalty for prolonged confrontation will be severe.

The "Proposition 103 Enforcement Act" reflects a trend already apparent in the other liability insurance markets: self-insurance mechanisms established to replace private insurers who are unwilling or unable to service adequately the needs of consumers in the marketplace. The reluctance of the insurance industry to cooperate in more modest reforms, such as those mandated by Proposition 103, could well add auto insurance to the list of functions for which citizens turn to government.

Endnotes

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3. Calfarm v Deukmajian (1989), 48 Cal 3d 805.
4. "Attorney General's Rollbacks," Statement of California Attorney General John Van de Kamp, May 31, 1990.
5. "Antitrust Guidelines for the Insurance Industry," State of California, Department of Justice, March 1990.
6. "Pick a Price, Any Price, A Report on Inconsistent Price Quoting of Automobile Insurance," California Public Interest Research Group, June 1987.
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Proposition 103: Repealing the Law of Supply

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November 8, 1988, will forever be remembered as the date on which California voters enacted Proposition 103, a sweeping overhaul of the way insurance is regulated in California.[1] Proposition 103 was one of five insurance initiatives that were offered to the voters in November 1988 and was the only one of the five that passed.[2]

The principal thrust of Proposition 103 is to change the way in which insurance rates are regulated in California. Although the most common approach to the regulation of property and liability rates nationally has been the prior approval approach, insurers in California had operated under an "open competition" rating law since 1947. Prior to Proposition 103, California law made it clear that competition, not government authority, is the preferred governor of rates and that barring the existence of an anti-competitive situation or practice, the Commissioner of Insurance was not to regulate rates specifically. Insurance companies were not required to file their rates for approval, but could use whatever their own experience or that of a rating bureau dictated. The system was cited as a model to which other states might aspire, and during the 1970s a number of other states actually enacted legislation following the California pattern. Ironically, several states with distressed automobile insurance markets were considering a California type of law at the time Proposition 103 was enacted.

Not only did Proposition 103 alter the regulation of rates, it also sought to repeal the economic law of supply by legislating a reduction in insurance rates. Finally, Proposition 103 eliminated numerous provisions of the Insurance Code that had been enacted over the years, dramatically restructuring the rules of conduct in the California insurance marketplace. Briefly summarized, Proposition 103 enacted the following changes:

Prior Approval System

Beginning November 8, 1989, most property and liability insurance rates are subject to prior approval.[3] The prior approval system enacted by Proposition 103 is a "modified flex rating" system. Applications for changes in rates must be submitted to the Insurance Commissioner for approval. Prior approval is required only when the proposed changes exceed specified boundaries. Proposed rates go into effect in 60 days unless the proposed increase exceeds 7 percent for personal lines or 15 percent for commercial lines, in which case prior approval is required. Prior approval is also required if, during the sixty days following the filing, (1) a hearing is called, or (2) a consumer objects to the increase.

Rate Rollback

As enacted, Proposition 103 mandated that insurance rates were to be rolled back to November 8, 1987, and then reduced by an additional 20 percent for those lines of insurance included under the law. Under the provisions of Proposition 103 as enacted, for one year after November 8, 1988, insurance rates could not be increased unless the Commission found that an insurer was substantially threatened by insolvency. This provision was challenged by insurers and, as discussed below, decided by the California Supreme Court.

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