A ROADMAP TO MARKET STABILITY FOR THE NEW JERSEY PRIVATE PASSENGER AUTOMOBILE INSURANCE MARKET

JOHN D. WORRALL[1]

MARCH 18, 2002

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EXECUTIVE SUMMARY

The election is settled and it is time to solve our auto insurance problem. While we have struggled for nearly 30 years with one "fix" after another, our system is still dysfunctional. The private passenger auto insurance system was supposed to be dramatically improved by 1997 law changes and the 1998 Automobile Insurance Cost Reduction Act (AICRA). The improvements arrived with much hoopla and a mandatory insurance rate roll-back of 15 percent. Drivers saw their premiums drop. Unfortunately, the system has not improved much. So what happened? Why isn't the system working?

For starters, the state has yet to adopt some of AICRA's promised cost savers. Medical, hospital and dental fee schedules are still not fully in place, and neither are the new rating territories. AICRA's fraud provisions are not fully realized.

But we must be realistic. Even when fully implemented, these changes may bring some relief, but they still are not going to solve the problem. Why not? New Jersey is an expensive place to do business. The costs of those things that help determine insurance rates and premiums (medical expenses, lawsuits and vehicle repairs, for example) have gone up, not down. New Jersey is the most densely populated state. Lots of vehicles, lots of traffic, lots of claims and losses. Also, people here drive expensive vehicles, and buy full coverage limits, which are relatively expensive.

More importantly, our insurance law is fundamentally flawed as discussed below. It virtually guarantees market inefficiency over time. The combination of flaws in the current law and the lack of implementation of the provisions of the 1997-98 changes in the law, together with mandatory rate reductions, is a recipe for market disaster.

Because of our regulatory excesses, broken promises and the unintended consequences of past automobile insurance law, we already have far fewer private passenger insurance firms willing to sell insurance in our state than in others. New Jersey has 67 companies that sell auto insurance, while Illinois has twice that many with 129. This is no accident. New Jersey has a highly politicized, very strict rate regulatory system, which requires insurers to obtain approval from the insurance department prior to making any changes in their rates (known as prior approval).

Illinois has ended the political grandstanding associated with auto insurance. We should do the same.

Several decades ago, Illinois adopted the open competition model for auto insurance. Insurers no longer have to appear before regulators to adjust prices. Nor do they have to file a ton of detailed, bureaucratic reports about every aspect of their business. The sky did not fall. To the contrary, the Illinois market has and continues to be very vibrant, with an open marketplace where competition sets the prices, not the government.

Five of the top ten auto insurers in the country do not do business in our state. Why? We have bad law and bad regulation, plain and simple. New Jersey is ready for the benefits of competition – the entry of new companies and the best insurance products at the most competitive prices.

Although it is painful to admit, we know that there are good reasons to expect our insurance rates to be high.

- **We live in the most densely populated state.**

- **We have more cars per square mile than any other state.**

  New Jersey has 822 cars per square mile - the U.S. average is 61! New Jersey's 822 is *double* the number for *neighboring* states.

- **We have the highest per capita income in the country, but costs are high in our state.**

We drive expensive cars and buy full insurance coverage. New Jersey is the second most expensive place to repair a car. We have great medical care, but medical costs are high. We are known for filing lawsuits, which drive up insurance costs.

- **Our insurance claims are usually the most expensive in the country.**

  Our average injury costs are twice the national average. They are one-third higher than the second most expensive state (Delaware), and 50% higher than the third most expensive state (New York)!

- **We have 500,000 uninsured drivers imposing costs on the rest of us.**

- **Some of the reasons for the high cost of insurance are unavoidable, such as many cars and high population density.**

  But others, such as bad insurance law and ill-advised regulatory schemes, are not. We can and should take action to improve them. Other states have, and we can, too.

- **We have too much regulation and it is destroying the market.**

  We adopt Band-Aid approaches and make believe we have solved our insurance problem. We have not. We do not have as much choice as consumers in other states, and if we do not solve our thirty-year old mess, we may soon have less.

- **We have lost many firms in the past, and we may soon lose more.**

  Both State Farm Indemnity and Newark Insurance are leaving the market. Ohio Casualty is giving up its auto insurance business. AIG has agreed to put its withdrawal plans on hold for two years, but over 1,000,000 of us may be looking for new insurers shortly!

- ***We have a dysfunctional regulatory system that hurts consumers and insurers alike.***

  It stifles competition and operates like a political circus. Insurance companies cannot adjust their prices when economic conditions change, which means that some consumers pay more than they should, others less. Consumers who do not even own a car can end up subsidizing someone who drives. A single working mother may end up subsidizing an upper-income teenage driver. New Jerseyans who drive safely may not drive as much because their rates are too high, and those who are careless may drive more because their rates are too low. Many will drive uninsured. We have set thresholds for lawsuits at very low levels, and then acted surprised when people have sued, ultimately driving up insurance costs.

- **We have far fewer insurers than other states, despite the substantial size of the market. Five of the top ten U.S. auto insurers do not want to do business in our state! Why have so many voted with their feet and abandoned our market?**

  We have prior approval price controls that allow political pressure to set rates. It is not unusual for insurers to wait a year for rate decisions that virtually always result in denial or partial approvals. Since it is the state that sets prices, rather than the market, we squander resources that could be devoted to fraud control and solvency regulation.

- **We breach implicit contracts, and act surprised when insurers and consumers do not trust us in the future.**

  We try to hide our pricing mess and the residual market problem it creates by coercing consumers to pay someone else's premium. We pass "take-all-comers" and non-cancellation rules to ostensibly protect consumers when in reality we are creating inefficiency and waste, discouraging firms from selling insurance here, and picking the pockets of some to pay for the costs created by others.

- **We pass laws that add costs and bureaucracy to an already over-burdened system.**

  We created the Joint Underwriting Association (JUA) to deal with the problem of the massive number of drivers who were unable to get coverage in the voluntary market following the implementation of strict prior price approval laws. We promised that the JUA was going to be run on a break-even basis, and promptly ran up a three billion dollar deficit. We passed half of it back to insurers to eat (beggaring consumers everywhere in America), and then surcharged N.J. drivers $222.

- In other words, we totally subsidized the assigned risk pool. We "solved" the JUA

problem by introducing the Market Transition Facility and promptly ran up another billion dollar deficit.

- **We pass laws and order reductions in prices without implementing the cost-reducing provisions of the laws.**

We act as if we live in a world without constraints. We pretend that if we say costs do not exist, they will disappear. They will not. As part our latest reform effort (the Auto Insurance Cost Reduction Act of 1998), we rolled back rates by 15% on the promise of promulgating:

- a new medical fee schedule;
- a dental fee schedule;
- a hospital fee schedule; and
- a new territorial map and new caps.

To date, there is no dental fee schedule, no hospital fee schedule, no new territorial map or new caps, and only a partial new medical fee schedule.

- **We actually discourage the entry and exit of firms with our regulatory behavior, broken promises and our insurance law.**

We act as if we can keep insurers in New Jersey by coercion. If they want to leave the auto insurance market because they cannot break even, we say "only if you surrender your licenses in all other lines." They are leaving because they do not believe they can break-even now, or in the future.

- **We have an "excess profits" law which is based on a fixed accounting rule that does not change when economic conditions (inflation, interest rates, etc.) change.**

This profit restriction law lowers the return insurers can expect to earn and discourages new firms from entering our market.

SEVEN STEPS TO A HIGHLY EFFECTIVE NEW JERSEY

AUTO INSURANCE MARKETPLACE

Outlined below are seven steps to a more efficient and cost-effective private passenger auto insurance regulatory system in New Jersey. Each of these steps is very important and their order is not intended to imply otherwise. All of them must be taken if we are to start down the road to a competitive marketplace.

1. ADOPT FLEXIBLE RATING

Flex-rating can help us out of this mess. If we follow the lead of South Carolina, New York, Kentucky, Missouri, Oklahoma, and Texas, and allow insurers to adjust their prices up or down within certain flexible bands, we can eliminate much of the grand inefficiency that goes with prior approval price control. We should probably start with a middle-of-the-road approach, using a 10% band, to avoid large initial shocks to the system. If we had such a system in place now, we would:

- not have lost so many firms and had more contemplating exit;
- have had more competition and consumer choice;
- have avoided the spectacle of tortured explanations for rate denials followed by post-election rate increases; and
- have saved the resources squandered.

2. ELIMINATE "TAKE-ALL-COMERS" AND NON-CANCELLATION RULES

The force of the "take-all-comers" and non-cancellation rules taken together is to weaken the link between behavior and true cost, and the premium drivers pay. Both of these rules should be eliminated. A good start would be to reduce the current 9-point rule. Not only does it foster subsidy, it probably increases average insurance cost, as well.

3. IMPLEMENT ALL PREVIOUSLY ENACTED REFORM MEASURES IMMEDIATELY.

It is crucial that we fully implement these law changes immediately. The longer we stall, the more distorted the market will become, the more New Jerseyeans will be scrambling for insurance, the more firms will try to exit our market, and the more difficult it will be to convince them that we will not "shake them down" should they enter the market. These do not require a law change. It has been OVER THREE YEARS since the Auto Insurance Cost Reduction Act of 1998 was enacted. We won World War II in less time than that.

4. ELIMINATE THE "LICENSE SURRENDER" PROVISION

Each line of insurance should stand on its own merits. Those who benefit from insurance protection should pay the costs of the protection. Our method of stalling exit, or discouraging it by forcing license surrender in other lines of insurance where insurers may be more efficient or better able to earn the opportunity cost of capital may be well intentioned, but it introduces subsidies across other lines of insurance, and it makes us less competitive with other states. We are ultimately shooting ourselves in the foot.

5. *ELIMINATE THE PROFIT RESTRICTION LAW AND ALLOW COMPANIES TO COMPETE FOR PROFITS*

The best regulator of profits is price competition. It is fostered by the entry and exit of firms who compete on price. Rules which inhibit entry and exit are not consumer friendly. You cannot get a 5% mortgage when the rate of inflation is 10%, and the normal profit level is not some tortured, unchanging 2.5% accounting rule. If we adopt flex-rating, implement our promised law changes and get rid of our "license surrender" provision, we will not have to worry about "excess profits." We should repeal this provision of our law. It flies in the face of modern financial theory, and lessens our competitiveness.

6. LEARN FROM OTHER STATES

We can learn a great deal from other states. South Carolina, Massachusetts, Washington, D.C. and Illinois all offer excellent examples.

- **South Carolina** – The state had many of the same problems we have. It suffered from market exit, few firms, high subsidies and strangulating regulation. It wanted to attract more insurers, phase-out the subsidies, and solve its availability problem. It largely has achieved these goals in a very short period of time.

  The first lesson we can learn from South Carolina is that even in a state with a very stressed market, providing some price flexibility can have a rapid impact on market stability, consumer choice and efficiency. South Carolina adopted flex-rating and the results speak for themselves.

  The second lesson we can learn from South Carolina is that repealing "take-all-comers" enables insurers to concentrate on different market segments, provide pricing based on the risk of the driver and reduce the inefficiency that cross-subsidies can bring.

- **Massachusetts** – The state tried to go from a strict prior approval price control regime, to a competitive rating state in one year. The subsidies for some drivers in the state were so large (the total subsidy was $500 million a year) that the political outcry was deafening. The state abandoned its reform plans before it had any chance of taking effect and now has even few insurers than we do. It has had a residual market problem to rival ours. Offering a transition plan like South Carolina, instead of following the Massachusetts model of going "cold-turkey" may provide the stability our market needs to adjust.

- **Washington, D.C.** – The District was a prior approval jurisdiction and it had an availability problem. It introduced competitive rating and its prices dropped, the assigned risk pool was depopulated, and most of its rate filings have been for small decreases.

- **Illinois –** The state has no rate regulation for the voluntary market. It has the largest number of insurers writing business in America. Less than one percent of its drivers are in the assigned risk pool. The state is 80 percent urban, with Chicago as its largest city, and its rates are hundreds of dollars less than ours. Insurance pricing is not a political event there. It is not an election issue. Illinois's rate changes tend to be frequent and small. The state prides itself on not providing barriers to entry or exit. It explicitly states that it wants its consumers to have the benefits of competition. The market and competition regulate rates.

7. FORM A BLUE RIBBON PANEL TO DRAFT A TRANSITION PROPOSAL TO INJECT COMPETITION INTO OUR REGULATORY SYSTEM

We have tried for years to finally end our auto insurance nightmare. We have passed some laws that can help. We have adopted tier rating, for example. Unfortunately, we also have passed other laws that have hurt more than they have helped by adding more bureaucracy to the system. We have tried to tighten up the threshold for lawsuits (the jury will be out on this for a few more years), but there is still much to be done. We should start by implementing laws already passed.

We must begin to dismantle our regulatory system before there is any serious market disruption. It is not consumer-friendly, it wastes our money, provides us with less choice and hurts our competitiveness. Our commercial auto market is not prior approval. Businesses buying insurance have more firms from which to choose, and they get the benefits of competition. We should, too. Let's form a Blue Ribbon Panel to draft the transition proposal that will start us on the road to the market efficiency that New Jersey drivers so sorely need and deserve.

The time is right to begin a transition to a competitive market. We have declared victory in the auto insurance wars too many times, all the while running up huge deficits and pretending not to notice. Let's do it right this time by attacking the real, long-term, underlying problem, rather that just treating the short-term symptoms.

A ROADMAP TO MARKET STABILITY FOR THE NEW JERSEY PRIVATE PASSENGER AUTOMOBILE INSURANCE MARKET

I. INTRODUCTION

Private passenger automobile insurance has been high on the reform agenda of the various (and would be) political administrations in New Jersey. We have paid the highest car insurance premiums in the country for many years, and elected officials have been living with the problem for the last three decades. New Jersey's long-suffering drivers have seen the latest of a three-decade chain of "reforms" legislated in 1997 and 1998. The intervening years have provided a glimpse of the impact of the 1997-1998 law changes. Despite some optimism at the passage of these reforms, the reality is that the private passenger automobile insurance market still suffers from many of the same ills that it has for years. It is not necessary to set out the full taxonomy here, but a few include:

- excessive rate regulation with not enough price flexibility to enable firms to adjust to changing economic conditions, or the market to generate the appropriate price signals for efficient resource use or to offer the appropriate incentives for safe driving. This price regulation, coupled with a "take-all-comers" rule and a fixed accounting "excess profit" rule, virtually guarantees market inefficiencies and, where possible, the **exit** of firms;

- insurers held captive, with their business in other lines of insurance used as leverage (or as thinly veiled instruments to subsidize the auto line) to delay or subvert market exit in the face of losses and surplus depletion - a recipe certain to discourage **new entrants,** and to further exacerbate the problems generated by price controls and unkept promises; and

- a system of rate caps which have generated a host of subsidies; penalizing good drivers and subsidizing bad ones; charging customers who live in some areas too much for their insurance, and those who live in other areas too little.

These fundamental flaws, and others discussed below, are virtually guarantees of market inefficiency over time, but they are also the portents of a potential market crisis. The combination of flaws in the current law and the lack of implementation of the provisions of the 1997-1998 changes in the law, together with mandatory rate reductions, is a recipe for market disaster.

Scrambling For Insurance And Voting With Their Feet

Because of our regulatory excesses, broken promises and the unintended consequences of past automobile insurance law, we already have far fewer private passenger insurance firms willing to sell insurance in our state than in others, but unless we take action, the situation will only get worse. State Farm Indemnity, a New Jersey-only writer, with over 800,000 risks insured has announced that it has filed withdrawal plans with the New Jersey Department of Banking and Insurance (the Insurance Department). American International Insurance Company of New Jersey, an AIG subsidiary which insures over 213,000 New Jersey drivers, announced, shortly after State Farm, its plan to withdraw from the state as well. It has agreed to place its withdrawal plans on hold for two years, having received a post election rate increase, but it is making no long-term promises to stay in the state. Newark Insurance Company, a major New Jersey auto writer with 90,000 customers in the state wants to leave. Ohio Casualty, with over 100,000 insureds, is turning its auto business over to Proformance, a small company with 23,000 customers in New Jersey,[3] and considering exiting the state.[4]

One in five New Jersey drivers will be searching for a new carrier in the near future. State Farm, New Jersey and the nation's largest provider of private passenger auto insurance, and AIG, New Jersey's six largest writer (and a top fifteen countrywide provider) could join five of the other eleven largest private passenger automobile insurers in America who have come to the conclusion that it is not in the best interest of their policy or stock owners to sell private passenger automobile insurance in New Jersey. These firms are not leaving the market, or refusing to write business here, because they have been earning excess profits. They are implicitly telling us that they do not think they can earn an adequate return in New Jersey. They are voting with their feet because they do not believe, based on repeated observations, that we have the political will to fix a broken system. New Jersey citizens will have fewer choices as a result of our regulatory system failures.

There are ways to improve the situation in the New Jersey private passenger market. The optimal solution is to adopt open competitive rating. However, in New Jersey, it may be impossible to see the immediate adoption of the open competition laws which bring a free market, with all of its inherent benefits, that the citizens of Illinois have enjoyed for decades. The distribution of insurance prices across our drivers is so warped that the immediate adoption of efficient prices may generate price changes that would be so large as to sap the political will. A transition to open competition may provide a stable environment and a platform that can generate the political will from which movement to open rating can be accomplished. Be that as it may, good public policy dictates that we consider temporary, incremental steps that can be taken to improve market efficiency and eliminate many of the costs of excessive regulation.

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[3] See Joseph B. Treaster, "With Promise of Rate Rise, Insurer Halts Plan to Leave," *New York Times,* Dec. 19, 2001.

[4] Randy Diamond, "Insuring Cars Gets More Costly," *The Record*, Dec. 19, 2001.

New Jersey Is A Great, But Expensive Place To Live

New Jersey is a fabulous place to live and to raise a family. It has a strong economy with a highly skilled and trained labor force, offers a variety of the arts, and has scenic beauty and beaches ranked among the best in the world. It has the highest *per capita* income in the country, but it is also an expensive place to live. Because it has a strong industrial base, part of which spans several of the most traveled super highways in the world, many people passing through the state think of New Jersey as an industrial megalopolis. It is the most densely populated state and has far more registered vehicles per square mile of land than any other state. In 1999, according to the Federal Highway Administration, New Jersey had 822 cars per square mile, with Connecticut second at 571.

The Insurance Council of New Jersey points out that this is much higher than the countrywide average of 61 vehicles per square mile, and is more than double the figures for our neighboring states, Delaware (314), New York (228) and Pennsylvania (201).[5] It will be difficult to change the impact of New Jersey's high population and traffic densities and they will always be a factor in costs. However, residents and state policymakers can help alleviate high traffic density and its impact on auto insurance costs through support for and use of public transportation, ride sharing, telecommuting, development policies, and other techniques that help reduce traffic congestion, particularly during periods of peak congestion when accidents are more likely to occur.

New Jerseyeans, in part because of their relatively high incomes, drive expensive cars. To protect themselves and others, they select high insurance coverages which are relatively expensive. New Jersey is the second most expensive place to repair a car after an accident, it has high medical costs and is known for its litigiousness. New Jersey's accident frequency is far from the highest in the nation. There were 3.87 property damage claims per 100 insured cars in the state in 1998, and there were 7.06 in Massachusetts, 5.89 in Washington, D.C., 4.95 in Rhode Island and 4.85 per 100 insured cars in Texas in the same year.[6] However, the costliness of New Jersey's insurance claims is usually the highest. In 1997, our average injury loss cost was over twice the national average, one third higher than the second most expensive state (Delaware) and almost 50 percent higher than the third most expensive state (New York).[7] Although the percentage of New Jerseyeans who drive uninsured ranks 33rd among the states at 12 percent, this translates to over half a million uninsured drivers who impose costs on the law-abiding, insured drivers of New Jersey.[8]

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[5] Insurance Council of New Jersey, *A Report on New Jersey's Efforts to Build a Better Automobile Insurance System*, Mar 27, 2001, p. 9.

[6] Insurance Research Council, *Trends in Auto Injury Claims: 2000 Edition*. Malvern, PA: IRC, p. 13.

[7] *Ibid.*, p. 53.

[8] Colorado ranked number one in the country with a 34% uninsured motorist rate, and North Carolina ranked 50th with 5% of its drivers uninsured. See Insurance Research Council, *Uninsured Motorists,* Malvern, PA., 1999.

New Jersey has had and continues to have the highest private passenger automobile insurance premiums in United States. Some of the reasons for the high cost of private passenger insurance in the state are unavoidable; for example, many cars and high density; but others, such as bad insurance law and ill- advised regulatory schemes, are not. We can and should take action to improve them. Other states have, and we can learn from their experience.

II. HOW DID WE GET OURSELVES INTO THIS MESS?

We have taken fitful steps to improve the system over time, but we have frequently introduced, in the same law, a change which improves system efficiency and other changes which make the system inefficient. The Insurance Reform Act of 1988, for example, introduced flex rating, which enhances market efficiency, but also introduced an "excess profit" provision which hurts market efficiency. Similarly, Public Law 1997 (Chapter 151) introduced tier rating, which enhances market efficiency, but it repealed flex rating, one of the major improvements in the 1988 law and a step toward letting price competition work.

The Wall Street Journal,[9] *Forbes Magazine,*[10] *The Philadelphia Inquirer,*[11] *The Star-Ledger*[12] and other leading publications have each recently called for reform of New Jersey's private passenger automobile insurance system. In this paper I will set out some of the steps we need to take to repair that system and restore the private passenger automobile insurance market to good health. We may not have the political will to do so in one fell swoop, but we can take the steps necessary to enable us to make the transition to a healthy, viable automobile insurance market. We have made many legislative, political and regulatory decisions in the past which we believed were intended to set the system right.

Unfortunately, many of these decisions had unintended consequences that have continue to plagued the New Jersey private passenger automobile insurance system today. In a case study for the Brookings Institution and the American Enterprise Institute, I set out the history of the New Jersey private passenger automobile insurance market over the last three decades.[13]

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[9] "Like a Good Neighbor," Review & Outlook (editorial), *The Wall Street Journal,* Aug. 27, 2001, p. A14.

[10] Ira Carnahan, "Listen Up, New Jersey" *Forbes Magazine*, Oct. 1, 2001, pp. 80-82.

[11] "Unfinished Business" (editorial), *The Philadelphia Inquirer*, June 25, 2001, p. A8.

[12] "Try a New Approach on Auto Insurance" (editorial), *The Star-Ledger*, June 15, 2001.

[13] John D. Worrall, "Private Passenger Auto Insurance in New Jersey: A Three Decade Advert for Reform." Presented at the AEI-Brookings Conference on Insurance Rate Regulation, January 18, 2001, Washington, D. C. Revised for publication, April 15, 2001. Forthcoming in J. David Cummins, ed., *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency,* AEI-Brookings Joint Center For Regulatory Studies: Washington, D.C.: 2002

Unfortunately, in large part, that history is an object lesson in how to destroy a market. The lesson was generated by ill-advised law and excessive regulation of the New Jersey market. A few of the many problems that history details include:

- excessive rate regulation and regulatory lag, with some insurers waiting over a year for rate decisions which virtually always result in ultimate decisions yielding a determination less than the rate indication filed by insurance company actuaries;
- nearly half of New Jersey drivers finding themselves unable to find insurance in the voluntary insurance market, and many insurers unable to break even at the maximum prices they were allowed to charge;
- residual market mechanisms amassing huge deficits which have been passed on to insurers without compensating income;
- insurers attempting to exit the sixth largest private passenger automobile insurance market in the United States with fully half of the top 14 private passenger automobile insurers either refusing to write insurance in New Jersey or currently attempting to leave the state;
- use of ill advised "excess profit" provisions which discourage market efficiency and additional firms from entering the market, reduce competition and the number of firms from which consumers can select;
- "take-all-comers" rules which thwart effective risk pricing and fraud control;
- monetary thresholds which were low and eroded by inflation, and weak verbal thresholds, both of which have encouraged lawsuits;
- **mandatory** benefits systems which limit consumer choice, are frequently among the highest in the nation, and increase the cost of the insurance product; and
- a large number of New Jerseyeans driving uninsured.

This history is embedded in the litany of our past "reform" efforts.

A Sketch Of Previous Reform Efforts

New Jersey Automobile Reparation Reform Act (P.L. 1972, c. 70)

By 1972, largely as a result of strict prior approval rate regulation implemented in the face of increasing insurance loss costs during the mid to late 1960's, over 400,000 New Jerseyeans were unable to purchase insurance in the voluntary market and found themselves in the Assigned Risk Pool. Lawsuits were mounting and costs were escalating. A 1972 reform law was supposed to rectify those problems. It called for the following changes.

- **The introduction of mandatory liability insurance**. New Jersey had been a financial responsibility and contributory negligence state.

- **The introduction of elective no-fault**. Consumers could select the "limitations on lawsuits" option or retain their right to sue. No-fault was the default option. This fundamental law change, together with the introduction of its personal injury protection (PIP) provisions are still affecting us today.

- **The introduction of mandatory unlimited medical benefits.** This law change provided for no choice in the amount of medical coverage drivers could select, regardless of other coverage that the insureds had or their ability to pay for benefits.

- The adoption of a **$200 monetary threshold.** This provision allowed for lawsuits to be filed when the $200 threshold was surpassed, which could easily be met by the medical expenditures on non-serious injuries. The $200 monetary threshold was rapidly eroded by medical cost inflation and led to a spate of lawsuits from those exceeding the monetary threshold. Despite being a "no-fault" state, we were a lawsuit factory with the concomitant increases in costs generated as a result.

Although these reforms were well intentioned, they neither stemmed the tide of increasing costs, nor the flood of New Jersey drivers into the Assigned Risk Pool. By 1978 the number of vehicles in the Assigned Risk Pool had risen to over one million! The market was in disarray, and given the price controls introduced earlier, insurers began to abandon ship. We lost nine insurers between 1976 and 1983, including some of the largest automobile insurers in the country. Geico, Safeco, Nationwide, and Progressive exited the market, and their departures were to be followed by others in the early 1990's. PIP did not eliminate the increase in bodily injury claims, which actually increased faster than PIP claims. The New Jersey Insurance Department pointed out that there were mandated premium cost increases of 248% for PIP, bodily injury and property liability between 1973 (January 1, 1973, was the effective date of the 1973 law) and 1982.

New Jersey Automobile Full Insurance Underwriting Association (P.L. 1983, c. 362)

In response to the market disarray generated by strict prior price approval and the law changes described above, with the 1983 law legislators were keen to deal with the problem of the massive numbers of drivers who were unable to secure insurance coverage in the voluntary market. With an increasing number of drivers in the Assigned Risk Pool, it is difficult to believe that responsible parties did not understand that the problem was one of inadequate rates and price controls, and not a problem with the design of the residual market mechanism. Be that as it may, the 1983 law change and its administration was an unmitigated disaster which led to further market deterioration, and a lack of trust which exists to this day. The two principal changes introduced in the 1983 law were the introduction of the Joint Underwriting Association (JUA) and the elimination of the Assigned Risk Plan, along with the introduction of rate caps.

Under the Assigned Risk Plan carriers were responsible for risks assigned to them, and hence they had incentive to control the costs on individual policies because their bottom line was directly affected by their cost containment activity. Under the JUA the incentive link was broken as the policies were "serviced" by "servicing carriers" and the outcome of all drivers in the JUA was shared by all carriers. The JUA was supposed to have been run on a break-even basis, with a Residual Market Equalization Charge factored into the rates to help ensure that the scheme would not be run on a deficit basis. The reality was that regulators were able to block the charge, and the JUA was run on a cash flow basis. **It rapidly accumulated a deficit of over three billion dollars**, half of which insurers were forced to eat. Drivers in the state were surcharged up to $222 to help cover some of the rest of the deficit.

In a state where insurers were already experiencing inadequate rates, and drivers were unable to find coverage in the voluntary market, permitting such a huge deficit to accumulate and then passing it back to insurers to pay from their surplus virtually guaranteed other insurers would try to abandon the New Jersey market, and that insurers would be reluctant to enter the New Jersey market any time soon. It also ensured that New Jersey drivers would be enraged with the size of the surcharges they would have to pay.

Caps on rates were introduced, which were, and are, thinly veiled systems of rate subsidies.

The 1988 Insurance Reform Act (P.L. 1988, c. 119)

By 1988, fully half of the private passenger automobile insurance business was in the JUA. The 1983 law changes did not halt the incessant increase in insurance loss costs, which doubled between 1980 and 1988. Inflation had eroded the $200 medical threshold to $56 and lawsuits were a mounting problem. The legislature produced the 1988 reforms which included:

- **The first verbal threshold requirement**, which eliminated the $200 medical threshold, and replaced it with language intended to limit suits to serious injury cases, and to reduce the rapidly increasing costs associated with tort. As will be described below, the 1997-1998 reforms had to amend this law provision, which failed to eliminate soft tissue suits and reduce legal costs to the system;

- **An excess profits provision**, which required insurers to refund "profits" in excess of a fixed accounting percentage to policyholders. The excess profits provision did not call for subsidies when insurers lost money, nor did it call for adjustment of the fixed accounting percentage when the cost of capital increased. Hence, whether the inflation rate was zero or twenty percent, insurers who earned more than a small fixed percentage over three years were required to refund that excess. This provision, which lowers the expected rates of return for insurers, is still on the books and both encourages firms to leave the market and discourages new firms from entering the market;

- **The introduction of flex rating to New Jersey**, which allowed insurers to implement small price increases or decreases without going through as much regulatory bureaucracy, and with the confidence that such increases or decreases would be acted upon in 45 days to two months;

- **A PIP co-pay and mandatory comprehensive deductible**, both of which were designed to offer drivers incentives to economize on benefit utilization, and hence to reduce insurance loss costs; and

- **Non-renewal of policy rules**, which allowed insurers to opt not to renew two percent of their current policies, and to decide not to renew one current policy for each two new policies that they wrote. Although insurers could hope to have more control over their loss costs through the non-renewal of selected policies, this was offset by the two-for-one provision.

The Fair Automobile Insurance Reform Act of 1990 (P.L. 1990, c. 8)

With the JUA amassing huge deficits, costs continuing to climb, lawsuits not abating, and surcharges mounting, the 1989 governor's race featured auto insurance reform as arguably the top issue in the campaign. Newly elected Governor Jim Florio quickly introduced his 1990 reform package. Unfortunately, some aspects of the law have hurt New Jersey drivers and insurers. Among the law's features were:

- **The introduction of a Market Transition Facility (MFT**) and repeal of the JUA. The Market Transition Facility was designed to provide a two year bridge, after which time New Jersey would return to the Assigned Risk Plan (the New Jersey Personal Automobile Insurance Plan). The JUA surcharges were eliminated, but the MFT ran up an additional deficit of over **one billion dollars** in its brief existence. This deficit was financed, in part, by surtaxes and assessments;

- **The adoption of a take-all-comers rule,** which required insurers to write insurance for any driver who had nine or fewer points. This rule ensured rapid depopulation of the involuntary market, but it really disguised the problem by forcing insurers to write policies they had every reason to believe would not break even. It prevented insurers from using cost-based underwriting rules, i.e. charging drivers on the basis of their expected loss experience. This rule, which is still law today, contributes greatly to market inefficiency and insurers' desire to exit the market;

- **The replacement of the unlimited PIP medical benefit with a mandatory $250,000 medical benefit**; **and**

- **The introduction of a license surrender** rule that required insurers exiting the private passenger automobile insurance business to surrender their licenses in all other lines. This provision hurts not only the consumer of private passenger insurance, but also consumers of other lines as well. A retiree on a fixed income who does not drive can end up paying a higher price for insurance in another line (or subsidizing drivers in the state) because of the nature of the auto insurance law. It reduces the number of firms, some of them very large and cost efficient, writing fire, homeowners, and other lines of insurance.

The 1997-98 Reforms: P.L. 1997, c. 151 and The Automobile Insurance Cost Reduction Act of 1998 (AICRA)

From 1990 to 1994, fourteen more insurers exited the New Jersey market. Insurers could not raise their prices, and they did not believe that the current law and regulatory system would enable them to earn an adequate return in the future. Although flex rating was available, its bands were too small (three percent increases or decreases were permitted) to enable firms to adjust their prices to changing market conditions. Insurers had been burned with promises that the residual market would not be run on a deficit basis, and they were not confident that future promises would be kept. As we shall see with the failure to implement some provisions of the 1997-98 reforms, their hesitance was well placed.

New Jersey continued to have the highest insurance rates in the country. Consumers had fewer firms from which they could buy insurance, and many drivers were subsidizing others. Fraud was a continuing problem, and about one in every eight drivers on our roads was driving without insurance. Governor Florio lost his re-election bid, and the new administration of Governor Christine Todd Whitman took three years to begin its own attempt at reforming the system. The 1997-98 changes included:

- **The introduction of tier rating**, which enabled insurers to offer policies with prices which are tied more closely to the expected costs generated by groups of drivers;

- **Urban enterprise zones (UEZ's)**, a provision that mandated that insurers sell the same percentage of their policies in areas designated as UEZ's, i.e. in New Jersey's cities, as they do in the rest of the state. This provision is designed to make coverage more available in urban areas where, because of state imposed price controls and high loss costs, some insurers have been reluctant to sell policies;

- **Expedited filings**, a rule which is designed to allow insurers to receive a quick decision, within 45 days in most cases, on requests for rate increases that were for three percent or less in total, and not more than five percent for any single coverage. This provision was implemented in December, 2002. The expedited filing provision repealed **flex rating**, which allowed insurers to avoid some regulatory burdens when they filed for small price increases in New Jersey. Flex rating is used effectively in other states as we shall see below;

- **Medical cost containment,** including **medical, hospital** and **dental fee schedules**. Some of the medical fee schedules have been adopted, but the rest of the medical cost containment provisions of the law have yet to be implemented;

- **Revamped rating territories**, which promised to revised the territorial rating system used to help determine insurance prices. The territorial system in use is over fifty years old. The promised territorial revisions are still not in place. Since population, density, and development changes over time, as well as the frequency and severity of claims, failure to implement this law change can result in distorted insurance rates;

- **Personal injury protection (PIP) reform**, including the elimination of a mandatory $250,000 PIP medical coverage requirement (an amount of insurance that was much higher than some drivers wanted to carry), and the introduction of a PIP arbitration system designed to limit disputes and their associated costs;

- **Strengthened verbal threshold provisions** of the law in an attempt to limit lawsuits for less serious injuries and focus on serious injuries or a bodily injury "which results in death; dismemberment; significant disfigurement or significant scarring; displacement fractures; loss of fetus or permanent injury";

- **Revised "caps" placed on rates**. The law changed the cap from a uniform 1.35 cap to a cap of not more 2.5 times the territorial rate base nor more than 1.35 times the state rate base, and not more than 1.25 times the state rate base for principal operators over 65 years old. In other words, the system of subsidies in the rates was changed;

- **Introduction of a** f**raud prosecutor**. The Office of Insurance Fraud in the Division of Criminal Justice is fighting New Jersey's longstanding problem of insurance fraud;

- **A** n**amed driver exclusion,** which permits policyholders to designate drivers who will be excluded from other than liability coverage on specified automobiles. Under prior law youthful drivers were, by default, assigned to the most expensive vehicle on a policy. This was a large burden for families with teenage drivers who were not allowed to drive the "family car" but were rated on that vehicle; and

- **Introduction of a basic policy** that offers $15,000 PIP medical coverage, $5,000 property damage coverage, but no bodily injury ($10,000 of optional BI can be purchased) coverage. This basic policy is designed to provide bare bones coverage to permit some of the over 500,000 New Jerseyeans who are driving uninsured with basic insurance protection.

Make Believe

- Despite thirty years of trying to hide from our problems, of making believe:
- that we can constantly suppress automobile insurance costs;
- that we can adopt temporary stop-gap measures;

- that we can deny consumers the benefits of lower insurance expenses and more choice;
- that we can ask one group of consumers to pay for another group's insurance and hide it from both groups forever;
- that we can simply pass our auto insurance bills to consumers buying other insurance products;
- that we can have virtually no barrier to filing lawsuits and be surprised when they are filed;
- that we can politicize the regulatory system and not pay a price for it;
- that we can attribute our high insurance costs to insurers earning "excess profits" even as they struggle to leave the state so they do not have to write automobile insurance here;
- that we can mandate unlimited benefits and not have to pay for them;
- that 75 corporations selling a standardized product in a state with a small geographic area should be regulated as if they were a natural monopoly;
- that we can roll prices back on the basis of law changes which we then stall or fail to implement;
- that we can erect barriers to entry and exit from our market and be surprised when we have fewer firms in our market than smaller states do; and
- that we can regulate prices by fiat every few years, granting price increases after elections, and do a better job than competition and the market do in Illinois where almost all of the firms selling insurance in New Jersey also operate and the pricing of insurance is not a political calculation.[14]

Unfortunately, sticking our collective heads in the sand, and making believe that our automobile insurance problem will disappear, has not and will not work. The longer we let the problem fester, the more distorted our market will become. Below, I set out a fresh start and new approaches we can take to restore sanity to our market.

Where Do We Go From Here?

The Wall Street Journal stated that it is "Time to clear this regulatory wreck from the highway." Now that the election is over, it is time to bring in the tow trucks. *The Philadelphia Inquirer* called for a fresh start after the election: "The next governor should think outside the

[14] New Jersey has granted five firms rate relief since the November 2001 election when the entire legislature and the governorship were up for grabs. See Eugene Kiely, "Auto Insurer Will Stay In State in Exchange for Rate Increase," *Philadelphia Inquirer*, December 19, 2001.

box - say exploring the deregulated, competitive insurance market ...". The election is over. The new governor is in place and it is time to begin thinking outside the box. "It's time," *The Star Ledger* points out, "for the state's leaders to remove car insurance from the political realm...The world of economics is much more promising." It's time, *Forbes Magazine* warns us, to "Listen up, New Jersey" and benefit from the experience of the regulatory reforms in the states of Illinois and South Carolina, and rid ourselves of the social costs imposed on New Jerseyeans by the problems in our own automobile insurance system.

Below, I focus on specific recommendations for law changes which will enhance market efficiency in New Jersey. I discuss some of the economic benefits of proposed changes to the law. I contrast these changes with current dysfunctional elements of the private passenger law and regulations to highlight the ways in which market efficiency can be improved. I also set out some of the direct and indirect (hidden) costs of regulation on the private passenger insurance market and explain how a dysfunctional system imposes costs on New Jersey drivers and firms. I also contrast the New Jersey private passenger automobile insurance experience with that of other states. The companies which sell private passenger insurance are largely the same across states, but they face different forms of regulation and insurance law in their various state markets.

However, the regulatory regime in New Jersey is so pathologic that five of the top eleven firms do not write private passenger business here, and as we have noted above, the largest (State Farm) automobile insurer has filed plans to leave the state, and the fourth largest property casualty insurer (AIG) has its plans on hold. Newark Insurance with 90,000 customers is leaving. These firms have over one million private passenger insurance policyholders. Some states rely on strict governmental controls, and others on competition and the laws of supply and demand to regulate private passenger automobile insurance. For example, Illinois relies on market competition and it has had neither a rating law nor concomitant price regulation for 30 years, and largely as a consequence has a flourishing market. Washington, D.C. has only recently abandoned strict governmental control and adopted a more market-oriented rating law with good results.

South Carolina, a state which suffered many of the ills that New Jersey does and which has recently adopted flex rating, has demonstrated that the dismantling of excessive rate regulation can result in a vastly improved market for both consumers and insurers. The adoption of flex rating, which New Jersey had during Governor Florio's administration, would immediately improve the New Jersey private passenger market. Massachusetts passed a reform law which would have eliminated the prior approval price regulation of its private passenger automobile insurance market, only to abandon the reform before it came to fruition. It still maintains a strict prior approval form of price regulation, not only making the insurance rates, but also controlling even the trivial details of the system.

III. RATE REGULATION AND PRICE CONTROLS

A. Price Competition and the Market: No Excess Profits and an Efficient Market

The degree to which states rely on the market and the natural forces of competition to regulate prices and distribute the automobile insurance product varies from Illinois (free market) to Massachusetts and New Jersey (strict prior approval price regulation). The overwhelming majority of economists and insurance professionals favor the market mechanism and competition as the best way to regulate insurance markets.[15] The prices established in competitive markets internalize insurance costs - those who generate the costs should pay for them - and offer the best safety incentives available.

If one wishes to engage in risky behavior, or engage in litigious activity, he may do so, but not by unduly imposing cost on others. If one wants to double the number of miles he drives, and hence increase the likelihood that he will have an accident, he can do so, but he will pay for his choices. The individual is the arbiter of what is in his best interest. The choices that he makes are a reflection of the relative value he assigns to his consumption choices. If he wishes to select insurance products which offer very strong protection, and high levels of benefit payments, he may do so, but he must pay a higher insurance premium which covers the **expected** costs for doing so, and pay the price through the lost opportunity to consume more of another good or service.

Since prices are determined at the start of a policy period, typically for a period of six months or one year, there can be differences between **expected** and **actual** costs. Private passenger automobile insurers work very hard to find ways to make the most accurate predictions about the loss experience of drivers. Their profitability, market share and ability to survive depend on meeting consumers' needs. Expectations play a key role in pricing and in the decision of insurers to commit capital to a state and to a line of business. Firms learn by doing –- experience matters – and will take past behavior of their policyholders into consideration.[16]

Insurance prices set in competitive markets generate expected returns which are sufficient to attract and retain resources. The price an insurer offers, and hence the return the insurer expects to earn, cannot be excessive or the insurer will lose customers to another insurance company. Since insurers use actuarial forecasts to determine the prices they offer to consumers, one would expect to see prices increase in the face of increases in expected costs, and decrease in the face of expected decreases in costs. The actuarial forecasts are generally based on trends in actual losses and in analyses of changes in insurance law and underlying economic conditions.

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[15] Edward L. Lascher, Jr., and Michael R. Powers, (1997) "Expert Opinion and Automobile Insurance Reform: An Empirical Assessment." *Journal of Insurance Regulation* 16(2) 197-222.

[16] In regulated markets, they must take past regulatory practice into account. Unfulfilled regulatory promises raise the cost of capital. We shall discuss this problem more fully below.

Since competitive markets generate profits which, by definition, are normal, some states find no need to regulate such markets with respect to price.

Entry and Exit: A Key to Normal Profits

The entry and exit of firms plays a key role in ensuring that over time profits will be neither excessive nor insufficient for the level of risk insurers will bear in the market. If an insurer cannot control its own expenses, is not efficient relative to other firms in its loss forecasts, cannot offer quality service or otherwise satisfy its customer needs, the insurer will be forced to leave the market. If the insurer expects that it cannot earn an adequate profit, it will exit the market and invest its resources where they can be employed more efficiently. Similarly, if the expected returns are abnormally high, additional insurers will be attracted to the market, and prices will be bid down.

The market is the regulator of prices and quantities. The ebb and flow of supply over time, the consumer's quest for the biggest bang for the bucks he spends, and the insurer's quest for profits, provide the most efficient mechanism for distributing insurance resources. Competition will ensure that there will be an optimal number of insurers in the market, that there will not be enduring long-term subsidies, and that innovations, if any, will be adopted. When the state delays or prohibits the entry and exit of firms, the barriers it erects are guarantees of market inefficiency, and hinder incentive response and market adjustments to changing economic conditions.

The Cost of Capital Changes with Economic Conditions

The cost of capital and "normal" returns adjust to changing economic conditions. This is a simple, fundamental rule of modern financial economics. Fixed "accounting" rules of thumb will not reflect changing economic conditions. Unfortunately, they will result in: barriers to consumers' knowledge of the true economic costs of their driving and in less consumer choice with respect to insurers; a sub-optimal allocation of insurance resources; an inability to correctly reward the most efficient firms; and an increase in insurance expenses, with the concomitant loss of efficiency that higher expenses bring.

B. Price Ceilings: A Recipe for Shortages, Subsidies, and Inefficiency

In insurance, as well as other markets, various levels of government can and do institute price controls. The price controls are generally adopted with an appeal to social equity, or a cry that the market is non-competitive or has failed.[17] As Dr. Robert Litan has pointed out in his

[17] See Dwight K. Bartlett, III, Robert W. Klein and David T. Russell (1999), "Attempts to Socialize Insurance in Voluntary Insurance Markets: The Historical Record." *Journal of Insurance Regulation*

recent Congressional testimony, "Auto insurance is a competitive industry. It is certainly not characterized by monopoly, the traditional basis for price and entry regulation. Nor is the product so complicated that it requires government to set rates to protect consumers."[18] In the face of the strongest evidence that such regulation is unnecessary, the price controls have taken the form of price ceilings in insurance markets. The price ceilings are designed to suppress rates, and prohibit firms from charging rates above a certain price. If the price ceiling is set above the market clearing price, it has little force because firms will compete for business and sell their product at a price below the maximum "allowed" by the government, but if the price ceiling is accompanied by "prior approval rate regulation," the scheme can squander resources which could be better used elsewhere, for example, in the detection of fraudulent claims.

If the price ceiling is set below the price which would be set by the competitive forces of supply and demand, the results are predictable. The resulting prices would not be signals of the best allocation of insurance resources. Over time one would expect to see more and more drivers having difficulty finding insurance in the voluntary market. If the state were successful in coercing insurers to offer insurance at prices which would not generate a competitive rate of return, insurers would abandon the market, exacerbating the coverage problem for drivers.

If the inefficiency of price controls were allowed to fester for long periods of time, the state would adopt a patch-work of reforms designed to deal with periodic crises that would erupt in the system. The state could respond in ways that would compound the problem. Examples would be to devise methods that would seriously delay insurers' exit from the market, or force insurers to exit markets in lines where they can compete and earn normal returns. The latter would export the pricing and economic inefficiencies to other insurance markets, and could impose costs on a different set of consumers. The former could result in the expropriation of capital from the policy owners of mutual companies or the retirement holdings of the equity owners of stock insurance companies.

Paying for Someone Else's Insurance

It should come as no surprise that state efforts to suppress the level of insurance prices on equity grounds are frequently accompanied by schemes to have some segment of the citizenry pay for another segment's insurance policies. Although such bluntness is seldom heard, one legislator's constituents benefit, while another's pays. The cross-subsidization resulting from such schemes does not have to be limited to one line of insurance, but can be exported to other states or lines of insurance. Essentially, to foster subsidization within private passenger automobile insurance, the price ceiling adopted by the state serves as the overall or "grand" price ceiling, but the state will allow only fixed percentage deviations from that average, or no deviations at all.

17(4), pp. 478-511, for a discussion of the phenomenon and especially the Michigan private passenger market.

[18] Robert Litan (2001), "Deregulating Auto Insurance," Remarks to the United States House Committee on Financial Services, Subcommittee on Oversight and Investigations. Aug. 1.

A simple example would be a “territorial rate cap.” New Jersey uses a set of geographic territories that has been unchanged for over 50 years as rating factors. The territorial rate caps are set at 35 percent. Rates could not vary across rating territories by more than that percentage. If the true, underlying costs varied across territories by more than that percentage, citizens living in one territory would fund part of the premiums of those in another, or insurers would have to bear the cost. A look at actual data may prove instructive. In Camden (Territory 7) 17 of every 100 insured cars had a personal injury protection (PIP) claim. The average loss cost **for all cars including those not involved in accidents** was $900 a year over the three-year period from 1995 to 1997! The average loss cost for Hunterdon, Sussex and Warren Counties (Territory 26) was $102 a year, with one PIP claim per 100 cars.[19] Cars garaged in Camden were 1700 percent more likely to generate a PIP claim, and the average loss cost was 900 percent higher. In is important to note that PIP is only one component of the automobile insurance premium, albeit, a very important one for Camden and New Jersey as a whole. However, there is also BI and PD Liability to consider for all drivers, and collision and comprehensive for many others.

The effect of the “caps” and the actual differential loss experience is that there is actually a system of price ceilings. One for the “grand” price, and others for subsets of the population with those implicitly being subsidized determined by the nature of the law and the legislative branch’s propensity to define “merit.” For example, if the actual experience of youthful male drivers indicates that they are over five times as likely to have an accident than 50-year-old females who are experienced drivers, but I cap their rates at twice the state average, I might find upper income teens driving on the backs of 50-year-old low income workers.

The population subsets can be as large as half of the insured population. If a state sets a price ceiling for its residual market (assigned risk pool or joint underwriting association), it may intentionally set it at a level which allows drivers in the pool to be subsidized. At one time in New Jersey, fully half of the drivers in the state were in the residual market,[20] and until very recently, this was also the case in South Carolina. Although the residual market experience was **much** worse than the voluntary market in New Jersey, the price allowed by the state was largely the same as that charged in the voluntary market. The safety incentives were lost and price signals effectively distorted. Some of the deficit was funded by a series of hidden taxes on drivers, but the state attempted to have the stockholders and policy owners of insurance companies, doctors and lawyers and other system agents eat a large percentage of the massive deficits which accumulated through the imposition of politically motivated, ill conceived price ceilings.

C. Types of Rate Regulation

Prior Approval Rate Regulation: ***Expectations And Broken Promises***

[19] See Table B-31, *Trends in Auto Injury Claims: 2000 Edition*, Malvern, PA.: Insurance Research Council.

[20] As we shall see below, South Carolina and Washington, D.C. successfully reduced their assigned risk pools by eliminating strict prior approval rate regulation.

States which have strict prior approval rate regulation regimes require insurers to make rate filings, with insurers presenting supporting documents for review and approval by the insurance department or its designee **before** those rates can be used by the insurer. This system and its Siamese twin, binding price ceilings, are a recipe for economic inefficiency. The prior approval system takes several forms, but as Professors Grace, Klein and Phillips point out, it is how the law is actually administered that matters.[21] The form of the various private passenger automobile insurance laws is set out by both the American Insurance Association[22] and the National Association of Insurance Commissioners.[23]

Professor Scott Harrington classifies a state as having a prior approval law if it "had either state made rates, a strict prior approval law, a prior approval law with an express 'deemer' provision (i.e., rates are deemed approved if no action has been taken by regulators a specified number of days after the rates were filed), a modified prior approval law requiring prior approval for changes in the relation between expenses and premiums, or a file-and-use law that required prior approval of deviations from rates filed by a rate advisory organization."[24]

Although New Jersey has a prior approval law with an express deemer provision, the actual operation and application of the law makes New Jersey have one of the strictest prior approval regimes in the United States. Strict prior approval rate regulation in our state substitutes the saber rattling of interest groups for the judgment of the market. It operates in politicized settings, replete with press releases baldly insinuating that insurance prices will not be adjusted during the political season. Although insurers can file for rate increases, they must run a gauntlet of paperwork and bureaucratic minutiae knowing that they face a high probability that their request for rate increases will be met with a resounding "no." They have recourse to an administrative law judge, but the judge's decision can be, and is, overturned by a political appointee, the commissioner of Banking and Insurance.

This political circus has resulted in excessive rate regulation and regulatory lag with some insurers waiting over a year for rate decisions which virtually always result in ultimate decisions yielding a determination less than the rate indication filed by company actuaries. The fiasco has led analysts to compare New Jersey to the former Soviet Union, "Even the Soviet

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[21] Their study of the South Carolina private passenger market and recent improvements that resulted from the law reforms should be required reading for members of the New Jersey Assembly and Senate. See Martin F. Grace, Robert W. Klein and Richard W. Phillips, "Auto Insurance Reform: Salvation in South Carolina," Presented at the AEI-Brookings Conference on Insurance Rate Regulation, January 18, 2001, Washington, D.C. (Revised for publication, April 2001).

[22] American Insurance Association, *Automobile Insurance Laws 2001*, Washington, D.C.: AIA Law Publications, 2001.

[23] National Association of Insurance Commissioners, *NAIA's Compendium of State Laws on Insurance Topics*, Kansas City, MO: NAIA. 2000.

[24] Scott E. Harrington, "An Econometric Analysis of Insurance Rate Regulation," Presented at the AEI-Brookings Conference on Insurance Regulation, January 18, 2001, Washington, D.C. p. 5. (Revised for Publication, April 2001)

Union would be hard pressed to match this economic disaster,"[25] and an editorial writer to offer the wry comment when AIG announced its plan to exit the New Jersey private passenger market: "It's worth noting that American International is a subsidiary of AIG, which does business in markets such as Uzbekistan. Apparently the Garden State is a dicier bet than a former Soviet Socialist Republic."[26]

Hiding the Assigned Risk Problem

New Jersey, as economic theory predicts it would, has had a history of over-populated assigned risk pools. The size of the population of drivers unable to find coverage in the voluntary market is a good indicator of the adequacy of insurance rates. If the state sets rates that do not adequately cover costs, insurers will refuse to insure those applicants whom they believe they cannot insure at a fair price. In thinly veiled attempts to mask this problem, New Jersey has introduced a "take-all-comers" rule that requires insurers to provide insurance to anyone who applies -- even those who would not meet the insurer's actuarial standards -- as long as the applicant meets some state-mandated criterion. In New Jersey, that criterion is that the applicant have less than nine points against his license. Although this gives the illusion that there is no residual market problem in the state, it is actually just another attempt to circumvent the judgment of the market.

The "take-all-comers" rule can be coupled with a "non-cancellation" rule, which can prohibit an insurer from not renewing an insured's policy. The force of the "take-all-comers" and "non-cancellation" rules taken together is to erode the ability of insurers to use their actuarial skills to accurately price their business and to compete. To the extent that the scheme increases the average loss cost for an insurer, it also will lead to requests for higher premiums and weaken the link between behavior and true costs and the premium drivers pay. Better drivers in a class will pay higher rates. Needless to say, both features should be eliminated or revised in a transition. Perhaps, a reduction in the number of points would be an appropriate way to begin to repair the damage done by a take-all-comers rule. Similarly, we should revisit the non-cancellation rule.

Expectations, Learning-by-Doing, and Broken Promises

Expectations play a key role in market behavior. As mentioned above, insurers' expectations are crucial to their pricing decisions. They are also crucial to their market entry and exit decisions, and, therefore, to the generation of appropriate returns to the private passenger insurance business. Insurers learn by doing. In the past, insurers have been informed that certain applications of the law would be enforced, or that actual insurance loss costs, including the opportunity to earn an adequate rate of return, would be covered by premiums. New Jersey has far fewer insurance groups writing business than states with less regulation, and firms considering entry into the New Jersey market would consider past regulatory behavior when deciding whether to enter.

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[25] Marjorie M. Bertie (1991), *Hit Me-I Need the Money.* San Francisco: ICS Press, p. 66.

[26] *Wall Street Journal, Ibid.*

If firms believe that the state, through the offices of its regulatory and political arms, has not acted in good faith in the past, market entry is less likely. For example, if insurers are told that the losses incurred in the operation of the residual market mechanism will be fully reflected in premium, but the residual market rates are suppressed even in the face of massive deficits, insurers will be reluctant to both take the state at its word, or to enter a market in which they believe they will be expected to bear, for reasons of political expediency, the cost burden of insurance losses. Similarly, if state-**mandated** *ex ante* price cuts are based on promised reforms which are not implemented, insurers considering market entry will discount any future promises of reform when doing the benefit-cost analysis of market entry.

Stalling Hurts Consumers, Insurers and Makes the Problem Worse

Delays in the implementation of cost-cutting measures, coupled with mandatory rate cuts are simply devices to attempt to subsidize the higher cost drivers in the state of New Jersey by passing the costs backwards to insurers and, perhaps, to the residents of other states. The time at which insurers must pay losses and expenses, together with the time at which they receive premium, play a key role in the financial health of the firm. Delaying the arrival date of premium increases (regulatory delay), or denying them, passes costs back to insurers and warps safety incentives. Similarly, delivering a high level of benefits without compensating premiums not only leads to resource inefficiency and firm exit from the insurance market, but it also leads to increases in benefit utilization and further upward pressure on prices.

Failure to implement law changes designed to reduce loss costs, provide the necessary administrative rules and procedures, and do so with timing synchronized to premium reductions, will not only disrupt the current market but also make it difficult for the state to convince firms to enter the state when we begin a serious reform**.** The 1997-1998 law change package came with a mandatory rate rollback of 15 percent. The rate roll-back was ostensibly conditioned on various provisions of the law, most of which have either not been fully implemented or not implemented at all, including:

1) the medical fee schedule;

2) the dental fee schedule;

3) the hospital fee schedule; and

4) the new territorial map.

It is crucial that we implement these law changes immediately. The longer we stall, the more distorted the market will become, the more firms will exit the market, the more New Jerseyeans will be searching for insurance, and the harder it will be to convince potential entrants that we will not shake them down should they enter the market. Adoption of the three fee schedules would affect insurance costs directly, and, therefore, loss costs and their distribution. If these legislated reforms were fully implemented, there would not be much opportunity for cost-shifting. If they were adopted in part, one might see faster growth in loss costs in non-scheduled areas. Reductions in loss costs realized by implementing the law already passed should be reflected in price and reduced insurance premiums over time.

The changes in the territorial rating plan should be adopted immediately. We fought and won World War II in virtually the elapsed time since the passage of the Automobile Insurance Cost Reduction Act (AICRA) in 1998, and we have yet to adopt the new plan and set of caps. The changes in the caps should be phased-in over a five-year period to minimize the shock that immediate price adjustment can bring.[27]

Implementing the new territorial map would affect the distribution of insurance prices. To the extent that the clusters adopted were more homogeneous with respect to the loss experience of their driving populations, and the relative rate caps were not as restrictive, the pattern of subsidies hidden in rates would be changed. Since the 1.35 cap was repealed by *AICRA*, wider bands would improve pricing efficiency. For example, if very dissimilar territories had rate caps which were 2.00, with 2.00 reflecting the relative loss experience, then territories with higher risk levels would see that riskiness reflected in their rates. If this resulted in higher cost drivers receiving smaller absolute subsidies, it could affect the driving behavior of such drivers in beneficial ways. Since prices would more accurately reflect loss experience, the incentives generated would be toward efficiency in the market.

Although there would be no immediate reduction in prices as a result of adoption of the new territorial map, since it is designed to be revenue neutral, behavioral change induced by incentives could result in future slower premium growth or reductions. Given the size of current subsidies, immediate implementation would result in rapid increases in premium for some highly subsidized groups. Such rapid adjustments can lead to political turmoil, the abandonment of reform and the disaster that Massachusetts has been experiencing for years.[28]

The recent implementation of the “expedited filing” provisions of the law may provide some improvement in market efficiency through its opportunity to generate some, albeit small, relief from artificially set price ceilings. Its implementation can serve as both a short term efficiency enhancer designed to help to stop the market bleeding and a signal that improvements in price flexibility are on the way. Several insurers had expedited filings approved in January 2002. However, the expedited filing scheme has several facets which diminish its longer term prospects as a facilitator of market pricing. Perhaps the most egregious and obvious flaw is the

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[27] This implies a 15 percent per year limit with a maximum differential of 2.00.

[28] Massachusetts is another state with an onerous form of prior approval rate regulation, virtually dictating the minute aspects of the rate setting process and generating state made insurance rates. We shall turn our attention to Massachusetts below. See Richard A. Derrig (1993), “Price Regulation in US Automobile Insurance: A Case Study of Massachusetts Private Passenger Automobile Insurance 1978-1990,” *The Geneva Papers on Risk and Insurance,* 18(67), pp. 158-173; and Laureen Regan, Sharon Tennyson and Mary Weiss (2001), “Automobile Insurance Regulation: The Massachusetts Experience,” for detailed analyses of the Massachusetts debacle. See Richard A. Derrig (2001), “Massachusetts and New Jersey Case Studies,” AEI-Brookings Insurance Regulation and Deregulation Conference January 18, 2001 (Draft June 1, 2001) for some of similarities and differences in the regulatory regimes in the two states.

provision's limitation of any rate increase to an average of three percent. However, the expediting filing provision not only limits the average, but it also limits the increase in any coverage to five percent. The effect of this aspect of the provision is to potentially maintain or provide for subsidies across coverages.

Time to Stop Cross-Coverage Subsidies

Since such subsidies can affect safety behavior and subsidize unsafe drivers, the cap by coverage is not efficient pricing. One can see this pattern of regulatory activism at a more macro level, as well. For example, a state that wished to subsidize its mandatory liability coverage and transfer part of the insurance costs to suburban or higher income drivers might adopt a scheme which has wildly different loss ratios by coverage. Evidence of such a scheme would be found in higher liability loss ratios and lower physical damage loss ratios.

Consider the New Jersey experience for the year 2000. The auto liability adjusted loss ratio (direct losses incurred divided by the difference between direct premiums earned and dividends paid to policyholders) was **87.6** ! The countrywide average was 76.3. The auto physical damage loss ratio was **46.6.** Although this is an embarrassment, it is not a misprint. The countrywide average loss ratio for auto physical damage was 68.4.[29] *Best's Review* shows that the Direct Defense and Cost Containment Expense Ratio is 10.0 for New Jersey, and only 5.4 for entire the United States. A good portion of the ratio (the old Loss and Loss Adjustment Expense)[30] goes to defend lawsuits.

D. <u>Competitive Rating Systems: The Way Forward</u>

Professor Harrington has classified a state "as having a competitive rating law if it permitted file-and-use, file-and-use in a 'competitive' market, use-and-file, filing only, no filing, or had flex rating with a large flex band."[31] Although there are differences in these schemes, they share one essential element. They are designed to let the forces of supply and demand determine the appropriate rate level in a state. As discussed above, the market mechanism is the most efficient regulator of prices and the optimal allocator of insurance resources. File-and-use laws require insurers to file their rates with the department of insurance before the rates are used. Colorado and Indiana are examples of states with file-and-use laws. Use-and-file laws enable insurers to use a new set of rates without prior department approval, but they require insurers to file their new rates with the insurance department within a specified period of time.

New Jersey already employs a file-and-use law for commercial auto lines. The New Jersey file-and-use provisions require insurers to file their rates within 30 days of their effective date and to explicitly list in the filing the date that the rates became effective. The contrast between the New Jersey private passenger automobile and the commercial automobile insurance

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[29] *Best's Review*, October 2001. p. 83 (liability) and p. 84 (physical damage).

[30] *Ibid.,* p. 83.

[31] Harrington, *op. cit.,* p. 5.

markets is striking. The commercial automobile market is vibrant, has more insurers writing the business, and is not politically contentious.

There are 67 insurance groups writing private passenger automobile insurance in New Jersey. In 2000, the direct premium for this business was $4.86 billion, making New Jersey the sixth largest private passenger automobile insurance market in the United States.[32] Although the commercial automobile insurance market was less than 20 percent of the size of the private passenger market with $0.9 billion of direct premium, almost twice as many insurance groups were active in the commercial market (117 groups). Missouri and Wisconsin are examples of other states which employ use-and-file laws. Illinois and Wyoming (in a competitive market) are examples of states which require **no filing**. [33]

Flex Rating Can Help Us out of Our Mess

The last category of competitive rating law is the flex rating with a wide flex band. Under flex rating schemes insurers do not need prior approval for rate changes which take place within certain bands. The price changes can be price increases or decreases. Typically, rate changes outside the bands require the insurer to request rate approval from the Insurance Department. Professor Harrington's taxonomy included the proviso that only flex rating systems with wide bands should be considered competitive rating schemes. This is because the wider the band, the lower the probability that price constraints inherent in price ceilings would be binding.

Kentucky, Missouri, New York, Oklahoma, South Carolina, and Texas are states which currently use flex rating systems. The price bands range from a modest seven percent price change band (rates may be increased or decreased without prior approval) in South Carolina and New York, to wider bands such as Texas's 30 percent, or Kentucky's and Oklahoma's 25 percent flex bands. Missouri has taken the middle road, adopting a 15 percent flex band. Flex rating schemes usually limit insurers to one rate change per year. **Although a flex rating system may not eliminate all of the inefficiency of "grand" price constraints described above, adoption of flex rating for the private passenger business would move the New Jersey market toward stability and efficiency and eliminate some of the waste associated with resources used in excessive regulation**. Our neighbor to the north, New York, adopted its flex rating scheme with market stability in mind.

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[32] *Best's Review, op. cit.,* p.80.

[33] No states currently have a "Filing only" law. See American Insurance Association, *op. cit.,* Rate Charts.

The best research evidence indicates that prior approval rate regulation is "reliably associated with greater volatility in loss ratios and expenditure growth rates."[34] There had been virtually no rate increases granted as filed filed in New Jersey since the passage of the Automobile Insurance Cost Reduction Act (*AICRA).* Between the November, 2001, election and the inauguration of our new Governor, James E. McGreevey, in January, 2002, some companies were granted much needed rate relief. We should not should not have our insurance premiums depend on election cycles. In addition, we have a fixed, accounting, "excess profits" provision in our law. Although the "excess profits" provision is economic madness and reveals our propensity to attempt to shift the blame from our legislative and regulatory functions to the firms which do business in our state, it can be a binding constraint. When the opportunity cost of capital is high, the accounting rule can expropriate capital. It can even do so when the actual profits earned are below the rate of return required for economic efficiency.

For example, when the rate of inflation is high, an expected nominal rate of return of 18 percent or more might be necessary to attract and retain capital to the private passenger automobile insurance business. When the inflation rate is low, capital markets might dictate that an expected nominal rate of return of 12 percent could suffice. Insurers earning 15 percent in the high cost of capital period could be required, under a fixed accounting "excess profits" rule, to refund premium to drivers, when the insurers were not even earning normal profits. As noted above, the "excess profits" provision can also discourage entry. To the extent that it can be binding, it also lowers the rate of return insurers can expect to earn.

Unfortunately, the regulatory strictures on rate relief and the fixed accounting "excess profits" rule can mitigate against rate reductions by firms. Since the future is both risky and uncertain, firms whose recent experience might be favorable may be reluctant to lower their prices because they do not believe that they will be able to increase their prices should their experience turn bad or changes in capital market conditions require them to file for rate relief. In other words, when interest rates and the returns in equity markets are low, the nominal return on an insurer's book of business may be low. The excess profit provision may not be binding. There will be a certain number of firms, given loss ratio variability, who might normally lower rates to their insureds if they had price flexibility up and down. Our current regulatory system works against rate relief for these New Jerseyeans. Such strictures are not at work in markets without price regulation.

Although the New Jersey private passenger automobile insurance market might not be able to entirely dismantle its regulatory system in one step, it should take a transition step by adopting a flex rating system with ten percent flex bands. A system with bands between South Carolina and New York (seven percent) and Missouri (15 percent) would start to restore pricing efficiency, firm confidence, and eliminate much of the pressure on firms to exit our market. It also would help to provide greater choice for New Jersey drivers. If New Jersey had adopted ten percent flex rating bands, failure to implement cost saving features of the Automobile Insurance Cost Reduction Act in good time would not have hurt the market so badly. ***A ten percent flex rating program, coupled with a five-year transition on territorial rate caps, would do much to provide the correct safety incentives and eliminate subsidies which mitigate against efficiency.***

[34] See Harrington, *op. cit.,* for a review of the evidence.

Although ten percent flex bands might not eliminate binding price constraints for all insurers in New Jersey – and the actuarial rate indications filed in the past two years would lead one to believe they would not – insurers would know that in deteriorating markets they would have some price flexibility and that they could get rate relief over time. In improving markets, they would know that they could reduce rates without fear that rates would be frozen at the reduced levels should market conditions deteriorate. If firms outside the market believed that New Jersey was serious and committed to some pricing flexibility, we would have taken the first step to inducing more of them to enter the market.

E. Let Each Line of Insurance Stand on Its Own Two Feet

Market entry and exit is essential to insuring consumer choice, enhancing competition, minimizing expenses, maximizing market efficiency and generating appropriate returns. Schemes designed to prohibit market exit, albeit for good intentions, have unintended consequences. Firms outside the market will not enter markets that they believe they will not be able to exit when they are unable to effectively compete. Similarly, if they do not think that they will have the ability to adjust prices to reflect their perception of current market conditions, they will be loathe to enter a market.

Our current system actually discourages market entry and exit. Each line of insurance should stand on its own merits. Those who benefit from insurance protection should pay the costs of the protection. Our method of stalling exit, or discouraging it, by forcing insurers to surrender their licenses in other lines of insurance where they may be more efficient or better able to earn the opportunity cost of capital may be well intentioned, but it introduces subsidies across other lines of insurance, and it makes New Jersey less competitive with other states. We are ultimately shooting ourselves in the foot.

IV. WHAT CAN WE LEARN FROM OTHER STATES?

A. Massachusetts

Massachusetts has been our chief competitor for the title of most dysfunctional auto insurance system. The first important lesson we can learn from an examination of the history of the Massachusetts system is that in a state with a system of well-entrenched, huge subsidies, making an immediate leap to competitive rating leads to rapid rate increases for those who have been the beneficiaries of the prior system. Massachusetts moved from its system of state-made rates to competitive rating in 1977.[35] The political turmoil caused by the application of true loss cost (risk-based) pricing led to a flood of complaints by those who saw their rates increase and resulted in an almost immediate return to state-made rates, huge subsidies and a history of large residual market shares.

None of this should be surprising to students of the New Jersey system, as we have experienced the latter two situations, as well as a variation on the former. The legislature's plan to eliminate the huge subsidies some drivers were enjoying at the expense of others would have internalized costs, and led to greater safety and more appropriate incentives. Given time, the plan would have worked, but it is important to underscore that Boston drivers still enjoy 21 percent subsidies on their compulsory coverages, and inexperienced drivers (primarily, but not entirely the young) subsidies of ten percent.[36] Perhaps, if Massachusetts had adopted a transition strategy, they may have been able to avoid the problems they are still experiencing. There are

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[35] See Derrig, *Geneva Papers*, pp. 159-160.

[36] Automobile Insurers Bureau of Massachusetts, *Actuarial Notice 01-2* (Subsidies in the 2001 Rates).

youthful drivers who are principal operators (Class 20) driving in the state of Massachusetts and enjoying subsidies of $1,000 for standard coverages; some subsidies are even higher.[37]

The Not Quite Ready for Competitive Rating Players

Each year since 1979, the commissioner has held a hearing to determine whether competitive rating should be used in Massachusetts, and the commissioner has decided in each of those years that the "environment for competitive rating is not quite ready yet," and the competitive rating law has been suspended. As in New Jersey, Massachusetts has competitive rating for commercial automobile insurance.[38] Massachusetts's private passenger law looks like a competitive rating law, but it is arguably administered as the strictest auto insurance price regime in America. Massachusetts allows intervention in its rate cases. The hearings are contentious, to say the least.

The Unbiased Forecasting Intervenors

Over a 13 year period from 1977 to 1990 "adversarial parties, those not connected to actual operations of insurance companies, advocated loss provisions in the rates that averaged 14 percent under prediction annually. While it is difficult to forecast future claim payments, thirteen consecutive years of massive under predictions lead to only one conclusion: biased rate-suppressing actuarial analyses, most of which were adopted by the commissioner."[39]

The adoption of consistently large underestimates of losses leads inexorably to inadequate rates. One would expect that actuarial forecasts, if they are unbiased, would be off by a positive amount in some years, and a negative amount in others. The odds of under-estimating true costs 13 years in a row is a staggering 8,192 to one, if these forecasts are independent, random events. In short, one could make a strong case that intervenors probably represent the interests of political pressure groups. They are not necessarily unbiased arbiters of pricing. Such intervention increases the cost of the regulatory process, and is among the weakest substitutes for the discipline of the market mechanism.

Sometimes High, Sometimes Low, But Too Low on Average

It would be natural to ask oneself whether the insurance industry overestimated loss costs during this 13 year period to produce rates which were too high, i.e. were the actuaries and insurance professionals at the Automobile Insurance Bureau of Massachusetts guilty of asking for rates which **would** have given them loss ratios lower than they had forecast. The industry **underestimated** losses by an average of three percent a year over the 13 year period.

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[37] *Ibid.,* Exhibit 1, p. 4.

[38] Derrig, *Geneva Papers,* p. 160.

[39] Ibid., p. 165.

What the Massachusetts Subsidies Really Cost

Glenn Blackmon and Richard Zeckhauser estimated both the size of the subsidy and the dead-weight loss generated in the Massachusetts system. The total subsidy was estimated at over $519 million in 1988. The dead-weight loss is the true economic loss society suffers when good drivers reduce their driving and bad drivers increase theirs or drive uninsured. Drs. Blackmon and Zeckhauser estimated the dead-wight loss to be $217 million annually. **These Harvard researchers, intimately familiar with their state's auto insurance system, concluded that: "Massachusetts suffers from significant dead-weight efficiency losses, hence high prices, because regulated rates for auto insurance deviate substantially from cost…neither risk-spreading nor egalitarian concerns justify this cross-subsidy scheme."[40]**

Massachusetts Leads the Way in Fighting Fraud

Massachusetts passed effective fraud measures and some of these have been adopted by New Jersey, which now has the largest fraud budget, $25.8 million in 2000, of any state.[41] Massachusetts, by contrast, with a private passenger market that is approximately 75 percent of New Jersey's size, had a fraud bureau budget of $5.4 million in 2000.

When Prices are Too High, Competition Will Force Lower Prices – Even in the Worst of Markets

Massachusetts also passed effective property damage reforms in 1989. The reforms allowed lower labor rates, the use of after market parts, and reduced comprehensive costs. Rate increases were granted in the first half of the 1990's, and bodily injuries fell over the sample period. In the last half of the decade, auto insurers competed vigorously for business, engaging in what Dr. Derrig has described as "price wars."[42] There is an important lesson to be learned here. Even in the face of price controls, if prices are perceived to be too high, the market will compete away excess profits and force insurers to offer lower prices and compete for business, making fixed accounting "excess profit" rules unnecessary.

The state of Massachusetts maintains a charade each year, suspending the state's competitive rating law, and finding that the private passenger auto markets will not be competitive during the coming year. Dr. Derrig quotes the 2000 decision: "These discounts and deviations, individually and in combination, effectively make private passenger automobile insurance available to a large number of consumers at a range of prices. Thus, current market

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[40] Glenn Blackmon is now Assistant Director, Telecommunications, Utilities and Transportation Commission, Washington. See his Kennedy School study (1990) with Professor Zeckhauser, and their shorter version in B. Glenn Blackmon, Jr. and Richard Zeckhauser, "Mispriced Equity: Regulated Rates for Auto Insurance in Massachusetts," *American Economic Review: Papers and Proceedings*, May 1991, pp. 65-69.

[41] *Best's Review, op. cit.*, p. 66.

[42] See Derrig, "Massachusetts and New Jersey Case Studies," p. 5.

conditions permit consumers to shop on the basis of price, as well as on the basis of considerations such as service...In 1977, when fully competitive rating was allowed, the cost of insurance for these two groups of drivers escalated dramatically. Public policy and past experience support a shift to competition only when mechanisms are in place to ensure that under a new system drivers in urban areas and those with less experience will not be, as they were in 1977, confronted with extraordinary rate increases."[43] The first half of the quotation implicitly admits that the market was competitive, and the second provides the rationale for controlling it and subverting the law.

We Feel Their Pain

Unfortunately, Massachusetts's drivers have fewer insurers than New Jersey, with two-thirds of the top 15 insurers refusing to write private passenger automobile insurance in Massachusetts. The state also has a system of subsidies that generate huge dead-weight losses, as described above. Nine of the top ten private passenger automobile insurers write virtually no business in the state.[44] Massachusetts employed the same schemes of forcing insurers to surrender their licenses to write other insurance lines when they exited the private passenger automobile insurance market. The barriers to entry and exit in Massachusetts cause the same economic dislocation there that they cause in New Jersey.

B. South Carolina

We Have Seen The Past

The South Carolina story was much like that of New Jersey and Massachusetts. It suffered from similar ills: market exit, few firms, high subsidies and strangulating regulation. The first important lesson we can learn from the South Carolina experience is that providing some price flexibility, even in a state with a very stressed market, can have a rapid impact on market stability, consumer choice and efficiency. South Carolina had a strict prior approval rate system. It introduced flex rating and it saw its rates drop sharply in 1999, its number of insurers increase and its residual marketshare shrink rapidly. Kevin Dietrich reported that the average expenditure for auto insurance dropped from $655 in 1998 to $575 in 1999. He dutifully reported to his South Carolina readers that New Jersey was once again the most expensive state with an annual expenditure of $1,033 per driver in 1999.[45]

South Carolina Law Changes Help

South Carolina made a number of changes in the law that would work to facilitate the entry of firms and reduce system subsidies. It basically repealed its "quasi-take-all-comers" rule, and enabled insurers to take only those risks that met their underwriting standards. With the

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[43] *Ibid.,* p. 10.

[44] Carnahan, *Forbes Magazine*, p. 82.

[45] R. Kevin Dietrich, "Auto Insurance Rate Decrease for South Carolina Residents," *The State-Columbia*, June 6, 2001.

entry of firms and changes in underwriting rules, good drivers could gravitate to companies offering lower prices, reaping the benefits of their safe driving. Higher risk drivers could select insurers who specialize in that market segment and charge higher premiums to reflect the risk. To avoid rapid rate increases for those enjoying residual market subsidies, a transition cap (10 percent) was placed on increases to cover the residual market deficit. Before its 1999 law change, South Carolina had the rate caps and price suppression that accompanies prior approval systems, which have taken their toll in Massachusetts and New Jersey.

How to Solve the Residual Market Problem Instead of Disguising It

As economic theory would predict, South Carolina had an availability problem with many drivers finding themselves in the residual market. If this all sounds familiar to New Jerseyeans, it should be. South Carolina had 43 percent of its drivers in the Reinsurance Facility (its residual market mechanism) in 1992. New Jersey had over 40 percent of its insureds in the Joint Underwriting Association from 1985 through 1988.[46] South Carolina's cumulative residual market deficit through 1999 was $2.4 billion, and its annual recoupment was $200 million a year by 1995.[47] Under the South Carolina plan, the residual market deficits could be recouped through a series of fees that all South Carolina insureds paid. In plain language, drivers in the voluntary market had to foot some of the bill for those in the residual market. This system of fees created a great deal of ill will and pressure for change. Again, this scenario should be familiar to all of the New Jersey drivers who have helped subsidize drivers in the pool. From the inception of its reform package on March 1, 1999 to September 30, 2000, the number of policies insured in the residual market dropped from 503,784 to 25,963. This is a 95 percent drop in just 18 months.[48]

Attracting More Firms, Offering More Choice and Lowering Price

Economic theory would predict that during the prior approval regime there would be exit from the South Carolina market and there was. Professors Grace, Klein and Phillips point out that in the face of South Carolina's strict prior approval price controls, the number of insurance groups selling private passenger automobile insurance in the state dropped from 78 in 1990 to 45 in 1998. South Carolina's law change took effect on March 1, 1999. The number of insurance groups increased to 55 in 1999, and the number of firms selling private passenger jumped from 96 in 1998 to 192 in 1999.[49] Consumers had more choice. There were more firms competing for price, and prices were tied more closely to true costs.

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[46] See Grace, Klein and Phillips, *op. cit.*, p. 35. for South Carolina, and Worrall, *op. cit.*, Table 13, for New Jersey.

[47] Grace, Klein and Phillips, p. 35.

[48] Jim Parker, "Auto Coverage Overhaul Misses Mark on Uninsured Motorists," *Charleston Post and Courier*, March 6, 2001, p.

[49] Ibid., p. 28.

Enacting Territorial Reform Instead of Stalling It

South Carolina's reforms allowed for expansion of the number of territories and the widening of territorial differentials. Unlike New Jersey, which passed territorial reform but has yet to institute the changes, South Carolina's have been employed with good effect. The expanded territories and the concomitant move to risk-based pricing will shrink dead-weight loss, strengthen safety incentives and reduce cross-territory subsidies.

New Jersey Bests South Carolina in Controlling the Uninsured Motorist Problem

South Carolina has had a much more severe uninsured problem than New Jersey. Recall that it has been estimated that 12 percent of New Jersey's drivers are uninsured. The estimate for South Carolina was 22 percent over the 1989-1995 period.[50] A recent February 2001 research survey by the Insurance Research Council estimates that South Carolina's uninsured driver rate is 28 percent, the third highest in the nation.[51] Dean Krueger, the South Carolina property and casualty division chief, recently estimated that rates would drop by 22 percent if South Carolina could reduce its uninsured motorist rate to the six percent level experienced by its neighbor, North Carolina.[52] As part of its reform package, South Carolina repealed its compulsory insurance provision. The state will allow drivers to pay a $550 fee to drive uninsured. Since South Carolina rates are low and the premium for safe drivers can be lower than $550, not many safe drivers have chosen to opt out of the insurance system.[53]

Grace, Klein and Phillips note that for those who do pay the $550 and opt out of the system: "If such a person is involved in any at-fault accident, he must satisfy any civil judgment that may be placed against him, pay a $300 reinstatement fee, and show proof of financial responsibility for three years."[54] Five hundred dollars of the fee goes to an uninsured motorist pool. The state has been selecting random samples of 500 drivers a day, sending letters to check for compliance, and suspending those who fail to respond or produce the appropriate proof of insurance or fee payment.[55]

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[50] *Ibid*., Table D. 6.

[51] Jim Parket, "Auto Coverage Overhaul Misses Mark on Uninsured Motorists," *Charleston Post and Courier,* March 6, 2001, p.

[52] Ibid.

[53] Jim Parker, "State Moves to Catch Uninsured Motorists," *Charleston Post and Courier*, May 6, 2001, p. A1.

[54] *Ibid*., p. 19.

[55] Professor Grace, Klein and Phillips note that 12,000 licenses were suspended in 1999. See p. 20.

These random samples, however, have been met with much resistance from South Carolina drivers and are going to be replaced with a computerized system. The new $25 million system is supposed to be ready in the spring of 2002.[56] South Carolina has a database which links insurance and DMV records, but according to Dean Kruger, it will be years before the highway patrol can run computer checks from their police cruisers. The Deputy Director of the South Carolina Department of Motor Vehicles, David Burgis, said, "To try to use it now for real-time law enforcement purposes would be a nightmare."[57] Although the reform package appears to be meeting most of its targets, it has not helped the uninsured motorist problem. New Jersey is doing a better job in this area, requiring proof of insurance coverage before purchasing a car, for example, which is currently under consideration in South Carolina.

C. WASHINGTON, D.C.

Adopting Competitive Rating Solved Their Residual Market Problem

Washington, D.C. and New Jersey are the only two jurisdictions classified as 100 percent urban. Washington is densely populated and driving in D.C. is similar in many respects to driving in New Jersey's many cities. Washington had a prior approval rate regulation regime for private passenger automobile insurance, as did New Jersey, South Carolina and Massachusetts. The District's neighboring states, Maryland and Virginia, had file and use laws for competitive markets.[58] Washington's principal problem was that there was not much of a market for standard and substandard risks. Although preferred risks could find coverage, others ended up in the assigned risk pool. The first important lesson we can learn from the District is that price flexibility and a large residual market do not go together. There is a plethora of research which indicates that the size of the residual market is significantly smaller in jurisdictions that use competitive rating systems than in those that use prior approval rate regulation.

The D.C. City Council wanted to solve its assigned risk problem, increase competition and reduce prices. It selected competitive rating as the way to achieve its goals. On June 26, 1996, it passed the *Automobile Insurance Amendment Act of 1996.* In a nutshell, the law repealed the prior approval rating scheme (D.C. Code 35-1703). With the elimination of a few words in the law, the District changed from a price control system to a file-and-use open competition system. The results were dramatic.

D.C. Mayor Evaluates Competitive Rating

Mayor Anthony A. Williams reported to the Chairperson of the Council of the District of Columbia, Linda Cropp, that "**Competition has increased in the automobile insurance market, rates have generally come down, tax revenues based on the sale of automobile insurance have increased, and the percentage of drivers in the assigned risk plan has been**

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[56] See "System Targets Uninsured Drivers" (AP), *The Augusta Chronicle*, May 7, 2001.

[57] Jim Parker, May 6, 2001

[58] See American Insurance Association, *Automobile Insurance Laws 2001*.

dramatically decreased."[59] The mayor was reporting on the analysis of the law change completed by Clark Simcock, the Supervisory Actuary of the Department of Insurance and Securities Regulation (DISR).[60] The Automobile Insurance Plan Service Office reported that from October 1997 to September 1998, the number of drivers assigned to the risk pool dropped from 1,103 to 263 a month.[61] The two-year month to month drops in monthly assignments to the residual market pool are staggering.

The monthly assignment of 1,103 drivers to the assigned risk pool in October 1997, fell to 303 during the month of October 1998, and to 115 drivers in October 1999. The comparable figures for the month of November were: 672 drivers in 1997, 234 in 1998, and 131 drivers in 1999. December showed a similar drop: 1997 saw 672 drivers assigned to the pool, with 233 in December 1998, and 108 during the same month in 1999.[62] The department actuary reported that the assigned risk plan "showed a decrease of 57.4% in 1998 over 1997, and in the first six months of 1999, there has been a decrease over the same period in 1998 of 66.0%."[63]

D.C. Drivers Get Lower Prices

The department actuary also reported on rate filing activity and the state of price competition in the District. He reported that there were 12 rate filings in 1997, with 17 in 1998 and 11 to his report date in 1999. "Nine of the filings in 1998 were for decreases in the rate levels. As a whole, the 1998 filings ranged from an increase of 13.3 percent to a decrease of 14.8 percent. So far in 1999, all but two of the eleven filings have been decreases in a range from a plus 1.4 percent to a negative 6.8 percent. **The price decreases reflect the pressure of increased competition, and the increase in the number of filings show that companies are seeking to meet the competition.**"[64] (Emphasis added) Seven companies entered the market the year after the law change and two exited in 1998 for a net gain of five companies writing private passenger business in the District.

D. <u>ILLINOIS</u>

What Flex Rating States Should Be When They Grow Up

In 1971, Illinois became a natural experiment on the effects of competitive rating. The state unintentionally let its insurance rate law lapse, and it had no filing requirement at all for

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[59] D.C. Law 11-160 Letter to Chairman Linda Cropp, October 19, 1999.

[60] See Clark Simcock, "The Market Effect of the 1996 Changes to the Automobile No Fault Law, *DISR Report*, October 1999.

[61] AIPSO, *Circular: GCB (DC) 99-11.*

[62] AIPSO, *ibid.,* and *Circular: GCB (DC) 00-01.*

[63] Simcock, p. 3.

[64] *Ibid.,* p. 4.

private passenger auto.[65] Finding that the competitive market proved to be an admirable vehicle for protecting its consumers, the state has never reinstituted a rating law. It became the first state which had no such filing requirement, and it remains a model of open competition. Firms simply file their rates with the department within ten days of their effective date. Since Illinois does not have a rate regulation law, insurers are subject to the antitrust provisions of the McCarran-Ferguson Act. Rate-making in concert or other collusive behavior would bring down the wrath of the law. The state does mandate uniform data reporting requirements.[66]

Over the more than 30 years with no rate law, Illinois has never had a problem with the competitiveness of its private passenger automobile insurance market. It has more insurers writing private passenger insurance than any other state. The state does regulate its assigned risk market, but the open competition in the state voluntary market is so effective that the number of its drivers in the assigned risk market is under one percent.

Rate changes in the voluntary market, which is, in effect, the entire market since the assigned risk pool is so small, tend to be frequent and small. The state prides itself on not providing barriers to entry or to exit and the department explicitly recognizes the role that entry and exit play in workable competition and the establishment of fair rates of return. The insurance department notes in its 1999 annual report to the General Assembly: "Our marketplace is easy to enter and exit. The industry is making reasonable, but not excessive profits."[67] The department's 2000 annual report notes: "Any potential for anti-competitive behavior is generally offset by the ease of entry and exit into and out of the marketplace and the large number of other insurers competing for the remaining market share."[68] The department notes that insurers "do not expect gigantic profits in good times to offset losses from bad years."[69]

The most important lesson we can learn from the Illinois experience is that we do not need an insurance rate law to regulate market conduct. In a large diversified state, which is over 84 percent urban and has five million people clustered in its Northeastern section, automobile insurance is not a political issue. Neither major political party is introducing legislation to

[65] Stephen P. D'Arcy, a Fellow of the Actuarial Society and Professor of Finance, presents an excellent history of the Illinois private passenger law and the state of the current market in, "Insurance Price Deregulation: The Illinois Experience," Presented at the AEI-Brookings Conference on Insurance Rate Regulation, January 18, 2001, Washington, D.C.

[66] See 215 ILCS 5/1201. Article XLII discusses insurance cost containment and is the source of the requirement of the Insurance Department's annual report to the General Assembly discussed below.

[67] Illinois Depart of Insurance, *1999 Annual Report to the Illinois General Assembly on Insurance Cost Containment*, April 15, 1999 (see, especially, Section V. Conclusion and Recommendation).

[68] Illinois Department of Insurance, *2000 Annual Report to the Illinois General Assemble on Insurance Cost Containment,* April 15, 2000. p. 39.

[69] *1999 Annual Report*.

regulate private passenger automobile insurance rates.[70] Neither party, nor the insurance department, issues press releases attributing the high cost of insurance to carriers doing business in the state. The percentage of uninsured drivers in the state over the 1989-1995 period was 12 percent, the same as it was in New Jersey.[71]

The state does not squander resources on unnecessary regulation, but rather directs them to solvency surveillance and market conduct watch. The Illinois Insurance Department states the case succinctly: "We want Illinois consumers to receive the best products at the best price, as quickly as possible from solvent, responsible insurers. We want to provide this environment without spending taxpayers' dollars needlessly on regulations that don't further this goal, or that aren't cost effective for the benefit provided. The Department believes that a market driven by competition continues to yield the best results for both the industry and insurance consumers ... both insurers and consumers suffer when regulations force consumers to incur costs disproportionate to the benefit provided...for private passenger auto and homeowners insurance, the Illinois open competition marketplace achieves essentially the same results as the country as a whole, without incurring the costs of additional burdensome and unnecessary regulation."[72] The Illinois market is where we ultimately want to be. We should use some of the South Carolina medicine to get us there.

IV. CONCLUSIONS AND RECOMMENDATIONS

There is an ample body of research which shows that rate regulation, on average, has little impact on price. It does, however, increase volatility, reduce the number of firms in the market, reduce consumer choice, increase insurance expense ratios and squander resources. The Illinois experience shows that we do not need rate regulation. In New Jersey we are strangling the market with regulation and discouraging market improvement with broken promises. We passed a reform package, rolled back rates and then failed to implement the cost-cutting and market enhancing measures in the law. This not only contributes to the current market mess and increases the likelihood that more firms will abandon the New Jersey private passenger market, it increases the likelihood that firms will be more reluctant to enter the market in the future. Those outside the market will remember the New Jersey residual market fiasco, and they will evaluate the current delay in implementation of the law as nothing more than a glorified shakedown.

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[70] Philip R. O'Connor and Eugene P. Esposito, "Modernizing Insurance Rate Regulation: Tacking to the Winds," A Report Delivered to the National Conference of Insurance Legislators Property Casualty Committee, April 26, 2001, discusses the lack of serious opposition to the competitive rating model in Illinois. See especially p. 29. Dr. O'Connor is the former Insurance Commissioner for the State of Illinois.

[71] *Insurance Research Council*, 1999.

[72] *1999 Report.*

Since premiums have already been rolled back, effective March 22, 1999,[73] further delays in implementing the medical, dental and hospital fee schedules, and the territorial rating feature will only cause further deterioration in the New Jersey market. These changes do not require legislation. The expedited filing provision was finally implemented in December, 2002, **four** years after it was enacted into law. We must do the same for medical, dental and hospital fee schedules. We should follow South Carolina's example and allow a transition on our territorial cap provisions to avoid market disruption. The longer we stall, the longer we endure deadweight loss, subsidies, firm flight and the less likely we are to attract firms back to the New Jersey market.

There is strong evidence that price competition is an effective regulator of rates. The District of Columbia's move to competitive rating and price flexibility shows us that higher-risk individuals can find coverage in the voluntary market, when insurers can charge the appropriate price. Illinois teaches us the same lesson. There are changes that we should adopt to help us turn our private passenger system around that will require legislative action. Massachusetts provides evidence that it can be dangerous to the political will to jump from strict price controls to competitive rating when there is an entrenched system of subsidies. South Carolina teaches us that flex rating, together with law changes designed to help achieve firm entry and risk-based pricing, can offer help to a market in grave distress. South Carolina virtually repealed its "take-all-comers" and non-cancellation rules. By doing so, and adopting flex-rating, South Carolina enabled insurers to price their risks and compete for business. It fostered the development of firms specializing in different classes of drivers, with high-risk drivers bearing more of the cost burden of their risky behavior. They also adopted a transition strategy on their residual market recoupments.

We should package these badly needed improvements in a legislative reform of our own. Adoption of a 10 percent flex rating would be a helpful start, but it also should come with an ability for insurers to select their own risks. The state already has adopted tier rating, a major improvement in our private passenger law and one designed to enhance market efficiency, but we still foster subsidy and try to disguise our residual market problem with take-all-comers and non-cancellation rules. Adopting price flexibility will enable firms to write standard and substandard risks at more appropriate prices and help to minimize the size of our assigned risk pool.

There is no need for an urban enterprise zone (UEZ) program in Illinois. With a state that has the city of Chicago, the residual market has a fraction of one percent of its drivers in the assigned risk pool, and the same percentage of uninsured motorists as New Jersey. There is no need for a UEZ program in Washington, D.C. There is no need for a UEZ program in South Carolina. And if we adopt the appropriate pricing mechanism, there will be no need for one in New Jersey. The size of the UEZ market should be reduced in the interim. Rates should be higher when loss costs are higher, and lower when they are lower.

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[73] N.J. Department of Banking and Insurance, *Order A99-102*, "In the Matter of Reduction in Rates to be Made Pursuant to Section 67 of the Automobile Insurance Cost Reduction Act. P.L. 1998, c. 21." January 4, 1999.

Illinois illustrates the benefits of ease of market entry and exit, both of which act to regulate profit levels and facilitate workable competition. Together with competitive pricing, it guarantees the optimal number of firms and the best prices for consumers. It is time for us to start encouraging it, instead of putting up entry and exit barriers which discourage competition and efficiency. Forcing firms that could compete effectively in other lines of insurance to surrender their licenses to write those lines should they exit the private passenger market is not friendly to consumers. It is dumb economics, bad public policy and ill-advised law. It should be scrapped as quickly as possible.

Our current, politicized method of rate regulation also should be scrapped as soon as possible. The determination of the appropriateness of rate requests should not be a political circus, replete with rent-seeking behavior on the part of system recipients. An independent panel should be appointed to hear contested cases, or the parties should go to binding arbitration. The findings of administrative law judges, currently mere eaters of rate payer's resources, should be taken seriously or the current system should be abolished.

Finally, commercial automobile insurance is not regulated in New Jersey. We can see that the market is healthy. Although the commercial automobile insurance market may bear some of the cost burden of subsidies to the private market, it has far more firms writing business than write in the private passenger automobile insurance market. Commercial customers enjoy all of the benefits of the competitive market which are enjoyed by the private passenger customers in Illinois. It is time that the private passenger customers in New Jersey started to enjoy them, too. The Illinois Department of Insurance has said it best: "After thirty years of achieving favorable results from open competition, in both personal as well as commercial lines, the Illinois Department of Insurance finds it ironic that other states are willing to go only half-way. The Illinois Department of Insurance believes that the personal lines consumer should receive the same benefits from deregulation as the commercial insured."[74]

It is time to adopt the measures already approved in the last reform package, and it is time, New Jersey, for the formation of a Blue Ribbon Panel to begin drafting the transition legislation that will start us on the road to the market efficiency that New Jersey drivers so sorely need and deserve.

[74] *1999 Annual Report.*