REPORT OF THE
JOINT SUBCOMMITTEE
STUDYING THE

Availability and Affordability of Liability Insurance, the Antitrust Exemption Afforded Insurers and the Reinsurance Costs Associated with Liability Insurance

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA

HOUSE DOCUMENT NO. 63

COMMONWEALTH OF VIRGINIA
RICHMOND
1989

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Insurance in the Commonwealth

To the Governor
and the General Assembly of Virginia
Richmond, Virginia

February, 1989

TO: The Honorable Gerald L. Baliles, Governor of Virginia,
and
The General Assembly of Virginia

I. INTRODUCTION

During the 1980's, the General Assembly has devoted a great deal of time to studying and reviewing insurance issues and insurance legislation. Much of that time spent by the General Assembly has been specifically focused on issues and legislation relating to the affordability and availability of liability insurance. During this decade, the General Assembly has enacted several laws which have proven to be positive steps towards addressing the affordability and availability issue. In 1988 the General Assembly passed House Joint Resolution Number 120 in order to ensure that affordable liability insurance would continue to be available to the citizens of this Commonwealth. Appendix 1 of this report contains a copy of that resolution. Specifically, the resolution asked that a joint subcommittee study the reinsurance practices of the insurance industry and the antitrust exemption afforded the insurance industry. The joint subcommittee was asked to study and consider whether the reinsurance practices of the insurance companies and whether the exemption afforded to insurance companies have had a negative effect on the availability and affordability of liability insurance.

The need to study the reinsurance practices arose from recent developments that suggested that the market for reinsurance may not be subject to forces of competition in the manner that has traditionally protected the consumer. Many reinsurers are now off-shore or out-of-state companies and out of reach of state regulation. Individual insurance companies may be paying more for reinsurance than they would if the reinsurance market were competitive. Because primary insurers by contract transfer significant amounts of their underwriting risk to reinsurers and because under present regulations and practices it is impossible to determine the reasonableness of the costs involved in reinsurance, many people speculate that reinsurance practices tend to raise the premiums for insurance coverage and thereby lessen the affordability and availability of insurance coverage. Many persons

believe that the not-so-at-arms-length negotiations between the insurer and a reinsurer tend to have negative affects on the availability and affordability of insurance. If the reinsurance market is found not to be competitive and the cost of reinsurance is therefore excessive, the forms of coverage that require reinsurance may become less available because of the high cost to the primary insurer of reinsuring these lines. Even when coverage in these lines is available, premium levels may be higher than they would be if reinsurance costs were not excessive. Also, the opportunity for self-dealing through the manipulation of the insurance rates is clearly present when a company reinsures with an affiliate.

Regarding the antitrust exemption, there is significant debate as to the merits of preserving this exemption and the affect it has on insurance rate-making and other industry practices. Under the McCarran-Ferguson Act insurance companies are afforded an exemption from the Antitrust Act. The availability of the McCarran-Ferguson exemption depends on three basic factors: (i) whether the challenged activity is part of "the business of insurance," (ii) whether the activity is "regulated by state law," and (iii) whether the activity constitutes an agreement to or an act of boycott, coercion, or intimidation. Agreements to boycott, coerce, or intimidate and such acts are excluded from the exemption and remain subject to the antitrust liability under the Sherman Act. Historically, the justification for the insurance industry's immunity from federal and state antitrust laws was that few insurers, if any, had a sufficiently broad base of data in any state or for any line or subclassification of insurance to support reliable statistical rate projections. By pooling claims and expense data, companies, arguably, could make more reliable the statistical projections that are necessary to prepare insurance rates. The immunity provision was thought to enable comparatively small insurers to be able to operate, resulting in a larger number of insurers than might otherwise occur if use of rate service organizations were not permitted. Presently, many persons question the industry's need to receive explicit pricing guidance and to file rates through rate service organizations and the supposed enhancement of competition that is produced by such reliance.

The membership of the joint subcommittee was appointed in accordance with HJR 120 as follows: from the House Committee on Corporations, Insurance and Banking the Speaker appointed Thomas W. Moss, Jr., of Norfolk, W. Tayloe Murphy, Jr., of Westmoreland, Lewis W. Parker, Jr., of Mecklenburg, William T. Wilson of Alleghany and Frank D. Hargrove of Hanover; from the Senate Committee on Commerce and Labor the Senate Privileges and Elections Committee appointed J. Granger Macfarlane of Roanoke, Richard J. Holland of Isle of Wight and Richard L. Saslaw of Annandale; as citizen members the Governor appointed John Robert Hunter, Jr., of Arlington and William F. Parkerson, Jr., of Henrico. Delegate Moss was elected chairman of the joint subcommittee and Senator Saslaw was elected vice-chairman.

II. EXECUTIVE SUMMARY

The joint subcommittee established pursuant to House Joint Resolution No. 120 of the 1988 General Assembly was charged to study three primary issues: (1) the practices by which insurance companies reinsure all or part of the risks they insure; (2) the advisability of repealing the insurance industry's exemption from the Commonwealth's antitrust law; and (3) the means of assuring the continued availability and affordability of liability insurance coverage to the citizens of the Commonwealth. The joint subcommittee held eight meetings and at each meeting met for several hours at a time in order to receive testimony from all of the interested parties. The work and deliberations of the joint subcommittee will be discussed in detail later in this report, but for the purposes of this summary it will suffice to say that the joint subcommittee considered eight separate recommendations: five of which were agreed to, two of which were not agreed to, and one of which the joint subcommittee decided was not needed at this time. All of those agreed to will require the introduction of legislation at the 1989 General Assembly.

This summary will discuss briefly each recommendation.

RECOMMENDATIONS AGREED TO REQUIRING LEGISLATION

Four of the five recommendations agreed to requiring legislation relate to the issue of availability and affordability. The fifth recommendation is a resolution to continue the study in all three areas that the subcommittee was requested to review under House Joint Resolution No. 120. The following are those recommendations requiring legislation:

1. To amend subsection E of § 38.2-1905.1 of the Code of Virginia to allow the Bureau of Insurance, the Attorney General's Office and other parties more time to review data filed pursuant to 1235 Supplemental Reports before the Commission is required to hold a hearing to determine which of those lines of commercial liability insurance designated as potentially troubled are in fact troubled lines. The amendment to that section establishes September 30 of each year as the date by which the hearing must be held. Under current law, the Commission is required to hold a hearing 60 days after the due date of the 1235 Supplemental Reports. The State Corporation Commission indicated to the subcommittee that the current two-month period contained in this section during which the Bureau is required to complete its review of the data submitted on each potentially noncompetitive or troubled line pursuant to § 38.2-1905.2 was not sufficient. The Office of the Attorney General agreed. The insurance industry, although it had no strong feelings in opposition to this recommendation, pointed out that the more time that there is between the filing of the data and the holding of the hearing the older or staler the information becomes. The joint subcommittee's vote was unanimous to support this recommendation.

2. To amend paragraph 7 of subsection E of § 38.2-1905.1 to eliminate the circular definition of the phrase "pattern of excessive rates" as currently exists between §§ 38.2-1904 and 38.2-1905.1. The recommended change would strike the word "excessive" in paragraph 7 and insert in its place "unreasonably high." At the meetings during the interim there was a significant amount of discussion concerning the interpretation of the wording of the two statutes and how the two statutes relate to each other. The joint subcommittee members found that if one were to apply the § 38.2-1904 subsection A definition of "excessive rate" to the term "pattern of excessive rates" found in § 38.2-1905.1 E.7., it would lead to a circular definition and would make the "pattern of excessive rates" determination meaningless. They found that the pattern of excessive rates is but one factor that the State Corporation Commission may use under § 38.2-1905.1 to determine whether sufficient competition exists to regulate rates in the line effectively. Further, they found that if the two-part definition of "excessive rates" in § 38.2-1904 is used to define "pattern of excessive rates" in § 38.2-1905.1 E.7., then the State Corporation Commission would first have to find that there was not a reasonable degree of competition in the line before it could use the "pattern of excessive rates" factor to determine whether competition was effectively regulating rates in that line. That is, they would have to answer the competition question before they could use the factor. The joint subcommittee found that certainly the General Assembly could not have intended such a circular result. Both the Office of the Attorney General and the Bureau of Insurance agreed to this recommendation. The insurance industry was not in agreement with this change. The joint subcommittee by a seven to three vote agreed to this recommendation.

3. To amend § 38.2-1905.2 to require all insurers to file a supplemental report as established by H.B. 1235 of 1987. Under current law, only those insurers actually writing business in one of the troubled lines or subclassifications are required to submit a report. This change would state that any insurer licensed to write the classes of insurance as defined in §§ 38.2-117 and 38.2-118 shall file such a report, provided, any such insurer that did not actually write any such designated line or subclassification of insurance in the Commonwealth during the reporting period shall be required only to report that it wrote no such insurance. The second change requested by this recommendation would be an amendment to provide that failure to file a substantially complete report shall constitute a failure to file a report. This recommendation was made to clarify a problem that arose during 1988 in trying to identify which licensed companies were obligated to file supplemental reports but did not. Because the current law only required those actually writing in such designated lines or subclassifications of insurance, it was difficult to tell from the records whether a company wrote no premiums for that line or subclassification or whether it just failed to file a report. Both the Office of the Attorney General and the Bureau of Insurance agreed to this recommendation, and the insurance industry voiced no strong objection to it. The joint subcommittee unanimously agreed to make this recommendation.

4. To amend § 38.2-2228.1 to establish a date by which the annual reports of all liability claims for personal injury and property damage covered under policies written by insurers must be filed with the Commission. The second change offered under this recommendation would provide that failure to file a report required under this section (which was originally established by H.B. 1234) would constitute a violation of the provisions of Title 38.2 of the Code of Virginia. The subcommittee found that the State Corporation Commission had concern under this closed-claim reporting statute that insurers could effectively argue that if they did not file these reports on time the Commission had no enforcement powers. The joint subcommittee decided that it should be clear that the Commission had the authority not only to set the date but to fine insurers if they did not file by the due date. Both the Commission and the Attorney General's Office agreed to this recommendation and the insurance industry representatives stated that they had no objection. The subcommittee voted unanimously to agree to this recommendation.

5. That a resolution be drafted to continue this study in all three primary areas: the availability and affordability of liability insurance, reinsurance and antitrust. The Office of the Attorney General requested this recommendation to be made by the joint subcommittee. The Bureau of Insurance had no recommendation in this regard and the insurance industry opposed the recommendation. The subcommittee found that many of the questions raised during the interim regarding the insurance industry's exemption from the antitrust laws and in the area of reinsurance cost were not adequately answered during the course of the study. Also, subcommittee members felt a need to continue to study the areas regarding certain services provided by rate service organizations to individual insurers, including the development of loss cost data and trending of that data. They felt that another year of study may provide the forum necessary to permit a more detailed examination of these issues. The joint subcommittee by an eight to two vote agreed to this recommendation.

RECOMMENDATIONS NOT AGREED TO

1. To amend § 38.2-1901, 38.2-1905.1 E.5., 38.2-1906, 38.2-1908, 38.2-1913, 38.2-1916 and 38.2-1923 to prohibit rate service organizations from filing the trending of loss cost data for insurers. The recommendation would have continued to allow rate service organizations to file developed loss cost data for insurers. The changes under this recommendation also would provide that the filing of loss cost data by rate service organizations would subject the line or subclassification of insurance to the "delayed effect" provisions of Chapter 19 of Title 38.2. This recommendation arose out of the antitrust issue and, more specifically, in an effort to balance the industry's legitimate need for development and trending of loss cost data against the potentially anti-competitive effect of such rate service organizations' conduct currently permitted by Title 38.2. This recommendation was an

alternative approach to the removal of the industry's current exemption from the Antitrust Act. This approach addressed the prohibition against allowing rate service organizations from filing trending factors regarding loss cost data. A compromise was reached between the Attorney General's Office and the Bureau of Insurance in making this recommendation. The compromise entailed (1) this prohibition against the rate service organizations filing of loss trending factors which are predictions of changes in the frequency and severity of losses over time and (2) continuing to allow rate service organizations to file loss development factors which are adjustments to reserves to unforeseen escalations between the occurrence of a loss and its ultimate resolution. The recommendation, had it been agreed to, would have required each individual company to trend its own loss data independently. The compromise was conditioned upon the fact that the Attorney General would seek a recommendation to continue the study.

This recommendation was made by the Attorney General's Office and the Bureau of Insurance and was objected to by the insurance industry. The joint subcommittee by a nine to one vote decided not to agree to this recommendation.

2. To amend § 38.2-1905.1 to add after paragraph 8 of subsection E of that section a new paragraph which would require that the Commission find that there has been substantial compliance with the supplemental report requirements of § 38.2-1905.2 by insurers writing a troubled line before the Commission finds competition is in effect a regulator of rates for that line. The Attorney General offered this recommendation to the joint subcommittee and testified that the supplemental reports required under § 38.2-1905.2 are essential to enable the State Corporation Commission to determine whether, in fact, competition is effectively regulating rates in a potentially noncompetitive line. The Attorney General pointed out that when there is not substantial compliance with the requirement for complete and timely supplemental reports the Commission is hampered in fulfilling its role under § 38.2-1905.1. The insurance industry observed that the effect of the change offered by this recommendation was a finding that competition does not exist solely on the basis of noncompliance. Industry representatives stated that there can be significant competition but not adequate compliance and therefore the line would be declared noncompetitive. Representatives pointed out that they did not think that this was the way to deal with a violation of § 38.2-1905.2 and that current law already provided penalties for violations of noncompliance with the law. They urged that such noncompliance be dealt with in a manner already provided by law. On a five to five vote this recommendation failed.

3. To amend Paragraph 7 of subsection E of § 38.2-1905 in order to clarify that investment income on surplus may be considered at the competition hearing on a troubled line in order to determine whether a pattern of excessive rates exists. This recommendation was offered as clarifying in nature because there was some discussion concerning and confusion existing whether investment income on surplus may be considered at the competition hearing. Due to the resolution of this issue between the Attorney General

and the State Corporation Commission, it was felt by the subcommittee that legislation was not needed in this area. This recommendation was not voted on since it was felt, by all parties involved, that the Commission presently considers this factor in its deliberations and, therefore, the change to the law was not needed.

III. WORK AND DELIBERATIONS OF THE SUBCOMMITTEE

The joint subcommittee held eight meetings during the course of its interim study. Beginning in July of 1988, the joint subcommittee held one meeting each month through the month of December. Each of those meetings was a public hearing and was held to elicit testimony from specific groups on specific issues. Two meetings were held in January of 1989 and they were scheduled as working sessions of the subcommittee. The subcommittee wishes to point out that, due to the considerable amount of testimony heard and written materials received, it would be impossible to include within this report all of the testimony and written statements submitted.

July 8.

At the July 8th meeting, the subcommittee heard from the Attorney General, the State Corporation Commission's Bureau of Insurance and representatives from the insurance industry. In her remarks, the Attorney General explored with the subcommittee some of the effects that the tort reform legislation and the insurance reporting legislation enacted by the 1987 General Assembly were having on the availability and affordability of liability insurance in the Commonwealth. With regard to the tort reform legislation, she stated that survey results and information received by her office, which are preliminary findings, indicated generally that the impact of that legislative package was positive in the sense of making insurance more available and affordable. With regard to House Bills 1234 and 1235 of 1987, she advised that the news was not as encouraging. She stated that the reports, which were to be filed by insurance carriers writing in those lines and subclassifications of liability insurance which were designated as potentially troubled lines and with insufficient competition, in many cases were flawed and incomplete. She noted, however, that although many of the reports were incomplete, the data that was submitted strongly pointed to the conclusion that the markets for these lines and subclassifications are highly concentrated and exceedingly profitable in ways that suggest the absence of effective competition. She testified that her office advocated that all of the seventeen lines that were designated by the Commission as potentially troubled should be made subject to prefiling and be declared noncompetitive. See Appendix 2 of this report for the Attorney General's entire statement.

On behalf of the Office of the Attorney General, Dr. John Wilson, an economist and consultant, and Professor Kenneth S. Abraham, a professor of law at the University of Virginia, addressed the issues of reinsurance and the

antitrust exemption. In studying both issues, Dr. Wilson stated that the subcommittee would want to consider how well competition and regulation are achieving economic results in the public interest. He explained that several decades ago competition and regulation were viewed as alternatives, but today regulation and competition are generally viewed as aimed at the same objective, that is, the best product or service at the lowest price. Regarding reinsurance regulation, Professor Abraham stated that there is none since reinsurance has traditionally been thought to be competitive primarily because its customers, insurance companies, are sophisticated enough to know if they are being overcharged. Professor Abraham stated that many questions have been raised against the traditional argument over the regulation of reinsurance. Professor Abraham explained that the suit filed by the nineteen Attorney Generals against the major reinsurers suggests that the market may not be as competitive as has thought to be the case. Dr. Wilson reminded the subcommittee that in studying reinsurance it will want to remember that with respect to commercial liability lines there is a greater propensity to reinsure part of the risk because of the large loss exposure. He also noted that in reviewing such reinsurance there is a need to know the number of exposures an individual carrier writes because the fewer the number of exposures the smaller the base to spread the risk. Professor Abraham emphasized that the overall profitability of a company is affected by the reinsurance cost it must pay and that these costs must be taken into consideration when the company sets its rates. Professor Abraham pointed out that the State Corporation Commission presently has no explicit authority to inquire into whether reinsurance rates are excessive when it reviews the rates of the primary insurer. It was also pointed out that information and data reported under the requirements of House Bill 1235 would not provide the Commission with information on how much of an insurer's premium is related to the cost of reinsurance. Although the Commission can obtain additional information on reinsurance from the companies, the Commission could not easily determine what part of an insurer's premium is related to reinsurance cost. Professor Abraham presented two solutions to the reinsurance issue. One solution, he stated, would be to have direct regulation of reinsurance rates. He explained that this would be difficult because may reinsurers are abroad or out-of-state and that obtaining Virginia-based data on reinsurance costs would be difficult because reinsurance rates are not predetermined. He explained further that reinsurance rates are customized for the particular risk involved. The second solution he offered would entail the leverage approach. He explained that without having to directly regulate the reinsurance costs, primary insurers could be required to justify their reinsurance costs. Under this solution, the State Corporation Commission would have more explicit authority to obtain more focused and detailed information in order to ensure that Virginia primary insurance rates are not inflated by excessive and unreasonable reinsurance costs and that the unreasonable rates are not passed on to consumers.

Regarding the antitrust exemption Dr. Wilson advised the joint subcommittee that it may want to consider how many insurance companies are writing in a specific line or subclassification of insurance, whether any dominate and the concentration levels. He noted that in Virginia in many of the individual subclassifications there are relatively few underwriters but that concentration is high. He advised subcommittee members that they would

want to determine how insurance companies interact and the level of their competition and whether they set prices through rate service organizations or set them individually. He noted that from the information filed with the Commission, a large number of companies writing commercial liability insurance adhere to rate service organization rates and do not deviate from them. He suggested that this is reason enough to look at the antitrust exemption carefully. It was pointed out that prior to 1944 courts had generally held that the antitrust laws did not apply to insurance companies. In 1944, however, in the United States v. South-Eastern Underwriters Association, 322 U S 533 (1944), the Supreme Court found that the industry came under the Sherman Act and therefore was under the antitrust laws. Thereafter, the insurance industry was able to convince Congress that the companies needed to be able to work together to share information, so that potential entry into the industry would be easy. They stressed the need for statistical information sharing and the roles of rate service organizations in providing such information on losses. They succeeded in their arguments and in 1945 the McCarran-Ferguson Act was passed which grants an exemption to insurance companies as long as they are effectively regulated by the state, except that actions involving boycotts, coercion, or intimidation still fall under the Act. It was pointed out that the exemption allows insurers to use rate service organizations for standard forms, prices, and other practices that normally would violate antitrust laws. Both Dr. Wilson and Professor Abraham questioned whether the use of rate services organization rates constitutes a violation of the antitrust laws since the use of such rates provides a focal point for increasing rates in concert. Professor Abraham presented two possible solutions for the antitrust exemption issue. The first suggests the elimination of the exemption entirely. It was explained that this solution would put the industry on the same footing as all other industries. It was noted that although this suggestion focuses on the repeal of the Virginia statutory exemption, it would have effect, notwithstanding the existence of the federal exemption, since the insurance industry is required to do business in accordance with state law. He pointed out that under this solution insurers would not be allowed to use rate service organizations. He offered a second solution which would limit the exemption from the antitrust laws, through carving out the authority of insurers by rate service organizations, to pool historical data regarding claims but not to use a rate that is used by most companies.

Mr. Steven Foster, Commissioner of the Bureau of Insurance, made some brief comments on the concerns raised by the Attorney General's testimony. He stated that he was also disappointed by the scope of inaccuracies and in the lack of reporting by a number of companies under the House Bill 1235 reporting requirements. However, he stated, despite the quality of the information it had received, the Commission was required by the law to hold the troubled-lines hearings. He stated that there are 590 companies licensed to sell property and casualty insurance in Virginia, but the Bureau does not know how many are actually writing in any one or all the troubled lines. He stated that 394 companies did file their reports on time, yet 53% of those were rejected because the data was incomplete. Further, he stated that 100

companies did not meet the May 1 filing deadline and had since filed their reports and have been penalized $250 for every two weeks they were late. He pointed out that although the companies that filed late reports were fined only $250 for every two weeks that they were late, when in fact the Commission has the authority to fine up to $1,000, the imposition of the penalty does not mean that the Commission will not take other actions against them. He noted that because this was the first year of filing under House Bill 1235 requirements, the Commission was not levying the maximum penalty authorized, but hereafter it would be enforcing the reporting requirements more vigorously, and it expected the insurance companies to adhere to the letter of the law.

With regard to the troubled-lines hearing, Mr. Foster stated that although the Attorney General's Office urged that all 17 lines be subjected to delayed effect, the Bureau recommended that only 11 should be. He explained further that the Bureau recommended that six of the lines not be subjected to delayed effect because requiring a prefiling of the rates in these lines may have a tendency to drive up the rates for these lines. He noted also that based on the information that the Bureau had received it recommended that those lines not be subjected to delayed effect, in part because of the number of companies writing such coverage in those lines. He noted that the number of companies writing in a particular line is only one factor at which the Commission can look in making its final determination in designating a line or subclassification as troubled and noncompetitive. He stated that the Bureau hesitated to recommend to the Commission that those six lines be subjected to delayed effect because of this.

With regard to the study of reinsurance and the antitrust exemption, Mr. Foster stated that Virginia presently does not regulate reinsurance rates and does not require reinsurers to file like primary carriers. He stated that many states are looking at the reinsurance issue and its effects on the overall market, and that there are a number of questions that have been raised concerning reinsurance. He cautioned the joint subcommittee that if Virginia by statute sets itself too far apart from other states, it could cause availability problems in Virginia. Additionally, he stated that he too has concerns when a reinsurance company is an affiliate of a primary insurer. He stated that on one occasion he has requested and received the results of an audit of an off-shore affiliate of a primary insurer in Virginia and that he has the right to ask for reinsurance contracts for review. Regarding the role of rate service organizations, he stated that there was some disagreement between the Bureau and the Attorney General's Office. He reminded the joint subcommittee that rate service organizations are licensed by the Bureau to file rates on behalf of insurance companies.

Mr. James C. Roberts, representing the insurance industry, responded to several of the concerns to which the Attorney General addressed her remarks. He stated that he would have to disagree with the Attorney General's remarks if she were suggesting that the failure of some insurance companies to report under HB 1235 was caused by stonewalling on the part of the industry. He explained that at the troubled-lines hearing, an exhibit was introduced by the

Bureau of Insurance which showed that 1,670 reports had been filed and only 393 were found unacceptable for any reason. He added that this is something that should not have been totally unexpected since the industry, during the 1987 legislative session, testified on HB 1234 and 1235, and told the General Assembly about some of the problems that it foresaw in passing such legislation. For example, he stated such testimony pointed out that the insurance companies have not been keeping the data in the format requested under HB 1235 and because of that it would take a long time to adjust their data collection system in order to comply with HB 1235. He reiterated that he did not believe there was any evidence of stonewalling.

With regard to reinsurance, Mr. Roberts stated that as the subcommittee begins to consider the subject it will find that experience in Virginia may have little to do with reinsurance. He explained that reinsurance is written by treaty and the reinsurer is not concerned with where the risk is located because it is writing risks all over the country. He stated that reinsurers tend to look at the risk itself as opposed to the state in which it is located.

With regard to the antitrust issue, he explained that rate service organizations use historical data in order to formulate suggested rates which no one is directed to use and from which many insurers deviate. With regard to rate service organizations, he pointed out that a number of companies do not have creditable historical data and thus use a rate service organization so they can stay in the insurance business and compete with those companies who have their own actuaries and formulate their own rates. He stated that the smaller companies have to make decisions presently about deviations from the rate service organization's suggested rates and thus the extent to which they will be competitive.

Generally, he stated that some of the approaches covered by Professor Abraham may not cover all that are available. He suggested to the subcommittee that its members look closely at what reinsurance is, where it is, and the amount of regulation to which it is subjected. He also suggested that they consider the basic underpinnings for the antitrust exemption. He offered to make a presentation to the joint subcommittee at a later meeting date to discuss the reinsurance and antitrust issues.

Mr. Dan Conway, with the Reinsurance Association of America, a trade association of 31 U. S. members, 24 of which are licensed or accredited in Virginia, stated that the main reason that he was appearing at this meeting was to offer the assistance of his association by putting together a panel of experts from within the industry to discuss with the joint subcommittee the net-worth, accounting and legal sides of reinsurance. He stated that he thought that this would be very helpful to them with the reinsurance issues since reinsurance operates on a higher level than primary insurance and it would require the subcommittee to look at a period of 10 to 15 years in order to understand the reinsurance market. He stated that if one were to look at a one-year period it would present a very distorted picture.

August 17.

At the August 17, meeting, the discussion was limited to the reinsurance issue. Testimony and written presentations were given by four individuals with practical and academic knowledge of the reinsurance business and by a consumer representative.

The first speaker was Dr. Scott E. Harrington, professor of insurance and finance at the University of South Carolina. Dr. Harrington first discussed the nature of reinsurance, essentially a transaction by which one insurer transfers to another part of the risk that it has assumed from the public. Reinsurance stabilizes the income of the company being reinsured, thereby reducing the risk of adverse results and the probability of the primary company's defaulting on its policies. Reinsurance also increases the primary insurer's capacity to write business. The various forms of reinsurance and how they are used to spread risks were also described.

Dr. Harrington next addressed the structure of the reinsurance industry. The reinsurance market for U.S. risks is competitively structured. Where barriers to entry are low, high concentration in a given market may not indicate a lack of competition. If prices are raised above costs, new entrants will drive prices down to competitive levels. Barriers to entry are very low in the reinsurance industry. Brokers can be readily accessed by new reinsurers or established reinsurers seeking to enter a new market. The markets for financial capital are highly competitive and capital is mobile. This ease of entry was illustrated by the large number of reinsurers that entered the market in the late 1970's and early 1980's, and there has been a large influx of capital into the reinsurance industry during the past few years. Citing data indicating that the concentration of the U.S. reinsurance industry is low compared to that of most major industries, Dr. Harrington concluded that the ease of entry into the reinsurance industry makes noncompetitive pricing highly unlikely.

Dr. Harrington next discussed the reinsurance industry's profitability. He noted that the industry's financial results are highly volatile over time. Combined ratios reported by A.M. Best indicate the higher volatility of reinsurance compared with primary insurance. The greater volatility is due to the greater difficulty in anticipating losses under excess of loss reinsurance contracts.

Dr. Harrington specifically analyzed the exhibits prepared by J.W. Wilson and Associates concerning the reinsurance industry's profitability. Data developed by Wilson indicated a 37.6% aggregate return on surplus for 26 specific organizations. But there are several problems with using the Wilson figures to suggest high profits in the reinsurance industry.

Using the same sources as those for the Wilson figures, the average return on surplus for the same organizations for the years 1982-1986 was 9%, significantly less than the figure cited by Wilson for 1986. The figure was -10.7% for 1984, and 2.4% for 1985.

Moreover, the Wilson figures include unrealized capital gains and realized capital gains on bonds that reflect appreciation of bond values for the years prior to 1986. Also the figures are calculated using beginning of year surplus. Return on surplus is more accurately determined using the average surplus. The use of beginning surplus overstates the return on surplus when surplus is growing. Including realized capital gains causes timing problems by attributing increases in previous years to the measured year. Unrealized capital gains are highly volatile.

Using the Wilson sample applying average surplus and excluding capital gains, indicates a rate of return of 14%. Applying the same analysis to 133 organizations reported by A.M. Best Company for 1986, the return on surplus was only 6%.

Dr. Harrington also analyzed other exhibits prepared by Wilson concerning growth in surplus and percentage growth in assets relative to growth in net premiums. The most important factor affecting surplus growth in both was the inflow of new capital from owners. Most of the remaining growth reflects either realized capital gains or unrealized capital gains. Dr. Harrington emphasized that it is inappropriate to discuss growth and surplus in the context of assessing profitability without identifying the extent to which growth reflects contributions of funds by owners. This is especially true since contributions were made necessary because of adverse reinsurance underwriting experience in 1984 and 1985.

Dr. Harrington also stated that it is essentially meaningless to compare written premiums and paid claims. The relevant comparison is between earned premiums, underwriting expenses, the total amount of expected future claim payments and the investment income that can be earned on premiums before claims are paid.

Dr. Harrington next discussed several difficulties in the evaluation of profitability. The relationship between premiums and expected claim costs must be determined. Future losses must be estimated and experience for lines of business with small volume or experience for individual contracts or reinsurance treaties will tend to be highly volatile. Dr. Harrington referred to this volatility as the "credibility problem." The credibility problem is particularly important at the reinsurance level where the volume of experience is smaller and the loss development in liability lines is much longer than at the primary level.

Dr. Harrington noted that cyclical effects aggravate availability and affordability problems, but persistent problems are caused by high and unpredictable claim costs. Premiums necessarily depend on expected total claim costs, underwriting expenses, investment income that can be earned on premiums prior to the payment of claims and the amount of capital needed to make it likely that the insurer will be able to honor its commitments to policy holders. The most difficult and important factor is the expected value of future claims. As uncertainty increases, the amount of capital needed to support the business increases. Accordingly, the amount of premium needed to compensate suppliers of capital increases and the amount of coverage may decline. It is not clear how greater regulation of insurance and reinsurance can alleviate these basic economic problems.

Dr. Harrington ended by emphasizing the following: (i) The U.S. reinsurance industry is competitively structured, with low entry barriers; (ii) There is no evidence that profits in the reinsurance industry have been excessive over time or in 1986; (iii) Given the credibility problem and long loss development of reinsurance contracts it would be very difficult, if not impossible, for regulators to evaluate the profitability for small lines or sublines of business or for a small number of contracts; and (iv) Availability and affordability problems primarily reflect high and unpredictable claims costs.

The second speaker was George E. Carpenter, who is the corporate reinsurance officer of the Nationwide Insurance Companies and has been involved in all aspects of the reinsurance business on behalf of Nationwide during the last 18 years. He noted that prior testimony suggests that some of the concern with reinsurance derives from figures compiled by J.W. Wilson & Associates to the effect that 11 of the largest insurance groups place an average of 83% of their reinsurance with affiliates. Apparently, there is fear of hidden profits in the reinsurance transaction.

He stated that an examination of the Wilson figures demonstrates that they include interaffiliate pooling, i.e., members of an insurance group pool their business and allocate premiums and losses in the same percentage that each individual company's business represents to the pool. There is no overhead or transaction cost that can be used to hide a profit. The purpose of the pool is to spread risk within the group so that a catastrophe in one line of business of one company will not render that company insolvent.

He noted that using the first group cited by Wilson as an example, the Aetna Group, readily available data demonstrate the 97.6% of reinsurance with affiliates represents pooling. Rather than the 83% cited by Wilson, only 2.4% of Aetna's reinsurance is retained within the group. Interaffiliate pooling is practiced by most large insurance groups. After a careful examination of the potential benefits and appropriate procedures, Nationwide implemented an intercompany pool with the approval of the Ohio Insurance Department.

He added that insurance departments have legitimate concerns about the fairness of interaffiliate transactions. For this reason, nearly all states have adopted a version of the National Association of insurance Commissioners' Model Holding Company Act. Given the relative size of pooling transaction, it would have to be reported, if not approved in advance, in virtually every jurisdiction. The Virginia version of the Holding Company Act (§ 38.2-1330 et seq.), gives the Commission jurisdiction over all "material transactions" between affiliates of domestic companies. Since the Commission can define a "material transaction" pursuant to § 38.2-1322,. the Commission has the authority to review transactions and prevent abuses.

The third panelist was William J. Gilmartin Jr., currently president of Brokers & Reinsurance Markets Association and who for 33 years supervised the reinsurance operations of the CNA Group. Mr. Gilmartin noted that prior testimony suggested that Virginia law be changed to require primary companies subject to Virginia's rate filing laws to supply a variety of data reports on assumed and ceded reinsurance based on line and subclassification for Virginia. The information would be used to determine whether to disallow any or all of the amount paid for reinsurance premiums if it is found to be excessive.

He stated that the manner in which reinsurance is written makes it impossible to report accurately premiums and losses by line or subline and by state. Reinsurance contracts are not standardized. They may cover several lines of business in several states or countries. They may cover a single risk or thousands. They may cover a percentage of the primary company's risk, the risk above a certain retention or the risk above a certain ratio of losses and expenses to premium. In certain liability sublines, it may take ten or more years before the reinsurer knows of a loss and even more before it is paid. A requirement to breakout experience in the manner suggested would result in a mountain of paper consisting of guesswork. This would not be useful data and, even if useful, would require substantial resource for analysis. Moreover, for reinsurance written on a proportional basis, the information would be redundant of data reported by the primary company.

Another proposal that was offered would require reinsurance contracts to be filed with the Insurance Bureau. Mr. Gilmartin stated that initially, this would be unworkable given the international nature of the reinsurance market. Secondly, each reinsurance contract is individually negotiated so the forms are not standardized --each one would have to be read. Even if this could be accomplished, Insurance Bureau personnel could not determine whether rates were adequate or excessive without an examination of loss history, loss development factors, the overall relationship between the parties and other relevant factors. Realistically it would not be possible to give such a prior review to thousands of reinsurance contracts.

He advised that a more useful approach would be to identify troubled lines of business and the companies that participate therein. The Insurance Bureau has the authority to make spot examinations of such companies to determine whether there are abuses in the reinsurance process that hinder competition. This responds more directly to the issue at hand without creating a burdensome and useless reporting process.

The fourth speaker on behalf of the reinsurance industry was Edmond F. Rondepierre, senior vice president and general counsel of General Reinsurance Corporation. He emphasized that the reinsurance market is extremely varied with many participants. General Re, the largest U.S. domiciled reinsurer, has less than 10% of the reinsurance written on U.S. risks and substantially less than 5% worldwide. Barriers to entry are low. Any licensed insurer can write reinsurance. Domestic companies are allowed to cede reinsurance to unlicensed reinsurers who need meet no regulatory standards.

He pointed out that given the ease of entry to the marketplace, capacity and competition expand virtually instantaneously when there is a perception that business can be written at a profit. Perception of profit is tied directly to the relative predictability of losses that must be paid in the future. If loss costs are very unpredictable, the underwriter might decline to provide a quotation or charge a premium commensurate with the high degree of risk. Predictability can be affected by a variety of factors such as changing theories of liability, political and regulatory climate and inflation in wages, medical and hospital costs and jury awards for noneconomic losses. The longer it takes for losses to be reported and resolved, the less the predictability.

He emphasized that it is erroneous to presume that there is no regulatory mechanism covering the cost of reinsurance. Insurance rates are made on the basis of gross losses expected under the insurance policy, whether or not any reinsurance is purchased. A primary company may keep all the premium or it may share it with a reinsurer. In either case, the premium charged by the primary must support all the losses. Therefore, the ratemaking standards apply to the premium charged to the insured without regard to the existence or nonexistence of any reinsurance arrangements.

The last speaker was Mr. Rick Cagan, representing Virginians for Fair Rates and Compensation. Mr. Cagan's presentation highlighted a major report focusing on one of the largest players in the reinsurance industry, Lloyd's of London. The report to which he referred is entitled Goliath. Mr. Cagan stated that since investigators and researchers must rely on information which Lloyd's has selected for public release, the full panoply of Lloyd's activity is not present in this report. However, he stated that some things are certainly clear. Lloyd's has been able to exercise its economic clout with impunity in this country because of its secrecy and dominance in the world and U.S. insurance industry, and because federal and state legislators are intimidated by Lloyd's. He added that legislators fear that if they enact tougher legislation Lloyd's will simply pull out from the U.S. market.

Mr. Cagan added that, unfortunately, lawmakers and the public have yet to realize the full consequence of Lloyd's power. For this reason, he stated, that public officials must start taking responsible steps to determine the extent of economic power that Lloyd's enjoys here, force Lloyd's to disclose pertinent information and develop programs to regulate Lloyd's and the rest of the domestic and foreign reinsurance industry operation in the United States. He emphasized that there are no easy, quick-fix solutions, but basic regulatory reform is a critical first step. He presented the following reforms that are immediately needed: (i) strong state or federal disclosure laws for surplus lines and reinsurers, such as Lloyds, operating in the United States; (ii) licensing standards for foreign reinsurers; (iii) alternative federal or state insurance programs; (iv) the repeal of the insurance antitrust exemption; and (v) civil suits against insurers for unfair practices.

September 21.

At the September 21 meeting, the discussion was limited to the antitrust issue and representatives of consumer groups and the insurance industry addressed the subcommittee.

The first speaker, Mr. Rick Cagan, stated that the consumer coalition he represents strongly supports the removal of the antitrust exemption now enjoyed by insurance companies operating in Virginia. He stated that in this time of increased pressure on consumers to find insurance coverage which is both available and affordable, the legislature must do everything within its authority to protect the consumer in the insurance marketplace. He stated that heading his association's list of priorities for insurance reform was the removal of the antitrust exemption. He emphasized that if there is going to be any semblance of free-market competition then this highly noncompetitive feature in our state law exempting the insurance industry from the antitrust

laws must be done away with. He stated that it is his association's belief that the insurance industry must do what every other industry in the Commonwealth does, that is, abide by the antitrust law which provides base-line protection from price gouging and guarantees a basic level of competition. He stated that 100% of the persons with whom his office has spoken to over the consumer hotline have indicated their support for the repeal of the antitrust exemption.

The next speaker was Ms. Jean Ann Fox, representing the Virginia Citizens Consumer Council, who stated that the repeal of the antitrust exemption is an important consumer issue. She noted that under the protection of the exemption, insurance companies had been able to engage in anti-competitive practices that hurt consumers and penalize other businesses. Price-fixing, setting agents' commissions, and other concerted actions by insurers combine to keep prices for insurance artificially high and to limit consumer choice. She stated that the effect of this exemption on consumers is one of immeasurable harm. As we saw during the liability insurance crisis during the 1980's, insurers are free to dramatically raise prices in concert, forcing consumers to pay for past years reckless price-cutting and fiscal irresponsibility. She stated that one of the primary anti-competitive effects of the antitrust exemption occurs in how rates are set. Insurance companies establish and own rate service organizations that collect and maintain data on which rates are based and that issue "advisory" final rates for insurance lines. She stated that several things result from the use of these rate service organizations' services, including price fixing and collusion in setting prices; publishing price data within the industry that is not available to buyers; tying arrangements where in order to buy what you want you have to pay for something else that the company is selling; price-fixing of agents' commissions; assignment of exclusive territories; and arbitrary cancellations. Finally, Ms. Fox stated that competition is good for consumers and that in the long run good for the insurance industry. She stated that the following are benefits that the citizens of Virginia would experience if the antitrust exemption were repealed: prices would be set competitively, efficiency would be rewarded, the cyclical nature of the insurance market would be lessened, insurance companies would have to play by the same rules as other businesses in Virginia, and price-fixing would end.

Mr. James C. Roberts, representing the American Insurance Association, and on behalf of his association and the National Association of Independent Insurers, the Alliance of American Insurers and the Nationwide Insurance Company, introduced a number of speakers from the industry to comment on the antitrust issue. Their first speaker addressed the stonewalling issue, and then the following speakers made presentations on the antitrust issue. Mr. Claus S. Metzner, an associate actuary with the Aetna Casualty and Surety Company, addressed the stonewalling issue. Mr. Metzner stated that in several instances the type of information requested under House Bill 1235 is simply not available to the insurance company in order to fill in the blanks on the forms supplied by the State Corporation Commission. For example, he explained, they do not have information concerning the number of exposures written. That type of information is never used in pricing insurance because they use collected premium information. In order to provide this type of information and make it available, his company would have to install a new data collection process which would take some time. That also applies to information concerning direct premiums written. That information is

retained for a short period of time but once the calculation is made on premiums earned it is deleted. Although that information is available for a short period of time and is later deleted, it could be retained for future purposes by doubling the size of the company's computer operation. Mr. Metzner stated that presently the company deletes that type of information because it cost-justifies what they absolutely need to keep. Mr. Metzner stated that without a lot of changes they could not go into the computer during the intermediate process and print a hard copy of that information.

With regard to start-up problems encountered by his company under the recording features of House Bill 1235, Mr. Metzner asserted that many of those problems could have been avoided if insurers had been given six months' start-up time rather than four months'. Mr. Metzner stated that the format for reporting under House Bill 1235 was not approved until four months before the date on which the information was due and that caused many insurers problems in reporting the proper information.

With regard to the format under which the insurers are required to report information under House Bill 1235, Mr. Metzner pointed out that the present format can create essentially meaningless and often misleading answers. With regard to information concerning "incurred but not yet reported reserves," he stated that he does not consider that information very meaningful under the current format because many companies use different techniques in allocating such reserves.

With this type of legislation, he continued the determination is made after the bill becomes law as to what is a troubled line and then the insurers are required to report the last five years' information. He stated that many insurers may not have recorded the type of information that is required since they may not have considered it meaningful. With regard to future reporting, it was indicated that they are not saying that they could not in the future report such information but it could take three to five years' lead-in time because it is not as simple as pushing a different button on the computer. He stated that it was not a matter of commitment but a problem in changing data entry over a period of years and also a problem with what lines may be considered troubled lines in the future.

Ms. Mavis A. Walters, executive vice president of Insurance Services Offices, Inc., was the next speaker. She explained to the subcommittee exactly what the insurance services office (ISO) is and what type of role it performs within the property and casualty insurance industry. Ms. Walters explained that those insurers that are ISO participants may choose the ISO products or services that they want to use and do not have to adhere to the advisory insurance rates or standard coverage parts developed by ISO. She stated that a company may determine that it wants to file a rate different from the advisory rate adopted by ISO. She stated that for personal auto lines, that of the top ten writers in Virginia, which represent 73% of such business, only two companies, which represent 11% of such business, have given ISO authority to file those rates. She added that of the top ten writers of homeowners insurance in Virginia only 3 or 13% of the business have given them the authority to file rates. She stated that the vast majority of those participating with ISO do not give ISO the authority to file rates.

With regard to ISO's position on the repeal of the antitrust exemption, Ms. Walters stated that ISO has no position because it does not take positions on public policy issues. Ms. Walters stated that ISO advisory rates do not enhance noncompetitive activity but just the opposite. She stated that the advisory rates are cost-based and allow many insurers to consider writing that class or line of insurance in another state; it serves as an inducement to write insurance, she stated.

Mr. Claus Metzner was the next speaker and spoke on the role of ratemaking organizations and how Aetna uses ISO data in its rate review activities. Mr. Metzner added that in he believed that Aetna paid somewhere around $2,000,000 for ISO services 1987 but that he could get the actual figure for the subcommittee.

Mr. W. T. Neal, senior vice president of Virginia Mutual Insurance Company, analyzed how the changing of the antitrust exemption will affect smaller insurance companies writing in the marketplace today. He stated that if the antitrust exemption were repealed it would not have as much effect on large companies as it would on small companies, and in his opinion it would reduce competition, increase the cost of the smaller companies and cause a loss of quality data in setting rates.

Mr. Gary Helton, representing the Virginia Farm Bureau Insurance Company, commented that his organization needs the data made available by rate service companies and other insurers in order to support rate levels. He stated that if the antitrust exemption were repealed the expense factor and their rates would have to increase and it is a major concern to his organization.

Mr. Craig A. Berrington, general counsel of the American Insurance Association, asserted that there is no need to amend the Virginia antitrust law to respond to issues raised by the Attorney General because the state insurance code already embraces a comprehensive regulatory scheme designed to foster competition and to prohibit anti-competitive conduct. He stated that the public policy reflected in subsection (b) of § 59.1-9.4 of the Code of Virginia which exempts from the antitrust laws conduct "authorized or approved" by a state statute or by a state or federal administrative agency when read in conjunction with the Virginia Insurance Code amply protects the citizens of the Commonwealth from anti-competitive practices in the insurance industry. He stated that monopolization, agreements to charge or adhere to any rate, agreements in restraint of trade, agreements that may substantially lessen competition, and refusal to deal are all clearly prohibited under the present insurance code. He stated that there is a need for sharing data and the expense for data exchange in that it affords responsible pricing and promotes public interest. See Appendix 3 of this report for Mr. Berrington's statement.

Mr. Anthony F. Troy, counsel for the American Insurance Association, agreed entirely with the statement made by Mr. Berrington that there is no need to amend Virginia's antitrust law; any amendments would hurt the

regulatory scheme that the General Assembly has meant all along. He stated that the General Assembly in the early 70's made an all-inclusive study of the antitrust laws which is documented in HD 20 of 1974. He noted that the antitrust exemption extended to insurance companies, as regulated businesses, is not unique to insurance, but is applicable to numerous industries which gain a measure of exemption from antitrust as regulated industry. Mr. Troy's entire statement appears as Appendix 4 of this report.

Ms. Lenore S. Marema, vice president of legal affairs of the Alliance of Legal Insurers, observed that under the present regulatory scheme and state of the law the General Assembly and the State Corporation Commission together have enough authority and power to assure that the public interest is being served. Ms. Marema stated that if the state insurance department does not have enough money to perform its regulatory duties, her organization would be willing to address that problem if it exists.

Mr. Charles Gibson, representing the Independent Insurance Agents of Virginia, feels that under the current system the insurance market is very competitive in Virginia and it remains competitive over a long period of time even in hard markets. For example, in the last six months prices have been falling and the market has been very competitive. With regard to there being a substantial difference in prices between companies, Mr. Gibson stated that that involves a capacity problem for writing insurance and for any one class of insurance for a company to write. He stated that if the antitrust exemption were repealed the agents would be affected in many ways: there would be a lack of formalization in formats in policy; there would be fewer companies to represent; and there would be a lack of uniformity among companies.

Mr. Robert W. Esenberg, vice president of governmental affairs of the Risk and Insurance Management, stated that his organization wanted to go on record as being against the repeal of the exemption afforded the insurance industry under the antitrust laws. Mr. Esenberg stated that competition would be reduced if the antitrust exemption afforded insurance companies were repealed. He affirmed that what is unique about the insurance industry is that other regulated industries are not required to predict the future of certain risks that may or may not happen. Other industries know what their cost of providing service is, whereas the insurance industry because of this prediction factor is not able to predict it with certainty. He concluded that presently under antitrust laws the insurance industry is not able to fix prices.

October 27.

At the October 27 meeting, the joint subcommittee heard from the Attorney General, witnesses who were experiencing availability and affordability problems with certain commercial liability insurance lines, Dr. John Wilson and Professor Kenneth Abraham, and the Bureau of Insurance. The testimony involved all three areas of the study.

The Attorney General focused on the issue of availability and affordability of liability insurance in light of the recent ruling by the State Corporation Commission wherein of the 17 lines designated as "potentially troubled" only 11 were ruled as troubled or noncompetitive. Appendix 5 of this report contains the Attorney General's statement. She pointed out to the subcommittee that a fundamental principle of law that guides all of those who are part of the rate-making process and that has been on the books in Virginia for at least forty years simply states that rates "shall not be excessive, inadequate, or unfairly discriminatory." She stated that the question that needs to be answered is: How can we make the statute work or is it necessary for further action to be taken by the General Assembly? She revealed that her purpose for appearing at the meeting was to respond to that question as Attorney General for the Commonwealth, and on behalf of the Division of Consumer Counsel. She emphasized that her office believes that the current law provides a clear and compelling standard for insurance regulation in Virginia: a mandate that rates be reasonable and that are neither excessive nor inadequate. She said that the law, in its current form, can be effective, and that she believed that the Bureau of Insurance has the necessary authority to obtain all the data required by the General Assembly and that careful, comprehensive analysis of that data by the Bureau can be enormously helpful in identifying troubled lines of liability insurance. She pointed out that with the proper agreement between her office and the Bureau of Insurance on the basic principles and the adoption of certain practices on the part of the Bureau to ensure timely and comprehensive collection of data and evaluation of data in accordance with guidelines adopted by the General Assembly, it was her belief that they could make the present statute work with little, if any, fine tuning.

The Attorney General offered several concrete suggestions which she stated would make a real difference in assuring that the current statutes work. She stated that the Bureau of Insurance, in surveying marketing conditions to identify potentially troubled lines, should not only survey an insurance company's agents and selected insurance consumers, but should do so in a systematic way and through established procedures. She emphasized that more consumer groups, trade associations and individuals should be surveyed in order to ensure equity and fairness in the survey. In order for the data collected from the survey, upon which the troubled lines report is based, to be truly reflective of market conditions in Virginia, the Bureau should widely disseminate the timetable for the Bureau's gathering of data so that all interested parties are advised well ahead of the process. Also, the Bureau should distribute guidelines which inform consumers, in simple terms, what information the Bureau finds relevant and compelling. Thirdly, the Bureau should develop and disseminate readily understandable guidelines along with the statute which advise consumer groups of the standard which the Bureau uses in determining whether to recommend a line as troubled. Finally, the Bureau should develop a systematic method of gathering information from consumers on a select number of lines a year, whether that information comes from telephone calls, focus groups, or other forms of contact.

Regarding the collection and analysis of the data that the industry is required to provide under House Bill 1235, once a given line of insurance is identified by the Commission as potentially troubled, the Attorney General offered the following as concrete suggestions to assure that the troubled lines process outlined in House Bill 1235 is effective in assuring reasonable liability insurance rates for Virginians:

- It would be helpful for the Bureau to pre-test its survey to find out if the industry has any problems understanding the questions themselves.

- It would be helpful for the Bureau to require all companies licensed to write any of the troubled lines to file a supplemental report, if only to tell the Bureau that they are not in fact writing those lines. This year the Bureau did not even know defintely how many companies writing each troubled line failed to submit such reports.

- It would be both helpful and prudent for the Bureau to state its rationale for finding any lines to be effectively regulated by competition, using all seven factors listed in House Bill 1235.

Eight witnesses followed the presentation given by the Attorney General. They all addressed their concerns with and their particular experiences with trying to obtain those six lines of insurance which were designated by the Commission as being effectively regulated by competition. Those lines were products and completed operations insurance; commercial contracting insurance; governmental and municipal liability insurance; school divisions insurance; day-care liability insurance; and recreational liability insurance.

Dr. John Wilson was the next speaker and his remarks centered on the adequacy of competition and the indicators or factors used to consider whether competition is an effective regulator for lines of insurance. His testimony featured exhibits which accompanied the Attorney General's presentation to the joint subcommittee. See Appendix 5 of this report. He stated that all the information appearing in the charts and exhibits comes from information reported by Virginia insurers to the State Corporation Commission. Generally, he stated, the charts for the six lines which were not considered troubled lines show handsome profitability, particularly when one compares these six to those considered troubled. Regarding the pie charts included in the exhibits, he explained that they indicate the role that the rate bureau plays in filing rates with the State Corporation Commission for the six lines of insurance considered as not troubled. Mr. Wilson pointed out that in looking at these charts, if one only looks at the number of companies writing in that line in Virginia, there is not a clear picture of price competition for that line. He pointed out that although one year is too short a period for to determining whether there is competition or not, he stated that there clearly exists a need for better data reporting, particularly with these six lines of insurance. With regard to the exhibit which shows rate requests

since 1982 by insurers writing workers' compensation insurance, he stated that this line receives the most scrutiny in a regulatory forum, since the insurers writing in this line must seek prior approval for their rates. He pointed out that the Office of the Attorney General had taken a very active role in these rate hearings and tangible results are shown in the chart. He stated that one can see a substantial difference in what was requested by the insurer and what was granted in the advocacy forum. He pointed out that Virginia has continued to have lower loss experience in this line than that experienced by the nation. He observed that if the same scrutiny were given for other lines lower premiums would result, but first the line must be determined troubled.

Professor Kenneth S. Abraham addressed the subcommittee on the reinsurance and antitrust issue. Professor Abraham stated that the subcommittee, in its first three meetings, had heard a lot of testimony on these issues, that in the July meeting the Attorney General had outlined various alternatives for the subcommittee, and that at the August and September meetings the insurance industry responded to those suggestions. He stated that the insurance industry's remarks were very general reactions to the suggestions of the Attorney General and there were a number of issues identified but not answered. In Appendices 6 and 7 to this report, Professor Abraham posed several questions which in his opinion needed to be answered before specific recommendations could be made with regard to the reinsurance and antitrust issues. Professor Abraham concluded his remarks by saying as the joint subcommittee looked further for added rate regulation, it needs to find out what else might be done with regard to rate regulation concerning reinsurance costs and the repeal of the antitrust exemption.

Mr. Stephen Foster, Commissioner of Insurance, spent most of his time responding to the comments made by the Attorney General's Office. Mr. Foster later made by letter dated November 23, 1988, a complete response to the Attorney General's presentation and it appears as Appendix 8 to this report.

November 29

Before the meeting began on November 29, the insurance industry submitted its response to questions concerning the reinsurance issue raised by Professor Abraham at the subcommittee's meeting of October 27. That response appears as Appendix 9 to this report.

At the November 29 meeting the joint subcommittee heard from representatives from the Independent Insurance Agents of Virginia, risk managers, the Commissioner of the Bureau of Insurance, representatives from the insurance industry, the Attorney General and a representative from Virginians for Fair Rates and Compensation.

The representatives from the Independent Insurance Agents of Virginia told the subcommittee that, because their membership was in the marketplace every day selling insurance, they were in an excellent position to report on

competition that currently exists in the marketplace. They stated that since the subcommittee had heard from the Attorney General's Office, the Bureau of Insurance and several consumer groups, they felt that it was time for the subcommittee to get some reaction from the people in the trenches. They stated that it was their belief that Virginia's open competition system is working to the benefit of the consumers. They noted that by allowing a company to raise its price through Virginia's file and use system, that company will stay in the marketplace; the companies that do not need a premium adjustment will continue to write at a more competitive level and they will beat the competitors priced above them. They stated that this principle has worked since 1973 in Virginia and it was their belief that it will continue to do so. They emphasized to the subcommittee members that it is important for them to know that the marketplace is alive again with competition. They pointed out that it was important to realize that the industry is on the down side of the insurance pricing cycle and is experiencing tremendous competition in the general liability marketplace. They agreed that there are some availability problems, but noted that forcing insurers to write these lines at inadequate levels is not the answer. They agreed that more information may be needed in the regulatory process. They stated that they agree that companies ought to have to justify the rates they charge.

The representatives of the insurance agents also discussed two areas on which the joint subcommittee had received testimony and about which, they stated, there were common misconceptions. The first area of concern they addressed was that of insurance companies selling insurance at "fixed ISO-developed rates." In explaining that this was a misconception, they pointed out that insurance agents are able to offer their clients discounts on premiums through the development of a rate modification factor. They pointed out that within that factor there are four items. The first item, package credit, allows the agent to offer a premium reduction to the potential insured when the company is writing more than one line of insurance for that insured. The experience credit item allows the agent to review the individual client's experience to determine whether a further premium reduction maybe offered if the client has good claims experience. The third item, schedule credit, offers a premium reduction to those clients whose style of management, safety awareness, cleanliness of operation, and other items of general insurability show that the client's operation is run in a way that reduces claims. The final item, commission expense reduction, involves the insurance agent's reducing his commission in order to be more competitive. The point that the agents were trying to make was that in many cases the insurance agents are able to offer a reduced premium to a potential insured and that fixed ISO-developed rates are merely guidelines to use and, in many instances, are reduced by this rate modification factor.

The second misconception that the insurance agents addressed was that there is little or no competition within many lines of general liability insurance, specifically the six lines that were judged to be competitive by the State Corporation Commission. The representatives of the insurance agents stated that overall competition within general liability lines is fierce. They stated that agents all over the Commonwealth can attest to more availability of product and increased pricing flexibility. However, they noted, that six years of intense competition from 1978 through 1984, combined with some staggering losses, left an indelible mark on some insurance companies and generally affected the ability of some insurers to get coverage. Some lines of insurance, they stated, where losses had been

historically difficult to predict, are not being readily written, even now during this period of new competition. In their testimony concerning those six lines of insurance which were judged to be competitive, the insurance agents offered testimony to demonstrate that there is competition in the marketplace and that if ISO-rates were charged, in some instances, the insured would have paid four times an annual rate if he had paid the ISO-manual rate.

In conclusion, they stated that they urged the joint subcommittee to keep alive the present system, which allows competition to be the regulator of the marketplace. They stated that they believe that their customers are best served by a balanced regulatory environment that encourages many players, but makes insurers responsive to the needs of consumers. In their opinion, they concluded, this is just the type of system that Virginia has in place today.

Representatives of the Risk Management Insurance Society testified that they were concerned with the statistical data being used by the Attorney General's office and that the data did not accurately reflect the profits of the insurance industry in Virginia. They stated that it was essential to define the type of data provided by the Attorney General in order to properly evaluate the results that the Attorney General's Office had submitted.

Mr. Steven T. Foster, Commissioner of the Bureau of Insurance, made comments which generally concerned the letter appearing in Appendix 8 of this report. He stated that with regard to the problems encountered under the requirements of House Bill 1235 and the insurance reports being submitted on time, the insurance companies had been given appropriate notice in order to comply with the law. He recommended fines for various companies who filed late but did not recommend that any have their licenses suspended since 1988 was the first year in which they were required to report. He emphasized that for 1989 it would be entirely different and he will strongly encourage insurers to abide by the law and, if they do not, appropriate sanctions will be levied. He stated that the insurers will have to go to whatever expense necessary in order to adhere to the law and the Bureau will have to make every effort to enforce the letter of the law.

Dr. Michael Ileo, an economist, spoke on behalf of the Bureau of Insurance and addressed the competitive atmosphere in the insurance market in Virginia and excessive profits. Dr. Ileo's concern focused on the accuracy of information provided by Dr. John Wilson's testimony. In his general comments to the subcommittee Dr. Ileo stated that in reviewing the competitive atmosphere in the insurance market and in trying to determine excessive profits, one must look with a long term view. He stated that loss ratios by themselves tell nothing about excessive profits or excessive rates. He stated that trying to determine profitability for a particular line of insurance is virtually impossible based on Virginia experience alone because the data are not collected. He continued that it may be possible with U.S. data. He added that the rates of return for insurers in Virginia offered by Dr. Wilson were grossly exaggerated. He pointed out that data reported by the insurance companies to the regulatory agency are prepared on a standard accounting practices (SAP) basis. He stated that normally the insurance companies retained their information on a basis of generally accepted accounting principles (GAAP). He emphasized that people looking at this type of information need to keep in mind the difference between GAAP accounting and SAP accounting. He noted that GAAP accounting stresses measurement of earnings from period to period, that is, matching revenues to

expenses, while SAP accounting stresses measurement of ability to pay claims in the future. He also advised that SAP accounting uses reserving standards adopted by state legislatures and is based on conservative estimates of future investment earnings. Under GAAP accounting, the experience expected by each company is used to determine the reserves it will establish for its policies. These GAAP reserves may be more or less than SAP reserves depending upon the company's experience in relation to that of the industry. He also pointed out that GAAP accounting stresses measurement of earnings on a stockholder perspective whereas SAP accounting takes the policyholder's perspective. He stated that GAAP measures the going concern of the company where as SAP is important to regulators. His point, he stated, was that one must be very careful in using data presented when the data mix the GAAP and SAP principles.

Dr. Scott E. Harrington, professor of Insurance and Finance at the University of South Carolina, spoke on behalf of the insurance industry. Dr. Harrington's remarks focused on the rate of return on surplus and the sensitivity of rate of return figures. Dr. Harrington advised the subcommittee that the members need to consider certain factors whenever someone reports on the measure of rates of returns in a given line of insurance and in a given state. He pointed out the calculation of rate of return by line and by state must be based on numerous assumptions and allocations of country-wide data which might not be appropriate for a particular state or line of insurance. He stated that estimated rates of return for a given line of insurance and a given state are highly volatile over time due to variability in losses. Calculated rates of return are strongly influenced by assumptions that are chosen. He stated that economic theory and available evidence provide only limited guidance about what assumptions to make. He emphasized that there is no generally accepted method of estimating rates of returns by line and by state, and as a result different analysts easily can come up with numbers that may differ by many percentage points. He stated that because of this problem, it would be advisable to avoid making important policy decisions based on estimated rates of return by line whenever possible. This difficulty, he continued, suggests the advantage of focusing on whether competition is likely to exist, as opposed to trying to conclude that profits were either too high or too low.

The Attorney General of Virginia stated that she hoped that the subcommittee would put out on the table for all to consider what assumptions each party to these meetings considers as valid, which will then allow the subcommittee to make a determination of the valid assumptions and what course to take. For example, with regard to incurred loss ratios, Virginia has a very low incurred loss ratio as compared to the national average. The average return on equity was much greater in Virginia than nationally during a ten-year period, and there is a picture of excessive profits in Virginia. Because of this, she stated that she had a real concern over the philosophical differences that exist between her office and the Bureau of Insurance with regard to those indicators to which each looks in order to determine whether competition is an effective regulator of rates. She summarized by saying that if the joint subcommittee believes that there is a problem with a lack of competition for commercial liability insurance in Virginia and with excessive profits, then there are two ways that it can go: either it can do those things to increase competition within the marketplace or regulate the lines of insurance.

Mr. Rick Cagen, representing Virginians for Fair Rates and Fair Compensation, stated that his association believes there is a need for traditional regulation. He pointed out that this subcommittee can set the policy in order to protect consumers and maximize competition, that the antitrust exemption needs to be eliminated and that advisory rates need to eliminated.

Chairman Moss suggested that the three parties involved in these hearings, the Office of the Attorney General, the insurance industry, and the Bureau of Insurance, should reduce to writing their suggestions as to what is needed in the three areas of the study and forward these suggestions to the joint subcommittee. He stated that once the joint subcommittee members have all of this information in front of them they will hold a work session to examine the suggestions and make recommendations. Following the November 29 meeting, the three parties submitted their recommendations to the joint subcommittee. These recommendations appear as Appendices 10, 11 and 12 to this report.

December 27

At the December 27 meeting the joint subcommittee heard briefly from the Office of the Attorney General, the Bureau of Insurance and the insurance industry.

Mr. Lane Kneedler, Chief Deputy Attorney General, presented the Attorney General's recommendations, which are found in Appendix 12 to this report. The explanation for those recommendations is also found in Appendix 12. Mr. Kneedler stated that after the joint subcommittee's last meeting the Attorney General and the Commissioner of Insurance met and were able to agree on virtually very item that appears in the Attorney General's letter dated December 21, 1988. He stated that where they did not agree, it is so stated in that letter.

Mr. Steven T. Foster, Commissioner of Insurance, made his presentation to the subcommittee, the substance of which appears as Appendix 11 to this report. Mr. Foster stated that he was pleased to stand before the joint subcommittee on behalf of the State Corporation Commission to state that they were in full agreement with all of the items mentioned by Mr. Kneedler. He noted that the Commission's legislation recommended in the letter dated December 9 has been thoroughly reviewed by the Attorney General and that he was able to report that both agreed on the purposes of the legislation which appear in that letter. He advised the joint subcommittee that under one of the proposals, rate service organizations' loss cost filings for automobile insurance would be subject to "delayed effect." He stated that this is not currently in the law and would be a legislative change. He pointed out to the subcommittee that there are certain areas addressed in the Attorney General's letter of December 21 which recommend that there be no legislation introduced because the problems that exist in those particular areas can be worked out administratively. With regard to the recommendation requesting the study to be continued, Mr. Foster stated that the Commission made no recommendation that the study be continued. Again, he noted that both the office of the Attorney General and the State Corporation Commission have agreed, in general, with everything, but there may be some slight differences in the wording of the legislative recommendations and therefore a need to work on the technical language appearing in the legislative recommendations. With

regard to the recommendation limiting the role of rate service organizations and their filings, Mr. Foster stated that if the General Assembly adopts this recommendation Virginia will be one of six states to have made such changes in their insurance statutes. He stated that it was the Commission's belief that there is no need to have the rate service organizations' expense component filed and that companies should do their own trending. He stated that it is still the Commission's belief that rate service organizations' development of data is a necessary and valuable service. With regard to the recommendations involving rate service organizations, Mr. Foster concluded that the proposals merely redefine their role and lessen that role compared to what it has been in the past.

Mr. James C. Roberts, representing the insurance industry, presented their submission made on December 15, which appears as Appendix 10 to this report. He urged the subcommittee to look with great care at the current laws and the purposes that they effectively serve. He stated that, in the industry's opinion, changes in proposals that are recommended by the Attorney General and the Bureau of Insurance are not needed. With regard to the recommendation concerning rate service organizations, Mr. Roberts stated that he had no empirical data available to give to the joint subcommittee, but that the industry people have said that in the five other states where those changes had been made the overall cost of insurance has increased. He added that if such changes were made, in some lines, the competitive edge may be given to the larger companies as compared to the smaller companies.

The members of the joint subcommittee made general comments concerning the recommendations submitted by the interested parties. Senator Chichester stated that this study had allowed a forum for the Attorney General and the Bureau of Insurance to express their differences on the insurance laws in Virginia. He stated that he saw an industry working very well with plenty of competition in the marketplace, and saw no need to add further regulation or create more bureaucracy since the existing insurance laws were adequate.

Delegate Wilson stated that with regard to the construction of §§ 38.2-1904 and 38.2-1905.1 there was a need to introduce legislation to correct differences in the interpretations of the phrase "pattern of excessive rates." He stated that although the State Corporation Commission and the Office of the Attorney General had reached agreement on the interpretation of this phrase and had recommended no legislation because of this agreement, he still wanted legislation introduced to put into the statute what this interpretation is, in order to avoid the Supreme Court's saying that the statutes do not do what the parties in agreement have said. He pointed out that while the subcommittee is studying this issue and has the mission to correct any misinterpretations of the statutes, it should take the opportunity to tighten these statutes in order to avoid any confusion on the part of the courts at a later time and thereby putting the Legislature right back where it was before this study started. He recommended that language be crafted in order to put into law the agreement between the parties. Delegate Wilson also commented that the Commission ought to have broad powers to look at commercial liability insurance lines and at individual insurance lines. He stated that the General Assembly may very well want to mandate that the Commission look at all commercial lines, but it should consider giving the Commission the authority to look at individual lines also. With regard to reinsurance, he stated that he would like to toughen the requirements on unregulated companies and on surplus lines companies. With regard to rate service organizations, he stated that he agreed with the recommendation made by Commissioner Foster.

Mr. Hunter remarked that he was pleased with the agreements reached and the recommendations made regarding the troubled lines issue. With regard to rate service organizations, he stated that although ISO is a very important player, he does not believe that data development or trending is necessary. He noted that smaller companies will incur more expenses because of the legislation, but he believes that the interim steps suggested by the Attorney General and the Bureau of Insurance are a step in the right direction. He stated that he believed that only historical data are needed, but that perhaps more study is necessary in order to support the fact that development is not needed. With regard to reinsurance, he noted that one of the key issues is obtaining information and for that the National Association of Insurance Commissioners would be a very good source.

Delegate Hargrove pointed out that if the General Assembly places more restrictions on rate services organizations it may have the effect of increasing the entire cost of the operations of the insurance companies and premiums may necessarily increase. He noted that in order to make an insurance market attractive to insurers, the insurance companies need to be able to make a profit and have as few barriers as possible to entry into the market and to competition. He stated that he was afraid that the long term effect of placing further restrictions on rate service organizations would be anti-consumer in nature. He advised the joint subcommittee that the business of insurance is cyclical and suggested that changes being proposed may exacerbate the problems already existing. He also advised that many of the factors which play into the process of making rates of insurance are beyond the control of the legislature.

Mr. Parkerson expressed concern for the delayed effect proposal and its significance to the insurance industry. He stated that all of the testimony presented to the subcommittee represented that the rate service organizations were helpful to the industry, and feared that further restrictions placed on rate service organizations would lessen competition.

Senator Macfarlane affirmed that the reason for establishing the joint subcommittee was to try to help those small businesses that were hurt as a result of high premiums and the chaos created in the insurance market between 1981 and 1985. He stated that the subcommittee's goal was for small businesses to be able to obtain insurance. He commented that he was in favor of continuing the study to look at the reinsurance and antitrust issues, and that this subcommittee should favorably consider the Attorney General's and the Bureau's recommendations.

Senator Chichester stated that when you look at the period between 1981 and 1985 you also need to look at the entire period between 1979 and 1986 and those years in which the insurers enjoyed a good insurance market. He observed that if history repeats itself prices will go down even further in 1989 and the first half of 1990, and then will go up due to the cyclical nature of the insurance business. He added that a little fine tuning is always good, but making wholesale changes, as being recommended, would be detrimental to the insurance market.

Senator Saslaw stated that he would not vote for a bill that would put any insurance company in dire straits. He suggested that somewhere between Senator Macfarlane's fine tuning and Senator Chichester's wholesale changes is where he would vote. He stated that he believed that some changes are needed, especially those regarding §§ 38.2-1904 and 38.2-1905.1.

The joint subcommittee did not vote on any of the recommendations that were submitted to it by the interested parties because some of the members of the joint subcommittee were absent at the December 27 meeting.

The joint subcommittee asked the staff to draw up a list of the recommendations submitted to it, identifying those changes which should be addressed by legislation and which should be addressed during the continued study. That list of recommendations appears in the next segment of this report.

IV. RECOMMENDATIONS OF THE SUBCOMMITTEE

The joint subcommittee held a meeting on January 10, but because all of the members of the joint subcommittee were not able to attend, the joint subcommittee took no action. The joint subcommittee adjourned the meeting with the understanding that it would reconvene on January 11 to vote on the recommendations submitted.

At the January 11 meeting the joint subcommittee voted on those recommendations requiring legislation and those recommendations that may be subject to continued study. The following is a list of those recommendations submitted to the joint subcommittee by the staff:

RECOMMENDATIONS REQUIRING LEGISLATION

1. Amend §§ 38.2-1901, 38.2-1905.1.E.5, 38.2-1906, 38.2-1908, 38.2-1913, 38.2-1916 and 38.2-1923 to restrict rate service organizations from trending the loss cost data. Rate service organizations would continue to be allowed to file developed historical loss cost data. These amendments also provide that the filing of loss cost data by rate service organizations will be subject to the "delayed effect" provisions of Chapter 19 of Title 38.2 of the Code of Virginia. The proposal appears as Exhibit I of the letter dated December 9 from the Commissioner of Insurance to the subcommittee. Also, this proposal appears as Recommendation IVA under Issue One and the discussion of Issue Two (Antitrust) of the Attorney General's letter dated December 21 of the joint subcommittee.

2. Amend § 38.2-1905.1E to allow the Bureau of Insurance, the Attorney General's Office and other parties more time to review the filed data before the Commission would be required to hold a hearing for the 1235 supplemental reports. The amendment sets September 30 of each year as the date by which the hearing must be held; current law requires the Commission to hold a hearing within 60 days of the due date of 1235 supplemental reports. This proposal appears as Exhibit II of the Commissioner's letter and Recommendation IIIH of the Attorney General's letter.

3. Amend § 38.2-1905.1E.7. to eliminate the circular definition of the phrase "pattern of excessive rates" as currently exists between §§

38.2-1904 and 38.2-1905.1. The amendment would strike the word "excessive" in paragraph 7 and insert "unreasonably high." This would make the paragraph read in part "Whether a pattern of unreasonably high rates exists within the line ...." This proposal is discussed in Recommendation IIIC of the Attorney General's letter. Although no language changes were offered, Mr. Foster and Mr. Kneedler agreed on the above language at the December 27 meeting.

4. Amend § 38.2-1905.1E.7 to clarify that investment income on surplus clearly may be considered at the competition hearing on a troubled line in determining "whether a pattern of unreasonably high rates exists." This proposal appears as Recommendation IIIF of the Attorney General's letter.

5. Amend § 38.2-1905.1 to add after paragraph 8 of subsection E a new paragraph to require that the Commission shall find substantial compliance with the supplemental report requirements of § 38.2-1905.2 by insurers writing a troubled line before it finds competition is an effective regulator of rates for that line. The proposal appears in Recommendation IIIA of the Attorney General's letter.

6. Amend § 38.2-1905.2 to require all insurers to file a supplemental report as established by HB 1235. Currently, only those insurers actually writing business in one of the troubled lines or subclassifications are required to submit a report. Also, the amendment would provide that failure to file a supplemental report by the due date established by the Commission would constitute a violation of Title 38.2. This proposal appears as Exhibit II of the Commissioner's letter and as Recommendations IIC, IID, IIE and IIF of the Attorney General's letter.

7. Amend § 38.2-2228.1 to establish the date by which the annual reports of all liability claims for personal injury and property damage covered under policies written by insurers must be filed with the Commission. The amendment also provides that failure to file a report required under this section (established by House Bill 1234) would constitute a violation of the provisions of Title 38.2. This proposal appears a Exhibit IV of the Commissioner's letter.

8. Draft a resolution to continue the study in all three areas: availability and affordability, reinsurance, and antitrust. The proposal appears as a Recommendation to the Antitrust and Reinsurance Issues discussed in the Attorney General's letter of December 21.

RECOMMENDATIONS WHICH MAY BE SUBJECT TO CONTINUED STUDY

A. Availability and Affordability.

The Attorney General and the State Corporation Commission resolved or are in the process of resolving divergent views on a number of issues, including the following:

1. Surveying the commercial liability insurance market and preparing the annual troubled lines report.

2. Enforcing substantial compliance with supplemental reporting requirements.

3. Determining the effectiveness of competition in regulating rates for a line of insurance based on all factors in § 38.2-1905.1E and requiring production of all data called for in § 38.2-1905.2B.

4. Relying upon a finding of a pattern of excessive insurer profitability as an indicator of noncompetition.

5. Determining the significance of low loss ratios.

6. Requiring the production of all data listed in § 38.2-1906A.1 in conjunction with rate filings.

7. Enabling the Attorney General and others to obtain information and provide input relating to "delayed effect" rate filings.

Anticipating that these matters can be addressed administratively by the State Corporation Commission, neither the Attorney General nor the Commission has recommended legislative action at this time. Should any area of disagreement remain unresolved or problems relating to such issues develop in the future, the subcommittee could, of course, undertake an examination in the next year of the need for remediation through legislation.

More generally, however, the subcommittee has been urged by the Attorney General to continue both the examination of the affordability and availability of liability insurance in the Commonwealth and the assessment of its insurance regulatory reforms.

B. Antitrust.

The Attorney General's compromise over continuing to allow rate service organizations to file the development of data on behalf of insurers was based on the agreement to support the compromise but also to recommend that the study be continued to answer many of the questions raised regarding the insurance industry's exemption and certain services provided by rate service organizations. This recommendation is made by the Attorney General in her letter, at pages 21-24.

C. Reinsurance

The same is true with the issue of reinsurance as with the antitrust issue in that the Attorney General felt many answers to the questions raised during the 1988 interim study were not complete. This recommendation for continuing the study is made by the Attorney General in her letter, at pages 25 and 26.

ACTIONS TAKEN BY THE JOINT SUBCOMMITTEE

The joint subcommittee agreed to recommend the introduction of legislation to cover five areas. Four of the five recommendations agreed to that require legislation relate to the issue of availability and

affordability. The fifth recommendation is a resolution to continue the study in all three areas that the subcommittee was requested to review under House Joint Resolution No. 120. See Appendix 13 of this report for copies of the legislative recommendations. The following are those recommendations requiring legislation:

1. To amend Subsection E of § 38.2-1905.1 of the Code of Virginia to allow the Bureau of Insurance, the Attorney General's Office and other parties more time to review data filed pursuant to 1235 Supplemental Reports before the Commission is required to hold a hearing to determine which of those lines of commercial liability insurance designated as potentially troubled are in fact troubled lines. The amendment to that section establishes September 30 of each year as the date by which the hearing must be held. Under current law, the Commission is required to hold a hearing 60 days after the due date of the 1235 Supplemental Reports. The State Corporation Commission indicated to the subcommittee that the current two-month period contained in this section during which the Bureau is required to complete its review of the data submitted on each potentially noncompetitive or troubled line pursuant to § 38.2-1905.2 was not sufficient. The Office of the Attorney General agreed. The insurance industry, although it had no strong feelings in opposition to this recommendation, pointed out that the more time that there is between the filing of the data and the holding of the hearing the older or staler the information becomes. The joint subcommittee's vote was unanimous to support this recommendation.

2. To amend Paragraph 7 of subsection E of § 38.2-1905.1 to eliminate the circular definition of the phrase "pattern of excessive rates" as currently exists between §§ 38.2-1904 and 38.2-1905.1. The recommended change would strike the word "excessive" in paragraph 7 and insert in its place "unreasonably high." At the meetings during the interim there was a significant amount of discussion concerning the interpretation of the wording of the two statutes and how the two statutes relate to each other. The joint subcommittee found that if one were to apply the § 38.2-1904 subsection A definition of "excessive rate" to the term "pattern of excessive rates" found in § 38.2-1905.1 E.7, it would lead to a circular definition and would make the "pattern of excessive rates" determination meaningless. It found that the pattern of excessive rates is but one factor that the State Corporation Commission may use under § 38.2-1905.1 to determine whether sufficient competition exists to regulate rates in the line effectively. Further, the subcommittee found that if the two-part definition of "excessive rates" in § 38.2-1904 is used to define "pattern of excessive rates" in § 38.2-1905.1 E.7, then the State Corporation Commission would first have to find that there was not a reasonable degree of competition in the line before it could use the "pattern of excessive rates" factor to determine whether competition was effectively regulating rates in that line. That is, the Commission would have to answer the competition question before it could use the factor. The joint subcommittee found that certainly the General Assembly could not have intended such a circular result. Both the Office of the Attorney General and the Bureau of Insurance agreed to this recommendation. The insurance industry was not in agreement with this change. The joint subcommittee by a seven to three vote agreed to this recommendation.

3. To amend § 38.2-1905.2 to require all insurers to file a supplemental report as established by H.B. 1235 of 1987. Under current law, only those insurers actually writing business in one of the troubled lines or subclassifications are required to submit a report. This change would state that any insurer licensed to write the classes of insurance as defined in §§

38.2-117 and 38.2-118 shall file such a report, provided, any such insurer that did not actually write any such designated line or subclassification of insurance in the Commonwealth during the reporting period shall be required only to report that it wrote no such insurance. The second change requested by this recommendation would be an amendment to provide that failure to file a substantially complete report shall constitute a failure to file a report. This recommendation was made to clarify a problem that arose during 1988 in trying to identify which licensed companies were obligated to file supplemental reports but did not. Because the current law only required those actually writing in such designated lines or subclassifications of insurance, it was difficult to tell from the records whether a company wrote no premiums for that line or subclassification or whether it just failed to file a report. Both the Office of the Attorney General and the Bureau of Insurance agreed to this recommendation, and the insurance industry voiced no strong objection to it. The joint subcommittee unanimously agreed to make this recommendation.

4. To amend § 38.2-2228.1 to establish a date by which the annual reports of all liability claims for personal injury and property damage covered under policies written by insurers must be filed with the Commission. The second change offered under this recommendation would provide that failure to file a report required under this section (which was originally established by H.B. 1234) would constitute a violation of the provisions of Title 38.2 of the Code of Virginia. The subcommittee found that the State Corporation Commission had concern under this closed-claim reporting statute that insurers could effectively argue that if they did not file these reports on time the Commission had no enforcement powers. The joint subcommittee decided that it should be clear that the Commission had the authority not only to set the date but to fine insurers if they did not file by the due date. Both the Commission and the Attorney General's Office agreed to this recommendation and the insurance industry stated that it had no objection. The subcommittee voted unanimously to agree to this recommendation.

5. That a resolution be drafted to continue this study in all three primary areas: the availability and affordability of liability insurance, reinsurance and antitrust. The Office of the Attorney General requested this recommendation to be made by the joint subcommittee. The Bureau of Insurance had no recommendation in this regard and the insurance industry opposed the recommendation. The subcommittee found that many of the questions raised during the interim regarding the insurance industry's exemption from the antitrust laws and in the area of reinsurance cost were not adequately answered during the course of the study. Also, members felt a need to continue to study the areas regarding certain services provided by rate service organizations to individual insurers, including the development of loss cost data and trending of that data. They felt that another year of study may provide the forum necessary to permit a more detailed examination of these issues. The joint subcommittee by an eight to two vote agreed to this recommendation.

Appendix 13 of this report contains the legislation introduced.

The following are those recommendations not agreed to by the subcommittee.

1. To amend § 38.2-1901, 38.2-1905.1E.5, 38.2-1906, 38.2-1908, 38.2-1913, 38.2-1916 and 38.2-1923 to prohibit rate service organizations from filing the trending of loss cost data for insurers. The recommendation would

have continued to allow rate service organizations to file developed loss cost data for insurers. The changes under this recommendation also would provide that the filing of loss cost data by rate service organizations would subject the line or subclassification of insurance to the "delayed effect" provisions of Chapter 19 of Title 38.2. This recommendation arose out of the antitrust issue and, more specifically, in an effort to balance the industry's legitimate need for development and trending of loss cost data against the potentially anti-competitive effect of such rate service organizations' conduct currently permitted by Title 38.2. This recommendation was an alternative approach to the removal of the industry's current exemption from the antitrust act. This approach addressed the prohibition against allowing rate service organizations to file trending factors regarding loss cost data. A compromise was reached between the Attorney General's Office and the Bureau of Insurance in making this recommendation. The compromise entailed (1) this prohibition against the rate service organizations' filing of loss trending factors which are predictions of changes in the frequency and severity of losses over time and (2) continuing to allow rate service organizations to file loss development factors which are adjustments to reserves to unforeseen escalations between the occurrence of a loss and its ultimate resolution. The recommendation, had it been agreed to, would have required each individual company to trend its own loss data independently. The compromise was conditioned upon the fact that the Attorney General would seek a recommendation to continue the study.

This recommendation was made by the Attorney General's Office and the Bureau of Insurance and was objected to by the insurance industry. The joint subcommittee by a nine to one vote decided not to agree to this recommendation.

2. To amend § 38.2-1905.1 to add after paragraph 8 of subsection E of that section a new paragraph which would require that the Commission find that there has been substantial compliance with the supplemental report requirements of § 38.2-1905.2 by insurers writing a troubled line before the Commission finds competition is in effect a regulator of rates for that line. The Attorney General offered this recommendation to the joint subcommittee and testified that the supplemental reports required under § 38.2-1905.2 are essential to enable the State Corporation Commission to determine whether, in fact, competition is effectively regulating rates in a potentially non-competitive line. The Attorney General pointed out that when there is not substantial compliance with the requirement for complete and timely supplemental reports the Commission is hampered in fulfilling its role under § 38.2-1905.1. The insurance industry observed that the effect of the change offered by this recommendation was a finding that competition does not exist solely on the basis of noncompliance. They stated that there can be significant competition but not adequate compliance and therefore the line would be declared noncompetitive. The industry representatives pointed out that they did not think that this was the way to deal with a violation of § 38.2-1905.2 and that current law already provided penalties for violations of noncompliance with the law. They urged that such noncompliance be dealt with in a manner already provided by law. On a five to five vote this recommendation failed.

3. To amend Paragraph 7 of subsection E of § 38.2-1905 in order to clarify that investment income on surplus may be considered at the competition hearing on a troubled line in order to determine whether a pattern of excessive rates exists. This recommendation was offered as clarifying in nature because there was some discussion concerning and confusion existing

whether investment income on surplus may be considered at the competition hearing. Due to the resolution of this issue between the Attorney General and the State Corporation Commission, it was felt by the subcommittee that legislation was not needed in this area. This recommendation was not voted on since it was felt, by all parties involved, that the Commission presently considers this factor in its deliberations and, therefore, the change to the law was not needed.

V. CONCLUSION

The joint subcommittee, in making these recommendations, notes that in 1987, several of the suggestions of the Joint Subcommittee Studying the Liability Insurance Crisis and the Need for Tort Reform and the Attorney General's state-based ratemaking and claims reporting proposals were enacted to address the crisis surrounding the affordability and availability of liability insurance in the Commonwealth. Members note that the 1987 enactments have proven to be positive steps. They find that the five recommendations for legislation that they are submitting to the 1989 General Assembly are further positive steps in order to assure that affordable insurance continues to be available to the citizens in the Commonwealth. Also, they find that more remains to be done and because of this they request that the study be continued for another year.

Respectfully submitted,

Thomas W. Moss
Richard L. Saslaw
Frank D. Hargrove
W. Tayloe Murphy
Lewis W. Parker, Jr.
William T. Wilson
John H. Chichester
Richard J. Holland
J. Granger Macfarlane
William F. Parkerson, Jr.
John Robert Hunter

APPENDICES

1. House Joint Resolution Number 120.
2. July 8 Statement by the Attorney General of Virginia.
3. September 21 Statement by Craig A. Berrington, Esquire.
4. September 21 Statement by Anthony F. Troy, Esquire.
5. October 27 Statement by the Attorney General of Virginia.
6. October 27 Paper on Reinsurance Submitted by Professor Kenneth S. Abraham.
7. October 27 Paper on Antitrust Submitted by Professor Kenneth S. Abraham.
8. November 23 Letter of Commissioner Steven T. Foster.
9. Industry Response to Questions Concerning Reinsurance.
10. Insurance Industry's Recommendations.
11. Bureau of Insurance's Recommendations.
12. Office of the Attorney General's Recommendations.
13. Legislation.

APPENDIX I

GENERAL ASSEMBLY OF VIRGINIA -- 1988 SESSION

HOUSE JOINT RESOLUTION NO. 120

Establishing a joint subcommittee to study the practices by which insurance companies reinsure all or parts of the risks they insure, the advisability of repealing the exemption from the Commonwealth's antitrust laws granting to the insurance industry, and means of assuring the continued availability and affordability of liability insurance coverage.

Agreed to by the House of Delegates, February 16, 1988
Agreed to by the Senate, March 2, 1988

WHEREAS, the ability to insure against risk contributes greatly to personal security and stable economic growth; and

WHEREAS, businesses and individuals in the Commonwealth have experienced difficulties in obtaining affordable insurance; and

WHEREAS, these difficulties have threatened to adversely affect the economic health of the Commonwealth; and

WHEREAS, a significant percentage of the insurance written by companies licensed by the State Corporation Commission to operate in the Commonwealth subsequently contractually transferred to other companies for purposes of reinsurance; and

WHEREAS, there is no existing legal mechanism to determine whether the expenses of insurance companies associated with reinsurance are reasonable; and

WHEREAS, the regulation of the insurance industry is a matter left exclusively to the states and in Virginia, to the State Corporation Commission; and

WHEREAS, the business of insurance, unlike virtually any other competitive industry, is exempted from most provisions of the antitrust laws of the United States and of the Commonwealth; and

WHEREAS, there is significant debate as to the merits of preserving this exemption and the effect which it has on insurance ratemaking and other insurance practices; and

WHEREAS, there is a need to determine whether the reinsurance practices of insurance companies and the exemption from the antitrust laws have negatively affected the availability and affordability of insurance; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That a joint subcommittee is established to study (i) the reinsurance practices of insurance companies; (ii) the advisability of repealing the insurance industry's exemption from the Virginia Antitrust Act; and (iii) the means of ensuring the continued availability and affordability of liability insurance in the Commonwealth.

The joint subcommittee shall consist of eleven members to be appointed as follows: five members from the House Committee on Corporations, Insurance and Banking to be appointed by the Speaker of the House; four members from the Senate Committee on Commerce and Labor to be appointed by the Senate Committee on Privileges and Elections; and two members representing the general public to be appointed by the Governor.

The joint subcommittee shall complete its work prior to November 15, 1988, and report its recommendations to the 1989 Session of the General Assembly.

The indirect costs of this study are estimated to be $13,255; the direct cost of this study shall not exceed $7,200.

APPENDIX II

Remarks before the House Joint Subcommittee on Insurance

July 8, 1988

ATTORNEY GENERAL MARY SUE TERRY

Mr. Chairman, members of the committee. Thank you for inviting me to appear before you here this morning.

I don't have to tell any of you how important the insurance issue is to us here in the Commonwealth.

The Virginia General Assembly has been in the vanguard nationally in the areas of insurance regulatory reform, and of tort reform.

Because of your work, Virginia's regulatory reform statutes are being used as models across the United States.

Because of your work, my Office has been asked to take a leadership role in a national organization that is working to make insurance more available and affordable for all Americans.

Now, you are being asked to do some more work. This committee has been asked to take the key leadership role in Virginia. And I am pleased to open these proceedings with a look at where we've been, and where we may wish to go.

First, the good news.

One of the most important tort reform measures supported by your predecessor, the Parkerson Committee, limited the liability of corporate officers and directors and granted immunity from civil liability to the officers and directors of certain charitable organizations.

These nonprofit organizations were having difficulty attracting volunteers to serve on their boards if liability insurance was not provided to them. The risk for these individuals was simply too great. However, D&O insurance costs were skyrocketing.

Upon the recommendation of my office and the Parkerson Committee, the General Assembly immunized all but willful misconduct for these individuals, and it limited to one year's salary the liability of paid officers and directors.

We are now evaluating the reach and effect of that legislation, and we hope to have definitive results later this year. The preliminary indications, I am happy to say, are encouraging.

Several nonprofit groups we have contacted have found their coverage more affordable, and one charity that previously found coverage unavailable has been able to purchase a policy.

Private colleges would appear to have felt the greatest impact. Washington & Lee's D&O premium renewal price from the same insurance company dropped from $31,000 to $24,800, and that institution was able to get five quotes. The lowest of them was one-third of the premium they paid in 1987.

Their broker said to us, "We have not found any underwriter that would concede that the legislation had anything to do with any change in their underwriting philosophy; however, the fact remains that Washington & Lee's situation is considerably improved."

Our preliminary survey bears out Washington & Lee's experience in two important areas:

1. The more sophisticated insurance consumers, and especially the private colleges, are experiencing the greatest savings, with premium decreases of 4 to 65 percent.
2. The decreases were most pronounced when the purchasers were aware of the new law, and discussed it with their agents or brokers.

Now, as we launch upon this new phase of our struggle with tort and insurance reform here in Virginia, it seems to me that this represents a good case study for the effects of tort reform.

This represented tort reform in its purest sense. It did not involve caps, it did not involve structured settlements.

This committee might like to know what impact this has had. It might be interesting to explore how the companies have taken this legislation into account.

If this type of legislation doesn't have an across-the-board effect on premiums, it calls into question the impact of tort reform standing alone.

Our Office will be surveying the industry to determine the impact on rates, and the Committee may wish to do so as well.

But based upon these preliminary findings, the message is clear: by itself, even decisive tort reform legislation will not bring down premiums. The insurance consumers must know about the changes, and use them to bargain with industry representatives who have no incentive to adjust their rates to compensate for tort reform -- even tort reform they themselves have advocated and lobbied for.

There is another area covered by recent legislation that I think bears our continued scrutiny. The news here is not exactly bad, but it certainly is mixed.

House Bills 1234 and 1235 -- the insurance regulatory reform package that passed in 1987 without a dissenting vote -- still are undergoing their shakedown runs.

We have a good relationship with the State Corporation Commission, and we are working hard to improve our relationship with the Bureau of Insurance.

As you know, my office plays two distinct roles with the SCC in these matters.

Under the law, we are charged with representing the interests of the consumer in rate cases and other proceedings before the SCC. And we have an equally vital role as a partner to the Commission and the Bureau of Insurance in the development of public policy concerning regulatory reform.

You have charged us in Va. Code, Sec. 2.1-133.1 not only with representing consumers, but with "making such studies related to enforcing consumer laws . . . as are deemed necessary to protect the interest of the consumer. . . "

In spite of the partnership, and the overwhelming mandate of the General Assembly, we still have a long way to go in implementing the reform legislation.

It appears that competition still is not an effective regulator of rates in a wide variety of commercial liability insurance subclasses, and there clearly are affordability problems in some lines, as well.

In December, the Bureau designated 17 lines and subclassifications as potentially troubled lines, with insufficient competition.

Under the law, carriers in these lines were required to file Supplemental Reports, detailing their level of activity and financial experience in Virginia as it affected those lines.

The disappointing news is that on May 1, when that additional data was due, many carriers -- we don't know many, unfortunately -- failed to file the required reports. This included the largest writer of legal malpractice insurance in Virginia -- which did finally file incomplete data several weeks late.

Over half of those that did respond filed reports that were so flawed that the Bureau rejected them as useless. Still other reports, while not rejected, were incomplete in ways that called their reliability and validity into question.

This, I would submit, is totally unacceptable.

The data reporting provisions were the heart of HB 1235. I would be disappointed in a process that found these lines of insurance to be competitive when the companies did not even submit the data you determined -- unanimously -- they should be required to submit.

Stonewalling by the insurance companies cannot be tolerated.

The crucial juncture is now before us.

Soon, the Bureau will be taking action with regard to the companies that failed to file, or that filed incorrectly.

I hope that the Bureau's response will be something stronger than a $250 fine.

As an advocate for the insurance consumers, we have taken the position before the SCC that these lines should be made subject to prefiling, and be declared noncompetetive.

This is more than justified, because the data, although incomplete, strongly point to the conclusion that the markets for these lines are highly concentrated and exceedingly profitable in ways that suggest the absence of effective competition.

Since so many companies failed to provide evidence of the effectiveness of competition, we have urged that all 17 lines be made subject to prefiling.

We are now awaiting a decision on this from the Commission, probably within the next month.

I am sure that these problems can and will be overcome. The General Assembly has made clear its wishes in this particular area, and it is up to us to carry them out. Rest assured, we will.

I mentioned earlier that your efforts in this area have placed Virginia in the national lead in a aggressive and thorough study of many facets of the insurance industry and its impact on consumers.

Last month, I was named chairman of the Committee on Insurance of the National Association of Attorneys General.

Twelve attorneys general, from states as diverse as Massachussetts and North Carolina, California and Iowa, serve on the panel. We will work together, looking to what you have done as a foundation.

My first official act was to call a meeting of the Committee, to be held here in Richmond this September. Our preliminary inquiries show that an unprecedented number of attorneys general and their staffs will take advantage of this opportunity.

I would like to take this occasion to invite members of this committee to participate in our sessions to the fullest extent possible.

It is gratifying to know that others around the country are looking to us for leadership.

But our primary concern, of course, is Virginia. And I, and those in my Office, look forward to working with this committee as you begin your examiniation of reinsurance industry practices, the state antitrust exemption, and the availability and affordabiity of liability insurance.

If I may, I'd like to take just a moment to give you a preview of what we will be presenting in these key areas.

Reinsurance -- insurance purchased by insurance companies in order to spread their risk -- is a business that most of us know little about.

It has recently been thrust into the national spotlight by a federal antitrust suit filed recently by 19 attorneys general.

But almost a year ago, we began examining the reinsurance practices of the leading insurance companies that were writing commercial liability policies in Virginia.

And we found, based upon preliminary data, that the forces of competition may not be working effectively in the reinsurance market.

Reinsurance is critical to the availability and affordability of commercial liability insurance.

I would hope that the insurance industry would agree that, whatever our differences on other issues, we should agree upon the need to control potentially excessive insurance costs.

At present, there is no satisfactory way to regulate reinsurance costs under Virginia law.

We suggest that the committee may want to consider ways of scrutinizing these costs, perhaps through reinsurance regulation, or perhaps by regulating the costs paid by primary insurers for reinsurance.

Secondly, you will be taking a new look at the insurance industry's substantial exemption from the antitrust laws of the Commonwealth and of the United States.

These exemptions permit rate service organizations to promulgate advisory rates, and even file rates on behalf of individual insurance companies.

Whatever Congress may do about repealing the federal exemption, it will be up to the General Assembly to decide whether it wishes to retain the exemption from our own antitrust controls.

You will be considering whether this exemption should be continued, or whether it should be discontinued because of its anticompetetive impact.

In the final analysis, of course, you will be considering what has been done -- and what needs to be done -- to ensure that liability insurance remains available and affordable for our businesses, professions, schools, and local governments.

John Wilson, an economist with exhaustive experience in the areas of insurance and utility reatemaking, will describe the operation of the insurance markets, the role of reinsurers, and the economic implications of the present antitrust exemptins enjoyed by insurance companies.

Next, Professor Ken Abraham, who teaches insurance law at the University of Virginia, will outline the legal structure in the areas you will be studying.

And finally, my Chief Deputy, Lane Kneedler, will sketch for you some of the possible options and approaches the Committee may wish to study in meeting its charge.

Thank you.

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STATEMENT OF THE AMERICAN INSURANCE ASSOCIATION

TESTIMONY
OF
CRAIG A. BERRINGTON
GENERAL COUNSEL
AMERICAN INSURANCE ASSOCIATION
BEFORE THE
VIRGINIA JOINT SUBCOMMITTEE STUDYING REINSURANCE,
THE INSURANCE ANTITRUST EXEMPTION, AND THE
AVAILABILITY AND AFFORDABILITY OF LIABILITY INSURANCE
RICHMOND, VIRGINIA
WEDNESDAY, SEPTEMBER 21, 1988
10:00 a.m.

American Insurance Association

The American Insurance Association is a national trade organization of casualty insurers.

PROFILE

The American Insurance Association is a full-service trade organization of casualty insurance companies. In its present form, the association combines three earlier organizations. One of those, the former National Board of Fire Underwriters, was organized in 1866, making it one of the oldest trade associations in the nation.

The various departments provide members with up-to-date intelligence on legislative, regulatory, judicial and technical developments relating to our industry. The AIA also maintains liaison with insurance regulators, federal and state lawmakers, other state and federal government officials, insurance and non-insurance industry groups and media—supplying information and assistance on issues of mutual concern.

A countrywide system of regional offices and local legislative counsel ensures prompt and rigorous attention to casualty insurance matters. At the same time, technical specialists from disciplines as diverse as law, economics and engineering educate members and outside publics on developments that may affect the industry and its services to the insurance-buying public.

TESTIMONY
OF
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GENERAL COUNSEL
AMERICAN INSURANCE ASSOCIATION
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VIRGINIA JOINT SUBCOMMITTEE STUDYING REINSURANCE,
THE INSURANCE ANTITRUST EXEMPTION, AND THE
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10:00 a.m.

Thank you, Mr. Chairman. My name is Craig Berrington. I am General Counsel of the American Insurance Association ("AIA"). AIA represents major property and casualty insurance companies across the United States and, along with the Insurance Information Institute, was pleased to sponsor the important debate you will be seeing on videotape about the insurance antitrust litigation and public policy. I appreciate the opportunity to be here today to give you AIA's perspective on the insurance antitrust litigation brought by the attorneys general of several states and to comment on the importance of the McCarran-Ferguson Act to the insurance industry and how it relates to the Virginia antitrust statutes and insurance code.

I applaud Virginia Attorney General Terry's decision not to join in the antitrust lawsuit, opting instead to address industry public policy issues with legislation rather than litigation. Mr. Chairman, we heartily agree that the debate on this complex issue properly belongs before you and your colleagues in the Virginia Legislature, not in federal court in California.

When the AG's first announced their lawsuits last March, they declared that their action held the key to the liability insurance crisis of the early to mid-1980's. In reality, Mr. Chairman, this litigation is quite narrow and technical and primarily concerns three issues: (a) the development of the claims-made version of a new commercial liability insurance policy; (b) the continued availability and content of the 1973 occurrence form version of the commercial liability

insurance policy; and (c) a clause that excluded pollution coverage from those policies.

While AIA is not a defendant in this litigation and is not speaking for them, we believe that the lawsuit raises important public policy questions about the role of state regulation of insurance, the extent of competition in the insurance business, and the true causes of the liability crisis. We cannot litigate the case here, today -- and should not try -- but we can discuss these underlying issues in the context of the litigation. There are six points I would like to make.

First, there is no need to amend Virginia antitrust law to respond to the issues raised by Attorney General Terry and the AG's lawsuit because the state insurance code already embraces a comprehensive regulatory scheme designed to foster competition and prohibit anticompetitive conduct. Insurance has been extensively regulated by the states since the mid-1800's. More than forty years ago, the primacy of state insurance regulation was reaffirmed by Congress when it swiftly enacted the McCarran-Ferguson Act in the wake of the Supreme Court's 1944 decision in United States v. South-Eastern Underwriters Association, 322 U.S. 533 (1944). Prior to this case, it was assumed that the issuance of an insurance policy was not a transaction in interstate commerce and that the states enjoyed a virtually exclusive domain over the insurance industry.

South-Eastern Underwriters reversed that view and held that a fire insurance company conducting a substantial part of its transactions across state lines was engaged in interstate commerce and that Congress did not intend to exempt the business of insurance from the reach of the federal antitrust statute, the Sherman Act. This decision raised widespread concern that the states would no longer be able to engage in taxation and effective regulation of the insurance industry.

Within a year of South-Eastern Underwriters, Congress passed the McCarran-Ferguson Act, carving out a limited exception to the federal antitrust law for the "business of insurance" to the extent that such business was regulated by state law. However, it provides that "boycott, coercion, or intimidation" are not exempt from federal antitrust enforcement, even if there is state insurance regulation.

The theory behind McCarran-Ferguson is that insurance is fundamentally different from other businesses because insurance requires the pricing of a product today based upon the prediction of costs in the future. Thus, collective activity to obtain data, analyze it, and develop common policy forms would promote more responsible pricing and, therefore, the public interest. The McCarran-Ferguson Act's legislative history amply demonstrates that the collective development of policy forms was one of the cooperative activities recognized by Congress as exempt from the antitrust laws. Further, the Supreme Court and lower courts have held that form standardization is protected

under the Act. Further, the development of standard policy forms is the only way to collect comparable data.

The state analogue of the federal antitrust law is the Virginia Antitrust Act, Va. Code §§ 59.1-9.1 to -9.18. The Virginia statutes prohibit such anticompetitive activities as contracts, combinations and conspiracies in restraint of trade; monopolies; and price discrimination. Recognizing that certain regulated industries may require a more finely tuned approach to policing market conduct, the Legislature exempted conduct authorized, regulated or approved by a state statute or by a state or federal administrative agency having jurisdiction of the subject matter and authority to consider the anticompetitive effect of such conduct. Va. Code § 59.1-9.4(b). Although no Virginia court appears to have construed this subsection, the Court of Appeals for the Fourth Circuit interpreted the phrase "authorized, regulated or approved" quite broadly. Williams v. First Fed. Savings & Loan Ass'n, 651 F.2d 910, 931 (4th Cir. 1981) (statutory requirement calling for prominent display of notice of due-on-sale clause in mortgage or deed of trust suffices to insulate such clauses from Virginia antitrust law).

In my view, the public policy reflected in subsection (b), when read in conjunction with the Virginia insurance code, amply protects the citizens of this state from anticompetitive practices by the insurance industry. A review of insurance rating laws demonstrates the balance struck by the Legislature

between preserving competition and the need for cooperative activity essential to the business of insurance.

Among the purposes of the rating law, as set forth in § 38.2-1900(B) of the insurance code, are to authorize cooperative action among insurers in the rate making process, to regulate such cooperation in order to prevent practices that tend to create monopoly or lessen or destroy competition, and to regulate the business of insurance in a manner that will preclude application of the federal antitrust laws.

Insurers and rate service organizations, like ISO, are explicitly prohibited under § 38.2-1916(B) from monopolizing or attempting to monopolize the business of insurance as well as making agreements to fix insurance rates, agreements unreasonably restraining trade, agreements that may substantially lessen competition, or agreements to refuse to deal with any person. Section 38.2-1924 authorizes cooperation among rate service organizations or among rate service organizations and insurers in rate making or in other matters within the scope of the rating statute. All such activities are subject to review by the State Corporation Commission ("SCC"). Subsections 38.2-1916(D) and (E) prohibit rate service organizations from interfering with insurers' right to make rates independently or from requiring members to adhere to any of its rates, policy forms, or underwriting rules. Section 38.2-317 requires that insurance policies and endorsements used in Virginia are subject to review by the

Commission and must filed at least 30 days prior to their effective date.

It is against this comprehensive statutory and regulatory backdrop that Attorney General Terry's efforts to amend Virginia's antitrust laws must be examined. I have reviewed the minutes of the Subcommittee's July 8th meeting at which John Wilson, Professor Kenneth Abraham, and the Attorney General testified. At that time, Professor Abraham presented the Subcommittee with two alternative "solutions": (1) eliminate the antitrust "exemption" or (2) limit the "exemption" by "carving out" the authority for insurers, through rate service organizations, to pool historical data regarding claims but not to develop rates. Mr. Tony Troy, a Virginia Antitrust Act expert with the law firm of Mays & Valentine and one of the Act's chief architects, is with me today, and he will be addressing the ramifications of these proposals.

Let me just say, Mr. Chairman, that no matter how hard the Attorney General tries to characterize the treatment of insurance under the Virginia antitrust and insurance laws as an "exemption," the simple truth is that the business of insurance is <u>not</u> exempt from state antitrust scrutiny. Monopolization, agreements to charge or adhere to any rate, agreements in restraint of trade, agreements that may substantially lessen competition, and refusals to deal are all clearly prohibited under the present insurance code.

Amendment of the state antitrust laws will disrupt the current statutory scheme that balances the public's interest in promoting a competitive insurance marketplace against the insurers and rate service organizations' vital need to develop policy forms and rates cooperatively and to share loss data -- activities conducted under the watchful eyes of the insurance commissioner and the SCC. In fact, the SCC's 1987 report to the Legislature specifically found that the property and casualty industry was competitive and that there was no evidence of anticompetitive behavior. In my view, prohibiting these critical cooperative activities will diminish competition, not enhance it.

Second, the cooperative activities leading to the development of the claims-made form at issue in the AG's antitrust lawsuits were both sanctioned by state insurance law and closely supervised by state insurance authorities. It is important to understand that the guts of the AG's lawsuit is the assertion that the process for developing the claims-made form for commercial liability insurance violated the antitrust laws. But, Mr. Chairman, in truth, it was undertaken pursuant to state law, enacted under the federal umbrella of the McCarran-Ferguson Act, and closely supervised by state insurance commissioners to assure that the public interest would be served.

It is extraordinary that litigation should now be brought by one group of state officials -- AG's -- to hold these defendants liable for their participation in state-authorized

"insurance form development process" controlled by another group of state officials -- the insurance commissioners. Let me explain.

Under McCarran-Ferguson the insurance code of every state -- including Virginia and the states of the AG plaintiffs -- has authorized cooperative activity to develop insurance policy forms, including the claims-made form. In addition to authorizing such collective activity, most state insurance codes specifically require that those forms be filed with insurance commissioners and approved by them. In every state, the insurance commissioner has the authority to prohibit, for good cause, the continued use of an insurance form. Further, insurance commissioners are authorized to disapprove and enjoin any activity by an insurer or rating organization that is unfair, deceptive, or discriminatory.

Mr. Chairman, these are very broad and powerful laws. Not only were these laws on the books empowering insurance commissioners to oversee the development of insurance policy forms, but those powers were, in fact, exercised energetically and forcefully throughout the entire process. From the beginning of ISO's research in 1977 on developing these new forms, through its publication of "Exposure Drafts" in 1982 and the intense debate that followed, the state insurance commissioners controlled the outcome.

They held hearings in many states. In addition, under the auspices of the Illinois Insurance Commissioner, large public

hearings were held in Chicago in July 1985, where representatives from all points of view were closely questioned by a panel of 18 insurance regulators. This exercise of insurance commissioner authority was unprecedented. In the year following the debate, 44 states approved the claims-made form and 48 approved the occurrence policy. Among the states not approving a claims-made policy were New York, Massachusetts and Texas [check Va.]. Thus, insurance commissioners made independent judgments based on their determination of the public interest in their own states.

This is a picture of a regulatory system working as it should, with insurance commissioners closely overseeing the process, making decisions, and permitting only those claims-made policy forms to be used that they thought were consistent with the public interest.

Third, cooperative activity to develop insurance policy forms serves the public interest and does not constitute a "boycott" under the McCarran-Ferguson Act. Supreme Court and federal case law, as well as the legislative history of the McCarran-Ferguson Act, amply demonstrate that an agreement concerning the terms of policy coverage, as well as decisions not to issue a particular policy form, do not constitute an illegal boycott. In St. Paul Fire & Marine Ins. Co. v. Barry, 439 U.S. 531 (1978), the Supreme Court defined "boycott" as a concerted refusal to deal on any terms. The Court made clear that

"boycott" does not include decisions by insurers on what terms of coverage they will offer, or what terms will be placed in the standard form policy. That point was re-emphasized just recently in UNR Industries, Inc. v. Continental Ins. Co., 607 F. Supp. 855 (N.D. Ill. 1984), motion denied, 623 F. Supp. 1319 (N.D. Ill. 1985), where the federal district court, held that allegations of an actual agreement among insurers to market a new claims-made policy -- an allegation broader than that made here -- failed to state a federal antitrust claim. In dismissing the plaintiffs' argument, the court stated: "[A]n agreement to change to a new type of policy is not a boycott and does not constitute coercion or intimidation. . . ." 607 F. Supp. at 862.

The legislative history of the McCarran-Ferguson Act is also clear that agreements concerning terms of coverage do not constitute a boycott. In Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205 (1979), the Supreme Court emphasized that the drafters of the legislation intended to exempt from antitrust attack certain cooperative activities regarding insurance, including the development of policy forms.

Thus, Mr. Chairman, the AG's are obviously straining to transform into a "boycott" the legitimate, state-sanctioned decisions by insurers on the terms of coverage of an insurance policy form. Neither the facts nor the law support that attempt. What the plaintiffs are really doing is misusing the "boycott" exception to attack the legitimacy of state insurance regulation.

The Texas boycott allegations raise even more public

policy concerns. The Texas suit, uniquely among the suits filed, claims that the defendants violated the antitrust laws by advocating changes in the Texas tort system. This claim is wrong and endangers our constitutional rights of free speech and to petition the government. There is an absolute constitutional right to make advocacy statements and for competitors to join together to advocate changes in the law. Under the Supreme Court's Noerr-Pennington doctrine, it is clear that no violation of federal antitrust laws can be predicated on lobbying and other similar concerted political activity by businesses to obtain legislative or executive action. The Texas claim appears to us to be essentially an effort to silence advocates of Texas tort reform. It, therefore, raises unsettling questions about the proper use of governmental power to harass and intimidate individuals engaging in legitimate political activity simply because certain public officials disagree with the opposition's view on important policy issues.

Fourth, although the lawsuit asserts that illegal insurer activity caused the reduction of pollution insurance availability, it is clear that this availability problem was caused by broad judicial interpretation of narrow pollution coverage, not by any "conspiracy." The complaint alleges that a conspiracy of the defendants caused the availability of pollution coverage to be eliminated or drastically reduced. I read this part of the lawsuit with utter disbelief. Those who have studied

the issue know why pollution coverage was -- as a practical matter -- eliminated from the general commercial liability insurance policy. It is not a secret. And it was no conspiracy. It resulted from court decisions. The ISO policy for commercial liability insurance had included a pollution exclusion dating back to the early 1970's. That exclusion was subject to an exception for "sudden and accidental" pollution events. If the discharge of contaminate was both "sudden" and "accidental," the damages from that discharge would be covered.

But, as exemplified by the now notorious Jackson Township case, Jackson Twshp. Mun. Util. Auth. v. Hartford Accident and Indem., 451 A.2d 990 (N.J. Super. Ct. Law Div. 1982), courts ignored the term "sudden" and ruled that the pollution exclusion clause did not bar coverage for incidents which developed over a long period of time (in some instances decades). As insurers could no longer rely on an appropriate and predictable interpretation of this policy language, they generally decided the policy language needed to be changed. But this change, too, was only put into effect where state insurance commissioners determined that it would be proper to do so. At the same time pollution coverage, whether nonsudden or sudden and accidental, continued to be covered by a separate pollution liability policy solely covering pollution risks.

Fifth, contrary to the AG's assertions, the insurance industry is highly competitive by every standard measure of

market structure and performance. I will not belabor this point today because I know that one of the nation's foremost insurance economists, Professor Scott Harrington, appeared before you last month to discuss competition in the insurance and reinsurance markets.

Briefly, let me highlight several indicators of the industry's competitiveness. The level of concentration in the industry is low. There are over 3500 property and casualty companies operating in the United States, and none of them has a market share in excess of 8.6%. Profits in the industry, although cyclical, are on the average below that of other industries. For example, from 1970 to 1985, a period that encompassed two complete underwriting cycles, the average return on net worth was 10.1% for the property/casualty insurance industry, compared to 11.8% for the group of noninsurance industries. The insurance industry fell within the bottom third of profitability ranking of all-industries.

Sixth, and perhaps most important, the causes of the liability crisis lie beyond both the allegations made by the AG's in their lawsuit and their public pronouncements. The AG's say that insurance industry collusion caused the liability crisis. But that contention has been rejected by economists and antitrust experts, as well as government regulators and commissions.

The liability insurance crisis of the mid-1980's occurred at the bottom of an insurance cycle. This particular cycle was unparalleled in its duration and severity. The reason for this unprecedented severity is clear: the naturally cyclical tendency of the industry was severely exacerbated by conditions in the national economy, generally, and the expansion of tort liability over the previous decade.

The insurance underwriting cycle is partially a reflection of, indeed an inseparable part of, the business cycle that characterizes a free market economy. During the late 1970's and early 1980's, our nation's economy was in deep trouble. Growth and productivity were stagnant. Interest rates, at times reaching double digits, was higher than it had been since the Civil War. The economy went into the deepest recession since the Great Depression, and then interest rates plunged. No other industry was immune from the roller coaster effects of this economic dislocation. It is simply unreasonable to expect that the insurance industry should have been immune too.

But the property/casualty insurance industry had to cope with more -- a decade long expansion of tort liability and an increase in average tort awards that outstripped the real growth in the GNP. At a time when premium volume remained constant, due largely to competitive forces and the impact of the trough in the nation's business cycle, losses increased dramatically.

Accompanying this increase in paid losses was the decline in predictability with respect to future losses. Insurers have substantially diminished confidence that they, or anyone else, can predict which legal doctrine will be the next to fall in a given state, the rate at which the new doctrine will spread from state to state, and the effect each of these will have on claim frequency and claim severity. Faced with record underwriting losses and eventually, falling rates, it was easy to predict that prices would have to rise if the industry was to survive.

This was no conspiracy, Mr. Chairman. It simply proves what should be self-evident: that insurance mirrors the economy in which it operates and the liability system it underwrites.

Thank you very much. I would be delighted to answer any questions you might have.

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APPENDIX IV

THE VIRGINIA ANTITRUST EXEMPTION FOR INSURANCE

REMARKS BY

ANTHONY F. TROY
COUNSEL FOR
THE AMERICAN INSURANCE ASSOCIATION

BEFORE THE

VIRGINIA JOINT SUBCOMMITTEE
STUDYING REINSURANCE, THE INSURANCE
ANTITRUST EXEMPTION, AND THE
AVAILABILITY AND AFFORDABILITY
OF LIABILITY INSURANCE (HJR 120)

GENERAL ASSEMBLY BUILDING
910 CAPITOL STREET
RICHMOND, VIRGINIA

WEDNESDAY, SEPTEMBER 21, 1988
10:00 A.M.

Mr. Chairman, members of the Committee, on behalf of my client, the American Insurance Association - which represents approximately 175 property and casualty companies - I appreciate the opportunity to appear before you this morning.

In 1972 and 1973 I had the privilege of serving as vice chairman to the VALC committee charged with studying and reporting on the antitrust and monopoly laws of the Commonwealth. That Committee, which was formed pursuant to the 1972 HJR 53, was chaired by then Delegate and now Judge Russell M. Carneal and included among its members Delegate Mary Marshall, who as you know, was an economist with the Department of Justice Antitrust Division, John H. Shenefield, who eventually became the Assistant Attorney General in charge of the Antitrust Division, and also then Senator and now Judge J. Harry Michael Jr. After a thorough two year study, the Committee submitted its report (H. Doc. 20 of the 1974 Acts of Assembly) and the General Assembly enacted, effectively intact, the recommendations which today constitute the Virginia Antitrust Act, Sections 59.1-9.1-9.18.

Substantively the recommendations of the Committee, as adopted by the General Assembly, had one major and highly desirable attribute. In contrast to the statutes of some other states, which enlarge the area of business conduct subject to treatment as per se unlawful, the Virginia statute chose a route of moderation and adapted in large part those provisions of the Federal Antitrust laws that relied principally upon the standard of reasonableness. Consequently, as a result, business conduct in the Commonwealth, that is reasonable and in compliance with Federal laws, would also be in conformity with the concepts of the Virginia Antitrust Act. In short, businesses in the Commonwealth did not have to concern themselves with two different standards of business conduct; one for compliance of Federal law and one for the Commonwealth. This is a highly desirable attribute, especially for businesses that must conduct themselves in a multistate or nationwide market, and it is an attribute that is conducive to economic growth here in the Commonwealth.

The same concept of ensuring uniformity and compatibility with various statutes at the Federal and State level was followed by the Committee in its recommendations of exclusions and exemptions from the State Antitrust Act as set forth in Section 59.1-9.4 of the Code of Virginia. Contrary to statements made by others who have appeared before this Committee, there is, in the Virginia Antitrust Act, no specific exemption for the insurance industry, nor is there a "state McCarran-Ferguson provision"; rather, the approach taken by the VALC and adopted by the General Assembly was to exempt from the Antitrust Act any conduct that is "authorized, regulated or approved (1) by a statute of this Commonwealth, or (2) by an administrative or constitutionally established agency of this Commonwealth or of the United States, having jurisdiction of the subject matter and having authority to consider the anticompetitive effect, if any, of such conduct."

To ensure the concept of uniformity, the Act further provided that nothing in the exemption would be intended to

alter, amend or modify any other exemptions otherwise existing. In short, however, it is obvious that the antitrust exemption is not one unique to insurance, but rather is applicable to numerous industries which gain a measure of exemption from antitrust, including, among others, the electrical industry, gas, water, telephone, air, motor and rail carriers, pipelines, ocean shipping, water carriers, stock exchanges, television and radio communications, banking, and a host of other industries including the insurance industry. For example, every industry regulated by the State Corporation Commission, including the mortgage lending and brokerage industry that was just added, gains a degree of exemption from antitrust laws, both state and federal (state on the basis of Section 59.1-9.4(b) and federal on the basis of the Parker Brown doctrine) to the degree that they are regulated.

In view of the broad implications of the existing structure of the antitrust laws of this Commonwealth, as well as the exceptions and exemptions that are built into that law, this Committee should closely and carefully contemplate the

consequences of adopting actions so cavalierly suggested by the Office of the Attorney General and its expert, Professor Abraham, when they suggest that you simply repeal all immunity completely. The alternative suggestion proposed of "carving out" the insurance industry from the exemption is more nebulous a proposal. It is not clear how such a proposal would operate, nor have the proponents for such alternative proposed any draft legislative language to accomplish such suggestion. Let us presume, however, that a proviso would be added to the exemption now set out in Section 59.1-9.4 of the Virginia Antitrust Act, stating that "provided, however, that the provisions of this section shall not be applicable to the insurance industry". What has been accomplished by the addition of such a proviso? I would suggest that the answer substantively is nothing, though I would be quick to add as a trial attorney that such a proviso would generate a noteworthy amount of litigation and be a boon to my profession; it would do nothing for the Virginia consuming public. Both the Office of the Attorney General, as well as

Professor Abraham, attempted to suggest that the non-applicability of the Virginia antitrust exemptions to the insurance industry would accomplish something - specifically, the ability of the Commonwealth to apply their own "antitrust laws". This statement, however, fails to analyze a number of antitrust concepts and is simply conclusory at best.

As indicated, the main philosophy of the Virginia Antitrust Act is that it is to be applied as consistently as possible with the principles and concepts set forth in the almost 100 years of the enforcement of the Federal Sherman Antitrust Act. This concept is set forth not only in the House Document 20 report of the VALC Committee, but also specifically in Section 59.1-9.17 which states that with regard to the construction of the chapter that it "shall be applied and construed to effectuate its general purposes in harmony with judicial interpretation of comparable Federal statutory provisions." More explicitly, the purpose of the exemption in Section 59.1-9.4(b) was "to ensure that the State antitrust laws will not conflict unnecessarily

with other statutes or regulatory schemes." See House Document 20 (1974), Acts of Assembly at 9.

Whether, in the antitrust parlance of "state action" (See Parker v. Brown, 317 U.S. 341 (1943)) or primary jurisdiction (See, for example, Hughes Tool Co. v. TWA, 409 U.S. 263 (1973) (regulatory jurisdiction of the then CAB exempted conduct of airline from antitrust scrutiny), or partial accommodation of antitrust laws (See, for example, Ricci v. Chicago Mercantile Exchange, 409 U.S. 289 (1973) (commodity exchange commission should make adjudication of facts within jurisdiction to aid antitrust court in deciding whether applicability of antitrust standards and remedies are consistent with statutory schemes), or the concepts of regulation and antitrust principles both being applicable; see, for example, Ottertail Power Company v. United States, 410 U.S. 366 (1973), or simply the Federal doctrine of pre-emption (see, for example, Schwegmann Brothers v. Calvert Distillers Corp., 341 U.S. 384 (1957) (state statute which substitutes public regulation for

private competition one thing, but state activity which merely seeks to free an industry from strictures of antitrust laws on the basis of a state judgment that in some sectors competition is not preferable will be invalid and pre-empted by Sherman Act) or whether one simply analyzes standard principles of construction such as, all statutes should be construed in harmony with each other; see Sutherland on Statutory Construction, Section 53.01, or that a specific statute will control over a more general statute if they are in conflict, regardless which one was enacted last, see Sutherland on Statutory Construction, Section 51.05, or that repeal of one provision is not presumed to repeal all other provisions, see Sutherland on Statutory Construction, Section 23.06, or the simple golden rule of statutory construction that one should give meaning to all statutes and the words all statutes to the extent feasible; see Sutherland on Statutory Construction, Section 45.12, it is obvious that "carving out" the insurance industry from the exemption currently set forth in the Virginia Antitrust Act accomplishes nothing other than confusion.

There would still remain the numerous statutory provisions regulating insurance as set forth in Title 38.2 of the Code of Virginia. It is obvious that under the antitrust concepts that I have outlined above or the principles of statutory construction that I have outlined above, these provisions of the insurance code would still be in existence and should prevail over any antitrust exemption or non-exemption, and would have to be applied and enforced. To the extent that a court may hold otherwise confusion would simply be further exasperated; such confusion would be of little benefit to consumers.

Remember that the only thing that the exemption does is to ensure that there is not unnecessary conflict between the antitrust act and other provisions of state law. The exemption, in my opinion simply makes explicit what the law and principles of statutory construction would make implicit, and that is that the more specific statutes in the insurance code should be given meaning and should prevail over the more general principles in the state antitrust act.

The reason for that, of course, is that it is presumed that the General Assembly, in mandating certain actions to be taken in the insurance code, recognizes the competitive or non-competitive impacts of such statutory mandates and requirements and it is presumed that the General Assembly intended those consequences. In short, this is really nothing more than what the McCarran-Ferguson Act, already allows. See 15 U.S.C. Section 1012. Other speakers will comment more extensively on the McCarran-Ferguson Act, but let me very quickly remind the Committee that first the insurance industry itself is not exempt from the antitrust law as a result of this act, but rather only the "business of insurance." Secondly, under the McCarran Act, regardless of what conduct is or is not undertaken by the insurance company, no conduct which would constitute any agreement to boycott, coerce or intimidate would be granted any sort of exemption from the antitrust laws, and thirdly and most importantly from the perspective of this Committee, it should be remembered that the McCarran-Ferguson Act exempts the business of

insurance only to the extent that such business is regulated by state law, (or as stated in the McCarran-Ferguson Act, the Sherman Act and similar Federal antitrust acts shall be applicable to the business of insurance "to the extent that such business is not regulated by state law";) consequently this General Assembly has within its power the ability to determine exactly what activity will or will not be subject to antitrust principles. If it desires that the full breadth of the antitrust laws be applicable to the insurance industry it can simply completely and totally deregulate the insurance industry and the full panoply of federal antitrust laws would become applicable to each and every aspect of all business transactions of the insurance industry. I doubt, however, Mr. Chairman, that this Committee nor this Assembly is ready to throw the industry in such a "briarpatch". Consequently, what provisions of the insurance code as opposed to the antitrust code should be modified or repealed? Those decisions, as indicated, are solely within the determination and legislative prerogative

of the Assembly. I'm sure, however, that the Assembly is not desirous of tampering with the provisions of Chapter 7 of Title 38.2, which prohibit certain interlocking directorships or certain mergers which might substantially lessen competition or tend to create a monopoly, nor for that matter the Assembly probably would not want to tamper with the provisions in Title 38.2 dealing with the ISO and similar rate service organizations, which prohibit those organizations from monopolizing the business of insurance, fixing insurance rates, unreasonably restraining trade, refusing to deal or interfering with insurers rights to make rates independently. See Section 38.2-1916.

As but a slight aside, since others will speak in more detail on the ISO aspects, let me emphasize, if I may from an antitrust concept, the economic impact in the marketplace of disseminating prices; I emphasize this because of some of the comments and suggestions that have been alluded to which effectively would abolish rate service organizations and their ability to operate. Professor Lawrence Sullivan, in his

antitrust hornbook series, discusses the economic effects of disseminating prices. He gives two hypothetical examples of price dissemination in different industries. The first industry is made up of approximately only 20 producers, all in one geographic region who approximately 40 years ago, constituted a cartel which was abandoned because of extensive cheating and fear of government prosecution. In the contrasting example, there are in excess of 3,000 relatively small sellers throughout the nation grouped in geographic regions who sell to several thousand buyers throughout the country. In the first hypothetical, Professor Sullivan emphasizes that any statistical type program of price dissemination could be characterized as a covert price fixing agreement, but in the large diversified industry, Professor Sullivan emphasizes the following and states that one should "mark this point" -- that "the wide and rapid dissemination of price and related information is one of the prerequisites for a competitive market. If most of the other prerequisites (most importantly, a large number of buyers and sellers, none with a

substantial market share, and a non-differentiated product) are present, the tendencies toward competitive behavior can be expected to be strong; adding the prerequisite of widespread information can be expected to make the market work more competitively. ... better information facilitates more rational self-interested conduct by the firm acting on the information." In short, it is not the conduct that is determinative, but rather an analysis of industry structure which would be critical to any prediction of a rational response. See Sullivan on Antitrust, Section 94 at 268. This type of information I hope would be stressed by this Committee before any visceral recommendation is made to abolish ratemaking organizations and their functions.

Let me close by adding one more comment regarding any potential "carving out" of the insurance industry for supposed applicability of the state antitrust laws. (As indicated, I think any such action by this Assembly would not have the intended effect) but let's assume that a court would hold otherwise. Let's recognize what would happen and call it what it

is - a turf war between the Bureau of Insurance and the Office of the Attorney General for the ultimate regulation of the insurance industry. Currently the Code contemplates that the Attorney General will be a consumer advocate before the State Corporation Commission. In that relationship the Attorney General will play an adversarial role either against the affected industry or against the specific Bureau within the State Corporation Commission that would be making recommendations regarding regulation of any specific industry, be it insurance, banking or utility ratemaking. The SCC sits in a judicial capacity determining on the basis of the advocacy presented and the facts and the applicable law, policies to be implemented in accordance and within the statutory guidelines that are now set forth by the General Assembly. True, the Attorney General, in Section 2.1-133.1 is also charged with making such studies related to enforcing consumer laws as are deemed necessary to protect the interests of the consumer, but those are studies which would recommend to this Assembly appropriate action to be taken on

behalf of consumers. That is a far cry from the Attorney General herself taking on a regulator role, and in fact this Assembly already recognized such a potential problem by emphasizing that the role of the Attorney General as an advocate shall in no way limit or alter the duties of any governmental body that the office appears before. See Section 2.1-133.3. If an exemption is abolished for the insurance industry, you will effectively allow the Office of the Attorney General to determine its own policy, guided only by the hand of their own interpretation of economic competitive principles, which will, in large part, on occasion clash with the regulatory scheme being enforced by the Bureau of Insurance, -- the agency most knowledgeable and with the greater expertise in the insurance field. That type of turf war will not inure to the benefit of any consumer and should be avoided.

APPENDIX V

REMARKS OF
ATTORNEY GENERAL MARY SUE TERRY
BEFORE THE
HJR 120 JOINT SUBCOMMITTEE STUDYING INSURANCE

OCTOBER 27, 1988

Mr. Chairman, a great deal has transpired on the liability insurance front over the past 12 months.

On the recommendation of the Bureau of Insurance, the SCC issued its first troubled lines report to the General Assembly, and found that there were indications of problems in just 17 of the hundreds of liability sublines written in Virginia.

The Bureau had its first experience collecting data from the industry, and along with our Office, had its first opportunity to sort through the data and make recommendations to the Commission as to which lines merited special ratemaking protection.

Since then, the Commission has applied the statute to determine that certain lines would receive special ratemaking protection, while others will not.

Meanwhile, A.M. Best, the Standard & Poor's of the insurance industry, has reported another year of low general liability insurance loss ratios, suggesting record profits for insurers in Virginia.

So where does that leave us?

The fundamental principle of law that guides all of us who are a part of the ratemaking process, and which serves as a North Star for our efforts, has been on the books in Virginia for at least 40 years. It states simply -- but absolutely unequivocably -- that "rates...shall not be excessive, inadequate, or unfairly discriminatory."

House Bills 1234 and 1235 were adopted unanimously by the General Assembly in 1987 as tools to ensure that this last principle of law prevails, not simply as words in the Code, but as a reality in the marketplace.

So what is reality in the marketplace?

It is as if we are playing the same old record, and the needle has stuck. You will note from the chart depicting historic loss ratios that Virginia has a rather undistinguished history of permitting excessive liability insurance rates in general liability lines.

I would like to be able to say that we have seen a reversal in that trend over the past year. But despite a softening in the market, and a reduction in some rates of 20 to 35 percent, profitability remains excessively high.

In 1987, for example, the incurred loss ratio for general liability insurance in Virginia was 59 percent. The cash loss ratio was 17 percent.

These are roughly the same ratios we had two years ago.

Mr. Chairman, we believe -- indeed, it is axiomatic -- that on a $450 million book of business in Virginia, an incurred loss ratio of 59 percent indicates excessive profitability for insurers at the expense of Virginia insurance consumers.

We believe -- and again, it is axiomatic -- that 17 cents on the dollar is an indefensibly low cash ratio for liability insurers in Virginia.

So, here we are at the end of our first year under the statute, approaching two threshholds; the threshhold of a second year of interpretation and application of the statute; and the convening of the 1989 session of the General Assembly.

The question is, can we make the statute work, or is it necessary for further action to be taken by the General Assembly?

My purpose for being here today is to respond to that question as Attorney General for the Commonwealth, and on behalf of our Division of Consumer Counsel.

First, Mr. Chairman, we believe that the current law provides a clear and compelling standard for insurance regulation in Virginia; a mandate that rates be reasonable, and neither excessive nor inadequate.

We believe that the law in its current form can be effective.

We believe that the Bureau of Insurance has the necessary authority to obtain all the data required by the General Assembly, and that careful, comprehensive analysis of that data by the Bureau can be enormously helpful in identifying troubled lines of liability insurance.

We believe that insurance has become such an essential commodity to business and professionals in Virginia that it is incumbent upon all of us who participate in the identification of troubled lines to make certain that our process is visible, understandable, inclusive, and rational.

What we do, and how we do it, should not only be in accordance with the Code, but also should make sense and should be fair.

Mr. Chairman, I reiterate these rather self-evident principles today because they must constitute the bedrock upon which my Office and the Bureau of Insurance discharge our respective responsibilities.

If they do not, then there is little hope for progress in ensuring that we meet the General Assembly's mandate for reasonable insurance rates for Virginians.

There must be a shared concern that we have a problem, a sincere belief that our statutes can work to address that problem, and a firm commitment to see that it happens.

If the Commissioner of Insurance believes as a general proposition that commercial liability insurance rates in Virginia are reasonable within the meaning of the Code, and if the Commissioner is not troubled by a 1987 incurred loss ratio of 59 percent and a cash loss ratio of 17 percent, then it would be helpful to know that, especially in view of the fact that the General Assembly based its major reform legislation upon its judgment that such ratios represented a cause for concern.

The General Assembly could then have the opportunity, if it wished, to adopt more legislation sending an even clearer signal of the depth of its concern in this area and of its requirement that rates for Virginians be reasonable and not excessive.

Perhaps the Bureau agrees that there is a problem, but does

not fully subscribe to the approach adopted by the General Assembly to address that problem.

If that is the case, then now is the time to have that discussed and debated so that the General Assembly might either change the statute or affirm its original intent.

Let me say that I have no pride of authorship, and have never contended that what we helped put on the books two years ago is perfect, and that I would be pleased to discuss with the Bureau and the insurance industry any proposed improvements in the statute.

Our focus today is upon the future. Where do we go from here?

Can we learn from the experiences of the past year and redouble our efforts to make the second full year under the statute really work? Or do we need to adopt additional legislation?

Let me reiterate: With the proper agreement on basic principles and the adoption of certain practices on the part of the Bureau to ensure timely and comprehensive collection and evaluation of data in accordance with guidelines adopted by the General Assembly, I believe we can make our present statute work with little, if any, fine-tuning.

I would like to devote the balance of my presentation to some concrete suggestions that I believe can make a real difference.

They fall into two major categories in accordance with the two vital functions which the Bureau provides under HB 1235:

1) to survey market conditions to identify potentially troubled lines; and

2) once it has identified the potentially troubled lines, to collect and analyze Virginia data about those lines.

First, the "troubled lines" survey.

As you know, Mr. Chairman, under the statute the SCC is required to report to the General Assembly each year on the troubled lines of commercial liability insurance in Virginia. Last year, the Commission relied upon the recommendation of the Bureau of Insurance in making its report to the General Assembly.

Last year the Bureau surveyed the market this way:

They sent out questionnaires to licensed insurance companies, insurance agents, and to selected insurance consumers, and they prepared a report for the SCC in which they recommended that 17 lines be set aside as "potentially troubled." But when my Office reviewed the report we could find no correlation between the underlying survey and the conclusions reached by the Bureau. Early in the process we expressed our concern to the Bureau. Our concern focused not only the subjective validity of the report itself, but also on fairness. And that is a concern we still have: there should be some objective basis upon which one can reasonably predict when the Bureau will recommend that a line be considered "troubled."

This year, the Bureau has sent out questionnaires to insurance companies, to surplus lines brokers and to insurance agents.

I am not in a position to tell you whether or not consumers

have been contacted in any systematic way, whether through surveys, focus groups, or trade associations.

Today, individuals who purchase some of the lines which the Bureau found competitive, i.e., insurance deemed affordable, available, and reasonable, are here to testify about their insurance problems. They are concerned and confused.

They are concerned because they still experience significant problems with affordability and availability of insurance for their businesses.

They are confused because they do not understand why the Bureau recommended special ratemaking protection for one set of lines but not for the lines they need, especially in view of data provided by the industry on the dual issues of profitability and market concentration in their lines.

They are concerned that the lines critical to them will not be placed on the troubled lines list again this year in view of the Bureau's recommendations and they do not know what additional information they can provide to make their cases any more compelling than they already are.

They don't understand why certain lines that appeared to be the least profitable for the industry, such as medical malpractice, received protection, when the profitability quotients for the insurance they buy were often two to three times as high.

They need to be reassured that our system is not geared to be responsive solely to the squeaky wheel, or the sophisticated insurance consumer, such as the doctor, the lawyer and the insurance agent.

While it is important for the Bureau to be responsive to the concerns of any insurance consumer or group of consumers, the troubled lines list should not consist solely of those consumers who knock on the Bureau's door. It should also include lines where the Bureau has knocked on the consumer's door, whether that consumer be a service station operator, delicatessen owner, barber or beautician. That takes time, commitment and resources. But it also ensures equity and fairness.

Here are some specific suggestions we would make if the data upon which the troubled line report is based is to be truly reflective of market conditions in Virginia:

First, the timetable for the Bureau's gathering of data should be widely disseminated so that all interested parties are advised well ahead of the process.

Secondly, the Bureau should distribute guidelines which inform consumers in simple terms what information the Bureau finds relevant and compelling.

Thirdly, the Bureau should develop and disseminate articulable guidelines in accordance with the statute which advise consumer groups of the standard the Bureau uses in determining whether to recommend a line as troubled.

Fourthly, recognizing that surveys by mail typically yield results that are marginal at best, the Bureau should develop a systematic and random method for gathering information from consumers of a select number of lines a year, whether that information comes from phone calls, focus groups, or other forms

of contact. Under current law, the Bureau has the authority to make this random sampling and our Office would be pleased to assist in any way that the Bureau or Commission would deem helpful.

In short, the troubled lines report represents an essential and critical first step in getting a handle on excessive rates in Virginia. It's not too late for this year's report to lay the foundation for effective rate making scrutiny for 1989 and our Office is prepared to assist in any way possible to help make that happen.

The Bureau's second critical role under HB 1235 is to collect and analyze the data the industry is required to provide once a given line of insurance is identified by the Commission as potentially troubled. You know what happened earlier this year.

Supplemental Reports from the industry were late, incomplete, or in some cases, absent.

Rather than taking the position that incomplete filing constitutes failure to file, and setting aside those companies and lines for special rate making scrutiny, the Bureau made recommendations on competitiveness based on incomplete data.

While companies that filed late were assessed modest penalties, I do not yet have information concerning the range of penalites for the companies that filed incomplete data. That information has been requested and the Bureau has indicated that it will share that information with our Office in the not too distant future.

Of more concern was the Bureau's willingness to make recommendations favorable to the insurers based on incomplete information in violation of the Code. The Bureau originally identified 17 lines as "potentially troubled." Thirteen of those lines are of interest to us: The Bureau provided additional ratemaking scrutiny for doctors and lawyers, for insurance agents and pest control operators, and real estate agents. But they denied additional ratemaking scrutiny to products manufacturers, to commercial contractors, to day care operators, to school divisions and municipalities, and to recreational liability.

Our practical concern is: how do these consumers obtain relief?

Why, when the Virginia Code says that insurance rates are not to be excessive, and when there is evidence on file indicating a 27% incurred loss ratio for day care, is day care not considered a troubled line?

Why, when there is evidence on file that shows a 21% incurred loss ratio for municipal liability, is municipal liability not considered a troubled line--especially when medical malpractice insurance, with an incurred loss ratio of 75%, <u>is</u> considered a troubled line?

Why, when there is evidence on file that shows a 16% incurred loss ratio for products liability, is products liability not a troubled line?

Why, when there is evidence that shows a 6% incurred loss ratio for school divisions liability, is school divisions not a troubled line?

In short, as we will more fully develop later, the average

of the incurred loss ratios of the lines the Bureau found competitive is 22.3%.

The troubled lines process outlined in HB 1235 can be effective in assuring reasonable liability insurance rates for Virginians -- but it can only be effective if all of the seven factors set forth in the Code are taken into account, especially evidence of excess profitability.

We believe evidence of excessive profitability is in itself evidence of troubled lines because the Code clearly provides that rates shall not be excessive.

Here are some concrete suggestions for what can be done to make a difference in 1989.

First, it would be helpful for the Bureau to pre-test its survey, to find out if the industry has any problems understanding the questions themselves.

For example, this year's survey asked whether companies deviated from the ISO rates, but many of the affirmative responses either did not indicate by how much the company deviated, or whether the company deviated by charging more than or less than the ISO rate. A simple pre-test could spot this kind of trouble and allow the Bureau to refine its questions.

Secondly, it would be helpful for the Bureau to require all companies licensed to write any of the troubled lines to file a Supplemental Report, if only to tell us they are not in fact writing those lines. This year, we do not even know for sure how many companies writing each troubled line failed to submit such reports.

Since we do not yet know what penalties the Bureau imposed on companies that did not file, or that filed substantially incomplete data, it would be premature to comment on the range of penalties. What I would hope is that in the future compliance with the laws of the Commonwealth be deemed a condition for doing business in Virginia, and that never again would the industry be given the benefit of failing to provide data in accordance with the Code and being declared competitive at the same time.

Finally, it would be helpful and prudent for the Bureau to state its rationale for finding any lines to be effectively regulated by competition--using all seven factors listed in HB 1235. It is simply not enough to count the number of companies writing, or seeking to write, each line of insurance and to conclude from that limited information that competition is or is not effectively regulating rates. The role of ISO is too dominant in Virginia to rely on numbers alone. Speaking of ISO, I'm pleased to learn of the Bureau's recommendation to prohibit ISO's promulgating advisory expense factors. That's certainly a step in the right direction and we would encourage the Bureau to join our Office in recommending legislation to prohibit ISO from filing advisory profit and contingency factors as well.

In conclusion, I would recommend some very specific suggestions for administrative procedures that would improve the ability of my Office and the Bureau of Insurance to work together in this troubled lines procedure.

A. It would be helpful for the Bureau to establish firm procedures for when "delayed effect" (troubled lines) rate

filings are deemed complete and, thereby, "filed." This affects the amount of time given to the Attorney General and other interested parties who may wish to analyze the filing and offer comments to the Commissioner. The SCC now agrees not to take action on a filing for at least 45 days from the date the filing was received. Often, the Bureau is still seeking supporting data during this entire period and considers the filing incomplete until such data is received. The rationale is common sense: newly submitted information can dramatically alter the landscape in these matters, but interested parties cannot comment responsibly on information to which they have no access, or too brief access before filing deadlines.

B. It would also be helpful if "discovery rights" were established for interested parties. Rate applications are not considered "formal proceedings" by the SCC and therefore the Commission's rules regarding discovery have not applied. We suggest formalizing a procedure whereby a party can express an interest in a rate filing and thereby join as a party with the right to request additional data.

Mr. Chairman, I've spent most of my time this morning talking about problems of affordability and availability, because consumers have told us that continues to be their concern in these troubled lines. Here with us this morning are a few of the consumers of those troubled lines of insurance, who can tell us in their own words why this continues to be a problem for them.

(Witnesses)

Mr. Chairman, that concludes my testimony and the testimony of our witnesses on the matter of affordability and availability. At this point, I'd be happy to answer your questions on these issues, and just want to remind you that some of my associates are prepared to talk about the problems we continue to see with the insurance industry's antitrust exemption and with reinsurance.

APPENDIX 3

EXHIBITS

ACCOMPANYING THE PRESENTATION OF THE

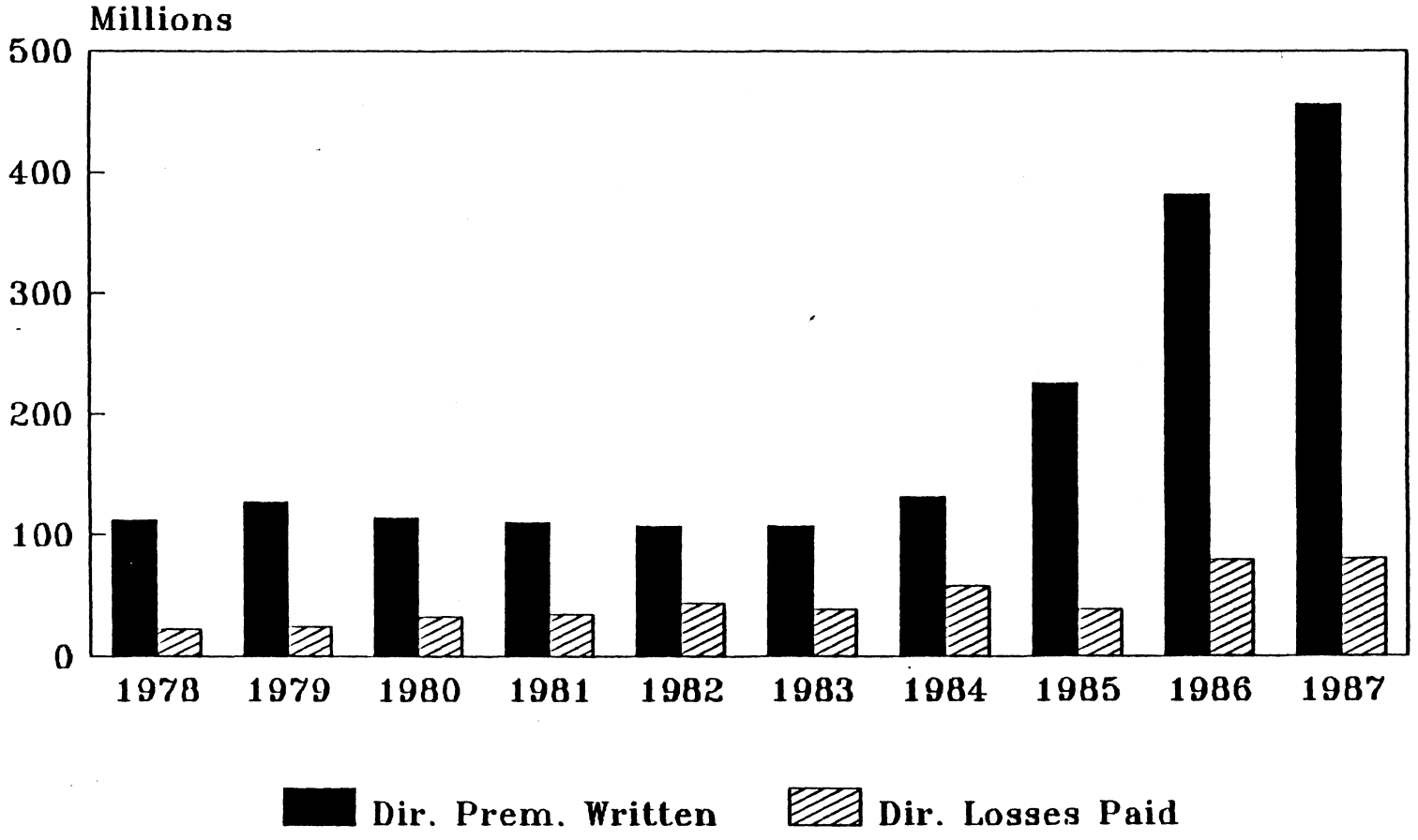
OFFICE OF THE ATTORNEY GENERAL

TO THE

JOINT SUBCOMMITTEE STUDYING THE AVAILABILITY
AND AFFORDABILITY OF LIABILITY INSURANCE,
THE ANTITRUST EXEMPTION OF INSURERS AND THE REINSURANCE COSTS
ASSOCIATED WITH LIABILITY INSURANCE - HJR 120

OCTOBER 27, 1988

VIRGINIA
GENERAL LIABILITY



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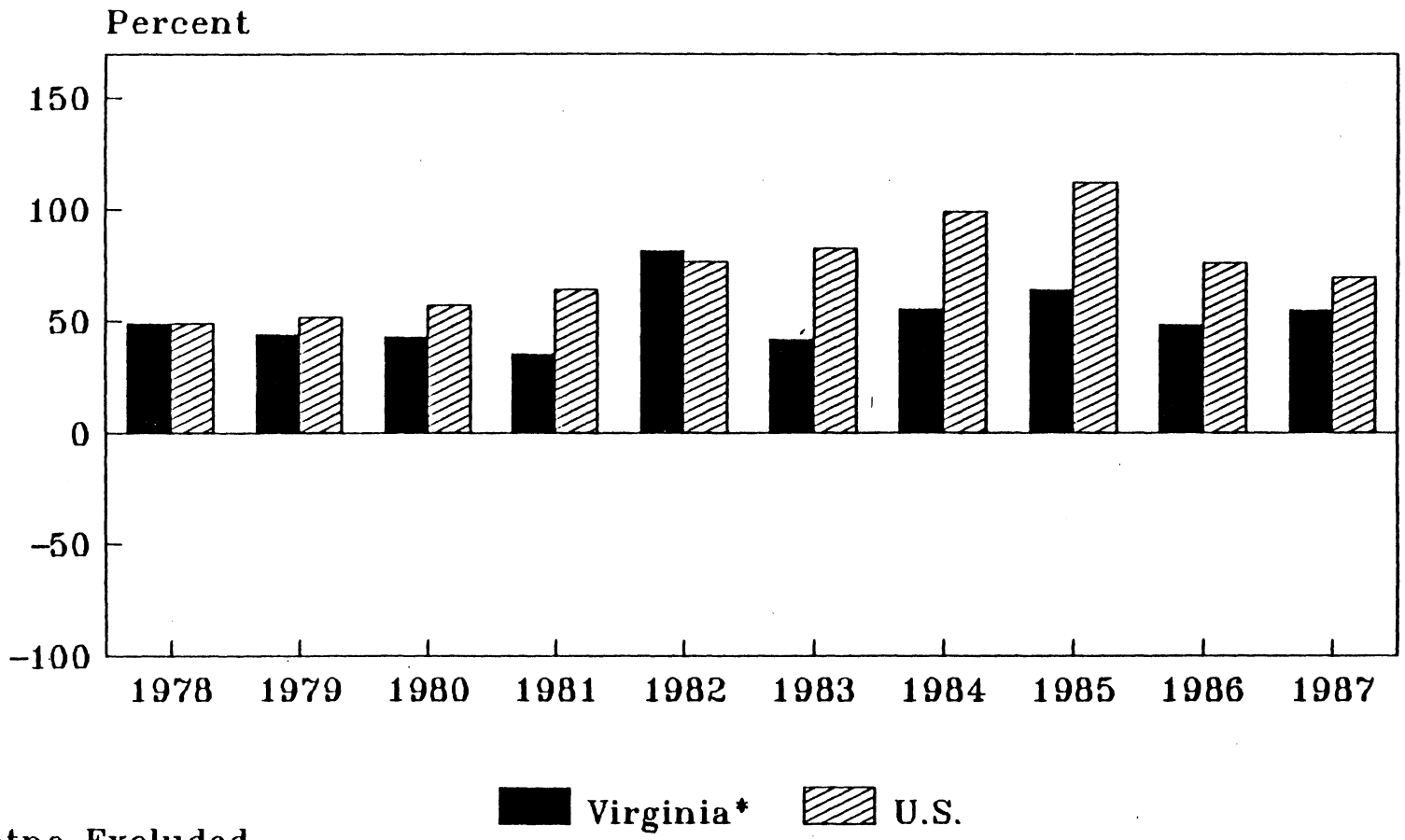
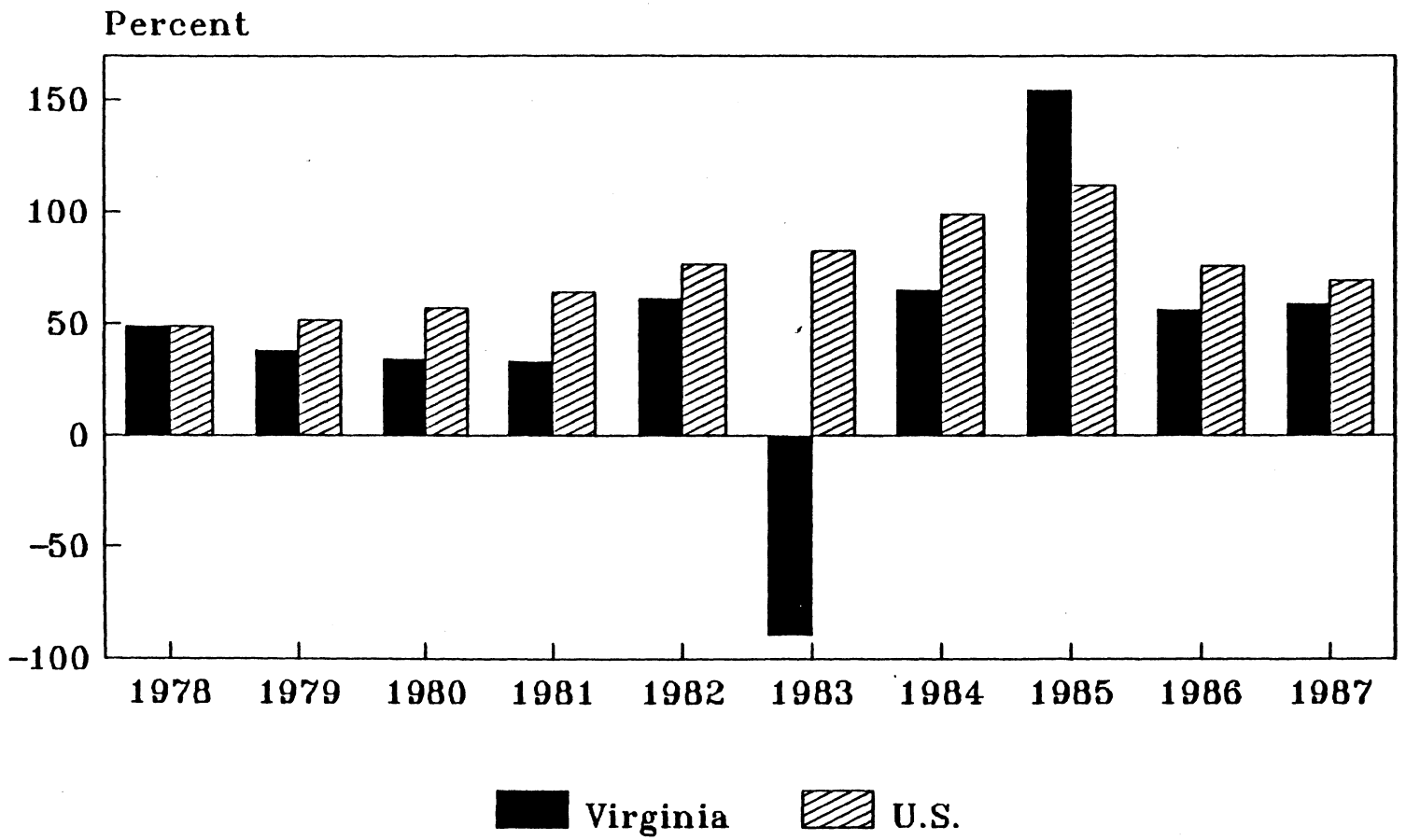
VIRGINIA AND U.S.
GENERAL LIABILITY LOSS RATIOS



* Aetna Excluded

Source: A.M. Best

VIRGINIA AND U.S.
GENERAL LIABILITY LOSS RATIOS



Source: A.M. Best

ORDER OF THE STATE CORPORATION COMMISSION
IN CASE NO. INS880219

Competition is NOT an effective regulator of rates for and "delayed effect" filing procedures shall apply to:

1. Medical Malpractice Liability Insurance
2. Lawyers Professional Liability Insurance
3. Public Housing Insurance
4. Real Estate Agents Errors and Omissions Insurance
5. Insurance Agents Errors and Omissions Insurance
6. Law Enforcement Agencies Insurance
7. Pest Control Insurance

Competition is NOT an effective regulator of rates for BUT "delayed effect" filing procedures shall NOT apply to:

1. Environmental Liability Insurance
2. Directors and Officers Insurance
3. Liquor Liability Insurance
4. Architects and Engineers Insurance

Competition IS an effective regulator of rates and "file and use" procedures remain in effect for:

1. Products and Completed Operations Insurance
2. Commercial Contracting Insurance
3. Governmental and Municipal Liability Insurance
4. School Divisions Insurance
5. Day Care Liability Insurance
6. Recreational Liability Insurance

VIRGINIA CODE § 38.2-1905.1 E

FACTORS TO CONSIDER IN DETERMINING WHETHER COMPETITION EFFECTIVELY REGULATES RATES

1. The number of insurers actually writing insurance within the line or subclassification.

2. The extent and nature of rate differentials among insurers within the line or subclassification.

3. The respective market share of insurers actually writing insurance within the line or subclassification, and changes in market share compared with previous years.

4. The ease of entry into the line or subclassification by insurers not currently writing such line or subclassification.

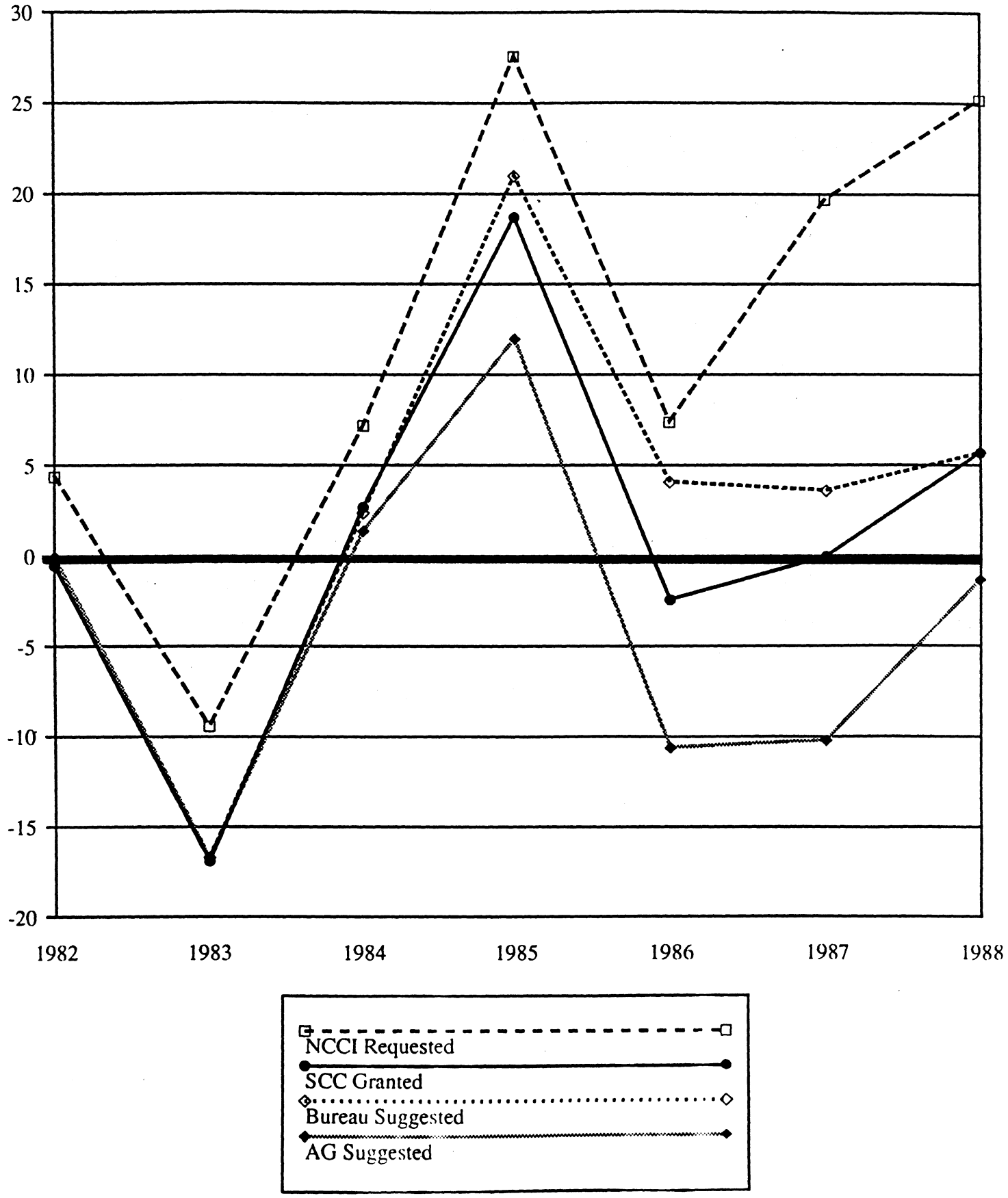
5. The degree to which rates within the line or subclassification are established by rating service organizations.

6. The extent to which insurers licensed to write the line or subclassification have sought to write or obtain new business within the line or subclassification within the past year.

7. Whether a pattern of excessive rates exists within the line or subclassification in relation to losses, expenses and investment income.

8. Such other factors as the Commission deems relevant to the determination of whether competition is an effective regulator of rates within the line or subclassification.

WORKER'S COMPENSATION - % CHANGE



General Liability Insurance
Profitability and Cash Operating Results
Virginia 1987

Profitability (Incurred Basis)

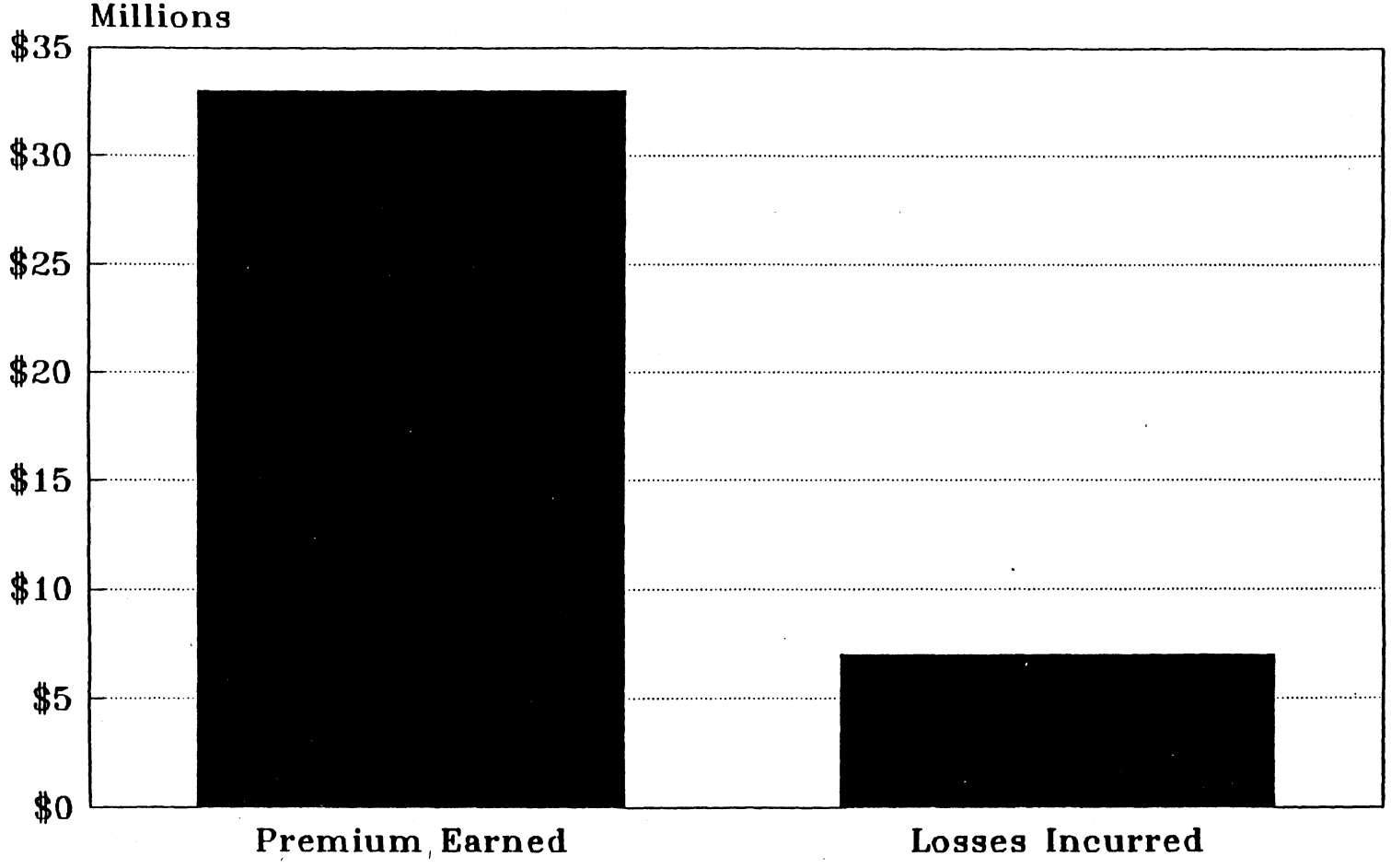
Premiums Earned	$426,634,000
Losses Incurred	$253,023,000
Expenses Incurred	$177,144,000
Underwriting Income	($3,533,000)
Investment Income	$ 77,270,000
Allocated Surplus	276,416,000
Rate of Return	27%

Cash Operating Results

Premiums Written	456,250,000
Investment Income	77,270,000
Losses Paid	80,083,000
Expenses Paid	133,061,000
Net Cash	320,376,000
Percent of Allocated Surplus	116%

Reported Operating Results
1987 Incurred Basis

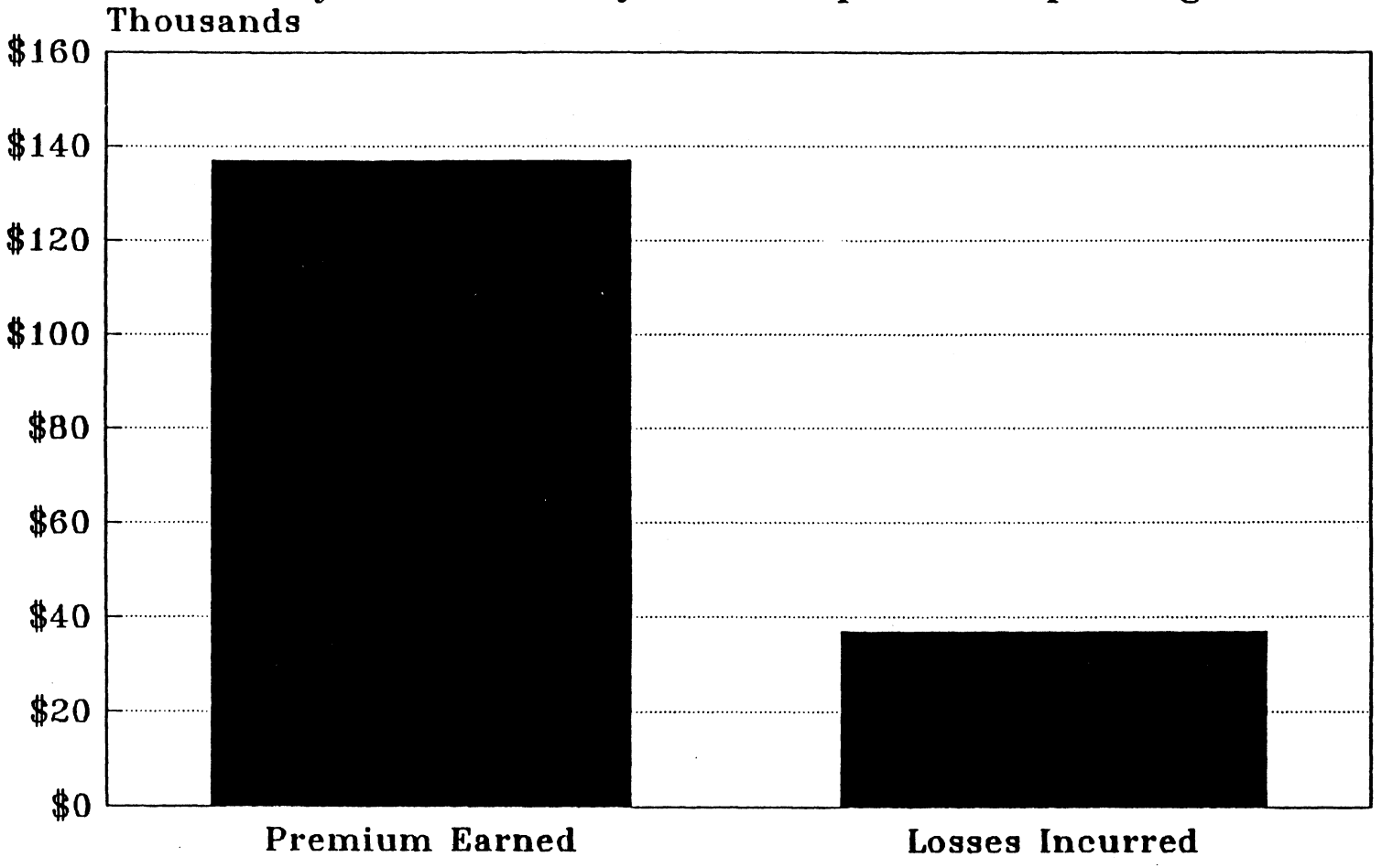
Commercial Contracting Liability, 97 Companies Reporting



Incurred Loss Ratio 22%

Reported Operating Results
1987 Incurred Basis

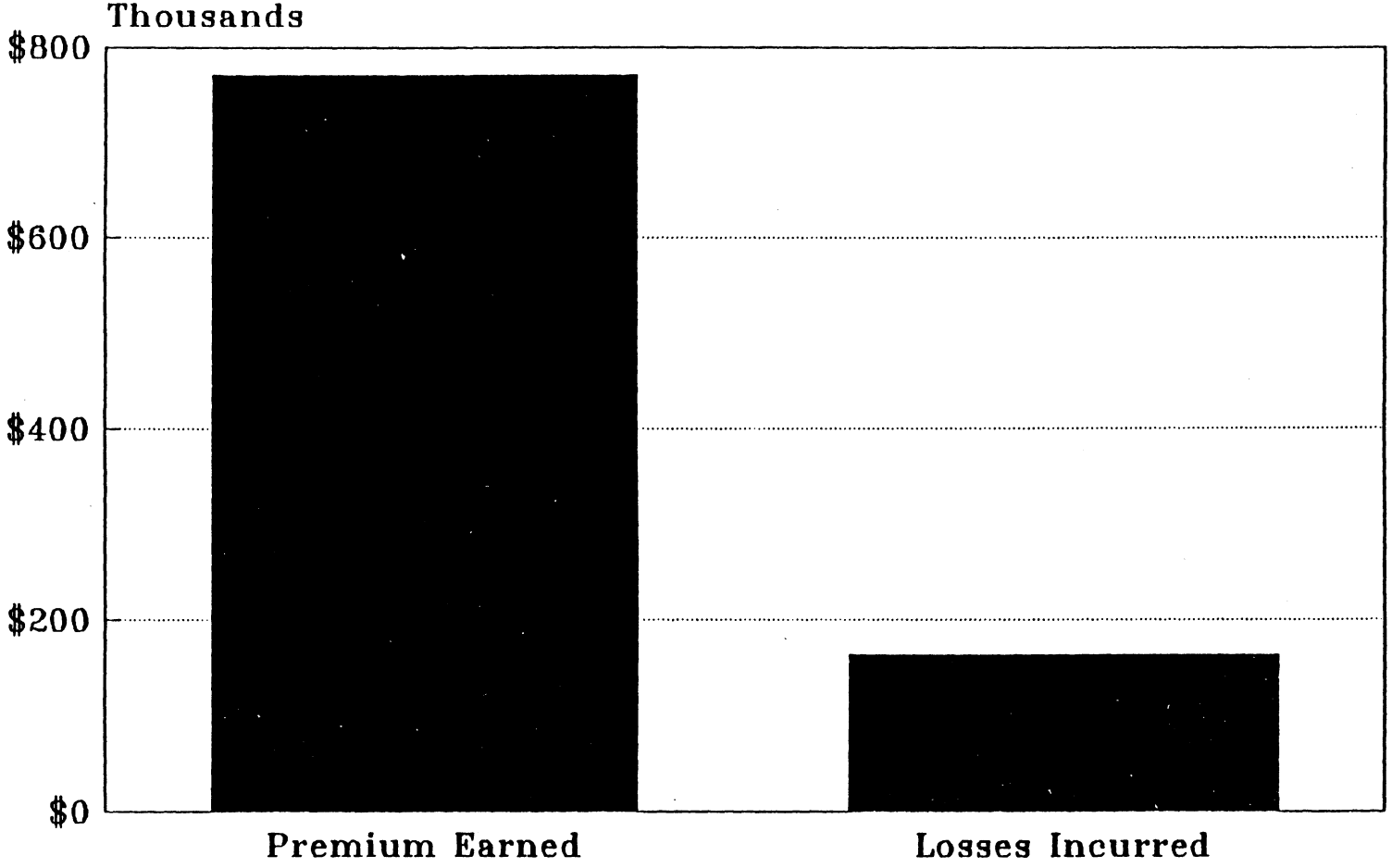
Day Care Liability, 52 Companies Reporting



Incurred Loss Ratio 27%

Reported Operating Results
1987 Incurred Basis

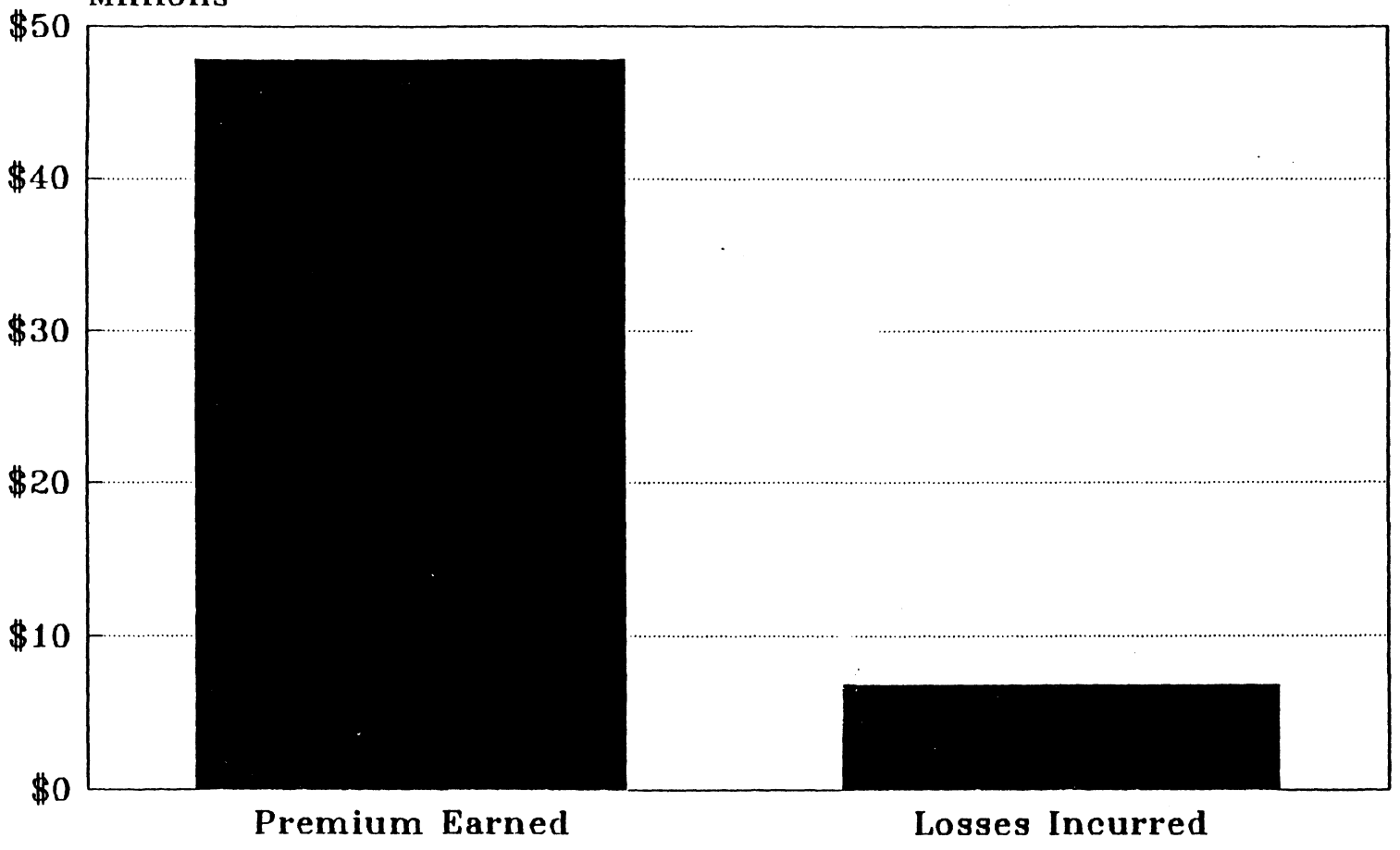
Municipal Liability, 44 Companies Reporting



Incurred Loss Ratio 21%

Reported Operating Results
1987 Incurred Basis

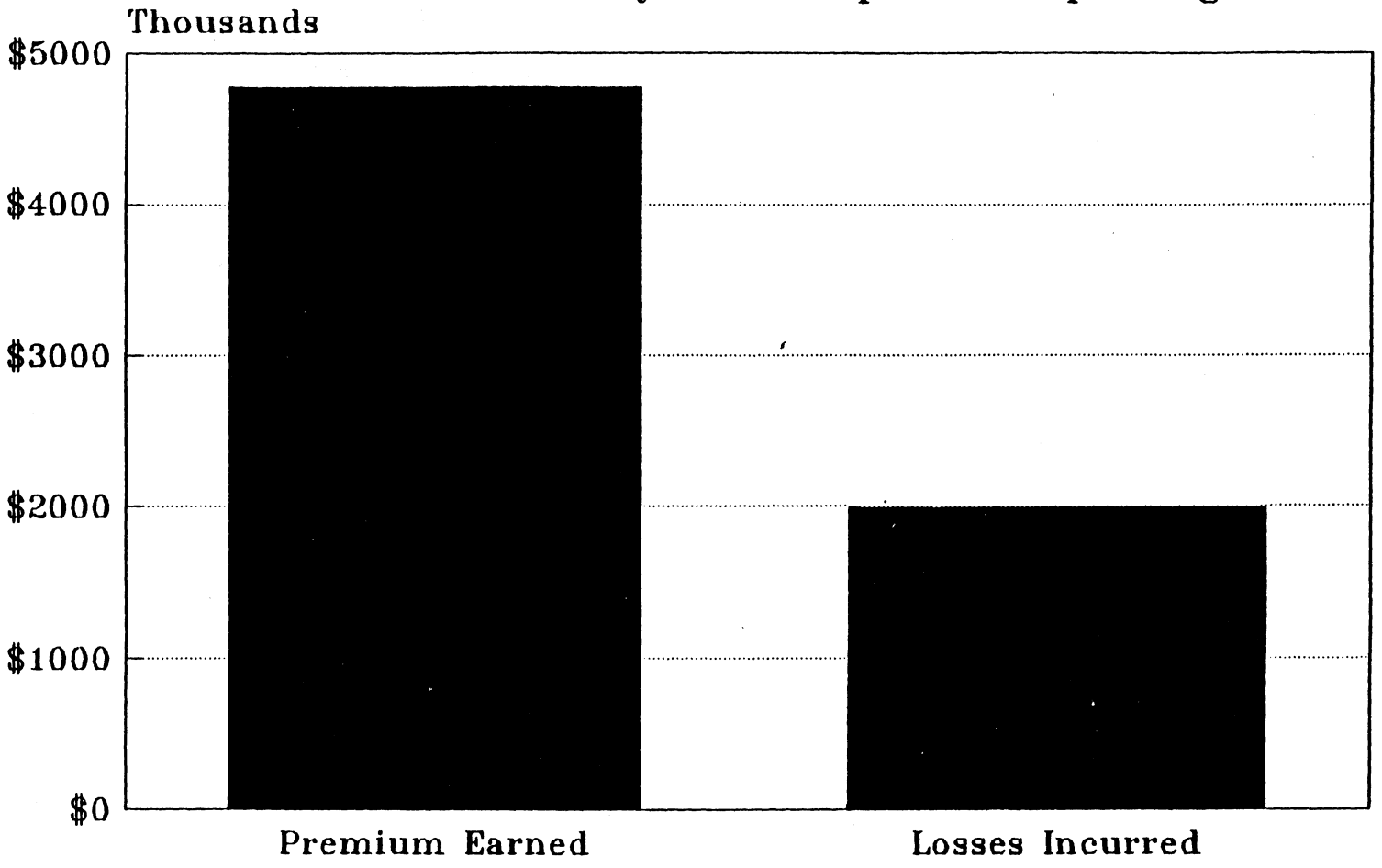
Products and Completed Operations, 147 Companies Reporting



Incurred Loss Ratio 16%

Reported Operating Results
1987 Incurred Basis

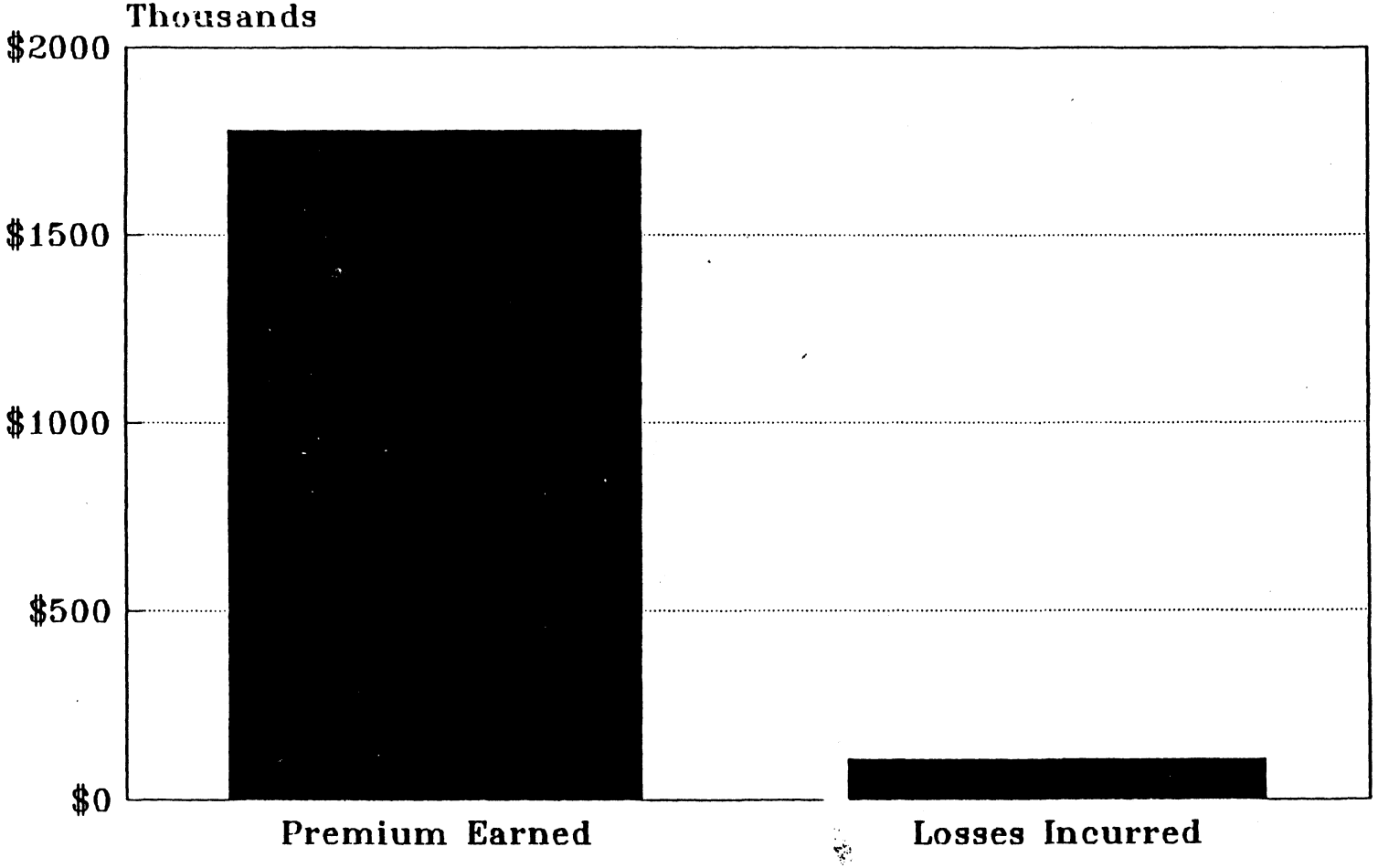
Recreation Liability, 82 Companies Reporting



Incurred Loss Ratio 42%

Reported Operating Results
1987 Incurred Basis

School Divisions Liability, 56 Companies Reporting



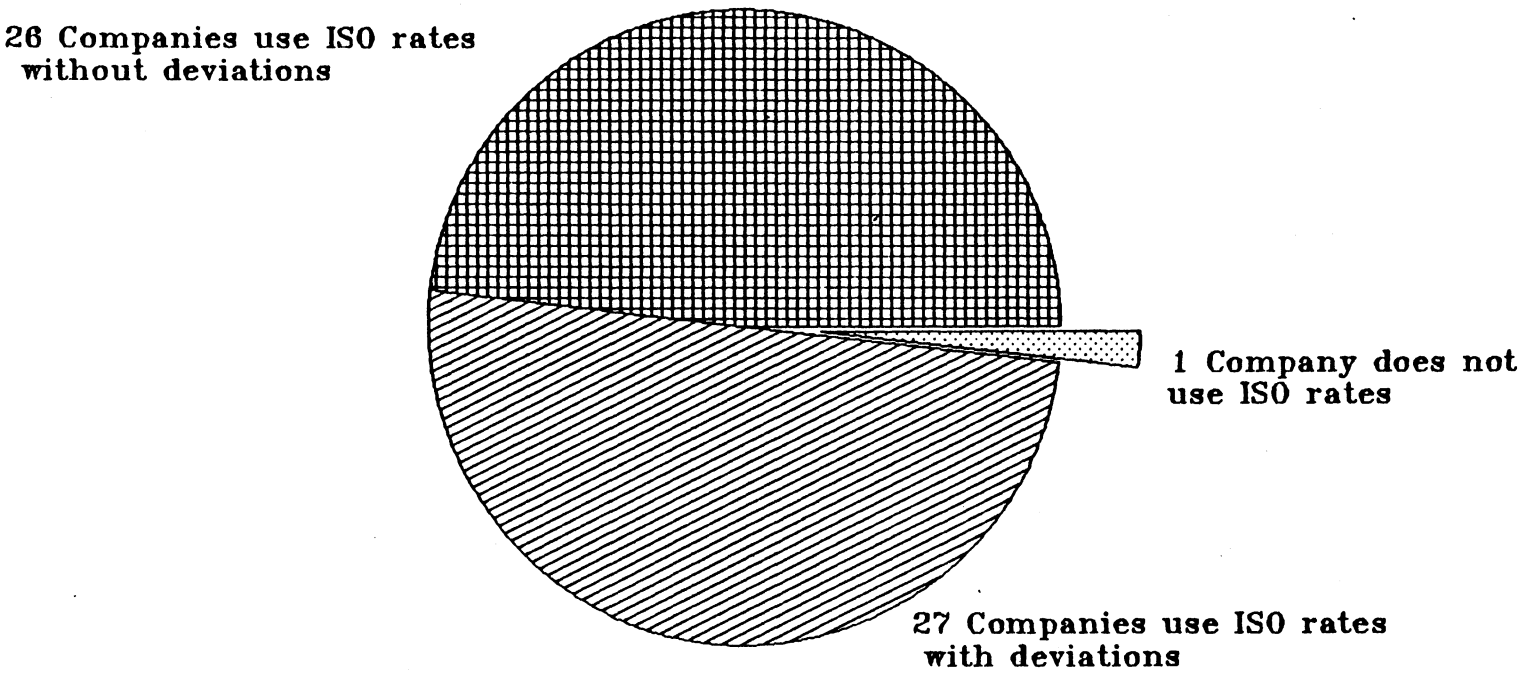
Incurred Loss Ratio 6%

Market Concentration in Virginia
(Percentage of Reported Written Premiums)

Line of Coverage	Largest Insurer	Four Largest Insurers	Eight Largest Insurers
Commercial Contracting	22%	46%	68%
Day Care Liability	18%	56%	85%
Municipalities	27%	76%	99%
Products & Completed Operations	9%	29%	49%
Recreation	21%	47%	71%
Schools	29%	65%	91%

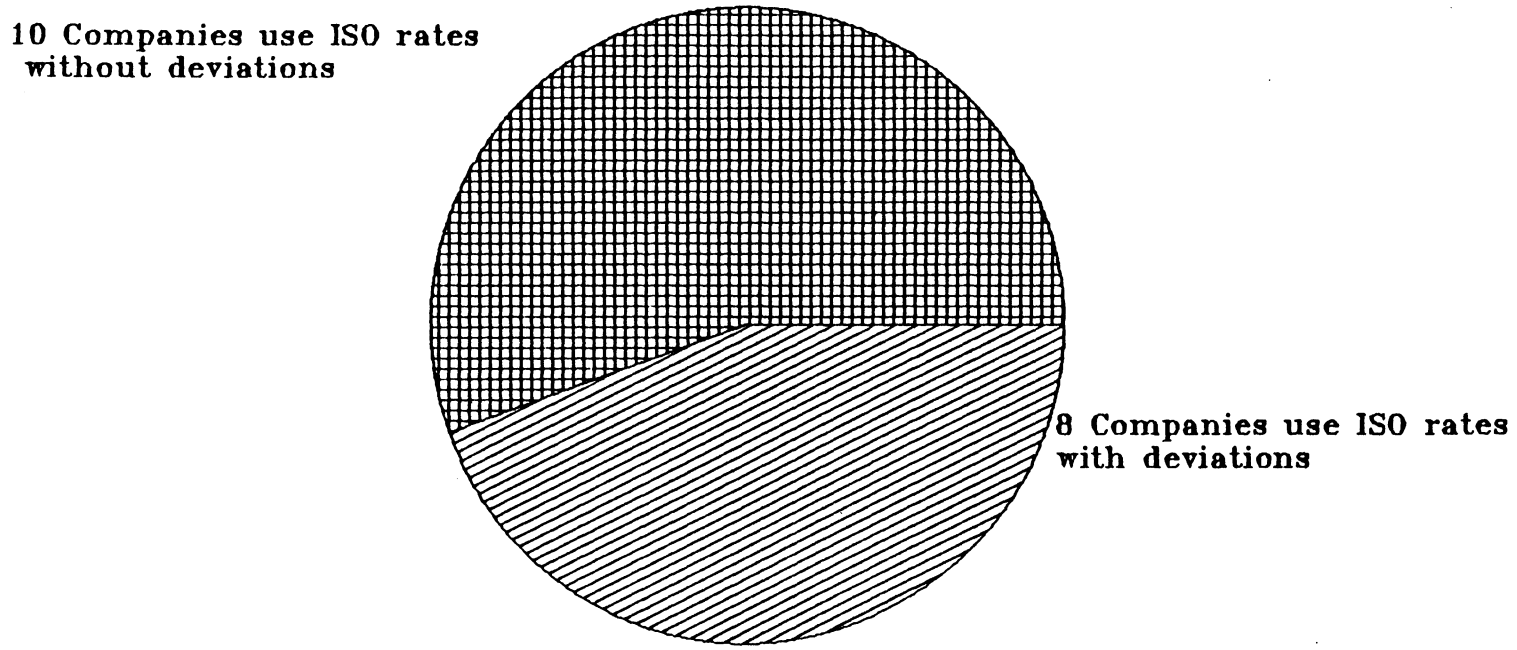
REPORTED USE OF ISO RATES
For Firms Seeking New Business

Commercial Contracting



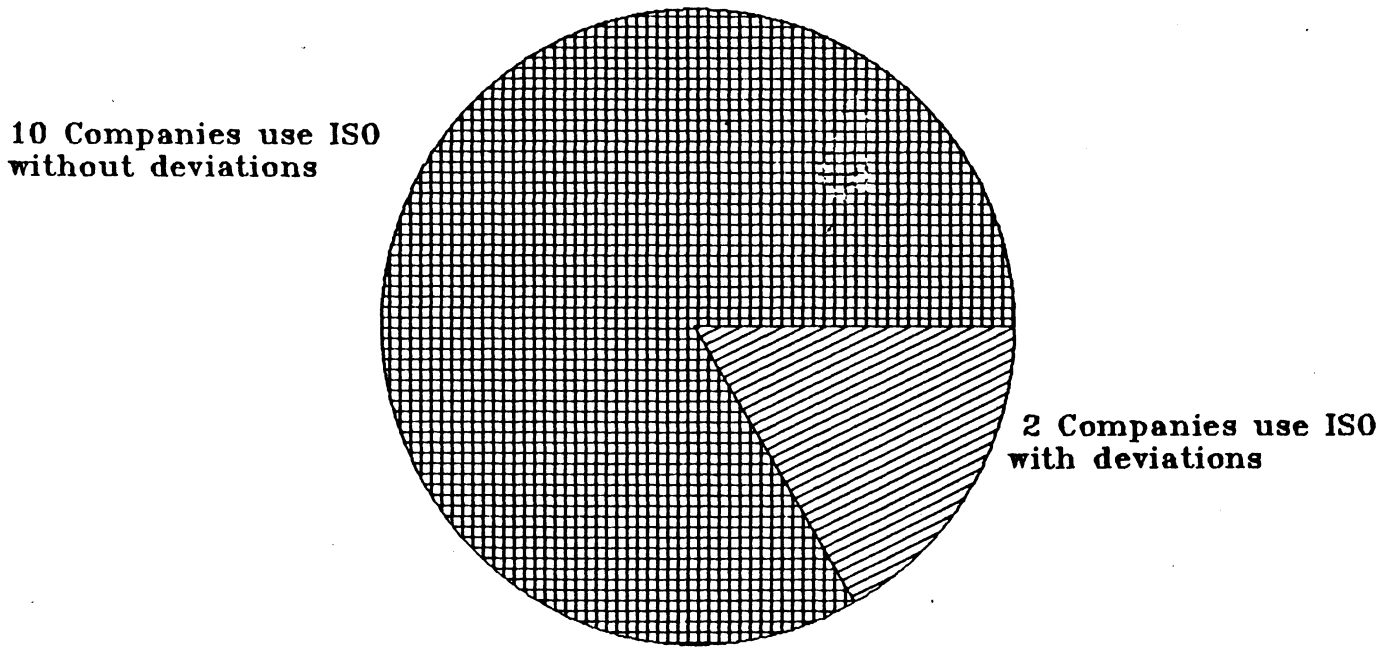
REPORTED USE OF ISO RATES
For Firms Seeking New Business

Day Care Liability



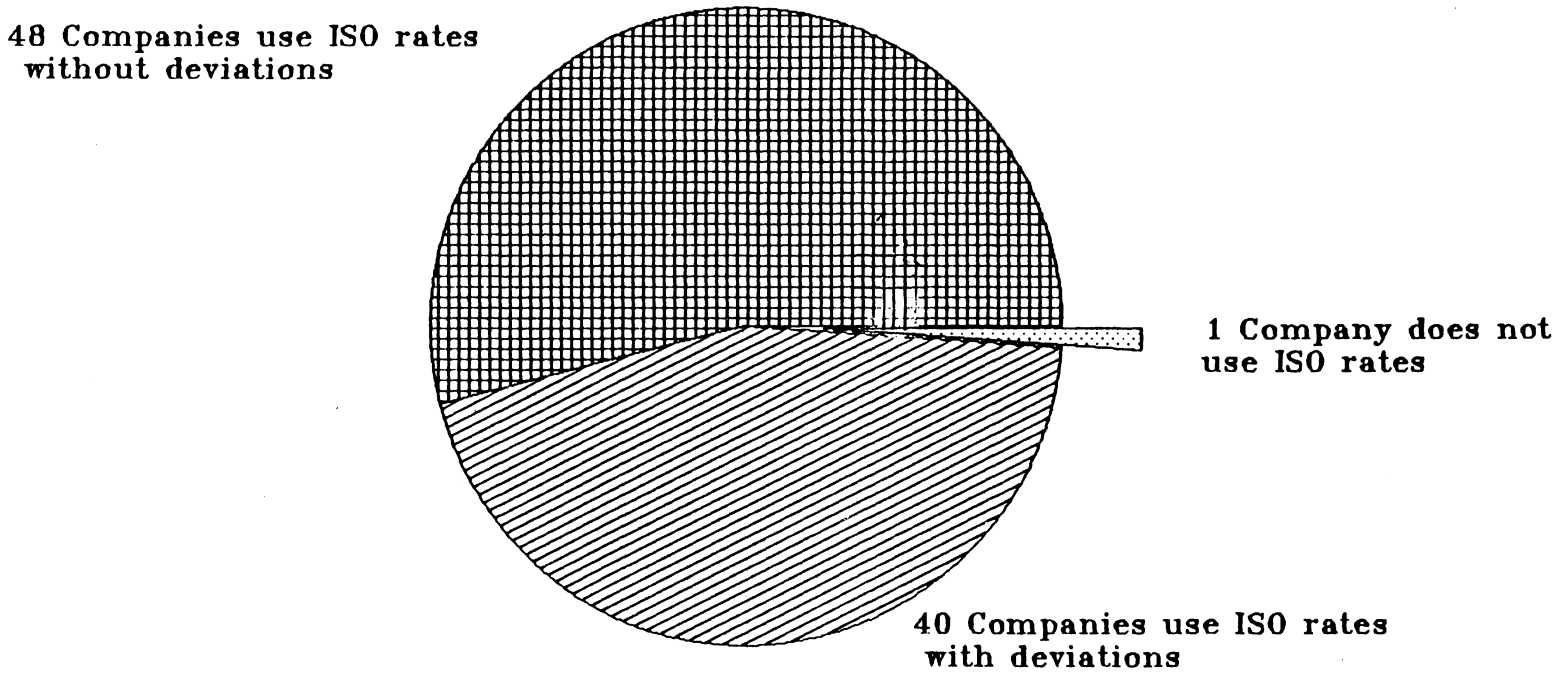
REPORTED USE OF ISO RATES
For Firms Seeking New Business

Municipal Liability



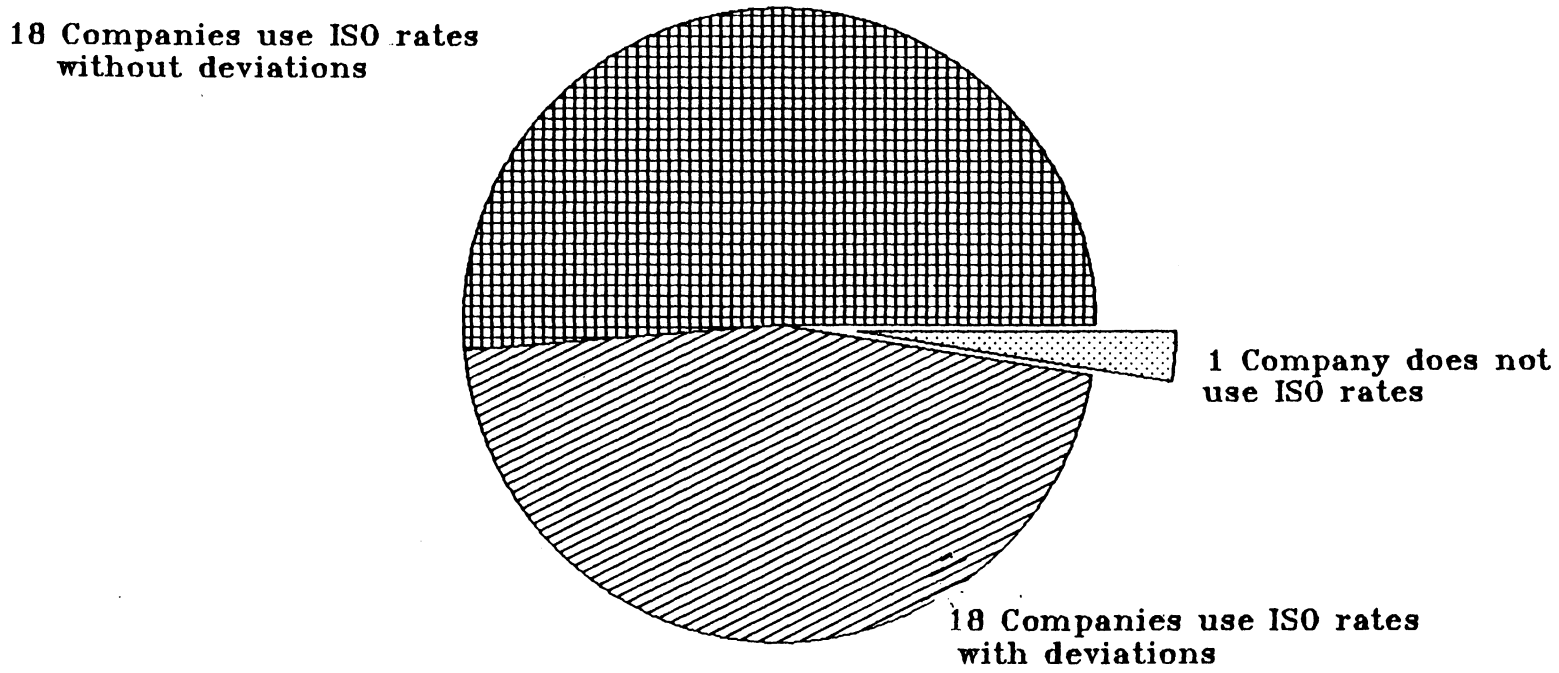
REPORTED USE OF ISO RATES
For Firms Seeking New Business

Products and Completed Operations



REPORTED USE OF ISO RATES
For Firms Seeking New Business

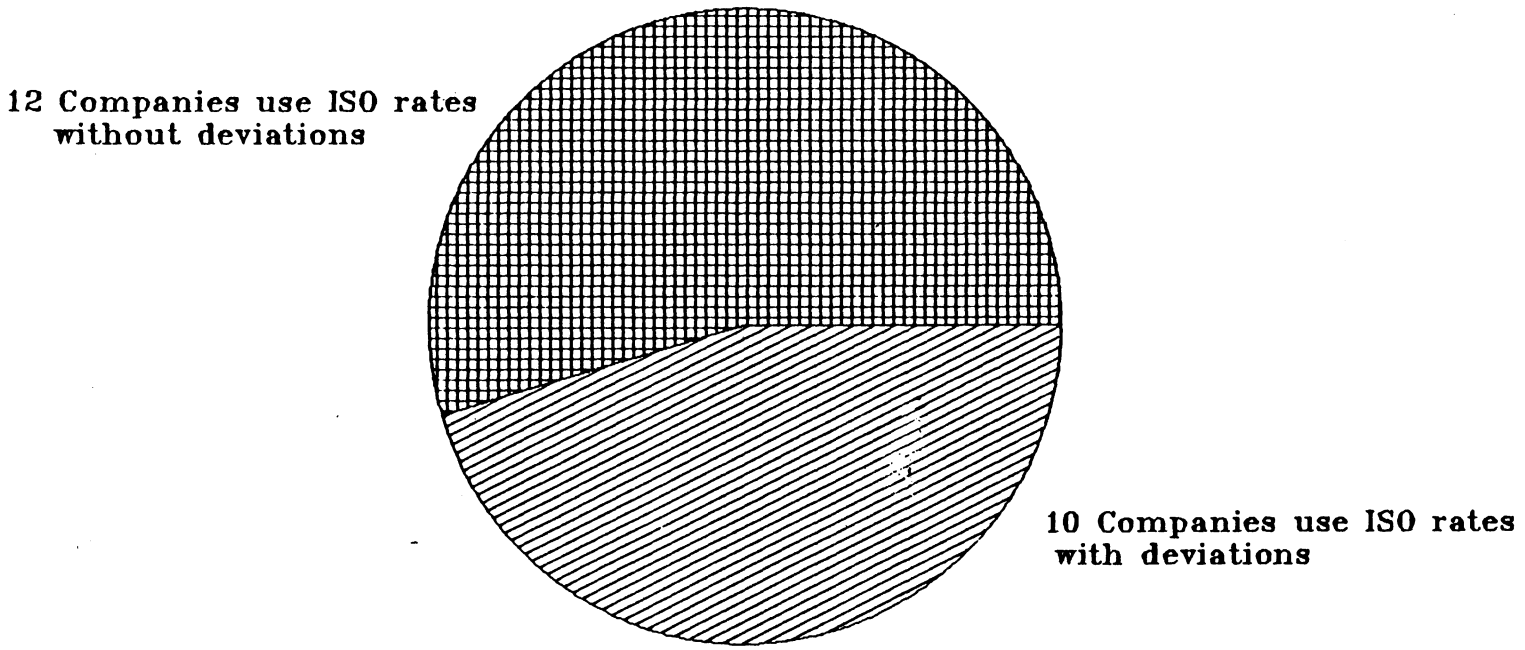
Recreation Liability



REPORTED USE OF ISO RATES

For Firms Seeking New Business

School Divisions Liability



Rate Components for General Liability Insurance

Percentage of Earned Premium
(1987)

Incurred Losses	66.25%
Loss Adjustment Expenses	22.23%
Commissions and Brokerage	11.54%
Other Acquisition Costs	3.61%
General Expenses	5.02%
Taxes Licenses & Fees	2.99%
Underwriting Income	-11.63%
Investment Income	24.95%

Source: A.M. Best, Aggregates & Averages

APPENDIX VI

REINSURANCE

A number of unanswered questions, critical to any decision about what regulatory action to take, remain on the table:

1. The industry has asserted that breaking out state-based data focused only on the business that commercial liability insurers reinsure -- such data as paid and incurred commercial liability premiums, commissions, expenses, and losses paid and incurred -- would be both difficult and expensive. This assertion has been made in general form, but not explained in detail.

- Precisely what would be difficult about providing such state-based data?

- How long would it take to set up a system for doing this on a regular basis?

- How costly would it be to develop this data?

2. The industry has asserted that the nature of reinsurance treaties would make preparation of state-based data regarding reinsured business difficult, and that any data produced would be arbitrary.

- In what specific ways are reinsurance treaties written that would make allocating reinsured losses on a state-by-state basis as difficult as the industry suggests?

- In what specific ways would these allocations be "arbitrary," as the industry suggests?

3. There have been general suggestions that requiring the filing of additional data regarding reinsurance transactions would greatly complicate the regulatory task now faced by the Bureau of Insurance and the State Corporation Commission.

- How great would the additional regulatory burden on the Bureau of Insurance and the SCC actually be if such state-based reinsurance data had to be filed by commercial liability insurers?

- In what ways might the Bureau set up procedures to look for patterns of abuse that would make it unnecessary to scrutinize each filing in detail?

4. The insurance industry has suggested that reinsuring among affiliated companies serves a pooling function that is perfectly legitimate and needs no regulatory scrutiny.

- To what extent could a system of more careful scrutiny of reinsurance among affiliated companies separate out the legitimate pooling transactions from possible abuses?

5. Consumer groups have suggested that the London reinsurance market is not competitive, and that this produces excessive premiums for primary insurance in the United States.

- Are the London and American reinsurance markets sufficiently competitive?

- Is data on reinsurance "marklet shares" alone enough to evaluate competitiveness?

6. The industry has asserted that there is no possibility of excessive charging on pro-rata reinsurance, because premiums paid equal the pro-rata share of the reinsurance.

- Does the practice of paying "commissions" to ceding insurers make excessive charging possible?

APPENDIX VII

ANTITRUST IMMUNITY

There are four unanswered questions here, each very important:

1. Both small and large companies assert that it would be unduly costly to prepare rates for each subclassification of commercial liability insurance, even if historical data on claims and expenses in each subclassification continued to be available, from ISO, for example.

- If ISO continued to develop and trend losses, wouldn't individual companies merely need to build in their own profit targets, expense estimates, and predictions of tort liability developments?

- Precisely why would that process of individual rate setting be too costly for individual companies?

2. The Commissioner of Insurance has proposed that rate service organizations be prohibited from filing average expense factors on behalf of individual companies. Each company would then be required to set rates based on its own expense projections.

- Does this proposal contemplate that rate service organizations still will be permitted to file advisory profit and contingency loading factors, or only loss data itself?

- If the former, why not require individual companies to set their own profit and contingency factors?

3. Any regulatory change may result in some disruptions, as companies learn how to comply with new requirements. Disruptions are occasionally severe but often are not.

- What short-term dislocations might result if rate service organizations were prohibited from filing advisory rates in Virginia? or if they were prohibited from filing average expense factors and profit and contingency factors?

- Would small companies be able to compete within a short time with industry giants?

- What might prevent them from doing so quickly enough to ensure their survival?

4. Even after short-term dislocations have ceased, modification of the antitrust exemption would have long-term effects.

- Over the long-term, could small Virginia-based companies survive?

- Might they not even turn out to be more efficient than industry giants in offering certain subclassifications?

- Under what circumstances?

APPENDIX VIII

STEVEN T. FOSTER
COMMISSIONER OF INSURANCE

Box 1157
RICHMOND, VA 23209
TELEPHONE: (804) 786-3741

STATE CORPORATION COMMISSION

BUREAU OF INSURANCE

November 23, 1988

The Honorable Thomas W. Moss, Jr.
Majority Leader, House of Delegates
Suite 715, Wainwright Building
229 West Bute Street
Norfolk, Virginia 23510

Dear Tom:

I appreciate the opportunity to respond to certain allegations and statements made by the Attorney General and her staff at the last meeting of the HJR 120 Joint Subcommittee held on October 27, 1988. The Commission indicated to you that I would provide a response in writing prior to the next meeting of the subcommittee. In addition, I will elaborate on several of these matters at the subcommittee's next meeting.

The Bureau of Insurance has diligently carried out the provisions of HB 1235 since its enactment by the 1987 General Assembly. The Bureau's administration of this important piece of legislation has been closely coordinated with the staff of the Attorney General's Office. John Wilson, economic consultant to the Attorney General, was intimately involved in designing the format of the HB 1235 supplemental reports which companies were required to file. Copies of the surveys which the Bureau has sent to companies, agents, brokers, and consumers have been freely provided to the Attorney General's Office when requested. The Bureau is willing to cooperate with the Attorney General's Office to the fullest extent possible in the preparation of the Commission's 1988 Annual Report to the General Assembly which is to be submitted on or before December 31, 1988.

After the 1987 Annual Report was submitted to the General Assembly, the Commission established a deadline for filing of the company supplemental reports. This past year a deadline of May 1 was set. The Commission then held a hearing within sixty days at which time all interested parties, including the Bureau and the Attorney General's Office, were heard relative to the "potentially troubled lines". The Bureau found eleven of the seventeen lines to be non-competitive. In the Bureau's recommendation to the Commission it was suggested that the remaining six lines of insurance remain "file and use" for the

upcoming year. At the hearing, the Bureau offered testimony based on the following factors:

1) The number of insurers actually writing insurance within the line or subclassification.

2) The extent and nature of rate differentials among insurers within the line or subclassification.

3) The degree to which rates within the line are established by rate service organizations.

4) The extent to which insurers licensed to write the line have sought to write or obtain new business within the line within the past year.

5) The ease of entry into the line or subclassification by insurers not currently writing such line or subclassification.

Contrary to the allegation of the Attorney General, my recommendation on the "troubled lines" was not based on the extent to which consumers "knocked on the Bureau's door". No doctors knocked on my door asking that medical malpractice rates be subjected to the delayed effect requirement of Chapter 19 of Title 38.2. Likewise no insurance agents, real estate agents, law enforcement officers, pest control operators, or public housing officials knocked on my door. The Attorney General's assertion that the Bureau recommendation was based on the "squeaky wheel" principle is false and without merit. At no time did the Attorney General speak to me between the date of the Commission's HB 1235 hearing on June 29th and the Joint Subcommittee's meeting on October 27th. If she had called or written, I would have been happy to explain the rationale behind the Bureau's recommendation.

A week after the subcommittee's last meeting, I met with the Attorney General to discuss my concerns relative to the working relationship between our offices. At that meeting, the Attorney General and I identified some philosophical differences that exist between us. I do not share the Attorney General's view that calendar year incurred loss ratios for a given year can be relied upon as the sole indicator of excessive profitability. Furthermore, I do not agree that a determination can be made concerning profitability by comparing earned premiums to incurred losses without considering expenses of the companies. To compare losses to premium without regard to expenses and investment income is misleading and unfairly represents insurance company performance.

As you know, the Attorney General has noted her appeal to the Virginia Supreme Court on the matter of the Commission's "troubled lines" ruling. For that reason, it would be inappropriate for me to address the Attorney General's questions to the Joint Subcommittee relative to the Commission's decision not to subject certain lines of insurance to the delayed effect requirements of Chapter 19. I do, however, welcome any input from the Attorney General's Office relative to the preparation of the 1988 Annual Report to the General Assembly. I made this same offer to the Attorney General at our November 4 meeting. To this date, I have received no input from the Attorney General's Office. Since the Commission's Report must be delivered to the General Assembly by December 31st, it is imperative that the Attorney General provide any input to me in a timely manner.

I would encourage the Attorney General to "put on the table" philosophical differences and disagreements over interpretation of the statute relative to the regulation of commercial liability insurance in Virginia. Differences of philosophy and interpretation of the statute do not indicate that the Bureau is any less concerned about the excessiveness, if any, of rates being charged Virginia commercial insurance consumers. I <u>am</u> concerned as to whether a pattern of excessive rates exists within a liability line of insurance in relation to losses, expenses, and investment income. Section 38.2-1909 of the Code of Virginia allows the Attorney General, the Bureau, or any citizen to request the Commission to investigate whether excessive rates are being charged to consumers in Virginia. I encouraged the Attorney General during our recent meeting to make such a request of the Commission if she has evidence that excessive rates are being utilized in Virginia. During her term as Attorney General, Ms. Terry has made no such request for an investigation. I would be happy to work with the Attorney General in the event such an investigation is requested.

It is important to emphasize the difference between a finding that a <u>rate</u> is, in fact, excessive, and an allegation that excessive <u>profits</u> are being earned by the "average" company writing commercial general liability insurance. The Attorney General mentioned during her presentation that, for over forty years, the Virginia law has stated that "rates...shall not be excessive, inadequate, or unfairly discriminatory". This statement is true. The Attorney General failed to state, however, that a significant change was made to the rating laws in 1973. The General Assembly in that year amended Virginia's prior approval rating laws to provide for a "file and use" procedure for commercial liability insurance rates. Implicit in this change was the assumption that competition would serve as an effective regulator of rates. This change was significant in

that it requires the Commission to consider the degree of competition which exists in the specific line or subclassification in its determination of whether an insurer's rate is "excessive". Section 38.2-1904A.1 sets out a two-prong test which must be applied in determining whether a rate is excessive:

> No rate shall be held to be excessive unless it is unreasonably high for the insurance provided and a reasonable degree of competition does not exist in the area with respect to the classification to which the rate applies. (Emphasis added)

This Section does not permit the Bureau to require a company to "pre-file" its rates based upon calendar year incurred loss ratios as published by A.M. Best. Even if expenses and investment income were added to the equation, the Commission would have to see evidence that specific companies are using specific rates which are unreasonably high and that a reasonable degree of competition does not exist in that particular line of insurance.

I would like also to comment on two other items discussed by the Attorney General and her witnesses. First, you will recall that Flip Hicks, Counsel for the Virginia Association of Counties (VACO), testified at the last hearing that two counties had jointly bid their liability insurance package and received four identical quotes from insurance companies. Some subcommittee members expressed concern about this indication of a non-competitive environment for municipal liability insurance. I contacted the county administrators of the two counties referenced by Mr. Hicks in his testimony. I subsequently contacted Mr. Hicks when I was unable to substantiate or verify his statement with these two county officials. Mr. Hicks informed me this week that he would write the subcommittee members a separate letter on this apparent discrepancy.

Finally, I would like to comment on the Attorney General's suggestion that the Bureau of Insurance require all companies licensed to write any of the "troubled lines" to tell us whether they are not, in fact, writing these lines. Unfortunately, House Bill 1235 as drafted by the Attorney General does not give us the authority to require such filings from the companies. Section 38.2-1905.2A states, in part, as follows:

> ...provided, such reports shall be required only of insurers actually writing such designated lines or subclassifications of insurance in the Commonwealth. (Emphasis added)

Although my office lacks the administrative authority suggested by the Attorney General, we would support an appropriate amendment to the statute.

Thank you for affording me this opportunity to respond to the Attorney General's presentation at the subcommittee's last meeting. I look forward to addressing the subcommittee in more detail on November 29th.

Sincerely yours,

Steven T. Foster
Commissioner of Insurance

STF/kjc

ccs: The Honorable John C. Chichester
The Honorable Frank D. Hargrove
The Honorable Richard J. Holland
The Honorable J. Granger Macfarlane
The Honorable W. Tayloe Murphy, Jr.
The Honorable Lewis W. Parker, Jr.
The Honorable William F. Parkerson, Jr.
The Honorable Richard L. Saslaw
The Honorable William T. Wilson
Mr. John Robert Hunter, Jr.
The Honorable Mary Sue Terry

APPENDIX IX

RESPONSE TO QUESTIONS RAISED CONCERNING REINSURANCE AT THE SUBCOMMITTEE'S October 27, 1988 HEARING

Edmond F. Rondepierre

Among the questions raised at the October 27th Hearing were several addressed to the subject of reinsurance. The following responses are numbered to correspond with the form of the written questions. A copy of the questions is also attached for convenient reference.

1. & 2. - Industry witnesses have testified that reinsurers generally do not capture data on a state by state basis because reinsurance agreements and pricing are not structured on a state by state basis, and such data would be insignificant or meaningless. There has been a request for elaboration on that point.

There are several basic forms of reinsurance coverage, and enumerable combinations and variations on those forms. Reinsurance programs are generally tailored to suit the requirements of the individual ceding insurer, and it is not possible to generalize without sacrificing accuracy. The question can best be answered by providing an abbreviated definition of several forms of reinsurance. The following list is by no means complete, but it is illustrative.

Aggregate Excess of Loss (or Excess of Loss Ratio) indemnifies the insurer when the aggregate of all losses subject to the reinsurance exceeds a stated amount (or a stated loss ratio) in a given period. The "trigger" is the aggregate of all losses, regardless of the amount of loss in any one state.

Catastrophe Reinsurance indemnifies the insurer if the cumulative amount of loss arising out of a single occurrence, or series of occurrences, exceeds a specified retention. The cumulative amount is determined without regard to the amount of loss in any one state.

Clash Cover is a form of reinsurance with a retention greater than the maximum policy limit on any single policy issued by the insurer. The reinsurance responds when loss from a common occurrence under two or more policies, (perhaps in different lines of insurance), exceeds the retention. The losses may of course be in different states.

As you will see from these few illustrations, if the insurer writes business in more than one state it would be difficult if not impossible to determine how much of the premium, or how much of the reinsured loss, was attributable to any one state. In addition, that information would serve no useful purpose to either the ceding company or the reinsurer. It doesn't appear that it would serve any useful purpose to a regulator.

There are of course other forms of reinsurance under which it would be possible to capture state by state data, however in most cases the information is not useful to either the ceding company or the reinsurer. Again at the risk of generalizing, pure quota share reinsurance involves a proportional division of the premium charged by the ceding insurer, and the losses follow the same proportional division. A review of premium and loss under such an agreement would produce the same result as the review of the gross premium and loss charged/incurred by the original insurer.

In the case of excess of loss reinsurance, the number of losses which penetrate the retention will be very much smaller than the total number of losses incurred. The number of such excess losses in any one state will frequently not be large enough for statistical credibility. Even if those losses could be isolated by state, the data would be insignificant. In such cases, as contemplated in the present Virginia Insurance Code Section 38.2-1904, rates or premiums are based on countrywide experience, or on judgment.

1B. - No such system could be set up for all forms of reinsurance. For those forms of reinsurance in which it is feasible to capture single state data, the time required to set up a system would vary considerably among reinsurers, and it is not possible to give an estimate of time applicable to all reinsurers.

For the same reason stated above, it is not possible to estimate costs for all reinsurers. It is evident, however, that the cost would be substantial because the information is not presently captured, and would serve no other purpose.

3. - For an individual insurer, the filing for a particular form of coverage or class of risks may involve policies reinsured under several forms of reinsurance (e.g., working layer, catastrophe, clash cover, etc.). Under the premise of the question, some allocation of reinsurance premium and loss to the particular form or class would have to be made. The Bureau of Insurance and the SCC would then have to evaluate the propriety of each of the allocated amounts. In effect, a single filing would become four or five or more filings.

Perhaps an even more basic illustration could be made if individual companies were required to make individual filings. The number of filings would be approximately 7,000. Some of the insurers may carry no reinsurance. Others may have three or four reinsurance

contracts which would apply to the subject of the filing. The number of filings then would become tens of thousands.

These illustrations demonstrate the point made in our testimony. Rates are made, filed, and reviewed on a gross basis - gross premiums and gross losses of the primary insurer - without regard to reinsurance. The Bureau of Insurance and the SCC determine whether the gross premium charged to a policyholder is excessive, or inadequate. Some of the insurers for whom that rate is approved may be heavily reinsured; others may carry no reinsurance. In either case, the premium charged to the policyholder is not affected. The reinsurance transaction is a division of the gross premium, and losses, between the insurer and the reinsurer.

Through its authority to examine the insurer, the Bureau of Insurance can, and does, examine its reinsurance arrangements. The Bureau of Insurance has the authority to order the termination of a reinsurance agreement which is found to be abusive. It is respectfully submitted that the examination of reinsurance arrangements in operation is both more effective and more efficient than prospective review.

4. - Under the existing insurance holding company laws (Virginia Insurance Code Section 38.2-1322 et. seq.) transactions among affiliates, including reinsurance, are required to be fair and reasonable. Such transactions are required to be reported to the Commission. The Commission has the authority to examine such transactions, and to order the modification or termination of transactions which do not satisfy the statutory requirements, to impose fines and penalties, and to revoke licenses.

5. - We are not aware of any basis for the suggestion. Some consumer groups asserted that the "soft" market of the early eighties was attributable to excessive competition among reinsurers.

It is generally understood that, today, an abundance of capacity exists in the reinsurance markets, both domestic and alien, and that they are highly competitive.

Data on market shares alone is not sufficient to evaluate competition. It is a useful criterion, but it must be considered in the context of other factors such as overall size of the market, the degree of specialization, ease of entry, and barriers to competition. At the August 17th hearing a good deal of testimony was devoted to describing the low barriers to entry into the Virginia reinsurance market.

6. - The practice of paying commissions does not make overcharging possible. As discussed above, insurance rates are made on a gross basis, without regard to the existence - or non existence - of

reinsurance. The reinsurance transaction involves a division of that gross premium between the insurer and the reinsurer. Reinsurance commissions are negotiated to reflect the costs of production, service, and taxes initially incurred by the ceding insurer. So long as rates are regulated on a gross basis, the division of that gross premium cannot result in overcharging the policyholder.

We are pleased to have had the opportunity to present our views to the Committee, and to offer information which we hope will be of value in your deliberation. We stand ready to answer further questions or to provide whatever additional information you may require.

EFR/jds
5976L/0972C

REINSURANCE

A number of unanswered questions, critical to any decision about what regulatory action to take, remain on the table:

1. The industry has asserted that breaking out state-based data focused only on the business that commercial liability insurers reinsure -- such data as paid and incurred commercial liability premiums, commissions, expenses, and losses paid and incurred -- would be both difficult and expensive. This assertion has been made in general form, but not explained in detail.

- Precisely what would be difficult about providing such state-based data?

- How long would it take to set up a system for doing this on a regular basis?

- How costly would it be to develop this data?

2. The industry has asserted that the nature of reinsurance treaties would make preparation of state-based data regarding reinsured business difficult, and that any data produced would be arbitrary.

- In what specific ways are reinsurance treaties written that would make allocating reinsured losses on a state-by-state basis as difficult as the industry suggests?

- In what specific ways would these allocations be "arbitrary," as the industry suggests?

3. There have been general suggestions that requiring the filing of additional data regarding reinsurance transactions would greatly complicate the regulatory task now faced by the Bureau of Insurance and the State Corporation Commission.

- How great would the additional regulatory burden on the Bureau of Insurance and the SCC actually be if such state-based reinsurance data had to be filed by commercial liability insurers?

- In what ways might the Bureau set up procedures to look for patterns of abuse that would make it unnecessary to scrutinize each filing in detail?

4. The insurance industry has suggested that reinsuring among affiliated companies serves a pooling function that is perfectly legitimate and needs no regulatory scrutiny.

- To what extent could a system of more careful scrutiny of reinsurance among affiliated companies separate out the legitimate pooling transactions from possible abuses?

5. Consumer groups have suggested that the London reinsurance market is not competitive, and that this produces excessive premiums for primary insurance in the United States.

- Are the London and American reinsurance markets sufficiently competitive?

- Is data on reinsurance "marklet shares" alone enough to evaluate competitiveness?

6. The industry has asserted that there is no possibility of excessive charging on pro-rata reinsurance, because premiums paid equal the pro-rata share of the reinsurance.

- Does the practice of paying "commissions" to ceding insurers make excessive charging possible?

APPENDIX X

MAYS & VALENTINE

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December 15, 1988

FILE NO.

BY HAND

C. William Cramme, III, Esq.
Deputy Director
Division of Legislative Services
General Assembly Building
Richmond, Virginia 23219

Dear Bill:

Please find enclosed the Joint Brief submitted on behalf of American Insurance Association, National Association of Independent Insurers, Alliance of American Insurers, Nationwide Insurance Companies, Reinsurance Association of America and Insurance Services Office, Inc. for the Joint Subcommittee Studying Reinsurance, Insurance Antitrust Exemption and the Availability and Affordability of Liability Insurance (HJR 120).

With kindest regards, I remain

Very truly yours,

Anthony F. Troy

80/442
Enclosure

BEFORE THE VIRGINIA JOINT SUBCOMMITTEE STUDYING REINSURANCE, INSURANCE ANTITRUST EXEMPTION, AND THE AVAILABILITY AND AFFORDABILITY OF LIABILITY INSURANCE - HJR 120

INTRODUCTION

This Joint Subcommittee was charged with an overview of issues associated with three specific areas that were to be studied: (1) the advisability of repealing the insurance industry's exemption from the Virginia Antitrust Act; (2) the availability and affordability of liability insurance in the Commonwealth, and (3) the reinsurance practices of insurance companies.

A review of the testimony, exhibits and information that has been presented to the Joint Subcommittee over the course of numerous hearings demonstrates first, that there should be no modification, repeal or any other statutory change made to the Virginia Antitrust Act. To do so would impact on the ability of the Bureau of Insurance to regulate and oversee rates and practices of the insurance industry. Moreover there should not be any additional modifications in the Insurance Code that would restrict the activity of rate service organizations - the premise for the Attorney General's called repeal of the exemption. To do so would adversely impact small insurance companies and the consumer. Secondly, it is clear that continued availability and affordability of liability insurance in the Commonwealth must be maintained under the competitive rate setting systems that were

put into effect fifteen years ago; a change from that competitive system would adversely impact consumers of insurance in the Commonwealth. Lastly, there should be no additional statutory nor regulatory burdens added in the reinsurance industry. Significant authority currently exists to investigate rates and examine companies to determine whether reinsurance arrangements may be a problem or a factor in rate issues; but more importantly, it is clear that the reinsurance industry itself is highly competitive and reacts accordingly.

I. ANTITRUST EXEMPTION

The Attorney General has advocated, as a first priority, the repeal of any antitrust exemption, at the state level, for the insurance industry. See Va. Code Section 59.1-9.4. The Attorney General would also seek, at the Federal level, repeal of the McCarran-Ferguson Act, 15 U.S.C. Section 1011-1015, which provides limited immunity to certain aspects of the business of insurance. The rationale for the Attorney General's advocated repeal is centered upon the role of rate service organizations, and more specifically, the Insurance Services Office (ISO), which is one of a number of rate service organizations that are authorized to file certain types of proposed rates in this Commonwealth. See Va. Code Sections 38.2-1908 and 38.2-2004. This Committee should review both an analysis of antitrust laws as well as the manner in which rate service organizations operate. A review will demonstrate that no statutory change should be instituted.

From the testimony heard by this Committee, it is manifest that (1) it would be inappropriate and ill-advised to make any modification of the existing state antitrust laws, and (2) the legislature already has in its power the ability to regulate any conduct where it deems such regulation appropriate.

Insurance has been extensively regulated by the states since the mid-1800's, and that concept remains uninterrupted to this date. The Supreme Court's 1944 decision in United States v. Southeastern Underwriters Association, 322 U.S. 533 (1944), (which held that a fire insurance company conducting a substantial part of its transactions across state lines was engaged in interstate commerce, and that Congress did not intend to exempt the business of insurance from the reach of the Federal Antitrust laws; specifically, the Sherman Act) lead to fears that there would be an undermining of the ability of states to engage in taxation and effective regulation of the insurance industry. Congress thus promptly enacted the McCarran-Ferguson Act, confirming what up to then was always presumed - that the issuance of an insurance policy was not a transaction in interstate commerce, and that states should be able to have exclusive domain over regulating the insurance industry.

As emphasized in testimony before this committee, the McCarran-Ferguson exemption is very narrow and limited. First, the insurance industry itself is not exempt from the antitrust laws, but rather only the business of insurance. This has proven to be an important distinction, ensuring that companies act competitively, while enabling "the business of insurance" to be

conducted pursuant to state regulated policy. Secondly, under the McCarran Act, it is clear that no conduct which would constitute any agreement of boycott, coercion or intimidation is granted any sort of exemption from antitrust laws. Thirdly and most importantly, the McCarran Act exempts the business of insurance to the extent it is regulated, or as stated in the McCarran-Ferguson Act itself, the Sherman Act and similar Federal antitrust acts shall be applicable to the business of insurance "to the extent that such business is not regulated by state law." Consequently, this Legislature has within its power the ability to determine exactly what activity will or will not be subject to antitrust principles.

The state analogue of the Federal Antitrust Act was based upon the same philosophy that exists at the Federal level. (This fact is clear, not only from the 1974 report of the VALC Committee charged with studying, reporting and recommending the new antitrust laws for the Commonwealth, but also from the Act itself, which mandates that the Virginia Act "shall be applied and construed to effectuate its general purposes in harmony with judicial interpretation of comparable Federal statutory provisions." See Section 59.1-9.17) (See also House Document 20, 1974 Acts of Assembly at 9, explicitly stating that the purpose of the exemptions set forth in Section 59.1-9.4(b) was "to ensure that state antitrust laws will not conflict unnecessarily with other statutes or regulatory schemes.") It was with these purposes in mind that the state antitrust Act, as adopted, set forth in Section 59.1-9.4 that conduct "authorized,

regulated or approved (1) by statute of this Commonwealth, or (2) by an administrative or constitutionally established agency of this Commonwealth, ... having jurisdiction of the subject matter and ... authority to consider the anticompetitive effect, if any, of such conduct, shall be exempt from the antitrust act."[1]

Again, it must be emphasized that the State Antitrust Act, similar to the McCarran-Ferguson Act, exempts activity only to the extent that it is regulated either by statute or administrative order of a state agency which, in the case of the insurance industry, is the State Corporation Commission. In short, the exemption applicable to numerous industries ensures that there is not unnecessary conflict between the antitrust act and other provisions of state law.

As the testimony before this Committee demonstrates, if the exemption was repealed as to the insurance industry itself, all of the provisions of Title 38 would still be in full force and effect. What would be created are numerous issues of statutory construction among conflicting principles of antitrust

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[1]It must be emphasized contrary to the allegations and statements made by the Attorney General's Office and a number of speakers that there is no specific exemption in the Virginia Antitrust Act for the insurance industry. The antitrust exemption is not one unique to insurance, but rather is applicable to numerous industries which gain a measure of exemption to the extent that their activities are regulated and thus mandated, including among other industries, the electrical industry, gas, water, telephone, air, motor and rail carriers, pipelines, ocean shipping, water carriers, stock exchange, television and radio communications, banking, and a host of other industries, including not only the insurance industry, but as an example, the mortgage lending and brokerage industry, which was just put under the jurisdiction of the State Corporation Commission at a recent session of the General Assembly.

laws and mandates set forth in the State Insurance Code. What ultimately would develop is a battleground for a turf war between the Bureau of Insurance and the Office of the Attorney General for the ultimate regulation of the insurance industry. The assurance of a proper methodology of regulating the insurance industry for the benefit of the consumers of the Commonwealth would not be created, but in fact would be destroyed.

Remembering that the purpose of the exemption is to ensure (1) against unnecessary conflict between the Antitrust Act and the other provisions of state law, and (2) that this Assembly, through specific statutes in the insurance code, can mandate the type of regulation that it deems advisable, then the call for the repeal of the antitrust act should quickly and soundly be rejected by this Committee. If it determines that statutory reform of some type is needed, then it should modify those specific provisions of the insurance code that are deemed appropriate for modification. This is the manner in which the scheme of regulation has always worked and the manner that is in the best interest of consumers. In short, amend the insurance code and leave the state antitrust act alone.

This brings into focus, however, exactly what provisions of the Insurance Code, as opposed to the Antitrust Act, should be modified or repealed? Also, how should rate servide organiztaions be treated? The Assembly, it is suggested, should not tamper with the provisions of Chapter 7 of Title 38.2, which prohibit certain interlocking directorships or certain mergers, which might substantially lessen competition or tend to

create a monopoly, nor for that matter should the Assembly tamper with the provisions in Title 38.2 dealing with rate service organizations such as ISO, which prohibit those organizations from monopolizing the business of insurance, fixing insurance rates, unreasonably restraining trade, refusing to deal, or more importantly, interfering with an insurer's rights to make rates independently. See Va. Code Section 38.2-1906.

The Attorney General's presentation before this Committee on October 27, 1988 did not offer any rebuttal to the legal analysis that has been presented to this Committee regarding the applicability of the State Antitrust Act. Instead, her office simply raises questions, such as what short term dislocations in the insurance industry might result if rate service organizations were prohibited from filing advisory rates in Virginia; would small companies be able to compete within a reasonable period of time with industry giants; over the long term, could small Virginia-based companies survive; what would happen to the industry and the ability for new companies to enter into the market if rate service organizations were prohibited from publishing certain data relating to rates; and what would happen if smaller companies, without the necessary resources to develop rates and trends in actuarial estimates, were prohibited from utilizing such rate organization data? In short, the questions raised are economic issues, not legal issues.

Prior to responding to such questions, an understanding of rate service organizations and the beneficial impact they have on the industry, is necessary. Preliminarily an understanding of

insurance itself is necessary.

Insurance exists because of uncertainty, that is, because of the inability of people and businesses to predict future events. In order to protect their assets, the financial consequences of future accidental -- and potentially catastrophic -- losses are transferred to an insurer in exchange for a premium.

An insurer can assume the risk of these losses and liabilities only by spreading them among many insureds, each of whom pays a relatively small premium. Determining the amount of insurance premium is a process that bears little resemblance to the way prices are determined in other industries.

Since the tangible benefits of an insurance policy are not received until after an insured buys a policy, the costs of that policy to the insurer are not known until long after the policy is sold. Firms in other industries are generally able to base their prices on known or knowable costs. At the time of sale, they usually know how much they have spent and will spend on labor, raw materials, equipment, transportation, and the other costs of the goods and services they sell. Insurers, on the other hand, face claim costs based on future fortuitous events outside their control and can only try to predict those costs at the time of sale. This is the essential insurance pricing problem and constitutes the essential difference between insurance and almost every other industry.

Central to the process of insurance ratemaking is the statistical database from which the insurer's future costs must

be estimated. As is generally the case with statistical analyses, the larger the statistical sample, the greater the probability that the predictions based upon it will prove accurate. (This principal is commonly referred to as the law of large numbers.) With a broad aggregate database of loss experience, the actuarial analysis of expected losses is more reliable.

No insurer enjoys a market share large enough for all lines and classes of insurance to develop actuarially sound rates based solely on its own loss experience and actuarial analysis. The insurance marketplace is characterized by many competitors, of which none has a dominant market share. This is particularly true in commercial lines insurance where, in addition to this fragmented market, the type of risks insured are not homogeneous. Indeed, there is an extraordinary variety of disparate risks in commercial lines insurance. An insurer with 5% of the overall market is likely to be writing policies for many different kinds of businesses. Commercial general liability insurance, for example, provides for more than 1,000 distinct classes, ranging from hardware stores to schools to hotels to coal mines, with many different territories, coverage options, deductibles and policy limits.

Competition is so significant, market share so fragmented among the companies writing commercial insurance, and commercial risks so disparate that probably no insurer in business today could price its product credibly without access to aggregate industry experience. Such small market shares do not

give individual companies enough statistical experience to generate credible statistical samples for specific risk classifications. In addition, most companies do not have the resources to employ sufficiently large actuarial staffs that would be needed to perform all the required analyses. Actuarial analysis, loss development, trending, etc., permits the underlying costs to be estimated in spite of the random fluctuation that appear in even aggregate actual insurance losses, and the costs can then be projected into the future. Therefore, the availability of a large aggregate data base of experience and accompanying actuarial analysis is critical.

Insurance Service Office, Inc. (ISO) is a licensed rate services organization that makes available to any participating insurer advisory rates which represent the average prospective loss cost for each class and includes provisions for the average expenses and profit. Insurers participating in ISO make their own independent pricing decisions, based on their own marketing strategies, after assessing how their book of business and their expenses compare with the industry averages. The more confident insurers are in their calculation of future costs, the less they need to seek a high contingency margin in the premiums they charge their insureds. Moreover, the more that insurers are able to base their pricing on accurate predictions of their future costs, the less likely that they will face future financial instability or insolvency and the less likely that they will default on their obligations to their insureds.

THE COOPERATIVE ACTIVITIES PERFORMED BY A RATE SERVICE ORGANIZATION ENHANCE COMPETITION BY ENABLING MORE INSURERS TO COMPETE, BY LOWERING BARRIERS TO ENTRY AND BY REDUCING THE COSTS OF CONTINUING IN THE MARKET PLACE

Individual company access to ISO's pooled data base, actuarial analysis and advisory rates makes statistically credible data available to any insurer that chooses to participate. The result is procompetitive. New insurers, small and medium-sized insurers, and even larger, well-established insurers entering new geographic arears or lines of insurance can use information gathered, analyzed and distributed by ISO to enter a new market or remain in an existing market.

A centralized rate service organization, such as ISO, provides insurers with the benefits of economies of scale through its pooled historical data base, professional staff and data processing equipment. If individual insurers had to provide entirely on their own the services now provided by a rate service organization such as ISO, many insurers would not be able to enter or remain in markets with the same reasonable degree of confidence in the measure of risk potential. All insurers would also incur higher expenses.

If an industry that markets its products largely through independent businessmen, there is great utility in the widespread availability of ISO manuals which contain gross advisory rates. There are seveal hundred insurers providing property/casualty insurance products in Virginia and literally thousands of independent insurance agents and brokers. Insurers do not use advisory rates in a lockstep fashion. Rather, ISO

advisory rates provide valuable information about the average prospective loss costs and average expense costs in each of the literally thousands of classes. Many insurers use this information to develop independent rate filings and programs. Others file percentage deviations to reflect differences between insurers in production costs, anticipated loss experience, risk selection and coverage terms. The flexible rating plan produces considerable independence and results in price variation by company. This is true regardless whether companies file percentage deviation.

Insurers participating in ISO make their own independent pricing devisions, based on their own marketing strategies, after assessing how their book of business and their expenses compare with the industry averages. After comparing their book of business to the ISO rates, some insurers may choose to price below the advisory rate in order to compete in the market to either maintain or gain market share. Insurers regularly depart from ISO's advisory rates by filing deviations from the ISO rate and by applying individual risk rating plan adjustments to account for an insured's own loss potential. Thus, the final price, although a function of the ISO advisory rate, often is quite different from one insurance company to another.

Furthermore, price is not the only means of competition in the insurance industry. Insurers also compete fiercely in terms of their distribution methods (e.g., independent agency, direct mail), their customer services and claims handling, their

packaging of coverages, and their specialization (e.g., by line of insurance, by geographic region, by class of risk, etc.)

Insurers need an advisory rate which reflects both pooled historical data and actuarial forecasting of that experience (e.g., loss development and trending).

As an alternative to her proposal of repeal of the antitrust exemption, the Attorney General has proposed that the insurance industry's antitrust exemption be limited by carving out the authority for rate service organizations to pool historical data only, but not to develop prospective cost information or rates. This proposal is not a viable alternative because insurers need prospective cost information which reflects both the pooling of historical data and actuarial forecasting.

To credibly forecase future loss costs for a particular line of insurance, two conditions must be satisfied. First, there must be available a reliable data base that provides an accurate history of losses paid or incurred on similar types of insurance coverages in the past. Second, there must be available a staff of skilled actuaries and economists. These professionals use historical data (claims that have been paid, along with related expense such as legal fees and other claim handling expenses) as a guide. By applying sophisticated mathematical and economic analyses to historical data, actuaries estimate the costs that can be expected to arise in connection with future insurance policies.

Most people can readily understand why the broadest possible data base incorporating historical data is essential to

the fair pricing of insurance. However, in addition, it is necessary to do sophisticated actuarial analysis of the pooled historical data to produce a realistic forecast on which future prices can be based.

Data collection, as essential as it is, is only the first step in the process of projecting future costs. Historical data can provide a good, although frequently incomplete, picture of past costs but give little information about future costs. Actuarial research skills and expertise, as well as proper judgment, are needed to produce prospective loss costs and rates.

When predicting future costs for a given coverage, the most recent similar policies for which data is available would seem to provide the information that is most related to these future costs. However, in "long-tail" lines such as commercial general liability insurance, it can take many years before enough claims have been reported and settled to accurately determine the ultimate costs on a set of policies. Consequently, general liability policies written in 1986 would provide very little in the way of loss information to use as a guide for pricing 1987 or 1988 policies. Only a portion of the losses that will ultimately be paid on those policies would have been reliably quantified by 1987 or 1988.

The insurer faces a dilemma. Ideally, it would like to use the loss information generated by the most recent policies, since the economic and social factors that affected the loss costs for those policies are more likely to be similar to those factors that will affect the loss costs associated with policies

that will be written tomorrow. Unfortunately, the most recent policies are those for which the information is the least complete. Historical data is incomplete because it does not reflect:

*Claims that will be reported after the evaluation date (incurred but not reported -- IBNR),

*Necessary refinements of the case reserves (additional information that later becomes available for known but as yet unpaid claims).

LOSS DEVELOPMENT

There is a resolution to this dilemma. It is called loss development. By analyzing the loss development of earlier policies, an actuary is able to make the best possible estimate of the total losses that will be ultimately paid out on policies that were written in recent years and for which only a fraction of the loss information is currently available. The actuary knows that the paid losses plus case reserves (the most current estimates of the losses that will be paid on unsettled claims that have been reported to the insurer) for the most recently written policies are not "mature" enough to be used without some type of adjustment. The adjustment that is needed for the losses on the most recent policies is due to the same phenomenon -- loss development -- that was observed on older policies.

Thus, in a sense, the actuarial technique called loss development does nothing more than fill in the otherwise incomplete picture given by an historical data base. A rate service organization is the logical and most cost-effective

entity to calculate the loss development factors needed to complete its historical data base. The alternative would be to force each company to individually reproduce essentially the same calculations, at significant cost on an industrywide basis.

Loss development refines the estimates of historical loss data as more information becomes available, that is as the policy year matures. However, loss development is not sufficient in itself to produce sound prospective loss costs or rates. It does not tell what loss costs will be for a future period when a policy, for which a premium is being collected now, will be in effect.

TRENDING

To determine what the loss costs will be for a future period, historical developed loss data for a number of years must be analyzed for frequency and severity trends. Actuaries calculate average claim costs, observe the trend in these costs and project this trend into the future. The frequency and severity trend factors developed through actuarial analysis are applied to developed historical loss costs to place them at the cost and frequency level anticipated for the period in which the new rates will be in effect. As with loss development, trending is based on verifiable historical facts. And as with loss development, it is far more efficient for the industry to take advantage of the economies of scale inherent in the calculation of these factual numbers by allowing a central entity -- a rate service organization -- to apply appropriate trend to its

developed historical loss costs.

As data gatherers, rate service organizations are well aware of the composition of the historical database, the various data elements available for analysis, along with changes in internal and external influences on insurance costs. This knowledge is essential in performing actuarial analyses for loss development and trend on a database. It enhances the accuracy of the projected results which, in the long run, leads to greater price stability, and increased competition/lower prices due to the greater confidence in prospective loss projections.

The Virginia Commissioner of Insurance has proposed that rate service organizations "be prohibited from filing average expense factors on behalf of member companies." Implicit in that proposal is the recognition of the value of the actuarial forecasting (i.e., trend, loss development) in prospective loss costs, a conclusion with which we concur. However, we do not agree that rate service organizations should be prohibited from filing average expenses for use by their participating insurers, because to do so would eliminate from the insurance marketplace the efficiencies that accompany a rate service organization manual including advisory rates.

As previously stated, insurers evaluate their own books of business, expenses and profit needs to determine their own pricing requirements in relation to ISO rates. To the extent that insurers are forced to individually replicate calculations that could be done once for use by all, insurers' costs -- and therefore insurance prices -- must necessarily rise. Small

insurers may not have -- nor be able to afford -- the actuarial expertise and sophisticated computer systems needed for loss development and trending undertakings. And the actuarial and computer resources maintained by larger insurers would need to be expanded in order to handle the additional workload.

Companies will have to rely on in-house or consulting actuaries to develop their rates from available industry data. Administrative costs should rise and be passed along to customers. At least in a transition period, rationing of scarce actuarial talent will pose many problems and present the likelihood of severe disruption in rate setting functions generally. Certainly during such a transition period, the effect of rate making uncertainties will likely have the effect of reducing capacity in "problem" lines and in certain territories, especially of more marginal competitors. Even over time, smaller companies will be disadvantaged from a cost and perhaps skill viewpoint in ways that should reduce the competitiveness of the industry.

Lastly, limiting the exemption by carving out authority to pool historical loss data only would create barriers to market entry and thereby reduce competition. As previously stated, the economies of scale which a rate service organization's advisory rates created permits prospective insurers and small companies to easily enter the market and compete. It also facilitates market entry for large insurers.

As previously pointed out, rate service organizations create economies of scale through cooperative actuarial

forecasting (trend, loss development of historical data) which enhance competition by facilitating market entry. To limit rate service organizations to the collection of historical loss data would negate those economies of scale and thereby make the costs of market entry prohibitive to many prospective insurers, small insurers and large companies considering writing new lines of insurance.

The creation of barriers to market entry would result in fewer insurers competing in the marketplace.

In short, the insurance industry is unique. It is not like the airline industry, which, with deregulation, has seen the failure and insolvency of numerous small companies and the merger and acquisition of numerous other industry giants. And what the Attorney General is advocating is deregulation of the insurance industry. It would adversely impact an insured. Deregulation of an airline industry might inconvenience a traveler. To allow volatility to enter the insurance market means potential insolvencies and the disruption (in the future) of the insurance and indemnification that numerous consumers today are relying upon in planning economic stability. In short, this Assembly has the choice of experimenting, as proposed by the Attorney General, and seeing if insolvencies will or will not happen, with their attendant dire consequences, or it can choose to continue the regulation of insurance by the State Corporation Commission, in accordance with the mandates as set forth in Title 38.2. The choice should be obvious.

II. AFFORDABILITY AND AVAILABILITY

The Subcommittee has heard allegations that the commercial liability insurance market in Virginia is not competitive, that insurers fix prices, and that insurer profits are excessive. The Attorney General's Office has suggested solutions to these alleged problems in the form of additional restrictions on permissible activities by rate service organizations and increased use of prior approval rate regulation. Three main points should be emphasized.

1. The commercial liability insurance market is highly competitive. The allegations of price-fixing and other forms of noncompetitive behavior are unsupported and inconsistent with the reality of the marketplace. Evidence of extensive flexibility and independence in pricing and of substantial price variation among companies was not considered by the Attorney General's Office.

(a) Market shares of the leading firms writing general liability insurance in Virginia are low and have been subject to considerable variation over time. Significant entry barriers for new firms do not exist. While the market shares of leading firms for the six "troubled" lines emphasized by the Attorney General's Office are higher than for the overall market, there are no significant barriers to entry by additional firms or to expansion by firms already writing business in these lines.

(b) Price-fixing through the advisory rate system of the Insurance Services Office (ISO) or any other mechanism would be illegal and subject to severe sanctions under existing

Virginia law (Virginia Insurance Code, Section 38.2-1916). Many commercial liability insurers make independent rate filings, including 30-40 percent of the insurers with positive written premiums for the six troubled lines in 1987. Many other insurers file percentage deviations from ISO advisory rates. These deviations are inconsistent with price-fixing. Individual risk-rating plans (which include expense modification, experience rating, and schedule rating plans) provide insurers that use the ISO advisory rate system with substantial flexibility in pricing. Moreover, substantial evidence of significant price variation exists. Given the illegality of price-fixing and lack of an enforcement mechanism for a price-fixing arrangement, it is highly unlikely that the ISO advisory rate system raises prices to consumers. Instead, the system is likely to benefit consumers by lowering the total cost of ratemaking, by facilitating entry by insurers into additional classes of business, and by helping to promote financially sound competition.

2. The assertions that insurance company profits have been excessive and that Virginia policyholders subsidize policyholders in other states are based on questionable and misleading analysis and interpretation of data on insurance company operating results. Given the evidence that the market is highly competitive, substantive changes in regulation are not warranted based on this analysis.

The assertions by the Attorney General's Office were based on (a) a comparison of written premiums and paid claims for Virginia general liability insurance, (b) a comparison of

Virginia's general liability insurance loss ratio to the countrywide loss ratio, (c) an analysis of the rate of return on surplus for general liability insurance in Virginia, and (d) low incurred loss ratios calculated with the HB 1235 data for the six troubled lines.

(a) Paid losses on current policies and for policies written in prior years cannot be meaningful compared to written premiums for current policies. When expected losses are growing rapidly over time, written premiums in a competitive market will exceed paid losses by a substantial margin, and the margin will tend to increase over time.

(b) The comparison of Virginia's loss ratio to the countrywide loss ratio and attendant discussion assumed that any difference in loss ratios across states indicated a difference in expected profits when policies were sold. The fact that Virginia's loss ratio was lower than the countrywide loss ratio was treated as prima facie evidence of excessive prices in Virginia and of subsidies from Virginia consumers to consumers in other states. This approach is not valid, especially in view of the evidence of vigorous competition in the Virginia general liability insurance market.

Many states have had high loss ratios for general liability insurance in recent years as a result of unexpected growth in losses. High loss ratios often were associated with severe availability problems. The impact of large, unexpected losses in a few large states can have a pronounced impact on the countrywide loss ratio. Calculations were done of the

countrywide loss ratio for general liability insurance in 1987 excluding experience for the five states with the greatest general liability insurance premium volume. The loss ratio excluding these five states was 61.2 percent, compared to a ratio of 59.4 percent in Virginia.

Moreover, in a competitive market the loss ratio that is expected when policies are sold will differ across states due to differences in underwriting costs per dollar of premiums and in the average length of time between the receipt of premiums and the payment of claims. These variables will be influenced by many economic and demographic factors. The Attorney General's Office should have asked whether Virginia's loss ratio was significantly lower than those in other states after controlling for factors that could effect differences in loss ratios across states in a competitive market. This question would be very difficult to answer. However, the evidence that the market is competitive should lead to the presumption that the observed differences in loss ratios were not caused by noncompetitive behavior. If the loss ratio in Virginia were too low, the profit incentive would lead new and existing insurers to expand their production in an attempt to increase market share and profits. These actions would drive prices down and increase the loss ratio to its breakeven level.

(c) The Attorney General's Office has claimed that the rate of return on surplus from writing general liability insurance in Virginia is excessive. Calculations of the rate of return on surplus for general liability insurance in Virginia are

based on numerous assumptions for which economic analysis provides little guidance. Rates of return are especially sensitive to assumptions concerning the amount of investment income and surplus that should be allocated to general liability insurance. The calculations also assume the applicability of countrywide expense and investment results to Virginia. The underlying loss experience also is volatile over time. Calculations of rate of return for general liability insurance for Virginia in 1987 under a variety of assumptions produced a wide range of figures. Assumptions used by the Attorney General's Office could significantly overstate the unknown true rate of return. Moreover, the evidence that the market is competitive makes it highly unlikely that the rate of return for general liability insurance in Virginia would be excessive.

(d) Incurred loss ratios for lines with small premium volume are highly volatile. For this reason, interpretation of the HB 1235 data on losses and premiums for the six troubled lines is problematic. It also is likely that reported losses for many of the companies did not include loss development or estimates of incurred but not reported losses. The omission of these items would substantially understate ultimate losses on the business reported. Furthermore, the ease of entry by additional insurers and of expansion by existing insurers again makes it highly unlikely that prices would be excessive given market conditions in these lines.

3. The proposals by the Attorney General's Office for regulatory change would be likely to harm the citizens of

Virginia. New restrictions on the activities of rate service organizations would be likely to increase insurance company operating costs and to impede rather than promote competition. They also could destabilize the market and lead to a greater number of insolvencies. Increased use of prior approval rate regulation probably would make insurance less available in the short run and more expensive in the long run. It also would be likely to result in subsidies from low-risk consumers to high-risk consumers.

(a) Given the evidence that the market is competitive, the alleged benefits of restricting the activities of the ISO are at best speculative. In contrast, it is certain that such changes would increase some costs that ultimately would be borne by consumers. Restrictions on the ability to disseminate prospective loss costs, including loss development and trend, could be especially harmful to consumers. The cost of developing and trending historical data would be likely to discourage some companies from writing business in many of the classes and subclasses of insurance with small premium volume. The result would be less competition. Some companies might continue to write business in certain lines without incurring the costs required to obtain developed and trended estimates of prospective loss costs. If so, a greater tendency to underprice during soft markets, less stability, and an increased number of insolvencies could result.

(b) Evidence from other states that have actively practiced restrictive prior approval rate regulation in recent

years suggests that political pressure to hold rates below prospective costs leads insurers to supply less coverage. The reduction in supply in turn leads to pressure for mandated markets, such as joint underwriting associations and reinsurance pools. Restrictive prior approval rate regulation and the mandated markets that follow have a pervasive tendency to raise rates for low-risk consumers so that high-risk consumers can pay lower rates. Restrictive prior approval rate regulation is likely to aggravate insurance affordability problems over time by distorting the incentives of insurers and consumers to control claim costs. It also is likely to result in long and costly rate hearings in which industry and government representatives and numerous paid consultants, advocates, and experts engage in irresolvable arguments about the level of rates that should be approved.

During the 1970's, Virginia replaced its system of prior approval rate regulation with a file-and-use system. This decision was made only after extensive analysis of the advantages of competition and of the evidence of competition in the Virginia marketplace. The Attorney General's proposal to turn back the clock and adopt prior approval regulation for more and more lines of insurance should be rejected. It would be harmful to the average consumer in Virginia.

III. REINSURANCE

At the Joint Subcommittee's first hearing, the Attorney General offered an "introductory and tentative" analysis of

reinsurance practices. Ms. Terry questioned whether the reinsurance industry is competitive and expressed concern that a large amount of reinsurance may be transacted among affiliates without regulatory oversight. In Ms. Terry's view, each circumstance, if true, could lead to excessive rates. A regulatory scheme was suggested that would require ceding companies to report on each reinsurance transaction by state, line and subclassification.

The Joint Subcommittee heard a full day of testimony concerning reinsurance practices. The testimony demonstrated that by any rational measure the reinsurance industry is highly competitive and reacts accordingly. The testimony also explained that figures concerning "interaffiliate reinsurance," which had concerned Ms. Terry, reflected intracompany pooling, which is closely regulated under the Virginia Holding Companies Act and similar or identical legislation in forty-three other states. Finally, the testimony explained that rates are reviewed on a gross basis and that the State Corporation Commission ("SCC") has significant authority to investigate rates and examine companies to determine whether, in the case of an excessive rate, reinsurance arrangements might be a factor.

In view of the evidence received by the Joint Subcommittee an attempt to develop a detailed reporting scheme for each reinsurance transaction should not be recommended. First, there is no evidence that undue influence by reinsurers has caused inflated rates. The competitive structure of the reinsurance industry strongly argues against this conclusion.

Secondly, a detailed reporting scheme would be unworkable and is unnecessary. To the extent reinsurance could be used to improperly influence rates, regulatory authority exists to deal with any abuse in a thorough and efficient manner.

1. The Reinsurance Industry is Competitive and There is No Evidence that Reinsurance Practices Cause Excessive Rates

Competitiveness is a function of both concentration and ease of entry. The competitive structure of the industry makes it very unlikely that reinsurance would exert an undue influence on rates. The reinsurance industry is relatively unconcentrated and has low barriers to entry.

At the August 17, 1988 hearing Professor Scott Harrington presented a detailed analysis of the reinsurance industry's competitiveness. He noted that the industry's aggregate concentration is low compared to most major industries. Harrington Testimony at 6. The largest U.S. reinsurer enjoys less that 10% of the U.S. market. Zech and Kroner, National Underwriter (August 29, 1988) II at 7. Moreover, reinsurance industry results reflect those of a volatile, competitive market. The average return on surplus for 26 reinsurers selected by Ms. Terry's expert was approximately 9% for 1982 through 1986, including a negative 10.7% figure for 1984 and 2.4% for 1985. This average is indicative of competition. See Harrington Testimony at 13. Importantly, much of the increase in surplus between 1985 and 1986 came from capital infusions from owners and investors. Owners and investors contributed large amounts to

surplus to replace that which had been lost the previous year and to strengthen their companies for the future. Id. at 16.

The volatility in the market is also reflected in the industry's combined ratio figures. For 1982-86, reinsurance combined ratios in percent were: 112, 121, 141 and 111, a range of 111 to 141. This compares to the aggregate market's combined ratios of 110, 112, 118, 116 and 108. Harrington Testimony at 9.

Perhaps more significantly, the reinsurance industry also has low barriers to entry. There are no financial barriers to enter the reinsurance market over and above those that must be met to enter the primary market. Harrington Testimony at 5; Rondepierre Testimony at 2. In Virginia a company with $2 million capital and surplus can receive a license to write property casualty coverage. Va. Code Sections 38.2-1024 to 1036. No additional requirements are imposed in order for a licensed company to write reinsurance in Virginia. Nor are there additional financial requirements imposed in order that a licensed company may take credit for the reinsurance ceded. Id. at Section 38.2-1316.A.1.c. In other words, a company may reinsure whatever line it is permitted to insure. In Virginia, reinsurance may also be provided by a non licensed company if it has capital and surplus of at least $2 million. Id. at Section 38.2-1316. Capital is free to flow into the industry and the Commonwealth when investors perceive a reasonable opportunity for profit.

2. **The Existing Regulatory Scheme Allows an Efficient and Thorough Review of Reinsurance Impact on Rates Without the Need to Produce and Review Volumes of Questionable Data.**

The suggested legislative approach is unnecessary and would be unworkable. The existing legislative scheme permits review of reinsurance arrangements in an efficient manner.

Extensive testimony has been provided concerning the impracticality of the suggested legislation. There are numerous types of reinsurance arrangements for which meaningful state based data cannot be produced. Some other types of reinsurance arrangements would provide data that duplicate primary company data. Importantly, in these cases where data could be produced, it would involve an immense amount of work for the filing companies and the SCC. Tens of thousands of separate filings would be required, and the data would be fragmentary and serve no useful purpose. No agency could be expected to deal with such a volume. Gilmartin Testimony at 4; Rondepierre Answers at 2-3.

However, the existing rate regulatory scheme provides an efficient, thorough means for avoiding potential, adverse impact on rates. Rates are made and reviewed on a gross basis. A rate is determined to be excessive or reasonable whether or not reinsurance exists. Va. Code Section 38.2-1904; Rondepierre Testimony at 8; Gilmartin Testimony at 7. If a rate is determined to be reasonable, no further inquiry is necessary. On the other hand, if a rate is excessive the SCC has extensive investigative and examination authority to determine the cause including whether reinsurance arrangements could be a

contributing factor. Rondepierre Testimony at 8.

Aside from the hearing process, Va. Code Sections 35.2-1904; 1910, the SCC has broad authority to investigate rates on its own initiative, or upon consumer request. Id. Section 38.2-1909. The SCC has authority to examine licensed companies. Id. at Section 38.2-1317. Additional authority empowers the SCC to order production by holding company members of "any records, books or other information papers ... necessary to determine the financial condition or legality of conduct of the insurer." Id. at Section 38.2-1332. The SCC can require licensed companies to file reports in addition to the Annual Statement concerning, among other things, "transactions or affairs of the insurer." Id. at Section 38.2-1301.

Under each investigative avenue the SCC can examine reinsurance arrangements. And, in fact, the agency frequently reviews reinsurance arrangements. Minutes of August 17, 1988, Hearing at 3-4. Using its existing authority to focus on circumstances where rates are thought to be excessive, or where the financial condition of the insurer is in question is far more efficient than attempting to review filings by each insurer detailing each of its reinsurance agreements for each risk by state, line and subclassification. Limited resources can better be focused on specific problems.

3. Extensive Additional Authority Exists Regulating Pooling Arrangements

One of the concerns that prompted the Attorney General's legislative suggestion was a fear that extensive

interaffiliate reinsurance could cause excessive rates. For example, Ms. Terry was concerned that approximately 80 percent of all reinsurance business of selected companies was placed with affiliates. A.G. Outline of Issues and Background Materials, July 8, 1988, Hearing at 4. In fact, however, these figures reflected interaffiliate pooling, not traditional reinsurance transactions. Insurance groups in fact retain very little reinsurance within the group. Carpenter Testimony at 5.

As explained, pooling serves the legitimate need of an insurance group to evenly spread results among its members by way of sharing (pooling) premiums and losses.

Pooling provides no means for hiding profits and in fact pooling, as all material interaffiliate transactions, is extensively regulated under the Virginia Holding Companies Act and similar acts in other states. Va. Ins. Code Sections 38.2-1322 et seq.; Carpenter Testimony at 6-7.

A "material transaction" with an affiliate must comply with numerous standards including the need to be "fair and reasonable." Id. at Section 38.2-1330, A.1. A material transaction includes "any reinsurance treaty or agreement." Id. Section 38.2-1322.

Prior written approval by the SCC is required for a material transaction between a domestic insurer and any affiliate involving more than either five percent of the insurer's admitted assets or twenty-five percent of the insurer's surplus, whichever is less. Id. at Section 38.-1331. In deciding whether to give approval, the SCC must consider whether the transaction meets the

statute's standards and whether it might "adversely affect the interest of policyholders." Id.

Each licensed insurer that is a member of a holding company system must register with the SCC. Id. at Section 38.2-1329. Foreign insurers subject to disclosure requirements and standards in their jurisdiction of domicile substantially similar to those adopted by Virginia are exempt from registration. However, the SCC can require such foreign insurer to furnish a copy of the registration filed in its domiciliary jurisdiction. Id. at Section 38.2-1329.B.2.

The SCC has the authority to examine the books and records of a company subject to the Virginia Holding Companies Act and the authority to employ experts at the company's expense for such an examination. Id. at Section 38.2-1332. Forty-four states have Holding Companies Acts similar to Virginia's. Official NAIC Model Insurance Laws, Regulations and Guidelines, Vol. 2 at 440-26.

Pooling agreements are subject to the Act and must receive prior approval. In addition, such agreements and any non-pooling interaffiliate reinsurance agreements are to be reported on the Annual Financial Statement, which all licensed companies must file with the SCC. Reinsurance ceded to affiliates must be separately stated. Schedule F, Part 1A, Section 1. Reinsurance assumed from affiliates must also be reported on the Annual Statement. Schedule F, Part 1A, Section 2. See Carpenter Statement at 7.

Pooling serves important risk spreading functions and is subject to close regulatory scrutiny.

The industry suggests that no legislative change be made concerning regulation of reinsurance. The evidence is that the proposed regulatory scheme is not needed and, in any case, could not accomplish its stated purpose. Interaffiliate reinsurance and pooling are extensively regulated under the Virginia Holding Companies Act. Rates are regulated on the basis of the gross rate charged to policyolders, without regard to the existence of reinsurance. The SCC has significant authority to investigate rates and examine companies to determine whether, in the case of an excessive rate, reinsurance might be a factor. The reinsurance industry has low concentration, ease of entry and is highly competitive. To the extent it would involve substantial additional expenses to insurers and to the SCC, the proposed regulatory scheme would increase costs to Virginia policyholders with no corresponding benefit.

Respectfully Submitted,

AMERICAN INSURANCE ASSOCIATION
NATIONAL ASSOCIATION OF
INDEPENDENT INSURERS
ALLIANCE OF AMERICAN INSURERS
NATIONWIDE INSURANCE COMPANIES
REINSURANCE ASSOCIATION OF AMERICA
INSURANCE SERVICES OFFICE, INC.

BY _____

APPENDIX XI

COMMONWEALTH OF VIRGINIA

EVEN T. FOSTER
SIONER OF INSURANCE

Box 1157
RICHMOND, VA
TELEPHONE: (804) 786-3741

STATE CORPORATION COMMISSION

BUREAU OF INSURANCE

December 9, 1988

The Honorable Thomas W. Moss, Jr.
Majority Leader, House of Delegates
Wainwright Building, Suite 715
229 West Bute Street
Norfolk, Virginia 23510

Dear Tom:

At the last meeting of the HJR 120 Joint Subcommittee, you requested that the State Corporation Commission submit recommendations for the Joint Subcommittee's consideration on or before December 15, 1988. I am forwarding a copy of the Commission's recommendations to each member of the subcommittee and to the Attorney General.

You will find attached Exhibits 1-4 which contain the Commission's six recommendations to the Joint Subcommittee. The Commission and I respectfully request that the Joint Subcommittee recommend to the General Assembly the adoption of the attached amendments to Chapter 19 of Title 38.2 of the Code of Virginia in order to effect the six recommendations.

Exhibit I contains a change to the Commission's earlier recommendation concerning the filing of rates by rate service organizations. The effect of this change to the Commission's earlier proposal would restrict rate service organizations from trending the loss costs data. Rate service organizations would be allowed to develop the historical loss costs data. In addition, the filing of loss costs data by rate service organizations will be subject to the delayed effect provisions of Chapter 19.

Exhibit II contains an amendment to Title 38.2 which has the effect of prescribing the hearing date for the House Bill 1235 supplemental reports. The Commission recommends that the hearing date be no later than September 30 of each year. This would allow the Bureau of Insurance, the Attorney General's office, and other interested parties more time to review the filed data before the

Commission would be required to hold a hearing. Under the current statute, the Commission must hold a hearing within sixty days of the due date of the House Bill 1235 supplemental reports.

Exhibit III contains two of the Commission's recommendations. The first change would have the effect of requiring all insurers to file a supplemental report as prescribed in House Bill 1235. Under the current statute, only those insurers actually writing business in one of the troubled lines or subclassifications are required to submit a report. The second change found in Exhibit III would explicitly provide that failure to file a supplemental report by the due date established by the Commission would constitute a violation of Title 38.2.

Exhibit IV contains the final two recommendations of the Commission. You will note that Exhibit IV is in reference to reports required by House Bill 1234. The effect of the first change found in Exhibit IV is to establish the date by which the 1234 reports must be filed with the Commission. The second recommendation found in Exhibit IV would explicitly provide that failure to file a report required under House Bill 1234 would constitute a violation of the provisions of Title 38.2.

If you, or any member of the Joint Subcommittee, have any questions concerning the six recommendations offered by the State Corporation Commission, please feel free to contact my office. I look forward to meeting with the members of the Joint Subcommittee at your next scheduled meeting to be held on December 27, 1988.

Sincerely yours,

Steven T. Foster
Commissioner of Insurance

STF/mlm

ccs: Members of the HJR 120 Joint Subcommittee
The Honorable Mary Sue Terry
William Cramme

§ 38.2-1901. Definitions. ---As used in this chapter:

"Market segment" means any line or class of insurance or, if it is described in general terms, any subdivision of insurance or any class of risks or combination of classes.

"Prospective loss costs" are historical aggregate losses and all loss adjustment expense projected through development to their ultimate value.

"Rate service organization" means any organization or person, other than a joint underwriting association under § 38.2-1915 or any employee of an insurer including those insurers under common control or management, who assists insurers in ratemaking or filing by:

(a) Collecting, compiling, and furnishing loss statistics;

(b) Recommending, making or filing supplementary rate information; or

(c) Advising about rate questions, except as an attorney giving legal advice.

"Supplementary rate information" includes any ~~manual or plan of rates~~ experience rating plan, statistical plan, classification, rating schedule, minimum premium rule, policy fee, rating rule, rate-related underwriting rule, and any other information not otherwise inconsistent with the purposes of this chapter required by the Commission.

"Supporting data" includes:

1. The experience and ~~judgement~~ judgment of the filer and, to the extent the filer wishes or the Commission requires, the experience and ~~judgement~~ judgment of other insurers or rate

service organizations;

2. The filer's interpretation of any statistical data relied upon;

3. Descriptions of the actuarial and statistical methods employed in setting the rates; and

4. Any other relevant information required by the Commission. (1973, c. 504, §§ 38.1-279.30, 38.1-279.40; 1986, c. 562.)

§ 38.2-1905.1. Report on level of competition, availability and affordability of certain insurance. -- A. The Commission shall submit a report or reports to the General Assembly, at least annually, concerning the lines and subclassifications of insurance defined in §§ 38.2-117 and 38.2-118, including those lines and subclassifications containing as a part thereof insurance coverage as defined in those sections, insuring a commercial entity. The report or reports shall indicate (i) the level of competition among insurers in Virginia for those lines or subclassifications, (ii) the availability of those lines or subclassifications of insurance and (iii) the affordability of those lines or subclassifications of insurance.

B. The Commission's report or reports to the General Assembly shall also designate all insurance lines or subclassifications defined in §§ 38.2-117 and 38.2-118, including those lines or subclassifications of insurance containing as a part thereof

insurance coverage defined in those sections, insuring a commercial entity, for which the Commission has reasonable cause to believe that competition may not be an effective regulator of rates.

C. The report or reports to the General Assembly pursuant to this section shall be made no later than December 31 of each year, the first report or reports to be made not later than December 31, 1987.

D. A copy of each report made pursuant to this section shall be sent by the Commission to the Division of Consumer Counsel of the Office of the Attorney General. Each report shall be a matter of public record.

E. Those lines and subclassifications designated pursuant to subsection B of this section shall be reviewed by the Commission for the purpose of determining whether competition is an effective regulator of rates for each such designated line or subclassification. The Commission shall hold a hearing or hearings for that purpose no later than two months following the due date of the supplemental reports required under § 38.2-1905.2 at which it shall hear evidence offered by any interested party. In determining whether competition is an effective regulator of rates for each designated line or subclassification, the Commission may consider such factors as it deems relevant to such determinations, including the following factors:

1. The number of insurers actually writing insurance within the line or subclassification.

2. The extent and nature of rate differentials among insurers within the line or subclassification.

3. The respective market share of insurers actually writing insurance within the line or subclassification, and changes in market share compared with previous years.

4. The ease of entry into the line or subclassification by insurers not currently writing such line or subclassification.

5. The degree to which rates within the line or subclassification are ~~established~~ affected by the filings of ~~rating~~ rate service organizations.

6. The extent to which insurers licensed to write the line or subclassification have sought to write or obtain new business within the line or subclassification within the past year.

7. Whether a pattern of excessive rates exists within the line or subclassification in relation to losses, expenses and investment income.

8. Such other factors as the Commission deems relevant to the determination of whether competition is an effective regulator of rates within the line or subclassification.

F. Notwithstanding any designation made by the Commission pursuant to subsection B of this section, the Commission may, upon petition of any interested party, hold a hearing to determine whether, under the factors set forth in subsection E of this section, competition is not an effective regulator of rates for lines or subclassifications not so designated.

G. "Commercial entity" as used in this section shall mean any

(i) sole proprietorship, partnership or corporation, (ii) unincorporated association or (iii) the Commonwealth, a county, city, town, or an authority, board, commission, sanitation, soil and water, planning or other district, public service corporation owned, operated or controlled by the Commonwealth, a locality or other local governmental authority.

H. The Commission shall adopt such rules and regulations including provision for identification from time to time of subclassifications of insurance necessary to implement the provisions of this section. (1987, c. 697.)

§ 38.2-1906. Filing and use of rates. -- A. Each authorized insurer subject to the provisions of this chapter ~~and each rate service organization licensed under § 38.2-1914 that has been designated by any insurer for the filing of rates under § 38.2-1908~~ shall file with the Commission all rates and supplementary rate information and all changes and amendments to the rates and supplementary rate information made by it for use in this Commonwealth; and each rate service organization licensed under § 38.2-1914 that has been designated by an insurer for the filing of supplementary rate information under § 38.2-1908 shall file with the Commission all supplementary rate information and all changes and amendments to the supplementary rate information made by it for use in this Commonwealth; both insurer and rate service organization as follows:

1. In cases where the Commission has made a determination under the provisions of subsection E of § 38.2-1905.1 that

competition is an effective regulator of rates within the lines or subclassifications designated by the Commission, or in the case of all other lines or subclassifications subject to this chapter and not designated under subsection B of § 38.2-1905.1, such rates, supplementary rate information, changes and amendments to rates and supplementary rate information shall be filed with the Commission on or before the date they become effective.

2. Where the Commission has made a determination pursuant to subsection E or F of § 38.2-1905.1 that competition is not an effective regulator of rates for a line or subclassification of insurance, such rates, supplementary rate information, changes and amendments to rates and supplementary rate information for that line or subclassification shall be filed in accordance with and shall be subject to the provisions of § 38.2-1912.

3. For any line or subclassification that has been designated pursuant to subsection B of § 38.2-1905.1, insurers shall continue to file their rates in the same manner then applicable to the line or subclassification until a final determination is made by the Commission pursuant to subsection E of § 38.2-1905.1 as to whether competition is an effective regulator of rates.

A1. Each insurer whose rate filings are subject to subdivision 2 of subsection A of this section shall submit with each rate filing, as deemed appropriate by, and to the extent directed by the Commission, the following information relating to experience in Virginia and countrywide:

1. Number of exposures;

2. Direct premiums written;

3. Direct premiums earned;

4. Direct losses paid identified by such period as the Commission may require;

5. Number of claims paid;

6. Direct losses incurred during the year, direct losses incurred during the year which occurred and were paid during the year, and direct losses incurred during the year which were reported during the year but were not yet paid;

7. Any loss development factor used and supporting data thereon;

8. Number of claims unpaid;

9. Loss adjustment expenses paid identified by such period as the Commission may require;

10. Loss adjustment expenses incurred during the year, loss adjustment expenses incurred during the year for losses which occurred and were paid during the year, and loss adjustment expenses incurred during the year for losses which were reported during the year but were not paid;

11. Other expenses incurred, separately by category of expense, excluding loss adjustment expenses;

12. Investment income on assets related to reserve and allocated surplus accounts;

13. Total return on allocated surplus;

14. Any loss trend factor used and supporting data thereon;

15. Any expense trend factor used and supporting data

thereon; and

16. Such other information as may be required by rule of the Commission, including statewide rate information presented separately for Virginia and each state wherein the insurer writes the line, subline or rating classification for which the rate filing is made and which the Commission deems necessary for its consideration.

A2. Where actual experience does not exist or is not credible, the Commission may allow the use of estimates for the information required by subdivisions 1 through 15 of subsection A1 of this section and may require the insurer to submit such information as the Commission deems necessary to support such estimates.

A3. Prospective loss costs filings may be made by licensed rate service organizations for informational purposes only; however, such filings shall not contain final rates. Each such prospective loss costs filing shall be subject to the delayed effect provisions of § 38.2-1912.

B. No insurer shall make or issue an insurance contract or policy of a class to which this chapter applies, except in accordance with the rate and supplementary rate information filings that are in effect for the insurer.

C. The Commission shall develop a uniform statement or format for requesting the information specified in subsection A1 of this section. Such statement or format shall be utilized by all insurers for all rate filings. (1973, c. 504, § 38.1-279.34; 1976, c. 278; 1986, c. 562; 1987, c. 697.)

§ 38.2-1908. Rate making and ~~Delegation~~ delegation of ~~rate making and rate~~ - filing obligation. -- A. An insurer ~~or rate service organization~~ shall establish rates and supplementary rate information for any market segment based on the factors in §38.2-1904. An insurer may use ~~rates and~~ supplementary rate information prepared by a rate service organization, ~~with~~ and may use ~~average~~ prospective loss ~~factors~~ costs ~~or expense factors~~ determined by the rate service organization, ~~or~~ with modification for its own expense, and with modification for its own loss experience as the credibility of that loss experience allows.

B. An insurer may discharge its ~~obligations~~ obligation to file supplementary rate information under subsection A ~~or A1~~ of § 38.2-1906 by giving notice to the Commission that it uses ~~rates and~~ supplementary rate information prepared and filed with the Commission by a designated rate service organization of which it is a member or subscriber. ~~Any insurer subject to the provisions of subdivision 2 of subsection A of § 38.2-1906 that files a modification to increase such rate shall comply with the provisions of subsection A1 of § 38.2-1906.~~ The Commission may by order require an insurer to provide information in addition to that filed by the rate service organization. ~~If the proposed modification is to reduce such rates, the Commission shall determine the additional information to be required.~~ The insurer's ~~rates and~~ supplementary rate information shall be ~~those~~that filed from time to time by the rate service

organization, including any amendments to the ~~rates and~~ supplementary rate information, subject to modifications filed by the insurer. (1973, c. 504, § 38.1-279.36; 1976, c. 275; 1982, c. 201; 1986, c. 562; 1987, c. 697.)

§ 38.2-1913. Operation and control of rate service organizations.-- A. No rate service organization shall provide any service relating to the rates of any insurance subject to this chapter, and no insurer shall use the service of a rate service organization for such purposes unless the rate service organization has obtained a license under § 38.2-1914.

B. No rate service organization shall refuse to supply any services for which it is licensed in this Commonwealth to any insurer authorized to do business in this Commonwealth and offering to pay the fair and usual compensation for the services.

C. Any rate service organization subject to this chapter may provide for the examination of policies, daily reports, binders, renewal certificates, endorsements, other evidences of insurance, or evidences of the cancellation of insurance, and may make reasonable rules governing their submission and the correction of any errors or omissions in them. This provision applies to the classes of insurance for which the rate service organization ~~files rates pursuant to § 38.2-1908~~ <u>is licensed pursuant to § 38.2-1914</u>. (1973, c. 504, § 38.1-279.41; 1986, c. 562.)

§ 38.2-1916. Certain conduct by insurers and rate service organizations prohibited. -- A. As used in this section, the word "insurer" includes two or more insurers (i) under common

management, or (ii) under common controlling ownership or under other common effective legal control and in fact engaged in joint or cooperative underwriting, investment management, marketing, servicing or administration of their business and affairs as insurers.

B. No insurer or rate service organization shall:

1. Combine or conspire with any other person to monopolize or attempt to monopolize the business of insurance or any kind, subdivision or class of insurance;

2. Agree with any other insurer or rate service organization to charge or adhere to any rate, although insurers and rate service organizations may continue to exchange statistical information;

3. Make any agreement with any other insurer, rate service organization or other person to restrain trade unreasonably;

4. Make any agreement with any other insurer, rate service organization or other person that may substantially lessen competition in any kind, subdivision or class of insurance; or

5. Make any agreement with any other insurer or rate service organization to refuse to deal with any person in connection with the sale of insurance.

C. No insurer may acquire or retain any capital stock or assets of, or have any common management with, any other insurer if such acquisition, retention or common management substantially lessens competition in the business of insurance or any kind, subdivision or class thereof.

D. No rate service organization, or any of its members or subscribers, shall interfere with the right of any insurer to make its rates independently of the rate service organization ~~or to charge rates different from the rates made by such rate service organization~~.

E. No rate service organization shall have or adopt any rule, exact any agreement, or engage in any program that would require any member, subscriber or other insurer to utilize some or all of its services, or to adhere to its ~~rates,~~ rating plans, rating systems, underwriting rules, or policy forms, or to prevent any insurer from acting independently. (1976, c. 279, § 38.1-279.44:1; 1986, c.562.)

§ 38.2-1923. Person aggrieved by application of rating system to be heard; appeal to Commission. -- Each rate service organization and each insurer subject to this chapter ~~that makes its own rates~~ shall provide within this Commonwealth reasonable means for any person aggrieved by the application of its rating system to be heard in person or by an authorized representative on his written request. Any person who makes the written request shall be entitled to review the manner in which the rating system has been applied to the insurance afforded him. If the rate service organization or insurer fails to grant or reject the request within thirty days after it is made, the applicant may proceed in the same manner as if his application had been rejected. Any person affected by the action of the rate service organization or the insurer on the request may, within thirty

days after written notice of the action, appeal to the Commission. The Commission may affirm or reverse the action after a hearing held upon not less than ten days' written notice to the applicant and to the rate service organization or insurer. (1973, c. 504, § 38.1-279.51; 1986, c. 562.)

§ 38.2-1905.1. Report on level of competition, availability and affordability of certain insurance. -- A. The Commission shall submit a report or reports to the General Assembly, at least annually, concerning the lines and subclassifications of insurance defined in §§ 38.2-117 and 38.2-118, including those lines and subclassifications containing as a part thereof insurance coverage as defined in those sections, insuring a commercial entity. The report or reports shall indicate (i) the level of competition among insurers in Virginia for those lines or subclassifications, (ii) the availability of those lines or subclassifications of insurance and (iii) the affordability of those lines or subclassifications of insurance.

B. The Commission's report or reports to the General Assembly shall also designate all insurance lines or subclassifications defined in §§ 38.2-117 and 38.2-118, including those lines or subclassifications of insurance containing as a part thereof insurance coverage defined in those sections, insuring a commercial entity, for which the Commission has reasonable cause to believe that competition may not be an effective regulator of rates.

C. The report or reports to the General Assembly pursuant to this section shall be made no later than December 31 of each year, the first report or reports to be made not later than December 31, 1987.

D. A copy of each report made pursuant to this section shall be sent by the Commission to the Division of Consumer Counsel of

the Office of the Attorney General. Each report shall be a matter of public record.

E. Those lines and subclassifications designated pursuant to subsection B of this section shall be reviewed by the Commission for the purpose of determining whether competition is an effective regulator of rates for each such designated line or subclassification. The Commission shall hold a hearing or hearings for that purpose no later than ~~two~~ September 30 ~~months~~ following the due date of the supplemental reports required under § 38.2-1905.2 at which it shall hear evidence offered by an interested party. In determining whether competition is an effective regulator of rates for each designated line or subclassification, the Commission may consider such factors as it deems relevant to such determinations, including the following factors:

1. The number of insurers actually writing insurance within the line or subclassification.

2. The extent and nature of rate differentials among insurers within the line or subclassification.

3. The respective market share of insurers actually writing insurance within the line or subclassification, and changes in market share compared with previous years.

4. The ease of entry into the line or subclassification by insurers not currently writing such line or subclassification.

5. The degree to which rates within the line or subclassification are established by rating service organizations.

6. The extent to which insurers licensed to write the line or subclassification have sought to write or obtain new business within the line or subclassification within the past year.

7. Whether a pattern of excessive rates exists within the line or subclassification in relation to losses, expenses and investment income.

8. Such other factors as the Commission deems relevant to the determination of whether competition is an effective regulator of rates within the line or subclassification.

F. Notwithstanding any designation made by the Commission pursuant to subsection B of this section, the Commission may, upon petition of any interested party, hold a hearing to determine whether, under the factors set forth in subsection E of this section, competition is not an effective regulator of rates for lines or subclassifications not so designated.

G. "Commercial entity" as used in this section shall mean any (i) sole proprietorship, partnership or corporation, (ii) unincorporated association or (iii) the Commonwealth, a county, city, town, or an authority, board, commission, sanitation, soil and water, planning or other district, public service corporation owned, operated or controlled by the Commonwealth, a locality or other local governmental authority.

H. The Commission shall adopt such rules and regulations including provision for identification from time to time of subclassifications of insurance necessary to implement the provisions of this section. (1987, c. 697.)

EXHIBIT III

§ 38.2-1905.2. Supplemental report; required for certain lines or subclassifications of liability insurance. - A. All insurers licensed to write the classes of insurance defined in §§ 38.2-117 and 38.2-118, or to write policies of insurance that include as a part thereof the classes of insurance defined in § 38.2-117 or § 38.2-118, shall file a report showing their direct experience in the Commonwealth attributable to all lines or subclassifications of liability insurance designated by the Commission in accordance with subsection B of § 38.2-1905.1; provided, such reports shall be required only of insurers actually writing any such designated line or subclassification of insurance in the Commonwealth. Such reports may be filed on an individual insurer basis by a licensed rate service organization designated by the insurer, provided that such filing shall include all of the information otherwise required from the insurer.

B. Each supplemental report shall be made pursuant to the rules and regulations established by the Commission and shall be on a form prescribed by the Commission. Each report shall include, to the extent directed by the Commission, the following information:

1. Number of exposures;

2. Direct premiums written;

3. Direct premiums earned;

4. Direct losses paid identified by such period as the Commission may require;

5. Number of claims paid;

6. Direct losses incurred during the year, direct losses incurred during the year which occurred and were paid during the year, and direct

losses incurred during the year which were reported during the year but were not yet paid;

7. Any loss development factor used and supporting data thereon;

8. Number of claims unpaid; and

9. Such other relevant information as may be required by the Commission. The term "number of exposures" as used in this subsection shall mean the unit of measure of risk which is used by the insurer for the designated line or subclassification. Each insurer shall indicate in its report the unit of measure, e.g., number of individuals insured, number of entities insured, payroll, square feet, etc., used by such insurer for each line and subclassification. Such insurer shall use such unit consistently in all reports required by this section.

C. Upon designating any line or subclassification pursuant to subsection B of § 38.2-1905.1, the Commission shall establish the date by which such supplemental report shall be filed with the Commission. Failure to file such supplemental report on or before the due date established by the Commission shall be a violation of this chapter.

D. The requirements of this section shall not relieve any insurer of any reporting requirement to which it is otherwise subject in the absence of this section. (1987, c. 697.)

§ 38.2-2228.1. Certain liability claims to be reported to Commission; duty of Commission; annual report; statistical summary. - A. All liability claims for personal injury or property damage covered under policies issued in Virginia and classified in § 38.2-117 or § 38.2-118, or Virginia policies containing as a part thereof insurance classified in such sections, insuring a commercial entity, shall be reported annually to the Commission by each insurer individually or by each insurer through a rate service organization designated by the Commission. The report shall not identify the parties. The report to the Commission shall state the following in a format prescribed by it:

1. Claims by the type of coverage;

2. The amount of all reserves established in connection with such claims and all adjustments thereto, updated on a quarterly basis until final settlement or judgment;

3. The amount paid by the insurer in satisfaction of the settlement or judgment;

4. The total number of claims;

5. Attorney's fees and expenses paid by the insurer in connection with such claim or defense to the extent these amounts are known; and

6. Any other relevant information which the Commission may require that is consistent with the provisions of this section.

The report shall include a statistical summary aggregating information collected by type of coverage. Each report shall be a matter of public record. The Commission may also examine claim files and reports of reserves contained in the Annual Statement of individual companies as deemed appropriate. In addition to the report required by

this subsection, the Commission may, on its own motion or at the request of the Attorney General, require an insurer to file detailed information regarding individual claims.

B. "Commercial entity" as used in this section shall mean any (i) sole proprietorship, partnership or corporation, (ii) unincorporated association, or (iii) the Commonwealth, a county, city, town, or an authority, board, commission, sanitation, soil and water, planning or other district, public service corporation owned, operated or controlled by the Commonwealth, a locality or other local governmental authority.

C. "Insurer" as used in this section shall mean an individual insurer or a group of insurers under common ownership or control but shall not include mutual assessment property and casualty insurers organized and operating under the provisions of Chapter 25 of this title.

D. The Commission may exempt an insurer or insurers from any or all of the provisions of this section if it finds the application of any such provision or provisions unnecessary to achieve the purposes of this section.

E. The Commission shall establish the date by which the report described in subsection A of this section shall be filed with the Commission. Failure to file the report described in subsection A of this section by the due date established by the Commission shall be deemed a violation of this chapter. (1987, c. 512; 1988, c. 188.)

Mary Sue Terry
Attorney General

H. Lane Kneedler
Chief Deputy Attorney General

COMMONWEALTH of VIRGINIA

Office of the Attorney General

R. Claire Guthrie
Deputy Attorney General
Human & Natural Resources Division

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Finance & Transportation Division

Stephen D. Rosenthal
Deputy Attorney General
Criminal Law Enforcement Division

Deborah Love-Bryant
Executive Assistant

December 21, 1988

The Honorable Thomas W. Moss, Jr.
Member, House of Delegates
Wainwright Building, Suite 715
229 West Bute Street
Norfolk, Virginia 23510

Re: Recommendations of the Office of the Attorney General to the HJR 120 Joint Subcommittee Regarding the Affordability and Availability of Liability Insurance, the Insurance Industry's State Antitrust Exemption, and the Practices of the Reinsurance Industry

Dear Tom:

The enclosed two items are submitted pursuant to your request at the November 29 meeting of the HJR 120 Joint Subcommittee for written recommendations from this Office on the various issues raised at the Joint Subcommittee's hearings over the past six months. The first item is a discussion of the various recommendations (with suggested statutory language where appropriate) which I have offered previously either at the Joint Subcommittee's hearings or in the chart I distributed at the November 29 hearing. The second item, for reference purposes, is the chart I distributed on November 29.

Although I had hoped to have conferred with the State Corporation Commission before December 15 regarding their recommendations and mine, scheduling conflicts occasioned by the December meetings of the National Association of Attorneys General and the National Association of Insurance Commissioners made that impossible. As you know from Commissioner Foster's letter to you of December 9, 1988, containing the State Corporation Commission's recommendations to the Joint Subcommittee, the Commission did not take any position on a number of the recommendations listed on the chart I distributed at the November 29 hearing. It seemed to me particularly important that I meet with the Commission and Commissioner Foster to try to resolve our differences before I forwarded our final

recommendations to the Joint Subcommittee. We therefore contacted both Judge Harwood and Commissioner Foster and informed them that we would not be submitting our recommendations until we had had an opportunity to discuss the recommendations with them. As Lane Kneedler indicated to you last week, a meeting with Judges Harwood and Shannon and Commissioner Foster was scheduled for this past Monday, December 19. I am very pleased to report that the meeting was quite constructive and produced agreement on a number of our earlier suggestions that either can be implemented administratively or can jointly be recommended to the Joint Subcommittee for enactment by the General Assembly. I was also very pleased that there seemed to be a shared view that the present statute, with minor adjustments, can be implemented effectively to ensure the availability and affordability of commercial liability insurance for the businesses and citizens of the Commonwealth, and a shared commitment to achieve this goal. I have indicated in the enclosed discussion of this Office's recommendations where I believe we can agree on the administrative implementation of a recommendation or on the need for legislative action.

We will be present, of course, at the Joint Subcommittee's December 27 meeting to discuss our recommendations. In the meantime, however, I hope that you or any other member of the Joint Subcommittee will not hesitate to contact me if we can provide you with a further explanation of, or additional information concerning, any of our recommendations.

With kindest regards, I am

Sincerely,

Mary Sue Terry

MST/bms
Enclosures

cc: Members of the HJR 120 Joint Subcommittee
The Honorable Preston C. Shannon, Chairman
The Honorable Thomas P. Harwood, Jr.
The Honorable Elizabeth B. Lacy
Commissioner Steven T. Foster
James C. Roberts, Esquire
C. William Cramme, Esquire

THE HONORABLE MARY SUE TERRY
ATTORNEY GENERAL OF VIRGINIA

Recommendations to the

House Joint Resolution No. 120 Joint Subcommittee

December 1988

TABLE OF RECOMMENDATIONS

INTRODUCTION

The enclosed materials are submitted by the Office of the Attorney General to the House Joint Resolution No. 120 Joint Subcommittee pursuant to the Chairman's request that this Office, the Commissioner of Insurance, and representatives of the insurance industry submit recommendations on the various issues raised at the Joint Subcommittee's hearings over the past six months.

At the Joint Subcommittee's hearing on November 29, 1988, the Attorney General distributed a chart listing the various recommendations she previously had made concerning the issues being studied by the Joint Subcommittee. Commissioner Foster's letter of December 9, 1988, containing the State Corporation Commission's ("SCC's") recommendations to the Joint Subcommittee, did not take any position on a number of the recommendations listed in the chart the Attorney General distributed on November 29. At a subsequent meeting on December 19 between the Attorney General, SCC Judges Shannon and Harwood, and Commissioner Foster, however, agreement was reached on a number of the Attorney General's recommendations that either can be implemented administratively or can jointly be recommended to the Joint Subcommittee for enactment by the General Assembly. We have noted in the discussion below those areas where agreement has been reached.

Finally, we are very pleased to note that, at the meeting on December 19, all those present expressed both a shared view that the present statute, with minor adjustments, can be implemented effectively to ensure the affordability and availability of commercial liability insurance for the businesses and citizens of the Commonwealth, and a shared commitment to achieve that goal.

This document is divided into three parts that correspond to the three issues being studied by the Joint Subcommittee:

- the affordability and availability of liability insurance in the Commonwealth;
- the insurance industry's state antitrust exemption; and
- the practices of the reinsurance industry.

ISSUE ONE

THE AVAILABILITY AND AFFORDABILITY OF LIABILITY INSURANCE IN THE COMMONWEALTH

The numbers and letters of the recommendations for this issue correspond to the numbers and letters on the chart distributed by the Attorney General at the HJR 120 Joint Subcommittee hearing on November 29, 1988, outlining the various recommendations she has made over the past six months on the need to ensure the affordability and availability of liability insurance in the Commonwealth.

I. TROUBLED LINES REPORT

A. Survey of the Commercial Liability Insurance Market

The State Corporation Commission ("SCC") is statutorily required by § 38.2-1905.1(A) of the Code of Virginia to report annually to the General Assembly on the level of competition among commercial liability insurers and on the availability and affordability of commercial liability insurance in the Commonwealth. This report is now generally known as the annual "troubled lines report." To assist the SCC in the preparation of this report, the Commissioner of Insurance ("Commissioner") and his office, the Bureau of Insurance ("Bureau"), conducted written surveys of the commercial liability insurance marketplace both this year and last. In the fall of 1987, the segments of the market surveyed included consumer groups; those groups were not systematically surveyed in the fall of 1988. On several occasions this year and last, this Office questioned the appropriateness of the Bureau's survey methodology, the comprehensiveness of its survey tools, and the adequacy of its analyses.

We believe that it is essential that an annual survey of the commercial liability insurance marketplace be conducted in a systematic manner, be subjected to analysis according to clear and certain standards, and be accompanied by a reasonable opportunity for input from interested parties, including the insurance industry, consumers, and consumer advocates. The SCC recently affirmed its commitment to these same goals, and we are confident that we will be able to work together to bring them to fruition. In particular, the Commissioner agreed to have his staff sit down with ours within the next several months, as his staff develops plans for collecting information for the 1989 troubled lines report, to discuss the process of preparing the report.

Recommendation I.A.1.

TIMETABLE FOR THE BUREAU'S GATHERING OF DATA SHOULD BE WIDELY DISSEMINATED

It is important that the public be advised of (1) the Bureau's obligation under § 38.2-1905.1(A) to assess on an annual basis the competitiveness of the commercial liability insurance market and the availability and affordability of commercial liability insurance in Virginia and (2) the public's opportunity to provide input to the Commissioner and the Bureau on these matters.

We have recommended to the SCC and the Commissioner that they publish the schedule established for gathering the necessary data and advise the public of the means by which which it can present that data to the Commissioner and the Bureau. The SCC and the Commissioner appear willing to implement this recommendation, and we would be pleased to assist them in whatever manner they would find useful.

Recommendation I.A.2.

GUIDELINES SHOULD TELL CONSUMERS IN SIMPLE TERMS WHAT INFORMATION THE BUREAU FINDS RELEVANT AND COMPELLING

So that the insurance industry and consumers can gain a clear understanding of the type of information the Bureau finds relevant to its inquiry, we have recommended that the Bureau or the SCC publish guidelines explaining what data they find useful and intend to rely upon in reporting to the General Assembly on the commercial liability insurance market in Virginia.

We believe the SCC and the Commissioner will implement this proposal, and we would be pleased to work with the Bureau staff on the development of such guidelines.

Recommendation I.A.3.

THE BUREAU SHOULD ARTICULATE THE STANDARDS BY WHICH IT DETERMINES WHETHER TO RECOMMEND A LINE AS TROUBLED

Along similar lines, we have recommended that the SCC and the Commissioner articulate the standards by which the determination is made that there is reasonable cause to believe that rates for a line of commercial liability insurance may not be effectively regulated by competition, as required by § 38.2-1905.1(B). Only then can the insurance industry and interested consumers form reasonable expectations about this important "trigger" to the commercial liability insurance troubled lines regulatory process in Virginia.

This articulation of standards needs to take place at two points in time--prior to the collection of data, so the public is aware of what standards are intended to be used, and in the annual troubled lines report itself, so it is clear what standards were in fact used. The earlier articulation would, of course, be general in nature and might be no more than a recapitulation, in layman's terms, of the statutorily authorized competition factors set forth in § 38.2-1905.1(E). The articulation in the annual troubled lines report itself, however, should set forth in some detail the standards by which the threshold determination was made that there was, or was not, reasonable cause to believe that rates for a given line of commercial liability insurance were not effectively regulated by competition.

We believe that the Bureau and the SCC will articulate the standards used for declaring a line "potentially noncompetitive" (i.e., "troubled"). As with the two previous recommendations, we would be pleased to offer our assistance to the Bureau staff in developing the articulation of the standards for distribution to the public prior to the collection of the data for the annual report.

Recommendation I.A.4.
CONTINUE SYSTEMATIC SURVEY OF INSURANCE CONSUMERS AS WELL AS INSURANCE COMPANIES AND AGENTS

The Code of Virginia does not require that the Bureau of Insurance conduct a survey of the commercial liability insurance market. The Bureau, however, has elected each of the last two years to gather information in such a manner. In 1987, it surveyed insurance companies, insurance agents, and selected insurance consumer groups. This year, it sent survey questionnaires only to insurance companies, surplus lines brokers, and insurance agents and made no provision for systematically gathering data from consumer groups. It did receive data from some individual consumers.

We have recommended previously that the Bureau adopt more comprehensive procedures for researching the competitiveness, availability and affordability of commercial liability insurance in Virginia that include receiving data directly from both consumer groups and individual consumers who purchase or may seek to purchase such coverages. Those procedures might include written surveys, public hearings, interviews, focus group meetings, etc.

Again, the SCC and the Commissioner have indicated to us their intent to continue to seek information from consumers in a comprehensive manner as part of their continued commitment to respond to the concerns and needs of our citizens.

Recommendation I.A.5.
- SYSTEMATIC AND RANDOM METHOD FOR EXAMINING A SELECT NUMBER OF LINES EACH YEAR

Recognizing that general surveys concerning the competitiveness, availability and affordability of commercial liability insurance, either by mail or by telephone, may yield inconclusive results, we recommended that the SCC and the Bureau develop a systematic method for randomly selecting a number of commercial liability insurance lines and subclassifications for special focus each year. Accordingly, we suggested that specific information be collected from insurers, agents, surplus lines brokers and consumers regarding the lines and subclassifications randomly selected for focus. Finally, we proposed that insurers writing these randomly-selected lines be required to file a Supplemental Report pursuant to § 38.2-1905.2.

We believe that nothing in the current law would prevent the SCC and the Bureau from performing a survey of randomly-selected lines. The 1987 troubled lines report, published in November 1987, was the first troubled lines report prepared by the SCC and the Bureau. The 1988 report will be published by the end of December 1988. In light of the Bureau's two years of experience in preparing the report, its resolve to conduct a rigorous examination of the commercial lines market in the future, and the desire not to divert resources from an examination of truly "potentially troubled" lines to randomly-selected lines, we are persuaded that it is not necessary at this time to require that such a randomly-selected lines survey be conducted.

B. Preparing the "Troubled Lines Report"

The annual troubled lines report is of critical significance because it triggers the entire commercial liability insurance regulatory process implemented by House Bill 1235 (§§ 38.2-1904, 38.2-1905.1, 38.2-1905.2, 38.2-1906, 38.2-1910, and 38.2-1912). It is essential, therefore, that this report is based on comprehensive data which is appropriately analyzed, and that its conclusions are objective, fair and reasonable.

Recommendation I.B.1.
AFFORD THE OFFICE OF THE ATTORNEY GENERAL AN OPPORTUNITY TO PROVIDE INPUT ON AFFORDABILITY AND AVAILABILITY OF COMMERCIAL LIABILITY INSURANCE AND THE DESIGNATION OF POTENTIALLY NONCOMPETITIVE LINES

This year and last, our Office sought the opportunity to review the preliminary recommendations of the Bureau of Insurance

to the SCC prior to the publication of the troubled lines report. Our intention was to consider the conclusions reached by the Bureau on the basis of its survey data and to offer, if appropriate, our own recommendations to the Bureau concerning potentially noncompetitive lines. The Commissioner, however, declined to share any preliminary conclusions and recommendations with us.

Our Antitrust and Consumer Litigation Section and our Insurance and Utilities Regulatory Section have special expertise in evaluating the effectiveness of competition as a regulator of rates and the economic conditions underlying the availability and affordability of goods and services. We believe, therefore, that we can effectively contribute to the publication of the annual troubled lines report and that other interested parties may be able to contribute to the report as well.

The Commissioner and the SCC have declared that they have been and will continue to be receptive to input from any source. Our discussions have indicated that, in the future, our Office will be afforded the input we have been seeking. The final recommendations and decisions on whether to designate particular lines as potentially troubled, or potentially noncompetitive, however, are and will remain, of course, the Commissioner's and the SCC's, respectively.

Recommendation I.B.2.
TRANSFER RESPONSIBILITY FOR PREPARING THE TROUBLED LINES REPORT TO THE DIVISION OF CONSUMER COUNSEL

Because the Division of Consumer Counsel ("Division") of the Office of the Attorney General is charged with the duty of representing the interest of consumers before state agencies, it would not be inconsistent with its purpose for the Division to be given the responsibility for preparing the annual troubled lines report to the General Assembly on competition in the market for, and the availability and affordability of, commercial liability insurance. If it were to be given responsibility for the report, the Division would provide the trigger for the regulatory process by designating potentially noncompetitive lines, while the SCC would retain the authority to determine, after a hearing, whether, in fact, rates for the designated lines are effectively regulated by competition.

Representations made by the Commissioner of Insurance at the most recent Joint Subcommittee hearing suggest a commitment on the part of the Bureau to produce more thorough and analytical annual troubled lines reports in the future. Because we also believe that the administrative recommendations previously described herein will be considered and adopted by the SCC and the Commissioner, we do not intend to recommend a legislative proposal at this time to transfer responsibility for preparation

of the annual troubled lines report to the Division of Consumer Counsel.

II. SUPPLEMENTAL REPORTS

Among the most important provisions of HB 1235 is the requirement that insurers writing potentially troubled lines and subclassifications of commercial liability insurance in Virginia file "Supplemental Reports" that provide certain data relating to their experience in Virginia in writing that insurance. This requirement, if fulfilled faithfully, enables the SCC to distinguish between lines of insurance that are effectively regulated by competition and lines that are so noncompetitive as to require special ratemaking scrutiny.

Accordingly, it is important that steps be taken to avoid the problems that plagued the 1988 Supplemental Reports. We have recommended that the following measures be implemented to achieve that purpose.

Recommendations II.A. and II.B.
PRE-TEST THE SUPPLEMENTAL REPORTING FORM TO DETECT POSSIBLE MISUNDERSTANDINGS and CONDUCT INSTRUCTIONAL SESSIONS FOR INSURERS WHO ARE REQUIRED TO COMPLETE THE FORM

The SCC recently noted the overall poor compliance and quality of the 1988 Supplemental Reports for the 17 lines it had designated in November 1987 as potentially noncompetitive. "The overall quality of the submissions was poor." Many of the Supplemental Reports were filed late, and fewer than half of the reports filed contained data of acceptable quality. See Opinion and Final Order, Ex Parte In re: Determination of competition as an effective regulator of rates pursuant to Virginia Code § 38.2-1905.1.E., at 3 (Va. State Corporation Commission, Case No. INS880219) (Sept. 16, 1988). It is most important that the level of compliance with the reporting requirements and the quality of the Supplemental Reports be improved significantly in 1989.

Although the 1988 reports were replete with problems, the mere fact that many insurers had experience this year completing the Supplemental Report form may contribute to improved results in the future. Nevertheless, for the benefit of insurers who have to file a Supplemental Report in 1989, and especially for those who will file for the first time, an effort should be made to detect and correct misunderstandings about the data to be reported.

We have recommended previously that the Bureau consider "pre-testing" the 1989 Supplemental Report form (and all substantially revised Supplemental Report forms in the future). In addition, we have suggested that the Bureau offer instructional sessions for insurers who are required to file a Supplemental Report. The Commissioner and the SCC have expressed the intention both to pre-test the 1989 form and to conduct a day-long seminar for insurers that desire instruction in completing the form. We would be pleased to assist the Commissioner and the SCC in these efforts.

Recommendation II.C.
REQUIRE ALL COMPANIES LICENSED TO WRITE ANY OF THE TROUBLED LINES TO INDICATE WHETHER THEY ACTUALLY WRITE ANY OF THE LINES

A problem arose this year in identifying which licensed companies were obligated to file Supplemental Reports but did not. This occurred because companies that were licensed to write a designated line, but in fact wrote no premiums for that designated line, were not required to file a report. Therefore, when records indicated that a licensed company had filed no report for a designated line, it was not clear whether it wrote no premiums for that line or whether it just failed to file a required report.

We believe there are several alternative means to address this situation. Section 38.2-1905.2(A) now provides that an insurer must file a "Supplemental Report" for a designated line only if it "actually writes" a designated line in the Commonwealth. In his letter of December 9, 1988, to the Joint Subcommittee, the Commissioner proposed to delete this exception, which would have the effect of requiring all licensed companies to file Supplemental Reports, and then rely on the SCC's discretion in § 38.2-1905.2(B)(with regard to what information insurers will be required to file) to require insurers who do not actually write a designated line merely to indicate that they do not write any of the affected coverage.

We believe that the Commissioner and the SCC could do what they propose without a statutory amendment. If, however, it is felt that legislative clarification would be desirable, we offer for the Subcommittee's consideration an alternative amendment that would require each licensed company to file either (1) its Supplemental Report for a designated line or (2) a statement indicating that it did not write the coverage. Such an amendment to Subsection A of § 38.2-1905.2 would be as follows:

> A. All insurers licensed to write the classes of insurance defined in §§ 38.2-117 and 38.2-118, or to write policies of insurance that include as a part thereof the

classes of insurance defined in § 38.2-117 or § 38.2-118, shall file a report showing their direct experience in the Commonwealth attributable to all lines or subclassifications of liability insurance designated by the Commission in accordance with subsection B of § 38.2-1905.1; provided, ~~such reports shall be required only of insurers actually writing any such designated line or subclassification of insurance in the Commonwealth.~~ any such insurer that did not actually write any such designated line or subclassification of insurance in the Commonwealth during the reporting period shall be required only to report that it wrote no such insurance. Such reports may be filed on an individual insurer basis by a licensed rate service organization designated by the insurer, provided that such filing shall include all of the information otherwise required from the insurer.

Recommendations II.D., II.E. and II.F.
MEANINGFUL PENALTIES SHOULD BE ASSESSED AGAINST COMPANIES NOT FILING COMPLETE OR TIMELY SUPPLEMENTAL REPORTS
and
FILING TIMELY AND COMPLETE SUPPLEMENTAL REPORTS SHOULD BE A CONDITION OF DOING BUSINESS IN THE COMMONWEALTH
and
INCOMPLETE FILING SHOULD CONSTITUTE A FAILURE TO FILE

According to information provided to this Office by the Bureau of Insurance, as of October 26, 1988, 102 companies paid penalties of $250 to $1,000 for filing late Supplemental Reports. Section 38.2-218 provides for penalties up to $5,000 for each knowing or willful violation of the insurance laws and up to $1,000 "per violation" without knowledge or intent, up to a maximum of $10,000 for a "series of similar violations resulting from the same act." More substantial penalties than were imposed this year could have been imposed under existing law, and if needed to deter untimely and inadequate Supplemental Reports, statutory amendments could provide for even greater penalties.

We believe that incomplete or inadequate filings, as well as late filings and failures to file, impose a burden on the SCC and other parties interested in the competition analysis. No meaningful decision can be made regarding the effectiveness of competition in regulating rates without the necessary data.

At the Joint Subcommittee's November 29 hearing, the Commissioner of Insurance indicated that, while he had decided not to impose substantial penalties on insurers that did not comply fully with the reporting requirements of § 38.2-1905.2 as insurers adjusted to the new requirements during the first year of the statute's application, insurers were now on notice that he

would take a more stringent approach in the future. On this basis, we do not intend to recommend an increase at this time in the penalties authorized by § 38.2-218.

The SCC and the Commissioner also have agreed that a separate penalty may be addressed for each required Supplemental Report not filed by an insurer, that a failure to file amounts to a willful violation of the reporting law, that failure to file a substantially complete Supplemental Report constitutes a failure to file, and that they have the authority to require the filing of timely and complete Supplemental Reports as a condition of engaging in the insurance business in the Commonwealth. We do not believe legislation is necessary to clarify the first, second and fourth points of agreement. Legislation may be required to make it clear that failure to file a substantially complete Supplemental Report constitutes a failure to file. Clarifying language could be added to the end of Subsection A of § 38.2-1905.2:

> A. All insurers licensed to write the classes of insurance defined in §§ 38.2-117 and 38.2-118, or to write policies of insurance that include as a part thereof the classes of insurance defined in § 38.2-117 or § 38.2-118, shall file a report showing their direct experience in the Commonwealth attributable to all lines or subclassifications of liability insurance designated by the Commission in accordance with subsection B of § 38.2-1905.1; provided, such reports shall be required only of insurers actually writing any such designated line or subclassification of insurance in the Commonwealth. Such reports may be filed on an individual insurer basis by a licensed rate service organization designated by the insurer, provided that such filing shall include all of the information otherwise required from the insurer. Failure to file a substantially complete report shall constitute a failure to file the report.

III. COMPETITION HEARING

Once a commercial liability line or subclassification has been designated as potentially noncompetitive and insurers writing that line have filed the required Supplemental Report, the SCC must hold a hearing pursuant to § 38.2-1905.1(E) to determine whether, in fact, competition is an effective regulator of rates for that line.

We have a number of concerns about the legal standards that apply to the SCC's determination of competitiveness. We have expressed some of those concerns in our Petition seeking reconsideration of the SCC's September 16, 1988 Order and in connection with our appeal of that case to the Virginia Supreme Court. Because the case is on appeal, the SCC and the Commissioner are understandably reluctant to discuss issues that

may affect that appeal. It is, therefore, difficult in some instances to identify where there may be room for agreement on those issues. Nonetheless, we offer the following recommendations for future consideration, and we stand ready to work closely with the SCC and the Commissioner to achieve a resolution of our differences in this area.

Recommendation III.A.
THOSE LINES FOR WHICH THERE IS NOT SUBSTANTIAL COMPLIANCE WITH THE REQUIREMENT FOR COMPLETE AND TIMELY SUPPLEMENTAL REPORTS SHOULD BE DEEMED "NONCOMPETITIVE"

The SCC and the Commissioner have a critical role under HB 1235: to collect and analyze the data the insurance companies are required to provide once a given line of insurance is identified by the SCC as potentially noncompetitive. The Supplemental Reports are essential to enable the SCC and the Commissioner to determine whether, in fact, competition is effectively regulating rates in a potentially noncompetitive line.

The SCC and the Commissioner are hampered in fulfilling this role when, in any of the lines designated as potentially noncompetitive, there is not substantial compliance with the requirement for complete and timely Supplemental Reports. Without the necessary information, the SCC and the Commissioner have no basis for finding that competition is effectively regulating rates. Under such circumstances, the SCC should be required to conclude that the line in question is noncompetitive. We therefore recommend that the SCC first find that there has been "substantial compliance" with the Supplemental Report requirements of § 38.2-1905.2 by insurers writing a troubled line before it finds that competition is an effective regulator of rates for that line. We believe that this recommendation can be implemented administratively, but the following amendment is offered as a statutory alternative. It would appear at the end of present § 38.2-1905.1(E) as an unnumbered paragraph:

> Provided, however, that the Commission shall not find that competition is an effective regulator of rates for any line or subclassification designated under this section, unless it finds that there has been substantial compliance with the reporting requirements under § 38.2-1905.2 for that line or subclassification.

Recommendation III.B.

THE BUREAU SHOULD STATE ITS RATIONALE FOR FINDING LINES TO BE EFFECTIVELY REGULATED BY COMPETITION USING ~~ALL~~ SEVEN FACTORS LISTED IN § 38.2-1905.1(E)

Section 38.2-1905.1(E) lists seven specific factors which the SCC may consider in determining whether competition is, in fact, an effective regulator of rates for a troubled line. The statute also permits the SCC to consider "other factors" that it deems relevant. See § 38.2-1905.1(E)(8). For the benefit of insurers and consumers alike, the SCC should describe the relative weight assigned to each of the seven factors listed in the statute and any other factor it decides to consider. If a line is found to be noncompetitive, the SCC's rationale would provide insurers with some guidance as to how to correct the situation. If a line is found to be competitive, the SCC's rationale would help consumers understand how their insurance problems might be due to causes other than a lack of competiton or excessive insurer profitability. We believe that this recommendation can easily be implemented administratively and that an amendment to § 38.2-1905.1 is therefore unnecessary.

Recommendation III.C.

"POTENTIAL COMPETITION" SHOULD NOT BE CONSIDERED ADEQUATE COMPETITION FOR REGULATORY PURPOSES

At the troubled lines competition hearing before the SCC in June 1988, and again before this Joint Subcommittee this fall, the Bureau indicated that it had based its competition hearing recommendations to the SCC on the "potential competition" it found in each of the lines that had previously been designated as potentially noncompetitive. At the Joint Subcommittee's November 29 hearing, the Commissioner explained, for the first time, that, in evaluating "potential competition" in a line, he had used five of the seven factors listed in § 38.2-1905.1(E) -- number of insurers, rate differentials in the line, ease of entry, use of a rating service organization, and the extent to which insurers licensed to write insurance in a line sought new business in that line during the past year. The Commissioner indicated that he did not consider two of the factors -- market share, or "a pattern of excessive rates" (excessive profitability) in the line in question. The failure to consider the "pattern of excessive rates" (excessive profitabiity) factor was particularly troubling.

We have had a significant and important disagreement with the Commissioner in the past over how a "pattern of excessive rates" in § 38.2-1905.1(E)(7) is to be determined. We are pleased to report that the Commissioner and our Office now agree on the following interpretation of the statute.

The disagreement was based on whether the Commissioner could consider the "excessiveness" of rates under § 38.2-1905.1(E)(7) unless he first found that competition did not exist in the line in question, as required by the definition of "excessive rates" in § 38.2-1904(A). It was our position that this interpretation of the relationship between § 38.2-1905.1(E)(7) and § 38.2-1904(A) was in error, and if correct, would represent the enactment of a circular definition by the General Assembly.

Section 38.2-1904 is applicable to all lines of insurance covered by Chapter 19 of Title 38.2 -- not just commercial liability lines. Furthermore, the section sets forth the "rate standards" the SCC is to use to examine particular rates filed or being used by a particular insurer. It does not apply to the examination of potentially noncompetitive lines of insurance to determine if competition is effectively regulating rates in those lines.

Section 38.2-1905.1(E)(7) sets forth one factor -- excessive profitablity -- which the SCC may consider in deciding whether rates in a potentially noncompetitive commercial liability line are being effectively regulated by competition. If the SCC decides that competition is not effectively regulating rates in such a line, that line will become subject to the "delayed effect" procedures of § 38.2-1912. This means that, when an insurer writing that line requests a rate increase, the insurer no longer may merely "file and use" the requested new rate. Instead, the requested rate must be subjected to an actuarial analysis by the Bureau and the SCC to determine whether the requested rate is reasonable. It is at this point, and not earlier in the competition hearing, that the definition of "excessive rate" in § 38.2-1904(A) becomes relevant.

"Excessive rate" is defined in § 38.2-1904(A) as one which is "unreasonably high for the insurance provided and [for which] a reasonable degree of competition does not exist...." Both the "unreasonably high" and "no reasonable degree of competition" aspects of the definition normally must be considered by the Bureau and the SCC. However, for a commercial liability line which has been subjected to the troubled line competition hearing, and which already has been deemed noncompetitive, the SCC would be required to consider only the "unreasonably high" aspect of the definition of "excessive rate" since the SCC already would have determined that a reasonable degree of competition does not exist in the line. In no event, however, is the two-part definition of "excessive rate" in § 38.2-1904(A) relevant until this later rate hearing.

To apply the § 38.2-1904(A) definition of "excessive rate" to the term "pattern of excessive rates" in § 38.2-1905.1(E)(7) would lead to a circular definition and would make the "pattern of excessive rates" determination meaningless. The "pattern of excessive rates" is one factor the SCC may use to determine whether sufficient competition exists to regulate rates in the

line effectively. If the two-part definition of "excessive rates" in § 38.2-1904(A) is used to define "pattern of excessive rates" in § 38.2-1905.1(E)(7), then the SCC would first have to find that there was not a reasonable degree of competition in the line before it could use the "pattern of excessive rates" factor to determine whether competition was effectively regulating rates in that line. That is, they would have to answer the competition question before they could use the factor. Certainly the General Assembly could not have intended such a circular result.

Since the Commissioner now agrees with the above interpretation of the statute, no statutory amendment is needed to clarify the matter.

All seven of the competition factors in § 38.2-1905.1(E) should be considered. If, for example, there is excessive profitability in a troubled line, "potential competitors" do not compete in fact. There is not true competition, therefore, to regulate rates effectively and the line should be found noncompetitive. The concern should be actual competitive results in the marketplace, and this is best evaluated by applying all seven factors listed in § 38.2-1905.1(E). Since we understand that the Commissioner's reasons for considering only five of the seven factors were based at least in part on the limited time he and his staff had available to consider the large quantity of data submitted (including deciding which of that data was acceptable and usable), and since both this Office and the SCC and the Commissioner are recommending that the review period be increased from 60 to 120 days (see Recommendation III H below), we are not making a recommendation at this time with regard to the seven factors set forth in § 38.2-1905.1(E).

Recommendation III.D.
IF "A PATTERN OF EXCESSIVE RATES" OR A PATTERN OF EXCESSIVE PROFITABILITY IS FOUND FOR A LINE OF INSURANCE, THE LINE SHOULD AUTOMATICALLY BE DEEMED "NONCOMPETITIVE"

Excessive profitability is the first inquiry that should be made. If excessive profitability is found, the line of insurance under review should automatically be deemed noncompetitve because, by definition, competition is not effectively regulating rates if profits for a given line are excessive.

It appears that the Commissioner and the Bureau staff will consider "excessive profitability" in making recommendations to the SCC in future competition hearings. We therefore do not intend to offer a statutory solution to the problem at this time.

Recommendation III.E.

EXCESSIVE INSURER PROFITABILITY MAY BE INFERRED FROM UNUSUALLY LOW INCURRED LOSS RATIOS

Our Office and our expert witnesses have repeatedly argued to the General Assembly, the SCC and the Commissioner that an unusually low loss ratio for a potentially noncompetitive line of insurance is an important indicator that insurers are reaping excessive profits from that business. The Commissioner and the Bureau staff have been reluctant to agree, however, that low loss ratios can suggest that a "pattern of excessive rates" and, hence, noncompetition may exist. We disagree strongly with this view.

These are issues that do not lend themselves easily to legislation. We anticipate, however, that they will continue to be the subject of discussion and debate in the regulatory arena and that some accord can be attained in the future.

Recommendation III.F.

THE BUREAU SHOULD CONSIDER INVESTMENT INCOME ON SURPLUS IN EVALUATING INSURER PROFITABILITY

The Commissioner of Insurance has recently verified that it is the Bureau's practice to include consideration of an insurer's investment income on surplus in evaluating that insurer's overall profitability. Such investment income on surplus clearly may be considered in reviewing a particular rate request. See § 38.2-1904(B)(1)(vii). Since, however, there may be confusion as to whether investment income on surplus may be considered at the competition hearing on a troubled line in determining whether a "pattern of excessive rates" exists in that line, it may be advisable to amend § 38.2-1905.1(E)(7) as follows:

> 7. Whether a pattern of excessive rates exists within the line or subclassification in relation to losses, expenses and investment income, including investment income on surplus.

Recommendation III.G.

REQUIRE BUREAU AND SCC TO CONSIDER ALL COMPETITION FACTORS SET FORTH IN § 38.2-1905.1(E) AND TO COLLECT AND CONSIDER ALL DATA LISTED IN § 38.2-1905.2(B)

When the General Assembly deliberated over HB 1235 in 1987, there was much debate about the breadth and depth of the information and factors that the SCC would require and consider in conjunction with a troubled lines competition hearing. Ultimately, the SCC was given considerable discretion in this regard, and to date, it has had only limited opporunity to

exercise that discretion. Furthermore, it appears that we are reaching an accord with the Commissioner and the Bureau on the collection of the data required by § 38.2-1905.2 and the competition factors to be considered pursuant to § 38.2-1905.1(E). It is not our intention, therefore, to offer a statutory amendment at this time to alter the present procedures.

Recommendation III.H.

EXTEND CURRENT 2-MONTH PERIOD TO 4 MONTHS FOR BUREAU TO REVIEW INSURANCE COMPANY DATA AND MAKE RECOMMENDATIONS TO SCC AS TO COMPETITIVENESS

The Commissioner has indicated that the current two-month period contained in § 38.2-1905.1(E) during which the Bureau is required to complete its review of the data submitted on each potentially noncompetitive, or troubled, line pursuant to § 38.2-1905.2 is not sufficient. We agree. We therefore support the Commissioner's recommendation that the introductory paragraph of § 38.2-1905.1(E) be amended to give the Bureau until September 30 of each year to review the submitted data:

> E. Those lines and subclassifications designated pursuant to subsection B of this section shall be reviewed by the Commission for the purpose of determining whether competition is an effective regulator of rates for each such designated line or subclassification. The Commission shall hold a hearing or hearings for that purpose no later than ~~two months~~ September 30 following the due date of the supplemental reports required under § 38.2-1905.2 at which it shall hear evidence offered by any interested party. In determining whether competition is an effective regulator of rates for each designated line or subclassification, the Commission may consider such factors as it deems relevant to such determinations, including the following factors:
>
> 1. The number of insurers actually writing insurance within the line or subclassification.
>
> 2. The extent and nature of rate differentials among insurers within the line or subclassification.
>
> 3. The respective market share of insurers actually writing insurance within the line or subclassification, and changes in market share compared with previous years.
>
> 4. The ease of entry into the line or subclassification by insurers not currently writing such line or subclassification.
>
> 5. The degree to which rates within the line or subclassification are established by rating service organizations.
>
> 6. The extent to which insurers licensed to write the line or subclassification have sought to write or obtain new business within the line or subclassification within the past year.

7. Whether a pattern of excessive rates exists within the line or subclassification in relation to losses, expenses and investment income.

8. Such other factors as the Commission deems relevant to the determination of whether competition is an effective regulator of rates within the line or subclassification.

IV. RATEMAKING

Recommendation IV.A.
BAR RATE SERVICE ORGANIZATIONS (e.g., ISO) FROM DISSEMINATING EXPENSE, PROFIT AND CONTINGENCY, AND TRENDING AND DEVELOPMENT FACTORS

The Attorney General's recommendations concerning the dissemination by rate service organizations of advisory expense, profit and contingency, and trending and development factors are discussed later in this report under "Issue Two: State Antitrust Exemption."

Recommendations IV.B., IV.C. & IV.E.
ESTABLISH FIRM PROCEDURES FOR WHEN "DELAYED EFFECT" RATE FILINGS ARE DEEMED COMPLETE AND THEREBY "FILED" AND THE 60-DAY WAITING PERIOD BEGINS TO RUN
and
ESTABLISH A REASONABLE AND CERTAIN PERIOD FOR INTERESTED PARTIES TO COMMENT ON COMPLETE RATE FILINGS
and
ESTABLISH DISCOVERY RIGHTS FOR PARTIES INTERESTED IN RATE FILINGS

We are confident that when the General Assembly enacted House Bill 1235 in 1987, it fully contemplated that a number of lines and subclassifications of commercial liability insurance would become subject to the "delayed effect" rate filing procedures that would enable the Bureau of Insurance and other interested parties to examine the reasonableness of a rate revision before it is put into effect. Part of what the General Assembly anticipated has, in fact, occurred. Initially, medical malpractice insurance and lawyers' malpractice insurance were the only two lines subject to these "delayed effect" provisions. On September 16, 1988, the SCC declared that rates for five additional lines (public housing insurance, real estate agents errors and omissions insurance, insurance agents errors and omissions insurance, law enforcement agencies insurance, and pest control insurance) also were "not effectively regulated by competition" and would be made subject to the delayed effect procedures. At the same time, however, the SCC held that six troubled lines were in fact "competitive" (products and completed operations insurance, commercial contracting insurance,

governmental and municipal liability insurance, school divisions insurance, day care liability insurance and recreational liability insurance).

Unfortunately, this second half of the General Assembly's mandate, the examination of filed rate requests, has not proceeded as anticipated. For example, much uncertainty still remains regarding the extent to and the manner in which interested parties, including the Division of Consumer Counsel of the Office of the Attorney General, may participate in the rate review process. As early as last February, in connection with an application by The Virginia Insurance Reciprocal ("TVIR") for an increase in lawyers' malpractice insurance rates, we began to seek guidance from the Bureau as to how to participate most effectively in the rate review process. Last June, we requested that the SCC implement several procedures to clarify how and when the Division, and the general public, might receive information and transmit recommendations regarding delayed effect rate applications.

Although communication with the Bureau and the SCC on this subject continued into the fall, with particular reference to the pending re-application by TVIR for an increase in lawyers' malpractice rates, a number of issues still need to be resolved. Some of the unresolved issues, such as the Division's right to discover supplemental rate information from filing insurers and the opportunity afforded to interested parties to provide recommendations to the Commissioner, will continue to resurface with every "delayed effect" filing. We therefore are recommending legislation to resolve these problems.

The recommendation set forth below is intended to establish a procedural timetable for the processing of an insurer's proposed rate revision for a line or subclassification of insurance deemed "noncompetitive" by the SCC. The proposed subsection to § 38.2-1906 would provide for a reasonable period of time, after a filing is deemed complete and before the Bureau acts on the rate request, during which the Division of Consumer Counsel could seek additional data, analyze any data provided, and provide a recommendation to the Commissioner. It provides further that the insurer be informed if its application lacks supporting information and establishes a date for the submission of the information necessary to complete the filing. It also establishes that the Bureau will not process a rate application without allowing the Division of Consumer Counsel either to participate or to inform the Bureau that it will not be participating in the evaluation of a rate request.

We believe that this recommendation can be implemented administratively, but offer the following statutory amendment -- the addition of a new Subsection A2 to § 38.2-1906 -- as an alternative:

A2. 1. The Commissioner shall determine whether a rate filing submitted by an insurer, whose rate filings are subject to subdivision 2 of subsection A, is in substantial compliance with the requirements of subsection A1. In the event the submission does not substantially comply, the Commissioner shall inform the insurer of the deficiencies and shall set the date by which the information necessary to complete the rate filing shall be provided. When the Commissioner determines that the rate filing is in substantial compliance with the requirements of subsection A1, he shall inform the insurer and the Division of Consumer Counsel of the Office of the Attorney General of such determination. The date the Commissioner has so informed the insurer and the Division shall govern all subsequent time limitations.

2. The Division shall then have ten days in which to inform the Commissioner of its intent to participate and to request from the Commissioner that the insurer provide responses to any additional requests for information, or to inform the Commissioner that it does not intend to participate in the matter.

3. In the event the Division intends to participate and requests that the insurer provide additional information, the Division shall have ten days from the date it receives a response to its requests for information to complete its investigation of the rate filing and to file its recommendation with the Commissioner.

4. If the Division informs the Commissioner that it intends to participate but does not request that the insurer provide additional information, the Commissioner shall inform the Division of the date by which the Division is to file its recommendation. When the Division does not request additional data, the date by which the Division shall be required to file its recommendation shall not be sooner than twenty-one days from the date that the submission is found by the Commissioner to be in substantial compliance with the requirements of subsection A1.

If this recommendation is adopted, either administratively or statutorily, we do not believe that formal discovery rights for the Division of Consumer Counsel will be necessary.

Recommendation IV.D.
EXCESSIVE PROFITABILITY/EXCESSIVE RATES MAY BE INFERRED FROM UNUSUALLY LOW INCURRED LOSS RATIOS

Our Office and our expert witnesses have repeatedly argued to the General Assembly, the SCC and the Commissioner that an unusually low loss ratio for a "noncompetitive" line of insurance

is an important indicator that an insurer or insurers are reaping excessive profits from that business. As discussed with regard to Recommendation III.E. above, the Commissioner and Bureau staff have been reluctant to agree, however, that low loss ratios can suggest that "excessive rates" may exist. We disagree strongly with this view.

These are issues that do not lend themselves easily to legislation. We anticipate, however, that they will continue to be the subject of discussion and debate in the regulatory arena and that some accord can be attained in the future.

Recommendation IV.F.
BUREAU TO CONSIDER INVESTMENT INCOME ON SURPLUS IN EVALUATING INSURANCE COMPANY PROFITABILITY

Section 38.2-1904(B)(1)(vii) authorizes the Bureau and the SCC, in the context of a ratemaking proceeding, to consider investment income on surplus when evaluating whether a rate change requested by an insurer is reasonable. The Commissioner of Insurance has recently verified that it is the Bureau's practice to include consideration of an insurer's income on invested surplus in evaluating that insurer's overall profitability. We do not believe, therefore, that it is necessary to offer legislation at this time to address this step in the profit analysis in a ratemaking proceeding.

Recommendation IV.G.
DISALLOW EXPENSES ASSOCIATED WITH OUT-OF-STATE VOTER INITIATIVES

The Commissioner has recently indicated that expenses incurred by insurers in conjunction with out-of-state voter initiatives will be disallowed in establishing insurance rates for Virginia. The Division of Consumer Counsel intends to follow this issue with interest, and will present recommendations on this subject to the General Assembly in the future if such appear warranted.

Recommendation IV.H.
REQUIRE BUREAU AND SCC TO COLLECT AND CONSIDER ALL DATA LISTED IN § 38.2-1906(A1) IN CONJUNCTION WITH RATE FILING

When the General Assembly deliberated over HB 1235 in 1987, there was much debate about the breadth and depth of the information that the SCC would require in conjunction with a delayed effect rate filing. Ultimately, the SCC was given discretion in this regard, and to date, it has had only limited

opportunity to exercise that discretion. It is not our intention, therefore, to offer a recommendation at this time to alter the present procedures.

ISSUE TWO

STATE ANTITRUST EXEMPTION

Section 38.2-705 provides that "[c]onduct subject to regulation, review or examination pursuant to this title [38.2] shall, in addition, be subject to the provisions of the Virginia Antitrust Act (§ 59.1-9.1 et seq.)." Section 59.1-9.4(b) of the Virginia Antitrust Act provides, however, that

> Nothing contained in this chapter [1.1, the Virginia Antitrust Act] shall make unlawful conduct that is authorized, regulated or approved (1) by a statute of this Commonwealth, or (2) by an administrative or constitutionally established agency of the Commonwealth or of the United States having jurisdiction of the subject matter and having authority to consider the anticompetitive effect, if any, of such conduct. Nothing in this paragraph shall be construed to alter or terminate any other applicable limitation, exemption or exclusion.

The relationship between these two sections is unclear and terms on the meaning of the term "conduct" in both statutes. If "conduct" means the "business of insurance," then the insurance industry would be totally exempt from the Virginia Antitrust Act since the business of insurance is, of course, governed by Title 38.2, a "statute of this Commonwealth," and is regulated by the SCC, a "constitutionally established agency of the Commonwealth having jurisdiction of the subject matter and having authority to consider the anticompetitive effect, if any, of . . . [the] conduct" of insurance companies. The only statutory anticompetitive controls on the insurance industry would then be those provided by the insurance laws (Title 38.2) themselves.

If, on the other hand, "conduct" means specific conduct, then the industry would have a much more limited exemption from the Virginia Antitrust Act that would apply only to the extent that the specific conduct is "subject to regulation, review or examination" under the insurance laws. We believe that the "specific conduct" interpretation of the relationship between §§ 38.2-705 and 59.1-9.4(b) is the correct interpretation.

Rate service organizations are permitted by Title 38.2 to prepare and distribute to insurers standard policy forms and to prepare and file rates and supplementary rate information on behalf of individual insurers, with average loss and expense

factors determined by the rate service organization. See § 38.2-1908(A). There is the potential in the insurance industry, therefore, for anticompetitive behavior at two levels -- among the insurers themselves, and through the rate service organizations which are permitted to prepare and file "benchmark" rates for individual lines of insurance.

Certain anticompetitive conduct is prohibited by Title 38.2. Price fixing by two or more insurers or by a rate service organization, for example, is prohibited. See § 38.2-1916(B)(2). But, certain potentially anticompetitive conduct, such as the preparation and filing of "benchmark" rates, is permitted.

The Joint Subcommittee received considerable testimony on the anticompetitive effect of the insurance industry's current exemption from the antitrust laws of the Commonwealth. There was also considerable testimony on the need of the industry, especially smaller insurance companies, for historical loss data. The issue becomes, therefore, how to balance the industry's legitimate need for historical loss data against the potential anticompetitive effect of some insurer and rate service organization conduct currently permitted by Title 38.2.

One solution would be to remove the industry's current exemption from the Virginia Antitrust Act but permit rate service organizations to prepare and distribute historical loss data. We believe that a strong case can be made for this approach.

An alternative approach would be to limit the potentially anticompetitive conduct in which a rate service organization may engage. This approach would address one potential source of antitcompetitive conduct -- the rate service organization -- but would still permit the insurers themselves to engage in whatever other potentially anticompetitive conduct is permitted by Title 38.2.

The Commissioner of Insurance originally proposed that rate service organizations be prohibited from filing rates, average expense factors, and profit and contingency load factors on behalf of individual companies. His original proposal would have permitted rate service organizations to continue to file trending and development factors on behalf of member insurers.

The Attorney General responded by urging the Joint Subcommittee to give serious consideration to going beyond the Commissioner's proposal, and prohibit, in addition, the filing of loss development and trending factors. (Loss development factors are adjustments to reserves for unforeseen escalations between the occurrence of a loss and its ultimate resolution; loss trending factors are predictions of changes in the frequency and severity of losses over time.) Under the Attorney General's approach, rate service organizations would be allowed to circulate historical data on claims and losses which companies

could use in setting their own rates, but would be prohibited from providing pricing guidance other than the distribution of actual historical data.

The prohibition of loss development and trending by rate service organizations would require each individual company to interpret and adjust historical loss data independently. This is no different from requiring each banker to make his own projection of future inflation and money costs in setting interest rates for long term loans. Moreover, this is the crucial calculation made in setting insurance rates; the remaining calculations are essentially mechanical. In contrast, forecasting developments and trends in loss payments involves the making of judgments. These are common business decisions, however. Different companies will differ about what past data may imply about the future, and they will, therefore, set competitive rates for the same coverage.

When loss development and trending are done by a single rate service organization, such as the Insurance Services Office ("ISO"), key discretionary features of insurance pricing decisions are made collectively. Even where the price that individual companies charge varies from ISO-filed rates, insurers will know ISO's prediction about future losses, and, as a result, they will know other companies' probable predictions as well. Consequently, especially in tight markets, rates will vary much less from company to company.

Although the Joint Subcommittee heard testimony that individual companies would find it difficult to compute their own rates, these claims are implausible. Witnesses who raised this view appear to have failed to distinguish between the different functions of rate service organizations, and were worried that all the functions of these organizations might be prohibited. If rate service organizations continue to prepare and make available data on historical claims and the loss adjustment expenses associated with individual lines and subclasses of coverage, such concerns should disappear.

Much of the testimony before the Joint Subcommittee argued that there is competition in Virginia's commercial liability insurance markets, as evidenced by deviations from ISO rates. Two points about this testimony should be underscored. First, whatever else this evidence suggests, if true, it proves that individual companies are capable of calculating their own rates without the aid of rate service organizations. Small deviations from an ISO rate may not prove this, but large deviations of the magnitude alleged certainly do. A company that purports to deviate by as much as fifty percent from an ISO rate is obviously not even using that rate as a so-called benchmark; it is ignoring the rate. Consequently, the industry's own evidence argues that it does not need the exemption for rate service organization filings that it claims is necessary.

Second, witness after witness before the Subcommittee--from within the insurance industry and outside it--testified that although there is currently competition in the market, during the "hard" portion of the insurance cycle of 1985 and 1986, rates from different companies were much more similar and tended to migrate to the ISO rate. This was crucially important testimony, for everyone understands that markets are sometimes competitive.

The point, however, is that the availability of ISO rates, at times when insuring capacity is shrinking and competition is weak (the "hard" portion of the cycle), encourages uniform premium increases to take place in concert, and to gravitate toward a collectively-set level. This is precisely what the testimony before the Subcommittee acknowledged took place in 1985 and 1986 and will occur again. The issue is not only whether there is competition now, but what can be done to assure competition during periods when competition is threatened by tight market conditions and anticompetitive activity.

Only by prohibiting rate service organizations from filing rates, including loss development and trending factors, can the anticompetitive threat of uniform pricing be curtailed. Only in this way will insurance companies be forced to compete with each other in tight markets, instead of raising rates in concert. For this reason, prohibiting uniform loss development and trending guidance by rate service organizations was considered by the Attorney General to be a matter of prime importance in limiting the scope of the insurance industry's exemption from Virginia's antitrust laws.

In his letter to the Joint Subcommitte of December 9, 1988, the Commissioner presented an amended version of his original rate service organization proposal. This newer proposal restricts rate service organizations from trending the loss costs data but continues to permit rate service organizations to provide the development factors. While this proposal does not go as far as we would have liked, it represents a step in the right direction. We have decided, therefore, to support in concept the Commissioner's December 9, 1988, rate service organization proposal (his Exhibit I), at least for the 1989 Session of the General Assembly.

In agreeing to support in concept this compromise, however, we emphasize that many of the questions we have raised over the past six months regarding the insurance industry's exemption from the Virginia Antitrust Act and certain services provided by rate service organizations to individual insurers, including the development of loss data, still have not been answered satisfactorily. While we have agreed to support the Commissioner's approach, therefore, we also strongly recommend that the Joint Subcommittee continue its study of the insurance industry's exemption from the Virginia Antitrust Act for one more year to permit a more detailed examination of the exemption and of the need for rate service organizations to develop loss data.

ISSUE THREE

THE IMPACT OF THE REINSURANCE INDUSTRY ON COMMERCIAL LIABILITY INSURANCE IN VIRGINIA

At the outset of the Joint Subcommittee's deliberations, and at various points throughout its meetings, questions have been raised regarding the impact of reinsurance on the market for commercial liability insurance in Virginia. We believe that these questions have not yet been satisfactorily answered.

First, the insurance industry has asserted that breaking out state-based data on the coverages that commercial liability insurers reinsure would be both difficult and expensive. Such data would include premiums, commissions, expenses, and losses allocable to reinsured coverage. The industry's assertions, however, have not been explained in sufficient detail to justify its claims. For example, there has not been a satisfactory explanation of precisely what would be difficult about providing such state-based data, how long it would take for setting up a system for collecting state-based data on a regular basis, or how costly it would be to collect this data.

Second, the industry has asserted that the nature of reinsurance treaties would make preparation of state-based data regarding reinsured coverage difficult, and that any data produced would be arbitrary. But there has not been any convincing showing of the specific ways reinsurance treaties would make allocating reinsured losses on a state basis difficult or arbitrary.

Third, there have been general suggestions that requiring the filing of additional data regarding insurance transactions would greatly complicate the regulatory task now faced by the Bureau of Insurance and the SCC; but these suggestions have been vague. How great would the additional regulatory burden on the Bureau and the Commission be? It should be possible for the Bureau to set up procedures that would avoid most of this burden by looking for patterns of abuse, instead of scrutinizing each individual reinsurance transaction or data submission.

In evaluating these arguments that state-based reinsurance data by line would be difficult and costly to assemble, it should be noted that every company writing insurance in Virginia is already required to provide direct premiums, losses, and reserves by broad lines for Virginia in its annual report (Page 14) and more narrowly for troubled lines in its troubled lines filings. By simply requiring the same data on a net basis, we would have key reinsurance information by line for the Commonwealth (since net reinsurance transactions are mathematically the difference

between direct and net premiums, losses and reserves). This would seem to be a straightforward reporting requirement that can be accomplished without any undue burden.

Fourth, this Office submitted evidence that there is a significant amount of reinsuring among affiliate companies in the commercial liability insurance field. The insurance industry argued that this practice sometimes constitutes risk pooling, rather than actual reinsuring. The potential for abuse, however, still exists. A system of more careful scrutiny of reinsuring among affiliated companies ought to be feasible, as a method of distinguishing legitimate pooling transactions from potential abuses.

Fifth, consumer groups have suggested that the London reinsurance market is not competitive, and that this produces excessive premiums for primary commercial liability insurance in the United States, including Virginia. The insurance industry responded by arguing that individual companies do not have large shares of the reinsurance market. It is not at all clear, however, that this evidence proves what the industry suggests. The evidence was general; data on shares of the market for commercial liability reinsurance would be more probative.

Moreover, where reinsurance is purchased through brokers, the practice of looking to the action of a "lead" underwriter to determine whether to reinsure a line of coverage may inhibit competition, notwithstanding that ultimate market shares may not appear to be unduly concentrated. And even where reinsurance is sold by direct writers without intermediaries, certain companies may be viewed by the remainder of the industry as leaders in certain lines. To the extent that this is so, a competitive market in reinsurance may not exist, despite the superficial evidence of unconcentrated market shares.

Finally, the insurance industry has asserted that there is no possibility of excessive charging for pro-rata reinsurance, because premiums paid for this form of coverage equal the pro-rata share of the coverage reinsured. The practice of paying a commission to a primary insurer ceding reinsurance, however, can provide an opportunity for reinsurers to vary the net cost of pro-rata reinsurance. To what extent this occurs remains an open question.

For all these reasons, the issues that prompted the General Assembly's concern about the influence of reinsurance continue to be unresolved. We therefore strongly recommend that this portion of the Joint Subcommittee's study be extended for a year to continue to try to obtain answers to these important questions.

OAG	Bureau of Insurance	Admin	Legis	NOTES
I. TROUBLED LINES REPORT				
A. Survey of the Commercial Liability Insurance Market				
1. Timetable for the Bureau's gathering of data should be widely disseminated.		✓		
2. Guidelines should tell consumers in simple terms what information the Bureau finds relevant and compelling.		✓		"Guidelines" should describe the information requested.
3. Articulable standards should be disseminated, by which the Bureau determines whether to recommend a line as troubled.		✓		"Standards" should describe the test used.
4. Continue systematic survey of insurance consumers as well as insurance companies and agents.		✓		
5. Systematic and random method for examining a select number of lines each year.			✓	
B. Preparing the Troubled Lines Report				
1. Afford the OAG opportunity to provide input on affordability and availability of commercial liability insurance, and designation of potentially troubled lines.	Bureau indicates it is receptive to input from any source.	✓		Disagreement over extent and timing of input.
2. Transfer responsibility for preparing "troubled lines report" to OAG Division of Consumer Counsel.			✓	

OAG	Bureau of Insurance	Admin	Legis	NOTES
II. SUPPLEMENTAL REPORTS				
A. Pre-test the questionnaire/form to catch possible misunderstandings, such as whether companies deviate UP or DOWN from ISO rates, and by how much.		✓		
B. Conduct instructional sessions for insurers who are required to complete the form.		✓		
C. Require all companies licensed to write any of the troubled lines to indicate whether they actually write any of the lines (i.e., a "yes" or "no" for each troubled line).	"HB 1235...does not give us the authority to require such filings from the companies. §38.2-1905.2 A states... 'such reports shall be required only of insurers actually writing such designated lines...'" [letter of Nov 23, 1988]	✓		OAG recommendation is not that each insurer licensed to write a troubled line complete a full "supplemental report" for each line but merely that each such insurer indicate ("yes" or "no") whether it actually writes each troubled line. This will enable the Bureau to know which insurers did not file a supplemental report as required, which the Bureau was not able to do with the 1988 supplemental reports.
D. Meaningful penalties should be assessed against companies not filing complete or timely supplemental reports.	Bureau has provided OAG with a list of penalties assessed as of Oct. 26, 1988--penalties ranged from $250 - $1,000 for 102 companies.	✓	✓	§ 38.2-218 sets forth penalties for willful or knowing violation ($5,000 per violation) or other violation ($1,000 per violation, up to a maximum of $10,000 for "a series of similar violations resulting from the same act"). More substantial penalties could be imposed within the authorized limits; higher maxima would require statutory amendment. Incomplete filings, as well as late filing or failure to file, should be penalized.
E. Filing timely and complete supplemental reports should be a condition of doing business in the Commonwealth.		✓	✓	§ 38.2-219 (C) (2) permits SCC to revoke license of company that violates order of SCC to cease violation of earlier order after show cause hearing. Statutory amendment would be needed to avoid this two-step process.
F. Incomplete filing should constitute failure to file.		✓		

OAG	Bureau of Insurance	Admin	Legis	NOTES
III. COMPETITION HEARING				
A. Those lines for which there is not substantial compliance with requirement that timely and complete supplemental reports be filed should be deemed "noncompetitive".		✓		
B. Bureau should state its rationale for finding any lines to be effectively regulated by competition, using all 7 factors listed in § 38.2-1905.1 (E).	In Nov. 23, 1988 letter to HJR Jt. Subcommittee, Bureau indicated that, in 1988 competition hearing, it offered testimony on five factors: 1) Number of insurers actually writing in a line; 2) extent & nature of rate differentials among insurers in a line; 3) degree to which rates are set by rate service organizations; 4) extent to which insurers licensed to write the line have sought new business in past year; 5) ease of entry into the line.	✓		Bureau did not indicate why it did not consider (1) pattern of excessive rates (excessive profitability) in troubled lines, or (2) market share in current year and change in market share compared with past year. See § 38.2-1905.1 (E) (3) and (7).
C. "Potential competition" is not adequate competition for regulatory purposes.		✓		Looking at 5 of the 7 statutory competition factors is not sufficient. Should consider all 7, and in particular "excess profitability" in a troubled line.
D. If excessive profitability is found, the line of insurance under review should automatically be deemed "noncompetitive."	"I am concerned as to whether a pattern of excessive rates exists within a liability line of insurance in relation to losses, expenses, and investment income." [letter of Nov. 23, 1988]	✓		

OAG	Bureau of Insurance	Admin	Legis	NOTES
E. Excessive profitability may be inferred from unusually low incurred loss ratios.	Does not agree "that calendar year incurred loss ratios...can be relied upon as the sole indicator of excessive profitability....I do not agree that a determination can be made concerning profitability by comparing earned premiums to incurred losses without considering companies' expenses." § 38.2-1904 A.1 "does not permit the Bureau to require a company to 'pre-file' its rates based upon calendar year incurred loss ratios as published by A.M. Best. Even if expenses and investment income were added to the equation, the Commission would have to see evidence that specific companies are using specific rates which are unreasonably high AND that a reasonable degree of competition does not exist in that particular line." [Letter of Nov. 23, 1988]	✓		Unusually low incurred loss ratio is an important indicator of excessive profitability in a troubled line. § 38.2-1904 (A) (1) is not relevant to the competition hearing, the purpose of which is to determine if competition is in fact effectively regulating rates in a troubled line. § 38.2-1904 (A) (1) is relevant only to a later determination whether a particular rate requested by a particular insurer is excessive. At a recent troubled lines hearing, OAG presented data covering four calendar years.
F. Bureau to consider investment income on surplus in evaluating insurance company profitability.	Bureau did not offer evidence on excessive profitability in 1988 competition hearing.	✓		§38.2-1905.1 (E)(7) would not prohibit Bureau from considering investment income on surplus in determining whether "pattern of excessive rates" (excessive profitability) exists in a troubled line. Such investment income should be considered. Statutory amendment needed to require consideration of investment income on surplus.
G. Require Bureau and SCC to consider all competition factors set forth in § 38.2-1905.1 (E) and to collect and consider all data listed in § 38.2-1905.2(B).			✓	
H. Extend current 60-day period to 120 days for Bureau to review insurance company data and make recommendation to SCC as to competitiveness.	Bureau has indicated to HJR 120 Jt Subcommittee that it needs more than 60 days.	✓	✓	SCC might be able to convene hearing within 60 days, then continue it until later, but legislative clarification would be preferable.

OAG	Bureau of Insurance	Admin	Legis.	NOTES
IV. RATEMAKING				
A. Bar ISO from disseminating expense, profit and contingency, and trending and development factors.	Recommends that ISO be barred from disseminating expense data and profit and contingency factors.		✓	Disagreement over trending and development factors.
B. Establish firm procedures for when "delayed effect" filings are deemed complete and thereby "filed," and the 60-day period begins to run.		✓		Problems arise when requests for additional data are promulgated
C. Establish reasonable period for OAG and other interested parties to comment on complete filing.	Bureau has stated that it will give OAG 45 days after original filing. In a recent rate case, Bureau asked for additional data from insurers; once data received by Bureau and filing deemed complete, Bureau gave OAG 16 days to submit comments.	✓		Tied in with IV.B. above. Problems arise when response to request for additional data is received towards end of OAG's 45-day period.

OAG	Bureau of Insurance	Admin	Legis	NOTES
C. Excessive profitability/ excessive rates may be inferred from unusually low incurred loss ratios.	Does not agree "that calendar year incurred loss ratios...can be relied upon as the sole indicator of excessive profitability....I do not that a determination can be made concerning profitability by comparing earned premiums to incurred losses without considering companies' expenses." § 38.2-1904 A.1 "does not permit the Bureau to require a company to 'pre-file' its rates based upon calendar year incurred loss ratios as published by A.M. Best. Even if expenses and investment income were added to the equation, the Commission would have to see evidence that specific companies are using specific rates which are unreasonably high AND that a reasonable degree of competition does not exist in that particular line." [Letter of November 23, 1988]	✓		Again, unusually low loss ratio is an important indicator of excessive profits in a troubled line. § 38.2-1904(A)(1) is relevant to an individual rate review. By definition, however, since the line already had to be declared noncompetitive before a request for rate increase could be subjected to "delayed effect" procedures, only the "unreasonably high" standard of § 38.2-1904(A)(1) would be applicable.
E. Establish "discovery rights" for interested parties.		✓		
F. Bureau to consider investment income on surplus in evaluating insurance company profitability.		✓	✓	§ 38.2-1904(B)(1)(vii) currently authorizes Bureau and SCC to consider investment income on surplus. Such income should be considered. Statutory amendment needed to require consideration of investment income on surplus.

OAG	Bureau of Insurance	Admin	Legis	
G. Disallow expenses associated with out-of-state (e.g., California) voter initiatives.	Bureau has indicated to OAG that it will not permit recoupment of such expenses; is examining procedures for identifying, segregating, and disallowing such expenses.	✓		
H. Require Bureau and SCC to collect and consider all data listed in § 38.2-1906(A1).			✓	

Mary Sue Terry
Attorney General

H. Lane Kneedler
Chief Deputy Attorney General

COMMONWEALTH of VIRGINIA

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Deborah Love-Bryant
Executive Assistant

December 23, 1988

The Honorable Thomas W. Moss, Jr.
Member, House of Delegates
Wainwright Building, Suite 715
229 West Bute Street
Norfolk, Virginia 23510

Re: Recommendations of Office of the Attorney General to the HJR 120 Joint Subcommittee

Dear Tom:

Enclosed is a draft bill containing all of the recommendations discussed in the materials accompanying the Attorney General's December 21, 1988, letter to you, including Commissioner Foster's suggestion with regard to rate service organizations (his Exhibit I enclosed with his letter to you of December 9). I thought the Joint Subcommittee might find it helpful to have such a document for its discussion on December 27.

With kindest regards, I am

Sincerely,

Lane

H. Lane Kneedler
Chief Deputy Attorney General

HLK/m

1989 SESSION

_____ BILL NO. _____

A BILL to amend the Code of Virginia by amending and reenacting sections numbered 38.2-1901, 38.2-1905.1, 38.2-1905.2, 38.2-1906, 38.2-1908, 38.2-1913, 38.2-1916, and 38.2-1923, relating to the regulation of insurance rates and rate service organizations.

Be it enacted by the General Assembly of Virginia:
1. That sections numbered 38.2-1901, 38.2-1905.1, 38.2-1905.2, 38.2-1906, 38.2-1908, 38.2-1913, 38.2-1916, and 38.2-1923 of the Code of Virginia are amended and reenacted as follows:

§ 38.2-1901. Definitions. As used in this chapter:

"Market segment" means any line or class of insurance or, if it is described in general terms, any subdivision of insurance or any class of risks or combination of classes.

"Prospective loss costs" are historical aggregate losses and all loss adjustment expense projected through development to their ultimate value.

"Rate service organization" means any organization or person, other than a joint underwriting association under § 38.2-1915 or any employee of an insurer including those insurers under common control or management, who assists insurers in ratemaking or filing by:

(a) Collecting, compiling, and furnishing loss statistics;

(b) Recommending, making or filing supplementary rate information; or

(c) Advising about rate questions, except as an attorney giving legal advise.

"Supplementary rate information" includes any ~~manual or plan of rates~~ experience rating plan, statistical plan, classification, rating schedule, minimum premium rule, policy

fee, rating rule, rate-related underwriting rule, and any other information not otherwise inconsistent with the purposes of this chapter required by the Commission.

"Supporting data" includes:

1. The experience and ~~judgement~~ judgment of the filer and, to the extent the filer wishes or the Commission requires, the experience and ~~judgement~~ judgment of other insurers or rate service organizations;

2. The filer's interpretation of any statistical data relied upon;

3. Descriptions of the actuarial and statistical methods employed in setting the rates; and4. Any other relevant information required by the Commission.

§ 38.2-1905.1. Report on level of competition, availability and affordability of certain insurance. - A. The Commission shall submit a report or reports to the General Assembly, at least annually, concerning the lines and subclassifications of insurance defined in §§ 38.2-117 and 38.2-118, including those lines and subclassifications containing as a part thereof insurance coverage as defined in those sections, insuring a commercial entity. The report or reports shall indicate (i) the level of competition among insurers in Virginia for those lines or subclassifications, (ii) the availability of those lines or subclassifications of insurance and (iii) the affordability of those lines or subclassifications of insurance.

B. The Commission's report or reports to the General Assembly shall also designate all insurance lines or subclassifications defined in §§ 38.2-117 and 38.2-118, including those lines or subclassifications of insurance containing as a part thereof insurance coverage defined in those sections, insuring a commercial entity, for which the Commission has reasonable cause to believe that competition may not be an effective regulator of rates.

C. The report or reports to the General Assembly pursuant to this section shall be made no later than December 31 of each year, the first report or reports to be made not later than December 31, 1987.

D. A copy of each report made pursuant to this section shall be sent by the Commission to the Division of Consumer Counsel of the Office of the Attorney General. Each report shall be a matter of public record.

E. Those lines and subclassifications designated pursuant to subsection B of this section shall be reviewed by the Commission for the purpose of determining whether competition is an effective regulator of rates for each such designated line or subclassification. The Commission shall hold a hearing or hearings for that purpose no later than ~~two months~~ September 30 following the due date of the supplemental reports required under § 38.2-1905.2 at which it shall hear evidence offered by any interested party. In determining whether competition is an effective regulator of rates for each designated line or subclassification, the Commission may consider such factors as it

deems relevant to such determinations, including the following factors:

1. The number of insurers actually writing insurance within the line or subclassification.

2. The extent and nature of rate differentials among insurers within the line or subclassification.

3. The respective market share of insurers actually writing insurance within the line or subclassification, and changes in market share compared with previous years.

4. The ease of entry into the line or subclassification by insurers not currently writing such line or subclassification.

5. The degree to which rates within the line or subclassification are ~~established~~ affected by the filings of ~~rating~~ rate service organizations.

6. The extent to which insurers licensed to write the line or subclassification have sought to write or obtain new business within the line or subclassification within the past year.

7. Whether a pattern of excessive rates exists within the line or subclassification in relation to losses, expenses and investment income, including investment income on surplus.

8. Such other factors as the Commission deems relevant to the determination of whether competition is an effective regulator of rates within the line or subclassification.

Provided, however, that the Commission shall not find that competition is an effective regulator of rates for any line or subclassification designated under this section, unless it finds that there has been substantial compliance with the reporting

requirements under § 38.2-1905.2 for that line or subclassification.

F. Notwithstanding any designation made by the Commission pursuant to subsection B of this section, the Commission may, upon petition of any interested party, hold a hearing to determine whether, under the factors set forth in subsection E of this section, competition is not an effective regulator of rates for lines or subclassifications not so designated.

G. "Commercial entity" as used in this section shall mean any (i) sole proprietorship, partnership or corporation, (ii) unincorporated association or (iii) the Commonwealth, a county, city, town, or an authority, board, commission, sanitation, soil and water, planning or other district, public service corporation owned, operated or controlled by the Commonwealth, a locality or other local governmental authority.

H. The Commission shall adopt such rules and regulations including provision for identification from time to time of subclassifications of insurance necessary to implement the provisions of this section.

§ 38.2-1905.2. Supplemental report; required for certain lines or subclassifications of liability insurance. - A. All insurers licensed to write the classes of insurance defined in §§ 38.2-117 and 38.2-118, or to write policies of insurance that include as a part thereof the classes of insurance defined in § 38.2-117 or § 38.2-118, shall file a report showing their direct experience in

the Commonwealth attributable to all lines or subclassifications of liability insurance designated by the Commission in accordance with subsection B of § 38.2-1905.1; provided, ~~such reports shall be required only of insurers actually writing any such designated line or subclassification of insurance in the Commonwealth.~~ any such insurer that did not actually write any such designated line or subclassification of insurance in the Commonwealth during the reporting period shall be required only to report that it wrote no such insurance. Such reports may be filed on an individual insurer basis by a licensed rate service organization designated by the insurer, provided that such filing shall include all of the information otherwise required from the insurer. Failure to file a substantially complete report shall constitute a failure to file the report.

B. Each supplemental report shall be made pursuant to the rules and regulations established by the Commission and shall be on a form prescribed by the Commission. Each report shall include~~, to the extent directed by the Commission,~~ the following information:

1. Number of exposures;

2. Direct premiums written;

3. Direct premiums earned;

4. Direct losses paid identified by such period as the Commission may require;

5. Number of claims paid;

6. Direct losses incurred during the year, direct losses incurred during the year which occurred and were paid during the

year, and direct losses incurred during the year which were reported during the year but were not yet paid;

7. Any loss development factor used and supporting data thereon;

8. Number of claims unpaid; and

9. Such other relevant information as may be required by the Commission.

The term "number of exposures" as used in this subsection shall mean the unit of measure of risk which is used by the insurer for the designated line or subclassification. Each insurer shall indicate in its report the unit of measure, e.g., number of individuals insured, number of entities insured, payroll, square feet, etc., used by such insurer for each line and subclassification. Such insurer shall use such unit consistently in all reports required by this section.

C. Upon designating any line or subclassification pursuant to subsectionB of 1905.1, the Commission shall establish the date by which such supplemental report shall be filed with the Commission.

D. The requirements of this section shall not relieve any insurer of any reporting requirement to which it is otherwise subject in the absence of this section.

§ 38.2-1906. Filing and use of rates. - A. Each authorized insurer subject to the provisions of this chapter and each rate service organization licensed under § 38.2-1914 that has been

~~designated by any insurer for the filing of rates under § 38.2-1908~~ shall file with the Commission all rates and supplementary rate information and all changes and amendments to the rates and supplementary rate information made by it for use in this Commonwealth; and each rate service organization licensed under § 38.2-1914 that has been designated by an insurer for the filing of supplementary rate information under § 38.2-1908 shall file with the Commission all supplementary rate information and all changes and amendments to the supplementary rate information made by it for use in this Commonwealth as follows:

1. In cases where the Commission has made a determination under the provisions of subsection E of § 38.2-1905.1 that competition is an effective regulator of rates within the lines or subclassifications designated by the Commission, or in the case of all other lines or subclassifications subject to this chapter and not designated under subsection B of § 38.2-1905.1, such rates, supplementary rate information, changes and amendments to rates and supplementary rate information shall be filed with the Commission on or before the date they become effective.

2. Where the Commission has made a determination pursuant to subsection E or F of § 38.2-1905.1 that competition is not an effective regulator of rates for a line or subclassification of insurance, such rates, supplementary rate information, changes and amendments to rates and supplementary rate information for that line or subclassification shall be filed in accordance with and shall be subject to the provisions of § 38.2-1912.

3. For any line or subclassification that has been designated pursuant to subsection B of § 38.2-1905.1, insurers shall continue to file their rates in the same manner then applicable to the line or subclassification until a final determination is made by the Commission pursuant to subsection E of § 38.2-1905.1 as to whether competition is an effective regulator of rates.

A1. Each insurer whose rate filings are subject to subdivision 2 of subsection A of this section shall submit with each rate filing, as deemed appropriate by, and to the extent directed by the Commission,the following information relating to experience in Virginia and countrywide:

1. Number of exposures;

2. Direct premiums written;

3. Direct premiums earned;

4. Direct losses paid identified by such period as the Commission may require;

5. Number of claims paid;

6. Direct losses incurred during the year, direct losses incurred during the year which occurred and were paid during the year, and direct losses incurred during the year which were reported during the year but were not yet paid;

7. Any loss development factor used and supporting data thereon;

8. Number of claims unpaid;

9. Loss adjustment expenses paid identified by such period as the Commission may require;

10. Loss adjustment expenses incurred during the year, loss

adjustment expenses incurred during the year for losses which occurred and were paid during the year, and loss adjustment expenses incurred during the year for losses which were reported during the year but were not paid;

11. Other expenses incurred, separately by category of expense, excluding loss adjustment expenses;

12. Investment income on assets related to reserve and allocated surplus accounts;

13. Total return on allocated surplus;

14. Any loss trend factor used and supporting data thereon;

15. Any expense trend factor used and supporting data thereon; and

16. Such other information as may be required by rule of the Commission, including statewide rate information presented separately for Virginia and each state wherein the insurer writes the line, subline or rating classification for which the rate filing is made and which the Commission deems necessary for its consideration.

A2. 1. The Commissioner shall determine whether a rate filing submitted by an insurer, whose rate filings are subject to subdivision 2 of subsection A, is in substantial compliance with the requirements of subsection A1. In the event the submission does not substantially comply, the Commissioner shall inform the insurer of the deficiencies and shall set the date by which the information necessary to complete the rate filing shall be provided. When the Commissioner determines that the rate filing is in substantial compliance with the requirements of subsection

A1, he shall inform the insurer and the Division of Consumer Counsel of the Office of the Attorney General of such determination. The date the Commissioner has so informed the insurer and the Division shall govern all subsequent time limitations.

2. The Division shall then have ten days in which to inform the Commissioner of its intent to participate and to request from the Commissioner that the insurer provide responses to any additional requests for information, or to inform the Commissioner that it does not intend to participate in the matter.

3. In the event the Division intends to participate and requests that the insurer provide additional information, the Division shall have ten days from the date it receives a response to its requests for information to complete its investigation of the rate filing and to file its recommendation with the Commissioner.

4. If the Division informs the Commissioner that it intends to participate but does not request that the insurer provide additional information, the Commissioner shall inform the Division of the date by which the Division is to file its recommendation. When the Division does not request additional data, the date by which the Division shall be required to file its recommendation shall not be sooner than twenty-one days from the date that the submission is found by the Commissioner to be in substantial compliance with the requirements of subsection A1.

~~A2~~ A3. Where actual experience does not exist or is not credible, the Commission may allow the use of estimates for the information required by subdivisions 1 through 15 of subsection A1 of this section and may require the insurer to submit such information as the Commission deems necessary to support such estimates.

A4. Prospective loss costs filings may be made by licensed rate service organizations for informational purposes only; however, such filings shall not contain final rates. Each such prospective loss costs filing shall be subject to the delayed effect provisions of § 38.2-1912.

B. No insurer shall make or issue an insurance contract or policy of a class to which this chapter applies, except in accordance with the rate and supplementary rate information filings that are in effect for the insurer.

C. The Commission shall develop a uniform statement or format for requesting the information specified in subsection A1 of this section. Such statement or format shall be utilized by all insurers for all rate filings.

§ 38.2-1908. Rate making and ~~Delegation~~ delegation of ~~rate making and rate~~- filing obligation. - A. An insurer ~~or rate service organization~~ shall establish rates and supplementary rate information for any market segment based on the factors in § 38.2-1904. An insurer may use ~~rates and~~ supplementary rate information prepared by a rate service organization, ~~with~~ and may

use ~~average~~ prospective loss ~~factors~~ costs ~~or expense factors~~ determined by the rate service organization, ~~or~~ with modification for its own expense, and with modification for its own loss experience as the credibility of that loss experience allows.

B. An insurer may discharge its ~~obligations~~ obligation to file supplementary rate information under subsection A ~~or A1~~ of § 38.2-1906 by giving notice to the Commission that it uses ~~rates and~~ supplementary rate information prepared and filed with the Commission by a designated rate service organization of which it is a member or subscriber. ~~Any insurer subject to the provisions of subdivision 2 of subsection A of § 38.2-1906 that files a modification to increase such rate shall comply with the provisions of subsection A1 of § 38.2-1906.~~ The Commission may by order require an insurer to provide information in addition to that filed by the rate service organization. ~~If the proposed modification is to reduce such rates, the Commission shall determine the additional information to be required.~~ The insurer's ~~rates and~~ supplementary rate information shall be ~~those~~ that filed from time to time by the rate service organization, including any amendments to the ~~rates and~~ supplementary rate information, subject to modifications filed by the insurer.

§ 38.2-1913. Operation and control of rate service organizations. - A. No rate service organization shall provide any service relating to the rates of any insurance subject to this chapter, and no insurer shall use the service of a rate

service organization for such purposes unless the rate service organization has obtained a license under § 38.2-1914.

B. No rate service organization shall refuse to supply any services for which it is licensed in this Commonwealth to any insurer authorized to do business in this Commonwealth and offering to pay the fair and usual compensation for the services.

C. Any rate service organization subject to this chapter may provide for the examination of policies, daily reports, binders, renewal certificates, endorsements, other evidences of insurance, or evidences of the cancellation of insurance, and may make reasonable rules governing their submission and the correction of any errors or omissions in them. This provision applies to the classes of insurance for which the rate service organization ~~files rates pursuant to § 38.2-1908~~ is licensed pursuant to § 38.2-1914.

§ 38.2-1916. Certain conduct by insurers and rate service organizations prohibited. - A. As used in this section, the word "insurer" includes two or more insurers (i) under common management, or (ii) under common controlling ownership or under other common effective legal control and in fact engaged in joint or cooperative underwriting, investment management, marketing, servicing or administration of their business and affairs as insurers.

B. No insurer or rate service organization shall:

1. Combine or conspire with any other person to monopolize or

attempt to monopolize the business of insurance or any kind, subdivision or class of insurance;

2. Agree with any other insurer or rate service organization to charge or adhere to any rate, although insurers and rate service organizations may continue to exchange statistical information;

3. Make any agreement with any other insurer, rate service organization or other person to restrain trade unreasonably;

4. Make any agreement with any other insurer, rate service organization or other person that may substantially lessen competition in any kind, subdivision or class of insurance; or

5. Make any agreement with any other insurer or rate service organization to refuse to deal with any person in connection with the sale of insurance.

C. No insurer may acquire or retain any capital stock or assets of, or have any common management with, any other insurer if such acquisition, retention or common management substantially lessens competition in the business of insurance or any kind, subdivision or class thereof.

D. No rate service organization, or any of its members or subscribers, shall interfere with the right of any insurer to make its rates independently of the rate service organization ~~or to charge rates different from the rates made by such rate service organization~~.

E. No rate service organization shall have or adopt any rule, exact any agreement, or engage in any program that would require any member, subscriber or other insurer to utilize some or all of

its services, or to adhere to its ~~rates,~~ rating plans, rating systems, underwriting rules, or policy forms, or to prevent any insurer from acting independently.

§ 38.2-1923. Person aggrieved by application of rating system to be heard; appeal to Commission. - Each rate service organization and each insurer subject to this chapter ~~that makes its own rates~~ shall provide within this Commonwealth reasonable means for any person aggrieved by the application of its rating system to be heard in person or by an authorized representative on his written request. Any person who makes the written request shall be entitled to review the manner in which the rating system has been applied to the insurance afforded him. If the rate service organization or insurer fails to grant or reject the request within thirty days after it is made, the applicant may proceed in the same manner as if his application had been rejected. Any person affected by the action of the rate service organization or the insurer on the request may, within thirty days after written notice of the action, appeal to the Commission. The Commission may affirm or reverse the action after a hearing held upon not less than ten days' written notice to the applicant and to the rate service organization or insurer.

Mary Sue Terry
Attorney General

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COMMONWEALTH of VIRGINIA

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December 26, 1988

The Honorable Thomas W. Moss, Jr.
Member, House of Delegates
Wainwright Building, Suite 715
229 West Bute Street
Norfolk, Virginia 23510

Re: HJR 120 Joint Subcommittee

Dear Tom:

Attached is a document prepared by our economic consultant, Dr. John Wilson, in response to several of the economic and statistical issues raised at the Joint Subcommittee's November 29 hearing.

With kindest regards, I am

Sincerely,

H. Lane Kneedler
Chief Deputy Attorney General

HLK/m

J. W. WILSON & ASSOCIATES, INC.

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UTILITY REGULATION
ANTITRUST ECONOMICS
TELECOMMUNICATIONS STUDIES
NATURAL GAS
TRANSPORTATION
INSURANCE RATES
REF:

December 12, 1988

MEMORANDUM

To: The Attorney General

From: John W. Wilson

Subject: The Ileo-Foster presentation at the November 29, 1988 Joint Subcommittee Hearing on HJR 120

At your request, I have reviewed the data presented by Michael Ileo and Steve Foster on November 29. There were a number of errors in Michael's presentation. They are summarized below:

Table 4 (Profitability)

Line 4: Michael's figure of $84.886 million was computed by multiplying the countrywide net loss adjustment expense ratio (i.e., net loss adjustment expense/net premiums earned) times Virginia direct premiums earned. By applying the net ratio to direct premiums, Michael has assumed that reinsurers' loss adjustment expense ratios are the same percentage as net. That is wrong. The net ratio Michael used was 33.55%, but the reinsurers' loss adjustment expense ratio is only 6.82 percent. Michael has therefore substantially overstated loss adjustment expenses.

Line 5: Michael's figure of $101.615 million was computed by multiplying the countrywide ratio of net expenses to net premiums written times Virginia direct premiums written. There are two errors in this computation. First, it again assumes that reinsurers' expense ratios are the same as net ratios. They are not. Second,

since all of the expense figures are "incurred", the ratio should have been computed on a premiums earned basis (e.g., Michael's computation counts unearned commissions as an incurred expense). By using premiums written as the base, Michael has overstated Virginia incurred expenses by $2.8 million.

Line 8 and Line 13: Investment income and surplus. These figures are based on erroneous assumptions. Michael assumed that average loss and loss adjustment expense reserves in Virginia were $760 million in 1987. Since we know that average loss reserves were actually $482 million (I supplied these figures to the Bureau's actuary, Tony Pipia, several weeks before the hearing), Michael's assumption implies that average loss adjustment expense reserves were $278 million. That amounts to 58 percent of loss reserves. In 1987, countrywide average general liability loss adjustment expense reserves were actually only 28 percent of countrywide loss reserves on a net basis. Since reinsurers have an even lower ratio of loss adjustment expenses to losses, the direct percentage would be even less than 28 percent. Michael has therefore overstated Virginia loss adjustment expense reserves by at least $150 million.

If this apparent error is corrected, Michael's surplus on line 13 changes to about $280 million, and his before tax return rises to 24 percent. Correcting for the expense errors noted above further raises the before tax return to over 27 percent. This compares with your own figure of 26.6 percent.

Line 11: Michael's 19.56 percent income tax rate assumes that 13 percent of all before tax income is returned as dividends to policyholders. Actually, in Virginia, dividends to general liability policyholders were less than 1 percent.

Table 3 (Converting rate of return to a GAAP basis).

The largest single difference between GAAP equity and statutory equity is that portion of unearned premiums that is prepaid to agents (commissions) and taxing authorities (premium taxes). In other words, GAAP equity includes unearned premium reserves. Thus, by converting rate of return to a GAAP basis, the profit rate is expressed as a percentage of owner supplied

capital plus policyholders' unearned premiums. Accounting matters aside, it would be very poor economic policy and even worse regulatory policy to require ratepayers to provide insurance company owners with a return not only on the capital supplied by the owners but also a return on unearned premiums advanced by policyholders. Because most non-insurance companies do not collect six or twelve months of revenues in advance from their customers, the statutory net worth of insurance companies is actually more akin go the GAAP net worth of non-insurance companies. In, short to convert to GAAP net worth, as Michael has done, would force insurance ratepayers to provide a return to insurance company owners on the ratepayers' own unearned premium dollars.

Table 2 (Value Line Profit Rates)

Setting aside the fact that they are shown on a GAAP basis (see criticism above) Michael's Value Line profit rates are not a good reflection of the general liability insurance business. Indeed, the data that he presents are for eleven selected parent holding companies that own certain property/casualty insurance companies as well as other types of businesses. As for their property/casualty insurance operations, the following table shows the percentage of premiums that were in the general liability line for each holding company.

1987 General Liability Net Premiums Earned As A Percentage of Property/Casualty Net Premiums Earned (By Selected Insurer Groups)
($000)

	P/C Premiums	G.L. Premiums	%
Chubb	2,910,478	788,366	27.1%
Continental	4,078,007	438,318	10.7%
Firemans Fund	3,470,340	620,498	17.9%
Ohio Casualty	1,356,629	156,172	11.5%
Orion Capital	438,673	105,863	24.1%
Progressive	986,188	0	0%

	P/C Premiums	G.L. Premiums	%
Safeco	1,413,394	69,721	4.9%
St. Paul	2,671,103	543,938	20.4%
Seibels	173,965	10,971	6.3%
Selective	374,502	37,065	9.9%
USF&G	3,567,763	540,296	15.1%
Total	21,441,042	3,311,208	15.4%

In addition to the fact that general liability is only a small part of these holding companies' property/ casualty insurance operations, the following points should also be noted: The Chubb holding company derives substantial profits from its life insurance and real estate development businesses. The Fireman's Fund holding company operates a $17.6 billion mortgage banking business. The Ohio Casualty holding company has subsidiaries in life insurance ($4.1 billion). and financing. The Orion holding company derives substantial profits from its real estate and management consulting subsidiaries. Almost all of Progressive's insurance business is high risk substandard automobile insurance. The Safeco holding company has subsidiaries in life insurance, health insurance, real estate, hospitals and mutual funds. St. Paul's major P.C. line is medical malpractice, but it also has subsidiaries in real estate and investment banking. Selective is primarily an auto insurer, and New Jersey accounts for over half of its business. In short, Michael's numbers in his Table 2 simply do not reflect general liability insurance operations.

Table 5 Comparison of A.G. and Insurance Bureau Rate of Return Recommendations in the Last Workers Compensation Rate Case:

The major difference between the AG's and the Bureau's rate of return proposals in the last Workers Compensation rate case was that the Bureau witness made the mistake of including holding company debt in his insurance company capital structure. The Attorney General was aware of this error, but did not make an issue of it in the proceeding, as there appeared to be no point in embarrassing the Bureau's witness by highlighting this mistake in his first appearance as an insurance rate expert. The Bureau witness had mistakenly concluded (from looking at holding company

financial statements) that 28.40% of workers compensation insurers' investor-supplied capital was debt rather than equity. In fact, virtually all of that debt was actually on the books of holding company subsidiaries engaged in non-insurance enterprises. It was largely as a result of this error (there was also a one percentage point difference in the equity return percentage) that the Bureau's before tax required return calculation was $11.8 million lower than than A.G.'s.

Sample Quotation Summary: The data presented by Steve Foster in this table are unreliable. For example, ten of the sample quotations presented are based on the April 1987 ISO rate. Both the "filed rate premium" and a "modified premium" are reported. One might expect the modified premiums to differ between companies based on varying deviations from the filed rate. But since the filed rate for each company is the same April 1987 ISO rate, the filed rate premiums should be the same. They are not. In fact, the April 1987 ISO filed rate calculations varied from $46,880 to $73,564. Likewise, six companies used the December 1988 ISO rate, but their calculated filed rate premiums ranged from $61,305 to $96,317. With this range of error in calculating filed rate premiums, it is not surprising that the calculated modified premiums also varied. It would be interesting to know if the range of error in actual insurance pricing is as wide as the error range that Steve obtained in his survey. If so, perhaps Steve could contend that rates are "competitive by accident."

Sue Terry
y General

Kneedler
eputy Attorney General

COMMONWEALTH of VIRGINIA

Office of the Attorney General

R. Claire Guthrie
Deputy Attorney General
Human & Natural Resources Division

Gail Starling Marshall
Deputy Attorney General
Judicial Affairs Division

Walter A. McFarlane
Deputy Attorney General
Finance & Transportation Division

Stephen D. Rosenthal
Deputy Attorney General
Criminal Law Enforcement Division

Deborah Love-Bryant
Executive Assistant

December 27, 1988

The Honorable Thomas W. Moss, Jr.
Member, House of Delegates
Wainwright Building, Suite 715
229 West Bute Street
Norfolk, Virginia 23510

Re: Recommendations of Office of the Attorney General to the HJR 120 Joint Subcommittee/Draft Bill

Dear Tom:

Enclosed please find a corrected Page 6 to replace the sixth page of the draft bill that I sent to you with my letter of December 23, 1988. Please note that the Attorney General did not intend to recommend an amendment to subsection B of § 38.2-1905.2. Accordingly, the fourth line of that subsection should not contain an overstrike (i.e., "..., to the extent directed by the Commission,..." should not be overstriken).

We regret any confusion or inconvenience caused by this oversight. You or any member of the Joint Subcommittee should feel free to contact me if you require any additional information regarding this correction.

Sincerely,

Lane

H. Lane Kneedler
Chief Deputy Attorney General

NOTE: CORRECTED PAGE 6 OF DRAFT BILL PREPARED BY AGO 12/23/88. FOURTH LINE OF § 38.2-1905.2(B) SHOULD NOT CONTAIN OVERSTRIKE.

the Commonwealth attributable to all lines or subclassifications of liability insurance designated by the Commission in accordance with subsection B of § 38.2-1905.1; provided, ~~such reports shall be required only of insurers actually writing any such designated line or subclassification of insurance in the Commonwealth.~~ any such insurer that did not actually write any such designated line or subclassification of insurance in the Commonwealth during the reporting period shall be required only to report that it wrote no such insurance. Such reports may be filed on an individual insurer basis by a licensed rate service organization designated by the insurer, provided that such filing shall include all of the information otherwise required from the insurer. Failure to file a substantially complete report shall constitute a failure to file the report.

B. Each supplemental report shall be made pursuant to the rules and regulations established by the Commission and shall be on a form prescribed by the Commission. Each report shall include, to the extent directed by the Commission, the following information:

1. Number of exposures;

2. Direct premiums written;

3. Direct premiums earned;

4. Direct losses paid identified by such period as the Commission may require;

5. Number of claims paid;

6. Direct losses incurred during the year, direct losses incurred during the year which occurred and were paid during the

LD6755528

HOUSE BILL NO. 1467

Offered January 20, 1989

A BILL to amend and reenact §§ 38.2-1905.1, 38.2-1905.2 and 38.2-2228.1 of the Code of Virginia, relating to commercial liability insurers' reports to the State Corporation Commission; penalties.

Patrons–Moss, Parker, Hargrove, Murphy and Wilson; Senators: Saslaw, Chichester, Macfarlane and Holland, R. J.

Referred to the Committee on Corporations, Insurance and Banking

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Be it enacted by the General Assembly of Virginia:

1. That §§ 38.2-1905.1, 38.2-1905.2 and 38.2-2228.1 of the Code of Virginia are amended and reenacted as follows:

§ 38.2-1905.1. Report on level of competition, availability and affordability of certain insurance.–A. The Commission shall submit a report or reports to the General Assembly, at least annually, concerning the lines and subclassifications of insurance defined in §§ 38.2-117 and 38.2-118, including those lines and subclassifications containing as a part thereof insurance coverage as defined in those sections, insuring a commercial entity. The report or reports shall indicate (i) the level of competition among insurers in Virginia for those lines or subclassifications, (ii) the availability of those lines or subclassifications of insurance and (iii) the affordability of those lines or subclassifications of insurance.

B. The Commission's report or reports to the General Assembly shall also designate all insurance lines or subclassifications defined in §§ 38.2-117 and 38.2-118, including those lines or subclassifications of insurance containing as a part thereof insurance coverage defined in those sections, insuring a commercial entity, for which the Commission has reasonable cause to believe that competition may not be an effective regulator of rates.

C. The report or reports to the General Assembly pursuant to this section shall be made no later than December 31 of each year, the first report or reports to be made not later than December 31, 1987.

D. A copy of each report made pursuant to this section shall be sent by the Commission to the Division of Consumer Counsel of the Office of the Attorney General. Each report shall be a matter of public record.

E. Those lines and subclassifications designated pursuant to subsection B of this section shall be reviewed by the Commission for the purpose of determining whether competition is an effective regulator of rates for each such designated line or subclassification. The Commission shall hold a hearing or hearings for that purpose no later than ~~two months~~ *September 30* following the due date of the supplemental reports required under § 38.2-1905.2 at which it shall hear evidence offered by any interested party. In determining whether competition is an effective regulator of rates for each designated line or subclassification, the Commission may consider such factors as it deems relevant to such determinations, including the following factors:

1. The number of insurers actually writing insurance within the line or subclassification.

2. The extent and nature of rate differentials among insurers within the line or subclassification.

3. The respective market share of insurers actually writing insurance within the line or subclassification, and changes in market share compared with previous years.

4. The ease of entry into the line or subclassification by insurers not currently writing such line or subclassification.

5. The degree to which rates within the line or subclassification are established by rating service organizations.

6. The extent to which insurers licensed to write the line or subclassification have sought to write or obtain new business within the line or subclassification within the past year.

7. Whether a pattern of ~~excessive~~ *unreasonably high* rates exists within the line or subclassification in relation to losses, expenses and investment income.

8. Such other factors as the Commission deems relevant to the determination of whether competition is an effective regulator of rates within the line or subclassification.

F. Notwithstanding any designation made by the Commission pursuant to subsection B of this section, the Commission may, upon petition of any interested party, hold a hearing to determine whether, under the factors set forth in subsection E of this section, competition is not an effective regulator of rates for lines or subclassifications not so designated.

G. "Commercial entity" as used in this section shall mean any (i) sole proprietorship, partnership or corporation, (ii) unincorporated association or (iii) the Commonwealth, a county, city, town, or an authority, board, commission, sanitation, soil and water, planning or other district, public service corporation owned, operated or controlled by the Commonwealth, a locality or other local governmental authority.

H. The Commission shall adopt such rules and regulations including provision for identification from time to time of subclassifications of insurance necessary to implement the provisions of this section.

§ 38.2-1905.2. Supplemental report; required for certain lines or subclassifications of liability insurance.–A. All insurers licensed to write the classes of insurance defined in §§ 38.2-117 and 38.2-118, or to write policies of insurance that include as a part thereof the classes of insurance defined in § 38.2-117 or § 38.2-118, shall file a report showing their direct experience in the Commonwealth attributable to all lines or subclassifications of liability insurance designated by the Commission in accordance with subsection B of § 38.2-1905.1; provided, ~~such reports shall be required only of insurers actually writing any such designated line or subclassification of insurance in the Commonwealth~~ *any such insurer that did not actually write any such designated line or subclassification of insurance in the Commonwealth during the reporting period shall be required only to report that it wrote no such insurance* . Such reports may be filed on an individual insurer basis by a licensed rate service organization designated by the insurer, provided that such filing shall include all of the information otherwise required from the insurer. *Failure to file a substantially complete report shall constitute a failure to file the report.*

B. Each supplemental report shall be made pursuant to the rules and regulations established by the Commission and shall be on a form prescribed by the Commission. Each report shall include, to the extent directed by the Commission, the following information:

1. Number of exposures;

2. Direct premiums written;

3. Direct premiums earned;

4. Direct losses paid identified by such period as the Commission may require;

5. Number of claims paid;

6. Direct losses incurred during the year, direct losses incurred during the year which occurred and were paid during the year, and direct losses incurred during the year which were reported during the year but were not yet paid;

7. Any loss development factor used and supporting data thereon;

8. Number of claims unpaid; and

9. Such other relevant information as may be required by the Commission.

The term "number of exposures" as used in this subsection shall mean the unit of measure of risk which is used by the insurer for the designated line or subclassification. Each insurer shall indicate in its report the unit of measure, e.g., number of individuals insured, number of entities insured, payroll, square feet, etc., used by such insurer for each line and subclassification. Such insurer shall use such unit consistently in all reports required by this section.

C. Upon designating any line or subclassification pursuant to subsection B of § 38.2-1905.1, the Commission shall establish the date by which such supplemental report shall be filed with the Commission.

D. The requirements of this section shall not relieve any insurer of any reporting

requirement to which it is otherwise subject in the absence of this section.

§ 38.2-2228.1. Certain liability claims to be reported to Commission; duty of Commission; annual report; statistical summary.–A. All liability claims for personal injury or property damage covered under policies issued in Virginia and classified in § 38.2-117 or § 38.2-118, or Virginia policies containing as a part thereof insurance classified in such sections, insuring a commercial entity, shall be reported annually to the Commission by each insurer individually or by each insurer through a rate service organization designated by the Commission. The report shall not identify the parties. The report to the Commission shall state the following in a format prescribed by it:

1. Claims by the type of coverage;

2. The amount of all reserves established in connection with such claims and all adjustments thereto, updated on a quarterly basis until final settlement or judgment;

3. The amount paid by the insurer in satisfaction of the settlement or judgment;

4. The total number of claims;

5. Attorney's fees and expenses paid by the insurer in connection with such claim or defense to the extent these amounts are known; and

6. Any other relevant information which the Commission may require that is consistent with the provisions of this section.

The report shall include a statistical summary aggregating information collected by type of coverage. Each report shall be a matter of public record. The Commission may also examine claim files and reports of reserves contained in the Annual Statement of individual companies as deemed appropriate. In addition to the report required by this subsection, the Commission may, on its own motion or at the request of the Attorney General, require an insurer to file detailed information regarding individual claims.

B. "Commercial entity" as used in this section shall mean any (i) sole proprietorship, partnership or corporation, (ii) unincorporated association, or (iii) the Commonwealth, a county, city, town, or an authority, board, commission, sanitation, soil and water, planning or other district, public service corporation owned, operated or controlled by the Commonwealth, a locality or other local governmental authority.

C. "Insurer" as used in this section shall mean an individual insurer or a group of insurers under common ownership or control but shall not include mutual assessment property and casualty insurers organized and operating under the provisions of Chapter 25 of this title.

D. The Commission may exempt an insurer or insurers from any or all of the provisions of this section if it finds the application of any such provision or provisions unnecessary to achieve the purposes of this section.

E. The Commission shall establish the date by which the report described in subsection A of this section shall be filed with the Commission. Failure to file the report described in subsection A of this section by the due date established by the Commission shall be deemed a violation of this chapter.

Official Use By Clerks	
Passed By The House of Delegates	**Passed By The Senate**
without amendment ☐	without amendment ☐
with amendment ☐	with amendment ☐
substitute ☐	substitute ☐
substitute w/amdt ☐	substitute w/amdt ☐
Date: _____	Date: _____
Clerk of the House of Delegates	Clerk of the Senate

1989 SESSION

LD9165345

HOUSE JOINT RESOLUTION NO. 382

Offered January 24, 1989

Continuing the joint subcommittee studying the practices by which insurance companies reinsure all or parts of the risks they insure, the advisability of repealing the exemption from the Commonwealth's antitrust laws granting to the insurance industry, and means of assuring the continued availability and affordability of liability insurance coverage.

Patrons--Moss, Murphy, Wilson, Parker and Hargrove; Senators: Macfarlane and Saslaw

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Referred to the Committee on Rules

WHEREAS, the 1988 Session of the General Assembly established, pursuant to House Joint Resolution No. 120, a joint subcommittee to study (i) the reinsurance practices of insurance companies, (ii) the exemption from the antitrust laws granted to the insurance industry and (iii) the availability and affordability of liability insurance; and

WHEREAS, the joint subcommittee heard considerable testimony on the three areas of the study; and

WHEREAS, a significant percentage of the liability insurance written by companies licensed by the State Corporation Commission to operate in the Commonwealth is subsequently reinsured with other companies, including corporate affiliates, for the purpose of sharing risks, and there is no existing regulatory mechanism to determine whether the expenses of insurance companies associated with reinsurance are reasonable; and

WHEREAS, the business of insurance and many activities of insurance companies enjoy exemptions from provisions of the antitrust laws of the United States and of the Commonwealth and there is significant debate as to the merits of preserving both these exemptions and the related practice of allowing insurers to establish rates and other industry policies through rate service organizations; and

WHEREAS, there is a need to determine whether the reinsurance practices of insurance companies, the exemption from the antitrust laws and the role of rate service organizations have negatively affected the availability and affordability of insurance; and

WHEREAS, although some issues appear to have been resolved by the joint subcommittee's deliberations, there are still many other issues within each of the three areas of the study that need more thorough and detailed study; and

WHEREAS, in its recommendations to the General Assembly the joint subcommittee requests that the study commenced pursuant to House Joint Resolution No. 120 be continued another year because it feels that businesses and individuals in the Commonwealth are still experiencing difficulties in obtaining affordable liability insurance, and these difficulties threaten adversely the economic health of the Commonwealth; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That the joint subcommittee established in 1988 pursuant to House Joint Resolution No. 120 be continued to study (i) the reinsurance practices of insurance companies, (ii) the advisability of modifying the insurance industry's exemption from the Virginia Antitrust Act and the role of rate service organizations, and (iii) the means of ensuring the availability and affordability of liability insurance in the Commonwealth.

The membership of the joint subcommittee shall remain the same and any vacancies that occur shall be filled in the manner as provided in House Joint Resolution No. 120 of 1988.

The joint subcommittee shall complete its work prior to December 15, 1989, and report its findings and recommendations to the Governor and the 1990 Session of the General Assembly as provided in the procedures of the Division of Legislative Automated Systems for processing legislative documents.

The indirect costs of this study are estimated to be $10,650; the direct costs of this

study shall not exceed $7,920.

Official Use By Clerks	
Agreed to By The House of Delegates	**Agreed to By The Senate**
without amendment ☐	without amendment ☐
with amendment ☐	with amendment ☐
substitute ☐	substitute ☐
substitute w/amdt ☐	substitute w/amdt ☐
Date: _____	Date: _____
_____	_____
Clerk of the House of Delegates	Clerk of the Senate