
Study of Insurance Ratemaking Procedures Under Article 14, Chapter 431, Hawaii Revised Statutes

A Report to the
Governor
and the
Legislature of
the State of
Hawaii



THE AUDITOR
STATE OF HAWAII

Study of Insurance Ratemaking Procedures Under Article 14, Chapter 431, Hawaii Revised Statutes

A Report to the
Governor
and the
Legislature of
the State of
Hawaii

Conducted by

KPMG Peat Marwick

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 93-19
December 1993

Foreword

In House Concurrent Resolution No. 354, the 1993 Legislature requested the State Auditor to conduct a study of casualty insurance ratemaking under Article 14, Chapter 431, Hawaii Revised Statutes. The purpose of the study is to determine whether Hawaii statutes and procedures ensure that casualty insurance ratemaking is fair and equitable and that the insurance rate regulation system effectively controls any manipulation of operational expenses, profits, and losses.

We obtained professional and technical expertise for the review from the Casualty Actuarial Practice of KPMG Peat Marwick. The consultant conducted the research, fieldwork, and analysis for the study and prepared a draft report. Our office participated in preparing the final report.

We join KPMG Peat Marwick in expressing our appreciation for the excellent cooperation and assistance extended by officials and staff of the Insurance Division of the Department of Commerce and Consumer Affairs.

Marion M. Higa
State Auditor

Table of Contents

Chapter 1 Introduction

Objectives of the Study	1
Scope and Methodology	1

Chapter 2 Hawaii's Insurance Ratemaking

Summary of Findings	3
Hawaii's Statutes are a Reasonable Form of Rate Regulation	3
Open Competition Rating Laws Produce the Lowest Cost to the Consumer	10
Reviews of Casualty Insurance Rate Filings Are Fair	13
Recommendations	16

Notes	17
-------------	----

Response of the Affected Agency	19
---------------------------------------	----

Chapter 1

Introduction

In House Concurrent Resolution No. 354, the 1993 Legislature requested the State Auditor to conduct a study of casualty insurance ratemaking under Article 14, Chapter 431, Hawaii Revised Statutes. The study involves a review of the casualty insurance ratemaking statutes and the rate review procedures of the Insurance Division of the Department of Commerce and Consumer Affairs (DCCA). The purpose of the study is to determine whether Hawaii statutes and procedures adequately ensure that casualty insurance ratemaking is fair and equitable and that the insurance rate regulation system effectively controls any manipulation of operational expenses, profits, and losses. To conduct this study, the State Auditor engaged the services of the Casualty Actuarial Practice of KPMG Peat Marwick.

Objectives of the Study

1. Determine whether Article 14, Chapter 431, Hawaii Revised Statutes, allows insurers too much flexibility in reporting their financial status for purposes of establishing insurance rates.
2. Identify and evaluate standards and procedures established by the State Insurance Division to carry out its responsibility to govern the casualty insurance ratemaking process.
3. Make recommendations based on findings in these areas.

Scope and Methodology

Our examination was conducted in two major parts. The first part included an evaluation of Article 14, Chapter 431, HRS. It was conducted principally at KPMG Peat Marwick's offices in New York and Los Angeles and at the College of Insurance Library in New York. Summaries were prepared of key provisions of the Hawaii rating statutes, the model rating laws promulgated by the National Association of Insurance Commissioners (NAIC), and the rating laws of selected states, including New York, Florida, Illinois, Indiana, Michigan, Washington, and Wyoming. The states selected represent a broad variety of rating laws. A particular examination was made of statutory provisions that affect the reporting and projection of loss experience, the reporting and allocation of operating expenses and how those expenses are treated in rate filings, and the experience period requirements, if any, for various lines of business.

Reliable sources were used for obtaining the current (as of the date of our review) insurance laws of the several states identified in this report and the model rating laws of the NAIC. Since insurance laws are frequently revised, the accuracy of the insurance laws cannot be guaranteed beyond our reasonable efforts. Many states have switched (some more than once) between laws requiring prior approval and laws with competitive ratings at various times over the past decades. We believe that our conclusions and recommendations are not affected by states changing their rating laws.

Our review and interpretation of insurance laws is from the perspective of a practitioner of casualty insurance ratemaking. Our findings and conclusions regarding those laws have not been reviewed by an attorney. Insurance regulators, attorneys, or courts may interpret those laws differently.

The second part of the study included the identification and documentation of the DCCA Insurance Division's standards and procedures for evaluating rate filings. This was conducted principally at the Insurance Division's offices in Honolulu. Those interviewed included the insurance commissioner, the Insurance Division's consulting actuary (actuary), the chief insurance rate and policy analyst (chief analyst), and others involved in the rate filing review process. Approximately 100 rate filings for different types of casualty insurance were reviewed, including, but not limited to, personal automobile liability and physical damage, homeowners, workers compensation, and general liability. The review focused on the consistency and accuracy of information provided by insurers seeking rate increases and the division's review of insurers' equity bases in determining an adequate return on equity. Also reviewed and evaluated was the flexibility the Insurance Division allowed insurers by projecting losses and loss adjustment expenses, and in the treatment of expense provisions in casualty rate filings. Finally, we identified alternatives to the return on equity criterion which can be used for reviewing and granting rate increases.

Our work was performed from July 1993 through November 1993 in accordance with generally accepted government auditing standards.

Chapter 2

Hawaii's Insurance Ratemaking

This chapter discusses Article 14 of Chapter 431, HRS, and compares Hawaii statutes with those of other states and the National Association of Insurance Commissioners (NAIC) model property and casualty rating laws. It also presents the results of our review of the Department of Commerce and Consumer Affairs (DCCA) Insurance Division's procedures for reviewing insurance rate request filings.

Summary of Findings

1. Hawaii's insurance ratemaking statutes are a reasonable form of rate regulation.
2. Amendments to the law to allow insurance rates to be determined by open competition in the marketplace may reduce insurance costs to the consumer.
3. The Insurance Division's standards and procedures are fair and thorough. The division uses sound judgment in reviewing rate requests.

Hawaii's Statutes are a Reasonable Form of Rate Regulation

Under Hawaii's casualty insurance rating statutes, insurers must obtain the prior approval of the insurance commissioner before implementing rate changes. Hawaii's statutes are virtually identical to those of other states that require prior approval of rate changes and to the NAIC *Property and Casualty Model Rating Law*. A prior approval provision gives the insurance commissioner more discretionary control of insurance rates than other forms of rate regulation. By requiring the commissioner to determine that proposed rates are not excessive, inadequate, or unfairly discriminatory, the law gives the commissioner virtually unlimited authority (subject to court review) to control insurance rates and to prevent unreasonable rates.

Ratemaking involves the projection of future revenues (including investment income), future claims costs, future claims adjustment expenses (a major component of which is defense costs), and other expenses. It requires a significant amount of judgment. Hawaii statutes explicitly recognize the key variables that affect insurance rates, yet they allow sufficient flexibility for insurers to charge reasonable rates and for the commissioner to ensure that rates are not excessive, inadequate or unfairly discriminatory.

Actuarial principles of casualty insurance ratemaking

To understand the purpose of certain provisions in casualty insurance rating statutes, it is useful to analyze them in the context of insurance ratemaking concepts from the Casualty Actuarial Society's *Statement of Principles Regarding Property and Casualty Insurance Ratemaking*. The criteria for property and casualty insurance ratemaking typically applied by actuaries are that they be actuarially sound, reasonable, adequate, and fair. The basic principles of property and casualty insurance ratemaking are:

1. A rate is an estimate of the expected value of future costs. An actuarially sound rate is prospective; it should not be designed to make up for past losses.
2. A rate provides for all costs associated with the transfer of risk, including a reasonable profit. This principle is necessary for the insurance system to be financially sound. The insurer is not guaranteed a profit but has the expectation of and a provision for a profit in the rates.
3. A rate provides for the costs associated with an individual risk transfer. Rates should not contain cross subsidies. Each statistically measurable and credible risk, or each class of risks, should pay the expected value of its future costs.
4. A rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer.

If rates are based upon principles 1, 2, and 3, then they are actuarially sound and comply with the four criteria typically applied by casualty actuaries. Note that fair discrimination (for example, different rates for different classes of business) is required for rates to be actuarially sound. In Hawaii, as in several other states, certain forms of potentially fair discrimination (at least, relative to actuarial principles) are prohibited by statute. In Chapter 431, Article 10C, Section 207, it states:

No insurer shall base any standard or rating plan, in whole or in part, directly or indirectly, upon a person's race, creed, ethnic extraction, age, sex, length of driving experience, credit bureau rating, marital status, or physical handicap.

Thus while there may be actuarially sound reasons for different rates for automobile insurance based upon such factors as age and length of driving experience, using these factors to develop different rates is against the law.

**Hawaii's insurance
ratemaking statutes**

Hawaii's insurance ratemaking statutes are contained in Article 14, Chapter 431, Hawaii Revised Statutes. The statutes follow actuarial principles and give the insurance commissioner broad authority to see that insurers follow sound actuarial principles and that casualty insurance rates are not excessive, inadequate, or unfairly discriminatory. The statutes explicitly state that their purpose is:

To promote the public welfare by regulating insurance rates to the end that they not be inadequate, excessive, or unfairly discriminatory, and to authorize and regulate cooperative action among insurers in rate making. Chapter 431:14-101.

As with all ratemaking statutes, there is an overriding provision that:

Rates shall not be excessive, inadequate, or unfairly discriminatory. Chapter 431:14-103(1).

Classification and experience rating

The statutes set out the basis for rate classifications and experience rating for individual risks:

Risks may be grouped by classifications for the establishment of rates and minimum premiums. Classification rates may be modified to produce rates for individual risks in accordance with rating plans which establish standards for measuring variations in hazards or expense provisions, or both. Chapter 431:14-103(5).

The statutes require that rates consider the effects of all relevant factors and specifically mention loss experience and expenses both within and outside the state. Chapter 431:14-103(2)(A) through (G) states that:

Due consideration shall be given to:

- (A) Past and prospective loss experience within and outside this State;
- (B) The conflagration and catastrophe hazards, if any;
- (C) A reasonable margin for underwriting profit and contingencies;
- (D) Dividends, savings or unabsorbed premium deposits allowed or returned by insurers to their policyholders;
- (E) Past and prospective expenses both country-wide and those specifically applicable to this State;

(F) Investment income from unearned premium and loss reserve funds; and

(G) All other relevant factors within and outside this State.

The provisions of Chapter 431:14-103(2)(A) and (E) may be modified somewhat by the commissioner:

After reviewing an insurer's filing, the commissioner may require that the insurer's rates be based upon the insurer's own loss and expense information. Chapter 431:14-104(h).

Prior approval

Rates must be filed before they can be implemented:

Every insurer shall file in triplicate with the commissioner ... every manual of classifications, rules, and rates, every rating plan, and every other rating rule, and every modification of any of the foregoing which it proposes to use....The filing also shall include a report on investment income. Chapter 431:14-104(a).

The statutes also provide for a 30-day waiting period after the filing date. The 30-day waiting period can be extended or shortened by the commissioner:

Each filing shall be on file for a period of thirty days before the filing becomes effective. The period may be extended for an additional period not to exceed fifteen days. Chapter 431:14-104(j).

The commissioner may authorize a filing which the commissioner has reviewed to become effective before the expiration of the waiting period or any extension thereof. Chapter 431:14-104(j).

If the commissioner does not have sufficient information to make a decision, the commissioner may require the insurer to provide additional information. The waiting period would then begin as of the date the information is furnished.

An insurance rate request filing is deemed approved unless disapproved within the waiting period.

Special considerations for motor vehicle insurance

Prior to 1992, special considerations for motor vehicle insurance rates in Chapter 431:10C, HRS, allowed insurers to *file and use* motor vehicle insurance rates. Under *file and use*, the presumption of compliance with insurance statutes was with the insurer. The insurer was required to

present sufficient information with its filing for the Insurance Division to determine compliance. If the Insurance Division did not object, then the rates could be implemented.

In 1992 the statutes were amended to require automobile insurance rate requests to follow the *prior approval* process. Under prior approval, the insurer still must demonstrate compliance with the statutes and present sufficient information to enable the Insurance Division to determine that the insurer's rates comply with the statutes. However, an affirmative approval is required before rate changes can be implemented.

The amendments also included provisions to reduce the underlying cost of providing automobile liability insurance. The no-fault threshold at which an insured could file a tort claim was increased to \$10,000; medical fee schedules had to be followed for treatment of injuries; the minimum required bodily injury liability limits were reduced; and insured motorists could no longer receive extra benefits based on the number of cars insured without paying additional fees.

The 1992 amendments also froze automobile insurance rates and rolled back rates 15 percent effective January 1, 1993.

The rate rollback provisions were challenged in a lawsuit. Similar statutes in other states (notably California and Nevada) have been overturned by state and federal courts. The Hawaii Attorney General determined that the rate rollback provision would be unconstitutional unless insurers were allowed to earn a reasonable rate of return. As a result, insurers were granted exemptions to the rollback provisions.

Reasonable loss experience

In setting rates, Hawaii statutes allow insurers to consider statewide and countrywide loss experience and expense experience. In practice, countrywide loss experience and expense experience are used in only a few situations. Insurers may prefer to use countrywide experience when:

1. Statewide loss or expense experience may not be of sufficient duration to be credible for very low frequency, high severity types of risks, such as boiler and machinery insurance.
2. The risks may not be state-specific, such as products liability.
3. General rate levels for a type of insurance may be based on statewide experience with certain specific classifications within the general rate based on a larger experience base to increase statistical credibility. An example is workers compensation rates because of the specific classification of jobs within a general job class. For example, office clerks can be classified based on statewide

experience, but office clerks in toxic waste disposal facilities might require classification based on countrywide experience because of the uniqueness of the job.

The statutes explicitly allow the commissioner to require an insurer to use its own experience in setting rates, without specifying that the experience necessarily be limited to Hawaii. In practice, the loss and expense experience used in rate filings for all personal lines and most major commercial lines, particularly workers compensation, is strictly Hawaii-based experience. The majority of expenses not related to claims are commissions and premium taxes, which usually are specific percentages of total premiums. Other expenses typically comprise much less than 10 percent of total premiums, and would require a large misstatement to produce materially different rates. Nonetheless, the commissioner has the authority to challenge expense provisions in rates.

Minimum experience requirement for fire insurance

We are aware of no insurance rating laws that require minimum experience periods for rate making except for fire insurance. The purpose of the five-year minimum experience period for fire insurance is to accumulate sufficient loss experience to be statistically credible for ratemaking purposes. Fire insurance is a very low frequency insurance coverage; fires (fortunately) are relatively rare occurrences. Claims frequencies for fire insurance do not appear to vary significantly over time, and limits on the cost of claims is typically established by the amount of insurance purchased.

Conversely, motor vehicle insurance is a higher frequency coverage. It is more likely that an insurer (or the insurance industry) would accumulate sufficient loss experience to be statistically credible within a shorter period of time. Using fewer years of loss experience shortens the length of time over which trends in claims frequency and claim cost inflation must be projected and, therefore, makes the rates more responsive to changing conditions.

If an insurer uses too short an experience period, then the commissioner may determine either: (1) that the resulting rates are excessive, inadequate, or unfairly discriminatory or, (2) that it is not possible to conclude whether or nor the rates are excessive, inadequate, or unfairly discriminatory. The commissioner has sufficient discretion to require insurers to use longer experience periods, if necessary.

Comparisons with other states

Other states' casualty insurance ratemaking laws differ somewhat from Hawaii's. We found, however, that the differences were not dramatic because most states follow NAIC model laws. Of the states we reviewed:

- Michigan and Washington have prior approval rating laws substantially similar to the Hawaii statutes and the NAIC *Property and Casualty Model Rating Law*;
- Illinois, Indiana, and Wyoming have competitive rating laws substantially similar to the NAIC *Property and Liability Model Alternative Competitive Pricing and Appropriate Support Systems Act*;
- New York has a unique provision for *flex rating* of certain commercial lines that precludes the need to make rate filings for rate increases or decreases of less than 30 percent and a prior approval rating law for other lines (principally, personal lines and workers compensation); and
- Florida has an optional system with the insurer's choice of a file and use (modified prior approval) statute with a 60-day waiting period or a use and file statute wherein rates must be filed within 30 days after their effective date.

Other than the five-year minimum experience requirement for fire insurance rates, we found no rating laws that required any minimum experience period.

Comparison with NAIC model rating laws

The National Association of Insurance Commissioners is a voluntary organization whose members are the top insurance regulatory officials of the 50 states, the District of Columbia, and the United States' territories and possessions. Formed over 120 years ago, its purpose is to promote uniformity in laws, administrative rulings, accounting and annual statement preparation, and examination practices related to insurance. The NAIC performs many functions on behalf of its members, including, but not limited to, the following:

- establishing the accounting rules used by insurance companies in preparing their statutory financial statements;
- maintaining a central office that coordinates cooperative financial examinations of interstate insurers and accumulates and disseminates financial and statistical information regarding insurance companies;
- certifying states' solvency regulation as being in compliance with the NAIC guidelines; and
- promulgating model insurance laws.

NAIC has two model rating laws. One is the *prior approval* law and the second is an *open competition* statute. The prior approval model law is officially known as the *NAIC Property and Casualty Model Rating Law*, and is very similar to Hawaii's statutes. The open competition model law is officially known as the *NAIC Property and Liability Model Alternative Competitive Pricing and Appropriate Support Systems Act*. This model law generally allows open competition to be the primary determinant of casualty insurance rates.

The Hawaii statutes in Chapter 431:14 are virtually identical to the *NAIC Property and Casualty Model Rating Law* in all significant respects. In most cases the language is identical. However, the NAIC model law has no special provisions for rate freezes or rate rollbacks.

Open Competition Rating Laws Produce the Lowest Cost to the Consumer

Excluding certain states with a history of abusive rate regulation, open competition (free market pricing) generally produces lower profit margins for insurers (and therefore, lower rates to consumers) than prior approval rate regulation. Hawaii's rating statutes authorize the insurance commissioner to disapprove rate filings if rates are excessive, inadequate, or unfairly discriminatory. Applied properly, the laws can be reasonably effective in preventing manipulation of loss and loss expense experience, operational expenses, profits, and losses to justify excessive rate increases. Prior approval rating statutes, however, do not necessarily result in the lowest possible rates to the consumer.

Open competition rating laws

Under the *NAIC Property and Liability Model Alternative Competitive Pricing and Appropriate Support Systems Act*, property and liability insurance (excluding workers compensation) rates are not regulated if the market is competitive. To protect the consumer, the model act permits regulatory oversight of the general marketplace. It states that,

A competitive market is presumed to exist unless the commissioner, after hearing, determines that a reasonable degree of competition does not exist.

If a competitive market does not exist, then rate regulation reverts to prior approval. It is important to recognize that open competition will not reduce the underlying costs of providing insurance. However, it will ensure that insurance coverage is provided at the lowest possible fair price. It is also important to recognize that the optimal market structure that results from a competitive environment will likely emerge gradually over several years.

The NAIC open competition model is designed to provide the same protection to the consuming public as the prior approval model. The model act states that:

Rates shall not be excessive, inadequate or unfairly discriminatory. The terms excessive, inadequate, and unfairly discriminatory are qualified as follows:

- A rate in a competitive market is not excessive.
- A rate in a noncompetitive market is excessive if it is likely to produce a long run profit that is unreasonably high for the insurance provided or if expenses are unreasonably high in relation to the services rendered.
- A rate is not inadequate unless such rate is clearly insufficient to sustain projected losses and expenses in the class of business to which it applies and the use of such rate has or, if continued, will have the effect of substantially lessening competition or the tendency to create monopoly in any market.
- Unfair discrimination exists if, allowing for practical limitations, price differentials fail to reflect equitably the differences in expected losses and expenses.

To enable the insurance regulatory body to monitor personal casualty insurance rates, the model law requires rates and supplementary rate information to be filed with the regulatory body within 15 days of their effective date. Rates for commercial casualty insurance risks need not be filed.

Studies of competitive rate laws

A number of studies of competitive rating laws have been done over the past 20 years. In every case, the evidence suggests that competitive rate regulation is at least as effective as prior approval rate regulation. It is also much less costly for the state to implement.

A 1978 study by the Virginia Bureau of Insurance concluded that:

At a minimum, the competitive rating system appears to be working at least as well as the prior approval system without requiring Bureau resources to be tied up.¹

A 1977 study, prepared for the Illinois Insurance Laws Study Commission by Robert C. Witt, Ph.D., compared and analyzed rates under open competition against those under prior approval. In the

analysis of automobile liability insurance rates, he found that open competition resulted in lower costs to the consumer. The study states:

- It appeared as if consumers had fared reasonably well under the unique type of competitive rate regulatory system (no rating laws) in Illinois;
- Since 1947, this state [California] has had a competitive rating law. Due to its relatively high loss ratio, it appears as if competition has protected the interests of automobile liability insurance consumers reasonably well in California; and
- The State of New York moved to a competitive rating law in 1970....Again, rate competition seems to have served the interests of automobile liability insurance consumers reasonably well in this state.²

Recent California experience

Proposition 103, passed in 1988, abolished the competitive rating laws in California for most property and casualty coverages, and established a prior approval rating law. Soon after the passage of Proposition 103, the California State Supreme Court issued a ruling that allowed insurance companies to better control automobile liability claims. More recently, as a result of the severe economic recession, people also have been driving significantly less. Claims frequencies and average claims costs for automobile liability insurance have dropped dramatically during the last three years, and personal automobile insurance has become very profitable for insurers.

Insurance rates have not been lowered

Under competitive rating laws, California consumers probably would have enjoyed the benefits of the reduction in underlying costs sooner, and those benefits probably would have been greater.

Underwriting profits for some companies have approached 20 percent of premiums, yielding returns on equity of 50 percent or more. Yet few companies have filed for rate reductions. Many insurers are reluctant to reduce rates because they fear that they may not be able to raise them if necessary. Many consumers are reluctant to change insurers for lower rates because they fear that their new insurer might abandon them. The competitive market forces are no longer there to force prices down to a reasonable level, or to guarantee the availability of coverage.

Prior to the passage of Proposition 103, the California insurance department's budget was less than \$30 million annually. It now exceeds \$100 million. Much of the California Insurance Commissioner's effort, since taking office in January 1991, has been directed toward

establishing regulations that would create a “cookbook” approach to ratemaking that would artificially depress rates. Those regulations have since been rejected by the California courts.

Virtually all of the price reduction efforts of the California insurance commissioner have been focused on personal automobile insurance; yet, for the past three years, personal automobile insurance in California has been one of the most profitable lines of business in the United States. The two insurers identified in 1993 by *Forbes Magazine* as producing the highest rates of return of publicly traded insurance companies in the United States over the last five years underwrite, almost exclusively, personal automobile insurance in California.³

Reviews of Casualty Insurance Rate Filings Are Fair

The insurance commissioner and the Insurance Division staff fairly and equitably enforce Hawaii's insurance rating statutes. They subject rate filings to thorough and competent review. The principal individuals involved in the review process are knowledgeable about Hawaii's rating statutes, rating statutes of other states, and the actuarial principles of ratemaking.

Standards and procedures for reviewing rate filings

All rate filings are logged in and reviewed within the 30-day statutory period, or any extensions thereto. The chief analyst reviews all rate filings of insurers with significant market shares. In addition, the Insurance Division's actuary reviews all rate filings referred by the chief analyst including, but not limited to:

- all rate filings made by rating bureaus, such as the Hawaii Insurance Rating Bureau, that affect a large number of insurers;
- all filings of insurers with large populations of insureds; and
- all filings requesting large rate increases.

Both the chief analyst and the actuary are experienced and qualified in reviewing property and casualty insurance rate filings. The actuary is an Associate of the Casualty Actuarial Society, a Member of the American Academy of Actuaries, and a Fellow of the Conference of Consulting Actuaries; he is also the Division Director and Chief Casualty Actuary for the South Carolina Department of Insurance.

In our Report No. 92-13, *Review of the Insurance Rate Increase Request by AIG Hawaii, Inc.*, we found that the division's standards and procedures were consistent with Hawaii's insurance laws, the Casualty

Actuarial Society's principles of ratemaking (except as constrained by statute), and established industry standards. We also found, however, that they were not formally documented.

Since then, the Insurance Division has significantly improved documentation of its review procedures. It has created a number of special forms to ensure that the Insurance Division staff has considered all pertinent information that are or should be included in a rate filing. Some forms are to be completed by the insurer and some are for the internal use of the division. The forms provide a record of the review of the rate filing.

Forms and check lists have been specifically developed for the following types of filings:

- internal checklist for major rate filings,
- insurer reference filing for the adoption of a rating bureau's prospective loss costs,
- calculation of insurer loss cost multiplier and loss cost modification factors (deviation from bureau rates),
- insurer expense constant supplement,
- special form for motor vehicle insurance rate filings, and
- internal questionnaire used to assist in the evaluation of requests for exemption from the rate freeze and rate reduction requirements of the 1992 amendments to Section 431-10C, HRS.

The staff are prompt in communicating the results of their review to the insurer or in requesting additional information. The insurer may provide additional information supporting its request, amend the rate request, or submit a new rate filing that complies with the recommendations of the Insurance Division staff. Through repeated interaction with insurer ratemaking personnel over several years, particularly with respect to motor vehicle insurance, the actuary and the chief analyst have trained many insurers to make rate filings that provide all the required information in a format that simplifies the Insurance Division's review process.

Calculations of premiums at current rates are checked for reasonableness using the timing and amounts of previous rate changes. From time to time, the Insurance Division compiles unpublished benchmarks for key steps in the rate calculation process, including loss development, frequency and severity trends, expense levels, and investment income.

Since the Insurance Division staff sees many rate filings, they are aware of the underlying phenomena and the costs and trends that affect casualty insurance rates in Hawaii.

Finally, as a reasonableness check, the Insurance Division compares average loss costs (the average dollars that cover the claims and loss adjustment expenses) under a proposed filing with filings made by the Hawaii Insurance Bureau, Inc. (HIB), and with other large insurers writing similar lines of business and market segments. HIB is an organization that makes filings on behalf of its members using the combined loss experience of many insurers representing a majority of the market in the state.

Sound judgment

The Insurance Division has been aggressive but fair in its application of the statutes to balance the competing interests of consumers and insurers. Using the discretion allowed by the statutes and the knowledge and information gathered through its regulatory efforts, the Insurance Division has prevented, as much as is practical, the manipulation of loss and loss expense experience, operational expenses, and profits and losses that might be used to justify excessive rate increases.

Consistent with the prior approval statutes, the Insurance Division requires insurers to demonstrate that the filed rates are consistent with the statutes before issuing approval. Frequently the rates that finally are approved are lower than those that were originally filed. In no situation of which we are aware did the Insurance Division's actions result in higher rates.

Return on equity is one measure of profit insurers can use in rate filings. However, most of the rate filings we reviewed used more traditional measures such as percentages of premiums. The Insurance Division reviews filings using return on equity, loss and expense ratios, investment income, and other, more subjective, factors to ensure that the requested rates are reasonable.

The Insurance Division requires insurers to provide sufficient loss and expense experience to allow them to conclude on the reasonableness of the rate request filings. The staff of the Insurance Division requires insurers to provide three years of information regarding actual expenses. The staff reviews and compares that information with the expense estimates included in the insurer's rate filings and against the division's operating expense benchmarks. In the filings we reviewed there were examples of staff requests for additional expense information which resulted in amendments by insurers to lower expense estimates.

Recommendations

We recommend that the Legislature consider changing Hawaii's casualty insurance ratemaking laws to let the marketplace establish rates through open competition. Should it consider changing the law, we recommend that the Legislature follow as a model the NAIC *Property and Liability Model Alternative Competitive Pricing and Appropriate Support Systems Act*.

Notes

Chapter 2

1. Virginia, Bureau of Insurance of State Corporation Commission of Virginia, *Update of the Bureau of Insurance's January, 1978, Report on Competition in the Property and Casualty Insurance Industry*, December, 1978.
2. Robert C. Witt, Ph.D, *The Automobile Insurance Rate Regulatory System in Illinois: A Comparative Evaluation*, prepared for the Illinois Insurance Laws Study Commission, July 30, 1977.
3. *Annual Report on American Industry*, *Forbes*, January 4, 1993, p. 167.

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Commerce and Consumer Affairs on December 10, 1993. A copy of the transmittal letter to the department is included as Attachment 1. The department's response is included as Attachment 2.

The department concurs with our findings and believes that its methodology in reviewing rate filings is compatible with prior approval or open competitive rating laws.

ATTACHMENT 1

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917



MARION M. HIGA
State Auditor
(808) 587-0800
FAX: (808) 587-0830

December 10, 1993

COPY

The Honorable Clifford K. Higa, Director
Department of Commerce and Consumer Affairs
Kamamalu Building
1010 Richards Street
Honolulu, Hawaii 96813

Dear Mr. Higa:

Enclosed for your information are three copies, numbered 6 to 8 of our draft report, *Study of Insurance Ratemaking Procedures Under Article 14, Chapter 431, Hawaii Revised Statutes*. We ask that you telephone us by Tuesday, December 14, 1993, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Thursday, December 23, 1993.

The Governor and presiding officers of the two houses of the Legislature have also been provided copies of this draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa
State Auditor

Enclosures



JOHN WAIHEE
GOVERNOR

CLIFFORD K. HIGA
~~FORBIDDEN~~
DIRECTOR
COMMISSIONER OF SECURITIES

SUSAN DOYLE
DEPUTY DIRECTOR

STATE OF HAWAII
OFFICE OF THE DIRECTOR
DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS
1010 RICHARDS STREET
P. O. BOX 541
HONOLULU, HAWAII 96809

December 14, 1993

The Honorable Marion M. Higa
State Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, HI 96813-2917

RECEIVED
DEC 16 8 50 AM '93
OFFICE OF THE AUDITOR
STATE OF HAWAII

Dear Ms. Higa:

Thank you for providing us the opportunity to review the report. We agree with the summary of findings; and believe that our methodology in reviewing rate filings, utilizing standards and procedures that are fair and thorough, are compatible with prior approval or open competitive rating laws.

Very truly yours,

CLIFFORD K. HIGA
Director

SKS:sl

g:legaud12