PERFORMANCE AUDIT

DEPARTMENT OF INSURANCE

Report to the Arizona Legislature
By the Auditor General
October 1989
89-8

DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

LINDA J. BLESSING, CPA
DEPUTY AUDITOR GENERAL

October 24, 1989

Members of the Arizona Legislature
The Honorable Rose Mofford, Governor
Ms. Susan Gallinger, Director

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Department of Insurance. This report is in response to a June 2, 1987, resolution of the Joint Legislative Oversight Committee.

The report concludes that the type of rate regulation does not significantly affect automobile insurance rates. Therefore, other reforms may be needed to address the rising cost of automobile insurance in Arizona. These reforms could include "no-fault insurance," and other tort reforms.

We also found that additional actions - including more legal services - are needed to investigate and resolve consumer complaints in a more timely manner.

My staff and I will be pleased to discuss or clarify items in the report.

Sincerely,

Douglas R. Norton
Auditor General

DRN:lmn

STAFF: William Thomson
Mark Fleming
Cindy G. Whitaker
Dennis B. Murphy
David J. Vidoni
Jennifer DuBois

2700 NORTH CENTRAL AVE. • SUITE 700 • PHOENIX, ARIZONA 85004 • (602) 255-4385

SUMMARY

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Insurance (DOI) in response to a June 2, 1987, resolution of the Joint Legislative Oversight Committee. This performance audit was conducted as part of the Sunset review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

The Department of Insurance was created in 1913 and placed under the direction of the Arizona Corporation Commission. A 1968 constitutional amendment created an independent Department of Insurance responsible for the licensing, control, and supervision of all insurers operating within the State of Arizona. As of August 31, 1989, this responsibility included the regulation of 2,548 insurance companies. Additionally, as of fiscal year 1988-89, 31,648 life and disability, and 17,324 property and casualty licensees were registered with the department.

Our preliminary work indicated that the department functions well in a number of areas. For example, DOI routinely conducts financial examinations to ascertain the financial status of domestic insurers. The department conducts these examinations more frequently than many other states' insurance regulatory agencies in an effort to protect consumer interests. Further, unlike many states, the department monitors certain aspects of insurers' practices by performing market conduct and rate examinations. In the area of consumer awareness, DOI regularly publishes information on complaints received about insurance companies and also publishes various premium comparisons. We did, however, determine that improvements can be made in the handling of consumer complaints.

Because Automobile Insurance Rates Are Not Significantly Affected by the Type of Rating System Used, Other Reforms Should Be Considered (see pages 7 through 19)

Although rate regulation is often a focus of discussions about controlling automobile insurance rates, other reforms may be needed to address the rising cost of automobile insurance in Arizona. Most states regulate automobile insurance rates in some form. Until recently, the trend in regulation was toward reliance on competition as a means of

preventing excessive rates. This approach was seen as more efficient and less costly than requiring insurers to obtain state approval before changing rates. Twenty-six states, including Arizona, use a competitive approach, while 24 states continue to use some form of prior approval.

Recently, several states have moved back to prior approval in order to control the cost of automobile insurance. However, discussions with insurance experts and a review of numerous studies and articles show that rates are not significantly affected by the system used. Some experts also warn that stronger regulation may create adverse results such as less insurance availability, more restrictive eligibility criteria, and expanded use of higher cost assigned risk insurance.

Rather than focusing on the type of rating system, many insurance experts suggest that reforms are needed to address the underlying cost factors behind rate increases. These experts strongly support no-fault insurance as a way to make insurance more efficient and affordable. No-fault insurance provides payment to an injured party through his or her own insurance company, regardless of fault, and limits the injured party's right to recover damages through the courts. Suits may be instituted only in cases where medical losses exceed a specified threshold or a certain level of injury is sustained. Thresholds are usually stated in monetary terms (currently $2,000 in the one state utilizing a monetary threshold), in verbal terms describing specific levels of injury (for example, "permanent and serious damage"), or a combination of both.

Thirteen states currently have some form of no-fault automobile insurance and various studies have shown no-fault systems to be an effective means for reducing insurance costs. However, no-fault insurance is not a panacea. Some states have found that no-fault actually resulted in higher insurance costs, primarily because the threshold for instituting lawsuits has been too low to substantially affect legal claims for injuries. As a result, nearly every state that has adopted no-fault has either increased its monetary threshold, changed to a verbal threshold, or established a combination monetary/verbal threshold.

Insurance experts and professional literature also suggest that other measures can reduce insurance costs and, ultimately, premiums. These include various tort reforms, such as limiting noneconomic losses, as well as improved traffic management and prevention of auto theft and fraud. Thus, the Arizona Legislature should consider all potential causes of high automobile insurance rates before focusing on any particular remedy.

Actions Are Needed to Reduce Delays of Complaint Cases Referred to the Attorney General's Office **(see pages 21 through 29)**

Many of the most serious complaint cases referred to the Attorney General are delayed excessively. Overall, 21 of the 53 cases involving misappropriation of funds and misrepresentation of facts to policyholders referred to the Attorney General during 1987 and 1988 were delayed for time periods ranging from 100 to over 500 days. For example, the Attorney General has delayed action for nearly one and a half years concerning a case in which DOI charged that an unlicensed individual misappropriated monies by failing to pay the State of Arizona an estimated $39,000 in taxes and penalties.

A major cause of the delays appears to be that DOI's legal needs exceed the number of attorneys assigned by the Attorney General to DOI. Both DOI and the Attorney General's Office state that DOI needs more legal support. However, the Attorney General's office maintains that it cannot provide more than the two attorneys already assigned. Several possible options for addressing DOI's legal needs exist and should be considered. If the Attorney General's office cannot assign more staff to DOI, then one solution would be for DOI to contract with private attorneys. A second alternative would be for DOI to create an attorney position within the department to help prepare complaint cases for prosecution. Third, DOI could fund an additional attorney position in the Attorney General's office.

The additional legal services needed by DOI could be funded by establishing a revolving fund, supported by department-imposed penalties. The Department of Banking uses this method to fund the additional legal services it requires.

High Staff Turnover, Heavy Workload, and a Manual System Slow Complaint Handling (see pages 31 through 36)

In addition to the significant delays occurring with more serious complaints, DOI is not resolving many routine complaints within the expected time frames. While the department has established an informal 30 working day standard for resolving routine complaints, 48 percent of these complaints exceed the standard by an average of about 5.5 weeks. Much of the delay in resolving these complaints is due to untimely responses from insurance companies and licensees. Although DOI requires a response from companies and licensees within 15 working days, 41 percent of the companies and licensees take longer to provide a final response.

Although DOI attempts to follow up on these complaint inquiries, high turnover among the department's investigators and a heavy workload impact DOI's ability to resolve complaints in a timely manner. During fiscal year 1988-89, for example, the department's six investigators handled approximately 8,000 written complaints. This workload is compounded by turnover. In 1987, the department experienced 100 percent turnover in its investigators. Two more resigned in 1988. Another problem is the department's current use of a manual system for tracking the 8,000 written complaints. DOI has begun to address these problems. However, further efforts are needed to alleviate them.

TABLE OF CONTENTS

	Page
INTRODUCTION AND BACKGROUND	1
FINDING I: BECAUSE AUTOMOBILE INSURANCE RATES ARE NOT SIGNIFICANTLY AFFECTED BY THE TYPE OF RATING SYSTEM USED, OTHER REFORMS SHOULD BE CONSIDERED	7
Trends in Regulation	8
Current Research Indicates No Significant Difference in Rating Systems	11
Experts Call for Other Insurance Reforms	14
Recommendation	18
FINDING II: ACTIONS ARE NEEDED TO REDUCE DELAYS OF COMPLAINT CASES REFERRED TO THE ATTORNEY GENERAL'S OFFICE	21
Complaint Cases Referred to Attorney General Are Excessively Delayed	21
Delays Are Caused by Several Factors	26
Recommendations	28
FINDING III: HIGH STAFF TURNOVER, HEAVY WORKLOAD, AND A MANUAL SYSTEM SLOW COMPLAINT HANDLING	31
Department Is Unable to Resolve Almost Half of Routine Complaints within Established Standard	31
Inadequate Staffing Levels and a Manual System of Tracking Complaints Have Contributed to Untimeliness	34
Recommendations	36
OTHER PERTINENT INFORMATION	37
AREAS FOR FURTHER AUDIT WORK	39
SUNSET FACTORS	43
RESPONSES	
Department of Insurance	
Attorney General	
APPENDIX	
BIBLIOGRAPHY	

LIST OF TABLES

Page

TABLE 1 - Department of Insurance Selected Workload Indicators, Fiscal Year 1988-89 (unaudited) 2

TABLE 2 - Department of Insurance Statement of FTEs and Actual Expenditures, Fiscal Years 1986-87, 1987-88, and 1988-89 (unaudited). 5

TABLE 3 - Type of Automobile Insurance Rate Regulation Used by the 50 States and the District of Columbia as of August 1989. 10

TABLE 4 Number of Days to Issue Notice of Hearing in Serious Cases Referred to the Attorney General during 1987 and 1988 24

TABLE 5 - Number of Days Serious Cases Pending after Referral to the Attorney General during 1987 and 1988. 25

TABLE 6 - DOI Resolution Time of a Sample of Routine Complaints Closed in Calendar Year 1988. 33

TABLE 7 - Insurance Company and Licensee Response Time to DOI Consumer Complaint Inquiries For a Sample of Complaints Closed in Calendar Year 1988 34

INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Insurance (DOI) in response to a June 2, 1987, resolution of the Joint Legislative Oversight Committee. This performance audit was conducted as part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

The Department of Insurance was created in 1913 and placed under the direction of the Arizona Corporation Commission. In 1968, Arizona voters approved a constitutional amendment that created an independent Department of Insurance. Arizona State Constitution Article 15, Section 5 establishes that all insurers operating within the State of Arizona shall be subject to "licensing, control and supervision" by a department of insurance as established by law. Arizona Revised Statute §20-101 statutorily establishes the department.

The department has extensive regulatory responsibility which has grown significantly in recent years. As of August 31, 1989, the department was responsible for regulating 2,548 insurance companies. In addition, as of June 30, 1989, 31,648 life and disability, and 17,324 property and casualty licensees (agents, brokers, solicitors, firms, corporations, or others licensed to transact insurance business) were registered with the department. Table 1 (see page 2) illustrates these and other recent department workload statistics.

Organization

The department is headed by a director who is appointed by the Governor. A deputy director assists the director, oversees the administration of the two Arizona guaranty funds, and coordinates all receiverships, conservatorships, and supervisions conducted by the department.[1]

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(1) Arizona has two guaranty funds - the Property and Casualty Guaranty Fund, and the Life and Disability Guaranty Fund. These funds assess member insurers to obtain monies for operating costs and the payment of policyholder claims when insurers become insolvent and are unable to meet their obligations.

TABLE 1

DEPARTMENT OF INSURANCE
SELECTED WORKLOAD INDICATORS
FISCAL YEAR 1988-89
(unaudited)

Current licenses:	
Life and disability	31,648
Property and casualty	17,324
Licenses issued:	
New	10,181
Renewal	18,342
Written complaints received	8,329
Telephone inquiries and complaints received	99,463
Filings received:[a]	
Life and disability	12,490
Property and casualty	20,739
Examinations completed:	
Financial[b]	260
Market conduct[c]	51
Companies' and agents' licenses suspended or revoked, or companies placed in receivership	88

(a) A filing is the term generally used to denote the request and related documentation for an insurance rate change or the use of a new insurance policy (or similar forms) by insurers. DOI reviews rate filings to ensure that rates will not be inadequate, excessive, or unfairly discriminatory. Form filings are reviewed and approved by DOI to protect consumers from misleading, ambiguous, or deceptive insurance forms.

(b) Financial examinations are a review of an insurer's financial status. Such exams assist DOI in monitoring the financial solvency of an insurer.

(c) Market conduct examinations are used by DOI to evaluate market conduct practices of insurers and their dealings with policyholders and claimants.

Source: Department of Insurance Budget Request for fiscal year 1991

DOI is divided into six divisions - Hearing, Corporate and Financial Affairs, Receivership, Consumer Affairs and Investigations, Rates and Regulation, and Information Systems.

- The Hearing Division conducts all administrative hearings held by DOI, issues orders, and provides legal assistance to the other divisions. In addition, this division assists in drafting insurance-related legislation and regulations. The Hearing Division has two employees.

- The Corporate and Financial Affairs Division is responsible for monitoring the financial status and solvency of insurance companies selling insurance in Arizona. Part of this responsibility includes assisting the director in supervision, conservatorship, and rehabilitation actions against financially troubled or insolvent insurers. The 13 division staff also assess and audit premium taxes and other fees, fines, and charges.

- The Receivership Division is responsible for organizing and tracking all receiverships, conservatorships and supervisions commenced by the department. The division consists of two limited appointment positions which are not included in the department's count of authorized FTEs.

- The Consumer Affairs and Investigations Division administers the department's consumer assistance programs and conducts investigations for administrative hearings or litigation regarding Arizona insurance law violations. This division has 20 employees.

- The Rates and Regulation Division is comprised of three sections: Licensing, Life and Disability, and Property and Casualty. The division licenses agents, brokers, adjusters, and other applicants. The division also reviews and approves advertising, policy forms, rates, and contracts (for certain insurance lines) utilized by insurers. Other division responsibilities include supervising market conduct and rate examinations, and conducting premium comparisons and availability studies. Twenty-seven staff perform these functions.

- The Information Systems Division is responsible for implementing the department's automation plan. The division is staffed with 2 limited appointment employees.

In addition to division staff, 16 DOI business office and administrative staff assist the director and deputy director.

The department conducts most operations in its Phoenix office. However, DOI maintains a small Tucson office, primarily to investigate and handle consumer complaints in southern Arizona.

Staffing

Department staffing levels have grown in recent years. The department had 61 authorized full-time equivalent (FTE) positions during fiscal year 1987-88. For fiscal year 1988-89, DOI was authorized 69 FTE positions, an increase of 8 new positions (see Table 2, page 5). For fiscal year 1989-90, DOI was authorized a total of 78 FTE positions, a gain of 9 new positions. These new positions consisted of three investigators, two insurance analysts, an examiner technician, and three clerks. In addition to its FTE positions, DOI is authorized two limited appointment positions for its Receivership division and two for its Information Systems division. DOI also utilizes approximately 40 independent contractors to perform financial, market conduct, and rate examinations of insurers. These examiners are paid through a revolving fund administered by the department. Insurance companies pay exam costs to the revolving fund.

Budget

The department receives a General Fund appropriation. Revenues from insurance premium taxes, licenses, other fees, charges, and civil penalties are deposited into the General Fund. According to the department's budget request for fiscal year 1989-90, fiscal year 1987-88 gross premium tax receipts totaled over $86.8 million dollars, while licenses, fees, and other charges amounted to over $3.2 million. Premium tax receipts for 1989 are expected to total over $99 million. For its operations, the department spent $2,397,566 during fiscal year 1988-89. Table 2 (see page 5) contains a summary of recent DOI expenditures.

Audit Scope and Purpose

This performance audit was conducted to evaluate the Department of Insurance operations, focusing on these three objectives.

TABLE 2

DEPARTMENT OF INSURANCE
STATEMENT OF FTEs AND ACTUAL EXPENDITURES
FISCAL YEARS 1986-87, 1987-88, AND 1988-89
(unaudited)

	1986-87	1987-88	1988-89
FTE Positions	61	61	69
Personal services	$1,366,729	$1,380,583	$1,507,098
Employee-related	272,297	259,864	323,576
Prof. & outside services	27,583	23,594	67,591
Travel, in-state	6,040	6,436	5,806
out-of-state	15,745	10,619	17,548
Other operating	352,327	402,410	452,756
Equipment	22,316	23,422	23,191
TOTAL	$2,063,037	$2,106,928	$2,397,566

Source: Arizona Financial Information Systems and the State of Arizona, Appropriations Report for the Fiscal Year Ended June 30, 1989

- To identify current trends and research regarding automobile insurance rate regulation.

- To determine if the department effectively handles serious consumer complaints.

- To evaluate DOI timeliness in investigating consumer complaints.

The audit scope focused on these three areas for several reasons. Our preliminary work indicated that the department appeared to be functioning well in some areas. For example, DOI routinely conducts financial examinations to ascertain the financial status of domestic insurers. The department conducts these examinations more frequently than many other states' insurance regulatory agencies in an effort to protect consumer

interests. Further, unlike many states, the department has been active in monitoring certain aspects of insurers' practices by performing market conduct examinations. In the area of consumer awareness, DOI regularly publishes information on complaints received about insurance companies and also publishes various premium comparisons.

In addition to the three objectives, we addressed the 12 statutory Sunset Factors (pages 43 through 49). This report also contains the section Other Pertinent Information (page 37) regarding DOI's efforts in implementing the recommendations contained in two previous performance audit reports of the department (reports 79-4 and 80-6). The section Areas For Further Audit Work (page 39) addresses issues we identified during the course of our audit but were unable to research because of lack of time.

This audit was conducted in accordance with generally accepted governmental auditing standards.

The Auditor General and staff express appreciation to the director and staff of the Department of Insurance for their cooperation and assistance during the course of our audit.

FINDING I

BECAUSE AUTOMOBILE INSURANCE RATES ARE NOT SIGNIFICANTLY AFFECTED BY THE TYPE OF RATING SYSTEM USED, OTHER REFORMS SHOULD BE CONSIDERED

Although rate regulation is often a focus of discussions on controlling insurance rates, other reforms affecting rates may be needed to address the rising costs of auto insurance in Arizona. Over the years, the trend in automobile insurance has been to move from prior approval rating systems to competitive systems. More recently, because the high cost of auto insurance has created consumer demand for lower rates, the focus in some states for alleviation of this concern has been on the rate approval process. To assess this issue, we contacted several insurance experts and reviewed more than 50 studies and articles. We found that rates are not significantly affected by the use of any particular type of rate regulation system, and that other reforms are necessary to reduce rates and premiums. (1)

Most states regulate automobile insurance rates to some degree to ensure that insurance will be available and affordable to consumers. Three main principles, as adopted by the National Association of Insurance Commissioners (NAIC) in 1945, guide state rate regulation. These principles state that rates must be 1) adequate (to maintain insurer solvency), but 2) not excessive (not unnecessarily high so as to produce exorbitant profits), nor 3) unfairly discriminatory (price differences must reflect expected loss and expense differences).

Most states have adopted various rating systems to regulate automobile insurance. These rating systems fall into two general categories - prior approval (noncompetitive) and competitive - although several variations of each exist. Prior approval systems require that rate changes be filed with the state's insurance regulatory agency prior to use. The insurance commissioner then either approves or disapproves the proposed rates. Competitive systems rely on market forces to set rates under the

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(1) See Bibliography.

assumption that there is adequate competition within the industry. Under this rating system, insurers may or may not be required to file rates with the state insurance commissioner. However, under all types of competitive systems, new rates may be used by an insurance company without the commissioner's prior approval. If a new rate does not meet the three principles of rate regulation, the commissioner can subsequently disallow it and require the insurer to make policyholder premium adjustments.

Trends In Regulation

Several trends in automobile insurance rate regulation have appeared. Before 1960, prior approval systems were commonplace. Many states moved toward competitive systems during the 1960s through the mid-1980s. In recent years, however, some states have returned or are considering a return to greater regulation because of consumer dissatisfaction over high premiums.

Move toward competitive systems in the past - Most states utilized prior approval approaches for rate reviews until the 1960s. This was believed to be an appropriate method to ensure reasonable rates. However, during the 1960s, state legislatures, following the general trend toward deregulation, began moving towards the adoption of competitive rating laws for automobile and most other property and casualty insurance lines. States adopted competitive laws because it was felt that adequate competition would prevent excessive rates and that such systems are more efficient and less costly to administer than prior approval systems.[1] This trend continued through the mid-1980s. By 1984, 25 states had implemented competitive rating laws for some insurance lines. Arizona enacted its competitive rating law in 1980.

Currently, some interest in stronger regulation - More recently, some states have moved to stricter regulation for automobile insurance in an effort to curb high and rapidly increasing rates. Auditor General staff

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(1) In the late 1960s, a National Association of Insurance Commissioners (NAIC) study of property and casualty rate regulation concluded that competition within the market should act as the predominant regulatory device. Ultimately, in 1980, the NAIC adopted a model statute for a competitive rating system.

completed a survey of the insurance regulatory agencies in the 50 states and the District of Columbia.[1] The survey results indicated that four states have changed from competitive systems to less competitive or noncompetitive systems since 1986. Maryland, New Mexico, and California changed from competitive to prior approval systems.[2] Kentucky changed to a less competitive flex-rating system.[3] Officials from these states stated that the changes were made in an attempt to slow rate and premium increases, and simply to make insurance cheaper.

While four states have recently increased regulatory efforts, two states - Iowa and Rhode Island - have shifted from prior approval to competitive systems. According to officials from these states, the reasons the changes were made was because of the inefficiencies and high costs of the former prior approval systems. The results of our survey, and one conducted in 1989 by the National Conference of State Legislatures, found that at least six other states, including Arizona, are currently studying possible changes to their automobile rate regulation system.

Table 3 (see page 10) shows the current status of automobile insurance rate regulation in the 50 states and the District of Columbia. The table indicates that slightly more than half of the states utilize competitive systems, while the remainder utilize noncompetitive systems.[4]

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(1) See Appendix for a discussion and copy of the survey.

(2) Prior approval regulation in California is the result of the passage of Proposition 103 in the November 1988 election.

(3) A flex-rating system is described as a blending of open competition and prior approval systems, requiring rate change approval by the regulator only if the change exceeds specified percentage ranges. Proponents of flex-rating contend that it will promote full, yet fair competition, while facilitating meaningful reviews of substantial rate adjustments - up or down - in order to avert rate inadequacy or excess over the long run. Flex-rating is mainly used for commercial property and casualty lines.

(4) Competitive classifications of rate regulatory laws include such systems as no regulation, information filing only (use and file), or no filing (of rate documents). Noncompetitive classifications would include systems such as prior approval, modified prior approval, state set rates, and generally, file and use laws. Flex-rating systems are a cross between competitive and noncompetitive systems.

TABLE 3

TYPE OF AUTOMOBILE INSURANCE RATE REGULATION
USED BY THE 50 STATES AND THE DISTRICT OF COLUMBIA
AS OF AUGUST 1989

No Regulation	Open Competition	Flex-rating	Prior Approval	State Set[a]
Illinois	Arizona	Kentucky	Alabama	Massachusetts
	Arkansas		Alaska	Texas
	Colorado		California[b]	
	Connecticut		Kansas	
	Delaware		Louisiana	
	Florida		Maryland	
	Georgia		Mississippi	
	Hawaii		Nebraska	
	Idaho		New Hampshire	
	Indiana		New Jersey[c]	
	Iowa		New Mexico	
	Maine		New York	
	Michigan		N. Carolina	
	Minnesota		N. Dakota	
	Missouri		Oklahoma	
	Montana		Pennsylvania	
	Nevada		S. Carolina	
	Ohio		S. Dakota	
	Oregon		Tennessee	
	Rhode Island		Washington	
	Utah		Washington, D.C.	
	Vermont		W. Virginia	
	Virginia			
	Wisconsin			
	Wyoming			
1	25	1	22	2

(a) State set rates are rates set by a state agency that all insurers must use.

(b) California was an open competition state beginning in 1947. However, as a result of the passage of Proposition 103 in a 1988 election, California voters changed the rating system to prior approval.

(c) New Jersey did not respond to our survey. The information presented in this table for New Jersey was obtained from the National Association of Insurance Commissioners and is current as of January 1989.

Source: Prepared by Auditor General staff from Auditor General automobile insurance survey, completed August 1989

Current Research Indicates No Significant Difference In Rating Systems

Current research does not clearly establish either of the regulatory approaches as superior. Generally, most research shows that no significant difference exists between the two rate regulation systems, and when a difference does exist, it usually indicates that competitive approaches provide more consumer value. Furthermore, some information suggests that *noncompetitive* systems are potentially harmful as well as more costly.

Reports show no difference in systems - Various studies and insurance experts indicate that no one type of rating system is most effective at controlling insurance costs and rate fluctuations. One insurance expert we contacted stated that the type of regulatory system used makes little difference in costs. No correlation exists between the two.[1] Other industry observers agree. A January 1988 insurance industry journal (Best's Review) states there is no clear consensus on the most effective method of rate regulation. The article cites industry and state insurance regulatory agency studies that indicate that prior approval systems are no more effective in controlling rate fluctuations than are competitive systems.

Several other studies supported these same conclusions. These studies analyzed the impact of rate regulation systems on price by comparing loss ratios. A loss ratio reflects the proportion of the premium dollar returned to insurance consumers in the form of loss payments. Accordingly, this ratio (a higher ratio means greater consumer value) shows some of the direct benefits that automobile insurance consumers have obtained in return for their premium payments. In each of the following three studies, no significant difference occurred among competitive versus noncompetitive states, or where such a difference did occur, the competitive approach gave consumers a somewhat greater value.

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(1) Jeffery O'Connell, Professor of Law, University of Virginia

- Philip R. O'Conner, Palmer Bellevue Corporation, in the study "Rate Regulation and Consumer Value In Automobile Insurance: A Review of Twelve Years (1975-86) of Loss Ratios In All States" (1989) concludes that the type of rate regulation either has no systematic effect on loss ratio levels or tends to have the effect, in competitive states, of increasing loss ratios somewhat, indicating greater consumer value.

- Kenneth Meier, in his book The Political Economy of Regulation: The Case of Insurance (1988), concludes that in no case are the rates in regulated states significantly different from the rates in less regulated states, a finding consistent with other empirical literature. The clear conclusion is that regulation, in general, has no impact on the price of insurance.

- Robert C. Witt and Harry Miller, in a December 1980 CPCU Journal article titled "A Comparative Analysis of Relative Costs Under Competitive and Non-Competitive Rate Regulatory Laws" found, using data for all states from the period 1971 through 1978, that, statistically, there is basically no relative cost difference between the two classifications of rate regulatory laws. The authors conclude that based on this finding, "there appears to be no empirical economic justification for the regulation of automobile insurance rates by regulatory authorities, especially when considering the costs of regulating rates."

Although most reports found no significant difference between rating systems, a report by the U.S. General Accounting Office (GAO) gave mixed results regarding premium reductions due to types of rating systems. In its report Auto Insurance: State Regulation Affects Cost and Availability (1986), GAO conducted two different analyses of the effect of noncompetitive and competitive ratings systems on insurance costs. However, the chairman of the Arizona Study Commission on Private Passenger Automobile Insurance, who is a statistical expert and Arizona State University professor, said that the analyses used by GAO are problematic, and the results of the analyses are not reliable. One of the analyses found that average premiums for physical damage insurance were statistically significantly higher in noncompetitve states, but found no statistically significant difference in liability coverage costs. The second analysis, a multiple regression analysis, showed no significant differences in the cost of physical damage coverage between competitive and prior approval states except in one case. The cost of liability coverage was generally higher in states that used competitive approaches, with the size of the cost difference dependent on the degree of urbanization of a state.

Stronger rate regulation may result in negative consequences - Some insurance experts also warn that stronger rate-making regulation will likely have adverse consequences that may outweigh any benefits of such a move. For example, a 1989 study on auto insurance issued by the Insurance Information Institute found that the results of some attempts to keep prices down through regulatory price controls have been negative. The report continues that this has resulted in less insurance, tighter eligibility criteria, cross-subsidies from low-risk to high-risk drivers, expanded residual markets, and substantial insurer operating deficits that ultimately produce higher premiums.

In further support of this view, an insurance expert suggests in a recent paper that regulation of voluntary automobile insurance market rates will reduce voluntary market coverage availability and thus, will force some drivers into the residual market, such as an assigned risk plan. The paper also warned that persistent limitations on rate increases below levels consistent with growth in expected claim costs are likely to cause insurers to withdraw from a state, may increase insurance company insolvencies, or both.(1) Another insurance expert cited similar information in a recent business journal article.(2)

In addition to these potential problems, it typically costs more to administer a noncompetitive, or prior approval type system. Many studies are quick to point out this concern. Additional insurance department staff are needed to review and approve the rate filings within specified time periods. Officials responding to our survey stated this to be true. In California, for example, direct costs of changing to prior approval resulted in insurance department budget increases of $2.1 million and 43 staff.(3) Maryland's budget increased by about $1 million when it implemented a prior approval system. If a typical

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(1) Scott E. Harrington, "Rate Regulation, No-Fault, and the Automobile Insurance Affordability Problem," unpublished working paper of the University of South Carolina, College of Business Administration, January 1989.

(2) J. David Cummins, "What's Driving Auto Insurance Up," The Wall Street Journal, January 5, 1989.

(3) In addition to the direct costs, an additional $15.6 million in resources have been allocated to other departmental functions that support, at least in part, the new prior approval system. Examples of these include equipment, administrative, actuarial, and legal services.

prior approval system were to be implemented in Arizona, DOI officials estimate it could cost over $1 million for 37 additional staff alone.[1]

Experts Call For Other Insurance Reforms

Research indicates that simply changing rate review and approval methods will not affect the cost of insurance because such changes do not address underlying problems. Some experts suggest that the implementation of a good no-fault system is key to reducing costs and improving affordability and availability. In addition, other measures may also be beneficial to this effort.

Support for no-fault - Some researchers strongly support a good no-fault system as a way to make automobile insurance more effective and affordable. In past years, a number of states have moved to no-fault automobile insurance. Experts studying these states have found that good no-fault systems can impact the cost of auto insurance.

No-fault insurance is a form of automobile insurance in which a person's economic losses, such as medical expenses, and loss of income, are paid by his or her insurer (through personal injury protection - "PIP") regardless of who was at fault. Such a law limits the ability of an injured party to sue for recovery of damages and for pain and suffering. Thus, the law avoids the necessity of determining, through litigation, who is at fault in an accident. Suits for pain and suffering can only be instituted when medical type losses exceed the "tort threshold" amount. Thresholds may be monetary (currently $2,000 in the one no-fault state

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(1) These estimates were based on a prior approval law in which rates must be approved within 30 days before their effective date (they usually "deem," or become effective, if not disapproved by this time), and no hearing is required. The estimates do not include other costs, such as additional computer usage, that would also be needed.

utilizing a monetary threshold), verbal (describing the kind or level of injury of the accident victim, for example, "permanent and serious damage" or disfigurement), or a combination of monetary and verbal.[1]

Currently, 13 states have some form of no-fault automobile insurance and most are mandatory plans. Our survey found that nine of these states have a combination of monetary and verbal thresholds. Three states have verbal only thresholds: Michigan, New York, and Florida. Massachusetts is the only no-fault state with a monetary only threshold.[2]

Scott Harrington, an insurance expert and professor at the University of South Carolina, maintains that the most effective way to reduce costs would be for states to adopt true no-fault auto insurance, or at least some type of tort reform. He believes the primary cause of high insurance costs is the rapid rise in bodily injury liability claims. Higher medical expenses, litigation costs, and pain and suffering awards have greatly contributed to these claims costs.[3] Other experts, Professor David Cummins of the Wharton School and Professor Jeffery O'Connell of the University of Virginia, share this view.

Various studies also recommend no-fault as an important element in insurance reform.

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(1) Although reduced legal costs is one potential benefit of no-fault, several other goals, or benefits, exist. These include the payment of medical costs and lost wages to more people, the avoidance of long delays inherent in tort litigation, and the assurance that victims suffering similar injuries will receive comparable levels of benefits. Officials of some states stated these other benefits as the major reason they implemented no-fault insurance.

(2) In addition to these 13 states, at least 7 others utilized PIP insurance, but do not limit an insured's right to sue. Such systems are referred to as "add-on" systems. Although not strictly no-fault systems (because there is no limitation on lawsuits), some professional literature refers to add-on systems as a type of no-fault. Officials of at least six states also told us that their states were either studying or considering adopting no-fault.

(3) According to Best's Insurance Management Reports (March 1989), "Economic Factors in Property/Casualty Insurance Claims Costs," from 1981 through 1988, the indexes (percent increase) for physicians' services (64.7%), hospital room rates (83.5%), auto body work (41.7%), and legal services (79.0%) have exceeded the general Consumer Price Index (30.2%).

- In the book, The Political Economy of Regulation: The Case of Insurance (1988), Kenneth J. Meier concludes that both his and other research convincingly demonstrates that policyholders benefit from real forms of no-fault insurance, that is, those that limit litigation. He further states that the consuming public would be well served by well-drafted, no-fault laws in the states.

- The U.S. Department of Transportation, in its 1985 report, Compensating Auto Accident Victims: 1984 Follow-up Report on No-Fault Auto Insurance Experiences, found that no-fault has led to reductions in the number of lawsuits and, thus, to significant savings in court and other public legal costs paid by the taxpayer. Although the study found that no-fault states, on average, had higher total insurance premiums than traditional states, this seemed to be due to states with unbalanced no-fault laws.(1) However, in nearly all other aspects, including faster payments to more insurance victims, no-fault was shown as superior to the regular tort system.

- The Alliance of American Insurers, in The Cost of No-Fault (1984) and "Reexamining the Cost Benefits of No-Fault," CPCU Journal, (March 1989), found that certain types of no-fault were effective in reducing insurance costs. These studies concluded that cost savings generally occur in those states that have adopted a strong tort threshold, particularly a verbal threshold. However, in states with weak thresholds, costs under no-fault are likely to be higher than under the tort systems they replaced. Both studies also found that, when comparing estimated tort injury coverage pure premium to no-fault injury coverage pure premium, the three states with verbal thresholds showed substantial cost savings under no-fault. For those states with monetary thresholds, the number of states that showed cost savings decreased as the threshold amount decreased, and in most add-on states it was determined that no-fault was typically more costly.

In addition to the above studies, initial findings of the Arizona Study Commission on Private Passenger Automobile Insurance also support no-fault insurance. The commission states in its interim report dated March 1989, that no-fault would be a fundamental solution to high insurance costs. In one of its recommendations, the commission states that no-fault insurance offers promise of real savings in the provision

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(1) "Balance" in a no-fault system refers to the extent to which the costs of no-fault benefits (medical, wage replacement, etc.) are greater than, equal to, or less than the savings made possible by the restriction on tort recovery (pain and suffering lawsuits and awards). Therefore, the savings in "unbalanced" states from restrictions on or reductions in tort recoveries is not as great as the cost of no-fault PIP benefits. Some studies indicate that high dollar and verbal thresholds are generally a factor in achieving balance in a no-fault state. Although an appropriate threshold may be the single most important factor in determining balance, other factors may also impact balance in a particular state.

and consumption of automobile insurance. It continues that "no-fault insurance is the one alternative which does appear to offer real savings in both the administration of an insurance program and in the cost of this product to the consumer."

Although a considerable amount of research tends to support no-fault as a useful alternative in the struggle to reduce the costs of automobile insurance, some states have encountered mixed results with no-fault. For example, some states have experienced significant premium increases as a result of no-fault. In many of these cases, the reason for this is that no-fault thresholds for tort recovery have often been too low to substantially impact bodily injury liability claims, especially when benefit levels are high.[1] To help alleviate this, many no-fault states have been strengthening their no-fault thresholds. Since the first no-fault system was adopted in 1971 by Massachusetts, most states that have adopted and continue to use no-fault have either increased their monetary threshold, moved to a combination monetary/verbal threshold, or moved to a verbal threshold in an effort to make their systems more effective and efficient. At least four states are currently considering changing to a verbal threshold.[2]

Other measures may also be beneficial - In addition to the potential benefits and cost savings of no-fault, other measures may also be useful in the effort to reduce automobile insurance costs, and ultimately rates and premiums. For example, the results of our survey and other research show that some states either have attempted or are attempting

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(1) In addition, come critics of no-fault contend that other problems exist with such a system. Critics allege no-fault may reduce driver responsibility and lead to more accidents, force individuals to purchase protection against the irresponsible acts of others, and not lessen the number of lawsuits.

(2) According to the DOI director, a constitutional amendment may be required if Arizona was to adopt a no-fault system. Specifically, Article II, Section 31 of the Arizona Constitution provides that "no law shall be enacted in this State limiting the amount of damages to be recovered for causing the death or injury of any person." In addition, Article XVIII, Section 6 states that "the right of action to recover damages for injuries shall never be abrogated, and the amount recovered shall not be subject to any statutory limitation."

comprehensive tort reform. Since 1982, at least nine States have enacted legislation placing limitations on noneconomic damage (pain and suffering) awards or amending or eliminating joint and several liability.[1] Officials we talked with in several other states said these reforms were made in an effort to help make insurance more affordable by reducing insurance company payouts. At least four other states have introduced similar legislation during 1989.[2]

Automobile theft is another significant cost factor in automobile insurance, and is said to be the fastest-growing crime in the U.S. According to the Insurance Information Institute, the largest component of comprehensive insurance cost is compensation for theft. In addition, the National Automobile Theft Bureau and other analysts have determined that fraudulent activities account for 15 to 20 percent of all auto insurance payments. As with tort reform, some states have either implemented or are considering various antitheft and antifraud initiatives to reduce these abuses.

Finally, other factors, though not directly related to insurance, can also impact automobile insurance costs and should also be considered when studying insurance reform. For example, traffic management concepts, including changes in speed limits and public education against drunk driving, may reduce the number and seriousness of automobile accidents.

RECOMMENDATION

The Legislature should consider other possible reforms to the insurance system in addition to the type of rating system used for automobile insurance. Other factors that should be considered include:

a. No-Fault insurance, particularly a plan with a strong verbal threshold

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(1) A liability is said to be "joint and several" when the creditor may sue one or more of the parties to the liability separately, or all of them together at his or her option.

(2) As is the case with no-fault insurance, a constitutional amendment may be required if a tort reform program involving a limitation on damages is pursued in Arizona.

FINDING II

ACTIONS ARE NEEDED TO REDUCE DELAYS OF COMPLAINT CASES REFERRED TO THE ATTORNEY GENERAL'S OFFICE

The Arizona Department of Insurance (DOI) could reduce delays of serious complaint cases referred to the Attorney General's office. Some complaint cases are delayed for hundreds of days within the Attorney General's office. Many of these delays can be attributed to the fact that DOI's need for legal services exceeds the number of attorneys assigned to DOI. However, DOI's failure to establish priorities and follow up on cases referred to the Attorney General has also contributed to the delays.

DOI is responsible for ensuring equitable treatment of Arizona citizens who purchase insurance. One method used by DOI for this purpose is investigating complaints received from consumers. Within DOI, investigations of consumer complaints are conducted by the Consumer Affairs and Investigations Division. According to DOI's fiscal year 1990-91 budget request, the division handled over 8,000 written complaints and responded to over 99,000 telephone inquiries and complaints during fiscal year 1988-89. Additionally, during this period the division was successful in assisting Arizona citizens in obtaining over $8.6 million in settlements from insurers. As noted below, more serious complaints (those involving possible statutory, or administrative rule or regulation violations) are referred by DOI to the Attorney General's office.

Complaint Cases Referred to Attorney General Are Excessively Delayed

Many serious complaint cases referred to the Attorney General are delayed. Although the Attorney General is responsible for prosecuting serious violations of insurance laws, action is sometimes delayed for time periods ranging from 100 to over 500 days.

Attorney General responsibility - The Attorney General is statutorily responsible for providing legal representation to the Department of Insurance. This representation encompasses a wide variety of issues including, for example, administrative and court actions involving potentially insolvent insurers, matters involving mergers, acquisitions, withdrawals and other financial regulatory requirements, and administrative and court actions relating to policy forms and rates. The Attorney General also serves as general counsel for the two guaranty funds. In addition, the Attorney General is responsible for prosecuting violations of Arizona's insurance laws. Arizona Revised Statutes (A.R.S.) §20-152.A. reads, in part:

> "If the director has cause to believe that a person has violated any penal provision of this title or other laws related to insurance ...he shall certify the facts of such violation to the attorney general, who shall bring and prosecute such action as may be required for the purpose of punishing the violation (emphasis added)."

In addition, A.R.S. §20-152.C. reads:

> "The attorney general shall prosecute or defend all proceedings brought pursuant to or resulting from enforcement of this title when requested by the director (emphasis added)."

Complaints involving possible insurance law violations, generally representing the more serious complaint cases handled by DOI, are referred to the Attorney General. After reviewing and accepting the case, the Attorney General drafts a Notice of Hearing for the director's signature, notifying the accused party of the charges against him or her. The Attorney General then prosecutes the case, usually in an administrative hearing before the department's hearing officer.

Serious complaints move slowly - Many of the most serious complaint cases referred to the Attorney General are excessively delayed. Overall, 21 of the 53 cases involving misappropriation of funds and misrepresentation of facts to policyholders referred to the Attorney General during 1987 and 1988 were delayed for more than 100 days. At least some of the delay appears to result from the Attorney General's slowness in issuing Notices of Hearings. For example, in almost every closed case in which a Notice of Hearing was issued, more than 25 days

passed between referral of the case to the Attorney General and issuance of the notice (see Table 4, page 24).[1] The average delay was 72 days. One case took 236 days. These delays occurred even though Attorney General officials indicate that when adequate investigations have been performed, they should be able to draft a Notice of Hearing for the director's review within one working day. Attorney General officials attributed the delays in issuing the Notice of Hearing to a combination of other DOI work being more critical and a lack of staff. They noted that some non-complaint cases (for example, those involving financially insolvent insurers) may affect thousands of policyholders and receive higher priority than many complaint cases. When staff are working on these cases, there is no one to work on complaint cases.

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(1) At the time of our analysis, of the 53 complaint cases reviewed, 15 remained open. The Attorney General declined to prosecute 3 cases and 35 cases were closed. However, of the 35 closed cases, a Notice of Hearing was not issued in 8 cases, usually because a Consent Order was signed by the licensee before the case reached this point.

TABLE 4

NUMBER OF DAYS TO ISSUE NOTICE OF HEARING
IN SERIOUS CASES REFERRED TO THE ATTORNEY GENERAL
DURING 1987 AND 1988

Number of Days to Issue Notice of Hearing [a]	Number of Closed Cases	Percentage of Total
1 - 25	5	19
26 - 50	9	33
51 - 100	7	26
101 - 200	4	15
More than 200	2	7
Totals	27	100

(a) This represents the number of days from the date the case was referred to the Attorney General until a Notice of Hearing was issued.

Source: Auditor General analysis of all misappropriation and misrepresentation complaint cases referred to the Attorney General during calendar years 1987 and 1988

A review of cases still open shows even more serious delays. As shown in Table 5 (page 25), 15 misappropriation and misrepresentation cases referred to the Attorney General in 1987 and 1988 have been open, on average, for nearly 300 days. These delayed cases represent serious violations of insurance laws, as illustrated in the following case examples.

CASE 1

On August 27, 1987, DOI referred a case to the Attorney General charging an insurance agency with misappropriation by having failed to pay the State of Arizona over $39,000 in surplus lines taxes and penalties (collected by the agent from policyholders and to be remitted to the State by the agent) during the period 1984 through mid-1987. Additionally, DOI contended that the agency had transacted insurance business without a license and had placed insurance through an unauthorized insurance company. During the course of their investigation, DOI found evidence to suggest that the principal individual behind the agency was not licensed to transact insurance business in Arizona and had lost his license in another state for misappropriation of premiums in 1985.

TABLE 5

NUMBER OF DAYS SERIOUS CASES PENDING
AFTER REFERRAL TO THE ATTORNEY GENERAL
DURING 1987 AND 1988

Complaint Case	Number of Days Pending with Attorney General[a]
A	540
B	484
C	445
D	415
E	336
F	322
G	294
H	268
I	268
J	206
K	206
L	206
M	172
N	113
O	113
Average Days Open	293

(a) This represents the number of days from the date the case was referred to the Attorney General until February 17, 1989, the date of our analysis.

Source: Auditor General analysis of all misappropriation and misrepresentation complaint cases referred to the Attorney General during 1987 and 1988

On February 17, 1989, 540 days (approximately 1.5 years) after referral, Auditor General staff reviewed the case and found that no formal action had been taken by the Attorney General. According to Attorney General officials, the delay was due to the technical nature of the case and inadequate time to conduct legal research needed to proceed with prosecution.

CASE 2

In October 1987, DOI received a complaint from a consumer charging a licensed agent of misappropriating $6,500 given to the agent in June 1983. The policyholder was unaware of the misappropriation until checking his account in September 1987. In early May 1988, after informal negotiations with the agent and his attorney, DOI was successful in obtaining restitution of the policyholder's money plus interest totalling nearly $12,000.

On May 25, 1988, DOI referred the case to the Attorney General to begin formal action against the agent's license.

On February 17, 1989, 268 days after referral, Auditor General staff reviewed the case and found that the Attorney General had taken no formal action on the case. According to Attorney General officials, delays in this case occurred because other assignments from DOI were perceived to be more important and there was insufficient time to work on this case.

Delays Are Caused by Several Factors

A major cause of the delays appears to be a lack of resources for DOI legal work within the Attorney General's office. However, some of the delays may be caused by a lack of direction by DOI.

Attorney General staffing - The biggest cause of delays appears to be the imbalance between the level of Attorney General staffing and the DOI legal workload. Currently, the Attorney General allocates approximately two attorneys to represent DOI.[1] Both DOI and Attorney General officials feel the department's requirements greatly exceed the workload capacity of two attorneys. As a result, lengthy delays occur in many of the assignments made by DOI. Furthermore, Attorney General officials feel that they will be unable to add staff for DOI at this time.

Several options for addressing DOI's legal needs are available if the Attorney General is unable to assign additional staff to DOI matters. One option would be to contract with private attorneys. The Attorney General's office has established contracts for private attorneys to provide legal services to the State. DOI has occasionally used these contracts to obtain attorneys to represent it in receivership cases. However, if DOI contracted for legal services at the same rate obtained by the Attorney General (at a minimum of about $100 per hour), a full-time attorney would cost over $175,000 annually.

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(1) The level of staffing assigned to DOI matters was increased by .5 of a position in late 1988. Prior to this time, 1.5 attorneys were assigned to conduct DOI legal work. In addition to the two attorneys currently assigned to represent DOI, an assistant chief counsel stated that he also conducts some DOI legal work when necessary.

A second option would be for DOI to fund an additional attorney position within the Attorney General's office. The Departments of Banking and Real Estate currently use this approach to meet some of their legal needs. According to the Attorney General's office, an additional attorney would cost approximately $45,000 to $48,000 annually (including related expenses).

A third alternative would be to create an attorney position within DOI to handle complaint cases. The Arizona Corporation Commission's Securities Division has its own attorneys who prepare cases for prosecution by the Attorney General. According to the DOI director, a departmental attorney would reduce the workload on the Attorney General staff and could lessen delays in handling complaint cases. At the Securities Division, the starting salary and related expenses for a mid-level attorney is approximately $37,850 (including related expenses). For DOI to utilize such a position, either special authorization from the Attorney General, or legisation exempting DOI from A. R. S. §41-192.E. would be necessary.[1] According to the DOI director, DOI has requested three attorney positions in its fiscal year 1990-91 budget request.

Funding for any of the three alternatives above could be accomplished by establishing a revolving fund supported by the civil penalties collected by the department. This would not only help provide the needed legal services, but would also have the effect of requiring those who create a need for the enforcement program to help pay part of its costs. The Department of Banking currently has such a revolving fund.

Another option would be to require Arizona's two guaranty funds to pay the cost of their Attorney General representation.[2] The Attorney

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(1) A.R.S. §41-192.E. states that "no state agency other than the Attorney General shall employ legal counsel or make an expenditure...for legal services."

(2) Arizona has two insurance guaranty funds established by law: the Property and Casualty Fund and the Life and Disability Fund. The funds' purpose is to protect policyholders in the event of an insurance company's insolvency by making payments to policyholders of insolvent companies. The funds are supported by a direct assessment on companies writing these insurance policies. The assessments also pay the administrative costs of each fund. However, neither fund currently pays for its Attorney General representation.

General currently serves as general counsel to the guaranty funds which require approximately 20 percent of one of the two attorneys' time. The DOI deputy director feels statutory authority currently exists for the two guaranty funds to pay for representation provided by the Attorney General. The department has suggested such an arrangement to the management of the guaranty funds, but no action has been taken yet to obtain payment from the funds.

Although both DOI and the Attorney General's office agree that the department requires additional legal support, the level of support needed has not been determined. An Attorney General official estimates that at least one additional attorney is needed to meet DOI's workload. However, neither the department nor the Attorney General's office has analyzed the workload created by DOI legal work. Therefore, any estimates of additional staffing made at this time are tentative because they are not based on workload analysis.

Lack of DOI priorities and follow-up - In addition to insufficient Attorney General staffing levels, DOI may have also contributed to the extensive delays because it has not established priorities and followed up on cases referred to the Attorney General for prosecution. Little evidence exists to suggest that DOI prioritizes complaint cases in relationship to other assignments made to the Attorney General. According to Attorney General officials, they receive assignments from five sources within DOI, each wanting priority of their work over the others.

Furthermore, little documentation exists to suggest that DOI actively followed up on complaint cases that had been with the Attorney General for long periods of time. Although many cases had been referred over six months ago, the only documentation supporting DOI follow-up was a January 1989 memo to the Attorney General inquiring as to the status of several complaint cases.

RECOMMENDATIONS

1. DOI and the Attorney General's office should review and analyze the department's need for legal services to determine the number of staff

required. The results of this analysis should be used as a basis for increasing the legal resources available to the department.

2. DOI should evaluate the alternatives for obtaining additional legal services for the department including:

   - Requesting the Attorney General's office to assign more staff to DOI

   - Contracting with private attorneys

   - Funding additional Attorney General staff

   - Obtaining authorization from the Attorney General, or requesting legislative exemption from A.R.S. §41-192.E. to add an attorney position to the DOI staff

   - Requiring the two guaranty funds to pay for legal services provided by the Attorney General

3. DOI should establish a system for prioritizing work referred to the Attorney General and follow up on cases referred to the Attorney General.

4. The Legislature should consider establishing a revolving fund, supported by civil penalties collected by the department, to be used to fund legal services needed for the department's enforcement efforts.

FINDING III

HIGH STAFF TURNOVER, HEAVY WORKLOAD, AND A MANUAL SYSTEM SLOW COMPLAINT HANDLING

In addition to the delays experienced with the more serious complaints, DOI is slow in resolving many routine complaints. Inadequate staffing levels coupled with a manual system of tracking complaint files appear to be the primary causes of untimely complaint handling.

The process for handling routine complaints is well established. After a written complaint is received, division management assigns it to an investigator. The investigator then notifies the complainant that an investigation has started. At the same time, a letter is sent to the party or parties the complaint is against notifying them of the complaint and requesting a response. Once DOI receives a response, the investigator evaluates the case and makes a decision. The investigator sends the complainant a letter outlining the company's response and his or her decision. The complainant has five days to appeal the decision before the investigation is considered closed.

Department Is Unable to Resolve Almost Half of Routine Complaints within Established Standard

DOI fails to resolve nearly half of all consumer complaints it receives in accordance with its established standards. DOI has fallen short of meeting these standards largely because of delays in receiving responses from insurance companies and licensees.

DOI has established informal standards to ensure the timely resolution of consumer complaints. According to the assistant director of the Consumer Affairs and Investigations Division, routine consumer complaints handled by the division should be resolved and a response sent to the complainant within 30 working days (6 weeks) of receipt.[1] This 30 working day

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(1) Routine consumer complaints are generally those complaints which do not involve a potential violation of statute or administrative rule and regulation. For example, such complaints may involve claim settlements or premium disputes.

standard is based upon several factors which include processing and analysis time by division investigators and staff, as well as 15 working days given to insurance companies and insurance licensees to respond to DOI's inquiry regarding the complaint.[1]

DOI has fallen short of meeting standards - While an informal 30 working day standard for resolving complaints has been established, DOI has fallen short of accomplishing this standard. An analysis of routine complaints handled by DOI indicates the average time to resolve complaints exceeded 37 working days. Much of the delay consists of the time it takes to obtain responses from insurance companies and licensees. However, DOI may not have the necessary authority to obtain more timely responses in some cases.

An Auditor General analysis of routine consumer complaints closed by DOI during 1988 indicates that 48 percent of complaints exceeded the 30 working day standard by 27 working days. As illustrated in Table 6 (page 33), 149 of the 308 sampled complaints exceeded the standard.[2]

Delays in receiving responses - Much of the delay in resolving these complaints is due to the time it takes to obtain responses from insurance companies and licensees. Upon notification of a complaint filed against them, DOI requires the company or licensee to provide a response within 15 working days. However, as illustrated in Table 7 (page 34), in 41 percent of a sample of complaints, companies and licensees took more than 18 working days to provide a final response to DOI.[3] In many cases, DOI attributes its inability to obtain timely responses from companies and licensees to investigator turnover. Turnover limits the department's ability to follow up because when investigators leave the department, their caseloads are neglected until reassigned to other investigators.

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(1) DOI issues licenses and regulates insurance agents, brokers, adjusters, solicitors, service representatives, and risk management consultants.

(2) We analyzed a statistical sample of 356 closed consumer complaints. However, some of the complaint files did not contain pertinent dates necessary for this portion of the analysis, or other analyses presented in this Finding.

(3) An additional three working days was added to the 15 working day requirement to reflect mailing time from DOI to the company or licensee.

TABLE 6

DOI RESOLUTION TIME OF A SAMPLE OF ROUTINE COMPLAINTS CLOSED IN CALENDAR YEAR 1988

Number of Working Days to Resolve Complaints[a]	Number of Closed Complaints[b]	Percentage of Total
0 - 30	159	52
31 - 40	51	17
41 - 50	32	10
51 - 60	26	8
61 - 75	15	5
76 - 100	15	5
Over 100	10	3
TOTAL	308	100

(a) This represents the number of working days from the date the complaint was received until a letter was mailed to the complainant containing DOI's position on the resolution of the complaint. Holidays were not excluded from the analysis.

(b) Of the 356 total closed complaints in the sample, 308 of the complaint files contained the information necessary to conduct this analysis.

Source: Auditor General analysis of a statistical sample of consumer complaints closed by DOI during calendar year 1988

Even if DOI could follow up on complaint inquiries in a more timely manner, it may not have the necessary authority to obtain timely responses for approximately one-half of the complaints. Presently, if the consumer complaint involves an insurance claim, the Unfair Claims Practices Act gives DOI the authority to require a response within 15 working days. If an insurance company or licensee does not respond within this time period, DOI can take such enforcement actions as issuing a Notice of Hearing and imposing civil penalities. However, in complaints not involving a claim, DOI's authority is less clear. According to the DOI director, statutory authority clearly outlining steps that DOI could take to enforce the 15 working day response requirement would help reduce delays in the complaints handling process.[1] Yet, as discussed below, such authority may not be

(1) Currently, however, there is no difference in response times between claims falling under the Unfair Claims Practice Act and those which do not.

TABLE 7

INSURANCE COMPANY AND LICENSEE RESPONSE TIME
TO DOI CONSUMER COMPLAINT INQUIRIES FOR A SAMPLE
OF COMPLAINTS CLOSED IN CALENDAR YEAR 1988

Number of Working Days To Receive Final Response[a]	Number of Closed Complaints[b]	Percentage of Total
0 - 18	198	59
19 - 25	41	12
26 - 30	16	5
31 - 40	24	7
41 - 50	21	6
Over 50	37	11
TOTAL	337	100

(a) This represents the number of working days from the date DOI sent an official notice informing the insurance company or licensee that a complaint had been filed until a final response was received upon which DOI could resolve the complaint. Holidays were not excluded from the analysis.

(b) Of the 356 total closed complaints in the sample, 337 of the complaint files contained the information necessary to conduct this analysis.

Source: Auditor General analysis of a statistical sample of consumer complaints closed by DOI during calendar year 1988

effective until DOI improves current staffing and information systems inadequacies.

Inadequate Staffing Levels and a Manual System of Tracking Complaints Have Contributed to Untimeliness

Inadequate staffing levels within the Consumer Affairs and Investigations Division have contributed to the delays in resolving consumer complaints. Additionally, the division's use of a manual system to track complaints has further contributed to the untimeliness of responses.

Inadequate staffing levels have contributed to delays - High turnover among the division's investigators has contributed to complaint-handling

untimeliness. In addition, the division may not have a sufficient number of investigators to ensure the timely resolution of complaints. DOI has attempted to address these problems.

DOI has experienced considerable turnover of its investigators in the past two years. In 1987, all six authorized investigator positions became vacant, resulting in a turnover rate of 100 percent. In 1988, two of the six investigator positions became vacant, a turnover rate of approximately 33 percent. According to the division's assistant director, the substantial turnover rates have reduced the division's ability to process complaints in a timely manner because additional time is needed for remaining investigators to become familiar with the cases of investigators who leave. Furthermore, new investigators require training and are unable to perform at the levels of experienced staff. The assistant director stated that he believes the most significant reason for the high turnover rate among investigators is the position's low salary level.

Beyond the problem of staff turnover, DOI may lack sufficient staff to handle the number of complaints received annually. In the three-year period between fiscal year 1985-86 and fiscal year 1987-88, the number of written complaints received by DOI steadily increased from 5,986 to 6,817, a 14 percent increase. However, during the same time period the number of investigator positions remained at six. Further, this increased workload came on top of a workload which appears higher than that of other agencies. For example, for fiscal year 1987-88, the Department of Real Estate received approximately 2,185 written complaints and had a staff of 11 investigators.

DOI has attempted to address the problems of turnover and insufficient staff. In early 1988 in response to the high turnover of investigators, the department was successful in upgrading three of the six investigator positions from Investigator IIs to Investigator IIIs. Additionally, the department requested and received three new investigator positions for fiscal year 1989-90.

Manual system to track complaints - A second factor contributing to DOI's untimely processing of consumer complaints is its use of a manual system to track complaints. Currently, DOI processes over 8,000 written complaints annually without the use of any automated systems. Complaint files are generated by clerical staff and an index card system is used to record and track the complaint file inventory. With this system, division management is unable to determine the age of the complaints inventory or to quickly determine the status of an individual investigator's caseload. According to DOI officials, each investigator is responsible for managing his or her caseload, with most using tickler files on their desk calendars to keep track of the progress of their cases.

The implementation of a new computer system may alleviate complaint processing delays attributed to this manual system. According to DOI officials, an agencywide automation project that was initiated this year will include the automation of the complaint-handling process. Although plans have not been formalized at this writing, DOI officials anticipate that the system will allow tracking of individual complaints as well as management reporting on the entire complaint inventory. Additionally, the system should reduce processing time of complaints. DOI expects this part of the system to be implemented by September 1990.

RECOMMENDATIONS

1. DOI should continue efforts to develop an automated system for complaint processing and for obtaining management reports on the status of the complaint inventory.

2. DOI should continue its efforts to increase the number of investigators, as well as possible upgrades of those positions, considering the anticipated effects planned automation will have on staffing needs.

3. The Legislature should consider granting DOI statutory authority comparable to that under the Unfair Claims Practices Act to allow enforcement actions on consumer complaints that do not involve claims.

OTHER PERTINENT INFORMATION

During the audit, we developed information about DOI's efforts in implementing the recommendations contained in two previous performance audit reports. These reports, issued by the Auditor General in 1979 and 1980 are Report 79-4, The Arizona Department of Insurance, and Report 80-6, Department of Insurance Consumer Complaint Function.

The 1980 report followed up on the prior audit report to determine if DOI implemented the recommendations made in 1979. The report indicated that the department generally had implemented the recommendations of Report 79-4 relating to consumer complaints. In addition, it noted that DOI had also greatly improved regulation of agents and companies, as well as consumer assistance.

During our current audit, we found that DOI has continued with earlier recommended changes and has made further improvements. For example, some significant changes in insurance laws have been made. Some of these changes include the collection of premium taxes on a quarterly basis rather than annually for most companies, the use of competitive rating systems rather than prior approval systems for most property and casualty lines, and the adoption of provisions relating to the Unfair Claims Practices Act.

DOI implementation of some audit recommendations has changed several departmental functions and processes. Regarding licensing, conditional licenses are issued to potential licensees prior to actual licensing, pending the results of applicant fingerprint checks. Also, applicant fingerprinting is now performed by a law enforcement agency or private company, and licensee testing is now conducted by a private company specializing in such testing.

DOI has also strengthened its consumer complaints process and has improved its consumer assistance programs. The department employs consumer specialists to provide assistance to the public. DOI now

analyzes and publishes information about complaints against companies, and also uses this information to identify companies for market conduct examinations. To aid consumers in comparison shopping, the agency also publishes personal auto and homeowner's premium comparisons at least once a year. In addition, the public also benefits from the review and evaluation of policy forms by department staff. Such reviews are conducted to ensure that policy forms are not misleading, and that the language used in the forms is clear and unambiguous.

Although the department has implemented most of the recommendations contained in the prior audit reports, in some cases, its actions have been limited. For example, it appears that DOI does not use data on total complaints for each agent to monitor and regulate agent conduct. Furthermore, DOI does not specifically document telephone complaints received. Overall, however, the department appears to have made substantial progress in implementing recommendations from the previous audit reports.

AREAS FOR FURTHER AUDIT WORK

During the course of the audit, we identified four potential issues that we were unable to pursue because they were beyond the scope of our audit or because we lacked sufficient time.

- **Is DOI adequately funded and staffed to regulate the insurance industry in Arizona?**

  Some studies indicate that more resources should be utilized in regulating the insurance industry in Arizona. A recent national study of state insurance departments found that most insurance regulators lack the necessary personnel and tools to provide adequate consumer protection and to monitor insurers for insolvency.

  The study suggests that at least 10 percent of the amount of a state's premium tax collections should be available for insurance regulation. DOI funding (General Fund) amounts to about 3 percent of premium tax collections. When compared to the 45 states (including the District of Columbia) included in the study, 34 (75%) state insurance regulatory agencies had higher budget to premium tax collection ratios than Arizona. In addition, when expressed as a ratio of budget to total state population, 39 states spent more than Arizona, often many times over.

  DOI officials contend that the department lacks enough staff to perform investigations and review rate and form filings. In addition, it appears that DOI may need additional analysts to review insurer financial information and conduct premium tax audits. Some of these assertions were supported in the March 1987 Report of the Arizona Property and Casualty Insurance Rate Advisory Council. The report states that DOI did not have adequate resources for effective rate/price regulation. Furthermore, the size of DOI's staff was significantly smaller than regulatory departments in other states even considering differences in population and insurance activity.

Further audit work is necessary to 1) determine specific staffing and other resource needs, 2) calculate total additional costs of these resources, and 3) plan for potential integration of these resources into the department.

- **Have the guaranty funds and the department acted responsibly regarding the sharing of information about insurance companies that may be having financial difficulties?**

Statutorily, the guaranty funds' boards of directors are required to inform DOI of any company which the boards and its members feel could be facing a possible insolvency. In essence, the boards have a responsibility to notify DOI of information they become aware of regarding financially troubled carriers or carriers conducting activities that could lead to insolvency. However, some board members are concerned that because they are employees of competing companies, sharing such information could lead to antitrust charges against their respective member companies.

In addition, in at least one incident, some board members of one fund felt that DOI acted inappropriately with information supplied by the fund about a possible insolvency. During a recent fund meeting, two members stated that after notifying DOI of possible problems with the company, DOI named the members in a follow-up letter to the company. Because of this, the two members said they would be hesitant to share information with DOI in the future. Further audit work is necessary to determine whether other states have similar reporting requirements and, if so, how they address the issues of possible antitrust violations and confidentiality of reporting. Additional work should also include obtaining legal opinions on these issues.

- **Does DOI perform market conduct examinations in such a manner as to properly protect Arizona consumers from inappropriate practices by insurance companies?**

Although DOI conducts more market conduct examinations annually than most other states, we identified several areas of concern regarding the manner in which DOI performs these examinations. In the five

examinations we reviewed, it appeared that DOI officials limited the scope of the examination to first party total loss automobile claims, an area in which violations are often found. Other areas such as sales, advertising, underwriting, and rating were given less attention, although the NAIC Model Market Conduct Examination Handbook suggests that these areas be reviewed as a part of a complete examination.

Once market conduct examinations have been completed, the amount of penalties and fines imposed by DOI may not be equitable. For example, in one examination reviewed, company officials violated insurance statutes by improperly deducting or failing to document nearly $36,000 of payments to claimants in 56 files identified by DOI examiners. The insurer agreed to make restitution and was fined $5,000. In a second case a company that improperly deducted or failed to document approximately $3,600 of claim payments in 27 claims and agreed to make restitution was fined $3,000. Although the first violation involved ten times the amount of the second case and twice the number of claims, the fine imposed on the first company does not appear to reflect the difference in the severity of the violations.

Finally, DOI may not be completing adequate follow-up to ensure compliance with orders issued as a result of a market conduct examination. For example, in one examination reviewed, DOI found a company had not complied with a consent order signed approximately two years earlier. Further audit work is needed to determine the adequacy of market conduct examinations completed by DOI.

- **Are capital and surplus amounts required of insurers by the State adequate?**

Arizona requires insurers to maintain certain amounts of capital and surplus in order to write insurance in the State. These requirements are intended to help protect policyholders if an insurer becomes insolvent. According to information obtained from a DOI official, Arizona capital and surplus requirements are often less than that

required by many other states. For example, Arizona ranks in the bottom 20 percent of the total general amount of capital and surplus requirements for life and disability insurers among the 50 states. Regarding requirements for property and casualty insurers for both single and multiple line carriers, at least 10 states have higher capital requirements and 26 states have higher surplus requirements.

Increases in these statutory requirements would likely increase an individual insurer's financial responsibility and reduce Guaranty Fund assessments and payouts. Further audit work is needed to determine the adequacy of Arizona's capital and surplus requirements, and the impact, if any, changes in these amounts would have on the insurance industry and the guaranty funds.

SUNSET FACTORS

In accordance with Arizona Revised Statutes (A.R.S.) §41-2354, the Legislature should consider the following 12 factors in determining whether the Arizona Department of Insurance (DOI) should be continued or terminated.[1]

1. **Objectives and purpose in establishing the department**

The Arizona Department of Insurance was created by the Legislature in 1913, as part of the Arizona Corporation Commission. In 1968, Arizona voters approved a constitutional amendment removing DOI from the direction of the Corporation Commission and establishing it as a separate agency.

The department was established to regulate the insurance industry in Arizona. As provided in the Arizona State Constitution, all insurers selling within the State shall be subject to licensing, control, and supervision by a department of insurance. Further, A.R.S. Title 20 authorizes the Arizona Department of Insurance to license insurance companies and agents, provide consumer assistance, investigate complaints from the public, review and approve insurance forms and rate filings, monitor the financial status of insurers, oversee the guaranty funds, and collect premium taxes and other fees.

The department has defined its objectives as:

- To administer Arizona insurance laws
- To protect Arizona citizens who purchase insurance
- To provide professional assistance to persons who purchase insurance
- To stimulate the insurance marketplace by encouraging competition

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(1) Should the Legislature decide to terminate the department, a constitutional amendment will be necessary.

2. **The effectiveness with which the department has met its objective and purpose and the efficiency with which the department has operated**

The department has met its objective of protecting and assisting the public. It has monitored the insurance industry and provided consumer assistance. During fiscal year 1987-88, for example, DOI reviewed over 34,000 rate and form filings, issued approximately 10,000 new and 15,000 renewal licenses, and monitored the financial status of over 2,500 insurers. In addition, each year DOI conducts and publishes premium comparisons and studies of various types of coverage available in the Arizona insurance market.

Since our previous audits in 1979 and 1980 (reports 79-4 and 80-6, respectively), DOI has made improvements in many of its operations. For example, DOI now uses a private company to conduct licensee examination testing. In the area of consumer protection and awareness, DOI publishes the number of complaints received annually against insurance companies. In an effort to strengthen its regulatory and consumer protection efforts, the department supported the adoption of the Unfair Claims Practices Act in 1981. This provides the department with greater authority over the marketing of insurance policies and the payment of claims by insurers. (See also Other Pertinent Information, page 37.)

However, our review revealed that the department could improve its consumer complaint investigations. Although the department handles thousands of written complaints annually, we identified ways it could improve the timeliness of its complaint investigations.

- The department could reduce the delay of serious consumer complaints by having all requests and assignments to the Attorney General's office made and prioritized by a single source within the department. In addition, the department and the Attorney General should evaluate alternatives to reduce delays within the Attorney General's office. Possible

alternatives include: 1) DOI funding an Attorney General position, 2) contracting for additional legal services with a private attorney, and 3) hiring a departmental attorney (see Finding II, page 21).

- The department could expedite its handling of routine consumer complaints by continuing its efforts to obtain and retain investigators. Additionally, the department should continue its efforts to develop an automated system for the complaint-handling process, which should allow individual complaint tracking and the ability to prepare management status reports of the entire complaint inventory (see Finding III, page 31).

Department management also feels that the department as a whole could be more effective and efficient in meeting its objectives if it had more staff. Although DOI has requested and received some additional staff positions in recent years, department management contends that staffing levels have not increased in proportion to the demands placed upon the department (see Areas For Further Audit Work, page 39).

3. **The extent to which the department has operated within the public interest**

DOI has generally operated within the public interest, accomplishing this in a variety of ways. For example, the department conducts and publishes automobile and homeowner's premium comparisons to assist consumers in obtaining coverage for the best price.

In addition, DOI helps protect the public by imposing requirements on insurers and monitoring those requirements. Examples of this include verifying capital and surplus amounts required to be maintained by insurers, routinely examining insurer financial information to identify potential solvency problems, conducting market conduct and rate examinations of insurers, and requiring insurers to disclose certain material information to prospective policyholders prior to selling policies.

4. **The extent to which rules and regulations promulgated by the department are consistent with the Legislative mandate**

A.R.S. §20-143 grants the director broad rule-making authority. Specifically, the law states that the director "may make reasonable rules necessary for effectuating any provision" of Title 20. According to the department, the Legislature also authorized the director to promulgate rules on specific subjects, such as Medicare supplement insurance and life-care facilities. In addition, the director has promulgated certain rules, as required by the Legislature, on the subjects of bail bond agents, service companies, and the readability of insurance forms.

The Attorney General reviews all rules proposed by DOI to certify that 1) the department has the power to promulgate the rules, 2) the rules are consistent with the department's statutory authority, and 3) the rules are appropriate in form.

5. **The extent to which the department has encouraged input from the public before promulgating rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public**

DOI appears to have ensured adequate public input on proposed rules and regulations. According to department management, the department encourages public input very early in the rule-making process. In fact, before the director decides to begin the formal process, DOI holds public meetings to solicit preliminary comments on proposed rules. A notice is published regarding this meeting and copies are sent to interested persons. The public comment is then reviewed and evaluated.

If the director decides to proceed with a proposed rule and DOI receives approval from the Governor's Regulatory Review Council, DOI then holds a formal public hearing. DOI circulates notice of this hearing to interested persons and to applicable industry and consumer groups. If significant public interest is expected, the department will issue a press release on the proposed rule. Following the hearing the department will generally allow a short time period in

which it will accept written comments. When a new rule is certified, the department typically issues a press release summarizing its effect.

6. **The extent to which the department has been able to investigate and resolve complaints that are within its jurisdiction**

The department has been able to investigate and resolve most consumer complaints it receives. During fiscal year 1987-88, the department's Consumer Affairs and Investigations Division handled approximately 7,000 written complaints from insurance consumers. However, the department could improve this function by resolving complaint investigations more rapidly (see Findings II and III, pages 21 and 31, respectively).

7. **The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under enabling legislation**

The Attorney General has the authority to prosecute actions on behalf of DOI. A.R.S. §20-152 authorizes the Attorney General to prosecute Title 20 violations, bring civil actions to enjoin the violation, and prosecute or defend all actions resulting from enforcement of Title 20 provisions. Furthermore, A.R.S. §20-401.04 provides that the Attorney General may enforce the orders of the director in Superior Court. Other criminal and civil enforcement statutes, in addition to Title 20 provisions, are also available to the department. A DOI Attorney General representative indicated that the Attorney General has a sufficient level of prosecutory authority to meet DOI's needs.

8. **The extent to which the department has addressed deficiencies in its enabling statutes which prevent it from fulfilling its statutory mandates**

DOI has actively addressed deficiencies in the insurance statutes over the years. For example, 11 bills proposed by the department from 1986 through 1988 were enacted by the Legislature. Changes resulting from these new laws were in the areas of license renewals, health-care service organizations (formerly referred to as health maintenance organizations, or HMOs), long-term care, and fees.

DOI submitted 9 proposals for consideration during the 1989 legislative session. Three of these bills are designed to increase consumer protection for health-care service organization enrollees (in the event of insolvency), long-term care policyholders and potential policyholders, and Arizona residents with group health coverage under out-of-state employer group trusts. Another bill changes medical malpractice rate statutes so that the director can more easily determine whether or not "free competition" exists and whether a rate is "excessive." These bills illustrate the department's efforts in addressing useful statutory changes.

9. **The extent to which changes are necessary in the laws of the department to adequately comply with the factors listed in the Sunset Law**

Based on our audit work, we recommend that the Legislature:

- Grant DOI specific statutory authority, comparable to the authority it currently has under the Unfair Claims Practices Act, to take enforcement actions against insurance companies and licensees who do not provide timely responses to those consumer complaint inquiries not falling under the act (see Finding III, page 31).

10. **The extent to which the termination of the department would significantly harm the public health, safety or welfare**

Regulating the insurance industry is necessary to protect the public in transactions which can significantly affect their financial welfare. Pursuant to federal law, regulation of the insurance business rests exclusively with the states. Accordingly, all 50 states regulate the insurance industry to varying degrees. Terminating the department would impact the public welfare because the federal government would most likely not assume regulatory responsibility. If DOI were terminated, another State agency would be needed to regulate the insurance industry for consumer protection purposes.

11. **The extent to which the level of regulation exercised by the department is appropriate and whether less or more stringent levels of regulation would be appropriate**

Our audit work suggests that the current level of regulation is generally appropriate. However, questions remain as to the most effective methods for regulating insurance rates (see Finding I, page 7).

12. **The extent to which the department has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished**

DOI uses private contractors to perform certain functions. For example, the department contracts with a private testing company to test license applicants. In addition, the department regularly uses approximately 40 independent contractors to conduct financial, rate, and market conduct examinations of insurers.[1] According to the department, this situation has proven to be more cost-effective than using State employees. On an as needed basis, DOI also contracts with court reporters for public hearings and with specialists for assistance with companies in receivership, or under supervision or conservatorship.

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(1) A.R.S. §20-148 allows DOI to contract for such services. These independent contractor examiners are compensated by the Insurance Examiners' Revolving Fund pursuant to A.R.S. §20-159. The revolving fund is reimbursed for examination costs by the insurance companies.

STATE OF ARIZONA
DEPARTMENT OF INSURANCE

ROSE MOFFORD
Governor

ABACUS TOWERS
3030 NORTH 3RD STREET, SUITE 1100
PHOENIX, ARIZONA 85012

SUSAN GALLINGER
Director of Insurance

October 23, 1989

Mr. Douglas R. Norton
Auditor General
2700 North Central Avenue
Suite 700
Phoenix, Arizona 85012

Dear Mr. Norton:

The Arizona Department of Insurance ("Department") appreciates the opportunity to respond to the report of the performance audit conducted by the Office of the Auditor General. The Department generally concurs with the findings and recommendations contained in the report. We strongly concur with the report's finding that the Department needs additional staff and funding to enhance our regulatory function.

Additionally, the Department has begun to address many of the concerns noted in the report. In fact, prior to and during the audit we began and, in some cases have already completed, many of the report's recommendations. Thus, rather than address all the points raised in the report, we offer the following comments and observations to clarify specific statements contained in the report.

FINDING I

The report makes a specific finding and recommendations regarding the regulation of automobile insurance rates. The Department agrees that legislative action is necessary to address the high cost of automobile insurance, and also agrees that all options should continue to be considered as is being done by the Arizona Study Commission on Private Passenger Automobile Insurance. It is important to recognize that under Arizona's competitive rate system described in the report, the law mandates that a rate shall not be held to be excessive if competition exists in the area covered by the rate. For this reason, in the area of automobile insurance, disapproval of a rate must be based upon a finding that the rate is inadequate or unfairly discriminatory.

The Department concurs with the recommendation that any reform of laws relating to automobile insurance must include provisions to combat insurance fraud because of fraud's significant impact on high automobile insurance rates.

FINDING II

The Department recognizes, as does the second finding of the report, that delay in bringing administrative or judicial proceedings is a problem and the Department is working with the Attorney General's Office to try to reduce the delay. While the Department is very pleased with the efforts and representation provided by the two attorneys who currently represent the Department, the workload (both in terms of the number and seriousness of cases) is simply too great to allow for anything but a very gradual reduction in the delay.

The Department has taken several steps to alleviate the problem of insufficient attorney resources. On some emergency cases, Department personnel have been appointed Special Assistant Attorneys General. For example, the Department's Deputy Director and Chief Hearing Officer acted as Special Assistant Attorneys General in the Department's litigation in the Maxicare bankruptcy. More directly and as set forth in the report, the Department's budget request for fiscal year 1991 includes a request for three attorneys. These attorneys would not function as Assistant Attorneys General, i.e. would not give legal advice to nor represent the Department during either judicial or quasi judicial proceedings which is the function of the Attorney General. Rather, they would assist the various divisions of the Department to speed and better prepare the cases to be sent to the Attorney General's Office and assist the Assistant Attorneys General with the preparation of Notices of Hearing, petitions and complaints to Superior Court and other aspects of the cases. When and if appointed by the Attorney General as Special Assistant Attorneys General, they could also directly reduce the current backlog of cases. In addition, these attorneys could draft the Department's rules required by statute so that when such rules are submitted to the Attorney General's Office for certification, less time will need to be spent by the Attorney General's Office reviewing, modifying and rewriting the rules for certification. Finally, it is the Department's understanding that the division of the Attorney General's Office representing the Department has requested funding for an additional attorney to represent the Department. We have provided the Attorney General's Office with data to support this request.

The Department does not feel that contracting with private counsel for representation on routine cases is the most efficient solution to the attorney resource problem. Although this method is useful in some circumstances, we agree with the report's finding that contracting with one full-time private attorney would cost in excess of $175,000 whereas one full-time

staff attorney could be hired for approximately $37,850. Moreover, full-time staff attorneys either at the Department or at the Attorney General's Office would develop the requisite expertise beyond that of most attorneys available in the marketplace.

The Department intends to continue its efforts to obtain funding for an additional attorney from the two guaranty associations. Such an attorney, in addition to providing representation to the guaranty associations, could assist in other guaranty fund and insurer insolvency related activities.

PRIORITIZATION OF CASES

The Department has prioritized cases since mid-1988.

In addition to working on the problem of an insufficient number of attorneys, the Department has taken steps to prioritize cases and other matters referred to the Attorney General's Office. Since the appointment of the current Director of Insurance in mid-1988, the Department has been in the process of implementing and refining prioritization procedures to be used by Department staff in referring matters to the Attorney General's Office.

We recognized that permitting each Division of the Department to refer matters to the Attorney General with priorities established by each Division rather than by the Department as a whole created the potential for conflicting priorities. As a result, each Division, with the exception of the Consumer Affairs and Investigations Division, directs all matters to be referred to the Attorney General's Office, including hearing files and requests for informal legal opinions, to a member of the Director's staff. The member of the Director's staff reviews the matter and determines its priority in light of the Department's other matters, then refers the matter to the Attorney General's Office, indicating its priority.

The Consumer Affairs and Investigations Division continues to refer hearing files directly to the Attorney General. The reasons for this include the large volume of hearing files this Division refers to the Attorney General, and the practice of having a senior investigator review and discuss the hearing files with the assistant attorney general as part of the referral process. If, however, the Consumer Affairs and Investigations Division needs to assign a case a higher priority when referring it to the Attorney General, this must be done through the Director's staff member responsible for prioritizing all the Department's cases. This permits the Department to assign priorities on a Departmental basis. In addition, the Consumer Affairs and Investigations Division must direct all

requests for informal legal opinions to the Director's staff member, as do all of the other Divisions.

The Department has implemented a tracking system

As part of the Department's efforts to better track matters referred to the Attorney General's Office, the Department prepares a monthly report that reflects the status of such matters. This report indicates the date and nature of any activity that occurred regarding hearing files and requests for informal opinions pending with the Attorney General's Office. Although this reporting process is fairly new, it is anticipated that it will permit us to better monitor and follow up on matters that have been referred to the Attorney General. We wish to thank the Auditor General's staff for its valuable input on this matter.

Almost all cases referred to the Attorney General's Office are serious. Thus, prioritization of cases by the Department will not reduce delays in resolving serious complaints.

We agree with the Auditor General that prioritization of complaints referred to the Attorney General is necessary and that the Department should take steps to ensure that such prioritization occurs and is well documented. The Department has, as noted above, established such a prioritization system. However, we also believe that because almost all cases referred to the Attorney General involve serious violations of the insurance laws, prioritization, no mater how refined, will not reduce delays in the resolution of serious cases. Every case involving insurer or licensee misconduct is serious and important to the Department. However, because of the Department's severely limited resources (in terms of numbers of investigators and attorneys), matters that adversely affect a large number of people will generally be given a higher priority by the Department when referred to the Attorney General's Office than other serious cases with a less pervasive impact. Cases of broad impact include cases involving insurer insolvency (such as Maxicare), allegations of widespread misappropriation or misrepresentation (such as Arizona Insurance Advisors which resulted in revocation of all insurance licenses and in restitution to consumers of approximately $50,000) and takeovers of Arizona's domestic insurers (such as the current $23 billion takeover attempt of B.A.T and Farmers Insurance Companies). These major cases often arise suddenly and require immediate action to protect the public health, safety and welfare. Therefore, they may be given priority over older cases involving isolated incidences of misconduct or even more recent cases of narrower impact. This in no way means that these lower priority cases are not serious or important, and certainly the Department makes every effort to see that they are resolved in a timely manner.

FINDING III

The Department essentially concurs with the third finding, especially with those portions of it which find that the Department has an insufficient number of investigators to handle the evergrowing workload. The Department is continuing its efforts to solve the problems in this area. Three current investigators have recently been promoted to Investigator IIIs from Investigator IIs. The Department has also obtained three additional investigator positions as requested in this year's budget; two of these positions have very recently been filled and interviews for the third position are ongoing. We hope these actions will increase morale by reducing the caseload for each investigator.

The report accurately notes that in 1987 the turnover rate for investigators was 100%. We are happy to report that from June 1988 to June 1989 the turnover rate for investigators has decreased to 13%. Moreover, once the above noted additional FTE investigator positions are filled (which is currently occurring), we anticipate an even lower turnover rate due to the resultant reduction in case backlog and the increased potential for career advancement.

In our 1991 budget request, we requested as a first priority three additional consumer specialists. If these positions are funded, the persons filling them will assist in dealing with the ever increasing number of telephone and written inquiries hence freeing more time for the investigators to resolve more complex complaints and violations.

AUTOMATION OF CONSUMER AFFAIRS

The report notes that one cause of delay in resolving consumer complaints is the manual system of tracking complaint files. The Department agrees that given the large volume of complaints the Department receives, a manual system for tracking these complaints is both inefficient and ineffective.

The Department is in the process of automating.

In November, 1988, the Department submitted a three-year automation plan to the Data Management Division of the Department of Administration. This plan,which is presently being updated, sets forth in detail the objectives and schedules for automating the Department. In December 1988, the Department, with the assistance and approval of the Data Management Division, acquired an IBM AS/400 mini-computer. The computer, as well as the salaries of the system operator, project leader, programmers and analysts, are currently paid from a computer fund created by the legislature from assessments collected from insurers and licensees.

The automation plan recognizes that the Department's ability to track an investigation from complaint to resolution on a manual system is extremely limited due to the number of files and persons involved. Automation will allow the tracking of the status of each complaint and will provide an aging report for more complex and lengthy investigations. Thus, many of the functions currently performed manually, including the preparation and mailing of routine forms, will become automated. When a complaint is forwarded to an insurer and a response is requested within a certain period of time, the automated tracking system will generate a reminder for the investigator on the date the response is due. If the response is not received when due, the investigator will take the necessary follow-up action.

The Department agrees that legislation is needed to require insurers and other regulated persons and entities to respond promptly to regulatory questions and requests for information. Without such authority, the Department could take no action if such requests were ignored. The Department will therefore request such legislation and thanks the Auditor General's staff for its excellent suggestion in this area.

OTHER PERTINENT INFORMATION

The Department concurs with the comments in this section.

AREAS FOR FURTHER AUDIT WORK

The Department defers comment on these areas until a full audit can be accomplished with respect to them except to note that the Department believes it is significantly underfunded when the scope and importance of its regulatory functions are considered.

SUNSET FACTORS

The Department fully concurs with the comments related to the Sunset Factors. The termination of the Department would leave Arizona consumers without any protection in connection with the business of insurance. Such a situation is simply untenable.

CONCLUSION

We would like to compliment the Auditor General's staff on the professional work they have done during the performance audit and for their constructive attitude and problem solving approach to the audit. We recognize that certain problems exist, mainly with delay in the completion of investigatory

matters and related proceedings involving litigation and believe these problems are caused by insufficient numbers of attorneys and investigators. We have and will continue to attempt to increase these resources. Considering the Department's resources, the vast scope and importance of the its regulation, the large number of licensed individuals and entities under its jurisdiction and the tremendous number of complaints and inquiries received, we believe the Department effectively regulates the business of insurance in Arizona. The Department very much appreciates the report's recognition of the funding and staffing inadequacies and will continue on-going action to implement all recommendations made.

Sincerely,

Susan Gallinger
Director

Attorney General
1275 WEST WASHINGTON
Phoenix, Arizona 85007
Robert K. Corbin

October 20, 1989

The Honorable Douglas R. Norton
Auditor General
2700 North Central Ave.
Suite 700
Phoenix, AZ 85004

Dear Mr. Norton:

Attorney General Corbin has requested me to respond to Finding 11 of the performance audit report on the Department of Insurance. However, first I want to thank your staff for meeting with Mr. Corbin, Patrick Murphy and me on October 12, 1989. The latest version of Finding 11 reflects some of the suggestions we made last week. We appreciate the time they spent with us, and the consideration shown.

We still have some serious concerns about some of the conclusions reached in Finding 11, and consequently we are submitting comments which are enclosed.

Again, thank you for your consideration.

Very truly yours,

W. Mark Sendrow

W. Mark Sendrow
Assistant Chief Counsel
Financial Fraud Division

cc. Bob Corbin
Patrick Murphy

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Attorney General's Response to Auditor General's Audit - Legal Services to the Arizona Department of Insurance

The audit overemphasizes the importance of the "complaint cases" in connection with legal services provided by the Attorney General to the Arizona Department of Insurance ("DOI"). These cases comprise approximately 20% of our workload for DOI. Thus, the audit examines one limited area of the Attorney General's representation of DOI.

The audit report's basic assumption appears to be that the complaint cases are the most important matters handled by DOI, and that each is equally important. Both assumptions are incorrect. Although many of the complaint cases involve serious violations of law, their impact on the public is usually less severe than an insurance company insolvency. Comparing the two cases cited by the Auditor General with insolvency cases dramatically illustrates this point. Contrary to the audit report, Case 1 involved a claim for approximately $10,000 in unpaid taxes, plus the possibility of a $30,000 civil penalty. Case two involved a single misappropriation which the former Insurance Director originally settled without revoking the agent's license, and only requested further disciplinary action when the restitution was not paid.

Contrast these cases with the recent Maxicare and Modern Pioneer Life insolvencies which affected the health and financial well being of thousands of policyholders. Maxicare insured 65,000 Arizona residents, and Modern Pioneer provided

health insurance to thousands of policyholders in Arizona and over 20 other states. It is often difficult, if not impossible, to predict when an insolvency will arise, and occupy an assistant attorney general for months to the exclusion of other cases. When such an emergency occurs the complaint cases discussed in the audit will invariably be delayed.

Another fallacy in the audit report is the assumption that every complaint case is very serious Some cases may involve the misappropriation of hundreds of thousands of dollars and numerous victims. Other cases may involve smaller losses and fewer victims. Consequently, the more serious cases receive priority attention which invariably results in delaying the prosecution of other cases such as those described in the audit report.

Case 1 in the audit report is an example of the type of case which is assigned a lower priority. That case is not a typical misappropriation case in which an insured is left without insurance coverage because his premium has been misappropriated by an insurance agent. As noted, Case 1 involved the non-payment of taxes; the unauthorized sales of insurance ceased; and no one had been defrauded. Since the case did not involve fraud, and since there is no statute of limitations barring the collection of the taxes or the assessment of penalties, it was given a low priority.

A third fallacy is that each complaint case when

submitted to the Attorney General is ready for prosecution. In fact, many of these cases require further preparation which delays their prosecution. Indeed, many cases are either sent back to DOI for additional preparation, or investigated further by the Attorney General's Office.

The comment at page 23 of the audit report that it should only take one day for the Attorney General to issue a notice of hearing is misleading unless placed in context. A one day turnaround presupposes that every case is ready for prosecution which is rarely true; that the Attorney General's support staff has nothing else to do, but to process files from DOI; that available attorneys are not otherwise engaged in other cases; that there are attorneys available to handle the resulting administrative hearings; and that DOI refers only one case at a time.

Not only are some complaint cases more important than others, DOI often gives a higher priority to administrative and court actions relating to insolvent insurance companies; administrative and court actions relating to policy forms and rates; court actions to enjoin and unauthorized and fraudulent conduct; and other matters concerning financial and regulatory requirements (mergers, acquisitions, withdrawals, regulation of third party administrators, regulation of life care contracts, regulation of service companies, etc.).

The audit report also ignores the statutory priority given to certain other cases, such as license denials. A.R.S. § 20-161(B) provides that the director "shall . . . hold a

hearing upon written demand therefor by a person aggrieved by any act . . . or order of the director . . . . (S)uch hearing shall be held within thirty days after receipt by the director of" a demand for a hearing. Under this statute, applicants who have been denied licenses are entitled to a prompt hearing. By enacting A.R.S. § 20-161(B), the legislature has assigned a higher priority to license denial cases than those discussed in the audit. This statutory priority affects the Attorney General's ability to prosecute the complaint cases, because the denial cases have the first call on resources.

The Attorney General would like to increase legal services for DOI, but has been unable to do so due to the State's budget constraints. The Attorney General is unable to shift available staff to represent DOI, because other agencies would suffer a reduction in their already inadequate legal services.

The Attorney General supports DOI's efforts to obtain additional staffing outlined on page 27 of the audit report, provided that DOI does not seek an exemption from A.R.S. § 41-192.E. It is the Attorney General's understanding that the Director of Insurance does not want to be exempted from A.R.S. § 41-192.E, but is only seeking authority to employ a person with legal training who would supervise the Consumer Affairs Division.

In summary, the delays in prosecuting the complaint cases result from the volume of work received from DOI. The

delay in prosecuting the specific cases examined in the audit report also results from the fact that those cases are simply not the most important cases referred from DOI to the Attorney General. Delaying them in favor of other cases, such as insurance company insolvencies, was deemed to be in the public interest by DOI and the Attorney General.

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APPENDIX

SURVEY METHODOLOGY

In an attempt to determine the type of automobile rate regulation and legal systems currently used by other states, and any insurance reforms they are considering, we conducted a telephone survey of the 50 states and the District of Columbia. All but one state, New Jersey, responded to our survey. In addition to responding to the survey, some states sent reports and studies for our review.

Our goal was to obtain information about auto insurance in three areas. First, we sought information regarding the major changes made to each state's auto insurance rate regulation system since 1986. Second, we sought information regarding tort reform enacted by the states since 1982 and reforms currently being studied which may have an impact on auto insurance. The third area involved no-fault insurance. We attempted to identify the types of no-fault used by the states, and the impact no-fault has had on auto insurance costs. In addition, we obtained information on the rating system currently in use in each state.

To obtain this information, we designed the survey with input from the director and other officials of the Arizona Department of Insurance, and the chairman of the Arizona Study Commission on Private Passenger Automobile Insurance. A draft of the survey was then submitted to the Department of Insurance for review.

Because of time constraints, we utilized a telephone survey. Surveyors were instructed to attempt to conduct the survey with department heads (directors, commissioners, superintendents). However, we were unable to obtain information directly from the department heads or other top officials in some states, and thus, we had to rely on responses from other department personnel.

Following review and analysis of the responses, additional calls were made to specific states to obtain clarification of responses and/or additional information.

A copy of the survey instrument is included.

SURVEY OF STATE AUTOMOBILE INSURANCE
RATE REGULATION

State _____ Date _____

Contact Name _____ Phone number _____

Contact Title/Agency _____

SECTION I

1. Has your state made major changes in the system used to regulate automobile insurance rates since 1986?

   Examples: From prior approval to open competition; from open competition to some form of prior approval.

   Yes ( ) No ( )

   If yes, please answer the following questions. If no, go on to question 2.

1A. Describe the changes made, including the system prior to the change and the system after the change.

_____

_____

1B. Why were these changes made? What specific problems was your state attempting to address?

_____

_____

1C. What were the results of the changes? Specifically, did the changes affect auto rates? Did the changes affect premiums paid by the public?

_____

_____

Have any formal evaluations of the results of the changes been conducted?
Yes ( ) No ( )

1D. If yes, please describe the general findings. (Ask for copy and the name of evaluator.)

_____

_____

1E. If no evaluations have been conducted, what is basis for determining impact of changes?

_____

_____

Did the changes affect the resources (ie, funds, personnel, etc.) needed by your state to regulate auto insurance rates?

( ) Yes, additional resources were needed to implement the changes.
( ) Yes, less resources were needed as a result of the changes.
( ) No.

1F. If needed resources changed, please describe the type of change (eg, additional staff needed to conduct additional reviews, streamlined procedures reduced needed staff, etc.) What was the actual change in staff levels and in the amount budgeted?

_____

_____

2. Is your state currently studying any changes to its system of establishing automobile rates? Yes ( ) No ( )

If yes, please describe the proposed changes and why they are under consideration.

_____

_____

3. Does your state require motorists to have automobile liability insurance? Yes ( ) No ( )

If yes, what limits are required?

_____

_____

4. Does your state require motorists to have uninsured motorist insurance? Yes ( ) No ( )

If yes, what limits are required?

_____

_____

5. Does your state have a special unit that investigates automobile insurance fraud?

( ) Yes, in the Department of Insurance
( ) Yes, in another agency.
Name of agency: _____
( ) No, no agency in this state has specific responsibility for investigating automobile insurance fraud.
( ) Don't know.

5A. If yes, please describe the reasons why it was established and the resources devoted to it (ie, staff, budget).

_____

_____

Has the fraud unit been beneficial? Yes ( ) No ( )

5B. If yes, what have been its benefits?

_____

_____

SECTION II

6. Has your state changed its tort system or implemented other major reforms affecting auto insurance since 1982?
Yes ( ) No ( )

Examples: Instituting no-fault insurance, limiting amounts recovered, etc.

If yes, please answer the following questions. If no, go on to question 7.

6A. Describe the changes made, including the system prior to the change and the system after the change.

_____

_____

6B. Why were these changes made? What specific problems was your state attempting to address?

_____

_____

6C. What were the results of the changes? Specifically, did the changes affect auto rates? Did the changes affect premiums paid by the public?

_____

_____

Have any formal evaluations of the results of the changes been conducted?
Yes ( ) No ( )

6D. If yes, please describe the results generally. (Ask for copy and the name of evaluator.)

_____

_____

6E. If no evaluations have been conducted, what is basis for determining impact of changes?

_____

_____

Did the changes in the tort system affect the resources (ie, staffing, funding) needed by your state to regulate auto insurance rates?

( ) Yes, additional resources were needed to implement the changes.
( ) Yes, less resources were needed as a result of the changes.
( ) No.

6F. If needed resources changed, please describe the type of change (eg, additional staff needed to conduct additional reviews, streamlined procedures reduced needed staff, etc) What was the actual change in the number of staff and the amount budgeted?

_____

_____

7. Is your state currently studying any changes to its tort system or other changes intended to affect auto rates?
Yes ( ) No ( )

If yes, please describe the proposed changes and why they are under consideration.

_____

_____

8. Does your state currently have a no-fault system for resolving automobile claims? Yes ( ) No ( )

If yes, please answer the following questions. If no, go on to question 9.

8A. When was the no-fault system instituted? _____
Is your state's no-fault system mandatory or optional?
( ) Mandatory for all motorists
( ) Optional, motorists may chose either no-fault or third party insurance coverage.

8B. Does your state's no-fault system allow injured parties access to the tort system? Yes ( ) No ( )

If yes, how is access determined?
( ) Losses exceed specified amount
What amount? _____

( ) Verbal threshold (eg, "permanent and serious damage")
What is specific description of threshold?
_____
_____

( ) Combination verbal/dollar amount
Please describe.
_____
_____

8C. Does your state's no-fault system permit attorney involvement in the claims process? Yes ( ) No ( )

If yes, under what conditions?
_____
_____

8D. Does your state's no-fault system permit recovery of noneconomic losses? Yes ( ) No ( )

If yes, under what circumstances?
_____
_____

8E. Prior to adopting its no-fault system did your state have any constitutional provisions guaranteeing citizens the right to recover damages through the court system? Yes ( ) No ( )

If yes, how was this right reconciled with the no-fault system?
_____
_____

8F. What has been the effect of no-fault in your state?

1. Were any savings realized immediately?
2. Have rates continued to increase? If so, has the rate of increase been faster or slower than under the tort system?
3. Have rates decreased?
4. Has the size of claims decreased or increased?
5. Have legal fees increased or decreased as a percent of premium?

Please describe.

_____

_____

Have any formal evaluations of the results of the changes been conducted?
Yes ( ) No ( )

8G. If yes, please describe the general findings. Ask for copy and the name of evaluator.

_____

_____

8H. If no evaluations have been conducted, what is basis for determining impact of changes?

_____

_____

9. Do you have any additional comments or observations about your state's experience with its automobile rate regulation system that would be helpful to the Arizona Legislature in reviewing options for reducing the cost of this insurance in Arizona?

_____

_____

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