ANALYSIS OF THE NEW JERSEY

FISCAL YEAR 2002 - 2003 BUDGET

DEPARTMENT OF BANKING AND INSURANCE

PREPARED BY

OFFICE OF LEGISLATIVE SERVICES

NEW JERSEY LEGISLATURE

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NEW JERSEY STATE LEGISLATURE

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DEPARTMENT OF BANKING AND INSURANCE

Budget Pages....... C-15, C-23, C-39, D-25 to D-32

Fiscal Summary ($000)

	Expended FY 2001	Adjusted. Appropriation FY 2002	Recommended FY 2003	Percent Change 2002-03
State Budgeted	$66,151	$68,164	$68,123	(0.1)%
Federal Funds	0	0	0	—
Other	7,154	10,570	10,570	0.0%
Grand Total	$73,305	$78,734	$78,693	(0.1)%

Personnel Summary - Positions By Funding Source

	Actual FY 2001	Revised FY 2002	Funded FY 2003	Percent Change 2002-03
State	495	509	555	9.0%
Federal	0	0	0	—
Other	4	5	5	0.0%
Total Positions	499	514	560	8.9%

FY 2001 (as of December) and revised FY 2002 (as of September) personnel data reflect actual payroll counts. FY 2003 data reflect the number of positions funded.

Introduction

The Department of Banking and Insurance is primarily responsible for the State's regulation and monitoring of the banking and insurance industries. The Division of Banking is charged with the chartering, licensing and supervision of banks, savings and loans, and a wide range of other financial institutions and firms responsible for consumer finance in this State. The Division of Insurance monitors and examines the policies, practices and financial condition of insurance companies, including the financial condition of health maintenance organizations, and licenses and regulates insurance producers. The division also monitors the business activities of real estate brokers and agents. The two divisions were formerly distinct departments, and were consolidated into the current Department of Banking and Insurance in FY 1997. The department is fully funded by the industries it regulates.

Key Points

- The department's recommended FY 2003 General Fund appropriation is $68.1 million, representing a decrease of 0.1 percent or $41,000 below the FY 2002 adjusted appropriation.

- The department's FY 2003 recommended budget supports 555 State funded positions, an increase of 46 or 9 percent above position levels in September, 2001. Most position growth will occur in Licensing and Regulatory Affairs (+22), Actuarial Services (+13) and Supervisional Examination (+10), while a decrease of 12 positions will occur in Administration and Support Services. These funded positions could change through implementation of an early retirement incentive program, a managed attrition program and other actions, as proposed by the Governor.

- The reduction of $41,000 comprises the elimination of supplemental funding for domestic fraternal benefit societies. Fraternal benefit societies have financial condition examinations conducted by department examiners and consultants. The Fiscal 2002 special purpose appropriation supports the department's cost of examining these societies' information processing system for year 2000 compliance.

- While appropriations for Insurance Fraud Prevention and Insurance Fraud Prosecution remain within the department, the fraud prevention investigator functions were shifted to the Department of Law and Public Safety in FY 1999 in an effort to provide more effective prosecution of insurance fraud related cases. These appropriations remain within the department's budget display because they are still funded through insurance industry assessments. However, all but $2.3 million of the $32.2 million appropriated for this purpose will be expended by the Department of Law and Public Safety. The $2.3 million will be utilized to fund the Anti-Fraud Compliance Unit within the Department of Banking and Insurance.

- A continued Special Purpose appropriation of $600,000 for the Actuarial Services Unit, within the Division of Insurance, is recommended to support the revision of the current territorial rating plan, a part of the division's automobile insurance reform initiatives. The Automobile Insurance Territorial Rating Plan Advisory Commission, established within the division, is responsible for redrawing the 50-year-old territorial rating plan used to set automobile insurance premiums throughout the State.

- The proposed FY 2003 budget anticipates revenues for the department of $90.6 million, an increase of $2.3 million or 2.6 percent, over the current year's estimate of $88.3 million. About $150,000 of this additional revenue is to result from increased banking examination fees, with the remainder attributable to increased license renewals and examinations.

Background Papers:

Program Description and Overview

The primary responsibilities of the Department of Banking and Insurance are the regulation and monitoring of the banking and insurance industries. The Division of Banking charters, licenses and supervises banks, savings and loans, and a wide range of other financial institutions and firms responsible for consumer finance in the State. The Division of Insurance monitors and examines policies, practices and the financial condition of insurance companies. The Division of Insurance also monitors the business activities of real estate brokers and agents. Previously, two separate departments, the former Department of Banking and Department of Insurance, were merged by P.L. 1996, c.45 (C.17:1-13 et seq.) to form the current Department of Banking and Insurance. The department is fully funded by the industries it regulates.

Division of Banking

The Division of Banking is responsible for chartering, licensing and supervising commercial and savings banks, savings and loan associations, limited trust companies and credit unions. The division is also responsible for licensing, examining and supervising a number of other financial service entities, including, but not limited to: licensed lenders (mortgage bankers and brokers, mortgage solicitors, consumer lenders, secondary mortgage lenders and sales finance companies); money transmitters and foreign money transmitters; insurance premium finance companies, pawnbrokers and check cashers.

The division consists of two offices, the Office of Depositories and the Office of Consumer Finance. The Office of Depositories conducts examinations of State-chartered banking and savings and loan institutions, and takes enforcement action if it discovers any violations of banking statutes or regulations. It also processes and reviews applications by depository institutions for new charters, branches, relocations, plans of acquisition, mergers, bulk sales, stock conversions and auxiliary offices. The Office of Consumer Finance examines, and when appropriate, takes enforcement actions against, the other entities regulated by the division and also investigates complaints filed by consumers.

In its oversight functions, the division works closely with the Federal Deposit Insurance Corporation (the FDIC insures the deposits of all chartered institutions); the Board of Governors of the Federal Reserve System, which oversees State-chartered banks that are members of the Federal Reserve System; and the federal Office of Thrift Supervision (OTS), which oversees savings and loan associations. The division and the Federal Reserve examine State-chartered commercial banks on an alternating basis. The division shares information with the OTS to decide whether State examinations of certain State-chartered savings and loan associations are necessary.

While the primary functions of the Division of Banking have not changed significantly in recent years, its responsibilities and workload have changed as a consequence of an increase in the number of new bank charters, the need to examine financial institutions, additional categories of licensure, and changes in State and federal laws and regulations.

The passage of the various federal laws in the 1990's significantly increased the division's workload, as well as its staff training requirements. More recently, the passage of the Gramm-Leach-Bliley Act of 1999 (GLBA) repealed the last vestiges of the Glass Steagall Act of 1933, including the restrictions placed on cross-industry affiliations, and authorized the creation of a new entity, the financial holding company, permitted to engage in underwriting and selling insurance and securities. GLBA also confirms state regulation of insurance, while prohibiting states from discriminating against persons affiliated with a bank; permits national banks to engage in new financial activities through financial subsidiaries; initiates processes for creating uniform nationwide licensing of insurance

Program Description and Overview (Cont'd)

agents and brokers; permits national bank subsidiaries and affiliates to sell all types of insurance, including title insurance; preempts state laws that interfere with affiliations between banks and insurance companies; and requires every financial institution to disclose its policy regarding the sharing of "non-public personal information" with affiliates and with third parties and requires that consumers be given an opportunity to "opt out" of sharing their non-public personal information with nonaffiliated third parties.

Other recent changes in State law include: the "Trust Modernization Act of 1999"; amendments to "The Credit Union Act of 1984"; the "New Jersey Money Transmitters Act"; major changes requiring depository institutions to offer basic low-cost checking accounts; allowing for State-chartered mutual savings banks; and permitting State-chartered capital stock savings and loan associations to convert their charters to State-chartered capital stock savings and banks.

Also included within the division is the **Pinelands Development Credit Bank**, which is empowered to purchase and sell development rights in the Pinelands region. The intent of the program is to simplify both the preservation of resources of the Pinelands area and the accommodation of regional growth influences in an orderly fashion.

Division of Insurance

The **Division of Insurance** monitors and examines the policies, practices and financial condition of insurance companies, including the financial condition of health maintenance organizations, and licenses and regulates insurance producers (brokers and agents). According to the department, the division has direct regulatory responsibility over approximately 110 domestic insurance companies, 106,000 licensed producers and 1,200 public adjusters. In addition, the division works in conjunction with the Department of Law and Public Safety to enforce insurance fraud laws, administers the Unsatisfied Claim and Judgment Fund, regulates the training and licensing of real estate agents and brokers and investigates consumer inquiries or complaints regarding these industries.

Over the past several years, the division has expanded and revised its responsibilities as a result of statutory changes and as a result of major events and changes within the insurance industry. For example, during fiscal year 2001 the Division of Insurance engaged in a significant effort to protect consumers of certain health maintenance organizations facing serious financial difficulties. To avoid future HMO insolvencies, legislation was enacted to provide for the licensure of "organized delivery systems" (ODS) that assume financial risk, and for the certification of those ODSs that do not assume financial risk. Pursuant to P.L. 1999, c. 409, the department is authorized to review financial risk sharing between and among HMO's and subcontractors. In addition, managed care regulations, together with new laws promoting expedited billing and payment processes, will increase the department's ability to monitor New Jersey's managed care industry and provide a stronger financial safety net for health care consumers and providers.

The "Automobile Insurance Cost Reduction Act," P.L. 1998, c. 21 (AICRA) provided for an overall 15 percent reduction in automobile insurance rates. Several cost-saving modifications were made to the existing system, including: the creation of a basic automobile insurance policy (implementation of the basic policy encourages motorists who otherwise would be uninsured to obtain required insurance coverage), in addition to the standard automobile insurance policy; and the adoption of medical protocols that reduce overuse and fraud in the treatment of injuries from automobile accidents, while ensuring that doctors provide necessary treatment to those who are truly injured. The law also established the **Office of Insurance Claims Ombudsman**, charged with the

Program Description and Overview (Cont'd)

responsibility to: investigate consumer complaints regarding insurance policies and the payment of claims; monitor the implementation of various insurance regulations; respond to consumer inquiries about policy provisions and coverage availability; and publish and distribute buyers' guides and comparative rates. Pursuant to AICRA, the fraud investigative functions of the former Division of Insurance Fraud Prevention were transferred to the newly created Office of the Insurance Fraud Prosecutor, housed within the Department of Law and Public Safety. At the same time, the Anti-Fraud Compliance Unit was established within the Department of Banking and Insurance. The Anti-Fraud Compliance Unit is charged with three primary functions: insurance industry compliance, collection of penalties and fines, and industry education. AICRA also established the Automobile Insurance Territorial Rating Plan Advisory Commission which is responsible for the revision of the current territorial rating plan, another aspect of automobile insurance reform. State law places a cap on the automobile insurance premiums that can be charged in certain areas of the State which are inadequate to cover the losses that are generated there and shifts those costs to other New Jersey drivers to subsidize the rates. The law therefore mandates the commission to review and revise these geographic territories for the first time in over 50 years.

As a result of the increase in competition within the automobile insurance industry, the department developed the "Consumer Handbook on Tier Rating," to educate consumers to "shop" comparatively for automobile insurance. This handbook provides concise, comparative information about New Jersey's automobile insurers, including a wide range of prices available for automobile insurance policies. According to the department, consumer "shopping" increased by 20 percent since the implementation of tier rating.

The Recommended FY 2003 Budget

The department's recommended FY 2003 budget of $68.1 million in Direct State Services funding, and $10.6 million from All Other Funds, is a decrease of $41,000 or 0.1 percent from the current fiscal year. The bulk of the $10.6 million in All Other Funds in the department's budget represents insurance industry assessments imposed to cover shared program losses related to the New Jersey Individual Health Coverage Program, P.L.1992, c.161 (C.17B:27A-1 et seq.). Budget language authorizes this program to operate from receipts.

The funding decrease of 0.1 percent is a result of a decrease of $41,000 that comprised supplemental FY 2002 funding for domestic fraternal benefits societies. A domestic fraternal society is any incorporated society, order or supreme lodge without capital stock conducted solely for the benefit of its members and their beneficiaries and not- for- profit, operated on a lodge system with ritualistic form of work having a representative form of government, and providing benefits pursuant to P.L. 1997, c.322 (C.17:44B-1 et seq.). Fraternal benefit societies have financial condition examinations conducted by department examiners in which a per diem rate is charged in addition to travel expenses. In addition, consultants from various accounting and actuarial firms work on the examinations. The supplemental $41,000 represents one-time funding, in lieu of examination fees above 1 percent of premiums, to support department costs of assuring the adequacy of the societies' information technology systems.

A continued Special Purpose appropriation of $600,000 for the Actuarial Services Unit, within the Division of Insurance, is recommended to support the revision of the current territorial rating plan, a part of the division's automobile insurance reform initiatives. The Automobile Insurance Territorial Rating Plan Advisory Commission, established within the division, is responsible for redrawing the 50-year-old territorial rating plan used to set automobile insurance premiums throughout the State.

Program Description and Overview (Cont'd)

The regulated industries fully fund the department. The proposed FY 2003 budget anticipates revenues for the department of $90.6 million, an increase of $2.3 million or 2.6 percent, over the current year's estimate of $88.3 million. These revenues include an estimated $16.3 million in revenues from the "Special Purpose Assessment" in FY 2003. Pursuant to P.L. 1995, c.156 (C.17:1C-19 et seq.), the Special Purpose Assessment consolidates certain insurance industry fees and charges to streamline the department's billing and collection process and to permit the department to charge insurers for all direct and indirect costs to the department.

Although appropriations for Insurance Fraud Prevention and Insurance Fraud Prosecution remain within the department's display in the Governor's proposed budget, these functions were transferred to the Office of the Insurance Fraud Prosecutor in the Department of Law and Public Safety. The appropriations remain within the department's display since the industry funds them through insurance assessments. The Department of Law and Public Safety will expend all but $2.2 million of the $32.2 million appropriated for this purpose. The Division of Insurance will utilize the remaining $2.2 million to fund the Anti-Fraud Compliance Unit within the Department of Banking and Insurance.

Fiscal and Personnel Summary

AGENCY FUNDING BY SOURCE OF FUNDS ($000)

	Expended FY 2001	Adj. Approp. FY 2002	Recom. FY 2003	Percent Change 2001-03	Percent Change 2002-03
General Fund					
Direct State Services	$66,151	$68,164	$68,123	3.0%	(0.1)%
Grants-In-Aid	0	0	0	0.0%	0.0%
State Aid	0	0	0	0.0%	0.0%
Capital Construction	0	0	0	0.0%	0.0%
Debt Service	0	0	0	0.0%	0.0%
Sub-Total	$66,151	$68,164	$68,123	3.0%	(0.1)%
Property Tax Relief Fund					
Direct State Services	$0	$0	$0	0.0%	0.0%
Grants-In-Aid	0	0	0	0.0%	0.0%
State Aid	0	0	0	0.0%	0.0%
Sub-Total	$0	$0	$0	0.0%	0.0%
Casino Revenue Fund	$0	$0	$0	0.0%	0.0%
Casino Control Fund	$0	$0	$0	0.0%	0.0%
State Total	$66,151	$68,164	$68,123	3.0%	(0.1)%
Federal Funds	$0	$0	$0	0.0%	0.0%
Other Funds	$7,154	$10,570	$10,570	47.8%	0.0%
Grand Total	$73,305	$78,734	$78,693	7.4%	(0.1)%

PERSONNEL SUMMARY - POSITIONS BY FUNDING SOURCE

	Actual FY 2001	Revised FY 2002	Funded FY 2003	Percent Change 2001-03	Percent Change 2002-03
State	495	509	555	12.1%	9.0%
Federal	0	0	0	0.0%	0.0%
All Other	4	5	5	25.0%	0.0%
Total Positions	499	514	560	12.2%	8.9%

FY 2001 (as of December) and revised FY 2002 (as of September) personnel data reflect actual payroll counts. FY 2003 data reflect the number of positions funded.

AFFIRMATIVE ACTION DATA

Total Minority Percent	26.7%	26.8%	25.5%	----	----

Significant Changes/New Programs ($000)

Budget Item	Adj. Approp. FY 2002	Recomm. FY 2003	Dollar Change	Percent Change	Budget Page
		ECONOMIC REGULATION			
ANTICIPATED REVENUE					
Total Anticipated Revenue	$88,327	$90,638	$2,311	2.6%	C-15

According to the Office of Management and Budget (OMB), the proposed increase in revenue is partly due to the recognition of certain banking and insurance fees collected by the department that previously would have been deferred to future years. The increase is also a reflection of the licensing schedule which, because it runs on a two year cycle, will produce higher renewal revenue in FY 2003. In addition, about $150,000 is expected to result from an increase in certain fees.

Budget Item	Adj. Approp. FY 2002	Recomm. FY 2003	Dollar Change	Percent Change	Budget Page
DIRECT STATE SERVICES					
Domestic Fraternal Societies	$41,000	$0	($41,000)	(100.0)%	D-30

According to the Office of Management and Budget (OMB), this reduction eliminates a one-time appropriation to fund the costs of assuring that domestic fraternal societies' information technology systems achieve year 2000 compliance.

Language Provisions

2002 Appropriations Handbook	2003 Budget Recommendations

Explanation

The proposed FY 2003 Budget for the Department of Banking and Insurance does not contain any changes in language provisions when compared to the FY 2002 Appropriations Act.

Discussion Points

1. The Governor's Budget identifies approximately $75 million in additional revenues from new or increased fees throughout State government.

! *Question*: Please identify the authority (i.e., legislation, executive order, or agency regulation) for any fee changes or other new State revenue sources reflected in the FY 2003 budget for your department. If legislation is required to implement these changes, what is the status of those bills?

2. The Governor's proposed budget recommends funding a total of 560 positions for the Department of Banking and Insurance. Since the department currently has 509 (State funded) filled full-time positions, the proposed FY 2003 budget would provide funding for close to 50 additional State funded positions.

! *Question:* Please provide a detailed summary of how many new employees the department expects to hire, as well as where these employees will be allocated within the department and when it expects to fill these positions. Please specify what types of positions are needed throughout the department, such as actuaries, fraud investigators, real estate investigators and clerical staff.

How many positions does the recommended budget of the department support within other departments? For example, how many positions in the Department of Law and Public Safety for the Insurance Fraud Prosecutors Office are recommended to be funded through the Department of Banking and Insurance?

3a. The Automobile Insurance Territorial Rating Plan Advisory Commission, established by the "Automobile Insurance Cost Reduction Act" (AICRA), was responsible for redrawing the 50-year-old territorial rating plan used in determining automobile insurance premiums throughout the State, no later than January 1, 2000.

! *Question:* Have the rules to establish standards for automobile insurance rating territories been adopted? Has the Commission established a common territorial rating plan? If not, what is the anticipated time frame for the Commission to adopt a common territorial rating plan?

3b. Section 27 of AICRA provides that an insurer may file a new territorial rating plan on or after 180 days following approval of the common territorial rating plan established by the Automobile Insurance Territorial Rating Plan Advisory Commission, or no later than January 1, 2000.

! *Question:* Has or would the department accept any new territorial rating plan filings from automobile insurers? Would the department accept, and/or approve these plans once received? If not, please explain why.

3c. C.17:29A-36, amended by AICRA, removes the 1.35 percent territorial rate cap on automobile insurance policies issued or renewed on or after January 1, 2000 or on the 180th day following approval of the common territorial rating plan, whichever is earlier.

! *Question:* Is the department applying the 1.35 percent territorial rate cap in reviewing and approving recent rate filings by automobile insurers?

Discussion Points (Cont'd)

4. The New Jersey Medical Malpractice Reinsurance Association was created in 1976 pursuant to the "Medical Malpractice Liability Insurance Act" (C.17:30D-1 et seq.) to solve a crisis in the market for hospital malpractice insurance and later physician malpractice insurance. The association was deactivated by the Commissioner of Insurance in 1982 because the commercial market had stabilized with respect to medical malpractice insurance. The FY 2002 revised General Fund revenue estimate includes the transfer of $11.1 million from the fund, one of the Governor's deficit closure actions. The statute provides that the association could be reactivated again, if determined to be necessary. Currently, the availability and affordability of medical malpractice insurance has become a public issue in this State, similar to the situation that occurred in the early 1970s.

! *Question:* Please explain the department's efforts to date in addressing the situation concerning the availability and affordability of medical malpractice insurance. What actions, if any, has the department taken regarding this issue?

Does the department believe that the current situation warrants re-activation of the reinsurance association? If not, under what circumstances would the department order re-activation?

Please discuss the current status of the New Jersey Medical Malpractice Reinsurance Recovery Fund, including any remaining balances in the fund or any outstanding claims against the fund.

5. State Farm Indemnity Company, which insures approximately 780,000 automobiles or 16 percent of the automobile insurance market, and is the State's largest automobile insurer, is currently seeking to cease doing automobile insurance business in this State.

! *Question:* What actions does the department plan to take with regard to this situation?

Have any automobile insurers filed a withdrawal plan? If so, how many have been filed and what number have been approved? Please list the companies that have received departmental approval to withdraw from the automobile insurance market. Does the department anticipate having to hire additional staff to address these issues?

6. Current law allows counties and municipalities to form joint insurance funds to self-insure for purposes of providing property, casualty, life and health insurance. The Bergen Municipal Employee Benefits Fund is a joint insurance fund which provides health insurance benefits for approximately 3,500 employees of the 41 member municipalities. The fund suffered losses of approximately $3.3 million in 2000 and $5.8 million in 2001 due to rising medical and hospital costs.

! *Question:* What action has the department taken with regard to the Bergen Municipal Employee Benefits Fund? Does the department anticipate increasing its role in the regulatory oversight of life and health joint insurance funds? What steps would be necessary for the department to undertake in order to accomplish that goal?

Discussion Points (Cont'd)

7. Predatory lending, which has become shorthand for describing a variety of lending practices that may be disadvantageous to borrowers, has received much media attention recently, heightening public awareness of this issue. Abusive or predatory lending - whether undertaken by creditors, mortgage brokers or home improvement contractors - may involve fraud or deception, manipulating borrowers through aggressive sales tactics or taking unfair advantage of a borrower's lack of understanding about loan terms.

! *Question:* How prevalent is predatory lending in the State? Please detail the current enforcement efforts engaged in by the department to address this situation. Is current law sufficient to adequately address the predatory lending problem? What public education efforts in regard to predatory lending has the department implemented or does it plan to implement in the future?

Background Paper: Horizon Blue Cross and Blue Shield of New Jersey Conversion Opportunity

SUMMARY

Horizon Blue Cross and Blue Shield of New Jersey may seek to exercise its authority to convert to a for-profit stock company. If and when this occurs, there could be a beneficial impact on the State budget.

Legislation authorizing the conversion of Horizon Blue Cross and Blue Shield of New Jersey (Horizon) from a non-profit health service corporation to a for-profit domestic stock health insurer was approved June 29, 2001 as P.L.2001, c.131 (C.17:48-49 et seq.). The financial realities of running a health insurance company in the twenty-first century prompted Horizon to seek this option.

Established in 1932 as Blue Cross, the company began operations as the first multi-hospital pre-payment system in the country. Ten years later, Blue Shield was established to provide coverage for medical and surgical costs. The first health maintenance organization (HMO) to operate in New Jersey was also established by the company in 1973. Most Blue Cross and Blue Shield plans across the nation were first established as not-for-profit entities and granted charitable charters at the state level. Blue Cross and Blue Shield plans offered health insurance coverage to anyone who desired it, regardless of health status, and utilized community rating to set uniform premium rates for local residents who enrolled in the plans. In most instances, the plans obtained special tax and regulatory treatment in exchange for this non-profit community-service mission.

While in the past Horizon had enjoyed a unique status in this respect, certain legislative reforms and market conditions resulted in major financial deficits by 1988. At that time, legislation authorizing the merger of Blue Cross and Blue Shield sought to address the company's financial difficulties, when assets fell short of liabilities and estimates of potential future claims by $278 million. Currently organized as a health service corporation, pursuant to the 1988 enabling legislation, Horizon's annual revenue exceeds $3 billion and its net worth was projected to reach $470 million by the end of 2000. However, under this organizational structure, Horizon can only generate funds for capital expenditures through premium increases. In order to avoid having to resort to premium increases for its policyholders, the company sought and obtained the legal authority to issue stock and become a publicly traded company. According to the company, Horizon currently provides health care coverage to over 2.5 million people, approximately 30 percent of the insured population in this State.

P.L.2001, c.131 provides that Horizon must establish a charitable foundation and contribute to it the fair market value of the company (most likely, 100 percent of the converted company's stock issued and outstanding) at the time of the conversion to satisfy the charitable obligations of the converting corporation to the people of the State of New Jersey. In 1997, Horizon proposed taking over Blue Cross and Blue Shield of Delaware and then merging the combined operation into Anthem Insurance, an Indiana-based holding company that then owned Blue Cross plans in three states. That proposed plan collapsed amid criticisms that the plan gave away to Anthem assets that belonged to the people of New Jersey. It was determined by the New Jersey Attorney General at that time that Horizon was a charitable organization and therefore some type of charitable foundation would need to be formed with the sale or conversion of Horizon.

Background Paper: Horizon Blue Cross and Blue Shield of New Jersey Conversion Opportunity (Cont'd)

The State's authority over the value and valuation of a private charitable organization derives from the legal doctrine of *cy pres,* a Norman French phrase meaning "as close as possible." Pursuant to common law principles, a charitable organization that changes its function or tax status must utilize its assets for a purpose as close as possible to the original one. The experience in other states, including California, North Carolina, Missouri and Georgia, where not-for-profit Blue Cross and Blue Shield plans sought to reorganize their corporate structures with little or no state oversight of the valuation of the private charitable enterprises, resulted in New Jersey's law. It requires, among other safeguards, that Horizon establish a charitable foundation to expand access to affordable, quality health care for underserved individuals and promote fundamental improvement in health status for all New Jersey citizens. The foundation is to be separate and independent of Horizon, and law requires that 100 percent of Horizon's value, currently estimated at approximately $470 million, be transferred to the foundation.

Pursuant to the provisions of P.L.2001, c.131, the following must occur before a conversion can be approved:

- filing of plan of conversion with Commissioner of Banking and Insurance and Attorney General at least 120 days prior to the proposed conversion date (which must include, among other things, a description of the manner in which the fair market value of the company will be transferred to the charitable foundation);
- filing documentation with the commissioner which details, among other items, the business plan of the converted company; five-year financial projections and comparative premium rate analysis of all policies in three years before and after filing of plan of conversion; and
- filing of petition for review of the foundation plan with Attorney General.

The law requires that a public hearing be held by the commissioner and the Attorney General on both the conversion plan and the foundation plan. The law also established a 15-member Health Service Corporation Conversion Temporary Advisory Commission (Advisory Commission) within the Department of Treasury to examine issues related to access to affordable, quality health care in New Jersey (it may also review experiences in other states related to the establishment of foundations in those states resulting from the conversion of not-for-profit to for-profit health insurers). To date, all but one of the Advisory Commission members have been appointed. The Advisory Commission will, in all probability, pay close attention to the recent efforts by Governor Pataki of New York to utilize a portion of the approximately $1 billion valuation proceeds from the conversion of Empire Blue Cross and Blue Shield to avert budget cuts to health care programs and pay for salaries and benefits for hospital employees in that state.

According to a December 14, 2001 press release issued by Horizon, the Board of Directors has authorized management to explore the process of converting the company to a for-profit publicly-held corporation. While there is no immediate plan to exercise the conversion option, current law provides Horizon with an additional means of meeting the substantial financial responsibilities it faces in the future through access to the equity markets and an alternative to passing costs to policyholders. A major determiner with regard to a conversion will be the market conditions for health insurance stocks over the next 12 months.

Background Paper: Medical Malpractice Insurance Problem

SUMMARY

New Jersey may be entering another period in which ensuring the availability and affordability of medical malpractice insurance requires State regulatory action with fiscal implications. Because the State experienced one such crisis, in the 1970's, a framework exists for addressing the issue.

The availability and affordability of medical malpractice insurance has again become an issue in this State. Some physicians publicly recite their struggle to obtain medical malpractice insurance and other physicians vent their frustration because they feel trapped by current circumstances, as medical malpractice insurers seek higher premiums and health maintenance organizations (HMOs) and the federal Medicare program decrease their reimbursement rates to physicians. Surgeons, obstetricians and gynecologists and certain other specialists are primarily affected at this time.

This is not the first time these problems have arisen. In the early 1970s, medical malpractice suits and paid claims were rising rapidly across the nation, and commercial insurers were withdrawing from underwriting medical malpractice insurance. It had been common for particular insurers to have agreements with special segments of the medical community for medical malpractice insurance. By the mid-1970s in New Jersey, hospitals, podiatrists and physicians all were encountering problems with their medical malpractice coverages.

The New Jersey Medical Malpractice Reinsurance Association was created in 1976 pursuant to the "Medical Malpractice Liability Insurance Act" (C.17:30D-1 et seq.) to solve a crisis in the market for hospital malpractice insurance. Although its primary intent was to stabilize the hospital medical malpractice market by making 100 percent reinsurance available to insurers, the act also allowed use of the association to back other kinds of medical malpractice insurance. In 1979, the act was amended to allow the association to write malpractice insurance directly, which it did. Between 1977 and 1982, the association either insured or reinsured about 3,500 physicians, 450 podiatrists and 68 hospitals. In 1982, the Commissioner of Insurance (now the Commissioner of Banking and Insurance) deactivated the association after a survey indicated that a commercial market for medical malpractice insurance again existed for physicians, podiatrists and hospitals. The association can be reactivated if needed.

The act provides that its purpose is "to assure that medical malpractice liability insurance is readily available to licensed medical practitioners and health care facilities by establishing a reinsurance association, requiring the association to reinsure medical malpractice liability insurance policies . . .," allowing it to write policies directly and permitting recoupment of losses through "surcharges on insureds." It also gives the commissioner the power to set up and operate the reinsurance association if insurance becomes unavailable for any class of licensed medical practitioners or health facilities.

The members of the association are the insurers writing personal injury and property damage liability insurance in New Jersey. The association is governed by a board of 12 directors, nine elected by the insurers and three producers appointed by the commissioner. The association is empowered, among other things, "[t]o provide separate accounts for categories and subcategories of insureds reinsured or insured by the association;" to contract for claims handling and auditing services; and to establish "fair and reasonable procedures to assess members whenever the assets of the association and the New Jersey Medical Malpractice Reinsurance Recovery Fund are insufficient

Background Paper: Medical Malpractice Insurance Problem (Cont'd)

to pay claimants as required by this act . . . ." The act directs the association to prepare a plan of operation for review by the commissioner. For the purpose of providing moneys to establish a recovery fund, the commissioner "shall establish reasonable provisions through additional premium charges for policies of the various categories and subcategories of medical malpractice liability insurance" to provide money for the recovery fund. A transfer to the General Fund of $11.1 million , or approximately 80 percent of balances remaining from the fund's active period, is one of the Governors' FY 2002 deficit closure measures.

It appears that history may be starting to repeat itself. As losses among insurers have been growing, several have collapsed or abandoned their customers to save themselves. Numerous recent occurrences have contributed to the current medical malpractice insurance scare. PHILCO Insurance Group, which insures some physicians in New Jersey and is the biggest insurer of physicians in Pennsylvania, was taken over by state regulators in Pennsylvania and filed for bankruptcy protection. Frontier Insurance Company in upstate New York was taken over by regulators last year. Zurich American Insurance Company raised their medical malpractice rates significantly and also sent out numerous nonrenewal notices to a number of physicians and some hospitals. Late last year, the Department of Banking and Insurance met with Zurich and ordered them to renew the coverages that they had not renewed because they had not complied with the block cancellation regulations. Zurich has complied with that request. The block cancellation regulation was adopted during the liability insurance crisis some years ago and prohibits the block nonrenewal of entire lines or classes of commercial insurance, except pursuant to a plan, submitted to the commissioner at least 60 days in advance of its implementation date, which is not disapproved within 30 days after its filing with the commissioner. (N.J.A.C. 11:1-22.2)

In addition, St. Paul Companies, the biggest commercial medical malpractice insurer in the nation, and Clarendon National Insurance Company announced last year that they are withdrawing from the medical malpractice insurance market. St. Paul has announced that it will no longer write medical malpractice insurance and that it plans to phase out coverage as physicians' contracts expire over the next 18 to 24 months.

The MIIX Group Inc. insures the largest number of physicians in the State. The Medical Inter-Insurance Exchange, which became the MIIX Group Inc., was formed in 1977 as a member-owned reciprocal company by the Medical Society of New Jersey to provide medical malpractice insurance for its members in response to the market constriction in the 70's. It became a publicly held stock company in 1999. It too has had financial problems. In 2000, MIIX suffered a loss of $36.5 million. In 2001, MIIX suffered a net fourth-quarter loss of $168.4 million, which resulted in a $157.6 million loss for 2001. Part of this loss came from MIIX setting $64.5 million aside in reserve accounts to pay off potential future losses from malpractice claims which had risen sharply and suddenly, particularly in Pennsylvania. A. M. Best Company, an insurance financial rating organization, lowered MIIX's financial strength rating from "Excellent" (A) to "Fair" (B-). MIIX immediately announced that it would stop writing malpractice insurance in five states - Texas, Ohio, Massachusetts, Illinois and Virginia. It also hired a financial consultant to examine its operations. On March 22, 2002, A. M. Best again lowered MIIX's rating to "Marginal" (C+) from "Fair" (B-), with the outlook continuing to be negative. MIIX has now announced plans to shut down a subsidiary, Lawrenceville Property and Casualty, and stop doing business in 19 of 24 states where it now operates. MIIX is also pulling out of the hospital malpractice insurance market. MIIX is rapidly withdrawing from those malpractice insurance markets which are not profitable and is going to concentrate on its core business in New Jersey, Connecticut and Delaware, which is profitable. MIIX is an insurance company and is regulated by the Department of Banking and Insurance. MIIX is working with the department toward a restructuring of its business plan.

Background Paper: Medical Malpractice Insurance Problem (Cont'd)

Commercial insurance tends to be cyclical in nature and it now appears to be on the downward part of the cycle. For a number of years in the past, the commercial insurance market was highly competitive, sometimes referred to as a "soft" market. Now the commercial insurance market is considered a "hard" market: generally, it is shrinking . Investment income is shrinking as interest rates and the stock market have declined. Insurers' surpluses (capital), that are necessary to write new business or continue to write current business, have decreased and reinsurance is becoming more expensive and is becoming less available on all risks, not just high risks. Medical malpractice insurers have these same financial problems and would currently have problems going to the markets to raise capital with their weak stock prices.

Premiums are increasing for medical malpractice insurance. Some increases are small and others are very large because those insurers are essentially withdrawing from the market. However, the cost of all property/casualty insurance, whether it is automobile insurance, workers' compensation, property insurance (especially on large apartment buildings), liability insurance or medical malpractice insurance, will increase because of the restricted commercial insurance market and the even more restricted reinsurance market, again, because of the catastrophic losses that have been sustained in the last year.

In addition to the insurers still writing in the market, medical malpractice insurance is exportable (can be obtained in the surplus lines market) and is available at a higher cost than the local market.

The medical malpractice insurance situation appears to be in particularly bad shape in such states as West Virginia, Mississippi, Florida, Pennsylvania and Texas. Part of the reason New Jersey may be faring better than some other states is because of the tort reform measures New Jersey enacted, such as reforms in joint and several liability, the collateral source rule and the institution of the affidavit of merit. Other states are considering similar tort reforms to address their medical malpractice insurance problems. Thus, it appears that these reforms may have had a positive impact on the overall medical malpractice insurance situation in this State.

Background Paper: Basic Automobile Insurance Policy

SUMMARY

Given the benefits of even basic automobile insurance coverage, the Department of Banking and Insurance could be doing more to promote the availability of low-cost basic policies.

One of the major innovations of the "Automobile Insurance Cost Reduction Act" of 1998 was the introduction of the "basic" automobile insurance policy, which provides for the minimum coverages necessary to be "street legal;" that is, in compliance with New Jersey's compulsory automobile insurance laws. When compared to a "standard" automobile insurance policy, the coverage under a basic automobile insurance policy is very limited.

The personal injury protection coverage under the basic policy may consist of only $15,000 for medical expense benefits, but includes up to $250,000 medical expense benefit coverage for permanent or significant brain injury, spinal cord injury or disfigurement, or treatment of other permanent or significant injuries rendered at a trauma center or acute care hospital immediately following the accident and until a doctor says that the injured party no longer requires critical care.

The liability coverage under the basic policy is limited to only $5,000 for property damage coverage and an option to purchase bodily injury liability coverage at a limit of $10,000 total for all persons, per accident. The Buyer's Guide that each insured is required to receive contains the following warning if the $10,000 bodily injury liability coverage is not purchased under a basic automobile insurance policy:

> CAUTION: If you do not have Liability Coverage, you will be responsible for paying for the pain, suffering and other personal hardships and some economic damages, such as lost wages, that you cause. The insurer will not pay a judgment against you or be obligated to provide or pay for a lawyer to represent you if you are sued. Your assets will be at risk, including the risk of having money deducted from your wages if a judgment is entered against you.

An insured choosing the basic automobile insurance policy is required to have the limitations on lawsuit option (verbal threshold) for pain and suffering suits.

Uninsured and underinsured motorist coverages may not be purchased as part of a basic automobile insurance policy. However, by regulation of the Department of Banking and Insurance, insureds may purchase collision and comprehensive coverages as part of a basic automobile insurance policy.

This basic policy is not for everyone. However, for those with few or no assets and limited incomes, its value exceeds the amount of the coverages contained in the policy when compared with the consequences of driving uninsured.

A person convicted for driving without insurance will be fined and probably be required to purchase a standard or basic policy through the Personal Automobile Insurance Plan (PAIP). The PAIP is a residual automobile insurance market mechanism that has higher rates than the voluntary automobile insurance market and continues to impose surcharges. The nine automobile insurance eligibility points that an uninsured driver earns when arrested and convicted of driving uninsured

Background Paper: Basic Automobile Insurance Policy (Cont'd)

means that automobile insurers are no longer required to insure the driver in the voluntary automobile insurance market and that those points will be used to determine the surcharge levied under PAIP.

However, the consequences suffered by an uninsured driver may, under certain circumstances, be far worse. Consider the case of an uninsured driver, injured by another driver who is later determined to be at fault. Despite being an innocent party, the injured uninsured driver is prohibited from suing the driver at fault for recovery of economic or noneconomic loss caused by the accident. This is known as the "no pay, no play" provision of law, and in denying the uninsured driver the chance to obtain compensation for losses. It can impose a severe "penalty" compared to the cost of obtaining the basic policy.

The number of uninsured drivers in the State are estimated to be between 350,000 to 500,000. There currently are only 6,900 drivers insured under the basic policy. The voluntary automobile insurance market has written 1,600 of the basic policies and the other 5,300 basic policies have been written through PAIP. It can be assumed that the basic policies written through PAIP were the result of insureds being arrested for driving without insurance and being required to purchase insurance. In reviewing these statistics, it is clear that the insurance industry and the Department of Banking and Insurance have not properly promoted the basic policy, because the gap between the estimated number of uninsured and the number of basic policies in force is too large. The message that the value of the basic policy exceeds the amount of the coverages contained in the policy is one that the department and the industry may wish to consider conveying more effectively in order to reduce the number of uninsured drivers and thereby reinforce the effectiveness of New Jersey's current automobile insurance system.

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Individuals wishing information and committee schedules on the FY 2003 budget are encouraged to contact:

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