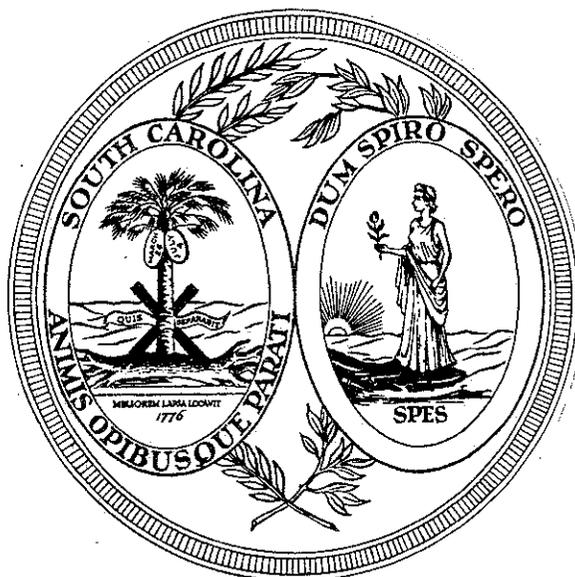


LAC

Report to the General Assembly

February 1997

# AUTO INSURANCE IN SOUTH CAROLINA



## Recommendations to

- Eliminate Recoupment Fees
- Increase Insurance Competition
- Improve Enforcement of Insurance Laws
- Replace the Reinsurance Facility



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# Legislative Audit Council

400 Gervais Street  
Columbia, SC 29201  
(803)253-7612  
(803)253-7639 FAX

---

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*Auto Insurance in South Carolina* was conducted by the following audit team.

### Audit Supervisor

*Senior Audit Manager*  
Thomas J. Bardin, Jr.

### Legal Counsel

Jane McCue Johnson

### Typography

Candice H. Pou  
Maribeth Rollings Werts

### Audit Team

*Senior Auditors*  
Priscilla T. Anderson  
Perry K. Simpson  
Andrew M. Young

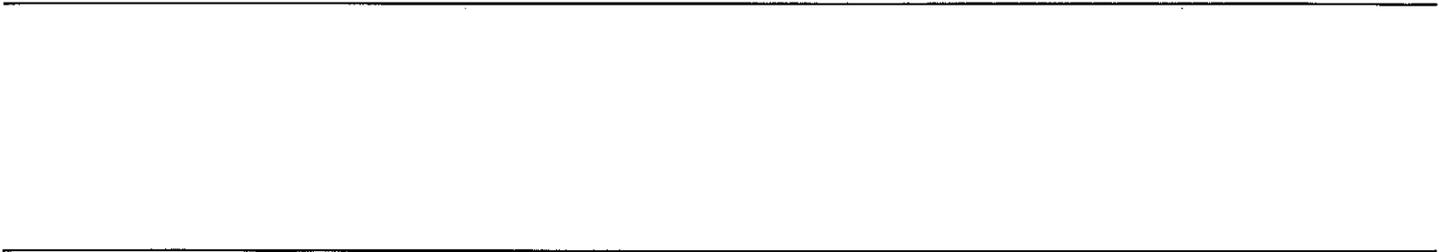
*Associate Auditors*  
Aimee M. Lingle  
Elizabeth W. Oakman

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Report to the General Assembly

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**AUTO INSURANCE  
IN SOUTH CAROLINA**



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# Executive Summary

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Members of the General Assembly, who were concerned about rising insurance recoupment fees paid by South Carolina motorists, asked us to conduct an audit of the South Carolina Reinsurance Facility. This audit addresses laws, policies, and practices in place since the facility's creation in 1974.

The reinsurance facility provides insurance for drivers in the *residual market*. Across the United States, the residual market generally consists of drivers who would have difficulty getting an insurance company to sell them a policy voluntarily, such as inexperienced drivers and those with bad driving records. However, through excessive regulation, South Carolina has greatly expanded the number of drivers in its residual market and has reduced competition among insurance companies.

We found that South Carolina has a large number of policies in its reinsurance facility. Payments for the accidents and injuries caused by drivers in the reinsurance facility are subsidized by drivers who are not in the facility. In addition, management practices of the facility have contributed to its high losses and high recoupment fees. We also found that the highway patrol and local law enforcement agencies have not enforced some state laws intended to deter uninsured drivers.

All of our recommendations are found in Chapter 5. The audit's objectives, scope and methodology are found in Appendix A. Our report is summarized as follows.

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## Why South Carolina's Reinsurance Facility is Large and Why It Loses Money

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In 1993, more than 42% (925,380) of South Carolina's policies were in the residual market. Georgia had less than 1% of its policies in the residual market while the national average was about 4%. South Carolina had more policies in its residual market than the cumulative total of California, Florida, Maryland, Ohio, and 39 other states (see p. 7).

The reinsurance facility is large mainly because state law, regulation, and policy have prevented insurance companies from charging premiums that are sufficient to pay the losses and expenses projected from many drivers. In addition, some agents, as authorized by state law, have been designated to cede (transfer) all of their policies to the facility. The General Assembly and the department of insurance have begun to institute reforms that will reduce the size of the facility but more could be done (see p. 9).

The reinsurance facility loses money each year because premiums on policies ceded are inadequate to pay for losses and expenses. To cover these shortfalls, South Carolina motorists paid the facility approximately \$1.25 billion in recoupment fees from 1988 to 1996 (see p. 16).

The amount of recoupment collected has not been sufficient to pay for losses of the reinsurance facility. For example, in FY 93-94, the facility needed \$233 million to pay for all losses and expenses, but had collected only \$195 million as of June 1996 (see p. 17).

There are other laws and practices that contribute to high recoupment fees. For example, insurance agents are paid a 10% to 12% commission on the recoupment fees that they collect. Prohibiting agents from earning commissions on recoupment would reduce recoupment fees by more than \$14 million annually (see p. 14). In addition, some motorists use illegal procedures to reduce their premium and recoupment fees (see p. 18).

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## How Management of the Reinsurance Facility Has Contributed to its High Losses

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The reinsurance facility has contracts with three insurance companies to investigate and pay the claims of policies sold by agents designated to sell insurance exclusively for the reinsurance facility. The contracts, however, reward the companies for maximizing the dollar amount of the claims they pay (see p. 21).

The reinsurance facility authorized payment of \$1 million on an ineligible claim. The facility paid the claim so that the company would not incur a "substantial hardship" (see p. 24).

The reinsurance facility has not penalized insurance companies or required them to reimburse the facility for undercharging drivers ceded (transferred) to the facility (see p. 25).

Since 1974, 170 insurance agents have been designated to sell insurance policies exclusively for the reinsurance facility. The policies sold by these agents have contributed substantially to the facility's losses. Designated agents were originally intended to have temporary, one-year appointments (see p. 26).

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## Ways to Improve Enforcement of Insurance Laws and Improve Traffic Safety

South Carolina has one of the highest highway death rates in the nation. Chapter 4 describes legislative changes which could improve traffic safety and lead to lower insurance premiums.

At least 10% (285,000) of South Carolina's motorists drive without liability insurance. Each year these drivers illegally avoid paying at least \$10.9 million in recoupment fees. As a result higher premiums and recoupment fees must be charged to motorists who comply with insurance laws (see p. 35).

The highway patrol and local law enforcement agencies have not enforced some laws that require motorists to prove they have liability insurance. In addition, law enforcement agencies have not always confiscated the automobiles of drivers found either driving under the influence or driving under suspension for the fourth time (see p. 36).

The state's program for seizing the license plates of uninsured automobiles could be improved (see p. 39).

More severe penalties for drivers who repeatedly drive uninsured or drive under the influence could improve traffic safety (see p. 40).

A "graduated" licensing system, which would require young drivers to demonstrate adequate driving skills before obtaining a driver's license, could improve traffic safety (see p. 43).

Additional methods to reduce the number of motorists who drive while intoxicated could improve highway safety (see p. 45).

*Our recommendations to improve South Carolina's automobile insurance system begin on page 51.*

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**Executive Summary**

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# How Drivers in the Residual Market Buy Insurance in South Carolina and Other States

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Driving in South Carolina is a privilege reserved for motorists who demonstrate competency in operating a motor vehicle and who comply with state insurance and safety laws. Any South Carolina vehicle operated on a public road must be covered by minimum liability insurance to compensate other persons for damages in the event of an accident. Motorists are not required to purchase physical damage insurance, which covers the policyholder's motor vehicle in case of accident or theft. In 1994, South Carolinians spent over \$1.4 billion to insure private passenger and commercial motor vehicles.

In this chapter, we discuss the systems used by states to help high-risk drivers obtain insurance. We also discuss the history of South Carolina's reinsurance facility and two types of insurance agents and companies.

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## What Is the Residual Market?

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The reinsurance facility provides insurance for drivers in the *residual market*. Across the United States, the "residual market" generally consists of drivers who would have difficulty getting an insurance company to sell them a policy voluntarily, such as inexperienced drivers and those with bad driving records. When given the option, the insurance companies do not usually sell policies to drivers when expected losses and expenses exceed premiums. Through excessive regulation, South Carolina has greatly expanded the number of drivers in its residual market and has reduced competition among insurance companies.

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## Three Types of Residual Market Systems

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Below we describe three systems used by states to provide access to insurance for drivers in the residual market. *It is important to note that there is variation among states using similarly named systems.* We have not summarized the systems used by Maryland and Massachusetts because they have systems that are used only in their respective states.

### Reinsurance Facility

Under a reinsurance facility system, each insurance company is required to sell insurance to any willing customer. If the insurance company determines that the driver is not a good risk, after selling the policy the company may cede the policy to a reinsurance facility, which is a joint risk pool of all insurance companies. Facility policies are serviced by the companies to whom the drivers originally applied. The losses and profits on facility business are

shared among all insurance companies. In South Carolina, the companies recover their losses on private passenger liability policies through a “recoupment” fee charged to each driver. New Hampshire, North Carolina, and South Carolina have reinsurance facilities.

### **Joint Underwriting Association**

A joint underwriting association (JUA) is similar to a reinsurance facility. Both are joint risk pools of all insurance companies. Under a JUA system, however, each insurance company is allowed to refuse to sell insurance to any driver, except for reasons prohibited by antidiscrimination laws. Drivers who are initially unable to obtain insurance are referred to one of a number of “servicing carriers” that sell and service policies for the JUA. The losses and profits on JUA business are shared among all automobile insurance companies. Florida, Hawaii, Michigan, and Missouri have JUAs.

### **Assigned Risk Plan**

Under an assigned risk plan, each insurance company *initially* is allowed to refuse to sell insurance to any driver, except for reasons prohibited by antidiscrimination laws. Drivers who are initially unable to buy insurance may appeal to an organization that assigns such drivers to insurance companies in proportion to company market share. Each company is required to sell insurance to its assigned drivers, for which the company receives premiums, pays claims, and provides service.

The losses and profits incurred by an insurance company from assigned drivers are not shared with other companies. As a result, the assigned risk system may give companies greater incentive to minimize costs and claims paid than other residual market systems.

The following 41 states have assigned risk plans:

Alabama	Delaware	Kentucky	Nevada	Oregon	Vermont
Alaska	Georgia	Louisiana	New Jersey	Pennsylvania	Virginia
Arizona	Idaho	Maine	New Mexico	Rhode Island	Washington
Arkansas	Illinois	Minnesota	New York	South Dakota	West Virginia
California	Indiana	Mississippi	North Dakota	Tennessee	Wisconsin
Colorado	Iowa	Montana	Ohio	Texas	Wyoming
Connecticut	Kansas	Nebraska	Oklahoma	Utah	

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## The History of South Carolina's Reinsurance Facility

From 1947 to 1974, South Carolina operated an "assigned risk" plan. However, in the early 1970's there were concerns about South Carolina's assigned risk plan. Critics of the plan believed that some drivers who were good risks (drivers who were unlikely to incur excessive losses) could only obtain insurance in the residual market and were required to pay excessive rates.

In 1972, the General Assembly created a committee to study the automobile insurance system in South Carolina. This committee issued reports in 1973 and 1974, finding that:

- Approximately 17% (200,000) of South Carolina's motorists purchased insurance through the assigned risk plan. This was the largest population of drivers in the residual market in the country.
- Approximately 150,000 uninsured motorists were driving on the state's highways. The rates of accidents and deaths on the state's highways were among the highest in the nation.
- Insurance premiums were high and often set arbitrarily.

As a result of its findings, the special committee recommended reforms of the insurance system. Recommendations included:

- Requiring every insurance company in South Carolina to sell automobile insurance to any licensed driver who could pay the premium.
- Requiring drivers to purchase a minimum amount of liability insurance to drive on South Carolina highways.
- Eliminating uninsured drivers in part by imposing severe penalties upon drivers convicted of driving without insurance and adding staff at the highway department to confiscate the license tags of uninsured motorists.
- Establishing within the South Carolina Department of Insurance a division to create a classification plan for establishing rates.
- Eliminating the assigned risk plan and creating a "reinsurance facility." Through the reinsurance facility, insurance companies would collectively insure the drivers they did not want to insure separately.

In 1974, the General Assembly enacted insurance reforms, including elimination of the assigned risk plan and creation of the reinsurance facility. In 1995, 92% of policies ceded to the reinsurance facility were for private passenger vehicles while 8% were for small commercial vehicles.

Premiums paid by drivers ceded to the facility are not high enough to pay the drivers' claims and the expenses of the facility. Until 1987, insurance companies would temporarily absorb losses of the facility and later pass the losses on to policyholders through rate surcharges.

In 1987, the General Assembly authorized the addition of a recoupment fee to each policyholder's insurance bill to reimburse insurance companies for paying the facility's losses on private passenger vehicles. Recoupment fees are collected by the insurance companies and are redistributed by the reinsurance facility to each company based on its share of the facility's losses. The calculation of the recoupment fee is based on a formula in state law (see p. 16).

The reinsurance facility is governed by a board made up of at least 19 members who are insurance company representatives, insurance agents, consumer representatives, and other interest groups. The director of insurance serves as chairman but has no vote except to break a tie. The facility had 14 staff positions in FY 96-97, and its annual budget was approximately \$1.1 million. The facility contracts with AIPSO, a company from Rhode Island, to provide rate making, audit, and data processing services. AIPSO is a nonprofit service association of insurance companies which serves residual markets in 49 states.

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## How Recoupment Points Affect Insurance Bills In South Carolina

Annual recoupment fees are charged to each driver based on his driving record for the past three years. For example, in FY 96-97 a driver with no traffic tickets or accidents in the last three years would have zero recoupment points and would pay a recoupment fee of \$50.33 for a full-coverage policy.

A driver with a ticket for speeding 15 miles over the speed limit would have one recoupment point, and would pay an annual recoupment fee of \$391.86. A driver with additional traffic tickets would be assessed additional recoupment points, depending on the violations. Table 1.1 outlines the amount of recoupment charged for each recoupment point.

**Table 1.1: Annual Recoupment Fee Charges by Recoupment Points in FY 96-97**

Recoupment Points	Liability Amount	Comprehensive Amount	Collision Amount	Total
0	\$33.94	\$5.91	\$10.48	\$50.33
1	\$229.52	\$58.58	\$103.76	\$391.86
2	\$459.04	\$117.16	\$207.52	\$783.72
3	\$688.56	\$175.74	\$311.28	\$1,175.58
4	\$918.08	\$234.32	\$415.04	\$1,567.44
5	\$1,147.60	\$292.90	\$518.80	\$1,959.30
6	\$1,377.12	\$351.48	\$622.56	\$2,351.16
7	\$1,606.64	\$410.06	\$726.32	\$2,743.02
8	\$1,836.16	\$468.64	\$830.08	\$3,134.88
9	\$2,065.68	\$527.22	\$933.84	\$3,526.74
10 or more	\$2,295.20	\$585.80	\$1,037.60	\$3,918.60

## Two Types of Insurance Agents and Companies in South Carolina

As of September 1996, 170 insurance agents were designated to sell policies exclusively for the facility. Policies sold through *designated agents* are serviced by three *designated companies* under contract with the facility. Section 38-77-590 of the South Carolina Code of Laws indicates that designated companies and agents were created to provide drivers better access to insurance and provide employment for agents who have lost their company affiliation.

Insurance agents and companies that have not been designated to sell policies exclusively for the reinsurance facility are sometimes called *voluntary agents* and *voluntary companies*. They include well-known companies such as State Farm, Allstate, and Nationwide.

Below are additional characteristics of these two segments of the market.

### *Designated Insurance Agents and Companies*

- Approximately 18% of private passenger liability policies in South Carolina are sold through designated agents and companies.
- The reinsurance facility approves the number and location of designated agents.

- All policies sold by designated agents are ceded to the reinsurance facility.
- Designated companies initially pay all losses. They later recover the losses on private passenger liability policies through recoupment fees charged to South Carolina drivers.
- Designated companies service the policies sold by designated agents.

***Voluntary Insurance Agents and Companies***

- Approximately 82% of private passenger liability policies are sold through voluntary agents and companies.
- Each voluntary company determines the number and location of its agents.
- When a voluntary company sells a policy, it is required to declare, within 30 days, whether it will retain the policy or cede it to the reinsurance facility.
- If a voluntary company cedes more than 35% of premiums to the reinsurance facility, the company is required to pay a penalty.
- Voluntary companies pay all losses on the policies they retain.
- Voluntary companies initially pay all losses on the policies ceded to the facility. They later recover the losses on private passenger liability policies through recoupment fees charged to South Carolina drivers.
- Voluntary companies service the policies sold by their agents, including policies retained and policies ceded to the reinsurance facility.

# Why South Carolina's Reinsurance Facility is Large and Why it Loses Money

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In this chapter, we note that South Carolina's method of regulating premiums has increased the number of motor vehicles insured through the reinsurance facility. In addition, we describe the factors that have caused the facility to lose money, one of which is inadequate premiums. And finally, we analyze the recoupment fee and why it has produced insufficient revenue.

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## Largest Residual Market in the United States

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South Carolina's residual market is larger than the combined total of 43 other states.

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South Carolina has had a larger percentage of private passenger policies in its residual market than any other state.

### Liability Coverage

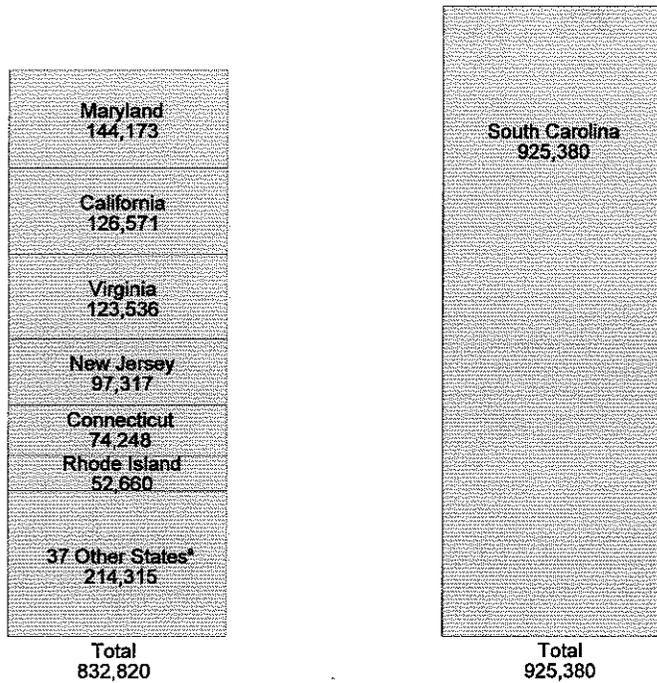
In 1993, about 42% of South Carolina's private passenger liability policies were in the residual market. This was the highest percentage in the United States. The national average was about 4%.

South Carolina had 925,380 policies insured in its residual market, the third largest number in the United States, exceeding 43 other states combined (see Graph 2.1).

### Physical Damage Coverage

In 1994, about 24% of South Carolina's private passenger physical damage premiums were in the residual market. This was also the highest percentage in the United States. The national average was less than 2%.

**Graph 2.1: 1993 Comparison of Private Passenger Policies in South Carolina's Residual Market With Policies in 43 Other States**



a Includes Florida, Delaware, Louisiana, New Hampshire, Kansas, Hawaii, Vermont, Illinois, Georgia, Alaska, Maine, Kentucky, Mississippi, Washington, Minnesota, Tennessee, Missouri, West Virginia, Oklahoma, New Mexico, Colorado, Indiana, Arkansas, Nevada, Alabama, Wisconsin, Oregon, Montana, Arizona, Idaho, Iowa, Nebraska, South Dakota, Ohio, North Dakota, Wyoming, and Utah.

---

## Why the Reinsurance Facility is Large

Insurance premiums in South Carolina vary widely from company to company. State law, regulation, and policy, however, control the manner by which insurance companies establish premiums. In this section, we conclude that the reinsurance facility is large mainly because insurance companies have been prevented from charging premiums that are high enough to cover the losses and expenses projected from many drivers. In addition, some insurance agents have been designated to cede all of their policies to the facility.

---

## What is An Insurance Premium?

A driver's insurance payment in South Carolina can be separated into two parts—a premium and a recoupment fee.

- A *premium* is the amount charged by an insurance company for its policy. When a company declares that it will retain responsibility for a policy's losses, it is permitted to keep the entire premium. By contrast, when a company cedes (transfers) responsibility for a policy's losses to the reinsurance facility, the company is required to cede the premium, minus allowable expenses, to the facility.
- A *recoupment fee* is the portion of an insurance payment used to offset losses from private passenger policies ceded to the reinsurance facility. Recoupment fees for physical damage insurance are being phased out.

---

## Rating Groups for Private Passenger Premiums

For private passenger insurance, South Carolina laws and regulations have required that insurance companies act with near-uniformity when placing drivers in specific rating groups. For example:

- Until 1996, regulation 69-13.4 required that each insurance company divide drivers into 22 specific rating classifications, based on factors such as their age, sex, marital status, driving distance to work, and whether they were farmers. It also divided drivers into eight territories based on their place of residence.
- Section 38-73-455 of the South Carolina Code of Laws and regulation 69-13.1 require specific surcharges and discounts based on the extent of a policyholder's accidents and moving violations during the prior 36 months.

- ❑ Regulation 69-13.2 requires specific credits and discounts for driver training and ownership of more than one motor vehicle. It authorizes unspecified credits and discounts for "good students," crashworthy bumpers, and defensive driver training.
- ❑ Section 38-77-360 prohibits insurance companies from increasing premiums as a result of certain first offense driving violations, such as "driving too fast for conditions" and "careless or negligent driving."

Laws and regulations like those cited above have not allowed insurance companies to use enough rating groups to ensure that premiums are consistently based on driver risk. For example:

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Insurance companies have been required to charge the same premiums to high- and low-risk drivers. As a result, insurance companies have ceded many drivers to the reinsurance facility.

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- ❑ Insurance companies have been required to place all persons 25 years old and older, who drive 10 or more miles to work, in the same rating group. However, the losses from the younger drivers in this group have been higher than the losses from the older drivers. From 1992 through 1994, bodily injury losses from persons 25 years old and older were equal to 72% of their premiums. Losses from 25- to 29-year-old, unmarried males were equal to 101% of their premiums.
- ❑ Insurance companies have been required to place residents of York County and Williamsburg County in the same territory. From 1992 through 1994, bodily injury losses from drivers in York County were equal to 67% of their premiums. Bodily injury losses from drivers in Williamsburg County were equal to 130% of their premiums.
- ❑ Insurance companies have been required to charge the same rates to a driver with a recent conviction for speeding not more than 10 mph over the limit, "driving too fast for conditions," or "careless driving" as to a driver who has never had a conviction.

Because insurance companies have been required to charge the same premiums to high- and low-risk drivers, premiums have not been high enough to cover the losses and expenses projected from many drivers. As a result, insurance companies have ceded many drivers to the reinsurance facility.

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## Recent and Proposed Changes In Private Passenger Rating Groups

In 1996, the General Assembly and the department of insurance made changes in the system for regulating private passenger automobile insurance so that more drivers will pay premiums based on their expected losses and expenses. These changes are expected to reduce the number of policies ceded to the reinsurance facility.

The General Assembly repealed regulation 69-13.4 and gave the department of insurance authority to establish rating territories by administrative order. The department issued an order in November 1996 that revised the mandatory, uniform territories for liability insurance and permitted companies to establish their own territories for physical damage insurance. Beginning in September 1998, companies will be permitted to establish their own territories for liability insurance. This flexibility will allow companies with different territorial claims experience to have different territories.

In repealing regulation 69-13.4, the General Assembly also gave the department of insurance authority to establish uniform classifications by administrative order. Department officials report that, in 1997, they plan to issue an order with revised rating classifications.

For physical damage insurance only, the General Assembly amended state law to allow insurance companies to charge multiple rates within each government-mandated rating group, beginning in October 1996, based on the relative risk of different drivers.

In addition, insurance department officials report that they plan to issue an administrative order with revised driving record surcharges and discounts in 1997, if given authority to do so by the General Assembly.

---

## Negative Effects of Government-Mandated, Uniform Rating Groups

Even when government-mandated, uniform rating groups are carefully established, they can produce negative effects. Uniform rating groups will not always match those that insurance companies would establish based on their own actuarial experience and marketing objectives. As a result, the percentage of policies ceded to the reinsurance facility may still be higher than it would without government-mandated, uniform rating groups.

Government-mandated, uniform rating groups can also cause insurance companies to incur extra administrative costs. Companies are required to modify the information systems they use in other states to conform to South Carolina's requirements.

It is important to note that government-mandated, uniform rating groups are not necessary to prevent racial or other illegal discrimination. Discriminatory rating groups could be deterred if state law required all insurance companies to have their rating groups approved by the department of insurance. Laws prohibiting discrimination would remain in effect. For example, §38-73-440 states, "In determining the premium rates to be charged on automobile insurance, it is unlawful to consider race, religion, national origin, or economic status."

---

## Insurers May Not Refuse to Sell Liability Insurance

Section 38-77-110 states that automobile insurance companies may not refuse to sell liability insurance to willing customers. This requirement is commonly referred to as a "mandate to write." In 1996, the General Assembly amended §38-77-110 so that companies could legally refuse to sell physical damage insurance to any driver, except for reasons prohibited by antidiscrimination laws.

Because companies may not legally refuse to sell liability insurance, when the expected losses from a policy are higher than the premium, the company has incentive to cede the policy to the reinsurance facility. Net losses from the facility are paid with recoupment fees charged to all South Carolina drivers.

In certain cases, companies may have incentive to avoid selling liability insurance to high-risk drivers. Section 38-77-950 prohibits voluntary companies from ceding more than 35% of premiums to the reinsurance facility. The reinsurance facility imposes a penalty on companies that exceed the limit. Some companies have terminated agents whose policies have incurred excessive losses.

---

### Designated Insurance Agents Cede 100% of Premiums

Although §38-77-950 allows voluntary insurance companies to cede *no more* than 35% of cedable premiums to the reinsurance facility, §38-77-590 requires designated agents to cede all cedable premiums to the reinsurance facility.

Some of the policies currently sold by designated agents might not be ceded in the absence of the designated agents. As a result, designated insurance agents contribute to the high percentage of policies ceded to the reinsurance facility. For a complete discussion of the system of designated insurance agents and companies, see page 26.

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### Prior Approval of Premium Levels

In addition to requiring uniform rating groups, state law, in §38-73-450, requires that automobile insurance companies obtain prior approval of premium levels from the department of insurance. We noted in our 1991 review of the department, however, that negative side effects can occur if premiums are maintained below levels that would have been produced by competition. The negative side effects include companies leaving the market and a high percentage of policies ceded to the residual market.

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### Effects of Premium Regulation on Market Concentration

From 1986 to 1995, the private passenger market share of the four largest companies increased from 51% to 64%. During this period many smaller companies stopped selling automobile insurance in South Carolina, including Hartford, USF&G, and Prudential. Restrictive premium regulation may have been a contributing factor to this exit from the market.

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### Reduced Regulation Would Create a Voluntary Market for High-Risk Drivers

If insurance companies could refuse to sell any type of automobile policy on a customer-by-customer basis, some companies would reject high-risk drivers. At the same time, other companies, if allowed to charge adequate premiums, would voluntarily serve most high-risk drivers.

Insurance companies in Georgia can refuse to sell insurance and can establish their own rating structures after approval by the state. In Georgia, 99.8% of policyholders were able to buy private passenger liability insurance in 1993 without entering the state's assigned risk program for high-risk drivers.

---

## Why the Reinsurance Facility Loses Money

The reinsurance facility loses money each year because premiums are exceeded by claims and expenses. One reason for these losses is that the premiums legally authorized for policies ceded to the facility have not been adequate. Listed below are additional factors that have either reduced revenues or increased claims and expenses:

Technical Flaw In the Recoupment Formula

The recoupment formula, established by §38-77-600, has a technical flaw that produces revenue insufficient to cover the losses of the reinsurance facility (see p. 17).

Use of Illegal Strategies to Avoid High Premiums and Recoupment Fees

Some married couples with two cars lower their insurance bill by inaccurately claiming that the more expensive car is driven by the spouse with fewer recoupment points. Another strategy is to falsely claim that a motor vehicle is used in a business owned by the insured, thereby qualifying for a commercial rate that does not include a recoupment fee (see p. 18).

Inadequate Incentives to Minimize Claims

Claims filed by the customers of designated agents are serviced by companies that are rewarded by the reinsurance facility for maximizing the amount paid to accident victims. Claims filed by other customers are serviced by voluntary insurance companies that are neither rewarded nor penalized by the reinsurance facility for the amount paid to accident victims (see p. 21).

Commissions Paid to Agents On Recoupment Fees

While recoupment was established to pay for losses incurred by the reinsurance facility, insurance agents earn income from recoupment fees. This is because state law allows insurance agents to receive commissions on recoupment fees paid by motorists. In FY 93-94 and FY 94-95, agents earned approximately \$32 million in commissions on recoupment fees. For FY 94-95, this amounted to approximately \$6 for each insurance policy.

Section 38-77-620(1) of the South Carolina Code of Laws provides that any recoupment charge paid by policyholders must be considered premium for calculating premium taxes and commissions. The reinsurance facility pays a designated agent 12% commission while voluntary agents are paid an average commission of 10% (see p. 32).

South Carolina motorists could save from \$14 million to \$18 million annually if the General Assembly prohibited agents from earning commissions on recoupment fees. Agents would still earn commissions on premiums:

Individuals Who Drive Without Insurance

More than 285,000 South Carolinians may be driving without the liability insurance required by state law. As a result, the reinsurance facility is losing at least \$10.9 million in recoupment fees (see p. 35).

If the above factors were addressed, net losses to the reinsurance facility would be reduced.

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## Investment Income From Premiums

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We reviewed the facility's potential for earning additional investment income on premiums. Because the facility operates at a loss, we found no evidence that it could earn investment income on premiums. Insurance companies use their own funds to pay for the facility's losses. At a later date, the companies are reimbursed with recoupment fee revenues for losses on the facility's private passenger liability policies. Insurance company losses on the facility's commercial and private passenger physical damage policies can be recovered through a premium authorized by the department of insurance.

To meet short-term obligations, the facility maintains cash and short-term investments of approximately \$3 million on which it earned \$199,000 in FY 94-95. This investment income slightly lowers the recoupment fees collected from motorists.

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## The Recoupment Fee Process

Losses incurred by the reinsurance facility are paid initially by South Carolina insurance companies. The purpose of the recoupment fee is to reimburse insurance companies for the losses they have incurred on the facility's private passenger policies. For example, from October 1, 1994, to September 30, 1995, the reinsurance facility earned \$490 million in premiums. Losses and expenses for private passenger policies totaled \$658 million, resulting in a net loss to the facility of \$168 million. The recoupment formula requires that the companies be reimbursed for their losses, plus interest, for the delay in reimbursement. Interest in this case totaled \$27.6 million. In order to raise revenue to pay for these prior losses, plus interest, an annual recoupment fee is added to the insurance bills of all policyholders.

State law does not allow insurance companies to charge recoupment fees on commercial policies. Losses on commercial policies ceded to the reinsurance facility are shared by all insurance companies.

As we will explain in this section, however, since FY 89-90, annual recoupment fees have not produced sufficient revenues.

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## History of the Recoupment Fee

As stated in Chapter 1, from 1974 to 1988, insurance companies were not authorized to charge recoupment fees for the losses they incurred on the facility's private passenger policies. Insurance companies complained that premiums adequate to cover their losses were not being authorized by the department of insurance. Some insurance companies stopped selling automobile insurance in South Carolina.

In 1987, the General Assembly enacted legislation which created the recoupment fee process. Section 38-77-600 requires insurance companies to charge each driver a recoupment fee, based on his driving record, to subsidize the losses incurred by drivers whose policies are backed by the reinsurance facility.

Recoupment fees in South Carolina were instituted on July 1, 1988, to pay for losses of the facility from October 1, 1986, through September 30, 1987. Each year, a recoupment fee is established based on the reinsurance facility's losses of the previous year. Page 5 shows the amount of recoupment charged based on each recoupment point.

Effective October 1, 1996, physical damage policies ceded to the reinsurance facility must pay self-sustaining rates. As a result, recoupment for physical damage losses incurred after October 1, 1996, was eliminated. However, because recoupment fees pay for losses incurred in previous years, physical damage recoupment fees will continue to be charged until 1998.

## Recoupment Revenues Insufficient to Pay for Facility Losses

For insurance policies effective from July 1, 1988, to July 1, 1996, private passenger drivers paid approximately \$1.25 billion in recoupment fees. This amount, however, has not been enough to reimburse South Carolina insurance companies for the losses they incurred (see Table 2.1).

**Table 2.1: Recoupment Collected for Policies Effective July 1, 1988–June 30, 1996**

Year	Amount Needed <sup>1</sup>	Amount Collected	(Shortfall) Surplus <sup>2</sup>
July 1988–June 1989	\$126,268,714	\$142,665,843	\$16,397,129
July 1989–June 1990	\$124,662,392	\$114,292,934	(\$10,369,458)
July 1990–June 1991	\$169,564,367	\$132,733,574	(\$36,830,793)
July 1991–June 1992	\$220,764,630	\$182,407,918	(\$38,356,712)
July 1992–June 1993	\$218,007,257	\$178,292,817	(\$39,714,440)
July 1993–June 1994	\$227,048,193	\$169,435,611	(\$57,612,582)
July 1994–June 1995	\$165,510,826	\$132,299,312	(\$33,211,514)
July 1995–June 1996 <sup>3</sup>	\$233,332,300	\$194,553,483	(\$38,778,817)

- 1 Amount needed is based on previous year's loss of the facility and interest approved by the facility's governing board on that amount.
- 2 Amount of recoupment shortfall or surplus is added to the amount needed in subsequent years.
- 3 As of June 30, 1996. Final amount not yet available.

Each year's shortfall has been carried forward and added to subsequent recoupment charges paid by South Carolina's motorists. The recoupment formula established by §38-77-600 has a flaw which does not allow all losses to be recouped (see Appendix B). In addition, the formula does not include a factor to adjust for high-risk drivers who stop driving or drive without insurance. To correct these technical flaws, drivers without recoupment points (they have no tickets or accidents) might be required to pay higher recoupment fees.

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## Illegal Actions Used to Avoid Recoupment Fees

Some drivers may use illegal strategies to pay lower insurance rates. Moreover, some insurance agents, to attract more business, may be using these strategies. Below we describe two strategies and investigations of their use by the South Carolina Department of Insurance.

- ❑ Among some married couples with two cars, one spouse has more recoupment points and drives the more expensive car. By illegally claiming that the spouse with more points drives the less expensive car, the couple can sometimes reduce their insurance bill significantly. Assume that a couple wishes to purchase full coverage for the husband's 1994 Chevrolet Cavalier and liability coverage only for the wife's 1990 Cavalier. The husband has three points on his driving record, while the wife has a clean record. If the husband falsely claims to be the customary driver of the older Cavalier, the couple can save as much as \$1,360 in annual premiums and recoupment fees. Officials with the department of insurance report that an investigation conducted in 1996 documented cases where insurance agents offered to "switch" drivers illegally.
- ❑ Premiums for commercial policies do not include additional recoupment fees. Drivers may falsely claim to be using their cars in some way which qualifies for the lower commercial rate. A driver with three recoupment points, for example, can save over \$2,600 in annual premiums and recoupment fees by purchasing full coverage on a 1994 Cavalier with a commercial policy. Furthermore, because of these potential savings, insurance agents may have incentive to attract more customers by selling commercial policies to noncommercial drivers. In 1995, the reinsurance facility ruled that a business license is required for purchasing a commercial policy. Officials with the department of insurance report that, in cooperation with the department of revenue, they are investigating whether drivers qualify for the commercial policy.

According to a spokesman for the department of insurance, it would be impossible to give a dollar estimate of how much these strategies are costing the reinsurance facility. However, when some drivers illegally avoid recoupment fees, other drivers are required to pay higher recoupment fees.

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## Conclusion

The reinsurance facility is large mainly because state law, regulation, and policy have prevented insurance companies from charging premiums high enough to cover the losses and expenses that are projected from many drivers. In addition, some insurance agents have been designated to cede all of their policies to the facility.

Reforms made by the General Assembly and the department of insurance in 1996 are expected to result in increased premiums paid by high-risk drivers to insurance companies and fewer policies ceded to the reinsurance facility. However, if state law allowed each insurance company to develop its own rating groups, the percentage of policies insured through the residual market could decrease further. In addition, company administrative costs could decrease.

If in conjunction with increased rating flexibility, companies could legally refuse to sell liability insurance, a private sector market would develop for serving high-risk drivers.

The facility loses money each year for a number of reasons. A primary reason is that the premiums legally authorized for policies ceded to the facility have not been adequate. Other reasons include successful efforts to illegally avoid high premiums and recoupment fees and inadequate incentives for insurance companies to minimize claims.

*Our recommendations to improve South Carolina's automobile insurance system begin on page 51.*

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**Chapter 2**  
**Why South Carolina's Reinsurance Facility is Large and Why it Loses Money**

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# How Management of the Reinsurance Facility Has Contributed to its High Losses

The governing board of the reinsurance facility consists of representatives of insurance companies, insurance agents, consumers, and other interest groups. The reinsurance facility has 14 employees who are responsible for daily operations.

In this chapter, we describe management practices and policies that have contributed to financial losses of the reinsurance facility.

## Costs to Service Facility Policies

The reinsurance facility pays insurance companies to service the policies that they cede to the facility. We reviewed the manner in which these companies are paid and found that additional measures could be implemented to lower costs.

## Designated Companies Rewarded for High Losses

The facility contracts with three insurance companies known as designated companies to service policies and to pay claims for all policies sold by designated agents. These companies are paid administrative expenses based on their contracted amount, ranging from 8% to 12% of the premiums written. For expenses associated with investigating and adjusting claims, the facility pays 9% to 11% of all claims paid. Therefore, the designated companies have a financial incentive to increase accident claims. In contrast, voluntary companies (such as State Farm and Allstate) are paid a percentage of premiums to cover both administrative expenses and expenses associated with adjusting claims. While there is less incentive for the voluntary companies to inflate claims, the reinsurance facility has not implemented incentives to lower costs for either voluntary or designated companies.

**Table 3.1: SCRF Reimbursements to Insurance Companies**

Expense Category	Designated Companies		Voluntary Companies <sup>2</sup>
	(As of 10/1/94) <sup>1</sup>	(Before 10/1/94)	
Administrative Expenses	8% to 12% of Written Premiums	16% of Written Premiums	Varies by Company, maximum of 23.4% of written premiums.
Payment of Claims and Adjustment Expenses	9% to 11% of Paid Claims	15% of Paid Claims	Varies by Company, maximum of 16.6% of written premiums.

- 1 On October 1, 1994, a contracted rate was set for each of the three designated companies.
- 2 Rates of the voluntary companies are based on expense data submitted by the individual carriers to AIPSO. The reimbursement rates for physical damage and liability insurance differ.

Claims paid by designated companies have been higher than claims paid on policies ceded by voluntary companies. In FY 94-95, losses and expenses of the designated companies totaled approximately \$292 million (\$279 million for private passenger and \$13 million for commercial vehicles). For this period, the facility paid \$1.61 in expenses and claims for every \$1 policyholders paid in premiums. For policies ceded to the reinsurance facility by voluntary companies, the facility paid only \$1.22 for every \$1 in premiums earned. Losses and expenses for voluntary companies were approximately \$378 million (\$340 million for private passenger and \$38 million for commercial vehicles).

Because designated agents and carriers are not financially accountable for the amount of claims paid, they have little incentive to keep costs down. In 1991, a subcommittee of the facility's governing board reviewed the system of compensating designated companies and concluded that compensation should be based on written premiums. However, the subcommittee did not develop a method to compensate these companies.

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The reinsurance facility has not implemented a system to reward companies for controlling claims costs.

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A 1994 report to the Senate Banking and Insurance Committee addressed the need for incentive systems to compensate designated companies. The report noted that "the more claims that are paid" by the designated company, the more the company earned.

The plan administrator for South Carolina's assigned risk plan for workers' compensation contracts with servicing companies. Servicing companies are rewarded for maintaining losses below a minimum amount. A disincentive applies when the carrier exceeds a certain amount. The incentive program is based on a statewide average loss ratio. The workers' compensation system in North Carolina uses a similar incentive plan.

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Bid Process implemented in 1994.

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In 1993, for the first time, the facility requested bids from insurance companies to service facility policies. The bidding had some positive financial effects. Reimbursements from the facility to the carriers for administrative expenses were reduced from 16% of the premiums to a range of 8% to 12% depending on the individual company. In addition, expenses for investigating claims were reduced from 15% of the losses paid to a range of 9% to 11% of the losses (see Table 3.1). According to facility records, payments to the designated companies were approximately \$22 million lower from October 1994 to December 1995 than the previous year as a result of contracts.

In addition, in many cases the facility pays the expenses of voluntary companies at a higher rate than it pays designated companies. The facility has not analyzed amounts paid for expenses to voluntary carriers to determine if expenses should be reduced.

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## Size of Claims Staff

In 1994, the Senate Banking and Insurance Committee report cited the importance of the reinsurance facility's audit staff in monitoring the adequacy of resources devoted to the settling of claims by designated companies. The committee also recognized the importance of staff for large voluntary companies, recognizing that there is a direct correlation between the size and experience of claims staff and proper claims handling. In addition, the report recommended that the facility's audit staff review the size and experience of company staff who handle facility claims. This is important because the reinsurance facility, not the insurance company, absorbs the losses settled by claims staff. If company claims staff is inexperienced or the number of staff is insufficient, more expenses are likely to be paid by the reinsurance facility.

According to a facility official, facility staff maintain up-to-date information on the experience of new claims management staff employed by the designated companies. However, the experience and size of claims staff such as adjusters are monitored to a lesser degree. Review of staff is limited to verification that the ratio of a claims supervisor to claims staff does not exceed one supervisor for seven staff (1:7). Facility staff do not review the claims staff ratio of large voluntary companies.

We reviewed the facility's operating manual and found that requirements concerning the size and experience of claims staff are vague. According to the manual, designated companies are to employ a resident claims manager, a claims manager, a designated agent field representative, and "sufficient personnel." According to facility staff, audit procedures have not been developed to examine the adequacy of claims staff.

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## Reinsurance Facility Oversight of Claims and Underwriting

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### Ineligible Claim Paid by Facility

The reinsurance facility audits member companies to determine whether they are ceding policies and paying claims in compliance with state law and agency rules. The facility is responsible for paying claims on more than 900,000 policies and ensuring that insurance companies pay the facility the appropriate premium on their policies. We found that there is inadequate incentive for companies to comply with some requirements.

In July 1995, the reinsurance facility authorized payment of an ineligible commercial automobile claim of almost \$1 million. As a result, policyholders of all South Carolina insurance companies pay for the loss through increased premiums.

During a November 1994 audit of an insurance company's records, the facility's claims manager determined that the facility paid two claims on a policy improperly ceded by the company. The company had sold a small commercial policy, which is usually eligible to be ceded to the facility, to insure the policyholder's used car business. The claims paid were:

- A June 1993 claim of \$33,820 for hail damage to 30 automobiles at the used car dealership.
- Personal injury and property damage claims totaling \$961,426 as the result of a single car accident in September 1993, involving a vehicle owned by the insured.

While investigating these payments, the facility's claims manager discovered that the major part of the policyholder's business came from salvage operations, not from the sale of used cars. The facility's plan of operation, however, lists salvage businesses among risks not eligible to be ceded to the facility. The claims manager, therefore, requested that the insurance company reimburse the facility for the two claims paid improperly.

The insurance company appealed the claims manager's decision, arguing that he should have notified the company about any problems with the policy during settlement of the first claim. The claims manager contended, however, that the company's claims adjuster should have observed the policyholder's salvage business while investigating the first damage claim and should have reported it.

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The reinsurance facility paid a \$1 million claim that should not have been paid.

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In May 1995, an appeals panel ruled that the company should pay the \$33,820 claim and the facility should pay the claim for \$961,426. In its decision, the panel stated that the company did not properly verify that the policy was eligible to be ceded. It also stated that the company should have learned that the policy was not eligible to be ceded when it investigated the first loss and the company should have canceled the policy. The panel stated that the application contained information indicating that the policy was not eligible to be ceded. The panel decided that it would allow payment of the larger loss of \$961,426 but not the smaller loss.

Although the \$961,426 claim was not valid under facility rules, it was nonetheless ruled valid in order to protect the insurance company from "substantial hardship." Facility rules, however, do not allow exceptions for hardship.

A consumer representative on the governing board requested that the board reconsider the panel's decision, concerned that it might set a precedent for future questionable claims. In July 1995, the board voted to uphold the decision of the appeals panel. Furthermore, in May 1996, the board adopted a change in policy that would authorize payment of such claims in the future.

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No Reimbursement or Penalty Required for Premium Undercharges

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The reinsurance facility has not required insurance companies to reimburse the facility when the amount they charge for policy premiums is found to be lower than the amount required by state law and regulation. Undercharged premiums result in lost revenue for the facility, which is passed on to consumers.

From January 1994 through March 1996:

- Net premium undercharges found during audits of private passenger policies were approximately \$35,600.
- For commercial policies, net premium undercharges found during audits were approximately \$219,300.

According to facility staff, premium undercharges of \$829,000 were detected from 1981 through 1995, for private passenger and commercial policies combined.

Undercharges for private passenger insurance are paid by all drivers through increased recoupment fees. Undercharges for commercial insurance are paid by all commercial drivers.

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## Designated Agents

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Designated agents sell insurance exclusively for the reinsurance facility. Below we describe why designated agents should be phased out.

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### History of Designated Agents

In 1974, the General Assembly recognized that insurance reforms could cause some insurance companies to terminate sales in South Carolina. This could leave some geographic areas of South Carolina without adequate access to an insurance agent.

To ensure that (1) all areas of the state had access to an insurance agent and (2) insurance agents who sold automobile insurance under the assigned risk plan did not lose their business, the General Assembly enacted legislation (now found at §38-77-590) creating "designated agents." In those locations of South Carolina determined to have insufficient markets, the director of the South Carolina Department of Insurance could, but was not required to, designate insurance agents to sell insurance exclusively for the reinsurance facility.

According to facility documents, a designated agent was to be appointed for only one year and renewed for an additional year only if the agent could show that he had made a "diligent effort" to obtain employment with a voluntary insurance company but was unsuccessful. Instead of a short-term remedy, the designated agent system has lasted for more than 22 years and increased from 46 agents working in 1975 to 170 designated agents as of September 1996 (an increase of 270%).

In June 1985, the governing board of the reinsurance facility assumed responsibility for assigning designated agents. Generally, the facility was authorized to designate an agent if he was terminated and met other criteria described below. The facility created a designated agent committee to consider information submitted by applicants and to conduct proceedings for designation. The committee makes a recommendation to the full board concerning designation.

In 1985, the statute was amended to establish qualifications for designated agents. Beginning in 1985, applicants had to be licensed as a property and casualty agent/principal before October 1974, continuously licensed since that date, and authorized by an insurance company to sell liability and physical damage insurance for private passenger vehicles. In 1987, the law was amended, decreasing the experience requirement to five years. In 1990, the law was again changed, increasing the experience requirement to ten years.

The number of designated agents has steadily increased since 1974 (see Table 3.2).

**Table 3.2: Designated Agent Appointments**

Year of Designation	Number of Designated Agents <sup>1</sup>	Cumulative Total Designations
1974–1975	46	46
1976–1980	31	77
1981–1985	13	90
1986–1989	24	114
1990–1991	28	142
1992–September 1996	28	170

<sup>1</sup> Agents designated in these years who are currently designated.

Source: Reinsurance facility records.

Insurance policies sold by designated agents are sometimes cheaper than policies sold by voluntary agents.

In 1995, designated agents sold more than 440,000 auto insurance policies, accounting for 18% of all policies sold in South Carolina. Policies sold by designated agents have generated large financial losses which are subsidized by the driving public through recoupment fees. In some instances, policies sold by designated agents are cheaper than policies sold by voluntary agents. We believe that the reforms being implemented by the South Carolina Department of Insurance and the recommendations we make in this report will lead to a more competitive insurance market. Designated agents would no longer be needed and could be phased out.

## Market Access

Our review indicated that many designated agents are in areas of the state already served by insurance agents in the voluntary market (see Table 3.3).

**Table 3.3: Designated Agents in Areas Already Served by Voluntary Companies**

City <sup>1</sup>	Number of			Population
	Total Agents	Designated Agents	Voluntary Agents	
Columbia	615	12	603	251,498
Charleston	364	7	357	240,019
Florence	168	5	163	67,020
Sumter	153	4	149	84,568
Orangeburg	77	2	75	43,128
Bennettsville	23	1	22	15,751
Cheraw	27	2	25	13,063
Lake City	38	4	34	11,631
Loris	24	3	21	11,189
Westminster	20	2	18	8,882
Latta	15	3	12	6,435
St. Stephens	12	2	10	5,629

1 Based on ZIP codes.

Source: Reinsurance facility records; South Carolina Department of Insurance records; and 1990 census data.

One reason designated agents are in areas already served by voluntary companies is because the facility has not considered the presence of existing agents for limited private passenger only designation [(LPPO) agents wanting to sell only private passenger policies and not commercial policies] as required by Section 38-77-595. Of 170 designated agents, only 16 agents (9%) had limited designated status. However, we found that the information provided on market accessibility when applying for LPPO designation was contrary to the need for a designated agent in the area, but the reinsurance facility still granted designation. For example:

- In March 1993, a person applied for limited private passenger designation. The location of his office was to be within ½ mile of another designated agent's office and within 1½ miles of the offices of several voluntary insurance companies. Nevertheless, in April 1993, the board designated this individual to sell private passenger automobile insurance.

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The reinsurance facility appoints designated agents to serve areas already being served.

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- ❑ In June 1992, an applicant for LPPO designation responded that seven voluntary insurance agencies and one designated agent office served the same geographic area that he planned to serve. The board approved designation for this applicant in August 1992.
- ❑ An agent from one of the voluntary companies cited in the previous example applied for LPPO designation in August 1992. Although the board had recently approved an LPPO designation in this area, this request for LPPO designation was also granted.
- ❑ As of December 1991, there were 10 designated agent offices and numerous voluntary insurance offices in Columbia. Nevertheless, the board approved an LPPO designation, resulting in 11 designated offices in the city at that time.

The facility's governing board has not established criteria to determine market need or marketing outlets. In June 1995, the board created a subcommittee to review this issue. As of November 1996, the subcommittee had not developed criteria to determine market need.

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Agents Designated After They Were Terminated by Voluntary Companies

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State law (§38-77-590) describes the second reason an agent is eligible to sell insurance for the reinsurance facility. It states that agents "may" be designated to sell policies (private passenger and small commercial) exclusively for the facility if they have been "deprived of a market" to sell automobile insurance.

The facility has approved designation when an applicant's contract with a voluntary company was canceled due to high loss ratios (the losses on policies sold by the agent exceeded premiums paid by policyholders). In some cases, companies specifically stated that the agent was unprofitable. These agents have been allowed by the state of South Carolina to sell unprofitable insurance policies, and losses have been paid by all drivers through recoupment.

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When voluntary companies have terminated agents for excessive financial losses, the facility has appointed the agents to be "designated agents."

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The facility has approved the following to be designated agents.

- In 1985, a person who was previously designated and became a voluntary agent reapplied for designation. This person was appointed as a designated agent when his business was unprofitable; in contrast, when his business became profitable he became an agent with a voluntary company. The agent reapplied for designation after his contract was canceled by the voluntary company effective October 1, 1985 due to an "unprofitable loss ratio each year" from 1981 to 1985. The facility's governing board approved the agent's designation to become effective on October 1, 1985.
- In April 1987, an agent who had previously been terminated by four voluntary insurance companies applied for designation. Facility documents confirm that the agent's termination from at least two of the companies was because he was causing the insurance companies to lose money. (Documentation regarding the reason(s) for termination by the other two companies was not included in the agent's file.) In May 1987, the reinsurance facility approved this person as a designated agent.
- An agent lost his contract to sell private passenger automobile insurance for a voluntary company because of "unprofitable loss results" in five of six years. The agent applied for designation in May 1993 and the reinsurance facility designated him in July 1993.
- A person who applied for designation in March 1989 was notified by a voluntary company that his contract had been canceled in February 1989. The agent's contract was terminated due to "excessively high loss ratios" for private passenger automobile insurance. In April 1989, the board notified this individual that he had been approved as a designated agent.

The facility believes it is required to approve designation if an agent's contract has been terminated by a voluntary company and the agent meets other requirements established in state law (excluding LPPO designations). Therefore, the facility has not considered the availability of voluntary companies and other factors when considering an applicant for "full" designation.

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## Transfer of Designation

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State law allows a designated agent to transfer his designation to a spouse, child, parent, or sibling upon the agent's retirement, incapacity, or death. Our review of designated agent files showed the following:

- ❑ A 35-year-old man adopted a 70-year-old designated agent for the purpose of transferring his business. As of November 1996, the reinsurance facility had not granted the transfer.
- ❑ In January 1986, a designated agent was convicted of defrauding the federal government. In July 1986, the agent requested that his designation be transferred to his wife. Immediately following this request, the facility's governing board voted to revoke his status as a designated agent. In September 1986, an appeals panel of the board reversed the board's decision to revoke the designation of this agent. In November 1986, the board approved the transfer of designation to this individual's spouse. The former agent agreed not to be involved in the business.

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For the purpose of transferring designation, a 35-year-old man, who wanted to become a designated agent, adopted a 70-year-old man.

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## Restrictions on Becoming a Designated Agent

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During our review of designated agent records, we noted that qualifications outlined for designation in §38-77-590 may restrict the appointment of women and minority agents. Our review showed that only 4 (2%) of the 170 agents designated as of September 1996 were minorities, and that 3 of these agents were located in the same geographical area. In addition, 27 (16%) were women.

According to insurance and reinsurance facility officials, certain laws restrict the appointment of minorities as designated agents. An official of the South Carolina Department of Insurance stated that this may be due to the reluctance of voluntary companies to employ minorities for fear that they will service a large volume of risky business. Since state law requires ten continuous years of experience as a property and casualty insurance agent to become a designated agent, the pool of potential minority designated agents is limited. The facility official stated that minorities have contacted the facility regarding designation but have not met legal requirements such as the experience requirement.

For example, an African-American agent applied for designation in 1986. Facility documents indicate that this applicant did not meet the criteria for designation in part because he was not licensed as a property and casualty agent before October 1974, a requirement at that time. This would result in

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Few women and minorities  
are designated agents.

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12 years of experience. However, the applicant had been licensed since 1976 and, therefore, had about ten years of experience.

Based on 1990 U.S. census data, South Carolina has a minority population of 31%. Minority agents have been granted designation in 3 of the state's 46 counties. Minorities in these counties account for only 7% of the state's minority population. For example, Williamsburg county, a rural location with a minority population of 64% has no minority designated agents. Additionally, there are no minority designated agents in Richland or Sumter counties, with minority populations of approximately 44% and 45%, respectively.

In 1987, the General Assembly recognized restrictions to appointment as a designated agent. The law was changed in 1987 to require only five continuous years of experience as a property and casualty agent in order to qualify as a designated agent. Also, legislation was passed authorizing, for three years, the facility's governing board to approve applicants who met all the requirements, except having a contract to sell property and casualty insurance. No minorities were granted designation during this period. In 1990, the experience requirement for designated agents was changed to ten years.

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Designated Agent  
Earnings

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The reinsurance facility pays designated agents 12% of the premiums as a commission. Voluntary agents generally earn an average of 10% commission. Insurance and facility officials stated that the discrepancy in the percentage of commission is due primarily to designated agents having more interaction with their customers. They stated that designated agents are likely to have more policy reinstatements due to lapses in coverage.

We calculated the commissions paid to designated agents in FY 94-95 and present the top 20 commissions in Table 3.4 . We were unable to determine the average expenses incurred by these agents, such as the costs of rent and office staff, and therefore have not estimated their net earnings. Also, the table includes only the commissions from policies ceded to the facility. Designated agents may sell other lines of insurance, such as homeowners insurance, and earn commissions selling these policies.

**Table 3.4: October 1994 to  
September 1995: Top 20  
Designated Agent Commissions**

Designated Agent	County	Gross Commission <sup>1</sup>
Agent 1	Richland	\$755,801
Agent 2	Greenville	\$696,428
Agent 3	Charleston	\$611,378
Agent 4	Richland	\$608,689
Agent 5	Richland	\$575,664
Agent 6	Charleston	\$568,165
Agent 7	Charleston	\$560,505
Agent 8	Florence	\$482,981
Agent 9	Charleston	\$449,353
Agent 10	Sumter	\$406,296
Agent 11	Anderson	\$368,998
Agent 12	Spartanburg	\$358,521
Agent 13	Horry	\$345,977
Agent 14	Aiken	\$342,038
Agent 15	Richland	\$341,067
Agent 16	York	\$340,795
Agent 17	York	\$333,391
Agent 18	Horry	\$317,858
Agent 19	Spartanburg	\$296,530
Agent 20	Greenville	\$266,762

<sup>1</sup> Commissions for designated agents are 12% of the amount collected in premiums and recoupment fees.

Source: Reinsurance facility and designated company records.

## Verification of Data on Ceded Policies

The reinsurance facility has not verified the accuracy of insurance data that companies must provide on ceded policies. Insurance companies submit to AIPSO financial information on policies, including the amount of premiums collected, recoupment fees, claims paid, and administrative expenses. AIPSO, located in Rhode Island, processes this information for the reinsurance facility which uses it to determine how much insurance companies are owed for claims and expenses. Therefore, these data have a major impact on the amount of recoupment fees. Facility staff conduct claims and underwriting audits but these reviews do not focus on all information submitted to AIPSO (see p. 24).

We found that insurance companies have submitted inaccurate data concerning their expenses. For example, when a company's expense to

service claims exceeds a certain limit, the facility requests the company to review the accuracy of its reports. For FY 96-97, 2 of 22 companies exceeding the expense allowance revised their reports. In one of these cases, the company's revisions resulted in a reduction in the facility rate of reimbursement from 34% to 28% of written premiums. The total expenses based on the revised rate will be determined in December 1997.

In the remaining 20 cases where the limit was exceeded, the companies stated that their expense data were correct and in some cases provided reasons for the increase. However, the facility conducted no follow-up to verify the accuracy of this data.

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## Conclusion

As a result of policies and practices of the facility's governing board, insurance companies have inadequate incentive to control costs that are paid with recoupment fees. The board has implemented a system in which companies are paid based on the amount of losses but has not developed a system to reward companies when costs are lower. The board has allowed the payment of ineligible claims by the facility and has not assessed penalties against companies charging a lower premium than required by law. Ineligible claims and undercharges result in higher facility costs which are ultimately paid by all South Carolina drivers.

Finally, according to facility records, the appointment of designated agents who sell policies for the reinsurance facility, was to be short term. However, the designated agent system has operated for over 20 years and the number of designated agents has more than tripled since 1974. Over 40% of the policies ceded to the facility are sold by designated agents.

We could find no reason to continue the system of designated agents and companies. If this system were phased out, and if insurance companies were given flexibility to charge adequate premiums, most high-risk drivers would find insurance companies that would sell them policies voluntarily. In addition, voluntary companies that specialize in serving high-risk drivers would be likely to open offices in South Carolina.

*Our recommendations to improve management of South Carolina's residual market begin on page 52.*

# Ways to Improve Enforcement of Insurance Laws and Increase Traffic Safety

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State law requires any South Carolina automobile operated on a public road to be covered by liability insurance. However, a large number of South Carolinians drive without insurance. South Carolina has one of the highest highway death rates.

In this chapter, we examine methods to improve the enforcement of insurance laws. We describe legislative changes which could improve traffic safety, which could lead to lower insurance rates.

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## Enforcement of Insurance and Safety Laws

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As previously discussed, all policyholders subsidize drivers in the reinsurance facility by paying mandatory recoupment fees. Drivers who do not purchase insurance avoid paying recoupment fees. In this section, we describe how law enforcement agencies have not enforced laws intended to detect and deter uninsured drivers and we discuss changes which could strengthen enforcement.

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### Uninsured Motorists

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One of the goals of the insurance reforms recommended by a legislative study committee in 1973 and 1974 was to eliminate uninsured motorists. This goal has not been achieved. In 1974, a legislative study committee estimated that approximately 150,000 vehicles in South Carolina were not covered by insurance. This was approximately 9% of the total vehicle population. The committee found this to “. . . constitute a most serious problem . . .” and made recommendations designed to reduce the number of vehicles being driven uninsured. These recommendations included increasing enforcement and creating stricter penalties for drivers found driving without insurance. The committee noted that reducing the number of uninsured drivers would reduce the uninsured motorists premium paid by South Carolina drivers by perhaps as much as two-thirds.

However, evidence indicates that the percentage of uninsured vehicles has not decreased and the total number of uninsured vehicles on South Carolina's roads has actually increased in the 22 years since the enactment of reforms to eliminate uninsured motorists. We reviewed several sources of uninsured motorist data and found that estimates of the percentage of uninsured motorists in South Carolina generally ranged from 9% to 11% (see Table 4.1). The most recent estimates placed the number of uninsured motorists from 10% to 16%. Applying these percentages to the total number of vehicles registered indicates that between 285,000 and 450,000 vehicles in South Carolina may be uninsured. In FY 94-95, state and local law enforcement agencies were responsible for the suspension of 8,449 drivers' licenses for driving uninsured vehicles.

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The number of motorists driving without insurance has been increasing.

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**Table 4.1: Estimated Percentage and Number of Uninsured Drivers in South Carolina for Selected Years**

Year	Estimated Percent Uninsured	Estimated Number of Uninsured Vehicles
1974	9%	150,000
1985	11%	251,343
1988	11%	272,502
1995	10%	285,299

Source: Legislative study on auto insurance, Insurance Research Council Report, Best's Insurance Management Reports; Department of Public Safety Financial Responsibility (FR) section statistics and interviews with FR staff.

Reducing the number of uninsured drivers can help lower insurance costs for all drivers. For example, the minimum recoupment fee for a liability policy was \$38.15 in FY 95-96. If all motorists purchased automobile insurance, as required by law, between \$10.9 million and \$17.1 million in extra recoupment fees could have been collected, thereby reducing recoupment fees for all drivers.

In addition, the average annual auto liability premium South Carolina motorists paid in 1994 was \$402. If all vehicles had this required coverage, then between \$115 and \$180 million in additional premiums could have been collected by insurance companies, thereby reducing auto insurance premiums for all South Carolina drivers.

## Enforcement of Proof of Insurance Laws

South Carolina law enforcement agencies have not strictly enforced laws that require motorists to maintain automobile insurance coverage. For example, the Department of Public Safety (DPS) has not enforced state laws requiring that motorists provide proof of insurance when stopped for a traffic violation or when renewing their driver's license.

Until June 1996, §56-7-12 of the South Carolina Code of Laws required that when a driver was issued a ticket for a moving violation by a police officer, ". . . [the motorist] must be furnished a written request form to be completed by him and his insurance company or the agent issuing the policy to verify liability insurance coverage." According to DPS officials, neither the highway patrol nor local law enforcement agencies have been enforcing §56-7-12. This law was amended June 5, 1996 dropping the requirement that a police officer give motorists a form. The law still allows an officer to give a motorist the form at his discretion.

Section 56-1-80 states that all persons obtaining a driver's license for the first time or renewing it " . . . must be furnished a written request form for completion and verification of liability insurance coverage." Failure to comply will result in suspension of the motorist's driver's license. While DPS does require newly licensed drivers to provide proof of insurance coverage, it does not require persons renewing their license to prove they have insurance.

DPS officials stated that the administrative costs associated with implementing these laws would be burdensome. Statewide, approximately 460,000 moving violation tickets were issued in calendar year 1995. Local governments and sheriff offices have also expressed concerns about the administrative and financial burdens created by this statute. One town passed an ordinance opposing the imposition of the administrative requirements of the moving violations program. A concern for police officer safety was also cited as a reason for not implementing the requirement. We did not find any other southeastern state which has a requirement that persons provide proof of insurance after being ticketed for a moving violation.

DPS issued approximately 69,000 new driver licenses and renewed approximately 440,000 in FY 94-95. According to a DPS official, the provision in §56-1-80 requiring verification of insurance coverage at time of license renewal was included because parents were failing to notify insurance companies when their teenage children obtained a license. However, DPS concluded that a law targeting just teenagers would be discriminatory. Thus, the provision requiring persons to provide proof of insurance when renewing a license was added.

Since DPS does not enforce these statutes, individuals driving without insurance are less likely to be detected. An increased number of uninsured drivers on the road can indirectly increase insurance costs.

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Law enforcement agencies have not enforced laws requiring motorists to provide proof of insurance.

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## Confiscation of Motor Vehicles

The Department of Public Safety (DPS) has not confiscated vehicles of motorists caught driving under suspension as required by law. Section 56-5-6240 of the South Carolina Code of Laws states that the vehicle of a motorist arrested for the fourth or subsequent offense driving under suspension (DUS) or driving under the influence (DUI) must have his vehicle confiscated by a law enforcement officer at the time of arrest.

We attempted to determine the number of vehicles that have been confiscated under this provision. However, neither DPS' Division of Motor Vehicles

(DMV) nor the State Highway Patrol maintains information on the total number of motorists with a fourth DUS or DUI who have had their vehicles confiscated.

We reviewed a sample of 33 tickets issued by the State Highway Patrol and various local law enforcement agencies in which the drivers had been cited for a fourth or greater DUS conviction within the last five years to determine if the vehicle had been confiscated. In 19 cases the vehicle was not eligible for confiscation because it did not meet the statutory requirements for confiscation. (For example, if the car's owner does not reside at the same address as the driver then the vehicle may not be subject to confiscation.) However, we identified 14 instances where the vehicle should have been confiscated. In 12 of the 14, the vehicle was not confiscated as required by law. Law enforcement officials gave varying reasons for not confiscating the vehicles.

- In three cases, the vehicles were not confiscated because the officer believed the cost of confiscation was greater than the vehicle's value.
- In four cases, lack of proper training in confiscation requirements was cited as the reason for failing to confiscate the vehicle.
- In one case, the vehicle was not confiscated after the fourth DUS but was confiscated after the sixth DUS.
- In one case, the vehicle was towed and then returned after the driver showed proof of insurance.
- In one case, the officer was unaware that the motorist was driving under suspension.
- In two cases, no reason was given for failing to confiscate the vehicle.

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Law enforcement agencies have not confiscated the vehicles of motorists caught driving under suspension as required by law.

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We requested information from the 46 county sheriffs on the number of confiscated vehicles turned over to them by the highway patrol. We received responses from 6 sheriffs who reported 12 confiscated vehicles turned over to them by the highway patrol. Greenville and Beaufort counties reported no confiscated vehicles being turned over to them in 1995. Lexington county reported receiving four confiscated vehicles and Charleston county reported receiving three vehicles from the highway patrol in 1995. We also requested the number of vehicles confiscated by sheriffs' departments under §56-5-6240. The 6 sheriffs' offices reported 83 vehicles were confiscated by their departments in 1995.

According to the National Highway Traffic Safety Administration (NHTSA), while confiscation laws are common across the United States, application of the law is rare. State and local law enforcement officials stated that the administrative costs associated with the confiscation of vehicles make confiscation a burdensome procedure. The process needed to obtain title to the vehicles is cumbersome. In addition, the vehicles that are confiscated are generally older cars and the amount of money received when the vehicles are sold is minimal. The NHTSA recommends that states establish a record-keeping system for monitoring the confiscation of vehicles.

By not actively confiscating vehicles, individuals with multiple convictions for DUS and DUI may continue to drive. This can result in increased insurance costs for South Carolina motorists. In a memo dated November 12, 1996, DPS notified all troopers of the requirement to seize vehicles of motorists caught for fourth offense DUS or DUI.

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## Seizure of License Plates of Uninsured Drivers

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South Carolina's program for seizing the license plates of drivers whose tags were suspended for failure to provide proof of insurance could be improved. In addition, the seizure efforts of local law enforcement agencies are inconsistent.

Section 56-10-45 of the South Carolina Code of Laws currently allows the Department of Public Safety to contract with local law enforcement agencies for the seizure of tags. However, according to DPS officials, they have not entered into any contracts. In addition, §56-10-45 allows local law enforcement agencies to retain the fines associated with failure to turn in license tags. However, a large number of individuals still are not having their tags seized.

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South Carolina's program for confiscating the license plates of uninsured vehicles could be improved.

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Between January and April 1996, the highway patrol received data indicating that 40,000 motorists may be driving without insurance and should have turned in their license plates. Only 27,000 (68%) of these cases were investigated during this time period. In response to our request for information on the number of tags seized, six sheriffs responded. The number varied significantly from county to county. For example, two counties reported they did not seize any tags. Another county reported collecting 3 tags while another reported collecting 350 tags.

One technique that is being tested in Florida to help increase the seizure of license plates is allowing repossession agencies to seize the tags of motorists who have failed to provide proof of insurance. This pilot project was begun in October 1995 for a three-county area of Florida. Under the program, "repo" agents are paid \$25 for each tag seized. As of October 1, 1996, 927 tags were seized by these agents. In an October 1996 review, Florida found that the program helped to reduce the number of uninsured drivers in the pilot counties. Improving the program for the seizure of license tags could help keep uninsured motorists off the road. In addition, it could result in increased revenue from reinstatement fees and help reduce insurance costs for all drivers across South Carolina.

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### Stiffer Penalties for Repeatedly Driving Uninsured or Driving Under the Influence

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Amending §56-10-270 and §56-5-6240 of the South Carolina Code of Laws to allow for confiscating the automobiles of motorists driving an uninsured vehicle for the third time, DUS third offense, or third offense driving under the influence (DUI) should be considered. South Carolina law (§56-5-6240) only allows for confiscation of a vehicle after fourth offense DUI or DUS.

Violators of the state's hunting and fishing laws face harsher penalties than violators of the state's DUS and DUI laws. For example, a person caught hunting deer or bears at night forfeits all the equipment involved, including guns, cars and animals. A person caught trawling for shrimp, fish, or crabs without a license or permit or taking shrimp out of season is subject to having his boat, rigging, and equipment being confiscated and sold to the highest bidder (see Table 4.2). These penalties are in addition to any fines or prison terms that can be imposed.

**Table 4.2: Comparison of Department of Natural Resources Violations to Major Traffic Violations**

Natural Resources Violation <sup>1</sup>	Property Subject To Confiscation
First and subsequent offense hunting bears out of season	YES
First and subsequent offense night hunting of deer or bears	YES
First and subsequent offense trawling for shrimp, fish, or crabs without a license or permit.	YES
First and subsequent offense taking or catching shrimp over bait during the closed season.	YES
Traffic Violation	
First, second, or third offense driving under the influence.	NO
First, second, or third offense driving under suspension.	NO
First, second, or third offense driving without insurance.	NO

1 Automobile, boat, and/or hunting and fishing equipment can be confiscated.

Source: South Carolina Code of Laws

First-time violators of some hunting laws face harsher confiscation penalties than motorists caught driving under the influence for the third time.

Other states have higher fines and longer suspensions for driving without proof of insurance. For example, in Hawaii, the fine is \$1,000. In South Dakota, the period of suspension is one year. In South Carolina, the maximum fine is \$200 and a license suspension of 30 days.

A study done by the National Association of Insurance Commissioners (NAIC) suggests that strict enforcement of the law, with mandatory and “significant” fines for first time offenders may be the key to lowering the uninsured motorist population. According to a 1989 NAIC report, “the risk of a \$100 fine may simply not be enough to counterbalance the relatively remote chance of being caught without insurance.”

Four of six county sheriffs responding to our survey suggested that stiffer penalties would help to reduce the number of uninsured and unsafe drivers on South Carolina’s roads. Approximately 8,500 (4.2%) of the 203,000 license suspensions processed in FY 94-95 were the result of driving without insurance.

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## Sampling Program for Uninsured Motorists

The Department of Public Safety has discontinued reviewing a random sample of vehicle registrations to determine if motorists are driving uninsured. Random sampling can be an effective means of determining the number of uninsured motorists statewide and enforcing uninsured motorists laws.

When a vehicle is registered, the owner is not required to provide proof of insurance. Instead, the owner signs a statement certifying that the vehicle is insured. Between FY 90-91 and FY 93-94, the financial responsibility (FR) section of DPS randomly selected approximately 500 vehicle registrations each week for verification. The FR section sent a letter to the insurance company shown on the registration requesting verification of insurance. The insurance company reviewed its records and then notified the FR section when its records indicated the person listed was not insured. The percentage of vehicles found to be uninsured using this method ranged from 0.2% to 1.4%. This suggests that most vehicles are covered by insurance at the time of registration.

Section 56-10-10 requiring owners to provide a statement certifying insurance coverage was amended in 1994. The amendment changed the reporting requirements so that the policy number and policy expiration date were no longer required. Without this information, DPS felt it could no longer continue the sampling program and it was discontinued.

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Random sampling of vehicle registrations could detect uninsured vehicles.

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We identified ten states that have sampling programs. In addition to its random sampling program, Illinois also has a targeted sampling program. For example, drivers who were cited for past violations, including driving without insurance, are sent questionnaires asking for proof of a current insurance policy. An estimated 15% to 24% of the motorists in the targeted groups have been found not to have insurance a year later compared to 4% of those checked as part of a random sample.

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## Other Policy Considerations

This section outlines several policy issues which could improve traffic safety. In 1973, a legislative study committee found that South Carolina had a proportionally high rate of traffic accidents and deaths. In 1992, South Carolina's death rate of 2.3 per 100 million miles traveled continued to be above the national average of 1.8. Only eight other states had death rates greater than South Carolina's. In 1994, there were 120,947 traffic collisions resulting in 847 deaths and 56,868 injuries in South Carolina. Other states have implemented laws and programs which have helped to reduce fatalities. Reducing the number of accidents and fatalities would help lower insurance premiums. Some examples are discussed below.

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## A Graduated Licensing System

Young drivers (teenagers) are involved in more vehicle accidents than the population as a whole (see Table 4.3). One program that could lower young driver accident rates is graduated licensing. In addition, raising the unrestricted driver's license age could also lower young driver accident rates.

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**Table 4.3: Nationwide Comparative Accident Rates by Age for 1990**

Age	Accidents Per Million Miles
16	43
17	30
18-19	15
20-24	5
25 and older	3

Source: Insurance Institute for Highway Safety.

South Carolina allows 15-year-olds to obtain a driver's permit. After holding a permit for 14 days and passing a road test, a 15-year-old may drive during daylight hours. In North Carolina and Georgia, a license may be obtained at age 16 without having a permit.

Young drivers drive fewer miles, but have more accidents than older drivers. Several characteristics distinguish teenage drivers from older drivers. Teenagers are more likely to be in single vehicle accidents, to make driving errors, to be driving too fast, and to have high passenger occupancy rates. Also, while only 20% of their time is spent driving at night, more than 50% of fatal accidents involving teenage drivers occur at night.

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A graduated licensing system could improve the driving skills of teenage drivers.

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Graduated licensing is based on the premise that younger drivers can improve driving skills and reduce crash rates by progressing through stages before reaching unrestricted licensure. Graduated licensing systems include three stages—a learner's permit stage, an intermediate or restricted stage, and full licensure. Some characteristics of the stages are:

***Learner's Permit Stage***

- Person must be a minimum age (for example 15 ½ years old).
- Pass knowledge test.
- All driving supervised by a licensed parent, guardian, or adult age 21 or older.
- Must remain accident- and conviction-free for six months to obtain an intermediate license.
- Permit canceled if applicant convicted of an alcohol-related offense.

***Intermediate Licensure***

- Person must be a minimum age (for example 16 years old).
- Pass road test.
- Successful completion of permit stage.
- Successful completion of basic driver education.
- Restricted driving hours unless supervised.
- Must remain accident- and conviction-free for 12 consecutive months.
- License revocation for alcohol-related offense.

***Full License***

- Must be a minimum age (for example 17 years old).
- Successful completion of intermediate stage.

Studies in California and Maryland involving drivers under the age of 18 showed a 5% reduction in the rate of accidents after they implemented graduated licensing. A comparison of licensing requirements and crash rates for young drivers in 5 northeastern states showed the highest rates of 16-year-old involvement in fatal and non-fatal accidents in states that allow unrestricted licensing at age 16. States that have nighttime driving restrictions for 16-year-olds had much lower overall accident rates.

Research has shown that graduated licensing systems reduce the number of teenage accidents. Eight states have graduated licensing. They are California, Colorado, Maryland, Massachusetts, New York, Pennsylvania, West Virginia, and Wisconsin. Illinois, New Jersey, Oregon and Vermont have partial graduated licensing.

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## Methods for Reducing Driving Under the Influence

In 1994, 16,589 (41%) of the 40,676 motor vehicle deaths nationwide involved alcohol use by drivers. Estimates place the cost of alcohol-related crashes in lost productivity, medical costs, property damage and other expenses at more than \$46 billion in 1995. In 1995, in South Carolina, alcohol or drugs were the probable causes in 5,412 accidents resulting in 138 deaths. A number of states have adopted measures to try to curb drunk driving. Among these measures are administrative license revocation, zero tolerance for underage drinkers, and establishment of "illegal *per se*" laws. These laws have reportedly contributed to reducing the number of fatalities involving alcohol. These laws can also help to lower insurance rates by making roads safer.

Further, under the federal Intermodal Surface Transportation Efficiency Act of 1991 (Pub. L. No. 102-240), states that adopt these types of laws can become eligible for incentive grants. According to a NHTSA official, South Carolina could receive between \$1.6 and \$4 million over five years which could be used to enhance enforcement and public relations efforts designed to curb drunk driving.

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## Zero Tolerance For Drivers Under 21

All 50 states have laws prohibiting the purchase and public consumption of alcohol by persons under age 21. Therefore, drivers under age 21 should have no alcohol in their blood systems. "Zero tolerance" laws provide for the immediate suspension of a driver's license for any person under age 21 who shows a blood alcohol content (BAC) level of .02 or greater. South Carolina is one of 23 states that do not have a zero tolerance law.

Nationwide in 1991, 20% of 15- to 20-year-old drivers involved in fatal crashes had a BAC above .10. Approximately 33% had BAC between .01 and .09. Since younger drivers are generally more inexperienced, any amount of alcohol can amplify driver impairment. The risk of a fatal crash for those under 21 with a low BAC is substantially higher than people over 25 with a low BAC. For example, male drivers aged 16 to 20 with a BAC between .01 and .04 have six times the fatality risk in single driver accidents of drivers over age 25 with a similar BAC level.

Zero tolerance laws can also serve as a strong deterrent since young drivers place a high value on having a driver's license. As of September 1995, 27 states and the District of Columbia have passed zero tolerance laws. A study

in Maryland concluded that its zero tolerance law resulted in an 11% reduction in collisions involving drivers under age 21 who had been drinking. A study of four other states showed a 34% decline in adolescent nighttime fatal crashes. Another study of 12 states with lower BAC limits for underage drinkers found a 16% decline in single vehicle nighttime fatal crashes for drivers under 21.

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### “Illegal *Per Se*” Laws Could Assist In Deterring Driving Under the Influence

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South Carolina is one of two states (Massachusetts is the other) which does not have an “illegal *per se*” DUI law. Under §56-5-2950 of the South Carolina Code of Laws, a driver with a blood alcohol content (BAC) level of .10 is inferred to be driving under the influence. However, having a BAC of .10 is not necessarily a violation. Under an “illegal *per se*” law, any driver who has an alcohol level at or above a certain BAC is deemed to be in violation of the law whether or not there is additional evidence, such as behavioral signs, of intoxication.

At a BAC of .10 drivers have been found to suffer from divided attention, have substantially reduced information processing skills, and have impaired performance of basic driving related tasks, (i.e. steering, braking, and speed control). The risk of death in single vehicle crashes is 48 times greater for drivers with BACs of .10 than for drivers with a zero BAC. In two separate reports to the United States Congress in 1991 and 1992, the National Highway Transportation Safety Administration (NHTSA) recommended that states establish illegal *per se* laws. In 1985, the Governor’s Office of Highway Safety recommended passage of an illegal *per se* law. Illegal *per se* laws make it easier for police officers since they provide an objective standard against which an officer can determine if the driver is in violation of the law.

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## Administrative License Revocation

One enforcement tool other states are using to control drunk driving is administrative license revocation (ALR). This is administrative action against a driver's license independent of any criminal action against the driver. As of March 1995, 38 states and the District of Columbia have ALR laws which allow for the immediate confiscation of a driver's license if a driver fails or refuses to take a blood alcohol test. Under these laws, the motorist's license is taken immediately by the arresting officer and the motorist is given a temporary driving permit for a specified period of time, during which the suspension may be appealed. If there is no appeal, or the confiscation is upheld, then the license is revoked or suspended for a prescribed period of time.

According to information provided by the Insurance Institute for Highway Safety (IIHS), because the license revocation is immediate and not dependent on a conviction, it is more effective than the traditional post conviction suspension. Even though motorists with suspended licenses will continue to drive in certain cases, a 1988 study showed they generally drive safer, with fewer accidents and traffic violations. A study by the IIHS found that these laws reduce the number of alcohol related nighttime traffic accidents by 9%.

In a number of states, ALR laws have been challenged as unconstitutional on the basis that they result in double jeopardy. The argument is that an administrative suspension of a driver's license followed by criminal prosecution for DUI punishes the person twice for the same offense. However, according to an official with the National Committee on Uniform Traffic Laws and Ordinances, the constitutionality of these laws has been upheld in every state in which they were challenged.

An additional concern is that violators may lose their jobs. However, two studies have shown that only about 1% of violators risk losing their jobs. The administrative costs of the program are generally covered by reinstatement fees paid by drivers at the end of their suspensions.

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## Consumer Information From the Department of Insurance

Consumers need information about automobile insurance so they can make informed decisions when choosing an insurance company. The department of insurance sponsors a variety of activities to assist consumers with questions and problems related to auto insurance. These activities include:

- Publishing a price comparison, mandated by law, of the 20 companies selling the most automobile insurance in the state.
- Providing brochures which explain how South Carolina's auto insurance laws, and any changes in them, affect the consumer.
- Maintaining a toll-free telephone line for consumers with questions or complaints about automobile insurance.
- Distributing consumer information at large public gatherings, such as shopping malls, auto shows, or the state fair.
- Speaking to civic and school groups and at senior citizens' centers.
- Maintaining a site on the Internet for quickly disseminating information on auto insurance to consumers across the state.

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## Efforts to Protect Consumers Against Discriminatory Practices

Effective October 1, 1996, state law no longer requires insurance companies to sell physical damage coverage to every consumer who requests it. Instead, insurance companies will decide whether to insure a vehicle for physical damage based on the driver's chance of having an accident.

Section 38-77-280(F) gives the director of the department of insurance authority to impose a fine of up to \$200,000 when an insurer, agent, or broker participates in a pattern of illegal discrimination in the sale of physical damage insurance. Illegal discrimination is defined as sales practices based on race, color, creed, religion, national origin, ancestry, territories not approved by the director, economic status, and income.

An official with the department of insurance reports that it is developing a program to help protect consumers from illegal discriminatory practices. The plan calls for the following activities:

- Publishing and distributing a brochure explaining what is in the new law and how it will affect consumers.
- Providing “shopper’s guides” for the best premium under the new law.
- Helping consumers investigate why an insurance company refused to sell physical damage coverage to them.
- Educating consumers on their rights using both published materials and community outreach programs.
- Obtaining names of consumers who have been turned down by insurance companies and comparing them with records at the department of transportation.

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## Alternative Automobile Insurance Systems

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As previously discussed, states have adopted different systems in an attempt to provide access to automobile insurance for all drivers (see p. 1). These systems include the use of reinsurance facilities, joint underwriting associations, and assigned risk plans. Another alternative that has been adopted by several states is the automobile insurance system known as no-fault.

No-fault is a system of insurance under which drivers involved in accidents recover financial losses from their own company, regardless of fault. However, under no-fault, the right of the victim to sue the driver is restricted. States with no-fault set a threshold below which individuals cannot sue. These thresholds are based either on a dollar amount (monetary) or on specific categories of bodily injury (verbal) such as death or serious disfigurement.

As of May 1996, 13 states had no-fault insurance laws. Three states (Kentucky, New Jersey, and Pennsylvania) have what is referred to as “choice” no-fault. Under this system, owners may choose whether or not to be covered under the traditional tort system (and, therefore, retain the right to sue) or be covered under a no-fault system, without the right to sue.

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## Conclusion

The number of uninsured drivers in South Carolina has increased since 1973. Uninsured motorists cost the state between \$10.9 million and \$17.1 million in uncollected recoupment fees and cause insurance companies to lose between \$115 and \$180 million in uncollected premiums. Stricter enforcement of the state's proof of insurance and confiscation laws, reinstatement of a sampling program for uninsured motorists, improvements in the seizure of license tags, and stiffer penalties for driving uninsured could help reduce these losses.

South Carolina's death rate per 100 million miles traveled has consistently remained above the national average. A number of states have passed laws which have led to a decrease in the number of accidents and fatalities. States that have implemented a graduated licensing system for young drivers have shown a decrease in the rate of accidents. In addition, states have passed a number of laws that have helped reduced the frequency of driving under the influence. These include laws that mandate zero tolerance of alcohol usage by young drivers, and administrative license revocation laws for motorists arrested for driving under the influence.

Stricter enforcement of current laws as well as the passage of additional laws could help reduce the number of uninsured and unsafe drivers on South Carolina's highways.

*Our recommendations to improve enforcement of traffic and compulsory insurance laws begins on page 54.*

# Recommendations to Reform South Carolina's Automobile Insurance System

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In this chapter we list our recommendations to reform South Carolina's automobile insurance system based on the following objectives:

- Insurance companies should be required to operate in a competitive environment.
- Premiums should be permitted to vary based on the statistical risk that a driver will cause the company to incur losses and expenses.
- Premiums should not be permitted to vary based on race, religion, ethnicity, and related factors.
- A process should exist to help drivers purchase a policy when they encounter difficulty finding an insurance company that will sell them a policy voluntarily.

The following recommendations, if fully implemented, would constitute a major reform of South Carolina's automobile insurance system. To minimize disruptions during transition, it might be advantageous to phase in these recommendations over a period of time, not to exceed three years.

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## Reducing the Size of South Carolina's Residual Market

The General Assembly should consider amending state law to:

- No longer require insurance companies to use state-mandated rating classifications, territories, surcharges, discounts, and credits.
- Add a requirement that insurance companies submit and obtain approval from the department of insurance prior to using rating classifications, territories, surcharges, discounts, and credits.
- Allow insurance companies to refuse to sell insurance to any driver for reasons other than race, religion, ethnicity and related factors.
- No longer require that specific premium levels be approved by the department of insurance.

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## Improving the Management of South Carolina's Residual Market

The General Assembly should consider amending state law to:

- Replace the reinsurance facility with an assigned risk system. The department of insurance should be consulted regarding the specific design of the assigned risk system.
- Eliminate recoupment fees charged to drivers.
- Repeal §38-77-590 of the South Carolina Code of Laws which authorizes the appointment of designated agents. As originally planned, designated agents should be allowed up to one year to find a voluntary company to represent.

If the General Assembly chooses not to replace the facility, it should consider requiring that all liability policies ceded to the reinsurance facility be ceded at a self-sustaining premium.

If the General Assembly chooses not to replace the facility, the reinsurance facility should:

- Implement a system to reward companies that reduce the claims and expense costs paid by the reinsurance facility.
- Analyze expenses that are paid to voluntary companies for ceded policies and determine if these expenses should be lowered.
- Not make exceptions to its rules of operation in authorizing payment of claims on policies ceded to the facility.
- Establish rules to recover premium undercharges from insurance companies and establish and enforce penalties for premium undercharges.
- Review on a regular basis the adequacy of claims staff employed by designated insurance companies and large voluntary companies.
- Conduct random audits to verify the accuracy of financial information submitted to AIPSO.

If the General Assembly chooses not to replace the facility, the South Carolina Department of Insurance should continue its investigations into illegal strategies used by drivers and insurance agents to pay lower insurance rates.

If the designated agent system is retained, the General Assembly should consider:

- Repealing §38-77-590(f) regarding the transfer of designated agents' businesses.
- Enacting legislation to prohibit the facility from appointing designated agents unless there is a need for an agent based on criteria developed by the facility.

If the General Assembly decides to retain the designated agent system, the reinsurance facility should:

- Develop and implement written criteria for determining where designated agents are needed.
- Develop criteria concerning the granting of designation to agents who have been terminated by voluntary insurance companies due to high financial losses.
- Review and recommend statutory changes concerning provisions that might restrict the appointment of women and minority designated agents.
- Not allow designated agents to earn a higher commission rate than the rate paid to voluntary agents.

If recoupment fees are not eliminated, the General Assembly should consider:

- Amending §38-77-620(1) to prohibit insurance agents from earning commissions on recoupment fees.
- Correcting technical flaws in the recoupment formula to eliminate under recoupment.

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## **Improving Enforcement of Traffic and Compulsory Insurance Laws**

The Highway Patrol and local law enforcement agencies should ensure that §56-7-12 and §56-1-80 of the South Carolina Code of Laws concerning proof of insurance are appropriately enforced.

State and local law enforcement agencies should comply with §56-5-6240 of the South Carolina Code of Laws requiring confiscation of vehicles of individuals with four or more convictions for DUI or driving under suspension (DUS).

The Department of Public Safety should develop a record-keeping system for tracking the number of vehicles confiscated and the disposition of these vehicles.

The General Assembly should consider implementing a pilot project to allow law enforcement agencies to contract with private entities to seize the license tags of individuals who have failed to provide proof of insurance.

The General Assembly should consider amending §56-5-6240 and §56-10-270 of the South Carolina Code of Laws to allow for confiscation of vehicles of motorists convicted three or more times for driving without insurance, driving under the influence, or driving under suspension.

The Department of Public Safety should consider re-instituting a sampling program of vehicle registrations. This sampling should target motorists that are likely to be uninsured.

The General Assembly should consider enacting legislation to implement a graduated licensing system in South Carolina.

The General Assembly should consider amending §56-1-40 of the South Carolina Code of Laws to make 16 the minimum age for obtaining a restricted driver's license.

The General Assembly should consider enacting a "zero tolerance" law for underage drinkers.

The General Assembly should consider amending §56-5-2950 of the South Carolina Code of Laws to provide that an individual with a blood alcohol content of .10 or more is deemed to be driving while intoxicated.

The General Assembly should consider enacting legislation to provide for the administrative suspension of drivers' licenses for drivers with a blood alcohol concentration at or above the legal limit.

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# Appendices

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**Appendices**

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# Audit Objectives, Scope and Methodology

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## Audit Objectives

Members of the General Assembly asked us to conduct a review of the South Carolina Reinsurance Facility. They were concerned about the rising recoupment fees and factors affecting insurance premiums charged to South Carolina motorists. We conducted survey work and met with the primary audit requestor to better define the objectives of this audit.

Our objectives, with reference to discussion of our findings, are listed as follows:

- Determine the advantages and disadvantages of an assigned risk plan (see p. 2).
- Determine the reasons the reinsurance facility was created in 1974 (see p. 3).
- Determine if rate regulation in southeastern states restricts insurance companies from charging rates based on drivers' risks (see p. 9).
- Determine the reasons the facility does not receive investment income (see p. 15).
- Determine the amount of losses incurred by the facility since recoupment laws were enacted, the amount of losses paid by recoupment and deficits created by under recoupment (see p. 17).
- Determine whether there are loopholes used by South Carolina drivers to avoid paying recoupment fees (see p. 18).
- Determine the incentives designated carriers have to reduce claims to the facility (see p. 21).
- Review staff oversight of claims and underwriting to the facility (see p. 24).
- Determine the continued need for designated agents (see p. 26).
- Review South Carolina policy and statutes concerning unsafe and/or uninsured drivers and enforcement of these statutes (see p. 35).

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## Scope and Methodology

This audit focuses on state laws, regulations, and policies governing the automobile insurance industry in South Carolina. To conduct this audit, we examined state laws and regulations governing the manner in which insurance rates are established. We also reviewed laws governing the South Carolina Reinsurance Facility. In addition, we reviewed laws governing the enforcement of compulsory insurance in South Carolina. We compared South Carolina's system for regulating automobile insurance to systems used by other states.

We examined the reinsurance facility's records concerning ceded policies. We also reviewed audits conducted by the reinsurance facility on paid claims, and the facility's system for verifying the accuracy of insurance information it obtains. We reviewed the facility's audits of premiums paid by companies ceding policies to the reinsurance facility. We reviewed facility records on designated agents and financial records concerning losses and expenses that are paid with recoupment fees. We reviewed the system used to calculate recoupment fees.

We reviewed information on traffic tickets issued by state and local law enforcement agencies. We contacted law enforcement organizations to determine if automobiles were confiscated as required.

We interviewed officials of the South Carolina Department of Insurance, the South Carolina Reinsurance Facility, the Department of Public Safety, and government officials from other states.

To achieve some of our objectives, we relied on computer-generated data maintained by the reinsurance facility. These data were processed by AIPSO, an organization under contract with the reinsurance facility to process insurance data for companies conducting business in South Carolina and other states. AIPSO is located in Rhode Island. We have not tested these data to determine their reliability. However, when these data are viewed in context with other relevant data, we believe that the opinions, recommendations, and conclusions in this report are valid.

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

# Why the Recoupment Formula Does Not Allow All Losses to be Collected

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Section 38-77-600 of the South Carolina Code of Laws requires the reinsurance facility to collect recoupment fees each year to pay for losses incurred by the facility in the previous year. However, as described below, state law prevents the facility from recouping all losses. The following explains how recoupment fees were established for bodily injury losses in 1994.

- A. In 1994, the facility's losses for bodily injuries were \$181,678,621.
- B. State law requires the reinsurance facility to divide losses by the total number of drivers ( $\$181,678,621 \div 2,259,466$  drivers). This provides an average recoupment per driver of \$80.41.
- C. Section 37-77-600 requires that recoupment fees vary per driver depending on their driving record:
  - Drivers with no recoupment points pay 38.6% of the average recoupment; to determine their fee, \$80.41 is multiplied by 38.6%, resulting in a recoupment fee of \$31.04.
  - Drivers with points pay the remaining 61.4% of the recoupment needed. Their fees vary based on the number of recoupment points they have been assessed.
- D. Because there were 1,927,209 drivers with no points, it is expected that \$59,820,567 will be collected ( $1,927,209 \times \$31.04$ ).
- E. The 332,217 drivers with recoupment points were required to pay 61.4% of the facility's losses, which totaled \$111,550,673 ( $\$181,678,621 \times 61.4\%$ ).

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Appendix B  
Why the Recoupment Formula Does Not Allow All Losses to be Collected

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F. The shortfall caused by the flaw in the formula can be calculated as follows:

1994 Reinsurance Facility Bodily Injury Losses	(\$181,678,621)
Total Amount Collected from Drivers with no Points	\$59,820,567
Total Amount Collected from Drivers with Points	\$111,550,673
<b>TOTAL Shortfall Due to a Flaw in the Recoupment Formula</b>	<b>(\$10,307,381)</b>

To correct this flaw, the formula could be changed to require drivers with no points to pay 38.6% of the recoupment needed ( $\$181,678,621 \times 38.6\% = \$70,127,948$ ). However, this change would require drivers with no points to pay higher recoupment fees. As an alternative, drivers with points could be required to pay higher fees. However, since drivers with points (15% of all drivers) already pay the majority of recoupment fees (61.4%), they might choose not to pay the additional fees and illegally drive without insurance.

# Agency Comments

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**Agency Comments**

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## **South Carolina Reinsurance Facility**

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D A GAY  
General Manager

P.O. Box 40 ■ West Columbia, SC 29171-0040  
(803) 791-5258

January 27, 1997

HAND DELIVERED

Mr. George L. Schroeder, Director  
Legislative Audit Council  
400 Gervais Street  
Columbia, SC 29201

RE: Legislative Audit Council Final Report: Auto Insurance in South Carolina

Dear Mr. Schroeder:

This letter will acknowledge receipt, on behalf of the South Carolina Reinsurance Facility Governing Board, of the final draft of the Legislative Audit Report referenced above.

Once again, we thank you and your staff for your diligent efforts in attempting to define and offer potential solutions for the auto insurance issues existing in the South Carolina marketplace.

In accordance with your request, we are enclosing our comments relative to the final Legislative Audit Council Report.

Please do not hesitate to contact me should you have any questions concerning our response.

Very truly yours,

D. A. Gay  
General Manager

DAG:kap  
Enclosure

cc: Mr. Lee P. Jedziniak, Chairman  
S. C. Reinsurance Facility Board of Governors

Mr. Phillip E. Love, Jr., Vice-Chairman  
S. C. Reinsurance Facility Board of Governors

## APPENDIX C

### SOUTH CAROLINA REINSURANCE FACILITY COMMENTS

**CHAPTER 1 - HOW DRIVERS IN THE RESIDUAL MARKET BUY INSURANCE IN SOUTH CAROLINA AND OTHER STATES. Pages 1-2 "What is the Residual Market?"**

**CHAPTER 2 - WHY SOUTH CAROLINA'S REINSURANCE FACILITY IS LARGE AND WHY IT LOSES MONEY. Pages 7-8, "Largest Residual Market in the United States"**

The generic definition of "residual market" as used in this Chapter is synonymous with "residual market mechanism" and does not necessarily equate with a true "residual market" in terms of risk population in South Carolina. The unique set of laws existing in South Carolina lumps the "nonstandard market" together with the "residual market" so that the size of the "residual market mechanism" is inflated.

Most states offer insurance companies the option of insuring less desirable "nonstandard" business at higher premiums which are less than those charged by the residual market mechanism. If the population of the "residual market mechanism" in other states were combined with the nonstandard market risks voluntarily written at higher than standard rates, the total segment of the market insured by both means would approximate the size of the Facility in South Carolina. The inflexible rating and underwriting system which prevails in South Carolina, however, provides insurance companies with only two choices: retain the business voluntarily at standard rates or cede the risk to the Facility at inadequate premium.

For this reason, a meaningful comparison between the population of the Facility with those residual market mechanisms of other states begs the question. Underwriting and rating flexibility designed to allow insurers to appropriately price business according to legitimate risk potential would result in creation of new voluntary markets which would depopulate the Facility or other residual market mechanism.

**CHAPTER 1 - HOW DRIVERS IN THE RESIDUAL MARKET BUY INSURANCE IN SOUTH CAROLINA AND OTHER STATES. Page 2 "Three types of Residual Market Systems"**

In describing an "Assigned Risk Plan", the Report omits reference to Plans utilizing servicing carriers and relies singularly on plans assigning drivers to specific insurance companies. Many commercial "Assigned Risk Plans" utilize servicing carriers to handle assigned risks. For example, the South Carolina Commercial Automobile Insurance Plan operating currently in South Carolina as well as similar plans operating in other states utilize servicing carriers.

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Many of the criticisms of the Assigned Risk Plan in place prior to 1974, which utilized a direct assignment system, related to service problems and significant inequities attributable to direct assignments. Many of these problems could have been eliminated by uniform treatment of risks placed in the residual market through a servicing carrier(s). Without suggesting a result, we believe the Report should at least consider the use of servicing carriers as a means of handling assigned risks and discuss the relative merits or demerits of the two systems. In a constricted market such as South Carolina, direct assignments may produce an unwanted, anti-competitive effect by discouraging market re-entry of nonstandard or voluntary carriers.

**CHAPTER 1 - HOW DRIVERS IN THE RESIDUAL MARKET BUY INSURANCE IN SOUTH CAROLINA AND OTHER STATES. Page 5 "Two Types of Insurance Agents and Companies in South Carolina"**

The Report erroneously states that the Facility determines the "number" and "location" of designated agents. In fact, the Facility determines only whether an applicant meets the statutorily enumerated eligibility criteria. It has no control over the number of qualifying applicants. A designated agent's location is set as that location the agent occupied prior to his application. Only changes in location after appointment are to be approved by the Facility.

**CHAPTER 2 - WHY SOUTH CAROLINA'S REINSURANCE FACILITY IS LARGE AND WHY IT LOSES MONEY. Page 14 "Inadequate Incentives to Minimize Claims"**

**CHAPTER 3 - HOW MANAGEMENT OF THE REINSURANCE FACILITY HAS CONTRIBUTED TO ITS HIGH LOSSES. Page 22 "The Reinsurance Facility has not implemented a system to reward companies for controlling claims costs"**

The Facility shares the Report's concern that payments to servicing carriers based upon a percentage of claims paid may produce a financial incentive for claim overpayment. It is for this very reason that the claims activities of servicing carriers are under constant scrutiny. Thus far, Facility management has found no evidence of claim overpayments or improper claims handling by the servicing carriers that would support any conclusion that a financial incentive is producing any claim overpayments by designated carriers.

The language of the Report at page 22, that "[c]laims paid by designated companies have been higher than claims paid on policies ceded by voluntary companies," implies that the absence of a financial incentive for designated companies to control claims costs has produced higher claim payments and losses. This is simply not true. *To the contrary, the average payment by designated companies were lower, not higher, than the average claim*

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*payment made by voluntary carriers during the FY 94-95.* The "South Carolina Reinsurance Facility Claims Summary Report, FY 94-95," a copy of which was provided to the Legislative Audit Council, yields the following comparative claims payment data:

**AVERAGE PER CLAIM COST BY COVERAGE (FY 94-95)**

Type of Carrier (Reporting Method)	BI Claims	PD Claims	Collision	Other
<b>VOLUNTARY CARRIERS</b>				
(a) By Claimant	\$ 8,015	\$ 1,952	\$ 2,506	\$ 923
(b) By Accident	\$ 6,378	\$ 1,892	\$ 2,193	\$ 667
<b>DESIGNATED CARRIERS</b>				
(a) By Claimant	\$ 5,216	\$ 1,830	\$ 2,175	\$ 680
<b>DESIGNATED AND VOLUNTARY CARRIERS COMBINED</b>	\$ 5,821	\$ 1,870	\$ 2,200	\$ 689

As the Report correctly notes, voluntary companies ceding policies to the Facility have no financial incentive to overpay claims. Because designated companies actually pay less per claim than voluntary companies on ceded business, it would be erroneous to infer from the higher combined loss ratios cited in the Report that claim overpayments are occurring. Rather, it is the higher incidence of accidents and claims involving designated insureds that is the reason for the higher loss ratios on designated business. For example, with respect to bodily injury claims in FY 94-95, whether considered by claimant or per accident, 54% of the total reported claims came from insureds written by servicing carriers. This fact is even more remarkable when considering that more than two-thirds of the risks ceded to the Facility during the period were produced by voluntary companies.

Finally, the Report overlooks the role of the claims audit in policing claims payments and serving as a disincentive for claims overpayment. Servicing carriers are subjected to annual claims audits. The standards imposed upon servicing carriers by the Facility for claims purposes are at least equal to, and most probably stricter, than the claims standards imposed by voluntary carriers on their retained business. The reports of all claims audits for both voluntary and designated carriers were made available to the LAC staff and demonstrate that there is no appreciable difference in the handling of designated versus voluntary claims. There is no evidence that designated claims are routinely overpaid or handled differently than voluntary claims.

**CHAPTER 2 - WHY SOUTH CAROLINA'S REINSURANCE FACILITY IS LARGE AND WHY IT LOSES MONEY. Page 15, "Individuals Who Drive Without Insurance" and Page 18, "Illegal Actions Used to Avoid Recoupment Fees"**

**CHAPTER 4 - WAYS TO IMPROVE ENFORCEMENT OF INSURANCE LAWS AND INCREASE TRAFFIC SAFETY. Page 35, "Uninsured Motorists"**

The Facility agrees with the Report's observations that large numbers of drivers are increasingly operating uninsured motor vehicles. Since 1974, insurance companies have collected a \$1 fee from every vehicle insured and transferred these funds to the DPS or its predecessor agency. These funds, which total more than \$40 million since 1974, were earmarked for enforcement of the compulsory insurance provision of the law. We have seen little evidence that these funds have been used as directed. We are unaware of any accounting that has ever been made to assure how these funds have been spent or to judge the efficacy of the expenditures to achieve enforcement. The Report fails to address these issues and misses an opportunity to evaluate DPS's use, if any, of these earmarked funds.

**CHAPTER 2 - WHY SOUTH CAROLINA'S REINSURANCE FACILITY IS LARGE AND WHY IT LOSES MONEY. Page 14 "Commissions Paid to Agents on Recoupment Fees"**

We agree with the Report's conclusion that if recoupment fees were not considered "premium" for purposes of calculating commissions, substantial savings on recoupment fees could be effected. However, it is unfair not to recognize the initial reason for the treatment of recoupment fees as "premium" for purposes of commissions and taxes. In 1987, when the statutory provision for recoupment fees was adopted, there was a corresponding, mandated reduction in premiums to remove the rating load for past Facility assessments. See Act No. 166 of 1987, Section 6 and SCID Bulletin 4-87 (June 12, 1987). The shift of prospective premiums from the base rate to a retrospective recoupment fee was thought by the legislature to justify the continued treatment of recoupment fees as premiums. The Report does not address this legislative basis for providing for commissions and taxes on recoupment collections.

Additional savings could also be effected if recoupment fees were not considered "premium" for purposes of premium taxes. It seems unfair to treat recoupment fees, which are in essence the shortfall in premium adequacy, as premium for one purpose and not the other.

**CHAPTER 3 - HOW MANAGEMENT OF THE REINSURANCE FACILITY HAS CONTRIBUTED TO ITS HIGH LOSSES. Page 22 "The reinsurance facility has not implemented a system to reward companies for controlling claims costs"**

The Facility has repeatedly examined proposed systems which would provide financial incentives to servicing carriers for controlling claim costs, only to conclude that there exists no logical or equitable basis for establishing or applying such incentives. One servicing

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carrier's book of business may differ materially from that of another, thus making uniform incentive criteria based on loss ratios impossible to establish. The 1991 subcommittee studying the matter was unable to reach a conclusion on this issue. The Bid Committee appointed by the Chief Insurance Commissioner also struggled with this question without any success. Finally, the servicing carrier bids under the State Procurement Process have locked the Facility into the present compensation system for a five year contract period.

Nonetheless, the effect of the bidding process has produced a substantial savings on the amounts paid in fees to servicing carriers, without increasing average claims payouts. The primary control on claims costs appropriately remains the claims audit process.

**CHAPTER 3 - HOW MANAGEMENT OF THE REINSURANCE FACILITY HAS CONTRIBUTED TO ITS HIGH LOSSES. Page 22 "Bid Process Implemented in 1994"**

The Report states that, in certain instances, voluntary company expenses are reimbursed at a higher rate than payments to designated companies. This observation is erroneous since the percentage of written premiums expense allowance reimbursed to voluntary companies consists of all underwriting and claims expenses, including allocated loss adjustment expenses. Servicing carriers, in addition to reimbursement of expenses at the bid percentage rates, are also reimbursed the actual dollar value of allocated loss adjustment expenses.

Voluntary carriers are reimbursed at a rate equal to the percentage of written premiums reflected by the carrier's actual expense component for its voluntary, retained business, not to exceed the calculated industry average expense component. It is unfair to suggest that neither the Facility nor anyone else analyzes the expense component of voluntary carriers to determine whether the expense reimbursement is excessive or can be reduced. A voluntary carrier's expense component is subjected to rigid scrutiny by the South Carolina Insurance Department in determining whether to approve the expense component of the carrier's rate filing. In no event is any voluntary carrier reimbursed any expenses in excess of that anticipated by its filed expense load, capped by the all-industry average expense load.

**CHAPTER 3 - HOW MANAGEMENT OF THE REINSURANCE FACILITY HAS CONTRIBUTED TO ITS HIGH LOSSES. Page 23 "Size of Claims Staff"**

Facility reviews of claims operations focus on two criteria: (1) the quality of the work product; and (2) the span of control by supervisory staff. The Facility does not micro-manage a company's claims staffing decisions. So long as these two requirements are met, no further inquiry into the efficacy of a company's claims staff should be required.

We take issue with the statement that "audit procedures have not been developed to examine the adequacy of claims staff." The entire claims audit process is designed to determine

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whether claims handling by both voluntary and servicing carriers is adequate and within industry standards. The Facility's Claims Handling Guidelines represent standards at least equal to, if not in fact higher, than those standards necessary to assure quality claims handling. In the final analysis, the level of experience or expertise of a claims staff is best judged by the quality of its claims handling. These claims audits are used to determine whether the company's claims process is deficient.

**CHAPTER 3 - HOW MANAGEMENT OF THE REINSURANCE FACILITY HAS CONTRIBUTED TO ITS HIGH LOSSES. Page 24 "Ineligible Claim Paid by Facility"**

The Report unduly criticizes the results of a contested appeal involving a singular loss, suggesting that the loss should not have been borne by the Facility or passed to other commercial automobile insurance risks through increased premiums.

First, the cited case was extremely complex and involved equities not discussed by the Report. The claim itself was not "ineligible"; rather, the policy form used to write the risk was incorrect. The specific risk was written on a "garage policy" form when a "commercial auto" form should have been used. However, the loss would have been payable regardless of the policy form used.

Second, the specific risk in the example had been erroneously written on a "garage" policy form because the policy application misrepresented that the risk had no salvage operations. The servicing carrier's treatment of the risk and choice of policy form was correct, based upon the application information. However, investigation revealed that the servicing carrier had no knowledge of the misrepresentation at the time it issued the policy and the servicing carrier is not implicated in the fraud. Administrative proceedings have been instituted involving this case and are presently pending a hearing before the Governing Board. It would be inappropriate to comment further given its present posture.

The May 1996 policy change referred to by the Report represented a position statement that a risk written improperly on a garage form that was otherwise a "mandated" risk eligible to be written on a commercial auto form should be reimbursed only to the extent reimbursement would be allowed if the risk were properly written on the correct form.

**CHAPTER 3 - HOW MANAGEMENT OF THE REINSURANCE FACILITY HAS CONTRIBUTED TO ITS HIGH LOSSES. Page 25 "No Reimbursement or Penalty Required for Premium Undercharges"**

The calculation of premium charges often involves the discretionary exercise of underwriting judgment in the application of manual rules and secondary rating characteristics. We agree that premium undercharges produce lost revenues which might otherwise offset losses.

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However, the purpose of underwriting audits is to encourage consistent application of manual rules so as to assure standard pricing practices. It is unreasonable to expect zero tolerance for errors given the subjective element inherent in the underwriting process. The undercharges cited in the Report lack materiality, do not substantially impact operating results and represent only a minor portion of the total premium collected. The undercharges detected in the private passenger premium audits during the period January, 1994 to March, 1996 represent only 0.003 of 1% of the premiums collected during the period. The undercharges detected in the commercial premium audits during the same period represent only 0.249 of 1% of the premiums collected during the period. In combination, the undercharges represent only 0.023 of 1% of all premiums collected.

**CHAPTER 3 - HOW MANAGEMENT OF THE REINSURANCE FACILITY HAS CONTRIBUTED TO ITS HIGH LOSSES. Pages 26-28 "History of Designated Agents" and "Market Access"**

Except in cases involving applications for Limited Private Passenger Only ("LPPO") designations after 1990, the Facility is not authorized by law to give any consideration to market accessibility in the appointment of designated agents.

As to LPPO designations, the Facility accepts as justified the Report's criticism that adequate criteria for determining the sufficiency of "market outlets" is not consistently evident in its consideration of previous applications for limited designated status. This inconsistency, however, was not the result of the Governing Board's failure to develop criteria for measuring market accessibility; rather, the inconsistent results stem from a division of opinion among Board members as to whether the lack of "market outlets" should be viewed from an insured's perspective or from the perspective of the displaced agent. On November 6, 1996, the Governing Board established a policy that the adequacy and accessibility of "market outlets" should be viewed from the insured's perspective. Accordingly, the criticism noted in the Report has already been rectified and uniform application of this criteria is expected in the future.

**CHAPTER 3 - HOW MANAGEMENT OF THE REINSURANCE FACILITY HAS CONTRIBUTED TO ITS HIGH LOSSES. Page 29 "Agents Designated After They Were Terminated by Voluntary Companies"**

State law, as supported by judicial decision, legislative history and administrative interpretation, does not permit the Facility to disqualify an applicant for "full" designation based upon the unprofitability of an applicant's book of business while a voluntary agent or the existence of other market outlets in the area of the applicant's business location. See Mungo v. Smith, 289 S.C. 560, 347 S.E.2d 514 (1986)(holding that the Facility has no authority to limit the application of Section 38-77-590 to only applicants demonstrating "want

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of access" in particular areas when the agent demonstrates an alternative statutory basis as having lost his agency contract with insurance companies by reason of the Insurance Reform Act). See also Act No. 166 of 1987, SECTION 28 (amending Act No. 1177 to eliminate an agent's termination for unprofitability as a disqualification for appointment) and S.C. Ins. Dept. Bulletin No. 5-87 (August 7, 1987) at pages 15-16 (interpreting Act No. 166, SECTION 28 to remove unprofitability as a basis for disqualification as a designated agent and limiting the disqualification to only "illegal" breaches of the agency contract).

Whatever may be the wisdom of the Report's observations concerning appointment of agents terminated because of high loss ratios or in areas serviced by other agencies, the Facility is not empowered by law to apply a disqualification contrary to legislative, judicial and administrative directives.

**CHAPTER 3 - HOW MANAGEMENT OF THE REINSURANCE FACILITY HAS CONTRIBUTED TO ITS HIGH LOSSES. Page 30, "Transfer of Designation"**

The Report makes no observations and draws no conclusions as to the transfer of designation other than cite two examples: the adoption of a 70 year old agent by a 35 year old man and the 1986 transfer of designation from an agent convicting of defrauding the federal government. The description of these events should be modified as follows.

As to the adoption situation, the Facility's Governing Board, after a contested hearing, denied the transfer based upon the adoption. The matter has been appealed by the designated agent to the Circuit Court and is pending resolution there of the legal questions involved. The Governing Board in its opinion took the position that an adult adoption as a means of acquiring a designation was not authorized by the statute.

As to the 1986 transfer by the convicted felon, the Facility staff has instituted an administrative hearing before the Governing Board for the agent's wife to show cause why the designation should not be revoked. The basis of the hearing is staff's claim that the former agent has not maintained his agreement to disassociate himself from the business. The action is pending and further comment would be inappropriate.

**CHAPTER 3 - HOW MANAGEMENT OF THE REINSURANCE FACILITY HAS CONTRIBUTED TO ITS HIGH LOSSES. Page 31, "Few women and minorities are designated agents"**

It is difficult to understand how or why these comments relate to a reduction in Facility losses, particularly since the preceding pages are directed to criticism of the Facility's appointing agents at all. Assuming, however, these comments are relevant to reduction of losses, the following response is warranted.

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No applicant representing any identifiable minority group meeting the statutory criteria of Section 38-77-590(c) has been declined appointment as a designated agent by the Facility. There are no laws restricting appointment of minorities as designated agents and the Facility is not responsible for legislative changes in the qualification criteria and the timing of applications by minority applicants. To the contrary, there are a number of minorities serving as designated agents at the present time.

In 1987, the legislature provided a three-year window of opportunity for minorities to apply for designation with a waiver of the requirement that the applicant be the owner and principal of an agency licensed to write and writing property and casualty insurance. See Act No. 166 of 1987, Section 29. Legislative history reveals this provision, which was added by the Conference Committee, was designed to relax the requirements for designation so minorities who had served as licensed agents but who were not otherwise the owner or principals in the licensed agency could qualify for appointment. Appropriate publicity was given to this provision in two Department Bulletins: S.C.I.D. Bulletin 4-87 (June 12, 1987) and again in S.C.I.D. Bulletin 5-87 (August 7, 1987). During the three year period, no minorities or other persons either applied for designation or sought application of the waiver.

The Facility rejects as unfounded any implication that it is responsible for any discriminatory application of the law. To the contrary, it has consistently applied the statutory eligibility criteria even-handedly, without reference to the applicant's gender or race. The Facility is fully aware of, and faithful to, its moral and legal obligations in this regard.

**CHAPTER 3 - HOW MANAGEMENT OF THE REINSURANCE FACILITY HAS CONTRIBUTED TO ITS HIGH LOSSES. Page 33, "Verification of Data on Ceded Policies"**

All financial data and reports submitted by member companies are subject to validation and verification by AIPSO, the Facility's central processor. Financial data is verified in three different ways.

First, AIPSO reconciles financial data on policies as reported by member companies with financial data reported by the member companies on their Annual Statements as filed under oath and with independent certifications with the Insurance Department.

Second, AIPSO performs "reasonability" checks on all member company's quarterly reports of data to the Facility. Current quarterly report data is compared with data reported during prior quarters to identify any statistically significant deviation in data reported. When an anomaly appears, the member company is contacted and required to verify the data submitted or to provide an appropriate data correction.

Third, AIPSO compares member company quarterly reports of data on ceded policies with actual ceded data reported monthly. Any difference in quarterly reported data from monthly

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cession reports is questioned and independent verification is obtained to support the data reported or the member company must submit a data correction.

In combination, these three validation and verification measures provide a reasonable, sufficient basis for verifying financial data on ceded policies.





# South Carolina Department of Insurance

1612 Marion Street  
Columbia, South Carolina 29201

Mailing Address:  
P. O. Box 100105, Columbia, S.C. 29202-3105  
Telephone: (803)737-6160

DAVID M. BEASLEY  
GOVERNOR

LEE P. JEDZINIAK  
DIRECTOR OF INSURANCE

January 28, 1997

## Hand-Delivered

The Honorable George L. Schroeder  
Director  
State of South Carolina  
Legislative Audit Council  
400 Gervais Street  
Columbia, South Carolina 29201

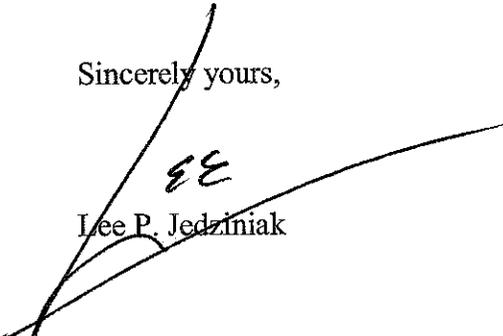
Dear George:

The State of South Carolina Department of Insurance has received and reviewed the Legislative Audit Council's Auto Insurance in South Carolina Report to this State's General Assembly. The Department of Insurance believes that any such well-intentioned recommendations and findings can only benefit the public of this State, and, therefore, welcomes any recommendations concerning the operations of the South Carolina Reinsurance Facility.

The Department of Insurance also commends you and your staff for your efforts and your ability to translate complex insurance issues into an understandable Report. Please be assured that, as the Legislature begins to review or to implement your recommended changes, the Department of Insurance will continue to assist in any way.

Naturally, if you have any further questions or comments in this matter or, as always, if I can help you in any way, then let me know. My office telephone number is (803) 737-6212. My office telecopier facsimile transmission number is (803) 737-6229.

Sincerely yours,

  
Lee P. Jedziniak

LPJ:pe





# South Carolina Department of Public Safety

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Office of the Director

January 27, 1997

Mr. George H, Schroder, Director  
Legislative Audit Council  
400 Gervais Street  
Columbia, South Carolina 29201

Dear Mr. Schroder:

Thank you for the opportunity to respond to the LAC Recommendations related to the review of automobile insurance in South Carolina. Attached are comments related to the specific recommendations that pertain to the Department of Public Safety.

Please let me know if you have questions regarding our comments or if you need additional information.

Sincerely,

William E. Gunn  
Interim Director

WEG/ibm

Enclosures

DEPARTMENT OF PUBLIC SAFETY  
RESPONSE TO LAC RECOMMENDATIONS  
JANUARY 27, 1997

*Recommendation:*

*The Highway Patrol and local law enforcement agencies should ensure that §56-7-12 and §56-1-80 of the South Carolina Code of Laws concerning proof of insurance are appropriately enforced.*

§56-7-12 states that a law enforcement officer who issues a traffic ticket for a moving violation may give the violator a form to verify liability coverage. The owner or operator must return the completed and verified form to the law enforcement agency that issued the form.

Any changes to §56-7-12 that requires the mandatory insurance of the insurance verification form would create an enormous problem on resources. Additionally, completion of this form on the roadside would increase the time spent exposed to traffic and the violator which is an officer safety issue. DPS does enforce verification of liability insurance through FR-10's whenever there is a traffic accident and conducts follow-up through the Administrative Enforcement Officers.

§56-1-80 was amended to delete the penalty for failure to return verification from the insurance company. Additionally, the amendment requires the customer to comply with the requirement at the time they visit a DMV branch office rather than sending a form by mail.

From a customer's point of view this creates frustration, additional trips to DMV offices, and longer DMV office lines. A number of states use self certification insurance coverage. Discussion with representatives from the S. C. Department of Insurance and the Insurance industry led DPS to the following developments:

- The redesign of driver's license renewal notice to include a reminder that a proof of insurance is required when renewing a license
- The redesign of driver's license application to include the insurance company name and policy number

- The development of a process to sample and verify insurance information. Those found not to be in compliance are to be penalized through the "falsification of affidavits" statutes.

**Recommendation:**

*State and local law enforcement agencies should comply with §56-5-6240 of the South Carolina Code of Laws requiring confiscation of vehicles of individuals with four or more convictions for DUS or DUI.*

*The Department of Public Safety should develop a record-keeping system for tracking the number of vehicles confiscated and the disposition of these vehicles.*

DPS concurs with this recommendation. Guidelines were sent out to DPS Troopers throughout the state in November 1996. A computer database system will be established to keep more formal records.

**Recommendation:**

*The General Assembly may wish to consider implementing a pilot project to allow law enforcement agencies to contract with private entities to seize the license tags of individuals who have failed to provide proof of insurance.*

DPS concurs with this recommendation. A quality team has been commissioned to develop this process.

**Recommendation:**

*The General Assembly may wish to consider amending §56-5-6240 and §56-10-270 of the South Carolina Code of Laws to allow for confiscation of vehicles of motorists convicted of third offense driving without insurance and for motorists convicted three or more times of driving under the influence or driving under suspension.*

DPS concurs with the recommendation.

**Recommendation:**

*The Department of Public Safety should consider re-instituting a sampling program of vehicle registrations. This sampling should target motorists that are likely to be uninsured.*

DPS concurs with this recommendation.

*Recommendation:*

*The General Assembly should consider enacting legislation to implement a graduated licensing system in South Carolina.*

DPS concurs that the concept of graduated licensing can be very effective. However, the structuring of components needs to be monitored carefully.

Presently, according to the American Association of Motor Vehicle Administrators (AAMVA), there is no state that has a comprehensive GDL system.

Eight states have three components of the GDL as outlined by the National Highway Traffic Safety Administration (NHTSA) and four, one being South Carolina, have two-tiered licensing. Currently, South Carolina has one of the highly recommended components of such a system, (nighttime driving restrictions).

*Recommendation:*

*The General Assembly may wish to amend §56-1-40 of the South Carolina Code of Laws to make 16 the minimum age for obtaining a restricted driver's license.*

DPS concurs with this recommendation.

*Recommendation:*

*The General Assembly may wish to consider enacting a "zero tolerance" law for underage drinkers.*

DPS concurs with this recommendation.

*Recommendation:*

*The General Assembly may wish to consider amending §56-5-2950 of the South Carolina Code of Laws to provide that an individual with a blood alcohol content of .10 or more is deemed to be driving while intoxicated.*

DPS concurs with this recommendation.

**Recommendation:**

*The General Assembly may wish to consider enacting legislation to provide for the administrative suspension of drivers' licenses for drivers with a blood alcohol concentration at or above the legal limit.*

Currently, South Carolina does not immediately confiscate the driver's license of an individual refusing to take a breathalyzer test. However, if a driver refuses, he/she is charged with implied consent and is automatically suspended for 90 days once law enforcement sends the refusal slip to the Driver Record unit of DMV. A regular class license is suspended for 90 days and a Commercial Driving license (CDL) is suspended for one year. The driver may still be charged with DUI after the initial suspension if convicted in court.

The administrative suspension of drivers' licenses may duplicate current practices and create additional administrative time.



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