AUTO INSURANCE REPORT

The Authority on Insuring Personal and Commercial Vehicles

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INSIDE

Conference Registrations On Record Pace (Again); Earlybird Discount Ends Soon

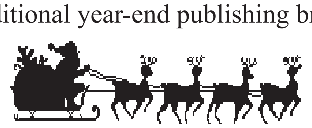
We already have more than 100 people signed up for the 2014 Auto Insurance Report National Conference, well ahead of last year's record pace that led to our 17th consecutive sellout. Also, the $100 earlybird discount ends on January 31. So if you want to attend, visit *www.riskinformation.com* and register soon. After the first of the year we will post the developing attendee list. AIR

AUTO INSURANCE REPORT

NATIONAL CONFERENCE 2013 · MAY 4 - 6 · THE RITZ-CARLTON, LAGUNA NIGUEL

Happy Holidays!

The next *Auto Insurance Report* will be published Jan. 13, 2014, following our traditional year-end publishing break.



What Doesn't Work: Consumer Federation Is Wrong; Prop. 103 Has Been a Disaster

Contrary to claims made in a recent report from the **Consumer Federation of America**, strict regulation of auto insurance prices in **California** has cost consumers billions of dollars since new rules were put in place in 1989. CFA argues that the regulations delivered more than $102 billion in savings through lower prices, but it fails to incorporate into its analysis the most basic data underlying all auto insurance pricing: claims costs.

An unprecedented decline in liability claims costs in the early 1990s – almost entirely unrelated to regulation – is the primary reason California insurance prices fell. While California regulation – in the form of mandated rate rollbacks – forced insurers to return that one-time bonanza to consumers right away, two decades of data across the United States show that when claims costs fall, prices follow regardless of regulatory structure.

Aside from that big rollback, close rate regulation has done nothing to save consumers money, but it's done a great job padding insurers' profits. California's regulatory structure has resulted in soaring auto insurance company profits by reducing price competition. If insurers had produced the same profit margins in California that they did in the rest of the country, the state's insurance prices would be even lower. Since 1989, insurers would have earned about $7 billion less in California, with all of that money resting in the pockets of consumers.

The CFA report, "What Works? A Review of Auto Insurance Rate Regulation in America," incorrectly credits California's decline in auto insurance costs with the 1988 passage of **Proposition 103**, a ballot initiative that brought strict regulation of insurance prices the next year.

California's average expenditure for personal auto fell from $747.97 in 1989 to $745.74 in 2010 (the most recent data available from the **National Association of Insurance**

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Commissioners). During the same period, the national average expenditure rose from $551.95 to $791.22. Though the 43% national increase is far short of the 76% rate of inflation during this time period, it still stands in stark contrast to California's decline. By extrapolating what Californians would have paid if their rates rose at the 43% national average, CFA calculates more than $102 billion in savings.

However, the relationship between falling insurance prices and increased regulation in California is a correlation without causation. The real reason for declining California costs is the decline in the state's personal auto liability claims. From 1989 to 2010, the 22-year period covered by the CFA report, California's paid losses for personal auto liability rose only 16.8%, or 0.76% a year, according to an *Auto Insurance Report* analysis of historical data generously shared with us by **A.M. Best & Co.**

> ***The primary reason California prices are lower is claims costs have fallen. Prop. 103 only forced the price cuts to happen sooner.***

For the rest of the United States (that is, the 51 U.S. markets minus California), liability claims paid rose 117.4% in the same time period, seven times faster than in California.

The remarkable change in California is most clear when you take inflation into account. Adjusted for inflation, California's liability claims paid have fallen $2.34 billion from 1989, an astounding 63% decline in constant dollars. Inflation-adjusted liability claims paid for the rest of the nation rose 23%.

If anyone deserves credit for the decline in auto insurance costs in California, it is the state's highest court. Almost all of California's deviation from the rest of the nation happened in the decade following the 1988 **California Supreme Court** decision in *Moradi-Shalal v. Fireman's Fund Insurance Cos.* That decision significantly restricted third-party bad faith claims in the state. The legal change dramatically altered the trajectory of underlying claims costs, which is and always has been the dominant factor in price.

In the first 10 years after *Moradi-Shalal* (1989-98), which is also the first decade after Prop. 103, California's paid liability losses fell 5.8%, compared to a 58% increase in the rest of the nation. That is a profound turnaround from the decade before (1979-88), when California's liability claims paid rose 258% compared to 166% for the rest of the nation.

As *Moradi-Shalal* became a permanent fixture in the market, it no longer influenced claims costs trends and California started looking more like the rest of the nation. In the 10 years from 1999 to 2008, California liability claims paid fell 29.4%, only slightly more the 28.1% decline in the rest of the nation.

Looking at average expenditure, CFA's preferred method of measuring the impact of an event on the market, proves the point further. In the first 10 years after *Moradi-Shalal*, California's average expenditure fell 5.3% from $747.97 to $708.61. During the same time period, the average U.S. premium rose 27% from $551.95 to $702.74. In the next 10 years (1998-2007), California's average expenditure rose 14.3% to $809.78, slightly more than the 13.6% increase for the rest of the country.

In each of these two 10-year periods, California differed profoundly in its relation to the national average. And yet, the regulatory regime was essentially unchanged. The reason for the big improvement since the enactment of Prop. 103 is not regulation, but rather the one-time change in the legal environment, which delivered almost all of its benefits to California consumers in the years after it happened and has since diminished into insignificance.

Total claims costs can be skewed by changes in the number of vehicles being insured, so we

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turned to the **U.S. Department of Transportation** for data on vehicle registrations, and here's what we found: When you consider the number of cars on the road, the claims data understates just how much claims costs have changed in California relative to the rest of the nation.

From 1989 to 2010, auto registrations in California rose a slight 1.5% to 17.98 million, while in the rest of the country registrations fell 9.9% to 130.89 million. All other things being equal, a rise in California vehicles relative to the rest of the nation should lead to a faster rise in claims costs. Just the opposite happened.

Fans of Prop. 103 have long discounted the argument that California's unique claims history is the reason for the falling prices.

The CFA report includes a lengthy discussion of the arguments by those, like us, who attribute the fall in prices to claims rather than regulation. But the report fails to look deeply enough to see the real trends as explained above.

J. Robert Hunter, director of insurance for CFA and the lead author of the report, told *Online Auto Insurance News*: "The insurance industry acts like these safety factors [such as DUI laws and airbags] only happened inside California. It's nonsense. And the regulatory arguments don't explain why there's been increases across the country. The data is the data."

Hunter is right in one respect: safety factors influencing claims costs happen the same way in California as everywhere else. The entire nation enjoyed a drop in claims costs due to less drunk driving, more restrictions on youthful drivers, the demographics of an aging baby boom, improved vehicle performance, etc. The numbers supporting this statement, in fact, are stunningly clear. Looking only at property damage claims, which strip out most of the impact of state court systems, California's incurred losses grew 98.624% from 1989 to 2010. In the United States, they rose 98.621%. We had to go to three decimals places to find a difference.

In paid claims the numbers are equally compelling. California physical damage claims paid rose 101.5% from 1989 to 2010, compared to 103.3% for the rest of the nation.

The CFA report argues correctly that *Moradi-Shalal* cannot explain everything. Comprehensive coverage, for example, is purely a first-party coverage, and as such it would not be impacted by *Moradi-Shalal's* restriction on third-party bad faith lawsuits. And yet California's average comprehensive premiums fell steadily while the national average rose steadily until 2004 – before falling along with California in recent years.

Again, we point out the correlation is not causation. The most likely explanation for California comprehensive premiums rising more slowly than the rest of the nation relates to the extraordinary run of weather events in the middle of the country over the past decade.

After a one-time decline in liability claims costs, California's prices and claims have moved in line with the rest of the nation.

The absence of hail, flood and hurricanes in California, as each of these perils becomes increasingly problematic for insurers elsewhere, is much more likely than regulation to explain the discrepancy. If regulation were the driving force, then why would the average increase in premiums for another first-party coverage, collision, be only modestly lower in California (43.6%) than in the rest of the country (47.1%) over the past 22 years? The reason is that relative to claims trends, regulation has had little to no impact on either of these coverages

Hunter is right that "the data is the data." But he and his CFA report co-authors failed to look closely enough at California liability claims data. California's unique legal environment drove down claims costs in a limited time frame, which kept insurance prices down. No other single fac-

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tor is even remotely close to having the same impact. Not accident rates. Not auto design. Not the economy. And certainly not regulation.

When profits represent 6.4% of premium over a decade, but claims consume 63% of premium, it doesn't take an actuary to realize claims are 10 times more important than profits in cost trends. Since Prop. 103 did very little to influence claims, how can these regulations be credited with a controlling influence over prices?

While discounting the impact of *Moradi-Shalal* – a seminal state Supreme Court decision that changed the face of California auto insurance – as a factor in the decline in auto insurance costs, the CFA report credits the power of Prop. 103 for lowering those same claims costs.

The report states: "Proposition 103 also created exceptional incentives for safe driving, incentives much greater than those that exist in any other state."

Prop. 103's provisions have had no measurable impact on claims costs – and they were not designed to do so.

A 20% discount for a clean driving record is one example. This does indeed put more weight on driving record as a factor in setting auto insurance prices, and it might, at the margin, influence a driver to avoid a moving violation. But this impacts consumers only to the extent that the regulation forces insurers to give this a greater weight than is actuarially justified. Consumers in every state know insurers surcharge for moving violations. We have seen no evidence suggesting California drivers are being more careful because of the actuarial machinations mandated by California regulation.

The same problem exists with CFA's argument that prohibiting the use of credit-based insurance scores increases driver safety. There is no evidence or logic to support this claim.

The only part of Prop. 103 that might have had a measurable impact on claims costs came from incentives for insurers to boost fraud-fighting efforts. We cannot quantify any real savings from Prop. 103's efforts in this regard, and insurers have never cited those incentives as a reason for increased spending on fraud fighting. But at least on paper, that is one part of the regulations truly aimed at reducing claims costs.

CFA also argues that Prop. 103 saves consumers money by limiting the expense ratio of insurance companies. That doesn't appear to be working. The simple expense ratio for personal auto insurance in the United States fell 0.4 points from 1996 (our oldest data) to 10.94% in 2012, according to data from **SNL Financial**. In California, the simple expense ratio rose 2.1 points during the same time period to 11.71%. In other words, California's expense ratio, once lower than the national average, is now both higher and headed in the wrong direction.

Comparing loss ratios from state to state can be a little tricky, since the expense ratio varies significantly based on the mix of insurers in a market. And that brings us to another of the unintended consequences of California's tighter regulatory structure: By limiting the tools insurers can bring to bear in pricing, the state has discouraged the most innovative insurers from aggressively competing for business in the nation's largest auto insurance market. **Geico** and **Progressive**, for example, two of the fastest growing insurers nationally due largely to lower-than-average prices, have significantly less market share in California than they do in the rest of the nation. A primary reason for the state's higher average expense ratio is the fact that these two insurers, with significantly lower expenses than their peers, are reluctant players in California.

Geico writes 5.8% of personal auto insurance premium in the California market, compared to 9.72% nationally. Progressive has 4.1% of California, compared to 8.4% nationally. These

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numbers refute CFA's suggestion that California is a more competitive market than the rest of the nation. The nation's most aggressive auto insurers are not aggressive in California.

CFA's arguments about the virtues of close rate regulation are partly based on the use of a **U.S. Department of Justice** measure of market competitiveness. The DOJ model is based on the Herfindahl-Hirshman Index (HHI), which will be familiar to many business school graduates. To perhaps oversimplify, HHI looks at the number of competitors in a market as a gauge of competition. CFA uses this to help prove that prior approval of rates leads to competition. To the uninitiated this might make sense, but anyone versed in state auto insurance markets (such as readers of *Auto Insurance Report*) will immediately see HHI is a naïve and flawed way to measure auto insurance market competitiveness.

The most competitive markets by HHI are in New England, where many small regional insurers sell through independent agents. While these are terrific companies, they have the highest selling costs in the nation, high expense ratios and lack the operating efficiencies of many of the larger insurers that deliver lower prices in most other markets.

HHI undoubtedly shows how many competitors there are and the degree of market concentration among the top players. But the presence of more competitors does not mean a market is more competitive. If 300 companies are standing still in one state, and in another state 100 companies are killing one another with improved product offerings, lower prices, service enhancements, etc., which market is better for consumers? Clearly, the market where competitors are more active is better for consumers. HHI is useful for some things, but it offers little to no value as a way to qualitatively measure whether a state is better or worse for insurance consumers.

While it is very significant, the modest participation of Geico and Progressive is not the only evidence of California's lack of price competition. The case against over-regulation is actually stronger than that.

Prop. 103 was designed to make it hard for insurance companies to take rate increases without close scrutiny. On that front it has been very successful. The campaign rhetoric for Prop. 103 took aim at purportedly excessive insurance company profits and promoted the idea that by limiting those profits insurance price increases could be kept in check.

What the authors of Prop. 103 could not have seen was that California claims costs were about to plummet. At first they plummeted both in total numbers and relative to the rest of the nation, either because of *Moradi-Shalal* or some other unforeseen force. Then, as the impact of this unique one-time event faded, California claims costs continued to fall along with claims costs in the rest of the nation.

> ***Prop. 103 was designed to make it hard to raise prices. The unintended consequence is that it is hard to lower prices as well.***

Poorly equipped to handle this change, California's regulatory structure has made matters worse for consumers. The rules not only make it hard to increase prices, they also unwittingly make it hard to reduce prices.

Insurers understood that if they asked for a big rate increase, the new system required a hearing that included not only the regulator, but third-party "intervenors" paid by the insurers to fight to keep prices down. Insurers were frustrated when Prop. 103 passed, but once the law was in place this was the process they expected.

At the time of passage, insurers feared California would turn into **New Jersey** or **Massachusetts**, where strict rate regulation kept insurers from charging enough to cover rising claims. Had claims had gone up, Prop. 103's scheme of

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making it hard to change prices would have successfully suppressed rates and lowered profits.

The real surprise came when claims continued to fall. Instead of asking for rate increases, insurers found their actuaries arguing for rate decreases. Presumably consumer advocates should be encouraging insurers that wanted to lower prices so they could win more customers. That's how you get a truly competitive market.

However, those insurers that took the first steps toward lower rates received quite a different reception at the Insurance Department and from intervenors. Ask for a 5% rate decrease and the regulator, sometimes along with intervenors, might demand a 10% decline. This came as a shock to the carriers, and it delivered a not unexpected, though certainly unintended outcome: no one asked to change rates, and profits grew.

> ***Insurers, unable to lower prices freely, have instead let profits rise above the national average ever since Prop. 103.***

This is exactly the wrong structure to deal with falling claims, and consumers have paid the price. On balance, insurers in California have kept prices stable even in the face of falling claims because regulation discourages them from lowering prices. There is also the fear that should you succeed in lowering prices, it would be difficult to bring them up if claims costs rise.

How can we say with such confidence that insurers are behaving differently? Because prior to Prop. 103, when insurers had more freedom in setting prices, they generated lower profit margins than they did after Prop. 103.

What is more, all of the large insurers operating in California also operate in other states, most of them across the entire nation. They keep their prices in California at a level that produces a higher profit than they earn in other states with less regulatory interference. In only three years since 1989 (2000-02) has the profit margin in California been below the national average.

We have been arguing this point for nearly two decades and would be happy to share with any reader a copy of our Sept. 12, 1994, issue, in which we first made this argument.

In that issue, we looked at the after-tax average profit margin for the four years prior to Prop. 103 (1985-88). In California, the average profit margin was 1.9%, while the national average was 3.9%. In the four years after Prop. 103 (1989-92), California's average profit margin was 8.8%, compared to the 6.9% national average.

If California auto insurers had merely earned the national average profit in the four years after 1988, consumers would have saved about $1.67 billion. If for some reason insurers continued their ruinous competition in the next four years (not likely, given falling claims), consumers would have saved $2.6 billion.

We have now conducted the exercise of calculating California's real profit compared to what would have been earned at the national average profit reaching back to 1989. Here is what we found: In the 23 years from 1989 to 2011, California's average personal auto profit margin was 8.7%. In the same time period, the U.S. average personal auto profit margin was 6.5%. (The total profit number was calculated by the NAIC until 1995, when it discontinued the calculation and *Auto Insurance Report* took up the task.)

Given California's $331 billion in premium earned during this period, the industry earned a profit of about $29 billion. But if price competition had been more aggressive, bringing California down to the national average profit margin of 6.5%, the total profit would have been about $22 billion. The difference of $7 billion would have belonged to consumers, while bonuses and profit sharing for insurance executive and employees, shareholder payouts, agent commissions, etc., would all be that much lower.

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A little bit more perspective: We ran each year's profit through the inflation calculator to get an understanding of the extra profits in 2013 dollars. The total was about $10 billion.

One of the conclusions of the CFA report is that other states should adopt California's regulatory structure, seeing it as a best practice. As it relates to consumers costs, it has done the exact opposite of what consumer advocates are seeking. If you want to lower auto insurance costs, California is not a model to follow in an environment where claims are falling, as they have been for years and seem set to continue going forward. (See AIR 8/26/13)

We don't mean to suggest that prices should not be regulated. There are many instances in which it is very important to do so. For example, **Florida's** economy could never handle an abrupt movement to purely market-based property insurance rates. As much of a mess as politicians have made of that market in the past two decades, left to their own devices insurers would have made things even worse by pushing up rates too far too fast.

And when Prop. 103 was first being considered, advocates of increased regulation were certainly on to something: auto insurers were charging too much. Depending on your perspective, insurers were either confused about dramatic changes in claims trends or they were taking advantage of weak regulation to gouge consumers.

Nationally, insurers were basing their prices on expected incurred loss ratios more than 10 points higher than the ultimate paid claims. In the decade leading up to Prop. 103 (1979-88), California's incurred loss ratio was 76.4%, but the paid loss ratio was 65.2%. In the rest of the country, the incurred loss ratio was 76.1%, and the paid was 65.4%.

In the decade that followed Prop. 103, the picture reversed, especially in California. Prop. 103 forced prices down, and paid and incurred loss ratios came into line. No can say for certain how long it would have taken California insurers to do this on their own; left to their own devices in other states that is what happened. But Prop. 103 was most certainly effective in making it happen right away.

California's incurred loss ratio for the first decade of Prop. 103 (1989-98) was 62.1%, and the paid loss ratio was higher at 64.1%. Nationally, the incurred loss ratio was 72.9% compared to the lower paid ratio of 67.3%. The gap between incurred and paid narrowed in the rest of the United States, but it did not reverse as in California.

Close regulation in the form of hundreds of millions of dollars of forced rebates and rate rollbacks helped consumers by forcing insurers to bring their California prices more closely in line with loss costs. The problem is the regulatory infrastructure stopped being useful once that was done and instead proved to be an impediment to lower prices for consumers. The author of Prop. 103, **Harvey Rosenfield**, once told us that the solution to this problem would be to force insurers once again to lower prices. That would work. But to do so the state would need to effectively set the prices for the marketplace. That has been tried elsewhere. It has always failed. When too much regulation distorts a market, the solution should not be even more regulation.

> ***Consumer advocates have been unable to lower prices, but they make a strong case for changing underwriting rules.***

Beyond rate regulation, Prop. 103 delivered a number of other changes. The law restricts the ways in which insurers may set prices for auto insurance, creating subsidies that lower costs for a number of consumer groups, such as those who live in cities, those who are irregularly insured, and those whose poor credit is predictive of auto insurance claiming behavior. Consumers who

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live in the suburbs (where claims costs are generally lower than in the cities), remain consistently insured (proven generally to make fewer claims than those who are inconsistently insured) and have superior credit ratings (proven generally to make fewer claims than those with poor credit), are all paying surcharges on their auto insurance as a result of Prop. 103.

This transferring of cost from one consumer to another is perfectly reasonable public policy, and it is perhaps the most important legacy of Prop. 103. Insurance is the business of sharing risk, and regulation has always sought to make public policy decisions on how best to share that risk. Whether or not insurers agree with these particular subsidies is not terribly relevant: California voters imposed them in 1988. When given the chance to change some of them, such as ballot challenges to the ban on prior insurance as a pricing tool, voters have affirmed their original decision. You may indulge your inner **Alexander Hamilton** and rail against the tyranny of the majority, but in that particular argument the winner is clear: majorities rule.

These subsidies do not substantially change the overall cost of insurance because they do not measurably change claiming behavior. They change the industry's operational efficiency and serve to reduce the level of competition. This has the effect of raising prices, but not nearly as much as changes to claiming behavior. They also have an impact on the ease of buying insurance for people in the subsidized group. If insurers make less money in the city than the suburbs, and cannot do anything about that, they work harder to sell in the suburbs than in the city.

The net effect of these underwriting and pricing rules is not substantially higher or lower overall costs, but rather a readjustment of who pays what.

If the advocates of Prop. 103 were to trumpet these public policy achievements as their primary legacy, we would be in full support. (See AIR 10/1/12. Subscribers can email us for a copy.) If these self-appointed consumer advocates gave up their fixation on price and focused instead on market conduct, underwriting rules and encouraging more competition, theirs might be a more appealing and successful enterprise. Californians seem to like their rules, or at least they don't dislike them enough to change them.

But trying to fabricate an argument that regulation reduces prices is another matter.

We appreciate CFA's desire to find statistical support for Prop. 103. After all, California's regulatory structure is the high watermark of achievement for a group of veteran consumer advocates. Not only have Prop. 103's advocates been unable to sell the California structure to other states over the past 25 years, they have also seen a number of states go the other way, adopting less stringent price regulation.

The Consumer Federation of America's numbers might be an interesting story for those who don't know better. But when the numbers are studied in greater detail it becomes clear that CFA's argument that strict price regulation saves money for consumers is simply not true. AIR

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