

RESTRICTED PRIVATE AUTONOMY AND DISCRIMINATION IN THE RATING, CLASSIFICATION AND UNDERWRITING OF AUTO INSURANCE IN AMERICA

by J. Robert Hunter

I am J. Robert Hunter. I currently serve as Director of Insurance for the Consumer Federation of America. I previously was Federal Insurance Administrator and Texas Commissioner of Insurance. I am an actuary and have worked as an actuary for insurance companies. My specialty is property/casualty insurance and particularly automobile insurance.

Insurance in America suffers from fundamental misconceptions that produce unfair results, particularly in rating and underwriting of auto insurance. You will recall that insurance was created by Phoenician ship owners who got together to spread the risk of ships sinking among themselves. What is today known as “the insurance company” is really the common fund created by the people. Indeed, the insurance company *is* the people.

The Phoenician’s, being shippers and therefore not much interested in record keeping, hired bookkeepers to keep track of the common fund. Just as the insurance company is the people, what we today call “the insurance company” is merely the accountant.

The system for rating and underwriting automobile insurance in America has serious deficiencies¹ due to the misunderstanding of the nature of insurance. Because of this, underwriting and rating conventions unfairly discriminate against many people as good drivers are “trapped” in classifications not representative of their individual risk or denied coverage for inappropriate reasons.

1 We must discuss both rating and underwriting together because one cannot remedy the rate problems without dealing with the underwriting problems at the same time.

The remedy for this requires government action because no insurance company can alone fix the problem because of adverse selection against any insurer out of the normal patterns of rating used by all carriers.

This discussion will give the background of auto insurance in America, followed by a discussion of the problems in underwriting and in rating of auto insurance and some of the better ideas to fix the system.

BACKGROUND OF AUTO INSURANCE IN AMERICA

Insurance in America is a necessity. Auto insurance is a particular necessity, in that each state requires purchase of insurance as a condition to drive a vehicle². Further, if the vehicle is financed, as the vast majority of autos are in America, the lender requires auto insurance to cover the collateral auto³.

Insurance companies are regulated by the individual states, not the federal government⁴. Because of the political might of insurance companies at the state level and the fact that most insurance commissioners come from the insurance industry and return to it after their regulatory effort ends, there is very weak consumer protection in place in our country.

This combination – required insurance and weak regulation – has led to serious problems in how auto insurance is marketed and rated.

2 Either directly through Mandatory Auto Laws or indirectly through Financial Responsibility Laws.

3 Indeed, if you lose your coverage the lender, through a process known as “Forced Order” will secure the policy for you at a very high cost (usually involving substantial kickbacks to the lender from the insurance company it uses in the Forced Order process).

4 The McCarran-Ferguson Act of 1945 delegated the authority to regulate to the states, with no oversight by the federal government and no standards for regulatory performance. The Act also largely exempted insurance from the application of anti-trust laws so cartel-like rating structures remain in place in America, even today. There is some movement to add a federal government aspect to insurance regulation in America because of the globalization of insurance, the entry of banks into insurance, the Internet’s impact and huge mergers of insurance companies.

While insurers were a tight cartel at one time, the advent of the direct writers with lower expense requirements forced the agency-based insurance companies to find new ways to avoid losing market share – by ever-tightening underwriting attempting to target “better” and “better” risks and by creating ever more refined insurance classifications. Of course, the direct writers maintained their premium advantage by following suit in making identical or similar underwriting and rating changes.

While insurance companies had historically engaged in a process known as “underwriting,” these new, more stringent underwriting approaches resulted in many people not being able to get insurance from normal channels for the first time.

Rivalry -- and I use the word “rivalry” here although insurance companies would call it “competition.” But they are inaccurate because they cannot compete on the pure premium (i.e. the part of the premium that is the contribution of the insured to the common fund), which is 60-70% of the premium. Competition does not impact driving accidents in any way and rivalry only shifts the loss payments from one company to another. So, rivalry in choosing risks who must have insurance leads to a dangerous anomaly, the more rivalry in the market, the fewer people get insurance the state compels them to have!⁵

As a result, states have created pools where the unwanted risks could get insurance. In auto insurance, the most typical approach is the “Assigned Risk Plan.”⁶ Under this plan, an unwanted risk is assigned randomly to an insurance company⁷ and written by that company at a very high charge. The premiums are pooled⁸ and losses are paid by the pooled funds. Unfortunately, the vast majority of persons in Assigned Risk Plans are “clean” risks, that is they have no record of claims or traffic tickets in the period used by insurance companies to determine driving record for rating purposes. This is

5 Not surprisingly, the first state to require auto insurance (New Hampshire) was also the first state to develop an assigned risk plan.

6 Other approaches include a Joint Underwriting Association (an insurer made up of all insurers in the state), a State Fund run by one state and the Reinsurance Facility approach. The latter approach is similar to that I propose later in this discussion.

7 The assignments are proportional to the writings of the insurance company to the total normal (“voluntary”) market premiums.

8 The servicing company keeps a substantial fee for this service.

directly due to so-called “competition by selection” engaged in by auto insurance companies.

A second major problem is the rating methods used by insurance companies. In the typical pattern of rating in the United States, the actuary sets the statewide premium first. Then, that premium is adjusted by data to set premium by region or what the American actuaries call “territories”. Then, within the territories, the premiums are adjusted up or down based upon such characteristics as how the car is used, make and model of car, the age and gender of the driver, use of the car (e.g. business or pleasure) and other factors based on driver and vehicle characteristics. American actuaries call these characteristics “classifications”.

Only after all of these territory and classification factors are derived and reflected in company manuals is the driving record even considered and reflected as a final step in the manual.

UNDERWRITING

In 1972, the Superintendent of Insurance for the State of New York said:

“Selection competition should have few admirers. It is capable of totally denying to some people the opportunity to buy insurance at all in a day when many forms of insurance have become legal and practical necessities.”⁹

Virtually no state has regulatory approval authority over the guidelines used by insurance companies to underwrite, that is decide whether to accept a risk or not. These underwriting guides are secret but we know that often they have abusive characteristics, such as income level, as components.

As one example, it is underwriting that has led to claims of “redlining” or refusing to write auto or other insurance because of where people live. Often these practices fall

9 Remarks of Benjamin R. Schenck, Superintendent of Insurance for the State of New York, October 9, 1972. Superintendent Schenck uses the industry term “competition” when rivalry is more accurate, but the point he makes is an important one.

particularly adversely upon inner-city residents, and most particularly upon blacks and other minorities. Lately both rating and underwriting have introduced the explicit use of credit reports, which discriminate further against the young, the poor and minorities¹⁰.

I have been involved in lawsuits over the last several years that have proven to juries that certain insurance companies have engaged in underwriting that amounted to racial redlining. Usually ZIP Codes (the mailing codes) are used for the redlining practice¹¹. Sometimes it goes down to neighborhood. One company even uses term like “white picket fence” to term a “good” neighborhood and “city ties” to term a “bad” neighborhood. The courts have levied penalties of millions of dollars on the offending insurance companies. Agreements to stop some (not all) of these practices have been agreed to by several of the largest insurance companies in the USA.

In auto insurance, underwriting selection pushes people into very high, unfairly rated insurance companies. As the U.S. Department of Transportation put it: “The change of an insured’s status from that of a ‘preferred risk’ to that of an undesirable or ‘high risk’ may be both precipitate and costly, as for example, when a youthful member of a family attains driving age or when a chargeable accident has been incurred.”¹²

Underwriting problems caused by selection are central to the rating problem. The fact is that, if one corrects the premium problem by regulation or statute, the insurance company can merely stop writing the formerly over-rated business. So, for example, if we decided to end the use of gender in auto insurance, then males would likely lose

10 Here’s how this works, using a real example. A woman filed for bankruptcy several years ago. The auto insurance company refuses to write her except through a very high rated affiliate because they believe that this shows higher risk. The fact that she did not go through with the bankruptcy and pulled herself out of it and became financially sound again the company says is irrelevant. They will not write her at their preferred rate.

11 Insurers guard their ZIP code data very carefully. They don’t want the public to see where they avoid writing insurance. When I was Texas Insurance commissioner, I took a busload of insurance company executives into ZIP Codes they would not write. They expressed amazement at the high quality of many homes in these ZIP Codes.

12 “Motor Vehicle Crash Losses and Their Compensation in the US”, U.S. Department of Transportation, 1971.

their normal insurance and have to go to the state high-risk pool (the “assigned risk plan”) or to a very high rated offshore insurance company (the “surplus lines market”).

So, in order to repair rating discrimination, we must repair the underwriting issue as well. Thus, government intervention is required to achieve fairness.

RATEMAKING

As a way to get into the rating part of this talk, let me tell you a story about an award dinner I attended when I served as Federal Insurance Administrator in the late 1970s. An auto insurance company had held safe driving tests around the country to try to identify what it termed to be “the 10 best teenage drivers in America.” After presenting the awards to the selected young men and women, the president of the insurer turned to me and asked me to say a few words.

I came up and simply asked the president, “Just how much would you charge these great young drivers for auto insurance in your company?” After an embarrassed silence he answered, “About three times the adult rate.”¹³

Auto insurance rates are often related to what appear to be non-risk related, immutable characteristics like age, gender, address, marital status and so forth. In America, as in Europe, we like to say you are “innocent until proven guilty.” But in the current rating system you are guilty, often forever. If you are young you are “guilty until proven older.” If you live in the wrong part of town you are “guilty until proven moved.” Single? “Guilty until proven married.”

This explains a key problem with auto insurance ratemaking in America. Rates are set based upon group averages, with minimal consideration of an individual’s qualities or detriments. The most careful drivers are often trapped into high rated classifications with no redress.

13 More even than an adult with a drunk driving conviction and accidents.

The mathematics of ratemaking are problematic. If one classification has one accident per 100 risks and another class has 2 per 100, the latter pays 100% more.¹⁴ No weight is given to the fact that the difference in frequency of accident between those drivers with no accidents in each class is only about one percent.

When rates are set the order of mathematical manipulation results in more statistical credit being given to where you live and other immutable characteristics than how you drive. An adult living in a rural area with drunk driving convictions can easily pay less than the ten “best drivers” can who happen to be young. If the order were simply reversed, studies show, the impact of territory would be reduced, the impact of driving record would be increased. Even the insurance company actuaries admit this would work, but they use this in only one state, where they were forced to adopt this minor improvement.

POSSIBLE SOLUTIONS

Consumer groups have long complained about the discriminatory effects of these underwriting and rating practices. In 1988, we supported the California Proposition 103 that would address the problems cited above. First, it required that insurers must give greatest weight to driving record, then miles driven, then years of experience, then everything else but it could have no more weight than the third factor.¹⁵

Second, Proposition 103 also mandated that good drivers be able to get insurance from the company the driver chose (i.e. no underwriting was allowed). Insurers have not been following this requirement and the state has done nothing to make them do so.

This combination of reforms would have one a long way to end the most serious discriminatory aspects of car insurance. The fact that the companies have kept these re-

14 Ignoring any differences in severity of accidents.

15 Although passed by the voters of California in 1988, the rating provisions have not yet been fully implemented because the insurance companies have kept them tied up in the courts with appeal after appeal as well as study after study by an Insurance Commissioner afraid of the political ramifications of fixing the system (rich people –who vote – would pay more if poor people – who don't vote – paid their fair share).

forms bottled up for more than a decade through court action and political pressure tactics show how strongly they cling to their practices of discrimination and their clout with the Insurance Department and the legislature and their cleverness in delaying things in the courts.

Our earliest ideas for reform were spelled out in a report I helped to author called “Full Insurance Availability,” a concept put forth by the Federal Insurance Administration in the 1970s¹⁶. Under this plan, insurance companies would write all applicants and cede (i.e. reinsure) the pure premium (the part of the rate available for covering claims) to a pool made up of all insurers. The insurers would retain the part of the premium they used for overhead expense and profit. Rivalry between insurance companies would no longer be focused upon avoiding any risk with any possible question marks. Rivalry would no longer be focused upon more and more classes of risk into which to place applicants. It would be focused on good service, low overhead cost and reasonable profit.¹⁷

This is the prime reason the contribution of insurance companies to the Gross National Product of the United States is measured as premiums less losses for auto and other property/casualty lines of insurance. The U.S. government recognizes that the losses are paid from a common fund and thus are a shift in dollars from consumers without claims to those with claims. There is no insurance “product” in any sense of the word and, thus, no “price” for it.

Full Insurance Availability would guarantee availability of required auto insurance to the consumer from the insurance company of the consumer’s choice. Insurance companies would be able to avoid any undue risk by ceding suspect risks to the pool without anyone knowing it except the company and the pool. If a claim occurred for a ceded risk, the pool would reimburse the insurer for the cost of that claim. If an insurer ceded too many good risks, that insurer would effectively subsidize the other insurance com-

16 *Full Insurance Availability*, Federal Insurance Administration, U.S. Department of Housing and Urban Development, September 1974.

17 Insurer rivalry can only impact overhead cost, not driving behavior. All of the insurance company rivalry possible to imagine would never stop even one auto accident from happening.

panies by contributing a lower than average loss ratio. If the pool lost money in the aggregate, that would be spread over all drivers.¹⁸

In 1990, I wrote a paper called “Private, Pay at the Pump Auto Insurance.”¹⁹ Under this proposed plan, the cost of auto insurance would be built into the gasoline prices. Service would be provided by insurance companies who would bid competitively for the service contracts of blocks of insureds. This would eliminate rating based on immutable characteristics and focus the attention of insurers on offering good service at low overhead cost. The so-called “selection competition” would end. The very serious problem we have in the U.S.A. of 20% of drivers being uninsured would end at once.²⁰ Our estimate of the savings was *at least* 50% of the premium.²¹

We²² studied the possibility of trying to get a plan like this put into effect in California, through the Proposition approach. But we found that the opponents were ready to spend millions, even hundreds of millions, of dollars to defeat the plan. Not surprisingly, agents hated the idea of no commissions; inefficient insurance companies hated the idea of sealed bids for blocks of business; lawyers hated the idea of making the plan

18 When I wrote Full Insurance Availability, the cost of eliminating all assigned risk plans in the nation would have increased the premium for “voluntary market” risks by \$1.75 and lowered the assigned risk average rate by \$46.15.

19 The financial writer, Andrew Tobias, used this information in writing his 1993 booklet, “Auto Insurance Alert, Why the System Stinks, How to Fix It, and What to Do in the Meantime.”

20 Theoretically this should not occur in states with laws requiring insurer notice of lapse of insurance to the state. There, the police are to pick up the plates of offending motorists. This rarely happens, partly because judges know that many poor people, who are “judgement-proof” (i.e. have no assets to pay a judgement) can’t afford insurance. If you are a youthful male driver in the “wrong” ZIP Codes of a city like New York or Los Angeles, you can easily be billed \$3,000 or more for required auto insurance.

21 All who bought petrol – i.e. all who drive – would be insured. The plan would have the added attraction of eliminating commissions to agents for insurance government requires citizens to have. As we drafted the concept, we made it pure no-fault, with higher benefits for economic damages than currently available to victims of car wrecks. Although the benefits were greater for doctor bills and wage losses, there was no pain and suffering benefit (we suggested that could be arranged separately if consumers wanted it). Another advantage to cost was that the friction costs of determining fault would also be eliminated. And that low cost for more benefits would be paid in easy installments – as petrol was purchased! Want to save on your insurance? Car-pool or walk or use the bus. The plan was estimated to have a significant pro-environment effect as people saw the cost of driving added to the point of sale of the fuel.

22 The prime mover in this effort was Mr. Tobias. He put up the money for the research and was going to fund the Proposition if it was viable.

an efficient, high-benefit no-fault approach and petrol companies hated the idea of gas prices being higher because their research (and ours) indicated that people would drive fewer miles if the cost of insurance were added to the pump price of gasoline.

Petrol companies, agents, inefficient insurers, and lawyers have one thing in common – lots of money to spend on defeating an initiative that would only benefit one group – consumers. So we backed off in the face of this torrent of cash against us. As Ralph Nader once said, “The greatest irony is that this lobbying against the consumer interests is paid for by the consumer’s money.”

CONCLUSION

This is a depressing time for automobile insurance consumer advocates in America. The insurers have control of the legislatures in every state and a strong Washington presence as well. As the World Trade Organization moves under the banner of “Free Trade” to make it even harder for nations to regulate any business, the pressure is on the states to remove even the inadequate regulation they have in place. Even country federal government controls are being overridden by bureaucratic, non-elected super-national organizations such as WTO. Virtually no one has recognized that insurance is not a “business” but a social exchange, which must be regulated in the public interest.

Proposals for a state-based charter where an insurer could go to any state it chose for a license to offer and service insurance in all states is being given serious consideration by the National Association of Insurance Commissioners.

Mergers are forming gigantic insurance companies with power beyond state control and even national control is in doubt. Globalized conglomerates wheel and deal beyond individual nation’s control. But, as corporations become global, Internet sales are becoming more and more intimate, in our living rooms and at our desktops. Banks are becoming insurers and vice-versa.

It is most unlikely that America’s auto insurance system can be repaired soon, given the current political environment. Free traders think any proposal for reform of even the most outrageous practices is government interference and per-se bad. Consumer

groups are fighting just to keep the system from becoming worse; it is not a time for reform.

Not yet. But we keep on making proposals and pointing out the flaws.

And we educate. We remind the people that the insurance company is the common fund created by the people. Someday, the people will recognize their role and take back control

One last point. While it is bad in American insurance regulation today, there is one institution that helps the little people. The last best defense in America is the courts. It is the last place where a little person can have a level playing field – and the insurers and other corporations hate that. Our legal system – the best in the world – is therefore under serious attack. If anyone came after our free-speech rights or our religious rights the way they are going after our legal rights, there would be hell to pay. But lawyers are easy targets and most people do not see the threat to their well being in the possible destruction of the last vestige of consumer protection still fully in place in our nation.

I sincerely appreciate the opportunity I have had to speak to you and to be on the same program with my dear friend Hans Dieter Meyer who has worked so hard for so long to help consumers of insurance receive better insurance protection at lower and fairer premiums.

Thank all of you so very much for your attention.

J. Robert Hunter

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