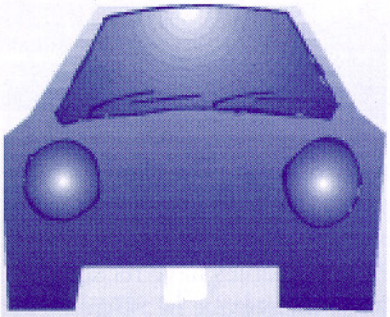
In Brief

Senate Research Center April 1999



Auto Insurance: The Bumpy Road to Deregulation

Insurance is a product that affects all Texans, and product affordability and a variety of product choices are important issues to everyone. Proposed changes in the state's mechanism for regulating insurance products and pricing are contemporaneous with other consumer issues the citizens of Texas face today. Deregulation of automobile insurance rates appears to be potentially beneficial to consumers, because increased competition could bring about lower rates. In addition, insurance providers contend that the current benchmark system, by which the Texas Department of Insurance (TDI) determines auto rates annually, remains cumbersome, outdated, and inflexible. Rate regulated insurance companies may only charge up to 30 percent above or below this rate. During the current 76th legislative session, three pieces of legislation have been proposed which relate to insurance regulation, S.B. 600 and H.B. 1637, sponsored by Senator Wentworth and Representative Dutton, respectively, and H.B. 3017, sponsored by Representative Smithee. These bills reflect the trend occurring across the nation, in which industry experts and policymakers are rethinking current approaches toward regulating the insurance industry.

In most states, the move toward deregulation has emphasized, primarily, rates for commercial lines, or insurance products provided to businesses. Deregulation of rates allows the free market to work by increasing competition and systematically correcting excessively high or unreasonably low rates. Industry experts explain that states have been slow to change insurance rate regulation for personal lines because the complexities of a deregulated insurance system may cause private individuals confusion over types of insurance products, pricing and product choices. Texas deregulated commercial lines in the last legislative session and is now considering deregulating personal lines. To better understand the challenges confronting the industry and state regulators in determining an insurance regulatory policy that is fair to all stakeholders, this report will examine the history of the current insurance rating system, the proposals that have been put before the current Texas Legislature, and alternative rating systems in place in other states.

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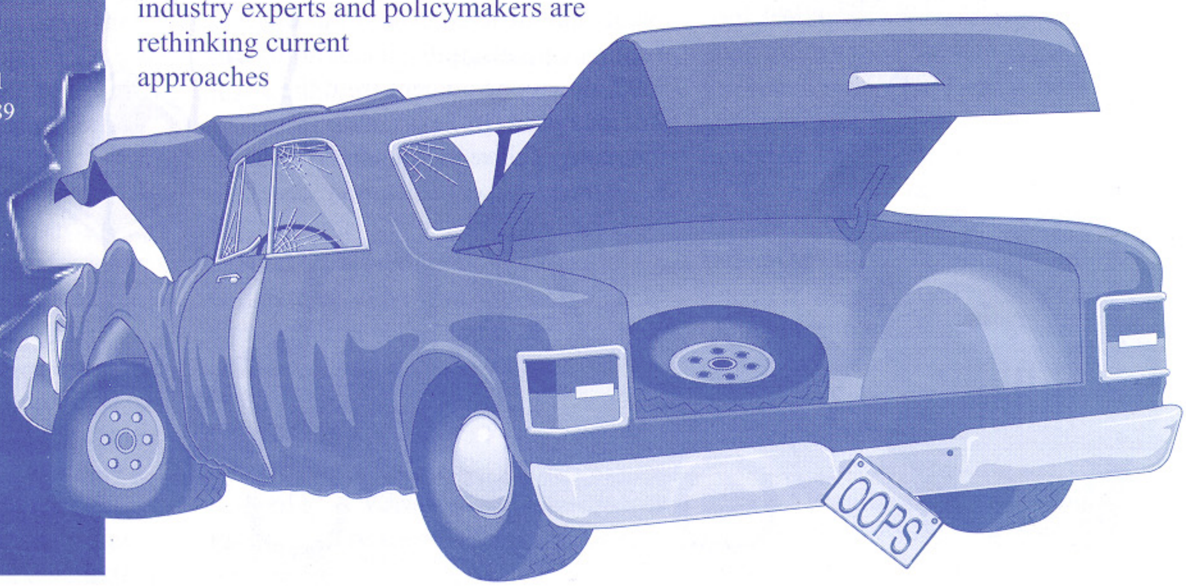


Insurance and the Public Interest

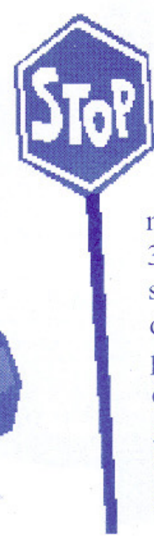
Over one hundred years ago, the first insurance policy covering a vehicle was written. In 1909, Kansas passed the insurance regulatory law, permitting an insurance commissioner to review rates to ensure against "excessive, inadequate, or unfairly discriminatory" practices. In 1914, the U. S. Supreme Court further justified the need for increased state regulation by determining that insurance was an industry "affected with a public interest." The court's reasoning followed two veins, firstly that having insurance is often a prerequisite to engaging in other business, and secondly that the consumer might be confused, and therefore at a disadvantage, by the complexity of insurance contracts. The National Convention of Insurance Commissioners adopted the "1921 Standard Profit Formula" which defined the meaning of "adequate but not excessive" rates, using a formula allowing a five percent margin to establish rates. By 1944, only three states lacked statutory rate controls. In most cases, states, at the minimum, provided for routine review of rates by the commissioner. The McCarran-Ferguson Act was passed in 1945 and provided for states to regulate the insurance industry.

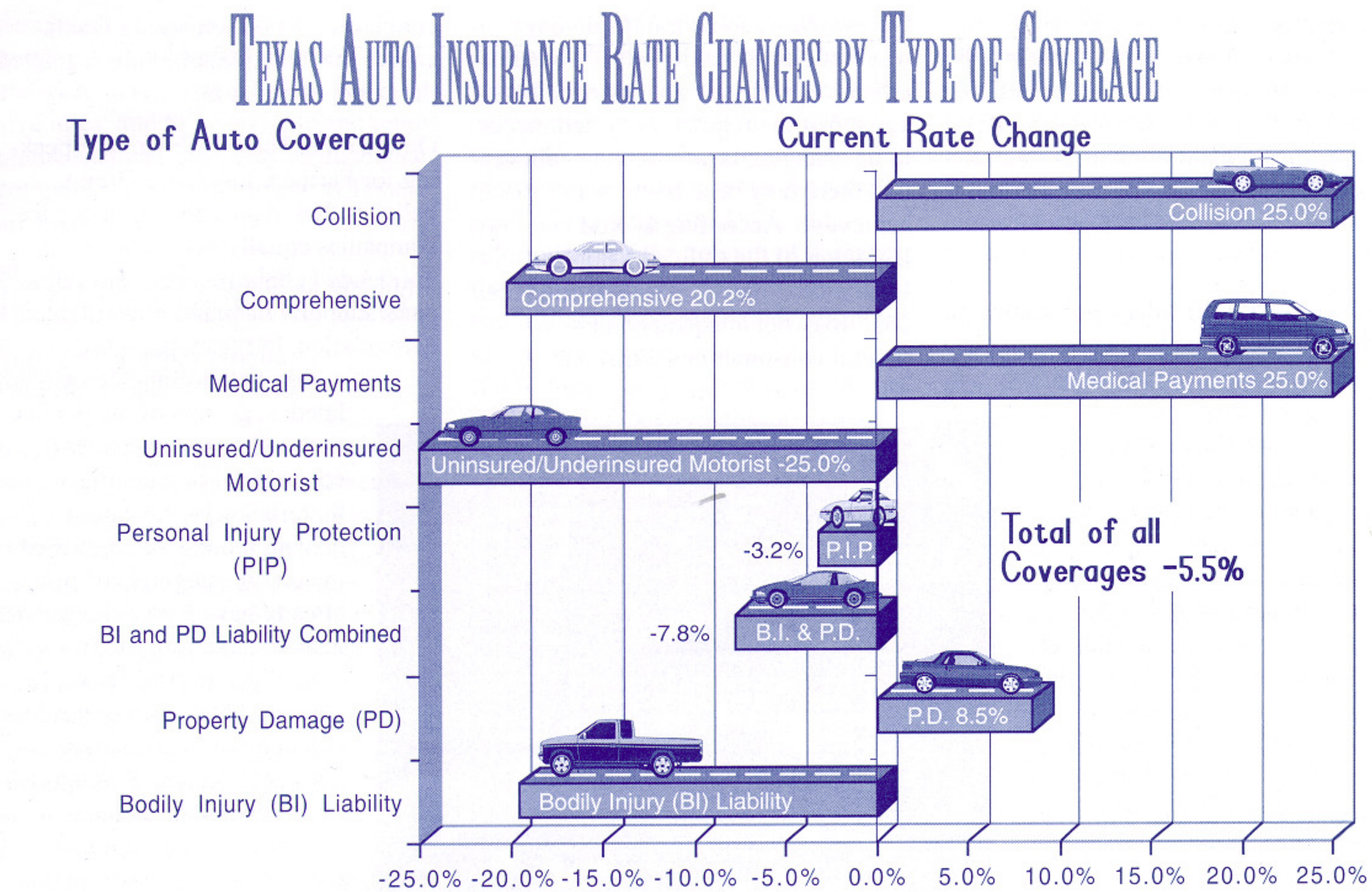
Decades ago, farmers and ranchers pooled resources to establish small and privately held insurance companies, known as county mutuals, sharing the risk as well as the profits. While most county mutuals are now subsidiaries of the major, nationally held insurance companies, their ability to expand market share and increase competition within their industry segment for consumers, has helped to spur the interest in rate deregulation for current rate regulated insurers.

Currently, the 24 county mutual insurance companies doing business in Texas are exempt from rate regulation, as opposed to the approximately 2,100 noncounty mutual companies. The regulated insurance companies, selling the same products and offering identical coverage, are subject to a rate benchmark above or below a 30 point flexband range, and within which rates charged must fall. These rate regulated companies are further required to use the Texas Auto Manual, which dictates all premium discounts and rating variables that may be applied. In 1998, the Insurance Information Institute, an industry advocate, estimated that the average annual auto insurance premium for the nation was $692, down one percent from the previous year. In Texas, auto insurance rates, following this trend, are also on the decline. The chart on page 3 illustrates that auto insurance rates for motorists insured by rate regulated insurance companies have recently dropped by an average of 5.5 percent, as a result of cuts ordered by former Texas Insurance Commissioner Elton Bomer. After a TDI study comparing nationwide rates showed that Texas rates were among the highest in the nation, Bomer also lowered rates for highrisk drivers enrolled in the state's assigned risk plan, the Texas Automobile Insurance Plan Association, effective as of March 1, 1999.

Currently Under Consideration, Two Different Approaches

Currently, S.B. 600, H.B. 1637 and H.B. 3017 are being considered as methods of deregulating insurance for personal lines. The effect of these bills, if adopted, would be to abolish the benchmark/flexband rating system. S.B. 600 and H.B. 1637 sponsored by Senator Wentworth and Representative Dutton, respectively, are identical and provide that every insurer will file its schedule of premium rates charged for motor vehicle insurance with TDI. Insurers are allowed to set the amount of price discounts that they will offer to consumers, but must adopt the policy contract, known as the form, established by TDI's commissioner. The commissioner may disapprove discount plans or forms that do not meet state standards. H.B. 3017, sponsored by Representative Smithee, takes a different approach to private auto insurance rate deregulation. This bill gives current rate regulated insurance companies more flexibility in setting rates





*Rate changes apply only to drivers insured by rate-regulated insurance companies.

Source: Insurance News Network, 1998.

but specifically maintains the state's regulatory oversight authority. Insurers must set rates according to the following: past and prospective loss experience inside and outside the state; any applicable catastrophe hazard; operation expenses; investment income; a reasonable margin for profit and contingencies; and, any other relevant factors inside and outside this state. They must also file rates and forms prior to their becoming effective with the commissioner who may disapprove any rate deemed excessive or any form that does not conform to state law. However, unlike the other bills, H.B. 3017 does not mandate a standard format for insurance contracts, allowing companies to write their own. It also is more comprehensive in that it includes property and casualty lines, which covers private passenger automobiles and residential property insurance, whereas the other two bills do not include insurance for residential properties.

Support for the bills comes from major insurance companies doing business in the state, the independent insurance agents' lobby, and county mutual companies. The concept behind such a proposition is the theory that deregulation will foster increased and open competition which will, in the long run, result in improved products and services for consumers as well as the desired lower auto insurance rates. Proponents of the bills contend that the current regulatory system is unfair in that county mutuals are treated differently under law than their counterparts. In addition, industry spokesmen such as Southwest Insurance Information Service argue that the benchmarking system is both cumbersome to write and to use, outdated because the system forces TDI to base auto rates on two-year old expense and loss data instead of reflecting current conditions, inflexible in that the system does not allow companies to either drop or raise rates and discounts with market changes, and more expensive because insurance companies must operate a second automation system just for the Texas market. Programming and equipment costs for the secondary automation system alone are estimated by the

Independent Insurance Agents of Texas (IIAT) to be approximately $78 million each year. Despite the anticipated drop in rates, major insurance companies remain in favor of rate deregulation because of the potential savings on expenses such as programming and equipment costs.

Advocates for the bills point to the loss of coverage enhancements, such as additions or alternatives to existing coverage, and premium discounts as other arguments in favor of deregulating the rating system. While consumers in other states may choose from a long list of enhancements to their insurance coverage, in addition to discounts for purchasing other types of insurance from the same insurer, Texas consumers are not offered these benefits due to difficulties in satisfying regulatory requirements. In response to fears that deregulation might spur a response other than competition among insurers, former Commissioner of the State Board of Insurance Lyndon Olsen said that "insurance companies are too greedy to collude."

According to deregulation exponents, the current auto insurance rate system is detrimental to consumers in the following ways: the ability of rate regulated companies to offer consumers more choices about coverage and rates is limited; and, that some drivers' rates are subsidized by the premiums of others. Industry experts agree that, in some cases, preferred risk drivers are paying higher premiums than necessary to help offset the premiums charged to higher risk motorists.

Nevertheless, some groups do have reservations about the bills. Consumer advocates and state agency officials agree that the regulatory system needs to be changed; however, they believe that there may be a better way to achieve it. According to Rod Bordelon of the Office of Public Insurance Counsel, S.B. 600 and H.B. 1637 may not adequately address several consumer concerns. He

wonders if the bills affect all insurers and consumers equally. He also believes that the rules for and differences between companies and subsidiaries should be clearly elucidated for consumers who may not necessarily be industry savvy. Given that major companies have subsidiaries including preferred, standard and county mutual companies, Bordelon would like to ensure that all companies are regulated the same, or not at all.

On the other hand, Bob Huxel, speaking for Farmers Insurance Group, believes that regulating all insurance companies equally may result in unintended consequences. His company supports the move toward rate deregulation, but fears that if all companies become deregulated, segments of the population will attract much less coverage. For example, motorists who have poor driving records or are placed in certain categories of risk already have fewer choices of insurers, and more so in certain geographic areas. In general, companies prefer less risk and will increasingly market to preferred categories of drivers rather than to drivers with substantial records. It is anticipated that county mutual companies, which were originally established for higher risk categories, will follow suit, leaving many consumers without insurers willing to sell them coverage.

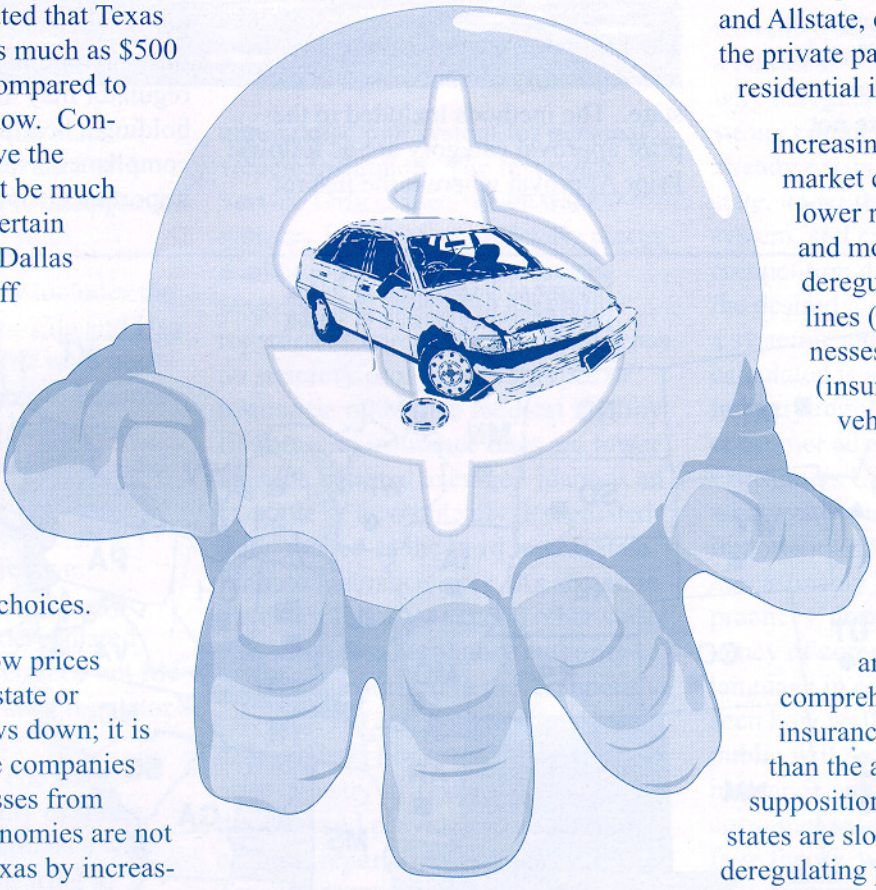
Rob Schneider, with the Consumers Union Southwest Regional Office, and TDI are both concerned that the language of the bills does not expressly prohibit excessive prices or discriminatory practices, nor is a standard for filing policies and rates being stipulated. Even proponents of S.B. 600, such as IIAT, have suggested that any legislation should address the issue of "forms," that is the filing of insurance contracts, so that they are consistent. Consumer advocates argue that there is a compelling need to maintain consumer safeguards if rates are deregulated. Safeguards such as TDI's oversight of marketing practices, its ability to determine and deny excessive rates, and to investigate and report on the financial solvency of insurance companies who do business in Texas are crucial.

The Promise of Deregulation and the Nagging Potential Pitfalls

It is difficult to predict to what degree auto insurance rates will be affected by a change to deregulation. Senator Wentworth has estimated that Texas motorists could save as much as $500 million in premiums compared to what they are paying now. Consumer advocates believe the potential savings might be much less, especially since certain geographic areas like Dallas already enjoy fairly stiff competition among insurers. Moreover, rate deregulation may not have the positive influence advocates would wish in markets and areas that are already underserved with few choices.

Another question is how prices will be affected if the state or national economy slows down; it is possible that insurance companies might try to recoup losses from other states whose economies are not as strong as that of Texas by increasing auto rates here. Certainly, the menu of choices and prices would be impacted if the Texas economy took a serious downturn. Consumers might face choices between the consistency of rates and discounts currently enjoyed, or the possibility of a vast array of insurance prices and products in the future.

In addition, the Consumers Union doesn't believe that giving more rate freedom to insurance companies will necessarily motivate them to lower rates. Companies have not been motivated to lower rates in the recent past. For example, in 1995, tort reform limited the amount of damages that consumers could win in lawsuits against insurance companies, resulting in enormous profits for insurers. Rates, however, were not reduced until TDI, flexing its regulatory authority, intervened in 1996 and 1998 and lowered them. In July 1997, the



Dallas Morning News reported that more than 89 percent of all auto policies in Texas charged higher premiums than the standard rates established by TDI. Rob Schneider of Consumers Union, along with other industry experts, contend that auto insurance rates in Texas remain at the highest boundary of the rate flexband.

This contradicts the theory that given rate flexibility, insurers will compete to attract customers by lowering prices. According to a *Dallas Morning News* article dated June 1, 1996, Representative Smithee fears that allowing insurers too much flexibility in setting rates could result in rate shock for consumers, due to companies drastically elevating prices. He also questions whether true competition will ever prevail because of the current market concentration among a small number of insurance companies in Texas. He cites the example that three companies, State Farm, Farmers and Allstate, control over 60 percent of the private passenger vehicle and residential insurance market.

Increasingly, states are relying on market competition to produce lower rates. Like Texas, more and more states are moving to deregulate rates for commercial lines (insurance for businesses), but not personal lines (insurance for personal vehicles and residences). Industry observers indicate the trend toward deregulating commercial lines rather than personal lines is because business owners are thought to better comprehend the complexities of insurance language and practices than the average consumer. This supposition is the reason why other states are slower to consider deregulating personal auto and residential insurance rates. A TDI spokesman observed that the assumption that small business owners are also astute insurance consumers may be faulty. If so, it is possible that many businesses are paying too much for commercial insurance. As previously stated, a deregulated rating system requires insurance consumers who can fully grasp the products and pricing systems offered by insurers.

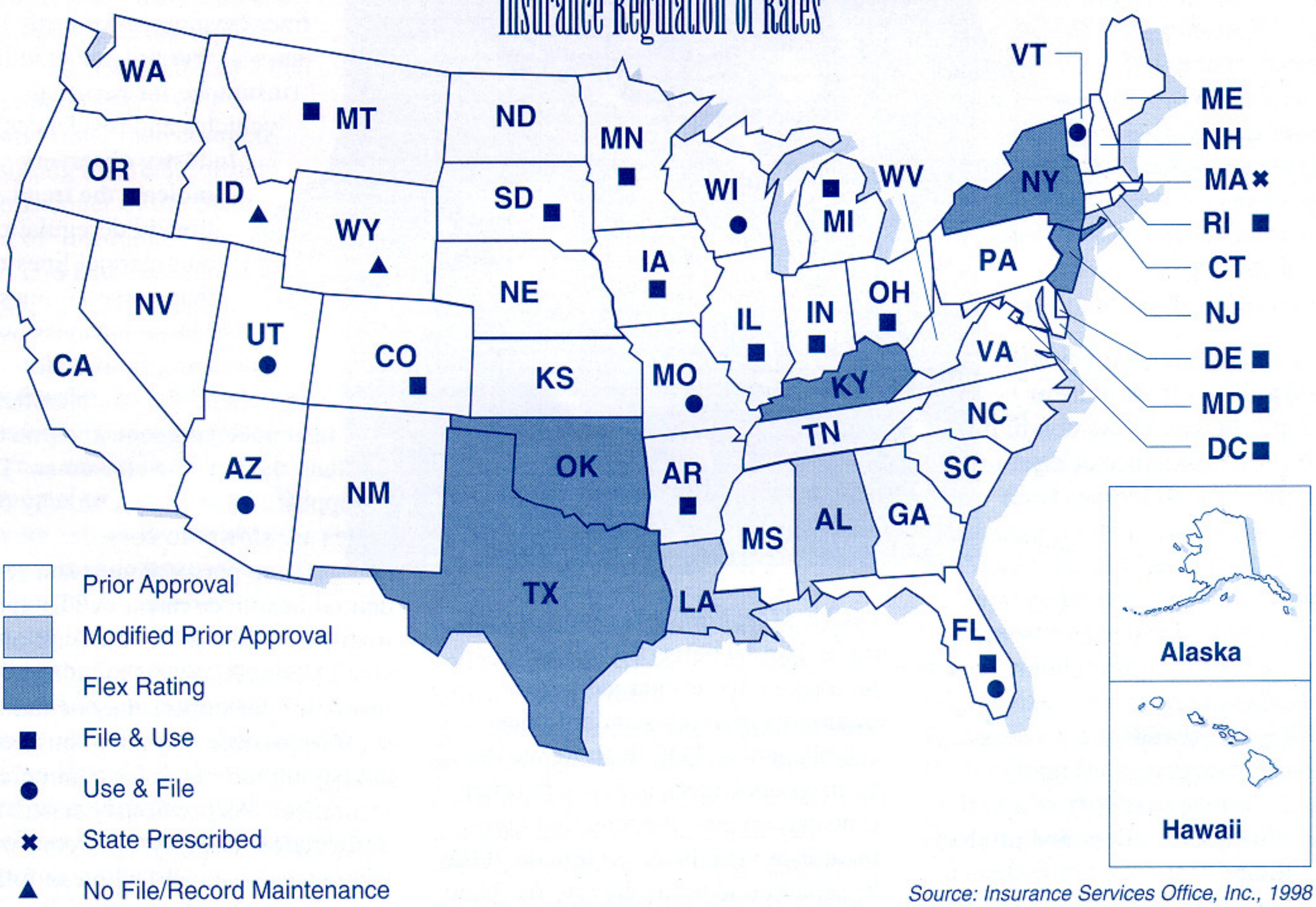
In the Case of Insurance, States Rule the Roost

The insurance industry is regulated by the states. According to the Insurance Information Institute, each state relies on the following principles in establishing its rate regulations: rates set at levels high enough for insurance companies to remain profitable and solvent; fair rates for consumers, who are compelled by law to maintain specific coverage; rate differences reflective of expected claims and expenses; and rates that are not discriminatory.

The Insurance Information Institute reports that most state regulation of insurance falls into two basic categories: prior approval or competitive systems of regulating personal motor vehicle insurance. The real difference between these two categories is not that one is competitive and the other is not, but that prior approval rates must be filed with the state's insurance commissioner, prior to use. The filings will then be approved or disapproved. Competitive systems do not require insurers to file rates, allowing insurers to increase rates without prior approval.

The following chart demonstrates the rate regulatory methods used in each state. The methods included in the prior approval category are as follows: Prior Approval wherein the insurer must file rates, rules, and forms with the state regulator for approval prior to use; Modified Prior Approval is much like prior approval, except that when insurers change rates due to claims losses, the rate change becomes effective immediately; Flex Rating, the system under which Texas currently operates, uses a benchmark rate and a specific range to which insurers must adhere; and, State Prescribed, a system that gives a state regulator entire control of rates and rules, with no range of rates offered. Depending on the statute, the filing becomes effective when a specified waiting period elapses or the state regulator formally approves the filing. A state regulator may disapprove a filing by holding a hearing if the filing is not in compliance with the law. The most important attribute of all these systems

Insurance Regulation of Rates



Source: Insurance Services Office, Inc., 1998

is that a state regulator, the State Board of Insurance in the case of Texas, has the authority to disapprove auto insurance rates and rules.

The competitive category includes the following rating systems: File and Use in which insurers must file rates and rules with a state regulator to become effective immediately or at a future date specified by the insurer; Use and File is almost identical to the File and Use system, different in that new rates always become effective immediately; and, No File/Record Maintenance, the most deregulated system, where the insurer need not file rates and rules with the state regulator at all, and rate changes become effective immediately. The state regulator may periodically examine insurer(s) to ensure compliance with the law. By holding a hearing to establish noncompliance, a state regulator may order discontinuance of the use of contract language if not in compliance with the law. Each of these systems is considered insurance rate deregulation, to some extent.

Of the fifty states, Illinois is most often touted as an example of an unregulated rate system for personal vehicle insurance. The Insurance Service Office, Inc., which tracks industry information, officially places it among the "file and use" states; nevertheless, Illinois is generally regarded as unregulated because it has no statutory provisions for types of insurance, other than medical liability. Illinois auto insurance rates are lower than the national average. Idaho is an example of a completely deregulated state, ranked as the third lowest state for auto insurance rates. As shown in the chart, there are several other states that assert less regulatory authority and are categorized in the competitive category, but are not completely deregulated. For example, the insurance industry in Texas is regulated by the state and provides some flexibility of rates; reported to average $726, Texas' rates surpass the national average of $685, ranking among the top 20 states for the highest rates. Massachusetts is located at the other extreme, operating under a system that is entirely state prescribed and possesses higher than average auto insurance rates. The preceding figures seem to support the idea that deregulation will lower rates; however, it is not necessarily true that the states which are more competitive also enjoy the lowest rates. Three of the five locales with the highest average rates in the country--New Jersey, New York, and the District of Columbia--fall within the competitive category.

Rate Constancy & Industry Control vs. Price Fluctuations & Competition A Regulator's Dilemma

Certainly, auto rate deregulation is not a panacea. The question remains as to why deregulation is necessary, if strong competition among insurers already exists in many areas of the state, under the current rate regulated system, and can be demonstrated that competition does not always achieve the desired lower rates. Nevertheless, a systemic change in the way rates are calculated is an idea supported by industry regulators, insurers, and some consumer advocates, excluding the Consumers Union. Regardless of what system is adopted, it will be important to protect consumers from unreasonably high rates, unfair practices, possible financial insolvency of companies, and inconsistent language in contracts. It remains to be seen how well the legislature and the public will accept a self regulated insurance industry without including consumer safeguards, despite laissez faire theory, which asserts that prices will decrease as supply increases in a free market system.

—by K. Alejandra Rocha, SRC

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