

Issue Brief

Proposed Rating Factors Will Raise Auto Rates in California

By Christian John Rataj
NAMIC State Affairs Manager – Western Region

Introduction

NAMIC and its state trade partner – the Pacific Association of Domestic Insurance Companies (PADIC) – vigorously opposes the implementation of proposed regulations regarding automobile rating factors in California.

The opposition by both groups focuses on five major areas:

1. The proposed regulations would create substantial rate dislocation in the auto insurance marketplace and will increase auto insurance rates for millions of licensed drivers in California.
2. The proposed regulations are not cost-based or risk of loss-based and will create substantial rate subsidies.
3. The proposed regulations violate California Insurance Code section 1861.05 by creating both excessive and inadequate rates for potentially millions of automobile policyholders.
4. The number of drivers in suburban and rural areas who will be unable to afford automobile insurance would increase.
5. The proposed rate regulations are inherently incompatible with the very concept of insurance underwriting.

Proposed Regulations Will Increase Insurance Rates for Majority of California Drivers

Two separate studies conducted during the past two years have concluded that these proposed regulations will increase rates for a majority of drivers in the state of California. Both the industry-sponsored study and the Department's study reflect that auto rate increases will be experienced by more than 60 percent of the drivers in California. Overall automobile rates will increase, on average, for 52 of California's 58 counties, mostly in suburban and rural areas of the state.

While offering automobile insurance throughout the state, the PADIC member-company policyholder base is located primarily in the suburban and rural areas of California. As a result, the negative impact on PADIC auto policyholders is even more dramatic. PADIC's largest member-writer of automobile insurance indicates that the adoption of this regulation likely would lead to increases in automobile insurance rates for 78 percent of its auto policyholders.

Proposed Regulations are Not Cost-Based or Risk of Loss-Based and Will Create Rate Subsidies

The existing auto rating factor regulations, while not perfect, are generally cost-based, which has minimized rate subsidization. The proposed regulations will move the rate-making process much further away from actuarially accepted cost-based rate-making for automobile insurance. By artificially reducing the actuarial weight given to the geographic-based risk of loss variables, such as frequency and severity of loss as categorized by geographic territory, automobile insurance rates in the inner city and urban areas of California will be artificially reduced, which will result in an inappropriate rate subsidization for these insurance consumers. An unintended and unavoidable consequence of this urban-market rate subsidization is a corresponding rate increase for other California drivers, such as those in suburban and rural areas of the state. Thus, drivers who live in suburban and rural areas will be forced to subsidize drivers living in urban areas. From a public policy standpoint, this rate subsidization is neither fair nor equitable.

Although the Department has indicated a willingness to consider allowing companies to artificially increase the actuarial weight of the three mandatory rating factors (driver safety record, miles driven and years licensed), this procedure will not meaningfully reduce the adverse geographic impact that will result from eliminating an insurance carrier's ability to provide its consumers with a rate that is based upon a thorough evaluation of all the pertinent rating variables necessary to ensure that a consumer's rate is commensurate with his/her particular risk of loss exposure.

Artificially increasing the actuarial weight of the three mandatory factors will reduce geographic rate dislocation, which actually shifts the actuarial weight to other rating factors, which may ultimately lead to serious unintended adverse rating consequences for insurance consumers. For example, artificially increasing the actuarial weight of the mandatory factor, miles driven, may actually increase rates for commuters in this state.

By artificially reducing the actuarial weight given to geographic-based risk of loss variables, such as frequency and severity of loss as categorized by geographic territory, the Department would be implementing a rate-making process that is

inconsistent with cost-based rating principles. Further, should the Department allow companies to artificially inflate the actuarial weight given to the three mandatory rating factors, the state will move even further away from the letter and spirit of the current cost-based rate-making law.

Proposed Regulations Will Create either Excessive or Inadequate Rates for Millions of California Drivers

Reducing the weight for frequency and severity of loss (territory) will create artificial rates that are not based upon the projected costs for claims. This simple move away from cost-based rate-making will generate either excessive or inadequate rates for millions of California drivers. Drivers in urban areas will, in general, be charged inadequate rates; drivers in suburban and rural areas will be charged excessive rates. Any additional artificial adjustments made to other auto-rating factors to lessen the impact of territorial dislocation will move even further away from cost-based rate-making.

California insurance code section 1861.05 indicates that a rate shall not be "approved or remain in effect which is excessive, inadequate or unfairly discriminatory." Historically, this standard is based upon a review of rates that are actuarially sound or cost based. Requiring insurance companies to apply artificial standards to develop auto-rating-factor class plans conflicts with this excessive, inadequate standard.

A further complication is the method of the Department's review and application of the excessive, inadequate standard. Will the standard of review for a rate filing be the same as for a class-plan filing where the distribution of rate is artificial? Can the Department reconcile this inconsistency?

Proposed Regulations Will Shift Affordability Issues to Other Parts of the State

The implementation of these proposed regulations will dramatically reduce rates in urban areas and, one would suppose, that once more urban drivers are able to afford auto insurance, they will purchase it. However, these regulations will dramatically increase rates in suburban and rural areas, potentially creating affordability issues for suburban and rural drivers. This will be particularly true in rural areas of California. With a lower standard of living and lower incomes found in rural areas compared to the urban areas, many rural-area drivers can ill afford the substantial

increase in auto insurance rates that they will be required to pay. In many respects, these proposed regulations may simply shift the affordability problems of urban areas to the rural driver. This shifting of the affordability issue is neither appropriate nor justifiable.

Proposed Rate Regulations are Inherently Incompatible With the Insurance Underwriting Concept

Insurance underwriting is founded on the basic tenet that a consumer's insurance premium should be correlated to the frequency and severity of his or her potential exposure to his or her risk of loss. Common sense tells us that an increased exposure to a particular risk equates to a greater likelihood of being adversely affected by that particular risk. Consequently, to provide insurance consumers with rates that are accurate, equitable and commensurate with their potential risk of loss exposure, insurance carriers need the underwriting freedom to evaluate and actuarially weigh all of the mandatory and optional rating variables.

Since actuarial studies have repeatedly demonstrated that automobile accidents and vehicle thefts occur more frequently and with greater severity in urban areas, it is only fair and logical for those consumers to pay premiums reflecting the higher potential for risk of loss. The proposed regulation would hinder an insurer in its ability to correlate

insurance rates to reasonable and legitimate risk of loss variables that are categorized by geographic location.

Conclusion

PADIC and NAMIC have asked the commissioner and his staff to consider additional study of the impact to California drivers of these regulations and to carefully consider other alternative measures that will reduce or eliminate rate dislocation and maintain the actuarially sound, cost-based, rate-making system.

Endnotes

Adapted from comments by the National Association of Mutual Insurance Companies (NAMIC) and the Pacific Association of Domestic Insurance Companies (PADIC) to the California Department of Insurance on February 24, 2006. PADIC-member companies write approximately \$1 billion in property/casualty premiums almost exclusively in California. NAMIC has 106-member insurance carriers writing business in the state of California that write approximately 23 percent of the property/ casualty insurance business in the state.

About the Author

Christian John Rataj is a state affairs manager for NAMIC.