AUTO INSURANCE: THE IRRELEVANCE OF REGULATION

Mark Nadel

LAX AND INCOMPETENT regulation of insurance is taken as an article of faith by many consumer groups. And not without some justification. A 1979 General Accounting Office report found numerous shortcomings in state insurance regulation, especially the absence of systematic procedures for determining whether consumers were being treated properly with regard to claims payments, rates, and protection against unfair discrimination. Insurance companies, on the other hand, say the regulatory system works well except in those few states where a hostile regulatory environment causes rates to be held too low in general or too low for particular groups—young male drivers, for example.

The truth of the situation does not lie in between these two extremes. It lies all over the place. Automobile insurance is at once well regulated, too rigidly regulated, too laxly regulated, and sometimes incompetently regulated. It is all these things because it is regulated almost exclusively by the individual states—with great differences in effectiveness and even in approach.

The issue of the effectiveness of this state-based system has been debated for some time. But there is a more subtle underlying issue here, as in some other areas of regulation—the relevance of regulation as now constituted. Even if the state insurance departments were far more effective in doing the things they are doing, the welfare of consumers probably would not increase noticeably, and the welfare of insurance companies would not decrease noticeably. The fact is, regulators are and always will be largely impotent to deal with many insurance-related problems.

Background

State regulation of insurance first appeared in the mid-nineteenth century and subsequently developed largely as efforts to supervise the

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private rate-fixing agreements that determined prices in the property-casualty field. Much later, with the state regulatory schemes threatened by a 1944 Supreme Court ruling that the sale of property-casualty insurance was subject to federal antitrust law, Congress passed the McCarran-Ferguson Act. It provided an antitrust exemption for the industry's rate-fixing activities to the extent that they were regulated by the states. Today all states have insurance departments. Although these departments have a number of functions including the licensing and financial examination of insurers and the enforcement of trade practice laws, generally their most visible function is to regulate property-casualty insurance rates—particularly automobile.

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It should be noted that property-casualty insurance, which covers property losses and the insured's liability to others, is very different from life (and health) insurance. The two industries have different actuarial and underwriting societies, different tax and regulatory laws, different sales practices, and so on. They also differ in that rate regulation is much more of an issue with property-casualty insurance than with life insurance (whose rates are generally unregulated).

The original and compelling reason for insurance regulation was the need for guaranteed solvency of insurance companies. An insurance policy is, after all, a contract under which customers pay a small regular predetermined premium in return for compensation should certain misfortunes occur. Thus, the long-term financial viability of the seller is a crucial concern to insurance consumers because what they are buying is reasonable certainty that future claims will be paid.

There was good reason for concern on this score in the late nineteenth century. Fire insurers competed intensely for business which was, in those days, funneled to them by independent insurance agents who frequently set rates and commissions themselves. This situation, coupled with inadequate actuarial systems, led to rates that were too low and eventually to major insolvencies. Following the Chicago fire of 1871 and the Boston fire of 1872, for example, scores of companies went under, leaving policyholders with unpaid claims. The states responded to the problem, first by encouraging insurers to engage in joint noncompetitive rate-setting, usually through private rating bureaus, and ultimately by regulating rates themselves. In short, price regulation—often viewed as a way to hold prices down—came into being in the property-casualty field because of fear that prices would not be high enough.

In the early days, the rating bureaus dominated pricing and, under the cloak of antitrust immunity, operated a cartel largely free of price competition. But today, even in rate-regulating states, this is no longer the case. Now the technique for ensuring solvency is not rate-setting, but a system of financial reserve requirements along with regular audits performed by the state insurance departments.

Do the States Really Regulate Rates?

Nonetheless, rate regulation is still widely practiced in automobile insurance. Currently twenty-nine states regulate the price on automobile insurance directly. Typically, individual insurers or insurers filing jointly through a state's rating bureau submit an application showing the loss experience in each territory and requesting a specified rate adjustment for the coming year. The state insurance department regulates rates either by requiring that they be approved prior to taking effect or by providing a waiting period after which they go into effect unless disapproved. The remaining states, twenty-one in all, use instead a scheme called "competitive rating" or "open competition": an insurer simply informs the insurance department what the rates will be and puts them into effect without having to win approval or acquiescence.

As would be expected, there is wide variety in the methods that price-regulating states employ. In a handful of states, rate regulation is a visible, highly charged, and politicized process. In most, however, it is more routine—and more superficial. Very few states do their own

actuarial analysis or subject the insurers' rate filings to a penetrating analysis.

A more important circumstance has gone largely unobserved. It is that the actual price paid for insurance is, in practice, not regulated at all. Only the base price of insurance receives regulatory attention. However, the actual price a consumer pays depends on two additional factors. The first is the classification system used to evaluate risk. An insurer applies a set of rating factors—age, sex, use of car—to the consumer, and then multiplies the base price by the appropriate ratings. Thus, the rate applying to a car used for commuting by a male between twenty-five and sixty-four years of age will usually be 1.25 times more than the rate applying to the car used only for pleasure driving. Young males may be charged as much as 3.75 times what other drivers pay. The second important factor that determines price is location or rating territory, with insurance rates varying according to the loss experience of the particular territories. In theory, both of these factors are subject to regulatory approval; in practice, few states scrutinize them.

The base rate approved by regulators is actually a number of base rates—one for each territory. Differences in the loss experience of territories in one year are taken into account the next year, when rates for territories having lower losses than the state average are adjusted downward relative to those with higher losses. State insurance departments do monitor these straightforward adjustments. What they generally do not look at, however, is whether the territories chosen make sense. In other words, is the territory sufficiently homogeneous relative to neighboring territories so that the insureds are being charged a rate that fairly reflects their loss expectancy? Maybe they are; but most state insurance departments do not know and do not endeavor to find out. As a practical matter, this determinant of pricing is not regulated.

Usually there is even less analysis of the personal classification system. In some states, classification has been a lively issue and in four the use of age or sex as a rating characteristic has been banned. However, most states pay scant attention to the classifications. For example, insurance companies are probably on firm ground in charging young drivers far higher premiums. But the size of the differential may be questionable. Studies have shown that using the personal classification system in conjunction with urban territories can result in rates that are much higher than warranted by loss expectancy. On the face of it, insurers have no reason knowingly to overcharge younger drivers, and they are probably right in the classifications that they establish. The prices set by those classifications, however, cannot be termed *regulated*, because only two states ever analyzed the actuarial basis of the insurers' classification plans—Massachusetts and New Jersey—and no state analyzes it regularly. Thus, the price the consumer pays above the base rate is not regulated.

Insurers regard the debate over the personal classification system as really a debate over social regulation or social engineering. And, indeed, an egalitarian impulse may lie behind the desire to do away with actuarially acceptable distinctions. Yet the fact is, those states that have addressed the classification issue may be viewed as the only states that are actually regulating price.

Is Rate Regulation Useful?

More important than the issue of how searchingly the states review insurance rate filings is the question of what difference it makes. Does such regulation really change anything? All the evidence suggests that the answer is no. The GAO study found very little difference in the cost of insurance between states that regulate rates and those that do not. Similar results were obtained by Richard Ippolito in his 1979 study. GAO also found that what differences do exist are only slightly related to various measures of regulatory effort in price-regulating states. Indeed the only factors that seemed to explain differences in insurance costs between states were highly idiosyncratic: New Jersey alone accounted for most of the total national variation among states. Price regulation, viewed nationally, simply does not hold price below the levels that are reached competitively in nonregulated markets. It may, however, reduce the efficiency of the market, as noted by Ippolito as well as by Paul Joskow. That is, in the most rigidly regulated states, regulation prevents the flexibility of rapid price adjustments; and there is some evidence that the "direct writers"—

firms like State Farm and Allstate which field their own agents instead of using independent agents and which therefore are able to realize marketing efficiencies that permit lower prices —would charge even less in the absence of rate regulation.

Does price regulation at least have the value of making insurance available? While almost all consumers are unhappy about the price of insurance, only a small number are unhappy because they cannot purchase the policy they want. Generally, those who are refused auto insurance are eventually able to buy coverage in a "residual market" of assigned risk plans, reinsurance facilities, and so on—a market mandated and regulated by state law. This residual market, interestingly, is subject to price regulation in all states and, unlike the voluntary market, is a case where regulators hold insurance prices below what would otherwise prevail. As one might expect, coverage in this market is frequently limited, nearly always more expensive, and usually a "loser" for the industry.

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It is sometimes alleged that "redlining" and other discriminatory underwriting practices limit the coverage available to people in particular parts of urban areas. With few exceptions, insurance departments have not done sufficient investigation to determine whether access to a legally mandated product is or is not being curtailed by clumsy or biased territorial boundaries and underwriting practices.

A great part of the availability problem, however, is caused by regulation itself. The proportion of drivers consigned to assigned risk plans is three times greater in rate-regulated states than in open competition states—a relationship that holds even taking into account the existence of compulsory insurance laws. Much of the difference is accounted for by the very few states that have attempted to keep overall insurance rates below what they would be in an unregulated market. To the extent that rate regulation is not irrelevant, then, it just creates an availability problem.

And no wonder! The structure of the property-casualty industry provides no rationale for price regulation. In auto insurance, the top fifteen companies account for slightly more than half of all business. In 1980 State Farm and Allstate had 17 percent and 11 percent of the business, respectively, but no other firm had more than 5 percent. This national pattern is repeated in most of the states. Moreover, the two industry leaders are generally recognized as forces for price competition. State Farm's meteoric rise, for example, resulted from its undercutting the prices of companies that stuck to the maximum rates set by rating bureaus. Indeed, the dominant factor in the insurance industry today is the continuing growth of the direct writers.

The industry is also characterized by relatively low natural barriers to entry and an absence of significant economies of scale. Indeed, the barriers to competition that do exist are generally imposed—rather than remedied—by regulation. These barriers include "fictitious group" laws prohibiting group auto insurance and "anti-rebate" laws preventing agents from discounting commissions. Thus, by any indicator, the property-casualty insurance industry is favorably structured for competition.

The competitive possibilities of the market have led most students of the field and nearly all insurers to recommend an end to active rate regulation. A Department of Justice study of 1975–76, published by the American Enterprise Institute in 1979, recommended a dual chartering system under which the companies that would like increased freedom on pricing and policy coverages could opt for a federal charter, thereby becoming exempt from state rate regulation. The National Commission for the Review of Antitrust Laws and Procedures recommended in 1979 that the blanket antitrust exemption for insurance be greatly cut back and that competition be encouraged. In late 1980 the National Association of Insurance Commissioners approved a model law for open competition, although the number of states with open competition has not increased much in the last ten years.

One cannot escape the conclusion that the only beneficiaries of rate regulation of auto insurance are the politicians: it enables them to

curry consumer favor by appearing to hold down rates. There is, moreover, an anomaly in this useless regulation. Oddly, while most states regulate automobile insurance rates, a market with robust competition, few supervise rates in insurance areas that are noncompetitive (such as private medicare supplement insurance), or are characterized by "reverse competition" (competition not for consumers but for agents, as in title insurance), or suffer from a complexity that will probably always defy consumer understanding (as does life insurance).

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Non-Price Regulation Ignored

That rate regulation, as practiced, is overly intrusive is not its only fault. It also distracts attention from other actions that could be taken to correct the market failures that limit the vigor of competition in the insurance market. Chief among these is inadequacy of consumer information—the fact that it is nearly impossible for a layman to know and compare the monetary value of policies. While this problem is particularly serious for life insurance (because there is not any commonly accepted and understood method of cost disclosure in that field), it exists even for standardized auto and homeowners insurance. Here the limitation on consumer information is uncertainty about the quality of the service purchased by the policy—for example, the speed and adequacy of claims settlements. Whereas after-purchase service is a factor that consumers *may* consider when they purchase other products, in insurance it is the *only* factor being purchased. And, as is seldom the case with other products and services, the consumer cannot readily see or evaluate the service until after the purchase. Because the policyholder's claims are so much less frequent than the premium payments, a self-correcting market simply does not exist.

Because of this market failure, consumers are unable to shop intelligently, even though in almost all states some companies offer rates below the state maximums. State insurance departments have at their disposal direct and minimally intrusive means of solving this information problem. For instance, they could produce buying guides setting forth information about prices and company quality. And, with very little effort, they could adopt a perfectly good indicator of company quality, one already available in the regulators' files but inadequately used and publicized. This indicator is the ratio of consumer complaints about a company's services to that company's volume—say, the number of complaints per 1,000 policies or per $1,000,000 of premium volume. Some complaints are no doubt frivolous or unfounded, but there is no reason to think that one company will have a higher proportion of unfounded complaints than another. Thus, if one company consistently has a complaint ratio considerably higher than the others it would tell the prospective policyholder that dealing with that company may be risky, even if it offers lower prices.

Both buying guides and complaint ratios exemplify what *could* be done—but is not. State insurance departments maintain complaint records but do not use them systematically in their own enforcement activities, and rarely make them available to consumers or to the press. Moreover, insurance departments do not monitor systematically the claims activities of insurers, so complaints are pretty much all they have to go on to get a comparative reading on insurers' conduct. In any case, it would be a relatively simple matter (and less expensive than direct regulation) to disseminate regularly the information about prices and complaint ratios that insurance departments already have. This, coupled with removing inefficient regulations, would have the effect of moving in the desirable direction of deregulation while still addressing problems in the market that seem to justify some sort of intervention.

Problems Immune to Insurance Regulation

One must admit, however, that non-price regulation of that sort will not solve the major problems of auto insurance. Are there other issues

that could be more profitably addressed? The answer is yes—but not by insurance regulators.

Overwhelmingly, the thing that bothers consumers most about auto insurance is its price. A recent Aetna survey found that 71 percent of the public thought that automobile insurance was too expensive, and most regarded the cost as very important to them personally. Despite this, a Lou Harris survey for Sentry Insurance found that most consumers blame not the insurance companies but rather inflation, the high cost of auto repairs, and the large number of claims. These factors do increase premium prices, and the costs involved are impressive. According to the Insurance Information Institute, the economic loss from traffic accidents in the United States was almost $58 billion in 1981. The cost of the major claims components of medical care and auto repairs has been rising faster than the general rate of inflation. Periodically, insurance companies demonstate that the replacement parts of an automobile far exceed the price of the auto itself. The Alliance of American Insurers has reported that the total for all the separate parts of a 1981 Mercury Lynx GL came to $22,561, or $16,057 more than the car's original list price. Auto theft, another element in rising premiums, produced losses of $3.2 billion in 1980, according to FBI records. All of these cost-raising factors—theft, repair costs, and medical costs—are, of course, outside the responsibility of insurance regulators.

Epilogue: An Unintended Impact

Ironically, one of the more significant effects of insurance regulation results from its lack of serious attention to the personal classification system. As the parents of every teenager know, insurance rates rise dramatically as soon as that teenager is added to the family insurance policy. And those rates rise again—as much as 44 percent—when the teenager becomes the owner or principal operator of a car. Surprisingly, in the debate over classification it seems to have escaped notice that those higher rates not only reflect teenagers' higher loss as a group, but provide a financial disincentive against teenagers' owning cars. This suggests that, if rates are excessive due to faulty or inequitable classification, there will be less teenage driving than there otherwise would be. The extent to which the added premium has turned potential teenage car owners into only part-time users of the family car is not known. Arguably, we should expect that just as higher gasoline prices have induced conservation, higher insurance rates will discourage teenage driving—resulting in fewer highway accidents and deaths and providing the unintended benefit of less gasoline consumption.

The irony is that automobile insurance regulation may . . . have its greatest success in what it does not do—regulation of personal classification. Its most expensive activity, rate regulation, is not effective. And . . . regulators are generally powerless to deal with what concerns consumers the most—the factors driving up prices.

The irony is that automobile insurance regulation may thus have its greatest success in what it does not do—regulation of personal classification. Its most expensive activity, rate regulation, is not effective. And as we have seen, regulators are generally powerless to deal with what concerns consumers the most—the factors driving up prices. In sum, then, insurance regulation does what is not needed, does not do what it could do effectively, and cannot do what is needed most. ■

Selected Readings

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