Texas Private Passenger Automobile Insurance Profitability, 1990 to 1998

A Report by the Center for Economic Justice

April 1999

This report reviews the loss ratio experience of Texas private passenger automobile insurers from 1990 through 1998 and with particular emphasis on the impact of "tort reform" on the liability insurance experience from 1996 through 1998.

Failure of "Tort Reform" to lower premiums for Texas automobile insurance consumers

The premise behind the mandatory "tort reform" rate reductions is that the benefits of "tort reform" – lower insured losses – should be passed on to consumers as lower premiums rather than insurers benefiting from lower loss ratios and higher profits. The Texas legislature sought to avoid the experience of the workers' compensation insurance market in the early 1990's when legislative changes led to massive reductions in workers' compensation insurance losses but increasing rates by workers' compensation insurers. It took a quasi-public workers' compensation fund writing almost 30% of the market and constant challenges by the Department of Insurance over a five-year period before workers' compensation insurers lowered rates commensurate with the reduced losses.

If "tort reform" rate reductions are being implemented correctly, we expect to see reductions in premiums while loss ratios remain steady. Under this scenario, the lower losses associated with "tort reform" are being passed on to consumers through lower rates and premiums, while insurers maintain reasonable loss ratios and profitability. However, as Table 1 shows, for private passenger automobile liability, precisely the wrong thing has happened – premiums have increased while loss ratios have dropped. Instead of "tort reform" benefits flowing to consumers, the benefits have flowed to insurers as billions of dollars of windfall profits. Liability premiums increased from the pre-tort reform 1994 and 1995 levels in 1996 and 1997. Only in 1998, fully three years after the implementation of *mandatory* tort reform rate reductions, did liability premiums decline from the previous year. But 1998 premium levels remained above pre-tort reform levels.

Further, overall Texas private passenger automobile insurance premiums continue to increase dramatically, suggesting that, on average, consumers are seeing no overall reduction in private passenger automobile premiums.

Excess Premiums and Profits in 1996, 1997 and 1998

Table 2 shows exactly how the benefits of "tort reform" have flowed to insurers as windfall profits. The table compares actual 1996 and 1997, and preliminary 1998, Texas private passenger automobile loss ratio experience to loss ratios determined by the Commissioner, in his 1997 benchmark rate order, to be reasonable. The technical notes accompanying this report provide details on data sources and methodology.

The premiums and rates for liability coverages were substantially excessive in 1996, 1997 and 1998. Liability premiums were excessive by 18.5%, 22.8% and 17.0% in 1996, 1997 and 1998, respectively. Stated in dollars, liability premiums were $928 million excessive in 1996, $1.187 billion excessive in 1997 and $869 million excessive in 1998 for a total of about $3.0 billion for the three years.

The dramatic excesses of the liability coverages led to excessive premiums for all private passenger automobile coverages combined. Total premiums were 9.3%, 14.5% and 10.5% excessive in 1996, 1997 and 1998 respectively. Stated in dollars, total premiums were excessive by $729 million excessive in 1996, $1.193 billion excessive in 1997 and $890 million in 1998 for total of about $2.8 billion for the three years.

Some insurers did return some excess premium to Texas consumers as policyholder dividends for 1996 and 1997. Table 3 shows total policyholder dividends of $49.0 million in 1996, $221.9 million in 1997 and $380.3 in 1998[1]. Even after deducting policyholder dividends from the excess premium figures, Texas private passenger automobile insurers reaped windfall profits from 1996 to 1998 of about $2.5 billion for liability coverages alone and $2.2 billion for all private passenger coverages combined. Assuming ten million insured vehicles, Texas automobile insurance consumers were overcharged an average of $220 per vehicle for the period 1996 through 1998.

Padded Reserves in the Early 1990s Mask Auto Insurers' Profitability

Some have argued that, when viewed over a longer period, Texas private passenger automobile insurers have not been overly profitable at all.[2] Rather, they argue the better profitability of 1996 and 1997 simply averages out the inadequate profitability of the early 1990's. Table 4, however, shows that Texas auto insurers masked their profitability in the early 1990's by dramatically overstating the reserves included with incurred losses.

Table 4 shows pure loss ratios for Texas private passenger automobile insurance from 1990 through 1998. "Paid Loss to Written Premium" relates dollars paid out by insurers in a calendar year to premium on policies written in that calendar year. "Incurred Loss to Earned Premium" relates paid losses plus changes in loss reserves for anticipated payments to premium earned on policies written in that calendar year. Incurred losses are considered a better indicator of losses associated with policies in a particular year and are used in developing automobile insurance rates. These loss ratios are termed "pure" because they relate losses to premiums without any other adjustment and represent the percentage of the premium dollar returning to consumers in claim payments.

[1] The 1998 policyholder dividend total is limited to the 75 companies whose experience was analyzed for 1998 and may understate total policyholder dividends.
[2] Bickerstaff and Whatley Consulting Actuaries, *Private Passenger Automobile Insurance Profitability in Texas 1988-97*, June 1998. A report prepared for State Farm.

Several items are noteworthy in Table 4. First, the comparison of paid-to-written loss ratios with incurred-to-earned loss ratios shows that incurred-to-earned loss ratios greatly exceeded paid-to-written loss ratios in the early 1990s. Insurers set aside substantial reserves in the early 1990s – resulting in high incurred-to-earned loss ratios – for claims they allegedly expected to pay out in coming years. If these reserve estimates were accurate, we would expect that after a few years, the paid-to-written loss ratios would increase as the claims from, say 1990 and 1991, were paid in 1992, 1993 and 1994. The reversal of paid-to-written and incurred-to earned loss ratios never occurred. Rather, the liability and overall paid-to-written loss ratios remained remarkably and consistently low. Table 4 shows that insurers padded reserves in the early 1990s and thereby masked their profitability.

Further evidence of over-reserving for automobile insurance is provided by insurance industry analysts Dowling and Partners Securities. Dowling and Partners have analyzed countrywide private passenger automobile insurance reserves for several years for their small clientele of very large investors.[3] The 1998 Dowling and Partners analysis shows $8 billion of "redundant" automobile liability reserves at the end of 1997 – representing about 12% of total automobile liability reserves. The Dowling and Partners study shows that the amount of redundant reserves did not change from the $8 billion total at the end of 1996. For example, aggregate incurred loss plus allocated loss adjustment expense ratios initially established by insurers at 83.8% in 1991 have been restated to 75.9% by 1997. The Dowling analysis shows reductions of 10.9% and 9.8% for 1992 and 1993 accident year experience loss and loss adjustment expense ratios since inception.

Paid-to-written loss ratios are not a good indicator of automobile insurance profitability over a shorter period – one or two years. However, the long-term, consistent pattern of overall paid-to-written loss ratios under 70% in Texas shows that Texas private passenger automobile insurers achieved reasonable or better-than-reasonable profitability from 1990 through 1995. After consideration of excess reserves, Texas auto insurers were profitable even before the windfall profits of 1996, 1997 and 1998.

Finally, it should be noted that the rate setting process starts with historical incurred losses. To the extent that historical incurred losses were exaggerated by excess reserves, rate indications during the 1990's were overstated.

Rate-Regulated versus Non-Rate Regulated

Some have suggested that Texas automobile insurance consumers would pay lower premiums if the benchmark with flexibility band rating system were eliminated and insurers were no longer subject to any rate oversight by the Texas Department of Insurance. A Progressive Insurance official has claimed that if automobile insurance

[3] As reported in "Auto Insurance Report" May 18, 1998 edition.

rates were deregulated and if all insurers did what Progressive does, Texas consumers would save $500 million annually.[4]

Table 7 shows that Progressive County Mutual – a non-rate regulated county mutual – has paid out much *less* of the premium dollar than rate-regulated insurance companies. Clearly, if every insurer did as Progressive does, then Texas automobile insurance consumers would have paid hundreds of millions *more* in insurance premiums. In fact, while the Texas Commissioner of Insurance has determined that a rate of return of around 11.5% to 12% is reasonable for Texas private passenger automobile insurance, Progressive has earned annual returns on equity from 17% to 19.3% countrywide from 1996 to 1998.[5]

Comments on the Bickerstaff & Whatley / State Farm Profit Study

In June 1998, the firm of Bickerstaff and Whatley (B&W) issued a report, commissioned by State Farm Insurance, responding to the Center for Economic Justice's March 1998 report on Texas private passenger automobile insurance profitability.[6] B&W argue the following:

1. Longer time periods should be used to measure profitability;
2. Comparisons of paid-to-written and incurred-to-earned loss ratios are inappropriate;
3. Current rate level adjustments (e.g., January 1, 1998 benchmark rate changes) were not adequately considered; and
4. The CEJ report included two mathematical errors.

B&W argue that a ten-year period is necessary to evaluate auto insurance profitability and that, when viewed over a ten-year period, Texas auto insurance has not been excessively profitable. The B&W arguments fail on several grounds. First, in the real world, profitability is not measured over a ten-year period for any purpose. Investors look to recent profitability. Ratemaking is based upon the most recent two or three years of experience. Insurers' decisions to enter or exit markets are based on less than ten years experience.[7] Regulators would not review ten years of loss experience to evaluate an insurer's solvency. The Texas Legislature, in establishing mandatory tort reform rate reductions did not reference direct the Commissioner to look at ten-year historical profitability in determining the necessary rate reductions.

[4] Press release of Progressive Insurance, February 23, 1999, "Auto Insurance Deregulation Could Save Texas Consumers More Than One-Half Billion Dollars Annually"
[5] "Insurance Industry," Investment Appraisal by A.G. Edwards, December 29, 1998.
[6] "Private Passenger Auto Insurance Profitability in Texas, 1988-1997," Prepared by Bickerstaff and Whatley, Inc. for State Farm Group, June 7, 1998.
[7] Evidence for insurers' market decisions being based upon fewer than ten years experience is shown by property insurers' drastically restricting writings in North Texas after hail storms in 1995 and by the influx of new entrants to the auto insurance market recently in response to the great profitability of auto insurance in Texas over the past few years.

Second, B&W are incorrect to claim that insurers have earned "below reasonable" returns on Texas automobile insurance from 1988 to 1997. B&W fail to consider the excessive reserves included in the incurred results over that period, as described above and shown in Table 4 of this report. B&W's effort to demonstrate that paid-to-written and incurred-to-earned loss ratios cannot be compared over time is also in error, as demonstrated by their own Exhibit 3 hypothetical model. B&W's model shows lower paid-to-written loss ratios than incurred-to-earned in the early years and then lower incurred-to-earned loss ratios than paid-to-written in the later years. But the B&W model shows, as hypothesized in the CEJ reports, that over time the excesses the incurred-to-earned loss ratio should be matched by excesses of paid-to-written loss ratios in later years. The actual Texas experience shows incurred-to-earned loss ratios exceeding paid-to-written loss ratios for many years and by significant amounts. There is no actual matching period of higher paid-to-written loss ratios. It is only in the past few years that paid-to-written loss ratios have exceeded the incurred-to-earned loss ratios and then by only a few percentage points.

The 1998 experience has shown that B&W were demonstrably wrong to argue that the CEJ analysis did not fully consider the modest rate reductions filed by insurers following the January 20, 1998 benchmark rate change. Contrary to the B&W arguments, Table 1 and 2 of this report show that Texas automobile insurance premiums and profitability were substantially excessive in 1998. Table 1 shows that the overall 1998 loss ratio was only 61.5% and Table 2 shows that premiums were excessive by $900 million compared to premiums levels based upon reasonable loss ratios. CEJ's analysis in early 1998 – that the modest rate decreases filed by insurers were insufficient and that deeper rate reductions were necessary – was accurate. It should be further noted that the Texas Department of Insurance challenged many insurers' early 1998 rate filings, resulting in many insurers filing additional rate reductions later in 1998. The excessive premiums shown for 1998 in Table 2 reflect even those additional rate reductions. *Given the modest rate decreases filed by top insurers in early 1999, current rate levels continue to be excessive.*

Finally, B&W did identify one mathematical error – the handling of service fees – that had a minor impact on the original analysis and is corrected in this report. B&W's allegation of a second error is incorrect – both allocated and unallocated loss adjustment expenses were, and are, correctly considered in the calculation of excessive premiums.

Technical Appendix

Table 1

The source of data is Texas Department of Insurance *Compilation of Page 14 Experience* from 1994 through 1997. The 1997 data came from the July 8, 1998 download from the NAIC database. The 1998 data came directly from page 15 of the Annual Statements of 75 companies. These 75 companies share of total market written premium, as reported in the 2nd Quarter 1998 Quarterly Report on Market Conditions, published by the Texas Department of Insurance is shown in Table 5. The companies included in the 1998 figures include the top 13 rate-regulated insurance groups and 17 county mutual insurance companies. Table 6 presents a list of the 75 companies.

Table 2

The source of the loss ratio data is Texas Department of Insurance *Compilation of Page 14 Experience* from 1996 and 1997. The 1997 data came from the July 8, 1998 download from the NAIC database. The 1998 loss ratio data came from 75 companies' Annual Statement page 14 reports. The source of the Unallocated Loss Adjustment Expense (ULAE), variable expense and fixed expense factors is Commissioner Bomer's 1997 benchmark rate decision. The Commissioner's determination of loss ratios and other rate provisions in that benchmark decision is deemed reasonable for this analysis.

The initial loss ratio (Line 1) is the sum of incurred losses and incurred allocated loss adjustment expense divided by earned premiums. The ULAE factor is applied to the incurred plus ALAE loss ratio to produce the total Loss plus LAE ratio in line 3. The percentage reduction in line 6 is equal to the negative of (((Line 3 + Line 5) / (1 – Line 4)) –1). Line 7, Earned Premium, comes from the *Texas Page 14 Compilation* for 1996 and 1997. For 1998, the total market Earned Premium is estimated from the 75 companies' Page 14 results, as shown in Table 5. Line 8 is the product of Line 6 and Line 7. Line 9, Percentage Excessive, is Line 8 divided by Line 7 less Line 8 and represents the amount that premiums were excessive above the reasonable level.

The calculations do not consider policyholder dividends of $49.2 million in 1996, $221.9 million in 1997 and $380.3 million in 1998.

Table 3

The source of data for policyholder dividends is Texas Department of Insurance *Compilation of Page 14 Experience* from 1994 through 1997. The 1997 data came from the July 8, 1998 download from the NAIC database. The remaining figures come from the calculations in Table 2. The 1998 data came from the 75 companies' Page 14 reports.

Table 4

Loss ratios were calculated from data published by the Texas Department of Insurance (TDI) in the *Compilation of Page 14 Experience* from various years, from 1990 through 1997. The 1997 data came from the July 8, 1998 download from the NAIC database. The 1998 data came from the 75 companies' Page 14 reports.

Table 5

This table shows the calculations of estimated 1998 total market premiums. The sum of written and earned premiums, respectively, are shown separately for county mutuals, rate-regulated companies and all companies for the 75 companies whose data was taken from the 1998 Annual Statement Texas Page 14 data submission. The market share columns are these 75 companies share of total market written premium as reported in the 2nd Quarter 1998 Quarterly Report on Market Conditions, published by the Texas Department of Insurance. The estimated total market written and earned premiums are the 75 companies' totals divided by the respective market shares.

Table 6

This table lists the 75 companies whose 1998 data were taken from Annual Statement Texas Page 14 data submissions.

Table 7

Loss ratios were calculated from data published by the Texas Department of Insurance (TDI) in the *Compilation of Page 14 Experience* for 1996 and 1997. The 1997 data came from the July 8, 1998 download from the NAIC database. The 1998 data came from the 75 companies' Page 14 reports.