

Docket No. 454-98-0244.G

**Texas Automobile Insurance Plan Association
Rate Hearing**

Prefiled Direct Testimony of Birny Birnbaum

May 1, 1998

1. Name and Qualifications

My name is Birny Birnbaum. I am a consulting economist specializing in insurance policy, rates and regulation. I offer this pre-filed direct testimony regarding rates for insurance obtained through the Texas Automobile Insurance Plan Association (TAIPA) on behalf of the Center for Economic Justice (CEJ).

A resume of my education and experience is attached as Exhibit BB-1. I have extensive experience in the analysis of Texas automobile insurance markets, rates and regulation. From 1991 to 1993, I served as the Chief Economist for the Texas Office of Public Insurance Counsel (OPIC). While at OPIC, I served as one of OPIC's expert witnesses in two benchmark automobile and two assigned risk automobile rate cases. From 1993 to 1996, I served as the Chief Economist and Associate Commissioner for Policy and Research at the Texas Department of Insurance. While at the Department, my responsibilities included the provision of technical advice to the Commissioner on numerous property casualty insurance matters. In that role, I reviewed and analyzed the evidence in two benchmark automobile and two assigned risk automobile rate hearings. I provided both economic and actuarial analysis to the Commissioner and drafted language for the Commissioner's rate decision orders. While at the Department, I also had responsibility for review and approval of all prior approval rate filings made pursuant to Article 5.101. I reviewed and took action to approve or send to the State Office of Administrative Hearings over 30 automobile rate and manual filings. I performed both economic and actuarial analyses of these filings, prepared requests for information and negotiated with insurers when I believed the proposed rates were excessive or the proposed rate classifications were not consistent with statutory requirements. Over the past five years, I have also performed economic and actuarial analyses as a consulting economist. I provided expert testimony in the most recent TAIPA rate hearing. In summary, I have extensive experience in issues involving automobile insurance, including both economic and actuarial analyses. I have particular knowledge of Texas automobile insurance markets and the operation of the TAIPA.

2. Summary of Recommendations

My recommendations at this time are as follows:

1. The rates for private passenger bodily injury and property damage liability coverages should be decreased by 41.0% and 3.2%, respectively.
2. The rates for private passenger uninsured/underinsured motorists bodily injury and uninsured/underinsured motorists property damage coverages should be established at 130% of the corresponding benchmark rates.

3. Background

An understanding of the structure and performance of the Texas private passenger automobile insurance market is necessary for evaluating TAIPA rate needs. The principal characteristics of the Texas private passenger automobile insurance market include:

1. There are three basic Texas automobile insurance markets – standard/preferred, non-standard and assigned risk.
 2. TAIPA has a distinct role as the third insurance market in Texas.
 3. The number of applications to TAIPA and the number of consumers insured through TAIPA has declined dramatically with the rate increases of July 1, 1995 and August 1, 1996.
 4. Consumers denied coverage in the standard/preferred market and forced to obtain insurance through TAIPA and county mutual insurance companies are disproportionately from poor and minority communities.
 5. The systematic denial of coverage by standard/preferred insurers to consumers from poor and minority communities constitutes redlining.
 6. The consequences of redlining on consumers from poor and minority communities are profound.
- 3.1 There are three basic Texas automobile insurance markets – standard/preferred, non-standard and assigned risk.

There are three basic private passenger automobile insurance markets in Texas.

Standard / Preferred Rate-Regulated Market

The first is the *standard/preferred, or rate-regulated, market*. The preferred consumers are those perceived by insurers as the least risky. These preferred risks are written by insurance companies with the most restrictive underwriting guidelines and the lowest rates. Preferred rates are about 10% to 15% above the benchmark rate. Standard risks, or consumers, are those perceived by insurers as a little more risky and are written by companies with slightly less restrictive underwriting guidelines and a bit higher rates. Standard risks are generally written at about 25% to 30% above benchmark rates. Standard and preferred risks are generally written by insurers regulated pursuant to *Texas Insurance Code 5.101*, including benchmark rating with flexibility bands and the rating rules of the *Texas Automobile Rules and Rating Manual*. In the third quarter of 1997, 74 insurers writing through about 206 companies wrote standard/preferred policies. The standard/preferred market represents about 70% of the total private passenger automobile insurance market in Texas, as measured by written premium.

Non-Standard County Mutual Market

The second market is the *non-standard, or county mutual, market*. High-risk drivers are written in the non-standard market by insurers with the least restrictive underwriting guidelines and the highest prices. Rates in the non-standard market are generally two or more times the benchmark rate. The non-standard market is generally written by non-rate regulated *county mutual insurers*. County mutuals are not subject to Article 5.101 and are not governed by the rating rules of the *Texas Automobile Rules and Rating Manual*. In the third quarter of 1997, 23 county mutual insurers wrote private passenger automobile policies.

The cost of insurance obtained through county mutuals is much higher than insurance obtained through the standard/preferred market. In addition to significantly higher rates, county mutuals generally charge policy fees, ranging from \$60 to \$125 for an annual policy. The policy fee is fully earned, meaning that the insurer gets to keep the full policy fee even if the consumer or the insurer cancels the policy in the first month. There are no policy fees in the standard/preferred market.

County mutuals typically use premium finance companies in lieu of company payment plans. The typical premium finance rate is over 30%. In the standard/preferred market, insurers are required to offer monthly payment plans to consumers. The fees for using the monthly payment plan are generally much less than the interest payments for premium finance.

In addition to the very high costs, the county mutual market has been the source of significant insurer abuses. In recent years, the Commissioner has issued warnings to consumers about “sliding” – the situation in which consumers are sold additional coverages that the consumer did not seek or want. The premiums for coverages like

accidental death and dismemberment and dues for motor clubs were added to consumers' policies and financed through affiliated premium finance companies.

Non-standard business is much more profitable than standard/preferred business in Texas. Investment guides and analyses routinely refer to non-standard auto as more profitable than standard/preferred auto. Private passenger automobile insurance loss ratios for county mutuals are typically lower than those for rate-regulated insurance companies – even though the same fixed expenses associated with the higher average premium of county mutuals would lead to a higher loss ratio.

The results of the non-standard, county mutual market in Texas – high costs, excessive profits, policy fees, premium finance, insurer abuses – result from both a lack of regulation and a lack of competition in the county mutual market. Consumers in the county mutual market are forced there because of rejection by the standard/preferred market. These consumers represent a captive market because they must purchase insurance, yet there are only a fraction of the number of county mutual insurers as of insurers writing standard/preferred business. In addition, as will be shown later in my testimony, the consumers rejected by the standard/preferred market are disproportionately from poor and minority communities. Thus, those consumers denied coverage in the standard/preferred market possess the least market power of any insurance consumers. In terms of regulatory oversight, there is no statutory requirement that county mutual rates be fair and not excessive. When the relative lack of competition and weak market position of consumers in the non-standard market is coupled with lack of regulatory oversight and absence of TAIPA as a meaningful alternative, the higher costs and profitability of the county mutual market are not surprising.

Assigned Risk Market

The third private passenger automobile market in Texas is the *assigned risk market*. Theoretically, consumers seeking to comply with Texas financial responsibility laws and denied coverage in the standard/preferred market can obtain insurance through TAIPA as an alternative to obtaining insurance through county mutuals. As will be shown later in my testimony, the excessive rates in TAIPA have virtually eliminated TAIPA as the third market.

3.2 TAIPA has a distinct role as the third insurance market in Texas.

TAIPA (as its predecessor, the Texas Automobile Insurance Plan) was created to allow consumers who were denied coverage in the standard/preferred market to purchase insurance and therefore be able comply with Texas financial responsibility requirements.

It is clear that TAIPA is intended as a third market in Texas, separate from the non-standard county mutual market and from the standard/preferred market. TAIPA is the home of good drivers rejected by the standard/preferred market and is not just another county mutual-like, high-risk insurer.

There is ample evidence to demonstrate TAIPA's unique role as the third market – the market for good drivers denied coverage in the standard/preferred market. First, although applicants to TAIPA are eligible if they have been rejected for insurance by at least two insurers writing automobile insurance in Texas, including insurers that are not rate regulated, the non-rate regulated county mutual insurers are not members of TAIPA and are not assigned policies through TAIPA. County mutuals do not get TAIPA assignments because county mutuals presumably write non-standard business that would otherwise end up in TAIPA.

Second, TAIPA would have no purpose if TAIPA were just another source of non-standard insurance. Because county mutuals are not rate-regulated, can write through multiple rating tiers and will write even the most risky consumer at some premium, TAIPA would have no meaningful role unless it were an alternative to county mutuals.

Third, the statutory requirements and limitations for TAIPA indicate that one of TAIPA's roles is to encourage greater voluntary writings by standard/preferred insurers. TAIPA represents a penalty to both insurers and consumers. To insurers, TAIPA represents forced business – policies the insurers must write even though the insurer would not write the policy if given the choice. Of course, this penalty for insurers is of their own making because the greater the rejections by the standard/preferred market, the greater the number of TAIPA assignments. TAIPA is a penalty to consumers because the consumer can only obtain minimum limits liability coverages through TAIPA, cannot obtain physical damage coverages through TAIPA and has no control over who his or her insurer will be. Thus, the basic structure of TAIPA exists to encourage insurers to write this business voluntarily and for consumers to seek insurance through other sources.

In addition, Article 21.81 contains other provisions which evidence TAIPA's role in encouraging greater voluntary writings by standard/preferred insurers. Article 21.81 Section 3 (c) states:

Among other provisions, the plan of operation must contain incentive programs to encourage members to write insurance on a voluntary basis and to minimize the use of the association as a means to obtain insurance. . . . One of these programs shall target underserved geographic areas which shall be determined and designated by the commissioner by rule. In determining which areas will be designated as underserved, the commissioner shall consider the availability of insurance, the number of uninsured drivers, the number of drivers insured through the association, and any other relevant factors.

Thus, one of the fundamental roles of TAIPA is to encourage voluntary writings by TAIPA members – standard/preferred insurers. TAIPA could simply not serve this role if TAIPA acted like just another non-standard, county mutual insurer.

The special role of TAIPA, distinct from non-standard county mutuals, has been acknowledged by insurers themselves through their acceptance and inclusion in the TAIPA plan of operation of the mandatory take-out program. Under this program, insurers must offer a voluntary market policy to consumers insured through TAIPA for three years without at-fault accidents or convictions. The rates for the voluntary policy offered must be at levels below the prevailing TAIPA rate.

In addition, the plan of operation does not assign quota to TAIPA members for voluntary business written by those members at rates above the prevailing TAIPA rates. Since the number of county mutuals is limited and not all insurers have county mutuals to write non-standard business, some insurers obtain prior approval for non-standard rates in rate-regulated companies. To provide fairness to the insurers who write non-standard business in rate-regulated companies, the TAIPA governing committee approved the provision in the plan of operation which states that the only vehicles eligible for determining quota for TAIPA members are those vehicles written at or below prevailing TAIPA rates.

In summary, TAIPA has a distinct role as the third insurance market in Texas, distinct from the standard/preferred and non-standard/county mutual markets. If TAIPA does not serve a role different from county mutuals, it is serving no meaningful function.

3.3 The number of applications to TAIPA and the number of consumers insured through TAIPA has declined dramatically with the rate increases of July 1, 1995 and August 1, 1996.

Exhibit BB-2 shows the history of monthly assignments by TAIPA to TAIPA members from 1990 to the present. The number of applications and monthly assignments has varied dramatically over this time period. Generally, there are five distinct groupings:

1. For 1990, the monthly assignments ranged from about 11,000 to 13,000.
2. In the first eight months of 1991, the monthly assignments ranged from 18,000 to 25,000.
3. Starting with increased enforcement of financial responsibility in September 1991 and continuing through June of 1995, the monthly assignments were generally in the range of 50,000 to 60,000.
4. Starting with a big rate increase on July 1, 1995 and continuing through July of 1996, the monthly assignments were generally in the range of 20,000 to 25,000.
5. Starting with another rate increase on August 1, 1996 and continuing through the present, the monthly assignments have declined from 8,000 to 10,000 to 5,000 to 6,000.

The current number of monthly TAIPA applications is less than half of the applications in 1990, even though the Texas population has grown significantly over the past eight years. In early 1990, TAIPA bodily injury and property damage liability coverage rates were only 27% above the then-manual rate. In early 1998, TAIPA bodily injury and property damage liability coverage rates are, in aggregate, more than 90% above the voluntary market benchmark rates.

As the table below shows, the change in TAIPA applications is reflected in the rapid decline in the number of vehicles insured through TAIPA:

<u>End of Quarter</u>	<u>Vehicles Insured Through TAIPA</u>	<u>Share of Total Vehicles Insured</u>
1995-1	821,813	8.4%
1995-2	816,906	8.3%
1995-3	687,420	7.0%
1995-4	562,159	5.8%
1996-1	452,785	4.6%
1996-2	376,779	3.8%
1996-3	335,140	3.3%
1996-4	282,237	2.8%
1997-1	185,086	1.9%
1997-2	143,478	1.4%
1997-3	117,746	1.2%

3.4 Consumers denied coverage in the standard/preferred market and forced to obtain insurance through TAIPA and county mutuals are disproportionately from poor and minority communities.

A number of studies of availability in Texas automobile insurance markets have demonstrated that people denied coverage from standard/preferred insurers are disproportionately from poor and minority communities. These studies include:

1. 1993 Study by the Office of Public Insurance Counsel (OPIC) of the Geographic Distribution of Private Passenger Automobile Assigned Risks;
2. 1993 Study by the Office of Public Insurance Counsel of the Location by ZIP Code of State Farm Agents;
3. 1993 Study by the Texas Department of Insurance (TDI), "Analysis of Texas Automobile Insurance Plan (TAIP) and Homeowners Markets";

4. 1994 Study by OPIC, "A Review of Auto Insurance Underwriting Guidelines Used in Texas";
5. 1994 TDI Analysis of Private Passenger Automobile Insurance Availability; and
6. 1994 Study by the Austin American Statesman of Private Passenger Automobile Insurance Availability.

I performed another analysis of private passenger automobile insurance availability last year. Exhibit BB-3 shows that consumers living in poor and minority neighborhoods are far more likely to be rejected by standard and preferred insurers and end up insured by county mutuals or through TAIPA, if they are able to afford the higher-priced insurance at all.

Exhibit BB-3, Sheet 1 shows that, even though the percentage of people insured through TAIPA in 1996 was much less than in 1992, the percentage of people insured in TAIPA and non-standard insurers has increased. The auto insurance rejection rates continue to be associated with the size of the minority population and median household income.

Race and income continue to be significant predictors of rejection by standard market insurers. To measure the strength and contribution of race and income to availability, I performed a linear regression and found both race and income to be statistically significant predictors of insurance availability for the 1996 experience. Even holding income constant and isolating the contribution of race alone, race is a significant predictor of insurance availability. Consumers living in high-minority ZIP Codes (80% minority) are two to three times more likely to be insured through TAIPA or non-standard insurers than consumers living in low-minority ZIP Codes (10% minority).

Exhibit BB-3, Sheet 2 provides an analysis of the auto insurance rejection rate by ZIP Code, but includes all ZIP Codes with total insured vehicles of at least 250 or more and for which 1990 Census data were available. This analysis addresses a potential problem with a few ZIP Codes included in the Exhibit BB-3, Sheet 1 analysis that had small populations but few or no insured vehicles. In addition, Exhibit BB-3, Sheet 2 provides a weighted average analysis in addition to the simple average analysis of Exhibit BB-3, Sheet 2. A simple average analysis may overweight ZIP Codes with relatively small vehicle counts. However, as Exhibit BB-3, Sheet 2 shows, there is little difference between the simple and weighted average results.

Exhibit BB-3, Sheet 3 provides an analysis of TAIPA-only vehicle counts by ZIP Code. This analysis provides evidence that drivers insured through TAIPA, even after the dramatic reduction in vehicles insured through TAIPA from June 30, 1995 to June 30, 1996, are disproportionately from poor and minority communities. Exhibit BB-3, Sheet 3 shows that as the percentage insured through TAIPA increases, the minority population of the ZIP Codes increases and the median household income decreases. The weighted average analysis, which is more accurate than the simple average analysis, vividly shows

this relationship. In addition, Exhibit BB-3, Sheet 3 shows that a large number of ZIP Codes are included in the categories of greatest TAIPA percentage. Fully 123 ZIP Codes show TAIPA percentages two or more times as great as the statewide average. There are several ZIP Codes with TAIPA percentages of over 20%, compared to the statewide average of about 3.8% at that time.

In addition to the basic facts of redlining, it is important and relevant to show what has happened to the distribution of vehicles insured through TAIPA as excessive TAIPA rates have caused the number of vehicles insured through TAIPA to plummet. Exhibit BB-4 shows the percentage reduction in TAIPA vehicle counts by county territory from June 30, 1995 to September 30, 1996. The exhibit also shows the change by county relative to the statewide average change. Exhibit BB-4 shows clearly that the decline in TAIPA vehicle counts has varied dramatically across Texas. The counties with the largest reductions are generally the poorest counties, including many counties in south Texas. This exhibit indicates that excessive TAIPA rates have had a disproportionate impact on the poorest consumers. Exhibit BB-5 provides the same analysis of changes in vehicle counts with the counties grouped into the 52 rating territories.

Exhibit BB-6 shows some of the impact of the excessive TAIPA rates. The exhibit compares the count of total vehicles insured as of June 30, 1996 with the U.S. Census population estimates for July 1, 1996. The ratio of insured vehicles to population varies dramatically by rating territory. While there are some problems with this ratio as a measure of uninsured vehicles, the figure does give order of magnitude indications. For example, more affluent areas may have more vehicles per person than less affluent areas, which would overstate the insured ratio in the more affluent areas and understate the insured ratio in the less affluent areas. In addition, some areas may have a greater percentage of non-driving age children than other areas. In these areas, the insured ratio would be understated. Even with these caveats, Exhibit BB-6 is frightening. I added a column to the exhibit that imputes a percentage of uninsured vehicles. In a few territories, the percentage of uninsured vehicles is over 50%. Even with the caveats described above, it is clear that the number of uninsured vehicles in some areas is large and far greater than the statewide average.

By comparing Exhibit BB-6 with Exhibit BB-5, we can see that the rating territories with the greatest reductions in TAIPA vehicle counts are also the rating territories with the highest estimates of uninsured vehicles. It is clear that excessive TAIPA rates have had a disproportionate impact on poor consumers and have worsened the uninsured motorist problem.

Exhibit BB-7 shows the distribution of insured vehicles by category of underserved ZIP Code. The Commissioner has designed certain ZIP Codes as underserved for the purposes of private passenger automobile insurance. There are four categories – 1, 2, 3 or 4 – with the higher number categories assigned to the more underserved ZIP Codes. Exhibit BB-7, Sheet 1 shows the share of insured vehicles by

major driver classifications for voluntary, county mutual and assigned risk markets. Exhibit BB-7, Sheet 2 provides the same analysis with an adjustment for 1996 experience to remove USAA County Mutual vehicles from the county mutual group and add those vehicles to the voluntary market group. This is appropriate because USAA has moved its standard business from one of its rate-regulated companies to the county mutual while continuing to charge generally standard rates. Exhibit BB-7, Sheet 2 shows that the share of vehicles insured in underserved areas in the standard market has remained essentially unchanged over the last few years. In contrast, the share of vehicles insured in underserved areas has increased in the non-standard market and decreased in TAIPA. While we would have hoped that the decrease in the TAIPA percentages are a result of take-out and incentive programs to encourage insurers to voluntarily write the business, the increase in non-standard percentages indicates that drivers leaving TAIPA are going to county mutuals, if they are able to purchase insurance at all.

3.5 The systematic denial of coverage by standard insurers of drivers in poor and minority communities constitutes redlining.

Insurers subject to the rate regulation of *Texas Insurance Code* 5.101 are subject to the rating rules promulgated by the Commissioner in the *Texas Automobile Insurance Rules and Rating Manual*. This manual, which prescribes the driver and territorial classifications, includes 55 rating territories. Each rating territory consists of at least one county, while some rating territories consist of multiple counties. Exhibit BB-8 shows the pages from the *Manual* describing the definition of rating territories.

The purpose of territorial classification and rating territories is to provide different rates for different geographic areas where expected costs are different. Thus, rates are higher in an urban county, like Harris County, than in rural counties, because expected losses, all other factors being equal, are higher in Harris County because of greater traffic density and higher costs of claims.

Rates for a particular risk, however, do not vary within a rating territory because a rating territory groups consumers of similar geographic risk. Because a rating territory represents an area of relatively homogeneous geographic risk, we would not expect dramatic differences in the writings of insurers by smaller geographic areas within the rating territory. Yet, the evidence shows that ZIP Codes with poor and minority consumers are much less likely to obtain insurance through standard and preferred insurers. Put another way, standard and preferred insurers do not make their insurance equally available throughout the rating territory. The practice of denying a consumer insurance because of where they live is called *redlining*.

3.6 The consequences of redlining on consumers from poor and minority communities are profound.

The consequences of redlining on consumers from poor and minority areas are profound. From the start, the requirement to purchase automobile insurance is a significantly higher financial burden on poor consumers than on middle- and upper-income consumers because the cost of automobile insurance represents a greater share of the poor family's income – an income that has much less available after purchase of basic food, shelter, transportation and medical care.

When consumers are denied coverage in the standard / preferred market, the costs of insurance skyrocket. As described above, consumers denied coverage in the standard/preferred market face significantly higher prices from county mutuals or TAIPA. It is critical to point out that vast majority of drivers insured through TAIPA were not denied standard/preferred coverage because of their driving record – the vast majority of TAIPA insureds have no at-fault accidents or convictions.

The high costs of insurance through county mutuals and TAIPA force many consumers who are denied coverage in the standard/preferred market to go without insurance because they simply cannot afford it. Exhibit BB-9 shows data from the Houston and Austin municipal courts, which show that hundreds of thousands of drivers receive citations annually for “failure to maintain financial responsibility” – driving without insurance. If we extrapolate the 220,000 citations a year in Houston and the 40,000 citations a year in Austin statewide, over 1,000,000 drivers a year receive citations for driving without insurance.

The costs of unaffordable insurance for poor people are far greater than a ticket and fine for no insurance. In 1994, fully one-third of the 5,000 prisoners in the Richardson jail facility were there because they could not pay the fines for driving without insurance. The combination of mandatory insurance and redlining by insurers has criminalized poverty and created modern day debtor's prisons.

The costs of unaffordable insurance and redlining create an environment where illegal activities, such as counterfeit proof of insurance cards, can flourish because the cost of illegal activity – including the potential for fines and other punishment -- is less than the cost of purchasing insurance. In addition, there are some areas in the state where, because strict enforcement of financial responsibility would put half the driving population in jail, the laws can simply not be enforced.

The combination of redlining and excessive TAIPA rates not only penalizes poor people for their poverty, but exacerbates the problem of uninsured motorists.

4. Bodily Injury and Property Damage Liability Coverages

I have employed the loss ratio ratemaking method to determine rate change indications for bodily injury and property damage liability coverages. With this method, the ratio of projected loss and loss adjustment expenses and fixed expenses to projected earned premium is compared to one minus variable expenses. The overall rate analysis is shown in Exhibit BB-10.

4.1 Projected Premium

It is necessary to adjust actual historical earned premium to premium at current rate levels. Historical premium is adjusted for rate changes implemented since that premium was earned. The adjusted premium is called premiums at present rates (PPR).

The normal assumption for PPR adjustment is that premium is earned evenly through the year. Thus, a rate change effective on July 1 is applied to half of the calendar / accident year premium. This assumption is not valid for TAIPA experience because the volume of TAIPA business declined dramatically after the June 1, 1995 rate change and declined further after the August 1, 1996 rate change.

Exhibit BB-11 shows the PPR factor calculation. The exhibit shows the TAIPA written premium by quarter from the beginning of 1995 to the end of 1996. These data come from the Texas Department of Insurance as reported by insurers in the Quarterly Call. This measure is not perfect because the written premium reported in the Quarterly Call covers all liability coverages and does not allow isolation of individual coverages. However, these measures are superior to either no adjustment at all or an adjustment based upon vehicles on policies in force at the end of each calendar quarter.

The result of the PPR calculation is the projection of premium that would be earned during 1999 at current rate levels for the same exposures in calendar / accident years 1994 through 1996.

4.2 Adjustments to Losses

The projection of losses to calendar / accident year 1999 adjusts actual historical losses in three ways. Actual historical losses, in this instance, mean incurred losses plus allocated loss adjustment expenses, as reported in the Annual Aggregate Experience compilation provided by TDI.

The first adjustment is loss development. Loss development refers to expected changes in losses over time as claims are settled, reserves adjusted and new claims associated with a particular calendar / accident year arise. Exhibit BB-12 provides a standard loss development analysis based upon TAIPA experience as reported in the Annual Aggregate Experience compilation provided by TDI.

The second adjustment is unallocated loss adjustment expense (ULAE). Loss adjustment expenses (LAE) are those costs associated with settling claims, as opposed to the claim payments themselves. LAE is typically divided into two groups. Allocated LAE are those expenses that can be associated with a specific claim. Incurred ALAE has been identified in the Annual Aggregate Experience compilation provided by TDI and combined with incurred losses. ULAE are those expenses associated with the general claim settlement process and not attributable to specific claims. At this time, I am utilizing the ULAE factors adopted by the Commissioner in the most recent TAIPA rate order.

The third adjustment is loss trend, which attempts to modify historical losses for changes in claim frequency and severity over time. Loss trend is typically one of the most significant and disputed components of the ratemaking process.

4.3 Loss Trend

The data used for loss trend analysis consist of earned car years, paid claims and paid losses. Earned car years is a measure of exposure – the amount of risk insurers were exposed to during the calendar quarter. One vehicle insured for the entire calendar quarter represents one-fourth earned car year. Thus, earned exposures reflect the actual exposure of policies in force during a particular calendar quarter. Paid losses and paid claims, on the other hand, represent the number of claims and losses paid during the calendar quarter. These paid claims and losses are likely to be associated with exposures from earlier calendar quarters. For example, a claim paid in December may be associated with a policy in force in January of that year. Thus, there is a mismatch between *earned* car years and *paid* claims and losses. The mismatch occurs because earned premiums are associated with a particular calendar quarter while paid claims and paid losses are associated with the exposures earned in any number of previous quarters. This mismatch between earned exposures and paid claims is worst for those coverages with a longer “tail” – losses are paid over a period of several years after the policies are written.

Although there is a mismatch between paid claims or paid losses and earned exposures, the paid claims and paid losses are used because these data are available quickly after the end of the calendar quarter. These data are available on a quarterly basis, typically just a few months after the end of the calendar quarter. Further, under normal circumstances, in which the number of earned exposures is relatively constant or increasing regularly over time, the mismatch of paid claims to earned exposures does not affect the trend analysis.

In a trend analysis, the goal is to evaluate changes in claim frequency and claim severity over time. When earned exposures are relatively constant or regularly increasing (or decreasing), the mismatch does not significantly distort the trend analysis. Exhibit BB-13, Sheet 1 illustrates a situation with generally increasing exposures – actual earned car years for the voluntary market from the TDI trend survey -- and an assumed actual claim frequency of 3.0% over the entire period. Obviously, the actual annual trend, or

change in claim frequency, is zero – the claim frequency is set at a constant 3.0%. To illustrate the payout of claims associated with a particular quarter's exposures over time, I assume that 50% of the claims associated with a particular quarter's exposures will occur two quarters after the quarter in which the cars were earned, 20% occur after three quarters, 20% occur after four quarters and 10% occur after five quarters.

In BB-13, Sheet 1, the claim frequency varies up and down from 2.85% to 2.97% over the period analyzed. The calculated frequencies are less than the actual frequency of 3.0% because the earned exposures are increasing. The frequencies vary slightly between 2.85% and 2.97% because the earned exposures are not increasing by a fixed percentage. However, the trend analysis of these data points will show an annual trend close to the actual trend of zero.

In contrast, a situation in which earned exposures fluctuate dramatically will cause serious distortions in the trend analysis. The TAIPA trend data show precisely this type of fluctuation in earned car years. Exhibit BB-13, Sheet 2 uses the actual earned exposures reported for TAIPA experience in the Department's trend survey. BB-13, Sheet 2 uses the same actual claim frequency of 3% and the same pattern of occurrence as BB-13, Sheet 1. The resulting claim frequencies show how fluctuating earned exposures distort the trend analysis. With actual TAIPA earned exposures with a constant actual 3% claim frequency, the trend data show claim frequencies ranging from 1.56% to 5.37%. More important than the great divergence from the actual frequency is the pattern of rapid increases. An analysis of these trend data would indicate a dramatic increase in claim frequency – on the order of a 50% average annual increase! – even though the actual frequency trend is zero.

BB-13 shows conclusively that the TAIPA trend data are not reliable for analyzing claim frequency and can not be used for that purpose.

Source of Trend Data

In the absence of reliable TAIPA trend data, the combined market trend data should be relied upon. If the same factors affecting frequency and severity of TAIPA business are also affecting voluntary market business, then combined trend data will identify changes in frequency and severity.

A choice of trend data is available – data from a special survey compiled by the TDI or so-called “fast-track” data compiled by national statistical agents. The Commissioner has stated his policy that fast-track data should not be used directly in the ratemaking process. Fast track data has specific limitations. First, the fast-track data are not reported by all insurers. Second, the fast-track data are not subject to the same data quality assurance procedures as ratemaking data. Of course, the absence of the entire set of data quality assurance procedures allows the data to be available many months earlier than would otherwise be the case. Third, the fast-track data do not separate out basic limits experience, but provides only total limits experience.

Normally, trend data provided by the Department are clearly superior to fast track data. Normally, trend data provided by the Department represent the entire market and have been subjected to complete data quality assurance procedures. And, normally, trend data provided by the Department break out basic limits experience.

However, in the current situation, the trend data provided by the Department does not have all these advantages. First, the trend data provided by the Department for this hearing do not represent the entire market. Rather, these data comprise only the experience of nine insurers for voluntary liability experience and eight insurers for involuntary experience. The fast track data contain almost all the experience of these nine insurers with the addition of the experience of many other insurers and, therefore, represents more of the market than the Department's trend survey.

Second, because the Department's trend data was obtained in a special survey, only basic data quality assurance procedures were performed. As a result, there is no assurance that the quality of the Department's trend data is better than that of the fast track data. In fact, because insurers have been reporting fast track data for many years, the fast track data is more likely to be accurate than the Department's survey data. In my experience as a regulator who issued numerous special surveys and calls to insurers, the quality of data provided in response to such calls is often less than excellent. Special calls often encounter data quality problems because insurers have never programmed their computers to produce this specific set of data. While the production of trend data should not have posed a problem to insurers, it still represents an ad hoc report to the Department.

Third, the overwhelming advantage of the fast-track data is its currency. The Department's data is available only through the end of 1996, while the fast track data are available through the end of 1997 – fully one more year of trend data. For the purposes of trend analysis, the most current data is clearly the most valuable because the more current data better reflects changes in claim frequency and severity.

In summary, the fast track data include more insurers than the Department's survey data and, therefore, comprises a larger share of the total market. The reliability of the fast track data is likely better than the Department's survey data. And the absence of separate basic limits experience in the fast track data is more than offset by the availability of a full year of more current experience.

Loss Trend Analysis and Selections

Exhibit BB-14 reports fast track data for Texas and show various analyses. The frequency and severity are calculated for a twelve-month period ending each calendar quarter. An exponential curve is fitted to these 12-month data points. The slope of the curve is the percentage change per quarter. The quarterly trend is annualized to present

an estimate of the average annual percentage change in frequency, severity and pure premium.

For bodily injury liability, the loss trends are significantly negative, meaning a dramatic reduction in loss costs. Part of this large decline is attributable to the effects of so-called tort reform. However, it is difficult to identify what portion is attributable to tort reform and what portion to other causes. Therefore, I have not applied a separate tort reform reduction for bodily injury losses.

In addition, I have separated the loss trend calculation into two periods. The first period extends from the midpoint of the calendar / accident year to the end of 1997 – the end point of the data for the trend analysis. The second period extends from the beginning of 1998 through the end of 1999 – the prospective part of the trend analysis.

I have selected –10% as the annual loss trend for the up-to-date portion of the bodily injury trend analysis. Given the absence of any tort reform reduction factor in my analysis, this selection is conservative. I have selected –2% for the prospective portion of the bodily injury trend analysis. This selection is very conservative because it assumes that reductions in loss costs will be substantially moderate in 1998 and 1999 as compared to 1995 through 1997 and because no tort reform reduction factor is utilized.

For property damage liability, I selected a 2% average annual trend for the entire trend analysis period. This selection reflects the improvement in loss costs over the most recent years.

4.4 Expense Provisions

At this time, I am utilizing the fixed expense and variable expense provisions adopted by the Commissioner in the most recent TAIPA rate order with one exception. The Commissioner adopted a 0% underwriting profit for TAIPA – the same provision as adopted by the Commissioner for liability coverages in the benchmark auto decision. Because TAIPA business has a greater loss ratio than voluntary business, TAIPA business will have greater investment income relative to a dollar of premium than voluntary business. To account for this difference, I have judgmentally selected a –2% TAIPA profit provision.

4.5 BI and PD Recommendations

Based upon the preceding analysis, I recommend a 41.0% reduction for bodily injury liability and a 3.2% reduction for property damage liability.

5. Uninsured / Underinsured Motorists Coverage

The uninsured/underinsured motorist coverages (bodily injury and property damage) provide compensation to a consumer (driver 1) who has been injured by another driver (driver 2) who does not have insurance (or adequate insurance) and who (driver 2) is the party at-fault in the accident. Thus, claims on UM/UIM coverage result from accidents in which the policyholder is not at-fault.

5.1 The causes of UM/UIM exposure

Some may argue that the likelihood of being in a not-at-fault accident with an uninsured motorist, i.e., the likelihood of using UM/UIM coverage, is higher with bad drivers because the bad driver is less able to avoid not-at-fault accidents compared to “good” drivers. However, the TAIPA experience shows clearly that the overwhelming reason why certain people are more likely to be in not-at-fault accidents with uninsured drivers is because they live in areas with much higher numbers of uninsured drivers. You are simply more likely to be involved in an accident with an uninsured driver if you live in an area with lots of uninsured drivers.

As the studies on availability show, drivers in poor and minority areas are much more likely to be denied coverage in the standard / preferred market and face the higher costs of county mutuals or TAIPA. As Exhibits BB-3 through BB-7 show, the areas with the greatest availability problems and the highest rate of TAIPA drivers are also the areas with the highest share of uninsured drivers.

5.2 Basing TAIPA UM/UIM rates only on TAIPA experience causes those consumers who were the victims of redlining to be further penalized because they were redlined in the first place.

The availability analyses show that consumers from poor and minority areas are disproportionately denied coverage by standard/preferred insurers. Consumers from poor and minority areas are also the ones most likely to be unable to afford the higher rates of TAIPA and county mutuals and, subsequently, go without insurance. Standard / preferred insurers contribute to the high percentage of uninsured drivers in poor and minority areas by redlining these areas. And it is precisely the large number of uninsured drivers in these areas that cause TAIPA UM/UIM experience to be worse than the industry average experience – TAIPA drivers come disproportionately from poor and minority communities.

Setting TAIPA UM/UIM rates on TAIPA only experience is unfair to TAIPA drivers who have no control over whether their neighbors purchase insurance or not. Some may argue that consumers decide where to live, in part, based upon the costs the neighborhood, including the costs of insurance. Yet, even if a consumer could decide to live in a neighborhood with few uninsured drivers, the consumer has no control over the decision of standard / preferred insurers to deny him or her coverage and cause him or her

to obtain insurance through TAIPA. In reality, people cannot and do not choose where they live based upon knowledge of how many neighbors are insured or uninsured.

5.3 The basis for UM/UIM risk classification does not include driver classification.

Exhibit BB-15 shows the UM/UIM rate pages from the *Texas Automobile Rules and Rating Manual*. The pages show that UM/UIM bodily injury rates are based only upon two geographic locations. There is one rate for all the “big city” rating territories and one rate for all other territories. There are no separate rates by driver classification, such as a higher rate for the otherwise riskier class 2 drivers than class 1 drivers. Rather, UM/UIM BI rates are only broken out for “big city” counties because, presumably, there may be a greater number of uninsured drivers or the costs of an average claim are higher. It should be pointed out that the composition of the group of “big city” rating territories goes back many years, at least to the late 1980’s. That may be the reason the grouping does not currently include territories with larger cities. It should be further noted that for UM/UIM property damage coverage, there is not even a territorial classification. For UM/UIM PD, there is only one rate for everyone across the entire state! In contrast, the rates for personal injury protection are differentiated on the basis on the bodily injury liability class rate amount. Thus, PIP rate classifications reflect both territorial and driver characteristics.

5.4 Basing TAIPA UM/UIM rates only on TAIPA experience is unfairly discriminatory and in violation of Article 21.81.

The risk of an UM/UIM claim is a function of where someone lives and not one’s driving record or driver classification. This is evidenced by the UM/UIM risk classifications in the *Manual*.

The reason why UM/UIM rates have neither a territorial risk classification or no classification at all is because the risk posed by a consumer for UM/UIM coverage is related only to geographic location. Thus, consumers within a geographic area pose the same risk of loss for UM/UIM coverage. It is unfair discrimination to treat consumers of the same class and essentially the same hazard differently. By setting TAIPA UM/UIM rates only on TAIPA experience, consumers of the same class and essentially the same hazard are treated differently. Assume that there are two drivers in Travis County who live next to one another and are otherwise identical except one is insured by a standard/preferred insurer and the other insured through TAIPA. For the purposes of UM/UIM rates, both drivers are of the same class and are of essentially the same risk -- they live in the same geographic area and are exposed to the same number of uninsured drivers. Yet, the driver insured through TAIPA will pay six times the amount for UM/UIM coverage than the other driver. This difference in treatment is unfair discrimination and is in violation of Article 21.81, which states that the Commissioner shall prescribe rates that are just, reasonable, adequate, not excessive, not confiscatory and not unfairly discriminatory for the risks to which they apply. In the case of

UM/UIM, the determination of risk is the geographic location of the risk, not the driver classification and not the fact the consumer is insured through TAIPA.

5.5 The rates for TAIPA UM/UIM coverages should be set at 130% of benchmark rates.

Ideally, the rates for both voluntary and involuntary market UM/UIM coverages should be set at a benchmark rate based upon total voluntary and involuntary market experience. This procedure would best reflect the nature of the UM/UIM exposure.

However, because rate-regulated insurers can simply file and use UM/UIM rates up to 130% of benchmark rates and it would not be sound policy to establish TAIPA rates below standard / preferred rates, I recommend establishing TAIPA UM/UIM rates at 130% of the benchmark rates for the respective coverages.

This concludes my pre-filed direct testimony.