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The Limitations of a Competitive Auto Insurance Market: How to Reduce Rates and Increase Insurer Profitability Simultaneously

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Auto insurance markets are atypical. To illustrate this, it is helpful to compare the market for auto insurance with the market for refrigerators. Manufacturers of refrigerators have a market incentive to produce the highest quality refrigerators as inexpensively as possible. If Company A can produce a better quality refrigerator than its competitors at a cost equal to or below those offered by the competitors, then Company A will gain market share. Similarly, if Company A can produce a refrigerator equal in quality to the refrigerators sold by competitors but can do so at a lower cost, then Company A will also gain market share. Over time, given these incentives, the refrigerator market will produce increasingly superior products at ever-decreasing costs. The benefits of competition to consumers of refrigerators are both obvious and substantial.

The market for refrigerators is an excellent example of an efficient market. The auto insurance market, in sharp contrast, is a very inefficient one, at least from the consumer's perspective, and is unlike most markets in the following important respects:

1. <u>Rational insurers want to sell their product only to *some* consumers.</u> In most markets, companies want to sell to as many customers as possible, but that is not the case in the auto insurance market. Since the insurer's cost of "making" the product is dependent on which consumers buy the product, the most efficient way for auto insurers to minimize "production" costs (and thereby make profits) is through "risk selection," the identification of the consumers whose insurance rates are mispriced by the market. Drivers overpriced by the market in the opinion of the insurer are attractive customers. Drivers underpriced by the market are considered to be undesirable customers. Ideally, the insurer would like to insure every overpriced driver – possibly at a rate slightly below market in order to attract the customers and still make a healthy profit – and would like to avoid insuring any underpriced drivers.

2. For an insurer, the ideal customer makes no claims and, ultimately, receives nothing of value. Insurance is one of the few products where the seller hopes to sell the buyer an expensive product without providing anything of value to the customer. This creates an antagonistic relationship between insurers and their customers, illustrated best in the situation in which an insurer denies a customer's claim. It also creates an incentive for a customer to engage in insurance fraud in order to receive some "value" from the insurer.

3. In 47 states, drivers are mandated by law to purchase auto insurance. Generally, if the price of a product becomes too high for a buyer, the buyer can refuse to purchase the product. Many drivers who pay the highest premiums have few assets and therefore do not need to buy auto insurance to protect them. They are required to purchase insurance, however, in large part to protect other drivers. (If insurance were optional, many drivers with few assets would drop their auto insurance, and the rates for the uninsured driver coverage would increase dramatically. Essentially, all uninsured drivers would receive a 100% rate decrease, which would be counterbalanced by increases in rates for the remaining insured drivers.)

4. Substantial cost reductions achieved by an individual auto insurer do not generally lower a statewide average auto insurance rate. In most markets, cost-saving innovations by individual companies cause market-wide reductions in the underlying cost of the product. This is not true in the auto insurance market, and this fact is particularly important because it leads to dramatic market inefficiencies. Specifically, as noted above in Item (1), an insurer tries to reduce the cost of its product primarily through risk selection. Risk selection does not, however, lower the statewide average auto insurance rate. The risks avoided by one insurer are written by another. This creates a zero-sum game where cost reductions achieved by one insurer are offset by cost increases born by another insurer. The statewide average rate remains unchanged, which should not be surprising since the underlying costs of the entire system – accidents, fraud, medical inflation, etc. – have not been altered.

The best ways to reduce a statewide average auto insurance rate are not cost effective for an individual insurer. The secret to lowering a statewide average auto insurance rate is simple. The states with the lowest underlying costs are also the ones with the lowest rates. Thus, if the underlying costs in a state are reduced, the statewide average rate will also drop. For auto insurance, the two main costs in the system are accidents and insurance fraud. Unfortunately, it is not cost effective for an individual insurer to expend its own resources to lower the number of accidents in a state (or even at a particularly dangerous intersection) or to try to collect enough evidence to break up a fraud ring. The reason it is not cost effective is that any cost reductions produced by accident reductions or by eliminating fraud rings will benefit not only the insurer in question, but also the other insurers in the state. Consequently, the insurer attempting to reduce accidents or fraud expends its own capital but produces no competitive advantage in the marketplace. That is a poor business decision.

Significant reductions in a statewide average auto insurance rate can be achieved, however, by using state government to organize an industry-wide effort to reduce underlying costs such as accidents and fraud. Since Massachusetts has the most highly regulated auto insurance system in the nation, it would be the jurisdiction best equipped to organize such an effort.[1] Furthermore, Massachusetts, with its very high premiums and highest-in-the-nation accident rate, would have substantial rate-savings potential. For example, it is much easier to achieve significant reductions in accidents in the state with the highest accident rate than in the state with the lowest accident rate. (Fewer accidents, of course, result in lower insurance rates.)

In addition, Massachusetts already has an administrative process that could be used to coordinate centralized cost-containment efforts. The state could use the annual auto insurance rate hearing to identify the most efficient cost-containment measures to implement. Not only is that hearing the most appropriate venue to make these determinations, but, most importantly, *it also provides the method to fund the implementation of the best measures identified at the hearing*. Instead of looking to the Legislature at a time when available funds are scarce, all of the funding would come from the insurance system itself. One possible scenario would be for the consumers to pay an extra 1% in premiums and have the insurers match that amount, producing nearly $100 million in funding the first year. If cost-effective measures were implemented, *consumers would soon see premium reductions and insurers would make higher profits*.

Some of the measures worth considering are these:

- Identifying and redesigning the 100 most dangerous intersections in the state;
- Improving lane markings, traffic lights, and street signs;
- Informing drivers clearly and regularly about the full cost of driving violations and at-fault accidents on individual rates;
- Enforcing traffic laws more effectively, in conjunction with reviewing existing traffic restrictions to make sure they are appropriate and not unreasonable (e.g., a 25 m.p.h. speed limit that clearly should be higher);
- Improving anti-fraud efforts in the areas of claim fraud and premium fraud;
- Attacking the incentives to commit fraud in order to avoid undue reliance on after-the-fact enforcement, which is generally less effective;
- Establishing discounts for taking driver education classes;
- Adopting a Primary Seatbelt Law;
- Implementing drunk driving initiatives;
- Establishing discounts for safer cars;

[1] In fact, Massachusetts has already created a centralized anti-fraud entity, known as the Insurance Fraud Bureau ("IFB"), which has been funded directly by insurers and indirectly by consumers (through their premiums). A larger investment in the IFB and the adoption of other anti-fraud measures would be prudent. Still, the reasoning behind the creation of the IFB is similar to what is recommended here for all areas of cost containment.

- Establishing discounts for consumers agreeing to use their own HMO for accident-related injuries;
- Establishing actuarially-supported SUV liability rates;
- Creating deductibles for certain glass claims;
- Prohibiting cell phone use while driving;
- Creating initiatives that focus on pedestrians and cyclists;
- Making it easier for consumers to switch auto insurers; and
- Disclosing to consumers better information about any discounts that insurers are offering.

The above list is certainly not an exhaustive one. The key to a successful hearing on cost-containment issues would be to involve many knowledgeable individuals in the process. Insurers, agents, regulators, legislators, public safety officials, consumer advocates, and other interested parties would offer different perspectives and insights. All ideas would be considered, with the goal of implementing the most cost-effective ones. The determination of cost effectiveness would require a long-term analysis (e.g., a proposal that costs $2 million but saves $1 million a year for the foreseeable future is a very worthwhile investment). Periodic reviews and evaluations would be necessary to determine whether the implemented measures had in fact reduced system costs. If done properly, the proposed process could produce rate reductions for consumers, as well as healthy profits for insurers, for more than a decade.