American Property Casualty Insurance Association
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Testimony of

American Property Casualty Insurance Association (APCIA)

Senate Finance Committee

SB 816 Motor Vehicle Insurance – Rate Filings –Trade Secrets and Factors Used to Establish Rates

March 15, 2023

Letter of Opposition

The American Property Casualty Insurance Association (APCIA) is a national trade organization representing nearly 60 percent of the U.S. property casualty insurance market. Our members write approximately 55.7 percent of all private passenger auto insurance sold in Maryland. APCIA appreciates the opportunity to provide written comments in opposition to Senate Bill 816. APCIA opposes this bill which would limit the use of territory as a rating tool into five distinct territories for personal auto and remove the protection of proprietary rate-related information as confidential commercial information.

Removing Trade Secret Protection

Senate Bill 816 would remove under Section 11-307 of the Insurance Article an insurer's designated "proprietary rate-related information" that is filed with the Insurance Commissioner for private passenger auto and designated as a trade secret under Maryland law. Proprietary rate-related information means a rating model and includes the formulas and algorithms given to rating factors. Rating factors are not considered to be proprietary and cannot be designated as such. Trade secret protection is afforded to all industries in Maryland and insurance rating models should not be signaled out. Insurers are in a competitive market and wish to protect their research from their competitors. There is a justification for removing such a designation.

Overview of Rating

For many years, there has been much controversy throughout the United States on the use of territorial rating in private passenger automobile insurance. Interest in this area partially stems from rising insurance losses in both automobile and homeowners insurance, resulting in higher insurance premiums for the policyholder. While some regulators and legislators have attempted to revise traditional rating criteria used by insurers, the property/casualty insurance industry maintains that the use of rating by geographical location, or territory, is an equitable and statistically-supported method of distributing costs among policyholders.

Automobile insurance loss costs are generally the highest in the city, attributable to: (1) the greatest number of claims incurred in the urban area; (2) the highest amount of loss dollars per claim; or (3) a combination of both. Probable factors contributing to higher insurance costs in the city include higher population and/or traffic density and greater exposure to crimes such as theft and vandalism.

If restrictions in geographical location as a rating factor were imposed and limited rating territories were used, in a state, then a redistribution of premiums among policyholders would be necessary. Those policyholders living in higher-cost areas would have a decrease in their premium, while policyholders in lower-cost areas would have an increase. In other words, the residents of less populated communities would be required unfairly to subsidize their counterparts living in the more heavily populated cities. Generally, it is the majority of policyholders in the state who would be affected negatively by this type of change.

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While some critics say it is wrong to differentiate in price on the basis of geographical location, insurers say it is wrong to require anyone to pay more than the amount reflected in his or her expected loss cost. Such an imposition is recognized by both insurers and the insurance-buying public. According to public opinion polls, a large majority of people feels it is unfair to make suburban and rural residents pay more automobile premium to help their urban counterparts. Insurance companies need to base their premiums on projected costs and differentiate among areas with varying loss potential. Restrictions placed on territorial rating would: (1) create forced subsidies for some policyholders at the expense of others and limited insurance products or services; (2) undermine the ability to influence responsible behavior on the part of individuals; and (3) cause a shift in the marketplace by companies, thus reducing competition.

Concept of Spreading Risk and Geographical Rating

Insurance is a method of reducing the uncertainty of financial loss through the transfer of risk by many individuals to an insurer. Since individuals generally cannot bear the financial consequence of a large loss, policyholders contribute premium payments to a common fund that covers losses and expenses. The policyholder thus exchanges the possibility of an unknown large loss for a comparatively small certain payment.

Insurers face the challenge of measuring risk; they need to know whether to accept a risk and how much to charge. Ratemaking involves measuring the probability of the occurrence of losses and the financial impact that may be expected to result from the hazards or perils against which insurance is provided. Since rates are determined before all future costs are known, the insurance pricing function is more difficult than that of most other businesses, making it among the most important and intricate company operations. Hence, the insurance industry is unique in American business because it cannot price its product like other businesses with full knowledge of costs and be guaranteed a return on investment. Each state, nevertheless, subjects insurance ratemaking to a specified type of statutory regulatory control; that is, rates may not be "excessive, inadequate, or unfairly discriminatory."

The basic principle underlying the development of insurance rates is the estimate of claims for the varying risks being insured during future months and a determination of whether current rates are adequate or inadequate to pay these losses. Loss experience is measured by two fundamental elements: (1) claim frequency; and (2) average loss or claim severity. Claim frequency is usually expressed as the number of claims occurring per 100 insured vehicles or housing units during one year. For example, if automobile collision coverage claims occurred at the rate of 10 per 100 insured car years (a car year is one car insured for one year), then the frequency is 10 percent. The average loss is the average cost of each claim paid or incurred for a particular coverage. The combination of these two factors is the loss cost, or the average amount of loss paid or incurred by the insurer for each vehicle or housing unit covered.

In most cases, the geographical area having the highest automobile insurance loss cost in each state has the highest claim frequency, the highest average loss per claim, or both. The highest loss cost typically reflects residents of the urban area.. This indicates that people living in these areas are the riskiest to insure, due to the most number of claims incurred per insured exposure and/or the costliest claims incurred in these areas. Clearly, the cost to provide protection to residents of these locations is greater than elsewhere.

Geographical Location in Ratemaking

No one can dispute the fact that automobile accidents, or vandalism and theft losses are more likely to occur in certain locations than in others. The cost of automobile accidents and property damage is more likely to be greater in certain areas as well. Hence, there is a need for insurance companies to distinguish those geographical regions with greater loss potential from those with less.

The territory must contain exposure risks sufficiently large and homogeneous to allow a reasonable accuracy of predicting loss costs by application of the concept of large numbers. For automobile insurance, territorial lines are drawn to commonly group motorists who operate vehicles under similar conditions and face similar hazards. For the sake of simplicity and equity, territorial boundaries generally were developed by using existing political demarcations, geographical features or contiguous zip code areas. The number and size of territories vary from state to state and among insurers; for example, states may comprise anywhere from about 3 to 90 automobile rating territories depending on the particular jurisdiction.

There are many reasons why losses and, hence, insurance rates vary by territory. Some characteristics contributing to loss potential in automobile insurance are population density, traffic density, motor vehicle theft rates, varying types of law enforcement, conditions and maintenance of roadways, health care costs, body shop repair rates, and claiming behavior. For example, population and traffic densities both provide a measure of congestion. The higher the population and the more vehicles there are, the more likely there will be automobile accidents and, hence, insurance claims. Urban areas tend to produce more claims per insured car than rural or suburban areas. Similarly, the cost of paying automobile insurance claims is higher in urban areas because hospital and medical expenses, repair costs, and legal fees tend to be substantially higher in these areas. It has also been found that residents in metropolitan cities typically are more prone to make injury claims than residents living elsewhere. Past studies have also shown that automobile accidents usually take place within five miles of home.

The use of geographical location, or territory, as a rating criterion has been found to be a practical method of allocating costs among policyholders. This indicator is also objective, clear and unequivocal, and based upon statistically supported data. Findings derived from the Property Casualty Insurers Association of America statistical database show that the traditional rating factor of territory is a proven predictor of loss, as insurance experience does vary broadly among different geographical areas. Limiting this variable in the ratemaking process would result in an inequitable redistribution of prices to maintain the same overall premium volume collected by insurers.

If the use of territorial rating were restricted, an increase in premiums for some policyholders would take place to offset the decrease in premiums given to others, unfairly overcharging those persons who actually have less loss exposure than other persons having greater exposure. This imposition usually affects the majority of policyholders in each state who live in the non-urban parts. Invariably, persons residing in rural communities would have premium increases, while their city counterparts would have decreases. The positive or negative impact on suburban and medium-sized city dwellers depends upon how their loss costs compare with the statewide average.

Consumer Survey Results

Even consumers recognize the inequity of forcing suburban and/or rural policyholders to subsidize their counterparts living in the city. In previous public attitude surveys conducted by the Insurance Research Council, the majority of respondents generally favor lower automobile insurance rates for drivers who live in suburban and rural areas because they have fewer accidents than drivers who live in cities. Once again, the majority of consumers feel it is somewhat or very unfair for lower-risk drivers to pay higher automobile insurance rates to compensate for decreases given to higher-risk drivers.

In summary, rating on the basis of territories evolved in order for companies to achieve equity among policyholders and to determine which areas are more likely to result in claims and how serious those claims might be. So that each group of policyholders pays its fair share of losses and expenses, insurers must continue to pursue sound and legitimate business practices and base their premiums on the exposure to risk.

Maryland Results[1]

Territory has been used for classification of personal auto risk. Without the use of territory in pricing, rates will not be reflective of the loss variances in the different territories. Furthermore, there would be subsidies created benefiting risker policyholders at the expense of policyholders in less congested areas with better loss experience.

For this analysis loss experience and average premiums[2] for each territory are compared to that of the statewide total to assess potential impacts of eliminating territorial rates and charging the statewide average premium to all Maryland personal auto policyholders.

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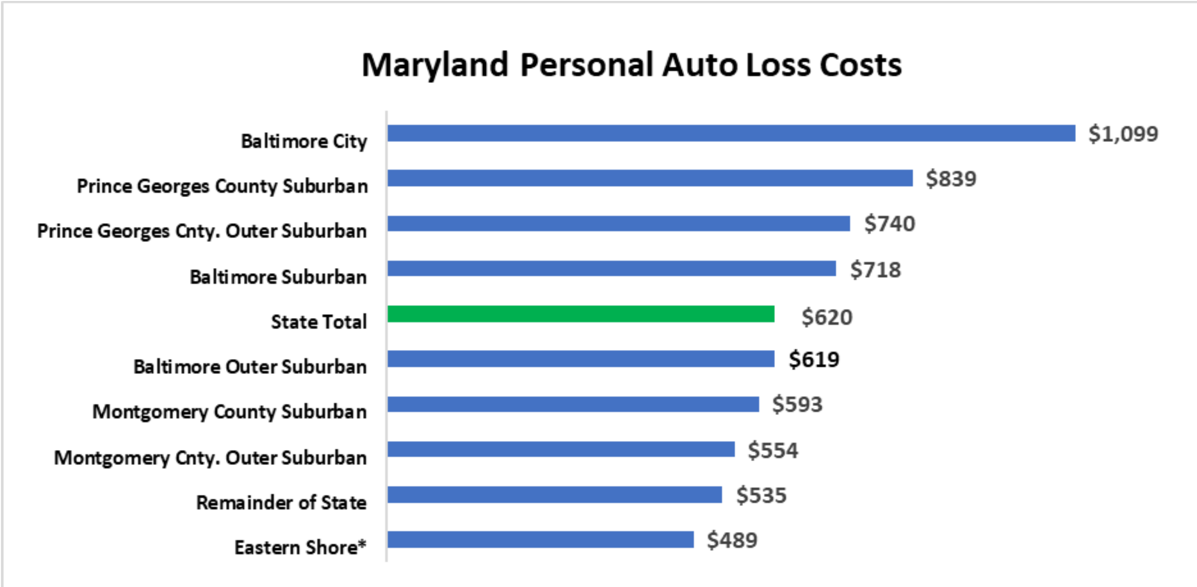
[1] APCIA prepared the estimates in this report using personal auto accident-year data as of March 31, 2021, from the Independent Statistical Service (ISS) reflecting 2018-2020 combined. Personal auto data analyzed include liability coverages (bodily injury and property damage liability, and uninsured/underinsured motorists) and physical damage coverages ($100 deductible comprehensive and $250 deductible collision.

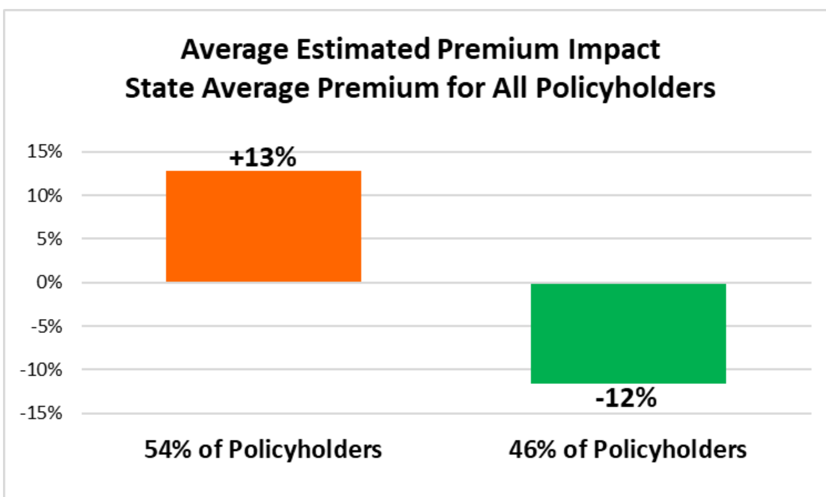
[2] Earned premium divided by earned exposure.

Policyholders in the areas of Baltimore and Prince Georges County, shown below, on average have loss experience above the statewide loss cost[3] (in general indicating higher total cost of claims), while other areas of Maryland have loss experience below the statewide average (generally indicating lower total cost of claims).



*Eastern Shore: Caroline, Southern Cecil, Dorchester, Kent, Queen Anne's, Somerset, Talbot, Wicomico, and Worcester Counties

If territorial rating were prohibited, some policyholders with better loss experience (and thus on average pay less than the statewide average) could potentially see a rate increase of about 13 percent (on average). The resulting higher premiums paid by this group of drivers with generally lower claims costs would then subsidize the potential 12 percent (on average) rate decreases for Marylanders with generally higher claims costs.



Below is the estimated potential average premium change by territory, should territorial rating be eliminated and all Maryland personal auto policyholders were charged the statewide average.

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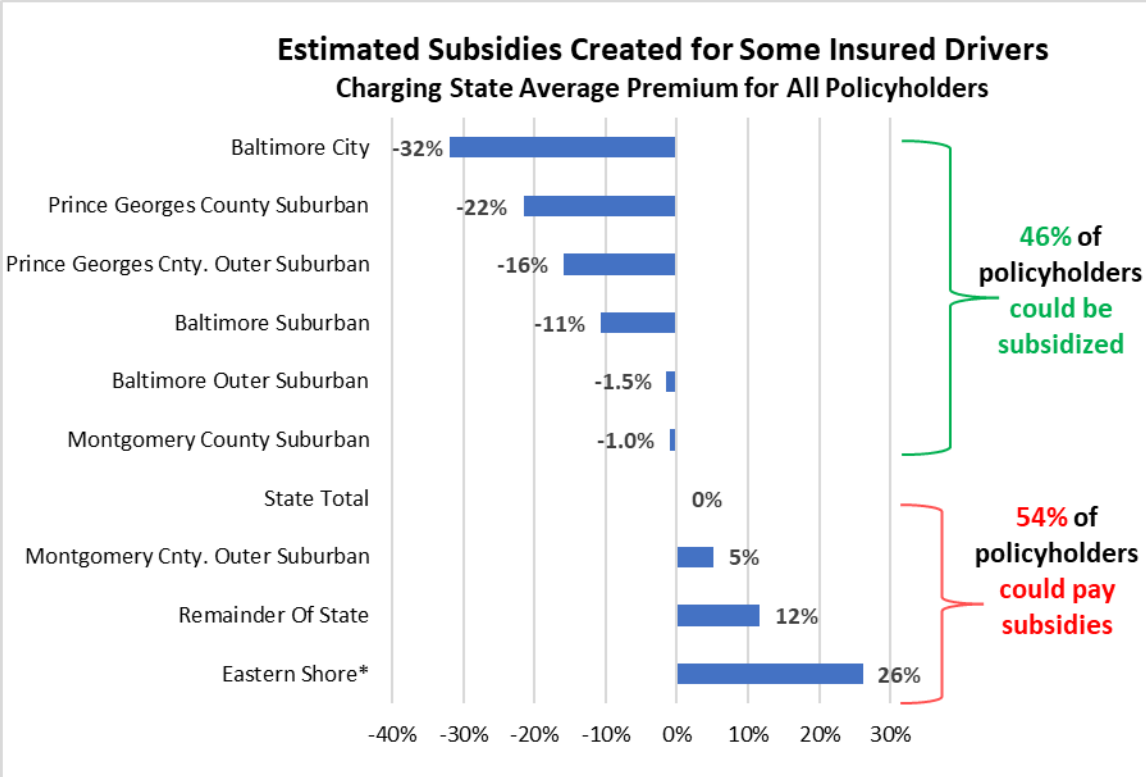
3 Average loss per insured vehicle (car-year).



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The debate on territorial rating has resulted, no doubt, in part from increases in the cost of insurance, especially to those living in metropolitan areas. Certain special interest groups feel that restrictions on the insurance ratemaking process will result in lower premiums for the policyholder. This is not the case, however, as affordability concerns cannot be mitigated over the long term by establishing artificial barriers on the risk assessment process and prohibiting the use of territorial rating. Rather, premium decreases should only take place when the true problem of high underlying claim costs is recognized and dealt with directly and successfully.

Conclusion

Trade Secret protection is provided to all businesses in Maryland and the insurance industry is not the exception. Removing this protection only benefits our competitors and not the public at large. Insurance companies should continue to have equal footing with other Maryland businesses. With regard to the present territorial rating system, most objections point toward the social philosophy that underlies the criterion of geographical location, and not on the validity of accepted statistical principles of risk assessment. The risk assessment process should be free of restrictions that would prohibit competition and bring about forced subsidies for some consumers at the expense of others. Should different criteria for territorial definitions and boundaries become justified, companies will take the initiative to incorporate them into their systems to benefit the insurance-buying public.

For all these reasons, the APCIA urges the Committee to provide an unfavorable report on Senate Bill 816.

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