

Texas Automobile Insurance Profitability 1990 to 1997

A Report by the Center for Economic Justice

August 1998

This report reviews the loss ratio experience of Texas private passenger automobile insurers from 1990 through 1997 and with particular emphasis on the impact of “tort reform” on the experience in 1996 and 1997.

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.

Excess Premiums and Profits in 1996 and 1997

Table 2 shows exactly how the benefits of “tort reform” have flowed to insurers as windfall profits. The table compares actual 1996 and 1997 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 and even more excessive in 1997. Liability premiums were 18.5% excessive in 1996 and 22.8% excessive in 1997. Stated in dollars, liability premiums were \$928 million excessive in 1996 and \$1.187 billion excessive in 1997 for a total of about \$2.1 billion for the two years.

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The dramatic excesses of the liability coverages led to excessive premiums for all private passenger automobile coverages combined. Total premiums were 9.3% excessive in 1996 and 14.5% excessive in 1997. Stated in dollars, total premiums were \$729 million excessive in 1996 and \$1.193 billion excessive in 1997 for a total of about \$1.9 billion for the two years.

Some insurers did return some premium to Texas consumers as policyholder dividends for 1996 and 1997. Table 3 shows total policyholder dividends of \$49.0 million in 1996 and \$221.9 million in 1997. Even after deducting policyholder dividends from the excess premium figures, Texas private passenger automobile insurers reaped windfall profits in 1996 and 1997 of \$1.95 billion for liability coverages alone and \$1.65 billion for all private passenger coverages combined. Assuming ten million insured vehicles, Texas automobile insurance consumers were overcharged an average of \$165 per vehicle for 1996 and 1997.

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.¹ 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 1997. "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.

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.

¹ Bickerstaff and Whatley Consulting Actuaries, *Private Passenger Automobile Insurance Profitability in Texas 1988-97*, June 1998. A report prepared for State Farm.

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 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.² 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 1997. 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 and 1997.

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.

Early 1998 results show continued reduction in liability losses

Data from the “Fast Track Monitoring System” show that Texas private passenger automobile bodily injury losses continue to decline in 1998. For the first quarter 1998, the average paid loss per exposure (or pure premium per earned car year, in actuarial parlance) declined to about \$111 from about \$123 in 1997 – a reduction of almost 10%. The first quarter 1998 figure stands fully \$65 less than the \$176 pure premium in the fourth quarter 1994 – a reduction of over 35% in three years.

The combination of current Fast Track data with the Table 2 calculations of excess premiums show that, even after rate decreases in 1998, Texas automobile insurance rates remain significantly excessive. Table 2 shows that 1997 premiums were 14.5% excessive. With declining losses and assuming overall rate reductions of 5% to 7% in 1998 to date, Texas automobile insurance rates remain at least excessive in the neighborhood of 10%.

² As reported in “Auto Insurance Report” May 18, 1998 edition.

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.

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 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 $((\text{Line 3} + \text{Line 5}) / (1 - \text{Line 4})) - 1$. Line 7, Earned Premium, comes from the *Texas Page 14 Compilation*. 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 and \$221.9 million in 1997.

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.

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.