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# The Competitiveness and Premium Excessiveness of the Home and Auto Insurance Industries in the State of Michigan

A market competition study initiated by
Commissioner Linda A. Watters.

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**Attachment: Galster Report – The Competitiveness and Premium Excessiveness of the House and Auto Insurance Industries in the State of Michigan**

## I. Introduction

Few issues have occupied the Michigan public policy arena as persistently as those surrounding the availability of affordable home and auto insurance. While Michigan laws ensure virtually universal access to home and auto insurance coverage, many Michigan citizens—particularly those living in urban cities and surrounding suburbs—have questioned the value of guaranteed access to insurance that they cannot afford.

From a legal standpoint, serious discussion of the issues surrounding insurance access and affordability begin with an examination of the relevant sections of the Michigan Insurance Code (hereafter "the Code"). The Code provides the statutory backdrop under which insurers operate in Michigan and sets forth the powers and duties of the Commissioner of the Office of Financial and Insurance Services.

As will be discussed in greater detail later, a Commissioner concerned about whether home and auto insurance rates are excessive has certain limited statutory tools at her disposal.[1] Under Michigan law,[2] before determining that rates are excessive, the Code requires the Commissioner to find that a reasonable degree of competition does not exist in the Michigan marketplace.[3] Finding an insufficiently competitive market is therefore a necessary precondition for any finding of excessive rates under the Code.

In December of 2003, spurred on by a substantial number of consumer complaints received by the Office of Financial and Insurance Services regarding high home and auto insurance premiums, Commissioner Linda A. Watters decided to hire a prominent Michigan economist, Dr. George Galster, PhD[4] to evaluate the Michigan insurance marketplace and report on whether his research found it to be sufficiently competitive.

In order to provide Dr. Galster and his team with the information they would need to conduct their analysis, Commissioner Watters initiated special data calls in January and February of 2004. Every insurer writing in Michigan provided actual premium and loss data by coverage and standard statistical territories, which were then analyzed by the economists.

The foundation for the scope of Dr. Galster's study can be found in the Code and corresponding administrative rules[5] promulgated over two decades ago by the Insurance Bureau.[6] Reduced to its essence, his inquiry addresses two fundamental questions:

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[1] It should be noted from the outset that high rates do not necessarily indicate that an insurance marketplace is dysfunctional. For example, high rates may reasonably flow from a variety of legitimate circumstances—for example, sustained periods of higher-than-average losses

[2] MCL 2109(1)(a)

[3] The theory being that in a competitive marketplace, market forces will drive out players charging excessive rates for their products.

[4] For Dr. Galster's curricula vitae, see: www.culma.wayne.edu/faculty/cvs/GG_resume_1-03.DOC.pdf

[5] R 500.1503

- Does a reasonable degree of competition exist for automobile and home insurance?

- Are automobile and home insurance rates unreasonably high?

## II. Brief Overview of Relevant Michigan Law

### A. The Code and Administrative Rules

Chapter 21, commonly referred to as the Essential Insurance Act (“EIA”) was added to the Insurance Code in 1980. The EIA sets rating and classification standards for automobile and home insurance sold on an individual basis.[7]

In Chapter 21, the Legislature defined “excessive” in the following way:

> A rate shall not be held to be excessive unless the rate is unreasonably high for the insurance coverage provided and a reasonable degree of competition does not exist for the insurance to which the rate is applicable.[8]

Unfortunately, a Commissioner concerned about potentially excessive rates is provided precious little guidance by this definition. Important issues such as “what constitutes an unreasonably high rate” and “how should competition be measured” are not effectively addressed by the Code. To promote consistency and clarity in determinations of excessiveness, the Commissioner promulgated rules that took effect in 1981.[9] These rules were based on widely accepted sound economic principles.

R 500.1503, which deals with excessive rates under the EIA, provides:

> For the purposes of section 2109(1)(a) of the code, both of the following provisions shall apply:
>
> (a) A rate is unreasonably high for the insurance coverage provided if it is unreasonably high in relation to anticipated losses or expenses, or both, or to the uncertainty of loss for the insurance coverage provided.
>
> (b) A determination regarding the existence of a reasonable degree of competition shall give due consideration to, at a minimum, all of the following:
>
> (i) The relevant market for the coverage or the type of insurance to

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[6] The Insurance Bureau was abolished by Executive Order 2000-4, which created the Office of Financial and Insurance Services.
[7] This is contrasted to insurance sold on a group basis, such as to members of the American Association of Retired Persons. Group rates are governed by MCL 500.2403 and 500.2603.
[8] MCL 2109(1)(a)
[9] Three identical sets of rules were promulgated, one for each rating chapter.

which the rate applies.

(ii) The number of insurers and the number of self-insurers actively engaged in writing or providing the coverage or type of insurance in the relevant market.

(iii) The distribution of rates and market shares for such insurers in the relevant market. Market shares may be measured either by premiums or exposures.

(iv) Past and prospective trends in the availability of coverage and coverage options for insurance of that type in the relevant market.

(v) Profits attributable to insurance of that type in relation to the profitability of other types of insurance, to the uncertainty of loss for that and other types of insurance, and to the amount of capital and surplus funds available to support premium writings for that and other types of insurance.

(vi) The ability and potential for firms to enter and exit the relevant market and for financial capital and surplus funds to be allocated to, and to be removed from, the relevant market.

The rules use losses as the measure of whether a rate is "unreasonably high" because insureds pay premium principally so they will receive claim payments for covered losses, not so insurers can use most of the premium to cover expenses or to build surplus. Traditionally, where a substantial and fair amount of premium dollars are being returned to consumers through the payment of losses, rates are considered to be reasonable.[10] The Galster Report—which uses loss ratios[11] as the touchstone for determining whether Michigan rates are unreasonably high—employs a methodology that is widely accepted among economists.

While there are many economic tests that could be employed to assess the competitiveness of a market, the rules mandate six standard measures as part of any determination. The Galster Report expressly addresses each of these factors.

## B. Role of the Commissioner Under Michigan Law

If the Commissioner has sufficient grounds to challenge an individual rate filing as excessive, she may order a hearing. For example, MCL 500.2114(2) provides:

> If after hearing initiated under subsection (1) or upon the commissioner's own motion pursuant to Act No. 306 of the Public Acts of 1969, as amended, the commissioner finds that a filing does not meet the requirements of sections 2109

[10] The theory being that if a high percentage of each premium dollar paid is returned to insured individuals as claim payments or claim reserves, this indicates that an insurer isn't realizing a windfall on the transaction. On the other hand, if a low percentage of each premium is used for claim payments or reserves for insured individuals , this is an indication that the insurer may be enjoying excessive profits at the expense of its customers.

[11] The "loss ratio" is the ratio of money paid out in claims, compared to the money taken in through insurance premiums. For example, if an insurer has a loss ratio of 1.15 this means it paid out $1.15 for every $1 in premium collected for a period.

> and 2111, the commissioner shall issue an order stating the specific reasons for that finding. The order shall state when, within a reasonable time after issuance of the order, the filing shall be considered no longer effective. A copy of the order shall be sent to the applicant, if any, and to each insurer and rating organization subject to the order. The order shall not affect a contract or policy made or issued before the date the filing becomes ineffective, as indicated in the commissioner's order.

If the requirements of this section are met, the Commissioner is compelled to issue an order stating that the individual rate filing in question is no longer effective.

The Commissioner can also find that a reasonable degree of competition does not exist on a statewide basis in the automobile or home insurance markets. For this, the Code provides a more draconian remedy— the EIA is temporarily suspended. MCL 500.2115(1) provides:

> If as part of a decision in a proceeding under section 2114, or in a separate proceeding on the Commissioner's own motion, held pursuant to Act No. 306 of the Public Acts of 1969, as amended, the Commissioner finds that a reasonable degree of competition does not exist on a statewide basis with respect to automobile insurance or home insurance, the Commissioner shall by order require each insurer which transacts that type of insurance in this state to comply with the provisions of chapter 24 or 26, as the case may be, with respect to that insurance which was the subject of the Commissioner's finding. The order shall take effect not less than 90 nor more than 150 days after the order is issued. On or after the effective date of an order issued under this subsection, none of the provisions of this chapter shall be applicable to the insurance which was the subject of the order.

In light of these provisions, it is clear that under the proper circumstances, the Commissioner is fully empowered to undo rates that are excessive.

Against this backdrop, the Commissioner retained Dr. Galster to analyze the competitiveness of the Michigan markets for home and automobile insurance to determine whether a reasonable degree of competition exists, and—where inadequate competition exists—whether rate levels in general, rather than the rates of any particular insurer, could be considered excessive.

## III. Key Findings of the Market Competition Study

### A. <u>Competitiveness of the Home Insurance Marketplace</u>

Home insurance policies were first grouped into three categories based on their comprehensiveness—with policies covering the fewest perils called "low quality," those covering the greatest number of perils called "high quality," and a middle category falling in between called "moderate quality." Data was collected and analyzed for each company, tabulated by each of the 25 home statistical reporting territories constituting the State of Michigan. Territories were also rated from “least competitive” to “most competitive.”

In the case of the low - quality homeowners policy segment, it was shown that there was limited competition. No territory was rated “most competitive,” 22 were rated as “moderately competitive” and three (Grand Rapids, Bay County, and Monroe County) as least competitive. Similar results could be found in the middle - quality policy group. No territory could be classified as “most competitive,” twenty-one territories could be classified as “moderately competitive” and four (Flint, remainder of Genesee County, remainder of Lansing area and Upper Peninsula) were classified as “least competitive.” Indicators for the high - quality homeowner policy found that this group was the most competitive. The study found substantial entry and exit between 2001 & 2002, and that between 72 and 120 companies compete in this segment. Four territories have low concentration, twenty have moderate, and only one has high (Kalamazoo). Four territories have low competition (Warren, Ann Arbor, Bay County and Ottawa County).

## KEY FINDINGS

### Low quality segment

#### Competitiveness
Limited competition in this segment. No territory was rated “most competitive,” 22 were rated as “moderately competitive” and three (Grand Rapids, Bay County, and Monroe County) as least competitive.

#### Excessiveness
Three territories (Flint, remainder of Lansing area, and Bay County) have average loss ratios below .60.[12] In light of this, homeowners with low quality products in Bay County were paying excessive amounts for home insurance products.

### Medium quality segment

#### Competitiveness
Limited competition in this segment. No territory was rated “most competitive,” 21 were rated “moderately competitive,” and four (Flint, remainder of Genesee County, remainder of Lansing area and Upper Peninsula) as “least competitive.”

#### Excessiveness
Generally speaking, loss ratios rarely fell below .60, although there were exceptional examples. Some territories with low loss ratios also fell outside the “most competitive” ranking.

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[12] The “loss ratio” is the ratio of money paid out in claims, compared to the money taken in through insurance premiums. For example, if an insurer has a loss ratio of .60, this means it paid out 60¢ for every $1 in premium collected.

When considering the largest companies, the following territories were not ranked "most competitive" and their loss ratios fell below .60 (Kent County (.40), remainder of Saginaw County (.55), Upper Peninsula (.41), and Northern Michigan (.49)). When all writers are considered, Ottawa County was the only territory not ranked "most competitive" with loss ratios below .60.

**High quality segment**

**Competitiveness**
The most competitive group with five territories falling within the "most competitive" class (Kalamazoo County, Oakland County, Muskegon County, Northern Michigan and the remainder of Southern Michigan). 16 territories fell in the "moderately competitive" class, while four territories were found to be "least competitive" (Warren, Ann Arbor, Bay County, Ottawa County).

**Excessiveness**
Two territories fell in the "least competitive" category and had loss ratios that were considered to be "excessive" because they fell below .60 (Ann Arbor (.48), Ottawa County (.49)). Homeowners in these two territories were being charged excessive premiums for high quality home insurance products.

## B. Competitiveness of the Auto Insurance Marketplace

Auto policies were grouped into three policy types—mandatory coverage, collision coverage, and comprehensive coverage. Data was collected and analyzed for each company, tabulated by each of the standard auto statistical reporting territories for Michigan. Territories were rated from "least competitive" to "most competitive."

## KEY FINDINGS

### Mandatory Insurance – Personal Injury Protection (PIP)

**Competitiveness**
Relatively robust competition in this segment, with eight territories considered to be "most competitive," thirty-three classified as "moderately competitive" and one (Jackson Outer) in the "least competitive" category.

**Excessiveness**
Seven territories were classified as "excessive" for mandatory insurance (Flint Inner, Lansing Inner, Monroe, Jackson Inner, Detroit Suburban, Ann Arbor Outer, Benton Harbor Outer) because their loss ratios fell below .60 and they were not ranked in the "most competitive" group.

**Collision Coverage**

**Competitiveness**
Five territories were considered "most competitive," thirty-five were classified as "moderately competitive," with two territories (Battle Creek Outer, Lansing Outer) classified as "least competitive."

**Excessiveness**
Average loss ratios rarely fell below .60, nor were they significantly below .60 when they did drop below.60. There were no statistical differences in loss ratios among urban, suburban and rural areas.

**Comprehensive Coverage**

**Competitiveness**
Six territories fell within the "most competitive" category, thirty-three were "moderately competitive" and three were considered to be "least competitive" (Battle Creek Outer, Port Huron City and Monroe Outer).

**Excessiveness**
Six territories were classified as excessive because they had loss ratios below .60 and they were not rated in the "most competitive" category. (Bay City & Saginaw City, Grand Rapids Inner, Detroit Semi-Suburban, Detroit Suburban, Pontiac, and Muskegon Outer).

## IV. Commissioner's Findings

The Commissioner finds that, as measured by standard economic tests and current statutory provisions, the markets for home insurance and private passenger auto insurance in standard statistical territories throughout the state are reasonably competitive based on 2001 and 2002 data.

Therefore, the rates charged by private insurers in those markets, if challenged by the Commissioner under Section 2114(2) could not be found to be excessive under current law, even if they were found to be unreasonably high in relation to covered losses.

While in most geographic territories, rates are not unreasonably high in relation to covered losses, premiums may still be unaffordable from a consumer's perspective—particularly in urban areas. Based on the foregoing, it is very clear that in many parts of the state, competition isn't doing enough for consumers. Insurers are not competing in a manner that actually makes insurance more affordable in these areas.

## V. Commissioner's Recommendations

The mechanisms for measuring competitiveness in the home and auto insurance marketplace found in the Michigan Insurance Code should be reviewed and updated. Specifically:

i. The Code should not require a finding of an absence of competition in order for rates to be considered excessive.

ii. Considering the available remedies, it would make more sense to evaluate market competition on a regional or some other basis—as opposed to a statewide basis.

iii. Considering the tremendous rate disparities across the state, Michigan should evaluate the continuing utility of territory as a primary rating classification for private passenger auto insurance and examine whether de-emphasizing territory in favor of driving history would serve to reduce rates in areas that currently have the highest rates.

iv. Considering the impact that persistent rate increases in the voluntary market have had on Michigan's residual market mechanisms, the method by which the facilities set their rates should be altered to permit them to provide more affordably priced insurance.

v. Where rates are excessive, the Commissioner should be given the authority to order refunds to policyholders who have paid too much. This would promote fairness, encourage companies to carefully avoid excessive rates, and make insurance more affordable.

vi. The evaluative factors used to measure competitiveness that are enumerated in the Code should be reexamined, prioritized, and assigned relative weights in the competition analysis.

vii. OFIS should be given the authority to develop, promote and spend agency funds on a comprehensive consumer awareness program designed to educate consumers on specific actions that they can take to reduce their home and automobile insurance premiums.

viii. OFIS should be provided the authority to develop, promote and spend agency funds on educational materials focused on and disseminated to local units of government that identify specific steps that community leaders could take to reduce insurance rates in their communities. This information would be comprehensive in nature, addressing law enforcement, traffic flow, public transportation, and ongoing community education efforts.

ix. Further study should be conducted, focusing on several areas, including:

1. Continuing to develop a comprehensive understanding—both on an individual policyholder level, and on a community level in areas experiencing extremely high insurance rates—of the specific factors that contribute to higher rates.

2. Whether existing delivery channels provide adequate means for Michigan consumers to access insurance products.

3. Why Michigan collision insurance rates are the highest in the nation and what specific steps can be taken to control auto repair costs?

## VI. Conclusion

This report has summarized findings that show this segment of the Michigan insurance marketplace is largely competitive. Unfortunately, these findings will offer little consolation for consumers in urban areas, where the unaffordability of insurance is a matter of critical importance both at the individual level and from a community redevelopment perspective.

The persistence of these issues provides some evidence of their complexity and underscores the need for all affected stakeholders to engage in a collaborative process designed to identify meaningful steps to reduce rates in urban communities. Because access to affordable insurance will remain a fundamental component of any successful redevelopment effort, these issues are particularly important as Michigan positions itself as a global competitor.