The Use of Education and Occupation as Underwriting Factors in Determining Policyholder Premiums for Private Passenger Auto Insurance

Written Testimony of

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Good morning Commissioner McCarty and members of the Committee and thank you for the opportunity to discuss the role of underwriting criteria in building and maintaining fair and equitable automobile insurance rating systems. My name is Robert P. Hartwig and I am President and Chief Economist for the Insurance Information Institute, a property/casualty insurance trade association based in New York whose members write over 60 percent of the premiums written in the United States. It's also my pleasure to say that I served with Commissioner McCarty on the Florida Commission for Long-Term Homeowners Insurance Solutions last year.

My comments today will address the benefits to policyholders associated with auto insurance rating systems that accurately reflect the individual risk characteristics of each driver as accurately as possible. I will also address the Consumer Federation of America's and New Jersey CURE's allegations that two rating criteria, occupation and education, are unfair to certain socio-economic groups.

UNDERWRITING CRITERIA: THE CORNERSTONES OF FAIRNESS, EQUITY AND ACCURACY IN RATING SYSTEMS

Risk or Cost-Based Pricing

Insurance premiums are messengers of risk. To the maximum extent possible, the premium charged should reflect the risk characteristics of each individual policyholder. Put differently, the premium must reflect the expected cost of providing the coverage sold. *Risk* or *cost*-based pricing provides consumers with many benefits. In the case of auto insurance, risk-based pricing reduces cross subsidies from drivers with relatively poor driving records who account for a disproportionate share of losses while rewarding motorists who are involved in fewer accidents and impose little, if any, cost on the system. By definition, a system of rates that accurately reflects risk and cost is fair and equitable. States that restrict actuarially valid underwriting criteria implicitly subsidize drivers with relative poor driving records at the expense of the state's better drivers.

The determination of fair and accurate rates requires insurers to identify risk factors that can be used to predict future loss. Over time auto insurers have identified many such factors including type of vehicle owned, miles driven, location, driving experience and numerous others, including education and occupation. No single factor determines eligibility for coverage or the premium charged. In fact, insurers simultaneously employ up to 20 or more risk factors.

Risk/Cost-Based Pricing Promotes Competition

Risk or cost-based pricing also enhances *competition*. To the extent insurers can employ actuarially valid underwriting criteria to better predict future loss, uncertainty is reduced. Reducing uncertainty leads unambiguously to more competition among insurers, more choices for consumers and lower average costs. Improvements in predictive modeling have also helped insurers underwrite even the toughest-to-place risks leading to reductions in the population of expensive, state-run residual market facilities across the country. Restrictions on actuarially valid underwriting criteria would lead directly to more uncertainty and therefore less competition, higher prices and growth in auto insurance markets of last resort.

Risk/Cost-Based Pricing Provides Benefits to Society

Society also benefits from risk or cost-based pricing. High auto insurance premiums offer poor drivers a significant financial incentive to improve their driving behavior, thereby reducing accidents, injuries and fatalities. These are socially desirable outcomes whose benefits are diminished when restrictions on actuarially valid underwriting criteria result in premiums that are less than accurate messengers of risk. In other words, when the message itself is statutorily redacted—in some way blurred, garbled or lost—the consequences for society are unambiguously negative because the incentive to improve driving behavior is diminished.

The Actuarial Validity of Underwriting Factors: Education and Occupation

All underwriting factors used by auto insurers, including occupation and education, have been actuarially demonstrated to enhance the insurer's ability to predict loss. Occupation and education are no different. If these two factors were not predictive, then no insurer, including GEICO, would bother to go through the time and expense of collecting such data. Indeed, a June 2006 study by the Maryland Insurance Administration (MIA), prepared under the auspices of Insurance Commissioner R. Steven Orr, found that (emphasis added):[1]

- GEICO's use of education and occupation as underwriting factors is *reasonably objective;*
- GEICO has demonstrated that education and occupation are *predictors of loss;*
- GEICO's use of education and occupation as risk characteristics *meets actuarial standards of practice and principles related to risk classification*;
- From an actuarial perspective, GEICO's use of education and occupation *is reasonable;*

As further evidence of the actuarial validity of occupation and education as rating factors, it must be noted that prior to entering the New Jersey auto market in 2004, Geico was obliged to submit its rating plan to the state for review. The New Jersey Insurance Department granted GEICO's request to operate in the state, approving its rating plan and use of education and occupation in the process.

Equity Considerations Associated With Underwriting Criteria

The Consumer Federation of America (CFA) in submitted testimony for this hearing urges the Office of Insurance Regulation (OIR) to "ban the use of ratemaking methods that directly base eligibility and premiums solely upon the educational background and

[1] Maryland Insurance Administration, Market Conduct Examination Report of the Property & Casualty Business of Government Employees insurance Company, GEICO Casualty Company, GEICO General Insurance Company and GEICO Indemnity Company, prepared by R. Steven Orr, Insurance Commissioner, June 8, 2006.

occupation of consumers" on the grounds that such information results in an "unjustifiable increase in insurance rates for many lower income and minority consumers."[2]

First, neither GEICO nor any other insurer uses either factor as a sole criteria for ratemaking purposes. Secondly, the allegation by the CFA and New Jersey CURE (a competitor of GEICO in the state of New Jersey) that the use of education and occupation disaffects lower income and minority consumers is entirely bogus and unsubstantiated. While the CFA goes through a fairly laborious (albeit irrelevant) exercise in its testimony to show that certain levels of educational attainment or occupation are associated with certain income levels, never once does CFA associate *risk* or *cost* or *relative loss* with either rating factor. Had it done so, the CFA would have found exactly what GEICO, other insurers and the Maryland Insurance Administration found—that occupation and education are not only actuarially valid predictors of risk as noted previously, but that they are not "unfairly discriminatory." To be specific, the MIA found that Geico's use of education and occupation do not cause any bias based "wholly or partly on race, color, creed, sex, or blindness of an applicant or policyholder or for any arbitrary, capricious, or unfairly discriminatory reason."[3]

GEICO's experience upon entering the New Jersey market is also illustrative. New Jersey is the most urbanized and densely populated state in the nation. It is also the only state in the country with all of its counties forming some part of a Metropolitan Statistical Area (MSA), the federal government's term for a heavily urbanized area. GEICO went from a zero percent market share prior to entering the New Jersey auto market in 2004 to become one of the state's leading insurers in just two years by offering policies to the full spectrum of New Jersey residents. It would have been impossible for GEICO to grow as rapidly as it did in a state as economically and ethnically diverse as New Jersey without penetrating every potential customer segment. It did this while using a significant number of actuarially valid risk factors, including education and occupation.

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[2] Consumer Federation of America, *Education and Occupation Classes in Auto Insurance*, Case No. 88544-06, January 30, 2007

[3] Section 27-501(a) of the Maryland Insurance Article.

Summary

The determination of fair and accurate rates requires insurers to identify risk factors that can be used to predict future loss. Risk or cost-based pricing also enhances competition and produces socially desirable outcomes. Education and occupation are just two of many risk factors and a recent Maryland Insurance Administration study has shown that both factors are actuarially predictive of loss and are not unfairly discriminatory. Restrictions on actuarially valid underwriting criteria would lead directly to more uncertainty and therefore less competition, higher prices and growth in auto insurance markets of last resort.

Thank you for the opportunity to address the Committee today. I would be happy to address any questions you might have.