

Consumer Opinions on Insurance Price Regulation

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Executive Summary

Virtually every state regulates insurance service prices, at least to some degree, although the economic rationale for such regulation remains unclear. For instance, home and automobile premiums are routinely set in ways that systematically overcharge some consumers groups so that others may benefit. Specifically, many state insurance commissions routinely set prices so that good drivers subsidize risky drivers, effectively encouraging behaviors that lead to increased accidents, traffic violations and the general endangerment of the public. There are also regulations that require inland homeowners to subsidize beachfront property owners, a practice which in many instances represents a subsidy for the rich at the expense of the less-privileged. No empirically-based economic evidence has been offered to show that these and other forms of price regulations produce consumer benefits that exceed costs. Instead, as justification, state commissions assert that insurance regulations are in the *public interest*.

To shed light on the merits of this justification, this study asks the public for their views of this price regulation. After all, who is better to decide what is in the public's interest than the public itself?

This study looks at two states where significant price regulation currently exists – namely, Massachusetts and North Carolina. A survey was conducted which asked 800 inland insurance consumers if they were aware of cross-subsidies in automobile and homeowner premiums, and what their attitudes are toward these cross-subsidies. The survey also asked consumers whether they believe that price regulation actually benefits consumers. The following are the highlights of this survey:

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- The majority of surveyed consumers were unaware that inland homeowners subsidize coastal property owners (84%) and that good drivers subsidize risky drivers (60%).
- According to the survey, 26% and 17% of consumers approved of cross-subsidies for coastal homeowners and risky drivers, respectively. In contrast, 64% of surveyed homeowners and 80% of surveyed drivers disagreed with the policy to cross-subsidize insurance services.
- Of those surveyed, 23% believed that state insurance regulations benefited consumers, while 51% thought that regulations did not benefit consumers in their state.
- In fact, 58% of surveyed consumers would prefer less insurance regulation, while only 12% believed that more regulation should be considered.

In summary, the majority of surveyed consumers disagrees with policies to cross-subsidize insurance services, do not believe that regulations benefit consumers in their state and would prefer less insurance regulation. Coupling these survey results with the fact that there exists no empirically-based economic evidence to justify price insurance regulation, it is clear that policymakers need to rethink the existence and prevalence of price insurance regulations among the states. The assertion that these state regulations are in the public interest is insufficient and is a view not shared with the public at large.

I. Introduction

Property and casualty insurance services are regulated for the stated purpose of protecting consumers, or more generally the *public interest*,¹ and, with few exceptions, state commissions regulate insurance prices across the U.S. Historically, regulations have been justified regulation based on the desire to keep prices from being too high, in order keep profit-seeking insurance carriers from charging excessive prices; and keeping prices from being too low, in order to maintain the solvency among the insurance carriers.² Since determining whether prices are too high or too low requires knowing exactly what the right market price should be, this invites regulatory intervention without answering the fundamental question of whether intervention produces any measurable net benefit for consumers.

A number of economic studies have questioned the need for price regulation and the justification of such regulation.³ One study found the insurance industry to be more competitive than any of the industries that were deregulated in recent decades, including railroads, trucking, airlines, security brokerage, banking and long distance telephone services.⁴ Another study found that the deregulated insurance market in Illinois had lower prices and more competitors than in the average regulated market –demonstrating insurance markets operate adequately and competitively without regulation and without harm to consumers.⁵ In short, net of all the costs and benefits, there has been no

¹ Protecting the public interest is the number one purpose usually cited by regulators. For example, see the National Association of Insurance Commissioners' stated mission at http://www.naic.org/index_about.htm.

² See Stephen B. Pociask, Joseph P. Fuhr and Larry F. Darby, "Insurance Regulation: Market or Government Failure? The American Consumer Institute, March 20, 2007.

³ Ibid. Also see Scott E. Harrington, "Insurance Rate Deregulation," Presented at the conference Rate Deregulation and Consumers, American Enterprise Institute, Washington, DC, September 21, 2006; and Scott E. Harrington, "Insurance Deregulation and the Public Interest," AEI-Brookings Joint Center for Regulatory Studies, Washington, DC, 2000.

⁴ Pociask, Fuhr and Darby (2007).

⁵ Stephen P. D'Arcy, "Insurance Price Deregulation: The Illinois Experience," Brookings Institution, Washington, DC, presented at the Insurance Rate Regulation Conference, January 18, 2001.

empirical evidence concluding that price regulation (on balance) actually improves consumer welfare.⁶

State commissions routinely promote regulations that socialize and cross-subsidize prices across customer groups, geographies and services on the grounds that they serve the public's interest, as well as what some commissions have referred to as "the fair and equitable treatment of insurance consumers."⁷ How do we know if price regulations equitable?

This study investigates insurance regulations and surveys consumers on their awareness and approval of policies that overcharge some customers so that others can pay less. If economic theory cannot support these regulations on the basis of efficiency and consumer welfare, shouldn't consumers at least support them on grounds that they are equitable? After all, who better to know what is in the public's interest than the public itself?

⁶ This was the conclusion of Pociask, Fuhr and Darby (2007).

⁷ Again, see the National Association of Insurance Commissioners' mission statement, available at http://www.naic.org/index_about.htm.

II. Hypothesis: Most Consumers Do Not Want To Pay the Insurance Premiums of Risky Consumers

1. Cross-Subsidy Defined

For the purpose of this paper, we define a cross-subsidy as a redistribution of revenue between consumers, such that one consumer pays a price that includes a monetary contribution towards another consumer's service. Effectively, a consumer pays more than the market price in order for another consumer to pay less than the market price. In this paper, we highlight two types of cross-subsidies that are prevalent in across the U.S. – one dealing with homeowners insurance and another with auto insurance services.

2. Insurance Regulations Subsidize Wealthy Coastal Properties at the Expense of Inland Consumers

Coastal properties tend to have higher incidence of losses due to severe weather storms and other natural phenomena. For example, in Florida, hurricanes have ravaged the state bringing with it massive storm surges and wind damage on both the Atlantic and Gulf coasts. These storms have led to the destruction and damage of prime real estate. Similarly, wild fires and mudslides have burnt thousands of homes in California, most notably the burning of the homes of millionaires in Malibu.⁸ In recognizing the vulnerability of these coastal areas, many states have cross-subsidies and some have statewide funds, as well as state-run insurance companies, that attempt to keep coastal homeowners insurance premiums lower than actual market prices, effectively pushing these costs onto all other property owners or ultimately taxpayers.

The irony in all of this is two fold – 1) the subsidy tends to benefit coastal properties that are largely considered exclusive real estate and, compared to inland homeowners, are more likely to be owned by wealthier homeowners; and 2) by subsidizing the insurance of more risky property, there is a greater incidence of building

⁸ “Flames Hit Star-Studded Malibu Enclave,” CBS/AP, January 9, 2007, available for download at <http://www.cbsnews.com/stories/2007/01/08/national/main2339723.shtml>.

in high risk coastal areas, which tends to lead to more insurance losses and higher prices for all homeowners – both coastal and inland. By encouraging building in these areas, the coastal property values have increased, which again increases the expected value of losses. As a result, inland property owners, who are often less affluent than coastal property owners, are forced to pay more for property insurance. In other words, these price regulations are tantamount to a subsidy that benefits the rich at expense of the poor. It is unclear exactly what is considered to be fair and equitable about these price regulations.

2. Insurance Regulations Subsidize risky drivers at the Expense of Safe Drivers

Another common form of cross-subsidy occurs when safe drivers, who would normally pay substantially lower insurance rates, pay higher rates in order to subsidize risky drivers. Because risky drivers tend to have more accidents, traffic tickets and claims, encouraging these drivers to drive by lowering their premiums has the unintended consequence of increasing total industry losses. This means that all consumers are forced to pay more because of this price regulation.

Keep in mind that risky drivers are more likely to be involved in car accidents and other forms of public endangerment. By subsidizing these drivers, public policy is encouraging risky behavior. This is supported by empirical evidence showing that these cross-subsidies create *incentive distortions* between high and low risk drivers, which leads to efficiency losses.⁹ Effectively, subsidized high-risk drivers will incur more losses, while overcharged low-risk drivers will incur less. If subsidies were intended to narrow the divergence in rates between high and low risk drivers, these cross-subsidies appear to have exactly the opposite effect by increasing the divergence in costs – thus perpetuating a bigger and bigger role for price regulation. As a result, the size of subsidies for inexperienced drivers can amount to hundreds of dollars, as shown in the table below. However, it is not clear that, overall, consumers have benefited by these regulations.

⁹ Sharon Tennyson, “Incentive Effects of Community Rating in Insurance Markets: Evidence from Massachusetts Automobile Insurance,” working paper, Cornell University, Ithaca, NY, March 7, 2007. pp. 35-37.

Cross-Subsidies to Inexperienced Drivers
Example of Massachusetts Automobile Insurance Market

	Inexperienced Drivers
Statewide	\$250.50
Boston Territories	\$400.28
Non-Boston Territories	\$162.39

Source: Adapted from Tennyson (2007), Table 5, p. 49, citing data from the Massachusetts Automobile Insurers Bureau for 2003.

In short, regulations make safe drivers pay more than they should so that bad drivers can receive more affordable insurance. What is the public interest here for protecting bad drivers? What is fair and equitable about these regulatory actions?

3. Test for Consumer Attitudes – A survey

Who is better to judge what is in the consumer interest than the consumer? We surveyed 800 consumers living in two states where homeowners and auto insurance cross-subsidies are present – 400 in Massachusetts and 400 in North Carolina. The consumer base was drawn from inland property owners – those living more than one hour or 60 miles from the shore. We asked these consumers if they were aware of these subsidies – both the coastal homeowner subsidy and the risky driver subsidy – and whether they approved of such policies. We also asked consumers whether they believed if insurance regulation was a benefit to consumers. Finally, we asked consumers whether they believed if insurance regulations should be increased, decreased or left intact.

4. Methodology

During the week ending May 11, 2007, a telephone survey was conducted based on a randomly drawn sample of 800 homeowners living in North Carolina and Massachusetts. A sample was limited to insured homeowners living inland in North Carolina and Massachusetts, and excluded those who property near the coast. Telephone calls were administered using random digit dialing and screened for a household decision-maker. Hispanic translation and interviewing was available, as needed. The

resulting sample size is sufficiently high to permit statements with reasonable statistical accuracy. At a 95% confidence level, the sample provides a confidence interval of $\pm 3.5\%$ in a worse case. Finally, the results were cross-tabulated by demographic and other relevant factors. The survey is included in **Appendix A** of this report and the tabulations are available online at <http://www.aci-citizenresearch.org/researchfinance.htm>.

III. Survey Results

1. Coastal Homeowners Subsidy

Several questions were posed to inland consumers regarding their homeowners insurance. All consumers were asked to identify themselves as a household decision maker, having homeowner's insurance and not owning coastal property. When asked about cross-subsidies that benefit coastal properties, only 15% of consumers were aware that such cross-subsidies existed, and 84% were unaware of these cross-subsidies.¹⁰ Massachusetts consumers were slightly less aware of these cross-subsidies (85%), compared to North Carolina consumers (83%). In short, consumers have not been adequately informed that these cross-subsidies are present in the rates they pay.

When asked how consumers felt about these cross-subsidies, 64% did not approve of them, while 26% did. In other words, most consumers were not aware that price regulations cross-subsidize coastal consumers and, if given a choice, they would oppose such subsidies. Therefore, the majority of the surveyed public does not see these cross-subsidies as fair and equitable.

2. Bad-Driver Subsidy

Of those surveyed, 96% of them also had auto insurance. Like with homeowners insurance, consumers were asked if they knew that good drivers subsidize bad drivers in their state. Of those responding, 38% of drivers were aware of the subsidy and 60% were unaware. Massachusetts drivers were more aware of these subsidies (43%) than North Carolina drivers (34%). When asked if they approved of policies that lowered rates for bad drivers, 80% of drivers did not like these policies and only 17% approved. In other words, most consumers with automobile insurance were not aware of the cross-subsidy and the vast majority disapproved of these price regulations.

¹⁰ 1% of consumers did not know or refused to answer this question.

3. Attitudes on Insurance Regulation

Consumers were asked about their attitudes regarding price regulation and consumer benefits. According to surveyed consumers, 51% of consumers believed that state insurance regulation did not benefit consumers, 23% believed that state regulation does benefit consumers and 26% were unsure or did not know. In summary, the survey showed that the majority of consumers do not see state insurance regulation as beneficial to consumers. The table below shows these results by state:

Do You Think That Most Consumers in Your State Are Benefiting from State Insurance Regulation?

	Total	Massachusetts	North Carolina
Yes	23%	18%	28%
No	51%	58%	44%
Don't Know/Refused	26%	24%	28%

When asked if they would prefer more regulation or less regulation, consumers clearly preferred less state regulation. The table below shows the state detail for each survey response and indicates consumer's dissatisfaction with insurance regulation.

In Your Opinion Should Policymaker Consider – Increasing Insurance Regulations?

	Total	Massachusetts	North Carolina
Yes	12%	9%	15%
No	72%	76%	68%
Don't Know/Refused	17%	16%	18%

In Your Opinion Should Policymaker Consider – Reducing Insurance Regulations?

	Total	Massachusetts	North Carolina
Yes	58%	64%	53%
No	23%	17%	29%
Don't Know/Refused	19%	19%	18%

In Your Opinion Should Policymaker Consider – Leaving Regulations Just as they Are?

	Total	Massachusetts	North Carolina
Yes	34%	32%	36%
No	48%	51%	45%
Don't Know/Refused	18%	17%	20%

IV. Conclusions

There is a lack of empirical evidence showing that insurance regulations produce consumer benefits that exceed costs. In the absence of economic support, regulations have been justified as being in the public interest. However, this study shows that public disagrees. Consumers disapprove of policies that regulate home and auto insurance prices. They also believe that consumers do not benefit from state insurance regulation and the majority of consumers surveyed would like to see less regulation.

These results challenge the contention that insurance regulation, including price regulation, is necessary and in the public interest. Given the lack of economic support for such regulation and the fact that the majority of consumers do not see this insurance to be in *their interest*, insurance regulatory reforms are clearly needed. More work is needed to identify these reforms, which regulations should be reduced and whether federal regulations would better serve the consumers.

APPENDIX A:**Summary of Inland Homeowner Survey Questions**

1. Do you live within an hour or 60 miles of the coast? (If yes, terminate)
2. Do you have homeowners insurance? (If no, terminate)
3. Do you own a second home near the coast? (If yes, terminate)
4. Did you know that current state regulatory system raises homeowner's insurance premiums so that homeowners with property near the coast can pay less?
 - Y/N/DK/Refused
5. Are you OK with state regulations that would make you pay higher insurance premiums so that property owners on the coast can pay less?
 - Y/N/DK/Refused
6. Do you have auto insurance? (If no, skip to #11)
 - Y/N/DK/Refused
7. In your opinion as a driver, how risky do insurance companies consider you to be?
 - A high risk driver
 - An average risk driver
 - A low risk driver
 - DK / Refused
8. Did you know that current state regulatory system raises car insurance premiums for good drivers so that risky drivers can pay less?
 - Y/N/DK/Refused
9. Are you OK with state regulations that would make good drivers pay higher car insurance premiums so that risky drivers can pay less?
 - Y/N/DK/Refused
10. Illinois has no insurance regulation and many states have less price regulation than your state. Do you think that most consumers in your state are benefiting from state insurance regulation?
 - Y/N/DK/Refused
11. In your opinion, should policymakers consider – (Asked as three separate questions)
 - Reducing state regulations?
 - Increasing state regulations?
 - Leaving regulations just as they are?
(Yes, No and DK/Refused)
12. Demographic questions on Income, race and sex