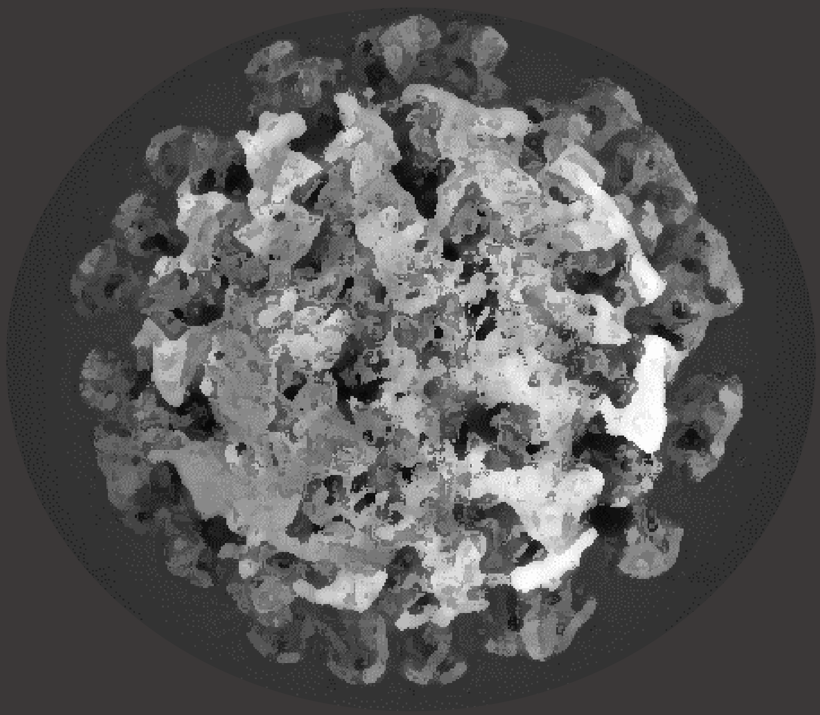


COVID-19 and Auto Insurance:

Evaluating the impact of COVID-19 on the Auto Insurance industry and embracing potential opportunities

Part 1: Revenue Pressure and Preservation

OUTPERFORM ASSOCIATES

Phil Wintering

Abstract

The COVID-19 pandemic and the resulting economic shutdown pose significant, even existential threats to every business, and companies in the auto insurance space are no exception. Every company has an urgent need to identify the threats to the business, and quickly develop an executable plan of action.

In this 6-article series we will:

- Explore the critical ways in which the auto insurance industry has been impacted by the COVID-19 crisis
- Share the thoughts and reactions of 14 auto insurance CEOs, Presidents, and EVPs
- Define many of the significant challenges ahead, and begin to look at the opportunities this situation may offer across interrelated and interdependent topics, including:
    1. **Revenue Pressure and Preservation**
    2. Distribution (COVID Impact by Market Segment)
    3. Distribution (COVID Impact by Primary Distribution Channel)
    4. Pricing and Underwriting
    5. Profitability
    6. Innovation

Methodology

This document is predicated on OutPerform's experience in the auto insurance space and extensive research into the present environment due to the COVID-19 pandemic. The challenges and hypotheses discussed in these articles were created in conjunction with CEOs, Presidents, or EVPs of more than a dozen companies in the auto insurance space, including executives from a Top 5 auto insurer, Mid-Sized Standard auto carriers, Non-Standard auto carriers, MGAs, and Insurtechs.

In our interviews with these executives, we found general agreement on some topics, and stark differences on others. Most of these differences correlate to the respondent's position in the marketplace (e.g. capitalization, rate adequacy, customer profile, state footprint, etc.). Based on all of these inputs, we have developed the most probable outcome(s). As a final note, due to the novel nature of our current environment, it is worth noting that the challenges we address here, and our recommended solutions, may change over the coming months.

Given the sensitive nature of some responses, our contacts asked that their comments be anonymized. We appreciate the input of all of the executives who shared their thoughts and time.

Executive Summary

It is safe to say that no one saw this coming. That is true across society and business generally and certainly true of the auto insurance space. While some companies have done a better job of preparing for potential disasters, no company in the auto insurance space (insurance companies, MGAs, Insurtechs, or agencies) is completely prepared for what is coming.

The industry at large will need to quickly and strategically confront this crisis. But, what can you do? What should you do? Unfortunately, there is not a simple answer, especially with the current level of economic uncertainty. Every company will face significant, yet unique, challenges demanding significant, yet unique, solutions which incorporate market position, target market, operational capabilities, distribution channel, regulatory environment, current rate adequacy, capitalization, writing to surplus, fixed costs, etc.

Each company's approach to these challenges over the next six to twenty-four months will significantly impact their viability and trajectory for years to come and, perhaps more importantly, will determine the industry winners coming out of the crisis.

It will not come as a surprise that Progressive and GEICO are the auto insurance companies best positioned to come out of the COVID crisis with a bigger, more profitable company. Their superior starting position is ensured by their large market share, low expense ratio, systems, superior data, and talent base. That said, this is an inflection point for everyone and there is no assurance that the big players will win in uncharted waters; more importantly, even if the big players come out on top, there will be room for others to significantly improve their market position, and capabilities going forward.

Again, "what do I do?" will be governed by your starting point. For some companies, it will be necessary to take more of a defensive posture in addressing coming challenges. For others, opportunities exist to take a much bolder approach. Defensive v. bold posture will vary by degree – the losers in this scenario will be the companies who simply wait for things to get "back to normal" while the winners will be those who adapt quickly to challenges, and identify and take advantage of the opportunities ahead.

Revenue Pressure and Preservation:

Revenue for insurance companies and MGAs is under tremendous pressure from COVID in a variety of ways. This will continue to varying degrees until this crisis is behind us. These pressures include premium refunds, bad debt, declining retention, reduced coverages and increased deductibles, and the potential of a looming soft market. Let's look at these in detail:

Premium Refunds: Consumer groups and some Insurance Departments started demanding a reduction in premium, as a result of the reduction in mileage driven and claims, even before any driving and claims data had been collected. In fact, Forbes reported the demands began as early as March 18th [1].

> "One of the first calls for car insurance refunds came from the Center for Economic Justice (CEJ) and the Consumer Federation of America (CFA). They raised concerns in mid-March about consumers overpaying for car insurance. They wrote a letter to state insurance commissioners on March 18 and called for the departments to direct car insurance companies to issue payment relief based on reduced mileage and fewer insurance claims."
>
> Forbes – April 15, 2020

The following day (March 19th) California Governor Gavin Newsome issued the first stay at home order, which was followed rapidly by New York, Illinois, New Jersey, and Ohio. By April 6th Allstate and American Family were the first to offer premium reductions on auto policies for April and May. The following day, the Louisiana Insurance Commissioner, Jim Donelon, approved the refunds and encouraged other companies to follow suit [2]. By April 13th California's Insurance Commissioner mandated that all carriers institute "initial" premium refunds for six lines of business, including private passenger and commercial auto insurance [3].

Refunds offered by all of the major insurance companies thus far are typically for 60 days and range from 15% to 35% of premiums [4]. Estimates of the impact of these actions range from $10 to $11.0 billion. Based upon the Insurance Information Institute's estimates of total U.S. private passenger auto (PPA) premium, the premium refunds (reductions) to date represents a 2020 revenue decrease for the auto insurance industry ranging from 4.1% to 4.5% [5].

In California the Insurance Commissioner's order was predicated upon consumer advocate demands, and a UC Davis study of consumer driving behaviors and accident frequency under the COVID lockdown. [6][7] This study [7] showed a reduction in collisions of approximately 60%, and a reduction of traffic volume of approximately 50% in California under the Governor's lockdown order.

Private Passenger Automobile Insurance, 2009-2018

($000)

	Liability				Collision/comprehensive			
Year	Net premiums written (1)	Annual percent change	Combined ratio (2)	Annual point change (3)	Net premiums written (1)	Annual percent change	Combined ratio (2)	Annual point change (3)
2009	$94,990,682	0.5%	106.2	2.7 pts.	$62,630,693	-2.2%	93.0	-2.8 pts.
2010	97,672,826	2.8	105.9	-0.3	62,595,851	-0.1	93.4	0.4
2011	100,369,441	2.8	103.8	-2.1	62,948,280	0.6	99.6	6.3
2012	103,429,677	3.0	103.2	-0.6	64,619,667	2.7	100.2	0.6
2013	107,446,382	3.9	103.6	0.4	67,452,663	4.4	98.7	-1.5
2014	112,354,903	4.6	103.8	0.2	71,096,640	5.4	100.2	1.5
2015	116,305,809	3.5	107.9	4.2	76,486,433	7.6	99.4	-0.8
2016	124,439,721	7.0	109.4	1.5	82,931,826	8.4	101.5	2.1
2017	133,745,174	7.5	105.5	-3.9	88,489,745	6.7	98.3	-3.2
2018	144,438,315	8.0	100.5	-5.0	96,469,904	9.0	93.7	-4.6

(1) After reinsurance transactions, excludes state funds.
(2) After dividends to policyholders. A drop in the combined ratio represents an improvement; an increase represents a deterioration.
(3) Calculated from unrounded numbers.

Since COVID state-by-state lockdowns are expected to end in phases and will most certainly conclude long after May 31st, it is reasonable to assume that more premium reductions will be demanded by consumer advocates and insurance commissioners.

> "According to UC Davis' Special Report on Impact of COVID-19 on California Traffic Accidents, reduced driving has resulted in fewer accidents, injuries, and fatalities on public highways and roads."
>
> CA Insurance Commissions Bulletin 2020-3, April 13, 2020

Many of the auto insurance executives we interviewed specifically expressed this concern, particularly since large states (e.g. CA, IL, MA, NY) have already telegraphed late and lengthy reopening periods. While some of these executives signaled more of a public relations posture, stating that they "stand ready" to commit to more premium reductions, others expressed frustration over give-backs without "sound data." Depending upon how many states mandate premium give-backs for an expanded period of time, the evolution of consumer pressure and carrier behaviors, and based upon federal reopening guidelines our rough estimate is that this could result in as much as an additional 1.5% - 3.0% reduction in 2020 PPA premiums.

It should be noted that most NSA auto companies indicated a significant reluctance to return premium, unless mandated by the state. This reluctance stems from a far greater exposure in the NSA space to bad debt (see below) than Standard and Preferred carriers. They are more apt to waive fees to ease financial burdens.

> **Insurance Commissioner Lara Calls for 60-Day Insurance Premium Grace Period Due to COVID-19 Outbreak**
>
> **SACRAMENTO, Calif.** – Insurance Commissioner Ricardo Lara today issued a Notice requesting that all insurance companies provide their policyholders with at least a 60-day grace period to pay insurance premiums. The Commissioner made the request to ensure policies are not cancelled for nonpayment of premium due to the novel coronavirus (COVID-19) public health emergency."
>
> CA Insurance Commissions Press Release, March 18, 2020

Bad Debt: Many auto insurance carriers face bad debt (and unfunded loss) exposure that would have been unthinkable in February. Through insurance department "requests" and mandates, auto insurance carriers are precluded from non-payment cancellations and non-renewals in several states [8][9]. As of March 25th, this included 27 states [10], by April 28th this had increased to 41 states [11].

Most states have issued orders for a moratorium on non-pay cancels, but the language of the orders varies significantly, ranging from a “request” to an “order.” Additionally, the language in some state orders are open to interpretation. The implementation of these mandates not only vary by state, they also vary by company.

Executive Comments on Cancellation Moratoriums

“I question whether they (the insurance commissioners) have the authority to order this.”

“There is no chance we will ever collect on these policy extension.”

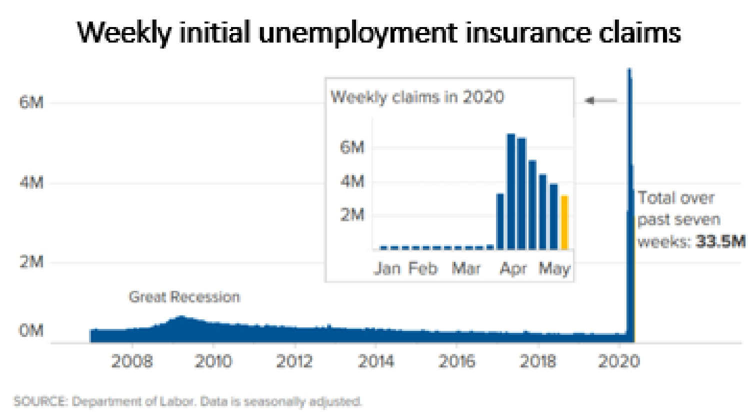
“We are sending out the cancellation notices, unless the consumer requests relief.”

“If we did this on every cancellation, it would create a capital event.”

Comments from various executive interviews, April 27 – May 6, 2020

These moratoriums, especially where they have come in the form of “orders,” have raised the greatest amount of ire on the part of the executives we interviewed. There is significant concern over setting a precedent around paying claims outside the policy’s contractual obligations.

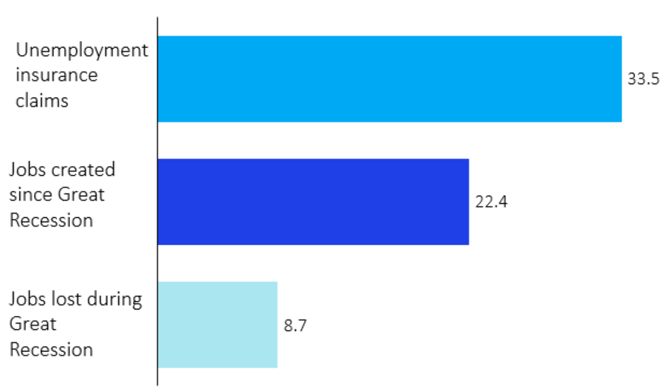
Because of these variations by state and in application by carriers, it is difficult to predict and calculate the exact impact this will have on revenue. This will, however, result in a significant amount of uncollected premium as many consumers opt to switch carriers rather than pay back premiums. If only a small fraction of the affected consumers (based upon average retention tables and historical non-pay cancellation rates) never pay for the coverage extended during the non-pay cancel or nonrenewal period it will very conservatively cost the industry between $450 and $900 million; increased unemployment could further exacerbate this problem, potentially tripling this figure. Even worse, in all of these situations, the insurance carrier will still be required to pay claims.



Declining Retention: Since the start of the COVID crisis and state lockdowns, employment has been in a free fall with more than 33.5 million jobless claims in just seven weeks [12].

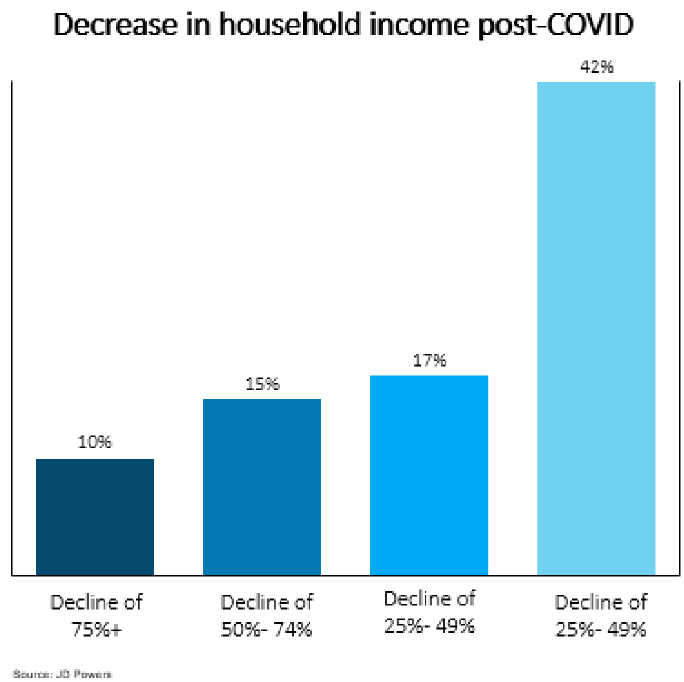
These are the worst job losses in U.S. history and will result in a dramatic departure from typical consumer behaviors. Simply put, we expect:

COVID Job Loss Surge (millions) as of May 7, 2020



Source: Bureau of Labor Statistics

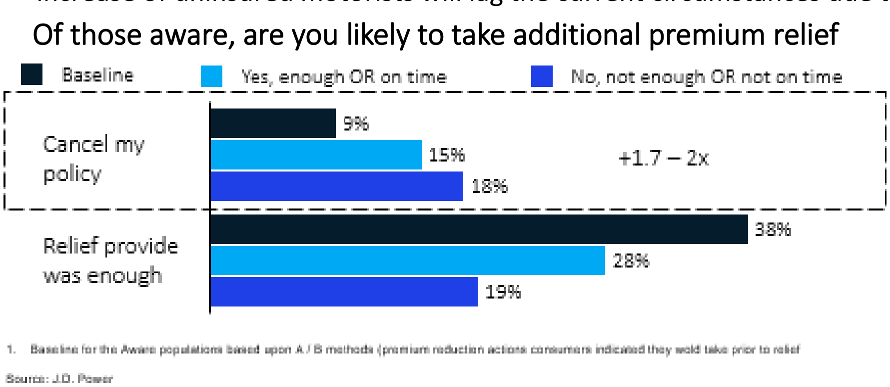
A significant increase in price sensitivity and auto insurance shopping: Typically, the Non-Standard auto (NSA) segment exhibits the greatest price sensitivity, as well as the highest rate of shopping and switching; resulting in six-month retention rates ranging from 35% to 55% (this varies greatly between companies based upon their definition of NSA, quality of the book, and distribution channel). By contrast, the six-month retention rate for the Standard market segment typically runs between 65% and 80%. OutPerform expects a dramatic increase in shopping in the coming months as a result of the 33.5 million new unemployment claims, especially in the Standard segment as financial pressures increase for consumers. According to a JD Powers survey (13) published April 16th,42% of households have seen at least a 25% reduction in household income, with 10% of households suffering more than a 75% drop in income.



The longer these historic unemployment numbers persist, the more probable it is that some typically Standard Risks will begin exhibiting price sensitivity, shopping, payment, and retention characteristics that are more common among NSA risks. Even some consumers who would typically be considered preferred risks may exhibit greater price sensitivity if unemployment numbers do not abate.

An increase in uninsured motorists: As household financial circumstances deteriorate, we expect an increase in the number of consumers going uninsured for a period of time. In fact, the previously mentioned J.D. Powers survey (13) found that of the consumers aware of the announced premium reductions, 57% believe this will help to ease financial tensions, but only 19% feel it will be enough to fully address their financial issues, and are considering additional measures to reduce costs. Of those surveyed, 18% are considering cancellation of their policy to cut expenses.

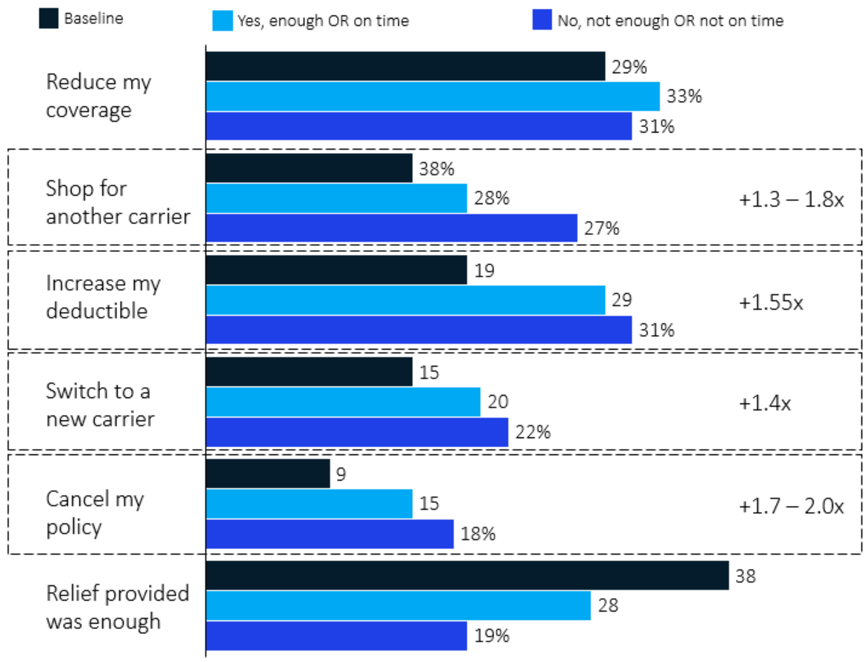
It is important to note that the expected impact on price sensitivity/increased shopping, retention, and an increase of uninsured motorists will lag the current circumstances due to:



- **Prohibitions on cancellations or non-renewals** during (and around) state lockdowns will keep retention rates from dropping, and in fact will increase retention numbers for a period of time. Of course, this increase will come without the benefit of paid premiums.
- **Extended consumer liquidity** through government stimulus checks and unemployment payments.

Once these initial blunting factors pass, and assuming unemployment persists, the impact on retention will become increasingly apparent and will accelerate. In our conversations with industry leaders, most projected a 10% to 15% reduction in typical retention rates for the Standard, Middle Market (MM), and Non-Standard auto (NSA) market segments.

Of those aware, are you likely to take additional premium relief actions?



1. Baseline for the Aware populations based upon A / B methods (premium reduction actions consumers indicated they wold take prior to relief

Source: J.D. Power

Reduction in coverages/deductibles: Most consumers seeking additional cost relief are currently considering less draconian options (than cancelling their policies), but these will still create additional revenue pressure. Of those who do not cancel policies, 31% have indicated a propensity to seek additional relief through reduced coverage and increased deductibles, which we expect to create additional revenue pressure in the coming months.

Soft Market – Price War?: In some market segments we are concerned that depressed revenues, greater price sensitivity and shopping, and reduced retention rates will result in rate reductions by some carriers in an attempt to maintain market share. The result of this would be to further depress carrier margins. While this could have an impact for carriers serving all market segments, we believe there is a far greater risk of this in the Standard, MM, and NSA market segments where unemployment is going to create the greatest volatility.

Soft Market – Executive Comments/Disagreement

"This will be the "softest" auto insurance market in my 40 years in the industry."

"This is going to be ugly, but we are well capitalized. Some monoline companies will not survive."

"No, I don't see a soft market. That won't happen. Better companies are won't do this."

"I don't think so. Companies have a lot more pricing discipline now."

CEO interviews, May 2020

When we presented executives with the potential of a coming soft market, we received responses ranging from great concern (36% of respondents) to uncertainty (21%), to completely ruling this out (43%). This issue had the greatest level of disagreement between carriers.

The timing of a potential soft market could start in the second half of 2020, but if this happens, we expect this to fully manifest in 2021. The duration of the potential soft market is impossible to calculate as the length of the economic downturn and resulting unemployment cannot be projected at this stage. Given carrier responses, we believe there will be additional revenue pressure from a soft market in 2020 and 2021; timing and revenue impact are dependent upon the carriers' ability to exercise pricing discipline in the face of some carriers lowering rates.

Conclusion:

Between existing and future premium reductions and give-backs, increased bad debt, an increase in uninsured consumers, a reduction in coverages and limits, an increase in deductibles, and the potential of a coming soft market there is no doubt that net premiums will decrease substantially in 2020. We believe the absolute best-case scenario for the industry is a drop in net written premium of 5%-6% in 2020, but expect an upper range as high as 11%-13%.

The impact of each of these revenue challenges will vary substantially by carrier and jurisdiction based on market segment concentrations, state footprint (e.g. insurance department mandates), decisions on future premium reductions, the depth and duration of the recession and most importantly, the strategy and decisions employed by each company. Unraveling the challenges, complexities and interdependencies caused by COVID will prove difficult for every company; taking the right approach to weather the storm is paramount to ensuring the future success of every company in the space.

We believe it is essential that every carrier and MGA in the insurance space step back at this critical moment to assess their unique situation and how this crisis will affect the company and their customers. From there, it will be essential to marshal the necessary resources and insights to construct achievable objectives and deployable plans to protect the company and take advantage of new opportunities.

Understanding the impact of the COVID crisis on revenue is just the first step in that process. In subsequent articles we will explore the critical interrelationships between revenue preservation, and the challenges to distribution and pricing in this crisis.

Coming Soon, Part 2: Distribution: COVID Impact by Market Segment – In this document we will explore revenue generation challenges and opportunities by market segment.

About OutPerform Associates:

We provide guidance and assistance to P&C insurance carriers in building, implementing and optimizing winning distribution and operational strategies.

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Citations

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