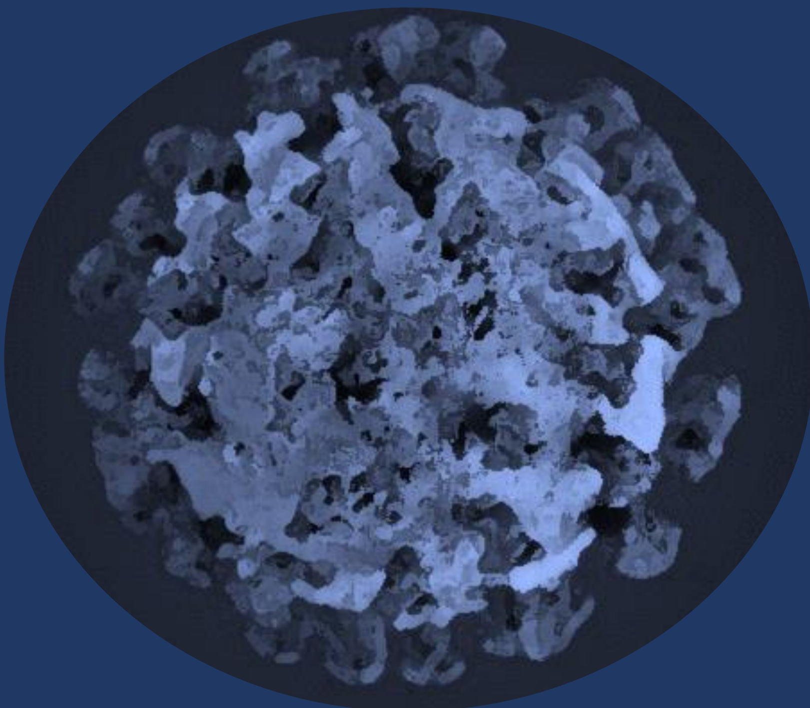


COVID-19 and Auto Insurance:

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

Part 2: Distribution – Impact by Market Segment

OUTPERFORM ASSOCIATES

Phil Wintering

Abstract

In Part 1, we showed how revenue pressure on the insurance space mandates quick, decisive, and, most importantly, tailored approaches to be taken by every company; the winners in this crisis will be those that identify the unique threats to their business and the unseen opportunities from the crisis, and develop strategies and executable plans to address these challenges and opportunities. This document continues to outline the key, foundational considerations building that strategy and operational plan.

In Parts 2 and 3, we will explore the impacts of COVID on distribution; Part 2 will explore the impact on distribution within each market segment while, in Part 3, we will focus on the impact by primary distribution channel as insurance companies begin to plan the path forward for their unique situation.

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 CEO's, Presidents, and EVP's
- 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 series 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 CEO's, Presidents, or EVP's 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, MGA's, 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 that shared their thoughts and time.

Executive Summary

As unemployment caused by the COVID economic shutdown accelerates, and consumer purchasing behaviors change due to stay at home orders and social distancing, there are significant challenges from disruptions to all distribution channels. These disruptions will create unique issues in each market segment. Additionally, in the coming months, consumer's savings will be quickly exhausted following the end of government subsidies and reduction of unemployment payments, causing consumer needs and thus behaviors, to be significantly altered across all auto insurance segments.

The effect of these conditions will result in changes to consumers underwriting profiles, reduced policy retention rates, and the potential of substantial movement of consumers between market segments. This will create significant challenges for carriers in identifying target consumers, as traditional underwriting data points will no longer accurately portray some consumers in the near term.

Distribution: COVID Impact by Market Segment

Over the next 24 months, marketing and distribution functions within the auto insurance space face tremendous disruption, pressures, and in some instances, opportunities. All of this will vary dramatically based on the target market segment, primary distribution channel, data and operational capabilities, current market position/pricing, and level of capitalization. In short, every carrier's situation is unique, and each carrier's strategy and implementation plan are more critical to a successful outcome than at any other point in time.

> **"The Forecast**
>
> *ITC predicts that quoting volumes will continue to remain below the expected quote activity settling between 24% and 27% for the week."*
>
> *ITC*, State of Insurance Rating COVID-19 Weather Report #5, April 27, 2020

While some of the expected distribution disruptions are already visible in the market, we believe there will be a lag of 90 – 120 days for many disruptive elements to emerge. The first, and most apparent of the current disruptions is the significant reduction in physical interactions with local insurance agents; ITC (TurboRater), one of the largest comparative rating engines for independent agents (IA's) reports that quoting in the IA channel has rebounded some in late April, but is still significantly off from year-over-year expectations [(1)]. During the same time period, the report shows higher online quoting, indicating that at least some of the IA shortfall in quoting has moved online.

> "Online quote requests were 22.4% above expectations for the week."
>
> *ITC*, State of Insurance Rating COVID-19 Weather Report #5, April 27, 2020

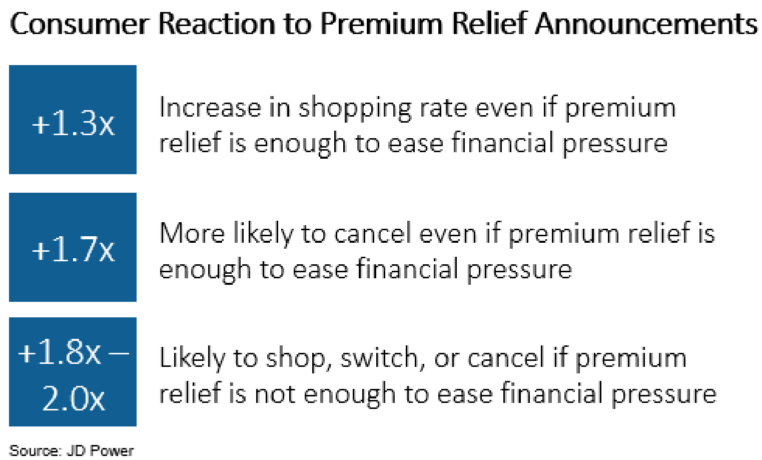
The primary disruption in distribution, however, will be felt once the economic effects of 33.5 million new unemployment claims begin to manifest. This manifestation has been temporarily blunted by:

- **Federal subsidy checks** sent to most U.S. tax payers
- Temporary increases in **unemployment benefits**
- Short-term **premium reductions** and **give-backs** by insurance carriers
- **State mandates blocking policy cancellations** for non-payment and non-renewal

As these stopgaps trail off over the coming months, we expect a significant depression of auto insurance retention rates. This will result in a significant increase in quoting through all channels, but while agency quoting may reach prior levels as a result, we still expect the local agent's proportion of quoting to be off significantly. Based on a J.D.

Powers survey of consumer outlook on premium relief[2],prior levels as a result, we still expect the local agent's proportion of quoting to be off significantly. Based on a J.D. Powers survey of consumer outlook on premium relief[2], the propensity of those surveyed to shop and/or switch auto insurance in the coming months will increase between 30% and 100% dependent upon circumstances at the time.

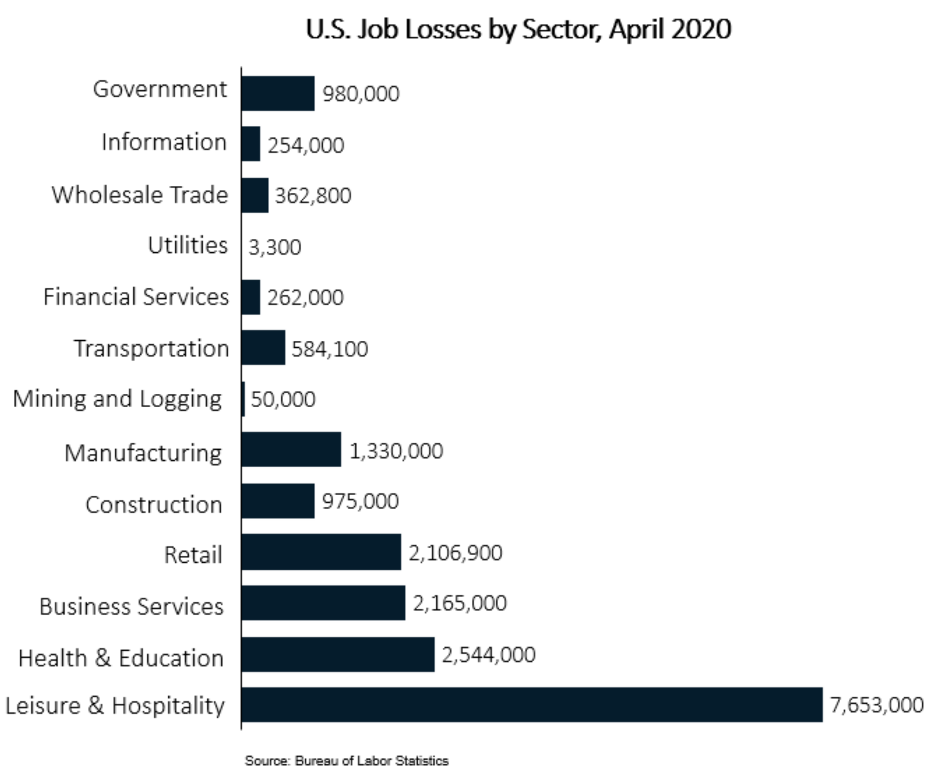
At that point, we believe there will be disruption of marketing and distribution functions across all market



segments, but the timing and depth of these impacts will vary depending on the percentage of consumers in each segment who are displaced in their employment, and the duration of that displacement. This article examines the impact on retention rates for each market segment individually.

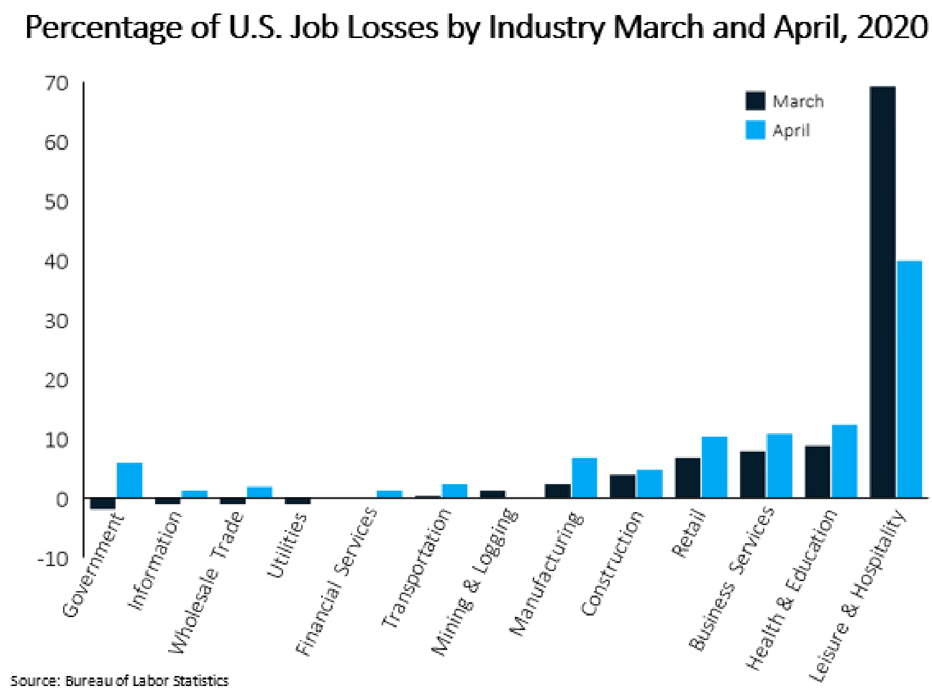
The Non-Standard Auto (NSA) and Middle Market (MM) Segments: In these as in all segments, the retention rate will be artificially inflated so long as state mandates against carrier cancellation or non-renewal for non-payment are in place. Once these mandates are removed, retention rates will decrease substantially.

More importantly for carriers focusing on NSA and MM consumers, moratoriums on non-pay cancels are a significantly greater financial issue than for the Standard and Preferred segments. While companies in the Standard and Preferred segments measure retention in years, the NSA and MM segments measure it in months. Average policy retention rates for carriers serving NSA and MM segments range from five to eighteen months (depending on the sub-segment of the market segment – there are many flavors of NSA), with an average of about twelve months. As a consequence, non-pay cancels occur on a much higher percentage of the NSA and MM book of business in any given period; at least one non-pay cancellation annually on 65% of NSA business is not uncommon. As we discussed in Part 1, depending on the jurisdiction, some carriers continue to issue non-pay cancellation notices, and only implementing these mandates when consumers request relief. Since carriers must still pay claims during this period and much of the uncollected premium will turn to bad debt, this

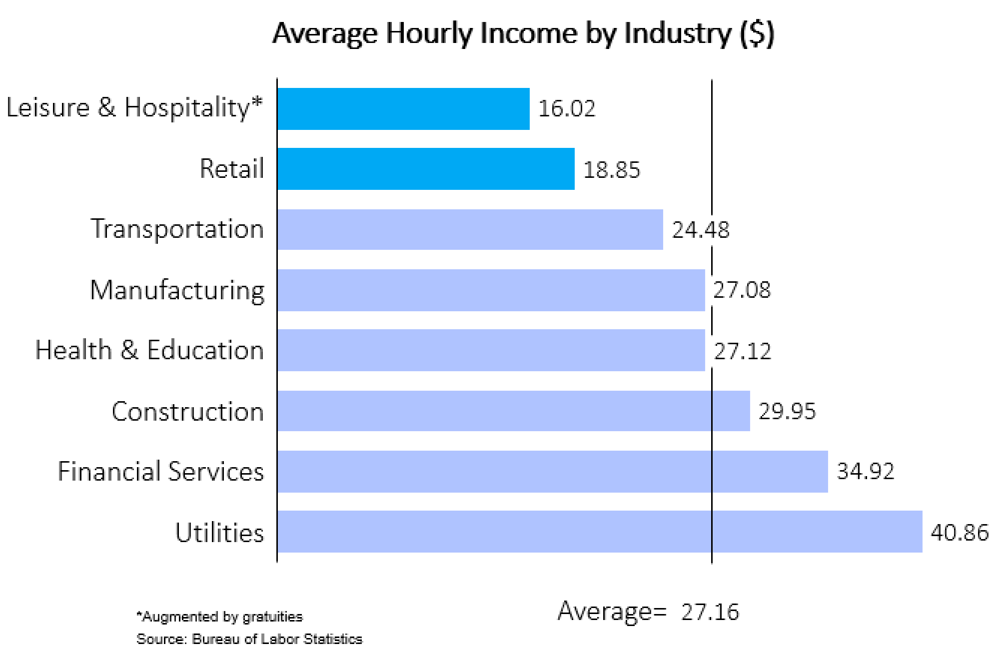


one mandate from insurance departments could increase NSA and MM carriers' combined ratios by as much as 3.8 points. For well-run NSA/MM carriers, that alone is the difference between a profit and a loss for the year!

Once temporary blunting factors like premium reductions, moratoriums on non-pay cancellations, and Federal subsidies are exhausted, we believe companies focused on the NSA and MM segments will experience the most immediate and frequent impact of any segments for several reasons:



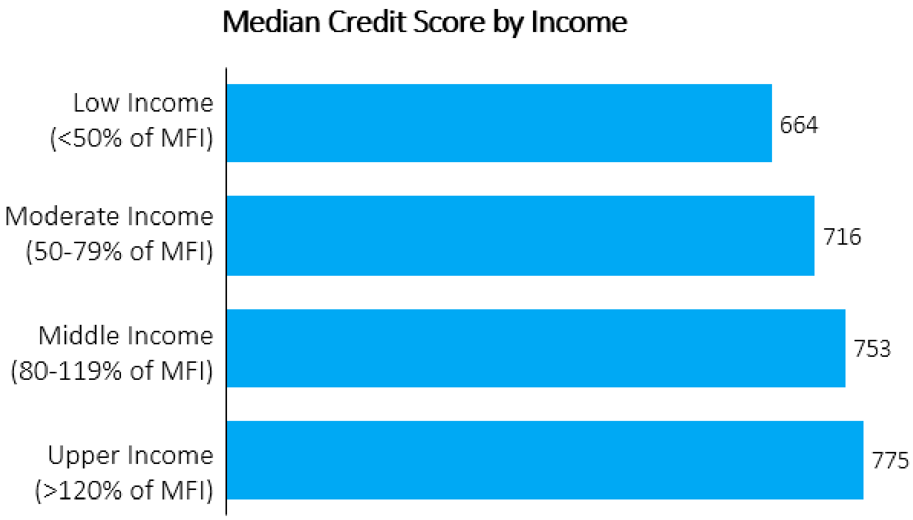
1. The Bureau of Labor Statistics (BLS) reported 662,200 new jobless claims in March as a result of the initial COVID shutdown, with 76.2% of these claims reported in the Leisure and Hospitality, and Retail segments. Jobless claims skyrocketed to over 19 million[3] just one month later. While COVID's impact spread to additional segments in April, Leisure and Hospitality, and Retail still comprised 50.6% of all jobless claims.
2. According to the BLS, average wage rate in the most heavily impacted U.S. segments is substantially lower than the national average of $27.16.



And while there is a dispersion of credit scores within each income segment, the average credit score drops significantly in lower-income segments [4]. As a consequence, a disproportionate share of the segments hardest hit in the COVID crisis tend to have credit scores that correlate with the NSA and MM segments of the insurance market.

It follows that lower-income workers will typically lack the savings necessary to weather the storm if rendered jobless, resulting in more dramatic modifications to their spending habits than other segments.

As the temporary factors blunting the economic impact for consumers dissipate, we expect the NSA and MM segments to experience lower retention, increased shopping rates, and a higher level of uninsured motorists. While NSA and MM carriers have experienced these conditions and behaviors in the past, we expect each to



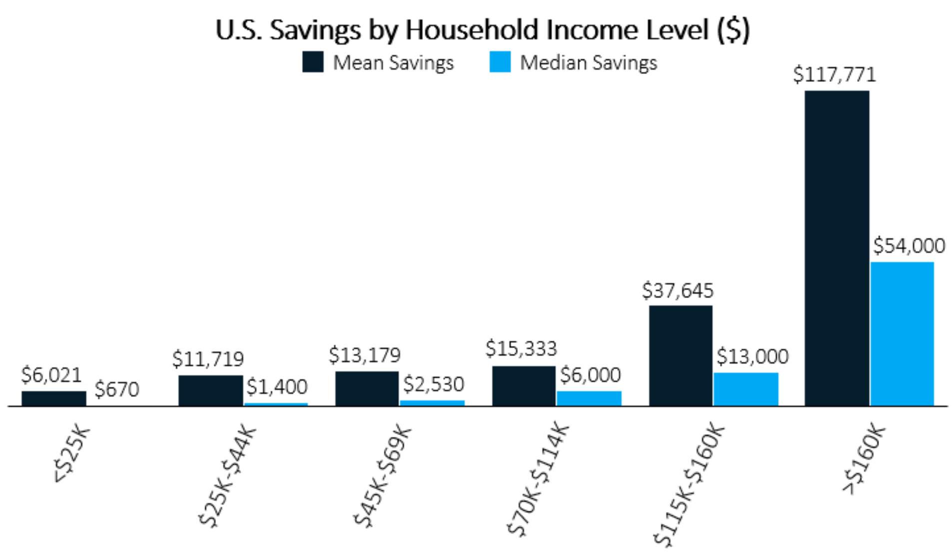
Average FICO Score is 703 with a range of 300-850
MFI = Median Family Income
Source: FICO

manifest at expanded levels, posing significant financial risk to these companies. It's worth noting that the impact of this on the carrier or MGA will vary by distribution channel (see Part 3 of this series for more detail), but in all cases this will result in greater acquisition and servicing costs.

Separately, economic disruption from the COVID crisis may cause consumers who no longer meet the Standard segment's underwriting requirements to be shifted into the NSA and MM segments; interestingly, this could actually provide a buffer to the NSA and MM segments, as these consumers tend to have lower loss ratios and longer retention periods.

The Standard Market Segment: Layoffs in lower income sectors (e.g. Leisure and Hospitality) do not only impact consumers in the NSA and MM market segments. As previously noted, there is a dispersion of credit scores around the mean at every income level, consequently, lower income consumers are in other auto market segments as well, especially the Standard market segment.

April BLS data shows significant expansion of new unemployment claims across all sectors, including Health and Education, Financial Services, Information Technology, Business Services and Construction, all of which tend to have higher average wages and credit scores which are closely correlated with the Standard and Preferred auto insurance market segments. As a result, the Standard market segment will not escape feeling the impacts of the COVID shutdowns.



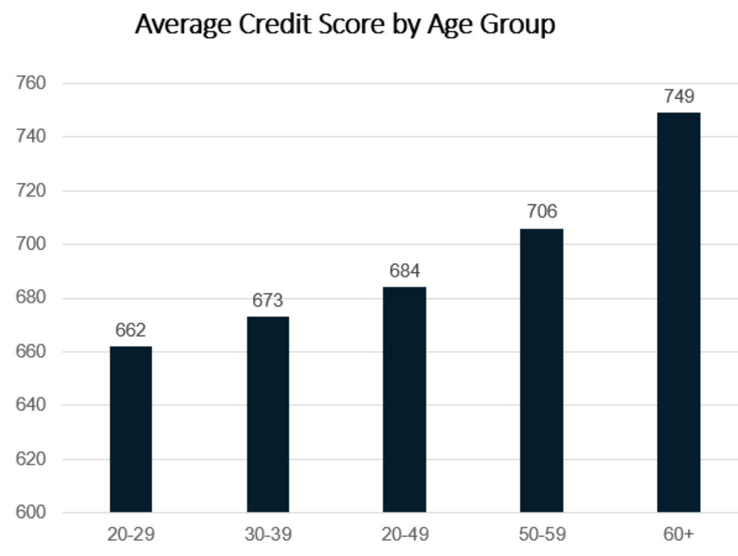
Source: Federal Reserve, Survey of Consumer Finances

It's tempting to believe that the higher wages and credit scores in the middle- and upper-income groups have resulted in higher savings rates. And, this will in turn support continued stability in consumer behavior for the Standard market segment in the face of rising unemployment; unfortunately, this proves incorrect, as there is only a limited correlation between additional income and the propensity to add significantly to savings. On average, middle-income households ($70,000/year) suddenly without income only have savings enough to cover 10 additional days (a total of 31) over lower income households ($25,000/year) who have been rendered jobless. So, while we do not expect a significant change in driving behavior for consumers in the Standard market segment, the behavior for unemployed insureds in this segment may quickly begin to replicate behavior more typical of the NSA and MM segments with regard to retention, price sensitivity, shopping, and payment behaviors.

We acknowledge that there is, in some cases, more room to tighten the financial “belt” in a household consuming $70,000/year, however, any additional financial flexibility will be short-lived. Additionally, the fixed level of unemployment benefits will have less impact on a percentage basis in covering household expenses at higher incomes. Therefore, we anticipate significant disruption for insurance carriers who focus on the Standard market segment in the coming months.

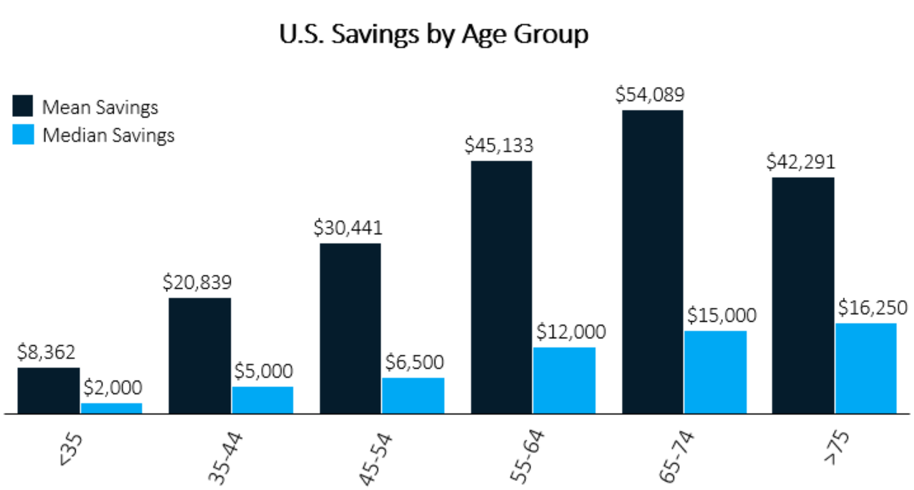
As a portion of the Standard market segment is compelled to begin exhibiting payment, retention, and credit scores more characteristic of NSA and MM segments, a sizeable portion of the market may no longer meet the underwriting requirements for Standard auto programs and pricing, creating a significant problem for companies from a retention and PIF (Policies in Force) standpoint. Standard carriers may need to find ways to adjust underwriting, pricing (see discussion in Part 4), and data collection to address how they evaluate consumers in the current situation and to avoid long-term ramifications to their PIF counts and premium volumes.

The Preferred/Ultra-Preferred Market Segments: Carriers focused on these market segments will face the smallest impact from a policy count standpoint, but will still experience substantial disruption, with increasing significance depending on the duration of the recession.



Source: Experian

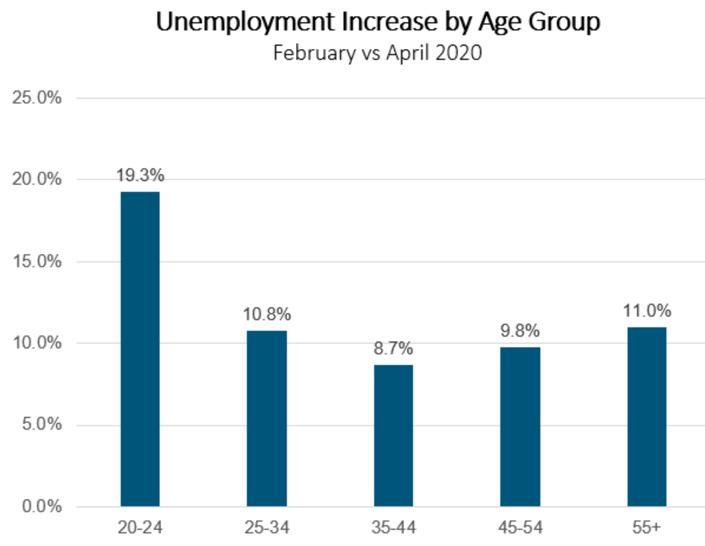
Consumers in the Preferred segments tend to be older, with significantly higher average credit scores[5], and have higher income and savings levels. Median household savings levels increase with each decade facilitating a longer capability to backstop lost income. For example, the median savings for the 55 – 64 age group are 140% higher than the 35 – 44 group and 500% higher than those under the age of 35. Unfortunately, this only amounts to median savings in the 55 – 64 age group of $12,000, so, while Preferred consumers in this age bracket can withstand unemployment longer, many, already faced with the financial pressures of retirement, will need to cut costs where possible.



Source: Federal Reserve, Survey of Consumer Finances

Most Preferred customer over-65 are already retired and on a fixed income, resulting in significantly less financial disruption. Yet, because of the expected reduction in the value of their investments, this group will still see declines in retention and more shopping than normal. The degree to which this occurs will depend on the ultimate level and duration of the financial recession.

Finally, while the growth in unemployment numbers through April are skewed towards industries with lower incomes, older demographics continue to have higher employment losses than the 25 – 34 segment. This rapid destabilization of, traditionally, the most stable demographic will have a detrimental effect on all auto insurance companies and segments, including and perhaps most of all within the Preferred segment. Without some form of accommodation, a portion of the existing book of Preferred business will migrate to the Standard, MM and NSA market segments.



Source: Bureau of Labor Statistics

Conclusion:

The unemployment crisis borne from the COVID shutdowns will have the broadest impact on the NSA and MM segments, but ultimately every segment will face significant, sometimes existential challenges over the next two years.

From the perspective of percent-of-business, NSA and MM segments will be affected the most by increasing unemployment, with the impact diminishing as you move into the Standard and Preferred segments. That said, the greatest operational, data collection and reporting, underwriting, and pricing challenges, and the greatest long-term negative impacts, may be felt in the Standard and Preferred segments, as some consumers migrate to lower pricing and underwriting segments.

Again, 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. Understanding how the COVID crisis impacts market segments, distribution channels (Part 3), and pricing and underwriting (Part 4) independently and together is paramount when constructing the strategy, objectives, and action plans deployed by your company.

At OutPerform, we can provide critical assistance in assessing companies' current capabilities and market position, identifying key challenges and opportunities, and building a strategy and solutions to address each one. We look forward to discussing this further.

Up Next, Part 3: Distribution: COVID Impact by Primary Distribution Channel – In this document we will layer the impacts of COVID on market segment impacts to further explore revenue generation challenges and opportunities in this challenging time.

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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