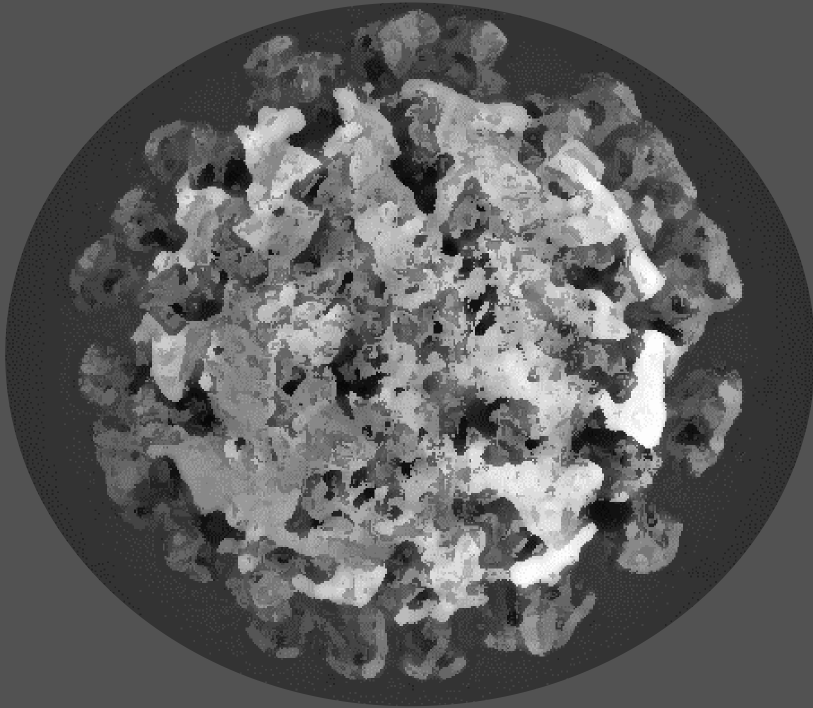


COVID-19 and Auto Insurance:

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

Part 4: Pricing & Underwriting Challenges

Phil Wintering

Abstract

In Parts 1, 2, and 3 we examined how the COVID-19 economic shutdowns have and will create revenue pressures throughout the auto insurance industry, as well as the potentially dramatic, yet uneven, impact of shutdowns on auto insurance market segments and distribution channels. More recently, we have published an update to Parts 1 & 2 showing that the anticipated impact of the COVID-19 shutdowns are indeed headed in the direction we anticipated. This reinforces the need for each company to quickly build tailored strategies driving decisive actions to limit negative impacts from COVID-19 shutdowns and take advantage of potential opportunities generated by the pending market uncertainty and upheaval.

In this document, we move to considering the impact on all of this to auto insurance pricing and the dramatic impact this may have on market conditions and individual insurance carriers.

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 25 auto insurance CEOs, Presidents, EVPs, SVPs and VPs
- 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 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 executives of more than two 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. More recently, we have also interviewed multiple national and regional independent agency executives to gain a greater perspective.

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's 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

In Part 2 of this series we discussed the impacts, challenges, and opportunities created across each market segment as a result of COVID-19; Part 3 then applied the lens of distribution channels to these segment-specific insights. Now, in Part 4 we take a look at the changing dynamics around auto insurance pricing from COVID-19 and how this affects, and in some cases compounds, the challenges and opportunities companies face concerning their revenues, market segments, and distribution channels.

Among the insurance executives we have interviewed for this series, there is substantial concern regarding the ability to accurately price auto insurance over the next two to three years. While the views of these executives vary based upon existing rate adequacy, capitalization, market segment, and region, there is some consensus in the overall uncertainty of the impacts of COVID-19 on pricing models and the timing of those impacts. Many of these executives pointed to specific areas of concern which we will explore here, but there are so many moving parts (e.g. duration of the pandemic and economic downturn, regional variations, federal subsidies, etc.) that there is not a common view of price adequacy moving forward; this volatility in loss trends may persist over the next eighteen to thirty-six months. Consequently, every company will need to evaluate their position in the market, the potential short- and long-term challenges explored here, and the capabilities and resources they will need in order to address their response strategy.

Executive Comments on Auto Insurance Pricing

"Trying to price accurately is going to be almost impossible for a couple of years."

"It (pricing) is just going to be a mess."

CEO interviews, May 2020

Distribution: Pricing & Underwriting – Coming Challenges

As most readers know, insurance pricing is predicated upon projecting future claims costs based upon prior losses by pricing factor, the trends in the underlying loss frequency and loss costs, and changes in consumer driving behaviors. COVID-19 is having and will continue to have, an impact in each of these areas; resulting in substantial changes to pricing inputs. Some of these changes will last only as long as the pandemic, others may be more permanent in nature. Many of these changes to the underlying pricing variables may be so profound that some rating attributes will be less measurable, less reliable, and therefore less predictive of future losses or future loss costs for an extended period. Worse, it is impossible at this point to know and understand the severity or duration of the pricing disruption from COVID-19.

Rate Adequacy: In the face of this uncertainty, the pricing impacts from COVID-19 will be different in the short- and long-term, will vary based on a variety of factors such as region, and the impacts may well fluctuate substantially.

In the short-term, industry revenues are shrinking at least 7% in 2020 and revenue reductions will persist into 2021. Despite this, profit margins are holding to improving for now, as the frequency of losses has been driven lower by the reduction in driving from COVID-19 shutdowns and working at home. For example, Progressive's second-quarter earnings statement showed an 87.7 combined ratio – a 2.7-point YOY improvement. Additionally, retention rates have not yet dipped for many of the executives we spoke with due to significant federal subsidies for the recently unemployed and steady auto insurance rates.

There is a much bigger concern, however, with rate adequacy going forward. The overall loss cost trend for the auto insurance industry appeared to be in the 3% - 4% range coming into 2020[1], with a 6% to 7% increase in severity, but a decline in frequency. This trend line has been disrupted dramatically; anecdotally down as much as 60% initially following the COVID-19 shutdowns and now down 10% - 25% depending on the company surveyed. Note that this also varies by state footprint and segment.

Concerns Rate Adequacy

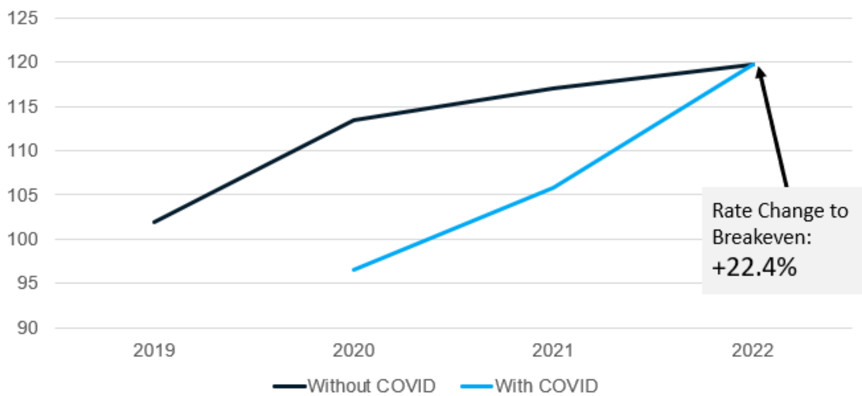
"We had quite a few rate increases that would have been filed in the second quarter. Those filings are on hold because we don't think we can get them approved. For now we're fine because frequency is down. By the time we come out of this though, we may be substantially underpriced in some states."

CEO interviews, May 2020

As the declining loss costs result in rate givebacks, pausing rate increase filings, and rate reductions in some cases, it is important to note that this could result in severe rate inadequacy going forward. Post-pandemic, as driving patterns move back in the direction of past behaviors, we can expect loss frequency rates to be more in line with past trend lines; while the ever increasing technological components deployed in evolving vehicle safety design will continue to drive loss severity[2]. Resuming prior loss cost trend lines after a substantial period of rate stagnation or decline could result in billions of dollars in losses for the industry.

This can be illustrated utilizing State Farm's recent 11% auto rate decrease nationally. In 2019, State Farm's auto combined ratio increased from 97.4 to 101.9, while premiums decreased 2.8%[3]. Typically, this would not result in filing a rate decrease; but, with the disruption to loss trends from COVID, this is the course State Farm has taken as it faces the pressure of a shrinking market share. Depending upon the ultimate loss trends through the rest of this year, this may result in State Farm regaining some market share. Assuming for our illustration that the total loss trend for 2020 is minus 20%, which would seem aggressive for the entire year, if everything else held constant this would work out in the short-term resulting in a 96.5 combined ratio, even with the rate decrease.

Projected State Farm Combined Ratios and Required 2022 Rate Change for a 100 COR



Assumptions:
- 25% Rate giveback for 70 days
- 11% average rate decrease, July 2020
- Prior loss trend of 3%
- 2020 COVID-19 loss trend of (-20%)
- Vaccine in 2021, fully rolled out by year-end. Return to prior trendline
- 2021 COVID-19 loss trend of +12.5% (recoup have a 2020 dip in trend)

The long-term impact of COVID and the State Farm rate decrease may not work out as well. For our illustration, let's assume that a vaccine or substantially improved treatments are introduced in the first or second quarter of 2021, with half of the downward pressure on loss cost trends in 2020 erased in 2021 and a full recovery in miles driven by Q1, 2022; this may drive the trend line back to its prior trajectory and result in the need for a 22.4% rate increase at the outset of 2022 for State Farm to breakeven that year. Note that the need for this rate increase could be lessened to a degree as a result of some businesses continuing to have employees work from home part or all of the time. At this point, however, it is impossible to know

how miles driven and traffic patterns will impact loss frequency and severity trends going forward. Assuming for the moment that insurance departments would approve that much of a rate increase coming out of the pandemic, which seems highly improbable, a rate increase of this size would result in a massive non-renewal rate. Simply put, there will be tremendous pricing risk from 2021 – 2023 for any actions or lack of actions in 2020.

Poorly capitalized carriers and MGA's may not survive that scenario. Given our illustration, the backdrop of falling revenues, and increasing policy retention risk, as carriers struggle to maintain scale we are hopeful that one of our panel's CEO is correct in the assessment that a severe soft market is unlikely due to companies having "more pricing discipline" than in the past. A severe soft market combined with a sudden and significant jump in loss trends at the end of the pandemic would be devastating to margins.

Thoughts on Price Adequacy Post COVID

"I'm not worried about being underpriced on the backend for now… Maybe I should be more concerned about that."

"Who knows what trends will be…If we need, rate we will try to take it…If your in California you're probably screwed coming out of this."

"I agree, with the disruption to loss trends, it is going to be tough ensure rates are appropriate for the next 24 – 36 months."

"We haven't thought that far out yet. Our focus has been on all the short term issues to this point…There is no 'COVID playbook, 'but we do need to get out ahead of this and start preparing for what is coming."

CEO interviews, May 2020

Rating Factor Disruption - Reliability: As COVID-19 lockdowns spread, consumer behaviors changed dramatically. The behavioral changes were not consistent across the country or by key rating criteria. These behavioral changes are also not constant. State lockdowns have not only been applied in a very uneven fashion, they are removed and reapplied unevenly. Consequently, consumer behaviors may change multiple times. Additionally, some of the behavioral changes impacting the reliability of rating factors are not driving behaviors and may not even be the consumer's behavior, but rather someone influencing the data or data collection. Let's take a brief look at several rating variables.

Miles Driven: This is the most obvious rating factor impacted by COVID-19. While not a direct rating factor for many carriers, the significant reduction in driving has had a large impact on loss frequency and rate givebacks for all carriers.

According to a report recently published by Cambridge Mobile Analytics[(4)], 63% of consumers are open to telematics-based rating, while only 5% of policies have a telematics component. Cambridge Mobile argues that the wide differential between interest in telematics-based pricing and actual policies is due to options offered to the consumer. If that assertion and these survey numbers are even "directionally correct," the current situation is ripe for a significant market share increase for telematics-based policies, as many carriers are more aggressively marketing existing telematics -mileage programs since the beginning of the pandemic. For these carriers, this is an opportunity to gain market share through lower rates, without making rate reductions. While this will result in lower written premiums in the near term, it has a lower probability of resulting in rate inadequacy as loss trends eventually return to a more normal pattern.

Tampa Bay Times

Traffic tickets down 92 percent as Florida cops focus on coronavirus

Directives vary among the largest police agencies in the Tampa Bay area. But police leaders say they want to keep the public and officers safe.

Violations: A reduction in miles driven has not only resulted in a reduction in loss frequency, it has also resulted in a significant reduction in traffic violations. Additionally, in many jurisdictions, traffic enforcement has been relaxed to avoid the spread of COVID-19

with traffic citations down over 90% in some locations[5][6], even as tickets for excessive speeds are up significantly[7].

CORONAVIRUS CALIFORNIA

Coronavirus: Citations for speeding over 100 mph jumps 87% compared to last year, CHP says

This will result in 10% - 20% lower rates for many consumers over multiple rating periods, even as their driving habits have not improved or in some cases have deteriorated. As loss trends ultimately return to a more natural trajectory, this lack of ticketing will result in further risk of rate inadequacy with lost surcharges and broader acceptability in better rating plans

Credit – Insurance Score: COVID-19 shutdowns and the resulting economic damage may create greater, long-term disruption to credit – insurance scoring as a rating and underwriting factor than any other factor.

With over 50 million job layoffs since the beginning of the shutdowns and over 17 million persistent unemployment claims, the potential exists for significant changes to consumers' payment behaviors resulting in dramatic decreases in credit – insurance scoring. This impact has yet to be felt due to federal unemployment subsidies and the reduction in "big ticket" purchases due to COVID. For example, millions of Americans' have forgone a vacation in 2020 with an average cost of $4,580 for a family of four[8]. As a consequence, and rather counter-intuitively, according to Experian, the average credit score to this point in the pandemic has actually ***increased*** as a result of COVID-19[9].

Overall Change in Consumer Finances Since January

Financial Attribute	January 2020	May 2020	Change
Average Score	681	686	+1%
Total average debt balance	$89,820	$89,273	-1%
Average credit card balance	$6,193	$5,338	-14%
Average personal loan balance	$15,965	$16,257	+2%
Average credit utilization rate	30%	25%	-15%
Average # of 30-day delinquencies in past 12 months	0.40	0.38	-6%

Source: Experian and VantageScore data

Unfortunately, there is a strong probability that credit-insurance scores will deteriorate substantially in the next 6 – 18 months as the federal COVID-19 subsidies are unsustainable, and the economic impact of COVID-19 shutdowns will be felt past the end of the pandemic.

Since insurance scores are a measure of responsibility with a high correlation to responsible driving, the expected reduction in credit – insurance scores from the pandemic will likely result in a decrease in the reliability of this measure in

Equifax:

Update - March 12: COVID-19 (Coronavirus) and Your Credit Score

Equifax is closely monitoring the outbreak of COVID-19 (Coronavirus) and the effect it is having on businesses and individuals. That's why we are taking measures to support consumers impacted by the Coronavirus while also working with creditors and lenders to minimize the effects on consumers' credit standing.

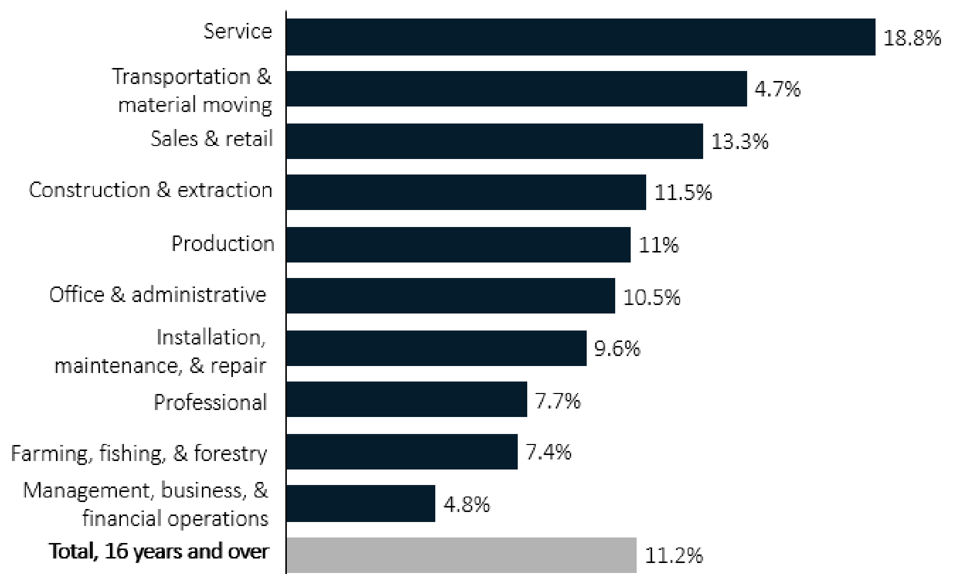
Consumers who are experiencing a financial hardship may be wondering how potentially late or reduced payments might impact their credit scores. We encourage individuals with concerns to contact their lenders and creditors to discuss their options. Additionally, the Consumer Data Industry Association is providing guidance to creditors and lenders on how they can work with those who are affected by the Coronavirus.

pricing and underwriting; as the reduction in score from the pandemic will not have the same correlation with driving behavior. As the three credit bureaus have no way to know the cause of credit change for individual consumers, it does not seem possible to 'normalize' credit scores for the impact of COVID-19; consequently, the credit bureaus can only offer information on how consumers can "manage" the impact to their credit score(10).

The net result of this will be further inconsistency in the impact of COVID-19 from consumer to consumer as some will receive the bureaus' messaging, while others will not. For example, let's assume two identical consumers with a 780 credit-score are laid-off for an extended period. Further, assume one of the consumers is unaware of the potential to mitigate damage to their credit score, misses payments to two creditors, and suffers a long-term drop to a 640 credit-score. At the same time, their 'doppelganger' becomes aware of the mitigation options, has a brief drop to their score, and quickly returns to a 780 score. As a result, there will be a substantial degradation to the reliability of credit as a rating factor. This could lead to over-pricing some risks, shrinking the size of the standard and preferred segments, an influx of lower-risk consumers into the middle-market and non-standard auto segments, and limiting the ability of some consumers to switch companies due to new business underwriting requirements. Worse, there is a strong possibility in the current political environment that this will give fuel to existing efforts to eliminate credit scoring from pricing and underwriting decisions.

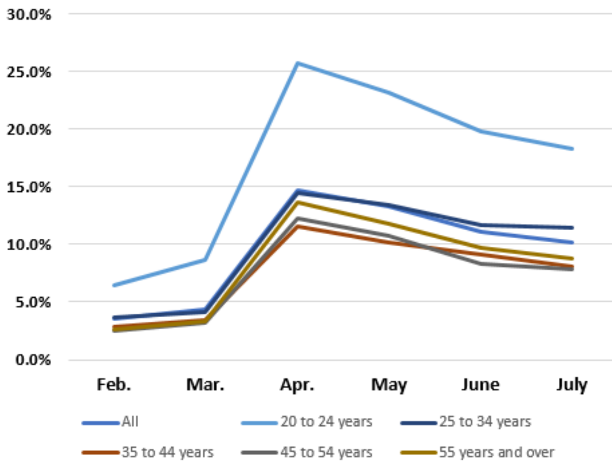
Predicting a disruption to the efficacy, and possibly the use of credit as a rating factor, is easy. Predicting the timing, severity, and duration of the disruption and damage to pricing models is far more complicated. This will be dependent upon the duration of the pandemic, the level and duration of unemployment from COVID-19, the continuance and level of federal subsidies to displaced workers, and the heightened social demands for "equitable" treatment in the use of credit scoring. While the impact of COVID-19 on insurance pricing and underwriting has been temporarily mitigated, under any circumstance the veracity of credit as a rating factor will be diminished and challenged over the next 24 – 36 months. In the extreme, COVID-19 could result in credit being lost as a pricing and underwriting tool in an expanding number of states.

Occupation: The veracity of the data supporting occupational rating relativities may also be in question as a result of the pandemic, as shutdowns, and therefore losses, will vary by industry and occupation in the near term. Some occupations require a physical presence, others can be conducted remotely, while others are on hold; and some occupations are considered "essential," while others are not permitted to function. As a consequence, the degree of disruption to driving patterns from COVID-19 shutdowns will vary substantially by occupation; and rating relativities based upon data during the period influenced by COVID-19 will be abnormally skewed. Obviously, while imperfect, predicating pricing relativities for occupation on data prior



to the pandemic makes sense in the near-term. Of course, some loss patterns between occupations will be temporary, but others will become more permanent. It will take a considerable amount of time post-COVID-19 shutdowns to have adequate data to recalibrate relativities between occupations. Depending upon each carrier's mix by occupation, this disruption will be more or less impactful to competitiveness and loss ratio. Depending upon the severity of these changes, carriers utilizing occupation as a rating variable may need to conduct external analyses of driving patterns by occupation to avoid adverse pricing anomalies.

Other Rating Factors – e.g. Demographics and Territory: COVID-19 will create turbulence with other rating factors as well, but we do not anticipate the same level of disruption. Let's look at two of these rating factors. First, while the impact of COVID-19 shutdowns on employment is more severe in some demographic groups – e.g. the 20 to 24 and 25 to 34-year-old age groups, which are over represented in the restaurant and hospitality industry – overall unemployment trends are similar across age groups. Additionally, while short-term driving patterns across demographic groups may change and have a corresponding short-term impact on loss costs, there does not appear to be circumstances in which the COVID-19 shutdowns will permanently change driving behaviors or loss costs by demographic. As a result, maintaining the demographic pricing relativities prior to COVID-19 would appear to be a prudent approach.



Similarly, territory loss costs will have short-term disruptions from the COVID-19 shutdowns. Unlike the demographic pricing relativities, however, there may be a longer-term impact on territory relativities if the significant shift to working from home persists past COVID-19. In this scenario areas with higher concentrations of stay at home workers may result in more permanent changes to loss costs by territory.

Fraud: Finally, some of the executives we spoke with had significant concerns regarding an increase in claims and rate fraud as a result of the COVID-19 shutdowns. Any crisis, especially a crisis with significant economic and behavioral disruption will tend to increase temptation/propensity for some people to "cheat around the edges" through an increase in "casual" fraud – e.g. Inflating damages claims, attempting to hide actual garaging location, etc. Economic and behavioral disruptions may also expose opportunities for more sophisticated fraud schemes. Fraud, whether organized or more casual seeks to avoid detection. Companies with the worst fraud detection/prevention turn out to be easy prey. While many carriers have excellent fraud detection efforts, in the near term everyone (including these carriers) may face additional challenges with fraud.

> **Fraud**
>
> **"I can't tell you what it is going to look like, but you know there will be a lot of fraud schemes coming out of this."**
>
> **CEO interview, May 2020**

If there is a significant increase in fraudulent activity, combining that with the potential of a soft market and a sudden increase in loss cost trends at the conclusion of the pandemic could be devastating to some carriers.

Conclusion:

As we have discussed previously, there will be substantial revenue, distribution, and channel challenges for insurers over the next three years. Just to add to the list of challenges, insurers potentially need to prepare for and address immense pricing and underwriting pressures over the next three years. Unfortunately, the economic and political – especially in an election year – landscape is very volatile and will continue to be for the near-term. As a result, carriers' pricing decisions could result in inadequate rates and substantial losses.

As events and driving behaviors unfold over the next 24 – 36 months, loss costs may be very erratic with the potential of loss cost spikes rather than trends over the next several years. This means that accurate pricing may be extraordinarily difficult over this time period. Additionally, the credibility of the data associated with setting rate factors relativities may be severely compromised over the next several years making overall pricing adequacy extremely susceptible to mix shifts in carriers' book of business.

While this will be a very challenging time from a pricing standpoint, there is a significant opportunity to profitably increase market share in this environment for insurers who make the right moves. To be one of those companies, it is essential to have a real understanding of the impact of shifting market conditions and to make disciplined pricing and market decisions. OutPerform can help insurers see and understand the marketplace and pricing challenges in these volatile times.

Up Next, Part 5: Profitability – In this document, we will explore the potential impact on insurance carriers' and MGA's bottom line.

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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