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TERRITORIAL RATING IN AUTO INSURANCE

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TERRITORIAL RATING

Many insurers use territorial rating (i.e., where a car is primarily garaged) as a predictor of risk. As a result, people who live and drive in more populous areas, which generally experience more accidents, often pay more for auto insurance.

Connecticut and Maine are the only New England states to require insurers to balance local and statewide insurance risks. This system, called a weighted territorial system, generally reduces auto insurance costs in urban areas and increases costs in suburban and rural areas.

ISSUE

Describe how auto insurers in Connecticut use territory as a rating factor when determining risk and premiums for private, non-fleet auto insurance (i.e., auto insurance purchased for personal, noncommercial use). Briefly compare Connecticut's limits on territorial ratings with those of other northeastern states, which generally do not impose limits, and California, which imposes significant limits. Discuss telematics as an alternative to territorial rating.

SUMMARY

Insurers consider several factors when setting auto insurance rates. One factor, called territorial rating, is based on where an individual garages his or her vehicle (typically the vehicle owner's registered address). Using this method, an insurer divides a state into distinct geographical territories and sets rates based on its aggregate loss experience in each territory. Loss experience, sometimes called "loss-cost," refers to the actual or expected cost to an insurer from claims for cars garaged in the territory. The higher the loss experience in a territory, the higher rate an insured may be expected to pay. In practice, this means auto insurance rates correspond to the level of risk assigned to a vehicle's principal garaging location.

Connecticut law requires insurers using a territorial rating system to balance an individual territory's loss experience with the statewide loss experience. This means that a total rate for a territory is calculated by combining 75% of the territory's loss-cost and 25% of the statewide lost-cost (CGS § 38a-686(b)(4)).

Most northeastern states, including Massachusetts, New York, and Rhode Island, allow insurers to use territorial ratings without requiring them to weigh both territorial and statewide experience. At least one state, California, prohibits territorial rating as a primary factor but allows it as a secondary factor.

One possible alternative to territorial rating is telematics, which is the use of driver-specific data to more accurately assess risk. Telematics may be used in conjunction with, or as an alternative to, territorial ratings.

AUTO INSURANCE RATES IN CONNECTICUT

Actuarial studies have shown that where a person garages his or her vehicle is a major predictor of loss. For example, the Casualty Actuarial Society calls geography "one of the primary drivers of claims experience" and "one of the most well-established and widely used rating variables" (see page 188 of the linked report). As a result, many insurers in Connecticut and other states use territorial ratings to calculate a baseline loss experience.

This loss experience is then combined with other risk factors, including age; gender; marital status; driving history; vehicle make and model; and in certain circumstances, credit score, to produce a "pure premium." A pure premium, synonymous with loss-cost, is the amount an insurer would have to charge to cover expected losses. (When loss-costs are discussed as a charge to an insured, they are often referred to as pure premiums.)

The pure premium is then combined with non-risk factors, including policy bonuses (e.g., a multi-policy discount for having multiple policies with the same insurer) and the insurer's profits and administrative costs, to arrive at the final premium charged to an insured.

TERRITORIAL RATING IN CONNECTICUT

Connecticut law does not require the use of territorial ratings, but insurers that use territorial ratings must mix territorial and statewide experience according to the 75%/25% statutory formula.

According to Connecticut Insurance Department officials, insurers' use of territorial ratings has gotten increasingly complex. For example, recent insurance filings from several companies show a wide range of territories, often with unique factors for bodily injury liability, property damage liability, medical expenses, and uninsured/underinsured motorist coverages assigned to each. Insurers' use of territorial ratings, including how they draw territories and calculate loss experience in each one, varies greatly from one insurer to the next.

Calculating Territorial Loss-Costs

Insurers calculate loss-costs as a function of the value of all the losses assigned to a territory. If a street divides two rating territories, an insurer must use the lower rate.

According to the Insurance Department, insurers assign a loss to a territory based on where a vehicle (or the "at-fault" vehicle in the case of an accident) is garaged and not where an accident or loss occurs. For example, if a Mansfield resident was at fault for an accident in Hartford, the loss experience is attributed to the Mansfield territory.

Creating Territories

Territories are often associated with one or more ZIP codes, but Connecticut regulations prohibit insurers from splitting a town or city into two or more territories, regardless of how many ZIP codes it has (Conn. Agencies Regs. § 38a-686-2). By law, insurers must file territories and associated ZIP codes with the department, which must approve any change to the list (CGS § 38a-686(b)(3)).

Effect of Territorial Rating

In general, territorial ratings increase auto insurance rates in urban areas and decrease them in suburban and rural areas. This is due to higher loss-costs associated with factors like increased traffic density and accident rates in urban areas. Higher loss-costs are generally associated with higher premiums.

Requiring a weighted system (like Connecticut's) generally lowers rates in urban areas when compared to an unweighted territorial rating system, as high loss-costs in urban areas are kept down when combined with the lower statewide loss-cost. Conversely, it increases insurance rates in suburban and rural areas with loss-costs lower than the statewide average.

History and Recent Legislative Proposals

PA 10-7 codified the 75%/25% territorial rating requirement, which the Connecticut Insurance Department previously set through administrative guidelines. Three bills were introduced in the 2015 legislative session that would have changed how territorial ratings are applied. None of the bills passed.

SB 238, as proposed, would have required insurers to use telematics data, when available, instead of territorial data in determining auto insurance premiums. The Insurance and Real Estate Committee reported a substitute bill that would have required the Insurance Department to study telematics.

HB 6163 would have changed the ratio to 50% territorial experience and 50% statewide experience. HB 6866 would have prohibited territorial rating and required insurers to use only an insured's driving history, driving experience, and annual miles driven as rating factors. According to the public hearing testimony on these bills, proponents of territorial rating argue it (1) accurately reflects risk and (2) benefits drivers by maintaining a competitive statewide market. Opponents of territorial rating argue it (1) unfairly increases premiums on urban drivers and (2) is unrelated to an insured's driving record. Both bills died in committee.

TERRITORIAL RATING IN NEW ENGLAND AND NEW YORK

Massachusetts, New Hampshire, New York, Rhode Island, and Vermont all allow insurers to use territorial ratings without requiring them to weigh or otherwise balance territorial and statewide experience. Maine actuarially limits the effect of territorial rating.

Massachusetts

According to the Division of Insurance, Massachusetts requires that the use of territorial ratings be actuarially justified.

New Hampshire

According to a New Hampshire Insurance Department official, there are no statutory or regulatory restrictions on territorial ratings, although all ratings must still be actuarially justified.

New York

New York law allows insurers to consider "all factors reasonably attributed to a class of risks" (N.Y. Ins. Law § 2304). We have contacted the New York Department of Financial Services for clarification and will update this report if we receive a response.

Rhode Island

According to the Rhode Island Department of Business Regulation (RI DBR), the state does not require a weighted territorial formula. In practice, insurers use territorial ratings to determine a base rate. However, Rhode Island prohibits insurers from using territorial ratings as a credit or reduction to the base rate (RI DBR Insurance Regulation 25).

Vermont

Vermont insurance statutes do not specifically mention territorial ratings. We have contacted officials at the Insurance Division of the Vermont Department of Financial Regulation for further information, and will update this report if we receive more information.

Maine

According to the Maine Bureau of Insurance, auto insurers use a credibility model for territorial rating. In general, a credibility model reconciles a territory's expected and actual risk. Maine uses a credibility weight for the territory and its complement weight for the state. (If a territorial rating is expressed as a decimal, the complement is defined as 1-territorial rating.) It is not clear if this is a statutory or regulatory requirement. We have contacted the bureau and will update this report if we receive more information.

TERRITORIAL RATING IN CALIFORNIA

California significantly limits territorial rating. We briefly describe California's territorial rating rules and the effect of limiting territorial rating systems below.

California prohibits insurers from using territorial rating as the primary rating method. In calculating risk, they must use three primary factors: the individual's driving safety record, number of miles driven annually, and number of years of driving experience. There are 16 optional secondary rating factors that an insurer may also use to calculate premiums, two of which (claim frequency and severity) are territorial components that reflect where the vehicle is garaged (Cal. Code. Regs. Tit. 10 §2632.5). Other secondary factors include vehicle type and performance capabilities, driver gender, and whether the driver completed a driving training course. The secondary factors cannot be weighted as heavily as the primary factors (Cal. Code. Regs. Tit. 10 §2632.8).

Proposition 103, adopted by California voters in 1988 (and fully enacted in regulations in 2006), established the mandatory and secondary guidelines described above. Prior to the enactment of Proposition 103, California insurers weighed territorial ratings more heavily. In addition, Proposition 103 regulated California insurers by requiring, among other things, rate increases to be approved by the insurance commissioner.

According to the California Department of Insurance, Proposition 103 "has saved consumers billions." However, it is unclear how much of the stated savings are due to restrictions on territorial rating use or another element of Proposition 103, which required premium increases be approved prior to use.

According to this report by ConsumerWatchdog.org, a national consumer advocacy group, California insurance premiums decreased by almost 7% in the period from 1989-2004, while rates nationwide increased approximately 45%. The same report notes the profitability of California insurance companies is higher than the national average.

One possible effect of limiting territorial rating was that insurers may choose not to write policies in the state. According to *The Regulation of Automobile Insurance in California*, there is no evidence insurers exited California as a result of Proposition 103.

TELEMATICS AND TERRITORIAL RATINGS

Telematics (sometimes called usage-based insurance, or UBI) is the process by which driving behavior is monitored through a small, in-car device (or an embedded system such as OnStar), which captures data like speed, acceleration, mileage, cornering, and stopping. The data is sent to the insurance company, which uses it to more accurately assess an individual's risk. As a result, safe drivers may be rewarded with lower premiums. Telematics may be used in place of, or in combination with, territorial ratings.

In Connecticut, at least one bill (SB 238) has been introduced to replace territorial ratings with telematics. Nationally, telematics is often discussed as a growing market. According to *Pay-as-you-Drive Auto Insurance in Massachusetts*, a report commissioned by the Conservation Law Foundation and the Environmental Insurance Agency, telematics based on mileage "would improve fairness by shifting weight in insurance pricing towards an individually controllable factor." The report suggests that using telematics to supplement territorial ratings most accurately predict risk.

Progressive Insurance launched the first telematics device (called Snapshot) in the United States in 1998. According to a National Association of Insurance Commissioner's (NAIC) report, at least Allstate, State Farm, and The Hartford also offer telematics-based policies. According to NAIC, telematics policies represent between 4% and 9% of the auto insurance market, and are expected to grow significantly over the next several years. Progressive, for example, has approximately $2 billion in telematics premiums from two million customers.

Potential Issues

Telematics policies raise several issues, among them self-selection, "big data" collection and analysis, customer uptake, and privacy and regulatory concerns.

Self-Selection. Telematics rewards safe drivers. As a result, more safe drivers may self-select into telematics policies. This may create a riskier driver pool, with higher premiums, for non-telematics policies.

Big Data. "Big data" refers generally to the collection of very large, and very broad, data sets. It is not clear if insurers' traditional assessment techniques are applicable to such analysis.

Customer Uptake. According to a Deloitte Telematics Report, 47% of consumers would need at least a 20% reduction in premium in order to install a telematics device. It is not clear if telematics can provide the level of savings to offset customer concerns like data collection and privacy.

Privacy. Many recent news articles express customer concerns about data collection and privacy (including this one from Insurance Business, which details the potential sale of data).

Regulation. As the telematics market grows, it is not clear if or how regulatory officials will approach the new policies, or if they have statutory authority to do so. According to a Connecticut Insurance Department official, Connecticut does not currently have regulations specific to telematics policies.

RESOURCES

The following resources are listed in the order in which they appear in the report, with the exception of statutory or regulatory citations, which are not listed below.

Casualty Actuarial Society, *Basic Ratemaking*, http://www.casact.org/library/studynotes/Werner_Modlin_Ratemaking.pdf, last visited October 16, 2015.

California Department of Insurance, *Information Sheet: Proposition 103 Intervenor Process*, http://www.insurance.ca.gov/01-consumers/150-other-prog/01-intervenor/info.cfm, last visited October 14, 2015.

Consumer Watchdog, *Proposition 103's Impact on Auto Insurance Premiums in California*, http://www.consumerwatchdog.org/resources/15years_Prop103.pdf, last visited October 14, 2015.

Dwight Jaffee and Thomas Russel, *The Regulation of Automobile Insurance in California,* http://faculty.haas.berkeley.edu/jaffee/Papers/Auto2.pdf, last visited October 14, 2015.

NAIC, *Usage-Based Insurance and Telematics,* http://www.naic.org/cipr_topics/topic_usage_based_insurance.htm, last visited October 20, 2015.

Joseph Ferreira, Jr. and Eric Minikel,*Pay-As-You-Drive Auto Insurance in Massachusetts,* http://web.mit.edu/jf/www/payd/PAYD_CLF_Study_Nov2010.pdf, last visited October 14, 2015.

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NAIC, *Usage-Based Insurance and Vehicle Telematics: Insurance Market and Regulatory Implications*, http://www.naic.org/documents/cipr_study_150324_usage_based_insurance_and_vehicle_telematics_study_series.pdf, last visited October 14, 2015.

Deloitte, *Telematics: Driving the Automobile Insurance Market Through Disruption,* http://irmka.scic.com/wp-content/uploads/2012/10/US_FSI_TelematicsPOV_072412.pdf, last visited October 14, 2015.

Insurance Business, *Major US Insurer Considers Selling Telematics Data*, http://www.insurancebusinessonline.com.au/news/major-us-insurer-considers-selling-telematics-data-201175.aspx, last visited October 14, 2015.

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