House Legislative Analysis Section
Olds Plaza Building, 10th Floor
Lansing, Michigan 48909
Phone: 517/373-6466

TERRITORY-BASED RATING

House Bill 5177 as enrolled
Public Act 98 of 1996
Second Analysis (3-8-96)

Sponsor: Rep. Gerald Law
House Committee: Insurance
Senate Committee: Financial Services

THE APPARENT PROBLEM:

One of the factors that determines how much drivers pay for automobile insurance is their place of residence or, more precisely, where they garage their cars. Auto insurers typically divide the state into territories and charge premiums based, in part, on the anticipated losses and costs in each territory. They justify this on the grounds that there are predictable differences in costs among areas due to the nature of the traffic patterns and congestion, theft rates, medical costs, auto repair expenses, the likelihood of lawsuits and the size of jury awards, and other measurable factors. This practice, generally, results in increased prices for insurance in urban areas, and particularly central cities, and lower prices elsewhere. When the Essential Insurance Act of 1979 was developed to address issues of availability and affordability of auto and home insurance throughout the state, as well as issues of fairness in choosing customers and setting prices, the issue of territory-based rating was a major topic for debate. Some critics of the auto insurance industry believed the practice to be unfair discrimination, partly because it based an individual's rates on factors over which he or she had little control, and partly because it led to drivers with almost identical characteristics paying different rates based on what appeared to be arbitrary residential dividing lines. Also, because the high cost of mandatory insurance coverage in some urban areas, notably Detroit, was a prime concern in the discussions about the affordability of insurance, territory-based rating appeared to have adverse social consequences.

(It should be noted that the Essential Insurance Act was passed in the wake of a Michigan Supreme Court decision -- known as the Shavers decision -- that had declared the no-fault law "constitutionally inadequate to assure that coverage is available at fair and equitable rates" and gave the legislature 18 months to repair the defects. The court said, among other things, that the legislature had to give "substantial meaning to the statutory standards [that] 'rates shall not be excessive, inadequate, or unfairly discriminatory.'" It also noted that the state's compulsory auto insurance scheme makes the registration and operation of a motor vehicle dependent on the availability of coverage at fair and equitable rates.)

The legislation eventually enacted, which took effect in 1981, permitted rating based on territory but imposed restrictions. It said, among other things, that a company could have no more than 20 different territorial rates; that the lowest rate based on territory could not be less than 45 percent of the highest such rate; and that a territorial rate could not be less than 90 percent of the rate in an adjacent territory. (The law also provided for exemptions from the restrictions under certain specified conditions.) These restrictions, however, were suspended in 1986 at the behest of the few insurance companies writing business in Detroit on the grounds that they put the companies at an economic disadvantage. Their argument was, in brief, that the territory restrictions were not having the intended effect but were producing unintended harmful effects. A company with a presence in high cost urban territories, they said, was at a disadvantage when competing in lower cost areas because the high rates it needed to charge in the high-cost territories dragged up the rates it charged elsewhere. Companies that did not market insurance in Detroit and other city centers did not need to be concerned about the viability of its center city rates and could charge less outstate. In essence, the so-called urban writers claimed their outstate rates contained subsidies for urban areas that made them uncompetitive. (Along with the suspension of the territory restrictions, the legislature imposed limits on how fast rates could increase in Detroit.)

The suspension of the restrictions carried a five-year sunset, and after several extensions of the sunset, the restrictions went back into effect in 1992 when legislators could not agree on overall changes to the no-fault automobile insurance system. The issue of territory-based rating has been one component of the major legislative insurance proposals of recent years, including the two comprehensive overhauls of auto insurance contained in two separate highly contested ballot questions that were defeated by voters. New legislation has been introduced focusing on territory-based rating.

THE CONTENT OF THE BILL:

Chapter 21 of the Insurance Code limits the use of territory-based rates by automobile insurance companies. It says a company can have no more than 20 different territorial rates; that the lowest rate based on territory cannot be less than
45 percent of the highest such rate; and that a territorial rate cannot be less than 90 percent of the rate in an adjacent territory. These restrictions were added by Public Act 145 of 1979 (known as the Essential Insurance Act) and took effect in 1981. Subsequent legislation suspended the restrictions from February 28, 1986 to April 1, 1992. House Bill 5177 would eliminate the restrictions and specify that automobile insurance risks could be grouped by territory.

Chapter 21 currently requires each insurer to establish a secondary or merit rating plan for auto insurance, other than comprehensive insurance, that allows surcharges for substantially at-fault accidents and traffic law violations (convictions and civil infractions) under Chapter VI of the Motor Vehicle Code. The bill would specify that an insured could not be merit rated for a civil infraction under the traffic laws for a period of time longer than that which the secretary of state's office carries points for that infraction on the insured's motor vehicle record.

Chapter 21 also contains restrictions on the use of territories in setting rates for home insurance. It permits three territorial base rates; says the lowest territorial rate for owner-occupied housing cannot be less than 70 percent of the highest; and says that the lowest territorial rate for rental policies cannot be less than 65 percent than the highest. The bill would eliminate these provisions and instead specify that home insurance could be grouped by territory.

The bill also would require the insurance commissioner to report in writing to the Senate and House standing committees on insurance issues by January 1, 2000, on the effect the bill has had on automobile and insurance premiums in the state.

MCL 500.2111

FISCAL IMPLICATIONS:

According to the Senate Fiscal Agency, the insurance commissioner would incur minimal costs in providing the report to the legislature required by the bill. Otherwise, the bill would have no fiscal implications. (See SFA floor analysis dated 1-30-96)

ARGUMENTS:

For:

The restrictions on the use of territories in setting auto insurance rates ought to be lifted because they have not achieved their intended goals and they represent an unwarranted regulatory intervention into free enterprise and the market system. The restrictions limit how many territory-based rates insurance companies can use, how much adjacent rates can differ, and how much greater the highest rate can be than the lowest. These, basically, are price controls. Insurance companies ought to be allowed to establish their own territories and sell insurance within those territories based on loss experience. They should not be made to build subsidies into rates in some territories to cover for lower-than-justified rates elsewhere. Industry representatives say that lifting the restrictions will lower rates in areas that are now subsidizing other parts of the state and will attract more insurance companies, and more competition for customers, to the high-cost urban areas. Currently, the incentive for companies is to seek out customers in low-risk areas where rates are artificially high and avoid customers in high-risk areas where rates are artificially low. Insurance companies say geography is just one of the factors on which rates are based and that it makes sense to divide the state into areas where groups of drivers have similar claims potential. Rating by territories is not unfair because exposure to risk does differ from place to place and rates should reflect that; repair costs, jury awards, medical costs, etc. vary geographically also. Insurance companies also say that tying prices directly to losses within a territory provides the appropriate incentive for residents within a territory to work to reduce losses.

One of the goals of the Essential Insurance Act, of which the territory restrictions were a part, was to increase the availability and affordability of auto insurance, particularly in Detroit and other central cities. The territory restrictions have not accomplished this. In fact, they have had the effect of keeping insurance companies out of the city. The few companies that do sell insurance in the city are penalized because the restrictions make it harder for them to compete outstate. Any increase in rates to keep up with an increase in losses in the city will mean an increase in rates in adjacent territories and in all other territories in the state, whether justified or not. Companies that do not write insurance in the city but who concentrate on suburban and rural areas can offer lower rates than companies that must set rates high enough to deal with losses in high-cost territories. One related drawback is that companies eventually will be forced to choose to serve the urban market or the outstate market, fragmenting the state's insurance market. The legislature recognized all this by suspending the territory restrictions from 1986 to 1992. Since then, the issue has been entangled with the many other controversies surrounding auto insurance. House Bill 5177 deals with that issue alone and allows the removal of territory restrictions to be judged on its own merits. Restricting territories was a well-intentioned experiment that failed. Similarly, restrictions on the use of territories in pricing home insurance also need to be lifted.

Against:

Among the likely results of this bill are higher insurance rates in urban areas, including Detroit, and more uninsured motorists. This will not be good for the future of the state's no-fault insurance system (which is generally well-regarded). Auto insurance in Michigan is mandatory. The courts have said that, because it is mandatory, auto insurance must be available at fair and equitable rates. To be available, insurance must be affordable. Affordability and accessibility of auto insurance, and fairness in the treatment of customers, were all at the heart of the Essential Insurance Act of 1979 and its restrictions on the use of territories by insurance companies. Recent legislative approaches to this problem have coupled lifting the territory restrictions with other offsetting measures. For example, House Bill 4156 of the 1993-94 session, which was passed by the legislature in 1993 but defeated at referendum, eliminated the current restrictions but also required that territories be of a certain size and required the 10 or so largest auto insurers to have an agent in each territory. (Very few companies currently have agents in Detroit; agents can only place business with companies with whom they have agreements.) These provisions were an attempt to mitigate the effect of territorial rating by spreading risks more widely and stimulating more competition among insurers. House Bill 4156 also required market assistance plans to help drivers in underserved areas shop around. House Bill 5177 does none of these things. It simply allows insurance companies to create as many territory-based rates as they want and charge whatever they want in those territories. (It should be noted that in the past, some critics of the insurance industry have argued that territorial distinctions are simply unfair and that territories ought be very large or even statewide. Insurers then would have to substitute other relevant factors in drawing up rates. As regards the argument by insurance companies that outstate drivers are "subsidizing" Detroit drivers, how can it be said that a city driver with no claims is subsidized by an outstate driver with several accident claims paying half as much in premiums?)

Opponents of this measure cite a study carried out for the Insurance Bureau in 1989 on the effect of the suspension of territorial rate restrictions. The study, they say, found that the lowest rates fell to 37-38 percent of the highest rate (from the 45 percent limit), but only because the highest rates increased and not because the lowest rates decreased; that the lifting of restraints did not make the so-called urban writers of insurance more competitive outstate; that the elimination of the 10 percent adjacent territory resulted in differences of 15-30 percent between adjacent territories; and that the number of territories used by insurers increased (up to a maximum 62). Opponents say all premiums were higher during the period studied than before the restrictions were lifted. They also say that the insurer with the largest market share increase in Detroit was the placement facility or "high-risk" pool, and that most of those insured by the pool were eligible to be underwritten by private commercial insurers and were not "bad drivers." Representatives of the insurance industry believe lifting the restrictions and letting the market work will over time make insurance more affordable and more available in Detroit and other city centers. But that does not appear to have been the experience when no restrictions existed or when they were lifted. The bill does not take those steps proposed in the past to increase the presence of the insurance industry in Detroit or other underserved city centers. Similar arguments could be employed to oppose lifting restrictions on the use of territory in the pricing of home insurance.

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.