The Low-Balling of the California Auto Insurance Claim

Insurers are paying less since accident victims lost their rights

Introduction

This report, based on data prepared by nationally recognized actuary Allan Schwartz[1] for the Foundation for Taxpayer and Consumer Rights (FTCR), analyzes changes in auto liability insurance claims after the 1988 ruling known as *Moradi-Shalal.*[2] As a result of this California Supreme Court decision, innocent, injured accident victims cannot file a lawsuit against the insurer of the at-fault driver for failure to pay the victim's medical bills, wage loss and expenses.

The report also studies the relationship between the cost of premiums and the value of claims since 1988. 1988, however, recorded more than one major change in the California insurance system. In addition to the Court's abrogation of legal remedies for accident victims, voters approved Proposition 103 which strictly regulates insurance premiums. Because of this confluence, the impact of the *Moradi-Shalal* ruling cannot be assessed without addressing the role of Proposition 103. We have, therefore, included a section about Proposition 103 prior to our analysis of the data.

Third-Party Claims

"Third party" claimants lost the right to sue insurers for unfair practices as a result of the 1988 *Moradi-Shalal* ruling. An innocent accident victim who submits a liability claim — a demand for money that is due as a result of an accident — to the insurer of the at-fault driver is known as a "third-party" (illustrated below). The at-fault driver is considered the "first-

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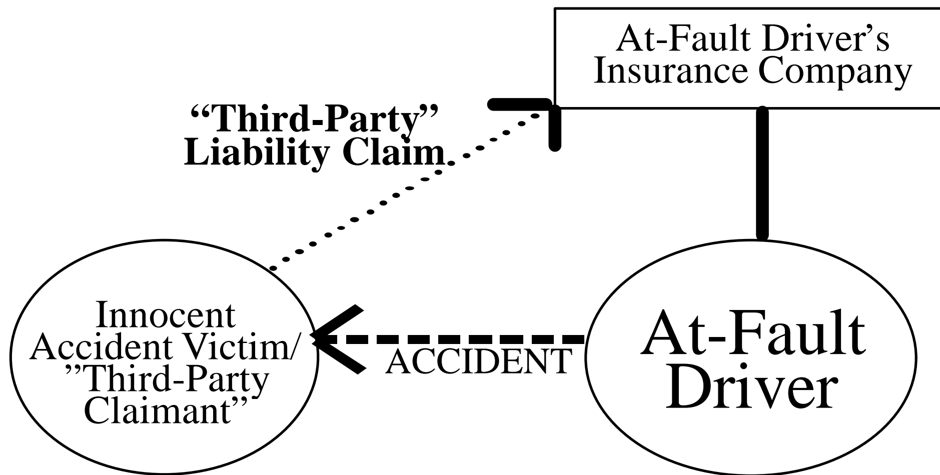
[1] Mr. Schwartz is an actuary with AIS Risk Consultants of New Jersey.

[2] *Moradi-Shalal v. Fireman's Fund Ins. Companies* , 46 Cal. 3d 287 (Cal., August 18, 1988). This ruling held that a third party claimant cannot sue an insurer for bad faith — when an insurer does not effectuate a prompt and fair payment on a claim. If an insurer acts in bad-faith with respect to a person the company directly insures, the first-party, that company can be sued for damages (*Egan v. Mutual of Omaha Insurance Co.* 24 Cal. 3d 809). A 1979 California Supreme Court ruling (*Royal Globe Ins. Co. v. Superior Court of Butte County*, 23 Cal. 3d 880) confirmed that third party victims also had the right to sue insurers for bad faith. The Royal Globe ruling was overturned by the 1988 *Moradi-Shalal* ruling.

party." If the at-fault driver's insurance company does not effectuate a fair and prompt payment of a claim, a "third-party" claimant in California has no legal remedies against the insurance company as a result of *Moradi-Shalal.*



Data

Mr. Schwartz reviewed auto bodily injury liability claims data for every state between 1988-1998.[3] This study examines 1) the average value of a liability claim (average settlement amount paid on a claim made by a victim of an auto accident), 2) the frequency of claims (number of claims settled per 10,000 insured automobiles) and 3) total liability losses to insurers (payments to injured accident victims) relative to the total number of insured automobiles. Additionally, the study looks at liability loss ratios, liability insurer profit margins, liability lawsuits and auto liability premium data.

1. Cost of Average Bodily Injury Liability Claim

California	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	Change 1988-1998
avg. claim (in dollars)	7326	7233	7578	7949	8164	8143	8040	7681	7314	7188	6996	–4.5%
% change from prior year		-1.3%	4.8%	4.9%	2.7%	-0.3%	-1.3%	-4.5%	-4.8%	-1.7%	-2.7%	–0.4% (avg. annual change)
adjusted claim (in 1998 dollars)	9874	9283	9207	9399	9448	9147	8766	8085	7488	7296	6996	–29.1%
Nationwide												
avg. claim (in dollars)	8223	8624	9048	9608	9913	10145	10108	9908	9460	9417	9540	+16.0%

[3] Source: Fast Track Data distributed by the Insurance Services Office (ISO)

% change from prior year		4.9%	4.9%	6.2%	3.2%	2.3%	-0.4%	-2.0%	-4.5%	-0.5%	1.3%	+1.5% (avg. annual change)
adjusted claim (in 1998 dollars)	11083	11069	10995	11361	11473	11396	11021	10429	9685	9558	9540	–14.0%

An average claim settlement for a third party claimant in 1988 was $7,326; in 1998 the average settlement fell to $6,996 for an overall decline of 4.5%, as compared to a 16.0% increase in the value of a claim nationwide. California is the only state in the nation in which average claim payments in unadjusted dollars fell every year since 1992.

After adjusting for inflation[4], the average liability claim declined by 14.0% nationwide, while third party claimants in California faced a decline of approximately 29.1%.

To illustrate the change, an innocent auto accident victim with a $1000 claim would receive nearly one-third less — less than $710 after adjusting for inflation — than he or she would have prior to the *Moradi-Shalal* ruling.

2. Annual Frequency of Bodily Injury Claims

California	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**Change 1988-1998**
claims per 10,000 insured vehicles	235	251	273	281	266	243	219	209	191	173	174	–26.0%
% change from prior year		6.7%	8.9%	2.9%	-5.6%	-8.4%	-9.9%	-4.8%	-8.7%	-9.3%	0.9%	–2.7% (avg. annual change)
Nationwide												
claims per 10,000 insured vehicles	106	111	115	118	118	121	123	124	119	118	115	+8.5%
% change from prior year		4.3%	4.3%	2.3%	0.3%	2.0%	2.0%	0.7%	-3.6%	-1.5%	-2.0%	+0.9% (avg. annual change)

Claim frequency indicates the number of claims paid by insurance companies per 10,000 insured automobiles.[5] Between 1992 and 1997 the frequency of claims fell every year in California (the frequency of claims increased by less than 1 percent in 1998). No other state saw a decline in claims every year in that time period. The frequency of claims in California in 1998 was 26% lower than in 1988, while it grew by more than 8% during that same time period throughout the nation.

3. Loss Payments per Automobile for Bodily Injury Liability

California	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**Change**

[4] Adjusted for inflation based on the Consumer Price Index (transportation sector).
[5] Frequency information is based on data reported by insurers.

												1988-1998
avg. loss/auto (in dollars)	172.36	181.57	207.22	223.70	216.94	198.28	176.40	160.43	139.51	124.30	122.04	–29.2%
% change from prior year		5.3%	14.1%	8.0%	-3.0%	-8.6%	-11.0%	-9.1%	-13.0%	-10.9%	-1.8%	–3.0% (avg.annual change)
adjusted loss/auto (in 1998 dollars)	232.30	233.03	251.83	264.51	251.07	222.73	192.33	168.87	142.82	126.16	122.04	–47.5%
Nationwide												
avg. loss/auto (in dollars)	87.27	95.43	104.38	113.36	117.31	122.46	124.40	122.76	112.95	110.72	109.90	+25.9%
% change from prior year		9.3%	9.4%	8.6%	3.5%	4.4%	1.6%	-1.3%	-8.0%	-2.0%	-0.7%	+2.5% (avg.annual change)
adjusted loss/auto (in 1998 dollars)	117.62	122.48	126.85	134.03	135.77	137.56	135.63	129.21	115.62	112.38	109.90	–6.6%

Insurance company liability cost (total amount insurance companies paid out in liability claims) per insured auto fell by 29.2% since the *Moradi-Shalal* decision in 1988. Nationally, liability losses increased by 25.9% during the decade. California was the only state in the nation in which insurance companies had lower losses in unadjusted dollars from one year to the next every year between 1992 and 1998.

After adjusting for inflation, California insurers have reduced their liability losses by 47.5%, while the inflation-adjusted decline nationwide has been only 6.6% . Since *Moradi-Shalal*, California insurance companies have cut in half the average losses they incur for each automobile they insure.

This dramatic reduction in losses, considered another way, means California insurance companies now use less than half of all liability premiums to compensate accident victims:

California Losses as a Percentage of Liability Premiums Earned (Loss Ratio)[6]

California	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**Change* 1988-1997**
Losses Incurred as a Percentage of Direct Premiums Earned	81.8%	75.0%	76.0%	66.1%	63.0%	63.1%	63.0%	58.0%	54.7%	48.8%	–40.3%

*Change: 1997 loss ratio was 40.3% lower than 1988 loss ratio {40.3 = 1-(48.8/81.8)}

Loss ratio shows the relationship between dollars a company takes in through premiums and the amount it pays out as a result of claims. In 1988 California insurers paid out more than four of every five dollars the companies earned in premiums. By 1997, insurance

[6] Source: NAIC 1997 Profitability Report. Below are the dollar figures for 1997 showing losses relative to premiums earned:

California	**Liability Premiums Earned**	**Losses Incurred**	**Losses as a Percentage of Premiums Earned**
Private Passenger Auto Liability	$8,541,628,000	$4,168,314,000	48.8%

companies paid less than half of the premiums earned, for a 40.3% reduction in loss ratio. California consumers paid more than twice as much in auto liability premiums as they received in the form of claims payments in 1997. This data does not include the investment income insurers earn from the liability premiums. If we included that data, the difference between dollars of insurance company revenue and dollars paid out in claims would be even greater.

4. Auto Liability Return on Net Worth, 1989–1997 [7]

California	1989	1990	1991	1992	1993	1994	1995	1996	1997	Average
Return on Net Worth as a percent of direct premiums earned	5.3%	3.6%	13.2 %	17.7 %	16.4 %	15.5 %	20.3 %	21.0 %	21.6 %	13.2%
Nationwide										
Return on Net Worth as a percent of direct premiums earned	0.5%	– 0.7%	4.5%	9.4%	10.1 %	9.0%	11.6 %	13.7 %	13.1 %	7.4%

California insurance companies have earned above average profit margins every year since 1989. California insurers have consistently seen profits 6–8 percentage points higher than the national average. In 1991, California insurers began to earn double-digit profits; that has continued through the nineties. Since 1989, California insurance companies have earned profits nearly twice the national average.

Proposition 103

A second major change in the California insurance system took place in 1988. Less than three months after the California Supreme Court ruled to disallow remedies for accident victims who do not receive prompt and fair payment of claims, voters approved Proposition 103 which strictly regulated insurance companies and led to a rate freeze on premiums. While the *Moradi-Shalal* ruling most directly affected the value of claims paid by insurers to accident victims, Proposition 103 impacted premium costs and the industry's method of determining premiums.

To the extent that it has been enforced by Insurance Commissioners and consumer advocacy organizations, including FTCR's "Proposition 103 Enforcement Project," Proposition

103 has moderated rates and held off the double digit increase in auto liability premiums experienced by the rest of the country during the 1990s. Proposition 103, when properly enforced, restrains excessive profits and requires insurance companies to justify the premiums charged to consumers.[8]

The data below show the dramatic impact of Proposition 103 on premiums:

Average Liability Premiums, 1989–1996[9]

California	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**Change 1989-1996**
Premium (in dollars)	519.39	501.34	522.95	510.71	512.44	502.39	508.62	512.27	–1.4%
% change from prior year		–3.5%	4.0%	–2.3%	0.3%	–2.0%	1.2%	0.7%	–0.2% (avg. annual change)
Adjusted Premium (in 1996 dollars)	651.14	595.12	603.98	577.33	562.27	535.04	522.92	512.27	–21.3%
Rest of Nation (excluding CA)									
Premium (in dollars)	317.32	338.55	358.52	381.69	402.01	410.99	416.75	430.94	35.8%
% change from prior year		6.7%	6.0%	6.4%	5.3%	2.2%	1.4%	3.4%	+4.5% (avg. annual change)
Adjusted Premium (in 1996 dollars)	397.81	401.88	414.42	431.48	441.10	437.70	428.47	430.94	8.3%

The regulatory controls imposed by this measure resulted in immediate premium reductions and set California apart from the rest of the nation. California auto liability premiums have dropped by 1.4% in unadjusted dollars since 1989, while in all other states, premiums have increased by 35.8%.

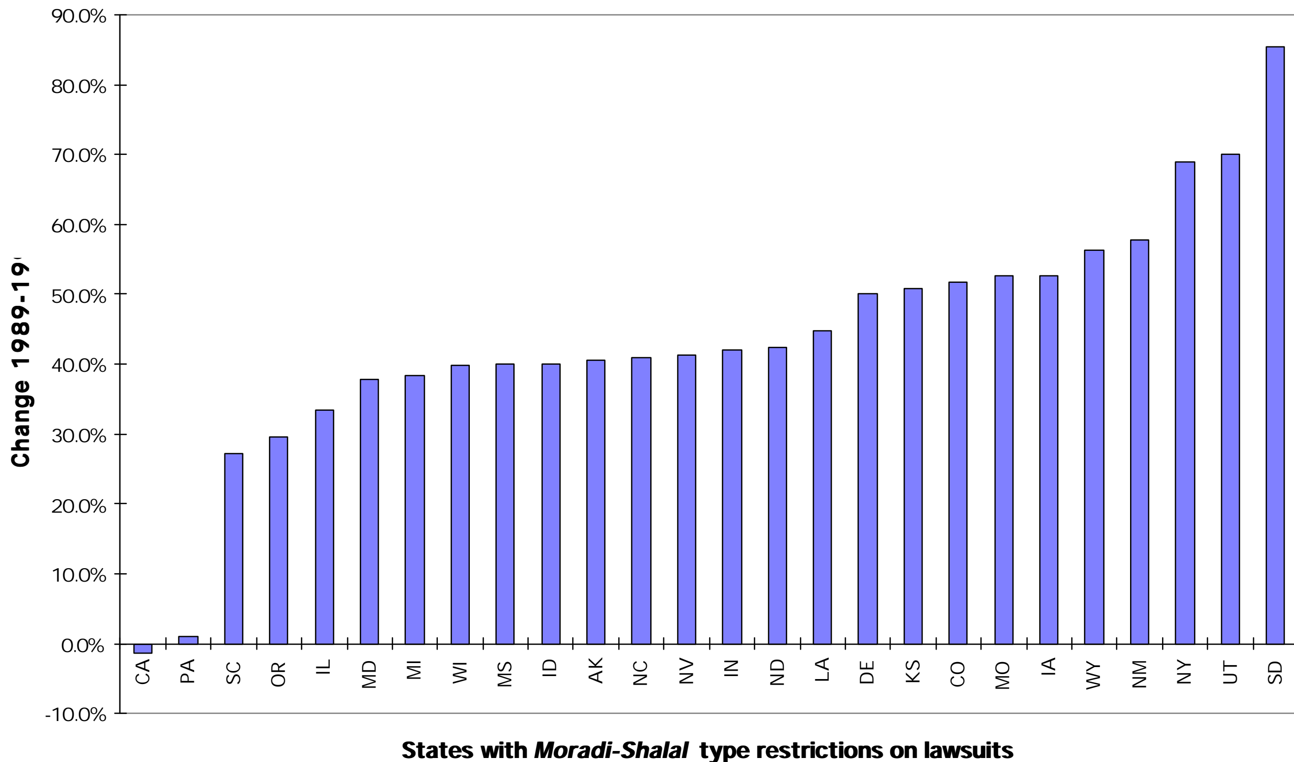
After adjusting for inflation, California premiums have declined every year since 1989 (except for a 1.4% increase in 1991), with 1996 premiums over 20% lower than those in 1989. Nationally inflation-adjusted premiums rose by more than 8%. Unlike losses, frequency and the value of a claim — none of which began to drop until 1992 or 1993 — California premiums began to drop between 1989 and 1990.

[7] Source: NAIC 1997 Profitability Report.

[8] Proposition 103 mandated a 20% rate rollback in property-casualty insurance premiums; instituted stringent controls on insurance company profiteering, waste, and inefficiency; ended monopolistic insurer practices; required insurers to base auto premiums on driving safety record rather than zip code; mandated a 20% good driver discount; and made the insurance commissioner an elective post. In addition to the rate rollback and other regulations, Prop. 103 imposed an immediate rate freeze and required that all rate changes after 1988 received the prior-approval of the Insurance Commissioner before being passed onto consumers.

[9] Based on NAIC data: calculation is liability premiums/liability written car-years.

When comparing California to other states with similar *Moradi-Shalal* restrictions on third party lawsuits it is clear that the only reason for the moderation of premiums since 1989 is the stringent rate regulation provided by Proposition 103. Across the country, other *Moradi-Shalal* states, without Proposition 103, experienced dramatic premium increases over the last decade.[10]



The insurance industry has suggested that limiting the right to sue will bring premiums down and that the converse is also true: holding insurance companies accountable will raise premiums. Data from the National Association of Insurance Commissioners, however, shows no relationship between the right of third parties to sue and premium levels. The chart illustrates the change in premium costs between 1989 and 1996 in states which have restrictions on third party lawsuits similar to the *Moradi-Shalal* ruling in California. California is the only state which saw a reduction in premiums and, other than Pennsylvania, all *Moradi-*

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[10] Source: NAIC State Average Expenditures & Premiums for Personal Automobile Insurance April 1998 (also December 1993 publication)

Shalal–like states saw rate increases of more than 25%, with most states above the national average of 35.8% for this time period.

According to the data, a limitation on third party, bad faith liability does not result in lower premiums as insurers suggest. The average increase in premiums in states which do not allow third party lawsuits was actually greater than the average increase in states that allow these suits.

Analysis

Since the *Moradi-Shalal* ruling, insurance companies have challenged accident victims' claims with an increased aggressiveness and without concern of legal challenge. Insurers have been less willing to settle a claim in a timely manner and, instead, offer unreasonably low settlements, a practice known as "low-balling." The study demonstrates that the 1988 *Moradi-Shalal* ruling led to a dramatic reduction in the amount insurance companies pay to injured accident victims for health care and other accident related costs. Because it took a few years for insurers to adjust claims practices to the *Moradi-Shalal* standards, and since a number of claims filed before the 1988 ruling remained in the system, the impact of the ruling on claims value and frequency became apparent after 1992.[11]

Insurers pay lower settlements as a result of the loss of right to sue insurance companies

The reduction in California settlement payments in the decade since the *Moradi-Shalal* ruling indicates an industry-wide change in business practices with respect to accident victims. Between 1992 and 1993 Californians began to see the dramatic reductions in the value of claims to accident victims (–0.3% in 1992, –1.3% in 1993, –4.5% in 1994, –4.8% in 1995). As is explained below, when the old cases against unfair insurers made their way out of the system, the "low-balling" of accident victims' claims became evident.

Under *Moradi-Shalal*, the only opportunity to recover an appropriate claim settlement when an insurer refuses to pay promptly is for an accident victim to pay their own costs or sue the at-fault driver to force the driver to pay the medical and other costs associated with the

[11] *Moradi-Shalal* stipulated that all third-party bad faith cases filed prior to the ruling could continue. These cases typically take one to three years to resolve through the courts.

accident, since no remedies against the insurance company are available.[12] As the data illustrates, as a result of *Moradi-Shalal* accident victims receive low-valued claims payments and, therefore, must pay the remaining costs out of their own pocket.

The frequency of claims decline

1992 marked the first year that claims frequency and liability losses declined in recent history.[13] Without the right to take an insurer to court for delaying prompt and fair payment of a claim, accident victims lost leverage they previously had to obtain a reasonable settlement. Particularly in the matter of small claims, it is difficult for accident victims to obtain legal representation (after the *Moradi-Shalal* ruling, it became more difficult for plaintiff's lawyers to take third-party cases); many innocent victims simply drop the claim and pay the costs themselves rather than fight for months and years to obtain an appropriate settlement. In this context fewer and lower claims have been paid to innocent accident victims as a result of *Moradi-Shalal.*

Proposition 103 also had some impact on the frequency of claims. With the Proposition 103–mandated reduction of premiums, insurance companies were forced to become more efficient to ensure profitability. This created an incentive to limit waste, fraud and inefficiencies. As a result, it is likely that Proposition 103 justifiably eliminated some fraudulent claims that in previous years might have been paid without investigation. However, *Moradi-Shalal* gave insurers motive and capacity to drive the average claim value far beneath the national average with impunity.

California insurance companies have reduced claim payments and increased profits

Insurance companies incurred nearly 50% less payments in 1998 than in 1988, after adjusting for inflation. At the same time, insurers' profit margins increased by 300%.[14] California insurance companies have earned record profits in the years since *Moradi-Shalal* by low-balling accident victims and, as described above, reducing the number of annual claims.

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[12] Of course this is not the way consumers expect the insurance system to work. Rather, Californians are required by law to purchase auto insurance to ensure coverage and not rely on lawsuits against individual drivers as a means to recover costs associated with an accident.

[13] Available data only goes back to 1984.

[14] Source: NAIC 1997 Profitability Report In 1989 the profit margin for California auto liability premiums was 5.3%, in 1997 the margin reached 21.6%.

Although Proposition 103 moderated premium costs for consumers (see above), the 1988 *Moradi-Shalal* ruling has allowed insurers to increase profits, not through efficiency or effective marketing, but at the expense of fair claims payments.

As the Loss Ratio table illustrates, consumers now pay into the system more than twice the amount insurers pay back to cover claims. Insurers have leveraged more profits out of premiums under *Moradi-Shalal* by ratcheting down the value of an average claim and, thereby, reducing total liability losses at a rate much faster than premium income has declined. Since 1989, California insurance companies have earned an average annual liability profit margin of 15.0% (18.75% since 1992) according to National Association of Insurance Commissioners (NAIC) data. California insurance company's auto liability profits have reached all-time highs because insurance companies no longer pay claims commensurate with the premiums paid by consumers.

Claims payments can go up without a rise in premiums

The excessive profit margins, furthermore, undermine the insurance industry contention that restoring accident victims' right to sue an insurer for misdealing will force insurers to raise premiums. By holding insurers accountable, companies will be less likely to low-ball accident victims and, therefore, insurers will increase claims payments to an appropriate level. However, California's regulatory system mandated by Proposition 103 does not allow insurers to charge consumers excessive rates. Considering the excessive profit margins insurers presently obtain, with proper enforcement of Proposition 103 insurers will not be allowed to increase premiums as a result of making fair claims payments to innocent accident victims. Insurance companies are already collecting premiums sufficient to pay out much higher claims and still obtain profits with a reduction in premiums.

Presently, consumers pay much more (over twice as much) into the system than is being returned to accident victims. To bring insurers into compliance with Proposition 103, consumers must "get what they pay for." That is, claims should be paid at an appropriate value rather than the severely eroded level that accident victims have seen since the *Moradi-Shalal* abrogation of legal remedies. Additionally, under Proposition 103 regulations, it is unlawful for insurers to pass punitive damage awards for bad faith (including the cases presently disallowed by *Moradi-Shalal*) onto consumers through premium increases. If the ban

on third party remedies were lifted, insurers would pay higher claims value, but due to their excessive profits, the companies could not justify raising premiums. In fact, under Proposition 103, premiums should still decrease if claims were valued at a reasonable level.

Conclusion

In his dissenting opinion against the *Moradi-Shalal* decision, Justice Mosk called the ruling a "'Royal Bonanza' for insurance carriers," and added that it "will be interesting to observe whether this judicial largesse causes insurance premiums to decrease or insurance profits to increase."[15] It is readily apparent that the denial of accident victims' rights has led to a financial windfall for insurance companies. It is the conclusion of the Foundation for Taxpayer and Consumer Rights that there has been a shift away from a fair balance of power in claims settlements. Reinstating the right of an injured motorist or pedestrian to take an unscrupulous insurer to court is necessary to encourage prompt and equitable settlement practices by insurance companies.

[15] *Moradi-Shalal v. Fireman's Fund Ins. Companies* , 46 Cal. 3d 287 (Cal., August 18, 1988)