

Low Price Loses: Internet Insurance Price Shopping

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Summary:

In the price transparent world of the Internet, it is likely that the insurance carrier with the lowest price is *under-priced* and will experience adverse selection.

We recently released research findings that the average consumer can reduce their auto premium by forty-percent through comparative price shopping on the Internet. Commentators on our research have raised several key questions crucial to understanding the Internet's impact on the market.

Issue: Internet price discounts will have limited impact because consumers do not shop solely for price – they require financial soundness of their insurers and a strong reputation for quality claim service. Most consumers will not sacrifice quality for price.

Issue: Internet price discounts are the result of new e-business companies attempting to buy market share. While these companies may have some cost advantages, total savings do not approach 40 percent. Therefore, the lower prices are not sustainable.

Issue: Internet price discounts are not widely available and only apply to specific subgroups of consumers.

Issue: Very few consumers are buying insurance on the Internet. Few companies are selling directly on the Internet. Therefore, the supposed “pricing crisis” has no substantive basis.

Issue: Internet comparative price shopping will only have a short or mid-term negative impact on the insurance industry. Carriers will adjust to the changing market in ways to restore profitability.

Finding: In our research 94 percent of the time the lowest price was from one of the following ten well-known companies: Allstate, CNA, Colonial Penn, Electric, GEICO, Hartford, Nationwide, Progressive, State Farm, or Travelers.

Finding: Internet price discounts are not sustainable and represent a significant challenge to the industry. However, the primary existing Internet sites that offer extensive price comparisons are dominated by existing major brands. E-businesses are not a major factor at this time.

Finding: Our research found large Internet savings in 35 states, which make up 86 percent of the American population. Consistently high discounts are available across business segments (preferred, standard, nonstandard). Ninety percent of Internet shoppers can obtain discounts of 26 percent and greater.

Finding: The evidence shows that consumers are increasingly comparative shopping on the Internet to select their carrier. It is not necessary for the consumer to buy on the Internet to receive the carrier's price.

Finding: Carriers will take steps to adjust to the changing market. In fact, winners and losers will be determined by the extent to which carriers understand the underlying causes of the changes and respond appropriately. Merely raising or lowering rates will not be adequate.

Key Finding: Low premiums obtainable through the Internet are not the result of carriers intentionally offering discounts but arise from structural flaws in current rating and pricing methods.

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We recently released research findings that the average consumer can reduce their auto premium by forty-percent through comparative price shopping on the Internet. Commentators on our research have raised several key questions crucial to understanding the Internet's impact on the market. Principal among the issues are:

- Internet price discounts will have limited impact because consumers do not shop solely for price—they require financial soundness of their insurers and a strong reputation for quality claim service. Most consumers will not sacrifice quality for price.
- Internet price discounts are the result of new e-business companies attempting to buy market share. While these companies may have some cost advantages, total savings do not approach 40 percent. Therefore, the lower prices are not sustainable.
- Internet price discounts are not widely available and only apply to specific subgroups of consumers.
- Very few consumers are buying insurance on the Internet. Few companies are selling directly on the Internet. Therefore, the supposed “pricing crisis” has no substantive basis.
- Internet comparative price shopping will have only short or mid-term negative impact on the insurance industry. Carriers will adjust to the changing market in ways to restore profitability.

In this report we attempt to advance our joint understanding of the issues through research. We went shopping. We obtained price quotes for personal auto insurance policies in 35 states constituting 86 percent of the American population. We priced multiple preferred, standard, and non-standard policies. For every state we obtained multiple urban and rural price quotations. The findings are consistent and compelling.

The number of Internet sites offering insurance quotations is increasing every day. For our study, we picked a single site: RealQuote.com. RealQuote reports that they provide auto insurance quotes for 500 companies in 37 states. We were able to obtain three or more quotations for our example policies in 35 states. As the number of sites and their coverages grow, it is reasonable to anticipate that full industry price transparency will result; prices will be available for all major companies in all states.

Savings was estimated as the weighted difference between the median quoted price and the lowest quoted price. An average of 19 quotes for each policy were obtained. Weights were based on carrier market share.

Internet Comparative Shopping Savings

Our study found Internet comparative shopping produced substantial savings for most consumer groups. Table 1 displays saving percent by business class. Overall, the Internet produced a 39 percent price reduction for the average consumer. Looking at the distribution of savings, we found that 90 percent of consumers would obtain savings of 26 percent and above. The top 10 percent of consumers would obtain savings of 54 percent and more.

The table also shows that savings apply to all business classes. The average preferred customer would obtain 46 percent savings, the standard business customer 36 percent and nonstandard 50 percent¹.

	All Segments	Business Segment		
		Preferred	Standard	Nonstandard
90 th Percentile in Savings	26%	31%	24%	30%
75 th Percentile in Savings	31%	36%	31%	36%
50 th Percentile in Savings	39%	46%	36%	50%
25 th Percentile in Savings	48%	53%	45%	55%
10 th Percentile in Savings	54%	56%	48%	67%

We did not find that State significantly predicted level of savings available through Internet shopping, although two of the most regulated states—Massachusetts and New Jersey—were not in the sample.

The primary predictor of Internet savings was the number of quotations available. For those policies that obtained ten or fewer quotes, the average premium reduction was 22 percent. This rose to 45 percent for policies that obtained over 30 quotes. The result is not surprising; more comparative shopping is likely to lead to lower prices. The result is also suggestive of the future. As Internet sites grow to include an ever-larger number of price quotes, the savings associated with Internet shopping will also grow.

Number of Quotes	Average Percent Savings
3-10	22%
11-20	39%
21-30	43%
31+	45%
<i>Total</i>	39%

Insurance consumers make their purchasing decisions on more factors than price alone. One major concern of consumers is the financial health of their insurer; they want to be confident that the

¹ These findings are consistent with the two other Internet comparative auto insurance shopping studies. Progressive Insurance has reported price variances across four large insurers averaging \$1,030 per year based on 89,994 ratings. Consumer Reports in September 1999 reported an average difference from median to lowest price for five major cities to be 49%.

company will have the capacity to pay their claims. Therefore, we examined the financial ratings of those carriers offering the lowest prices on the Internet.

The results are shown in Table 3:

<i>Financial Rating</i>	<i>Percent of Lowest Price Quotes</i>
A++	12%
A+	51
A	14
A-	14
B	9

Contrary to predictions, the low price leaders were also companies showing significant financial health.

If consumers were to limit their purchases to insurers with ratings of A or above, would Internet price shopping still produce substantial savings? To address this question, we excluded all quotes from insurers with less than A ratings and re-estimated price reductions. Under these conditions savings from Internet shopping fell from an average of 39 percent to 36 percent.

Consumers also buy insurance on the basis of company reputation. A relatively small number of companies produced the large majority of low-price quotes. Ninety-four percent of the lowest price quotes came from 10 companies:

Allstate	Colonial Penn	GEICO	Nationwide	State Farm
CNA	Electric	Hartford	Progressive	Travelers

Clearly consumers do not need to buy no-name insurance to achieve substantial savings through Internet price shopping.

The current high frequency of these companies may be more a function of which carriers' prices are available on the Internet rather than which carriers are offering the actual lowest prices. As the prices of more and more carriers appear on the Internet, the list can be expected to change.

The question remains as to why such wide price discrepancies exist that allow consumers to achieve major premium savings while maintaining high quality and financial strength. Our research led to the conclusion that the Internet exposes inherent and structural weaknesses in current insurance pricing methods. The result is the Internet has the potential of leading to mass adverse selection. The result will be an increase in the level of available discounts.

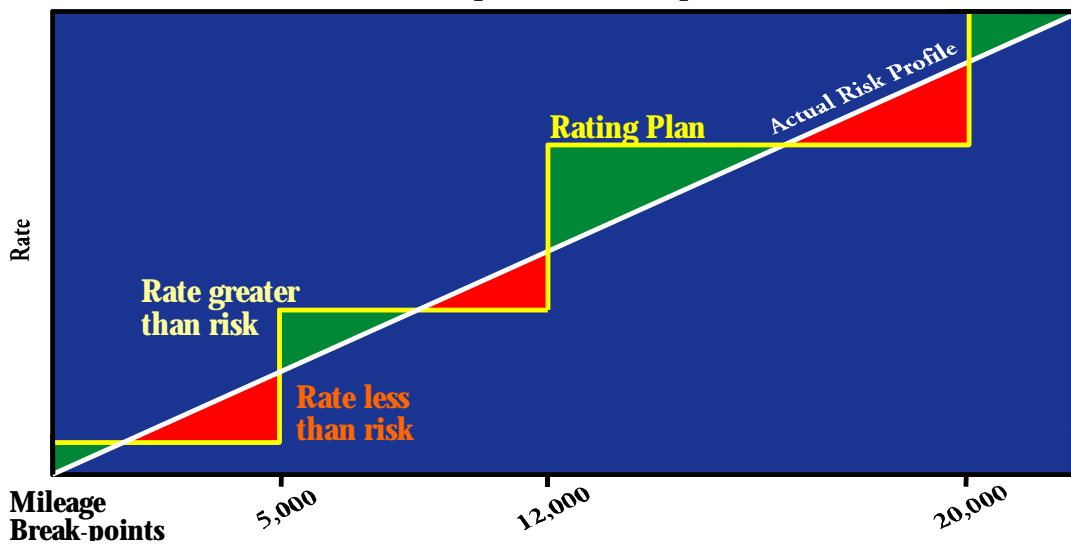
What are these pricing methods and how does comparative shopping on the Internet lead to adverse selection? We found four factors:

Stair-step rating. Insurance carriers do not know their costs in advance of selling a particular policy. Insurance prices are set by the expected results of a group of insureds. In any given year, most auto insureds will have no claims, but the costs of claims must be spread over all insureds.

To deal with this, insurance carriers create pools of insureds and estimate costs for the pool. But pooling methods vary from carrier to carrier. Grouping policies into pools is done by creating different “buckets” or “steps” on rating elements, such as age of the drivers, years of driving experience, cost of vehicle, annual mileage, location, violations, and accidents of the drivers.

Typically wide steps are used for the groupings. For example, drivers under age 25 may be grouped together, or annual miles from 5,000 to 10,000 may be grouped together. Grouping causes “stair-step” rates. Chart 1 (below) illustrates how “stair-step” rates collect more than adequate premium over part of the “step” and less than adequate premium over the other part of the step.

Chart 1: Example of "Stair-step" Rates



Different cut-points. Each carrier picks its own dividing lines. Suppose one carrier, A-OK Insurance, groups annual mileage from 5-10,000 and 10-20,000 while a second carrier, Buddy Insurance, groups 5-12,000 and 12-18,000. If you drive 11,000 miles annually, you would be at the less risky end of A-OK’s higher priced range and at the riskier end of Buddy’s lower priced range. So A-OK would charge you more than you deserve, and Buddy will charge you a little less than you deserve. If you were shopping based on the cut points between groups, you would likely select the carrier in which you are most often just under the top end (riskiest) cut point on each rating element. Unfortunately for the carriers, you don’t have to know anything about rating plans – picking the lowest price takes care of this for you.

The following simplified example (Table 4) illustrates how a single carrier might rate two similar people.

Table 4: Rating example of similar risk profiles with very different premium		
	Alex	Bruce
Car	Same	
Driving record	Same	
Address	521 Oak Street	601 Oak Street
(They live one block apart in same neighborhood.)		
Zip code	94102	94117
Age	25	24
Mileage per year	10,000	11,000
Calculating Premium		
Base rate	\$800	\$800
X Mileage factor	0.7	1.0
X Geographic factor	0.9	1.4
X Age factor	1.3	1.7
= Total Premium	\$655	\$1,904

Despite the fact that Alex and Bruce have nearly the same profile, Bruce's premium is almost three times the premium Alex is charged. The only reason for the difference in premium is the placement of the insurance carrier's cut points: territories divided by zip codes, lower rates at age 25, higher rates over 10,000 miles. In this example, Alex is at the risky end of the "step" just shy of the cut point for higher rates. Bruce may need to find a company that cuts at age 24, 12,000 miles, and uses different geographic territories. Comparing prices will locate the company for him.

Different weights. Policy rating is actually more complicated than the example above. Not only do carriers select different "cut points," they also weight each rating element differently (e.g., some put more emphasis on mileage, others on driver experience or territory) and they may use different rating elements (e.g. some carriers only look at commute mileage and don't rate on annual mileage). So if a consumer's risk profile is at the high end on a rating element, the consumer will likely get a lower price from a carrier that doesn't emphasize that rating element. Again, the consumer does not need to know the weak points in the rating plan. For example, a salesman that drives his own car 80,000 miles per year but does not commute for work would get a very high premium from a company that weights annual mileage and could get a discount from a company that emphasizes commute but does not count annual mileage.

When combined, stair-step rating, various rating cut points, and different rating variables and weights create major pricing discrepancies across carriers for identical risks. The result is that comparative shopping on the Internet introduces the possibility of mass adverse selection.

Insurance carriers must develop strategies to protect their profitability. Understanding of the carrier's vulnerabilities to Internet shopping (and the specific characteristics of the carrier's rating plans and mix of business which drive the vulnerabilities) is critical to developing an effective strategy.

About the authors

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