Auto Insurance Report

The Authority on Insuring Personal and Commercial Vehicles

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Inside

The Grapevine

2003 Data Has Arrived, Market Tables Begin Soon

As we went to press our annual pile of by-state, by-line, by-company data arrived from the **National Association of Insurance Commissioners**. We'll be deep in processing this week, and if the gods of data management smile on us we will begin our run of tables starting in two issues with the 300+ largest personal auto insurers in the nation. Also during the next few weeks we will expand upon last week's report on pricing sophistication – **InsurQuote** continues to refine its data points – and watch for some insights into new developments in claims management. Finally, the Property conference is filling quickly. Check our web site for details. AIR

"The Canary In The Coal Mine" – The Nonstandard Auto Market – Is Still Singing, At Least For Now

Editor's note: At the Auto Insurance National Conference last month two of our favorite nonstandard auto executives regaled the audience with ideas and insights. Jeff Dailey, president of newly public Bristol West, and Jim Schallert, chief executive of California's Western United, are both savvy and experienced. Below find excerpts of a conversation shared with Auto Insurance Report Editor and Conference Chairman Brian Sullivan. We've left out most of the laughs – insurance jokes for insiders don't translate well to the written word – and we simply don't have space for everything that was discussed. For that, you have to join us at the conference . . .

Auto Insurance Report Editor Brian Sullivan: One of the interesting things about the nonstandard market is it kind of like the canary in the coal mine. When the personal auto business is going south, it usually starts with the nonstandard market. And when things are going to get better, it frequently starts with the nonstandard market. And so we are sitting here in the sweet spot of the marketplace, and everyone is asking how long this is going to last and how might it end, because it usually ends badly. I think that what is important, if you want to see what is going to happen, is to look at that canary and tried to get a really good understanding of whether or not it is starting to choke, or whether it can continue singing for a while.

I think this time around will be a little different than last time around. I can't believe I am going to say this out loud, but I think the marketplace is smarter than it has been in the past. That is a dangerous supposition to make when you are speaking about personal auto, but I think one that

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is worth making. One of the reasons it might be smarter is that there are a lot of smart people running some of the companies, especially at the leading edge and we are really fortunate to have two of them today, Jeff Dailey and Jim Schallert.

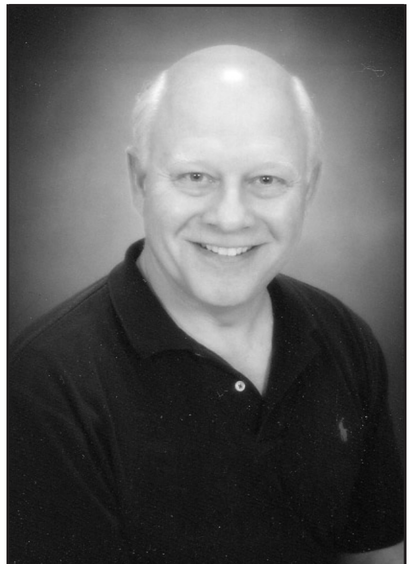
Let me start by asking where you think we are in the nonstandard cycle. Things were horrible two years ago, things are wonderful right now. Do we have a little run here, or are we started to head down?

Bristol West President Jeff Dailey: I think we still have a little run. The thing that is unpredictable, and I certainly don't have a better crystal ball than anybody else, is what is going to happen to gas prices. If gas prices continue to go up, I think you are going to see frequencies drop faster in nonstandard because those are the people who are more economically challenged.

> ***Economically challenged nonstandard customers will have to reduce driving if gas prices hit $3. Frequencies would almost certainly fall significantly.***

Vehicles are a lot safer today than they have been in the past. I have a car now that when I back up if I am going to hit something it beeps at me. Those kinds of things should drive down frequency. I think we have got some built in rate protection in terms of vehicle symbol drift, so that will help. It's hard to argue that the cycles will disappear forever, but you really have to get a sense for where the macro trends are to have a prediction on that.

Western United CEO Jim Schallert: California aside – and I think you have to treat that as kind of separate entity – I think some of the points that Jeff brings out are exactly what might cause an acceleration of the deterioration, because the prosperity of the nonstandard market normally triggers a stimulus in the standard and preferred markets to jump into the pond and typically into the deep end . . . I hope that Jeff's prediction, and yours, are right and that there will be a soft landing, but I fear that there is too abundant a level of stupidity out there. (They're) not going to be able to resist.



Jim Schallert, CEO
Western United Insurance

Sullivan: Are you starting to see the standard and preferred carriers reach down into your markets and are your agents starting to lose customers to some other bigger companies that are not normally in the nonstandard sector?

Schallert: We are seeing it peripherally. You see it with the counts and so forth that come in each week, and anecdotally and talking to your marketing reps. I think it is happening. Then you get some of the more robust price competitive nonstandard competitors that are out there, and you can spot them coming up in the comparative rating software, where they are starting to tweak the valves and take deep dives to gather up as much business as they can –

Dailey: That is starting to happen.

Schallert: – Yes, it is happening today.

Dailey: My sense is that competition is tougher among other nonstandard players rather than the standard markets coming down . . .

Sullivan: You think of the early 90s, there was a whole class of nonstandard writers who were small and closely held who would attack ag-

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gressively – insanely? – and then back away. It was a volatile market with volatile players. Some of them have been sucked up into major carriers now, and that takes away some of that entrepreneurial edge. I don't know if that makes them smarter. But they are gone. What kind of company do you think will be successful in this nonstandard market going forward in the next couple of years?

Dailey: The companies that will be successful in nonstandard I think will have three skill sets. They have to be excellent pricers. The presentation yesterday was exactly on point, it was a standard market presentation more so than nonstandard, but it absolutely applies (we wrote last week about the conference presentation on emerging pricing sophistication). They have to be great at claims, really indemnity control, and by and large nonstandard is an agent play, so they have to be great with the agents who control that market share.

Schallert: Just to add to that on the claims side, I think that the carriers that take fraud control and preemptive fraud actions to an art form will have the leading edge on this. It is one thing to have a tight claims operation and keep your settlements down. But the fraud component in this is bigger and bigger. The tools are out there, all it takes is clever people to apply them in a way to give you an edge.

Sullivan: The old strategy in nonstandard was, someone would call up and say "someone stole my car" and the claims person would say "no they didn't" and hang up on them. And with a lot of minimum limits policy there was not a lot of sophistication involved. Either it was send a check, or you didn't. Do you really think advancing claims skills is really going to be that controlling a factor in nonstandard?

Schallert: It is a business where pennies on the dollar make the difference between success and failure. There just aren't the margins, and if there are as we are seeing today, that void is going to get filled very quickly. So it comes down to what you can do below the radar to leverage edges that are not readily discernible by your competition . . . Fraud seems to be a wide open frontier. I know there are folks out there that have taken it to an art form and are pushing the envelope. You need to be a fast follower at least to succeed.

Jeff Dailey, President
Bristol West Insurance

Skill at fighting fraud can be a critical competitive advantage. Either innovate, or follow fast.

Sullivan: There are probably 50 people in the room who were at our first conference in 1998, when we had Phil Urban of Guaranty National (now CEO of Grange Mutual) and Mark Niehaus of Progressive (still there) talking about nonstandard auto. Phil said there was no way an organization could have a claims organization that could handle both nonstandard and standard risks. They are so vastly different that if you have a standard company and you start trying to settle nonstandard claims you are going to get run over. Mark's argument and Progressive's argument was, "No, you can handle this entire spectrum of claimants." And I have heard the same arguments from a State Farm claims person, who said "Half of my claims are not State Farm customers, and a chunk of those are non-

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standard. It isn't like I don't run into this." Do you think that these standard companies can successfully come down into the admittedly trickier area of nonstandard auto?

Schallert: My opinion is no. Let's take one of the ultra preferred markets out there. Part of the claims handling philosophy is velvet gloves, assume positive intent, the customer is right, bend over backwards, look at coverage, we want good coverage feedback. And if you take and apply that to the opposite end of the spectrum you are going to get taken to the cleaners. I think one of the reasons that Mark's premise is accurate with Progressive is that Progressive cut their teeth on the nonstandard market, and they learned the nuances of dealing with a nonstandard first party claim. That is something that State Farm has never had to deal with. They deal with it peripherally, but it is a small proportion of their settlements, so they really don't focus on refining that technique.

> ***Nonstandard claims operations can reach to standard, but the other way around is tough.***

Dailey: I agree completely. If you think about our nonstandard book, three quarters of the people we deal with in claims are not our customers. You can't take the approach "I'm not paying you" and hang up. That's a very dangerous approach. I think a nonstandard organization can move up. But I agree that a standard organization would have a tough time moving down.

Sullivan: Do you think as a result that nonstandard is going to remain a distinct sector? Yesterday we were talking about underwriting and pricing, and it was suggested that underwriting is kind of going away as a concept. If you come in the door I am going to offer you a price. I am probably not going to say no. Everyone will try to write the whole spectrum of customers. Or do you think nonstandard will remain a distinct segment as it always has?

Dailey: It would be very interesting if we could get the people in this room to define nonstandard. I don't think it is a distinct segment today. I think as the market changes the definition of nonstandard blurs. I think you have an urban environment, that is truly what most people think of as nonstandard. I don't think Best (industry rating agency and statistics provider A.M. Best Co.) would define it that way, but if you look at the Best A-4 pages, to me that is not a distinct nonstandard segment at all.

Sullivan: In the past it was probably pricing and agency, in the future it might be that claims is the differentiator. Some people are going to say, I can get my price down there, but I just can't write that customer because I just can't cope with the claims challenge.

How much do you think the changing ethnic demographic changes the game in places such as Florida, Texas, and California – three really big states where nonstandard is a big player. Because nonstandard at least in my experience has always been better able to handle immigrants and the first generation Americans of immigrant parents. Do you think that the fact that this is a rising tide in the United States is a bonus for nonstandard?

Schallert: It is a bonus, but when you say be able to handle I also think there has been a lot of mishandling of that segment. The winners that deal with the segment with respect and dignity, and work that bond are going to come out on top. The carriers that have thrived on abusing that sector of the population –

Sullivan: Of which there have been many.

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Schallert: Yes, there have. In California there have been shakedown artists that put some of the post office posters to shame. I think it is a new dawn in terms of the growth of the minority communities and the immigrant communities in California and Texas and these other areas and the company that breaks the code and recognizes that these folks are paying probably the largest proportion of their disposal income for something they absolutely need every day to get to and from a job that puts bread on the table, when that can be equated and balanced against the respect that they are due, it is going to be a winner.

Sullivan: Jim Pouliot yesterday was talking about a thought that he had of maybe carving out a separate company that would almost be like a Spanish speaking insurance company. (Pouliot, chief executive of the insurance operations of CSAA, the Auto Club of Northern California, spoke eloquently on the future regional insurance companies on the first day of the conference. CSAA owns Schallert's Western United.) Do you have foreign language policies and a Spanish and Vietnamese (telephone) operators? You are both in the same kind of markets.

Dailey: We do have Spanish forms that we send out and a Spanish (telephone) line. But frankly, we don't do a good enough job at that. The other thing that I would add to what Jim says, I think what we are going to find over time is that this is going to be a bonus for the nonstandard market, with the rising immigration. I also think we are going to find the data interactions talked about yesterday are different in this segment than they are in the population at large. And I agree with what Jim said, to deal with the marketplace with respect you have to provide access so they can do business with you. The nimble who understand the different pricing interactions are also going to be a big winner. Non-standard, especially since they are well positioned in urban markets and to deal with the claims are going to be in the better position to win in that market.

Brian Sullivan, Editor
Auto Insurance Report

Sullivan: One of the concerns I have heard, and I would be interested in your takes on this, about Spanish language documentation is that the insurance policy is a legal contract. And translating it and giving someone this Spanish document, you can't position it as a legal document, because of course it is all about interpretation of language. So when a person reads it, there is no case law about the Spanish language interpretation of it. So are your Spanish language materials marketing materials, or summaries of policies or have you actually translated the policies?

> ***A great opportunity awaits the insurer that can figure out how to succeed in the immigrant communities.***

Schallert: We have not translated the policy forms for that very reason. But we have descriptors, the billing forms and so forth. We try to take it right up to the edge.

Dailey: To your point, ours are all reviewed by Spanish speaking attorneys, we will not put a form out in the marketplace unless a Spanish-speaking attorney has actually reviewed the form.

Sullivan: Is it actually a policy form?

Dailey: No, it is not a policy form.

Sullivan: That is a barrier, and I don't think you

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will ever be able to cross that.

Schallert: I think maybe NAFTA will open the doors. It will take a partnership or a cooperative relationship with a carrier in Mexico, to bring a policy in that has the interpretation or the tightness and maybe run with that. I am not certain of all the nuances. You have to think through what could happen there. If you think about where the expertise is. (Mexico) is where the expertise lies. And you start with that as the core and build off that.

Dailey: Your point is right. You are going to wind up having cases that are tried over interpretations, and ultimately at some point there are going to be Spanish policies, there will be disputes over policy terms, there will be cases tried on it and there will be guidance on how you can do that in the future. That is just inevitable and it has to happen.

> ***Independent agents may not own the nonstandard business forever, but there are no signs that another distribution channel is ready to make a challenge.***

Sullivan: How about other languages? In a sense Spanish is easy because there are tens of millions of Spanish-speaking people in the southern tier of the United States as well as up in the Northeast. How about Vietnamese and other relatively large ethnic groups, that remain a tight community, retain their language focus. Do you have other languages that you are working in as well?

Schallert: At Western we do not today. We have ad hoc support for those based on the diversity of our employee population. At our parent company, CSAA, there actually is a language line that supports 28 different languages. And there is multi-lingual documentation being sent out, I believe, in 48 different languages.

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Dailey: AT&T also has a language line that we use. The problem with communities other than Spanish, our policy services organizations are in Florida, where it is very easy to attract a very good Spanish-speaking work force, and in Cleveland, where it is not quite as easy. But for us to attract a Vietnamese workforce in Florida or Cleveland, it's not going to happen.

Sullivan: One of the things we have been talking about is trying to price in a more sophisticated way for a customer base with no prior insurance. The concept for most insurers in looking at customers with no prior insurance is to basically avoid those people and surcharge them at the standard and preferred level. A lot of your customers have no prior insurance, so you need another data point. How do you set a price for a customer on whom you have little traditional information? Is it still happening at the agency level where the agent is making the old front-line underwriting decision. Are agents looking at the customer and deciding "I think this person is a good risk, because I have been in the business 42 years and I am a good judge of who is going to make a claim." How do you do this?

Unidentified commentator: I think you are giving the agent way too much credit here. The agent is thinking "I think you have $250 in your pocket." (Knowing laughter, including sheepish guffaws, if such a thing is possible, from the many agents and brokers in the audience.)

Schallert: Relative to California, you have to price it uniformly. Prop. 103 wraps you up pretty tightly. You can't get creative even if you wanted to. I suspect there are variables that are out there that you can use for credit, stability, and every-

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thing else that is being applied, to that population.

Dailey: As you start writing that business, in California most people don't qualify for the good driver discount, so you end up getting a little bit of a price increase as a result of that. In other states you give a surcharge because there is no verifiable driving record. We are going to end up finding other data points that we can correlate to loss behavior and be able to price it better in the future.

Sullivan: Do you think that independent agents who have dominated nonstandard auto will continue to do so? Do you think there is anything that you think would challenge their basic ownership of that business?

Schallert: My own personal feeling is no. I think that the composition of the average clients that goes to those shops, that demographic will continue to grow or stay the same size, probably grow.

Dailey: You think about nonstandard and a direct operation, because of the very short retentions it just doesn't work. We are seeing in a lot of our markets very sophisticated large brokerages and agencies and they are very good at attracting customers whether it is through advertising or through the Internet. I think they have a real handhold on that market and I don't see anything that is going to disrupt that in the near term.

Sullivan: Yesterday we talked a lot about branding, and we looked at the poor results and low growth of nonbranded companies. I am thinking about both of you and I know you are not running Super Bowl ads and you are not at the Rose Bowl with a big plane flying a banner around the top. What is your feeling in terms of the value of brand within the nonstandard business as it relates to the customer, and as it relates to the agent?

Schallert: I don't think it has that great an effect on the customer for nonstandard. Frankly, for the agent the brand allegiance there is based on ease of use, consistency, and reliability in the carrier.

Dailey: I think the brand is really at the agency level. I don't think advertising for us would really drive a lot because if you were really to present people with a choice especially nonstandard customers, "Oh I have heard of that Bristol West company, I have not heard of Western United. I think I'll pay a little bit more for Bristol West." I don't think that is going to happen. I think they would go with Western United.

Sullivan: How do you think the reinsurers are going to play in this next market phase? They really drove the price insanity in much of the country in the last cycle. My favorite deals of all time – and I wish I was in some of these – is where I

> ***Reinsurers are much smarter than even five years ago. Will they stay that way?***

am an MGA, and you are a reinsurer giving me millions of dollars of capital. You are going to pay me at top line commission, and you make all your money on the bottom line. I am in charge of the price, and handling the claims. And you say to me as we sign the papers "Please make sure I make some money." So the agent writes a gillion dollars of money-losing business, collects a giant commission check and says to the reinsurer, "Oh, I'm sorry." And the reinsurer says "I wonder what happened here?" That deal seems to be gone, but now with everyone making money in the market, are the reinsurers going to come back?

Dailey: If you are looking for a time to predict when the cycle is going to turn it may be when there is a rush of reinsurers back because it will probably be exactly the wrong time. We really

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don't see competition changing that much with MGAs backed by reinsurance. We are hoping, and as I have been told a bunch of times hope is not a very good strategy, but we certainly hoping that they are not going to come rushing back in and make the same kind of terrible deals they have made in the past.

Schallert: I think that the temptation that exists for primary carriers to jump in and try to get a piece of the profitability that is floating around also exists for the reinsurers. So while there will be caution, there are going to be those who really listen to the pitch and hear "I'm doing a 'me-too' on company XYZ and look at their margins and I am just taking the price 10% below and here I go and don't you want a piece of this?" And there is going to some young MBA sitting there who signs up.

Sullivan: From what I can hear, the reinsurers are saying they are not going into a deal when the MGA does not have some skin in the game. I think as long as your interests are aligned, it works. But when the agent makes money on the top line, and the reinsurer makes money on the bottom line, they have diametrically opposed interests. The MGA wants volume at any price, and the reinsurer wants underwriting profit. These things don't go together. Have you seen these new structures?

Schallert: I am sorry but the MGA's have gone to school on this one. I think the reinsurers are going to be babes in the woods. Skin in the game is all relative and I think a clever MGA can structure a deal where they come out on top after they have had their skin.

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That's all we have room for. As you can imagine, there were nervous chuckles from reinsurers during the last conversation, but we have to hope that Schallert is mistaken, and that reinsurers can re-enter the market through more intelligent partnerships that will empower entrepreneurs without setting fire to valuable reinsurer capital. Given history, it is probably wise to be a skeptic, but we remain convinced this market cycle is different than the past, and that there is hope for a more intelligent end to the current profit boom.

Dailey and Schallert set us straight on a number of fronts. The keys are clear. You have to be great, not just good, at claims management, especially on the fraud front. That claims knowledge has to get tied back to pricing. The newest pricing segmentation is good, but will take some tweaking if it is going to work well in hard-core nonstandard markets where there are fewer data points on an applicant. This is a shopping-sensitive market where if you can find a pricing edge you can make a fortune in a hurry, and put a major hurt on your competitors.

The vote for independent agents was strong, and subsequent conversations at the meeting confirmed a general sense that today's nonstandard agents are well positioned to protect their franchise.

Finally, we have this uneasy feeling in our stomach about profits. Every sign points to continued market health, and an eventual "soft landing" where profits fall gently, without the abrupt collapse of the last cycle. Of course, because it is being said by all, it can't be true. AIR

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