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**The Liability Deductible: A Possible Solution To
Rising Claim Costs and High Premiums**

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Even though the Casualty Insurance industry has gone through many transformations since the first Fire Insurance policy was issued in 1735, the industry's dual objectives remain essentially the same to this day: to provide financial protection to its policyholders at affordable costs. While the industry has been very successful in meeting the ever changing needs of its customers, it has not been as successful in keeping the costs of insurance down, particularly on the Automobile personal line. Today, as many as 1 in 7 motorists hit the roads without insurance * – even in states where insurance is compulsory. One study shows that roughly 1 in 10 at-fault automobile accidents involve an uninsured motorist **. The lack of effective insurance laws is one of the contributing factors to the uninsured motorist problem. However, most agree that the underlying cause of the problem is the cost of insurance.

To encourage and reward good driving habits, the industry gives discounts on premiums to insureds with clean driving records. The discount amount often increases as the insured's number of incident-free years increases. By the same token, to discourage irresponsible driving habits, an insurance policy is surcharged for accidents and traffic violations. This is one of the standard rating practices used by the industry in an attempt to promote and reward good driving habits which most believe is the only way to contain losses and therefore keep premiums low. Despite endless efforts from both the insurance industry and lawmakers (through insurance reforms) to keep insurance costs down, affordable insurance protection remains one of the most difficult financial challenges for most insureds today.

There have been many arguments about the high cost of insurance. The industry attributes it to the high medical costs, the lack of good insurance laws which restrict the rights of the injured to sue regardless of the magnitude of injury, and liberal jury awards. These costly litigations inevitably add to the costs of insurance. Pro-consumer groups, however, often argue that the industry is not an efficiently run business. Insurance companies are protected by the McCarran-Ferguson Act. This Act exempts them from the federal anti-trust laws which apply to most other businesses. Because of this special privilege, companies often collude in their business decision makings. They can set rates high because there is no competition. As these arguments drag on, losses keep growing and the average claim settlement keeps rising. As insurance companies need to raise premiums to pay for losses, policyholders keep reaching deeper into their pockets to pay for protection.

Raising rates relieves loss pressure for the industry, but it does not address the bigger and more important issue which is loss prevention. It seems the only way to lower premiums is to reduce losses. And the most effective way to reduce losses is to lower accident frequencies. And, perhaps, the only sensible way to lower accident frequencies is through good driving habits since nearly 80% of all documented auto accidents are results of improper driving. The table below shows the breakdown by type of improper driving for the latest available year, 1990. (1989 shows similar figures).***

Improper Driving As a Factor In Accidents

| | <u>Fatal Accident</u> | <u>Injury Accident</u> | <u>All Accident</u> |
|----------------------|-----------------------|------------------------|---------------------|
| Improper Driving | 65.8% | 77.8% | 77.8% |
| <i>Speeding</i> | 24.9% | 20.2% | 16.3% |
| Failed to Yield | 9.6% | 18.3% | 18.2% |
| Passed Stop Sign | 2.5% | 2.4% | 1.9% |
| Disregarded Signal | 1.9% | 5.0% | 4.0% |
| Drove Left of Center | 8.1% | 2.7% | 2.4% |
| Improper Overtaking | 3.8% | 1.8% | 2.3% |
| Made Improper Turn | .4% | 1.6% | 2.6% |
| Followed Too Closely | .7% | 7.6% | 8.7% |
| Other | 14.0% | 18.3% | 21.3% |

Both discounts and surcharges on premiums don't seem to influence driving habits much. Perhaps, a Liability deductible would be a more effective tool in controlling driving habits. A driver would be more hesitant in making an improper driving move if he knows that he is responsible for the first dollars incurred. Currently, the industry has deductible options for most of the coverages it offers with the exception of the Liability subline where the need for loss control is most pressing. The deductible has never really been viewed by the industry as a loss deterrent or a driving-habit-control mechanism. Its main purpose is to free the Claim departments from having bothered with small claims. The Uninsured Motorist Property Damage deductible illustrates this point. A Liability deductible for the Property Damage coverage can be used for this purpose. A large number of Property Damage claims settled over a 3-year period shows that more than half of these claims are of loss size \$1,000 or less and account for almost 20% of the total Property Damage losses.****

Given the complex Legal system that we have, it is a far-fetched idea of suggesting a compulsory Liability deductible. If this were possible, under this plan, each insured would have to carry a Liability deductible of an amount varied directly to his liability limit – the higher the liability limit, the larger the deductible amount. Or, perhaps, drivers with substandard driving records would be required to carry a Liability deductible of an amount directly related to the number of demerit points on their driving records.

A Liability deductible, thus, can serve as a premium reduction incentive (responsible drivers would tend to choose this option to lower their premiums), an expense reduction mechanism which frees Claim departments from having to deal with small claims, and, most importantly, as a loss deterrent. The Liability deductible, then, can be a possible cure to two of the industry's most pressing problems: rising claim costs and high premiums.

- * Best's Insurance Management Reports, Property/Casualty, No.5, February 26, 1990.
- ** All-Industry Research Advisory Council, Uninsured Motorist Facts and Figures, 1984, page 2.
- *** The 1993 Information Please Almanac, Accident Statistics, page 834.
- **** Claim data from Metropolitan Property and Casualty Insurance Company for calendar years 1990-1992. Detailed data are available upon request.