April 2, 2009

The Impact of First-Party Bad Faith Legislation on Homeowners Insurance Claim Trends in Washington State

INTERIM FINDINGS

In 2007, the Washington State Legislature enacted the Insurance Fair Conduct Act (known today as R-67), which established a statutory private cause of action for insurance policyholders to sue their insurance companies if they believe the company has unreasonably denied their claim.[1] In addition, the Act authorized the payment of punitive damages equal to three times the actual damages sustained by the policyholder, along with other costs, including attorneys' fees and court costs. The legislation was approved by voters in a public referendum in November 2007, and the new law became effective December 6, 2007.

The adoption and implementation of R-67 was vigorously opposed by many in the business community because it was expected to lead to an increase in both the number of frivolous lawsuits and the cost of insurance claims by significantly altering incentives affecting claimants and insurance companies during the claim settlement process. By February 5, 2009, over 1,000 notices of intent to file lawsuits pursuant to the new law had been filed with the Washington Office of the Insurance Commissioner.[2] Soon after the adoption of R-67, the Insurance Research Council (IRC) initiated a plan to monitor key insurance coverages in the state in order to assess the law's effect on the insurance system. This is an interim report on that assessment. As explained below, IRC estimates that R-67 may have increased homeowners insurance claim costs in the first three quarters of 2008 by $58 million.

Methodology

To assess the impact of R-67 on homeowner insurance, IRC examined trends in the number of claims per 100 insured homes (claim frequency), the average claim cost (claim severity), and the average claim loss per insured home (loss cost) before and after implementation of the new law.[3] Approximately ten percent of the notices filed with the Office of the Insurance Commissioner by individual (non commercial) claimants involved homeowners insurance coverage. IRC analyzed quarterly exposure and loss data on paid homeowners claims from the Fast Track Monitoring

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[1] Engrossed Senate Substitute Bill 5726, Washington State Legislature, 2007 Regular Session.

[2] Stephanie Ferrell, Forms and Records Analyst, Office of the Insurance Commissioner, e-mail response to IRC public records disclosure request, February 10, 2009. Approximately 81 percent of the notices were filed by individual (non commercial) claimants and approximately 19 percent were filed by commercial policyholders. Notices filed prior to the enactment date of R-67 are excluded from the analysis.

[3] Homeowners policy forms HO-1, HO-2, HO-3, and HO-5 were included in the analysis. Experience for renters and condominium owners policy forms was not included.

System[4] for Washington and a group of three control states (Arizona, Minnesota, and Utah). These states were selected for comparison because they did not provide a statutory private cause of action for first-party bad faith insurance claims prior to the enactment date of R-67.[5] Washington, prior to the enactment of R-67, also did not provide a separate statutory cause of action for insurance claims.[6] Homeowners claims experience attributed to a catastrophic storm occurring in early 2008[7] were excluded from the analysis.

The comparisons between Washington and the control group of states involve the first three quarters of 2007 and the first three quarters of 2008.[8] IRC calculated frequency, severity, and loss cost statistics for each of these two periods and then calculated the changes from 2007 to 2008 for Washington and the control group of states. Differences in 2007-to-2008 changes between Washington and the control group of states were then calculated. Using this method, IRC was able to control for underlying cost differences between the states.

Although the focus of this report is homeowners insurance, R-67 is also expected to impact private passenger auto insurance coverage. In fact, IRC found that 33 percent of the notices filed by individual (non commercial) claimants involved uninsured motorist (UM) or underinsured motorist (UIM) claims, 21 percent involved personal injury protection (PIP) claims, and 2 percent involved both UM/UIM and PIP claims. The Fast Track Monitoring System does not include information on UM/UIM coverage. Because of the interaction of PIP and UM/UIM coverage and because evidence from other research suggests a substantial potential impact of first-party bad faith legislation on UM/UIM claims,[9] it would not be appropriate to present findings for PIP claims alone. Therefore, private passenger auto experience is not included in this analysis. IRC is engaged in an effort to obtain UM/UIM data that will allow it to analyze the potential impact of R-67 on private passenger auto insurance. Findings from that analysis will be presented in future IRC reports.

Findings

After monitoring the three quarters that followed implementation of R-67, IRC has found that enactment of the new law may have had a significant potential impact on the homeowners line of business. There are several reasons to view the findings presented below with caution. For example, the time it takes for incentive changes such as R-67 to impact participant behavior and become evident in industry statistics is unknown. It is possible that insufficient time has elapsed for the full and ultimate effects of R-67 to be reflected in Fast Track data. It also is possible that other factors unrelated to R-67, but not identified by IRC, may have contributed to the experience

[4] The Fast Track Monitoring System is a service of Independent Statistical Service, Inc. (ISS), Insurance Services Office, Inc. (ISO), and National Independent Statistical Service (NISS).

[5] General Reinsurance Corporation, *Bad Faith Laws for Property/Casualty Claims* (2008). Minnesota adopted first-party private cause of action legislation in 2008. The new law became effective on August 1, 2008.

[6] Prior to the enactment of R-67, a private cause of action was available to claimants under the state's Consumer Protection Act. However, the standards for finding bad faith on the part of an insurer and the punitive damages available to claimants were greatly expanded with the enactment of R-67.

[7] "Catastrophes: Insurance Issues," Insurance Information Institute, www.iii.org/media/hottopics/insurance/catastrophes (accessed March 19, 2009).

[8] Fourth quarter data are not examined because it would include experience prior to and after enactment of R-67. To ensure comparability from 2007 to 2008, fourth quarter data from both years are excluded.

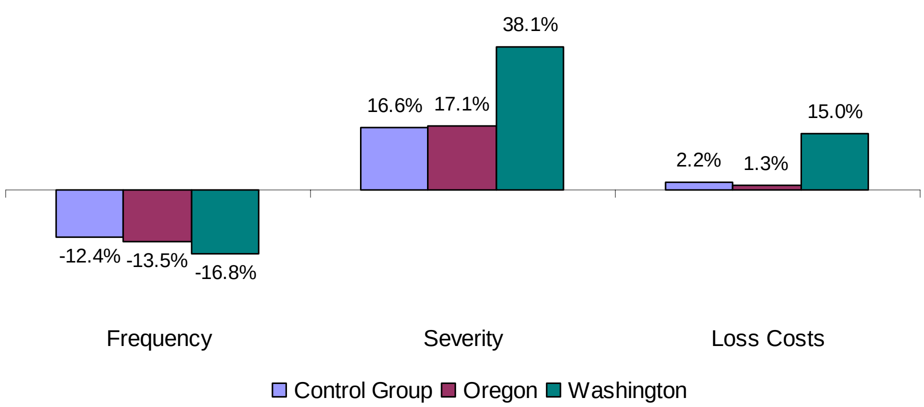
[9] Sharon Tennyson and William J. Warfel, "First-Party Insurance Bad Faith Liability: Law, Theory, and Economic Consequences," National Association of Mutual Insurance Companies, www.namic.org/insbriefs/080926BadFaith.pdf (accessed March 29, 2009).

following the enactment of the new law. Despite these possibilities, we believe the findings are sufficiently credible to merit consideration. Other reasons for viewing these findings with caution are discussed at the end of this report.

Figure 1 depicts the change in experience that occurred in Washington, the control group of states, and Oregon during the period immediately following the passage of R-67. Oregon is included in the analysis because it and Washington were both affected by a catastrophic winter storm that occurred January 4-9, 2008, approximately one month after the effective date of R-67. The storm caused $745 million in insured losses across 13 states. Although catastrophe losses are excluded from the analysis, comparing Washington with Oregon helps determine whether the storm may have affected the claim environment as it applies to the settlement and value of non catastrophic claims.

Washington and the control group of states experienced similar declines in the frequency of homeowners insurance claims during the first three quarters of 2008. The severity of claims increased in Washington and the control group states. However, the increase in severity was much greater in Washington than in the control group—38.1 percent compared with 16.6 percent. That this effect was somehow related to the 2008 catastrophe event appears unlikely based on the experience in Oregon, where changes in frequency, severity, and loss costs were almost identical to the changes in the control group of states. If the increased severity experienced in Washington had been related to the January 2008 catastrophic storm, then Oregon should have experienced a similar increase in claim severity. It did not.

Figure 1
Homeowners Coverage, Percentage Change First 3 Qtrs. 2007 to First 3 Qtrs. 2008
(Excluding catastrophe losses)



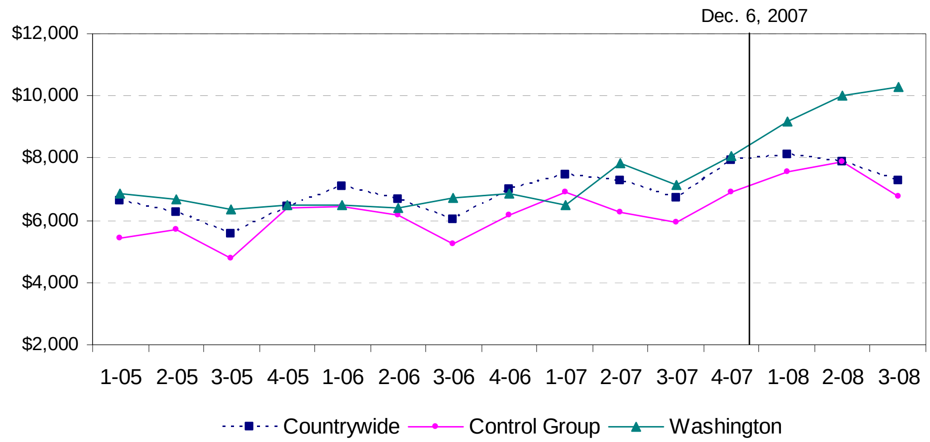
Additional insight was gained by reviewing and comparing trends before and after another catastrophic storm that occurred February 3-4, 2006, and caused $55 million in insured losses in Washington and Oregon (the only states affected by the storm).[10] Because this event occurred in the middle of the first quarter, IRC compared frequency, severity, and loss cost trends in the second, third, and fourth quarters of 2005, with those same quarters in 2006. In this comparison,

[10] Insurance Information Institute, "Insurance Fact Book," 2008, p. 109.

the experience in Washington was much more similar to the experience of the control group of states. Loss costs in Washington grew 8.7 percent, compared to 4.1 percent for the control group of states. Loss costs in Oregon grew more rapidly (27.8 percent) than in either Washington or the control group states.

Figure 2 more closely examines severity trends from the first quarter of 2005 through the third quarter of 2008 by depicting average homeowners claim severity for Washington, the three-state control group, and for all business countrywide. As the figure illustrates, the three-state control group and the countrywide series reveal very similar patterns, with peaks tending to occur in the first or second quarter of each year. Washington has followed a less pronounced cycle of shorter duration. Although severity was already on a slightly upward path, beginning in the last quarter of 2007, it began to follow a clear upward trajectory that was more pronounced than before.

Figure 2
Homeowners Severity Trends
(Excluding catastrophe losses)



Based on this analysis, while stressing the preliminary nature of the findings, IRC estimates that the implementation of R-67 may have resulted in as much as $58 million in additional losses for Washington's homeowners insurance system during the first three quarters of 2008. Homeowners loss costs (average claim cost per insured home) in Washington increased 15.0 percent between the first three quarters of 2007 and the first three quarters of 2008. In contrast, loss costs in the three-state control group increased 2.2 percent. Assuming that the difference between these figures (12.8 percentage points) represents additional costs attributable to R-67, then the additional cost per insured home is $36.52. With approximately 1.6 million insured single-family housing units in the state,[11] $36.52 per insured home produces $58 million in additional insured losses. This estimate applies only to the first three quarters of 2008 and may change with the analysis of additional experience over subsequent periods.

[11] "Washington State's Housing Market: A Supply/Demand Assessment," Washington Center for Real Estate Research, www.wcrer.wsu.edu/WSHM/2006%20Annual/SF_Invent_2006.pdf (accessed March 19, 2009). We assumed that 88 percent of all single-family homes are actually insured.

Cautionary Note and Future Updates

The findings presented above should be viewed with caution. It is possible that insufficient time has elapsed for the true and full effects of R-67 to become evident in the Fast Track data. Little is known about the length of time required for law changes such as R-67 to affect the behavior of system participants and for the effects to become evident in information sources such as Fast Track. Another reason for caution is that the Fast Track system is only one source of information. Other data may be useful to corroborate the findings presented here and shed additional light on the effects of R-67. It also should be acknowledged that the frequency, severity, and loss cost statistics used in this analysis are characterized by natural variation over time. While we believe it is unlikely that the recent trend in the severity of homeowners insurance claims in Washington is due to natural variation, the possibility that it is cannot be totally ruled out. Finally, while IRC examined the potential influence of catastrophe events, there may be other forces or developments at work that IRC has not identified, but which could have influenced the findings presented here. Despite these reasons for caution, we believe the findings are sufficiently credible to merit distribution and consideration by those interested in the potential effects of R-67 in Washington, as well as the potential effects of similar legislation being debated in other states.

IRC will continue to incorporate subsequent updates of Fast Track experience into this analysis as they become available. In addition, IRC will examine the potential effect of R-67 on private passenger auto insurance as data on UM/UIM coverage becomes available.

IRC
INSURANCE RESEARCH COUNCIL

Insurance Research Council, a division of the
American Institute for Chartered Property Casualty Underwriters
718 Providence Road
Malvern, Pennsylvania 19355-3402
610.644.2212, www.ircweb.org