

Auto Insurance Residual Markets

May 1, 2007

A residual market exists when insurance companies in the competitive market refuse to provide coverage to certain individuals. Generally, these individuals are considered too risky for insurance companies to write and would therefore not be profitable. Since law requires basic auto insurance coverage, there must exist a market that will insure those individuals that are denied by all insurance companies. This market, called the residual market, is set up by state regulators to insure those people who cannot obtain insurance. The residual market is not sustainable by itself because the level of premiums is not enough to sustain losses, so the insurance industry has to take a share of the losses. Since all insurance is regulated on a statewide basis, each state has unique consequences for this residual market.

The size of the auto residual market is dependent on each state, but as an aggregate represents 1.6% of the total auto insurance market for private passengers and 2.7% for commercial premiums (Automobile Insurance Plans Services Office). Two states encompass the majority of the residual market, North Carolina and Massachusetts. North Carolina has 24% of total premiums in the residual market and Massachusetts has 6.5% in the residual market. In North Carolina, the state's regulatory system inhibits insurers from using most risk classifications, and therefore insurers are not able to charge rates that reflect the underlying risk of the insured. This leaves insurers in a difficult position and many just refuse to write coverage. Since the residual market cannot adequately cover the losses that are underwritten, losses are spread across the state to all of the insurance companies.

Massachusetts has been trying to develop a system that will spread the risks in the residual markets fairly to all insurance companies writing auto insurance in that state. This system assigned a number of risky drivers to each insurance company based on market share, but since loss experiences are random, some insurance companies paid more money out for losses relative to their market share. In the end, this caused more insurance companies to not want to write in Massachusetts, which in turn increased the size of the residual market.

The residual market will exist since insurance is a necessary item. However, a small residual market benefits everyone, including consumers. When insurance companies have to take on extra losses that are not being priced in their premiums, losses will occur. When insurers write policies for future periods, prices will have to include a plug for taking on losses from the residual market. This will in term raise insurance for all consumers and could potentially increase the residual market. If state regulators allow competition and insurers to price on all valid risk classifications, the residual market will decrease and consumers will eventually get coverage at lower prices.

Source: Insurance Information Institute, *Hot Topics and Issues Update, Residual Markets*.

<http://www.iii.org/media/hottopics/insurance/residual/>. April 30, 2007.

<http://www.iii.org/media/hottopics/insurance/residual/>