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**CONSUMERS AGAINST
HIGHER INSURANCE RATES -
WASHINGTON**

**THE IMPACT OF
ENGROSSED SUBSTITUTE SENATE BILL 5726
ON INSURANCE RATES**

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BACKGROUND

First-party bad faith laws, statutes, regulations and judicial decisions define the process and remedy for policyholders who have disputes with their insurers regarding claims under insurance policies. The process and remedy vary significantly by state, but exist in some form in most states, including Washington, prior to the passage of Engrossed Substitute Senate Bill (“ESSB”) 5726.

The General Cologne Re report provides background on first-person bad faith claims in the United States:¹

“Bad faith claims are increasingly common and costly for insurers. Many bad faith allegations do not result in jury awards, but insurers expend considerable resources to defend or settle these claims. And when they do culminate in a plaintiff verdict, the financial punishment for bad faith often exceeds \$1 million – the median punitive award for bad faith – and carries negative publicity and regulatory repercussions for the insurer.

Property insurers are exposed to bad faith claims and high verdicts just like their casualty counterparts. These first party bad faith claims typically involve allegations that the insurer improperly denied coverage, underpaid a loss or delayed payment without adequate justification. These claims can spring from any type of property claim. Mold has spawned almost a cottage industry for filing bad faith lawsuits, but even small fire and vandalism losses can trigger bad faith suits, particularly when arson or fraud is raised.”

¹ “Bad Faith for Property Claims – A review of the law on first-party bad faith liability in all 50 states”, General Cologne Re research publication by Arthur Harris and Sue Stein, December 2002

Engrossed Substitute Senate Bill (“ESSB”) 5726 was enacted by the Washington legislature in April 2007 and signed by the governor in May 2007. However, because a petition for referendum was filed, ESSB 5276 will become law only if approved by Washington voters in the November 2007 election. The proposed law would increase the financial exposure to insurers by increasing the damages recoverable in a first-party bad faith action. Upon a finding of bad faith in claim settlement, the court could award total damages in an amount up to three times the actual damages and would be required to award reasonable attorney fees and actual and statutory litigation costs, including expert witness fees. This law would apply to all insurance contracts except for certain health insurance plans.

ESSB 5726 would introduce additional risks and uncertainties which would fundamentally alter the dynamics of the claims settlement process. These types of changes are often alleged to increase insurance costs by increasing incentives for claimants to pursue marginal claims and decreasing incentives for insurers to defend against potentially frivolous or unwarranted claims. Milliman Inc. (Milliman) has been asked by the Consumers Against Higher Insurance Rates (CAHIR) to evaluate the potential impact of ESSB 5726 on insurance costs in the State of Washington.

This report presents the results of our research on this matter. In the next section, we describe our understanding of the proposed law and the changes it will occasion in Washington. Following that, we briefly discuss the underlying economic theory, which predicts that permitting punitive damages in first party claims can lead to a change in claiming behavior that is expected to increase insurance costs. We then describe the analysis we undertook to investigate whether states which have implemented punitive damages in first party bad faith

cases have experienced a higher rate of increase in costs attendant to the change. Finally, we compare our results to those found in other research, and show that our conclusion – that the introduction of punitive damages in first party bad faith situations leads to measurable increases in insurance costs – is consistent with these findings.

ESSB 5726

The following discussion of the proposed law and the changes it would impose on Washington law is based on input provided by attorneys familiar with the laws of the State of Washington. The authors of this report are not lawyers and cannot provide professional opinions on legal matters.

First party bad faith actions are recognized under existing laws in the State of Washington. Under ESSB 5726, “Any first party claimant to a policy of insurance who is unreasonably denied a claim for coverage or payment of benefits by an insurer may bring an action in the superior court ...” As we understand it, the statutory standard of “unreasonable” in the proposed law does not change what a plaintiff has to prove in a first party bad faith claim: the “reasonable” standard already exists in Washington. What would change under ESSB 5726 is the potential damages that can be awarded for violation of the “reasonable” standard. Moreover, unlike bad faith laws in other states, the Act does not expressly require a showing of malice, intent or recklessness to award treble or punitive damages.

As noted, the amount of damages that may be awarded in a case where an insurer is judged to have unreasonably denied a claim would change significantly under the proposed law. Under the existing law, awards from first party bad faith actions were limited to actual damages plus a \$10,000 cap on punitive damages, as specified by the Consumer Protection Act. Under ESSB 5726, courts could award up to three times actual damages without a cap.

In addition, under the existing law, reasonable plaintiff attorney fees are routinely awarded in first party bad faith actions. ESSB 5726 states: “The Superior Court **shall**, after a finding of unreasonable denial of a claim for coverage or payment of benefits, ... , award reasonable attorneys’ fees and actual and statutory litigation costs, including expert witness fees, to the first party claimant of an insurance contract who is the prevailing party in such an action.” According to attorneys familiar with Washington law, the proposed statute would lead to some increase in frequency of awards for plaintiff attorney fees and costs. It would also increase the amount to the extent of previously unrecoverable expert witness fees.

In the proposed law, it is unclear whether “actual damages” includes damages for non-economic losses such as emotional distress. Washington courts have held under other statutes that “actual damages” was synonymous with “compensatory damages” and included compensation for mental anguish. If such non-economic damages are included in “actual damages”, then they would also be subject to the treble damages provisions of the statute.

Although ESSB 5726 clearly states that it applies to “first party claimants”, we have been advised that third parties may assert first party claims based upon assignments of first party rights. A third party may settle with an insured for a stipulated judgment subject to a covenant-

not-to-execute, and take assignment of the insured's rights against the insurer. To the extent this assignment occurs, the proposed law would also raise insurance costs for third person coverages.

ECONOMIC THEORY AND INSURANCE CLAIMS

Economic theory suggests that individuals make decisions to maximize their welfare. As respects the incentives to file an insurance claim, this theory would predict that individuals will compare the expected benefits of a potential claim to the expected costs of claim filing, and to the extent that the benefits exceeds costs, claims will be filed. From the plaintiff's perspective, the proposed law would increase the potential recovery without added cost of disincentive. From the insurer's perspective, once a claim is filed, there is a decision as to whether to contest or settle the claim: the claim will be settled (as opposed to contested) if the expected costs due to contesting the claim exceed the benefits (reduction in claims costs) of doing so. One corollary of this theory is that, to the extent that an environmental change either increases the benefits of filing or the costs of contesting a claim, the incidence of claims, and hence insurance costs, will increase.

This approach to claiming behavior is entirely within the mainstream of economic theory. For example, in a seminal paper entitled, "*The Selection of Disputes for Litigation*", Priest and Klein state the following:

“This paper presents a model of the litigation process that clarifies the relationship between the set of disputes settled and the set litigated. According to our model, the determinants of settlement and litigation are solely economic including the expected costs to the parties of favorable or unfavorable decisions, the information that parties possess about the likelihood of success at trial, and the direct costs of litigation and settlement.”²

Our analysis is based on the same general theory.

² See Priest, George and Benjamin Klein, The Selection of Disputes for Litigation, *Journal of Legal Studies*, Vol. XII

Applying this general theory to the circumstances surrounding ESSB 5726, we would expect the provisions of the proposed law, if approved by the Washington electorate, to increase claims costs, both first party and assignment of third party, for a variety of reasons. Most generally, under ESSB 5726, there is a greater economic incentive to pursue bad faith actions, because if successful, awards will cover all attorney fees and litigation costs and awards could include up to treble actual damages for insureds. Thus, from the perspective of plaintiffs, the potential benefits of claim filing increase dramatically, because potential recoveries may far exceed policy limits under the treble damages provisions. Also, from the perspective of insurers, the potential costs of contesting claims increase significantly, since damages may exceed policy limits and legal costs are likely to be higher to defend charges of bad faith. In both instances, the impact of these changes is to create incentives to increase the rate of claims filing and, to the extent that such claims are ultimately successful, to increase the cost of claims as well.

Specifically, for first party coverages, we expect claim costs to increase in several ways if ESSB 5726 becomes law:

- More first party bad faith actions will be filed due to the possibility of uncapped treble damages introduced in ESSB 5726.
- First party bad faith claims will settle for higher amounts under ESSB 5726.
- ESSB 5726 will change insurer claim settlement practices, which may lead to increases in loss adjustment expenses (there may, however, be less loss adjustment expense on claims the insurer chooses to settle instead of contesting).
- First party claims (including “padded” or fraudulent amounts) will settle at higher amounts as insurers attempt to avoid bad faith actions and associated costs.

- Claim frequency will likely increase as insurers settle some marginal claims that would have been denied under the prior law, in order to avoid the risk of litigation.

For third person coverages, the proposed law would have a similar impact on claim costs. We expect an increase in the number of claims where first party rights under the insurance contract are assigned to a third party and an increase in claim costs for those claims. We also expect an increase in the cost of settling other claims as insurers adjust their claim settlement practices to avoid the potential of bad faith actions.

A recent Washington Supreme Court decision in “*Woo v. Fireman’s Fund*” demonstrates the impact ESSB 5726 could have on a single claim. Woo sued his insurance company for bad faith when the insurer declined to defend him for what was characterized as “intentional tortious conduct”.

Woo, a dentist, played a practical joke on his employee, a dental assistant. While she was sedated for oral surgery, Woo attached fake boar tusks in her mouth and took pictures of his creation. When the assistant was eventually shown pictures of herself, unconscious and ultra-toothy, she resigned her position with Woo and eventually filed suit against him. Woo’s insurer refused to represent Dr. Woo under his dental malpractice insurance policy on the basis that the policy covered dental work and not practical jokes.

Dr. Woo hired a lawyer and settled with the dental assistant for \$250,000. He then filed a bad faith action against his insurer. The jury found that Woo’s insurer acted in bad faith and awarded him \$750,000 in emotional distress damages. The court then found coverage by estoppel,

ordered the insurer to reimburse Woo for the \$250,000 settlement, half of his defense costs, and approximately \$600,000 in attorney's fees for the coverage and bad faith action, and awarded punitive damages of \$10,000 under the Washington Consumer Protection Act. The Washington Supreme Court reaffirmed the judgment.

If the Woo case had been adjudicated under ESSB 5726, the judge could have tripled at least \$1 million of Woo's judgment. This case illustrates the potential additional costs that would be added to the Washington insurance system by ESSB 5726. These additional costs will eventually be passed on to Washington consumers in the form of higher insurance premiums.

DATA SOURCES AND ANALYSIS

Our approach to this assignment was to research available data and reports associated with first party bad faith laws and to compile data on automobile insurance costs in the states that have had some type of change in first party bad faith laws during the last thirty years. Based on our discussions with attorneys knowledgeable about these statutory and judicial provisions, we believe the proposed Washington law change is unique; there is no prior law change in any other state that exactly parallels ESSB 5726. However, we were provided a list of states and the effective dates of changes in first party bad faith laws. Our empirical approach to evaluating the cost implications of these law changes was to compare the cost trends in those states to countrywide averages, and observe any change in the relative loss costs in the years following the law change. In addition, we will discuss related reports and data uncovered by our research.

Other States and Coverages

The proposed Washington law approach to first party bad faith actions is different than any other state's current laws. However, there are similarities which we will examine. We have chosen five states where there was some type of law change in the last thirty years that related to first party bad faith actions. These states and the effective year of the law change are listed in the following table:

State	Effective Year
Georgia	2001
Oklahoma	1995
Rhode Island	1981
Texas	1995
Louisiana	1990

In comparing other state law changes to the proposed law change in Washington, we focused on two main provisions: the legal standard used to establish bad faith and the amount of damages that can be awarded in such a case. Recapping the Washington law in these areas, the standard used to determine bad faith did not change and remains “unreasonably denying a claim”. The amount of damages allowable in Washington’s ESSB 5726 is reasonable attorney fees and defense costs and up to three times actual damages (most likely including non-economic damages). A comparison of the five states listed above with the Washington law follows:

Georgia – The 2001 Georgia law change increased the cap on damages available for first party bad faith actions. The Georgia standard is a bad faith refusal to pay a claim, and this standard did not change in 2001. Most likely, this is a higher standard than the Washington “unreasonable” standard. In 2001, the limit on punitive damages was raised from 25% of the insurer’s liability to 50% of the insurer’s liability. The change in potential damages available (from 25% to 50%) and the total amount available under current Georgia law (50%) are significantly lower than Washington. We would expect the increase in claim costs due to ESSB 5726 to be more than any change observed in Georgia from the 2001 first party bad faith law change.

Oklahoma – In 1995, Oklahoma enacted a first party bad faith law. The Oklahoma standard is “reckless disregard of duty, intentional and with malice”. This is clearly a higher standard than the Washington “reasonable” standard, and a more typical standard for awarding punitive damages in excess of actual damages related to an insurance claim. Punitive damages in first party bad faith cases can be \$100,000, \$500,000 or unlimited, depending on the degree of conduct determined. The potential damages available resulting from the Oklahoma law change

are higher than Washington, but the standard for awarding those damages is higher. We expect the increase in claim costs due to ESSB 5726 would be more than any change observed in Oklahoma data from the 1995 first party bad faith law change, because we expect the higher Oklahoma standard to limit the number of bad faith claims as compared with Washington under ESSB 5726.

Rhode Island – In 1981, Rhode Island enacted a first party bad faith law. The Rhode Island standard is “wrongfully and in bad faith refused to pay”. This standard is more similar to Oklahoma than to Washington’s “reasonable” standard. Punitive damage are allowed, but not specified in the Rhode Island law. We are not sure if potential damages available resulting from the Rhode Island law change are higher or lower than would occur in Washington under ESSB 5726, but the standard of awarding those damages is higher. We expect the increase in claim costs under ESSB 5726 to be more than any change observed in Rhode Island data from the 1981 first party bad faith law change, because we expect the higher standard to limit the number of bad faith claims as compared to with Washington under ESSB 5726.

Texas – The 1995 Texas law change increased the cap on punitive damages available for first party bad faith actions from two times actual damages to three times. The Texas standard is “a violation of unfair claim practices” and this standard did not change in 1995. Most likely, this is a higher standard than Washington’s “reasonable” standard. We expect the increase in claim costs due to ESSB 5726 would be more than any change observed in Texas from the 1995 first party bad faith law change, because both the higher standard in Texas and the amount of damages in Washington went from \$10,000 to three times actual damages, while Texas changed from two times actual damages to three times actual damages.

Louisiana – The 1990 Louisiana law change introduced a first party bad faith law. The Louisiana statute defines bad faith in several ways, including “a breach of duty to reasonably settle claims”. Most likely, this standard is similar to the Washington “reasonable” standard, but may be slightly higher. The Louisiana statute allows for actual damages resulting from the breach, and a penalty of the greater of \$5,000 or two times the actual damages resulting from the breach. We expect the increase in claim costs due to ESSB 5726 would be more than any change observed in Louisiana from the 1990 first party bad faith law change, because under ESSB 5726, a plaintiff could be awarded up to three times actual damages, while in Louisiana the award can only be up to three times the amount resulting from the breach.

Data Sources

To address this issue, we compiled data known as “Fast Track” data for a period of time that encompasses the years surrounding the law change related to first party bad faith in the five states referenced above and in the total US.

The Fast Track Monitoring System, developed circa 1974, is a set of quarterly statistical reports reflecting loss trends in private passenger auto and homeowners experience. Prepared jointly by the Property Casualty Insurers Association of America, Insurance Services Office, Inc., and National Independent Statistical Service, data are submitted by about 50 auto insurance companies that comprise 70% of the nationwide business. Fast Track reports were initially prepared to evaluate whether there was a relationship between insurer claiming behavior and the gasoline shortage in the early 1970s. These reports contain the most up-to-date information on auto and homeowner insurance claims; because of their timeliness and unique quality, they are

invaluable to the NAIC and state insurance regulators, insurance companies, vendors, and others for tracking insured losses and other purposes.

The data contained in Fast Track reports include earned exposures (i.e., number of insured cars or homes), and paid loss and paid claim data, from which claim frequency, average cost per claim (or claim severity), and average cost per insured car (or pure premium) are generated. Data are available for the major auto coverages (bodily injury liability, property damage liability, all comprehensive, all collision, and personal injury protection, if applicable) and for homeowners in total. The underlying Fast Track data used in this analysis is available from the authors upon request.

ESSB 5726 would directly affect all first party insurance coverages. It would also apply to all types of insurance except certain health insurance plans. We have focused this analysis on personal lines of insurance (auto and homeowners) because Fast Track data is readily available for these types of insurance. Within the personal lines of insurance, first party coverages include the non-liability portion of the homeowners policy (approximately 85-90% of losses), auto uninsured motorists coverage, auto personal injury protection, auto medical coverage, auto collision coverage and auto comprehensive coverage. We expect the loss costs for all of these coverages, to some extent, would be impacted by ESSB 5726.

ESSB 5726 would introduce economic incentives for plaintiffs to file first party bad faith actions. Because the final award is a function of the actual damages, there is more incentive to file a bad faith action on larger claims. We would expect homeowners and uninsured motorist coverage to provide the most incentive, followed by personal injury protection. Collision,

comprehensive and medical will have a lower incentive because of generally lower severity of actual damages.

Unfortunately, uninsured motorist and medical coverage data is not available from the Fast Track system. We analyzed the data from the other coverages and determined that the inherent variation from year to year due to catastrophes and other factors overpowers any observations we can make on the impact of the law change for homeowners and comprehensive coverages. PIP coverage only exists in states with some variation of no-fault laws and was not available in our sample of five states. We thus focused on collision coverage.

Several comments about the data are appropriate as noted below:

1. We relied on PCI legal research to identify states with changes to first party bad faith laws, and the year in which the law was implemented. We did not independently evaluate the state laws. The identified states and year of change are shown in the table above.
2. For the data source, we relied on publicly-available Fast Track data for private passenger automobile and homeowners. This database is available quarterly by state and also available for all states combined.
3. As described previously, our approach was to compare countrywide trends in insurance cost to the cost trends in states with a first party bad faith law change. In effect, the countrywide trend data serves as a “control variable” in our analysis: it is intended to capture all the

underlying economic and environmental factors that affect claim costs in all states simultaneously.

The Fast Track data measures the underlying claim costs for automobile or homeowners insurance over time, and will reflect all underlying influences on the pure premium. However, there are numerous state-specific factors that affect the *level* of costs within each state. It is not the purpose of this study to model or isolate all of the environmental and economic impacts on pure premium, nor is it our intent to precisely quantify the impact of a change in first party bad faith laws on the level of pure premium using Fast Track data. We are simply observing whether the first party bad faith law change affects the *trends* in costs. We believe that the Fast Track nationwide data is an appropriate control data set for this purpose.

4. The following considerations concerning the Fast Track data used in our analysis should be noted:
 - A single Fast Track report contains only five years of data. We used ten years of data in our analysis so multiple reports were needed for each state.
 - The mix of companies included in any given Fast Track report may differ slightly from quarter to quarter. In order to maintain the same mix of companies for each state analysis, the state data and the nationwide control data was obtained from the same Fast Track report. Nationwide control data used in the report will differ in each report because of the company mix.
 - We chose to use 4-quarter moving data.
 - For simplicity, the analysis was done using year-end Fast Track reports.

- Paid data was used in our analysis.
 - The authors can be available to explain the details of the calculations and assumptions used in this analysis.
 - There is some inherent variation or noise expected in paid Fast Track trend data, especially in smaller states.
5. The data used in our analysis is on a paid basis, where the paid losses and claim counts represent claims closed in the quarter regardless of when the accident occurred. For collision claims, the time between the date of an accident and the payment and closure of a claim is generally short. We would expect the impact of the law change to be reflected in the claims data within a year or two.
6. The first party bad faith law changes were enacted in different years in the different states. For each state included in the analysis, we accumulated ten years of data, but because of the nature of claims closing quickly for collision coverage, we focused on the data one year prior to two years after the change in the law.

Analysis – First Party Coverages

Turning now to the analysis, for each year in the sample, we calculated the annual trend in claim frequency, claim severity and pure premium (the product of frequency and severity) in each state and countrywide. We then compared each state's trend to the countrywide average, and determined the amount by which it differed from the average. As mentioned, we would expect that before the first party bad faith law change, claim cost trends in the states would not deviate systematically from the countrywide average. However, in the years following the change, we

would expect average claim costs to increase more rapidly, and therefore, to systematically exceed the countrywide average.

Our sources were only able to identify the year of the law change in these states and not the day or month. For collision coverage, we expect the impact of a law change to start being reflected in the paid data almost immediately after the effective date of the law change because generally collision claims close quickly. An increase in bad faith actions on collision claims would tend to delay settlement of these claims, but because of the nature of the coverage, we would expect even these claims would be reflected in the paid data within a couple years of the effective date.

If the effective date of the law change was early in the year, we would want to base the measurement on the year prior to the law change, and if the effective date of the law change was late in the year, we would want to base the measurement on the year of the law change.

Below is a chart displaying a summary of our results:

FIRST PARTY BAD FAITH LAW CHANGES			
Difference in State Paid Pure Premium Trend Relative to Countrywide 2-Year Change			
State	Year of Law Change	Based on Year of Law Change	Based on Year Prior to Law Change
Georgia	2001	7.7%	1.9%
Oklahoma	1995	1.1%	3.5%
Rhode Island	1981	0.9%	12.6%
Texas	1995	6.3%	7.5%
Louisiana	1990	2.6%	8.9%
Average		3.7%	6.9%

Our premise, that trends in states with law changes that expanded or broadened first party bad faith actions would have a greater increase in pure premiums than countrywide in the years after the law change, is observed in the data. The pure premium trends in each of the five states exceed the countrywide pure premium trends two years after the law change. This is true when measuring the change from the year prior to the law change, as well as when measuring the change from the year of the law change. This empirical evidence suggests there will be an increase in insurance costs in Washington if ESSB 5726 becomes law.

While the average impact of the change across the five states initially may appear relatively small – from approximately 3.5% to 7% – recall that this is not the absolute increase in costs, but simply the amount by which the cost increases in these states exceeded the average rate of increase countrywide. For example, if the average countrywide trend was 5%, then the introduction of first party bad faith would roughly double the annual rate of increase on costs (assuming an impact at the mid-range of the interval). Thus, while the impact on the level of costs may appear small, the impact on the change in costs could be much larger. In addition, as described previously, we expect that ESSB 5726 would impact insurance costs more than any of the five states used in the analysis, and that it would have a greater impact on first party coverages with larger claims, such as homeowners and uninsured motorist, than on collision coverage.

To evaluate the potential impact of these changes on consumers in Washington, consider that in 2007, the estimated average personal auto premium in Washington (for consumers purchasing

full coverage) is \$1,083, while the estimated average homeowners premium is \$758.³ Now assume a typical household with two autos and a home: in 2007 such a household would pay a total of \$2924 for insurance coverage. However, as noted, insurance costs tend to increase over time; for example, if the average trend in costs was 5% per annum, then absent any other changes, in 2008, the aforementioned household would pay 5% more for insurance, or a total of \$3070. Of course as we have discussed, ESSB 5726 could potentially cause Washington cost trends to substantially exceed countrywide trends, implying that costs in Washington could escalate far more rapidly than the countrywide average.

In order to provide a sense of the dollar impact of these changes, assume that ESSB 5726 causes annual trends in costs to exceed the countrywide average by 7%, the value at the upper end of our estimated range.⁴ Under the hypothetical example, the average premiums in Washington in 2008 would be:

Estimated 2008 Average Premiums State of Washington			
	Automobile	Homeowners	Household
Without enactment of ESSB 5726	\$1,137	\$796	\$3,070
After enactment of ESSB 5726	\$1,213	\$849	\$3,275

Under the hypothetical example, the increase in average premiums in Washington in 2008 would be:

³ Estimated based on data provided by Property Casualty Insurers Association of America from the NAIC Auto Insurance database and the NAIC property insurance reports.

⁴ As mentioned in the discussion above, we would expect the cost increases due to ESSB 5726 to be greater than was experienced in other states, and greater for coverages other than collision. Since our range is based on collision coverage trends in the five states reviewed, it is not unreasonable to believe that the increase in Washington would be at the upper end of the range. Of course, other assumptions would produce different results.

Estimated Increase in 2008 Average Premiums State of Washington			
	Automobile	Homeowners	Household
Without enactment of ESSB 5726	\$54	\$38	\$146
After enactment of ESSB 5726	\$130	\$91	\$351

Extrapolating these results to all lines of property casualty insurance in Washington, we observe that in 2006, direct written premiums for all property and casualty lines of business in the state were \$8.8 billion.⁵ Excluding the health lines and trending the remaining premium at 3% annually, we estimate that 2008 property and casualty (non-health) premiums will be approximately \$9.3 billion. If ESSB 5726 increases premiums in Washington by 7% and is affirmed by the voters in November, it will cost consumers in excess of \$650 million annually.

EVIDENCE FROM THIRD PARTY COVERAGES

In this report, we have evaluated the impact of changes in first party bad faith laws on the cost of insurance by focusing on cost changes in first party coverages. In a previous report, however, we performed a similar analysis, observing changes in insurance cost trends associated with changes in third party bad faith laws.⁶ In that study, we identified six states which implemented the doctrine of third party bad faith during the sample period, and observed the cost trends in those states relative to countrywide trends for the seven years following the law change.⁷ The results of our analysis indicated that in the seven years following the introduction of third party

⁵ The premium data are from Highline Data, as filed by all property and casualty insurers in their 2006 annual statements. We provide this extrapolation for illustrative purposes only; we have not evaluated whether the impact on all lines of coverage would be the same as on first party coverages.

⁶ See our earlier study entitled “The Impact of Third Party Bad Faith on Insurance Costs”, May 8, 2007, available from the authors on request.

⁷ We looked at trends for a longer time period in that study because the changes in third party bad faith laws are more likely to cause changes in the patterns of filing and settling liability claims, which may take many years to emerge, investigate and settle. In this report, since the law change affects first party rights, the impacts are more likely to be felt in the first party coverages, which have much shorter time patterns.

bad faith, five of the six states had higher cost trends than countrywide, with an average difference of more than 50% over the period (or an annual difference of more than 6% per year).

In addition, we also noted that in our sample of 42 state/year observations (six states for seven years each), we found that in 33 of the 42 cases, the annual change in costs within the state exceeded the countrywide change in costs during that year, oftentimes by a very large margin. The likelihood that we would observe 33 instances where state trends were greater than countrywide, if third party bad faith claims truly had no effect of costs, is very slim indeed – in fact, the probability of observing such an outcome is less than 2 in 10,000. As stated in the report: “We believe this demonstrates clearly that the introduction of third party bad faith claims tends to increase insurance costs, and would likely increase costs in Minnesota.”

While we recognize that the proposed Washington law change, ESSB 5726, affects first party rights, not third party, we believe the results of our earlier study are probative nonetheless. The underlying hypothesis of both studies is that participants to the insurance transaction make rational economic decisions as to whether to file, litigate and/or settle claims. These decisions are conditioned on an implicit cost/benefit analysis, where the parties consider the potential payoffs associated with alternative behavioral choices and weigh those benefits against the attendant costs. As discussed here (and in our earlier report), anything that affects the balance between the expected benefits and costs will affect the existing patterns of insurance claims.

For example, consider the current situation in Washington. From the claimant’s perspective, the decision as to whether to pursue a first party bad faith claim is made based on existing legal rules, and the potential recoveries associated with claim filing. Also, from the insurer’s

perspective, claims are settled or litigated based on the potential costs associated with the alternative options. ESSB 5726, if it becomes law, would introduce the opportunity for treble damages, as well as provisions that require the insurer to bear attorney and expert witness fees if the plaintiff prevails, and the balance between the costs and benefits associated with bad faith claim filing and settlement will change dramatically.

From the claimant's perspective, the expected benefits of claim filing would increase and the expected costs would decline. Obviously, such changes should lead to an increase in the rate at which claims are filed. From the insurer's perspective, on the other hand, the expected costs of contesting a claim would increase dramatically, which should lead to a decrease in the rate at which insurers contest potentially unreasonable or fraudulent claims. Thus, from both sides, we would expect an increase in insurance claims and costs. In this sense, the results of our study on third party bad faith can be useful in indicating the cost impact of changes in first party bad faith rules, since in either case the change in legal doctrine changes the balance between benefits and costs of claim filing. Given that both types of law changes (i.e., both first party and third party) tend to increase potential recoveries by claimants and increase expected costs for insurers, they should both lead to the same types of behavioral response.

As to the magnitude of the cost increase associated with the introduction of third party bad faith, we did not conduct an analysis to quantify the impact in terms of dollar costs per insurance policyholder. However, we noted that previous research by Hamm, based on a carefully specified econometric model, concluded that the presence of a third party bad faith doctrine is associated with an increase in auto BI liability insurance premiums of up to 14.5%. Our

findings, that annual trends in costs after the implementation of such a doctrine are clearly higher than in other states, are broadly consistent with the Hamm results.

CONCLUSIONS

The previously cited General Cologne Re study on bad faith states: “We feel safe in concluding that bad faith, and first party bad faith in particular, is costly for insurers and worth considerable effort to control.” The principal results of our analysis are broadly consistent with this conclusion – that is, legal and judicial changes that permit or expand the rights to file first party bad faith claims against insurers have led to increases in insurance costs. While we have attempted to measure this effect using cost changes in personal lines of insurance, the main reason for this is the ready accessibility of long-term data series that permit the observation of cost impacts across a broad cross-section of the insurance industry. However, we believe that the same general results would prevail in commercial lines as well as personal lines, because in principal, the factors driving the cost increases are common across all lines of insurance.

Those factors relate largely to the predictions of economic theory – that is, legal changes that either increase the expected benefits of claim filing for plaintiffs, or increase the expected costs of contesting claims for insurers, will tend to increase the frequency and/or severity of insurance claims. If we apply this general economic theory to the circumstances surrounding ESSB 5726, we would expect the provisions of the law to increase claims costs related to both first party bad faith, as well as the assignment of first party rights to third parties. Our observation of the cost trends in a number of states that have made related changes in their laws is consistent with such a prediction. As to the magnitude of the cost increase, we have not conducted an analysis that quantifies the impact in terms of dollar costs per insurance policyholder. Our findings, that the costs of both first party and third party insurance coverages would increase due to ESSB 5726, are consistent with our study of first party law changes in five states and with our research of

other sources. The magnitude of the costs increases will ultimately be determined by the Washington judicial system, if the voters allow ESSB 5726 to become law.