In Defense Of Rate Regulators

BY MARTIN M. SIMONS

Insurers accuse regulators of suppressing rates for political reasons, but almost all rate denials and revisions are based on sound actuarial assumptions.

Underwriting cycles became evident soon after insurance was first written by merchants for seagoing vessels. There are many causes of the cycle, including inaccurate ratemaking techinques, overzealous competition, unforeseen economic changes and regulatory pressures. Currently, many property/casualty insurers cite regulatory pressures as a major reason for the problems they now confront. While such pressures may be present, a close examination of the criteria underlying rate regulation provides a better understanding of the situation.

Establishing property/casualty insurance rates for the future, based on an analysis of past experience, is a process fraught with probable error. Actuarial science, as underwriters know, is more art than science. At best, it provides only an estimate of future expectations. Although techniques have been developed to maximize their accuracy, the estimates often prove to be inaccurate.

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There are many instances in which current ratemaking methods produce insufficient income for insurers to earn a reasonable profit. In most states, property/casualty insurance is a profitable business, albeit to a lesser extent than most other industries. The shortfalls generally derive from inaccurate industry estimates, unforeseen economic changes and other aspects of the ratemaking process.

Rate-level development requires the forecasting of several variables, each of which includes a range of possible outcomes that affect its accuracy. Since the estimate and the occurrence almost always differ, because of the many variables that must be forecast, any rate may be questioned or appropriately replaced by one derived from a different approach to the process.

Despite the inherent drawbacks of the ratemaking process, regulators must determine whether a filing meets the statutory criteria

for ensuring that rates are not excessive, inadequate or unfairly discriminatory. To make that determination, regulators must analyze the individual components of each rate filing, including projections based on past experience.

A typical rate filing review involves analyses of past rate revisions, loss trends, premium and loss development, expenses, taxes, assessments, investment income and an underwriting profit margin that will produce a reasonable rate of return for the insurer. However, insurers and regulators often use different methodologies, experience periods and underlying assumptions resulting in significantly different conclusions as to the appropriate rate. Regulators and insurers may differ even on the basic criteria that should be used to calculate future rates.

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For example, most insurers calculate trends using linear or exponential models. In many cases, however, regulators find that neither model produces satisfactory results and may select a different technique. Similarly, there are several actuarially accepted methodologies for calculating loss development, and even when the parties agree on a method, there may be different opinions on the number of years of past loss reserving experience to use in estimating future loss development. Revisions made by regulators to account for perceived inaccuracies are not necessarily intended to suppress rates, even when they are lower than those in the original filing.

If the regulator sees underlying changes in an insurer's expenses that have not been appropriately accounted for in the rate filing, he or she may use a different approach to forecast expenses. In many filings, insurers fail to separate variable expense components related to premium changes from fixed expenses that are independent of rates. Accounting for such differences does not constitute rate suppression.

Calculations in filings for rate revisions frequently use standard formulas with little or no regard for changes in the underlying criteria. However, changes brought about through legislation, improved enforcement of statutes, shifts in unemployment, the costs of services and other criteria do not necessarily fit into the formula approach. Regulators frequently are aware of changes in their own states that affect rate calculations based in part on projections of past experience. The results of a formula approach to ratemaking also are questionable when erratic statistical data is included in the past experience.

DIFFERENCES OF OPINION

Investment-income calculations are another area in which regulators and insurers often have differences of opinion. Recent changes adopted by the National Association of Insurance Commissioners for the accounting methodologies used in the Profitability Report and the Insurance Expense Exhibit point out that regulators and insurers have inherently different views of a company's return on equity. Insurers generally view the appropriate profit margin as a derivative of expected earnings from the product while the filed rates are in effect. They view the requested rates as an investment in the future, independent of current reserves held for that line of insurance. In contrast, regulators look at each insurer's expected total return, including investment income, from the line under consideration.

These two approaches account differently for investment income on current loss reserves, unearned premium reserves and surplus. The issue of whether or not investment income on surplus should even be considered in the rate filing, as well as the method of allocating that surplus, has produced heated discussions between regulators and insurers.

Even in states where regulators are accused of intentionally suppressing rates, there is competition that runs counter to insurers' past experience. Overzealous competition continues to be a major contributor to underwriting cycles, even though it is generally ignored in most discussions on the topic.

FACTS OMITTED

The growing residual markets for automobile and workers' compensation insurance also has been cited as evidence that some states are rate suppressors. In reality, most insurers don't want to underwrite the risks placed in residual markets because of their size, location or type, or for other reasons that are not directly related to rate levels.

Regulators generally have actuarially supported reasons for taking exception to an insurer's or an advisory organization's filed rates. Proponents of the rate-suppression scenario often omit this fact in their zeal to place the

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onus for negative results on the regulator. Insurance industry ratemakers are biased by their individual corporate goals and objectives. This natural and understandable bias frequently shifts their focus from increased profitability to maximum market share. Even casual observers should recognize that insurers' inconsistent objectives are the root cause of the underwriting cycle.

ROOTING OUT THE BIAS

In the proper execution of their duties, regulators must review each rate filing with an eye toward determining where biases may have entered into the insurer's ratemaking methodologies. Critics point to the fact that regulators are more likely to reduce a rate request that is considered excessive than to increase one that appears to be inadequate. However, in the interests of consumers, regulators may allow an insurer to forfeit a portion of its profit potential for market-share considerations, unless it is detrimental to the company's financial stability.

Current pressures mandate that regulators review each transaction, whether related to rates or not, for its potential effect on the insurer's solvency. It would be unwise for the regulator to arbitrarily suppress an insurer's rates to the extent that the company becomes a burden on the state's guaranty fund and, ultimately, the public. This necessary interrelationship between rate and solvency regulation is why responsibility for the two must lie with a single entity. Rate regulation without regard to solvency regulation is doomed to failure.

AWAITING THE SHIFT

The underwriting cycle will continue to plague regulators and insurers. When the cycle again shifts to overzealous competition, it will be interesting to see where insurance industry pundits lay the blame and whether they will be as willing to label their own counterparts as rate suppressors. Meanwhile, as the subject of regulatory rate suppression continues to be aired, the industry, the press and the public must understand that rate filing denials are based on substantive actuarial support and not on regulators' desire to lower premiums for political reasons. □