When making decisions regarding rates or any other aspect of the insurance process, the regulator must constantly balance economic, legal and social criteria in order to maximize the benefits to citizens.

Rate Regulation Revisited

BY MARTIN M. SIMONS

Most states have enacted statutes mandating that rates for property/casualty insurance not be excessive, inadequate or unfairly discriminatory. Along with insurer solvency, these requirements delineate the primary objectives of rate regulation. Generally, the subject is explored no further except for the occasional textbook definition of the terms excessive, inadequate and unfairly discriminatory. In reality, however, because of the complexities and social interest in property/casualty insurance rates and the ratemaking process, these criteria, at times, are actually defined by certain other rate regulatory objectives:

- Social congruity.
- Maintenance of availability.
- Rate stability.
- Minimizing political ramifications.
- Maintenance of affordability.
- Maximizing benefits to citizens.

As an example, the requirement that rates for property/casualty insurance not be unfairly discriminatory is colored by the jurisdiction involved. In one state, private passenger automobile insurance rates must reflect the differences in the claims experience of youthful and adult drivers. Another jurisdiction requires different rates for youthful males than it does for youthful females. In yet a third jurisdiction, neither age nor sex may be utilized as a rating criterion.

The definition of unfair discrimination in these instances may be completely contradictory, regardless of actuarial or statistical considerations or classification experience differentials. In fact, in the first example, discrimination is mandated, while in the third it is prohibited by statute. Legislative mandate, therefore, has defined what constitutes unfair discrimination, and social congruence becomes a mandated objective of auto rate regulation.

The varying degrees of no-fault automobile insurance and the varied treatment of involuntary market mechanisms in workers' compensation and automobile insurance are other examples of social congruence. Because of their extreme impact on large segments of the public and the resulting legislative and consumer involvement in the establishment of rates and rating plans, these lines epitomize the concept of social congruence.

The need for adequate property/casualty insurance protection by virtually all aspects of modern society creates a secondary objective of insurance rate regulation: the maintenance of availability. When the regulator calculates the reasonable rate of return that is to underlie an insurer's rate levels, the number of insurers providing similar coverage will alter the level that may be considered reasonable, since the regulator is aware of the extreme negative ramifications of a lack of availability for a given line of insurance in his or her jurisdiction. The situation in general liability insurance in the mid-1980s created a lack of availability that brought this objective to the forefront of commercial liability insurance regulatory activity.

COMPETING FOR PREMIUMS

The liability crisis also increased the awareness of the necessity for insurance rate stability. Prior to the crisis period, insurers were competing for premium dollars by charging rates that were less than adequate. Economic forces as well as increasing industry operating losses combined to make continued competition untenable at the rate levels then current, and the result was an increase in rates for all classes of liability insurance.

In addition to filed rate increases, insurers called on methods that are

MARTIN M. SIMONS, ACAS, MAAA, a previous contributor to Best's Review, *is chief casualty actuary and Property and Casualty Division director of the Department of Insurance in South Carolina.*

mainly outside of the regulatory process to obtain an additional influx of dollars, and the result was an extreme increase in premiums. These actions intensified the regulators' concern for rate-level stability, but, in reality, regulators had little control over the stability of commercial lines insurance rates during that period because the availability of coverage took precedence over the stability of rate levels.

In many cases, usually because of short-range marketing considerations and the phase of the underwriting cycle, an insurer may postpone for several years increasing rates for a specific line of insurance to their actuarially appropriate level. When the cycle phase changes, and the insurer determines the need for rates that are more adequate, the increase that is necessary becomes one that, because of its magnitude, may be socially unpalatable.

POLITICAL RAMIFICATIONS

For example, let us assume that ABC Insurance Co.'s private passenger automobile experience in State X for 1986 indicates the need for a 13% rate increase. For marketing purposes, ABC's management decides to postpone the necessary increase. One year later, the experience worsens, and the need now is for an increase of 22%. Again, fearing a decrease in market share, ABC decides to wait. In 1988 ABC determines that the losses in State X have become too high and files for a 31% increase in private passenger auto rates.

Newspaper headlines now proclaim, in bold print, "Insurer Seeks 31% Automobile Increase." Policyholders immediately contact their state legislators and call for tough and decisive regulatory action to disallow the gluttonous actions of the insurance industry. Suddenly, the regulator is confronted with another rate regulatory objective, that of minimizing political repercussions.

If ABC had filed for a 13% increase in 1986 and an 8% increase in 1987, even if the approved amount had been less than what was requested, the need for an increase in 1988 would have been substantially lower, and the political ramifications would have been less extreme. Insureds must be able to cope with increases in insurance rates. Most budgets can handle modest increases but when several years' increases are implemented at once, the public becomes extremely vocal, and the resulting pressures on the regulator and, subsequently, on the insurance provider, increase.

While this objective relates to political ramifications, it also relates directly to the goal of stability. Here again, as with some other objectives, it appears that the regulator has little control over insurer actions that run counter to that stability.

DIFFICULT AND CONTROVERSIAL

The most difficult objective to quantify, and perhaps the most controversial to deal with, is the maintenance of affordability. Often, even though other objectives have been met, insurance prices reach a point at which, in perception or in reality, insureds can no longer afford adequate coverage.

Those insureds are faced with several alternatives of varying degrees. They may limit or cease operations completely, decide to continue operating with little or no insurance coverage or attempt to find alternative sources of coverage. During times of a perceived or actual lack of affordability, the private insurance sector loses market share, the economy suffers and, at times, claimants are unable to ob-

tain adequate indemnification for their losses.

The public becomes extremely vocal during these times, and the pressure on the rate regulator again increases as legislators, consumer groups and the public at large demand solutions. At this point the paramount objective of all regulation takes control—the need to maximize the benefits for the citizens for whom the regulator is responsible.

PRIMARY CONCERNS

At the basis of state regulation of insurance is the premise that, because they lack homogeneity, states face different problems of differing magnitudes and respond with different solutions to maximize the benefits to their citizens, while working within the confines of statutory definitions and mandates.

Whether the regulator is appointed or elected, this must be his or her primary concern in dealing with all aspects of regulation. Regulation without a sincere regard for the citizens of the state is tantamount to economic suicide for each of the more than 50 officials who are responsible for insurance regulation in the United States.

When making decisions regarding rates or any other aspect of the insurance process, the regulator must constantly balance economic, legal and social criteria in order to maximize the benefits or, at times, to minimize the detrimental impact to the citizens of the state.

A REASONABLE RATE

As we can see, then, the six objectives cited earlier play an extremely influential role in rate regulation, and the actuaries on both the regulatory and industry side of the picture may not play as primary a role in the establishment of rates as has been believed. Society sets the acceptable standards for "fair" discrimination. The availability of a given insurance product or coverage plays a major role in establishing a reasonable rate of return to the insurance company, and marketing or social considerations often cause the final outcome of the insurance pricing process to run counter to the actuary's statistically calculated recommendations.

Mathematical and statistical methods used to determine rates that are not excessive, inadequate or unfairly discriminatory are often preempted by marketing decisions or social and political pressures. At this point in the process, because of the disparities between the "indicated rate" and that which is ultimately placed in effect, the insurance company actuary can provide, at best, an estimate of the impact that eventually will be felt.

While this may seem to apply strictly to states with a prior-approval type of rating law, the recent activity in California attests to the social, political and marketing pressures in an "open competition" environment as well. The passage of Proposition 103 places the public in a direct rate-regulatory role, and only the long-term final outcome will determine the extent and effectiveness of that role.

Rate regulation, therefore, is often predicated to a greater extent on stability and affordability than on a specific, actuarially calculated level of adequacy or system of classification. The lack or perceived lack of stability is the nemesis of all facets of the property/casualty insurance industry.

Insurance executives in decision-making capacities can help bring about the stability necessary for adequate regulation. In reaching pricing and marketing decisions, they must balance their company's marketing needs with the need for a specific profit level, and these decisions must be made on a constant and ongoing basis. This does not preclude the inclusion of marketing and underwriting desires in the final result, even when those desires do not completely agree with the actuarial calculations.

LONG-RANGE PLAN

Such criteria, however, must be incorporated as part of a long-range plan in order to minimize rapid upward and downward movements in the rate levels. It would be naive to believe that all of the forces that cause a lack of insurance rate stability can be removed, but appropriate actions on the part of regulators, legislators and those in the industry can lessen the extreme fluctuations that are present in the property/casualty industry.

Of course, there still will be those jurisdictions where, for various reasons, the industry will find itself in an untenable position. In these jurisdictions, regulators and legislators must work with the industry to bring pricing, profitability and regulatory objectives into agreement with the economy. □