THE CHANGING REGULATORY ENVIRONMENT (SEMINAR ON RATEMAKING, 3/91)

D. Lee Barclay

CAS SEMINAR ON RATEMAKING
"THE CHANGING REGULATORY ENVIRONMENT"
March 14, 1991

D. Lee Barclay, FCAS, MAAA

Introduction

Why would a casualty actuary, in his or her right mind, become a regulator?

Maybe there's no good answer for that. But I can tell you this: It's not because the pay is better than in the private sector. It's not for the excitement of attending NAIC meetings at exotic locations throughout the United States. (I remind you that this year's NAIC Spring Zone meeting is to be held in Charleston, West Virginia.) It's not for the pleasure of reviewing totally unorganized rate filings prepared by underwriters or marketers who are unfamiliar with actuarial methods. It's not for the privilege of examining companies whose loss-reserving data base contains no more than what is necessary to fill out Schedule P. And it's not for the sheer joy of doing battle over a disapproved rate filing or an examination adjustment to reserves.

As you can tell, I love my job!

Whatever the reason, by the last count I have, "Government" employs about 40 CAS members, and all but a handful of these work for state insurance departments. That's about 2% of the CAS membership. As a member of this tiny minority, I appreciate the opportunity to speak to you today--assuming, of course, that you can temporarily set aside your questions regarding my sanity.

As an actuary and a regulator, I would like to focus on the actuary's role in rate regulation, my perception of current trends in rate regulation, and some key questions for the future.

<u>The Regulator's Role</u>

The role of every regulator is largely determined by state law. As an actuary in regulation, I must work under this restriction. For everything I do, I must find my authority in a statute. If the authority is not there, I can't do it. If something I do is beyond that authority, it can be undone through the administrative hearing process, or through the courts--embarrassing both myself and the Commissioner's Office.

Even in prior approval states such as Washington, it is clear that competition--not the Insurance Department--is the primary regulator of rates. Whether competition is an <u>adequate</u> regulator of rates will always be a matter of debate, and I don't propose to answer that question today. In theory, at least, competition should result in rates that are neither excessive nor inadequate--rates that are in line with insurers' costs. And in theory, competition should yield rates that are not unfairly discriminatory--because adverse selection gives insurers an incentive to develop more accurate classification systems.

However, I believe that rate regulation has significant benefits. First of all, it is a needed control where competition is lacking. The degree of competition varies by line, by region (even within a state), and over time. And the degree of competition cannot always be easily determined from the market structure. For example, in my state there is heated competition for medical malpractice business, even though there are only about five active insurers in this market and one of them has a 50% market share. Many more companies sell inland marine insurance, but the level of competition is much lower. In the context of time, when the rate cycle turns and the soft market becomes hard, some sellers abandon some classes, but there are still many sellers. The nature of the competition is suddenly different, however.

Second, rate regulation educates insurers. There are a surprising number of small- to medium-sized companies out there who simply do not know what they're doing when it comes to making rates. They have heard the word "actuary," but they have never used one. Concepts such as trend, loss development, and credibility are unfamiliar to them. The rate approval process forces them to learn ratemaking methods. (Some have even attended the CAS Seminar on Ratemaking, at a regulator's suggestion.) The approval process protects these amateur ratemakers from making poor decisions based on false interpretations of data. And it shields their competitors from the effects of having someone out there selling at irrational rates.

Third, rate regulation can be used to promote solvency. Rate regulation and solvency regulation are generally viewed as being at cross purposes with each another. This is one argument that has been used against federal regulation of solvency: at least under state regulation, the same regulator has to deal with both rates and solvency, and so cannot regulate rates and ignore solvency considerations. Still, state insurance departments are not known for disapproving rates on the grounds that they are inadequate. Politically, it is difficult to explain to the public why the insurance commissioner has told companies to get their rates up. However, it can be done, and it is done in some states.

Fourth--and I admit this is a minor point--we regulators catch company errors. For example, a recent rate filing in Washington involved a 15% base rate reduction to account for a change in the base deductible. Unfortunately, the insurer applied the factor twice and printed rates that were 15% below what it intended. We caught that error before the rates were used. I presume the company would have caught it eventually, but I'm not sure when.

Trends in Rate Regulation

With the passage of Proposition 103 in California and growing consumer pressures in other states, it is no secret that the current trend is toward stricter regulation of rates. The arguments about the virtues of the free-market economy and the fall of communism in Eastern Europe seem to be falling on deaf ears.

I can tell you little that you don't already know about trends in regulation. But I do believe that trends will follow public perceptions. In fact--and unfortunate as this may be--they may be based more on appearances than on reality. Everybody thinks insurance costs too much--and will continue to think that, even if the friendly, local actuary can show that it's really a good deal. Everybody thinks insurance companies make too much money. And because the insurance business is so esoteric, the public assumes that companies are making even more money than what's reported in the newspaper. In states without significant rate regulation, there is a perception that nobody is protecting the consumer from being ripped off by the rich insurance companies. Insurance commissioners--and appointed ones often have close ties to the industry--are seen as industry lackeys. Recent scandals in several states have reinforced this view. And we could hope that few people saw the CNN report last year on the interaction between commissioners and the industry at NAIC meetings, but there are bound to be more reports like that.

In sum, truth often has some bearing on public perceptions, but the connection may be rather tenuous. In any case, it is the perceptions that will determine the future of rate regulation.

Key Questions for the Future

I would like to leave you with two key questions regarding the future of rate regulation.

First, how much rate regulation is the insurance industry willing to accept as good for it? In the context of the Persian Gulf war, we've heard references to "drawing a line in the sand." Exactly where will the insurance industry draw its line in the sand, and fight regulation only when the regulators cross that line?

I am beginning to understand that there may be many lines in the sand. The industry is not united on where to draw the line--how much regulation, and what form of regulation, is acceptable. For example, insurers are taking different positions on changes to the McCarran-Ferguson Act. Some may prefer federal regulation to state regulation--one gorilla instead of 50 monkeys, as the comparison goes. As one of the monkeys, I can understand that.

Everyone would recognize that it is good public relations for the industry to accept a modest amount of regulation. When the industry fights regulation that appears reasonable, it generates negative public opinion. But the question is how and when to translate this realization into company decisions.

I would like to use a recent controversy in Washington State as an example. Last December our insurance commissioner adopted a new regulation on property and casualty ratemaking. Under our prior approval system, the rule provides a framework in which insurers can show that their rates are not excessive, inadequate, or unfairly discriminatory.

The approach we took was to rely on the "Statement of Principles Regarding Property and Casualty Insurance Ratemaking," which the CAS adopted in 1988. If we started with something that actuaries agreed on, the opposition would, we hoped, be minimal. Our rule actually incorporates Principle No. 4 of the CAS document, which defines the standard that appears in most state rating laws as follows:

> A rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer.

According to the CAS statement, "Such costs include claims, claim settlement expenses, operational and administrative expenses, and the cost of capital."

Our rule is flexible in that it does not prescribe a particular model to be used in determining an insurer's cost of capital. Nor does it set a maximum rate of return or range of returns. It lists several ways in which an insurer may establish its cost of capital or target return on equity. The insurer must then choose an underwriting profit provision that is consistent with its target return.

Faced with a regulation like this, the industry must ask: On which side of our line in the sand does this regulation lie? Should we accept it? Can we live with it? Should we fight it?

We found that companies drew very different lines in the sand. If we continue with the Persian Gulf analogy and liken the adoption of this regulation to Iraq's annexation of Kuwait--that's an unfortunate comparison, because the regulation is not <u>nearly</u> so bad--we could say that some insurers drew the line to the south of Kuwait, and some to the north. The lines in the sand were that far apart! Several insurers supported the regulation, noting that it was actuarially sound and suggesting that it would streamline the rate approval process. A handful of insurers opposed the regulation in the belief that it was a clone of Proposition 103 and that the rate of return concept had no place in the rate review process.

Some elements of the insurance industry went so far as to propose legislation to overturn the rule. One proposal, for example, was a bill that would permit the insurance department to disapprove a rate, in a competitive market, only if the rate were found to be inadequate. "Excessive" and "unfairly discriminatory" would no longer be grounds for disapproval. Now regardless of whether such a system would be better or worse, the proposal was so patently one-sided that it quickly generated bad press for the industry. What do the insurance companies want? They want the commissioner to protect <u>them</u> against inadequate rates, but the commissioner should not be allowed to protect the <u>public</u> against excessive or unfairly discriminatory rates.

So where do you draw the line? How hard do you push for freedom from regulation? How much rate regulation is desirable as a safeguard against the more onerous regulation that can arise from a consumer revolt?

The second--and last--"key" question I would like to leave with you is more of a short-term issue--but it could be a long-term problem, if the industry's rate cycles continue unabated:

How disruptive will the next hard market be? We all believe the hard market is coming, but we don't know exactly when. The industry has yet to live down the tarnishing of its image that resulted from the last hard market. People still talk about the liability insurance crisis of the mid-1980's. I would suggest to you that, if the next hard market is anything like the last one, the cry for stricter regulation of rates will be renewed with more vigor and more public support than ever before.

Conclusion

Before I conclude my comments, let me say that I believe that increased use of actuaries--both consultants and state employees--will continue to be one aspect of the changing regulatory environment. Regulators will be seeking more information from company actuaries, as well. Actuaries have the skills to perform analyses upon which regulators can base reasonable decisions. We actuaries can make valuable and sensible contributions to public policy discussions relating to regulation. We must be willing to step forward and participate.