ABSTRACT OF THE DISCUSSION OF PAPERS READ AT THE PREVIOUS MEETING

EXPERIENCE RATING *In Rem* AND *In Personam*—LEON S. SENIOR

VOL. XI., PAGE 211

WRITTEN DISCUSSION

MISS EMMA C. MAYCRINK:

This paper not only introduces a novel idea, but is in itself unique, in that it treats of an administrative problem instead of the usual subjects which have been presented at the meetings of the Society. The fundamental problems of making rates, rating plans and rules governing their application, are urgent and must necessarily come first. This might be termed the legislative function. Of no less importance in the development of casualty insurance is the interpretation and final administration of the plans which have been adopted. Unquestionably the executive and judicial functions demand thought and study since a lack of intelligent and consistent application of laws and codes tends to defeat their purpose and to destroy public confidence in the entire system.

Mr. Senior's paper is in itself a discussion. Both sides of the argument are given, and since the conclusion finally drawn appears to conform to the rule as it now stands in the New York plan and is practically the same as that in the plan issued by the National Council on Compensation Insurance for most of the other states, further discussion would be superfluous.

It might, however, be noted in passing that the idea of making the risk the criterion for merit rating, regardless of ownership, if followed to its inevitable conclusion, becomes as fantastic as Frankenstein—a mere matter of structure and mechanisms lacking authoritative control. The Industrial Schedule which is devoted almost entirely to the physical hazards embodies the idea of a merit rate based on the tangible evidence disclosed by an inspection of the risk, or to be more specific, the plants making up the entire risk. Experience rating was devised, whether wisely or not, to measure those other intangible features of the

risk, good or bad, dependent to a great degree upon the individual ownership or group of owners and those to whom they delegate authority.

It is stated that the status of the ownership and control is not permanent and the suggestion is that it is not always easy to follow the gamut of changes which may take place. Is it not equally true that the risk is also a variable, changing with, and dependent upon, the ownership?

It would seem that decisions under this rule should be governed entirely by what we are trying to do. If the experience rating plan is to measure the so-called morale, the rules of the plan should follow the fundamental intent. It is to the ownership and management which is controlled by the ownership that we look for the policies which produce the risk's experience.

The rule to exclude experience upon change of ownership was evidently inserted to discourage attempts to avoid the results of charges resulting from poor experience. The difficulty which has been met with in its application is invariably encountered in applying any plan of merit rating based upon experience. When there are no bad accidents the assureds are eager to receive the reward of a lower rate and demand that even greater credence be given to individual risk experience. When, however, frequent or severe accidents occur they seek to reduce the penalties or avoid them entirely.

This rule of the experience plan, as well as others which are apt to provoke controversy, should be definitely phrased so as to minimize any chance of avoiding the penalty of heavy loss experience by the use of some pretext such as transfer of stock from one member of the family to another or by simply hiring a new manager or a new foreman. Nor should it be necessary to call upon a committee of underwriters to go into the details of the various financial reorganizations to determine whether a change of ownership has occurred. This can only be determined by an intimate knowledge of the companies' books of accounts. Examination into these details in committee sessions takes valuable time. Furthermore it is not exactly an underwriting question.

To allow a company to drop its old experience, the change should be so patent that the risk no longer resembles its former self any more than it resembles an entirely different risk. Any

other interpretation of the rule certainly encourages attempts to avoid charges and opens the way to unfair discrimination.

MR. SYDNEY D. PINNEY:

Of all questions referred to rating organizations for decision in connection with the application of the Experience Rating Plan perhaps the one which recurs most frequently is with respect to the elimination of the past experience of a risk on the grounds that there had been a material change in management of the plant in question. The rules of procedure incorporated in the Experience Rating Plan provide that the past experience shall be disregarded only if the change in management is material, but that if the change is merely nominal, then the past experience shall be utilized in determining the experience modification. It is evident that the terms "material change" and "nominal change" require clear cut definition or otherwise the element of judgment will play too great a part in the decisions rendered by the rating organization, and this may lead to inconsistencies, if not actual inequities.

In discussing this subject Mr. Senior has not only dealt with the problem of giving a clear interpretation of the existing rule but has also discussed the merits of an altogether different procedure which, in brief, would require that the experience should follow the plant or operations instead of following the person or persons responsible for the management of the plant or operations. The principle of having the experience follow the plant or operations is designated by Mr. Senior as "experience rating *in rem*" and the present procedure is referred to as "experience rating *in personam*." The author has confined himself for the most part to a review of the discussion which took place in the Rating Committee of the New York Board relative to this proposal. The subject was considered from the legal viewpoint as well as from the underwriting viewpoint and the arguments for and against the proposal are enumerated under each of these general headings. A careful reading of Mr. Senior's article leaves the impression that much more might have been said particularly in favor of "experience rating *in personam*" than appears in the summary of the arguments presented in the Rating Committee. The arguments favoring "experience rating *in rem*" are not in every case convincingly answered by the opponents of the pro-

posed change. In preparing this article Mr. Senior has evidently avoided supporting either one side or the other but has recorded merely the opposing viewpoints as brought out in the Rating Committee discussions. It might do no harm therefore in this discussion of Mr. Senior's paper to elaborate somewhat further in the hope of answering more specifically the arguments raised in favor of "experience rating *in rem.*"

One of the points stressed in favor of the proposal was that the purchaser of an enterprise should inherit the past experience as one of the assets or liabilities of the risk. This viewpoint is diametrically opposed to the fundamental principle justifying experience rating which is to the effect that the experience is subject to control by the assured. Naturally, it would not be a very difficult accomplishment to justify to the purchaser of an enterprise a reduction in his insurance rate due to the past experience of the plant, but it certainly would be a different proposition when it came to charging an increase in rate for unfavorable experience incurred in the plant before he had anything to do with it. For the sake of illustration, let us consider that the past experience of a plant is similar to that more or less intangible asset—good will. Suppose a manufacturer, A, who has an excellent reputation for turning out a certain product takes over the plant of manufacturer B, whose product is of inferior grade. A is going to manufacture his product in the plant purchased from B. A will introduce his method of manufacture and his name and guarantee will attach to the product. It is obvious that the product will still carry the high reputation of A and there will be no impairment of this reputation due to the fact that it happens to be manufactured in a plant which under a different owner and process produced an inferior product. This analogy leads to the conclusion that the experience modification should be based upon the past experience incurred under the supervision and management of the assured. If the purchaser of the enterprise is just starting in business and therefore has no past experience the only fair treatment is to write the risk at manual rates. If the purchaser of the enterprise is one who has been in business for a number of years previous, then the experience developed under his previous operations should determine the experience modification applied to his compensation insurance rates for the newly purchased plant.

Supporting the proposal of "experience rating *in rem*," it is reasoned that one would expect that the experience in a particular plant would be the same under new management as it had been under the old. If the truth of such a statement were admitted there would be little point in safety work of any kind. We would simply admit that accident frequency and severity would always be the same in plants using similar methods of manufacture regardless of differences between such plants as respects the guarding of machines, education, type of employee, etc. In the case of contracting risks it is evident that such a hypothesis could hardly be supported for here the management and control plays a most important part in the development of the compensation experience.

The argument is raised that there would be no inducement for the new owner to remedy the equipment of a newly purchased plant unless it was directly brought to his attention that he is the legitimate successor to the past experience. This argument is one-sided, since it considers only the case where the past experience has been unfavorable. If we consider the proposition from the other viewpoint, *i. e.*, where the past experience has been favorable, would it not be reasonable to expect that the owner, if given the benefit of an experience credit which he had not earned, would be in the position of having obtained something for nothing and consequently would not appreciate the value of this credit. Would he not be even less inclined to stimulate safety work and thereby better the experience of the risk than if he were to be written at manual rates? Certainly, if the past experience of the plant has been unfavorable, the insurance carrier will be most careful to call to the attention of the new owner the necessity for keeping his experience down to a minimum for, with the risk written at manual rates, it is apparent that the insurance carrier may suffer an abnormally adverse loss ratio unless this is done. Furthermore, it appeals to the writer that a new owner would be more inclined to strive to produce favorable experience if given a fresh start by writing his risk at manual rates than if he were penalized at the outset with the faults of his predecessor. The present plan of experience rating does not respond quickly to changes in the experience developed by a risk and, therefore, if the new owner were to be penalized at the outset with a debit, even though he were to bring about a decided

improvement in the working conditions and experience of the plant, it would take years for this to reflect itself in his compensation rates. Therefore, it is felt that the fairest treatment in such cases is to disregard the past experience where there has been a material change in ownership and management and give the assured the benefit of manual rates.

The statement is made that "experience rating *in rem*" would be simpler in application than the present procedure, since it would no longer be necessary for the rating organization to decide questions as to whether or not the changes in ownership and management were of a nominal or material character. Whereas it is true that "experience rating *in rem*" would eliminate the necessity for deciding questions as to changes in ownership and management, there would be introduced other difficulties which would be far more serious than those which are encountered under the present procedure. As brought out in Mr. Senior's paper, it would be necessary to revamp the definition of the term "risk" and, furthermore, there would be a very nice problem involved in the keeping of experience data for experience rating purposes. The idea might possibly be worked out in the case of manufacturing plants which have more or less permanent locations but, when it is attempted to follow the procedure through in the case of contracting operations, we are immediately confronted with the problem of segregating experience by individual contracts which, as time went on, would probably result in considerable confusion, if not in chaos. Imagine the difficulties which would ensue under such a system if, in addition to changes in ownership and management, there were also concurrent changes in the insurance carrier, and this would probably happen in the majority of cases.

The solution, therefore, seems to be in the direction of clarifying the present rule. As a matter of fact, "experience rating *in personam*" is not so very far removed from "experience rating *in rem*" for, under the present rule, the procedure is to follow the experience of the risk as at present defined unless conclusive evidence can be shown why such experience should be disregarded. In the majority of cases "experience rating *in rem*" and "experience rating *in personam*" are of course identical. When the occasional case is met with where there has been a change in ownership and/or management, the burden of proof always rests

on the side of those advocating the elimination of the past experience of the risk. If, however, it can be definitely shown that the change in ownership and management is of such a nature as will affect the conditions responsible for the experience of the risk, then and then only is it proper to exclude the past experience.

The revised ruling adopted by the New York Board which is quoted in Mr. Senior's article represents a decided improvement in the clarification of the rule and should go a long way toward eliminating the element of judgment which has caused most of the difficulty in rendering decisions on doubtful or borderline cases. The National Council on Compensation Insurance and the National Bureau of Casualty and Surety Underwriters have adopted a set of rules defining "nominal changes" and "material changes" in management which are more detailed than those incorporated in the New York Experience Rating Plan but to all intents and purposes the New York rule should prove altogether satisfactory.

Mr. Senior has directed attention to one of the most troublesome features in connection with the administration of experience rating and it is felt that Mr. Senior's intelligent analysis and review of this subject not only will prove most helpful to rating organizations and insurance carriers in dealing with this problem but also is a valuable contribution to the literature available for the education of all students of compensation ratemaking and its related problems.

MR. GEORGE F. HAYDON:

The title "Experience Rating *In Rem* and *In Personam*" incorporates within itself a degree of allurement and promise which the body of the article bears out in the fullest measure. Mr. Senior elected to elaborate on a subject which easily leads itself to dissection, one which is very definitely alive and, despite any disposition which may be made of it at present or in the future, will always remain a potential subject for renewed discussion.

In referring to the proposal that the present mode of procedure stipulated in Rule No. 32 be upset, Mr. Senior states in part that

> "the new proposal should be divided so as to give proper weight to the legal as well as to the underwriting aspects of the case, and that preference should be given to the legal viewpoint as being the more important of the two."

In this connection, unless my observations have misled me, Mr. Senior can always be relied upon to dignify the most mundane and unexpected subject with the mantle of the Law. To the mind untrained in legal technique, invoking or anticipating a legal sequence is merely courting unnecessary tribulation and creating an atmosphere or screen behind which the legal wizards may befuddle the senses. It must be admitted, however, that the mantle brings to our otherwise sadly maligned system of Experience Rating a degree of added importance resulting in a psychological reaction of no mean measure. But is the added prestige a good investment? Does it make for an enduring admiration without a penalty attachment? Might it not be that the precedent of making a legal inquiry into a specific rule or practice might provoke similar treatment in the case of other rules and practices, with the prospect of never ending and interminable quibbles and misunderstandings? In the interest of smooth application—not expediency by any means—might it not be advisable to study each problem on its merits and be governed by the procedure which promises to ensure the most equitable treatment to all concerned, and leave out any suggestion of resorting to legal technique, except as such technique may be made to serve as a factor, with no more weight than the remaining considerations which, combined together, constitute the whole?

Turning to the merits of the question, Mr. Senior has not committed himself to any personal opinion except as to act as arbiter of the various opinions offered and to draw certain conclusions therefrom. The outstanding impression gained from a careful perusal of the opinions, is that considerable thought and study was given generally before the conclusions were reached; this being equally true in the opinions given in favor of the proposal, as in the case of those cast against it. Of the five opinions given by the Committee of distinguished lawyers, three were in favor of the proposal and two against, which, from the standpoint of numerical weight, would award the decision in favor of the proposal. This, however, was reversed in the case of the opinions submitted by the underwriters, wherein it is noted that out of conclusions reached by seven underwriters, three were in favor of the proposal and four against. Grouping the two sets of conclusions together, we find an even division, there being six in favor of the proposal and six against. Adoption of this method of

measurement, without further consideration, suggests a deadlock; hence, it becomes necessary to examine the worth of the conclusions and draw an arbitrary decision therefrom. This then introduces the element of personal opinion, and it is with a definite knowledge of treading on delicate ground that I undertake the trespass.

A summary of the high lights for the proposal, submitted by both the legal profession and underwriters, appear to be substantially as follows: That new ownership should inherit experience on a basis similar to that upon which it accepts the degree of good will and other intangible but influencing circumstances which may be bequeathed to it; that it is logical for the experience to follow the risk because the mental picture created in the mind of the underwriter is that of a tangible physical matter which promises to remain indefinitely and which is expected to ride along as a distinct and individual unit regardless of management change, paying the penalty of its own sins, and collecting its own rewards, this being particularly true in the case of manufacturing establishments; that the management of a plant may go out of business entirely, in which event, under the application of the existing rule, the experience of the risk would become lost; that if the experience is not held to follow the risk, there would be no inducement or incentive for the successor to cure, correct and remedy the equipment of the risk, the experience arising out of which was unfavorable; finally, should the experience follow the risk rather than the person, the uncertainties of the schedule and legal requirements fixing material changes in ownership and management would be definitely avoided and thereby solve a present day rating difficulty. In short, it is claimed that the proposal would create a situation which would be simple, effective and equitable.

An analysis of the conclusions against the proposal might be summarized as follows: That it is unfair to charge a new ownership with the misdeeds or ill luck of a previous one, if only from the standpoint of handicapping a new ownership inheriting poor experience as compared with one inheriting good experience, or, none at all; that in those cases where unfavorable experience is due to poor physical conditions, the penalty will continue to be imposed regardless, by virtue of the application of the schedule rating system; that experience rating is intended to measure the

moral quality of the management and thus, manifestly, should follow the management responsible for such experience; that, if an assured owns or acquires separate enterprises, each enterprise, for the purpose of experience rating, would have to be treated as a separate risk rather than part of the whole as at present; that, in the case of contractors, in the event of new ownership, on account of the absence of physical characteristics, it would be much more logical for the experience to follow the person than the risk. In short, any proposal to reverse the existing rule, would introduce a grave note of discrimination.

If the foregoing can be accepted as a true picture of the high lights then, from an impartial review, I am not satisfied that Mr. Senior's conclusion

> "that the theory for Rule No. 32 seems to be in accord with the general principle of the plan itself; that it is not proper either in law or insurance practice to charge a new owner with the sins of the past or to give rewards for experience not earned under his supervision"

is a fair and balanced judgment of the various opinions. On the contrary, if either one of the viewpoints is more meritorious than the other, I am inclined to believe that Mr. Senior has selected the wrong one. This may not necessarily mean that the reversal of the present rule is the proper thing to do, for it is quite within the realms of possibility that the proponents of the new proposal made the best of their case, and that the champions of the existing practice did not; however, the fact remains, and it is difficult to conceive how Mr. Senior could award the laurels to either viewpoint with such degree of definitiveness.

In conclusion, it would be out of harmony with the pleasure I derived in perusing the article, to do so without first paying tribute to the clarity of Mr. Senior's expression and to the purity of his English, it being of a character calculated to give sweetness to any article which otherwise may be very mediocre and, which decidedly Mr. Senior's is not.

AUTHOR'S REVIEW OF DISCUSSIONS

MR. LEON S. SENIOR:

Of the three discussions submitted on this paper, Miss Maycrink and Mr. Pinney favor the theory that experience rating shall follow *in personam*, while Mr. Haydon appears to take exception

to this view. After paying a graceful compliment to the author for the manner in which the subject has been presented, he questions the necessity of delving into the law of the case. The impression I get is that Mr. Haydon feels that the points involved could be settled on underwriting principles without reference to the law. I think the answer to Mr. Haydon is that we are forced to recognize the legal question since our practice affects important property rights. To deprive an employer of the right of using past experience amounts to a deprivation of property rights and cannot be done without a justifiable legal basis. The very essence of the workmen's compensation policy is to protect the employer against losses arising because of certain legal liabilities. The nature of the insurable hazard differs: first, because of differences in state laws, and second, because of differences in the physical character of the risk. The law furnishes the foundation for the contract, and it would be just as impossible for the underwriter to ignore the legal principles involved in experience rating as to ignore the differences between the New York and Wisconsin laws in determining premium rates for New York and Wisconsin risks. Aside from this criticism, Mr. Haydon thinks that I have reached the wrong conclusion in sustaining the advocates of experience *in personam*. It is to be regretted, however, that Mr. Haydon's judgment is not supported by more definite reasons. No effective answer is presented to the particular obstacle which confronts the proponents of experience *in rem* in the treatment of contracting risks. If experience *in rem* is sound it should not be difficult to establish its value for contracting as well as manufacturing risks. The theory, however, seems to break down completely in the case of contracting operations. It is conceded that experience *in rem* does not fit in properly with this type of risk. Here we are confronted with personal and corporate organizations. To apply experience *in rem* would seem to be out of the question. Miss Maycrink makes that clear in a very effective sentence: "The idea of making the risk the criterion for merit rating, regardless of ownership, if followed to its inevitable conclusion, becomes as fantastic as Frankenstein—a mere matter of structure and mechanisms lacking authoritative control." This is the whole story in a nutshell. Mr. Pinney makes a telling point by an apt illustration: If a manufacturer with a high reputation, turning out a fine

product, purchases another plant turning out an inferior product, it is reasonable to believe that the purchaser will change the character of the plant and its product so as to compare favorably with the original plant. This example furnishes a perfect analogy and provides an excellent argument in support of the idea that experience rating should follow the owner and not the *res*.

It is a matter of deep satisfaction that the subject so lightly treated in my original paper has been carefully discussed by competent critics. I am grateful for the generous form of the criticism and believe that the discussion will prove useful in the application of the principle to cases that arise in daily practice.

STATE REGULATION OF INSURANCE RATES—CLARENCE W. HOBBS

VOL. XI., PAGE 218

WRITTEN DISCUSSION

MR. A. H. MOWBRAY:

We, of the insurance business, are apt to think of ourselves as being excessively subject to regulation if not persecution by state officialdom. It is well, therefore, that we have now and then from the pen of an experienced legislator and public official so sound an exposition of the tendency of legislative thinking on the regulation of economic activities in general as is contained in the earlier paragraphs of Mr. Hobbs' paper.

It is difficult to discuss a descriptive paper such as this, especially when written by a master hand and none can dispute that Mr. Hobbs' experience in public life makes his such. One can only comment on the philosophy of the situation and the policy of action indicated.

If one may digest the analysis of the situation as set forth in this paper, we should say that it shows a beginning of regulation to enforce competition, now passing out of date but still leaving certain traces in the statutes, in some cases at variance with the spirit if not the actual letter of later legislation in the same jurisdiction. This is followed by a tendency to supervise cooperative regulation following through to definite state regulation which in turn tends to develop into actual state prescription.

There is evidence in the material adduced by Mr. Hobbs of the lack of community of interest between the agent and the company or companies he represents, for example in legislation forbidding

cooperation to regulate commissions and, though not mentioned by Mr. Hobbs, resident agent laws. We are all inclined to look after our own interests first even when we are charged with the responsibility of agency. But class legislation of this kind in the long run being inimical to the business as a whole is adverse to the best interests of the agents themselves. Despite the existing keen competition to secure agents the burden is on the companies it seems to me to bring home to the field men as a whole the proper realization of this fact. This is especially so because of the power of the agents as a body in local affairs and through local representatives on legislation of which the laws cited are evidence.

There is a tendency to resist with all our force interference with our own lives, that is, if we are the usual type of Anglo-Saxon individualists. But force tends to call forth force in opposition and rarely is reaction the road to power. There is a real danger to the companies in the possible abuse of power of State officials charged with regulation of rates. Mr Hobbs has outlined the legal resources and the attitude of the courts, from which it appears that relief can be had from them only on reasonable proof that rates are or have become confiscatory. Difficult as it is to offer convincing proof in the case of such public service corporations as railroads, it is far worse in our business especially without clearly accepted standards. Such standards are accepted in the field of life insurance and they should be in ours.

Mr. Hobbs has quoted the usual official standard in the following language:—"Now adequacy for rate making purposes is determined by taking the aggregate loss experience of the carriers concerned and the aggregate expenses, and comparing the results with the rates." (Page 272). But can we accept this as it stands? Must we not consider the trend of experience, the likelihood that over a long period of time it is getting better or worse? And must we not recognize the effect of the economic phenomenon known as the business cycle? If it has an effect on our experience it seems to me we must. We may not adjust our rates accurately to its swing. But if we do not, must we not consider its variations in selecting the period for test? Or rather, since not we but the officials and the courts will make the tests, must we not find the evidence that will convince them in this regard. I have had the privilege of participating in making a study that

seems to point clearly to a cyclic swing and we expect to present the results in a paper at this meeting.

Naturally this Society is the forum in which the facts leading to such standards can be most impartially and successfully brought out and Mr. Hobbs' paper should spur us to further effort in this regard.

MR. MORRIS PIKE:

It is a privilege to be permitted to discuss the very interesting and informative paper delivered by Mr. Hobbs on the subject of State Regulation of Insurance Rates.

Mr. Hobbs has ably presented the philosophy and theory behind this regulatory movement and has furnished detailed information with respect to its genesis and nature. The paper under observation is conspicuous for the numerous citations of the legal authorities both in the insurance and the public utility field, the latter field having been subjected to a degree of regulation somewhat similar to that in the insurance line and having the added advantage in that many of its regulatory statutes have already come before the judicial authorities for determination.

With respect to the arrangement of Mr. Hobbs' paper, I have one suggestion to make, and that is that possibly some of the readers of his paper might be aided by a table presenting a concise summary of the insurance statutes of the forty-eight states. It would not be a simple task to adequately so summarize the statutes but possibly the benefit to be derived therefrom might warrant the undertaking.

The reader of Mr. Hobbs' paper cannot but be impressed with the heterogeneous character of the insurance statutes of the various states. The business of insurance has long been regarded as affected with a public interest and calling for State supervision. This supervision has subjected to its scrutiny the solvency of the carriers; the imposition of taxes; the fixing of limits of liability on individual risks; the filing of annual reports on condition and affairs; the examination of the nature and amount of the carriers' investments, capital stock and deposits; and, latterly, jurisdiction over rates, policy forms and profits. In particular, multitudinous differences make their appearance in insurance rate making laws affecting such matters as:—

> Prohibition against acting in concert; membership in rating organizations; membership in stamping offices; permission to deviate from the rating organizations' rate level; the filing of rating data; the filing of experience statistics; approval as to non-discriminatory character of rates; approval as to the adequacy of rates; approval as to the reasonableness of rates; manner of determining such non-discriminatory, adequate or reasonable rates; exemptions for certain lines of insurance; exemptions for certain types of carriers; approval of policy forms and clauses; etc.

This diversity in the extent and manner of insurance regulation can not but be reflected in diversity in the carriers' methods of conducting the business. The increased cost of doing business in compliance with the various requirements has often been referred to by company executives. How much money would be saved by a uniform system of regulation can only be estimated. Certain it is that the discord engendered by the differences in the state laws does not promote efficiency and that a uniform set of regulations would go a long way toward reducing the expense of conducting the insurance business and ultimately, therefore, toward reducing the cost to the public.

A measure of uniformity in insurance legislation has, however, been obtained through the efforts of the National Convention of Insurance Commissioners, an organization of state supervisory officials organized for the purpose of discussing problems of mutual interest and conferring with respect to their regulatory problems from a national point of view.

Anti-discrimination

A word or two may not be out of order with respect to Mr. Hobbs' comments upon anti-discrimination laws, with particular reference to his statement that

> "The principle that all persons are entitled to equal treatment by insurance companies is the natural concomitant of the doctrine that insurance is a business public in its nature."

Many statutes prohibit the employment of unfairly discriminatory rates. It is, however, at times a perplexing question as to when a discrimination ceases to be fair and becomes unfair. It surely was not intended that all persons should receive equal treatment irrespective of the character of the hazards of their

risks and the above quotation is not to be interpreted in that light. Then again, the term "hazards" has often been subjected to close analysis. Does it connote merely a risk's physical hazards? Possibly at the time of the enactment of many of the state laws, underwriters depended, mainly, if not exclusively, on the evaluation of physical hazards in rate making. More recently, however, especially in workmen's compensation line, consideration has been given to a risk's past experience as disclosed by an experience rating plan for determining the hazards under observation. Indeed, the laws of a number of states, California, Georgia, Delaware and Pennsylvania, for example, take official cognizance of the merit rating plans in vogue in the workmen's compensation line.

In addition to rate variations depending upon the "hazards" disclosed by the application of a schedule evaluating a risk's physical features and a merit rating plan for measuring its general "desirability" or "undesirability," distinctions in rates are made for the presence or absence of clauses in the policy contracts affecting the extent of the carriers' net liability. The use of such clauses as the deductible collision clause or the monthly reducing clause in connection with automobile insurance has generally been regarded as calling for rates different from those applied to other forms of automobile contracts.

In recent years attention has been directed towards the expense factor in insurance rate making as perhaps justifying additional differences in rates. An insurance rate may be subdivided into a "pure premium" and a "loading." Differences in the "pure premium" may be expected to provide for variations in hazards and in policy contracts. A variable "loading" can likewise reflect differences in the expense of conducting the business. Of the various factors entering into the "loading" the allowance for commissions is perhaps the most readily determinable and most important. Differences in the rates of commission paid for various lines of insurance or even for classes of risks in a given line are reflected in the corresponding insurance rates. It is a more difficult problem to weigh the differences in some of the other items composing the loading factor such as "home office supervision" and "inspection of risks." On the question of graduating the expense loading in the workmen's compensation line by size of risk, the interested reader is re-

ferred to Mr. Hobbs' comments on pages 16, 17 and 18 of his "Report Relative to the National Council on Compensation Insurance made to the National Convention of Insurance Commissioners" under date of December 9th, 1924.

In other words, the determination as to whether or not a discrimination in rates is unfair may at times become a complicated matter involving, or coming close to involving, questions of adequacy and reasonableness of rates.

Reinsurance Business

It has been heretofore generally held that a state's interest in rating matters could properly be confined to the direct insurance relationship of the carriers and their policy holders. Little, if any, attention has been given in rating laws to reinsurance agreements between companies. In particular the New York Rating Law neither expressly includes or excludes reinsurance business from its jurisdiction. From time to time, it has been alleged that the absence of such regulation presents a loophole calling for legislative action. The possibility has been cited of a group of Insurance companies designating one of their number to operate at other than "board" rates while the remaining members of the group employ "board" rates but accept nevertheless reinsurance lines from the "non-board" company. Such an arrangement would encourage the use of unfairly discriminatory rates, large assureds being referred to the "non-board" company to be accepted at its rate level with the understanding that the line would be reinsured in whole or in major part in the "board" companies. Aside from the specific use of discriminatory rates as alleged above, the question has been raised whether a company which accepts through reinsurance, business at a rate level other than that employed by it for direct insurance, is not employing two rate levels in violation of the laws of such states as require the filing of a schedule of rates and adherence thereto.

Some company organizations have regulated their members' reinsurance activities to the extent of prohibiting their reinsuring the business of non-member companies. Aside from this indirect and limited control of rates probably inspired more by the desire to discourage this form of assistance to non-member companies than to maintain uniform rates, little restriction has

been placed by company organizations upon reinsurance underwriting practice. Furthermore, no control has been exercised over commissions on reinsurance business so that a given gross premium can be readily adjusted through the commission payment to yield an agreed upon net premium for the sake of accommodating a particular insured, broker or insurer. It is not to be expected that regulation of the complicated problems arising in reinsurance underwriting will be entered upon lightly or hastily. In such states as permit the companies to employ discounts from or surcharges to "board" rates, restriction upon reinsurance agreements might deprive such companies of an adequate reinsurance market.

This problem too, is therefore not without its complications.

Inter-State Risks

State insurance laws are generally applicable specifically to risks located within their boundaries. In view of the heterogeneous character of the state laws an assured often finds itself subject to different degrees of regulation in the various states in which it transacts business. It has been charged that upon occasion liberal discounts have been permitted on portions of risks located in non-regulated states to offset the requirements upon the portions in the well regulated states. Such a course of action not only constitutes an evasion of the spirit of rate regulation but reacts against the states with the higher requirements, the business of men of the latter being held to a rate level higher than that required of their competitors in the adjoining states. The importance of the item of insurance cost has been attracting attention of late, especially in the automobile line and consideration has been paid to the competitive advantages possible under differences in state regulation. These differences have been so marked as to encourage underwriters to hope from time to time for a national rating system operating with the sanction of public authorities. It is hardly to be expected, however, that such relief is to come from the federal authorities so long as the decision of the United States Supreme Court holding that insurance is not a commodity and, therefore, is not subject to inter-state regulation, stands. Stress must therefore be laid upon the already mentioned activities of the

National Convention of Insurance Commissioners towards encouraging uniformity in state regulation and upon the efforts of the rate making organizations to control their membership nationwide where permitted by law.

Regulation of the Fire Insurance Line

In addition to the many details of state regulation of insurance rates as presented by Mr. Hobbs, there are several special features of this regulation as applied to the fire insurance line, that are perhaps worthy of special reference.

Valued Policies

The first of these is the attitude of the various states towards what are known as "valued" policies. From the standpoint of the degree of protection they offer, insurance policies fall into two classes—those which seek to indemnify the policy holder to the extent of the value of the loss suffered and those (not so often met with as the first class) which provide for the payment of a stipulated sum on the occurrence of a certain contingency irrespective of the actual value of the loss sustained at the time. A common example of the first of these policy forms is to be found in the automobile collision insurance clause wherein it is provided that

> "The Company shall not be liable beyond the actual cash value of the property at the time any loss or damage occurs and the loss or damage shall be ascertained or estimated accordingly, with proper deduction for depreciation however caused, (and without compensation for the loss of use of the property), and shall in no event exceed what it would then cost to repair or replace the automobile or such parts thereof as may be damaged with other of like kind and quality; such ascertainment or estimate shall be made by the Assured and the Company, or if they differ, then by appraisal as hereinafter provided."

A common example of the second of the above classes is to be found in the life insurance contract, where the carrier agrees to pay the face amount of the policy (subject, of course, to adjustments on account of unpaid premiums, dividends and interest) upon the occurrence of the eventuality insured against. There

is here no question as to whether the deceased (if the contingency insured against was "death") was overinsured for the life insurance contract is not a contract of indemnity.

The coverage provided by the standard fire insurance policy of the state of New York falls within the first of the above classes, the insuring clause thereof reading:—

> "In consideration of the stipulations herein named and of.................... dollars premium does insure .... and legal representatives, to the extent of the actual cash value (ascertained with proper deductions for depreciation) of the property at the time of loss or damage, but not exceeding the amount which it would cost to repair or replace the same with material of like kind and quality within a reasonable time after such loss or damage, without allowance for any increased cost of repair or reconstruction by reason of any ordinance or law regulating construction or repair and without compensation for loss resulting from interruption of business or manufacture, for the term of .... from the...................day of.................. ....19...... at noon, to the........................ ....day of................................ ....19 ...... at noon, against all DIRECT LOSS AND DAMAGE BY FIRE and by removal from premises endangered by fire, except as herein provided, to an amount not exceeding.................... Dollars, to the following described property while located and contained as described herein, or pro rata for five days at each proper place to which any of the property shall necessarily be removed for preservation from fire, but not elsewhere, to wit:"

In Arkansas, however, the amount of insurance stated in the policy becomes in the event of a total loss, the liability which the insurance company is to meet irrespective of the actual value of the property destroyed at the time of fire. In other words, the value of the property at the time of total loss is fixed at the face amount of the policy. This form of statute is quite popular throughout the West and South of the country, approximately

half of the states of the Union having enacted laws of this sort. Its aim is generally considered to be a desire to prevent overinsurance on the part of agents. It was feared that some agents were overinsuring property and extracting from the public premiums in excess of those required for adequate protection. In behalf of the valued policy laws it has been stated that companies are thereby urged to be careful to adjust the amount of insurance to the value of the property covered. As against such laws, it has been argued that they would encourage overinsurance since the carriers are not in a position to inspect and reinspect all risks with a view to adjusting the insurance to the value of the property without incurring considerable expense.

Anti-Coinsurance Laws

For many years fire insurance underwriters have where practicable, differentiated between policyholders who carry adequate insurance and those who insure only a small percentage of their property. Where partial losses predominate, the latter class of policyholders are able to obtain as much actual protection as the former and at less cost. To offset the situation coinsurance clauses have been introduced in fire insurance policies to automatically relate the carriers' liability to the proportion of the value of the property insured at the time of the fire. A typical coinsurance clause in New York state provides that:—

> "If at the time of fire the whole amount of insurance on the property covered by this policy shall be less than 80 per cent. of the actual cash value thereof, this Company shall, in case of loss or damage, be liable for only such portion of such loss or damage as the amount insured by this policy shall bear to the said 80 per cent. of the actual cash value of such property."

However, a number of states view with disfavor the use of coinsurance forms, probably because their application introduces a "correction factor" in the amount of insurance and may thus penalize an insured in the time of urgent need. Thus, the states of Arkansas, Florida, New Hampshire and Ohio prohibit the employment of coinsurance clauses covering buildings. Other states such as Indiana, Kentucky, etc., leave it optional with the insured to accept or refuse a coinsurance clause. Where the use of coinsurance forms is optional, fire underwriters usually

make an allowance in rate for their employment. An extreme case of such rate differential is to be found in the action of a rating organization controlling one of the side lines written by fire insurance companies in establishing a 900% surcharge for the non-use of its coinsurance provision.

Standardization of Underwriting Practices and Rating Forms

Attention should be called to the movement now on foot in the fire insurance lines towards effecting a standardization of underwriting practices and rating forms throughout the country. There are at the present time about forty-five rating and inspection company organizations concerned with fire insurance underwriting. Some of these organizations are confined to individual cities; others function for entire states or large sections of states while still others function for groups of states. Numerous differences in their methods of operations extending to the very nature of the schedules employed by them are also apparent.

The National Board of Fire Underwriters with which are affiliated the majority of fire insurance companies doing business in the United States, has appointed a committee to cooperate with the National Convention of Insurance Commissioners to bring about this much desired standardization. The results of this Committee's deliberations are being looked forward to with great expectation although the obstacles in its way are not to be minimized.

AUTHOR'S REVIEW OF DISCUSSIONS

MR. CLARENCE W. HOBBS:

The discussions submitted by Messrs. Mowbray and Pike on my paper "State Regulation of Insurance Rates," are phrased in such kindly terms and present so little evidence of divergence in opinion, that I am hardly justified in doing more than to express my sincere appreciation of both discussions and adding a word as to one or two points presented.

1. Mr. Mowbray quotes the phrase "Now adequacy for rate making purposes is determined by taking the aggregate loss experience of the carriers concerned and the aggregate expenses, and comparing the results with the rates," and questions whether this can be accepted as it stands. On this point he is quite cor-

rect. The statement was not intended to be more than a general indication of the data by which adequacy is determined, and is far from a complete picture of the entire process of determining adequacy. The experience data as they stand indicate no more than what has been the experience of the past series of years. A comparison of these data with the rates shows nothing more than whether those rates would for that series of years have yielded an excess or produced a deficiency of premium. It is of at least equal importance to determine whether the conditions then experienced now prevail or will prevail in the immediate future; for to these present or future conditions rates must be adjusted. The experience record to be sure if sufficiently extensive and properly analyzed may yield valuable clues as to the trend in loss ratios, and such trends should undoubtedly be taken into consideration. If the changes in loss ratios can be definitely and closely linked up with the business cycle, a long step forward will have been taken towards the goal of a compensation rating system which adjusts itself with speed and accuracy to the ever varying conditions of the business. Hence, the study which Mr. Mowbray refers to is of great importance.

It may be added that supervising authorities have not refused to permit pure premiums to be adjusted for rate making purposes by means of factors designed to bring rates to the average level indicated by assumed future conditions. The possibility of a rate revision coming to the attention of the courts is, of course, by no means remote, and the criteria which will be applied by them not at all certain. It may, however, be doubted if a court would confine itself solely to the experience record, and not take into consideration such very pertinent elements as whether the experience shows that loss ratios are progressively increasing or decreasing. Undoubtedly, in looking to the future, the courts would desire that any theory of trends should be backed up and supported by a convincing background of fact. It is to be hoped, that before emergency arises, Mr. Mowbray's investigation may be able to supply this background.

2. Mr. Pike suggests the preparation of a table presenting a concise summary of the insurance statutes of the forty-eight states. Certain publications have at one time or another prepared summaries of what they consider the leading points of the several insurance codes, or at least the points of most practical

use to their subscribers. In the preparation of these summaries, however, there is an abundant opportunity either for error in interpretation or for error of omission, so that their practical utility is on the whole slight. As a rule, the value of a summary is about in inverse proportion to its conciseness. A more valuable work would be to prepare a compilation of the insurance laws with annotations, indexes and cross-references, so that the corresponding laws in the several states could be readily assembled and compared. Several states issue well edited and complete indexes of the insurance law, but quite a number leave much to be desired both in the compilation and the indexing.

3. Mr. Pike has given some attention to the statement "The principle that all persons are entitled to equal treatment by insurance companies is the natural concomitant of the doctrine that insurance is a business public in its nature." He points out very justly that it must not be inferred that persons are entitled to equal treatment irrespective of the character of their risks, and further that physical characteristics are not the only elements of hazard which should be taken into consideration. He refers to differences in hazard measured by past experience, differences produced by variations in the insurance contract, differences in expense. Undoubtedly, all these may properly be reflected in the rate without producing legal discrimination. One may go a step further and state that no two risks are precisely the same in hazard. The ordinary language of the anti-discrimination law is to inhibit discrimination between risks of the same class or involving the same hazards. In the absence of positive regulation, the only limits on a company's power to classify its risks or to recognize differences in hazard are those established by the rule of reason. One prominent underwriter has stated the anti-discrimination law is a dead letter. It is not quite that, but its possibilities are distinctly limited, and we have seen the states extend the principle of this law by attempting to regulate classifications, determine uniform policy forms, and delve into the practices of companies and rating organizations in assigning risks to classes and in a word into all the detail of rate making and rate administration. Mr. Pike points out that the problems of discrimination and the problems of adequacy and reasonableness of rates are very closely allied and this point is unquestionably well taken.

One would like to go into the points raised by Mr. Pike's very illuminating comments upon reinsurance, uniform state laws and the effect of the valued policy law and the anti co-insurance law as affecting fire insurance, but this opens up such a spacious field that no causual notice can do them justice.

AUTOMOBILE RATE MAKING—H. P. STELLWAGEN

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WRITTEN DISCUSSION

MISS M. E. UHL:

In presenting his paper, "Automobile Rate Making" at the last meeting of the Society, Mr. Stellwagen has rendered an important service to students of automobile insurance. He has given a very complete, clear and detailed exposition of the method of rate making developed by the Automobile Department of the National Bureau and employed in the rate revisions of 1923 and 1924. (I might add here that the method used in the 1925 revision is essentially the same as that for the two preceding years). While a considerable amount of literature dealing with workmen's compensation insurance is now available, very little has been written on the subject of automobile insurance from a strictly actuarial point of view. Mr. Stellwagen's paper is, therefore, peculiarly valuable and timely.

The problem of automobile rate making has, of course, increased in importance rapidly in recent years with the demand for this type of insurance which accompanies the increased use of the automobile. To meet this situation, a system of automobile rate making has been developed which is believed to be as sound as the body of available statistics permits. The methods in use at the present time already compare favorably with those employed for workmen's compensation insurance.

Mr. Stellwagen has described so fully the development in automobile rate making up to the date of his paper that there remains very little opportunity for discussion of the paper itself. I shall therefore merely attempt to supplement what he has written by a few comments which may be helpful to those who study this subject.

In the first part of Mr. Stellwagen's paper he makes a brief reference to the Automobile Statistical Plan. I should like to point out here that the territorial schedules given in the automobile manual to which rates are actually assigned have never been in complete agreement with the territorial divisions for which experience is accumulated under the Automobile Statistical Plan. In the beginning a comparatively few manual territories were set up based almost wholly upon judgment. Later the Automobile Statistical Plan was formulated and the country was divided into many independent statistical territories upon the basis of judgment with the idea that the existing manual territories would be justified by statistics accumulated or that more and different manual territories could be set up where the statistical evidence indicated the necessity therefor. The manual territories have subsequently increased until at the present time there are about as many manual as statistical territories with a troublesome lack of coincidence in many cases between the assignments under the statistical codes and those in accordance with the manual. For instance, in the automobile manual the city of Rochester in Monroe County, New York, together with ten adjacent townships is defined as "Rochester territory" and assigned to a certain rate schedule. The manual defines "Rochester suburban territory" as the remainder of Monroe County with the exception of three townships which are assigned to the "Remainder of state" territory schedule. Thus, the manual provides three territory schedules within Monroe County, New York. But the statistical plan provides two territorial divisions for Monroe County, namely, "Rochester city territory" comprising the city of Rochester alone (not including the ten adjacent townships as in the manual) and the remainder of Monroe County which is coded as "Rochester surrounding." The inconvenience of this disagreement between manual and statistical territories is obvious. There no longer exists any reason for discrepancy between the manual and statistical territories. It has accordingly been decided that beginning with policy year 1926, the manual and statistical territories will be made to coincide.

Further on in Mr. Stellwagen's paper, he explains the treatment of the incomplete policy year used in the rate making process. He points out that the factor applicable to the immature experience is a combination of an earned factor and a decreasing

cost factor. Obviously, it is not possible to estimate exactly what the earned factor would be unaffected by decreasing or increasing cost. It is, of course, necessary to take into account the element of increasing or decreasing cost. As long as costs decrease or increase uniformly year by year there is no danger involved in using approximately the factor as calculated. However, if a period of decreasing costs should be followed abruptly by one of increasing costs, or vice versa, the development of the experience for the incomplete policy year would not be similar to that of the preceding year and the adjustment of pure premiums and indicated rates (see steps 3 and 9 under heading "Derivation of Average Territorial Rates" described in Mr. Stellwagen's paper) would be out of line. Fortunately, the use of the ultimate factor as described has worked out very satisfactorily thus far, and the uncertainty involved in the use of the factor is perhaps more than off-set by the advantage resulting from the use of the later experience.

The second step in the process of establishing territorial rates as described in the paper under discussion consists of the selection of pure premiums with regard to trends and local conditions. This step consists of a study of the territorial pure premiums for each of the policy years used in the experience together with the average pure premiums for all years and the selection of a pure premium for each territory. Mr. Stellwagen states that in the selection of pure premiums, "particular attention is paid to trends in the experience." It occurs to the writer that as a possible refinement of the work at this point, a definite system of weighting might be introduced, assigning greater weight to the pure premium of the later years. For instance, where the experience of three years is used, weights of 1, 2, and 3 might be applied to the experience beginning with the earliest year in order to take account of the trend in a uniform way for all territories. In this connection, Mr. Stellwagen states that "consideration is also given to any local conditions of recent development." This consideration enters into the process of selection when, for instance, a recently organized and well established safety movement is functioning. In such a case the experience developed during the years before the safety organization was established might be entirely disregarded. I believe, however, that such instances are not sufficiently frequent as

to seriously interfere with the operation of a weighting scheme in the general procedure.

With the rapid growth of the business of automobile insurance and with the introduction of the principle of compulsory insurance, more and more attention will certainly be given to the scientific development of rates for this line of insurance. The situation at the present time as respects automobile rate making should be regarded as very favorable inasmuch as the methods have already at this comparatively early date been developed on a sound actuarial basis.