PROBLEMS OF RATING ORGANIZATIONS

BY: JOSEPH M. MUIR

The present movement toward experimentation, flexibility and diversity in rating systems in the casualty insurance field raises a question as to the future status of casualty rating organizations. Traditionally, these organizations have been leaders in their fields with rating systems designed to meet the needs of their affiliated companies with what has been considered to be sufficient latitude within those rating systems to place their members and subscribers in a position to compete among themselves, as well as to compete with non-bureau companies. This concept of bureau operation, with basic manual rates being based upon a broad spread of compatible statistics, is taking on an entirely new complexion. The advent of the agency filing system promoted from within rating organizations, particularly in relation to automobile liability insurance; the construction currently being placed upon the deviation section of the casualty rate regulatory laws in some quarters; and the ever-growing desire on the part of individual companies enrolled in rating organizations to experiment, is bringing about a complete change in the position, from the standpoint of ratemaking, which rating organizations hold in the industry.

It is common knowledge that during the past three years agency filings and alternate filings by rating organizations on behalf of individual companies have increased in number at a substantial rate. Initially, only the most daring management of a bureau affiliate ventured outside the fold of the rating organization's orthodox rating systems. As time went on, however, other companies became more venturesome and joined in the movement. The extent to which this situation now prevails is evidenced by the number of such filings which the three principal rating organizations in the automobile field; namely, the National Bureau, Mutual Bureau and National Automobile Underwriters Association, have processed.

If we accept what seems to be true that this movement has gained such momentum that the participants—having experienced the questionable virtues of freedom of choice in their rating systems—have adopted the premise that competition is an underwriting factor that should be met through diversity in the rating structure, then future ratemaking as a function of a rating organization, compared with the traditionally accepted practice, will be unrecognizable.

As diverse rating systems become more prevalent, the statistics developed thereunder will become less compatible. This results in weakening the broad statistical base used by rating organizations and necessitates the introduction of new stabilizing elements into the ratemaking program. It is not suggested that time, experience and tradition have brought into being a ratemaking system which currently uses all the appropriate elements and is beyond the stage of improvement. It is suggested, however, absent a broad, sound statistical ratemaking base, such as that derived from a common statistical plan, a common grant of coverage, a common class of business, and a common underwriting practice, innovations in ratemaking techniques will require reasonable checks and balances to assure their worth and effectiveness. Companies which have relied upon a rating organization's rate promulgations to give them a reasonable and profitable book of business, may be placed in a difficult position to maintain their standing if the rating organization's statistical base should narrow to the point of producing unreliable results and not be offset by stabilizing ratemaking elements. A problem facing rating organizations in performing their ratemaking functions is the establishment of techniques to offset the drain on the reservoir of compatible data.

If it is feasible to establish a common denominator among the various diverse rating systems processed by a rating organization, the likelihood of determining pure premiums for very broad classifications or for very broad territories, offers a means by which such data may be utilized with reasonable assumptions. If the volume of business in this category should be substantial by the very nature of the number of contributors, a rating organization's functions may narrow to more closely resemble those of a statistical organization. Under such circumstances there is a question whether a rating organization, with its path molded to a future as a statistical source primarily, can service its affiliated companies with pure premium experience from which rates may be developed. If there is an average pure premium which will meet the requirements of all companies, a rating organization's ratemaking functions can contribute immeasurably to the entire industry. Even if this is not the case, perhaps several sets of pure premiums could be established to reflect different degrees of exposure. For example, in a simple sense, a de luxe offering might be made with a companion in the economy-type class, the latter being streamlined to include only the necessities.

Packaging, such as we have in the multi-peril field, can chip away at traditional forms of coverage and leave what may be considered the least desirable exposure from a loss and expense standpoint. Ratemaking in connection with such combination of coverages in package policies reflects the elimination of adverse selection with respect to certain elements of exposure, and lays emphasis upon the "sweetening" effect from the spread of risk. This leaves the standard coverage form with the high hazard elements of the exposure subject to rating on a basis that must be marketable and at the same time not unprofitable. Packaging of coverages has become an integral part of our business, and schedule forms are losing their popularity as well as their identity in some cases. A problem of a rating organization is designing a rating structure for such forms as we move through the transition to what eventually may be solely a packaging concept.

In the general area of service to its affiliated companies, a rating organization distributes statistical exhibits in various forms. In order to keep abreast with the multiplicity of rating systems used by the principal competitors of bureau companies, more elaborate statistical exhibits should be prepared by the bureau. The problem is to determine the forms which will be most productive and usable for the purpose intended. An improper interpretation placed upon the data by a company specializing in a particular area could prove to be costly. Errors resulting from such a situation could be troublesome to a company in retaining what it considered to be a desirable distribution of business. It should be the responsibility of the rating organization to see that its statistical releases are clear and understandable. Conveying to bureau companies the extent to which such data can be given credibility is a problem for the rating organization to resolve.

Where rate filings of rating organizations are not recognized, such as is the case in the State of Tennessee with respect to automobile insurance within the past year, individual member companies may elect to adopt the agency filing route with a ratemaking program based upon the rating organization's rate revision compilations. If the individual carrier's experience indications are comparable to those produced by the rating organization's rate filing procedures, it is a safe assumption that the agency filing will be given clearance. On the other hand, if this is not so, particularly if the individual carrier's results are less favorable, question arises as to the propriety of using the bureau compilations for support on the premise that the provision of the statute with respect to adequacy may not be met.

The statutes specifically provide for companies to band together in rating organizations for the purpose of ratemaking and this recognizes that those who participate through this channel will be favored with rates that reflect the average experience. Presumably this meets the test of the statute with respect to reasonableness and adequacy. Rating organization filings for individual companies may have a different status in this respect. If so, the rating organization is faced with the problem of supporting the individual company filings and may be up against the proposition of justifying the inclusion of experience for certain affiliated companies in producing the over-all average where such companies have introduced revisions of their own.

Changes in the rating laws will play an important role in the ratemaking problems of a rating organization. It is conceivable that under a "file-and-use" statute for example, the rapidity with which competitive rate filings could cross the desks of state supervisory officials could put considerable pressure on a rating organization's ratemaking schedule. It is not clear how state supervisory officials would process such filings and it is just as unclear how a rating organization would keep its companies competitive with all the schemes that would be tried, and do so by timing its activities to recognize promptly the effect such competitive "file-and-use" filings would have upon a bureau company's business. Prior approval legislation, on the other hand, has posed numerous problems to the industry, and there is no reason to believe that in the future that type of legislation would produce any different results under comparable administrative machinery.

To the extent rating organizations have been recognized as being proper parties in interest, they have been in a position to represent their companies. In some quarters, however, the status of a rating organization as a proper party in interest has been challenged. Supporting rate filings before state supervisory officials or in connection with judicial proceedings is one of the major responsibilities a rating organization has in its relationship with its companies. To keep it that way should be an industry objective.

For several years reference filings have been accepted by various states where the reference was to a rating system or coverage program introduced by a rating organization. The insurance departments which have adopted this system have relieved reference filers of any responsibility for supporting their use of the bureau rating system. Contrarywise, rating organizations have supported their filings and in many instances this has been done at considerable expense. The double standard which results from this type of administration is not conducive to enhancing the stature of a rating organization. In fact, if it continues to spread it could create serious problems.

Some time ago we entered the motor age and industry girded itself to accommodate a nation on wheels. We have now advanced to another phase of mechanization which is the electronic era. Electronic accounting machines are giving way to electronic computers, and electronic computers are revolutionizing our industry. Ratemaking functions of rating organizations are moving closer to this electronic computer atmosphere with all of its attendant complications. Many companies have spent years in programming their operations and are beset with problems. Rating organizations are no exception and their experience may be expected to follow the same pattern in the ratemaking field. As rating systems become more refined—there is a very definite trend in that direction—ratemaking material will follow the same pattern. As statistics become more refined, more operations are involved in producing them. This poses a problem for rating organizations in their relations with companies which delay in filing their statistical reports. It may be anticipated that this problem will increase in magnitude unless means are found to handle this function more expeditiously.

While more directly related to rate promulgations and rate administration than to ratemaking as such, a rating organization's relations with the public are of considerable importance. Ratemaking which has a substantial effect upon a particular community may aggravate company-policyholder relations. Where the company is affiliated with a rating organization, a complaint generally finds its way to the lap of the latter. Ways and means must be found to cope with this problem which cannot be permitted to become serious.

Rating plans which provide for modifying basic rates to reflect the degree of hazard in individual risks or to measure the variation of expenses among risks, fall into the general category of ratemaking. On a very limited scale, some rating plans in use are predicated upon objective standards and are designed to produce like results under like conditions. On the other hand, flexibility in rating plans is the rule rather than the exception, and competition is the controlling factor in determining what the individual risk's rate shall be. When rate regulatory statutes were enacted more than a decade and a-half ago and the states took steps to put implementing machinery into operation, it was reasoned that the transition from non-regulation to regulation necessitated the acceptance of certain rating influences. Among these was flexibility in rating plans. It is hardly conceivable that representations can now be made that the transition period is still with the industry. Rating plans are being reviewed in certain quarters and it may be expected that these rating devices will be subject to closer and closer scrutiny as to the propriety of perpetuating them.

The production segment of the insurance industry came to the fore in the State of New York sponsoring legislation which, when enacted, required the state supervisory officials, in approving rates, to give consideration to commissions paid during the most recent annual period. While it may not be altogether clear what the practical effect this legislation will have from the standpoint of a rating organization's ratemaking functions, it is common knowledge that the legislation prompted considerable controversy and was found objectionable by other segments of the industry. Just recently it was announced in the press that the same source that sponsored the so-called Barrett-Russo Law, to which I just referred, is also planning to submit a proposed "Statistical Rating Law" to the 1963 Legislature of the State of New York. The word is out that the intent of this latest legislation is that "Rates shall be based on the most comprehensive statistics available" and also that "the standards . . . enunciated shall apply to all filings . . . whether designed as deviation, independent, group, bureau or otherwise." It is also reported that elsewhere in the proposed bill it is required that consideration shall be given to past and "provable" prospective loss experience "of all insurers" and also to past and "provable" prospective other expenses—whatever that may mean in this sense. If this legislation or similar legislation should become the law, it would materially affect the ratemaking practices of the rating organizations.

Adverse developments in classification loss experience prompting a refinement in classification differentials brings to the fore the question as to the propriety and desirability, in the ratemaking process, of establishing limitations on the maximum change in the high hazard classifications. If this principle is to be put into practice in order to keep the classification system reasonable and marketable, the correction in the off-balance with further limitation to prevent wide fluctuations in rates requires investigation and study.

Experiments are being carried on in the personal lines automobile liability field to determine the reliance which may be placed upon new measurements of exposure. Exposures by occupational pursuits have been studied for some time. More recently the academic standing of youthful drivers has been investigated and psychological testing of drivers is currently quite prevalent. The extent to which these studies will produce results that will eventually find their way into ratemaking systems is yet to be determined.

In conjunction with the future ratemaking problems of rating organizations it appears that a very important appendage must be added in the form of an expansion of existing research functions. With the electronic equipment now available, the demand will very likely increase for more activity in statistical research. This will necessitate carriers furnishing much more additional statistical information than is presently reported and it is conceivable that in due course rating organizations, in addition to performing in their own field, may be called upon to handle operations for affiliated companies which are now performed by those companies individually.

MULTIPLE PERIL RATEMAKING AND STATISTICAL PROBLEMS

BY: SEYMOUR E. SMITH

The growing development of package policies embracing two or more major lines of insurance presents problems of considerable magnitude in both the statistical and ratemaking areas. The statistical problem might appropriately be mentioned first. Up to this point, with the exception of the homeowners policies, the various individual rating organizations have taken the position that statistical data for the coverages or lines of insurance which fall within their normal jurisdiction should be separately broken out and reported within their usual classification assignments. For the long pull, this seems to offer a rather serious problem so long as the development of the various package policies is geared toward what are considered to be the most desirable risks. While it is not known whether or not this will be the pattern in the future, at least up to this point, generally speaking, the various packages have been developed by companies or groups of companies with the apparent objective of attracting to themselves so-called "cream" business.

If experience under these package policies, which are written at a discount