UNDERWRITING PROFIT IN FIRE BUREAU RATES

LAURENCE H. LONGLEY-COOK

VOLUME LIII, PAGE 305

DISCUSSION BY STANLEY C. DU ROSE JR.

The author presents an interesting discussion and defense of the hypothesis in fire insurance bureau rate making that, "For rate adequacy, we must limit the data to the experience of stock companies, as otherwise they will not, on the average, experience the underwriting profit assumed in the rating formula."

Mr. Longley-Cook has recited three of the arguments usually given for the exclusion of mutual company underwriting experience from stock underwriting experience in the bureau rate making process. However, there are other equally valid arguments for the inclusion of the experience of all bureau members and subscribers in the rate making process.

I believe the paper would have had better balance and been more convincing if the author had presented his rationale set in a matrix of the legal and actuarial issues involved with rate making in concert.

Consider for example the typical rate making statute under which most rating bureaus operate. The only lawful way in which insurers may act in concert in the making of rates is through the device of a rating bureau. Insurers are relieved of their obligations under the law to file rates by becoming a member or subscriber to a rating bureau. One of the fundamental questions then is whether or not the rate law contemplates that companies making rates in concert may use the underwriting experience of only a portion of the insurers so acting in concert in rate making. This is a question for lawyers to debate, but I suggest that it may be quite difficult to establish as a matter of law that an insurer has a right to use rates predicated upon experience other than its own underwriting experience, without any requirement for a showing that such rates are appropriate for its underwriting and plan of operation.

The rate law contemplates that the rating bureau file rates on behalf of member and subscribers companies. If the bureau were making and filing rates for stock insurers based exclusively on stock insurers underwriting experience, then it would seem that the law would require that the same bureau would make and file rates for non-stock insurers based on

the underwriting experience of such insurers. This would be especially true if it could be shown that the volume of such experience was indeed credible. It has yet to be established that member and subscribing companies of a fire insurace rating bureau would agree that they could survive the results of an intensely competitive market wherein a higher rate level were to be promulgated for stock insurers than the rate level promulgated for non-stock insurers by the same bureau.

The author in his paper seems to assume that stock insurers by writing business through the American Agency System are not capable of writing an average cross section of the fire insurance risks placed with all insurers. This assumption is based on empirical data that needs a much greater depth of study and evaluation. A comparison of stock and mutual claim frequency and severity would be helpful. Consideration should be given to the underwriting control that stock insurers can and do exercise, and also to the significant volume of business that is written by non-stock insurers operating through the same American Agency System and not infrequently on the same risks and through the same agents.

In respect to the question of statistically credible differences in loss ratio based on combination by corporate form, I suspect that grouping by other criteria such as Direct Writer vs. American Agency System companies would produce similar statistically credible differences in loss ratio.

It seems to me that an important point which the author has not mentioned is the matter of the manner in which claims are adjusted by stock insurers and non-stock insurers. It is possible that any difference in loss ratio between stock and non-stock insurers could be accounted for by claim adjustment practices and procedures. This in itself would be an interesting study to pursue. The argument could be made that the reason why stock and non-stock loss ratios for workmen's compensation, as presented by the author, are so nearly alike is that there is a rigid framework of law governing claim adjustments.

Some of the same bureau rate making problems just mentioned are also involved with the question of conversion, to a common rate level, of the underwriting experience produced from deviated rates. The basic truths of pure premium rate level calculation should not be arbitrarily abandoned merely because fire rate levels are usually determined by loss ratio rather than by pure premium methods.

If there is a competitive market and if we assume that the bureaus were to make rates only on the underwriting experience of the stock

American Agency System insurer, then it would seem not unreasonable to conclude that at some point in time such insurers would be victims of the process of adverse selection and, therefore, increasing rate level. This would be followed by the stock insurers writing less than a majority of the risks being insured. This raises the question as to when the bureau and the stock insurers would reach the point at which they would have to reverse their position and demand that rates be made on a combined underwriting experience of all members and subscribers to the rating bureau. I do not think it proper to assume that merely because stock insurers at present may have a majority of the business written in some geographic areas and in some risk classifications this will always continue to be true. Is there not a responsibility to determine now the principle that will govern what is to be done when the market shares become more equalized? The automobile insurance business is an interesting case history in the matter of increasing rate levels, adverse selection, and decreasing market share.

A review of the situation that presently exists in the rate making system of the principal physical damage insurance rating bureau is also of interest. A significant percentage of the underwriting experience that is combined for rate making purposes is generated by insurers specializing in the writing of insurance on financed vehicles. For many years, the underwriting experience of such companies has been consistently and substantially poorer than that of all other members and subscribers. In this case, the bureau has rejected any suggestion that the underwriting experience of such companies should be considered separately.

I believe the author has done a service by opening a discussion of a controversial subject that has many facets and about which there is much conversation but all too little thoughtful evaluation and written dissertation. The paper is obviously a valuable contribution to the works of the Society. Indirectly if not directly, it points up items that are urgently in need of further study. It suggests that fire rate making schedules are probably less than adequate in the differentiation and measurement of hazard and risk. This is a subject in need of attention by actuaries. The paper further points up the uncertainty of the requirements of the law relating to rate making by bureau. This needs the attention of both actuaries and the legal profession. In the meantime, insurance regulatory officials should not be condemned if in operating under rate laws that are obsolete they are slow in approving rate making schedules that do not adequately measure risk.