value of actuaries to their companies, and at the same time dramatically increase the need for the actuarial services rendered by statistical and advisory ratemaking organizations.

## THE CONSULTANT

LEWIS H. ROBERTS

The pricing of insurance is important at several economic levels. At the most parochial level, from the insurance company's point of view, its rates determine the amount and kind of business that it will attract and the profitability of that business. The interest of an actuary in the price of insurance often begins and ends at this level.

From the standpoint of the industry as a whole, the price of insurance determines its profitability and the extent to which it is used as a means of meeting risk, as opposed to other alternatives such as the self-assumption of risk or its elimination through cessation or change in mode of operation. According to economic theory, competition should redound to the benefit of the general public by forcing the price of each coverage to the lowest level consistent with an acceptable profit to the insurer. The aggregate of individual decisions on the amount and kind of insurance purchased at the offered price then determines the extent to which society utilizes insurance as a means of meeting risk. It is in this way that a competitive economic system determines the allocation of economic resources generally.

At the level of the individual company and at the level of the industry as a whole, the price of insurance performs the same economic function as the price of the product of any other business. The insurance industry, however, has a special function in the general economy which transcends the selling of its own product. It determines and assesses from policyholders one of the major costs of carrying on almost every enterprise — the costs of a wide variety of unpredictable contingencies. Inclusion of the insurance cost in the price of a commodity then forces buyers to consider whether they want the product enough to bear the cost of accidental damage and injury to persons that accompanies its production, sale and use. Thus, the insurance industry plays an extremely important role in guiding society to an economically efficient allocation of resources in all industries, not merely its own.

When the government regulates insurance prices, it becomes the arbiter

at all of these levels of economic activity. For example, in sanctioning an automobile classification system and rate schedule it not only decides the price of insurance for each individual but also influences the number of cars that will be sold, their price, who will buy them and how much disposable income remains to their purchasers.

It is a basic tenet of a free enterprise society that in the absence of monopoly or unfair competition the best method of pricing commodities and thereby determining the way society allocates its resources is in the market place, through contracts arrived at by free and open bargaining. To be sure, there is ample justification for stringent regulation of the insurance industry in some areas. Unconscionable policy provisions and various undesirable pricing practices, including both unfair discrimination and unfair competition, must be carefully watched for by regulatory offiicals. However, given the present competitive nature of the industry, it is difficult to see any greater need or justification for strict control of insurance prices than for control of prices generally. On the contrary, the absence of a free market has been a bar to the most efficient fulfillment of one of the actuary's most important economic roles — the accurate determination and assessment of that component of a product's or activity's total economic cost due to accidental damage and injury.

Through "prior approval" rate regulation, insurers are straight-jacketed into a "yes" or "no" position on each risk within a classification. The insurer can only accept the risk at the stipulated price or refuse it. That is, he *may* be permitted to refuse it, subject to the limitations on underwriting discretion imposed by Assigned Risk Plans, Fair Plans, and other expressions of public policy. This inflexibility results in a proliferation of such plans and other mandatory rulings which amount to the subsidizing of bad risks by good ones. The insurer cannot play his legitimate pricing role in the economy.

In a competitive environment there should be very few really bad risks. Most risks can be good ones — at the right price. It is squarely up to company actuaries and consulting actuaries to determine that right price by using more flexible and complex techniques than those presently in general use. A company that relies comfortably upon familiar broad classification and territorial systems and depends upon its underwriters to keep it out of trouble will head downhill fast. Other, more enterprising, insurers will attract the best risks from each classification. Otherwise, to break even the

company must increase rates, but as it does so the next most desirable layer of risks becomes vulnerable to competitors. We must drive this point home to our companies and to our clients before their competitors do — too late.

Under these conditions the actuary's life is far more stimulating intellectually than under bureaucratically administered pricing regimes. He must be constantly competing to develop better rating techniques. Each improvement should result in his winning some "apples" from his competitors and unloading some "lemons" on them. There ought to be no need for the unloading of lemons to take the form of refusal to insure since that is no longer a rational approach except in extreme cases. It should come about through raising the rate for an unprofitable risk to a more adequate level, thus causing it to go to another company that is still unwittingly pricing it too low. This process will have the economically desirable effect of contiually narrowing the gap between what each policyholder pays for insurance and what he should be paying.

Another gratifying aspect of such competition is that it is unlikely ever to end. Insurance ratemaking, as we know it now, is at once so susceptible to improvement and so potentially complex that there should always be room for improvement — and someone with an idea for accomplishing it. At the not imaginary extreme of refinement, the known probability of loss for some risks becomes so high that insurance is economically not feasible and should be replaced either by direct funding or, much better, by prevention of loss. Safety is furthered through the pressure of rates and the pricing of extreme cases off the road or out of business.

Of the utmost importance to the success of open competition is our willingness and ability to quote a price for risks that many insurers have studiously avoided in the past. Except for those cases where special circumstances exist, such as moral hazard, illegality, or overwhelming catastrophe potential, *the only bad risk is an underpriced one.* We should recognize this and act accordingly.

Open competition should not be looked upon, however, as a panacea whereby uninsurable risks will suddenly become insurable. There will still be coverages that are so potentially catastrophic or so expensive that it will be impossible for the insurer and the risk to reach a meeting of minds in the market place. The insurance industry should not be blamed for this, nor should it be looked upon as a failure of the competitive system. If we price a person out of the market we are telling him that the true economic cost,

including insurance, of the enterprise that he is contemplating is more than he is willing or able to pay. Possibly it will be desirable as a matter of public policy that the enterprise be subsidized by other policyholders or by society in general. When that is the case, it can be accomplished by techniques similar to those used in the past. Open competition should alleviate the need for these methods but it will not completely eliminate it.

## THE CONSUMER AND THE EDUCATOR

C. ARTHUR WILLIAMS*

"Open-competition" rating laws include all rate regulatory laws that prohibit agreements among insurers (except those under common control) and rating organizations to adhere to certain rates or rules. In early 1970 eleven states had such laws. In varying degrees these laws assign a greater role to competition in the determination of insurance price levels and price structures than other rate regulatory laws and involve the state insurance department less directly in ratemaking.

In five states insurers need not even file their rates — California, Florida, Idaho, Illinois (where filing may be required by regulation), and Montana. Three require filing within a stated period after the rates become effective — Connecticut, New York, and Wisconsin. In the other three — Georgia, Minnesota, and Oregon — insurers must file rates no later than their effective date. In some of these states the commissioner has the authority to impose more severe filing requirements if he finds the existing price competition to be insufficient or irresponsible.

### *The Consumer Viewpoint*

Intelligent consumers will judge open competition rating laws primarily on their ability to provide an adequate supply of insurance at reasonable prices consistent with a "fair" profit for "efficient" insurers. If open competition laws work perfectly, each insured should pay a premium that is reasonable, adequate, and not unfairly discriminatory, in the private equity sense. An adequate supply of insurance should be forthcoming for all insureds at some price. If one insurer is inefficient necessitating high expense charges, earns excessive profits, or overcharges one group of insureds relative to

* Dr. Williams, who was a guest panelist, is Professor of Economics and Insurance in the School of Business Administration, University of Minnesota. He is a Past President of the American Risk and Insurance Association.