

INSURANCE RATES AND RATE REGULATIONS (92-1)

EO 1. INSURANCE CONCEPTS:

1. A **cause of loss** (aka **peril**) is a force that causes a loss.
2. A **hazard** is anything that increases the frequency or severity of loss.
Hazards fall into four categories:
 - a. **moral hazards** (active inducement of loss),
 - b. **morale hazards** (passive indifference to loss),
 - c. **physical hazards** (physical conditions of the insured object or its environment), *and*
 - d. **Legal hazards** (*chance that judges can't read policies and juries can't render rational verdicts*).
3. **Insurance** is a contractual agreement to transfer risks of financial loss from the insured to the insurer in exchange for payment of the insurance premium.
Underwriting protects insurers against hazards by
 - a. requiring insureds to take actions to reduce or to eliminate hazards,
 - b. setting premiums high enough to cover losses resulting from hazards, *and/or*
 - c. refusing coverage.
4. **The law of large numbers** states that when the number of similar, independent, exposure units (cars, homes, lives) increases, the relative accuracy of loss predictions also increases. Insurance pools the loss exposures of many insureds, letting insurers predict the group's losses and charge adequate premiums to cover those losses.
5. **Indemnification** restores a party who has had an insured loss to the same financial position he had before the loss occurred.

EO 2. **HOW TO CALCULATE AN INSURANCE PREMIUM:** To calculate an insurance premium, determine the exposure base, the exposure unit, and the rate.

The exposure base is the variable chosen to approximate the loss potential for a particular line of insurance. Workers' compensation insurance uses payroll as the exposure base.

Exposure bases for other types of insurance include gross sales, area, admissions, and total cost of contracts.

The exposure unit is the unit of measurement of the exposure base.

Example: Payroll is often the exposure base.

Each \$100 of payroll is often the exposure unit.

The insurance rate is the price per unit of insurance.

The insurance premium is the total cost for all units of insurance under a policy.

THE PREMIUM equals the rate times the number of exposure units.

*[An **insurance rating plan** creates an objective system for calculating insurance premiums by defining the exposure base and specifying the rate per exposure unit.*

Most rating plans define distinct classifications of insureds and operations and use rates that reflect each classification's loss exposures.]

EO 3. **EXPOSURE BASE CHARACTERISTICS:** The ideal exposure base

1. **reflects the size of the exposure**--so **total losses** (average loss frequency times average loss severity) increase as the number of exposure units increases;
2. **responds to inflation**--by automatically self-adjusting for inflation;
3. **is easily measured**--in objective units (dollars, square feet) based on easily obtainable data;
4. **is difficult to manipulate**--to minimize intentional mis-reporting by insureds; *and*
5. **is acceptable to regulators and society**--so that
 - a. regulators are confident that the base provides a good measure of the exposure *and*
 - b. members of society don't feel unfairly discriminated against.

INSURANCE RATE COMPONENTS: An insurance rate consists of three components:

1. an expected loss component (aka **pure premium**),
2. an expense component, *and*
3. an allowance for profit and contingencies.

The expense component and the allowance for profit and contingencies are usually combined into a single element known as the **expense loading**.

Pure premium equals the dollar amount of losses incurred during the experience period divided by the number of earned units of exposure.

The gross rate equals pure premium divided by the **expected loss percentage** (100 percent minus the expense loading percentage).

MODIFICATIONS TO MANUAL RATES: A **manual rate is the rate found in a rating manual or on a rate table. **The manual premium** equals the manual rate times the number of exposure units.**

Insurers modify manual rates to reflect the insured's loss experience and/or other risk factors.

RATING CLASSIFICATIONS are the loss-causing characteristics used for rate classification purposes.

There are **three possible methods of spreading the cost of insurance among insureds:**

1. **Single rate system**--uses one rate that is too high for some insureds and too low for others. It leads to adverse selection and causes insurers to reject applicants with high loss exposures.
2. **Individual rating**--assigns each insured an insurance rate that reflects its own individual loss characteristics. But, individual rating is expensive and creates potential for unfair discrimination.
3. **Class rating**--separates insureds into defined categories (classes) and then applies the same rate to all class members. Class rating narrows the variation of exposures within a class, thereby minimizing the chance for adverse selection by insureds.

The ideal classification system strikes a balance between complexity and simplicity.

A complex classification system will group only the most homogenous insureds, *but* the resulting classes each may be too small to benefit from the law of large numbers.

A simpler classification system produces larger groups, *but* does *not* offer the most competitive rates to all insureds.

EO 4. **RATEMAKING GOALS: The ideal rating system should**

1. **produce the correct price per unit of exposure**--just high enough to cover losses and expenses while providing adequate profit;
2. **produce stable rates--by using** long experience periods, statistical isolation of catastrophic losses, *and* **credibility factors** (measures of the actuary's confidence in the past loss data as indication of future losses) to avoid undue rate fluctuations;
3. **respond to changes in loss exposures**--by using **trend factors** (adjust past loss data to reflect recent trends) and **merit rating plans** (adjust individual insureds' manual rates to reflect actual experience) so rates rise if loss frequency and/or severity increase and fall if they decrease;
4. **encourage loss control**--by encouraging specific loss control measures or rewarding successful loss control [*See below.*];
5. **provide for profit and contingencies**--to create a margin for error in the rates, *and*
6. **be simple**--to avoid complicated calculations.

An **experience rating plan** increases the insured's rates for a future period based on its loss experience in a prior period.

A **retrospective rating plan** adjusts the insured's premium for a given period based on its experience during that same period.

A **schedule rating plan** adjusts the insured's premium to reflect characteristics not reflected in its experience rating.

- EO 5. **RATE REGULATION GOALS** [*a common exam question*] **ensure that rates are**
1. **adequate**--high enough to pay all claims and expenses and to maintain insurer solvency,
 2. **not excessive**--low enough to prevent insurers from earning unreasonable profits, **and**
 3. **not unfairly discriminatory**--using substantially similar rates for loss exposures that have substantially similar expected losses and expenses.

[Regulatory objectives conflict because the public wants the lowest possible rates but insurers need to charge enough to pay claims and provide an adequate return on capital. Also, when insurance regulation holds rates down for one group of insureds, other groups have to pay higher rates to keep the insurer solvent.]

SIX MAJOR TYPES OF STATE RATING LAWS:

1. **Mandatory rate laws**--A state agency sets rates and requires compliance by all licensed insurers.
2. **Prior approval laws**--The state insurance department must approve all rates before they are used.
Disadvantage: Approval delays may cause 'new' rates to be out-of-date by the time the insurer can use them.
3. **File-and-use laws**--Insurers file rates with the insurance department and use them pending the department's approval.
The department may disapprove the rates if they can **not** be justified or if they violate state law.
4. **Use-and-file laws**--Insurers use their own rates but must file them within a prescribed time period.
5. **Flex rating laws**--Insurers can use rate changes within a band of percentages without prior approval.
6. **Open competition**--Insurers do **not** file rates with the insurance department, **but** the department has the authority to monitor competition and to disapprove rates.

[Supporters of prior approval laws argue that prior approval laws

1. *require insurers to use actuarial data to justify rate changes,*
2. *promote insurer solvency, and*
3. *keep rates reasonably low.]*

[Supporters of open competition argue that

1. ***prior approval laws***
 - a. *can cause inadequate rate increases,*
 - b. *may subsidize rates for high-risk insureds, and*
 - c. *can drive insurers from the state and increase the size of residual market plans; however,*
2. ***open competition***
 - a. *is less expensive to administer,*
 - b. *overcomes the limitations of prior approval laws, and*
 - c. *keeps rates reasonable and equitable.]*

EO 6. **THE RATE FILING PROCESS:** **When filing rates with state regulators, an insurer must submit** rate schedules, explanations of the methods the insurer used to calculate the rates, **and** enough statistical data to justify the rate changes.

An insurer is not required to adhere to all bureau rates.

An insurer may file a **deviation filing** (request to deviate from bureau rates).

The insurer must show that its individual loss costs are very likely to be either higher or lower than the regulator's prospective loss costs.

An insurer that does not subscribe to a rating bureau must calculate and file its own rates (**independent filing**).

Small and new independent filers must base their rate calculations on experience data from other insurers, either in place of or combination with their own experience data, **and** demonstrate that their rates comply with statutory requirements.

INSURANCE ADVISORY ORGANIZATIONS are independent corporations that perform services for their member companies and subscribers.

Insurance advisory organizations

1. develop rating systems;
2. collect and tabulate statistics;
3. research and monitor important insurance issues;
4. provide forums for discussing those issues; *and*
5. educate insurers, regulators, and the public about insurance issues.

Insurance advisory organizations include

1. **the National Council on Compensation Insurance (NCCI)** (for workers' compensation and employer's liability insurance),
2. **the Insurance Services Office (ISO)** (a multiple-line rating bureau for property and liability insurance except workers' compensation, ocean marine, aviation, and surety bonds),
3. **the American Association of Insurance Services (AAIS)** (develops policy forms, manual rules, and rating information for property and casualty insurers), *and*
4. **state rating bureaus** (state government agencies and insurer-owned bureaus that provide services to property-casualty insurers in one state).

EOs 7 + 8. **STATE VERSUS FEDERAL INSURANCE REGULATION:** Insurance regulation is slowly changing from a predominantly state-regulated system to a federally regulated system. That change is evident when looking at the history of insurance regulation since 1944.

In 1944, in its **Southeastern Underwriters Association (SEUA)** decision, the Supreme Court held that insurance *was* 'commerce among the States' and *was* subject to federal law. That decision created the need for a federal agency to regulate the insurance industry. The federal government didn't have an agency that was prepared to regulate the industry. Further, the states did *not* want to lose their authority to regulate the insurance industry.

In 1945, Congress passed the **McCarran-Ferguson Act**, which still exempts the insurance industry from federal antitrust laws to the extent that our industry is regulated by the states.

In 1999, Congress passed the **Gramm-Leach-Bliley Act (GLB)**, which allows a single corporation to offer combined banking, insurance, and securities products and services *and* raised the notion of creating a national insurer licensing system *if* states did not adopt uniform licensing laws. GLB reaffirmed the McCarran-Ferguson Act by trying to reconcile federal banking and security laws with a state regulatory system for insurance.

Currently, the House Financial Securities Committee is considering a bill called the **State Modernization and Regulatory Transparency (SMART) Act**, which would require state insurance regulators to enforce uniform standards to a wide array of insurance issues *and* would preempt state regulation of insurance rates.