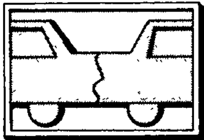
Conclusions and Recommendations



The auto insurance regulation system in North Carolina is out of kilter. While most close observers agree that the system needs changing, no consensus has developed as to what changes should be made. The 1985 General Assembly and the newly elected Commissioner Long will probably enjoy a traditional "honeymoon" period. Hence major changes may not be forthcoming soon.

One major change on the minds of many analysts of the industry is deregulation. "We feel it is the most responsible system," says John McMillan, who discussed the matter when still a lobbyist for Allstate. "We're in a very competitive business. We can be responsible in the marketplace if there is price competition among the companies. If market factors allow us to make reductions, we need to have the ability to make that reduction—provided the statute also permits us to react to the market factors that necessitate rate increases. That's the quid pro quo."

Benjy Seagle of Aetna adds, "The NAIC Advisory Committee study on competitive rating recommended a regulatory system based on price competition as the system most responsive to the needs of consumers and the industry."[34]

Consumer advocates, however, worry about the effects of a deregulated system. "Despite the complicated system we have now, it's better for consumers generally than open competition," says legal services attorney Mike Calhoun. "With competition, the industry underwrites on the basis of surrogates and extreme subjectivity, which works heavily against poor people."

Much of the insurance industry favors competition in lieu of regulation. Competition might protect consumers against excessive *overall* rates. But would competition protect *individual* drivers against socially inequitable rating criteria? The best evidence is that it clearly would not. Much of the industry continues to advocate age and sex discrimination, and many industry representatives seem to consider only statistical equity—not social equity—as a measure of fairness. Therefore, there is a need for continued regulation of the driver classification system, even if companies are allowed to compete freely within that structure.

The framework of this article departs in at least three significant ways from traditional propositions put forth by most industry representatives. First, industry representatives do not appear to distinguish between statistical and social equity. Second, they generally favor charging higher rates for reinsured drivers. The third difference in approach concerns investment income.

Many representatives of the industry seem to reject—or perhaps fail to acknowledge—the distinction between statistical equity and social equity in forecasting which groups of drivers will cause insurance losses.

There is no question that reinsured drivers do cause more losses than drivers in the voluntary market. However, there are no criteria for ceding drivers to the Reinsurance Facility and no record of why companies choose to do so. There is no way of determining whether the higher rates are socially equitable. This is unacceptable, particularly given the industry's penchant for socially inequitable rating criteria, such as age and sex.

In North Carolina, only income earned on "policyholder" funds is considered in setting rates. These include unearned premiums (money) paid in advance) and unallocated loss reserves (money soon to be returned to the policyholders). Yet, according to the NAIC, North Carolina's ratemaking formula would yield exorbitant profits if one considers *all* investment income, including the return on the "surplus" that stands behind insurance policies.

As Joseph Johnson of UNC-Greensboro points out, surplus "represents capital belonging to shareholders." Yet, money earned on surplus is part of the shareholders' total return on investment. If regulation is to stand in lieu of competition to protect consumers against excessive rates, regulators must consider *all* investment income. This is particularly problematic in the Reinsurance Facility, since companies retain the surplus behind reinsured policies.

Commissioner Long has proposed that a new legislative study commission redraft by 1987 all property and casualty statutes, which includes auto insurance. Perhaps the suggestions below can help to prepare those who will rewrite these laws. Meanwhile, some short-term changes would make the proposed 1987 overhaul more meaningful in the long run.

Short-term Recommendations

1. Improve the Data Reporting System of SDIP Points. As many as 60 percent of the SDIP points that should be assessed are not. This flaw in the SDIP system must be addressed before policymakers can determine what structural revisions are needed. Currently, insurance companies do not monitor often enough official driving records kept by the Division of Motor Vehicles; convictions for violations do not automatically result in SDIP points. This system could be improved in several ways, such as reducing fees for the critical "MVR" form, requiring drivers to report violations to insurance companies, or requiring clerks of court to send notices of convictions to insurance carriers. Possible solutions to this problem are summarized in the sidebar on pages 44-45. Any of these changes would require some action by the General Assembly.

2. Reduce the Surcharge Percentages for Drivers With More Than Two SDIP Points. Persons with high numbers of SDIP points pay excessive rates, primarily because surcharges for SDIP points are too high (see Table 4). Any major changes in the SDIP system should be made in the larger context of the proposed 1987 overhaul of the whole auto regulatory system. Meanwhile, Commissioner Long and the Rate Bureau have the administrative authority to give immediate relief to drivers with high points. These drivers should not have to wait until 1987 for equity. Administrative action on the surcharge would not involve major structural changes. This change would require "increasing the base rates, which would impact drivers without points, and this has been the political difficulty," says Paul Mize. "It would take courage to correct."

3. Allow Group Liability Rates. Currently forbidden by law, true group liability coverage could reduce pressure on the ratemaking system. Administrative costs could be cut drastically, and the rating system might be altered along the pattern of group health insurance.

Long-term Recommendations

Since 1973, piecemeal tinkering and political confrontation have resulted in a contradictory and complex auto insurance regulation system. The recommendations below should be viewed in the context of an overhaul of the entire system.

The insurance industry "does not oppose revisions to the driver classification system or in the Safe Driver Insurance Plan," says Aetna's Seagle. "We support more equitable plans than what we presently have, but one must realize x number of dollars is needed from our rate projections and if the SDIP surcharges are adjusted, base rates would also have to be adjusted to compensate for that difference."

While each recommendation can stand alone, all are interrelated, and should be understood in that way.

1. ***Revise Driver Classification System.*** As currently structured, the ratemaking system is neither statistically nor socially equitable. A person's driving record seems inadequate as the primary tool for ratemaking because so few drivers cause most of the violations and accidents. On the other hand, demographic measurements, such as age and sex, are unfair because they penalize too many people who are good drivers. A driver classification system should attempt to be both statistically and socially equitable, where possible. Specifically, it should:

a. ***Use Mileage Driven as an Explicit Factor in Setting Rates.*** Currently, mileage is considered indirectly in the car use category (farm, pleasure, commuting, business). It should be an explicit factor for rates; mileage is measurable, socially equitable, and statistically related to the risk a driver poses to an insurance company.

b. ***Reject Efforts by the Insurance Lobby to Restore Age and Sex as a Rating Factor.*** Age and sex are actually surrogate measures for other driving characteristics, such as recklessness. Penalizing all persons in such a demographic group with higher rates is unfair to the good drivers in that group.

2. ***Revise the Safe Driver Insurance Plan.*** In 1982, 80 percent of the cars were rated at 0

SDIP points. Hence, too few had enough points to bear a large portion of the cost of the insurance system through excessive rates. The current SDIP penalty schedule may not measure accurately the relative severity of various accidents and violations in relation to the likelihood of future insurance losses. One driver could be assigned 10 points either for a single conviction for driving while impaired while another would have 10 points for *five* accidents causing injuries or damages in excess of $500. Do these drivers represent the same risk to the insurance company? This is the proper question to answer with the SDIP system. Punitive rates for drunk driving, for example, are not appropriate within an insurance rating system, but should be dealt with through the judicial system. Specifically, policymakers should:

a. ***Adjust Surcharges to Reflect Anticipated Losses.*** In the total market, drivers with 2 or more points paid too high a rate in 1982 (see Table 4). The higher the number of points, the more excessive were the rates. With reduced surcharges, the SDIP system can play its proper role: to anticipate losses according to driving record. With the current excessive rates, the SDIP system is punitive.

b. ***Eliminate Facility Surcharges, or Remove Link to SDIP System.*** Clean risks in the Reinsurance Facility pay the same rates as comparable drivers in the voluntary market, even though they cause more losses. In addition, the facility continues to lose money even though its rates are supposed to be self-sustaining. These revenue shortfalls are offset by surcharges against all drivers with SDIP points. The Supreme Court has ruled that these surcharges are not premiums and thus are beyond the regulatory reach of the Insurance Commissioner.

As a result, the already excessive cost of insurance for drivers with SDIP points is increased even further, and a proportion of the facility's operation is essentially unregulated.

The need for surcharges could be eliminated by a revision of the driver classification plan, consideration of investment income, and a change in the way facility rates are set. The SDIP system was not designed as an auxilliary to the involuntary market mechanism, which is what it has become.

3. ***Consider Eliminating Higher Rates in the Reinsurance Facility.*** Nationwide, North Carolina has among the highest percentages of auto policies in the involuntary market. Mandatory liability insurance puts pressure on companies to cede drivers to the facility. But one of every five policies is now ceded, resulting in a dual system of rate regulation in the state, with drivers in the facility who are not "clean risks" paying 40 to 44 percent higher rates in 1984. The higher rates in the facility, as a practical matter, subvert the classification plan; the facility itself has become part of the classification system through the back door, as it were.

Originally, higher rates were not allowed for drivers whose policies were ceded to the facility; different rates have existed only since 1977. Eliminating this difference could greatly simplify the ratemaking process, and would probably be the easiest way to achieve social equity among all drivers—whether in the voluntary or reinsured market.

4. ***If the Dual Rate System Is Not Eliminated, Consider Other Revisions to the Reinsurance Facility.***

a. ***Require Criteria for Ceding Policies to the Facility.*** Companies may cede as many policies as they wish for whatever reasons they wish. This allows companies to subvert the North Carolina law prohibiting ratesetting according to age and sex. If a company chooses to cede a policy because of age, sex, or other demographic factors, the rate on that policy is automatically 40 to 44 percent higher—if that policy has any SDIP points or if the driver has been driving less than two years (i.e., any policy that is not a "clean risk"). In effect, the facility is now part of the classification plan, without criteria.

b. ***Reduce Rates for Reinsured Drivers with Points.*** Rates are excessive for drivers in the facility who are not "clean risks." Predicted and actual losses of high-point drivers in the facility are not a great deal higher than they are for drivers with comparable records in the voluntary market, yet the reinsured drivers pay much higher rates.

c. ***Increase Rates for Reinsured Drivers with 0 SDIP Points.*** Clean-risk drivers do not pay their fair share. In 1982, 63 percent of the reinsured drivers had 0 points. Low rates for these drivers resulted in a loss ratio of 136 percent, far above the overall average loss ratio for the facility (see Table 6).

5. ***Include All Investment Income in the Rate Formula.*** The N.C. Rate Bureau files rates based on a formula that anticipates a five percent underwriting profit for insurance companies. The National Association of Insurance Commissioners, whose predecessor group set the five percent standard in 1921, has found that an arbitrary underwriting income percent is no longer an appropriate standard. The NAIC, and other

national analysts, contend that an overall projected income approach should be incorporated into the rate formula and that the underwriting margin should vary from year to year, depending upon interest rates for a given year. In North Carolina, only some investment income is currently considered in setting rates.□

FOOTNOTES

[1] Rates calculated by John Watkins, assistant general manager, N.C. Rate Bureau and N.C. Reinsurance Facility. He based them on the North Carolina minimum liability coverage of 25/50/10; 25/50/10/ means that the insurance covers up to $25,000 per person for bodily injuries, up to $50,000 per accident for total bodily injury payments, and up to $10,000 for property damage liability.

[2]NCGS 20-309. Technically, compliance with the financial responsibility law may be by means other than automobile liability insurance, but for all practical purposes, North Carolina has mandatory liability insurance.

[3]For companies, NCGS 58-248.31(a); for agents, 58-248.32(a).

[4]Insurance companies may, however, cede drivers to the Reinsurance Facility for any reason they choose.

[5]NCGS 58-30.3 and NCGS 58-124.19 (4).

[6]"Statement on Automobile Insurance Regulation before the Insurance Study Committee, State of North Carolina," John W. Hall, September 16, 1982, p. 24ff.

[7]See profitability studies put out by the National Association of Insurance Commissioners, which provide raw data on computer tapes according to states and lines of insurance.

[8]NCGS 58-30.4 enables the N.C. Rate Bureau to provide for a surcharge for people with less than two years of driving experience.

[9]A first speeding violation, if less than 10 mph and not in school zone, does not result in an SDIP point. NCGS 58-30.5.

[10]NCGS 20-16 (a) (5).

[11]The 27.2 percent surcharge is really two surcharges: 1) the loss recoupment surcharge and 2) the surcharge to offset inadequate rates for "clean risks" in the facility. Clean risks are drivers with no points and more than two years' driving experience. In 1984, the loss assessment surcharge was 22.4 percent; the clean risk surcharge was 4.8 percent.

[12]Ben F. Loeb, *Motor Vehicle Laws of North Carolina,* Institute of Government, University of North Carolina at Chapel Hill, 1984.

[13]Hall's 1982 "Statement" (see footnote 6), p. 34ff.

[14]*Allstate Ins. Co. v. Hale,* 270 NC 195, 154 SE2d 79 (1967).

[15]NCGS 58-30.2 and Regulation 10.0305. The statute is somewhat ambiguous. It appears that group insurance is not prohibited if the rates under a master policy are not lower than those charged for individual policies covering similar risks. "But this is really a prohibition against true automobile group insurance," says Benjy Seagle of Aetna.

[16]The best known industry plan, perhaps, is the "260 Plan" developed by the Insurance Services Office. The plan included, among other features, declining rates for young males as they got married and settled down.

[17]John Rawls, *A Theory of Justice,* The Belknap Press, of Harvard University Press, Cambridge, Mass., 1971.

[18]Andrew Tobias, *The Invisible Bankers,* The Linden Press, Simon & Schuster, New York, N.Y. 1982, p. 194.

[19]NCGS 58-30.4 & .5. Because of litigation between the industry and the commissioner, the SDIP system did not take effect until 1977.

[20]See footnote 11.

[21]In Table 3, the loss ratio does not always decline at the upper point levels, probably because the categories had such a small number of drivers.

[22]The coefficient of correlation in the linear regression analysis was .95.

[23]J. Richard Stewart and B.J. Campbell, "The Statistical Association between Past and Future Accidents and Violations," The University of North Carolina Highway Safety Research Center, December 1982.

[24]Tobias, *op. cit.,* pp. 15-16.

[25]Paul Mize, general manager of the Rate Bureau, says that a rate calculation presupposes that all companies will actually charge the Rate Bureau's rates, in full, and will pay no dividends to policyholders. In calendar year 1983, adds Mize, the total of the dividends to policyholders and the rate discounts allowed through deviations amounted to approximately 3.4 percent of the premiums which would have been written had all companies utilized the rates filed by the Rate Bureau, on voluntary business, without deviation.

[26]*Report of the Investment Income Task Force to the National Association of Insurance Commissioners,* June 1984, p. 8.

[27]NCGS 58-124.19 (1).

[28]*Report of Investment Income Task Force. op. cit.,* pp. 8-9.

[29]See NCGS 58-124.19. The law requires ratemakers to consider investment income earned or realized by insurers from their unearned premiums and unallocated loss reserves generated from business within this state.

[30]*State ex rel. Hunt v. North Carolina Reinsurance Facility,* 302 NC 274, 275 SE2d 399 (1981).

[31]Insurance Information Institute, *Insurance Facts, 1983-84 Edition,* New York, N.Y., 1983, p. 43.

[32]Under the assigned risk plan, persons (risks) who were unable to obtain insurance in the voluntary market were assigned to insurance companies. The distribution of risks among the companies was based on each company's proportionate share of the insurance business in the state for each particular coverage.

[33]The results of these calculations are available from the North Carolina Center for Public Policy Research.

[34]*The Report of the Advisory Committee on Competitive Rating to the National Association of Insurance Commissioners, May 1980.*