G. D. "Red" Culp, N.C. Farm Bureau Mutual Insurance Company, presides at the 1984 N.C. Rate Bureau annual meeting (above). At right, insurance company representatives in attendance.

How the System Works

Regulating Rates

by Bill Finger and Jody George

On October 23, 1984, the North Carolina Rate Bureau held its annual meeting at the Velvet Cloak Inn in Raleigh. The 40 to 50 members present reviewed the annual report and elected five member companies to the Bureau's governing committee. Then, 25 minutes after it was called to order, the annual meeting of the Rate Bureau adjourned until next October.

"I can only remember one or two meetings that lasted longer," says Paul Mize, general manager of the Rate Bureau since it began in 1977. "It is very seldom that any controversial information comes up, and controversy should not arise if we are doing our job correctly."

Controversy or not, a 25-minute annual meeting hardly suggests the impact this group has on insurance rates in North Carolina. Since 1945, when Congress passed the McCarran-Ferguson Act,[1] the state of North Carolina has had increased responsibility for regulating insurance. The Rate Bureau, the Department of Insurance, and the legislature are the key actors in this regulatory process. Together, they must work to ensure that "rates shall not be excessive, inadequate, or unfairly discriminatory."[2]

"Excessive rates are patently unfair to policyholders and give insurance companies unwarranted profits," says William Hale, an insurance specialist, formerly with the General Assembly's Research Division and now a deputy commissioner in the Insurance Department. "Inadequate rates, on the other hand, threaten the solvency of insurance companies, which must meet their expenses and be allowed to make a 'reasonable' profit, as required by state law."[3]

Until 1977, three separate rating organizations collected statistical information and proposed uniform, statewide rates for workers' compensation, automobile, and fire and property lines of insurance.[4] In 1977, the General Assembly consolidated the three into a single N.C. Rate Bureau.[5]

"The work of the three bureaus was so interrelated that for the sake of efficiency it made sense to have them under the same roof and under the general management of the same person," says Hale.

The 1977 law defined the responsibilities of the Rate Bureau as covering three types of insurance informally called "essential" lines: private passenger (non-fleet) automobile, residential property, and workers' compensation. These lines are considered "essential" because they are an economic necessity for most consumers or are required by state law (see Table 1).

All other types of insurance are considered "non-essential" (even though health, credit, life, and other types of insurance are purchased by most people). In North Carolina, no rating bureau has jurisdiction over "non-essential" lines of insurance. See Table 1 for more on how various types of insurance are regulated.

All companies offering policies for an *"essential" line* of insurance must belong to the Rate Bureau. The Rate Bureau, in turn, has two principal duties: 1) to propose an industrywide system of rates; and 2) to establish standard policy forms. The Rate Bureau develops the rate schedule and the policy forms for private auto, property (includes homeowners' coverage), and workers' compensation insurance. This has a profound effect on virtually all consumers. The Department of Insurance usually *reacts to* what the Rate Bureau does, although the commissioner may call a hearing at any time to consider rate changes.

The N.C. Rate Bureau

The constitution of the N.C. Rate Bureau, a nonprofit organization, prescribes a 12-member Governing Committee and four standing committees: automobile (9 members), property (9 members), workers' compensation (10 members), and legal (6 members). Each company that belongs to the Rate Bureau, regardless of the amount of insurance business it writes in the state, has one vote in the election of the Governing Committee and in deciding any other matter that comes before an annual or a special meeting of its members. This ensures representation of the interests of the smaller companies.

The member companies bear the cost of operating the Rate Bureau. They pay in proportion to their respective North Carolina premium writings for the insurance lines under the Bureau's jurisdiction, with a minimum annual fee of $50 per company for each of the three lines for which the company is licensed by the Commissioner of Insurance.

The Rate Bureau—along with the North Carolina Reinsurance Facility, the North Carolina Insurance Guaranty Association, and the North Carolina Life and Accident and Health Insurance Guaranty Association—is located at 1700 Hillsborough Street in Raleigh. A 60-person staff runs these four organizations, varying its time among the four groups as necessary. The Rate Bureau requires about two-thirds of the staff time. Paul Mize heads all four groups (For a discussion of the Reinsurance Facility, see page 50.)

North Carolina Rate Bureau Governing Committee, 1984-1985

Stock-Held Company	Term Expires
Allstate Insurance Company	1987
Integon General Insurance Company	1986
State Capital Insurance Company	1985
The Travelers Insurance Company	1986
U.S. Fidelity & Guaranty Company	1987
U.S. Fire Insurance Company	1985
Non-Stock Company	
Harleysville Mutual Insurance Company	1986
Liberty Mutual Insurance Company	1985
Lumbermens Mutual Casualty Company	1987
Nationwide Mutual Insurance Company	1985
N.C. Farm Bureau Mutual Insurance Company	1987
Pennsylvania National Mutual Casualty Insurance Company	1986

Much of the insurance industry advocates "open competition" in lieu of rate regulation.

Setting Rate Schedules

The Rate Bureau files an *industrywide* rate schedule for each of its three lines with the Insurance Commissioner, under a "file and use" system. The rates go into effect on a date *specified by the Bureau*, following a mandatory 90-day waiting period. The commissioner may hold a hearing on the filings and may reject them entirely or in part. If the commissioner rejects some portion of the rate increase, the Rate Bureau must appeal the ruling to the N.C. Court of Appeals for the new rate schedule to take effect. Any rate increases must be kept in a separate escrow account until final resolution of the increase by the courts.[6] A similar escrow account must also be used if the commissioner orders a rate reduction which is appealed and not implemented.

The Rate Bureau develops its rate schedule using this process:

- companies report claims, premiums, and general costs of operation to the Rate Bureau;
- the Bureau hires private statistical organizations (usually the ISO, the Insurance Services Office) to compile the company data;
- Bureau actuaries use this data to propose new rate schedules to the Bureau's appropriate technical advisory committee (auto, property, or workers' compensation); and
- the Bureau's Governing Committee (see box on page 13) reviews the advisory group's recommendations and files the final schedule with the Commissioner of Insurance.

Individual companies may offer lower rates (or higher, which is possible) than the industrywide standard by requesting "deviations" directly from the Commissioner of Insurance. Approval of downward deviations is usually routine. The Rate Bureau has no authority over deviations, although they are filed with the Bureau as well as with the Department of Insurance.

Most non-essential lines of insurance—where individual companies or rating organizations file rate schedules with the commissioner—also operate under a file-and-use system (see Table 1). A significant exception is some health insurance filings, which follow a "prior approval" system. Under the "prior approval" system, used for all types of insurance until 1977, the Insurance Commissioner had to approve any rate increases *before* they could take effect.

Developing Policy Forms

In 1979, the General Assembly passed the Readable Insurance Policies Act, which required specific tests for format and readability for homeowners', private passenger automobile, life, and health insurance policies.[7] The act requires the Insurance Commissioner to review the forms to ensure that they are readable by a person of "average intelligence, experience, and education."

For homeowners' and private passenger auto insurance, the Rate Bureau had to rewrite all of the numerous policy forms and revise the rating manuals to correspond to the new forms. The job took almost two years to complete. "The companies must maintain separate forms for North Carolina," says Mize. "This adds to administrative costs."

To alter an existing policy form, either a member company, a rating organization (on behalf of a member company), or the Rate Bureau itself proposes a new form to a Bureau technical advisory committee (automobile, property, or workers' compensation). The auto and property committees each have a standing policy forms subcommittee. The workers' compensation committee uses an ad hoc subcommittee as necessary.

"The problem of policy forms does not rear its ugly head very often with workers' compensation because it is commercial insurance and the forms have been standardized for a long time," says Mize.

The technical advisory committees send any proposed policy form change to the Bureau's Governing Committee, which in turn files the proposed new policy form with the Insurance Commissioner. Unlike the rate schedules, policy forms follow a prior approval system. Companies may use these forms if the commissioner approves them or if no action is taken by the commisisoner in 90 days.[8]

Almost all "non-essential" lines of insurance follow the prior approval system for policy forms.

A Rate Bureau and Open Competition

Much of the insurance industry advocates "open competition" in lieu of rate regulation. This could take either of two forms: 1) competitive rates within a state regulated rate system or 2) an essentially unregulated market in which insurers set their own rates. To some extent, option one above describes the current North Carolina system.

Table 1. Regulating Insurance Rates and Policies in North Carolina, by Type of Insurance[1]

Type of Insurance	Whether Insurance is Required by Statute or by Lenders[2]	Groups Proposing Rates and Policy Forms to N.C. Dept. of Insurance	Regulatory Authority of N.C. Dept. of Insurance: Rates	Regulatory Authority of N.C. Dept. of Insurance: Policy Forms	Type of Insurance Covered by the Readable Policies Act[3]
"ESSENTIAL"[4]					
1. Automobile (private passenger, nonfleet)					
a. Liability	Yes, NCGS 20-309	N.C. Rate Bureau[5]	File and Use[6]	Prior approval	Yes
b. Physical damage	Yes, by Lenders	N.C. Rate Bureau	File and Use	Prior approval	Yes
2. Property (residential):					
a. Fire, liability	Yes, by Lenders	N.C. Rate Bureau	File and Use	Prior approval	Yes
b. Personal property	Not Required	N.C. Rate Bureau	File and Use	Prior approval	Yes
3. Workers' compensation	Yes, NCGS 97-93	N.C. Rate Bureau	File and Use	Prior approval	No
"NON-ESSENTIAL"[4]					
4. Automobile (commercial)					
a. Liability	Yes, NCGS 20-309	Companies or Rating Organizations[7]	File and Use	Prior approval	No
b. Physical Damage	Yes, by Lenders	Companies or Rating Organizations	File and Use	Prior approval	No
5. Credit	Yes, by Lenders[8]	Companies[9]	File and Use	File and Use	No
6. Flood and Storm	Not Required[10]	Companies or Rating Organizations	File and Use	Prior approval	No
7. Health Insurance					
a. Blue Cross/Blue Shield	Not Required	Blue Cross/Blue Shield	Prior approval	Prior approval	Yes
b. Commercial Companies	Not Required	Companies	File and Use	Prior approval	Yes
8. Health Maintenance Organizations (HMOs)	Not Required	HMOs	Prior approval	Prior approval	Yes
9. Liability (products, professional and general)	Not Required	Companies or Rating Organizations	File and Use	Prior approval	No
10. Life and annuities[11]	Not Required	Companies	File and Use	Prior approval	Yes/No[12]
11. Mortgage[13]	Not Required	Companies	File and Use	Prior approval	No
12. Property (commercial)	Yes, by Lenders	Companies or Rating Organizations	File and Use	Prior approval	No
13. Title[14]	Yes, by Lenders	Not regulated	Not regulated	Not regulated	No

FOOTNOTES

[1]Includes only the major forms of insurance. Others not mentioned include accounts receivable, animal, boiler and machinery, crime and surety, crop, glass, marine, protection and indemnity, valuable papers, and water damage. Also, fidelity bonds are not covered by this chart.

[2]Banks, savings and loans, and others who loan money usually require borrowers to purchase insurance for the item for which the money is loaned. In this column, "lenders" indicates that *most lenders, but not all*, require such a purchase.

[3]The Readable Policies Act (NCGS 58-364 to 58-372) requires that insurance policies be written in simple and commonly used language.

[4]North Carolina law differentiates between "essential" and "non-essential" lines of insurance. Essential lines are private passenger automobile, residential property, and workers' compensation; non-essential lines are all other types of insurance.

[5]The N.C. Rate Bureau, created by the 1977 General Assembly, files and promulgates rates for private passenger automobile insurance, residential property insurance, and workers' compensation insurance.

[6]Under "file and use," the Rate Bureau files rates with the Insurance Commissioner. The proposed rates go into effect on a date specified by the Rate Bureau, following a mandatory waiting period of at least 90 days. Some analysts prefer to call the North Carolina system "modified" file and use, for this reason: If the commissioner disapproves the proposed rates, they may go into effect *only if* the commissioner's order is appealed *and if* the premium amounts considered excessive are deposited in a special escrow account during the appeal. The escrow provision—but not the waiting period—also applies to four "non-essential" types of insurance (commercial automobile, flood and storm, liability, and commercial property).

[7]A rating organization collects data and sets rates for member companies—usually small companies that do not consider it cost efficient to determine rates themselves.

[8]Credit insurance, not required by law, is almost always required by lenders. Unlike most types of insurance, under credit policies, the insured and the beneficiary are *different people*. The *borrower buys the insurance*, but the *beneficiary is the lender*.

[9]The rates for credit insurance are set out in NCGS 58-348 to 58-350. NCGS 58-347 requires insurers to file credit insurance rates with the Insurance Commissioner.

[10]In 1969, federally subsidized flood insurance became available through private insurance companies. In 1977, the federal government took over this joint program entirely, under the Federal Insurance Administration. Flood insurance is available in about 15,000 communities, which must agree to plan and carry out land use control measures to reduce future flooding.

[11] An annuity is a contract that provides an income for life or for a specified period of time.

[12]Life insurance policies are covered by the Readable Policies Act; annuities are not.

[13]Mortgage insurance pays off a mortgage balance upon the death of the income-earning homeowner.

[14]Title insurance protects a person's title to a piece of real property.

"In today's market, for the essential lines, you get away from the standard rates," says newly elected Commissioner of Insurance Jim Long. "You may have deviations of 5, 10, and sometimes 15 percent or more downward from that standard rate. So you are seeing more of a competitive nature in the market now in the essential lines."

In the non-essential lines, adds Long, "You see a great deal of competition. You will probably see this as a growing trend as you see more and more deregulation in insurance and banking."

Eliminating regulation entirely would, in theory, result in far more competition than the deviation-from-a-standard system. Robert Hunter of the National Insurance Consumer Organization points out that competition can work only when consumers can effectively comparison shop. Standardized policies assist consumers to some extent, but comparison shopping in insurance still seems far down the road. Going from a K-Mart to a Sears to a Belks to compare prices, quality, and service on household goods, for example, simply is not the method of shopping for insurance products.

In recent years, both Virginia and South Carolina have debated the issue of competition in making major changes to their rate regulation systems. As neighboring states, they are often used for comparisons in legislative debates. Moreover, the two states adopted contrasting regulatory systems within the context of open competition. As Table 2 shows, both Virginia and South Carolina generally embraced a system of "open competition"—that is, neither state has a rate bureau. But the extent of rate regulation in the two states lies at opposite ends of the spectrum.

Since 1974, Virginia has allowed companies to use any rates they wish, so long as they file them with the Department of Insurance. "We cannot disapprove rates as excessive as long as there are a sufficient number of companies offering [the coverage]," says Virginia Deputy of Insurance Paul Synnott. With a sufficient number of companies, Synnott explains, competition should keep rates down rather than letting them become excessive.[9]

The Virginia Bureau of Insurance can disapprove rates "only if they are so low as to endanger solvency or to be unfairly discriminatory," adds Synnott. The state has no standard for determining what rates are "unfairly discriminatory," he says, other than "not being supported by the reasonable expectation of the Virginia unfair trade practices laws." Under this system, he says, homeowners' rates have not gone up, after adjusting for inflation, and auto rates have increased only modestly. "The system works extremely well."

South Carolina, like Virginia, allows individual companies to compete on rates. No rate bureau sets industrywide standards. But unlike Virginia, South Carolina operates under a "prior approval" system, where the Insurance Commissioner must approve rates before they can go into effect. Prior approval allows for a more rigorous test of whether rates are excessive, inadequate, or unfairly discriminatory, says Joe P. Barnett, assistant to the Insurance Commissioner. "If you have compulsory [automobile liability] insurance, it would be recommended to have prior approval of rates," he says. Otherwise, companies would take advantage of poor people by raising their rates until the poor could not afford to drive, adds Barnett.

How would open competition affect other aspects of the ratemaking system, such as the hearing process and the monitoring of rates for consumers (see Table 2)? A full-scale examination of the systems used in Virginia, South Carolina, and other states would assist state policymakers in sorting through this complex question.

"Any insurance regulation system will work," says Long. "If you look at the 50 states, you will find variations and major differences, and all of them work reasonably well. The question is, 'Which works best for North Carolina?'"

Long hesitates to say, however, which system he prefers for this state. "You can crank any combination of factors into the system—the file and use system, the old prior approval, or competitive rating. Any of them will work," he says. "Finding the best absolute system for this state is going to take us some time. Us—being the Commissioner and the General Assembly, together with the companies being regulated, the agents, and the public." □

FOOTNOTES

[1]59 Stat 34 (1945), as amended, 15 USC 1011-1015.

[2]NCGS 58-124.19(1).

[3]NCGS 58-124.19.

[4]The three bureaus were: the Compensation Rating and Inspection Bureau of North Carolina, the North Carolina Automobile Rate Administrative Office, and the North Carolina Fire Insurance Rating Bureau.

[5]NCGS 58-124.17. See also Session Laws, 1977 (chapter 828, section 6) and 1981 (chapter 888, sections 1-3).

[6]NCGS 58-124.20 to 58-124.22.

[7]NCGS 58-364 to 58-372.

[8]NCGS 58-124.29.

[9]There are several exceptions to this system, says Synnott. For workers' compensation, uninsured auto coverage (mandatory in Virginia) and "assigned risks" (similar to the policies ceded to the N.C. Reinsurance Facility), companies operate on a prior approval system. Rates must ultimately be approved either by the commissioner or by the courts. Individual lines of health insurance operate on still another system.

Table 2: Ratemaking Systems, Selected States, 1984

Automobile (Private Passenger), Homeowners', and Workers' Compensation

State	Mandatory Rate Bureau in State[1]	System of State Regulation: Auto (private passenger) & Homeowners'	System of State Regulation: Workers' Compensation	Who Monitors Rates for for Consumers	Role of Commissioner in Rate Hearing
California	No[2]	None, Pure "open competition"	Prior approval	Rate Regulation Div., Dept. of Insurance	Appoints hearing officer
Florida	No	Use and file	Prior approval	Department field officers	Can appoint hearing officer
Illinois	No	None. Pure "open competition"	Use and file	Commissioner	None
New Jersey	No	Prior approval	Prior approval	Public Advocate	Acts on recommendation of Administrative Law Judge
New York	No	Prior approval; File and use[3]	Prior approval	Property Casualty Bureau	Appoints hearing officer
North Carolina	Yes	File and use	File and use	Commissioner	Consumer advocate or hearing officer
South Carolina	No	Prior approval	Prior approval	7-member Ins. Commission, Commissioner, and separate Consumer Affairs Div.	Appoints or acts as hearing officer
Virginia	No	File and use	Prior approval	Commissioner	Representative of Ins. Department

FOOTNOTES

[1] Several states, such as South Carolina, require companies writing workers' compensation insurance to belong to a national, licensed rating organization.

[2] A mandatory rate bureau promulgates rates for workers' compensation.

[3] Private passenger automobile insurance operates under prior approval. Homeowners' insurance operates under file and use.

Chart by Jody George, from mail and telephone survey of selected states.