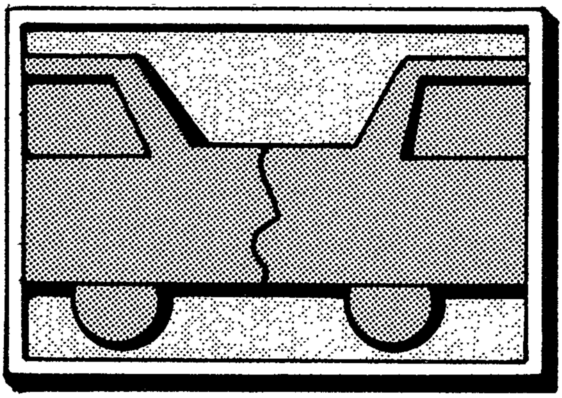
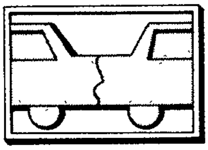


by Steve Adams

Understanding the auto insurance regulatory system in North Carolina requires patience and persistence. This eight-part article first explains the system that has evolved, particularly during the 12-year tenure of John R. Ingram (1973-85). It then examines assumptions underlying the regulatory process, including: how demographic considerations affect statistical and *social equity in setting rates, why "reinsured" drivers are treated differently than drivers in the "voluntary" market, and how investment income affects consumer auto premiums. Finally, recommendations are offered to the legislature and Commissioner James E. Long, including: considering all investment income in the ratemaking process, allowing group auto insurance policies, consider eliminating the dual system of rates for drivers in the reinsured and voluntary markets, and reducing the excessive surcharges for drivers with bad driving records.*

Policy, Politics, and Philosophy: The Context for Auto Insurance



A farmer in eastern North Carolina buys a new 1984 Ford Escort. His driving record is unblemished. When he goes to his insurance agent to buy liability insurance, as state law says he must, he is told the annual premium will be $78.

On the same day, a 17-year-old in Charlotte applies for liability insurance on his new red Corvette. In a year and a half of driving, he has held on to his license despite convictions for speeding over 75 mph (twice), for a fender-bender resulting in damages of $750, and for passing illegally. He uses his car for work. The insurance agent tells the teenager his annual bill—for liability insurance alone—will probably be $1,727. This will buy no more coverage than the farmer gets for $78.[1]

The farmer and the teenager represent the range of rates North Carolinians pay for basic auto liability insurance, which covers damages to *others* in accidents in which *you* are at fault. Is it fair for one consumer to pay 20 times more than another for the same coverage? The question is complicated by two basic facts. The state regulates insurance rates, making them a matter of public policy, not just a matter of the marketplace. Second, liability insurance is a legal and practical necessity.

North Carolina law requires anyone who registers a car with the Division of Motor Vehicles to have liability insurance.[2] The insurance is on the vehicle, rather than the driver. For sake of simplicity, however, insuring the car and insuring the driver are used interchangeably in these articles.

The law also requires companies and agents that sell auto insurance in North Carolina to accept all applications for liability coverage.[3] If a company determines that a person is not a good risk—as it probably would in the case of the teenager—it can transfer or "cede" the policy to the N.C. Reinsurance Facility. The facility is a pool through which insurers share the losses of drivers they consider poor risks. Drivers whose policies are ceded to the facility are called "reinsured" drivers.

As new car owners, the teenager and the farmer would also need comprehensive and collision coverage. Although these are not legally required, lending institutions require them as a condition of issuing car loans. *Collision* covers damage to your car in accidents, regardless of fault. *Comprehensive* covers theft and other damages (fire, vandalism, etc.) caused by something other than a crash.

To keep this discussion in manageable bounds, the following articles focus on *liability* insurance. Despite some significant differences, rates for collision and comprehensive are set in basically the same way as liability rates. In approaching this topic, it is important to keep several distinctions in mind.

Setting Overall Rate Levels vs. Allocating Insurance Costs Among Drivers. Setting overall rate levels involves determining the insurance industry's revenue requirements. In contrast, allocating costs among drivers involves determining who pays—setting the odds, if you will—for individual drivers through a driver classification system. An oversimplified example shows the difference: Suppose the revenue requirements were $200, and there were only two drivers. The

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Steve Adams, a Raleigh-based writer, has covered insurance issues for seven years, as a reporter and editorial writer. Photos and artwork by Carol Majors.

$200 could be obtained either by charging both drivers $100 or by charging one $150 and the other $50. Thus, determining the overall rate level ($200) and setting up a system for classifying drivers ($150 vs. $50) are separate issues.

Statistical Equity vs. Social Equity. One method of classifying drivers—the one the insurance industry appears to prefer—is similar to oddsmaking. This approach requires finding the most accurate way available for predicting which classes of drivers are likely to have accidents and charging them accordingly.

The result of such oddsmaking might be *statistically equitable* but *socially inequitable.* Many drivers, especially the poor, might be priced out of the market, perhaps on the basis of factors beyond their control. Driving is an economic necessity; liability insurance is legally required; and ratemaking is a matter of public policy. These are compelling social reasons to keep rates reasonable for all drivers. This might sacrifice statistical precision for the sake of social equity.

Demographic Characteristics vs. Driving Behavior. Historically, the insurance industry has classified groups of drivers according to such criteria as age, sex, marital status, place of residence, and car use. Such demographic characteristics, for practical purposes, are beyond a person's control. Insurance companies sometimes have also classified drivers by occupation and various personal characteristics, although this is not permitted in North Carolina.[4] Drivers in some categories appear to be more likely to cause accidents than others. Insurance underwriting is a *prospective* enterprise, attempting to estimate *future* losses according to *classes* of drivers. But demographic classifications inevitably penalize many safe drivers.

The alternative to demographic criteria is basing classifications on behavior. People with poor driving records may be expected to cause more than their share of accidents. People who drive many miles are more likely to have accidents than those who only putter around town. North Carolina's present system relies both on demographic criteria and on driving record, leaning more heavily on the latter. Mileage is considered only indirectly, except for the "car use" category that distinguishes between commuting more or less than 10 miles.

Ratemaking vs. Punishment. Should insurance ratemaking entail moral judgments? Should, for example, drivers convicted of drunk driving pay *more* than their fair share of the cost of the insurance system because they have done wrong? As a matter of public policy, there are compelling considerations against punitive rates. The strongest is that punishment for breaking the law is the proper province of the criminal courts and not a matter for profit by private businesses.

These four distinctions have become more evident in the last 12 years, as the state's insurance laws and regulatory system have been repeatedly revised. Throughout his tenure, former Insurance Commissioner John R. Ingram (1973-85) campaigned as a consumer advocate, doing battle with the insurance industry in the hearing rooms, in the legislature, and in the courts. The insurance industry, meanwhile, maintained one of the largest and most experienced core of lobbyists in the General Assembly and spared no expense to win administrative and judicial battles.

Like boxers, Ingram and the industry would retire to their corners after each round, then return to center ring, sparring again and again. The result was a series of piecemeal changes, observes William Hale, for many years an attorney in the legislature's General Research Division and now a deputy commissioner in the Insurance Department. (The "landmark dates" sidebar summarizes these changes.) The state has still not decided on a consistent approach to auto insurance regulation.

Ingram advocated rates based primarily on driving record rather than on demographic factors. In 1975, for example, at Ingram's urging, North Carolina took the national lead in banning age and sex as factors in determining insurance rates.[5] Before this law took effect in 1977, men under 25 (particularly single men) paid substantially higher premiums. Under the new law, the age and sex test has been replaced with an automatic 100 percent increase in rates for drivers with less than two years' driving experience.

The insurance industry, in contrast, tended to advocate setting rates much in the manner that oddsmakers set point spreads, preferring demographic driver classifications, particularly age and sex. John Hall, chairman of the insurance department at Georgia State University, explained this process to a North Carolina legislative study committee in 1982: "[T]here are significant, statistical, predictive differences between individuals .... The most satisfactory surrogate unit so far discovered for measuring these differences involves age and gender. Young drivers do have significantly greater average loss costs than those of us who are older. Young females have significantly better records, on average, than younger males."[6]

While the insurance industry lost the battle on rate discrimination based on age and sex, it won major concessions on overall rate levels. Most notable were the right to put rate increases

Landmark Dates in Automobile Insurance Regulation

by William K. Hale and Jody George

Insurance Commissioner in Office	Date	Action Taken
Daniel C. Boney (1927-42)	1931	First auto financial responsibility law enacted.
William P. Hodges (1942-49)	1947	Financial responsibility laws rewritten.
Waldo C. Cheek (1949-53)	1953	Financial responsibility laws rewritten; Assigned risk plan established;
Charles F. Gold (1953-62)	1957	Compulsory automobile liability insurance law enacted. NCGS 20-309; Safe driver reward plan established; Uninsured motorist coverage established. NCGS 20-279.21(b)(3).
Edwin S. Lanier (1962-73)	1973	N.C. Motor Vehicle Reinsurance Facility replaces assigned risk plan; higher rates not allowed for drivers in Facility. NCGS 58-248.27ff.
John R. Ingram (1973-85)	1975	Rates may no longer be based on age or sex of insured. NCGS 58-30.3; Driver Classification plan simplied. NCGS 58-30.4; Current Safe Driver Insurance Plan passed. NCGS 58-30.4.
	1977	"File and use" replaces "prior approval" system of regulation. NCGS 58-124.20; Deviations from mandatory rates permitted. NCGS 58-124.23; Drivers in Reinsurance Facility allowed higher rates than drivers in the voluntary market; facility rates require no waiting period, as do voluntary market rate filings. Reinsurance Facility required to break even and may recover losses by recoupments. NCGS 58-248.34; Six percent annual limit on rate increases (voluntary market and Reinsurance Facility) put into effect. NCGS 58-124.26.
	1979	"Clean risks" ceded to Reinsurance Facility do not have to pay higher facility rates. NCGS 58-248.33(1); Reinsurance Facility begins to implement recoupment surcharges; Underinsured motorist coverage authorized by law. NCGS 20-279.21 (b)(4)
	1981	Recoupment surcharges barred for drivers with no SDIP points in or out of the Reinsurance Facility. NCGS 58-248.34(f); Supreme Court rules that recoupment surcharges are not subject to review and approval of commissioner because they are not rates. *State ex rel. Hunt v. North Carolina Reinsurance Facility,* 302 NC 274; Six percent annual limit on rate increases taken off facility rates, so there is no maximum to these rates; Maximum annual rate increase for voluntary market tied to consumer price index (CPI).
	1983	"Clean risks" allowed one speeding violation (10 mph or less over limit and not in school zone) without being assigned points under Safe Driver Insurance Plan. NCGS 58-30.5; Annual limit on voluntary market rate increases (tied to CPI) expires by operation of law, so there is no maximum to these rates.
James E. Long (1985-)		

Table 1. Top 10 Auto Liability Insurance Writers in North Carolina, 1983 (for private passenger autos, in millions of dollars)

Nationwide Mutual Insurance Co.	$71.3
State Farm Mutual Auto. Insur. Co.	63.4
Allstate Insurance Co.	47.9
N.C. Farm Bureau Mutual Insur. Co.	30.7
Aetna Casualty and Surety	21.5
Integon General Insur. Co.	14.4
U.S. Fidelity & Guaranty Co.	11.4
Travelers Indemnity Co.	10.9
Lumbermens Mutual Casualty Co.	10.8
South Carolina Insurance Co.	10.6
Total for Top 10	$292.9
Total for All Companies	$486.8

Source: N.C. Rate Bureau

into effect under a "file-and-use" system and a complicated system of surcharges to offset losses of the N.C. Reinsurance Facility.

Despite the 12-year controversy and makeshift adaptations of the law, both consumers and the insurance industry have fared reasonably well. On average, North Carolinians pay among the lowest auto insurance rates in the nation. In recent years, the auto insurance industry has achieved profits in North Carolina at approximately the national average.[7] (For a list of the top ten auto insurance companies in North Carolina, see Table 1 above.)

In 1983, the average cost of insurance per car, for all types of coverage, was $237 in North Carolina, nearly a third less than the national average of $323. The state ranked 46th in cost of insurance among the 50 states and the District of Columbia. Only such rural states as Tennessee and Alabama had lower average rates. The highest rates were in New Jersey, New York, and Massachusetts, all heavily urban (see next page).

North Carolina's low rates, however, are not so much a triumph of consumer-oriented regulation as a reflection of the state's social climate and mostly rural character. "The basic characteristics of the legal, social, economic, and religious climate of the state generate lower losses," Georgia State's Hall explains. "Even at an adequate level, insurance rates in North Carolina should be lower than in almost any other jurisdiction in the United States."

Even though the state ranks 10th nationally in population, it has no city of more than 400,000. Accidents are more frequent in heavy city traffic than in less densely populated areas. Medical services and auto repairs also tend to be more expensive in urban areas, and large awards to plaintiffs by juries in some states have driven up insurance rates.

The protracted battle between the insurance industry and the insurance commissioner may have come to an end with the election of James E. Long as Ingram's successor. "I will have a more open-minded style," Long says. "I'll be willing to hear the facts before making decisions. The weaknesses in our system have been the confrontation between the department and the companies and/or the [N.C.] Rate Bureau [which files statewide rates on the companies' behalf], the confrontation between the department and the General Assembly, and the confrontation between the department and the agents. Those have combined to bring the whole system into one of confrontation rather than cooperation."

Long has not set an agenda for reform, although he does propose recodification by 1987 of the laws governing auto, homeowners, and workers' compensation insurance. His priorities as commissioner, he says, will be twofold: "to keep rates as low as possible and to maintain [rates] at an adequate level to maintain [company] solvency."

The issues before Long and the legislature, however, run deeper than balancing low overall rates against company solvency. This eight-part article explains why four areas, in particular, need attention. The sections that follow set forth the original research that leads to the assertions in this introduction.

1. Demographics. Classifying drivers on the basis of factors beyond their control remains an issue. The industry would like to set rates on the basis of age and sex, and some industry lobbyists are advocating deregulation in general. Since no violations or accidents are charged against 80 percent of the state's vehicles, driving record alone appears limited as the primary tool for setting varying rates. Moreover, the system of assessments for poor driving records is badly flawed because drivers are not required to report traffic violations to their insurers. Better reporting of accidents to insurers would improve the usefulness of driving records to predict which drivers will cause losses. A simple solution remains elusive, however. The best that can be done in this article is to explain the problems.

2. Equity. The current system of classifying drivers results in excessively high rates for drivers with poor records. Drivers like the teenager with the Corvette pay punitively high rates, according to the latest available data. In addition, there are so few drivers with bad driving records that their high rates do not significantly reduce the cost of insurance for "good" drivers. Thus the driver classification system is neither statistically nor socially equitable and needs to be revised.

3. Overall Rate of Return. If the current formula for setting overall rates worked as it is designed to, it would produce unreasonably high profits for insurance companies. The formula ignores most income earned on investments, despite the fact that this is a major revenue source for insurance companies. The high profits have not materialized only because companies generally have not earned the five percent underwriting profit contemplated by the formula. The formula should be changed to reflect *all* investment income.

4. The Reinsurance Facility. Current law governing the N.C. Reinsurance Facility needs revising. Drivers who have had accidents or traffic violations pay higher rates (currently, 40 to 44 percent higher) if they are ceded to the facility. But there are no criteria whatever for assigning drivers to the facility; thus, insurance companies have the option of boosting some drivers' rates for any reason they please. Average rates charged to reinsured drivers with poor driving records appear excessive. In addition, the ratemaking formula needs to be examined, specifically in relation to *total* investment income.

The following sections are intended as a guide through the maze of automobile insurance regulation in North Carolina. They describe how the system works, provide some statistical analysis, and conclude with proposed solutions.

Premiums by State—North Carolina Near the Bottom

In 1981, North Carolinians paid an average of $211 for automobile insurance—48th among the 50 states and the District of Columbia. Two years later, the average was $237, and the ranking was 46th (see list below). From 1981 to 1983, the average North Carolina auto premium jumped 22 percent, 5 percent higher than the national average.

Best's Insurance Management Reports calculated these average premiums by taking the total direct premiums written and dividing by the number of auto registrations for each state. Premium data came from Best's Executive Data Services. Auto registration statistics are estimated totals from the Federal Highway Administration and are slightly inflated due to the inclusion of taxicabs.

Average Automobile Premiums

1983 Ranking	State	1983 Average Premium	% Increase 1981-1983
1	New Jersey	$516.89	25.5
2	New York	429.20	22.1
3	Massachusetts	424.73	25.4
4	Alaska	399.80	19.0
5	Pennsylvania	390.93	22.6
6	Nevada	387.37	1.9
7	District of Columbia	384.67	50.5
8	Louisiana	377.57	8.5
9	California	368.17	9.6
10	Maryland	364.21	23.2
11	West Virginia	355.89	37.8
12	Hawaii	355.38	22.3
13	Arizona	348.38	19.7
14	Texas	340.55	40.0
15	Connecticut	339.34	14.5
16	Rhode Island	332.45	22.6
17	South Carolina	330.11	19.1
18	Michigan	326.81	8.7
19	Delaware	322.31	14.7
20	Colorado	315.01	24.1
21	Illinois	309.27	17.8
22	Oregon	302.09	11.7
23	Washington	301.05	13.9
24	Minnesota	298.25	6.9
25	Georgia	295.00	19.4
26	New Hampshire	292.45	24.9
27	Arkansas	287.98	31.5
28	Missouri	287.73	11.4
29	Virginia	282.61	23.6
30	Kansas	282.38	12.0
31	Florida	281.22	20.2
32	Oklahoma	281.19	19.6
33	Vermont	268.00	8.6
34	Utah	267.53	9.3
35	Wyoming	263.07	2.1
36	Nebraska	256.31	5.3
37	Indiana	255.94	12.0
38	Maine	251.43	8.4
39	Montana	250.64	-1.4
40	North Dakota	248.61	4.9
41	Idaho	246.28	6.1
42	Wisconsin	242.74	7.2
43	New Mexico	241.63	-2.0
44	Ohio	241.15	7.5
45	Kentucky	238.90	5.8
46	**NORTH CAROLINA**	**236.91**	**22.2**
47	Iowa	234.45	4.6
48	Mississippi	231.56	9.6
49	Tennessee	216.48	17.7
50	South Dakota	211.10	7.0
51	Alabama	205.86	10.0
National Average		**$322.63**	**17.4**

Source: Best's Insurance Management Reports, On-Line Reports, No. 26, December 3, 1984.
For more information, call *On-Lines Report* Editor Virginia Vogt, 201-439-2200.