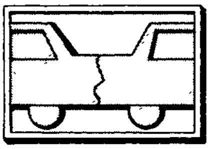
The N.C. Reinsurance Facility



The teenager in Charlotte with an abysmal driving record pays $1,727 a year for liability insurance to earn the legal privilege of driving while the farmer with a clean record pays only $78. The teenager might in fact be a terrible gamble for an insurance company because of his age, his gender, his car, or his personal recklessness. But there is an escape for his insurance company. Any auto insurer in North Carolina must offer liability insurance to this teenager, but it may cede this policy to the N.C. Reinsurance Facility if it wishes.

All states have some sort of "shared" or "involuntary" market to provide coverage for high-risk drivers. In 1981, one of every four of the state's cars were insured through North Carolina's involuntary market, the Reinsurance Facility. Only two states had a higher percentage, and only 10 states had more than 10 percent of its cars in the involuntary market.[31] In 1982, the percentage in North Carolina declined slightly to 22 percent.

In 1973, the legislature replaced the "assigned risk" plan with the Reinsurance Facility.[32] At first consumers had no need to be concerned if their policies were ceded to the facility, because the rates were the same as in the voluntary market. But the facility was sustaining heavy losses, and the auto insurers had to absorb these losses without being able to pass them along to consumers through recoupment surcharges.

By 1977, the insurance companies were complaining loudly about inadequate rates in general and the facility in particular. There had not been an auto liability rate increase since 1973, and the facility losses totaled $62 million in the first three years of operation. In response, the legislature adopted two key industry proposals: 1) allowing the facility to charge higher rates for ceded policies; and 2) allowing the industry to charge all drivers (those in the voluntary and involuntary market) recoupment surcharges to cover facility losses. For drivers with no SDIP points, the legislature later forbade both higher rates in the facility (1979) and recoupment surcharges (1981).

Allowing higher rates inside the facility gave birth to a dual ratemaking system. Car use, territorial variations, SDIP points, and driver experience apply to both systems. The Reinsurance Facility Board of Governors, however, files an entirely separate rate schedule with the Insurance Commissioner. (For more on exactly how the facility works, see sidebar on next page.)

Table 5. Percent of Car Years Ceded to N.C. Reinsurance Facilty, 1982

SDIP	% Ceded
0	17%
1	30%
2	30%
3	45%
4	57%
5	66%
6	77%
7	83%
8	85%
9	87%
10	85%
11	88%
12	92%
Not Eligible	20%
TOTAL	21%

Source: N.C. Rate Bureau

At first, rates in the facility were only about 10 percent higher than in the voluntary market, says John Watkins, assistant general manager of the Reinsurance Facility and the Rate Bureau. By 1984, however, those rates were 40 to 44 percent higher for drivers with SDIP points.

Insurers may cede as many policies as they wish to the facility and for any reason they wish. Driving record appears to be a major factor. Two of every three policies with 5 SDIP points, and more than 90 percent of those with 12 points, were ceded to the facility in 1982 (see Table 5). But a major criterion for ceding had to be something other than driving record: 63 percent of all reinsured cars in 1982 had 0 points (see Table 6).

The driver classification system, in theory, is supposed to allocate the cost of insurance among

Administering the N.C.

All auto insurance companies writing policies in North Carolina must belong to the Reinsurance Facility. The member companies and the Commissioner of Insurance choose a board of governors, which hires a general manager (see board listing below). Paul Mize has headed the facility since it began in 1973. The board establishes rates for reinsured policies, working closely with the ratemaking committee of the N.C. Rate Bureau.

By law, the facility operates on a nonprofit, no-loss basis. This means that once an insurer cedes a policy to the facility, the company can neither earn a profit nor suffer a loss from that policy. Insurers service claims on ceded policies; the facility does not have a

NORTH CAROLINA REINSURANCE FACILITY BOARD OF GOVERNORS. 1984 - 1987

Voting Members (3-year terms)

Company[1]	***Represents***
Aetna Casualty & Surety Company	American Insurance Association
Allstate Insurance Company	National Association of Independent Insurers
Lumbermens Mutual Casualty Company	Alliance of American Insurers
South Carolina Insurance Company	All Other Stock Insurers
State Farm Mutual Automobile Insurance Company	All Other Non - Stock Insurers
Licensed Agent[2]	
J. Earl Ramey	———
John Riley	Carolinas Association of Professional Insurance Agents
John Wooten	———
Richard Yarbrough	Independent Insurance Agents of North Carolina

Non - Voting Members

Commissioner of Insurance	North Carolina Department of Insurance

FOOTNOTES

[1]The three company associations select their representatives according to their own procedures. Companies not affiliated with the associations select representatives at the Reinsurance Facility's annual meeting.

[2]The Commissioner of Insurance selects these, all of whom must be licensed, resident North Carolina insurance agents. For each of the association representatives, the commissioner must choose from two names submitted by each association. There are no such restrictions on the other two agents.

drivers. Since reinsured drivers with points pay higher rates on the basis of whatever criteria an insurer chooses, the dual ratemaking system subverts the classification plan. The Reinsurance Facility has become a *de facto* part of the classification plan—with no criteria for who is ceded to it.

Regulating the criteria for ceding drivers to the facility would force insurers to comply with the spirit of the North Carolina law. Now, insurers may cede policies on the basis of age and sex, for example, thus legally skirting the ban against using those factors in setting rates.

The unwritten criteria that insurance companies use for ceding policies must have some logic. Reinsured drivers do cause more losses than drivers with the same SDIP points in the

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Reinsurance Facility

staff of agents, adjusters, and underwriters.

When the facility suffers losses, the board assesses member companies based on each company's share of the auto liability market in North Carolina. The companies pass this expense on to consumers through "recoupment surcharges" to all policyholders with SDIP points. This surcharge must be "identifiable" on a person's bill.

If a company cedes a policy to the facility, it must notify the policyholder *only* if the cession results in a different premium than the policyholder would have in the voluntary market. Drivers with 0 SDIP points and more than two years' experience, called "clean risks," may not be charged an increased rate in the facility. But clean risks in the voluntary market often pay a lower rate than those in the facility because of downward "deviations." Deviations from the industrywide rate schedule are allowed in the voluntary market but rarely, if ever, occur in the facility.

If a ceded policy results in a higher premium, the company must inform the policyholder:

- that the policy is ceded and subject to facility rates;
- of the difference between the facility rate and the voluntary market rate; and
- that he/she may request a written explanation of why the policy was ceded; and that the insurer must supply a specific reason (or reasons) on request.

A policyholder may seek insurance through a new agent or company after being notified that his or her policy has been ceded to the facility.

Rates for the facility are set independently of rates for the voluntary market. The automobile committee of the Rate Bureau proposes separate rate schedules to the governing boards of both the Rate Bureau and the Reinsurance Facility. The facility board files a rate schedule with the Commissioner of Insurance under a file-and-use system. There is no 90-day waiting period before the increases may go into effect. But an escrow account must be used for increases not approved by the commissioner, if the case is appealed into court.

The Rate Bureau is not responsible for developing facility rates but doing so saves time and money, Mize says. "Nobody questions who is stepping on toes," he says. "It makes sense to streamline in order to avoid duplication of effort." □

John Watkins, assistant manager of the N.C. Reinsurance Facility, reports on facility operations at the 1984 annual meeting. Facility Manager Paul Mize is seated.

Table 6. Comparisons Between Voluntary Market and Reinsurance Facility, 1982

SDIP	% OF CAR YEARS Voluntary	% OF CAR YEARS Reinsurance Facility	AVERAGE RATE Voluntary	AVERAGE RATE Reinsurance Facility	LOSS RATIO Voluntary	LOSS RATIO Reinsurance Facility	LOSS/CAR YEAR Voluntary	LOSS/CAR YEAR Reinsurance Facility
0	84.8%	63.0%	$ 94	$103	66%	136%	$ 62	$140
1	4.0	6.3	115	134	88%	127%	101	170
2	5.8	10.0	142	165	59%	97%	84	160
3	1.6	4.9	172	200	59%	79%	102	157
4	.9	4.8	203	232	47%	79%	94	183
5	.3	2.3	222	266	52%	66%	116	175
6	.1	1.9	271	308	51%	68%	140	211
7	.1	.9	311	354	48%	64%	149	227
8	.0	.7	344	397	91%	69%	314	273
9	.0	.3	380	456	92%	45%	351	207
10	.1	1.1	439	481	27%	40%	120	193
11	.0	.3	441	562	44%	51%	192	286
12	.0	1.4	511	613	52%	40%	266	244
Not Eligible	1.6	1.4	127	144	31%	28%	40	40
TOTALS	100%	100%	$102	$150	65%	102%	$ 66	$152

Source: Basic data, N.C. Rate Bureau. Calculations and table design, *North Carolina Insight.*

voluntary market. Reinsured drivers caused, on the average, $152 in losses per car year compared with $66 for the voluntary market (see Table 6).

In both the voluntary and reinsured markets, loss ratios generally decline as points increase. Reinsured policies with 0 and 1 points had loss ratios substantially above the facility average, and thus paid too little in premiums, relative to other reinsured drivers. Drivers with more SDIP points had lower-than-average loss ratios. Rates were too high for drivers in the high-point categories both within and outside the facility. (However, in the voluntary market, particularly, the number of drivers in the higher point categories is too small to permit reliable generalizations.)

Breaking down the voluntary and involuntary markets by SDIP point groups shows more about which categories might be paying too much. Clean risks in the facility are not paying their fair share. Their loss ratio was more than double that of drivers in the voluntary market with 0 points, but they paid only 10 percent more in premiums ($103 compared with $94).

Under the current arrangement, setting fair rates is difficult. Two rate schedules must be filed with the commissioner, one for the voluntary market and one for the reinsured market. The industry is supposed to make profits or sustain losses only in the voluntary market. Moreover, the Rate Bureau does not consider all aspects of investment income in its formula, nor are recoupment charges legally considered premiums. Finally, the Reinsurance Facility has some investment income of its own ($11 million in 1983), yet insurance companies continue to earn interest on the "surplus" (funds held in reserve) that backs up policies in the facility. Thus, companies would make a profit on reinsured drivers if the facility, standing alone, broke even, as the law requires.

Ratemakers are caught in a mathematical maze. What rates are fair? Predicted loss ratios can be calculated separately for the voluntary and involuntary markets for 1982. Again, the predicted rates are calculated to give each point group a 75.2 percent loss ratio—the same as the actual loss ratio for the combined voluntary and involuntary market.

The results indicate that the 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. Since most drivers with high numbers of points are ceded, this is not surprising. According to the predicted rates for the voluntary and involuntary markets, the only drivers who are paying too little are reinsured drivers with fewer than 5 points. All other drivers pay more than their fair share.[33]