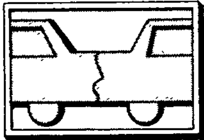
Underwriting and Investment Income—How Much Profit?



The N.C. Rate Bureau bases its auto filings with the Insurance Commissioner on a loss ratio of 67 percent, says Bureau General Manager Paul Mize. Put another way, the Rate Bureau files rates anticipating that for every $1 in earned premiums, it would have to pay out 67 cents in claims and related expenses. The difference in the $1 and 67 cents, says Mize, is 28 cents for all administrative costs (including commissions, taxes, licenses, and fees) and 5 cents in underwriting profits and contingencies. (These figures apply to the Rate Bureau filings for the voluntary market and to clean risks ceded to the Reinsurance Facility, but not to the other policies ceded to the facility.)

In his book, *The Invisible Bankers,* Andrew Tobias points out that a bank safeguards money for little charge while living off the investment income the deposits earn but that insurance companies are unable to do this. "For every dollar we collectively 'deposit' with an auto insurer, for example, only 65 cents or so is available for our collective withdrawal," writes Tobias. "The rest of our dollar, *plus* the interest the insurance company earns on it, goes to expenses, overhead, and profit."[24]

The administrative costs of the insurance industry are one major reason for this difference. "It takes 1.9 million people to staff the insurance industry," Tobias reported in 1982. "The banks presided over three times as much money, handled vastly more 'transactions'—and yet managed to make do with about a quarter of a million fewer people."

Cutting administrative expenses through group policies and other streamlining efforts is a potentially explosive issue. Agents, underwriters, and administrative staff could lose their jobs. The number of superfluous insurance industry employees in 1982 was probably close to a million, Tobias calculated.

Joseph Johnson of UNC-Greensboro says that Tobias' "facile and surface analysis" does not adequately explain that banks charge service fees on demand deposits and are able to modify interest rates on both the cost and income side at will. Johnson goes on to say that a discussion of excessive administrative costs should consider the issue of deregulation. "To date, at least, deregulation in other industries—banking, airlines, telephones—has met with mixed reviews as to efficiency gains," he says.

The National Association of Insurance Commissioners (NAIC), the Conference of Insurance Legislators, and other independent national groups should examine the issue of administrative expenses since it is a critical factor in setting rates. Commissioner Long could pursue this issue within the NAIC, a group that has recently tackled some tough issues, such as investment income.

In North Carolina, Rate Bureau filings are calculated to yield 5 percent in *underwriting profits*—i.e., earned premiums less claims and related expenses, and less administrative costs.[25] The National Convention of Insurance Commissioners, the predecessor of the NAIC, established the 5 percent standard in 1921. More than 60 years later, investment opportunities for the insurance industry have increased dramatically, as has the volume of money it manages.

B. F. (Benjy) Seagle III of Aetna, at the 1984 annual meeting of the N.C. Rate Bureau.

In June 1984, the National Association of Insurance Commissioners released a report on a three-year study by its Investment Income Task Force. Composed of insurance regulators from 10 states, the task force had an advisory committee chaired by Richard J. Haayen, president of Allstate Insurance Company. The 95-page report included charts, tables, and financial jargon as well as some clear language for the layman.

The 1921 profit formula or any other formula based on "an arbitrary and unsupported percentage of premiums . . . is no longer appropriate for use in those states which engage in the direct approval of property/casualty rates," the report concluded.[26] "If the industry were to currently earn 5 percent of premiums in addition to investment income (which historically it has not), its total rate of return on net worth after tax would be approximately *25 percent*" (emphasis added).

North Carolina, like most states, does not allow rates to be "excessive, inadequate, or unfairly discriminatory."[27] Allowing companies to charge rates that could produce a 25 percent profit appears excessive.

Interest rates, which vary from year to year, have a substantial effect on investment income. The NAIC found that in 1983, an underwriting *loss of 5.5 percent* would have yielded a 16 percent return on net worth, a level more appropriate to 1983 investment opportunities. Unable to find any economic justification for the traditional 5 percent allowance, the NAIC recommended "for those states which engage in direct approval of rates . . . that the ratemaking/review process include a measure of profitability based upon a *total return to equity analysis*" (emphasis added).[28] In North Carolina, only a portion of return on investments is considered in ratemaking.[29]

Some auto insurers were not happy with the NAIC report, and the industry issued a formal response, says Benjy Seagle of Aetna. Seagle also points to a resolution passed by the NAIC's Commercial Lines (D) Committee as another indication that the investment issue is a complex one. "The NAIC recognizes that any methodology for reflecting investment income in the ratemaking/rate review process should be flexible in its application," the resolution reads.

The Rate Bureau calculates that a 67 percent loss ratio figure will produce a 5 percent underwriting profit. If that is true, the 75 percent loss ratio of 1982 would produce a 3 percent underwriting loss. But in 1982, industry spokesmen did not complain publicly about low profits, as they had in earlier years.

Even if the Insurance Department begins considering all investment income in reviewing auto rates, it cannot consider as income the recoupment surcharges assessed to all drivers with SDIP points to cover the Reinsurance Facility losses. The N.C. Supreme Court has ruled that recoupment surcharges are not rates and therefore not subject to review by the Insurance Commissioner.[30]

Such an approach to recoupment is proper, says Mize, because the purpose of the recoupments is for the insurers to recover already paid assessments. Mize points out, for example, that as of June 30, 1984, auto insurers had paid $27 million in loss assessments to the Reinsurance Facility which *they had not yet recouped* from their policyholders. "This is money which, if the carriers had it, would be utilizable to produce investment income," says Mize.

Hence insurers, reasons Mize, go through a period when they cannot earn investment income on their recoupment surcharges. But Mize seems to stop short in describing the full financial cycle. After the companies *have collected* the $27 million—the figure used by Mize (see paragraph above)—then the funds *are* available for investment. This surcharge system removes much of the risk from reinsured business. This $27 million must be collected specifically to cover the facility assessments, but it is still $27 million going to insurance company bank accounts.

The companies have a capital investment surplus sufficient to cover the outlay, while the Reinsurance Facility does not have such a capital surplus. To an investment portfolio, $27 million in recoupment charges is not different from $27 million in direct premiums, despite the lag time.

The ruling by the N.C. Supreme Court suggests the important and complex role the Reinsurance Facility has come to play in regulating auto rates.