CHAPTER ONE
THE LEGAL PERSPECTIVE: APPROPRIATE PROFIT MARGINS IN PROPERTY & CASUALTY INSURANCE RATES

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OVERVIEW

The appropriate standard for determining profit margins for property and casualty insurance rates has been and is being influenced by lawyers, judges and insurance commissioners as well as investors, actuaries and economists. The contribution from the former groups is one that comes from quite a different perspective emphasizing legal and political considerations rather than financial or actuarial ones. Also, the articulation of the appropriate standards when originating from the legal/regulatory community is usually qualitative rather than quantitative. This often results in debates about how a qualitative legal standard should be translated and quantified into a particular profit margin in an insurance rate. The purpose of this chapter is to discuss some of the most prominent legal standards for determining insurance company profit margins and how those standards are evolving and affecting insurance pricing activities today.

STATUTORY AND CONSTITUTIONAL STANDARDS FOR PROFIT MARGINS

The common legal standards affecting profit margins in insurance rates are those contained in the insurance rate regulatory statutes in effect in a majority of states.[1] These provisions are:

> Rates shall not be excessive, inadequate, or unfairly discriminatory....
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> Due consideration shall be given to... a reasonable margin for profit and contingencies.

Another important source for legal standards in this area is constitutional law. The Fifth Amendment to the United States Constitution (and similar provisions in most state

[1] There are a number of states that have enacted unique statutory or regulatory provisions that may either directly or indirectly affect the profit provision in insurance rates. For example, a few states have enacted requirements relating to the consideration of some or all of an insurer's investment income in the ratemaking process. Other states have adopted specific profit requirements (primarily affecting the personal auto insurance line) such as the excess profits statute in Florida or the "Clifford Formula" in New Jersey.

constitutions) prohibit government from taking the use of private property without providing for a hearing (due process of law) and paying just compensation. The 5th Amendment to the United States Constitution provides:

> No person shall be... deprived of life, liberty or property without due process of law; nor shall private property be taken for public use without just compensation.

The traditional statutory requirements for insurance rates were developed in 1946 as a part of the Model Prior Approval Act adopted by the National Association of Insurance Commissioners (NAIC). This model law grew out of the then current legal thinking relating to antitrust enforcement. Because the NAIC Prior Approval Rating Law authorized certain joint anti-competitive pricing activities by insurance companies through rating bureaus (cartels), the law also authorized the government regulator to prohibit the earning of monopoly profits by all insurers (including bureau members and nonmembers).

These legal requirements were based on the theory that government should be given the power to control insurance rates and profit margins because competition could not be relied on to do so. If a proposed rate was too low in relation to costs it was assumed to be an indication of attempted monopolization and predatory pricing; if the rate was too high, it was assumed to be an indication of the intent to earn monopoly profits. Competitive discipline on pricing decisions and profit margins was assumed not to be effective due to the legalization of joint pricing behavior. In other words, the legal theory underlying even the earliest insurance prior approval rating laws was similar to the legal theory underlying public utility rating laws, i.e., government control of prices was needed to prevent unreasonable restraints on trade and the extraction of monopoly profits in a non-competitive market.[2]

This similarity in underlying legal theory remains true today despite the very real and significant differences between the markets for most public utilities and insurance markets. One can argue that the competitive nature of insurance markets should obviate the need for direct government price controls. However, given the presence of insurance rate regulatory statutes, it is very difficult, if not impossible, to assert successfully in any legal forum that rate regulation common law principles are not applicable legal precedent for interpreting that law. This history helps explain why the legal precedent developed in the area of public utility price regulation has been and is now being used to help determine the appropriate legal standards for insurance company profit margins.

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[2] The fact that many in the industry and regulatory ranks advocated legalization of joint pricing activities to enhance insurer solvency and keep in check the tendency towards ruinous competition does not affect the underlying legal theory of prior approval rate laws at least as it affects profit margins.

PUBLIC UTILITY COMMON LAW PRECEDENT

Today when an insurance rate case is briefed by lawyers before an administrative law judge, court or other tribunal, the precedent cited usually involves several public utility rate cases as well as insurance rate cases. The United States Supreme Court decision in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944) is central to most arguments involving the appropriate profit margins for regulated entities including insurers. In the Hope case, the Supreme Court established certain basic principles governing the question of what constitutes "just compensation" as required by the 5th Amendment to the Constitution. It also tends to be central in arguments concerning whether the rate fixed or approved by government is "inadequate" or whether it fails to provide a "reasonable margin for profit" under the applicable statutory standards. Chief among the Hope principles is the requirement that the rate afford the regulated firm an opportunity to earn a fair and reasonable return and cover its cost of capital. As Justice Douglas explained:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses, but also for the capital costs of the business. These include service on the debt and dividends on the stock.... By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. (320 U.S. at 603.)

Hope adopted the views expressed earlier by Justice Brandeis in his opinion joined in by Justice Holmes in Southwestern Bell Telephone Co. v. Public Service Commission, 26 U.S. 276 (1923):

> The compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business. Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of the capital, whatever the nature of the security issued therefore; the allowance for risk incurred; and enough more to attract capital.... A rate is constitutionally compensatory, if it allows to the utility the opportunity to earn the cost of the service as thus defined. (26 U.S. at 290.)

These early legal standards relating to profitability are ambiguous as to whether a Total Return Analysis[3] is the more appropriate approach from a legal standpoint or whether an Operating Return Analysis is required.[4] On the one hand, the language used by the Supreme Court seems to require an analysis that evaluates the riskiness of the business, an ability to compare returns among different industries and a method for determining a return on assets invested in the business. On the other hand, the language used often contains a clear distinction between operating expenses and capital charges implying the need for an analysis that separates the two and includes a positive operating return.

As the Hope doctrine has been interpreted by regulators, lawyers and judges in the ensuing years it has become clear that what the law guarantees is not the actual earning of a profit itself, but rather the opportunity to earn a fair and reasonable rate of return. Thus, inefficient companies or companies trying to sell products in a dying market are not guaranteed a profit by the presence of regulation. In Market Street Ry. v. Railroad Comm'n., 324 U.S. 548 (1945) the United States Supreme Court held that rate regulation need not guarantee a profit to a company trying to operate a business in a declining industry, the street car business. The Court allowed the rate regulator to restrict reasonable returns to the salvage value of the property rather than its acquisition cost. Justice Jackson wrote:

> [A] company could not complain if the return which was allowed made it possible for the company to operate successfully. (324 U.S. at 566.)

Likewise, in Permian Basin Area Rate Cases, 390 U.S. 747 (1968) Justice Harlan upheld the regulator's decision to impose area-wide benchmark rate caps for natural gas pipeline companies. The benchmark rates were calculated using a profit factor based on a

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[3] Total Return Analysis means:

$$\frac{A+B+C}{D}=\frac{A+B_1+B_2+C}{D}$$

[4] Operating Return Analysis means:

$$\frac{A+B}{E}=\frac{A+B_1+B_2}{E}$$

Where:

A = Underwriting Profit/Loss

B = Investment Income (II) on current insurance operations ($B_1 + B_2$)

B_1= II on assets equivalent to loss and loss adjustment expense reserves.

B_2= II on assets equivalent to unearned premium reserves.

C = II on surplus properly converted to net worth.

D = Surplus properly converted to net worth.

E = Earned premium.

comparable earnings standard for the average pipeline company. (The profit factor allowed was a yield on equity of 12% in 1966.) The Court held:

> [N]o constitutional objection arises from the imposition of maximum prices merely because high cost operators may be more adversely affected than others, or because regulation reduces the value of the regulated property. (390 U.S. at 812.)

The natural gas pipeline companies had mounted a facial challenge to the area rate caps arguing that they were unconstitutional because the Commission had not set rates on an individual producer basis. The Permian Court upheld the maximum area rate procedure that the Commission had used stating that any rate selected by the Commission "from the broad range of reasonableness permitted by the Act cannot properly be attacked as confiscatory." The Court held:

> We do not suggest that maximum rates computed for a group or geographical area can never be confiscatory; we hold only that any such rates...intended to balance the investor and consumer interests are constitutionally permissible. (390 U.S. at 769.)

The Supreme Court also addressed the concern raised in Permian that the Commission failed to provide individualized relief from the group rates for a specific gas producer if the group rates were confiscatory in that particular, as-applied case. The Commission had declared that a producer would be permitted appropriate relief if it established that its "out-of-pocket expenses in connection with the operation of a particular well exceed its revenue from that well under the applicable area price."

In reviewing the Commission's regulations the Court of Appeals remarked that "out-of-pocket expenses are not defined and we do not know what they include." (390 U.S. 771 n. 35.) As a result, the Court of Appeal remanded the case to the Commission for a definition of the term "out-of-pocket expenses." The Supreme Court reversed holding that the Commission had not committed a fatal error in failing to define this term:

> We cannot now hold that, in these circumstances, the Commission's broad guarantees of special relief were inadequate or excessively imprecise. (390 U.S. at 772.)

Moreover, in Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168 (D.C. Cir. 1987) Judge Robert Bork interpreted the Hope doctrine not to prohibit losses when those losses were due, not to government action, but instead due to bad management decisions, bad luck or inefficient operations. What the Jersey Central Court said was that "absent the sort of deep financial hardship described in Hope, there is no taking and hence no obligation to compensate just because a prudent investment has failed and produced no return." (810 F.2d at 1181 n. 3.)

In a more recent United States Supreme Court decision reaffirming the holding in the Hope case, Chief Justice Rhenquist in Duquesne Light Co. v. Barasch, 488 U.S. 299, 109 S.Ct. 609 (1989) identified three factors that critically impact the determination of whether the rate of return permitted by rate regulation is "fair and reasonable":

> The overall impact of the rate orders, then, is not constitutionally objectionable. No argument has been made that these slightly reduced rates jeopardize the financial integrity of the companies, either 1) by leaving them insufficient operating capital or 2) by impeding their ability to raise future capital. Nor has it been demonstrated that 3) these rates are inadequate to compensate current equityholders for [their] risk.... (488 U.S. at 312.)

The Court in Duquesne also suggested that the rate methodology selected for use by the regulator would not, in and of itself, subject a rate order to constitutional attack:

> The economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties. Errors to the detriment of one party may well be cancelled out by countervailing errors or allowances in another part of the rate proceeding. The Constitution protects the utility from the net effect of the rate order on its property. (109 S.Ct. at 619).

Thus, the constitutional analysis being used by the courts focuses on the end result of the rate order rather than the efficacy of any single ratemaking methodology; it is the impact of the rate order that matters and not the theory underlying the calculations.

As a result of these more recent court decisions, considerable debate has been generated concerning the meaning of statutory and constitutional standards as to what constitutes a fair and reasonable return under the law. For example, one major issue being debated today is the question of whether the cost of capital is the constitutional measure of a "fair rate of return" or whether there is some other lesser standard that passes constitutional muster. Another related issue is how to quantitatively express the "end result" of the allowed rate so that it can be determined whether the constitutional confiscation standard has been violated.

Currently, there are numerous articulations of the legal standard relating to allowable profit that arise from these public utility cases. Each of these articulations may create the same or different requirements depending on which standard or standards are applied and how they are interpreted. For illustration purposes, the following list is a simplified summary of some of the current legal standards:

COMMON LAW PUBLIC UTILITY PROFITABILITY STANDARDS SUMMARY

1. A rate must contain a provision for the capital costs of the business. (Hope)

2. A rate must contain a return to the equity owner commensurate with returns on investments in other enterprises having corresponding risks. (Hope)

3. A return must be included in the rate which allows the company to operate successfully. (Permian Basin)

4. A rate is not unconstitutional absent deep financial hardship. (Jersey Central)

5. A rate is not unconstitutional if the out-of-pocket expenses in connection with a particular portion of a firm's business do not exceed its revenue from the allowed rate for that portion of the business. (Permian Basin)

6. A rate is not unconstitutional if consumer interests are balanced against investor or company interests and rates are not exploitive. (Hope, Permian Basin)

7. The constitution guarantees the opportunity to earn a profit; it does not guarantee a profit itself. (Market Street)

8. The constitution protects a company from the consequences of the end result of a rate order, but does not dictate the use of any particular methodology. (Hope, Permian Basin, Duquesne)

INSURANCE COMMON LAW PRECEDENT

Courts examining profitability issues arising out of recent insurance rate cases have used the precedent and legal standards developed in the area of public utility rate regulation, but have added an insurance perspective that helps illuminate the practical effects of these standards on insurance rates. In Calfarm v. Deukmejian, 771 P.2d 1247 (1989) insurers challenged a statutory rate rollback of 20% enacted in Proposition 103 as facially unconstitutional and confiscatory. The statute did not allow relief from the rollback unless an insurer was threatened with insolvency. The California Supreme Court citing Hope held that "a rate may be confiscatory even though it does not threaten the insurer's solvency." (771 P.2d at 1254). It struck down the insolvency standard as violative of the Constitution and substituted a requirement that relief from the rollback must be granted an insurer if the rollback rates were "inadequate in that they did not contain a fair and reasonable rate of return." (771 P.2d at 1254).

In its discussion of the constitutional problems with the insolvency standard, the California Supreme Court recognized that rates are charged by state and by line of

business whereas the insolvency standard referred to the financial condition of the entire company as a whole:

> Many insurers do substantial business outside of California or in lines of insurance within this state which are not regulated by Proposition 103.... In such a case the continued solvency of the insurer could not suffice to demonstrate that the regulated rate constitutes a fair return. (771 P.2d at 1254.)

Importantly, the California Supreme Court also recognized with disapproval that the original Proposition 103 insolvency standard encompassed the profits not only from current rates, but also from past rates:

> If an insurer had substantial net worth... it might be able to sustain substantial and continuing losses on regulated insurance without danger of insolvency.... [The rollback] rates which might be below a fair and reasonable level might compel insurers to return to their customers surpluses exacted through allegedly excessive past rates. But the concept that rates must be set at a less than a fair rate of return in order to compel the return of past surpluses is not one supported by precedent.... No case supports an unreasonably low rate of return on the ground that past profits were excessive. (771 P.2d at 1254.)

These standards articulated by the Calfarm Court which focus on a by-line, by-state profitability analysis, and which specifically exclude a rate which compels the return of "past surpluses", argue for a profitability analysis which looks at whether a rate is expected to produce a positive operating return.

An operating return approach is also one that seems to flow from the decision of the Ninth Circuit Court of Appeals in Guaranty National Ins. Co. v. Gates, 916 F.2d 508 (1990). In Gates the Federal Circuit Court of Appeals struck down a Nevada rollback statute because it "permitted only marginal or break-even rates." The Ninth Circuit noted that the Nevada rating law defined insurance rates as inadequate "if they are clearly insufficient, together with the income from investments attributable to them, to sustain projected losses and expenses in the class of business to which they apply." [Section 686B.050(3) Nev. Rev. Stat.] This Nevada statute clearly refers to a zero operating return.

The Federal Court concluded that the break-even operating return standard contained in the statute is not sufficient to guarantee the constitutionally required "fair and reasonable rate of return." Judge Levy wrote:

> From the investor or company point of view, it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business.... Because Section 686B.050(3) specifically defines

> "inadequate" in a constitutionally unacceptable fashion, we may not simply sever the insolvency provision... as the California Supreme Court did in Calfarm. (916 F.2d at 515).

Even when a Court is upholding insurance rate regulation which uses a total rate of return methodology it is interesting that the legal articulation of the profitability standard applied seems to be more consistent with an operating return approach. In 20th Century Ins. Co. v. Garamendi, 878 P.2d 566 (1994) the California Supreme Court upheld the Commissioner's Proposition 103 rollback regulations[5] and the rollback ordered for 20th Century Insurance Company as legal based on its conclusion that 20th Century was able to "operate successfully during the period of the rate and subject to then-existing market conditions." Justice Mosk wrote:

> At least in the general case such as this, confiscation does indeed require "deep financial hardship" within the meaning of Jersey Central. Hence, it does not arise... whenever a rate does not "produce a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks, and which is sufficient to attract capital." Profit of that magnitude is, of course, an interest that the producer may pursue but it is not a right that it can demand. It is "only one of the variables in the constitutional calculus of reasonableness."
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> ...This follows from the fact that under Hope, a regulated firm may claim that a rate is confiscatory only if the rate does not allow it to operate successfully.... Indeed, a rate can threaten confiscation only when it prevents the producer from "operating successfully" as that phrase is impliedly defined in prior opinions and is expressly used in this, viz., operate successfully during the period of the rate and subject to then existing market conditions. (878 P.2d at 617, 618.)

One way to interpret this language is that it is legally important to have a profit margin which is based on a total return analysis that identifies reasonable investor expectations and enables a comparison of insurance company returns with those in other industries. This evidence can be used to determine whether a proposed rate is excessive (i.e., outside the range of reasonableness on the high end). However, this analysis is not legally sufficient to determine whether a rate is inadequate or confiscatory (i.e., outside the range

[5] The Commissioner had adopted in regulations a profitability standard representing the "minimum constitutionally permitted rate of return" of 10% of a calculated "leverage norm." The 10% figure was derived from an historical analysis of the property and casualty insurance industry without reference to the returns in other industries of comparable risk or investor expectations. Leverage norms were developed to determine each company's surplus for use in converting the 10% return on equity to a percentage of premium that could be used directly in adjusting rate levels. The leverage norms were premium to surplus ratios derived by an arbitrary allocation of industry-wide actual surplus to line of business; an individual company's leverage norm was then calculated based on its own distribution of business.

of reasonableness on the low end). In order to determine whether a rate is confiscatory one must look not at investor returns or comparable earnings, but at whether the company is able to operate successfully during the period of the rate, to cover out-of-pocket costs and avoid deep financial hardship, however these terms might ultimately be defined.

There are a number of other reported insurance rate cases that uphold an operating return approach, but these cases do not have a constitutional dimension. The Courts simply apply a usually unique statutory provision requiring the use of an operating return. For example, in State ex. rel. Commissioner of Ins. v. North Carolina Rate Bureau, 261 S.E.2d 671 (1979) affirmed 269 S.E.2d 602 (1980) the North Carolina Courts held that it is not proper to consider investment earnings on capital or stockholder supplied funds in ratemaking although investment earnings from funds attributable to insurance operations is appropriate. The North Carolina rating law required consideration of "investment income earned or realized from unearned premium and loss and loss experience reserve funds generated from business within this state" in the rate approval process.

Likewise, Courts have upheld the insurance commissioner's decision to use an underwriting profit in the rates. In Insurance Department v. City of Philadelphia, 173 A.2d 811 (1961) the City, representing auto insurance consumers, argued that the profit factor used in ratemaking should be calculated as a percentage of invested capital and not as a percentage of earned premium. The Court upheld the Commissioner's order approving the rate change. It found that the use of the words "reasonable margin for underwriting profit" in the statute was intended to exclude investment income from consideration. The rejection by the Court of the ratemaking approach proposed by the City was based primarily on a finding that the statutory language constituted a legislative intent to distinguish between the competitive automobile insurance market and the provision of services by a monopoly public utility. As a result, it was found to be unnecessary to determine a return that could be compared with the returns in other industries because competition was assumed to be controlling the profit margin.

Moreover, Courts have addressed and upheld the insurance commissioner's ratemaking decisions when a total rate of return approach was used. In Attorney General v. Commissioner of Ins., 353 N.E.2d 745 (1976) the Massachusetts Commissioner rejected the use of a profit margin expressed as a percentage of premium as the "shoddiest component" of ratemaking and substituted a capital asset pricing model. The insurance rating law applicable to automobile insurance rates in Massachusetts provides that "due consideration shall be given to a reasonable rate of return on capital after provisions for investment income." The Court upheld the Commissioner's decision and approach to the profit provision based on the statutory language.

The foregoing discussion of the legal standards applicable to insurance profit margins should be adequate to communicate the fact that the legal and regulatory communities are no more in agreement on the appropriate approach to insurance rate profit provisions than are the actuarial and financial communities. Many regulators and legislatures prefer not to deal with the issue. Instead they rely on the competitive market to produce appropriate

profit margins. A few regulators, legislatures and reviewing courts require an evaluation of rates using a total return analysis by finding it necessary to calculate the cost of capital and to compare insurance returns by line, by state with returns in other industries of comparable risk. Others focus on the return from current insurance operations and insist that any proper evaluation indicate whether this return is positive. Some seem to refer to more than one type of profit margin as they articulate the applicable legal standards.