# So You're Thinking About Rate Regulation...

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While the recent Supreme Court decision on the Federal Trade Commission's action against various title insurance rating organizations offered less of a blueprint for ratemaking than had been anticipated, pent-up demand for national rate regulation has led title insurers and agents in more and more jurisdictions to consider proposals to establish new ratemaking enviroments.

The purpose of this article is not to recommend one particular system as a panacea, since local conditions have a profound influence on what type of rate regulatory approach will best serve title insurers, their agents, and the consuming public. Rather, what I hope to accomplish is to provide a *framework for analysis* that can help those considering a proposed program of rate regulation (including no regulation at all) to determine the likely consequences of the proposal's adoption.

The framework for analysis I recommend is summarized in Table 1. My approach is to consider a rate proposal as being created by making a series of *decisions* as to how various *areas* of the rate regulation process will be designed. Within each decision area, there are a series of *options* which can be selected. The choices made among these options will have certain *implications* for the way the rate regulatory system will work.

**Rating Procedure**

The various procedural options that are available include use and file, file and use immediately, file and use with a delay, file and use and justify, and prior approval. These different methods, which we have listed in order of increasing intensity of regulatory agency involvement, have different consequences in three major areas: rate stability, rate adequacy, and cost of compliance.

Depending on the jurisdiction, a low intensity of regulatory involvement can either contribute to or militate against rate stability. In some jurisdictions, a low level of regulatory involvement in title insurance rate review has been accompanied by rates that have remained unchanged for many years. In other jurisdictions, a low level of regulatory involvement has been accompanied by a blizzard of filings. The same variety of outcomes also has characterized states with a high level of regulatory rate review activity. It is important to assess the attitude of the particular regulatory authority in the jurisdiction which is considering a new form of rate review to predict how this factor is likely to play out.

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There is a similar ambiguity in the effects of rating procedure on rate adequacy. It is often believed that rate adequacy is best assured by open market forces, and that regulation serves only to constrain profitability to unrealistically low levels. This conventional wisdom, however, is often belied by experience. Situations have arisen in which unregulated rates have been held to unrealistically low levels by excessive competition, with negative consequences for policyholders, for insurers, and for agents. Conversely, jurisdictions exist in which thoughtful regulation has assured rate adequacy over the peaks and valleys of the real estate cycle. Much of this variability in performance can be attributed to the degree of attention paid in the initial drafting of the statutes and regulations under which the rate regulatory system operates to the economic principles which guide regulatory rate review.

In terms of the cost of compliance, there is (unfortunately) little ambiguity in the trend: more intense levels of regulatory involvement produce materially higher costs of compliance. These increased costs include both external costs (primarily fees for attorneys, accountants, actuaries,

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economists, and other experts) and internal costs (including expenses for additional data collection and analysis, hiring of additional regulatory compliance staff, and substantial demands on top management time). It is important to determine whether the prospective benefits of a new rate regulatory framework outweigh these costs.

### Ratemaking Entity

There are three common entities that make title insurance rate filings: the individual company, the rating organization, and the state. The choice of which of these entities will be used affects three primary areas: the cost of compliance, the speed of regulatory response, and control of the rate review agenda. The effects are both direct and indirect.

On a direct level, the use of a rating organization has the effect of spreading the cost of preparing a rate filing among all the organization members, which tends to reduce individual company cost. However, because of the importance of conforming to both the letter and the spirit of the law in terms of antitrust compliance in the joint rate filing area, this form of filing demands the simultaneous adoption of rating procedures which have a high level of active regulatory involvement, which indirectly produces a countervailing upward pressure on compliance costs. Similarly, the promulgation of rates by the state places no direct ratemaking cost on the individual company. However, this direct cost avoided is more than offset by the typically high cost of providing the extensive data required by the state to perform its own ratemaking calculations, and by the costs of presenting evidence at rate promulgation hearings.

The speed of regulatory response is affected by the nature of the filing entity primarily through the indirect effect on the level of regulatory involvement. In theory, the lower the amount of analysis that the regulator is called on to perform, the quicker can be its response. However, this theoretical trend can be modified by many factors. For example, the existence of a statutory clock which forces the pace of regulatory decision-making can render decisions faster in a promulgated rate state than those made in a file and use state in which individual company filings cannot be processed expeditiously because of budgetary strictures on available clerical resources.

Finally, it is important to consider the effect of the choice of filing entity on the locus of power for setting the rate regulatory agenda. Individual company filing, of course, allows the individual insurer to focus proposed rate changes in the areas most important for its own business. The individual company loses some of this autonomy by participating in a joint ratemaking system. However, this loss of autonomy is offset in large part by the increased strength of the organizational voice, which still maintains a title insurer perspective.

In contrast, when the state makes the rate, the focus of change will be determined from a government perspective, and insurer considerations often can be presented only reactively rather than proactively. This potential difficulty can often be ameliorated , however, by the maintenance of good ongoing liaison with the regulatory authority.

### Scope of Regulation

There are two areas in which the scope of regulation needs clear definition: the nature of the charges under regulation; and the nature of the players under regulation. In terms of charges, the questions that arise include the issue of risk rates vs. all-inclusive rates, and the questions of establishing rates for "ancillary charges" such as closing and escrow services. These choices can have a profound impact on the effective-

# Table 1

*Choosing A Framework for Rate Regulation*
*The Options and Their Consequences*

| Decision Area | Options | Implications for |
|---|---|---|
| Rating Procedure | Use & File | Rate stability |
| | File & Use immediately | Rate adequacy |
| | File & Use with delay | Cost of compliance |
| | File & Use & Justify | |
| | Prior Approval | |
| Filing Environment | Individual Company | Cost of compliance |
| | Rating Organization | Speed of response |
| | State promulgation | Control of agenda |
| Scope of Regulation | "Risk Rate" only | Effectiveness of regulation (loopholes) |
| | "All-Inclusive Rate" Mix & Match | |
| | Risk Rate | "State action" scope |
| | Search Fee | Bar issues |
| | Examination Fee | |
| | Closing Charge | |
| | Related Charges - Searches & Abstracts | |
| | Agent's Commission Split | Probability of ANY rate relief |
| | Pricing of Title Evidence Sold to Agents by Underwriters | |
| Data Reporters | Underwriters only | Justifying commission as expense or income |
| | Underwriters and Agents | |
| Scope of Data Collection | Underwriter Data | |
| | Overall Profitability (UFRP) | |
| | Policy Statistics | Justifying ANY rate change other than an across-the-board increase or decrease |
| | Broad Categories | |
| | By Manual Paragraph | |
| | Endorsements | |
| | Non-Policy Statistics | |
| | Loss Statistics | Meeting usual insurance regulator expectations |
| | Policy Year | |
| | Reason for Loss | |
| | Defalcations | |
| | Agent Data | |
| | Audited vs. unaudited | Data credibility |
| | Tax basis vs. GAAP basis | |
| | Cash vs. accrual | |
| Forum for Rate Review | Informal Administrative Meeting | Cost of compliance |
| | Public Hearing | Role of media |
| | Informational | Role of politics |
| | Adversarial | "State action" |
| Criteria for Rate Approval | Profitability of Underwriter | Distinction from property-casualty line standards |
| | Percentage of Revenue | |
| | Return on Investment | |
| | GAAP vs. Statutory | |
| | Profitability of Agent | Preventing unsupported split caps & cuts |
| | Equity of Public Impact | |
| | Refinance | Public acceptance of product and title industry |
| | Reissue | |
| | Bulk Rates | |
| Techniques of Rate Review | Rating formulas | Smoothing the profit cycle and bolstering solvency in the long run |
| | Experience Periods | |
| | Mathematical forms | |
| | Economic Assumptions | |
| | Practical judgement | |
| Enforcing Compliance with Filed Rates | Complaints to regulator | Preserving effective and fair competition |
| | Rate compliance field audits | |
| | By underwriter | |
| | By regulator | |

ness of regulation. In some areas, unregulated portions of the total charge may rise to excessive levels because of the absence of countervailing market forces. In other areas, unregulated charges may drop to nothing due to ferocious, perhaps excessive, competition. The idiosyncracies of the specific venue must be considered carefully to be sure that the objectives of rate regulation, particularly the promotion of industry solvency, will be met by the form of regulation adopted.

Another area that requires careful consideration is the interaction of the rate regulatory environment with other regulatory spheres. For example, exclusion of particular types of charges from regulation may open up the issue of antitrust exposure. Conversely, inclusion of other particular types of charges under regulation may cause conflicts with definitions of legal practice or other professional activities.

Analogous considerations arise in determining which players to draw under the regulatory tent. In particular, it is essential to address the question of whether agency retention ratios, or the pricing of title evidence transferred between insurer and agent, will be brought within the regulatory ambit. The balance to be struck here is a particularly delicate one. On the one hand, these items traditionally have been set entirely by the marketplace. On the other, regulatory attention nationwide is focused on these questions. In many cases, regulatory overview of these charges may be essential if needed rate relief is to be obtained by the insurers, or unwarranted caps on and cutbacks in the amounts retained by agents are to be avoided.

## Data Reporters

The mutuality of interest of insurers and agents in an effective rate regulatory regime also affects the issue of data collection. Rate regulation in any form imposes a burden on the regulator to examine both prices and costs of production of the title insurance product. Except in a few jurisdictions, it has been regulatory practice to treat agency retention as just one more insurer cost, and to treat it as almost a "black box" not subject to further analysis. As long as this approach is in place, data for rate review can be provided entirely by insurers. However, where a closer examination of agency retention rates has become a regulatory imperative, the problem of justifying agency retention as a cost to insurers is transmuted into the problem of justifying agency retention as revenue to the agent. In such an environment, data on agent op-

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erations becomes central to rate review, and an effective rate regulatory regime must provide the regulator with sufficient authority to obtain it.

### Scope of Data Collected

Because data are expensive to collect, both insurers and agents are rightly inclined to collect as little as possible, *consistent with efficient running of their businesses.* It is important to recognize that the management of the rate review process is an integral part of running a title business efficiently. Nothing drops to the bottom line faster than a needed rate increase.

At a minimum, some reporting is needed of overall profitability of insurers. The most widely used mechanisms for such information are the Annual Statement (Form 9) and the ALTA Uniform Financial Reporting Plan. However, this information, useful as it is, can only be applied to justify across-the-board changes in the overall level of charges. If rate regulation is being considered in a jurisdiction in which it is likely that more complex changes in the structure of rates may be needed, it is necessary to consider more extensive forms of data collection. In particular, it becomes crucial to collect information on the number of policies of different types written, as well as the dollar amounts received.

In jurisdictions in which individual insurer ratemaking predominates, it is theoretically possible for each company to determine for itself which data it needs. However, an alternative approach often used by regulators is the development of a uniform "statistical plan" adopted and collected by the regulator from all insurers. The development of such uniform data can be beneficial even in the individual company filing context because it makes it easier and quicker for regulators to analyze submitted filings.

Agent data collection systems have only been used in a few jurisdictions, so the development of appropriate systems to support a particular form of rate regulation requires considerable work. One of the most important issues that needs to be addressed is data credibility. In achieving this objective, it is necessary to make choices as to whether to require that agency statements be audited; whether books need to be maintained on a GAAP (Generally Accepted Accounting Principles) basis or whether another basis, such as an income tax basis, is acceptable; and whether cash basis accounting or full accrual accounting will be required.

### Forum for Rate Review

There are several choices as to the forum in which rate review will take place. At the simplest level, the primary forum can be informal administrative meetings, augmented by correspondence. At the other end of the spectrum is the full-blown administrative hearing, replete with calendars, agendas, jousting adversarial counsel, and television cameras. Surprisingly, either mechanism can lead to good or to bad results. In determining where in the spectrum to position the review mechanism, it is necessary to consider the effect of the choice on three areas: the cost of compliance; the importance of media and political factors; and the effect on antitrust exposure.

In terms of compliance cost, the effect is unambiguous: small, informal meetings are cheaper than big, contested hearings. However, this direct cost advantage can be more than offset by delays and arbitrary denials which cannot be effectively appealed.

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In terms of media and political factors, the general effect is also unambiguous: the more formal, and hence public, the review forum, the greater the role played by the media and by political considerations. Again, however, this is a two-edged sword. In some jurisdictions, the political climate may be so polarized that a public forum cannot calmly weigh the relevant issues; in others, bureaucratic barriers ranged against rate rationalization may best be overcome through public debate.

Finally, in the event that a joint ratemaking system is under consideration, much weight must be placed on preservation of the "state action" exemption from antitrust liability. Early consultation with antitrust counsel is essential to ensure that the choice of forum dovetails appropriately with the rest of the ratemaking structure.

### Criteria for Rate Approval

Almost all rate regulatory statutes incorporate the language that "rates shall be neither excessive, inadequate, nor unfairly discriminatory." Thus, any rate regulatory system must address two aspects of the rate structure: *profitability* and *equity*. These two aspects require different perspectives.

In developing a rate regulatory system for title insurance, it is helpful to incorporate as much specificity as possible into the enabling statute with respect to criteria for determining what constitutes excessiveness or inadequacy in a rate. This specificity is important in order to prevent title rates from being judged by inappropriate property-casualty benchmarks. For example, vague language invites the mechanical application of the small profit loadings used in property-casualty lines that generate huge volumes of investment income--to title insurance rates that generate only modest amounts of investment income. In contrast, language requiring that rates generate profit sufficient to attract capital investment to the title insurance industry do not lead to this unfortunate result. In a similar vein, language restricted solely to the need for a rate to protect insurer solvency ignores the need to preserve the viability of the agency sector in title insurance, where it is essential to effective distribution of the product. In contrast, language which explicitly recognizes the need to preserve the viability of both insurer and agency sectors does not produce such a risk.

In terms of equity, a title insurance regulatory system must be able to respond to public perceptions of inequity in a balanced manner, which neither alienates the public nor impairs insurer solvency or agent viability. Thus, for example, it must provide a coherent framework for trading off discounts for refinance transactions against more realistic minimum charges so that industry revenues are not unreasonably reduced, while consumers are not unfairly burdened. Specific enabling language which recognizes the existence of such tradeoffs can be very useful.

### Techniques of Rate Review

It is a popular truism that "the devil is in the details," and nowhere is this more true than in the implementation of a rate review process. The outcome of arcane arguments about whether a trend line should be straight or curved can have impacts amounting to hundreds of millions of dollars. Any system of rate review will be subject, in some measure, to these difficulties. In consequence, adoption of any system of rate regulation commits the industry to an ongoing investment in technical knowledge.

The choice of a regulatory system should recognize these practical realities. Thus, for example, a rate review system which incorporates a fixed annual (or biannual, or triennial, or any other fixed period) cycle can limit the frequency with which rates will be changed, and can allow some prediction of likely regulatory actions. Enabling language that recognizes the existence of the real estate cycle can minimize the likelihood that occasional periods of prosperity will be used to reduce rates so abruptly that the following trough has catastrophic effects.

## Enforcing Compliance

A regulated rate system without adequate enforcement is worse than no regulation at all. It rewards the violator in the short run by allowing it to obtain business it might not have obtained by adhering to required rates, and punishes the policyholder in the long run by degrading the insurer's solvency. Accordingly, any rate regulatory system that is to confer beneficial economic effects must incorporate effective compliance enforcement mechanisms.

Enforcement programs can have two prongs: a complaint review mechanism, and an auditing mechanism. In both cases, running the enforcement program costs significant amounts. It can be helpful to include an enforcement funding mechanism in the legislation establishing the ratemaking system, with a proviso setting aside funds raised through any special fees or taxes for this specific purpose.

Complaint review mechanisms generally require regulatory employees to respond to complaints by a process of investigation and sanctions. This formal process is much preferable to the use of informal mechanisms, such as complaint review committees of rating organizations, because of the antitrust issues that any nongovernmental mechanism would raise.

Auditing programs to check for rate compliance can also be carried out by regulatory employees, but there are viable alternatives here. It is worthwhile examining whether rate auditing can be more cost effectively performed by the field audit staff of the insurer itself, or by a public accounting firm, given the nature of the prevailing rate structure and available public resources.

## Conclusion

Rate regulation is neither inherently good nor inherently evil. Rather, rate regulation will achieve reasonable and positive economic objectives precisely to the degree that it is carried out through a system which embodies careful thought about what is to be achieved and how to achieve it.

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