The State Supervision of Motor Insurance Business

by

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As you have been told repeatedly in the course of this seminar, Motor Insurance is a very political class of business, since in most countries it is compulsory, and therefore affects and concerns a very large part of the population - one might say, the public as a whole. As a result it is only natural that Motor Insurance is very closely supervised by the Insurance Commissioners and other officials in charge of insurance supervision, this in spite of the fact that it is not a typical long-term class of business - like, for instance, life insurance, which requires solvency guarantees extrapolated far into the future.

In order to define and explain the exact role of insurance supervision in the field of motor insurance, some preliminary remarks on the scope and purpose of insurance supervision in general seem necessary. At the risk of repeating myself, I cannot avoid recalling briefly why insurance supervision was set up some hundred years ago almost simultaneously in Europe and the United States of America and how it evolved during our century to become in practically all countries of the world an important factor in insurance.

The principle of State supervision of insurance emanates directly from the very nature of the insurance transactions. In fact, every buyer of insurance cover, having paid his premium receives a piece of paper - the insurance policy - bearing a promise that if and when a certain event occurs, he will be entitled to claim an indemnity for his loss. However, what the policyholder and other possible beneficiaries want is not only the right to present a claim, but also the certainty that they will obtain their indemnity, which depends on the trustworthiness of the insurance company which issued the policy. The desire to protect the public against the sale of insurance by fictitious or totally unsound companies was the initial reason behind the establishment of State insurance supervision.

Primarily designed to prevent total fraud, namely the sale of insurance by totally insolvent concerns, insurance supervision initially took the form of solely checking and auditing the published accounts of the insurance concerns; it was left entirely to the discernment of the public to draw conclusions from these accounts. However, in almost all the countries concerned it was very soon felt that this type of supervision (often called the "freedom-with-publicity" system) did not provide sufficient protection to the public, because, whereas insurance cover projected into the future is of a dynamic nature, balance sheets show only a static picture which may

UNCTAD/INS/52
GE.71-52215

deteriorate drastically from one day to the next. For this reason, a new type of insurance supervision, aimed at ensuring a dynamic long-term solvency of the insurance concerns and including a thorough supervision of assets and liabilities was gradually developed and introduced.

To the concept of solvency, as the sole objective of insurance supervision, many countries later added another principle : that of equity. These countries considered that insurance supervision could effectively protect the public only if it also covered some other essential points, such as the conditions of the contracts offered and the tariffs applied. The term "protection of the public" was given a much wider interpretation, to include promotion of a sound and efficient insurance market in which the public finds adequate insurance services at fair prices. This latter type of extended insurance supervision will have to be discussed in detail at the present meeting, because it is of particular importance in connexion with the State supervision of the third party motor insuranve business.

In fact, two additional very important factors play a role when the Commissioners are called to supervise the third party motor insurance business : first, since this type of cover is compulsory in almost all countries, the public is obliged to buy it, even if the insurers offer inadequate cover at exhorbitant price - i.e. when they go against the principle of equity; second, the beneficiaries of the cover are third parties not involved in the choice of the insurer by the policyholder, who might prefer to insure with a less solvent insurer offering cover at lower price. This would obviously endanger the quality of cover from the point of view of its solvency, to the detriment of third parties victims of accidents.

In other words, the task of the insurance supervisor when supervising the third party motor insurance business is a very extensive one, because he has to protect the public - possible victims of car accidents - both against the policyholders - owners of the cars - and their insurers. Hence the absolute necessity of fairly large scale insurance supervision, especially as the effects of motor accidents may extend many years into the future, either because the courts take their time in finalizing indemnities, or because the victims often receive indemnities spread over many years.

As in most insurance classes, measures aimed at securing solvency, on the the one hand, and equity on the other, begin at the level of tariff approval. In principle motor insurance rates must be high enough to secure the solvency of the insured portfolios, but moderate enough to allow the purchase of insurance cover by all those who are obliged to do so. Control of motor insurance tariffs is therefore a key function of any Supervisory Authority. I do not call, of course, "control of tariffs" the freezing of these tariffs at some technically unsound level. On the contrary, I believe that the Supervisory Authrority should be closely associated with the way the companies compute their tariffs and be ready to defend their adequacy against political pressures. In general, tariffs can be controlled in three ways : individually, i.e. tariff by tariff submitted, in relation to the extent of cover and to the technical results of the company submitting it; semi-collectively, i.e. on the basis of the so-called minimal tariffs for each kind of cover, below which no insurer is allowed to reduce his rates whatever his individual experience may be; uniformly, by declaring a tariff compulsory for all insurance concerns transacting a certain kind of business.

As you all know, it is the third solution which prevails in motor insurance. All motor insurers pool their statistical data and make them available to a technical Committee, or to the Supervisory Authority itself, which computes a third party motor insurance tariff and declares it compulsory for the entire national insurance market. In this connexion the question arises of how often this exercise of computing a motor insurance tariff should be effected. My answer is most categorical : every year. In other words there should be a permanent machinery collecting annual data, fitting them into a pre-agreed comprehensive formula and issuing for each calendar year a new tariff, based on that of the preceding year as corrected by the newly collected data.

Once such a solution is proposed and negotiated with all persons concerned - i.e. with insurers, policyholders, consumers' associations, politicians, price control services, etc. - and agreed by all, the eternal, very frustrating discussions on whether a tariff is still adequate or not would be eliminated and the current tariff would come out automatically every year with the help of a sliding series of data, where each new set of annual data would replace those of the furthest removed year in the series. Please note that this system is not a recent invention of mine, since I was connected with its first introduction in Switzerland some fifteen years ago. I can assure you that - after some initial problems - such a system functions perfectly, to everyone's satisfaction.

A uniform tariff, even when on the whole it functions well, does not mean of course that every company which uses it for selling motor insurance is automatically safe and solvent. The Supervisory Authority must perform its usual controls of current solvency on a company by company basis, namely by receiving from each company annual returns, evaluating the pending liabilitiss, checking the existence of sufficient assets to cover these liabilities, etc. Particular attention should be paid to those insurance companies which have the habit of delaying the payment of claims for several years, which is sometimes a sign of latent, hidden insolvency.

There are very diverging opinions on the role the Supervisory Authority should play in the case of claim disputes between the insurers and the insured. Some Commissioners refuse all involvement, on the basis that the interpretation of the terms of an insurance contract must remain exclusively in the hands of the courts, whilst other Commissioners transform their services into arbitration courts and settle most claims disputes themselves.

The most common solution is that the Commissioners try to encourage the insurers to be expeditious in settling claims, without interfering in the substance of each claim which, in case of disputes, remains the privilege of the appropriate courts. Whichever system prevails in a country, the Supervisory Authority should be informed about the attitude of each insurer vis-à-vis his insured as regards a fair and prompt settlement of claims.

In third party motor insurance, like in most other compulsory types of insurance, the scope of cover offered in each contract, and a substantial part of the wording stipulating the terms of that cover, are either prescribed by the Supervisory Authority, or subject to its preliminary approval. The intervention of the Supervisory Authority can either extend to the standardization of the entire contract, or limit itself to the most important articles of each policy, which should be clear and straightforward and avoid offering the prescribed minimum cover in an obscure and ambiguous manner. On the other hand, the companies should be encouraged to propose improvements for the sake of greater clarity, so that policyholders can understand better their rights and obligations.

But let me go back once again to the problem of the uniform motor insurance tariff and give more detailed indications on how it should be computed, from the Supervisory Authority's point of view. To simplify the illustration, let us assume that a given national motor insurance portfolio (for instance, all cars other than taxis, busses, lorries, etc., that is all vehicles that are referred to as "private cars") form one group only for which only one premium has to be computed. In order to be able to compute such a premium, the following data have to be registered for a number of years and on a strict calendar year basis :

(a) number of cars insured in a given calendar year;

(b) amount of gross premiums written - received and receivable - for that calendar year;

(c) number of claims incurred in the said year, with correction for claims incurred but not reported;

(d) amounts paid and payable (reserved) for claims incurred in the said calendar year;

(e) commissions, management expenses and other costs incurred in the calendar year;

(f) net investment income on reserves for claims incurred in the year and still pending.

It is clear that for the calendar year just preceding the date of computation the above data comprise only a few exact figures (number of cars, amount of gross premiums, expenses, etc.), whilst most other figures are estimates (number of not reported claims, cost of outstanding claims, etc.). As years go by, the data of preceding years becomes increasingly definite and estimates become unnecessary. At least five years are needed to establish a solid basis for the extrapolation of what the premium of the sixth year should be, to cover the costs and to produce a given, pre-arranged small profit. By preparing this extrapolation year after year - namely by eliminating each time the data of the first year on the list and by adding those of the latest one - one gets a very solid estimation of what the new premium of the coming year should be.

In motor insurance there are factors that the insurer cannot control or influence, namely the number and cost of accidents, the level of awards given by courts, etc. There are, however, some other factors which can clearly be influenced by the attitude of the insurer, and it is the duty of the Supervisory Authority to prevent companies from increasing unnecessarily their heavy motor insurance accounts. One of the most obvious factors is the commissions paid to agents and other intermediaries. It is felt that in all compulsory classes of insurance business, particularly in third party motor insurance, the sales commissions should be very small. Many Supervisory Authorities in both developed and developing countries intervene effectively in this field and ensure that commissions and other management expenses are kept at very low levels.

All the above considerations are mainly technical in their nature and concern the preventive and corrective role of insurance supervision aimed at effective protection of the policyholders and other beneficiaries of motor insurance contracts. However, I should like to close by stressing the political role that a Supervisory Authority should be ready to play in motor insurance, since that class of business - as already mentioned - is a very political subject concerning a very wide public and open to all kinds of attacks, especially those of consumers' associations, automobilesclubs, etc. It is the primary duty of the Supervisory Authority to face squarely such attacks, to defend sufficiently high tariffs, and to ensure that - whichever motor insurance system is used in the country, - it permits the operation of a strong and healthy insurance market. It is neither the duty of the policyholders in other classes of business, nor even that of the shareholders of the insurance companies, to pay systematically for the deficits of an underrated motor insurance market.