

CHAPTER NINE

THE CONFIRMED OPERATING RETURN APPROACH

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One approach to the regulation of insurance rates, and in particular the profit provision, which is by no means new but which is consistent with the developing legal principles in this area and also simple enough to be practical and fair in the rate regulatory context is the "Confirmed Operating Return" approach. It is an approach which encompasses both total return and operating return analyses.

The Confirmed Operating Return contemplates the development of a range of target operating returns expressed as a percentage of premium. The process of developing the range of target operating returns would first involve the selection of a range of total rates of return on net worth by reference to cost of capital or comparable industry returns analyses on an all-lines, all-states basis for a company group or, on an industry-wide basis for a particular line and state. This range of total returns can then be converted to a range of operating returns expressed as a percentage of premium. This process allows one to check or confirm the range of target operating returns for consistency with investor expectations on an overall basis and also allows a comparison with returns in other industries. However, in directly proposing or regulating the rates of any individual company, in any one state or line, the operating return range would be the one and only standard used.

The following illustration shows a typical conversion from a selected total rate of return of 15.5% of equity to an operating return of 5% of premium.

Relationship of Insurance Profit Measures

1)	Total Rate of Return (after tax) (% of GAAP Equity)	15.5%
2)	Ratio of GAAP Equity to Surplus	1.10
3)	Total Rate of Return (after tax) (% of Surplus)	17.0%
4)	Investment Income on Surplus (after tax)	7.0%
5)	Operating Return (after tax) (% of Surplus)	10.0%
6)	Leverage Ratio: Premium to Surplus	2 to 1
7)	Operating Return (after tax) (% of Premium)	5.0%

The total rate of return can be selected by any one of several methods, many of which are discussed in other chapters in this book. The ratio of GAAP Equity to Surplus, investment income on surplus, and the premium to surplus ratio can be selected by reference to industry practice and industry results. This conversion illustrates how an operating return of 5.0% of premium can be equivalent to a total rate of return of 15.5%.

Once a target total rate of return has been selected and the conversion from total rate of return to operating return has been accomplished, the resulting operating return can then be used to evaluate an individual insurer's rates in a particular line and a particular state. This process provides the necessary information to evaluate rates from a legal point of view.

The Confirmed Operating Return approach thus uses a total rate of return analysis but only at the proper level. A total return analysis is an appropriate basis for determining a target rate of return for owners of and investors in entire insurance company groups in comparison with the returns produced by companies in other industries that compete for investment capital. It is relevant to owners because it measures the return on the amount or the value of their investment. It is comparable to other industries because all are measured on a reasonably consistent basis. However, the returns for companies in other comparable industries are not usually broken down by division, by product line or geographical area, so in order to compare properly insurance industry returns to returns in other industries the appropriate level is the entire insurance company group or the entire insurance industry. The Confirmed Operating Return approach uses the information provided by a total return analysis in the most appropriate way possible while a similar analysis applied by individual company, by line, by state would not.

This Confirmed Operating Return approach also has significant benefits for use directly in rate regulation because the profit allowance can actually be used to adjust premiums while a rate of return on equity or net worth standing alone cannot. Insurance rates are developed by company, by line, by state and an operating return lends itself to these types of breakdowns whereas a total rate of return does not. Another important reason for the use of a Confirmed Operating Return in the rate regulatory process is that it does not create any counter-currents to solvency regulation in that it does not purport to regulate each individual insurer's actual premium-to-surplus ratio; it does not require arbitrary allocations of an insurer's surplus.

Thus, the Confirmed Operating Return is relatively simple and avoids many controversial issues.¹ At the same time, the range of operating returns selected does consider investment income on net worth because it was derived from an equivalent range of total

¹ One example of a controversial issue that should be mentioned is the treatment of capital gains, both realized and unrealized. To the extent that capital gains and losses are attributable to surplus rather than to returns on assets equivalent to insurance operations reserves, many of the controversial issues associated with this subject are avoided in the context of a rate hearing by using the confirmed operating return approach advocated here.

returns on net worth and its appropriateness has been confirmed by comparison to the total returns of other similar industries and investor expectations.

The Confirmed Operating Return approach is important from the legal perspective because it allows clear delineation to be made between an insurer's overall performance and the results of its insurance operations for a particular line and particular state. An operating loss using this measure means that the premiums paid by consumers in a particular line and state plus the investment income generated from those premiums is expected to be less than the claim costs and all other expenses (not including cost of capital) associated with the insurance coverage. In other words, a negative operating return means a company has not been allowed enough revenue to cover its out-of-pocket costs for that state and line. Any rate anticipating an operating loss necessarily means that investment earnings on capital put in place prior to the period of the rate must be used to guarantee performance.

If a court or other tribunal is presented with a total return analysis as the only measure of profit in an insurance rate case, no evidence is present that distinguishes between the successful operation of the insurance business and the investment results from past profits. The result is confusion and an inability to distinguish returns on the core insurance business from unrelated investment returns. A court cannot evaluate whether a company is operating successfully, whether a company is able to cover out-of-pocket expenses, or whether rates are inadequate pursuant to certain statutory and constitutional requirements without a way of differentiating between current insurance operations and investment returns on capital.

Investment income generated from an insurance company's capital or net worth must be separated for purposes of evaluating profit provisions by line, by state and by individual company in a group because capital plays a dual role for an insurer. An insurance company's capital is invested and produces an investment return whether or not the company actually issues any insurance policies. The investment returns generated by net worth are indicative of the degree of risk associated with the nature of those specific investments. An insurance company exposes capital (which remains invested) to additional risk by entering the business of insurance. This additional risk is that the capital may be called upon to satisfy claims and pay expenses if the insurance operation is unprofitable. If there is no return on insurance operations, there is no reason to remain in the insurance business, at least not in the state or line that produces no operating return.

How positive the insurance operating return must be is dependent upon the risk associated with the insurance business. Since there is some risk associated with the insurance business, the operating return must be positive at least to some degree. No insurer can operate successfully, maintain its financial integrity or attract capital and at the same time suffer operating losses. An operating loss means that an insurer's total returns were penalized because it entered the insurance business and placed its capital at risk in that business.

Any legal analysis of the insurance profit provision requires information concerning cost of capital, returns in other comparable industries and investor expectations, but evidence is also needed which separates profit on current insurance operations from investment returns on net worth or capital. The Confirmed Operating Return approach outlined above is an approach to establishing appropriate profit margins in property and casualty insurance rates that satisfies both legal requirements.