Basis and Practice of Schedule Rating

Address in part of Mr. John B. Laidlaw, Canadian Manager, of the Norwich Union Fire Insurance Society, before the Vancouver Insurance Institute.

Mr. Laidlaw in opening, remarked on the value of Insurance Institutes, his long connection with the Toronto organization, and the undoubted benefit they have been to agents, managers, and all engaged in the business, and to some extent to the general public.

Now it has not been suggested to me that I should follow any particular line, so I will touch upon two or three phases of Fire Insurance, and the first is the question of rates. I suppose there is nothing that is so to the forefront in the Insurance business as the rate. If you are canvassing an insured, the first question he asks is as to the rate and if you are offering a risk to the Company, the first question they ask is as to the rate, and the difficulty always is to fix a rate which is equally satisfactory to the insured and to the Company; for if it is not satisfactory to the insured he will not insure, and if it is not satisfactory to the Company they will refuse it, and the problem is to make the rates so just and equitable that they will be acceptable to the public, and at the same time do justice to the Companies.

Now you often will hear men who are considering the question of rates lament the fact that the Companies are not able to show a reason for a rate by statistics relating to the particular class of risk that extend over a period of years, and you will find men who perhaps have not looked into the matter very deeply who think it should be a very simple thing, because all they would have to do would be to ascertain what the losses had been and fix the rate upon that basis. Now that is a very false idea, and one that as Insurance men it is wise to combat. The Mutual Companies do levy an assessment, and their rate is an assessment or in the nature of an assessment based upon past experience, but our rate is a premium which the insured pays in advance, and for which we carry the risk during the term agreed upon.

Now what we have to do what our problem is, in fixing the rate, is not so much to look upon what has happened, but to look particularly upon what may happen, and so in practice a mill may be insured at 10 per cent and it will burn down and be rebuilt and then be insured at 3 per cent. Now that rate is not based on past experience; it is based on the future probabilty. If a company fixes its rates or guides its affairs solely on past experience, without regard to the present conditions, they will be behind the times continually, and they will never succeed. The secret of success in the Insurance business is to so appreciate the hazard and the constant changes that occur as to estimate accurately the probability of loss, and base your rate and your practice thereon. For that reason, often a Company that is a non-tariff will succeed, the reason being that the Companies through their associations were behind the times. They were fixing their rates too much on past experience, and too little on present conditions; so if the water works in Vancouver were to break down or if a number of manufactories, very dangerous manufactories, were to be established in the City it would be no proper guide for you to say, "well, the loss experienced in Vancouver for the past number of years has been very slight, and you should not increase the rates." You should deal with the changed conditions. And conversely, if you have had a very bad experience in Vancouver, and have lost a great deal of money in the city, but if the city makes fire breaks and removes hazardous conditions and provides good water works and fire appliances you will be justified and warranted in reducing rates. For that reason, the Companies or any organization of Companies which base their rates solely upon the past experiences will never be able to accomplish what is intended, that is, to fix a rate which will enable the Companies to carry the risk during the period of the policy. We promise to carry the risk for one or three years, and our rates should be fixed accurately, so that we will be able to carry the hazard during the term of the policy.

In formulating the rates and estimating what should be a fair charge, the Companies as a whole have gradually developed the present system of schedule rating, There was a time when fire insurance first started, when uniform rates were charged for all classes of risks, dwellings, stores, and factories, without regard to their construction, whether brick or frame, or the difference between furniture or buildings, or whether there were fire appliances or whether there were none; but it was not long before there was a distinction made and going back one hundred years you will find very crude schedules being used wherein a distinction was made between brick and frame, dwellings and stores, and stores and factories.

It was found, however, that although these were varied from time to time, it was necessary to make still greater variation and so about forty or fifty years ago there grew up the practice in the United States and Canada of having expert rating officers. These were men who had had considerable experience as managers or special agents of Companies, who were employed to go from town to town and prepare a book of rates, which was their estimate of the rate which should be charged on each risk. They had nothing to guide them except a sort of intuitive knowledge and their past insurance experience. They would know that a frame building was more likely to burn than a brick, that a carpenter's shop was more hazardous than a machine shop, and upon this they developed a system of rating. In some parts of Canada that system is followed to a greater or less extent today. It was found however that these men would sometimes get up in the morning with a slight bilious attack, and it would be found that where under exactly similar conditions they had named one per cent, they would be naming 1½ on an identical risk on a different day. Then possibly they fell sick and a substitute was obtained to do the work, and he would make a different guess; so the system brought about gross, unfair discrimination between similar risks and it was seen that some sort of a guide had to be formed. Thus was formed the system of schedule rating, based on the opinion of several experienced men, that a frame building used as a store should be rated so and so, if it had a shingle roof it should be a little more, if it was used for a carpenter's shop it should be a little more, and from that beginning schedules have been formed which are varying in their structure and more or less intricate more or less analytical, but all following the general principle of taking into consideration the varying features of each risk, and fixing for each particular feature of the risk a certain definite charge and making up in that way the rate which should be charged. In other words an analysis of the varying factors that entered into the mind of the original expert rater so he would not be unduly affected by a bilious attack, and a consistent system be established.

In regard to discrimination, our whole modern system of rating is based principally on discrimination, but it is fair discrimination as against unfair. If we rate two risks exactly alike, one at 1 per cent and the other at 1½, that is unfair discrimination, but if we rate a brick building at at 1 per cent and a frame building badly exposed at 3 per cent, we have made a rate relatively in accordance with the hazard, and that is fair discrimination, and it is necessary that we deal fairly with the public.

The public are interested in the solvency of Fire Insurance Companies and they are also interested in being