Consumer Federation of America

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before the
Casualty Actuarial and Statistical (C) Task Force
of the National Association of Insurance Commissioners
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CASTF SHOULD REJECT THE CAS DRAFT SOP ON RATEMAKING

The Draft Statement of Principles (SOP) proposed by the Casualty Actuarial Society (CAS) should be rejected because they open the door to unfairly discriminatory practices and weaken the long-standing actuarial standards that have guided the actuarial profession to develop rates that are based on the cost of transferring risk. The draft SOP is a radical shift away from ratemaking toward a new, undefined process called "insurance pricing," which will allow considerations long-held to be unrelated to rates and unfair to the public to become part of the actuarial process.

1. BACKGROUND

The current Casualty Actuarial Society Statement of Principles ("SOP") for Ratemaking assures that rates are cost-based. This has been a problem for those insurers who seek to move away from cost-based rates. A prime example of an attempt to move away from cost-based rates is the growing use of "Price Optimization."[1] Towers Perrin explains this new idea: "Traditionally, many industries, including the insurance industry, have priced their goods and services based on supply-side factors (cost to produce the product plus a margin for profit). However, this cost-plus-profit approach leaves a lot of money on the table in the form of lower margins from existing customers and lost revenue from prospective customers. According to AMR Research, between 1% and 5% of value is lost across all industries because companies do not know enough about their customers' willingness to pay or don't have the ability to profit from this knowledge. Pricing can be the most potent weapon companies have. When a more sophisticated pricing approach is implemented, operating profit increases significantly, much more than when other factors such as variable cost, volumes or fixed costs are adjusted..."[2]

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[1] "Of the companies with over $1B GWP, 34% currently optimize their prices and an additional 29% are planning to adopt optimization in the near future." 2013 North America Auto Insurance Benchmark Survey, Earnix, 2013.
[2] Price Optimization: A Potent Weapon for Innovative Insurers, 2007.

Price Optimization relies on an analysis of the elasticity of demand of customers to raise prices above the cost-based level on some segments of the policyholders known to be less likely to change insurers when prices go up.

There is great inertia in the personal lines insurance market. People tend to not shop much. A recent survey of American personal lines policyholders showed that 24 percent of auto policyholders had never shopped for auto insurance (27 percent never did for home insurance), 34 percent had rarely shopped for auto insurance (33 percent for home insurance) and only 27 percent shopped within every other year for auto insurance (20 percent for home insurance)[3]. Price Optimization tries to find these inert policyholders and jack up their prices. The poor, who shop less,[4] are particularly vulnerable to Price Optimization.

On October 18, 2012, the CAS presented an aptly named webinar, "Price Optimization vs. Actuarial Standards" where questions were raised on the practice of adding things to "cost-based analytics," things such as demand considerations (how much can rates be raised above cost-based to reflect inertia in certain market segments) and competition. The panel wrestled with questions like:

- "Price Optimization – How does it fit with the actuarial profession?" (Noting, "cost-based analyses are clearly actuarial," but not saying the same about demand and competitive considerations.)
- "Is it ratemaking?"
- "Is it in compliance with the Statements of Principles and Actuarial Standards of Practice?"
- Do the ratemaking standards cited above "mean that Price Optimization is NOT ratemaking" (Emphasis in original)
- "Should (or may) an actuary consider outcomes other than cost when making rates?"

One panelist said the regulators have a duty to control the use of Price Optimization but that the CAS and the industry has no duty to warn them that it is developing or in use. (Even though one of the panelists said that regulators are "at an incredible disadvantage" when they attempt to analyze things like Price Optimization.) One panelist said (twice) that the use of Price Optimization "could be unethical." Another said that the laws in the states requiring that rates be fair leads to tension since "Price Optimization does advantage one segment over another..." Some of the panelists admitted that there is a tension between the CAS Standards and the use of Price Optimization. One said that the CAS must revisit the Standards to "get up to date." When asked if the actuarial Standards had to be changed so Price Optimization could comply, one panelist answered, "Yes. The tension is there and must be relieved. We need a safe harbor."

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[3] The Voice of the Personal Lines Consumer, Deloitte, 2012
[4] "From Poverty, Opportunity," Brookings Institution, 2006.

The CAS issued a Discussion Draft of a proposed SOP for Ratemaking last year, with comments due from CAS members on June 10, 2013. It was clear to CFA that this draft contained the "safe harbor" to allow Price Optimization to comply with the SOP. On May 17, 2013, I wrote to the CAS objecting to the Draft on the grounds that it would allow Price Optimization to occur and complaining that the cover letter and other material sent to the CAS membership did not make this important change from cost-based rates clear to the membership. I also raised my concerns with this (CASTF) Task Force and with all of the nation's Insurance Commissioners.

On May 22, 2013, your Chair, Richard Piazza, wrote to the CAS expressing this Task Force's concern "with the shift in emphasis from loss based ratemaking principles to principles that encompass subjective market driven ratemaking." On May 21, 2013, Commissioner Jones of California warned the CAS that he agreed with CFA's concern that "the new language appears to open the door to allow new pricing schemes such as 'price optimization...'" He went on to say that "we would consider such distinctions to be unfairly discriminatory."[5]

Under this scrutiny, the CAS withdrew the 2013 Draft SOP on Ratemaking. Now, it appears that they are trying to do the exact same thing, i.e., open the door to Price Optimization, once again.

2. ANALYSIS OF THE CAS DRAFT SOP

On May 12, 2014, the CAS sent a "Preliminary Version of the Revised Draft of the CAS Statement of Principles on Ratemaking" to this Task Force. In CFA's view, as we explain below, the draft once again opens the door to what Chairman Piazza called "subjective market driven ratemaking" and what Commissioner Jones said was illegal unfair discrimination. Worse, the transmittal letter from the CAS once again does not make clear that the effect of the changes in the Draft would be to open the door to Price Optimization and other such non-actuarially-sound methods.

A) The Principles Section in the Draft is fine

The Draft Principles are clear that a rate is an estimate of the expected value of all of the future costs related to risk transfer. A rate must be an actuarially sound estimate of those costs (or it fails to meet the statutory standards).

The costs are claims, LAE, and the usual insurance expenses such as commissions, other acquisition, taxes, policyholder dividends and general expenses. Profit, reflecting investment income, is also included, along with a contingency provision.

[5] I **attached** the materials mentioned above for your easy reference.

So far so good. CFA sees no problem with this. These are the traditional Standards for Ratemaking. The problem is the other changes in the SOP change the SOP from one limited to ratemaking to a new thing not found in the actuarial SOP before and undefined in the Draft SOP but much broader than ratemaking, a thing called "insurance pricing" where there are no limits on what final prices might be.

<u>B) Three proposed changes to the SOP open the door to "subjective market driven ratemaking" methods such as Price Optimization</u>

<u>i) The definition of ratemaking in the Draft SOP</u> no longer contains this statement: "This process involves a number of considerations including marketing goals, competition and legal restrictions *to the extent they affect the estimation of future costs associated with the transfer of risk*. This Statement is limited to principles applicable to the estimation of these costs." (Emphasis added)

Therefore, "this process" (i.e., ratemaking), and the considerations of "marketing goals, competition and legal restrictions" are no longer limited to estimation of future costs. Marketing goals (e.g., elasticity of demand) and competition are the very two adjustments that Price Optimization makes to the rate *after* that rate is calculated in accordance with the traditional Ratemaking Standards. The Draft SOP no longer limits rates to the historic cost-based Standard.

ii) The <u>data section of the current SOP is eliminated</u>. These two data paragraphs are gone:

"Data——Historical premium, exposure, loss and expense experience is usually the starting point of ratemaking. This experience is relevant if it provides a basis for developing a reasonable indication of the future. Other relevant data may supplement historical experience. These other data may be external to the company or to the insurance industry and may indicate the general direction of trends in insurance claim costs, claim frequencies, expenses and premiums.

"Organization of Data——There are several acceptable methods of organizing data including calendar year, accident year, report year and policy year. Each presents certain advantages and disadvantages; but, if handled properly, each may be used to produce rates. Data availability, clarity, simplicity, and the nature of the insurance coverage affect the choice."

The current SOP limits data to cost data that either are directly related to the transfer of risk such as claims, LAE, and the other costs discussed earlier or it limits other data that "supplement historical experience" to that which impacts "general trends in insurance claims costs, claim frequencies, expenses and premiums." It does not allow such data as data on elasticity of demand. Removing these data limits opens the door for use of such data and models upon which the price elasticity of demand relies.

iii) The "Conclusion" section of the draft SOP is also changed. Here are the key changes (new material underlined, removed material crossed out):

> "By interacting with professionals and analyzing data from various fields including underwriting, marketing, law, claims, and finance, the actuary has a key role in the ~~ratemaking~~ insurance pricing process."

Here the use of data from marketing and other disciplines are specifically allowed under the Draft SOP for the first time, without the limits mentioned above. Should the actuary be analyzing data from marketing for example? It makes sense if marketing shows that consumers are unlikely to continue to buy certain coverages for some reason, which might affect premium trend. That is allowed under the current SOP. This new language allowing data from often inappropriate (in a determining-the-cost-of-risk-transfer sense) clearly allows the use of Price Optimization since other (non-determining-the-cost-of-risk-transfer) data would always be used in a way that resulted in a move of prices away from the cost-based levels.

The drafters, to make clear that this move away from cost-based ratemaking is not violating the Principles for rates in the Draft SOP (which remain cost-based) shift the thrust of the SOP from "ratemaking" (since rates still have to be cost based) to a new concept, "insurance pricing." "Insurance Pricing" is a regulatory nightmare, something much broader than ratemaking where actuarial soundness becomes irrelevant, tests of whether a final insurance price (I almost said "rate" but that is no longer the case) are ambiguous if any exist and insurance consumers, often required to purchase the coverage by state law or lender fiat, are fair game for whatever the market will bear.

3. WHAT CASTF SHOULD DO WITH THIS DRAFT SOP

This Task Force should make clear that you oppose the Draft SOP and return it to the CAS for rethinking.

(As an aside for the actuaries on the Task Force, I must state that, as an actuary, I find it exceedingly strange that an organization representing actuaries would propose a Draft SOP on Ratemaking that so obviously diminishes the important role actuaries have always had in the ratemaking process.)