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Comments of J. Robert Hunter, FCAS
on the Discussion Draft of Statement of Principles
Regarding Property and Casualty Insurance Ratemaking

This is in response to the captioned Discussion Draft for which comments are due on June 10, 2013.

The draft does not impact Principle 1, which says "a rate is an estimate of the expected value of future costs." Principle 2 is similar and also unchanged, "a rate provides for all costs associated with the transfer of risk." These are the traditional requirements that an actuarially sound rate be "cost-based."

This cost-based approach has been widely accepted as the basis of proper ratemaking. For example, in the CAS W-Forum of Winter 2009, Mike Miller, FCAS, wrote an article, "Disparate Impact and Unfairly Discriminatory Insurance Rates." Here is a portion of the first part of the Abstract: "Historic actuarial literature, general insurance literature, and legislative histories reveal 'unfairly discriminatory rates' to be a cost-based concept. A rate structure is unfairly discriminatory if the insurance premium differences between insureds do not reasonably correspond to differences in expected insurance costs."

But this historic requirement is under attack by those seeking to make rates in a new way, a way in which rates are not cost-based but based on other than cost-based considerations and, indeed, move the rate away from being cost-based. The prime example of such a trend is in the growing use of "Price Optimization." 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..."[1] In other words, you can gouge some segments if you use Price Optimization.

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[1] Price Optimization: A Potent Weapon for Innovative Insurers, 2007.

One insurer in Europe (where Price Optimization is more developed) used a sample of one percent of a particular market segment within a line of insurance to test Price Optimization. It used a test like this:

"EXAMPLE: On 1% of customers apply the following test model:

- 1st 10% increase price 0.5%
- 2nd 10% increase price 1.0%
- 3rd 10% increase price 1.5%"
- Etc.…

This was used to see how much rates could go up over the cost-based level to find the maximum profit level from the mix of higher than cost-based prices and the level of consumers opting to leave as the price rises. This is obviously a long way from traditional pricing approaches.

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 insureds 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)[2]. Price Optimization tries to find these inert policyholders and jack up their prices.

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 that "cost-based analyses are clearly actuarial," but not saying the same about demand and competitive considerations.)
- "Is putting the three considerations together an actuarial exercise?"
- "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?"

The participants in the webinar were:

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[2] The Voice of the Personal Lines Consumer, Deloitte, 2012

- Jeff Kucera, moderator. He was with Allstate and Tower-Watson before retiring.
- Mike McPhail, USAA
- Chet Szczepanski, with Donegal Insurance.

They did a good job and the discussion was lively and interesting.

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.”

And that is what this draft change to the Statement of Principles Regarding Property and Casualty Ratemaking seems to me to be all about, although this goal is not stated in the draft or other materials I have read pertaining to the release of the draft. It would be really inappropriate if the CAS put out a draft without stating the real intent of the changes if the intent is to allow Price Optimization to pass muster under the SOP.

Here is the language, part of the “Conclusion” section, which I think explodes the historic principles of cost-based ratemaking (underlined language new, struck through language deleted):

The actuary, by applying the ratemaking Principles in this Statement, will derive an estimation of the future costs associated with the transfer of risk. Other business considerations <u>including marketing goals, competition and legal restrictions</u> are also a part of ~~ratemaking~~ <u>determining the final price</u>. By interacting with professionals from various fields including underwriting, marketing, law, claims, and finance, the actuary has a key role in the ratemaking process and <u>determining the final price</u>.

Note that the draft subtly introduces “determining the final price” as distinct from “ratemaking.” This change by itself is shocking since the actuaries apparently thereby relinquish the role of determining insurance prices.   Worse, this language, combined with the addition of using unlimited “marketing goals and competition” in "determining the final price," opens the door to full-fledged Price Optimization. Marketing goals and competition are mentioned in the current Statement of Principles as follows: "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." Note that marketing goals and competition can, under the current SOP, be used only "to the extent they affect the estimation of future costs associated with the transfer of risk," thereby not allowing the things that Price Optimization does like raising prices above costs to maximize profit of insurance companies.

I oppose this change. If CAS does not intend to open the door for Price Optimization, it should immediately say so, withdraw the draft and fix the language.

However, if a change of this magnitude is intended, (i.e. a change in the fundamental cost-based nature of insurance pricing) the CAS should withdraw the draft and reissue the document with a clear explanation of the rationale and the anticipated impacts on policyholders, particularly on the poor who shop very rarely. Further, prior to any decision on a change of this magnitude, CAS should open the door widely for input to the NAIC, individual state commissioners, the FIO, consumer groups, insurers and other interested parties to aid in this historically important decision-making process. What CAS may be proposing ends the era of risk-based pricing forever in favor of a system that lets insurers charge what the market will bear. It should not be done stealthily in the dark recesses of the actuarial society alone.

I also have to ask one final, very basic question: What is the purpose of having principles at all if cost-based indications can be ignored by insurers by adding non-cost-based considerations to alter the actuarially-indicated rate?

Sincerely,

J. Robert Hunter

J. Robert Hunter, FCAS. MAAA

(Note: For identification, the writer is Director of Insurance at Consumer Federation of America and formerly served as Texas Insurance Commissioner)

cc: James J. Donelon, NAIC President and Chair of the Casualty Actuarial and Statistical Task Force; Ben Nelson, NAIC CEO; Kevin McCarty, Florida Insurance Commissioner, Immediate NAIC Past President; Mike Chaney, Mississippi Insurance Commissioner and Chair of the Property and Casualty Insurance (C) Committee; Sharon Clark, Kentucky Insurance Commissioner and Chair of the Market Regulation and Consumer Affairs (D) Committee; Dave Jones, California Insurance Commissioner; Benjamin Lawsky, Superintendent, New York Department of

Financial Services; Eric Nordman, Director of Regulatory Services, NAIC Staff; Aaron Brandenburg, Manager I, NAIC Staff; Mike McRaith, Director, Federal Insurance Office.