Consumer Federation of America

COMMENTS OF
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TO THE
NAIC CASUALTY ACTUARIAL AND STASTICAL TASK FORCE
REGARDING THE
ACTUARIAL STANDARDS BOARD (ASB) SECOND EXPOSURE DRAFT
OF ASOP, PROPERTY/CASUALTY RATEMAKING

When the ASB entitled the second exposure draft as "Actuarial Standards of Practice – Property Casualty Ratemaking," they made two fundamental errors. The so-called "Standards" are not standards at all and the draft has nothing to do with "Ratemaking." First, by failing to address the critical contemporary attack on the actuarial process by such "innovations" as price optimization (now banned in 18 states), the document might be better described as "Generic Overview of Some Actuarial Terms, None of Which Are Binding" or, put more simply, "Who Needs Actuaries Anyway?" Second, the Draft ASOP does not provide substantive parameters for setting rates charged to consumers, so it can hardly be termed a "Ratemaking Standard"

Principle 4 of the extant CAS Principles of Ratemaking states:

> *Principle 4: A rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer.*

Clearly, the term "rate" in this legal context in place in virtually every state means the rate charged to the policyholder, not some part of that rate.

But under this Draft ASOP, Article 1.2, "Scope," states that "This standard is limited to the estimation of future costs. While the actuary may play a key role in the company's decisions in determining the price charged after taking into account other considerations, such as marketing goals, competition, and legal restrictions, this standard does not address these other considerations."

In response to comments on this point, the reviewers from ASB state clearly: "the ASOP provides guidance on the estimation of future costs, not the price charged," making the ASOP useless for regulation of insurance rates as traditionally defined and, as we will see below, pretty much useless for any purpose.

In other words, these so-called "Standards" do not apply to "rates" as understood in the laws of the states[1]. Instead it applies only to an undefined new term, "future costs." It achieves this, in part, by redefining two terms: "rate" to mean "An estimate of all future costs per exposure unit associated with an individual risk transfer" and "premium" as "The final price charged for the transfer of risk."[2] Previous to this new definition of rate, a definition obviously forced to allow this Draft to appear to cover "Ratemaking," everyone understood rate in the classic sense of the price charged to an insurance consumer, per exposure unit. "Premium" has always been defined as the rate times the exposure units.

The ASOP struggles internally with this changed definition of "rate." For example, in 3.7.1 the ASOP states that "the actuary should adjust the historical exposure and **premium** data to reflect a consistent **rate** and exposure level." (emphasis in original) Rate level is always based on the price charged to the consumer, not "future costs" levels (which no one tracks). Also, at 3.7.3, the ASOP says that "the actuary should consider additional adjustments to the historical data needed to reflect the environment expected to exist in the future period when the **rates** will be in effect." (emphasis in original) Obviously, the only thing "in effect" will be the rates actually charged to the consumer, the "future costs" are hardly put into effect by themselves. Clearly, in both of these examples, ASB uses the word "rate" using its traditional meaning, the price charged to the consumer, per exposure unit.

<u>Even the development of the undefined "future costs" are not determined by these so-called "Standards"</u>

In CAS Principle of Ratemaking #4, shown above, the rate meets state legal standards if it is an "actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer." Note that, in the ASB Draft, the term "expected value" is gone.

"Expected value" has always been understood to be the point estimate of the rate charged to the consumer that is derived by the actuarial calculations. In fact, these point estimates serve as the basis regulators use to determine if prices meet the legal standards of state law (not excessive, not inadequate and not unfairly

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[1] For example, in the Texas Insurance Code Chapter 2251.002(4) "Rate" is defined as "the cost of insurance per exposure unit, whether expressed as a single number or as a prospective loss cost, adjusted to account for the treatment of expenses, profit, and individual insurer variation in loss experience, before applying individual risk variations based on loss or expense considerations." Of course, the generally understood definition of "rate" is the price the consumer pays to insure her car or her home (e.g., $500 a year for a car). "Premium" is generally understood to be the number of exposure units times the rate (2 cars times $500 equals a premium of $1,000)

[2] We will not spend much time here on premium, but do point out that International Risk Management Institute (IMRI) defines "rate" as "A unit of cost that is multiplied by an exposure base to determine an insurance premium." So the rate cannot be the premium as this ASOP struggles to create for the first time in the history of mankind.

discriminatory). A regulator's responsibility is to ask: what is the indicated rate (i.e., the point estimate or "expected value") and how does the selected rate compare with that? Selected rates that depart too much from that level are, or should be, disapproved.

But this ASOP removes "expected value" from the Standards. A commentator asked "what judgment (does) this Standard make about price optimization in light of the discrepancy between price optimization and setting rates to be the expected value of future costs." While we address price optimization more directly below, here we are interested in the discrepancy between rates that have been adjusted from the cost-based level (for instance via price optimization) and the "expected value" or the point estimate, which is the test of legality of the price. The ASB reviewers state, in response to the question that, "The reviewers have eliminated any reference to expected value and believe that using the phrase "estimation of future costs" provides sufficient guidance in the selection of the intended measure for ratemaking." In other words, even the new "future costs" determined under the draft ASOP are not clearly a result of the statistical analysis; it is pick and choose, hardly a "Standard" at all.

Question 4 of ASB's "Request for comments makes the intent clear: "The task force eliminated the reference to 'expected' value of all future costs to eliminate the possible confusion that the only appropriate estimate of all future costs was a mean value without any consideration of potential variability, Is this change appropriate? Does this change lead to confusion about what was being estimated?"

This question makes clear that the intent of ASB is to remove the point estimate (or mean value), the very basis of regulation of prices used to test if rates meet the legal requirements of being not excessive, not inadequate and not unfairly discriminatory.

This creates a fundamental disconnect from the regulatory process that cannot be resolved, as ASB attempts, with the caveat in Section 1.2 stating: " If the actuary's role involves reviewing rates developed by another party, the actuary should use the guidance in section 3 as is practicable." Under this draft the point estimate is gone and the actuarial equivalent of the Wild West has arrived where not only do we no longer derive actual rates to be charged to actual consumers, we don't even adhere to statistics.

CFA answers the question "Is this change appropriate?" with a resounding NO!

<u>Price Optimization and other questionable insurer practices used to move rates away from cost-based are allowed, if not encouraged, under these so-called "Standards"</u>

The scope of the ASOP makes clear that price optimization and any other adjustments to the selected "future costs" (there is no more point estimate of the

indicated rate so who knows where the starting point is?) are fine with the ASB and, to make sure there is no control over this outrageous practice now banned in 18 states, is placed outside the four corners of this so-called "Standard."

To make sure these standard-less Standards crafted by ASB went far enough and did not let a modicum of control of price optimization slip through by mistake, the ASB "Request for Comments" section of the Draft asks, in Question 3, "Is it clear that this ASOP does not provide any guidance on the use of what is generally referred to as 'price optimization,' which relates to the company's decisions in determining price?"

CFA's answer to that is: It sure is and that is an abdication of ASB's Standard-setting role!

Astonishingly, this draft, which was created by actuaries, undermines the actuarial profession by making actuaries far less important in the ratemaking process

In addition to the scope saying clearly that the "actuary **may** play a key role" in establishing prices, the ASOP clearly diminishes the role of the actuary in the ratemaking process[3]. The actuary no longer produces an indicated rate. She produces an estimate of "future costs" which does not have to be even close to the heretofore important point estimates. Who needs actuaries if estimates need not be close to the real number? She **may** have a role in establishing the final rate, but likely not since the modelers need not be actuaries. For instance, economists are much better at elasticity of demand than are actuaries, according to the people involved in price optimization.

Can lower actuarial salaries be far away? We wonder if the savings the insurers will achieve by diminishing the role of the actuaries will be passed through to consumers.

Conclusion

Since proper regulation is impossible under the terms of the Draft ASOP, this Draft puts consumers at great risk of being charged unfair and excessive rates (and by "rates" I mean the rates that they will be charged). Consumer Federation of America requests that CASTF oppose adoption of this misguided Draft ASOP.

[3] Emphasis added.