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January 31, 2015

Via email to Diane Tremblay (dtremblay@casact.org)

Bob Miccolis c/o Diane Tremblay
President, Casualty Actuarial Society

4350 N. Fairfax Drive
Suite 250
Arlington, VA 22203

RE: Discussion Draft of Statements of Principles Regarding Property and Casualty Insurance Ratemaking

Dear Bob:

Thank you for the opportunity to provide comments on the discussion draft of the Casualty Actuarial Society's (CAS) *Statement of Principles Regarding Property and Casualty Insurance Ratemaking*. The American Academy of Actuaries[1] Casualty Practice Council (CPC) has reviewed the document, and we are pleased to provide the CAS with the following suggestions and edits. As you know, the CPC is comprised of actuaries with diverse experiences and opinions; the suggestions and edits that follow represent the view of the majority of CPC members.

First, we encourage the CAS to incorporate an introduction or preamble to the Statement of Principles that more fully addresses the role and intent of the document in relation to existing Actuarial Standards of Practice (ASOPs) and the U.S. Code of Professional Conduct. The existing Statement of Principles on Ratemaking is widely circulated and has a diverse audience. An introduction would be helpful, particularly because the document lacks the context that ASOP No. 9 provided before its repeal. We note at the outset that the reference to the term "Ratemaking" in the title and elsewhere in this Statement of Principles would be more accurate if it was characterized as "risk transfer cost estimate" or a similar phrase.

We have three categories of comments resulting in suggested edits:

1. Scope/Purpose
2. Intended measure
3. Additional suggestions

[1] The American Academy of Actuaries is an 18,000+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

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1. Scope/Purpose

As stated in the introduction of the Discussion Draft, “The Principles in the Statement are limited to that portion of the ratemaking process involving the estimation of costs associated with the transfer of risk.” We believe that the document’s intent would be more accurate if references to ratemaking were replaced by references to estimating costs, as described in the attached redlined document.

In a sense, the proposed edits simply clarify the intent of the document, which is to address only that portion of the ratemaking process associated with the transfer of risk. Revising this Statement of Principles to more clearly focus it on estimating risk transfer costs is consistent with the change in the loss reserving principles to principles regarding unpaid claims estimates. It is important to clarify that these actuarial principles are strictly applicable to estimating risk transfer costs. Also, this change could better describe actuarial estimates of risk transfer costs in settings in which the terms “ratemaking” and “rates” are not commonly used, as in alternative risk transfer mechanisms.

We are recommending that the reference in the principles to “not excessive, inadequate or unfairly discriminatory” and “actuarially sound” be removed from the revised principles. While we note that these are important criteria in state regulations and statutes for many lines of property and casualty insurance, we believe that these terms should not be within the scope of the principles. The Actuarial Standards of Practice are the appropriate place to address such regulatory elements and to address any other considerations that may vary by product, purpose, or jurisdiction in contexts in which rates are regulated and subject to specific filing requirements. We expect this CAS Statement of Principles, on the other hand, to be applicable in all instances of estimating risk transfer costs, regardless of product, purpose, or jurisdiction. We understand that this Statement of Principles is considered by actuaries in jurisdictions outside of the U.S., where these terms may not be recognized or appropriate. For the same reasons, we suggest revising the wording in the Conclusion and removing references in this Statement of Principles to “equity” and “availability,” terms that are commonly referred to in U.S. statute and regulation.

With the removal of the references to “not excessive, inadequate or unfairly discriminatory” and “actuarially sound,” little remains in Principle 4. We suggest the substitution of a new Principle 4 that explicitly acknowledges the inherent uncertainty in estimating future costs.

2. Intended Measure

Similar to the proposed principles on unpaid claim estimates and the existing ASOP No. 43, we believe that the concept of an intended measure is also applicable to estimating risk transfer costs. It is important because terms like “expected value” and “expected cost” are not sufficiently specific to provide readers with a common understanding. Moreover, an “expected value” estimate may differ for different types of insurance. For example, traditional insurance may use the mean as the estimate, whereas a captive may estimate costs at a specified percentile in excess of the expected value or mean of the loss distribution. Suggested edits to this end are provided in the attached.

3. Additional suggestions (line numbers correspond to attached marked-up draft)

Line 1: The title of the Principles should be changed to "Actuarial Principles." Even though the CAS is an actuarial organization, the use of the word "actuarial" in the title will make this document appropriately distinguishable and recognizable by various audiences and authorities.

Lines 19-22: In general, the introduction to the cost descriptions does not match the costs that follow. For example, "claims and claims settlement expenses" are listed, but "losses and loss adjustment expenses" are defined. We suggest a simplifying edit that sidesteps listing the costs and makes clear that the defined costs *may* be included when estimating risk transfer costs. The suggested edit is provided in the attached document.

Line 33: Change to "<u>These expenses are</u> also known as claim adjustments expense<u>s</u>"

Lines 47-48: Investment expenses are not part of general administrative expenses and are specifically excluded in the definition of general administrative expenses in ASOP No. 29, section 2.3. We therefore suggest changing the definition to: "are all other operational and administrative costs <u>associated with the transfer of risk</u>."

Lines 49-55: Change the definition of underwriting profit and contingency provisions to a definition of cost of capital so that it matches the introduction in Lines 19-22.

Lines 58-59: Change "including" to "including but not limited to mechanisms …."

Lines 78-80, 83: We suggest removing the last two sentences in the introduction to Principle 3. In particular, the phrase "for each individual in the class" here, and in Principle 3 itself, is too limiting because it fails to recognize rating techniques beyond class or manual rating such as experience rating.

The CPC is also submitting comments to the Actuarial Standards Board regarding the proposed ASOP on *Property/Casualty Ratemaking*. We are enclosing a copy of those comments herein.

The CPC appreciates this opportunity to provide comments to the CAS. We hope these observations are helpful, and we welcome further discussion. If you have any questions about our comments, please contact Lauren Pachman, the Academy's casualty policy analyst, at pachman@actuary.org or (202) 223-8196.

Sincerely,

Shawna Ackerman, MAAA, FCAS
Vice President, Casualty Practice Council
American Academy of Actuaries

Enclosures

Discussion Draft: CAS Statement of Actuarial Principles ~~Regarding~~for Property and Casualty ~~Insurance Ratemaking~~Prospective Risk Transfer Cost Estimates

The purpose of this Statement is to identify and describe actuarial principles applicable ~~in the determination and review of property and casualty insurance rates. The Principles in this Statement are limited~~ to ~~that portion of the ratemaking process involving~~ the estimation and review of the costs associated with the transfer of risk~~. Although this Statement addresses~~ for property and casualty insurance and ~~casualty insurance ratemaking, the Principles contained in this Statement apply to other~~alternative risk transfer mechanisms or techniques.

This Statement consists of three parts:

I. DEFINITIONS
II. PRINCIPLES
III. CONCLUSION

I. DEFINITIONS

~~*Ratemaking*~~*A Risk Transfer Cost Estimate* is ~~the process of estimating~~an estimate, consistent with an intended measure, of the future costs associated with the transfer of risk ~~in insurance~~. Various types of intended measures include but are not limited to expected value, mean, actuarial central estimate, or ~~other risk transfer mechanisms.~~specified confidence level percentile.

~~The estimation~~Examples of ~~of~~ costs associated with the transfer of risk may include but are not limited to the ~~such costs as claims, claim settlement expenses, operational and administrative expenses, and the cost of capital. Summary descriptions of these costs are as~~ followings:

—*Claims* are demands for payment under the coverage provided by a plan, program, or contract.

—*Losses* are the costs of claims that are subject to coverage.

—*Loss adjustment expenses* are the costs of administering, determining coverage for, settling, or defending claims even if it is ultimately determined the claim is invalid. ~~It is~~These expenses are also known as *claim adjustment ~~expense~~expenses*.

—*Commission and brokerage expenses* are the costs associated with compensation to agents and brokers.

—*Other acquisition expenses* are all costs, except commission and brokerage, associated with the acquisition of business.

—*Taxes, licenses, and fees* are ~~all~~the costs from taxes and miscellaneous fees, with the exception of income taxes.

—*Policyholder dividends* are a non-guaranteed return of premium charged to operations as an expense.

—*General administrative expenses* are all other operational and administrative costs associated with the transfer of risk.

~~-~~—The *cost of capital* reflects both the amount of capital needed to support the risk transfer and the expected return on that capital. When a risk transfer cost estimate includes an underwriting profit and contingency ~~*provisions* are~~provision, the ~~amounts~~provision is the amount that, when considered with net investment and other income~~, provide~~ associated with the transfer of risk, reflects an appropriate total ~~after-tax return. The underwriting profit includes a charge for the risk of random variation of expected costs while the contingency provision includes a charge for any systematic variation of the estimated costs from the expected costs.~~return on capital.

—*Alternative Risk Transfer* is the use of techniques other than traditional insurance and reinsurance to provide risk bearing entities with coverage or protection, including~~ entities~~, but not limited to mechanisms such as self-insurance pools, captives, risk retention groups, Takaful, etc~~, etc~~.

II. PRINCIPLES

~~Ratemaking~~ The process of estimating risk transfer costs is prospective because ~~-~~the ~~property and casualty insurance rate must be developed~~estimate is made prior to the transfer of risk.

Principle 1: A ~~rate~~ risk transfer cost estimate is ~~an~~a reasonable estimate of the ~~expected value of~~ future costs associated with the transfer of risk~~.~~, consistent with the intended measure.

~~Ratemaking~~ The process of estimating risk transfer costs provides for ~~an estimate of~~ all the ~~expected~~ risk transfer costs so that the ~~insurance~~risk transfer system is financially sound.

Principle 2: ~~A rate provides~~ For the risk transfer mechanism to be financially sound, the risk transfer cost estimate needs to provide for all costs associated with the transfer of risk.

~~Ratemaking provides for the estimated~~The process of estimating costs may reflect the costs of an individual risk transfer ~~so that equity among insureds is maintained.~~. When the experience of an individual risk does not provide a credible basis for estimating these costs, ~~it is appropriate to consider the~~ the aggregate experience of similar risks may provide a reasonable basis. ~~A rate estimated from such experience is an estimate of the costs of the risk transfer for each individual in the class. A properly defined classification plan enables the development of actuarially sound rates.~~

Principle 3: A ~~rate estimated from such experience~~ risk transfer cost estimate for an individual risk transfer is an estimate of the ~~costs of the risk transfer for each individual in the class. A properly defined classification plan enables the development of actuarially sound rates.~~
intended cost measure, reflecting the~~rate provides for the estimated~~ costs associated with an individual risk transfer.

The actual risk transfer costs can be known only when all attendant policies have been issued, expenses have been incurred and paid, claims have occurred, and all losses have been paid. A prospective risk transfer cost estimate may be subject to significant uncertainty, depending on the nature of the risks being transferred and the future unknown circumstances affecting the ultimate risk transfer costs.

Principle 4: ~~A rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate~~ The uncertainty inherent in the estimation of ~~the expected value of all~~ future costs associated with ~~an~~the individual ~~risk~~ transfer~~.~~ of risk implies that a range of risk transfer cost estimates can be reasonable.

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III. CONCLUSION

This Statement provides principles applicable to the ~~determination~~estimation and review of ~~property and casualty insurance rates~~the costs associated with the transfer of risk. The Principles contained in this Statement provide the foundation for the development of actuarial procedures and standards of practice. They are not intended to supplant actuarial standards of practice, nor do they rise to the level of authority held by such standards or any applicable laws, rules, or regulations.~~It is important that the Principles be employed to derive rates that protect the insurance system's financial soundness and promote equity and availability for insurance consumers.~~

The actuary, by applying informed actuarial judgment and the ~~ratemaking~~ principles in this Statement~~,~~ will derive an estimation of the future costs associated with the transfer of risk. ~~Other business considerations are also a part of insurance pricing. 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 insurance pricing process.~~