



AMERICAN ACADEMY *of* ACTUARIES

June 20, 2014

Wayne H. Fisher
President
Casualty Actuarial Society

c/o Mike Boa
Director of Communications
Casualty Actuarial Society

Re: Preliminary Version of the Revised Draft of the CAS Statement of Principles Regarding
Property and Casualty Ratemaking

Dear Wayne:

The American Academy of Actuaries'¹ Casualty Practice Council (CPC) appreciates this opportunity to provide comments concerning this Preliminary Version of the Revised Draft of the Casualty Actuarial Society (CAS) Statement of Principles on Ratemaking (Preliminary Revised Draft) that you have provided us. As you may recall, the comments you received last June on the Statements of Principles, which included a section on the CAS Statement of Principles on Ratemaking, were those of Mike Angelina alone and were not the work of the CPC or any other Academy work group.

Having said that, we are pleased with the significant changes made by the CAS Task Force on Principles in this Preliminary Revised Draft. This letter makes several suggestions for your consideration as the CAS Task Force develops the next exposure draft.

We agree with the primary objective of revising the CAS Ratemaking Principles, "to update them [the principles] and to revise them where necessary to contain principles only, not standards of practice." We support the removal of content from the CAS Ratemaking Principles that "does not describe or explain an actuarial principle." In particular, the CAS Ratemaking Principles should be as clear as possible that they do not provide practice guidance to actuaries. Rather, practice guidance for actuaries practicing in the U.S. should be reserved for ASOPs promulgated by the Actuarial Standards Board (ASB).

An ASOP for ratemaking that is aligned with U.S. regulation is needed, and we support the ASB's efforts to develop such an ASOP. Also, the CPC is considering the development of an actuarial Practice Note on ratemaking and pricing.

The CPC has distilled its comments to the following four key issues within this Preliminary Revised Draft:

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.

1. Stated Purpose of CAS Ratemaking Principles
2. Potential Change of Name from *Ratemaking*
3. Support for Modernization in Lines 44-45 and 47-49
4. Support for Modernization in the Closing Paragraph in Lines 84-88

Stated Purpose of CAS Ratemaking Principles

The original CAS principles date back to the late 1980s, before the ASB was created to produce the type of information for practicing actuaries that has since been the purpose of ASOPs: to “identify what the actuary should consider, document, and disclose when performing an actuarial assignment. The ASB’s goal is to set standards for appropriate practice for the U.S.”² The purpose of the revised Ratemaking Principles is set forth in the Preliminary Revised Draft as follows:

The purpose of this Statement is to identify and describe 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 of costs associated with the transfer of risk. Although this Statement addresses property and casualty insurance ratemaking, the Principles contained in this Statement may apply to alternative risk transfer mechanisms or techniques.

This section of the Preliminary Revised Draft should be clarified to avoid potential issues for actuaries who have relied on the Statement of Principles on Ratemaking. If the CAS does not intend for actuaries to rely on the Statement of Principles on Ratemaking as practice guidance, then the section of the Preliminary Revised Draft that discusses its purpose should clarify that point. Also, we recommend the avoidance of language in the Preliminary Revised Draft that might indirectly provide guidance; the CAS may want to consider changing the content of the Preliminary Revised Draft and the style of the wording of each of the principles so that they are more educational and conceptual.

We recommend that the CAS explain the purpose of the Statement of Principles on Ratemaking, which we understand as providing educational and conceptual material. The wording of the Statement of Principles on Ratemaking should be clear to avoid any misinterpretation that noncompliance would signify that an actuary inevitably has violated actuarial principles. Compliance with actuarial standards is paramount.

Potential Change of Name from Ratemaking

We support the changes to the definition of Ratemaking in lines 17 and 20 of the Preliminary Revised Draft, as this language better reflects the actuarial work product created within ratemaking processes. However, this language prompted significant debate among members of the CPC about whether the name of the Statement of Principles on Ratemaking should be changed. This would be analogous to changing the name of the Statement of Principles on Reserving to the “Ultimate Claim Estimates” Principles. One suggestion was to change the “Statement of Principles on Ratemaking” to the “Statement of Principles on Risk Transfer Cost Estimates.” However, some CPC members viewed this as a subset of a broader body of ratemaking concepts. If the CAS retains the “Statement of Principles on Ratemaking” name, then the CPC recommends that this topic be subjected to further review by a broader population of practicing actuaries in the next exposure draft. As an educational document, the principles would be quite valuable to those who are looking for an expanded

² See <http://actuarialstandardsboard.org/aboutasb.asp>.

explanation of a range of concepts, including underlying risk transfer cost estimation, how insurance rates are determined, and possibly how actuaries contribute to the pricing process.

Support for Modernization in Lines 44-45 and 47-49

The complexity of underwriting profit and contingency provisions have expanded greatly with our understanding of variance around the expected value, cost of capital, and systematic variation within ratemaking methodologies. Thus, the new sentence in lines 44-45 seems to us to be a constructive addition. However, the distinction between an underwriting profit and a contingency provision may require further explanation. These terms may not be used as consistently as the Preliminary Revised Draft anticipates.

Similarly, the addition of a definition for “Alternative Risk Transfer” is an important reflection of the expanding complexity of ratemaking methodologies. However, this defined term is only used in the Introduction to this Preliminary Revised Draft.

Support for modernization in the closing paragraph in Lines 84-88

The CPC is aware of the extensive debates over certain pricing issues, where actuarial ratemaking leaves off within a broader consideration of pricing. We support the wording of lines 84-88 of the closing paragraph, which clarifies the difference between ratemaking and pricing while also making clear that actuaries are involved in the broader pricing process. The closing paragraph reflects the modernization and growing complexity of risk transfer cost estimation, ratemaking, and pricing. We encourage expanding the content of the principles to further assist actuaries in explaining these concepts and to assist those who consider input from actuaries in these areas.

The CPC subgroup tasked with responding to the Preliminary Revised Draft considered some additional comments about existing ASOPs and another report that might be helpful to the CAS in developing the next exposure draft. Those comments are in Attachment 1.

Again, thank you for allowing the CPC to comment on this Preliminary Revised Draft in advance of its next exposure. We hope these suggestions are helpful to the CAS Task Force on Principles, and we welcome any further discussion or review that may be helpful to this process. 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,

Michael E. Angelina, ACAS, MAAA, CERA
Vice President, Casualty Practice Council
American Academy of Actuaries

ATTACHMENT 1

- **ASOP No. 12, Risk Classification:** Some of the issues that are relevant for consideration in this discussion on the Statement of Principles on Ratemaking may have already been addressed in ASOP No. 12, *Risk Classification*. ASOP No. 12 applies to all practice areas and has been in effect since December 2005. ASOP No. 12 requires an actuary to consider the “Relationship of Risk Characteristics and Expected Outcomes” (section 3.2.1), whereby, “Rates within a risk classification system would be considered equitable if differences in rates reflect material differences in expected cost for risk characteristics. In the context of rates, the word *fair* is often used in place of the word *equitable*.”³ This ASOP may already address how actuaries in practice should consider the statutory requirement for rates that are not unfairly discriminatory (Principle 4), as well as the concept of rates based on expected costs (Principle 1).
- **Future Cost Estimates and Intended Measure:** As mentioned above, the Exposure Draft on the CAS Statement of Principles on Reserving reflected ASOP Nos. 36 and 43, in which the concept of “intended measure” was adopted when estimating the costs of unpaid claims. Similarly, it may be more appropriate for the term “rates” in the CAS Statement of Principles on Ratemaking to refer to “future cost estimates associated with the transfer of risk.” The concept of “intended measure” may also be applicable to future cost estimates, because, with respect to the estimation of costs that are appropriate for insurance premium rates, the intended measure may differ when applied to characteristics of insurance risk transfer. For example, rates based on estimates of the future cost of claims for infrequent and very costly catastrophes might be based on a different intended measure (e.g., catastrophe reinsurance cost or solvency capital cost) as compared to the intended measure of the costs for high frequency, low severity claims (e.g., expected value).

It could be very useful for the CAS Statement of Principles on Ratemaking to describe the concept of intended measures as it might apply to ratemaking (i.e., how the characteristics of risk and uncertainty might be reflected in cost estimates). For example, a description of how rates might include reasonable compensation for bearing risk (profit and contingencies based on an assessment of risk and uncertainty) over and above the estimated expected value of future claims, expenses, and policy costs.

- **Actuarial Soundness:** The concept of actuarial soundness is currently included in the CAS Statement of Principles on Ratemaking. However, this discussion would be more helpful if it was expanded beyond the sole reference to the “reasonable and not excessive, inadequate, or unfairly discriminatory” criteria.

In May 2012, the Academy’s Actuarial Soundness Task Force issued *Actuarial Soundness, A Special Report*, which provides an overview of the uses of the terms “actuarial soundness” and “actuarially sound” in state and federal legislative and regulatory contexts to inform regulators and the general public about the meanings and implications of these terms. It could be very useful for the CAS Statement of Principles on Ratemaking to include a

³ See ASOP No. 12, *Risk Classification*, available at http://www.actuarialstandardsboard.org/pdf/asops/asop012_132.pdf.

description of actuarial soundness in terms of the intended measure or risk characteristics applicable to the transfer of risk. The Academy's report may be useful in considering how to better describe the term "actuarial soundness" in the context of rates. The principles can play an important educational role in describing and explaining the concepts of actuarial soundness, unfair discrimination, adequacy, class rating, individual pricing, etc.

The development of tests or objective criteria for actuarial soundness might be conducted in concert with the development of actuarial standards or other technical practice guidance, such as an Academy Practice Note. The Academy's practice notes are intended to assist practicing actuaries in understanding the various commonly accepted approaches used by actuaries to meet external requirements, such as regulations and actuarial standards. Also, the typical content of a practice note can present "current or emerging approaches" to selected actuarial tasks.⁴ A practice note on ratemaking could provide examples of applications from the principles and relevant ASOPs. A practice note that underscores the application of the principles may also be helpful to the regulatory community.

- **ASOP No. 8, Regulatory Filings for Health Benefits, Accident and Health Insurance, and Entities Providing Health Benefits:** The ASB has recently completed significant revisions to ASOP No. 8. This revised ASOP will be effective in September 2014 and addresses the statutory requirements regarding rate filings for health insurance, and many of those requirements are very similar, if not identical, to the requirements for rate filings for property and casualty insurance. For example, the revised ASOP addresses the regulatory requirements of "rate adequacy," "rates not excessive," and "rates not unfairly discriminatory"⁵ (Section 3.11), as well as methods for determining expenses, the time value of money, trends, profit margins, reinsurance, and provisions for adverse deviations (Sections 3.4.4 – 3.4.10). The revised ASOP also requires disclosure of the actuary's definition of "actuarially sound" if that term is used in the rate filing (Section 4.1 f).

The development of a similar ASOP for property and casualty rate filings along the lines of the recently-revised ASOP No. 8 could be a valuable means by which features removed from the revised CAS Statement of Principles on Ratemaking could be reintroduced as part of the ASOPs. The CAS Statement of Principles on Ratemaking would serve as the educational and conceptual foundation for the practical guidance provided by the ASOP.

⁴ See <http://www.actuary.org/content/guidelines-developing-practice-notes>.

⁵ See http://www.actuarialstandardsboard.org/pdf/asops/asop008_176.pdf.