Email to the Actuarial Standards Board (ASB) (comments@actuary.org)
(cc: ASB@actuary.org, kennedy@actuary.org)
From J. Robert Hunter, FCAS, MAAA

Re: Your October 2019 Memo to Actuaries
"Request for Input – Property/Casualty Rate Filing ASOP"

This is in response to your Request for Input ("RFI").

(1) There is Already Guidance for Actuaries making P/C Rate Filings

In your request you state that "There is currently no ASOP providing guidance to actuaries on the actuarial aspects of the selection of final rates and property/casualty rate filings." That is misleading from my perspective as an actuary. Actuaries involved in P/C rate filings today have SOP guidance from the Casualty Actuarial Society in the document "Statement of Principles Regarding Property and Casualty Insurance Ratemaking" (SOP-P/C Rates). Those principles are as follows:

"Principle 1: A rate is an estimate of the expected value of future costs. Ratemaking should provide for all costs so that the insurance system is financially sound.

Principle 2: A rate provides for all costs associated with the transfer of risk. Ratemaking should provide for 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 aggregate experience of similar risks. A rate estimated from such experience is an estimate of the costs of the risk transfer for each individual in the class.

Principle 3: A rate provides for the costs associated with an individual risk transfer. Ratemaking produces cost estimates that are actuarially sound if the estimation is based on Principles 1, 2, and 3. Such rates comply with four criteria commonly used by actuaries: reasonable, not excessive, not inadequate, and not unfairly discriminatory.

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."

The fundamental concept underlying all four principles, obviously, is that insurance rates must be risk-based.

Why are neither that fundamental concept nor the four CAS ratemaking principles mentioned in your request? Shouldn't any proposed SOP use the principles in place as a starting point?

(2) There is Great Risk if the Purpose of this Exercise is to Move Toward Rates that are not Risk Based

Your RFI raises serious doubts in my mind about the direction you have chosen. For instance, the RFI states you seek an "ASOP providing guidance to actuaries on the actuarial aspects of the selection of final rates," The request goes on to say "[t]he proposed standard would provide guidance to actuaries regarding the actuarial aspects of a rate filing for the filing actuary, the regulatory actuary, and the reviewing actuary. The ASB requests your assistance and guidance in determining which components are actuarial in nature."

These statements strongly imply that the new SOP would entertain the notion that filings would include non-risk-based considerations in the determination of final rates, opening the door to price optimization and other, unknown, deviations from actuarial soundness.

What I must ask you is, in determining to issue this Request, did the ASB Board (or whoever approved this RFI) consider the trouble that a faction of the Casualty Actuarial Society ("CAS") got itself into when it tried to slip price optimization into the SOP-P/C Rates standards? This is a vital question as I explain immediately below, and I pray you will not fall into a similar trap because that would unleash the fury of many who have already fought and won this battle.

I attach my June 10, 2014 letter to the Casualty Actuarial and Statistical Task Force of NAIC, which explains the problem with trying to alter ratemaking from a risk-based basis to some other, undefined, sort of work product. It resulted in CASTF opposing the new proposal, along with opposition from insurance commissioners and other parties. The proponents of changing the CAS ratemaking principles relented when it was clear that the regulators would find rates based on other-than-risk-based considerations illegal. For example, California Commissioner Dave Jones said, in his letter to CASTF of May 21, 2013 (attached): "There are no differentials allowed based on whether the applicant or insured is more or less likely to look elsewhere for a lower price; we would consider such distinctions to be unfairly discriminatory."

If it is your intent (or the intent of those pushing for this new P/C Rate Filing ASOP) to move in the direction of allowing rates where actuarial findings can be altered to maximize profit or for other corporate objectives, I encourage you to say so clearly to the actuaries whom you have asked to give input regarding this idea and let them know about the long-standing and overwhelming opposition to such a move. Please do not mislead the actuaries if your intent is to open the door to price optimization and other possibly nefarious methodologies to raise rates above the actuarially sound level.

On the other hand, if it is not your intent to move in this inappropriate direction, you should say so clearly so that the purveyors of price optimization software and certain insurers who do not mind overpricing customers for reasons unrelated to risk will not bombard you with rationales calling for an ASOP that comports with their non-risk-based (and remunerative) desires.

(3) There is one Other Danger: Possible Violation of Antitrust Law

The McCarran Ferguson Act doesn't permit collective pricing decisions unless specifically supervised by regulators (e.g. rate bureaus). The ASB might be offering guidance on how to select final rates. This is no different than, for example, CAS holding a session on how to calculate final rates at a conference and that would run afoul of antitrust. Every industry meeting starts with a reading of the antitrust prohibition. See the CAS antitrust policy, for example, at https://www.casact.org/professionalism/policiesProc/index.cfm?fa=antitrust

As you see, the CAS statement reads, in part:

"Certain activities are regarded by courts as unreasonable by their very nature and are considered illegal *per se*. When an activity is designated a *per se* antitrust violation, a conclusive presumption is created that the activity was engaged in for no other purpose than to restrain trade. Practices within the *per se* category include agreements to fix or set prices, fees, rates, or commissions, as well as certain kinds of agreements to boycott competitors, suppliers, or customers. Note that the concept of "price fixing" encompasses agreements not only to raise prices but also to lower or stabilize prices. Virtually any agreement, arrangement, or understanding among competitors that involves tampering with free market prices, fees, rates, or premiums is a *per se* antitrust law violation.

"Under the McCarran Ferguson Act, the "business of insurance" is exempted from the federal antitrust laws when a state has regulated particular insurance activity. The McCarran Ferguson Act exemption applies to three kinds of practices within the insurance business: Practices that transfer or spread policyholders' risks, practices that are integral to the policy relationship between the insurer and the insured, and practices that are limited in effect to entities in the insurance industry. Under the McCarran Ferguson Act, if an activity involves one of these three kinds of practices, and if the state has regulated that aspect of the insurance industry (as most have), *federal* antitrust laws do not apply. But *state* antitrust laws will apply unless the state also specifically exempts the "business of insurance" from its antitrust laws (many have not)…

"Despite the exemption from federal antitrust law in some instances, Casualty Actuarial Society members cannot afford to ignore the federal laws. Interpretation of the McCarran Ferguson Act has narrowed the scope of the three "business of insurance" practices. For this reason, it is the policy of the CAS not to rely exclusively on the McCarran Ferguson exemption, but also to carefully undertake all activities to avoid anticompetitive effects."

Unlike an entity such as Insurance Services Office which is regulated as an advisory organization, ASB is not regulated by anyone, so it is likely exposed to federal and state antitrust law application. While ASB ASOPs for individual components of the rate may pass muster since these only guide rate filing components not final pricing, full rate filing advice is much closer to a prohibited activity if not a *per se* violation. Even though it is an advisory organization, ISO no longer files final rates.

(4) The Process Underlying This RFI Needs to be Made Transparent to Actuaries as they Consider Responding

Your request says it was "approved" by the ASB. Was this approval done by the Board? Could you please identify the people involved in that approval and the process by which approval was given? (i.e., was there a Board Meeting? Did anyone make a presentation on the subject? Were materials handed out? etc.)

Your website FAQ section invites outside groups or individuals to suggest ideas for ASOPs. Was this Request for Input generated after requests from outside ASB itself were received? If so, please identify the sources of such requests and supply copies of these materials or notes of calls or meetings with such entities/individuals. If not, please provide whatever material was distributed to the Board in support of initiating this RFI.

Consumer Federation of America

Statement of J. Robert Hunter, FCAS, MAAA
before the
Casualty Actuarial and Statistical (C) Task Force
of the National Association of Insurance Commissioners
June 10, 2014

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]

[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."

---

[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.

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

i) The definition of ratemaking in the Draft SOP 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 data section of the current SOP is eliminated. 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.)

DAVE JONES
Insurance Commissioner

Mr. Richard N. Piazza, ACAS
Chief Actuary
Louisiana Department of Insurance
Post Office Box 94214
Baton Rouge, LA 70804

May 21, 2013

Re: Statement of Principles Regarding Property and Casualty Insurance Ratemaking

Dear Mr. Piazza,

I am sending this to you in your capacity representing Commissioner Donelon as the Chair of the Casualty Actuarial and Statistical (C) Task Force. I am very concerned about the recent proposal for changes to the conclusion of the "Statement of Principles Regarding Property and Casualty Insurance Ratemaking" under consideration by the Casualty Actuarial Society (CAS). Certain of these changes were brought to my attention by Robert Hunter, Insurance Director for the Consumer Federation of America.

These are the proposed edits to the conclusion of that document that are of my concern:

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 including marketing goals, competition and legal restrictions are also a part of ~~ratemaking~~ determining the final price. 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 determining the final price.

Mr. Hunter, who is a Fellow in the CAS, pointed out in his May 17 letter to the Society that these proposed changes to the conclusion of the Statement of Principles do not harmonize with a fundamental tenet of actuarial standards, that rates be based on the expected value of all future costs (as is stated in the four Principles listed earlier in the same Statement). I agree with Mr. Hunter that the

300 Capitol Mall, Suite 1700
Sacramento, California 95814
Phone (916) 492-3500 • Facsimile (916) 445-5280

new language appears to open the door to allow new pricing schemes such as "price optimization" to enter into the discussion of actuarially sound ratemaking. In price optimization, price differentials are imposed into the determination of premium with the purpose of charging each insured the highest price expected to receive that consumer's acceptance.

In California, property-casualty insurance rates are set without regard to competition. There are no differentials allowed based on whether the applicant or insured is more or less likely to look elsewhere for a lower price; we would consider such distinctions to be unfairly discriminatory. It is our position that any such adjustments to the rates would be inconsistent with the actuarial principles. While the proposed edits to the Principles do not explicitly indicate that such pricing activities will reside within the actuarial realm, the language is sufficiently vague as to allow this interpretation. I am hopeful that the Casualty Actuarial and Statistical Task Force shares my position and that the Task Force will communicate this objection to the Casualty Actuarial Society regarding the proposed edits to the conclusion of the Statement of Principles.

Sincerely,

DAVE JONES
Insurance Commissioner