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Appendix 2

Comments on the Exposure Draft and Responses

The exposure draft of this revision of ASOP No. 12, *Risk Classification for All Practice Areas*, was issued in September 2004 with a comment deadline of March 15, 2005. Twenty-two comment letters were received, some of which were submitted on behalf of multiple commentators, such as by firms or committees. For purposes of this appendix, the term “commentator” may refer to more than one person associated with a particular comment letter. The task force carefully considered all comments received. Summarized below are the significant issues and questions contained in the comment letters and the responses, which may have resulted from ASB, General Committee, or task force discussion. Unless otherwise noted, the section numbers and titles used below refer to those in the exposure draft.

GENERAL COMMENTS	
Comment	Several commentators suggested various editorial changes in addition to those addressed specifically below.
Response	The task force implemented such suggestions if they enhanced clarity and did not alter the intent of the section.
Comment	One commentator noted that the ASOP should deal with the ability of an insured to misrepresent or manipulate its classification.
Response	The task force believed that the considerations raised by the commentator are adequately addressed by sections 3.2.3 and 3.2.4.
Comment	One commentator thought that a section on public and social policy considerations should be added to the standard.
Response	The task force believed that social and public policy considerations, while essential aspects of the way the public views the profession, did not belong in an ASOP dealing with the actuarial aspects of risk classification.
Comment	One commentator questioned whether the ASOP would apply to company selection criteria (tiering criteria) and schedule-rating criteria that may be part of a rating scheme.
Response	The task force believes that the ASOP applies to the extent the selection or schedule rating criteria, used by a company as part of the risk classification system, creates the potential for adverse selection.
Comment	One commentator believed that the ASOP could conflict with proposed state legislation to ban credit as a rating variable and suggested adding an additional consideration in section 3 that the actuary should select risk characteristics in order to avoid controversy or lawsuits.
Response	The task force believes it has addressed issues regarding applicable law, industry practices, business practices, and testing the risk classification system under various scenarios.
Comment	In the transmittal memorandum of the exposure draft, the task force asked whether the key changes from the previous standard were appropriate.
Response	Several commentators responded that the changes were appropriate and some suggested additional

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	changes that are discussed in this appendix.
Comment	One commentator expressed concern regarding the expansion of scope and the implications in actuarial work that would be otherwise unrelated to risk classification and the expansion of scope to the public policy arena in general.
Response	The task force has added modified wording in the standard to clarify that in all cases the standard applies only in respect to design, reviewing, or changing risk classification systems related to financial or personal security systems.
Comment	Two commentators believed that the revised standard should discuss the purposes of risk classification similar to the discussion in the previous standard. One commentator noted the discussion about encouraging “widespread availability of coverage” in particular.
Response	The task force retained a brief discussion of the purposes of risk classification in appendix 1 but did not believe it was appropriate for the ASOP to provide additional education about the purposes of risk classification. The task force noted that a white paper on risk classification that could contain such material is being developed.
Comment	Several commentators noted that the previous ASOP No. 12 had been very useful in court proceedings and recommended that the task force retain some of the wording in section 5 of the previous ASOP. One commentator suggested strengthening the revised standard so that actuarial testimony would be given greater weight by the courts in interpreting rate standards. Another commentator suggested strengthening the ASOP by adding an explicit statement that one objective during the development and use of risk classification systems is to minimize adverse selection.
Response	The task force reviewed the revised standard with these concerns in mind but concluded that the revised standard represents current generally accepted practice and provides an appropriate level of guidance. The task force considered the specific suggestions with respect to additional wording and incorporated some of the wording regarding adverse selection from the old section 5.5 into appendix 1.
Comment	In the transmittal memorandum of the exposure draft, the task force asked whether it was appropriate for the ASOP not to use the terms “equitable” and “fair.” Two commentators believed that the ASOP should use or define these concepts because they have been used in court proceedings, but the majority of commentators believed that it was appropriate not to define them and that the standard adequately addressed these concepts.
Response	The task force agreed that the ASOP should not define subjective qualities such as “equitable” and “fair.” As the result of ASB deliberation on this issue, language was added to section 3.2.1 to discuss what was meant by the terms “equitable” and “fair.” These terms are intended to apply to a risk classification system only to the extent the risk classification system applies to rates. As such, a formal definition was not added. Court decisions notwithstanding, there is no general agreement as to what characterizes “equitable” classification systems or “fair” discrimination. The task force also considered the possibility that further discussions about such issues might become part of the proposed white paper on risk classification that the American Academy of Actuaries is developing.
Comment	One commentator questioned why the standard offered separate guidance for “risk characteristics” (section 3.2) and “risk classes” (section 3.3). Another commentator believed there should be greater differentiation between the concepts of “risk characteristic” and “risk classification.”
Response	The task force believed that the ASOP uses these terms appropriately and made no change.
Comment	One commentator thought that section 3.3.2 should include guidance on appropriately matching the risk with the outcome when establishing a risk class.
Response	The task force believed that section 3.2.1 addressed this comment and noted that section 3.3.2(a) requires sufficient homogeneity with respect to outcomes.

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Section 1.2, Scope	
Comment	In the transmittal memorandum of the exposure draft, the task force asked whether it was appropriate to include the actuary’s advice within the scope of the standard. Several commentators agreed that including guidance on actuarial advice was appropriate. One commentator believed that the disclosure requirements in section 4 could be burdensome to an actuary who has provided brief oral advice.
Response	The task force kept actuarial advice within the scope of the standard and intended that the disclosure requirements in section 4 should apply to any actuarial advice that falls within the scope of the standard.
Comment	One commentator questioned what was meant by “legislative activities” as an example of a professional service.
Response	The task force intended that “legislative activities” could include drafting legislation, for example.
Comment	Several commentators questioned the meaning of “personal security system.” One commentator questioned whether the definition of “financial or personal security system” would exclude share-based payment systems from the scope of the standard. The commentator recommended that the standard be revised to include such systems.
Response	The task force intended that the ASOP should apply if share-based payment systems or stock options were part of a financial or personal security system, as defined in the section 2.5. If such plans were not part of a financial or personal security system, the ASOP would not apply. The task force chose not to expand the scope to include such plans in all situations but did clarify the definition of “financial or personal security system.”
SECTION 2. DEFINITIONS	
Comment	One commentator suggested that a definition of experience be included, citing the definition of “experience” in the previous ASOP (old section 2.5), which includes the wording, “Experience may include estimates where data are incomplete or insufficient.”
Response	The task force agreed that experience may include estimates where data are incomplete or insufficient but did not believe that the old definition was necessary in the revised ASOP.
Comment	One commentator suggested that a definition of “reasonable” be included.
Response	The task force disagreed and did not add a definition of “reasonable.”
Section 2.1, Advice	
Comment	One commentator suggested that “other work product” was not needed, since the standard already listed “an actuary’s oral, written, or electronic communication.”
Response	The task force revised the language to clarify that “communication or other work product” was intended.
Comment	One commentator believed that a definition for “advice” is not needed.
Response	The task force disagreed and retained the definition of advice.
Section 2.2, Adverse Selection	
Comment	In the transmittal memorandum of the exposure draft, the task force asked if the definition of “adverse selection” was appropriate or whether an alternative definition (included in the transmittal letter) would be preferable. Many commentators responded, some agreeing with the original, some with the alternative, and some suggested other wording. The other wording was most often to change the phrase, “take financial advantage of.”
Response	The task force believed that some of the reasoning on the part of the commentators who preferred the current version did not accurately describe adverse selection. The task force ultimately decided to use the alternative definition in the standard and believed that it better addressed some commentators’ concerns that the other definition could have a negative connotation with respect to motivation.

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Comment	One commentator suggested that “antiselection” is synonymous with adverse selection and that should be made clear in the definition.
Response	The task force agreed and added that reference.
Section 2.4, Credibility (now 2.3)	
Comment	Two commentators believed that within the definition of “credibility” the language concerning “predictive” was confusing.
Response	The task force retained the definition as it is used in several other ASOPs.
Section 2.5, Financial or Personal Security System (now 2.4)	
Comment	Several commentators questioned the meaning of “personal security system.”
Response	The task force clarified the definition.
Comment	One commentator suggested that “impact” be modified to read “financial impact.”
Response	The task force disagreed and revised the definition of “financial and security systems” to delineate the impacts.
Section 2.6, Homogeneity (now 2.5)	
Comment	One commentator believed the definition of “homogeneity” needed revisions to include the concept of grouping similar risks. Another commentator found the definition unclear.
Response	The task force believes that the current definition is appropriate for this ASOP.
Section 2.7, Practical (now 2.6)	
Comment	One commentator believed the definition of “practical” was much too broad and needed to be more actuarial in nature. Alternatively, the commentator suggested dropping it and relying on section 3.2.4.
Response	The task force believed the definition was appropriate and made no change. Section 3.2.4 addresses actuarial practice with respect to practicality. While “practical” is used there and in other places, it is always modified by its context.
Section 2.8, Risk(s) (now 2.7)	
Comment	One commentator suggested that the definition of risks as individuals or entities seemed too limiting and noted that covered risks can also include pieces of property or events.
Response	The task force disagreed, believing that “entity” could encompass property and events.
Comment	One commentator suggested that a unit of risk be defined at the basic unit of risk.
Response	The task force disagreed and made no change.
Section 2.9, Risk Characteristics (now 2.8)	
Comment	One commentator suggested defining risk characteristics as “measurable or observable factors or characteristics, each of which is measured by grouping similar risks into risk classes.”
Response	The task force disagreed and made no change.
Section 2.11, Risk Classification System (now 2.10)	
Comment	One commentator believes the definition of “risk classification system” is circular since “classify” is used in the definition.
Response	The task force agreed and revised the wording.
Comment	One commentator recommended that the term “risks” be changed to “similar risks” in this definition just as in the old definition of risk classification that used the phrase “grouping risks with similar risk characteristics.”
Response	The task force disagreed and made no change.
Comment	One commentator suggested replacing “groups” with “classes.”
Response	The task force disagreed and made no change.

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SECTION 3. ANALYSIS OF ISSUES AND RECOMMENDED PRACTICES	
Section 3.2.1, Relationship of Risk Characteristics and Expected Outcomes	
Comment	One commentator expressed concern with the standard’s differentiation between the section’s quantitative and subjective factors.
Response	The task force did not intend to be prescriptive as to how to quantify the ratings scheme and believed that the ASOP was sufficiently specific. The ASOP does not address rate adequacy. Selection is the focus, not quantification.
Comment	One commentator believed that “clinical” was not an appropriate adjective to describe the experience an actuary is allowed to use.
Response	The task force intentionally used the term “clinical.”
Comment	One commentator believed that if the classification cannot be measured by actual insurance data, then it is not really a risk classification system.
Response	The task force disagreed and made no change.
Comment	One commentator suggested that the three points addressing why risk classification is generally used be moved to background information.
Response	The task force agreed that such educational language was more appropriate in an appendix than in the body of the ASOP and has moved it.
Comment	One commentator believed that it may be difficult to deal with the process and procedures involved with considering the interdependence of risk characteristics and their potential impact on the operation of the risk classification system.
Response	The task force did not change the language to address this comment but notes that section 3.2.4 addresses considerations regarding practicality.
Section 3.2.2, Causality	
Comment	A number of commentators expressed concern with establishing a cause-and-effect relationship while others thought the standard did not go far enough in this regard.
Response	The task force agreed that, where there is a demonstrable cause-and-effect relationship between a risk characteristic and the expected outcome, it is appropriate for the actuary to include such a demonstration. However, the task force recognized that there can be significant relationships between risk characteristics and expected outcomes where a cause-and-effect relationship cannot be demonstrated.
Section 3.2.4, Practicality	
Comment	Two commentators suggested the use of examples of practical considerations.
Response	The task force revised the section to indicate that the language shows examples of practical considerations.
Comment	One commentator suggested that “theoretical,” as used in section 3.2.4, be defined.
Response	The task force replaced “theoretical” with “other relevant.”
Section 3.2.5, Applicable Law	
Comment	One commentator thought that the proposed language in this section was much too broad.
Response	The task force disagreed with the comment and made no change.

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Section 3.3, Considerations in Establishing Risk Classes	
Comment	One commentator expressed concern that the documentation requirements for these considerations represented an increase from the previous version.
Response	The task force thought the documentation requirements were appropriate and necessary and made no change.
Section 3.3.1, Intended Use	
Comment	One commentator noted that stratifying data sets in loss reserving is different from risk classification, which is done to price risks, and believed that loss reserving permits more flexibility. The commentator stated that the definition of a risk classification system does not apply to loss reserving.
Response	The task force agreed with the first concepts but disagreed with the final sentence and therefore made no change.
Section 3.3.2, Actuarial Considerations	
Comment	With respect to section 3.3.2(a), one commentator suggested replacing the word “for” in the first line with “within” for clarification.
Response	The task force agreed and made the suggested change.
Comment	With respect to section 3.3.2(b), two commentators questioned what was intended by the use of the term “large enough.”
Response	The task force believed the language was sufficiently clear and made no change.
Comment	One commentator pointed out that there are often classes that, individually, have associated experience with low statistical credibility and believed that alternatives to credibility should be included in section 3.3.2(b).
Response	While the task force agreed that there are situations in which actuarially sound classification plans will have individual classes where the experience has low statistical credibility, the task force believed that credibility is a desirable characteristic of risk classes within a risk classification system and that no expansion to include alternatives was necessary.
Comment	One commentator suggested replacing “statistical predictions” with “predictions” in section 3.3.2(b) to avoid the implication that underlying statistics were required. Another commentator suggested that the term “predictions” needed explanation.
Response	The task force agreed with these comments and replaced “predictions” with “inferences” and edited the language to improve its clarity.
Comment	One commentator suggested that the last sentence of section 3.3.2(b), while accurate, was irrelevant.
Response	The task force agreed and eliminated the sentence.
Comment	With respect to section 3.3.2(c), one commentator suggested the need for definitions of “accuracy” and “efficiency.”
Response	The task force believed that the existing language regarding the actuary’s professional judgment was sufficient in determining the meaning of “accuracy” and “efficiency” and did not add a definition of either word.

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Comment	Several commentators suggested that section 3.3.2(d) be eliminated. A number of those commentators also pointed out that the language was both inconsistent with current actuarial practice and inappropriate as an implied requirement.
Response	The task force agreed and deleted the section.
Section 3.3.3, Other Considerations	
Comment	Several commentators pointed out that the last sentence of the section was unclear and might inadvertently require a degree of testing and determination that was not intended.
Response	The task force deleted the last sentence of the section. In addition, section 4.1, Communications and Disclosures, was clarified as to what disclosures are appropriate.
Section 3.3.4, Reasonableness of Results	
Comment	One commentator found the parenthetical wording confusing.
Response	The task force believed the examples were appropriate and made no change.
Comment	One commentator found this section ambiguous in the context of establishing risk classes. Another commentator suggested that a cost-based definition of reasonable be added or that the section be deleted entirely.
Response	The task force retained the section but clarified the wording by mentioning the intended use of the risk classes. The task force did not believe additional clarification of “reasonableness” was necessary because reasonableness is a subjective concept that may depend on the actuary’s professional judgment. The task force also notes that the <i>Introduction to the Actuarial Standards of Practice</i> discusses this concept in further detail.
Section 3.4, Testing the Risk Classification System	
Comment	One commentator indicated that it may be preferable to substitute the word “or” for “and” on the second line so that the sentence reads, “Upon establishment of the risk classification system or upon subsequent review. ...”
Response	The task force did not agree and believed the word “and” was appropriate because testing should be carried out both upon establishment and upon subsequent review.
Comment	One commentator wanted to substitute “continuing” for “long-term” viability in the second line. The commentator believed that the usual issue is the current and near-future viability of a system, not its long-term prognosis. Also, another commentator said that the requirement to “test long-term viability” is new and questioned its meaning.
Response	The task force considered alternative wording but ultimately decided that the existing wording best reflected that the actuary should check the risk classification system for viability both in the short-term and in the long-term.

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Comment	One commentator believed that testing the system is set out as something the actuary should do, if appropriate, rather than as something the actuary should consider. The commentator believed that the paragraph implied a duty to test in some situations, without describing explicitly what those situations would be (i.e., when testing would be “appropriate”). The commentator suspected that the situations described in sections 3.4.1–3.4.3 were the kind of situations that the task force had in mind as situations where long-term testing would be “appropriate.” However, as currently written, the commentator thought that a stronger duty could be implied. The commentator suggested that section 3.4 itself should read, “...the actuary should consider testing the long-term viability of the risk classification system. ...”
Response	The task force believed that the existing wording conveyed the concept that the actuary considers whether testing is appropriate and made no change.
Section 3.5, Reliance on Data Supplied by Others (now Reliance on Data or Other Information Supplied by Others)	
Comment	One commentator believed that the provision for reliance on data supplied by others was not needed in this ASOP because ASOP No. 23, <i>Data Quality</i> , addresses this.
Response	This task force agreed and revised the section to refer to ASOP No. 23, using wording consistent with other recently adopted ASOPs and exposure drafts.
SECTION 4. COMMUNICATIONS AND DISCLOSURES	
Section 4.1, Communications (now Communications and Disclosures)	
Comment	One commentator suggested changing the phrase “when issuing actuarial communications under this standard” to “when issuing actuarial communications that include elements of actuarial work within the scope of this standard.”
Response	The task force retained the original language to be consistent with other ASOPs.
Section 4.2, Disclosures (now 4.1, Communications and Disclosures)	
Comment	One commentator stated that some of the disclosures, notably section 4.2(a) and 4.2(c) (now 4.1(a) and 4.1(c)), are impractical, since they might require the actuary to begin with the universe and then disclose everything that is not utilized. The commentator suggested replacing these disclosure requirements with a communication that defends the choice of risk classification system and notes in that defense how compliance with applicable law and business practices affected the selection, rather than describing all the alternatives that would have been available in the absence of such constraints.
Response	The task force did not agree that the requirement to disclose significant limitations required a discussion of all alternatives that would have been available in the absence of legal or business constraints. The task force noted that the listed disclosures proceed from considerations required in section 3 and modified the wording of the disclosure requirements to be more consistent with that section, including revising the lead-in sentence to require disclosure of the significant impact of such considerations.
Comment	One commentator stated that the disclosure issue is heightened by the expansion of scope into the public policy arena and stated that excessive disclosure requirements may weaken the actuary’s ability to influence the discussion of public policy.
Response	The task force disagreed with the comment and noted that, while the scope of the standard now includes regulatory activities, legislative activities, and statements regarding public policy, the scope does so only in the context of the performance of professional services.

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Comment	One commentator suggested deleting section 4.2(a) (now 4.1(a)), which requires disclosure of significant limitations due to compliance with applicable law, noting that other ASOPs have tended not to include this requirement except where the limitations seriously distort the work product.
Response	The task force disagreed with this comment, noting that significant limitations on the choice of risk characteristics are likely to distort the risk classification system and therefore should be disclosed.
Comment	Several commentators expressed opinions regarding the requirement that the actuary should disclose whether quantitative analyses were performed relative to items being disclosed. One commentator expressed strong objection to this requirement, asserting that the requirement would be counter-productive and would reduce the number of quantitative analyses being done. Another commentator agreed and noted that the disclosure issue was heightened by the expansion of scope to the public policy arena, where an advocacy position may be taken. A third commentator objected to the requirement to disclose that quantitative analyses were <i>not</i> done but suggested requiring that any analyses that were done be summarized. A fourth commentator suggested exempting certain of the required disclosures from the requirement to consider quantification. A fifth commentator pointed out that, while the actuary was required to disclose whether quantitative analyses were performed, the actuary was only required to consider providing the results of those analyses in the disclosure.
Response	The disclosure requirement for the actuary to consider providing quantitative analyses of the impact of the items being disclosed was removed, and instead similar wording was added as a new section 3.4.4, Quantitative Analyses, which guides the actuary to consider performing such analyses, depending on the purpose, nature, and scope of the assignment.
Comment	In the transmittal letter for the exposure draft in request for comment #6, the task force asked whether there were any situations in which the requirement in section 4.2(c) (now 4.1(c)) to disclose any significant limitations created by business practices of the financial or personal security system would not be appropriate. Two comments were received, both agreeing with the appropriateness of the requirement.
Response	The task force retained the requirement.
Comment	Two commentators suggested substituting “indicates” for “creates” in section 4.2(d) (now 4.1(d)).
Response	The task force agreed, changed the wording as suggested, and made other revisions for clarity.
Comment	In the transmittal letter for the exposure draft in request for comment #7, the task force asked whether the requirement in 4.2(e) (now 4.1(e)) to disclose the effects of adverse selection was appropriate. Three commentators addressed this request for comment, and all agreed the requirement was appropriate. However, one commentator suggested that there be no requirement to quantify the impact.
Response	The task force retained the requirement in what is now 4.1(e) and also removed the requirement to consider providing quantitative analyses. Additionally, the task force deleted section 4.2(f) after determining that it was already covered by ASOP No. 41, Actuarial Communications, to which section 4.1 refers.
APPENDIX (now Appendix 1)	
Comment	One commentator expressed concern with the citing of the textbook <i>Selection of Risks</i> by Shepherd and Webster.
Response	The task force believed that citing the Shepherd and Webster book was appropriate but added a new lead-in sentence to the citation to indicate that the references cited provide additional background and context with respect to risk classification.