

Comment #10 – 12/29/14 – 11:15 a.m.

Section 1.2 In the last sentence of the first paragraph of this Section, the new Actuarial Standards of Practice are limited to the estimation of future costs and does not address other considerations that may affect the price charged to the policyholder, such as marketing goals, competition and legal restrictions. This language means that the proposed Standards allow the movement of prices away from the cost/risk based levels and therefore will not be useful for consumer protection or for regulation of insurance. For that matter, it does not control the behavior of actuaries who could simply say, when challenged, that what we did was part of our marketing or competitive actions, not our ratemaking activity. Clearly, this language would allow the unfettered use of Price Optimization and other models that would move the prices away from the cost/risk-based levels toward whatever the market will bear. I explain in considerable detail why Price Optimization is dangerous for America's consumers and for regulators in a lengthy Comment I made on the CAS Discussion Draft Regarding P/C Ratemaking, which has the same flaw as the ASB's Draft Standards (my comments are being submitted as part of this comment as an attachment to this email [see below]). I oppose including the above language in Section 1, point 2 (Scope) of the SOP. If you go forward with this approach, you surely need to include a requirement of disclosure of any actions taken to move a price away from cost/risk-based to the regulators and an impacted policyholder.

John Hunter

To: Robert Miccolis, President, CAS (RMiccolis@deloitte.com)

To: Diane Tremblay (dtremblay@casact.org)

From: J. Robert Hunter, FCAS, MAAA

Via email 12/23/14

Comment on the Discussion Draft of the Statement of Principles Regarding Property/Casualty Insurance Ratemaking dated 10/15/14
(For First Time Allowing the Moving of Prices Away from Cost-based levels)

I write this to strongly oppose the discussion draft, which allows “selecting a price that deviates from cost-based indications” for reasons such as “when a more sophisticated pricing approach is implemented, operating profit increases significantly.” The draft allows any method to be used to alter prices away from the cost-based level, including Price Optimization and other elasticity of demand models.

It appears that the CAS has moved toward endorsing Price Optimization (your November 16, 2014 presentation to CASTF provided the first public acknowledgement of this shift, and my assessment of that presentation is attached as Exhibit 1). The CAS memo to “CAS Members” regarding the Draft, however, and astonishingly, makes no mention of Price Optimization and this policy shift as a driving force behind the Draft. It seems that the membership should be made aware of the monumental change the Discussion Draft entails. Indeed, before taking further action on the Statement of Principles, CAS should

directly and without bias apprise the membership of the relationship between the draft language and the pricing practice known as Price Optimization.

Only when the membership is properly apprised of the underlying objective of the nebulously worded draft, and after there has been sufficient time for member responses, would it be reasonable to consider such changes.

As I have had the opportunity to unpack the seemingly subtle alterations to the Principles, I offer this memo to explain my strong disagreement with the Draft and CAS's underlying position on Price Optimization. Please include this memo and the attached material in the record of the membership reaction to the Discussion Draft.

The CAS Statement of Principles Regarding Property/Casualty Ratemaking is very clear that rates are predicated on "the expected value of future costs associated with the transfer of risk." Thus, ratemaking must be cost-based. While this remains a precept of the proposed CAS Principles, the Draft also contains language that directly conflicts with this long-standing principle, thus dismantling the cost-based standard as a bedrock of the actuarial profession. The critical changes in the language of the SOP are contained in the final paragraph of the draft document:

"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 ratemaking 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 ratemaking insurance pricing process."

(Note: underlined material is newly added, crossed through material is deleted.)

The new language removes any limitations that ratemaking place on the actuary and installs a new, undefined and totally non-restrictive concept, "insurance pricing," allowing the actuary to participate fully in making prices that do not meet the Principles otherwise applicable. Thus, price optimization or any other method insurers might devise to move rates away from being cost-based is authorized by these so-called "Principles." It is shocking to me as a Fellow of the CAS that the Society would propose a set of Principles that not only have no impact on the ultimate prices that policyholders will pay but acts to remove the actuary from the central role she has in ratemaking today.

I should point out that the new "Actuarial Standards of Practice for Property/Casualty Ratemaking" are "limited to the estimation of future costs and does not address other considerations that may affect the price charged to the policyholder, such as marketing goals, competition and legal restrictions." (Emphasis in original) Thus this only covers what is really ratemaking, as the title of the proposed SOP makes clear, not items that the CAS for the first time proposes allowing under the broad and undefined "insurance pricing" invention. It does, however, through the language quoted, seem to acknowledge that policyholders will not be protected by the Standards of Practice, which appears to make the Standards useless from a consumer protection/regulatory point of view in the

same way that the Principles will become useless under the CAS discussion draft formulation. I will be communicating my opposition to including the above language in Section 1, point 2 (“Scope”) of the SOP to the Actuarial Standards Board in due course.

Historically, the CAS Principles aimed to ensure that the actuarial profession serves a common good of developing transparently risk-based rates that yield fair and adequate results without unfair discrimination or excessive rates. This draft, however, seems only aimed to provide protection for insurance companies that want to (or already have begun to) veer away from cost-based rates toward some non-actuarial basis for pricing such as price elasticity of demand and other “business considerations.” Presumably, the Draft is created to overcome the nettlesome problem of Principles that exist today on paper but no longer comport with the practices of insurers already deep into the use of price optimization and the interests of consulting firms seeking to ply their price optimization software.

This dramatic shift in principles seems to have been foreshadowed in an October 18, 2012 CAS webinar that I monitored, aptly named “Price Optimization vs. Actuarial Standards” where questions were raised about the practice of what the panel described as “adding things to cost-based analytics.” Here are but two of the questions the panel discussed:

- “Is it (price optimization) in compliance with the Statements of Principles and Actuarial Standards of Practice?” and
- Do the ratemaking Standards “mean that Price Optimization is NOT ratemaking” (Emphasis in original CAS documents)

Particularly important to the current Discussion Draft, one panelist said that the CAS must revisit the Standards to “get up to date.” When asked if actuarial Principles had to be changed so Price Optimization could comply with law, a panelist answered, “Yes. The tension is there and must be relieved. We need a safe harbor.”

The proposed language cited above is meant to provide just such a “safe harbor,” and appears to have been introduced to protect industry use of price optimization already going on in violation of the current CAS Principles. Earnix, a vendor of Price Optimization software has released a survey of insurers that shows that about half of the large (greater than \$1 billion in written premiums) companies use it today. This “safe harbor” is intended to eliminate any conflict between pricing and Principles, and, in so doing, eliminate the protection of American policyholders that the current Principles provide. This “safe harbor” is intended to remedy the legal and ethical issues raised by the use of price optimization in violation of current Principles. This “safe harbor” is what is before CAS members in reviewing the Discussion Draft, even though CAS leadership has negligently and, one assumes, intentionally withheld this fact from members of the Society.

The temptation to file rates that take price optimization all the way to an individual policy level is great. Regulators were assured by the CAS in its presentation that “price

optimization operates at the rating factor level” and that regulatory review could be done by comparing the indicated and proposed factors. Even if that were the case, use of price optimization can result in illegally excessive or unfair prices. But it is certainly unfair discrimination to price individual policies based on price optimization/elasticity, ignoring the rating factors. Not only is it unfair, it is impossible to regulate this individualized pricing approach. Yet, as my December 16, 2014 letter (Attached as Exhibit 2) to the nation’s insurance commissioners makes clear, Allstate is using price optimization to price at the individual policy level in Wisconsin and many other states. So your promise to the regulators is already breached and the pressure to move to individual prices where retention/elasticity models work the most powerfully will see it breached again by many insurers, either openly in rate filings or surreptitiously through underwriting, tiering and in other hidden ways.

I urge the leadership of the CAS to remove the changes to the Principles that allow movement of prices away from cost-based levels – including price optimization – and that you do so because you finally come to realize that such changes would expose consumers, particularly low- and moderate-income consumers and minorities, to significant harm. Moreover, I urge that you remove these proposed changes because they would also undermine state regulatory efforts to ensure rates are not excessive or unfairly discriminatory, as most state insurance departments are only beginning to recognize that the practice is in place and need to have confidence that our profession is ethically bound to answer to principles that are cost-based and not compromised by non-risk-based considerations. Finally, I urge that you rescind these proposed changes, because adopting these so-called “principles” would also signal the end of the unique position actuaries hold in the ratemaking space in the insurance industry. As Towers-Watson revealed in its July 28, 2014 presentation before the NAIC Auto Insurance Study Group, economists do price optimization better than actuaries. It remains a surprising and disturbing fact that the CAS leadership takes a position that likely undermines the actuarial profession.

Sincerely:

J. Robert Hunter, FCAS, MAAA

{Two attachments to be added}