To: Actuarial Standards Board January 14, 2015

From: Gordon Hay, F.C.A.S., M.A.A.A., C.P.C.U.

Re: Exposure Draft – September 2014: Property/Casualty Ratemaking

Briefly, I think the standard of practice should address actuarial practice when the circumstances include pricing that differs from actuarially indicated rates.

When pricing for some segment is anchored far below expected future costs, what is the actuary to do beyond considering the establishment of a premium deficiency reserve? Some examples might help. What if a decision is made to "buy market share" in a particular combination of companies, states and products? What if the actuary has reason to believe schedule rating has been or is being abused? What if market conditions are in some strong disequilibrium such as in the 1990's when homeowners was chronically and widely underpriced while personal auto was more profitable than indicated? And what about the subsidies created by "Price Optimization?"

The last sentence in the Scope paragraph states "This standard is 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."

Without straying out of this Scope, I believe we can and should address considerations that confront pricing actuaries when prices materially differ from indicated rates. My suggestion is to insert material such as the following after section 3.17:

3.18 Pricing that differs from **rates** -- In this standard of practice, we define "Rate" to mean "An estimate of the expected value of all future costs associated with an individual risk transfer."

a. For reasons that range from legal constraints to marketing and underwriting goals, circumstances arise in which pricing intentionally departs from such **rates**.

b. Historical premium data, if generated by pricing that differs materially from actuarial **rates**, should be adjusted to a "**rates**" basis before giving adjusted historical premium data a role in estimating future costs.

   1. Insurers frequently use **rate** stability rules (a.k.a. transition rules or premium-capping rules) with the result that the effects of a **rate** change on a particular date are essentially spread out over a series of policy periods that may take years to final resolution. In using historical premium data to review **rates** to which such rules have been applied, it is necessary to account for the remaining premium effects of previous **rate** changes.

   2. If it is deemed impractical or impossible to adjust historical premiums for a material difference between prices and **rates**, the actuary's options include using a pure premium method, or extending historical exposures by current **rates**. Either of these approaches would avoid reliance on historical premium data.

c. The actuary should recognize that pricing intentionally and materially different from actuarial rates is likely to exacerbate adverse selection.

1. In effect, the insurer is attracting some targeted policyholder profiles with below-cost pricing, while either discouraging some other policyholder profiles with above-cost pricing or enduring overall pricing that is below the indicated **rate** level.

2. Pricing that differs materially from actuarial **rates** is likely to skew the insurer's mix of business toward overall unprofitability. If this effect is strong and sustained, the resulting trend toward underpriced risks will generate successively higher indicated **rate** changes. Such a trend ultimately may prevent achievement of the intended goals, and may even jeopardize the insurer's financial viability.

3. Therefore the actuary should watch more closely for trends in profitability due to the changing mix of business than would be necessary if actuarial **rates** were implemented.

4. The pricing actuary is generally expected to monitor such consequences, elevate emerging concerns and offer viable, timely counter-measures.

Now, is this suggestion consistent with current practice, or "raising the bar?" My own view, based on decades of pricing work, is that this has been one of the key responsibilities, and a significant risk management contribution. Rather than shy away from it at this point, I think we should give it renewed emphasis by explicitly addressing it in the Ratemaking ASOP.

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