NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research

Comment #12 – 4/29/16 – 12:48 p.m.

TO: ASB Comments
American Academy of Actuaries
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FROM: Michael McKenney, Chair
Casualty Actuarial and Statistical (C) Task Force

DATE: April 28, 2016

SUBJECT: Comments on the ASB's Second Exposure Draft of ASOP *Property/Casualty Ratemaking*

Thank you for the opportunity to comment on the Actuarial Standards Board's (ASB's) second exposure draft of the Actuarial Standard of Practice (ASOP) regarding *Property/Casualty Ratemaking*.

As you know, the Casualty Actuarial and Statistical (C) Task Force exists under the National Association of Insurance Commissioner (NAIC) Property and Casualty Insurance (C) Committee. The Task Force's mission is to identify, investigate and develop solutions to actuarial problems and statistical issues in the property and casualty industry. Our members include the state insurance regulators tasked with reviewing property and casualty insurance rates in accordance with state laws, actuarial principles and actuarial standards of practice. As such, we have great interest in the ASB's proposed ASOP *Property/Casualty Ratemaking*.

We note that the proposed ASOP contains a new, inconsistent definition of "rate." ASOP 29, ASOP 30 and Principle 1 of the Casualty Actuarial Society's (CAS's) *Statement of Principles Regarding Property and Casualty Insurance Ratemaking* each define rate as "an estimate of the expected value of future costs." The Task Force is concerned that the ASB will be creating a new definition of rate in the proposed ASOP by removing "expected value" and this new definition will be inconsistent with existing standards of practice and principles.

Item #4 under "Request for Comments" notes that the ASB "eliminated the reference to 'expected' value of all future costs to eliminate the possible confusion that the only appropriate estimate of all future costs was a mean value without any consideration of potential variability." Is this change appropriate? Does this change lead to confusion about what is being estimated?

While the Task Force understands the concerns regarding the potential for variability from the mean value, it believes these concerns are appropriately addressed through the use of the profit and the contingency provisions in the ratemaking process. It notes that the CAS's *Statement of Principles Regarding Property and Casualty Insurance Ratemaking* states, "The rate should include a charge for the risk of random variation from the expected costs. This risk charge should be reflected in the determination of the appropriate total return consistent with the cost of capital and, therefore, influences the underwriting profit provision. The rate should also include a charge for any systematic variation of the estimated costs from the expected costs. This charge should be reflected in the determination of the contingency provision."

Further, ASOP 30 defines "contingency provision" as "A provision for the expected differences, if any, between the estimated costs and the average actual costs, that cannot be eliminated by changes in other components of the ratemaking process."

ASOP 30 also states, "The actuary should include a contingency provision if the assumptions used in the ratemaking process produce cost estimates that are not expected to equal average actual costs, and if this difference cannot be eliminated by changes in other components of the ratemaking process."

"While the estimated costs are intended to equal the average actual costs over time, differences between the estimated and actual costs of the risk transfer are to be expected in any given year. If a difference persists, the difference should be reflected in the ratemaking calculations as a contingency provision. The contingency provision is not intended to measure the variability of results and, as such, is not expected to be earned as profit."

The Task Force therefore recommends that the definition of rate in the proposed ASOP be the same as its current definition in ASOP 29, ASOP 30 and the CAS's *Statement of Principles Regarding Property and Casualty Insurance Ratemaking.*

Another concern voiced by members was that the ASOP addresses actuarial ratemaking but appears inconsistent or lacks clarity when using important terms such as "rate," "premium," "price charged," "overall rate," and "premium charged." These terms should be defined and used consistently throughout the ASOP.

The Task Force also wishes to share that it engaged in considerable discussion regarding the following sentence in Section 1.2:

> *While the actuary may play a key role in the company's decisions in determining the price charged after taking into account other considerations, such as marketing goals, competition, and legal restrictions, this standard does not address the other considerations.*

Some members believed the sentence to be unnecessary as the preceding sentence notes, "This standard is limited to the estimation of future costs." They were uncomfortable that the inclusion of this sentence seems to provide authorization for the actuary to consider characteristics unrelated to the estimation of future costs in setting insurance prices. It was also noted that taken together, the two sentences may be inconsistent by permitting the actuary to engage in activities to which the ASOP would not apply.

Some thought inclusion of this sentence contradicts the CAS's 1988 *Statement of Principles Regarding Property and Casualty Ratemaking* that requires the same considerations be used by the actuary in ratemaking only to the extent they affect the estimation of future costs associated with the transfer of risk. Additionally, some noted that while state laws permit many considerations be used in support of rates including judgment and other relevant factors, these other considerations must remain predictive of expected losses and expenses for the rates to not be excessive, inadequate or unfairly discriminatory under state law.

Others believed the sentence recognizes the reality of the rate development process leading up to the rates filed with state regulators. The Standards are focused on the actuary's role in estimating a rate but recognize that the selection of the rate to be filed with regulators (and used to calculate a premium) generally is not left to the actuary alone and may not be the actuary's best estimate. Removing the sentence and leaving only the preceding sentence would be nebulous without the clarification provided by the sentence's inclusion. These members found the sentence's inclusion to appropriately recognize the current realities of how decisions regarding the setting of insurance prices are made. Its inclusion permits the actuary to participate in those decisions, and may relieve the actuary from having to certify the filed rates that reflected other non-actuarial considerations but lets the actuary only certify the indicated rates. Further, some members believe that without the sentence it appears the filed rates must be the actuarially indicated rates. This would be an undesirable outcome if the sentence was removed from the ASOP and may conflict with state law that explicitly allows for other relevant factors, judgment and considerations in the support of filed rates.

Several members noted that it may be helpful if revised CAS principles on ratemaking could be considered along with the exposed ASOP. Some members do not believe the CAS principles need to be revised.

Finally, some members expressed concern that the listed considerations could be used in price optimization and without additional clarification its inclusion might contradict portions of the NAIC *Price Optimization White Paper*. Other members noted that the listed considerations are much broader than that which defines price optimization and that state laws or regulations, including those related to price optimization, are unaffected by standards of professional organizations.