

Title of Exposure Draft: Proposed ASOP 12 Revision (Exposure Draft): Risk Classification (for all practice areas)

Comment Deadline: May 1, 2024

Instructions: Please review the exposure draft, and give the ASB the benefit of your recommendations by completing this comment template. Please fill out the tables within the section below, adding rows as necessary. Sample for completing the template provided at the following link: <http://www.actuarialstandardsboard.org/email/2020/ASB-Comment-Template-Sample.docx>

Each completed comment template received by the comment deadline will receive consideration by the drafting committee and the ASB. The ASB accepts comments by email. Please send to comments@actuary.org and include the phrase 'ASB COMMENTS' in the subject line. Please note: Any email not containing this exact phrase in the subject line will be deleted by our system's spam filter.

The ASB posts all signed comments received to its website to encourage transparency and dialogue. Comments received after the deadline may not be considered. Anonymous comments will not be considered by the ASB nor posted to the website. Comments will be posted in the order that they are received. The ASB disclaims any responsibility for the content of the comments, which are solely the responsibility of those who submit them.

I. Identification:

Christopher J. Monsour, FCAS, CSPA, MAAA

II. ASB Questions (If Any). Responses to any transmittal memorandum questions should be entered below.

Question No.	Commentator Response

III. Specific Recommendations:

Section # (e.g. 3.2.a)	Commentator Recommendation (Please provide recommended wording for any suggested changes)	Commentator Rationale (Support for the recommendation)
1.2	In the sentence that currently reads "The guidance in this ASOP does not apply to actuaries when performing actuarial services with respect to individual pension benefit calculations or nondiscrimination testing", clarify the scope of "nondiscrimination testing". I can't be more specific as it is unclear whether the Task Force intended this to apply only to pension plans or more broadly to employee benefits such as flexible-spending accounts.	Without some sort of scoping, "nondiscrimination testing" almost surely creates a broader carve out than the Task Force intended. (It is not clear that this should be read with the word "pension" and, even if it were, that probably makes the carve out narrower than intended.)
1.2	Give examples of classifications to which the standard does and does not apply.	Ambiguity is present because many activities an actuary might undertake, such as the design of marketing plans or bonus commission structures, classify risk subjects, but the underlying work may not be actuarial in nature. Is the standard intended to apply in such cases?

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1.2	Delete the final sentence of the first paragraph, beginning "This standard also applies..."	"Using" a risk classification system without even modifying it should not need to be subject to this standard. "Use" is still governed by other applicable standards, like ASOP 53 in the case of property/casualty.
2.1	Reword definition of "Adverse selection".	<p>Two critical elements of the definition in the current standard are missing and should be restored somehow.</p> <p>First, adverse selection involves an element of choice OR the use of "information known or suspected". (There is always a choice of purchasing the policy or not.) The new definition should continue to include both possibilities. Indeed, information asymmetry is generally treated as a key element of adverse selection.</p> <p>Second, adverse selection occurs when financial disadvantage occurs to the security system *even if it does not threaten its "effectiveness" or viability*. This element of the definition also needs to be restored.</p>
2.4	Insert "similar" before "risk subjects".	In the case of a classification dimension with no natural ordering (such as jurisdiction), groupings should be justified based on a credible similarity, and not either on an arbitrary reason or on similarities of historical outcome that have inadequate credibility (e.g., grouping a state as fast or slow developing based on four claims).
2.6	<p>Don't use the term "Risk measure".</p> <p>Provide a definition of "expected outcome" instead.</p>	<p>"Risk measure" is already a term of art in actuarial science, as well as in broader statistical and financial practice, and it means things like deviance, variance, penalized loglikelihood, etc., in statistical practice, and also value-at-risk, tail-value-at-risk, expected policyholder deficit, etc., in financial practice.</p> <p>The items listed here are risk *outcomes*, not risk measures. Since actuaries may need to leverage concepts such as deviance when making risk classification decisions, reusing "risk measure" with a different meaning is not appropriate.</p> <p>The previous standard used "expected outcome" without a definition. This terminology should be continued, and ambiguity avoided, by defining "expected outcome" as referring to expected value of the mitigation provided. (Note, "provided", not "owed"....a risk subject does not benefit from a promise that is not fulfilled.)</p> <p>It is important to keep the focus on expected outcomes. Allowing any risk measure (e.g., the median) on an equal footing would remove historically valuable objectivity from this standard.</p>

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2.7	Clarify definition of “Risk Subject”	It’s not clear whether an additional insured under a commercial general liability policy would count as a risk subject. What about a third-party claimant? My guess is that the additional insured is included in the definition, but not the third-party claimant. However, I would prefer not to guess.
2.8	<p>Replace this with “Unintended Consequences – Impacts or outcomes on specific risk subjects, on the health of the financial or personal security system, or on the principal resulting from the use of a risk classification framework that is not intentionally designed to result in such impacts or outcomes. “</p> <p>Remove “bias” and “unintended bias” from the draft.</p>	<p>Unintended consequences go way beyond bias. For example, implementing a risk classification dimension for not-at-fault claims may impact an insurer’s reputation in the marketplace and the claiming behavior of its risk subjects. The actuary is typically well-placed to warn of such problems. Many of the worst impacts on risk subjects will occur not from bias but from undue alignment of classification approaches of many insurers—the question for the risk subject is whether the *marketplace* is fair.</p> <p>Furthermore, the word “bias” should be avoided in this standard. Again, reusing with another meaning a term that already has a technical meaning in statistical and actuarial practice is unwelcome and confusing. Furthermore, many statistical techniques (e.g., lasso) and actuarial credibility create *intentional* bias. It is surely strange to address unintentional bias while being silent on intentional bias. Furthermore, the definition in the draft is incoherent, as bias is a matter not of outcomes but of expected outcomes.</p>
Section 2, additional definition	Add a subsection defining “Continuous Risk Factor” as: “Continuous risk factor: In lieu of grouping into risk classes based on the values of risk characteristics (which corresponded to a step function), the actuary may estimate risk as a function (often but not always continuous) of the risk characteristic(s) in question.”	<p>In current practice, risk traits may be treated on a continuum rather than as classes. This is embedded in current practice (e.g., generalized additive models), and it is of long-standing practice (experience mod).</p> <p>It is absolutely essential to acknowledge continuous risk factors because:</p> <ul style="list-style-type: none">(a) Sometimes extrapolation is required. Rate per \$100 for buildings worth more than \$100,000,000 may be difficult to treat as a class question, as there may not be enough large buildings to credibly divide this group into several classes. This does NOT mean that the rate per \$100 for a \$100,000,000 and a \$500,000,000 building should be the same.(b) Even when risks are divided into classes, in modern practice they are often divided into classes too small to be credible by preferentially borrowing strength from neighboring classes as the complement of credibility.

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2.5 (related to above row)	Rephrase as: “Risk Classification Framework--The system, process, or schema used to assign risk subjects to risk classes, or to assign them to continuous risk factors, based on the risk characteristics of each risk subject.	To accommodate the introduction of continuous risk factors.
3.2.4 (related to above row)	After “risk class” add “or to the construction of a continuous risk factor”.	To accommodate the introduction of continuous risk factors.
3.2.7(a) (related to above row)	“the balance among homogeneity within risk classes, heterogeneity between risk classes, and credibility of the individual risk classes; in the case of continuous risk factors, the avoidance of extrapolation, and justification for sharp changes. In all cases, residuals on both in-sample and out-of-sample data should be examined.”	To accommodate the introduction of continuous risk factors.
3.2.9	Change “should” to “may, if appropriate”	As phrased in the exposure draft, 3.2.9 calls for work that is not always needed. 3.2.9 calls for work that is not always needed. For example, it would require every ratemaking analysis to include a study of whether the market conditions would create adverse effects on solvency if a dimension were not included. (The “are the competitors doing it, too?” question.) This is often relevant, but, for example, it may not be relevant is the goal of the analysis is to produce a technical price for input to further processes.
3.4	Replace “unintended bias” with “unintended consequences” in the text and the header	To cohere with the suggested revision to 2.8
3.5	Delete this subsection.	Complying with applicable law is covered by 3.1.5 of ASOP 1. Introducing non-actuarial terminology like “protected class” is not helpful. It will result in ambiguities if regulations should use the phrase incompatibly with this ASOP.
4.1.(g)	“Effectiveness.....on.....” needs to be rephrased.	This is not standard English usage and is needlessly confusing.

IV. General Recommendations (If Any):

Commentator Recommendation (Identify relevant sections when possible)	Commentator Rationale (Support for the recommendation)
Please retain section 3.4 of the current standard, on testing the risk classification system.	As risk classification systems become more complex and more constrained, the opportunities for financially disadvantageous results multiply. We should not remove guidance to test for such issues.
In section 4, consider retaining the disclosures required in the current standard regarding “significant limitations due to compliance with applicable law” and “significant limitations created by business practices”	These are more likely than ever to be issues, and, while the exposure draft does require the actuary to consider these things, it should continue to require disclosure when there are significant limitations.

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I recommend moving back to a discussion draft stage for the revision of this ASOP.	<p>Some of the concepts introduced in this draft ASOP (“protected classes”, “unintended bias”) are inconsistent with historical practice and are not properly the domain of actuaries. Many are already covered by the requirement to comply with applicable law. Indeed, phrases like “protected classes” will simply be millstones if regulatory language moves on to other terms or never settles on a single framework across jurisdictions. The purpose of ASOPs is not to usurp the role of the regulator, but to guide sound *actuarial* practice.</p> <p>As I hope the ASB will remember from its recent decision to decouple from regulations on the choice of discount rates, sound practice ought to be kept separate from regulation.</p>
The Task Force should hold hearings or solicit feedback on current practices (e.g., by means of a survey) to gather more information on current practice.	The Current Practices section of the transmittal letter is very heavy on regulatory developments (which are tangential to an ASOP) but light on technical practice (risk classes as continua, regularization techniques that introduce statistical bias intentionally). The Task Force should collect more information to inform its next draft.
Please include the exposure date in the draft.	<p>Dating a draft “September 2023” with no indication that it was not exposed until January 11, 2024 (that date is only available on the website, not within the document) is misleading.</p> <p>The ASB may also wish to consider finding a way to shorten such time lags.</p>

V. Signature:

Commentator Signature	Date
Christopher J Monsour, FCAS, CSPA, MAAA	30 April 2024