PRICE OPTIMIZATION – REGULATORY CONCERNS

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What's wrong with Price Optimization?

- It's not inappropriate to want to maximize profit, growth, or retention.

- Price Optimization affects the selected rate/factors, not the actuarially indicated rates/factors.

- Rate setting has always included an element of judgment, whether it's reflecting competitors' rates or growth goals for a class or territory. Price Optimization formalizes that process.

- Therefore, there is "good" and "bad" Price Optimization.
  - "Bad" Price Optimization violates actuarial ratemaking principles and/or state laws regarding unfairly discriminatory rates.

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- 13 States have issued Bulletins regarding price Optimization:

California	Maine	Pennsylvania
District of Columbia	Maryland	Rhode Island
Florida	New York	Vermont
Indiana	Ohio	Virginia
		Washington

- Some other states have started requiring carriers to declare if Price Optimization or retention models were used in developing the proposed rates, and to describe those models in detail.

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Key points in these bulletins:

- Rates should be based on risk of loss and expenses, not on insured's (or group of insureds') characteristics that are unrelated to loss and expense.
  - Insured's price elasticity is specifically not permitted.
  - What about a large class' (such as territory) price elasticity if the adjustment meets certain constraints?
- Two insureds with similar risk profiles should pay the same rate.
- Filings must disclose if they used non-risk-related factors to help determine the insured's final premium.
  - Question: What if an insurer used pure judgment, not any "non-risk-related factors", to adjust the indicated rates on a broad class level, like in the old days? Is that not permitted now?
- Filings not in compliance with the above must be replaced.

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<u>Recommendations to Filers:</u>

- Describe any model that is used in making rating tier assignments or adjusting indicated rates, factors, relativities up or down to obtain the proposed rates, factors, relativities.

  - What inputs are used in the model? How do they relate to risk of loss or expense? (For example, insured's prior rate changes, or has consumer complained about its carrier?)

  - What is the source for the input variables, and how do you ensure that the data is complete and accurate?

  - What attributes are predicted by the model, such as price elasticity or retention projections?

  - What is the level of the model output? (Class plan level, sub-class level, individual rating?)
    - Ratebook optimization vs. Individual price optimization.

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<u>Recommendations to Filers</u>:

- Selection of a proposed rate (rating factor or rate relativity) should generally fall between the current rate and the actuarially indicated rate.

  - Adjustments should generally be made at a broad class/rating parameter level, so two identical risks receive the same adjustment.
    - Use of retention models at a broad class level may be acceptable if resulting rates are within the range.

  - Adjustment factors should be directionally consistent with the loss and/or expense data.

  - If outside this range, disclose such and explain how such rate satisfies state law and actuarial ratemaking principles. (Example: Curve smoothing would generally be acceptable.)

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Recommendations to Filers:

- Rating classes/groups/cells should not be so granular as to render them statistically unreliable.

- Capping renewal increases most likely acceptable.
  - AL does not permit an off-balance factor to be built into the rates.
  - Insurer should disclose any differences between new and renewal pricing caused by adjustments other than capping.