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THE USE OF PRICE OPTIMIZATION IN INSURANCE RATEMAKING

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ISSUE

Have any state insurance departments explicitly banned property and casualty insurers from using "price optimization" in the ratemaking process?

SUMMARY

Insurance regulators in the District of Columbia and 12 states have issued bulletins or other notices to property and casualty insurers barring the use of price optimization in the ratemaking process. The states are: California, Delaware, Florida, Indiana, Maine, Maryland, Montana, Ohio, Pennsylvania, Rhode Island, Vermont, and Washington. Additionally, New York's insurance department issued a letter to insurers requesting that each submit information to the department on its use of price optimization to enable the department to study the matter further (letter dated March 18, 2015).

PRICE OPTIMIZATION

There is no universally accepted definition of price optimization. But insurance regulators describe it generally as an insurer's use of sophisticated data mining tools and modeling techniques during the ratemaking process to vary rates based on factors other than a person's risk of loss. The goal of price optimization is to charge an insured person the highest amount he or she will tolerate before shopping for alternative coverage or not renewing a policy (e.g., see Delaware Bulletin No. 78, dated October 1, 2015).

The National Association of Insurance Commissioners (NAIC) has prepared a draft white paper on price optimization to explore whether it is proper for insurers to use it during the ratemaking process. According to the paper, "[r]atemaking is the process of establishing rates used in insurance or other risk transfer mechanisms. This process may involve a number of considerations, including estimates of future claims costs and expenses, profit and contingencies, marketing goals, competition, and legal restrictions." (The draft white paper is available at http://www.naic.org/committees_c_catf.htm.)

The use of price optimization has come under increasing scrutiny by insurance regulators because rates are subject to statutory requirements. Statutory rate standards in most states require that rates not be excessive, inadequate, or unfairly discriminatory (e.g., see CGS § 38a-686). According to the NAIC white paper, actuarial principals dictate that "a rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer."

In general, a rate is unfairly discriminatory if two policyholders with the same actuarial risk profile are charged different rates for the same policy.

INSURANCE DEPARTMENTS ISSUE NOTICES

Insurance departments in the District of Columbia and 12 states have issued notices to property and casualty insurers barring the use of price optimization in the ratemaking process. The regulators primarily find that because price optimization varies rates based on a factor other than risk of loss (e.g., a person's willingness to pay), it violates the statutory requirement that rates not be unfairly discriminatory. Table 1 identifies the 13 jurisdictions' notices.

Table 1: Insurance Department Notices on Price Optimization

Jurisdiction	*Notice*	*Date Issued*
California	Notice Regarding Unfair Discrimination in Rating: Price Optimization	February 18, 2015
Delaware	Bulletin No. 78	October 1, 2015
District of Columbia	Bulletin 15-IB-06-8/15	August 25, 2015
Florida	Informational Memorandum OIR-15-04M	May 14, 2015
Indiana	Bulletin 219	July 20, 2015
Maine	Bulletin 405	August 24, 2015
Maryland	Bulletin 14-23	October 31, 2014
Montana	Advisory Memorandum	September 18, 2015
Ohio	Bulletin 2015-01	January 29, 2015
Pennsylvania	Notice 2015-06	August 22, 2015
Rhode Island	Bulletin 2015-8	September 18, 2015
Vermont	Bulletin No. 186	June 24, 2015
Washington	Technical Assistance Advisory 2015-01	July 9, 2015

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