

STATUS OF THE PRICE OPTIMIZATION DEBATE

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I. Introduction

Price optimization is a method of using the data collected by personal lines insurers to apply predictive analytics to determine consumers' rate sensitivities and adjust the premium accordingly. [2] The industry and regulators disagree on what price optimization is, how it is to be defined, and whether it is an acceptable rating methodology. In the last year, the National Association of Insurance Commissioners ("NAIC") and some states have taken actions to address the question. This regulatory update provides an overview of the activity that has taken place in recent months and provides a status of the current debate over price optimization.

II. Background and Activity at NAIC

In 2014, the NAIC instructed the Casualty Actuarial and Statistical (C) Task Force (the "Task Force") to investigate the topic of price optimization and prepare a white paper for dissemination and discussion (the "White Paper"). The Task Force created the Price Optimization Working Party that was assigned with the task of preparing the White Paper. The Working Party and Task Force drafted the White Paper, which the NAIC Property and Casualty Insurance (C) Committee adopted on November 21, 2015. [3] The Executive (EX) Committee and Plenary then adopted the White Paper on April 16, 2016 at the Spring Meeting. [4] The final White Paper defined price optimization in Paragraph 14(a):

'[P]rice optimization' refers to the process of maximizing or minimizing a business metric using sophisticated tools and models to quantify business considerations. Examples of business metrics include marketing goals, profitability and policyholder retention.

The White Paper recommends that state regulators consider a number of activities regarding price optimization, including issuing bulletins to address insurers' use of methods that result in non-cost based rates. (As the following section indicates, most states that took action did so before the Task Force issued its final White Paper. Activity at the state level has slowed down since late 2015.) The White Paper also recommends that states consider enhancing requirements for personal lines rate filings to improve transparency and that states analyze models used by insurers to ensure that models adhere to state law and actuarial principles.

Supporters of the NAIC restrictions on price optimization assert that the process is unfair and violates basic unfair practices laws that provide rates cannot be excessive, unfair, or unfairly discriminatory. [5] Proponents of such restrictions also assert that the use of price optimization results in unfairly discriminatory rates for low-income and minority consumers. [6] While the White Paper was being drafted and considered, Consumer Reports ran a Special Report on Auto Insurance (the "Special Report"), which addressed price optimization and raised concerns about the insurance industry's usage of price optimization in the pricing of auto insurance. [7] Industry supporters of price optimization argue that they are already subject to unfair practice laws and that price optimization results in price stability and limits policyholder disruption.

III. State Activity

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At the same time the Task Force was focusing on price optimization, the states were reviewing the issue and, in many instances, took regulatory action. To date, twenty jurisdictions have acted. Maryland was the first state to prohibit the use of price optimization in its Bulletin 14-23 issued on October 31, 2014. [\[8\]](#) The Maryland Bulletin defines price optimization as “the practice of varying rates based on factors other than risk of loss.” [\[9\]](#) The next state to prohibit the use of price optimization was Ohio which, in its Bulletin 2015-01, describes the practice as pricing “based upon factors that are unrelated to risk of loss in order to charge each insured the highest price that the market will bear.” [\[10\]](#) The states that have taken some action to restrict to price optimization are (in chronological order):

- Maryland – Bulletin No. 14-23 (Oct. 31, 2014) [\[11\]](#)
- Ohio – Bulletin No. 2015-01 (Jan. 29, 2015) [\[12\]](#)
- California – Notice Regarding Unfair Discrimination in Rating: Price Optimization, 2/18/15 [\[13\]](#)
- New York – Letters to property/casualty insurers (no bulletin) (Mar. 18, 2015) [\[14\]](#)
- Florida – Informational Memorandum OIR-15-04M (May 14, 2015) [\[15\]](#)
- Virginia – Property and Casualty Filing Guidelines Handbook (June 2015) [\[16\]](#)
- Vermont – Bulletin No. 186 (June 24, 2015) [\[17\]](#)
- Washington – Technical Assistance Advisory 2015-01 (July 9, 2015) [\[18\]](#)
- Indiana – Bulletin No. 219 (July 20, 2015) [\[19\]](#)
- Pennsylvania – Notice 2015-06 (Aug. 22, 2015) [\[20\]](#)
- Maine – Bulletin No. 405 (Aug. 24, 2015) [\[21\]](#)
- District of Columbia – Bulletin 15-IB-06-8/15 [\[22\]](#)
- Rhode Island – Bulletin No. 2015-8 (Sept. 18, 2015) [\[23\]](#)
- Montana – Advisory Memorandum (Sept. 18, 2015) [\[24\]](#)
- Delaware – Bulletin No. 78 (Oct. 1, 2015) [\[25\]](#)
- Colorado – Bulletin No. B-5.36 (Oct. 29, 2015) [\[26\]](#)
- Minnesota- Bulletin No. 2015-3 (Nov. 16, 2015) [\[27\]](#)
- Connecticut – Bulletin No. PC-81 (Dec. 4, 2015) [\[28\]](#)
- Alaska – Bulletin No. B 15-12 (Dec. 8, 2015) [\[29\]](#)
- Missouri – Bulletin No. 16-02 (Jan. 12, 2016) [\[30\]](#)

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Some state departments of insurance have indicated they will not take specific action with respect to price optimization. For example, Illinois Acting Director Anne Melissa Dowling stated:

As there is no agreed-upon definition as to what is entailed in the term ‘price optimization,’ we don't plan to address an undefined notion. We are, however, aware of many new and innovative pricing models, responding to the market demand for more individualized pricing. [31]

IV. Litigation and Regulatory Actions

Several class actions have been filed against insurers for the alleged use of price optimization. In Washington, for example, *Slocombe v. The Allstate Corp.* [32] was filed in February 2015 and alleged that the defendant based its premiums on factors other than risk of accident. The case was voluntarily dismissed by the plaintiffs. A second case, *Durham v. The Allstate Corp.*, [33] was filed by the same law firm and alleged similar facts. The plaintiffs also voluntarily dismissed *Durham*. In two California cases, *Stevenson v. Allstate Ins. Co.* [34] and *Harris v. Farmers Ins. Exchange*, [35] the plaintiffs relied on various statements that appear to have been obtained from the social media pages (primarily *LinkedIn*) of insurance company employees in order to allege that companies were engaging in price optimization. Plaintiffs in these cases have also asserted that statements and disclosures contained in financial statements confirm insurers’ use of price optimization in personal lines rates. In both *Stevenson* and *Harris*, the California Department of Insurance obtained stays of the lawsuits pending proceedings before the California Insurance Commissioner.

To date, no states have taken legislative action to address price optimization. However, at least two jurisdictions to date have taken proactive steps in the rate filing process to help ensure that insurers are not utilizing price optimization. On April 29, 2016, in its publication, “The New Prior Approval Rate Application Process,” [36] the California Department of Insurance added the following statement to its Prior Approval Rate Application:

I declare under penalty of perjury under the laws of the State of California, that the information filed is true, complete, and correct, and that price optimization methods or models have not been used in the development of the final rates for any segment of the filed rating plan.

The Alabama Department recently added the following to its rate application:

Does this filing utilize a Price Optimization or Retention Model/Tool? If yes, provide details under Supporting Documentation.

Other states are likely to take similar actions to ensure that insurers are not violating rules regarding price optimization.

V. Problems for the Industry

Given the actions outlined above and the growing number of states prohibiting the use of price optimization, the insurance industry faces uncertainty as to what extent it may utilize price optimization in rating personal lines insurance. A second problem is the difference in how the industry defines price optimization as opposed to the narrow and inconsistent definitions applied by the states that have addressed the issue to date. Each state that has addressed the issue by bulletin or other publication has varied in how it defines the term “price optimization,” which means that insurers writing personal lines business in numerous states face challenges in understanding what rating and pricing practices are permitted by the regulators and making sure they are in compliance with the patchwork of activity around price optimization. While the issues are being addressed,

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there is some risk for property and casualty insurers that their practices will be reviewed and they will be the subject of market conduct investigations.

VI. Conclusion

Price optimization has long been used in unregulated industries to set prices and determine the consumer's likelihood to shop for pricing of a particular product or service. In addition, property and casualty insurers have long used the ratemaking process as a starting point, taking into account more qualitative factors in pricing such as retention and conversion rates, and often temper price increases over a multi-year period to prevent overly burdensome rates. Many in the industry disagree with regulators such as the Ohio Department of Insurance, which asserted in its Bulletin that price optimization "represents a departure from traditional cost-based rating." [37] On the other side of the equation, many insurers and reinsurers have had rate increases rejected by a state despite actuarial justification for the increase requested. The White Paper acknowledged that no universal definition of price optimization exists and suggested that states consider various steps to address the issue. Insurance companies will need to continue to monitor developments in the price optimization field and act to minimize their risks of not being in compliance with the patchwork of bulletins and other regulatory action that currently exist.

[1] This article is based in part on a presentation by the author in July 2016 at the ACI's 12th National Forum on Insurance Regulation with Fred Karlinsky, Greenberg Traurig LLP (FORC Member) and Steve Harris, AIG Property Casualty.

[2] While there is no universally accepted definition of price optimization, this definition attempts to provide a fair assessment of what price optimization is.

[3] See http://www.naic.org/cipr_topics/topic_price_optimization.htm.

[4] Final White Paper, as adopted, *available at* http://www.naic.org/documents/committees_c_catf_related_price_optimization_white_paper.pdf.

[5] See, e.g., Tex. Ins. Code § 560.002(b) ("A rate used under this code: (1) must be just, fair, reasonable, and adequate; and (2) may not be: (A) confiscatory; (B) excessive for the risks to which the rate applies; or (C) unfairly discriminatory.").

[6] As noted on the NAIC webpage on price optimization, consumer advocacy groups raised concerns that "the practice discriminates against low-income consumers who tend to shop around less frequently than wealthier consumers." http://www.naic.org/cipr_topics/topic_price_optimization.htm.

[7] *Available at* <http://www.consumerreports.org/cro/car-insurance/auto-insurance-facts-myths/index.htm>.

[8] http://www.naic.org/documents/committees_c_catf_related_maryland_bulletin.pdf.

[9] Md. Ins. Admin. Bulletin No. 14-23, at 1 (Oct. 31, 2014).

[10] *Available at* <http://insurance.ohio.gov/Legal/Bulletins/Documents/2015-01.pdf/>.

[11] *Available at* http://www.naic.org/documents/committees_c_catf_related_maryland_bulletin.pdf.

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- [12] Available at <http://insurance.ohio.gov/Legal/Bulletins/Documents/2015-01.pdf>.
- [13] <https://www.insurance.ca.gov/0400-news/0100-press-releases/2015/release022-15.cfm>.
- [14] <http://www.insurancejournal.com/news/east/2015/03/20/361413.htm>.
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- [19] Available at http://www.in.gov/idoi/files/Bulletin_219.pdf.
- [20] Available at <http://www.pabulletin.com/secure/data/vol45/45-34/1559.html>.
- [21] Available at <http://www.maine.gov/pfr/insurance/bulletins/pdf/405.pdf>.
- [22] Available at <http://disb.dc.gov/node/1107816>.
- [23] Available at http://www.naic.org/documents/committees_c_catf_related_rhode_island_bulletin.pdf.
- [24] Available at http://csimt.gov/wp-content/uploads/PriceOptMemo_091215.pdf.
- [25] Available at <http://delawareinsurance.gov/departments/documents/bulletins/domestic-foreign-insurers-bulletin-no78.pdf?updated>.
- [26] Available at http://www.naic.org/documents/committees_c_catf_related_colorado_bulletin_oct_2015.pdf.
- [27] Available at <http://mn.gov/commerce-stat/pdfs/insurance-bulletin-price-optimization.pdf>.
- [28] Available at <http://www.ct.gov/cid/lib/cid/BulletinPC-81-PriceOptimization.pdf>.
- [29] Available at <https://www.commerce.alaska.gov/web/Portals/7/pub/Bulletins/B15-12.pdf>.
- [30] Available at <http://insurance.mo.gov/laws/bulletin/documents/Bulletin16-02.pdf>.
- [31] Steve Daniels, *State Insurance Regulators: Look Out for Yourself*, Crain's Chi. Bus. (Jan. 2, 2016), available at <http://www.chicagobusiness.com/article/20160102/ISSUE01/301029996/state-insurance-regulators-look-out-for-yours>
- [32] No. 15-2-03508-8 (Wash. Super. Ct. 2015).
- [33] No. BC 571810 (Cal. Super. Ct. 2015).
- [34] No. 15-cv-04788 (N.D. Cal. Mar. 17, 2016).

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[35] No. BC579498 (Cal. Super. Jan. 25, 2016).

[36] *Available at*

<https://www.insurance.ca.gov/0250-insurers/0800-rate-filings/0200-prior-approval-factors/upload/The-New-Prior-App>

[37] *Available at* <http://insurance.ohio.gov/Legal/Bulletins/Documents/2015-01.pdf>.
