RISK CLASSIFICATION STANDARDS

By Michael A. Walters

Reviewed by Robert A. Bailey

SUMMARY OF THE PAPER

The author discusses the current issues related to risk classification in insurance. He distinguishes those qualities which flow from the nature of insurance, from those that attempt to redistribute wealth via a subsidy. From a description of the nature of insurance he derives a set of necessary and sufficient standards for insurance classifications which he summarizes into three broad categories: homogeneous, well-defined, and practical.

The author also discusses other characteristics which may be desirable but which are not necessary to make a classification system valid and appropriate. These include controllability, incentive value, causality, separation, social acceptability, and admissibility.

The author concludes with a discussion of regulation versus competition. He suggests that natural competition will enforce the standards he defined as necessary and that regulation, to the extent it interferes with industry pricing practices, would create a subsidy.

SUMMARY OF THE REVIEW

Insurance pricing is a combination of rating classification and underwriting selection. The author defines necessary and sufficient standards for rating classification which are not met by underwriting selection or insurance pricing as a whole. It is unreasonable to assert that it is necessary for rating classifications to meet certain standards when the pricing structure as a whole does not meet those same standards. The author's acknowledgment that pricing standards are necessary and appropriate, and his focus on only that portion of the pricing structure which the industry chooses to make visible, while ignoring the entire pricing structure, illustrates the inconsistent standards practiced by the insurance industry, and indicates why many believe that governmental intervention into the insurance pricing structure is necessary and appropriate.

SUBSIDY

The author suggests that regulators should not act in a manner so as to turn the insurance mechanism into a subsidy program. By defining what constitutes a subsidy in a manner justifying industry practices, the unsurprising conclusion is that regulators should keep their hands off. The author's definition of "subsidy" lacks a certain degree of persuasiveness and clarity.

His definition of subsidy is: "If, however, lower risk insureds were identified in a system and were useable as a rating classification, the failure to reflect those differences would constitute a subsidy." (page 709) This definition depends on which lower risk insureds are identified by a system, without qualifications as to whether the system is truly competitive or truly efficient. None of our present systems are ideally competitive, ideally efficient, or free of manipulation and control. If a system is controlled in some way then those who control it are in a position, under this definition, to define as subsidy anything that interferes with their objectives. Two examples of a controlled system that might not have identified the low risk insureds to the same degree as a more competitive system are the systems in effect (1) when the industry conspired together to reduce competition among themselves in the South Eastern Underwriters era and used a simple uniform classification system, and (2) when Massachusetts set uniform classifications for all insurers. Accordingly it is not surprising that the author, using this definition, concludes that regulatory interference with industry practices would create a subsidy.

Inasmuch as the author acknowledges "the impossibility of knowing a risk's true expected loss" (page 697) and that it is "not necessary (or even likely) for a classification to have identical expected losses for all risks within the class," (page 698) it appears that subsidy is always present to some degree and the question is not an objective "Is there subsidy?" but an inquisition, "Who caused the subsidy?" and a subjective and an endlessly debatable "How much subsidy is too much?"

CLASSIFICATION STANDARDS

The standards the author advocates in defense of the industry's present rate classification practices are equally applicable in condemning the industry's present underwriting practices, which are just as integral a part of the pricing system as rate classifications are.

For example, the author advocates that risk classifications be "well defined, . . . to ensure that each risk is actually placed in the right classification and to avoid unequal application of the classification system." (page 699) This is precisely what underwriting practices are not. It is unreasonable to advocate that rate classifications be well-defined when they are modified by an underwriting selection process which is not defined and which invites unequal application of the classification system.

To illustrate how an underwriting selection process could result in an unequal application of a classification system: a driver who meets the classification definition for a class offered by the Unfair Insurance Company, might be declined by the underwriter if he is from a minority racial group and accepted otherwise. If a reason for declination is requested, many reasons would be available, such as, "He parks his car on the street at night", even though the company may insure other drivers who park on the street at night.

The author's third standard (page 696) is: "The classes should be exhaustive and mutually exclusive; that is, an individual should belong to at least one, but only one class with respect to each rating variable." This flies in the face of the common practice of refusing to insure many applicants, meaning that many individuals find they do not belong to any class offered by the insurer. The author summarizes this standard (page 699) by saying, "'Exclusivity' precludes two different rates for the exact same risk." This flies in the face of the common practice of most insurance managements to have at least two insurers with different rates for the same risk. It is unreasonable to insist that a part of the pricing system should "be exhaustive and mutually exclusive" when the whole pricing system is neither. It seems that as we increase the clarity of the rate classes, we simultaneously increase the unclarity of the underwriting process so that the pricing system as a whole remains unchanged.

The author's quotation of SRI's statement: "The regulator's determination of what is unfairly discriminatory should relate only to the use of variables whose predictive validity cannot be substantiated and to unequal application of a classification system." (page 704) is applicable as a condemnation of the industry's present underwriting practices - using unsubstantiated variables to decline risks or to put them in a higher rated affiliate, and to unequally apply the classification system by declining or rating up some risks that meet the classification definition of the lower rated affiliate.

The author summarizes his seven standards "into three broader categories which can describe a set of necessary and sufficient conditions for insurance classifications: i.e., homogeneous, well-defined, and practical." (page 697) The author acknowledges that insurance classifications are not homogeneous. As discussed above, the pricing system as a whole is not well defined, opening the door to unequal application of it. In view of the insurance industry's pricing system being not homogeneous and not well-defined, for someone to then advocate that the only remaining standard should be "practical" (from the insurer's point of view) conveys the appearance of an industry that is insensitive to the public's perception of the industry's pricing system. The public is more concerned about whether the system is fair to the public then whether it is practical for the insurers. And the public perceives that it is not fair to the public because of the industry's failure to meet the two standards conceded by the author as "necessary" namely that the pricing system be homogeneous and well-defined. The author's paper, by concentrating on only a part of the pricing system, rate classifications, and ignoring an equally important part, underwriting selectivity, which negates the part he describes, illustrates why the public feels that insurance prices are unfair and why the industry fails to understand why the public feels that way.

ALTERNATIVE STANDARDS FOR CLASSIFICATIONS

The author touches upon what the reviewer regards as the single, fundamental standard for classification in a competitive market. "If, for example, it costs an insurer ten dollars on each policy for all to find only a small portion of risks who could save twenty dollars, it is not worth the effort." (page 699) This could be restated as, "A classification criterion is economic and appropriate if

the reduction in expected losses for those who meet the criterion exceeds the cost of measuring the criterion for all who apply. The classification criterion which is most economic is the one that achieves the highest ratio of the reduction in expected losses for those who meet the criterion versus the cost of measuring the criterion for all who apply." This definition is the logical outcome of a competitive market. Under this definition, if sex is more correlated with expected losses and is cheaper to measure than, say, psychological attitudes, it is more economic in a competitive market as a classification criterion. Since no criterion is perfectly correlated with expected losses or is costless to measure, no classification criterion is perfect. It is a question of degree and relative efficiency and cost, questions that a private competitive market is ideally suited to determine.

As the author points out, some segments of the public criticize some classification criteria on the grounds that they are not perfect. Unfortunately, we do not have a choice between a perfect system and an imperfect system. Our choice is between a system controlled by profit motivated insurers competing against each other or a system controlled by government and the political process or some combination of the two. The results of our choice will affect the economic value of insurance to the many private property owners and small businesses who depend on insurance, and will affect in a small degree the economic ability of the United States as a whole to compete in the world market against other foreign economies.

Some segments of the public also criticize some classification criteria on the grounds that they are offensive, such as race, religion, occupation and income level, regardless of how economic they may be. The suspicion exists that insurers do use such criteria but attempt to conceal such use by not openly defining and disclosing all the criteria they use in their pricing systems, which embrace both rating and underwriting procedures. This suspicion is expressed in the accusation that the pricing system is "unfair". The suspicion will persist as long as the risk classification criteria are not "well-defined" and publicly disclosed.