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RISK CLASSIFICATION

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Brief update on the current environment for risk classification, including regulatory development and court cases.

MR. DANIEL F. CASE: The overall theme of this meeting is "Expanding Actuarial Horizons". The subject of this session, risk classification, is an area in which there is a fear that our horizons may contract if we are not careful. It may be that the best way to avoid a contracting of our horizons is to expand our outlook beyond the confines of the traditional, time-tested principles of risk classification. Thus we may have to find innovative solutions to the risk classification problems, while, of course, avoiding approaches which are mostly enervative. On the other hand, what we may need more than innovation is communication. Or maybe we need both.

MISS BARBARA J. LAUTZENHEISER: There are at least eleven Federal Agencies administering bans against sex discrimination, although not all of these deal with retirement plans or insurance. Numerous cases dealing with retirement plans have been filed in the courts, and one of them has reached the Supreme Court. Various states have issued regulations which affect our ability to classify risks. The issue will not go away.

Federal Agencies

Four Federal Agencies--the Wage and Hour Division of the Department of Labor, the Office of Federal Contract Compliance (OFCC), the Department of Health, Education and Welfare (HEW), and the Equal Employment Opportunity Commission (EEOC)--have regulations regarding equality in retirement plans and insurance. President Carter recently proposed a consolidation which would eliminate the overlap in this area by giving EEOC primary responsibility for enforcement of equal employment opportunity laws. What are the implications of this proposal?

Initially, all four agencies used the same guidelines--equal contributions or equal benefits. Then, in April, 1972, EEOC changed to equal benefits only. For a while, it was the only one to do so. Later, OFCC and HEW began considering a change, not just to equal benefits only, but to a unisex approach. Other differences arose. President Ford ordered the Equal Employment Opportunity Coordinating Council (EEOCC) to study the issues and recommend one approach. The official report has never been released, but there have been published indications that it contained a recommendation for legislation requiring equal periodic benefits for all retirees selecting single life options. It is said that EEOC refused to sign because it wanted equal periodic benefits in all options and all insurance. The recommendation must have been packed in Mr. Ford's suitcase when he left the White House--it has not been heard of since.

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This leaves us with a number of questions. If EEOC is given primary responsibility for enforcement of all laws on this subject, as Mr. Carter proposes, will they continue to require equal periodic benefits? How will they reconcile this with the Equal Pay Act? Will they require unisex to solve both the Civil Rights Act and the Equal Pay Act? Will they require unisex in all insurance?

Again, at present only EEOC requires equal periodic benefits. The other three agencies--OFCC, HEW and the Wage and Hour Division--allow either equal benefits or equal contributions. Meanwhile, another Federal agency is about to enter the picture. The U.S. Civil Rights Commission is planning a consultation later this month on discrimination against minorities and women in pensions and health, life and disability insurance.

Action in the Courts

The courts are also involved; all the cases thus far deal with pensions. The first case was a class action in the Indiana State Courts. The lower court decreed that the Indiana State Teachers Retirement Fund Board practice of using the 1971 GAM table with a five-year setback for females, providing a greater monthly annuity to males than to females, is "based solely on sex" and is therefore discriminatory. The court reasoned that because other factors which affect life expectancy were not considered, sex should not be considered either. The Indiana Appeals Court affirmed the decision by a 2-1-2 vote. The swing vote concluded that the plan was discriminatory because no evidence was presented proving that women teachers live longer than male teachers. The U.S. Supreme Court let the lower courts' decision stand by refusing to hear the case.

The second case was Henderson v. Oregon State Teachers Retirement Fund. The lower court held that Title VII of the Civil Rights Act prohibits the use of sex segregated life expectancy tables in calculating refund annuity benefits for State Employees. Interestingly, the court refused to issue an order that "unisex" tables be used unless and until the decision was appealed and affirmed. Appellate briefs were filed and oral argument was to have been heard on October 3, 1977. On that date the U.S. Supreme Court ruled that it would hear the Manhart case, and the 9th Circuit Court of Appeals decided in the interest of judicial economy to suspend activity in the Oregon case pending the Supreme Court decision.

The third case is Manhart v. City of Los Angeles Department of Water and Power--the case which has gone to the Supreme Court. Under this plan, females made larger monthly contributions than males to receive equal benefits. The question before the court is whether Title VII prohibits pension plan contribution rates based upon separate mortality tables to provide equal benefits. The lower court relied heavily on the reasoning in an EEOC decision which said, in part:

> All that...sex segregated actuarial tables purport to predict is risk spread over a large number of people; the tables do not predict the length of any particular individual's life. Because actuarial tables do not predict the length of any individual's life, any claim that such tables may be used to assure equal pension payments over a lifetime between males and females must fail.

The lower court concluded:

> Because the Department of Water and Power's practice in question here violates these considerations by applying the general actuarial characteristics of female longevity to individual female employees who, in reality, may or may not outlive individual male employees, the Court concludes that plaintiffs have established a case of discrimination under Title VII.

The words unfortunately are equally appropriate to any of our classification systems. They possibly prohibit grouping and hence any insurance. As we heard this morning, the Academy and the Society jointly filed an amicus curiae brief in the Supreme Court. We are now waiting to hear whether or not the Supreme Court agrees.*

There are also six cases pending against Teachers Insurance and Annuity Association. Only one has been decided--Colby College and TIAA-CREF v. EEOC. This was decided in favor of separate tables, but was only won as a matter of statutory interpretation of Title VII without going into the substance of the case, so that it did not involve the kind of reasoning just quoted. It was a particularly important decision, since the plaintiff was the EEOC. The decision is being appealed, but this appeal also has been suspended awaiting the Manhart decision from the Supreme Court.

In another TIAA suit, Peters v. Wayne State University and TIAA-CREF, a lengthy trial has just been concluded in Federal Court in Detroit. The bulk of the testimony involved actuarial issues. This case also appears to have come to a halt pending the outcome of Manhart. Other TIAA suits around the country are all basically suspended until the Supreme Court speaks in Manhart.

State Regulation

There are many state laws and regulations prohibiting rating or rejection because of genes (e.g., sickle cell trait); severe disability; mental or physical handicap; blindness; or deafness. Other laws and regulations do not prohibit but do restrict rating, unless based on sound actuarial principles and a reasonable classification system and related to actuarial claims experience, for such reasons as sex and marital status, handicap, sexual preference, or disability. An Ohio law prohibiting unfair discrimination against handicapped persons defines handicap as:

> a medically diagnosable, abnormal condition which is expected to continue for a considerable length of time, whether correctable or uncorrectable by good medical practice, which can reasonably be expected to limit the person's functional ability, including but not limited to seeing, hearing, thinking, ambulating, climbing, descending, lifting, grasping, sitting, rising, any related function, or any limitation due to weakness or

*Editor's note: The Supreme Court decided, on April 25, 1978, that the challenged differential violated Title VII, but that it was inappropriate for District Court to allow a retroactive monetary recovery in this case.

> significantly decreased endurance, so that he cannot perform his everyday routine living and working without significantly increased hardship and vulnerability to what are considered the everyday obstacles and hazards encountered by the non-handicapped.

Fortunately, the law specifically permits reasonable classification of handicapped persons for determining insurance rates. Nevertheless, the definition could include advanced heart disease and terminal cancer.

Several states exhibit extensions going from one restriction or classification to another. For example, Maine restricted rating for blindness in 1976 and for deafness and developmental disability in 1977. Developmental disability includes mental retardation, cerebral palsy and epilepsy. The law prohibits rating for these disabilities per se, although an extra rate is allowed if the general health and the cause of disability warrant an additional premium. I don't know how conditions warranting an additional premium are determined.

Another example is Florida, which in 1975 prohibited discrimination because of spinal cord injury, amputation, and visual disability and in 1976 broadened the prohibition to include the mentally and physically handicapped.

Among the latest developments is a Michigan bill which would replace "either equal contribution or equal benefit" language with the following:

> An employer shall not: segregate, classify or otherwise discriminate against a person on the basis of sex with respect to a term, condition or privilege of employment, including a benefit plan or system.

Professors of mathematics were testifying at the legislative hearings about construction of mortality tables and "overlap" theories.

One week later, hearings at a legislative subcommittee of the Minnesota House resulted in a bill making it an unfair discriminatory practice for any insurance company to charge differential premiums because of the sex or marital status or principal occupation of a homemaker being changed to a requirement that an insurance company, upon request and to the satisfaction of the commissioner, justify any differentials in premiums based on sex, marital status or occupational status as a homemaker or manager of a household, as being based upon sound actuarial principles, valid classification systems and claims experience statistics which establish significant and substantial differences in class rates. The bill provided for civil action to recover actual damages including attorney's fees. This bill died in committee and never reached the House. It took a fair amount of industry and actuarial education of the legislators, particularly by local people.

There have been two encouraging signs at the state level: a California bill would require different premiums by sex for life insurance and annuities; and an NAIC model regulation to eliminate unfair sex discrimination acknowledges differences in rates for health insurance, life insurance, and annuities.

Issues

In spite of the fact that differences in mortality between the sexes appear in all statistics around the world and for nearly 200 years, it is still possible to ask whether the differences will narrow as women enter more high pressure jobs. According to a Census Bureau statement cited in the Wall Street Journal for July 26, 1977, fewer heart disease deaths have significantly contributed toward increasing the life span of women by four years and of men nearly three by the next century. So even a decrease in heart disease deaths will benefit women more than men. Meanwhile, the differences continue to widen. Tables from the National Center for Health Statistics--not insurance data--show that the difference in life expectancy at birth between white male and white female, which was 1.2 years in 1920, had increased to 5.7 years in 1950 and to 7.7 years in 1974. The difference between non-white males and females has increased even more drastically, from 0.3 years in 1920 to 8.3 years in 1974. The differences persist at the older ages; life expectancy at 65 is four years apart for white males and females and three years apart for non-white males and females.

The real issues are social, not factual. Some say that companies should eliminate classification by sex as they did classification by race--the differences are society's fault and will change.

Classification by race was eliminated because it was felt that the differences were due to the poorer socio-economic conditions forced on non-whites. When society is to blame, the results should not be used against individuals. With respect to race, this judgment has validity. Tables from the National Center for Health Statistics show that the difference in life expectancy at birth between white males and non-white males was 8.9 years in 1920, 7.4 years in 1950, 6 years in 1974. A similar pattern exists between white and non-white females. Thus the differences between the races are narrowing. Furthermore, life expectancy at 65 is now the same for white and non-white males and only one year apart for white and non-white females. This is quite a different pattern from the sex differences, which are widening. The difference in mortality by sex is apparently not due to socio-economic conditions or social injustice, but to biological factors; in fact, it exists even prior to birth.

The economic impact of a social decision to ignore differences between males and females would also be significantly different from that of a decision to ignore differences, even if they were of the same magnitude, between whites and non-whites. Only 13 percent of the population is black; over one-half is female.

Another social argument we have to face is that people should not be penalized for something beyond their control. This was mentioned at the annual meeting of the Society of Actuaries in Boston last year by Dr. Jean Mayer, President of Tufts University. He said that body type is more predictive of mortality than weight but not as acceptable for classification as something "wicked" such as overweight or smoking. Sex is not within control of the individual--not generally, any way--so it too becomes an unacceptable classification in the eyes of many. This is also true of the various disabilities and handicaps mentioned earlier. Impairments such as cancer, tuberculosis, diabetes, and epilepsy are also beyond control of the person. Yet for economic reasons it is necessary to charge different premiums for these if a person is going to be left free choice to buy or not buy, with no limit on the amount he can buy.

It is also argued that guaranteeing individual rights leaves no room for classification for any purpose, including insurance. According to the original EEOC decision:

> All that...sex segregated actuarial tables purport to predict is risk spread over a large number of people; the tables do not predict the length of any particular individual's life.

In some states some physical and mental handicaps cannot be used as a reason for charging extra premiums. According to an Iowa regulation:

> Individuals shall not be considered to have a different life expectancy solely because they are blind, partially blind, or physically disabled.

In some states auto rates can no longer vary by age, sex or marital status. Some also prohibit classifying by length of driving experience--others require it.

It all boils down to the point that some people don't care about facts--that women do live longer and are living longer and longer as time goes on; that some don't care about the cause of the differences, whether they are socio-economic due to injustices of society or biological which will continue regardless of elimination of social injustices; and some don't care about costs.

Social proponents are not dissuaded by the fact that social purposes, which may be perfectly appropriate for mandatory designated benefit, designated contribution plans, are not appropriate in a free market system. Some actually want the costs spread--for instance, to make auto premiums affordable for the highest risk groups. Some say they want to ignore differences in cost, if the employee has to pay, just let the employer make up the difference. Attorneys for Manhart and Peters (the Wayne State case) have said Title VII permits different rates when employers are paying but not when employees are paying. But what does that do to equal compensation?

As the speaker said at the general session this morning, our job is futurism and futurism is the ability to perceive the realities of the present as they affect the future. I charge you to become aware of the problem and see the trends. Paul Revere's ride would have been for nothing if no one had listened.

MR. WILLIAM S. GILLAM: Property and casualty insurance may be divided into personal lines, such as private passenger automobile and homeowners insurance, and commercial lines, such as workers' compensation, commercial automobile, and commercial fire and allied lines. In the personal lines, the insured is an individual, or an individual and spouse, whereas in the commercial lines, the insured is generally a corporation, parternership, or an unincorporated association. Recent controversy about risk classification has been greatest in the personal lines, particularly private passenger automobile. I will limit my comments to this kind of insurance.

Although much of the controversy involves the criteria used in formal classification systems, unfair discrimination has also been charged in connection with the underwriting* and marketing phases of property and casualty

*The term is used here in the narrow sense of the acceptance or rejection of risks.

insurance operations, including the use of residual market mechanisms. My discussion this afternoon will be limited to the formal classification procedures.

In property and casualty insurance, risk classifications have been determined primarily by competition operating under the state rate regulatory laws, which, among other things, declare that rates shall not be "unfairly discriminatory". However, only about one-third of the state laws include provisions defining, or otherwise describing, what constitutes a rate which is unfairly discriminatory. None of these laws provides a clear-cut basis for distinguishing between fair and unfair discrimination; the interpretation and administration of the laws by the various state regulatory authorities has been the determining factor in the past.

Restrictions on Risk Classification

Over the last several years, a large number of bills have been introduced in state legislatures proposing laws restricting risk classification, hearings have been held in quite a few states on this subject and restrictive administrative regulations have been considered. The principal classification criteria in connection with which restrictions have been considered are age, sex, and marital status--generally pronounced, and considered, as if they were one word--and geographical criteria, generally referred to in the business as territories.

A. Age, Sex, and Marital Status

As far as age, sex, and marital status are concerned, restrictive action has been taken in three states: Hawaii, North Carolina and Massachusetts.

The Hawaii law, effective September 1, 1974, does not permit classes for automobile insurance to "be based, in whole or in part, directly or indirectly, upon race, creed, ethnic extraction, age, sex, length of driving experience, credit bureau rating, or marital status."

The North Carolina law provides that, after September 1, 1975, no insurer may use age or sex in rating private passenger automobiles. It also mandates surcharges for involvement in accidents, convictions of moving traffic violations, and being licensed less than two years.

In Massachusetts, Commissioner Stone's decision on 1978 automobile insurance rates forbids the use of age (except 65 and over), sex, marital status and driving to and from work as classification criteria but mandates higher rates for operators licensed less than three years.

B. Geographical Criteria

As far as rates varying by territory are concerned, there has been considerable agitation over the last few years in a number of large cities--Chicago, Baltimore, Boston, Los Angeles, Miami, etc.--for doing away with such rating differences. In several instances, the controversy arose

because insurers had subdivided the cities for rating purposes. It was charged that the primary purpose of such subdivision was to isolate certain racial or ethnic groups, that is, that territorial rating was being used as a proxy for other criteria which are generally accepted as being unfairly discriminatory. This charge was certainly made in Chicago. There was no quarrel with the concept of territorial rating; the law that was passed by the Illinois legislature in 1972 limits such rating only within the city of Chicago and, in fact, applies only to the liability coverages.

In Los Angeles, the situation also initially involved subdivisions of the city and minority groups but legislation that has been introduced goes further, proposing to eliminate all territorial rating.

Otherwise, the concern about territorial rating is largely a reflection of the affordability issue. Experience clearly shows higher loss costs, due both to greater frequencies and higher average claim costs, in urban areas where residents are generally less able to afford the higher premiums.

Principles Underlying Classification Systems and the Selection of Classification Criteria

Only in the last few years has much thought been given to principles or guidelines in connection with risk classification. In 1975, the property and casualty insurance business sponsored an independent study by Stanford Research Institute on "The Role of Risk Classification in Property and Casualty Insurance." The SRI report was published in May of 1976. I recommend this report, or at least the Executive Summary, as required reading for anyone interested in this question.

Since this report was published, there has been considerable thought and discussion on this subject by many segments of the business, including the regulatory authorities. I will attempt to summarize briefly the varying viewpoints as objectively as I can.

It seems to me that the principles that underlie the selection of classification criteria can be divided into three basic categories: those dealing with statistical justification, social acceptability, and practicality. I believe that most knowledgeable people in the property and casualty insurance business would agree that each of these need to be taken into account. Controversy arises because of the differences in the importance, or weight, assigned to each.

A. Statistical Justification

Over the years, the primary consideration as to whether a particular criterion might properly be used in rating classifications has been the availability of statistical data demonstrating differences of experience. Some would make this almost the sole criterion. Others take the position that statistical justification is essential but not sufficient.

Still others state that, "being actuarially correct has nothing to do with being right."

I might mention that there are two other types of statistical justification that are receiving considerable attention at this time. The first is the way in which the interrelationships between the various classification criteria are dealt with. The second is the question of how expenses are allocated to the various risk classifications.

B. Social Acceptability

The question of whether the insurance buying public, or its representatives, find the criteria used in risk classification acceptable has come to the fore only in the last few years.

In recent decades, numerous laws have been enacted, both at the federal and state level, prohibiting the use of race, color, religion, or national origin as a basis of discrimination. It matters little whether such statutes apply specifically to insurance. The important thing is that there is now nearly universal acceptance that using such criteria as a basis of discrimination in any endeavor is alien to the ideas, principles, and tastes of the great majority of our citizens.

In recent years, the elimination of sex discrimination in all aspects of our economic and social life has been a goal of many. As a result, the use of sex as a classification criterion in insurance has also been challenged. Barbara Lautzenheiser has outlined the situation in the life, health, and pension fields. In private passenger automobile insurance, where there are differences, female operators are accorded more favorable rate treatment than males of the corresponding age. Nevertheless, the use of sex as a classification criterion in private passenger automobile insurance has been challenged, along with age and marital status.

Social acceptability, in the minds of those who feel most strongly about it, is determined most importantly on the basis of causality. It is not claimed that there needs to be a cause and effect relationship than can be demonstrated scientifically, but there needs to be a reasonable connection in the minds of policyholders between the criterion used and the event being insured against. Whether this is the case in connection with a particular criterion is, consequently, a matter of individual judgment.

Other advocates of social acceptability believe that classification criteria that cannot be controlled, or changed, by the individual should be avoided. Age and sex are, of course, examples of this.

Time does not permit more than mention of other characteristics of classification criteria that some observers believe make them socially unacceptable. It is charged that it is unfair to conclude that, because certain individuals have a particular characteristic in common, they also share other characteristics.

Criteria that rely upon information which many people consider no one else's business are unacceptable to many. Others claim that the classification system should be non-regressive. And finally, it is rather generally agreed that classification criteria should involve objective determinations rather than subjective.

C. Practicality

Critics of classification systems often appear to be unimpressed by practical considerations. Those who are called upon to apply classification rating systems in the real world must nevertheless take into account the cost effectiveness of the rating system. This involves such factors as the degree of refinement, the determinability and verifiability of the classifications to which individuals are to be assigned, and the consistency of the criterion, that is the lack of change over time.

Conclusion

In the three states that have mandated restrictions on classification criteria, the regulatory systems place little reliance on competition in determining the rating structure for private passenger automobile insurance. If the insurance business hopes to make its view of competition work effectively in other states, it must give more attention voluntarily to social, economic, and political factors. Otherwise we risk being forced to do so by regulatory decrees or through the legislative process.

MR. ARNOLD A. DICKE: Many people assume that sex mortality differences are due to "work tensions". In order to "substitute facts for appearances and demonstrations for impressions," it might be useful to study the correlation between some socio-economic indicator (occupation or income) and mortality, breaking the results by sex. Such correlation studies might well influence public opinion.