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RISK CLASSIFICATION AND PRIVACY

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What are the implications of the Privacy Study Commission's recommendations? What legislative developments have occurred? What can be expected? The Academy Task Force report on risk classification. Fundamental principles of classification. If experimentation in classification is prohibited, how can modifications be justified? If it is feasible to do so, should we take an amicus curiae position in risk classification court cases? Do the traditional state anti-discrimination laws need to be made more specific?

MR. RONALD E. TIMPE: A good starting point for today's discussions seemed to be a review of the fundamental principles of risk classification as they have been practiced in the past, and comments on recent influences affecting these principles. I looked at Selection of Risks by Pearce Shepherd and Andrew Webster and found a rather concise statement that risk classification is based on the idea "that every insured should contribute his fair share toward the risk involved - that only applicants who are exposed to comparable degrees of risk should be placed in the same premium class".

This statement explains the risk classification process by describing the end result - the grouping of insureds into homogeneous risk pools so there is an equal expectation of claim which is commensurate with the premiums being paid. This idea seems appropriate for a mutual company striving for equity among its policyowners and for a stock insurance company this seems to be a practical and competitive approach.

The actual classification process usually has as its basis an underwriter's worksheet on which debits and credits are noted, with a starting point that the "standard risk" accepted by a company has the value of 100%. Debits and credits are determined based on a review of the proposed insured's occupation, avocation, health history, family history, current health findings and habits and morals. The debits and credits are then totaled and a risk classification results.

For many years, the general practice was to accept as a standard risk a numerical rating from this process of up to 140%. At the older ages a standard risk classification would require a numerical rating of 120% or less. This illustrates that there is a broad classification of standard risks. Insureds with numerical ratings in excess of the standard risk classification are grouped into substandard classifications and charged extra premiums.

The application of this risk classification process has remained unchanged for many years except for modifications in the assignment of debits and credits due to experience studies of impaired lives.

Basic ideas of risk classification have not changed, but influences in the past few years have become intense. For many companies, the last five to ten years have brought applications for significantly increased amounts of

coverage, competitive pressures to reduce the cost of insurance, increased difficulty in gathering underwriting information, higher cost of underwriting data and new relationships with agents, applicants and suppliers of underwriting information. The basic principles of homogeneous groups of risks will remain the foundation of private insurance but we are seeing changes as companies react to these influences. Many companies are broadening the standard risk classification of the younger issue ages due to the cost and difficulty of obtaining underwriting information. There seems to be a contrary trend because of the competitive pressures when large amounts of insurance are involved. Many companies are offering "select" or "superselect" discounts on special policies of $100,000 or more if the insured can provide the necessary evidence of good health.

The legal environment in which the risk classification process exists is changing. In the past, the situation for life insurance generally has been that companies were prohibited from "unfair discrimination between individuals in the same class and equal expectation of life in the rates charged for any contract of life insurance or of life annuity or in the dividends or other benefits payable thereon, or in any other terms and conditions of such contract". As is often pointed out, the risk classification process involves discrimination, where the word relates to the observation of differences between or among individuals. It does not relate to the other definition of discrimination which is to favor one person or group over another. The laws allow discrimination but are intended to prevent unfair discrimination. We have been interested in equity through valid discrimination and appropriate risk classification. Under the laws, we have felt comfortable that we could use equity rather than equality in risk classification.

The legal environment is changing and many states have considered statutes which increase the burdens of insurers to justify the risk classification process. A couple of examples of the changes occurring would be helpful. There are laws prohibiting rating or rejection in life and health insurance on account of sickle cell traits or hemoglobin C trait, blindness, deafness, and sex or marital status. In other states, there are prohibitions on risk classification "unless bona fide statistical differences in risk or exposure have been substantiated".

MR. JOHN H. COOK: Not everyone in the insurance industry knows that there was a Federal Privacy Protection Study Commission. Not everyone knows that the Study Commission issued a report last summer. Not everyone is going to read the full report. But if you have any concern about privacy protection (and you should have) read the first chapter. Then if you are at all impressed with what you have read, look at Chapter 5 on the Insurance Relationship. This is obviously the most significant single chapter affecting us.

In the environment of the Insurance Relationship the Commission identified three public policy objectives. These were briefly, to minimize intrusiveness, to maximize fairness, and to create a legitimate enforceable expectation of confidentiality. To promote these three objectives the Commission drafted 17 recommendations which, in their opinion, would also respect the need for information and strengthen the relationship between the insured and the insurer.

What is the background that brought these recommendations into being? What is it that brought the Privacy Protection Study Commission into existence? What is the issue that had to be resolved?

One hundred years ago all American citizens enjoyed certain constitutional rights. These rights were referred to in the Declaration of Independence as inalienable rights and among these are Life, Liberty and the Pursuit of Happiness. Whether or not the right to privacy was guaranteed under the Constitution was not clearly determined at that time. About 90 years ago two young lawyers focused the spotlight on the question of common law in relation to privacy. For the next 80 or more years, developments on privacy protection continued at an evolutionary pace; but after the experiences of the early 1970's, including Watergate, action shifted into high gear.

By this time we already had the Federal Fair Credit Reporting Act which established certain requirements involving investigative consumer reports, including disclosure requirements where adverse life insurance underwriting decisions were influenced by information contained in these reports. Now we acquired the Federal Privacy Act of 1974. That Act was limited in its application to agencies of the Federal Government. Although private industry was not specifically directed to comply with the requirements of the Privacy Act of 1974, they were exempt subject to a specification in that Act that a Commission be established to study the need for similar controls in the private sector.

A Privacy Protection Study Commission was established in 1975. The Commission labored for two years in its investigation. It heard testimony from over 300 witnesses. Included among those who testified are many from the life insurance industry, including Chuck Walker of New England Life, Bob Seiler of Allstate Life, Doug Murch of Prudential, Tom McDermott of Metropolitan, Bill Creamer of New York Life and many others.

There is one aspect of privacy protection that I wish to bring to your attention. Here we are concerned with two not necessarily compatible but simultaneous objectives. Each objective is, of itself, desirable. The unfortunate part is that they work at cross purposes with each other.

On the one hand there is the need to expedite the conduct of business. In order to do this, it is necessary to assemble information. That information consists of many elements. Some of these elements pertain to society and masses of people. Others of these elements pertain to individuals. At the same time that there is a need to expedite the conduct of business there is the need to protect the individual in society from an undue invasion of privacy.

In a totalitarian state this need to protect the individual would be ignored, but ours is not a totalitarian state. It often happens that these two needs are dramatically opposed. If we maximize the information available for the conduct of business, we embarrass individuals with excessive exposure to public scrutiny. If we maximize privacy rights we impair the judicious conduct of business. Each member of society, by virtue of his dual role, is a beneficiary of each of these opposing activities. As an object of information gathering, each individual has a desire for personal privacy. As a consumer of the benefits and services that derive from information gathering, each individual has a stake in the development of that information.

Just to illustrate this conflict, a consumer entering into a contract must reveal certain information about himself to satisfy the other contracting party that the contract will prove beneficial. The extent of information revealed should not exceed the reasonable need for information. There are

situations where it has been judged that the need for information is valid but the loss on the part of the consumer, due to public disclosure, is excessive. Such a judgment is obviously a matter of opinion and the opinion is very apt to be influenced by the perspective. The consumer sees the exposure to public scrutiny. The businessman sees the consequences of an ill-advised decision. The conflict here is not about the relevancy of the information but rather about the propriety of such information. There are complexities that lie beneath the surface of the relevancy/propriety issue in the insurance area. At this point let me merely report that the Privacy Protection Study Commission took note of this element of conflict and recorded as its first recommendation, involving the insurance relationship, that there be mechanisms whereby individuals could question the propriety of information collected.

I referred earlier to 17 recommendations. I have just now identified one of them. I will not bore you with a recitation of the other 16. Let me characterize the recommendations by saying that they are a blend of voluntary, state, and federal action. A high percentage of the objectives can be achieved by voluntary adoption within the insurance industry of most of the recommendations.

In general, the Commission produced a thoughtful, comprehensive, and well-written report. It proposes legislative action in some areas. What, if anything, will happen depends on how poorly or how well the insurance industry responds in a voluntary way to the report.

MR. ROBERT J. RANDALL: I intend to describe the Report of the American Academy Task Force on Risk Classification. I should qualify my description by pointing out that I have been critical in public statements and letters of several aspects of the Report. I'll defer those criticisms to my later remarks and try to be objective in this description.

The Task Force was appointed in January, 1977, and comprised the following:

Michael J. Mahoney, F.S.A., Consulting Actuary
Milliman & Robertson, Inc.
Chairman

John P. Clark, F.S.A., Second Vice-President and Actuary
Paul Revere Life Insurance Company

William S. Gillam, F.C.A.S., Associate Actuary
Insurance Services Office

Barbara J. Lautzenheiser, F.S.A., Vice-President and Actuary
Bankers Life of Nebraska

W. James Mac Ginnitie, F.S.A., F.C.A.S., F.C.A., Vice-President
Tillinghast, Nelson & Warren, Inc.

Ethel C. Rubin, A.S.A., Actuary, U. S. Civil Service Commission

Richard M. Stenson, F.S.A., Vice-President and Associate Actuary
Equitable Life Assurance Society

The Report was released to all members of the Academy and five sister actuarial organizations August 18, 1977, accompanied by a letter of strong endorsement signed by the six presidents.

The Report consists of six parts:

1. Summary and recommendations, which I'll discuss last.

2. The Legal Framework outlining laws, regulations, and court decisions.

3. Appendix A on Life Insurance.

4. Appendix B on Health Insurance.

5. Appendix C on Sex rating in Property and Casualty Insurance.

6. Appendix D on Geographical rating in Automobile Insurance.

The Legal Framework begins by describing state laws and regulations. All states have laws at least as strong as the NAIC model Unfair Trade Practices Act, which prohibits unfair discrimination between individuals of the same class, or risk expectation. More recently, the Report states, some states have gone beyond this general definition to outlaw use of specific criteria, race, religion and national origin. Even more recently, bills have been passed or introduced prohibiting or limiting criteria such as handicaps or certain specified diseases. Residual risk plans for automobile insurance also limit the classification process.

Federal agencies have suggested banning sex distinctions in insurance ratings. Several cases are in the courts asking that sex distinctions in employee benefit plans be outlawed. The Manhart case has since been decided by the Supreme Court.

The appendix on life insurance discusses group and individual separately, and also race, sex, and other criteria where government limitations may or have been imposed. The general conclusions are that the results have been or will be harmful.

Similar discussions are presented in the remaining three appendices. Let me quote a few conclusions:

> "The consequences of restriction are much more severe in individual life insurance than...in group life insurance..."
>
> "Inability to have separate rates by race has forced them [companies with largely black markets] to have to use their higher mortality black rate or face insolvency. This higher rate is non-competitive in the white market and hence the growth of these companies has been restricted to only black markets."
>
> "If higher (for females) unisex rates had to be used, it could once again make individual life insurance too costly for these low income women."

"If age or sex...were not allowed as a rating parameter, groups with...[low costs] would probably have to subsidize other groups. This could cause these low cost groups to leave the market in favor of government coverage or self-insurance."

"One obvious consequence of uniform statewide [automobile] rates would be that residents of lower rated territories would have to pay increased premiums, and the differential would effectively constitute a subsidy of the higher rated territory insureds. (Once this is understood, the political appeal of uniform rates diminishes.) Another consequence would be that companies with disproportionate shares of their business in lower rated territories would be unable to compete in the higher rated territories, and would seem to avoid business there. Those with concentrations of business in the higher rated territories would have rates that would be uncompetitive in the lower risk territories and would be unable to maintain their market share in those territories. Their experience would worsen, necessitating even higher premiums, and ultimately they would end up specializing in the higher risk territory, except that the number of competing insurers in each territory would be reduced. Overall this could result in higher expense levels because of failure to realize the economies of scale that statewide operation permits."

To return to the summary and recommendations, I'll again quote from the Report.

"Therefore, on the basis of its analysis, the Task Force makes the following recommendations:

1. That the Academy communicate to the Membership the level and areas of restriction of classification already prevailing, and that the principles of classification and insurance are being challenged.

2. That the Academy establish a Task Force group to determine the financial and actuarial implications and consequences of restricting the classification process. For practical purposes the study might be limited to the more significant classifications (race, sex, physical/mental impairments, age, geographical location, etc.) and their effect on pensions, life insurance, health insurance and automobile insurance. (Illustrations of the consequences of restrictions on classification for life, health and property/casualty insurance are attached in Appendices A through D).

3. That the Academy, as a professional body and without assuming either an adversary or an advocacy position, establish a Task Force to determine the best way to communicate to legislatures, lawyers, jurists and the public at large, the consequences of any effort to limit or prohibit the classification process.

4. That the Academy establish a Task Force to initiate a study (possibly funded by the Actuarial Research Fund) of those classifications now being used, to substantiate or invalidate their credibility."

MR. COOK: There has been much legislation and regulation in recent years affecting the life insurance industry and serving to restrict the risk classification process. This is a concern to me because of the external pressures that are limiting an underwriter in the exercise of his function. At the same time, I have another concern. My other concern results from pressures originating inside the life insurance industry. These pressures are intended to protect the ability to underwrite but, in practice, they service the opposite purpose.

Let me describe a few familiar scenes for you. I am sure you have all observed these scenes before. I would like to remind you of them and I would like to present my views of what I consider to be the key elements.

Have you ever observed a group of life insurance underwriters as they discuss the increasing problems they face? It is tough enough to be charged with the responsibility of separating the select risk from the impaired risk. There is always that gnawing fear - if I approve this million dollar application today, am I going to have to defend a first year claim tomorrow? But if I don't approve the case, I will have the Agency Vice-President on my neck. The decision is not always an easy one to make.

Let us add another ingredient. The underwriter has made his decision and he has classified the risk as Substandard at Table 8. The trouble is that the characteristics of the case which influenced the underwriter in his decision-making process have just been declared out-of-bounds by the Insurance Department. The underwriters have been told they cannot rate an applicant solely because of those characteristics. The underwriters throw up their hands in despair. They cry out, "Look at what they are doing to us! Just look at what they are doing to us!"

How does this sound when it reaches the ears of the legislators and regulators? It sounds so self-serving and selfish. It is likely to antagonize members of pressure groups who are trying to push through some type of reform. I do not deny that reforms that are proposed for the control of the insurance industry do not always result in improvement. If we react to these with, "Look at what they are doing to us", it sounds as though we believe that society exists for the purpose of supporting the insurance industry. In fact, if there is any justification for the existence of the insurance industry, it is because we provide a service for society. If proposed reform impairs that service, let us make that the point of our complaint.

Let us take another look at the life insurance underwriter as he considers a thirty year old male applicant. If the applicant is 5 feet 2 inches tall, weighs 220 pounds and has a blood pressure reading of 150/100, the life underwriter is likely to classify him as a high Substandard. If the applicant also has an exophthalmic goiter, a loud rumbling diastolic heart murmur and is suffering from an inoperable malignant brain tumor, the underwriter may even decline to insure. It has been said that the objective of the underwriter is to classify the risk so that each insured will be charged a premium that is commensurate with his risk of loss. I disagree with that statement. In fact, I maintain that such an objective is both socially undesirable and actuarially unsound.

Life insurance underwriting involves decision-making in a field that is characterized by uncertainty. The source of the uncertainty may be chance

and it may be ignorance. It is the function of the underwriter, to the extent possible, to eliminate the uncertainty that results from ignorance. When an insurance applicant knows something about himself that the underwriter does not know, there is exposure to anti-selection. When that knowledge concerns something relevant to the risk of loss, the underwriter must gain a position of at least equal knowledge or there will be anti-selection.

What I am saying here is consistent with the traditional statement of the objective of underwriting. That objective was restated by Al Morton in his paper, "Individual Life Insurance Underwriting Principles and Practices - A 1976 Review". That paper was discussed in a concurrent session at the annual meeting of the Society of Actuaries in Boston last October. The statement made by Al Morton was, "Life Insurance Underwriting is the process of risk selection. Its objective is to insure that each person who buys life insurance pays a premium appropriate for his individual estimated risk." The problem lies in the interpretation of that remark by the insurance regulators and by the legislators.

I could play devil's advocate and ask, "Why is it necessary that we properly assess the risk? Why is it necessary that each applicant pay a premium appropriate for his individual estimated risk? Why not charge all applicants equally?" The trouble is that the stated objective is not an objective in itself. The objective is not to collect from each insured a premium commensurate with his risk of loss. There is nothing intrinsically wrong with charging premiums based on equality instead of equity. Equality works for social insurance and it works for group insurance. But it does not work for personal insurance. The reason it does not work is because personal insurance is optional. Whether or not to buy and how much to buy are options of the individual. I believe it is the responsibility of the professionals in the insurance industry to state loud and clear the real objective of life insurance underwriting. To classify the risk is only a means to an end. The objective is to avoid the financial chaos that would result from unrestricted anti-selection. Unless and until we get this point across to the Insurance Departments and to the state legislators, we run the risk of the destruction of insurance as we know it today.

This brings me to my third point involving a serious threat of breakdown of communications. One statement that I have heard too often from responsible people in our industry is, "Pending legislation, if enacted, will result in the destruction of the insurance industry." That sounds dramatic. If I were to make that statement, I could be told - and I have been told - all I care about is to protect my job. Who would be hurt if the insurance industry were to be destroyed? I would be hurt because my job would be gone. Many others would be hurt because their jobs would disappear. I could survive, however, because I would devote my efforts to some other line of work. Others in the industry would likewise look elsewhere. But this does not mean that there would be no permanent damage if private insurance were to disappear.

The legislators write the laws by which we are governed. The law may seem unfair but that does not make it unconstitutional. Legislation may require that impaired risks be insured without any increase in premium. We could complain about this and about what it would do to the cost of insurance. We can even say that it will be the destruction of our industry. But this fails to get the important message through. We must put it in terms that the legislators will listen to. Their first concern is not about our industry. It is the private citizen, the voter, who is their first concern. Those of us in

the insurance industry who would speak about the impact of unreasonable demands must point to the ultimate result and the ultimate victim. The message we must convey is that destruction of equitable insurance will deprive the citizen of his right to elect his own insurance program to meet his individual needs.

I have another concern involving a breakdown of communications. Protection of the right of privacy has brought with it a vast array of proposed legislation. Some of this legislation would impose requirements that are staggering to think of and prohibitively expensive. The recordkeeping that could be required is almost beyond imagination. A common reaction is to point to the millions of dollars that it would cost the insurance industry to comply with these requirements.

Let us look at those millions of dollars carefully. They represent an element of expense. There are all kinds of expenses. In my own company, last year, the sum of our insurance expenses and taxes, exclusive of Federal Income Tax, amounted to more than $1.1 billion. What are the three principal factors affecting the cost of life insurance? A three-factor dividend formula takes account of each one separately. In such a dividend system there is one portion of the dividend attributable to interest. Another portion reflects mortality and a third portion of the dividend is a contribution, positive or negative, from expense margin. The excess of the charge made in the annual premium to cover expenses of operation over the actual expenses incurred is available for distribution as divisible surplus in the form of a dividend.

Any expense that is incurred in the administration of the business is ultimately borne by the policyholder. Accordingly, any increase in cost of operation is an increase in cost to the insurance buyer. Such a recognition will not necessarily deter the consumerists or the pressure groups. It would bring to their attention, however, that the net result of their efforts can be a cost increase to the public. It is for this reason that I strongly advocate a careful restraint in our language. Let us never say that a requirement will cost the insurance industry so many millions of dollars. Instead, let us tell the full story that it will increase the cost of insurance for the consumer.

I have still another concern, when I listen to actuaries discussing the pricing function in relation to risk classification. There are many decisions to be made where there is more than one reasonable choice. Should broad underwriting classes be used or narrow ones, high non-medical limits or low limits? When is it appropriate to order an EKG or an X-Ray? Should we issue without an attending physician's statement? Should we order an inspection report? I would be the last man to say there is only one right set of answers and that all other answers are wrong.

What bothers me, though, is to hear the pros and cons of various risk classification proposals. Is it right to charge equal premiums for males and females or should the rating structure provide for different rates? Maybe it would be equitable for the company to do it one way but that might be inequitable for the policyholder. When I hear this said, I try to find out what the speaker means by equity. I do not understand how equity can be a function of which end of the barrel you are looking down. It bothers me to think that you can set an equitable price that I have to pay but the price is inequitable to me. I submit that equity is not so contradictory.

I do not claim that equity is unique. Many considerations have more than one equitable resolution. But what is clearly inequitable for one party must also be inequitable to the other. At the same time, I do not claim to have an iron-clad definition of equity. However, I do suggest that equity be considered as the avoidance of an opportunity for anti-selection. Any opportunity for members of a minority group to exercise a discriminatory and selfish selection, at the expense of the majority, in the setting of contract terms, constitutes an inequity.

I have one last point to bring out this afternoon. This last point is a reflection of my own interpretation of the actuarial aspects of risk classification. Let us go back in history a little less than two years.

Late in 1976 the American Academy of Actuaries established a Task Force charged with considering the unisex situation. The Task Force was to report back to the Board of Governors what posture the Academy should take with regard to this question. In the course of its deliberations, the Task Force expanded its charge to include restrictions on classifications spreading to all classes: race, sex, physically handicapped, age, geographic location, etc. Last summer the Task Force filed its report and that report contains four recommendations. I think it is significant that the first recommendation was to communicate to the Academy members the existing situation.

I attended an Actuarial meeting in New York last fall where one session was devoted to consideration of the report of that Task Force. Much to my disappointment, the four recommendations, included in the report of the Task Force, were ignored in the discussion. The nature of many of the comments that were made is a perfect illustration of the lack of comprehension on the part of the general membership of the Society of Actuaries and of the Academy of the importance and the magnitude of the problem that faces us.

The average actuary does not appreciate that there exists in this country today a galloping theory of entitlement. This theory says, "I need something and, therefore, I am entitled to it. Since I am entitled to it, you are obligated to give it to me." This theory is espoused by members of groups exerting pressure on the legislative and regulatory bodies. These groups comprise people with a common characteristic which may be a genetic or an hereditary impairment, a physical disability, or a mental or an emotional disturbance. It may be the characteristic of marital status, of sex, or of sexual preference. It may be a hazardous avocation or a non-conformist life style. Most individual groups are small. But the onslaught of additional groups is overwhelming. For the industry to face up to individual pressures, as they approach us from individual states, would be attempting to sweep back the tide with a broom. Carried to the extreme, the pressure of these groups, operating against risk classification procedures will result in the breakdown of the economic security of the insurance product. We will have a substitution of equality in place of equity. As an aftermath of this, there will be a demand to remove private administration from the insurance function. This will be the end of insurance as we know it today.

The existence of this threat is not recognized by enough of those who should be most expert in appreciating its consequences, namely, those who are responsible for the pricing and the financial security of the product. It is for this reason I heartily endorse recommendation number one of the American Academy of Actuaries Task Force and that is for the Academy to communicate to its membership the level and areas of restriction of classification already prevailing and that the principles of classification and insurance are being challenged.

Here I have stated six of my pet peeves. I have given my views after criticizing what I find to be the common expression. To a great extent, I consider mine to be a voice crying in the wilderness to bring to the attention of others something that should be obvious but is too often overlooked. In closing, let me identify my pet peeves once more.

1. Don't say, "Look at what they are doing to us."

2. Do say that life insurance underwriting is necessary to avoid the financial chaos that would result from unrestricted anti-selection.

3. Don't say, "You are destroying our industry."

4. Do say that expensive restrictions will increase the cost of insurance for the consumer.

5. Don't say that equity is a one-way street.

6. Do keep alert to the limitations that are being imposed on the risk classification process. Discrimination is not a dirty word. Whether you like it or not, we are in the business of discrimination. Without it, there would be no life insurance business and that would deprive the citizen of his right to elect his own insurance program to meet his individual needs.

MR. RANDALL: I will begin by reporting briefly on a three-day "Consultation on Discrimination Against Minorities and Women in Pensions and Health, Life, and Disability Insurance" which was held by the United States Civil Rights Commission April 24-26 in Washington, D. C. The purpose was to provide background to the Commission for a more intensive study and report the Commission plans to make on this subject. There were nine papers presented and six or seven of them dealt largely with the same questions actuaries and the insurance industry are now discussing as "Risk Classification." I presented a paper on "Risk Classification and Actuarial Tables" which attempted to describe in layman's language the underwriting and rate-setting processes as dynamic processes aimed at maintaining individual equities. Each paper was discussed by three reviewers and then the presentor and the discussants were questioned by the five Commissioners and the Staff Director. Most of the participants were from government agencies, universities and research foundations, and consumer groups. The opening paper was presented by Dr. Herbert Denenberg, former Insurance Commissioner of Pennsylvania, and the final paper, titled "The Response of the Insurance Industry", by Richard Minck, Chief Actuary of the American Council of Life Insurance. Two other actuaries participated, Presidents-Elect of the Society of Actuaries and the American Academy of Actuaries, Paul Barnhart and Dale Gustafson. The discussion dealt largely with sex discrimination.

Of course, the key point I would like to make here was the great contrast in attitude between that consultation and the Academy Risk Classification Report. The prevailing attitude there was that extensive unfair discrimination exists and that government action is needed to correct it. The Risk Classification attitude is that extensive unwise governmental intervention exists, or is threatened, and that industry and professional action is needed to prevent and arrest it, and there is little or nothing wrong with the risk classification process.

Where does the truth lie? The rest of my discussion attempts not to answer this question definitively, but to throw some added light on certain aspects.

First, I will present my specific criticisms of the Risk Classification Report. My strongest criticism had to do with the paragraphs on race, especially those on page 17 and 18. The report states "the proportion of our total population that is non-white is so small (10%) that the impact has been minimal." According to the U. S. census reports, the proportion is 13%. The report says further that "Companies with predominately white markets have tended to avoid non-white markets." My company, The Equitable Life, is vigorously pursuing the non-white market, and so are many other major companies. Actually, I do not know any that are not, though there may be some. Finally, the report says that companies with traditionally black markets have been restricted to such markets as a consequence of the legislation prohibiting racial discrimination. The clear implication is that such companies want to introduce racial distinctions into their rate structure. When I asked Barbara Lautzenheiser where she got this information, she said an executive of a black-owned insurance company had made such a statement to her at some governmental hearing; however, she did not remember his name. I have written to the presidents of three leading black insurers, Bill Kennedy of North Carolina Mutual, Jesse Hill of Atlanta Life, and Ivan Houston of Golden State Mutual, and all three strongly support my views. I have asked that the Academy issue an amending statement. After several negative responses, it appears now that something may be done. The last letter I have from President-Elect Dale Gustafson says in part:

> "I am impressed that if you, Jesse Hill, Bill Kennedy and Ivan Houston are all in agreement that the Academy statement on risk classification is seriously in error, then it must be seriously in error.
>
> "I know it must be frustrating to you. So far, all you have been getting is arguments from me and conversation from others. You will see more concrete steps in the immediate future."

There is a broader comment which can be stated in several ways. In my paper to the U. S. Civil Rights Commission, I attempted to do this by answering these questions:

1. Has the life insurance industry's pricing system produced fair and equitable results? Can it continue to do so?

   Yes. Though there have been past inequities, the system as it has evolved has removed most of those practices and has the flexibility to maintain and improve equity for the future.

2. More specifically, are pricing differences based on sex fair and equitable?

   Yes, because there are substantial and statistically valid differences in mortality and morbidity rates and the best evidence to date is that such differences reflect inherent biological factors which can only be recognized thru explicit pricing by sex.

3. To what extent are oversight and regulation by and for the public desirable?

> The aim should be informed, restrained, and responsible government oversight, leaving with the insurance industry the maximum flexibility feasible in the risk classification process. The general principle of fair and equitable treatment for all should be public policy. On the other hand, specific directives or restrictions by government should be limited to demonstrably unfair practices which are not being corrected by the industry.

Some past practices may be viewed as inequities by some and sound business practices by others. With respect to race, some of the practices included:

1. Lower commission rates were paid on policies issued to blacks. The Equitable for a while paid 5% instead of 50% while, according to the history by Marquis James, the Metropolitan paid no commissions.

2. Some companies, including the Prudential and Northwestern Mutual, refused for a period of years to issue policies to blacks.

3. For industrial life insurance, 2/3 of the benefit payable to whites was paid to blacks, or alternatively, all blacks were automatically classified substandard. In 1935, the New York Insurance Law prohibiting racial distinctions in rates was amended to prohibit distinctions in commissions to agents. Yet some companies continued for quite a few years practices which clearly seemed in violation.

4. Metropolitan and Prudential in more recent years have discontinued sale of industrial and have removed racial distinctions on existing policies by retroactively "equalizing" the benefits payable. However, according to a statement made by Deputy Commissioner Eleanor Lewis of New Jersey at the U. S. Civil Rights Commission hearing, industrial insurance as now sold represents a rip-off of lower-income workers.

With respect to sex, the New York Insurance Department in 1974-75 conducted hearings examining the propriety of underwriting and marketing distinctions based on sex. As a result, the Department issued Regulation 75 prohibiting such distinctions. Later on the Department conducted a study on cost differentials by sex for disability income insurance and amended Regulation 62 to permit rate differentials by sex only within limits based on the study. The report of the hearing stated:

> "The hearing record clearly demonstrates that insurance companies have engaged in underwriting practices that make numerous distinctions based on the sex of the applicant or policyholder. Examples of the more common distinctions that were found to exist are as follows:
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> -- offering insurance policies with waiting period to females while at the same time offering policies to males that either contain shorter waiting periods or no waiting period;
>
> -- offering males higher benefit levels than are offered to females;

-- offering policies to males with a definition of disability that is more favorable than the disability definition set forth in the policies that are offered to females;

-- offering coverage to males in certain occupations while denying coverage or offering more limited coverage to females in the same occupation categories;

-- offering coverage to males gainfully employed at home while denying or offering reduced coverage to females similarly employed;

-- affording males a more favorable issue age than is offered to female applicants;

-- requiring female applicants to submit to a medical examination while not requiring males to submit to such an examination;

-- denying females many of the insurance options that are available to males; and

-- denying females waiver of premium provisions that are available to males or offering such provisions to females only for policy limits that are lower than available to males.

More often than not, such underwriting distinctions emanate from unjustified subjective views of the role of women in our society."

I also have a brief comment to make with respect to the validity of mortality differentials by race and sex. There seem to be generally held opinions that the differentials by race which have been observed are largely attributable to socio-economic factors, while the sex differentials are largely attributable to biological factors. What evidence supports these views? I would like to report here some results obtained by one of my Equitable actuarial associates, Irwin Vanderhoof, in connection with other work he and Aaron Tenenbein are doing on theories of mortality. Research done by Strehler and Mildvan* in the early 1960's indicates that Gompertz' law can be derived by considering mortality as the result of a combination of risks in the environment and gradual loss of vitality during life and further that Gompertz' law fits almost all demographic data for all countries between the age of 35 and 80. Their theory shows further that one Gompertz constant depends largely on environmental factors while the other depends largely on inherent aging factors. Vanderhoof has fitted Gompertz's law to the four sections of the 1969-71 U. S. Life Tables, white males, non-white males, white females, non-white females. His results show that the racial tables differ largely in the environmental constant while the sex tables differ largely in the aging constant.

MR. TIMPE: The Privacy Study will probably result in regulations for the insurance industry which will cause some administrative difficulty and may

*General Theory of Mortality and Aging. Strehler and Mildvan Vol. 132, Science Magazine, 1960.

even result in a reduction of the underwriting information which is gathered. This could result in less precise classification of risks, with only a partial tradeoff of reduced underwriting cost. However, we will learn to live with the additional privacy regulations. I expect the regulations will be reasonable and they will not result in alteration of the basic underwriting principles. My overview of the privacy matter is not intended to discount the vigor which must be shown by the industry in working on these matters. We must depend on some individuals, companies and associations working diligently for the best mutual results of the purchaser of insurance and the insurance companies. Also, we need to recognize that the time to solve the problems will be lengthy and debates will be heated.

Our greatest concern would seem to be the possibility of the various states adopting dissimilar, inconsistent or conflicting privacy regulations. Additionally, we must be concerned about progressing to any type of privacy situation whereby the insurance industry's ability to gather medical history information or current medical findings is limited. For example, it would be very dangerous if we are progressing toward a situation where we can seek attending physician information only with respect to admitted medical history and the potential insured can protect other information.

The limitations being considered on the risk classification process should be of much greater concern to the industry than the privacy matters. Basic principles of the risk classification process could be altered and these are vital to the operation of a private insurance system. The limitations on the risk classifications process are developed at the state level where the environment for passing regulations is often characterized by the following:

1. Election of officials to office as "activists" or as champions of causes,

2. Effective special interest influences,

3. Inability to study thoroughly and understand consequences of regulation and legislation,

4. Desires for consumer freedom and protection with the resulting burdens placed on the business community.

Some of the impetus to regulate risk classification and other areas of the insurance industry could be alleviated if there were better understanding of how the insurance industry operates. Legislators and regulators should be made more aware of the competitive nature of our business. Companies strive to insure as many lives as possible and there is pressure for low cost insurance to the standard risk. There is also pressure to favorably classify substandard risks so the field force can place the business and not be undersold by another company with a lower substandard rating.

Additionally, it must be recognized that the underwriting process requires judgement. There are combinations of impairments, new types of impairments and rare impairments that the professional underwriter and medical doctor must underwrite and classify based upon their expectations of mortality results because suitable statistics are not available. We should be encouraged to insure risks on which statistical information is not available, recognizing that the competitive nature of the business will result in a broad acceptance of risks and a reasonable classification of risks.

To the extent that legislators and regulators desire evidence of suitable risk classification, we should conduct mortality and morbidity studies on a broad range of impaired lives. These mortality studies need not be refined to the extent desirable for underwriting and product pricing nor be on insured lives, but merely must be evidence of the general level of mortality experienced by impaired lives. If such mortality and morbidity information were available at the time limitations on risk classifications were being considered, it would obviate the need for legislation and regulation and ease the burdens on the risk classification process.

Thus, we can stress the competitive nature of the insurance business, we can inform others that risk classification involves an appraisal of facts and then a judgement; and we can perform mortality and morbidity studies on impaired lives in an effort to protect basic principles of the risk classification process.

MR. DANIEL F. CASE: It seems to be important, in our dealings with regulators and the public, to be able to produce data. We are less likely to have imposed on us an out-and-out prohibition of adverse underwriting action on the basis of a specified type of impairment if we can show some data indicating that that impairment is associated with substandard mortality. I think that the National Association of Insurance Commissioners project on discrimination against the blind is reaching a reasonable result at least in part because of data on blind insured lives that were furnished by two individual companies. I would like to urge that any companies that have data on particular impairments share them with the trade associations. Of course, we are interested in data which show no extra mortality as well as in data which do show it.