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Equitable Discrimination and Long-Term Care Insurance

by Bruce A. Stahl

The speedometer on my 12-year-old Beemer has not worked regularly for a couple of years. Sometimes it works fine, and sometimes it swings from 0 to 120 mph and back within half of a second, and may lock at either 0 or 120. Two dealerships could not repeat the problem in the shop, and it would have been costly in terms of time and money just to have the problem identified. While I do not always have the benefit of a speedometer, I can still drive safely. Rather than spend a large sum of time and money, I drive with the flow of traffic.

Often actuaries do not always have a speedometer to help them with risk classifications. In order to classify risk characteristics safely, actuaries can follow the flow of traffic by following Actuarial Standard of Practice (ASOP) #12, Risk Classification.

The first paragraph of ASOP #12 provides the ASOP's purpose. "This actuarial standard of practice (ASOP) provides boundaries to actuaries when performing professional services with respect to designing, reviewing, or changing risk classification systems." Pricing or certifying rates may involve all three, "designing, reviewing, or changing risk classification systems." Yet, in my opinion, pricing or certifying rates *requires* one—reviewing the systems. My opinion is based upon language in the Scope of ASOP #12. "Risk classification can affect and be affected by many actuarial activities, such as the setting of rates. …" and "This standard also applies to actuaries when performing such activities to the extent that such activities directly or indirectly are likely to have a material effect, in the actuary's professional judgment, on the intended purpose or expected outcome of the risk classification system."

Section 3.2.1 of ASOP #12 helps us understand how rate classifications may be reviewed. "Rates within a risk classification system would be considered equitable if differences in rates reflect material differences in expected cost for risk characteristics."

In an environment where the actuary knows all of the relationships within or among a multitude of risk characteristics, it may be possible to price with every possible risk characteristic in mind. Yet the pricing or certifying actuary generally finds that such an environment is merely a future hope, and not yet a present reality.

The Rate Classification ASOP, #12, again recognizes that the actuary does not always have a speedometer, and provides further guidance to the actuary. Four relevant examples:

1. *"Objectivity.* The actuary should select risk characteristics that are capable of being objectively determined."
2. *"Practicality.* The actuary's selection of a risk characteristic should reflect tradeoffs between practical and other relevant considerations." Such considerations may include "the cost, time, and effort needed to evaluate the risk characteristic."
3. *"Industry Practices.* When selecting risk characteristics, the actuary should consider usual and customary risk classification practices for the type of … system under consideration."
4. *"Business Practices.* When selecting risk characteristics, the actuary should consider limitations created by business practices related to the … system."

When the pricing or certifying actuary heeds the standard of practice, it keeps him from exceeding the speed limit. For example, the actuary may consider whether a married applicant, applying without the spouse, should be classified the same for setting premium rates as a married applicant applying with his spouse. For long-term care insurance, an actuary may have followed any of the four items above in deciding against doing so. Objectively, the impact from the presence of a spouse in insured experience is often only known when both apply and are issued coverage. Practically, it is costly and difficult to underwrite a spouse who does not apply for coverage. And for many years, industry and

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business practices have been contrary to classifying business based merely upon being married, and to do so would require that an actuary alter the system rather than classify risk characteristics according to the existing system.

ASOP #12 also provides actuarial considerations when establishing risk classes. They include Adverse Selection and Credibility. Using the same example of the married applicant applying without the spouse, the *credible* insured experience has generally been from married individuals who applied together, relative to single individuals and to married individuals who did not apply with their spouse (think objectivity again). The historical data has generally not been identified otherwise (think business practices again.) Furthermore, actuaries have generally not believed the industry practice of granting discounts to spouses to be antiselective. To the contrary, granting a discount to spouses separately may encourage adverse selection.

However, if charging a different premium rate is contrary to statute or regulation, the Actuarial Standards of Practice is not the actuary's standard. Rather, the statute or regulation is.

Similarly, members of a particular association or individuals who are list-billed may actually be part of a different morbidity risk classification, simply because the members of the association, or individuals associated enough to be list-billed, may have characteristics that make them less costly risks. For example, they may tend to have social activities of some kind, and perhaps this implies a way of life that makes the participants less apt to need or seek benefits.

Yet, even if there were no difference in the morbidity risk in association discounting, there is certainly a demonstrable difference in the cost of distributing or administering the business. The objectivity of the category is clear from an expense standpoint. ASOP #12 says, "Rates within a risk classification system would be considered equitable if differences in rates reflect material differences in expected cost for risk characteristics." It defines Risk Classification System as, "A system used to assign risks to groups based upon the expected cost or benefit of the coverage or services provided." Smaller distribution expenses contribute to a different expected cost.

However, if charging a different premium rate is contrary to statute or regulation, the Actuarial Standards of Practice is not the actuary's standard. Rather, the statute or regulation is.

Pricing or rate-certifying actuaries should be familiar with the NAIC model act on Unfair Trade Practices. This model act defines unfair trade practices as consciously disregarding or frequently "making or permitting any unfair discrimination between individuals of the same class and of essentially the same hazard in the amount of premium, policy fees or rates charged for any accident or health insurance policy or in the benefits payable thereunder, or in any of the terms or conditions of such policy, or in any other manner."

The definition refers to "unfair discrimination between individuals of the same class and of essentially the same hazard." If the definition referred only to the latter, individuals of essentially the same hazard, an insurer might not legally charge different premium rates for policies which provide the same benefits. Yet the definition did not isolate the hazard, but specifically included the notion of the "same class." In so doing, the regulation refers us back to the concept of risk classifications, and the actuaries to their standard of practice, ASOP #12.

The model act on Unfair Trade Practices appears to have been designed with the confidence that actuaries will be able to drive the pricing and rate certification processes without a speedometer, without being able to precisely measure all the risks. In other words, the model act seems to anticipate that actuaries will heed ASOP #12. Therefore, the act seems to maintain ASOP #12 as the standard. Those who satisfy the principles of credibility, avoidance of adverse selection, objectivity, and practicality, all within the limitations of business and industry practices, should be driving below the maximum speed, setting risk classifications within the boundaries of the state regulations and laws. ■