STATE OF CONNECTICUT

INSURANCE DEPARTMENT

Bulletin PC-81
December 4, 2015

To: All Companies Licensed To Write Property and Casualty Insurance
Re: Price Optimization

While there is no universally accepted definition of price optimization, the practice, in some of its applications, involves the use of factors not specifically related to an insured's expected losses and expenses but are used to help determine or to adjust an insured's premium. An example would be using an individual policyholder's response to previous premium increases to determine how much of a premium increase the policyholder will tolerate at renewal before switching to a different insurer. This practice can result in two policyholders receiving different premium increases even though they have the same loss history and risk profile. It can also result in premiums that are excessive or inadequate.

This Bulletin is intended to remind insurers that their rates and rating methodologies must comply with several important provisions of Connecticut law:

- Under Conn. Gen. Stat. section 38a-686(a), 38a-686(b) and accompanying regulations, rates shall not be excessive (in a non-competitive market), inadequate or unfairly discriminatory. Insurers, in making rates, are to give consideration to past and prospective loss experience, fire and catastrophe hazards, reasonable margins for underwriting profit and contingencies, to past and prospective expenses, investment income earned or realized and to all other factors, including judgment factors, deemed relevant within and outside this state.

- Under Conn. Gen. Stat. section 38a-686(b), risks may be grouped by classifications for the establishment of rates and minimum premiums and such rates may be modified to produce rates for individual risks in accordance with rating plans that provide for recognition of variations in hazards or expense provisions or both.

- Under Conn. Gen. Stat. section 38a-686(b), rating plans shall establish actuarially sound eligibility criteria and rating principles for determining significant risks that are to qualify under the plan. Rating plans that treat individuals having similar risk characteristics equally are deemed to produce rates that are not unfairly discriminatory.

- Under Conn. Gen. Stat. section 38a-688, insurers are required to file all rates and supplementary rate information to be used in this state as set forth in that section.

The personal risk insurance rating practices under chapter 701 of the Connecticut General Statutes and implementing regulations evidence a clear purpose and intent that insurers classify risks according to cost-based considerations; rating plans are to be grounded in insurance loss and expense and insurers are required to disclose those considerations fully in their rate filings. The Department would view the failure of an insurer to fully comply with such rating statutes as a violation of Connecticut laws for which appropriate enforcement action will be taken[1].

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[1] The Commissioner does not intend this Bulletin to prohibit or restrict the mass marketing of insurance property and casualty insurance in compliance with chapter 703 of the Connecticut General Statutes (Conn. Gen. Stat. section 38a-802 *et seq.*) or to prohibit non-fictitious groupings as described in Conn. Gen. Stat. section 38a-827.

Connecticut rating laws and unfair trade practice statutes when taken as a whole require insurers to group individual policyholders into credible and actuarially sound risk-based classifications and treat similarly situated policyholders equally with respect to insurance pricing. Rating plans in which insureds are grouped into homogeneous rating classes should not be so granular that resulting rating classes have little actuarial or statistical reliability. Likewise, the use of sophisticated data analysis to develop finely tuned methodologies with a multiplicity of possible rating cells is not, in and of itself, necessarily a violation of Connecticut's rating laws *as long as the rating classifications and rating factors are cost-based.* [2]

Therefore, insurance rating practices that adjust premiums, whether included or not included in the insurer's rating plan, are not allowed when the practice cannot be shown to be cost-based. To the extent practices are not cost-based, the following practices, at a minimum, are considered by the Department to be inconsistent with statutory requirements that "rates shall not be ... unfairly discriminatory" and as such are prohibited:

a. Price elasticity of demand[3] on an individual level;
b. Propensity to shop for insurance;
c. Retention adjustment at an individual level; and
d. A policyholder's propensity to ask questions or file complaints.

Any insurer that uses price optimization methodologies to rate personal lines policies delivered or issued for delivery in Connecticut will need to submit revised filings that remove such factors within sixty (60) days after the date of this Bulletin. Insurers must also disclose on the System for Electronic Rate and Form Filing ("SERFF") General Information page whether the company uses non-risk-related factors such as price optimization or elasticity of demand to help determine personal insurance premiums. Insurers with currently pending rate filings will need to amend them to disclose this information. Insurers that fail to do so and are later determined to have used price optimization or elasticity of demand or failed to disclose such use to the Commissioner may be subject to disciplinary action.

If you have questions concerning this Bulletin, please contact George B. Bradner, Property Casualty Division Director at george.bradner@ct.gov or **(860) 297-3866**.

Katharine L. Wade

Katharine L. Wade
Insurance Commissioner

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[2] A "cost-based" rate is an estimate of all future costs associated with an individual risk transfer and is developed from and consistent with the expected claims, claim handling expense, underwriting expenses, policy acquisition expense, a reasonable profit, investment income and other risk transfer costs.

[3] Price elasticity of demand shows the relationship between price and quantity demanded and provides a calculation of the effect of a change in price on quantity demanded. *See generally* http://www.economicsonline.co.uk/Competitive_markets/Price_elasticity_of_demand.html and http://www.investopedia.com/terms/d/demand-elasticity.asp for a discussion of this topic.