11.   (2 points)

The fourth principle of Property and Casualty Insurance Ratemaking states:

> A rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it
> is an actuarially sound estimate of the expected value of all future costs associated
> with an individual risk transfer.

a.   (1 point)

Defend the assertion that experience rating supports the principle that a rate
should not be unfairly discriminatory.

b.   (1 point)

Suppose the industry experience rating plan assigns too much credibility to
individual experience for large insureds and assigns too little credibility to
individual experience for small insureds. Argue that in a competitive insurance
market, rates will not be unfairly discriminatory.

Question 11:

Model Solution 1

Part a
The main goal of experience rating is individual risk equity. Experience rating recognizes that each risk has a different loss potential, so by modifying rate appropriately, the expected profit potential for each risk can be made equal. This ensures that equity is achieved and rates are not unfairly discriminatory. Otherwise, risks with lower loss potential within the class would subsidize other higher loss potential risks.

Part b
Large risks with credit mods will have worse experience than expected. Similarly, small risks with credit will have better experience that expected. Forces of supply and demand in competitive market will push rates down for large debit and small credit risks. All risks now pay rates commensurate for their exposure to loss so rates are not unfairly discriminatory.

Examiner's Comments:
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Part a
Responses that defined experience rating rather than explaining how experience rating is not unfairly discriminatory did not receive credit. As an example, mentioning that experience rating uses historical losses did not receive credit but those who explained those historical losses are predictive of future loss potential did.

Pat b
Responses that explained what a competitive market is did not receive credit but those that explained how insureds would react in a competitive market did. Stating that adverse selection would result did not receive credit as it misses how insureds would compete for preferred business. Candidates were also expected to mention how large and small insureds would perform given the incorrect credibility.
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