

Providing Services Across
Financial Services Sectors[Insurance](#) | [Pensions](#) | [Hearings & Decisions](#) | [Licensing & Registration](#) | [Who We Regulate](#) | [About FSCO](#) | [Publications](#)[Home](#) > [Publications](#) > [Bulletins](#) > [Property and Casualty - Auto Bulletins](#) > Automobile Insurance Underwriting Rules and

Risk Classification Variables

Text size: [Property and Casualty -
Auto Bulletins](#)[Pension Bulletins](#)[Monitoring and
Enforcement Bulletins](#)[Licensing Changes
Bulletins](#)[Bulletins by Sector](#)

Bulletin

No. A-1/01

Property & Casualty

- Auto

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Automobile Insurance Underwriting Rules and Risk Classification Variables

To the attention of all insurance companies licensed**to transact automobile insurance in Ontario**

The Financial Services Commission of Ontario (FSCO) has received enquiries from insurers about using various underwriting grounds and risk classification variables. There has been considerable interest in the use of underwriting rules and rating variables which are based on the financial circumstances of the insured. FSCO does not approve of the use of underwriting rules or risk classification variables which are directly or indirectly related to social and/or economic status.

The purpose of this bulletin is to clarify the factors which are taken into consideration by FSCO in determining the acceptability of underwriting rules and risk classification variables.

BACKGROUND

In 1997, an application was received for a proposed risk classification system which included rating on the basis of the following "lifestyle" variables:

- credit card possession;
- credit history;
- bankruptcy status;
- residence stability;
- employment stability;
- employment status.

These factors were new to the province of Ontario and were considered unacceptable. The application was not approved and a hearing was called. The hearing did not proceed as the insurance company involved elected to withdraw the application.

FSCO continues to receive enquiries about the use of these and other related variables which are not acceptable.

UNDERWRITING RULES

Legislative requirements

The *Insurance Act* requires that insurers file with the Superintendent of Financial Services (Superintendent) the underwriting rules they intend to use to decline to issue, terminate or refuse to renew a contract or provide coverage. Insurers are prohibited from using underwriting rules which in the opinion of the Superintendent are subjective, arbitrary, bear little or no relationship to the potential risk to be assumed by the insurer, or are contrary to public policy. Section 5 of *Regulation 664* also specifically lists some unacceptable underwriting grounds.

Statutory standards

Subjective and Arbitrary

Both of these concepts imply an element of individual perception and interpretation rather than concrete, externally verifiable procedures. As much as possible, the grounds must be clear, fixed rules and not subject to interpretation. Underwriting rules must not be discretionary and must not be based on an unreasonable premise. *Little or no relationship to the risk to be borne by the insurer in respect of an insured*

The rules must bear relationship to the risk. There must be direct linkages between the decision to accept or decline the risk or coverage, and the potential for a claim.

Contrary to public policy

Consideration must be given to grounds which would not be in the interest of the public as a whole, even though there might be statistical support showing a correlation to losses.

Any grounds which transgress the *Human Rights Code* and the *Canadian Charter of Rights and Freedoms* such as those based on religion, race, nationality or ethnicity are unacceptable. Other factors contrary to public policy were listed in the Technical Notes issued to the industry in 1997. These include declining insurance on the basis of:

- age, sex or marital status of the individuals to be insured under the policy;
- newly licensed drivers, where this is the sole factor for the declination;
- drivers who are "new" to Canada;
- lapse in coverage;
- principal location of the insured automobile unless such a decision is for a business purpose and is not a pretext for unfair discrimination;
- the person to be insured under the policy has been convicted of an event unrelated to driving an automobile or automobile insurance;
- vehicles with United States exposure;
- withdrawal from a segment of the marketplace that could result in market disruption (e.g. declining non-group business).

In addition, section 5 of *Regulation 664* sets out a number of prohibited underwriting factors such as those based on occupation, profession or employment status, level of income and the existence of physical or mental disability. None of these factors or surrogates for them is considered acceptable.

RISK CLASSIFICATION SYSTEMS

Legislative requirements

The statutory standards under the *Insurance Act* require that risk classification systems be just and reasonable, reasonably predictive of risk and distinguish fairly between risks. An insurer's rates must be just and reasonable, and

neither excessive in relation to the financial circumstances of the insurer nor impair the solvency of the insurer.

In addition, the Superintendent cannot approve an application for automobile insurance rates or risk classification systems if the Superintendent considers that it would be in the public interest for the Financial Services Tribunal to hold a hearing on the application.

Statutory standards

Reasonably predictive of risk and distinguish fairly between risks

Both of these statutory standards are based on actuarial concepts. An actuarially sound risk classification system should:

- reflect expected cost differences;
- be applied objectively and consistently;
- be practical;
- be cost-effective;
- be responsive to change; and
- minimize anti-selection.

Just and reasonable

Apart from the actuarial soundness of a risk classification system, the statutory standards require that the system be "just and reasonable." The application of this standard involves discretionary authority on the part of the Superintendent, to consider factors other than actuarial soundness, such as societal fairness. Therefore, a factor that is statistically valid may not necessarily be just and reasonable.

In determining whether the elements of a risk classification system are just and reasonable, one or more of the following indicators may be assessed:

- Are the risk classification variables directly linked to driving behaviour?
- Are the risk classification variables linked to automobile insurance-related fraud?
- Are the risk classification variables under the control of the individual?

- Do the risk classification variables encourage better driving?
- Will insurance consumers intuitively connect the risk classification criteria with their classification and/or rates?
- Is one or more of the risk classification variables a surrogate for some other unacceptable rating factor?

Risk classification systems that include criteria which assess social and/or economic status are not just and reasonable. FSCO would not be prepared to approve an application which includes any of the previously listed "lifestyle" variables or similar variables. In fact, the Ontario Human Rights Commission indicated that those "lifestyle" variables could contravene Part 1 of the *Ontario Human Rights Code*.

Hearings in the public interest

Even if the other components of the statutory standard are met, a hearing may be held when it is in the interest of the public to do so. Public interest issues include possible effects on the following:

- the availability of insurance to consumers and impacts on the service provided;
- the cost of insurance to consumers;
- the availability of information to consumers;
- the ability of consumers to assess and choose insurers;
- market stability and competition within the industry;
- insurer and intermediary operations and performance;
- insurer-intermediary relationships;
- insurers', intermediaries' and consumers' disclosure of information requirements.

In some cases, the ultimate impact on the market may be more fully explored through the hearing process. A hearing provides the opportunity to receive input from a variety of interested stakeholders on proposed risk classification variables. Where proposed variables are a dramatic departure from current industry practice, there are likely to be several, sometimes opposing, views from insurance industry stakeholders. It is appropriate to consider these viewpoints before unique risk classification criteria are approved.

A hearing also assists in testing some of the underlying assumptions and ensuring that the information is complete and reliable, and that the conclusions reached are valid.

INFORMATION COLLECTION

As part of the review of underwriting rules and risk classification plans, FSCO may also consider the source and type of information that is collected by insurers. There may be privacy concerns with the collection and use of information not strictly required for underwriting or risk classification. Insurers are expected to confirm that any personal information collected, especially financial information, is obtained for legitimate purposes and adequately protected.

In addition, the maintenance of data and the quality of data, especially where an alternative source of collection is relied upon, may also require scrutiny. In the past, there have been concerns raised about the reliability and subsequent use of such information.

CONTACT

Should you have any inquiries regarding this bulletin, please contact your rate analyst in the Automobile Insurance Analysis Division at FSCO.

Dina Palozzi

Chief Executive Officer and

Superintendent of Financial Services

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Page: 621 Find page:



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