



AMERICAN ACADEMY *of* ACTUARIES

**Banking and Financial Services Committee
U.S. House of Representatives**

**Hearing on
Homeowners' Insurance Regulation**

**Testimony Presented
By**

**Paul O'Connell, FCAS, MAAA
Chairperson, Catastrophe Working Group
American Academy of Actuaries**

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The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, regulators and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance

The American Academy of Actuaries appreciates the opportunity to provide comments to the House Banking Committee on the prospect of federal reinsurance for homeowners' insurance coverage in catastrophe-prone areas. The Academy hopes that you find these comments helpful as you review H.R. 219, the Homeowners' Insurance Availability Act of 1997. The actuarial profession is uniquely qualified to examine the issues relating to insurance and reinsurance of natural disasters because of actuaries' extensive practical experience in pricing natural disaster coverage for the private marketplace.

The House Banking Committee has asked the Academy to comment on the actuarial provisions contained in H.R. 219. Specifically, this testimony discusses the need for a federal program, the attachment point for federal coverage, the determination of risk load, the federal limit of liability and eligible losses.

The Need for a Federal Program

As stated in H.R. 219, among the findings of Congress are that "the lack of sufficient insurance capacity threatens to increase the number of uninsured homeowners . . ." and ". . . while State insurance programs may be adequate to cover losses from most natural disasters, a small percentage of events are likely to exceed the financial capacity of these programs and the local insurance market." Therefore, ". . . Federal reinsurance for State disaster insurance programs will improve the effectiveness of such state initiatives and increase the likelihood that homeowners' insurance claims will be fully paid in the event of a large natural catastrophe . . ."

To summarize, the authors of H.R. 219 believe that a federal reinsurance program is needed because the private insurance marketplace does not have sufficient capacity to ensure payment of losses to residential property in the event of a truly severe natural disaster such as a major earthquake or hurricane. Although this may be currently true of the traditional insurance and reinsurance market; it should be noted that there have been attempts, (e.g., Chicago Board of Trade options, catastrophe exchanges, "Act of God" Bonds), with varying degrees of success, to move beyond the traditional market and to tap the capital markets for capacity for catastrophic perils. This notion is discussed in H.R. 219, which requests that the Secretary of the Treasury report to Congress on "... the extent of the market for resale of reinsurance contracts under this Act in the capital markets."

One of the roles of a federal reinsurance program could be to determine in advance whether there is sufficient capacity in the private markets— both insurance and capital. This will help the federal government achieve the stated desire for the program to "... not interfere in the private markets." Such determination would have to be performed annually and would have to explore all available options including newly developing and emerging products or markets. The federal government would not want to stifle the development of new derivatives or other securities that may help resolve such capacity shortages.

Attachment Point for Federal Coverage

H.R. 219 proposes to provide \$25 billion of excess coverage to state insurance programs and state reinsurance programs. Each state program has a limited ability to cover residential property losses for catastrophic perils, which is defined as the state claims paying capacity. The federal government

does not want to interfere with the private market; therefore, the attachment point needs to balance the state capacity with the private marketplace's ability and desire to provide coverage.

H.R. 219 provides for a minimum attachment point for existing state programs to be the greater of:

- (a) \$2 billion; or
- (b) the current claims paying capacity of the eligible state program, as of the date of enactment of the Act.

For new programs, those commencing on or after January 1, 1998, an additional test is included such that the minimum attachment point is the greater of (a) or (b) above or:

- (c) "an amount, determined by the Secretary in consultation with the National Commission on Catastrophe Risks and Insurance Loss Costs established under section 10 of the Act, which is sufficient to cover eligible losses in the State for all events having a likelihood of occurrence in any 12-month period that is greater than one percent."

Because a tiered test is applied, it is possible that the federal attachment point will be greater than the state's claims-paying capacity, leaving a gap or loss corridor. Such a loss corridor can have positive effects, such as providing the state with incentive to aggressively pursue private market coverage and to be vigilant on claims settlements. However, if there is no private capacity available what are the consequences? Will the state treasury have to fund the losses? Will claim payments to the insureds be prorated?

In a time of a major catastrophe, a state's resources will be severely stretched. Tax revenues will be reduced and there will be damage to infrastructure and government buildings that may be self-insured. The federal program and state funds would cover only residential property losses. However, there will also be significant commercial insurance losses. Before one can propose a formula that may lead to a loss corridor between the state and federal programs, the issue of funding for this corridor needs to be addressed.

In the federal attachment formula, a \$2 billion threshold is used as one of the tests. This threshold will either prove to be irrelevant (i.e., all states will easily satisfy the test or it will prove to be difficult for all to reach) or it will create uneven access to the federal program favoring large states and/or states with significant exposure to catastrophes. Congress should consider whether such uneven access is the intent of this legislation.

Determination of Risk Load

There are a number of considerations that need to be explored when determining an appropriate risk load. In the Act, the definition of the risk-based price seems to infer that it is intended to be simply the expected costs or expected losses. Therefore, an additional risk load will be appropriate. The magnitude of the risk load should depend upon a number of considerations.

Assuming that the risk-based price is in fact an estimate of the expected losses under the program without an additional risk load, the following need to be considered when determining the risk load:

1. Repayment by state program -- Section (7) Paragraph (6) explains the terms of repayment should a state program collect from the federal government. It infers that federal government will ultimately be fully reimbursed for coverage provided. If this is true, the only risk borne by the federal government under the program is credit risk, or the risk that the state will be unable to fully repay. Timing risk is eliminated since the state program requires repayment of interest costs.

2. Codifying a risk load -- The legislation states that the risk load shall be not less than the risk-based price. We recommend against stating a risk load or even a minimum load in the legislation. Any number stated will be used as a benchmark by the private insurance or reinsurance industry. In addition, while a minimum may be appropriate today, it is possible that over time the appropriateness of that minimum may change, and in the future that minimum load may prove to be excessive.

3. Risk load based on specific state circumstances -- A risk load needs to reflect a variety of circumstance specific variables, in addition to the repayment terms noted in item 1 above. These variables include the probability of catastrophic losses, the federal attachment point, and the concentration of exposures in a given area. Because these variables will change over time, it is essential to review the risk load on a regular basis.

4. Repayment to State Programs -- The Act does not discuss what happens to the accumulated premiums in the event that no eligible event occurs. The potential for

return of premiums and/or investment income to the states needs to be factored into the risk load calculation.

5. Actual Market Pricing -- Real markets do not always behave as theory predicts; therefore it is not sufficient to rely solely on a theoretical approach when calculating a risk margin. Consideration needs to be given to the then-current competitive environment, as well as the cost of capital for the private market. A theoretically sound price that is below the market demands will interfere with that market.

It is our recommendation that the National Commission advise the Secretary on both the risk-based price and the risk load and that each be based on the state programs' specific variables. The Secretary should also look to the private market as a guide for an appropriate risk load.

Federal Limit of Liability

The Act sets a maximum limit of \$25 billion on annual payments under all contracts for the federal program. Since coverage of up to \$25 billion will be offered to each qualified state program, the total coverage in force may be many times this maximum limit. The Act does not specify how this maximum limit would be shared in the case of multiple eligible events, or in the case of a single event that affects more than one state program. Of particular concern is the timing differences in the payment of losses. Should an eligible event occur early in the year, would the federal government hold back funds otherwise payable in anticipation of additional eligible events later in that year? For example, if a January earthquake were to occur, the federal program would not know what

percentage of the coverage limit would be available to the affected state program until the year ended. Therefore, payments to the state program and payments to the homeowners would likely be delayed.

The language concerning the time period of coverage also needs to be refined. In the Act, it states ". . . the maximum amount paid for all events in any single year by the Secretary pursuant to claims under all contracts for reinsurance under this Act shall not exceed \$ 25 billion". This could be read as an annual payment limit, but not a coverage limit. For example, if a single event or series of events occur in a twelve-month period with damages equal to \$50 billion but payments extend over a two-year period of time, would the federal program pay up to \$25 billion each year? Or is the intent to limit the payment to \$25 billion for all events *occurring* in a single year regardless of when the payments are made?

We have assumed that all federal reinsurance contracts will run concurrently, therefore have a common inception date. If contract effective dates are staggered, then the issue of aggregate payment limits and proration of claim payments will be more difficult to manage.

Eligible Losses

In the definition of eligible losses included in the Act, there is a time limit noted as "... claims for property losses covered by qualified lines that are paid within the 3-year period beginning upon the event ...". While we understand the desire to put a time limit in place for payment of losses, it should be noted that all loss payments for the 1994 Northridge earthquake were not paid within in a three-year period. An even more severe event could easily result in loss payments extending over a period of time well in excess of three years.

Other Considerations

The Act places a higher standard on new programs than on existing state programs. Not only is there a third test in the determination of the federal attachment point, but new programs are required to charge premiums rates that, "... at a minimum, are sufficient to cover the full actuarial costs of such coverage ...". No such standard is present in the Act for existing state programs.

The Act requires repayment from a state program in the event that program receives claims payment from the federal program. However, the Act also gives the State insurance commissioner the authority to terminate a state program if the commissioner believes that the program is no longer needed. How will the federal program be reimbursed if the State commissioner ends the state program?

Congress should consider the interrelationship (if any) between the federal reinsurance program established in this Act and federal disaster relief programs. In particular, should the reinsurance program established in the Act increase the availability of homeowners' coverage in catastrophe prone

areas, then there may be a savings to the federal government in the form of reduced disaster-relief outlays. On the other hand, if disaster relief outlays continue to be made available to states that do not establish their own reinsurance programs, then the incentive to establish state programs that address this issue may be severely diminished.

The Academy supports the inclusion of professional actuaries on the National Commission on Catastrophe Risks and Insurance Loss Costs. The Academy would be available to work with the Secretary to identify actuaries who are qualified to serve on this Commission.

Conclusion

The stated goal of the Homeowners Insurance Availability Act of 1997 is to provide protection to state insurance programs to ensure solvency in the event of a catastrophic event, while at the same time, not interfering in the private marketplace. We have identified sections of the current Act where we believe that the Academy could provide expert analysis and support to Congress. The American Academy of Actuaries is available to provide assistance to Congress on this legislation or any subsequent Acts that are proposed on this topic.