AMERICAN ACADEMY of ACTUARIES

September 20, 2000

The Honorable Bill Archer
House Ways and Means Committee
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Archer:

I am writing on behalf of the American Academy of Actuaries[1] Catastrophe Insurance Work Group to comment on S. 1914 (the Policyholder Disaster Protection Act of 1999). My comments are directed to actuarial issues pertaining to the determination of the proposed fund cap in the legislation.

As an initial matter, the existence of a policyholder disaster protection fund may not necessarily increase the policyholder surplus available to pay claims from a catastrophic event. This is because insurers, rating agencies and regulators typically evaluate policyholder surplus in relation to the total risk of the enterprise. Building a segregated policyholder disaster protection fund may well lead to a lower level of required policyholder surplus as insurers, and rating agencies look to total policyholder surplus in relation to total risk assumed.

The voluntary nature of the policyholder disaster protection fund may not best meet the intention of the legislation to minimize failures in the private insurance system following a major natural disaster unless it is employed in a regulatory framework in which insurers demonstrate their financial responsibility to deal with major disasters using one or more acceptable approaches (reinsurance, surplus, securitization, contributions to a policyholder disaster protection fund, etc.). Financially weaker insurers may not be in a position to build a segregated surplus account, but could still remain active in the insurance market writing business that would be prone to loss in the event of a natural disaster.

There is a high level of diversity and a significant difference in exposure to catastrophes within the property and casualty insurance industry. Variations in exposure to catastrophic losses among regions are substantial. Catastrophe exposure also varies by market, i.e. homeowners and small business versus large commercial and industrial. Many companies focus on a just a portion of the total market, such as homeowners, or large

[1] The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

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commercial. This tendency to specialize causes even greater variation in actual insurer experience to a given catastrophe.

The fund cap multipliers do not vary by region. However, since the multipliers are intended to determine a maximum reserve, the lack of variation is less critical if the multipliers are set at a high enough level. Insurers presumably are free to set their reserves at a level most appropriate for their specific circumstances. However, if the multipliers are set too low, some companies may be able to take full advantage of pre-tax reserves, while others would not. The amount of inequity would depend directly on the level of the multipliers (i.e., the higher the multipliers, the less the potential inequity).

Individual insurers routinely assess their exposure due to catastrophic risk and management relies on these assessments in meeting their fiduciary responsibility. Assessment of these exposures (typically referred to as determining a company's "probable maximum loss") is necessary for management of the loss exposures within the company, in setting underwriting strategies, and determining the amount and structure of reinsurance and other capital protection programs. This assessment is also used to compile information on the exposures and underwriting considerations for reinsurance companies, rating agencies and regulatory agencies. These assessments could be used to set a fund cap tailored to the specific exposure of an individual insurer to catastrophic loss, or to set a minimum threshold for demonstrating an insurer's ability to survive a catastrophic event. The American Academy of Actuaries has affirmed to the National Association of Insurance Commissioners (NAIC) that such probable maximum loss caps can be determined with reasonable accuracy.

The bill does not provide any quantitative insight into the legislative intent in setting the fund cap multipliers. Understanding the intent of the multipliers is necessary in order to evaluate their effectiveness over time. For example, were the multipliers determined so as to have a specific probability that no more than a certain percentage of insurers would fail in the event of a catastrophic event with a one in a specific number of years probability? The House Committee should clarify the legislative intent of the multipliers or provide a mechanism to establish and monitor these standards.

The return period is a critical parameter that should be established in the bill in order to ensure consistency and minimum reserve standards among insurers. There are a number of specific issues to consider:

- Should the probable maximum loss cap contemplate a 1 in 100 year, a 1 in 250 year or a 1 in what number of years probability?

- Should the cap reflect exposure from a single event or from annual losses beyond a 1 in 100 year, a 1 in 250 year or 1 in what number of years probability?

- Should the parameters vary based on the relationship between the fund cap, the probable maximum loss and the risk-based capital of the insurer?

The legislation does not include workers' compensation as a qualified line of business. However, since all types of commercial, corporate and industrial businesses are included in the scope of the bill, workers compensation losses following certain catastrophes, such as earthquakes, could significantly increase the risk of insurer failure for commercial lines companies, if the catastrophe occurred during business hours. As one step, the House Committee may want to consider including workers compensation for specific states with a significant earthquake exposure, so as to provide a more comprehensive fund in the event of a major earthquake.

Finally, the bill does not provide a mechanism for evaluating or modifying the fund cap multipliers over time or for collecting information about the effect of the multipliers. The House Committee might consider authorizing a commission to meet periodically (perhaps every five years) to review the participation by insurers and reinsurers, the experience with the funds, actual catastrophe experience, the continued appropriateness of the multipliers and other aspects of the policyholder disaster protection fund structure, and make recommendations the commission deems appropriate. The Commission would need members who are experts in risk management and analysis, and should include professional actuaries as well as others trained in risk assessment. Professional actuaries, as defined by membership in the American Academy of Actuaries, are experts who use statistical analysis to calculate the cost of future risks such as loss costs. Members of the American Academy of Actuaries must also comply with a Code of Professional Conduct that imposes stringent standards for conduct, qualifications, and practice.

The American Academy of Actuaries Catastrophe Insurance Work Group would be glad to work with the House Committee as it considers the policy implications of S. 1914. If you have any questions or would like additional information, please feel free to contact our Work Group through Greg Vass, Casualty Policy Analyst, American Academy of Actuaries at 202-785-7865 or vass@actuary.org.

Sincerely,

Wayne Fisher, FCAS, MAAA
Chairperson, Catastrophe Insurance Work Group

cc: House Committee on Ways and Means