



AMERICAN ACADEMY *of* ACTUARIES

September 26, 2007

The Honorable Nancy Pelosi
Speaker, House of Representatives
H-232 U.S. Capitol
Washington, DC 20515

Re: HR 3121

Dear Madam Speaker:

The Flood Insurance Subcommittee of the American Academy of Actuaries¹ has reviewed the provisions currently in H.R. 3121 that affect the financial well being of the National Flood Insurance Program (NFIP). In particular, we have analyzed the sections of the bill that would direct the NFIP to add wind peril coverage to its program.

We appreciate the difficulties faced by homeowners and business owners as they try to protect their properties against losses caused by hurricanes. Hurricane Katrina illustrated the issues that arise when claims are made for damage that may have been caused by both wind and water (coastal inundation and rainstorms). Because the two perils currently are insured by two separate entities, one of which is the federal government, having a single policy and federal issuer covering both perils might seem to be a solution to this issue.

We have identified several financial and other issues that we believe should be considered when assessing this bill. We hope our observations will inform the discussion as the bill is being evaluated.

In the current version of the bill, anytime the NFIP borrows from the Treasury to pay claims, the NFIP must stop issuing new multiperil policies and renewing in-force multiperil policies, until the borrowed amount is repaid with interest. Even if “actuarial rates” are correctly calculated and charged, borrowing may be required at some point, perhaps as soon as the first year that coverage is offered. The bill effectively requires that the NFIP discontinue multiperil coverage until the loan is repaid, making it unlikely that the program would be able to collect enough premium income to repay the loan. A better course would be to increase multiperil premiums, thereby increasing revenue to the program. In addition, the bill would abruptly require policyholders to find coverage elsewhere when their policies expire.

¹ The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces, and work groups regularly prepare testimony and provide information to Congress and senior federal policymakers; comment on proposed federal and state regulations; and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions, and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure that high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

In the context of catastrophe insurance, the likelihood of higher than average loss is low, but the severity of each such loss is high. Thus, charging rates that are adequate in the long term, based on average-year losses, will not provide enough money to pay for high-severity losses if they occur early in the renovated program. Private insurers incorporate an additional load into the insurance rate to account for the inherent risk level of the coverage. This load is sometimes called a risk load or a contingency provision and is part of an actuarially sound rating structure. The concept of a contingency provision is not unique to private insurers; the current NFIP rates contain a very modest contingency provision. The presence of a risk load helps build up a fund to pay for large losses, especially early in the program.

The bill states that rates shall be “based on consideration of the risks involved and accepted actuarial principles, and including operating costs and allowance and administrative expenses.” As noted above, “actuarial rates” should include a provision for the inherent risk level of the coverage. The wind losses insured by NFIP are likely to be highly volatile, even compared to other catastrophe insurance losses. The Subcommittee is troubled by the absence from the bill of a definition for “actuarial rates.”

Even if actuarially sound rates are established, such rates do not guarantee sufficient funds to cover every potential event. The current flood program is over \$17 billion in debt. Adding wind peril coverage would increase the potential for further large losses in excess of available funds.

After the NFIP’s nearly 40 years in existence, there are still a large number (approximately 25 percent of current insureds) of properties with subsidized rates. Adequate hurricane insurance premiums could lead to political pressure on Congress to suppress rates if property owners regard their premiums as unaffordable. One of the reasons private companies have either stopped or limited the writing of coverage in coastal areas is that state regulation has kept companies from charging adequate rates. It is unclear whether the insureds on the coast are going to be willing to pay adequate premiums to the federal government.

There is also the issue of potential cross-subsidies between properties immediately along the coast and those inland. Significant differences exist in wind hazard levels between coastal and inland properties. The phrase “actuarial rates” implies the establishment of multiple rate zones to account for the differences in hazard level. If, however, inland property rates subsidize coastal rates, inland property owners may opt not to purchase multiperil coverage from the NFIP, and find cheaper wind rates in the private market. Thus, the revenue generated by collected wind premiums would be significantly lower than expected losses and administrative costs of the program.

Other, non-financial issues in the bill remain unresolved, including availability of coverage and the elimination of ambiguity between wind and water damage. As for availability, while availability issues exist along the coast, state-run entities typically write wind coverage policies in coastal states.

We question whether offering a wind/water policy will eliminate all coverage confusions. Private insurers offer other coverages (such as non-flood water damage, sewer, and drain) that will occur at the same time as a wind/water event. This could lead to problems similar to those that arose in the aftermath of Hurricane Katrina.

We hope that our discussion of these issues will be of assistance in the consideration of H.R. 3121. If you have any questions, please feel free to contact Lauren Pachman, the Casualty Policy Analyst at

the American Academy of Actuaries. The Flood Insurance Subcommittee would be glad to provide further assistance or additional information to the House of Representatives upon request.

Very truly yours,

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cc: House Minority Leader John Boehner
Members, House of Representatives

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