TESTIMONY OF JOHN W. ROLLINS, FCAS, MAAA

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"THE NATIONAL FLOOD INSURANCE REFORM AND MODERNIZATION ACT OF 2010" and

H.R. 1264, "THE MULTIPLE PERIL INSURANCE ACT OF 2009"

FINANCIAL SERVICES – SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

U. S. HOUSE OF REPRESENTATIVES, APRIL 21, 2010

Good afternoon, Ms. Chair and Members. My name is John Rollins. I am an actuary holding the highest qualifications in the Casualty Actuarial Society and American Academy of Actuaries. I have worked in Florida property insurance for the last eleven years and served as chief actuary of both private insurance companies and the state-run "wind pool" of Citizens Property Insurance Corporation. I have testified to lawmakers in several states on the issue of government-backed property insurance systems in disaster-prone areas, and published several research papers on the subject.

After many years of observing public policy decisions and their impact on property insurance markets and public finances, my message to you today is this: <u>In designing rates for any property insurance program ultimately supported by taxpayer capital, great care should be taken that the legislative definition of the phrase "actuarially sound" conforms to the principles of the U.S. casualty actuarial profession</u>.

Some background is in order. We know that an insurance policy is just a promise to pay for a pre-defined type of possible future loss in exchange for an up-front premium. By law, insurance contracts must be backed by capital sufficient to pay claims, even if many claims occur at once and costs are well in excess of the premiums charged. Disasters by definition are infrequent, unpredictable, and severe; for these events, required monies may be twenty or more times the average annual loss contemplated in the premium. The job of actuaries is to determine a fair premium. This job becomes difficult when the losses are catastrophic, and yet more difficult when the supporting capital is provided in other than an arms-length economic transaction – such as via government support.

The relevant Casualty Actuarial Society principle 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*". Each word or phrase in this statement has implications for pricing decisions for government-backed insurance programs.

- First, the phrase "not excessive, inadequate, or unfairly discriminatory" is the core definition of a <u>lawful</u> rate in most states. Therefore, actuarial soundness is historically a sufficient condition for a lawful rate; alternatively, rates cannot generally be actuarially sound yet unlawful.
- Second, such rates must reflect <u>expected</u> costs. It is not sound to peg the rate to the most favorable, most unfavorable, or other convenient outcome – rates must reflect the probability-weighted average over the range of tenable outcomes. In catastrophe ratemaking, this means scientific models simulating thousands of years of activity are useful, since any recent snapshot of activity may show very low or high losses.
- Third, such rates must reflect <u>all</u> costs, not just those we prefer or those we can easily quantify. Rates are to be made on a cost basis rather than an economic or "what the market will bear" basis, but real costs incurred to issue a properly capitalized policy must all be reflected.

- Fourth, such rates must reflect future costs; rates may not be made to recoup past losses. Past data may or may not be predictive of future losses, but past experience does not represent an “account” to be squared by raising or lowering future premiums.
- Finally, and critically, actuarially sound rates must reflect the costs of risk transfer. Rates must include a provision for the cost of capital required on demand to pay claims after catastrophic events. Private insurers transfer risk through reinsurance and risk-sharing arrangements, paying those costs immediately. Government programs can borrow from future taxpayers to fund today’s risks; the cost of that capital may be arguable, but actuaries and economists widely agree it cannot be zero. Therefore, an actuarially sound rate for a government-backed insurance program must be greater than simply the expected annual loss to the program plus provisions for known expenses.

The record shows that failure to implement actuarially sound rates in such programs at both the state and federal levels has had unwelcome consequences, including

- Overdevelopment of environmentally sensitive areas, as low insurance rates offered by government –backed insurers and subsidized by future taxpayers encourage consumers and developers to underestimate the risk and build in harm’s way;
- Expansion of the risk in government-backed insurance pools as private insurers retreat from risky areas in which they cannot or will not compete with subsidized rates, and crowding out of private investor capital which otherwise would be at risk in lieu of taxpayer capital;
- Depletion of the public treasury as new debt must be incurred under stressed market conditions just after major disasters, then serviced by potentially generations of taxpayers;
- Wealth transfers from all taxpayers to an often high-income subset of residents living in risky but picturesque areas, as all taxpayers pay proportionately to service debt incurred due to underfunded programs.

Despite the fact that enabling legislation frequently utilizes the phrases “actuarially indicated” or “actuarially sound”, rates for many existing programs, such as state wind pools and the National Flood Insurance Program, do not reflect a proper cost of capital provision as envisioned in actuarial principles. I believe the lack of a comprehensive and consistent definition of the phrase, and conformity to this definition when the rates are actually set, is partially to blame. I urge lawmakers to carefully define the concept of actuarially sound rates at every stage of legislation, development, and continuing implementation of government-supported property insurance programs.

Thank you for the opportunity to appear before you today.