AMERICAN ACADEMY *of* ACTUARIES

May 4, 2011

The Honorable Spencer Bachus
Chairman, U.S. House Financial Services Committee
2246 Rayburn House Office Building
Washington, DC 20515

The Honorable Barney Frank
Ranking Member, U.S. House Financial Services Committee
2252 Rayburn House Office Building
Washington, DC 20515

Re: H.R. 1309, The Flood Insurance Reform Act of 2011

Dear Chairman Bachus and Ranking Member Frank:

As you prepare to consider H.R. 1309, "The Flood Insurance Reform Act of 2011," the American Academy of Actuaries'[1] Flood Insurance Subcommittee appreciates this opportunity to share an actuarial perspective on the legislation and its possible effect on the National Flood Insurance Program (NFIP).

First and foremost, we support the reauthorization of the NFIP for at least 5 years. We believe that reauthorization will help to stabilize the market for flood insurance as the program regains stability.

Additionally, we strongly support efforts to provide a better financial base for the NFIP. As such, we are encouraged by the provisions of this bill that move toward a rate structure that will better match potential loss payments with premium income. These provisions include an increase in deductibles for subsidized rate properties, an increase in the maximum annual premium change allowed, and new rules to phase in "full actuarial rates."

Terms such as "full actuarial rates" and "actuarially sound rates" are often cited to describe the premiums for programs like the NFIP. There are no standard definitions for these terms, but the *Statement of Principles Regarding Property and Casualty Insurance Ratemaking*, promulgated by the Casualty Actuarial Society, says that a rate should provide "for all costs associated with the transfer of risk." The NFIP ratemaking process identifies a "full actuarial rate" as one that appropriately covers the expected average annual loss for a property, plus a small risk load. The process of transitioning from the NFIP's existing rate structure to one that employs actuarially sound rates will necessarily involve addressing the program's existing $17.775 billion

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

1850 M Street, NW Suite 300 Washington, DC 20036 Telephone 202 223 8196 Facsimile 202 872 1948 www.actuary.org

Treasury debt, which was incurred following the catastrophic losses suffered in the 2005 Gulf Coast hurricanes. Resolving the issue of the outstanding debt is critical to the program becoming more financially sound; however, the bill does not address this issue directly. Currently, a significant portion of the NFIP premium goes to paying off the debt and interest on the debt. Even so, it will be decades until the debt is paid off, even if no extreme catastrophic events occur in the meantime. Ultimately, for the NFIP's financial stability to be improved, the debt may need to be waived, or a specific cost provision that will be used for repayment may need to be added to the premiums.

We are encouraged by the provisions of H.R. 1309 regarding the expansion of coverage to provide protection for commercial business interruption and living expenses connected to the loss of use of a residential property. It is important that these expansions of coverage be adequately funded, and these provisions aim to adequately fund such coverage by virtue of the language included in Sections 4 (c)(5)(B) and 4 (c)(6)(B), both of which require that such coverage be made available at chargeable rates that are not less than the estimated premium rates for such coverage.

However, there is an element of the coverage expansion that is impractical. Section 4 (c)(5)(C)(ii) provides that these business interruption and loss of use coverages will only be available if the NFIP Administrator can determine that "the national flood insurance program has the capacity to make such coverage available without borrowing funds from the Secretary of the Treasury." This provision could mean that the NFIP would be unable to borrow to pay these specific losses, but such a constraint would be implausible because borrowing is done to pay for all losses associated with an event, not specific types of losses associated with that event. Inevitably, this provision forces the NFIP Administrator to predict in advance whether the NFIP will need to borrow under any circumstances before making available the business interruption and loss of use coverages. This is problematic, as no matter how adequate the rates are for flood insurance, there will be major events like Hurricane Katrina, which will overwhelm the available funds in the NFIP.

Section 8 of H.R. 1309 as introduced authorizes studies concerning the possible privatization of flood insurance. While this seems a reasonable policy goal, it may not be practical. The reasons that private insurance companies exited the flood insurance market decades ago still exist. Without a government mandate on consumers to buy policies, those who do buy insurance would likely be those who could reasonably expect to need it. Also, companies have found that flood insurance losses are very volatile; for private companies to want to enter the market, they would have to have significant loads[2] in their rates for uncertainty and for the use of their capital (that is, the assets that they must hold to be able to pay their claims in all situations). The private market rates would be substantially higher than the current rates.

Section 8 also provides for participation from the private market by allowing the Administrator to purchase reinsurance. It appears that the wrong section of the National Flood Insurance Act is sought to be amended to allow for this new possibility.

[2] As with any investment, the higher the volatility of potential results, the higher the required average return on that investment. For the private sector to offer coverage for a volatile peril like flood, rates would need to include a higher profit or return than would be required for a more stable product.

The NFIP could potentially benefit from purchasing reinsurance in certain situations. However, for the reasons described above, the NFIP's current rating structure likely would not provide enough revenue to purchase a significant level of reinsurance. Reinsurance providers would likely require a return commensurate with the risk of the coverage provided. Current NFIP rates do not incorporate and reflect a cost of capital commensurate with this risk. Should this reinsurance provision be enacted, we offer our expertise to assist in this new endeavor for the NFIP.

The previous discussion of the program's $17.775 billion Treasury debt, the potential for future borrowing, and the rating structure of the NFIP bring into focus a central issue to consider when debating the financial future of the NFIP. Congress's stated purpose in authorizing the creation of the NFIP was, in part: "…so that such flood insurance may be based on workable methods of pooling risks, minimizing costs, and distributing burdens equitably among those who will be protected by flood insurance and the general public." Flood insurance premiums for the program have been developed using an approach that focuses on keeping premiums at a level below market rates to encourage participation. Also, many of the non-insurance activities of the NFIP that benefit the public at large are funded with premium revenues. This current structure does not facilitate the minimization of borrowing. While there is always the potential need to borrow, if minimizing this potential is a priority, the ratemaking approach, and the regulations that provide for this approach, will need to change.

The American Academy of Actuaries' Flood Insurance Subcommittee hopes that you will find these comments helpful and would be pleased to assist you in your efforts to reauthorize the NFIP. If you have any questions, please feel free to contact Lauren Pachman, the Academy's casualty policy analyst, at pachman@actuary.org. Again, thank you for this opportunity to comment on the proposed legislation.

Sincerely,

Stuart B. Mathewson, FCAS, MAAA
Chair, Flood Insurance Subcommittee
American Academy of Actuaries

cc: The Honorable Judy Biggert
Chair, Subcommittee on Insurance, Housing and Community Opportunity
2113 Rayburn House Office Building
Washington, DC 20515

The Honorable Luis Gutierrez
Ranking Member
Subcommittee on Insurance, Housing and Community Opportunity
2266 Rayburn House Office Building
Washington, DC 20515