"Actuarial Soundness" and Public Insurance Entities

BY RADE MUSULIN

An interesting actuarial issue has arisen in Florida with regard to the appropriate rates to be charged by its property residual market entity, Citizens Property Insurance Corp. The issue has implications for many government-related insurance programs, such as the Terrorism Risk Insurance Act or a possible federal backstop for severe natural disasters.

Setting the right rates in residual markets is often troublesome, because a number of economic and social considerations must supplement traditional actuarial items such as expected losses, expenses, and so forth. For example, if the residual market's rates are competitive with those of the voluntary market, the residual market may draw risks out of the voluntary market and become a disruptive force. On the other hand, most residual markets have been created to provide coverage where the price required by the market is deemed unaffordable, implying rates below the market's.

Insured property subject to catastrophes poses a particular challenge because of the additional complication of the often enormous sums of capital required to support underwriting risks. What is the appropriate cost of capital for an entity that does not have to hold capital but instead funds large losses through assessments or taxes on the general population?

In the mid-1990s, Florida policy-makers tried to address these thorny problems by requiring that rates for the property residual market be set at the top of the market, as determined by a straightforward calculation of major company rates. The idea was to address both the residual market's competitive position and impute a cost of capital as contained in the voluntary market rates.

Recently, back-to-back seasons with huge hurricane losses have exhausted Florida's Citizens Property Insurance Corp. funds in its high-risk account and led to over a billion dollars in deficits, which will become assessments on policyholders throughout the state. At the same time, voluntary market losses are creating pressure that will drive up market rates and, through the top of the market formula, residual market rates.

Interestingly, this situation has led to calls from both those facing higher Citizens' rates and those facing Citizens' assessments for it to charge "actuarially sound" rates. Many non-actuaries in public policy work mistakenly believe that a requirement for an "actuarially sound" or "actuarially indicated" rate will always result in a precise answer with little uncertainty as to how to calculate it. Unfortunately, absent clear guidance about the public policy objectives regarding the residual market entity, actuaries may have a difficult time determining what the "actuarially sound" rates are.

Actuarially sound rates should be based on our Standards of Practice, Statement of Principles, and Code of Conduct. Those tools are designed to guide actuaries in making actuarial, rather than public policy, decisions.

Consider how this issue affects the Florida Hurricane Catastrophe Fund (FHCF), a state-created reinsurer providing $15 billion of coverage. The FHCF promulgates "actuarially indicated" rates that contain no risk load or cost of capital and are one-third of those reflecting equivalent cover in the private market. The FHCF's rates are consistent with our standards because the public policy planners in Florida provided for capital by creating an assessment base on policyholders to fund any deficits and made clear that the FHCF was to provide coverage priced at long-term expected loss cost.

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The FHCF example shows why it is important for public policy-makers to do more than just require that rates be "actuarially sound" for entities such as property residual markets in hurricane-prone states. For example, should there be a loading for an imputed cost of capital from assessments? Should there be some cap on rates to promote affordability?

Actuaries must help public policy-makers understand that we need direction in answering such questions; otherwise, actuaries risk having to make public policy choices that fall outside the scope of our usual professional practices.

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