

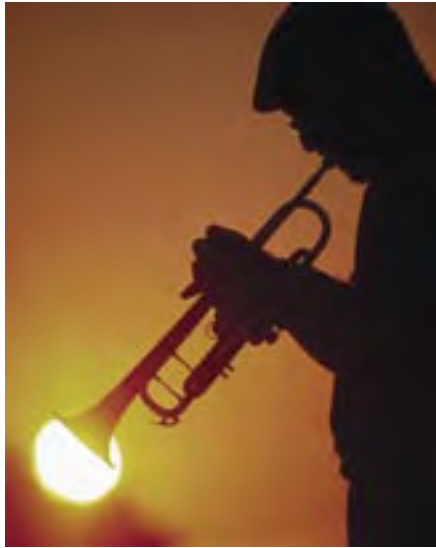


NAIC Defers Meeting, Not Work

IN THE WAKE OF Hurricane Katrina, the National Association of Insurance Commissioners (NAIC) canceled its fall meeting, scheduled for Sept. 10-13 in New Orleans. But action on many Academy projects continues to move forward.

In August, the Committee on Property and Liability Financial Reporting delivered a 241-page report on risk transfer in P/C reinsurance to the NAIC's Casualty Actuarial Task Force (CATF). The report contains the results of a survey of current industry practices as well as a summary of alternative approaches to evaluating risk transfer that were suggested by practicing actuaries. The report doesn't endorse any given option but gives possible advantages and disadvantages of various approaches.

Begun last April at the request of the NAIC, the report is intended to assist in an NAIC analysis of risk transfer in the context of reinsurance accounting. New York insurance superintendent Howard Mills, quoted in a Sept. 6 *Best's Insurance News* article on the Academy report,



said the report confirms that there is no universal standard to define what finite reinsurance is but also broadens the scope of risk transfer alternatives, making it clear that one size will not fit all.

Subsequent to the cancellation of the fall meeting, the NAIC's consideration of the report was re-scheduled for an interim meeting in Kansas City, Mo., on Oct. 25-26. In the meantime, the Academy is proceeding with plans to develop a practice note on risk transfer that is aimed at actuaries who are asked to assist company CEOs and CFOs in this area. The practice note should be completed by the end of the year.

CATF also received a memo in August from the Medicare Part D Subgroup, with proposed health risk-based capital (RBC) instruction and health RBC formula changes, proposed life RBC instruction and life RBC formula changes, and explanatory slides. Regulators will be reviewing the Academy's work by conference call.

Widely expected to be adopted by the NAIC's ex-
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Extreme Weather: Bad Luck or New Norm?

BY RADE MUSULIN

AMONG THE MANY PROBLEMS that will affect actuaries trying to price hurricane-exposed policies in coming years is evaluating whether the unusually severe seasons observed recently reflect a random streak of bad luck, a multi-decade cyclical oscillation within a stable long-term climate pattern, or a shift in climate conditions driven by global warming.

Since Hurricane Andrew exposed the limitations of using a few decades of historical data to develop property insurance prices, actuaries have increasingly turned to sophis-

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ticated catastrophe simulation models. To date, the predominant view of modeling experts has been that models should reproduce the observed frequency and severity of hurricanes over the past century or so. In fact, the Florida Commission on Hurricane Loss Projection Methodology, which was created by state statute to review models, codified this view. But if a model's estimate is designed to randomly reproduce the average hurricane frequency and severity observed over the past century, then it will not show cyclical variation or a shift to more activity over time due to global warming.

Consider a deck of cards. Select a card at random, then replace it in the deck and select a card again. The probability of getting a black face card on several successive draws is low, but possible, and constant over many repetitions. In this case, unusual results are the result of randomness in the card selection process.

Most experts agree that hurricane activity in the Atlantic basin follows a cyclical pattern over several decades. For example, activity in the 1940s through the mid-1960s was above average, while from the mid-1960s through the 1980s it was below average. Models could be, but generally are not, adjusted to reflect a cyclical pattern. If they were, the long-term average would not change, but the forecast over shorter time horizons would.

Consider another card analogy, where three decks of cards were combined by taking all of the spades and clubs from a second deck and adding them to the first, then taking all of the hearts and diamonds from a second deck and adding them to a third. If cards are randomly selected from each of the two remaining decks, the probability of a black face card will be higher in one and lower in the other but the same in total as in the single-deck example. In this case, a cycle could be simulated by selecting a card from the first deck 20 times in a row, then selecting a card from the second deck 20 times in a row, and so forth.



Scientists are not in agreement on whether the recent activity in the tropics is a consequence of global warming. Several prominent experts have discounted a link between recent extreme seasons and global warming, while others have produced studies showing an increase in severe storms is unrelated to the multi-decade cycle.

Consider a final twist on the card analogy, where a single deck is used but a black face card is added on each draw. The probability of getting a black face card would increase over time, so the long-term average would no longer be the correct estimate for either a short or a long period. This is an example of parameter shift over time.

Actuaries facing hurricane exposure should consider the potential impact of cycle and parameter shifts on their estimates. This is particularly important if the frequency of severe hurricanes is changing, because damage functions are non-linear. Actuarial Standard of Practice (ASOP) No. 39, *Treatment of Catastrophe Losses in Property/Casualty Insurance Ratemaking*, states that ratemaking procedures using models should "...appropriately reflect the expected frequency and severity distribution of catastrophes." It is not sufficient simply to show that a model reproduces the past; the model should simulate the conditions that are expected to exist in the future.

Unfortunately, it is unlikely the scientific community will reach a consensus on whether global warming is affecting hurricane activity anytime soon, forcing actuaries to rely on conflicting expert opinions in unfamiliar areas. When doing so, actuaries should refer to ASOP No. 38, *Using Models Outside The Actuary's Area of Expertise (Property and Casualty)*, carefully document their assumptions, and make users aware of factors contributing to significant uncertainty.

Rade Musulin is chairperson of the Academy's Communications Review Committee, a member of the Update's editorial board, and vice president - operations, public affairs, and reinsurance for the Florida Farm Bureau Insurance Cos. in Gainesville, Fla.

CASUALTY PRACTICE COUNCIL IN BRIEF

► In a Sept. 8 **letter**, the Workers' Compensation Subcommittee warned the Senate Judiciary Committee that an asbestos bill pending in the Senate could invite double filing of claims and cost the workers' comp system billions of dollars.



What's wrong with this picture? Perhaps Fido doesn't quite understand his assignment. Be sure you do when you take one on.