

with generally accepted actuarial principles and practices.” It also noted that “in applying the term as a description of actuarial work, it becomes incumbent upon the actuary to provide the support and documentation necessary to show users that the work has been done with skill and care by a qualified practitioner.”

Ackerman said that she hopes the report will help policymakers and legislators see the benefit of being more precise when using

these terms. This could be achieved by including a reference to a particular Actuarial Standard of Practice or Statement of Principle in the statute or rule, for example, or by adding instructions to address the desired funding levels from premium and non-premium sources in the case of catastrophe programs.

Also serving on the task force were Steve Alpert, Lee Barclay, Donna Novak, Arthur Panighetti, John Pedrick, and Kevin Russell. ▲

Viewpoint

Sounding Off on Soundness

BY RADE MUSULIN

THE ACADEMY'S SPECIAL REPORT on actuarial soundness provides an excellent review of the concept in all practice areas. I urge you to read it, particularly if you work in public policy development or ratemaking.

The term “actuarially sound” has been creeping into statutes at both the state and federal levels for many years. In the casualty arena, it is generally used by well-intentioned people who (often mistakenly) assume that directing an entity such as a flood program or windpool to adopt actuarially sound rates will reduce or eliminate deficits and allow actuaries to determine unambiguously what the appropriate rate is. But such a requirement unfortunately is not a magic elixir that will eliminate deficits, nor does it provide clarity as to how to establish rates.

Government insurance pools usually are created to solve an affordability or availability problem arising from an inability of private insurers to charge what they consider to be actuarially sound rates and/or for consumers to afford to pay such rates. Pools have various funding sources (assessments, levies, or taxes) external to the policyholder base to bridge the gap. Determining the proportion of pool funding that needs to come from policyholder premiums vs. other sources is beyond the scope of actuarial standards; direction must be provided to actuaries as to the expected contribution of various funding sources to loss costs.

This issue is particularly important in pools that cover catastrophic losses from earthquakes, floods, or hurricanes. Rates in such pools have to consider not only the appropriate provision for expenses and long-term loss costs but also whether a loading for the cost of capital is appropriate. Private entities offering coverage against catastrophic loss must hold capital or buy reinsurance to cover losses in excess of current-year revenue and reflect such costs in their rates. In addition, all losses in private entities must be funded in advance. Government pools covering catastrophic loss, on the other hand, can borrow funds from the Treasury—as the National Flood Insurance Program has. Or they can issue post-event bonds funded by assessments on a broad population—as the Florida Hurricane Catastrophe Fund (FHCF) has. This means that not all costs associated with a transfer of risk from a policyholder to a government pool have to be reflected in the rate charged by the pool.

The balance between the revenue generated by policyholders at risk of loss and from the “assessed masses” obviously is a critical public policy consideration in designing a government pool. Getting that

balance right requires direction from elected officials. Simply mandating that pool rates be actuarially sound does not provide actuaries with enough information to determine appropriate premium levels.

I faced this issue head-on when I served on the Advisory Council of the FHCF. The FHCF had been formed specifically to offer reinsurance coverage to Florida insurers at a cost below that which was commercially available at the time. Unlike private reinsurers, it had the ability to issue post-event tax-exempt bonds to fund losses. Repayment of the bonds was funded by assessments on insurance policies, including policies, like auto policies, that were not covered by the FHCF.

It was proposed that FHCF reimbursement premiums be set at a level equal to long-term expected losses and expenses without a risk load for capital costs. I was involved in some long discussions as to whether such premiums were “actuarially sound.” I eventually concluded that I was unable to state they were unsound, since the legislature had specifically created the FHCF to offer a source of low-cost capacity and provided a funding source to cover deficits from outside its policyholder base. Whether such premiums were “fair” or economically appropriate was a legislative issue outside the actuarial realm.

I was once asked by a Florida legislator what the effect would be of mandating that rates for Citizens Property Insurance Co. (the property residual market) be actuarially sound. To his great surprise, I replied that I did not know—because actuaries had no idea what actuarial soundness meant in the context of Citizens without some direction from policymakers.

Now, thanks to the thorough work of the Academy's Actuarial Soundness Task Force, we are in a better position to answer that question. Unfortunately for those seeking a silver bullet for difficult questions of ratemaking in government pools, the task force concluded:

“While not all publicly based catastrophe programs rely on outside sources of funding (e.g., taxpayer dollars or assessing a broader policy base), when they do, additional examination is needed to evaluate actuarial soundness. Instructions in the enabling legislation are necessary to address the level of funding that is expected from premium income and the level that is intended to come from non-premium sources.”

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