



Property Casualty Insurers  
Association of America

Shaping the Future of American Insurance

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David Kodama  
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September 28, 2007

Hon. Kevin McCarty  
Chairman  
Property and Casualty Insurance (C) Committee  
National Association of Insurance Commissioners  
2301 McGee Street – Suite 800  
Kansas City, MO 64108

**Re: Public Hearing on Catastrophe Modeling – PCI Testimony**

Dear Commissioner McCarty:

PCI is a trade association representing over 1,000 property/casualty insurers that write almost 40 percent of the homeowners insurance sold in the United States. Because of that, we have a deep interest in how these markets work and the tools and access to information that support the financial security provided by the insurance industry. The following are pertinent statements regarding your study of an appropriate regulatory framework for monitoring the activities of catastrophe risk modelers and the use of near-term catastrophe models for pricing property insurance.

Catastrophe risk models are the most sophisticated tools available for the assessment of extreme-risk exposure. The hurricane models used within the insurance industry today are primarily the product of over 20 years of development by private, independent modeling firms and state funded research teams. Hurricane Andrew (1992) first brought industry awareness to their capabilities. However, it was not until the record hurricane seasons of 2004 and 2005, that catastrophe risk models gained widespread use by insurers, reinsurers, rating agencies and the capital markets as a tool for establishing standards for cat risk pricing, capitalization requirements and risk management strategies. Coupled with significant scientific development and enhanced understanding of hurricane activity, this recent experience brought about updates, recalibration and further evolution of the models. Previously, insurers and reinsurers relied on hurricane catastrophe models based upon a 100+ year historical-based outlook. Since 2005, “near-term” loss estimation models have been developed that reflect a five-year outlook, providing probable maximum loss estimates using scientific research and assessment of expected hurricane activity over the upcoming near-term period. This therefore provides an insurance company with an assessment of its catastrophe risk over a period that better aligns itself with the overall exposure period of the company’s in-force book of policies.

Scientific experts forecast that the nation faces increased frequency and severity of major catastrophes in the near future as well as continued property development, population growth, and rising real estate prices in catastrophe-prone areas. Without the ability to price

for coverage to the full extent of the insured risk, regulatory constraints can increase an insurer's potential for insolvency, threatening market disruption, increasing cost and the potential for unpaid policyholder claims. These conditions have led to increased political pressure on the insurance industry to make homeowners coverage more available and affordable.

Regulatory or statutory requirements to use only models based upon a single, "one-size-fits-all" set of assumptions limits the potential use of multiple models to gain greater information, decreases the actuarial soundness of the pricing and underlying security of the insurance product, and limits competition among risk modeling firms, ultimately discouraging continual improvements in the technology and science. Hence, the output from any credible catastrophe risk model or models based on any reasonable set of assumptions, i.e. expected frequency, severity, etc, must be considered acceptable for ratemaking purposes.

Rating agencies (e.g. A.M. Best, Standard & Poor's) assign an insurer a financial strength rating which incorporates an opinion of the insurer's ability to respond to the financial stress of a severe catastrophe. Catastrophic loss is one of the most significant threats to the financial strength and credit quality of property and casualty insurers due to the significant rapid and unexpected impact that can occur. Because the science and technology behind catastrophe risk models are ever evolving, rating agencies, whose assigned rating and opinion affect the market viability of the insurer, expect the most financially secure insurers to utilize and consider the results of multiple models in the overall management and pricing of their catastrophe risk exposure.

A regulatory or statutory rejection of the use or consideration of a "near-term" model in ratemaking effectively disregards a consensus view within the science community that elevated sea-surface temperatures and overall hurricane activity in the Atlantic basin region will, over the near-term horizon, raise the uncertainty and therefore risk potential along the coastline and the impact on regional insured losses. Such a rejection will artificially suppress rates, increase the subsidy of high-risk exposures, reduce loss prevention incentives, and undermine the ability of insurers to manage their catastrophic risk. This will ultimately threaten the financial solvency of an insurer, which is of utmost concern to the rating agencies, insurer management, and all stakeholders including policyholders.

PCI supports the ability of insurers to develop and use rates based upon all available information, tools and analysis relevant to its catastrophe exposure, without regulatory or statutory intervention. PCI does not endorse any single catastrophe risk model or underlying assumptions. However, PCI supports the right of insurers to consider any such modeled results that provide for the following:

- An appropriate probable maximum loss estimation of the catastrophic risk; and
- An accurate assessment of the assumed risk relative to the insurers overall underwriting risk appetite and financial position.

Today, catastrophe risk models are designed to provide vital intelligence about the risk exposure from extreme-probabilistic events for which history provides little to no actual experience. It is this scientific-based, unbiased information that is critical to the insurer's

continuing financial health and ability to meet the obligations to all its policyholders, even after the most severe catastrophic losses.

Thank you on behalf of PCI and our members for the opportunity to provide input on this very important issue. PCI and its members look forward to working with you further.

Sincerely,

A handwritten signature in black ink, appearing to read "David Kodama", with a long horizontal flourish extending to the right.

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cc: Michael McRaith  
Eric Nordman