Consumer Federation of America

CENTER FOR ECONOMIC JUSTICE

March 19, 2007

The Honorable Walter Bell
NAIC President
Commissioner, Alabama Department of Insurance
201 Monroe St, Ste. 1700
Montgomery, AL 36104

Dear Commissioner Bell:

On March 27, 2006, we wrote a letter to then-President Alexander Iuppa of the NAIC calling on the NAIC to "reject dramatic changes proposed last week by Risk Management Solutions (RMS) to its hurricane modeling methods that will lead to unjustified increases in homeowners and other property/casualty insurance rates and to begin a public examination of these proposed changes. We also urge you to immediately take steps to increase regulation of third-party organizations whose work has such a significant impact on insurance rates and availability." (Please see attached letter.)

We never received a response from the NAIC, despite the immense impact of the catastrophe modelers' decisions on consumers and the NAIC's contention that consumer protection is the top priority of state insurance regulators. Since the letter a year ago, the scientific community has strongly criticized the use of "near-term" projections to increase projected catastrophe loss costs by up to 90 percent for some states on the Atlantic and Gulf coasts. Indeed, even one of the firms that develops catastrophic risk models AIR Worldwide Corp. – (AIR) -- has criticized the practice, but is still utilizing the approach to compete with other major cat modelers.

We repeat our urgent regulatory recommendations from last year's letter below and ask that, this time, you provide us with a timely written response to this request:

1. **Exert regulatory authority and oversight over the cat modelers' loss cost activities.** We ask you to explain to the public how the activity of cat modelers differs from that of ISO in providing loss costs to insurers and why regulators exercise authority and oversight over ISO's loss cost activities but not over the loss cost activities of cat modelers.

2. **Exert regulatory authority and oversight over insurers' use of cat modelers' loss costs.** While cloaked in a patina of science, the cat modelers work is driven by key assumptions grounded more in public policy than in science, including what is the appropriate time frame for analysis, whether the maximum loss is a one-in-50-year event, a one-in-100-year event or a one-in-1,000-year event or whether demand surge is included in the projected loss costs, to name just a few. The assumptions utilized by the cat modeling firms have a massive impact on the output of the models. At the recent

RAA cat modeling conference, Frederico Waisman presented his annual comparison of the models, in which he entered the same information into models developed by AIR, EqeCat and RMS and found that the results varied dramatically – by as much as 100 percent in some cases. We ask you to explain to the public why the vast majority of the states exert no authority or oversight over insurers' use of cat modelers' loss costs despite the massive impact on insurance availability and affordability.

3. **Charge the Property Casualty (C) Committee with the task of determining the appropriate regulatory oversight of and best regulatory practices concerning cat modelers** and other third-party suppliers of information used by insurers in developing their rates, including tier placement guidelines. If you do not believe these tasks are of sufficient importance to make them a priority activity this year for the C Committee, we ask you to explain why other activities, such as vetting a proposal to end rate regulation in favor of an "insurance exchange," are deemed to be a higher priority.

As we explained in our letter last year, RMS adopted a short-term (5-year) projection, replacing the method the scientists had assured us was proper, a long-term projection where a good year or bad year of hurricane activity/damage would not have much impact. We stated in the letter that, "While RMS claims that this massive increase is necessary for scientific reasons, the evidence indicates that the primary reason for the change appears to be not science at all, but politics." We warned NAIC that "RMS has become the vehicle for collusive pricing." The huge increase in rates that ultimately occurred because of NAIC's negligent inaction, was due to pressure from insurers, as we pointed out in the letter.

We also stated that, "Insurers often try to position supposedly objective and independent third parties as the public decision-makers when it is insurers themselves who want to increase rates. For decades, the third parties that often performed this function were ratemaking (advisory) organizations such as Insurance Services Office (ISO). At least ISO and other rating organizations were licensed by the states and subject to regulation, because of the important impact they had on rates and other insurance tools, such as policy forms. However, even ISO and other regulated advisory organizations are prohibited from collusive pricing activity that is not subject to state insurance regulation."

Consumers and businesses in coastal areas have suffered significant harm in the form of unjustified rate increases because the NAIC took no action to end collusion and the retreat from science by the modelers. Florida, to its credit, did not allow the new model to be used by primary insurers and it appears as if Georgia has not allowed it either. In the meantime, residents in the 18 states along the coast have been paying rates up to 50 percent higher solely because of the changes adopted by RMS and other modelers. At the same time, it has become more and more obvious that those who questioned the scientific legitimacy of the modeling changes were correct.

Consider the series of investigative articles on this topic that ran in the *Tampa Tribune* earlier this year indicating that the scientists consulted by RMS on their model no longer support the methodology that was used. "On Saturday, one of the scientists whom Risk Management Solutions consulted, Jim Elsner, a professor of geography at Florida State University, told the Tribune that the company's five-year model 'points to a problem with the way these modeling groups are operating' and that the results contain assumptions that are 'actually unscientific.'… Thomas R. Knutson, a research meteorologist with the National Oceanic and Atmospheric Administration in Princeton, N.J., and another Risk Management expert panelist, said Saturday the five-year timeline didn't come from the experts. 'I think that question was driven more by the needs of the insurance industry as opposed to the science,' he said."[1]

Scientists not employed by RMS are also speaking out: "'It's ridiculous from a scientific point of view. It just doesn't wash well in the context of the way science is conducted,' said Mark S. Frankel, director of the Scientific Freedom, Responsibility & Law Program at the American Association for the Advancement of Science, in Washington… Charles Watson, an engineer who specializes in numerical hazard models, said RMS acted irresponsibly. 'Especially for something with trillions of dollars in property value, and peoples' lives and livelihood are literally at stake in these decisions. It is irresponsible to implement before peer review. There are tremendous policy implications.'"[2]

Even RMS's competitors are stating that the methodology for the 5-year model does not represent good science. In an article in *Contingencies*, the magazine of the American Academy of Actuaries,[3] AIR's Senior Vice President, David A. LaLonde, said, "We [AIR] continue to believe, given the current state of the science, that the standard base model based on over 100 years of historical data and over 20 years of research and development remains the most credible model." AIR's entire premise in the article is that short-term projections, like five years, are not appropriate. Since AIR followed RMS's lead in using the 5-year model despite their misgivings, LaLonde acknowledged that policyholders have experienced rate increases of "as much as 40 % higher than the long-term average in some regions." AIR also seems to confirm the possibility of collusion between modelers and insurers, stating that, "...many in the industry challenged catastrophe models and called for a change."

To date, NAIC has been absent on an issue that is vital to millions of Americans who live and work near the nation's coastlines. As stated above, this regulatory negligence has harmed millions of consumers. NAIC could still assure that cat modelers will never again be allowed to dramatically change their methodologies to the detriment of consumers without significant oversight. Please inform us as to whether NAIC will change course and quickly address this serious concern.

Y ours Very Truly,

J. Robert Hunter
Director of Insurance
Consumer Federation of America

Birny Birnbaum
Executive Director
Center for Economic Justice

1 New Speaker Challenges Insurance Risk Projections, Tampa Tribune, 1/10/07
2 Ethicist Questions Insurance Rate Data; Tampa Tribune, 1/12/07
3 What Happened in 2006? Contingencies, March/April 2007

cc: Commissioner Sandy Praeger, NAIC President-Elect
Commissioner Roger Sevigny, NAIC Vice President
Commissioner Jane Cline, NAIC Secretary-Treasurer
Commissioner Kevin McCarty, Chair of NAIC C Committee
Alex Sink, NAIC CFO