STUDENT OF THE INDUSTRY PARTING SHOT

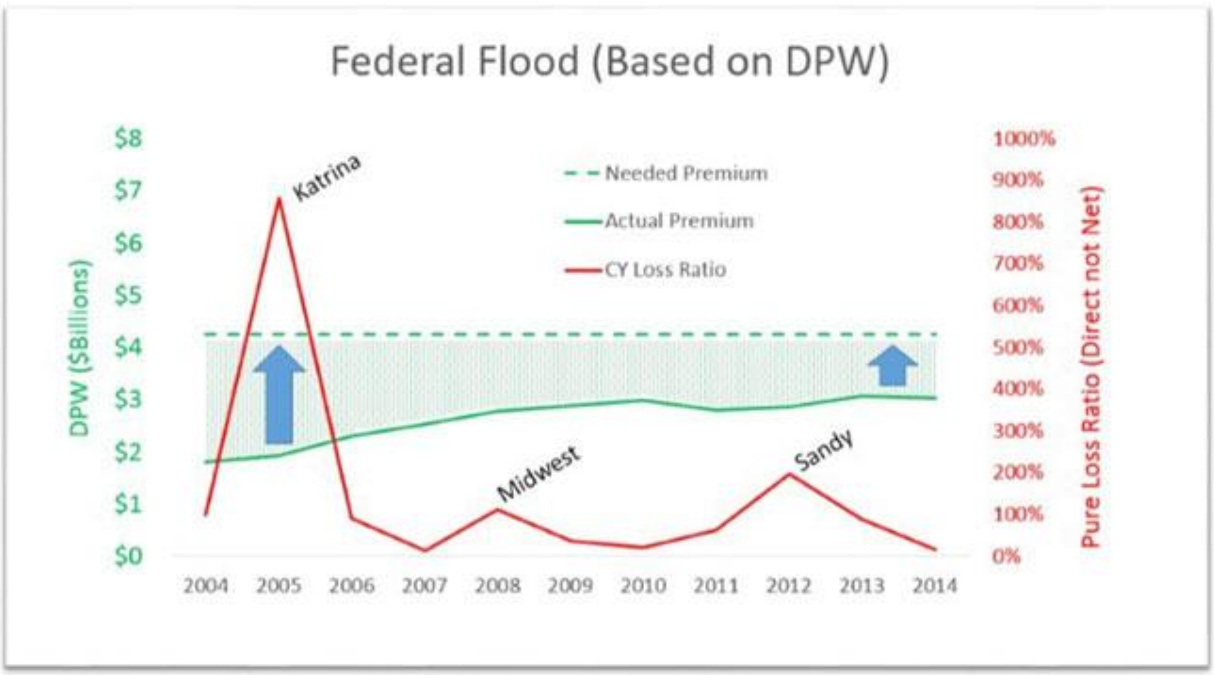
Hand Wringing and Flood Insurance...How Far Off Is Success Really?

By Paul Buse, President of Big I Advantage®

Recently there has been a lot of press on flood insurance, notably last Friday on NPR's All Things Considered: "Lawmakers To FEMA: Flood Plan Overhaul Is 'Too Little, Too Late'." The gist of the article left me with some unanswered questions on the analysis but on looking at industry data in trying to make sense of the author's profitability conclusions, I was by struck something positive. I'm always astounded how well federal flood insurance works and for how long it has worked. Lost on many outside our industry is the idea that the insurance industry does an impressive job on delivering what insurance text books would tell you is IMPOSSIBLE: Flood insurance lacks "independent exposure units." That is, with this loss exposure if there is one loss, there are many losses.

Of course, given the reality of the challenge of flood insurance, the federal government stepped in and it insures the losses and it uses the services of about 30 insurance companies to manage losses. Few consider the alternative of a federal disaster workforce large enough to handle the next major hurricane sitting idle between catastrophes as a viable solution. There were issues with loss adjustments in Hurricane Sandy but considering the challenge, would a government workforce have been better? We'll have to wait and let Congress decide.

On the positive side, let's not lose sight that progress that has been made. We landed a functional vehicle on the moon. Is some sort of sustainable and functional disaster insurance approach harder than that? When one considers the potential of catastrophe bonds and the capabilities of the U.S. insurance industry, I am optimistic that there is a solution that can bridge the gap. Below is a graphical representation of how close we are and, also and importantly, the fact that we are getting closer. Consider in the last 11 years we have had Katrina, long-term and widespread Midwestern floods, and Sandy, and we are only the green shaded area short of something the insurance industry would provide coverage for on its own? You can draw your own conclusion but it's more than half-way there and getting closer.



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Source: : A.M. Best Aggregates & Averages, Industry By Lines Direct Written Premium and Loss Ratio (note, loss ratio above does not include loss adjustment expense or LAE). The above consideration of "needed premium" (shaded green and blue arrows) is a general one. What is shown is $4.25 billion in premiums as needed to cover the insured loss exposures since 2004. That is based on the average losses over past 11 years plus 3.6% LAE increased by the approximately insurance industry expenses of 30%.

The Answer to Last Week's Contest: Claim Cost Inflation

The answer to last week's puzzle on the mathematics of claim cost inflation is based on the combination of Frequency and Severity and the result in claim costs increasing. Total claim cost increases result from the product of Frequency change (expressed as how 100% would change) and Severity (expressed the same way or "1" + the percent change). In our example severity was assumed to increase by 3.141592%. The question was what would frequency have to increase by to result in total claim cost increases of 6%. Some of you identified the number as a truncated version of *pi*. There is not significance to that choice beyond it makes for a long number so it was easy to see if you got the right answer. Below is the answer, which required some algebra to get the exact answer.

(1 + Severity%) * (1 + Frequency%) = (1 + LossCostChange%)
1.03141592*(1+Frequency%)=1.06
Frequency%=1.06 ÷ 1.03141592
Frequency%=.02771344 or 2.771344%

P.S. I can't possibly discuss flood without encouraging you to check out our very own Big "I" Flood program. Visit www.iiaba.net/Flood to learn more about our WYO program with Selective.

The product and eligibility may have been revised or discontinued since the original article was written. Review the Information page for each product on Big "I" Markets for current content and instructions.