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STABILIZING INSURANCE MARKETS FOR COASTAL CONSUMERS

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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STABILIZING INSURANCE MARKETS FOR COASTAL CONSUMERS

Wednesday, September 13, 2006

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Kelly, Brown-Waite, Feeney, Hensarling, Campbell, Foley, Shaw; Kanjorski, Hooley, Moore of Kansas, Hinojosa, Israel, Clay, Baca, Lynch, Scott, and Wasserman-Schultz.

Chairman BAKER. I would like to call this meeting of the Subcommittee on Capital Markets to order this morning.

I am advised that Mr. Kanjorski, the ranking member, is on his way, and in order not to keep our distinguished panel waiting unusually long, agreement has been reached to proceed, and we do expect his arrival momentarily.

The committee meets today to examine and hear witness testimony on the state of readiness of our Nation's insurance industry and the ability of State governments to meet the needs of constituents facing increasing frequency and severity of natural disasters of all sorts.

I wish to make clear that it is not my intention that this meeting be viewed as a response merely to a Hurricane Katrina/Rita problem, nor even just as a hurricane response concern. In fact, this should be the beginning of a thorough and longstanding examination of all peril risk, including earthquakes, wind, and any other calamity which may befall American people, wherever they may be.

The remedies that have been suggested have been varied, and the remedies that are attempted to be put in place at the State level have resulted in varying consequences. I note that, in California, with the creation of the California Earthquake Authority, to date, I am told, no more than 13 percent of Californians have availed themselves of that coverage.

By contrast, in the State of Florida, with the creation of their CAT fund, it has, to some observers, been over-subscribed and, in 2005, resulted in a $1.4 billion operating deficit.

So the consequences of these market aberrations are significant, and the remedies attempted to seek resolution have obtained varying results.

In order to put a Louisiana perspective on our problem, however, I wish to enter into the record a statement from the Greater New Orleans, Inc., organization, and particularly their addendum in which they give specific examples of what has occurred since the storm. For example, a particular restaurant located in the French Quarter which did not flood, which did not suffer wind damage, in the prior year paid $27,000 for their 2005 coverage, which included a 2-percent wind deductible, with a maximum deductible under any circumstance of $25,000. The 2006 renewal for the same limits is $242,000. That is up from $27,000, and includes a deductible of 5 percent. That is more than doubling the deductible, with no dollar limit on that withholding.

The second is with regard to a health care provider with $1.5 billion in property insured. The previous policy had a wind limit of $200 million in damages to be paid. The total premium was $1.3 million. The renewal has a wind limit coverage of $25 million, down from $200 million, and the premium stays the same.

Now, I am not one to inject myself into business operations, nor to express concern about someone having to pay increased premiums in light of duly identified risk. In each of these cases, neither business entity made a claim or suffered a loss during the course of Katrina.

One of the remedies I wish to examine is how site-specific the risk assessment is by the industry in determining, property by property, whether they are likely to suffer loss, which leads us to the building code discussion. If we know there is a frame of wood constructed to less than adequate standards, it would be understandable for that business owner to pay a higher premium than someone built on an elevated site with a steel structure, but yet that screening of risk by property does not appear to be effectively utilized today.

Others have suggested various remedies, from the full-scale creation of a Federal backstop to various variations in tax reserving, but I do not believe that a clear remedy has yet been identified, and this committee's work will take us through many hours of hearings to finally seek that remedy.

As I have said, this is not a one-State problem, it is not a one-party problem, it is just a big problem, and I want to commend the members of the committee—Ms. Brown-Waite, Mr. Feeney, Ms. Wasserman-Schultz, and Ms. Maloney—each of whom have expressed various recommendations about resolution. As well, today, we have Mr. Shaw and Mr. Foley joining the committee—and I ask unanimous consent that they be considered members of the panel for today's considerations—who have come from their State's concern with their own perspectives about how resolution might be achieved.

As a result of reading the testimony, and members' expressions of interest, I intend, assuming there is no unforeseen calamity befalling political fortunes, early next year to engage in a series of roundtable discussions. As the ranking member knows, we have done this on other matters of consequence, and we do not get all

stakeholders around the table at one time, but we afford everybody a chance to be heard, and I believe, if we begin this process in January, before we get into the difficulties of the storm season next year, perhaps the House can come to some resolution on needed reforms, and so, I thank all the members of the panel who have given of their time today.

There are many others who wish to be heard, and as we go forward, we will ensure that all perspectives have been made available to the members, and with that, I would recognize the ranking member, Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

This morning, the Capital Markets Subcommittee returns to an issue that we have often reviewed in the past—the availability and affordability of insurance in coastal areas.

From our past work on these matters, we know that the cost of reinsurance typically rises after major events, particularly as providers reassess risk. Most recently, this contraction has led to problems in rebuilding along the Gulf Coast after Katrina.

In addition, 7 of the 12 most costly disasters in our Nation's history occurred in 2004 and 2005, so others are also affected.

I share the concerns of my colleague about helping the communities affected by these catastrophes. I also want to ensure that we take effective steps to ensure that people who live in less risky areas pay appropriate and reasonable rates for their insurance policies.

While today's hearing will allow us to gather the additional views of a number of experts on these matters, we are still awaiting the results of the three catastrophic insurance studies being prepared by the Government Accountability Office.

In the next Congress, we should hear from the GAO about the findings on these matters.

In the meantime, today's hearing will help us to better discern the quality of the adjustment process and consumer confusion in the insurance products that they should purchase and at what levels.

We will additionally look into what, if any, role the Federal Government should play in providing natural catastrophic insurance. I have, however, long had deep reservations about inserting the Federal Government into the private markets.

Finally, I hope that we will explore the interest in creating an all-perils policy that would protect homeowners regardless of the cause of the damage. This product would cover perils like floods, fire, hurricanes, wind damage, and earthquakes in just one policy.

While this type of product would end consumer confusion about what coverage they need and likely result in less litigation about insurance settlements, it would also come at a considerable cost.

In sum, I look forward to hearing from our witnesses. This is a topic that deserves Congressional action and review, and I can assure the future ranking member that we will continue it next year.

Chairman BAKER. I appreciate the gentleman's optimism.

Ms. Brown-Waite.

Ms. BROWN-WAITE. Thank you very much, Mr. Chairman.

Mr. Chairman, I would like to ask unanimous consent to enter a statement into the record from the National Association of Realtors.

Chairman BAKER. Certainly, without objection.

Ms. BROWN-WAITE. Thank you very much. In this, it highlights the fact that it is a national problem, and it certainly is having an impact on the cost of rents, as well as a slowdown in the housing market. So I think it is certainly very pertinent.

Thank you.

I cannot thank the chairman enough for holding this hearing today.

The insurance crisis that Florida and many other States are facing is imminent, and we need to find solutions immediately.

I also want to thank the witnesses who are here. We certainly have an array of them from various areas in our great Nation.

As many of you know, I have introduced H.R. 4366, the Homeowner's Insurance Protection Act, with my colleague, Mr. Shaw, who is here today, and the bill has many cosponsors.

As I have been meeting with industry groups and other members, I hear claims that the market is stable, there is enough reinsurance, and that there is no problem. Well, to those people making those claims, I would suggest that they visit Florida, Mississippi, Alabama, South Carolina, New York, and many other States.

Basically, every person living in Florida is a victim of a market that is nowhere near stable, and it is not just Florida. I am not talking about millionaires who live on the beach, as the cliche goes. I am talking about retirees living on Social Security, young families, and people just starting a business, as well as farmers whose families have been in Florida for centuries.

Florida homeowners' premiums are increasing at double-digit rates, or their policies are dropped entirely, and they have to get insurance from the State's insurer of last resort; Citizens is the name of the entity that was created.

This insurer of last resort will soon become the largest insurer in our State, which will spell even more of a disaster.

However, if homeowners are facing affordability questions, business owners are facing a threat far worse: availability.

Because there is no Citizens insurance property coverage, Florida has moved past the initial outrage stage and is now in full-blown panic.

Business owners are no longer scared because their rates will increase. They are having to close their doors and leave the State, simply because they cannot get insurance. No area, including Florida, can withstand this type of economic meltdown.

Congress has to find a solution to this crisis, and I recognize that the solution is multi-faceted.

The solution should include States passing and enforcing strong building codes and mitigating disasters before they strike, ensuring that companies are writing prudently, that they are purchasing adequate amounts of reinsurance, and that they are not over-exposing themselves.

Also, relieving the market of unnecessary regulatory burdens and giving insurers the tools that they need to enhance competition,

such as allowing them to build up tax-free reserves; certainly making sure that the insurers of last resort are the private insurers, not the Federal and State Government, as my bill does by creating a Federal catastrophic fund, not funded by taxpayer dollars.

Giving homeowners and business owners the tools that they need to prepare for disasters themselves, like my colleague, Mr. Feeney, does by creating the catastrophic savings account, is also another approach. I hope that all the panelists here today have some innovative suggestions as to what Congress can do to help you better provide a more affordable product to our constituents around the country, because we should refuse to wait until the next big disaster hits, whether it is a hurricane, earthquake, or tsunami, before Congress wakes up and enacts a solution to a crisis that already is on our doorstep.

Mr. Chairman, I thank you very much, and I look forward to hearing from our speakers today, and I yield back the balance of my time.

Chairman BAKER. I thank the gentlelady and want to commend her for her hard work on this subject and assure her and Mr. Shaw, the cosponsor of the measure, that the committee will examine carefully those recommendations as we proceed in future weeks.

Mr. Israel?

Mr. ISRAEL. Thank you, Mr. Chairman, and thanks also to our ranking member, for convening this hearing.

Congresswoman Carolyn McCarthy, my colleague from Long Island, and I sent a letter to the chairman and ranking member some time ago requesting this hearing, and we deeply appreciate your responsiveness on a very critical issue.

I'm on the Armed Services Committee, and we're conducting a markup today on the issue of military tribunals. So I am going to need to do a lot of shuttling back and forth, but this issue is critically important to my constituents.

I represent Long Island, New York. In fact, a few months ago, I saw a computer model of what would happen to Long Island in the event of a Category 3 hurricane, and Mr. Chairman, it was good news and bad news.

The bad news for me was that the entire north shore of my Congressional district, on the Long Island Sound, would be flooded. The entire south shore of my district, along the Atlantic Ocean, would be flooded. That's the bad news.

The good news for me, Mr. Chairman, is that, on Long Island, it is the waterfront properties where most Republicans live, because they can afford those properties, and so that is kind of a divine form of redistricting.

The fact of the matter is that it does not matter, as you said, Mr. Chairman; it is not a Democratic problem, it is not a Republican problem, it is a big problem, and it is a problem for my constituents on Long Island.

Already two insurance companies have made the decision either to provide limited renewals of homeowners policies or not to sell any additional homeowners policies at all. This is creating considerable frustration and concern in my district.

I think that there are some sensible solutions to this, and I hope to play a constructive and bipartisan role in pursuing those solutions.

I appreciate the fact that insurance companies need to ensure that they can meet their obligations and provide levels of protection to my constituents, but we cannot leave anyone literally high and dry. We need to develop a national framework for this.

I am a cosponsor of Ms. Brown-Waite's bill, and I think it is a good step.

I am absolutely open to all other steps, and look forward to continuing to have a dialogue with industry, with consumers, and with my colleagues on this committee to find an ultimate solution that is effective, that is sensible, and that is also fair.

I thank the chairman and yield back the balance of my time.

Chairman BAKER. I thank the gentleman for his statement.

Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman, for holding this important hearing to examine the state of the natural catastrophe insurance market.

Clearly, the 2005 hurricanes wreaked a tremendous loss in human lives and in economic loss, live property damage, with over $50 billion in insured losses, and so, consequently, we have Congressional interest and public debate on the issue of how to address disaster financing.

A key question before us today is how did the insurance markets perform in this catastrophe? Were they successful, or is there clear evidence of market failure? As I examine the record, I think the answer is that the market performed reasonably well, at least the private sector did. The insurance industry demonstrated resiliency and flexibility in the wakes of these historic devastating hurricanes, and was able to successfully settle most of the Katrina and Rita claims, certainly without a significant weakening or disruption of the overall financial strength.

However, not surprisingly, a range of very legitimate issues have arisen from wind versus water lawsuits to the question of affordability.

This has caused insurers at both the State and Federal regulators to reexamine our current market structure, and I know this committee will be very actively engaged in this issue in the weeks and months ahead, and we should, but if history is our guide, I fear there may be a tendency for the Federal Government to overreact and respond simply with new Government programs and subsidies that may only make the problem worse, and they could certainly do so by distorting pricing mechanisms that match premiums to the level of risk being assumed and allow realistic capital levels to be accumulated by insurers.

Compared to private markets, the Federal Government's track record in insurance programs is somewhat suspect, and should give anyone pause before considering an expanded Federal role like a Federal backstop. Certainly, we should note that the Federal flood insurance program is broken and insolvent, and Congress has had to increase its borrowing authority three times.

The PPGC has just posted a $23 billion deficit and projects billions in unfunded liabilities, and I need not talk about the future of Social Security.

Federal insurance programs or taxpayer subsidies do not always work well, and moreover, they tend to disrupt the private sector markets that are functioning reasonably well.

Instead of examining ways to shut down or displace the private markets, I would hope that we would review existing regulatory and tax structures to identify and remove obstacles, to strengthen the private insurance markets. We need to look at certain State and local policies dealing with building codes, code enforcement, land use planning, and certainly risk-based pricing is critical.

So I hope that, as we try to stabilize the market, increasing affordability and availability, that we do not simply make the problem worse, and I hope that the cure does not prove worse than the disease, and with that, I yield back the balance of my time.

Chairman BAKER. I thank the gentleman.

Ms. Hooley?

Ms. HOOLEY. Thank you, Mr. Chairman, and Ranking Member Kanjorski, for holding this hearing, and I thank our witnesses for taking the time to be here today to talk about this really important issue.

At a time when many insurance companies have either stopped writing new policies in some areas or withdrawn from the at-risk markets entirely, homeowners are having an increasingly hard time finding insurance, and if they find it, it's not always affordable.

So not only are we facing a greater number of disasters each year, but the cost of those disasters is increasing, as well, as more people move to high-risk areas and the value of their land continues to rise.

As a result, I have serious concerns about the availability of homeowners and catastrophic insurance in high-risk areas, and I question if the private market alone can continue to sustain the necessary coverage. At the end of the day, homeowners need to be able to find and afford adequate coverage, and we must take whatever steps are necessary to try to achieve that goal.

In addition to strengthening the insurance market, I also believe that we must take a preemptive step to reduce the cost of catastrophic disasters and encourage mitigation whenever possible.

I worked to pass language that would reinforce existing legislative mandates for FEMA to map the risk of mudslides, which happens in my State, in Oregon. It is provisions like these that will help the insurance industry, consumers, and small businesses to better judge the dangers posed by flooding or other risk.

Strengthening building codes and investing in risk-mitigation codes are simple ways we can help control the costs from the next major disaster.

The one thing I would urge all of us to remember as we continue this discussion is that this is not just an issue that concerns the Gulf Coast States, although they have certainly been hit the hardest in recent disasters.

I am looking forward to hearing the testimony from all of you, and particularly your suggestions on how to fix the catastrophic in-

surance system throughout the country and provide greater access to homeowner's insurance, and I thank you for being here today.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentlelady.

Ms. Kelly?

Ms. KELLY. No statement.

Chairman BAKER. Mr. Feeney?

Mr. FEENEY. Well, Mr. Chairman, I know we share a great interest in natural disasters, and I am really grateful to the chairman for having this hearing. I want to thank Commissioner McCarthy from Florida ahead of time for his testimony and for the great work that he has done in Florida.

In Florida, obviously, we have a long history of hurricanes.

Representative Brown-Waite, Representative Foley, and I were there in the aftermath of a 1993 storm called Andrew, and we learned a great deal about the mistakes we made in terms of things like lax building codes. We had companies at the time that were 80-percent concentrated in market share in two counties.

You know, I came from Philadelphia. Benjamin Franklin started the first insurance company, and he knew enough not to let three or four wood houses on the same block have the same insurer, but somehow, prior to 1993, our insurance regulations were lax in that regard. We have come a long way, and by the way, there is no State that does disaster preparedness and disaster response better than Governor Bush's Florida, and I congratulate you as part of that important team.

I have to tell you that Congressman Shaw has been a leader in working Federal tax policy in the aftermath of natural disasters, so that people get equitable treatment as they go fix their own problem, as opposed to having the Federal Government come in and do it for them, and I agree with much of what my colleague, Jim Hensarling said, that the only way to do this right is to get healthy markets in the insurance industry up, and we need an almost exclusive provider of insurance, and we have to figure out, at a Federal and State level, although with local help with building codes and enforcement, how to do that.

Having said that, regulation of insurance companies is something that the government must do. Whether it's done at the Federal level or the State level is a little bit of an interesting question.

We have traditionally done it at the State level exclusively, but you know, when I go to take out a loan for my home, and when the loan company shows up with a check for $200,000 so I can do my closing, I do not particularly care at that point, once I have my $200,000, about the fiscal health of the mortgage company. I do not really care if they go under tomorrow. I have my house, and I do not have any loss or threat to myself.

On the other hand, if I pay life insurance premiums for 60 years, for example, and then die, and the insurance company does not have reserves to pay the claims to the heirs that I spent a lifetime trying to protect, then I have had a big loss there, and especially my heirs have had a big loss. The same thing is true in all types of insurance.

So the government's responsibility is to make sure that companies have adequate reserves to pay for the risks and the claims

that they have assumed, and no other entity—this is not something that can be done exclusively by the private sector, in my view.

There are too many companies that would take our premiums and run off to Mexico with the money, or be in flight, or just simply mismanage it, and that is why we have to have regulations, and we can debate about where those regulations are best handled.

I will tell you that I do believe, as the ranking member said, that insurance must be a risk-based approach to make this successful.

We do not want people in high and dry safe areas bearing enormous subsidies for people who decide to build a stick home out in the Keys of Florida for $5- or $6 million. It is just fundamentally unfair to have that sort of cross-subsidy, but having said that, the whole idea of insurance is to take advantage of the law of big numbers and to spread the risk, and the further you can spread the risk, whether it is health insurance or life insurance or any other policy, including property and casualty, the better off we are, and there may be an important Federal role in terms of doing that.

I will end with this: Either tomorrow or the next day—I am sure Commissioner McCarthy is going to be there—I understand that the Governor, led by Lieutenant Governor Jennings, is going to have a statewide summit of all the important parties, probably, in the west coast of Florida, as I recall, and the policymakers in Florida understand this.

There are no easy answers, but this is not a partisan issue. Democrats and Republicans alike understand the threat, and let me describe it very briefly, and then I will end with that.

One of two things will happen, if we do not get this right, to the State of Florida, and other States along coastal areas, or along the Mississippi, or that are threatened by earthquakes.

Either we will misregulate and companies will pull out of the market and people will not be able to get property and casualty insurance—by the way, the crisis in Florida is even greater, in many respects, in the commercial markets than in the homeowners market.

If that happens in Florida, we will see a job loss for virtually all of the Realtors in the State, as well as for the people who do surveying; the people who do title insurance; the people who write loans; loan officers; and the people who provide concrete for sidewalks.

The entire construction industry, and all of their suppliers will literally shut down, and we will have not a recession but a depression, and that will affect the national economy, since we are about 8 or 10 percent of the national economy, and by the way, in things like job growth, the fastest growing major State.

The other thing that we will do is that we will have a State that mismanages the risk for political reasons.

They will put everybody in, as Congresswoman Brown-Waite said, a government-based insurance company. Citizens is what we call ours.

That is a perfect policy, because everybody gets insurance, and things move along nicely, and it works until you have an event, because the reason that State governments have to set up JUA's is that no actuary in their right mind would ever let private capital take risks that are unnatural.

We have to de-populate Citizens, and I encourage all States that have similar problems, whether it is auto or health or whatever, to de-populate the government-backed, because the only reason the government is involved is that nobody in their right mind would otherwise be doing this.

Chairman BAKER. Can the gentleman begin to sum up?

Mr. FEENEY. Yes, I will.

If you have a JUA like Citizens that is the major insurer, it works great until you have an event, and then we will have an economic catastrophe, to include bankrupting an otherwise very healthy State, and thank you, Mr. Chairman. As you know, I am passionate about some of these issues. I apologize ahead of time for being long-winded.

Chairman BAKER. The gentleman's passion is clearly understood and appreciated.

Mr. Lynch?

Mr. LYNCH. Thank you, Chairman Baker, and also, I want to thank Ranking Member Kanjorski for the wonderful effort in facilitating, really, a bipartisan discussion of this issue.

We all understand the threats to consumers generally and families in our district that are located in coastal communities.

I want to thank the panelists, as well, for coming forward and helping the committee with its work.

I recognize a lot of faces here today that were with us back in June when, in the Housing Subcommittee, which I sit on, we also had a similar debate about the affordability of insurance to those communities generally as a result of natural disasters, and especially in the context of Hurricanes Katrina and Rita, and since hurricane season is in full bore right now, this hearing could not have come at a more opportune time.

I know in the past decade we have seen the rising toll that natural disasters have placed on homeowners insurance markets in parts of the country that frequently experience catastrophic events.

Last year alone, there were a total of 27 storms in the Atlantic region, which included 14 hurricanes, and not only that, but in my State of Massachusetts—and I live in and represent a coastal community in Massachusetts, a State that is not in the exposed position that many of my colleagues face in southern States along the Gulf. In Massachusetts, we actually faced four situations, four Federal disaster declarations in 2005, and I know that the GAO is currently conducting several studies to further assess the need for changes in the catastrophic insurance market. I look forward to those results coming out.

In the meantime, I realize there are general problems in the quality of the adjustment process, overall insurance policy coverage, and what is most important to all of our constituents is the general affordability of coverage. That is where the rubber meets the road for a lot of us. Whether it is commercial customers or residential customers, it is simply astounding the burden that some of our families are facing in light of these natural disasters.

I look forward to hearing from the distinguished panel and exploring various ways in which we in Congress can address the problem that is arising and we are currently facing in the catastrophe insurance market, and I also have another hearing that is

going on—I did not schedule this—on national security and emerging threats. So I am going to have to shuttle back and forth from that hearing, but this is very important, this discussion, and I look forward to hearing from the great panel that we have here in terms of their suggestions and recommendations on how we address this problem.

Thank you, Mr. Chairman. I yield back.

Chairman BAKER. I thank the gentleman.

Mr. Campbell?

Mr. CAMPBELL. Thank you, Mr. Chairman.

I represent a coastal district of southern California, no hurricanes, but we have earthquakes, we have mudslides, we have floods, potentially, and theoretically, tsunamis, in addition to fires, and other various plagues that hit us now and then.

Mudslides, which recently hit my district, are uninsurable except from Lloyd's, generally. Earthquakes—in California, the State law requires that earthquake insurance be offered with homeowners insurance. However, today less than 15 percent of all homes in California are covered with earthquake insurance. A tsunami—you can tell me what would happen if that were to occur, and then there is obviously the flood problem that we have, and not a lot of people have flood insurance either.

So I am very interested to hear the testimony, with the understanding that the most recent natural disasters that have caused great loss of property value and life have been hurricanes, but there are others in other parts of the country, and the one thing that is constant is that wherever you live in this country, you are subject to some natural disaster and not to all, and so, I will be interested in your comments on how we can look at risk pools that run across the different types of natural disasters that can occur in different parts of the country.

Thank you, very much.

Chairman BAKER. I thank the gentleman for his statement.

I recognize Ms. Wasserman-Schultz, and as all other Floridians, want to acknowledge her intense interest in this subject and her contributions today.

Ms. WASSERMAN-SCHULTZ. Thank you. Thank you very much, Mr. Chairman, and Ranking Member Kanjorski, as well, for convening this important hearing.

Mr. Chairman, it is particularly important because we are the committee of jurisdiction, and I am really pleased to see that we have been able to bring such a distinguished panel together.

We have to come up with a bipartisan solution to this growing insurance crisis in our country, and as the gentleman from Florida, Mr. Feeney, mentioned, we mostly do things right in Florida when it comes to insurance-related disasters, but I would not have quite described Florida as Jeb Bush's Florida. I think Florida can generally be described as Floridians' Florida, just to add that. We were reminded just a few weeks ago—and just so you know, Mr. Feeney knows I mean that affectionately.

We were reminded just a few weeks ago, during the one-year anniversary of Hurricane Katrina, that we, as a Nation, are still ill-prepared to deal with a catastrophe. We have gone through planning and mitigation efforts and execution of coordinated responses.

We have a long way to go until we can assure Americans that we can keep them safe in the face of a catastrophe, but we are here today because the economic resonance from disasters like Hurricanes Katrina, Rita, and Wilma have left an indelible fingerprint on our Nation.

Hundreds of thousands of families and small businesses across the Gulf coast are struggling to rebuild, and I think that is an important point.

Mr. Campbell just mentioned that he does not suffer from hurricanes in his community, but I absolutely agree with you, it is a very important point to note, we have natural disasters all over this country, and this is a national problem that needs a national solution. These catastrophes have reshaped our Nation's personal and commercial insurance markets, making it even more difficult for affected regions to recover.

Events of late have led regulators, industry stakeholders, and public policymakers to reconsider the efficacy of existing models and regulations.

The market perception of exponential increases in the risk affiliated with catastrophic events has resulted in precipitous declines in insurance coverage availability, at astronomical costs to policyholders, and I am using those really major words because there is no other way to describe it.

This is a significant, significant problem. I could tell you story after story of individuals who have had gargantuan increases in either their residential property insurance quotes or commercial.

It is just unbelievable, and it is happening most acutely in Florida, where the issue is not just price but availability.

The insurance market is literally drying up in front of our eyes, and the economic impact, as Mr. Feeney describes, can already be felt. This problem is not endemic to Florida, and it is happening across the Nation. It is really obvious that our current system is broken. There is no silver bullet. There is a patchwork of regulation and state-based risk pooling that is not working.

We were very fortunate to create a State catastrophe fund in Florida, but that is not going to help us survive on our own.

I mean we cannot continue down the path that we have been traveling without having change, and change in the way that we think about managing catastrophes nationally in this country.

These storms do not recognize State boundaries. They do not say, okay, I am going to stop at the Florida border, up in north Florida, and I am not going to go any further, because there is no CAT fund past this line.

We have to think about that when we consider mechanisms to hedge risk affiliated with these events, and at the end of the day, all of America's taxpayers are on the hook, regardless of where the disaster strikes. We have already spent more than $100 billion in response to Katrina, and the question is, do we plan and prepare for events in an effort to minimize cost to the American taxpayer, or do we wait around for the next storm and throw astronomical sums of money at the problem?

I mean that is really the question that we have in front of us, and I think the lesson learned from Katrina is that the wait-and-

see approach, the, you know, go like this approach—that does not work.

The huge failure of coordination and mismanagement of relief funding has resulted in untold losses of hard-earned taxpayer dollars.

It seems especially foolhardy when we know that there are policies that we can adopt that minimize cost and stabilize markets, and we need a comprehensive national solution to this national problem.

I have introduced a bill with my colleague from Delaware, Mr. Castle, H.R. 5891, the Catastrophic Disaster Risk and Insurance Commission Act of 2006, and Mr. Chairman, we spent a number of years when I was in the Florida legislature—and I was elected the year that Andrew hit south Florida, and the only way that we were able to finally bring all of the stakeholders together around the table to develop our State catastrophe fund was when we had a statewide commission that our university president sat on, and they came together and made objective recommendations to the legislature, and with input from all of the stakeholders, and we were able to get something accomplished, and I want to thank Mrs. McCarthy, Mr. McHenry, Mr. Israel, Mrs. Hooley, Mr. Crowley, and Mr. Hinojosa for signing onto that bill.

I know the chairman is still considering the best approach to this problem, and I know that he will agree with me that we cannot solve this problem unless we bring all of the stakeholders to the table, and I truly appreciate your commitment, Mr. Chairman, to roundtable discussions.

We need to move forward together on this problem, with all of the stakeholders.

Congress has been too slow to respond.

It is time we had a comprehensive solution to a national problem, and I commend the committee for convening today's hearing. I do hope our panelists will focus on solutions to the problem, but it is time for us to act on this problem before the next big storm hits, and I do want to close by welcoming our State's insurance commissioner, Kevin McCarty, who has done an absolutely fantastic job on his leadership nationally on this issue. Thank you so much.

I yield back the balance of my time.

Chairman BAKER. I thank the gentlelady.

I wish to welcome the senior member of Ways and Means to our considerations today, Mr. Shaw, who has made his own contributions on this subject matter, and recognize that, going forward, whatever the remedies that might be considered certainly could have Ways and Means jurisdictional reciprocity, and I appreciate the gentleman's willingness to participate in our hearing today, and look forward to working with him in the future. The gentleman is recognized.

Mr. SHAW. Thank you, Mr. Chairman, and I would ask unanimous consent that my full statement be made a part of the record.

Chairman BAKER. Without objection.

Mr. SHAW. Mr. Chairman, Ranking Member Kanjorski, and members of the committee, what you are hearing today is a distress call coming out of the State of Florida. We are not going over

the cliff yet, but we are heading toward the cliff, and it is an economic cliff that is going to create tremendous hardship for the people of Florida.

You have heard several references today to Hurricane Andrew.

In the aftermath of Hurricane Andrew, I went down to Homestead, and I could not believe the devastation. I came back to Washington and studied the insurance plan that the Federal Government had set up for flood protection, and using it for a model, I filed the first windstorm insurance program, which recognized the fact that it was going to be a dying market for windstorm insurance in the State of Florida.

What has happened here—I would like to also express to Mr. Kanjorski, who made reference to this, as well as my friend from the State of Texas, that—reference to the private sector.

In many parts of the State of Florida, there is no private sector when it comes to windstorm insurance. I can assure you that you would not be hearing positive things about what we are doing from Mr. Feeney if there were, but there is not.

It is now up to us.

What we have in the State of Florida is a CAT fund, it is called, and many States—I think some eight States have such a fund, and what Ms. Brown-Waite and I have developed is a program of reinsurance.

It is a program that backs up the State CAT funds, that is paid into by the insurance companies upon the collection of their premiums.

This is not a tax that we are going to be spreading all across the country.

The whole theory of insurance is to take a known risk and spread it across as wide an area as you possibly can. That is what insurance is, but what has happened here—and I can tell you, in my own State of Florida, that there is not one square inch of Florida that has not been devastated by some hurricane over the last 2 years. Listen to it. We had Wilma, Rita, Charlie, Frances, Ivan, and Jenny. I am just talking about south Florida here. The whole State has been hit.

So what happens—that risk that is supposed to be spread all across a wide area has all felt its share of devastation.

Now it is time for us to take a close look at bringing it back so that we can spread the risk across this country, and what it simply does—we have an insurance program in the State of Florida, which has been made reference to already, called Citizens Insurance, which sets up reserves and is paid into.

To give you an example of the economic hardships that so many of my constituents are having, for a house which is actually under the average house in my district of $250,000, the premium is $5,000, and the deductible is not affordable for many of the people that I represent. If we can have a reinsurance program on the national level—and there is no reinsurance program that is affordable at all in the private sector, but if you can have that, then the reserves that would have to be way up here for any one State, being backed up by a reinsurance program, this reserve can come down and make sure that this is affordable.

I can assure you, Mr. Chairman, that in Louisiana and Alabama, Mississippi, Georgia, Florida, South Carolina—go all around the coast.

We are going to be facing a crisis where the private sector has pulled out of the market.

In the State of Florida, so many of the insurance companies, and maybe all of them, have formed so-and-so insurance company of Florida. So they recognize they do not even want the risk of loss for their company to be spread across the country, even these big national insurance companies.

We are going to have to work together, Mr. Chairman, and I look forward to—I know Mr. Foley has a bill that he wants to speak about which also is not incompatible with the bill that we are talking about, which will also do us a great deal of good, and I will leave it to Mr. Foley to explain exactly what that bill does, but it would have jurisdiction in front of the Ways and Means Committee.

Mr. Chairman, I can assure you that, if I have anything to do with it next year—and I simply hope—I hope that I do—if I am chairman of the Ways and Means Committee, you will have no problem with turf battles with my committee, and I hope the same would apply here.

We are going to work together in partnerships next year to see that this happens and that windstorm insurance, which is required, together with—I would say to my friend from California, it also includes earthquake insurance, which you cannot even buy in your area—that we will come back with a bill that will be good for the whole coastal nation and other areas, the coast of our Nation, together with other areas which are prone to other disasters, even earthquakes, and I think even volcanoes are in there, so we can say aloha to our friends in Hawaii, and I am hopeful that we can come back—and I can assure you you will have my every cooperation in putting this bill together for Louisiana and Florida and all of the other States that are affected by this.

I yield back, and I appreciate your allowing me these few minutes.

Chairman BAKER. I thank the gentleman for his fine statement and assure him of my appreciation for his assistance and my pledge to be of assistance to him and the committee going forward in the next session and seeking an appropriate resolution.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Chairman Baker. I want to thank you and Ranking Member Kanjorski.

I would like to ask unanimous consent that the following materials from the Texas Department of Insurance be submitted for the hearing record.

Chairman BAKER. Without objection.

Mr. HINOJOSA. They include summaries of the Texas sea coast insurance market for residential property and commercial property and lists of the following. One is a list of casualty companies, fire and casualty companies, risk and retention groups, and title companies licensed in Texas since January 2005 through August 2006.

It also includes a list of withdrawal plans filed in Texas since Hurricane Rita.

It includes a list of property and casualty carriers operating in Texas from the 2005 year-end available data.

Mr. Chairman, I am very concerned that certain insurance companies have decided not to issue new property and casualty insurance policies in certain areas of my district. I am particularly concerned about the insurance industry's approach to issuing property and casualty insurance in what are known as tier one and tier two areas. According to the Texas Department of Insurance, the following counties in my Congressional district fall in tier one areas: Refugio and San Patricio County. In tier two areas, they include Lee County, Brooks, Goliad, Hidalgo, Jim Wells, and Live Oak Counties.

I respectfully request of each witness to provide in writing an explanation of their understanding of the definition of tier one and tier two areas. I also request an explanation as to why the counties I have mentioned fall in either tier one or tier two category, and also, I ask for an explanation of the impact this designation will have on the constituents in my district, both financially and in terms of insurance coverage.

That information is very important to me, as I am sure my friends in Florida, Louisiana, and Mississippi are searching for answers to those questions.

Mr. Chairman, my goal here is not to punish the companies that have decided either not to issue new policies in certain areas of my district, nor is it to punish them for deciding to restrict the issuance of new policies in Texas Congressional District No. 15.

I merely seek an explanation for their decision. I seek a better understanding of the impact Hurricanes Katrina and Rita have had on their bottom line.

I want to ensure that the insurance companies operating in Texas have the ways and means to provide property and casualty insurance to all my constituents.

Thank you very much, Chairman Baker, and Ranking Member Kanjorski. I appreciate the opportunity to make these comments.

I yield back the remainder of my time.

Chairman BAKER. I thank the gentleman.

I also welcome today a visiting member from the Ways and Means Committee who has made his own contribution in the debate with this proposal.

Mr. Foley is recognized.

Mr. FOLEY. Thank you very much, Mr. Chairman. I think everything has been said, but not everyone has said it. So let me at least belabor what is a very, very important point, and I think what you have heard from many of the panelists or the Members of Congress, virtually every State has been, to some degree, impacted by natural disaster.

Mr. Israel mentioned what would happen off of Long Island.

Max Mayfield showed us drawings this year that indicated the northeast may become a victim of a hurricane this year much to the same potential and degree of devastation as has hit Florida.

We had nine hurricanes in the last 2 years, 4 of them back to back, causing $22 billion of losses.

My sister received her insurance premium today. It was $8,500 for a home that my parents bought in 1957 for, I believe, $7,500.

The insurance is now more than the original purchase price of the home.

Insurance is causing fiscal calamity in Florida, affecting every level of society.

Homeowners who are in condos will see assessments to the degree that they will simply be unable to continue living in our Sunshine State.

It is no longer an option of scraping together a few additional dollars to pay a premium. It is becoming a sense of urgency that I have not witnessed in my entire adult life.

No question the insurance companies were ravaged. We know that.

When you have had the kind of exposure and experiences in the last couple of years, it is impossible to assume an insurance company, under its traditional methods, would be able to weather those storms, excuse the pun.

I think you have also heard from many members that there are a lot of collective ideas that have been proposed, a multitude of bills that all have merit, which is what this committee and this Congress needs to undertake, is to collaborate in a bipartisan fashion to figure out the answers.

I agree with the gentleman from Texas. I do not want the Federal Government to be the financial backstop for catastrophic problems. We have to find a way for a private sector initiative.

Since Hurricane Andrew, we have seen so many companies become subsidiaries of themselves—Allstate Florida, State Farm Florida—because if something happens there, then they are able to bankrupt that company and not affect the parent, and I am not using those two companies pejoratively. It is just examples of the latest trend in trying to abrogate a loss to the parent company.

Yet we will also see mudslides, earthquakes, and tornados. In fact, an earthquake occurred off the Gulf of Mexico just the other day, an extraordinarily rare occurrence for Florida, but it portends calamity for other States, as well.

My proposal, the Policy Disaster Protection Act, would work to correct that.

It would give insurance companies the option of building up reserves over a 20-year period on a tax-deferred basis, much like an IRA account, where the insurance companies can place in this account pre-tax dollars that can be used for disaster mitigation alone. If they take it out for any other purpose, it is taxed like it would be your IRA, accordingly with a penalty. It would take years to build, which is why Ginny Brown-Waite and Clay Shaw's bill is important as an adjunct to this.

I thank our State insurance commissioner, because I know he has spoken about this bill, both bills, in forums throughout the Nation, but the bottom line for all of us who serve in the Congress, the 455 Members of the House, and 100 Members of the U.S. Senate, you may not think this is a problem for you.

Your insurance companies may be not raising premiums triple and quadruple digits, but if you experience what Florida has, and New Orleans has, and California has, and Texas has, and the wildfires and all the other unanticipated disasters, you, too, will be

facing this difficult, difficult problem. You cannot buy a house without insurance.

First thing they say is, go get a binder, get a policy, then we will insure your mortgage, or we will give you a mortgage. So it will set in motion the end, if you will, of Paradise Lost in our State if we cannot grapple with this.

So I appreciate the attention the chairman has placed on this issue.

I appreciate all of the individual members who are grappling with solutions, and I just hope we can take pieces of each of these proposals and weld together a solution that will help bring down this urgent crisis.

Chairman BAKER. I thank the gentleman for his statement and participation.

Mr. Kanjorski for a unanimous consent request.

Mr. KANJORSKI. Mr. Chairman, I ask unanimous consent that the statement of Congressman Delahunt be included in the record at this time.

Chairman BAKER. Without objection.

Mr. Clay, did you have a statement?

Mr. CLAY. Yes. Thank you, Mr. Chairman. Let me thank Ranking Member Kanjorski and the other members of the committee, as well as the witnesses.

Mr. Chairman, I am concerned about the limitations of insurance policies and the pay-outs that are left for the government to make because of the shortfall in insurance coverage from the private industry.

These shortfalls could be for various reasons: denial of claims, lack of coverage offered, or no insurance coverage, to name a few.

I am especially concerned by the dismissal of claims by companies because of disagreements of whether the property was damaged by wind or water.

We have catastrophic losses because of hurricane-force winds and the accompanying rains and floods. Yet, families have problems getting insurance settlements, although they have insurance for these occurrences.

I am deeply concerned with the methods of reducing losses employed by the insurance industry. We have policies that are being issued that settle the water damage versus wind damage dispute by stating that if the property was damaged by both, the losses are not covered, even if there was wind damage as well as flooding, and even if the wind damage occurred prior to the flooding.

However, I guess that I should feel better about this type of policy, because families are told up front that they will be left up the creek.

I guess we need to ask the proverbial question: Do we need this insurance at all?

If you are not going to cover the losses, do we need it at all?

Mr. Chairman, I will stop there, and ask unanimous consent to insert my statement in the record.

Chairman BAKER. Without objection.

Mr. Baca, did you have a statement, sir?

Mr. BACA. Yes. Thank you very much, Mr. Chairman.

Today's hearing is especially important given the impact of last year's hurricane both on our consumers and insurance market.

About $23 billion, or about 25 percent, of the Federal assistance following Hurricanes Rita, Wilma, and Katrina is going to compensate persons who did not have insurance coverage for catastrophic events, but many victims are still waiting on their checks.

I hope this hearing helps us better understand the scope of the problem that insurance claims need to be facing. For instance, it has been seen and reported that despite being hit with catastrophic losses, insurers have been record prices that can handle catastrophic losses in the future, so it still impacts them.

Yet, we are seeing a trend among insurance to reduce their exposure to losses, with some insurance, like Allstate, reducing the coverage in everyday drastic ways. I am concerned that if this trend continues, it will have a serious impact on availability and affordability. Higher rates, declining coverage, and periodic non-renewal on large scales will have a negative impact, particularly on low-income consumers in underserved communities.

I think the discussion today will help us get a better understanding and a handle on these issues and what we can figure out for the best course of Federal involvement, and I look forward to hearing from the witnesses, especially as it pertain to those that cannot, and I know that it was mentioned about wildfires, especially in our area, where those individuals are not covered in the San Bernardino and surrounding areas that have been impacted a lot in our area.

So thank you very much, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Scott, do you have a statement?

Mr. SCOTT. Yes. Thank you, Mr. Chairman. I appreciate this very timely and important hearing. It is important, especially given the fact that hurricane risks are expected to increase over the coming decade, and would have repeats of hurricanes or the level of Katrina and Rita that we had back to back last year.

There is an economic problem.

As risk increases, losses increase, which will cause rates to increase.

Natural disasters affect different regions of the country and cause a collapse of insurance coverage at the local level, and since the States regulate insurance products, it is controversial to create Federal regulation of insurance.

However, it may be necessary to create some form of Federal reinsurance to help States create stronger insurance markets, and Congress must improve disaster preparedness.

We have to find ways to expand the insurance market to cover more people, and the Federal and State Governments must coordinate to expand coverage protections, and there are many good ideas proposed on how to help provide catastrophic insurance, and I am certainly open to discussing them, but I think it is very important that I raise some major concerns and some questions that certainly give rise here.

For example, are there regulatory or legal barriers to allowing more foreign reinsurers to enter the U.S. market?

Are American insurance companies at a tax disadvantage when compared to foreign reinsurance companies?

What would be the estimated cost to the Treasury of eliminating the current tax on premium reserves, and is there general agreement that there should be incentives to build premium reserves to pay for future catastrophes, or has there been any problem with credit rating agencies affecting the ability of insurers to finance new bonds, very complex, complicated issues here that we must resolve.

One other important question is why does the Federal Government need to be involved with this issue when many reinsurers and insurers have opposed these proposals and stated that the private market can handle natural disaster risks, and then this important one: Is there enough insurance capacity to cover the Nation's homeowners in the event of a major natural disaster, and has the national market been tested sufficiently to give lawmakers here in Congress an adequate indication that the market is prepared, serious questions, serious issues that will be brought to the forefront. It is important that we make sure that we have all of insurance capable to expand, to cover.

Are we prepared to do this?

A very interesting hearing. I'm looking forward to it. I yield back my time.

Chairman BAKER. I thank the gentleman for yielding.

I believe that concludes all members' statements.

Appearing as a witness today and enduring opening statements is a bit like being in Louisiana and waiting on the hurricane.

You do not know when or where, but you know it is coming.

Well, we finally got to it.

I wish to welcome each of our witnesses and to thank them for their patience in participating today.

As is the usual practice, your formal statement will be made a part of the official record. We ask that, if possible, you limit your remarks to 5 minutes, to enable member questions to follow, and as you can see from the statement participation, there is broad interest in this matter and a deep and abiding concern, and we appreciate each of you bringing your perspective.

Our first witness today will be Mr. Kevin M. McCarty, commissioner for the State of Florida but appearing here today on behalf of the National Association of Insurance commissioners.

Please proceed at your leisure.

STATEMENT OF KEVIN M. McCARTY, COMMISSIONER, STATE OF FLORIDA, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. MCCARTY. Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee, I really want to thank you for the opportunity to be here today to testify on the role of the insurance departments and insurance commissioners in helping to stabilize the coastal insurance market in view of the catastrophes we have recently experienced.

My name is Kevin McCarty, and I am the insurance commissioner of the State of Florida. I am here today representing the National Association of Insurance Commissioners, as the chair of their

property committee, and as the chair of the committee on catastrophe insurance working group.

As the chairman has already stated, we are not here merely because of the natural disasters of 2004–2005, or because of Hurricane Katrina.

As I testified in June, catastrophe events are a great equalizer, and the hurricanes, earthquakes, floods, and tsunamis do not discriminate against inland people or coastal people, rich people or poor people or Republicans or Democrats. The issues in the marketplace today will affect all Americans, regardless of their status in life or their political affiliation.

That is why we need to concentrate on a bipartisan solution.

I am very proud of the Florida delegation and the number of meetings that we have had and the number of bills that have been sponsored which I think deal with a very complicated issue that has no simple solution. If it were simple, we would have done it by now.

Today, I would like to provide a perspective on some of the things we should consider on a national and local and State level when we consider managing national catastrophes.

What I would like to talk about is what mechanisms are in the States that have been used that perhaps have helped alleviate the problem and, in other cases, have potentially exacerbated the problem.

We need to look at a number of the things that you have already mentioned for pre-catastrophe planning, like tax-deferred catastrophe reserves, allowing insurance companies to accumulate capital to pay, and maximizing the use of the private sector.

We need to look at mitigation. If you look across the table, everyone at this table will agree that mitigation is a very powerful tool for reducing future losses and minimizing cost increases for consumers.

We need to look at consumer savings accounts and empowering consumers so that they can make decisions and save money and hopefully mitigate against future losses.

We need to look at a myriad of State and Federal programs that are out there, and once we look at all of these other things, at what point do we need to have, if at all, a Federal catastrophe plan?

The markets have spoken to us over the last couple of years very loud and clear.

The cost of CAT insurance had undergone unprecedented rate increases.

The cost drivers in the system include many things.

We have underestimated our losses with our computer models.

We have increased capital requirements because of changes in A.M. Best requirements and stress tests in our insurance marketplace, and quite frankly, our markets are attracted to go other places where they can get better rates of return.

Much has been written and has testified to about the role of regulation, and has actually been referred to as price controls that have been widely used as an impediment to the marketplace.

In actuality, very few States exercise price controls. That does not mean that States do not have a role in the review of the cost of insurance. As a matter of fact, we have a responsibility to ensure

not only that the rates are not excessive but they are not inadequate or unfairly discriminatory.

The goal here is to tell insurance companies what they charge is within the laws of the State, which means that it fits within that State's statutory guidelines.

I am very proud to have today, sharing some time with me, my colleague from South Carolina, Director Eleanor Kitzman.

She is here from a State that was not directly impacted by the storms of 2004 or 2005.

As a matter of fact, it has been several decades since her State has been hit with storms, but she is seeing in her State some of the very things that we are seeing in Louisiana, Texas, and Florida, and this is very, very significant rate increases, but more importantly, we are seeing a contraction in the marketplace, and another contraction in the marketplace in what is called the surplus lines. We simply have no more capacity in certain areas of our country, including the State of Florida.

I recently concluded a trade mission with Governor Bush to visit the folks in the Lloyd's syndicate, and they said Florida is a great market, you are doing a lot of good things, but we do not have anymore capacity for your State.

Eleanor has suffered similar situations in her State, and she has a State that is widely viewed as a free market State, and despite the fact that it is a free market State, there is a very limited amount of capacity through those increases in rates, both in the primary market as well as in the secondary market.

The markets have told us they have taken about all the catastrophic risk they can in certain areas. That does not mean there is not reinsurance widely available in other places, but in the places that need it the most, in the aftermath of these storms, they are having grave difficulty securing that coverage.

While the average cost of reinsurance in the United States rose about 76 percent in 2006, most of this catastrophe coverage has not gone to the coastal States.

Price increases in Florida, in South Carolina, and in other parts of the Gulf Region have increased 300, and 400, and up to 1,000 percent, as already been testified to by Members of Congress who have experienced that in their own districts.

As a long-term response, empowering consumers will mean that the State and local governments will need to adopt better building codes, enforce building codes, and use proper land management plans that hopefully will reduce catastrophic exposure.

We all agree that mitigation techniques will work. Florida has embarked on a novel mitigation program which we hope will do a lot to reduce the frequency and severity of losses in our States.

These efforts will take time, and these efforts will require a lot of money and resources.

Unfortunately, we need to do more, and one of the things we need to do, I believe, is not necessarily embark on a large Federal program.

I have been a major proponent of Ginny Brown-Waite's bill, Representative Brown-Waite's bill, and there have been other bills out there looking at a Federal backstop. We looked at—PCI had suggested some funding mechanisms for State pools.

We also have seen auction programs that have been put out there to help private and public partnerships, but we can do some other things, like, under the current system, we could look to creating some catastrophe reserves, as been proposed by Representative Foley.

I think that will go a long way toward augmenting the capital development within the private sector for a private sector solution.

Also is to allow consumers to accumulate capital through the catastrophe savings account, as has been proposed by Representative Feeney.

This will allow consumers to accommodate capital, protect them from the higher deductibles, but also could be used for them to invest in mitigation devices, which will ultimately save consumers money not only on their insurance but on their deductibles.

Given the wide variety and complexity of the concept of these various programs, I would strongly endorse the concept presented by Congresswoman Wasserman-Schultz on the creation of a national commission on catastrophe preparation, to look at and weigh the myriad of programs and how they can interrelate.

Clearly, there are a number of forward-thinking ideas we need to consider, but they should be framed with the answer with one thing in mind: What will it do for the affordability and availability of coverage? Ultimately, this is not just an insurance issue; this is an economic recovery issue.

Without the ability for working people in the Gulf Region and the Atlantic Region to secure homeowner coverage and business coverage, our economic development in this region is in peril, and this will dramatically increase costs for all States, even though those do not believe they have a catastrophe exposure.

The lessons of recent CAT's have only been the warning that we have to start making some serious decisions, because it is not a matter of if, but when, the next disaster will be here, and the question is, did we learn the lessons of 2004 and 2005, and are we willing to have the vision and the patience and the wherewithal to prevent these economic catastrophes in the future?

Thank you for your time.

[The prepared statement of Kevin McCarty can be found on page 89 of the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

Our next witness is Ms. Wendy Baker, the president of Lloyd's of America.

Welcome.

STATEMENT OF WENDY BAKER, PRESIDENT LLOYD'S AMERICA, INC.

Ms. BAKER. Good morning, Mr. Chairman, and members of the subcommittee. Thank you for inviting me to testify here today on behalf of Lloyd's of London, the world's leading specialist insurance market.

Last year's record-breaking storm season presented significant challenges to the global insurance market. Although the first half of this year's Atlantic storm season has not proven as deadly nor as costly as the early part of the 2005 season, it is nevertheless im-

portant to continue the dialogue on protecting the United States economy from large-scale catastrophic losses.

Lloyd's is very pleased to participate in today's hearing, and commends the subcommittee for recognizing the continuing need for stability in the coastal markets.

The United States is the largest overseas market for Lloyd's underwriters.

In Florida and the Gulf States, Lloyd's functions as an eligible surplus lines insurer and a reinsurer.

In this region, Lloyd's is a significant direct insurer of industrial and utility property, particularly in the offshore oil and gas sectors.

Lloyd's also insures many other businesses and high-value residential properties.

Accordingly, we thank the members of this subcommittee, as well as the other members of the House Financial Services Committee, for leading the way in promoting serious analysis and dialogue on the tough issues, such as catastrophe mitigation and regulatory efficient and uniformity, which necessarily impact the stability of both the U.S. economy and our global industry.

Our responsibility to our U.S. policyholders going forward is to avoid complacency.

We realize that we must ensure that we can continue to meet the future challenges that the marketplace and Mother Nature will present.

We commend you, Mr. Chairman and the members of the subcommittee, for recognizing that, although markets have recently responded to large-scale disasters, the Federal Government must also avoid complacency and anticipate future challenges.

Specifically, I recognize that the Federal Government's role is broader than simply providing immediate relief for losses and that policy initiatives and mitigation measures play a crucial role in stabilizing the markets.

Regulatory and litigation reform for the underlying direct market can have a material beneficial impact on the availability of reinsurance capacity.

Likewise, land use planning and public policies which affect the changing concentration of exposed values in coastal States may be an important component of long-term stability.

While the insurance and reinsurance markets tend to adjust to dislocations on their own in time, public policy can and should play a role in improving that market response.

For example, most of the natural disaster bills which have been introduced by members of the Financial Services Committee over the past year have included mitigation measures such as encouraging the development of mitigation programs by States, as well as standards for the construction and maintenance of buildings, to protect against future disasters.

Reinsurers and direct insurers alike are interested in the efficacy of these measures.

As a major U.S. income tax payer, Lloyd's also notes the dialogue initiated by this subcommittee and in the tax writing committees regarding the use of tax policy to encourage expansion of natural catastrophe risk capacity.

At Lloyd's, we have our own initiatives to meet future challenges. We continue to refine our realistic disaster scenarios, which help us anticipate potential losses and ensure that both syndicate level and market level exposures will permit us to handle catastrophic losses.

The severity and frequency of catastrophic events is increasing, and we must make sure that we stay ahead of them.

This year, Lloyd's will add two scenarios with losses of up to $100 billion.

Also, while the role global climate change plays in recent or future losses may be subject to debate, Lloyd's is contributing to worldwide efforts to find some answers.

As we consider our responsibility to our policyholders here and how to continue meeting them, U.S. lawmakers and regulators might also consider their responsibilities to help ensure that the global insurance market is well positioned to handle increasingly severe and costly natural disasters in the United States.

In this regard, we would like to raise two specific issues with you today.

First, we believe it to be important to create greater uniformity, simplicity, and efficiency in State regulation of the surplus lines insurance to streamline placements for large commercial policyholders and to modernize State regulation of reinsurance.

We, therefore, commend your leadership, Chairman Baker, and that of Mrs. Brown-Waite, and all cosponsors and supporters of H.R. 5637, the Non-Admitted and Reinsurance Reform Act of 2006.

We were gratified to see the Financial Services Committee take such a strong bipartisan stand in favor of these goals, with invaluable leadership from you all and Chairman Oxley.

We pledge to continue to work with you and your colleagues on both sides of the aisle, State insurance regulators, and other interested stakeholders to continue to build consensus for greater uniformity in surplus lines and reinsurance regulation, as well in all aspects of insurance regulation.

We also recognize the efforts of Representatives Shaw and Foley and other members of the Ways and Means Committee to examine how tax policy might be used to address capacity issues.

Second, it is important to recognize that most of the reinsurance protection provided to the United States market comes from reinsurers based outside of the United States. It is altogether appropriate to use global capacity, as this provides a buffering effect to a blow that would otherwise have to be sustained entirely by the local economy.

Data from the Insurance Information Institute demonstrates the significance of the foreign reinsurance market to economic recovery in the Gulf and southeast coast.

In 2005, some primary insurers with exposure in those regions had up to 60 percent of their gross losses covered by reinsurance. Approximately one-third of the insurance industry's $60 billion loss from last year's three hurricanes was paid by reinsurers based outside of the United States, including Lloyd's.

One way to address the capacity issues before us today is to maximize the participation of the world's strongest and most stable reinsurers in the U.S. catastrophe risk market. This can be accom-

plished by reorienting U.S. credit for reinsurance rules to focus on soundness and security. Specifically, the rules should focus on the financial quality of reinsurers and the security that they provide, rather than the geographic location of their headquarters. Appropriate weight should be given to external valuators, such as the financial ratings assigned to reinsurers by third-party rating services, and the actual claims paying records of those reinsurers.

Once again, we thank you for your leadership. We also urge you to continue efforts to ensure that the global reinsurance market, as a whole, is in the best position to meet the insurance needs of the United States consumers, especially in high-risk coastal areas, where specialist overseas insurers such as Lloyd's provide a critical source of insurance and reinsurance capacity.

I thank you for your attention.

[The prepared statement of Ms. Baker can be found on page 65 of the appendix.]

Chairman BAKER. I thank the gentlelady for her statement.

I take pleasure in introducing a Baton Rouge constituent.

Mr. David Daniel is a principal in Daniel & Eustis, who appears here today as a representative of the Independent Insurance Agents and Brokers.

Welcome, sir.

STATEMENT OF DAVID DANIEL, DANIEL & EUSTIS, ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS AND BROKERS OF AMERICA

Mr. DANIEL. Thank you, Mr. Chairman, and members of the committee.

My name is David Daniel, and I am pleased to be here on behalf of the Independent Insurance Agents and Brokers of America to provide my association's perspective on the issue of natural disasters. I currently serve on our national association's executive committee.

I am also the head of Daniel & Eustis Insurance Agency in Baton Rouge, and am partnered with the Eustis Insurance Agency in New Orleans.

As a Louisianian, I first want to thank you, Chairman Baker, and Members of Congress, for the assistance that has been given to the Gulf Coast, and for holding this important hearing.

This issue has impacted my own family, friends, and coworkers, not to mention millions of Americans and many other communities across the country.

The Big I is extremely grateful for your continued work on this issue and for the opportunity to share its views on what we feel is a matter of critical importance.

I could not be more proud of the members of our association for their efforts after Katrina.

Many of our members had their own homes and businesses destroyed, but they set up makeshift offices in order to serve consumers and ensure that their claims were being properly handled.

Employees from my own partner agency in New Orleans had to move to my office in Baton Rouge, where we set up a double-wide office trailer with 42 work-stations. Employees arrived at my office

one by one, often in tears, with no home and no possessions, but they went right to work to serve the customers.

Now, more than a year later, there are many employees in my own agency who are still displaced and living in trailers.

My point is that independent insurance agents are truly on the front lines, and that we offer a unique and balanced perspective on the issue of natural disasters.

We understand the capabilities and challenges of the insurance market that both insurers and consumers face when it comes to insuring against catastrophic risks.

Our approach to the issue of natural disaster insurance comes from a very simple perspective. We are here to serve consumers' needs.

We strongly believe that our industry must come together with policy makers to find a common solution that will encourage insurer participation in at-risk markets. In short, we welcome all proposals and will consider all reasonable ideas that lead us to a healthy and competitive insurance marketplace.

Recently, substantial insured losses from natural disasters have diminished insurers' capacity and, more importantly, their appetite for catastrophic losses in general.

The cost of coverage has greatly increased. Wind deductibles have skyrocketed, and adequate limits of coverage are not always available.

The Big I believes it is no longer enough to say that the private market can handle catastrophic risks when coverage is not sufficiently available at affordable rates.

In fact, it is our experience that private market coverage is scarcely available at any rate in some areas. This is fact becoming an availability problem, rather than an affordability problem.

The reality is that many insurers have stopped writing homeowners and other property coverages in at-risk markets. With another difficult hurricane season upon us, something needs to be done to ensure that residents of these areas can find adequate insurance coverage.

With these experiences in mind, I would like to stress that this issue is not simply a Gulf Coast problem, it is a national problem, as Chairman Baker and several of you have already recognized.

Thank you for that recognition, and we strongly agree.

Regardless of our exposure to natural disasters, we are all impacted as taxpayers, and history has proven that more tax dollars are going to be spent by the Federal Government in ad hoc post-disaster funding if there is not a structure in place to encourage the private sector to take on additional risk.

Only a program that is national in scope will be able to generate enough capacity to cover the most devastating events.

The Big I believes the best solution is for a Federal role to be in place before the events happen, to have a clear, well-structured mechanism that encourages the private sector to handle as much of the risk as possible, and to only trigger Federal involvement as a last resort upon private marketplace failure.

Specifically, the Big I supports a Federal catastrophe reinsurance program to serve consumers and protect taxpayers living in all areas across the country. We are also open to a number of potential

solutions, with limited Federal involvement, including tax-free reserving and catastrophe savings accounts, among others.

Further, Big I supports efforts to reduce the cost of disasters, whether it is through mitigation, enhanced building codes, or financial incentives to mitigate risks.

Finally, we support the creation of a national commission to study all of these proposals and make recommendations to Congress. In conclusion, I commend you, Mr. Chairman, for convening today's hearing.

We also thank the Members of Congress who have displayed leadership and initiative by proposing legislative solutions to these difficult issues.

Achieving a consensus within the insurance industry for a solution to this growing problem has been elusive, but we hope your continued focus on this issue will encourage the public and private sector to develop new and innovative solutions.

We stand ready to assist you in any way we can, and we urge you to see this fight through to the finish.

Thank you.

[The prepared statement of Mr. Daniel can be found on page 76 of the appendix.]

Chairman BAKER. Thank you for your statement and your participation here today.

Our next witness is Mr. Franklin W. Nutter, president of the Reinsurance Association of America.

Welcome, sir.

STATEMENT OF FRANKLIN W. NUTTER, PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA

Mr. NUTTER. Mr. Chairman, thank you very much, and thanks to the members of this committee, many of whom have been active in this discussion and have offered very creative ideas for addressing this issue. We look forward to working with the committee in the form of the roundtable discussions you mentioned, or in the form of a commission, if that's what the Congress should do, in addressing the various ideas and trying to solve this problem.

The Reinsurance Association is a national trade association representing property and casualty insurers that specialize in reinsurance.

All of our member companies are either domiciled here in the United States or are the U.S. subsidiaries of foreign companies.

The concept and role of reinsurance is well understood by this committee and has been mentioned several times by members of the committee and by other witnesses. Reinsurers have participated in assisting the recovery from natural catastrophes for well over a century in this country.

Typically, reinsurers will ultimately bear about one-third of the cost of natural disasters. In the case of the events of September 11th, two-thirds of those losses ultimately were absorbed by the reinsurance industry.

The role that reinsurance plays in this risk transfer mechanism was highlighted in a report issued in August 2006 by A.M. Best, the rating organization, that stated several factors contributed to the insurance industry's stability in 2004–2005, noting the transfer

of risk to the global reinsurance market and greater use of capital market solutions.

It is quite clear from the information presented to this committee that 2004 was a dramatic year of hurricane activity and insured losses in this country.

In that year, the global reinsurance market paid about a third of the losses that were ultimately borne by the insurance industry.

As is also well-documented, 2005 was an unprecedented year for losses.

Again, the reinsurance industry played a critical role. Estimates are that 60 percent of these losses from 2005's hurricane season in the United States will ultimately be borne by reinsurers.

It is therefore clear that the reinsurance market served to supply global reinsurance capacity to the United States.

Estimates are that insurers and reinsurers in Bermuda will bear $11 billion of the losses from 2005 alone; U.S. reinsurers, $7 billion of losses; London and the Lloyd's market, $6 billion; and European reinsurers, $6 billion.

The 2004–2005 hurricane seasons are clearly indicative of the risk transfer that exists between insurers and reinsurers in the country.

Despite these heavy losses, estimates are that reinsurance capacity committed and in place in the United States in 2006 has increased by 30 percent. As in 1993, after Hurricane Andrew, and in 2001, after the terrorism losses of 9/11, the capital markets promptly provided new reinsurance capital and capacity. The same dynamic appears to have happened after 2005.

Since Hurricane Katrina, approximately $24 billion in new capital has been raised to support underwriting needs, notably for U.S. catastrophe risk. Of that, nearly $8 billion was invested in new, start-up reinsurance companies. The remainder was replenishment of capital positions of existing reinsurers.

An additional $4 billion has been invested in special purpose reinsurance vehicles, whose investors collaborate to provide extra underwriting capacity to existing reinsurers. Market reports are that nearly $4- to $6 billion of catastrophe bonds were invested in U.S. catastrophe exposure since Hurricane Katrina.

Despite this new capacity, there are still insurance market dislocations in Florida and in some areas of the Gulf coast.

Demand for reinsurance increased in these peak zones in 2006 at a greater rate than the reinsurance supply was able to meet.

The reasons for this should be highlighted.

Certainly the rating agencies—notably, Standard & Poor's and A.M. Best—have made additional capital requirements associated with insurance companies to support their catastrophe exposure.

In addition, the insurance catastrophe models, which are widely used by State officials, as well as by insurance companies, have been revised for the hurricane season in 2006. Based upon new data, an assessment of increased frequency and severity was added to these models.

Reports are that the Florida catastrophe models—and by that, I do not mean the State of Florida but models associated with Florida risk—increased 60 percent for frequency of hurricanes and 40 percent for severity of those hurricanes.

In the Gulf Coast, those catastrophe models were revised for an additional 20 percent increase in frequency and 15 percent for severity. Insurance company managements obviously reacted to the increased perception of risk in these areas, as well.

This confluence of development has resulted in demand for catastrophe protection in peak catastrophe zones greater than supply.

The RAA believes that this imbalance will be temporary, however.

It has been typical in the insurance and reinsurance cycles that, following major cases, spikes in reinsurance rates are followed by new market participants, leading to increased competition and price moderation. Ultimately, free markets will create a more diversified insurance and reinsurance market that will spread risk widely, increasing capacity and price competition.

We recognize that reinsurance plays a critical role in this debate, and we look forward to working with the committee and the members who have offered ideas to solve this problem in finding an appropriate solution.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Nutter can be found on page 104 of the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

Our next witness is Mr. Gregory W. Heidrich, senior vice president, policy development and research, representing the Property Casualty Insurers Association of America.

Welcome.

STATEMENT OF GREGORY W. HEIDRICH, SENIOR VICE PRESIDENT, POLICY DEVELOPMENT AND RESEARCH, PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA

Mr. HEIDRICH. Thank you, Mr. Chairman, Ranking Member Kanjorski, and members of the committee, for the opportunity to present our views and to address the issues of this hearing.

I am here representing the 1,000-plus members of PCI who write some 40 percent of the Nation's homeowner's insurance. Because of that business, our members are deeply interested in the work you are doing.

Our members commend you and your colleagues for examining this issue, not just for the hearing today but in the work you are doing every day.

There are a number of interesting and important proposals that many of your colleagues have offered to address the catastrophe issue: Homeowner's Insurance Protection Act, Policyholder Disaster Protection Act, Catastrophe Savings Account Act, Catastrophic Disaster Risk and Insurance Commission Act, and many others.

These proposals deserve discussion and debate, but we commend you most of all for offering concrete ideas and for being willing to hear our views.

From our standpoint, the problem we face is straightforward: more hurricanes of greater intensity and no less exposure to other natural disasters, more development and population growth and much higher property values in catastrophe-prone areas, more Americans with more of their net worth exposed, building codes

and code enforcement that are not strong enough, and we are still letting people build in areas that are at even more risk.

As insurers, we strongly prefer to use market solutions to the problem, but as you know, we do not operate in a free market for rates, for product development, or many other aspects of our business, and obviously, people already live in catastrophe-prone areas, so we have to deal with that, as well.

Our members have identified a number of ideas that we would like to offer for your consideration.

First, State and local governments need to review and, where necessary, strengthen building codes, code enforcement, and land use policies.

To help with this process, our organization will suggest and support legislation, wherever we can, to strengthen existing codes or adopt new ones.

The solution should be tailored to local needs, in some areas perhaps strengthening the wind-borne debris requirements in an existing code, in other area perhaps new statewide minimum building standards.

Second, new investments in loss prevention and mitigation are important.

To help with that, we will support new Federal funding for community loss prevention and mitigation projects or training new code inspectors.

Third, we think more should be done to expand private market capacity.

We will suggest and support a variety of ideas to reduce market restrictions, including unnecessary controls on prices, product design, or other measures. We know change of this type is hard, but we also know it is the only way this problem can be solved in the long term.

We understand some have concerns about this approach, but we've seen great success from market reforms in solving other serious availability and affordability problems.

Most notable recently are the reports from New Jersey, where car insurance reform has made a tremendous difference, and we think the same can happen in property markets over time.

Fourth, we are looking carefully at the idea of letting insurers create voluntary tax-deferred catastrophe reserves in advance of an event. As has been mentioned this morning, Representative Foley has a bill that would do that, and our member tax committee is discussing his proposal right now. In concept, many of our members like the idea a lot, and we hope to give him constructive feedback very soon.

Finally, we have also looked at the role of the State and Federal Governments in financing catastrophe risk.

We see the inevitability of extraordinarily large natural disasters or mega-catastrophes, and that is why we have looked at possible financing roles for both the State and Federal Governments.

With respect to the States, we think some States may ultimately need catastrophe funds for additional access to reinsurance.

We will look very carefully at proposals on a State-by-State basis to decide if we will support them. We will look at whether private markets have freedom to respond, the effects of a catastrophe fund

on the private market, and whether there are cross-subsidies involved.

With respect to the Federal Government, we are looking at a different approach.

Again, we think there are potential natural disasters so large and so damaging that they may require some Federal involvement, although we believe markets should address events below the level of true mega-catastrophes.

We think there could be benefits in offering well-managed State catastrophe funds the opportunity to borrow from a Federal facility to meet immediate liquidity needs after a very severe event.

We think a line of credit for State catastrophe funds could be set up in advance, would need to be based on sound credit standards, and would need to be the obligation of the citizens in the State borrowing the money. In addition, we think a line of credit should be tied to a demonstration that a State is doing everything it can to free up its markets and attract as much private capital as possible so this does not become a permanent solution.

In conclusion, I would like to express again our members' appreciation to you, Mr. Chairman, and your colleagues, for the opportunity to discuss our ideas with you, and finally, if you will indulge me one personal observation, I wanted to add that your subcommittee and your subcommittee staff, with whom I have worked personally, have been the leaders in Congress on these issues. Your committee staff is known personally by me and by our member companies. We deeply respect their knowledge of our industry and the issues we face, and we look forward to continuing to work with them.

Thank you.

[The prepared statement of Mr. Heidrich can be found on page 82 of the appendix.]

Chairman BAKER. I appreciate the gentleman's kind compliments.

I would represent to him there is extreme division of opinion on that observation, however.

Our next witness is the Honorable Marc Racicot, appearing here today as president of the American Insurance Association.

Welcome, sir.

STATEMENT OF HON. MARC RACICOT, PRESIDENT, AMERICAN INSURANCE ASSOCIATION

Mr. RACICOT. Thank you, Mr. Chairman, and members of the committee.

AIA represents major property and casualty insurers doing business across the country and around the world, and we appreciate very much the opportunity to testify this morning on a matter of extraordinary importance to our members, and to the Nation as a whole, namely insuring natural catastrophic risk, and I commend the committee and its members and your leadership, Mr. Chairman, in examining proactive approaches to the management of this risk.

The first anniversary, of course, all of us know, of Hurricane Katrina devastating the Gulf Coast was just 2 weeks ago, and during the past year, we have seen firsthand the terrible destruction

this unprecedented storm inflicted, and it has been both breathtaking and heartbreaking, at the same time, for us to witness all of the calamity that has visited people along the Gulf coast.

Today, I would like to briefly address how AIA believes we can and must both rebuild the Gulf coast safely and take steps to prevent future catastrophic loss in communities from Texas to Maine.

The Gulf and Atlantic coasts are beautiful places to visit and to live, unquestionably, but they also present undeniable dangers. Contrary to what some insurance critics believe, the threat to coastal populations and property is not insurance; it's hurricanes. Mother Nature is the problem, and she is relentless. We should be honest about those risks.

Insurance is one mechanism that helps us be honest about those risks. It provides consumers an alert to the relative risk and cost of coastal development. Insurance also is a critical tool to protect and restore some of what Mother Nature takes away.

The historic devastation from the 2005 hurricanes was met with an unprecedented deployment of insurance industry resources. The good news is that well over 90 percent of the Katrina-related claims in Louisiana and Mississippi have been settled.

AIA member companies will not be satisfied, however, until every single claim is resolved. Insurers to committed to paying all damages that fall within their insurance contracts with customers.

In the wake of Katrina, our members have set about to work very hard with State and Federal officials to strengthen the financial safety net for both homeowners and businesses. We believe that we must expand these efforts, both in scope and depth. We have arrived, we believe, at a historic moment for the U.S. property protection system and that we must examine all of the interdependent elements of this system to make sure they support rather than undercut each other.

To that end, AIA has developed a holistic national hurricane preparation and response agenda. The goal is to keep our integrated, multi-faceted, risk-bearing financial mechanisms working for the benefit of all Americans.

The AIA natural catastrophe agenda includes proposals designed to have immediate positive effects on the market, as well as proposals for longer-term benefits. The agenda includes, first, protective measures to keep people out of harm's way, and to strengthen their ability to resist future hurricanes; second, regulatory and legal reforms to improve the stability of insurers' operating environments; third, tax incentives that encourage individuals to take more responsibility for hurricane preparation and response; and finally, national flood insurance program reforms to ensure that the NFIP continues its vital role in protecting homes and businesses.

I would like to take a moment to highlight the importance of loss prevention and reduction.

Mitigation works. The evidence is in. It is absolutely true that mitigation works. Strong and well-administered building codes, policies to encourage retro-fitting of existing structures, like the new program in Florida, and sensible land use planning are effective.

These and other loss prevention tools can make the difference between a community recovering relatively quickly from disaster,

with citizens returning to homes and jobs, and a community remaining devastated and an economy remaining stagnant for many months or longer.

I would also like to highlight the role of regulatory and legal reforms in improving the stability of insurers' operating environments.

Too often, State regulation of insurance has become captive to political pressures that hold down premiums in risk coastal areas. True risk-based pricing encourages responsible behavior and discourages dangerous behavior among consumers. It also meets the test of basic fairness.

Mr. Chairman, we have heard many good ideas presented here this morning for further inspection and review and scrutiny, and we very much look forward to participating in that opportunity for discussion with our colleagues, our friends and neighbors, and our fellow citizens across the country to address the problems that confront all Americans and the U.S. property protection system, and we thank you very much for allowing us this opportunity to participate in today's hearing.

[The prepared statement of Mr. Racicot can be found on page 110 of the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

Our next witness is Mr. Charles Chamness, president and CEO of the National Association of Mutual Insurance Companies.

Welcome.

STATEMENT OF CHARLES CHAMNESS, PRESIDENT AND CEO, NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Mr. CHAMNESS. Good morning, Chairman Baker, Ranking Member Kanjorski, and members of the committee.

My name is Chuck Chamness, and I am the president of the National Association of Mutual Insurance Companies. NAMIC's members underwrite more than 40 percent of the property casualty insurance premium in the United States.

NAMIC is pleased that you, Mr. Chairman, and the members of this committee, are making a serious effort to understand the nature of catastrophic risk and the role the insurance industry and the Federal Government can and should play to better prepare for and manage future large-scale natural disasters.

With respect to the subject of this hearing, which is contained in its title, "Stabilizing insurance markets for coastal consumers," I have good news and bad news.

The good news is that, despite the enormous challenges property insurers have faced in the wake of last year's hurricanes, I can report that almost all claims have been paid.

Take-up rates for the flood insurance program have increased significantly.

People in the affected regions are rebuilding at record rates, and a recent study found that nearly 90 percent of those who filed claims in Mississippi and Louisiana are satisfied with their insurance company.

As we all know, 2005 was one of the worst years for natural disasters in American history. Hurricane Katrina alone caused approximately $40.6 billion in insured losses and 1.7 million claims.

Yet, one year later, roughly 95 percent of homeowners' claims and 99 percent of auto insurance claims have been settled.

As a result, while residential building permits decline nationwide, Louisiana and Mississippi actually saw building permits increase.

Despite the magnitude of insurers' losses in 2005, their prudent risk-management strategies have enabled them to stand ready to respond to future catastrophes.

While the insurance industry has done a good job weathering the 2005 storms, the bad news is that most forecasters predict the 2005 storm cycle will be the norm for the next several years.

It was recently estimated that a level five hurricane hitting Miami could cause over $130 billion in insured losses.

It also is estimated that there is a 20-percent chance that a $100 billion event will occur within the next 10 years.

Despite these dire forecasts, NAMIC believes that the private insurance market is well equipped to provide coverage for most types of natural disaster under most circumstances. That said, we also recognize that a true mega-catastrophe such as a high category hurricane striking heavily populated areas could potential exceed private market capacity.

While NAMIC supports several Federal proposals that could help stabilize the market, we must be careful not to create government programs that disrupt the private insurance market.

With that cautionary note about the use of government interventions, I will offer a few observations.

First, it is an unfortunate fact that rate suppression forces low-risk property owners to subsidize the insurance costs of high-risk buyers by paying inflated premiums. In addition, heavy regulation of pricing inevitably reduces supply.

Second, government-sponsored or government-imposed rate suppression can have the effect of distorting public perceptions of risk.

Federal and State Governments bear the cost of the economically irrational decisions that result by paying for disaster aid to repair of properties that should not have been built in the first place.

Third, it is important for lawmakers, judges, and the general public to understand the cyclical nature of property insurer profits, how profits relate to surplus, and the role of surplus in ensuring that insurers are able to meet their contractual obligations to policyholders.

Finally, the Nation's courts must preserve the sanctity of contracts, and with respect to insurance contracts, this often means deferring to the authority of State insurance regulators that approved the contract language as part of the rigorous form-filing process that insurers must follow. If trial lawyers or others succeed in retroactively rewriting insurance contracts that were approved by insurance regulators, they will undermine the predictability upon which the healthy insurance system is based.

These observations aside, we believe there are several measures that Congress should consider.

First, NAMIC supports financial incentives to encourage States to adopt and enforce strong statewide building codes.

Second, we support the concept of amending the Federal tax code to allow insurers to set aside a portion of premium tax in tax-ex-

empt policyholder disaster protection funds. We also support the concept of allowing homeowners to create tax-free catastrophic savings accounts which could be used to pay hurricane deductibles and costs associated with retro-fitting properties.

Third, we believe that the national flood insurance program should be reformed. This is an area in which NAMIC strongly praises the work of this committee and all the work that you have accomplished in this area.

We believe that H.R. 4973 goes a long way in addressing some of the shortcomings that currently exist within the NFIP.

Specifically, we strongly support moving all second homes to actuarial rates and stronger enforcement measures in the bill.

In conclusion, NAMIC realizes that those who live and do business in catastrophe-prone areas will face serious challenges in the years ahead. We believe the most effective mechanism for addressing these challenges is a private insurance market whose defining characteristics are open competition and pricing freedom.

Congress can play a constructive role by reforming the national food insurance program, offering tax incentives for companies to reserve funds for future disasters, and providing incentives for States to enact and enforce effective statewide building codes.

Thank you for giving me the opportunity to testify on this issue of vital importance to NAMIC member companies and the U.S. economy.

I look forward to working with you and to helping consumers in coastal areas meet the challenges involved in effectively managing the risk of natural catastrophes.

[The prepared statement of Mr. Chamness can be found on page 71 of the appendix.]

Chairman BAKER. Thank you for your statement. Thanks to each of you.

I would like to engage in fairly extensive questioning today, but the schedule is not going to permit that. Therefore, I am just going to make a statement before Ms. Brown-Waite takes the chair in my absence, leaving you at the mercy of the Florida delegation.

I wish to make clear that this committee will work very diligently, that this is—the announcement of our intended roundtable discussion process will only be a supplement to the committee's formal inquiries.

Accordingly, to each of you who have testified, and to the broader audience who are interested in this matter, I would request that any statements, papers, studies, findings, recommendations, or observations that you would choose to forward to the committee in the coming days and weeks—between now and our return next year, there will be a lot of staff work preceding members' return to engage in the meaningful discussion.

I do not wish to have an environment in which any stakeholder feels their perspectives have not been very carefully considered.

Mr. Nutter, with regard to the reinsurance matters and the data which you provided to the committee today, I would like to have more extensive analysis of that role of the industry in meeting the identified need. I do believe that we should observe whatever needed reforms that may be considered that it is in the backdrop of the broader insurance regulatory world that natural catastrophe re-

sponses are, indeed, a critical and pivotal State, but in order to seek an appropriate remedy, we should examine the broader elements that constraint investment, whether it be Lloyd's global investment in the United States or whether it be a regional firm trying to reach across the Louisiana boundary to Mississippi.

Accordingly, I have strong interest in seeing uniformity of building code.

Perhaps there should be a Federal minimum standard beyond which locals can exceed or choose to do as they see fit. There should be some Federal leadership with regard to pricing. When I understand a State reviews a rate application, they look only to the jurisdiction over which they have responsibility.

If the company works in 12 States, how does that relate to the overall company solvency and risk profile in the remaining 10 or 11 States in which they operate?

We need to have a much better risk analysis of where companies are highly concentrated in unique lines of business and to understand the make-up of the industry's risk profile at this window of opportunity.

Hence, I see this as a significant problem, but I also see it as the first real opportunity in my entirety of service in the Congress where we can get everybody in a room, talk about this, and perhaps come together with some conclusion, realizing that not everybody is going to be happy, but this has to get done, and I, as would not be a surprise to anyone, am a very free-market supporter and have the strongest of beliefs that this can be reconciled without draconian Federal intervention.

However, it may be necessary, under some set of very difficult triggers that get pulled, much like our terrorism reinsurance matter, for that to be a remedy that should be properly contemplated.

I haven't reached any conclusion at all.

What I do know is we need a great deal more information to get to a studied, defensible resolution that does not aggravate an already difficult circumstance, and so, I make a sincere request of each of you, and those who may be listening who have an interest in helping to educate this committee, because I do not intend to let the committee's jurisdiction be farmed away.

We are going to do this work, we are going to come up with a recommendation, and we are going to get it to the House floor next year for the House's consideration, and this is far too important for us not to fully understand the full range and scope of our problem and all the potential remedies that might be available to us, and I appreciate your courtesy in participating here, and Ms. Brown-Waite will assume the chair.

Thank you.

Ms. BROWN-WAITE. [presiding] I think everyone heard the chairman say that we are going to be acting next year on a proposal.

It may be a combination of many of the ideas that have been put forth by so many Members of Congress whose States are impacted.

We have heard terms such as risk-based pricing and catastrophic prone areas. I would venture to guess that there are probably only one or two States that are not in catastrophic-prone areas.

I would like to—because we have so—so many of our members had other committees to go to, and I have one later and might not

be able to ask the questions that—I have several questions, but I would only like to ask just one, and that would be to Mr. Nutter and also Ms. Baker.

I have met with various groups and been told that there is capacity out there to cover a large-scale natural catastrophe, but you know, there is more to this crisis than just capacity issues. I am hearing more and more from primary insurers that reinsurance rates are just becoming unaffordable, and of course, we all know that those rates are passed on to the consumers, be it a business owner with property and casualty or whether it be a homeowner.

So what actually do you believe can be done to make the reinsurance market more affordable, and I would ask either Mr. Nutter or Ms. Baker.

Mr. NUTTER. I would be glad to answer first. I assume that Ms. Baker would also join me in this. The spikes in reinsurance rates are clearly driven by a variety of things. As has been discussed by the committee, the losses of the last 2 years, particularly in Florida but in the Gulf Coast, as well, have fallen across the insurance sector but largely into the reinsurance community. Indeed, the last 2 years in the global reinsurance market have been an unprofitable market as far as catastrophe losses are concerned.

One of the things that took place following 2005 is that the catastrophe modeling firms have revised their assessment of both frequency and severity in Florida and in the Gulf Coast. This has caused companies to reassess what their catastrophe exposure is.

In addition, the rating agencies, notably A.M. Best and Standard & Poor's, revised the capital charges that they apply to these companies, insurance and reinsurance companies, for the catastrophe risks that they face. This confluence of factors has spiked reinsurance rates, even at a time when there is increased capacity being committed into the United States by U.S. and non-U.S. reinsurance companies.

One of the things that clearly needs to take place, as several of the witnesses have mentioned, is a recognition that it is not insurance companies or reinsurance companies that pay losses; it is consumers, and in the case of some States, taxpayers and policyholders who have not had these losses.

The funding mechanism into the system clearly needs a period of adjustment.

We would encourage the committee, as you do look at this over time, not to take a snapshot of July 1, 2006, and look at the reinsurance market but to look at it through this hurricane season and to look at the historical pattern of some spike in pricing followed by new capital coming in, and tend to be moderation in pricing.

That is what I would expect to take place. That is the historical trend in the market.

Ms. BROWN-WAITE. Ms. Baker?

Ms. BAKER. Yes. I would certainly agree with what Mr. Nutter has said.

In terms of Lloyd's specifically, I could make a few comments.

Mr. McCarty mentioned earlier that he had been in London and was told that, in terms of Florida, basically, we're full-up.

What we have seen over the last few years—and you can call it global warming, climate change, or whatever—is certainly an in-

creased severity and increased frequency, and we looked at our RDS, our realistic disaster scenarios, about 2 years ago, certainly pre-Katrina, and we thought there could be something that was a $6 billion Gulf coast storm, and, you know, in fact, we came pretty close to that.

We then looked at other coastal areas. We looked at Florida. We, as I had mentioned earlier, have a scenario for a $100 billion loss; for instance, a category four into Miami.

We then, as a marketplace, have to look at ourselves and make sure that we can pay those claims. So we have to stress-test our market on a syndicate level to make sure that our individual syndicates that write reinsurance—and not just the United States. I mean we write worldwide, so we have to protect a lot of policyholders.

We looked at that and said if we have $100 billion in a loss, what do we need to do to be able to make sure that the market can bear that loss, and in some cases, that would mean that a syndicate that at some point might write $500 million of business in Florida may then have to only write $400 million, so that, as a whole, the market can bear the losses.

So in short, I would say we have an issue with capital, we have an issue with frequency and severity of the hurricanes certainly in the last few years, and maybe it is climate change, but it could be one of these, you know, current trends that you get every 40 years, that you have a sort of change in surface temperature of the Atlantic.

So we could maybe hope it might be that, but those are a lot of the other, I think, issues that come to bear when you deal with Gulf Coast exposures.

Ms. BROWN-WAITE. Just a follow-up question. While, so far, we are at the—almost the middle of September, the projected hurricanes have not struck. How long does the market take to adjust? I know you do certainly more than one-year forecasting.

How long does it take to adjust, and if there are no major hits hit year, what sort of price adjustment will there be, or will the reinsurance rates still remain high and continue to severely affect our constituents, not just in Florida?

Ms. BAKER. I am sure that Mr. Nutter will have a comment on this, as well, but I would venture to say that the rates probably will not climb, but they will become static if we do not have another hurricane. We have 2½ months to go, and we certainly have, as I said, other exposures around this continent.

I mean we could have an earthquake in California tomorrow, but barring any large catastrophic loss, I would venture to say that the rates on catastrophe reinsurance business would probably start to flatten out in the next year or so.

Mr. NUTTER. Madam Chairwoman, I would add that if you looked at Hurricane Andrew in 1991 and asked that question, looking in retrospect, what you would see is new capital coming into the reinsurance market, and the spike that occurred in pricing after Hurricane Andrew moderated.

Admittedly, we had quite a few years without any significant hurricane activity, which would affect that, but the prices, the rate on-line, if you will, moderated dramatically, really, until this year.

There was no spike in rates, not even after 2004, notwithstanding the losses.

The other thing to keep in mind about reinsurance pricing is that it is a factor in insurance rates, but it is not passed through directly in the rates.

So numbers that sound extraordinarily high in the reinsurance pricing become a consideration in the rate filings that insurance companies do. It is not the only driver of consumer prices.

There are clearly other considerations, many of which have been mentioned here, about increased perception of risk and increased assessment of risk and severity and frequency.

Ms. BROWN-WAITE. David?

Mr. DANIEL. I would just like to add that, of course, we are not just talking about regional hurricanes here. We are talking about anywhere in the country, and no place is immune.

Everyone has skin in the game, whether you are an insured in Florida or Louisiana, or you are a taxpayer in a central State.

You either pay your insurance premium or you pay billions out in tax dollars, and we just continue to suggest that it is far better to have a mechanism in place to encourage the voluntary marketplace to provide as much coverage as possible rather than to have the taxpayers pay much more on the back end.

Ms. BROWN-WAITE. Mr. McCarty.

Mr. MCCARTY. I just have a little different perspective on the potential in terms of the long-term rates.

I believe we are in for a—this is a long-term transitory period of upward pricing in rates. Even after Hurricane Andrew, when we had millions, billions of dollars recapitalized, we had the creation of the Bermuda market, we did not see prices go down in Florida. Prices continually have gone up to Florida, even though we had enjoyed a relative period of calm in terms of storms. Coupled with that, we had, actually, in some cases, if you talk individually with the reinsurance underwriters, there was an excess of capital in the marketplace, so they actually were providing quota share reinsurance which would allow participation through the primary writers and the reinsurers, so that there was additional capacity, for sure, but that did not reduce prices.

When I was visiting in Bermuda and in London, it was made very clear to me that the expectation in Florida is that you are a very good writer, you are a very good market for us, you have—your insurers have probably the best detailed information, you have the best data collection. The problem is you continue to have exposure that outstrips their ability to have capacity.

The other thing you have to remember—we are $1 trillion of exposure.

They can only take so much of that. When you have increased capacity in the world—and they do—that is great for hurricanes in Hawaii, because there is additional capacity there, but because of the exposure of a Florida, of a New York, my belief is, with increased frequency and severity of storms, with increased seismic activities—we witnessed a earthquake in the Gulf of Mexico. I mean there is an increased potential of economic disasters around the world that is going to continue to cause strain in the marketplace.

Even though we have additional capacity in Florida, we will not see those rates go down. I think that is going to be generally true of the Gulf States and generally true of the Atlantic States.

Now, that may not—that is what I have been told by individual writers who write 85 percent of the market in Florida.

Ms. BROWN-WAITE. If you could provide to my office, and the other Florida members' offices, the various company rate increases and what percentage of that rate increase you believe is due to the escalating cost of reinsurance, then we will also have it entered into the record, if you would be so kind.

Mr. MCCARTY. I think that is a very important point, Madam Chairwoman, because if an insurance company has to pay "X" million dollars in premium for risk transfer and I do not provide that with that rate relief, then they are not going to collect enough premium to pay their reinsurance bill. So I am jeopardizing the solvency of an insurance company.

Obviously, one of my responsibilities as the insurance commissioner is to ensure that insurance companies have capital reserves and risk transfer mechanisms to ensure that they have the wherewithal to pay claims, and if a company has a 80-to-90-percent rate increase with regard to that, they do pass that on.

Suppressing that rate would only put Florida in a position of rendering its insurance companies insolvent, and that is not an option.

Ms. BROWN-WAITE. Ms. Wasserman-Schultz, I believe you have some questions.

Ms. WASSERMAN-SCHULTZ. Thank you, Madam Chairwoman.

Commissioner McCarty, I know you referred in your testimony to the situation in South Carolina, and in spite of the fact that that it is a State that has what is viewed in the industry as a relatively good regulatory market, in spite of that fact, even with the competitive rating that they have, they still have significant increases in their property insurance and availability issues.

So why, in spite of the regulatory environment there being at least favorable to the industry, are they still experiencing the same problems?

Mr. MCCARTY. You know, first of all, I think Director Kitzman and myself would agree that we need to have risk-based premiums. It should not be people who have—live in higher-risk areas should not be subsidized by people—having said that, we believe that there is a balance that you need to strike.

South Carolina is simply evidence to the fact that the exposure or risk of exposure—there is a limit in the capacity of worldwide insurance.

They have surplus lines companies—those are companies that are unregulated, they get to charge whatever premium they want—are telling the director of South Carolina they do not have any additional capacity for her State at this time.

That may change over time. I do not question that. More capital markets are wonderful things, but I think what I am suggesting is that we used kind of politically charged terms sometimes, like price controls, when, in fact, what we have is a regulatory regime that reviews those rates to ensure that those rates are not excessive but also not inadequate.

I mean we want to make sure the company is charging enough premium, buying reinsurance. I had to encourage five or six companies in Florida to raise their rates, much to the chagrin of constituents of Florida, because I wanted them to purchase the reinsurance.

So that is what we do. That is part of our job.

The point I was trying to make with Eleanor, and why she is here, because they do have a very—what is considered favorable to the insurance industry, so that they get the kind of rate relief that they want.

I am going to tell you, I have sat down privately with insurance companies, and so has the director of South Carolina, and said, frankly, it does not matter what the rate is. I cannot buy the coverage, or I am a large company, large companies that we know that make up 20, 30 percent of the market share, cannot take anymore exposure at any price.

So while we want to be sensitive to pricing and ensure that there is price adequacy and ensure that they are going to be able to collect the premium for—to purchase the reinsurance or other alternative reinsurance mechanisms that are coming into the marketplace from the venture capital markets, which is great, but I just do not want us to believe that somehow the regulatory framework, in and of itself, which in most States, 32 States, is use and file, which means they charge the rate first and then justify it 30 days later, and they still have the regulatory—an administrative procedure system where we have to demonstrate that the rate is not excessive.

So I think that we sometimes put a disproportionate amount of emphasis on the regulatory framework.

I think we all should work towards modernizing our regulatory frameworks to provide incentives for companies to come into our States.

At the same time, I think our consumers, when they get a 90-percent—I know people in your districts have gotten 400 and 500 percent rate increases, and they want to know that somebody is looking at this, and I think there was a case that you will recall after Hurricane Andrew, an internal memorandum from a company that said we just had a huge devastating hurricane in Florida, this is a great time for us to take advantage of this situation, and I think you might recall that situation, and those kinds of things really cause consumers to be very frustrated and angry, and they want to have some sense that there is some regulatory framework there that ensures that consumers, understanding they have to pay more for premiums, understanding, to the extent we can explain it, the costs of global reinsurance, want to make sure that somebody is looking out that they are not being gouged.

Ms. WASSERMAN-SCHULTZ. Madam Chairwoman, you know this—we were both in the legislature when Andrew hit, and one of the most frustrating aspects of the issue of rating was that, for years and years before Andrew hit, the insurance industry was low-balling rates.

I mean they were competing down here, so that they were not adequately charging their customers, so that they could build more of a customer base, and when we lost, I think, seven insurance

companies after Andrew, it became very clear that they were not capitalized enough, that they did not have enough reinsurance.

There were a host of problems, and those have been addressed, and I agree, a regulatory environment that might be different could be helpful, but Governor Racicot, you mentioned in your testimony, which is part of the reason I asked Commissioner McCarty this question, that tougher and more uniform building codes, greater enforcement of those codes, more rating freedom, mitigation, that those are things that would be part of a solution for you and your industry representatives for the Gulf Coast insurance crisis, and I assume on down to Florida as well, but what I want to know from you, because I do not think you are being disingenuous, but I have a hard time believing that if all of those things happened, that at that point—what I want to know from you is could you represent that your industry would offer both residential and commercial property insurance at reasonable rates if the things that you say need to happen actually happened?

Mr. RACICOT. I can tell you that our companies would offer coverage at rates that were actuarially sound and that reflected the real cost.

I mean the fact of the matter is that—

Ms. WASSERMAN-SCHULTZ. Well, let me just interrupt you for one second, because I just got over my Blackberry that Nationwide Insurance in Florida just asked for a 106-percent increase in residential property insurance.

I mean I do not know anyone that would define that as a reasonable—

Mr. RACICOT. I do not think that you can isolate one single thing that we are recommending and say that it would be the solution all by itself.

There needs to be protective and mitigation methods that are employed and undertaken. There needs to be regulatory reform. There needs to be legal reform.

Ms. WASSERMAN-SCHULTZ. Let us say that all of those things happened.

Mr. RACICOT. At the end of the day, it is our belief that is where you should proceed first.

Now, the fact of the matter—other solutions have been proposed, but free market principles have served this country particularly well with its insurance and private property protection system over the course of the last 150 years, and when you think about the fact that we are talking about an industry, a private industry that makes claims payments in the neighborhood of about $300 billion a year to its consumers or customers, you have to recognize that it is a vital and critical part of the fabric of our American existence, and to preserve it and to keep it strong and not to compromise its infrastructure, its architecture, is extremely important, because I do not think the government at any level is inclined or is in a posture to be able to take over that responsibility.

So what we are saying is that obviously there are situations that may require bridge mechanisms that have been undertaken in the past and may need to be explored by this particular committee, but there is no panacea that is available here, and at the end of the day, risk-based pricing, regulatory control—

Ms. WASSERMAN-SCHULTZ. Governor, what I am not hearing you say is that the answer is not yes.

So you say that you need these elements in order to be able to make insurance, commercial and residential, available and affordable, but you are not saying unequivocally that if those things occurred—

Mr. RACICOT. If all of the things that we are recommending to you occur, then it is our belief and we can say confidently that, at the end of the day, if there is a risk-based system in place and actuarially sound method and formula of determining premium, that that coverage will be available.

Ms. WASSERMAN-SCHULTZ. Who determines that? The industry?

I mean it is a moving target.

Mr. RACICOT. Nothing subject to our human affairs is capable of absolute definition, but what I am telling you is that, based upon 150 years of doing business and representations that we are able to confidentially make before the committee, that other scenario I described, we can address the issues, the private property protection issues that are existing in this country.

Ms. BROWN-WAITE. I appreciate the gentlelady's questions, and we will be able to come back to you, but we have other members who also have meetings to go to. So what I would like to do is, you know, come back to you, because your time is up.

I would like to recognize the gentlelady from New York, Ms. Kelly.

Ms. Kelly?

Ms. KELLY. Thank you, Madam Chairwoman.

I request unanimous consent to insert in the record this article from Carl Hiaasen, "Just say no to stronger building code." It is from the Miami Herald.

Ms. BROWN-WAITE. Without objection, so ordered.

Ms. KELLY. Thank you very much.

Commissioner McCarty, it has been noted that part of the problem in Florida's insurance market is that the capitalization requirements are less than in States like New York, even though the risk of catastrophic loss is so much higher.

What steps has Florida been taking to encourage higher capital requirements among Florida insurers and a greater ability to withstand the risks of your market?

Mr. MCCARTY. Florida has a minimum capital surplus requirement for a property market to be $5 million, which, frankly, is less than some States and is greater than others, and is within the national standards for the National Association of Insurance Commissioners.

$5 million for some property coverage is adequate.

Clearly, in a State with $1.9 trillion of property exposure, $5 million capital in surplus does not provide much in the area of coverage.

Part of the regulatory process that we go through is that a company is required to demonstrate through their business plan that they have adequate reserves or adequate capital to—adequate risk transfer mechanisms.

As I testified earlier before, before the hurricane season 2004, quota share insurance was readily available, which would allow

that $5 million to be leveraged. With $5 million, you cannot write very much coverage, many policies in Florida.

One of the other things that the legislature has done is provided a surplus build-up program so that they provided matching funds of up to a half-a-billion dollars, so that we would raise the capital of some of these small surplus companies from $5- to $10 million to about $50 million, which puts them in, of course, a much better position to purchase reinsurance and leverage across the State.

We would, as part of our regulatory framework and our solvency surveillance—most companies would not be able to write very many policies with $5 million.

Additionally, I would like to see the standard for that to go to $20 million.

Unfortunately, the signal that sends to the investment market is that Florida already has a difficult time attracting capital; certainly attracting $5 million, $10 million, when you leverage that against writing ratios with reinsurance, now they are setting this bar at $20 million, but I certainly would agree with you that higher minimum capital surplus standards would be beneficial, particularly since those very small cap companies write such a de minimis amount of coverage in Florida, it really does not have much of an impact on the capacity problem we have.

Ms. KELLY. Mr. McCarty, why should Florida try to exempt itself from the rules that help prevent insurance loss?

Other States, like my State, New York, are shoring up their building codes.

So why should Florida exempt itself from that? Does that make any sense to you?

Mr. MCCARTY. Florida has the strongest building code in the country, by far.

We have a small exception that was made in the panhandle of Florida, from Franklin County to Alabama, that was—that building code is stronger than the building code that was in there before.

My guess is when they conclude the study that is expected to be completed at the end of this year, that they will go up to the international standard.

Florida has the strongest building codes overall. A very small portion of our population lives in that panhandle.

Florida has the strongest building code. Dade County and Broward County have an advanced building code, above the international standard, and—

Ms. KELLY. Excuse me, but we are talking not about those counties. I am focused, really, on the issue here, which is the panhandle.

Mr. MCCARTY. I fully agree with you. I am embarrassed by the fact that that the Florida Building Commission, after I testified on two occasions—all of the insurance trade associations at this table were participating in that discussion, and they opted to do something. My guess, ma'am, I believe, in the next couple of months, the Florida legislature will overturn that decision and those building codes will be strengthened.

Ms. KELLY. Mr. Nutter, I would like to ask you a question, because your testimony suggests that, for hurricane risk, there is sufficient reinsurance available at market rates, but many people

have commented that those companies have reduced coverage in areas—reduced coverage in areas that—what I am essentially focusing on is the fact that Allstate has dropped out of the hurricane insurance market in my home county, and what we have done is—people have commented—other people here have commented about the fact that companies are reducing coverages—the ones that are reducing the coverages the most are those that refused to buy reinsurance in the past, and they have kept all the risk for themselves, rather than hedging against the risk.

I would like to know if you could explain to the committee how the low hurricane decades of the 1980's and most of the 1990's encouraged that kind of behavior and the role that insurance should have been playing for those companies—it is puzzling that they would have pulled out, and I know that is kind of a disjointed question, but I hope you can figure out what I am asking, which is basically, can you explain how that happened and perhaps offer a correction?

Mr. NUTTER. Mrs. Kelly, I do not represent Allstate, and I would not presume to speak on behalf of that company. Let me try to answer your question without any specific reference to Allstate or any other company.

Clearly, insurance companies assess the risk that they are willing to retain.

They look at their capital base. They look at their own internal analysis of their catastrophe exposure, and then they choose whether or not to engage in buying reinsurance and transfer that risk into other markets.

In periods of low activity, hurricane or earthquake activity, those companies are likely to determine that they can retain risk and not pay the cost of reinsurance to transfer the risk.

Some companies, particularly major personal lines companies, are very large in terms of their capital base and their ability to absorb risk. They may have made determinations that they would retain risk; a business judgement that may or may not have been right in any given year.

Certainly, Allstate is now a major buyer of reinsurance in 2006 relative to their prior position, as reported in the marketplace.

I mentioned in the testimony that, in fact—

Ms. BROWN-WAITE. If you could please sum up—

Mr. NUTTER.—rating organizations, in particular—Standard & Poor's, A.M. Best—have put these companies under greater scrutiny to assess their risk, as have the insurance departments. You see a greater demand for reinsurance than in the past. Just to clarify something you said; in peak zones, it is fairly clear that the reinsurance marketplace, while having added capacity this year, is still inadequate for the demands that are being made.

Ms. KELLY. Thank you.

Ms. BROWN-WAITE. Mr. Clay Shaw, you are recognized.

Mr. SHAW. Mr. Nutter, I would like to follow up on Ms. Kelly's line of questioning, talking about the reinsurance is available now.

We are only talking about windstorm here.

In the coast of south Florida, the reinsurance is available in all parts of that area?

Mr. NUTTER. I cannot speak about individual companies in south Florida, but what I can say is that every insurance company in the State of Florida is required by law to purchase reinsurance from the Florida Hurricane Catastrophe Fund.

So they certainly are reinsured through the Florida CAT fund, as we call it. They may have purchased reinsurance in the private—

Mr. SHAW. I am talking about the private sector.

Mr. NUTTER. They may have purchased reinsurance in the private market if they deemed that their catastrophe exposure exceeds what the CAT fund can provide them.

I do not have access to the individual reinsurance programs of companies, so I cannot answer your question directly.

Mr. SHAW. Is that a common practice?

Mr. NUTTER. A common practice to—

Mr. SHAW. Can it be bought at competitive rates? I am talking about the reinsurance, because that is what we are here to talk about.

Mr. NUTTER. Well, the reinsurance market is a competitive global market.

Other than the catastrophe fund in Florida, which sets its own rates, the reinsurance market is globally competitive.

So yes, it is a competitive rating environment.

Mr. SHAW. Do you see a need for a national catastrophic fund?

Mr. NUTTER. The private market, both insurance and reinsurance, have, to date, handled the catastrophes we have had, including the events of 9/11 and certainly the events of 2004 and 2005.

I just want to emphasize something I said a couple of times.

We recognize that the market—the reinsurance market probably is not meeting the demands for reinsurance in peak zones—south Florida—

Mr. SHAW. Mr. Nutter, the Florida legislature just had to put over a billion dollars into the CAT fund in order to keep Citizens afloat.

That is not the marketplace working, believe me, and Citizens is not part of the free market system. It is an insurance of last resort that was the creation of the Florida legislature, and we have huge problems.

Now, I am sure you can insure anything if you are willing to pay enough for it, but the problem is that the premiums have actually gone through the roof.

The private markets have failed us in regard to windstorm insurance.

If it had not, we would not have Citizens. We have no need for even being here at this particular hearing, but the people at home are suffering. It is like getting an unwanted second mortgage on their house, and we have to get some results, and we have to get some relief, because I can tell you right now, the rates that we are experiencing throughout the State of Florida and throughout the Gulf coast are going to exceed our ability to pay, and when that happens, the economy starts to fall through, people start walking away, the insurance—the real estate market will fall through the floor.

It is a question of whether or not the mortgages are going to continue to require catastrophic insurance or windstorm insurance, which has been viewed now as a catastrophic insurance.

Insurance companies have limited their exposure on a State-by-State basis.

That is not what insurance is about. That is not what we want. That is not the free enterprise system working. This is wrong. Mr. McCarty, can I talk to you a little bit about that? How did that happen?

How did it happen that the insurance companies were able to form subsidiaries of such-and-such insurance company of Florida? We all see it on our premium notices. How did that happen?

Mr. MCCARTY. Well, sir, that occurred before my time.

Mr. SHAW. I know it did, but you know how it happened.

Mr. MCCARTY. Well, the insurance industry was under a tremendous amount of pressure after Hurricane Andrew, particularly those that were stock traded companies.

In order for them to maintain their A.M. Best ratings, which we readily admit is a driving force in a lot of decisions made in the industry, they had to limit their exposure in Florida.

So large companies set up subsidiary—we refer to them as pup companies—so that they could limit their exposure in Florida.

When I was educated on my trade mission to London, one of the underwriters said, you know, if you were purchasing this on a national basis, you could leverage this against a national account and would be in a better position to purchase it.

Now, it may not reduce it, but it would have put them in a better position to purchase it.

So in some ways, having this separation of these companies and limiting their exposure—it is a benefit to the company, to the stockholders of the company. There is no question about it. Was it a prudent business decision to make? Absolutely. Was it helpful to Florida? Not generally.

Mr. SHAW. Yes, sir.

Ms. BROWN-WAITE. The gentleman's time is up, but I will allow Mr. Daniel to have one minute.

Mr. DANIEL. Thank you.

Just to support your point that there is a void in the free market, in Louisiana, we are insuring many companies with—many insureds with unaffordable deductibles that could put them out of business if a storm came along, inadequate coverage, because it is not available. Just this week, I renewed a policy in a surplus lines company for a small business, happens to be a sausage manufacturer in Lafayette, Louisiana.

They have no wind coverage. We could not find anything that was affordable to them. That was in the surplus lines market. It is unregulated for rates, and it is, as I recall, a concrete block building.

So mitigation is great, rate flexibility is great, we support those things, but it is not the only answer.

Thank you.

Mr. SHAW. Thank you, Madam Chairwoman, and I thank the committee for allowing some of our interlopers here to take part in

today's hearing. This is terribly important to the people of the State of Florida.

Ms. BROWN-WAITE. You are very welcome, Mr. Shaw.

Before I recognize Representative Mark Foley, I would like to ask Kevin McCarty a question.

Kevin, you were not the insurance commissioner at the time—it was an elected post—when the Florida legislature—and Mr. Foley was in the legislature at the time, as was Representative Wasserman-Schultz.

When the pup companies were created, it was at a time after Hurricane Andrew, when the companies were fleeing the State.

So it almost was a way—a stop-gap measure, by creating the pup companies. First of all, many of us had the opportunity to vote on it.

It was something done by the then-insurance commissioner, but I had been told at the time that there was an implied consideration, an implied—I do not want to use the word "promise," but some language that was given to the insurance commissioner that the parent companies would serve as the guarantor, even though these pup companies were created.

May I have your comments on that, first of all, and again, I would request that we be informed how much of the insurance rate increase—and by the way, Mr. McCarty just told me that the company I am insured with just asked for a sizeable rate increase, also.

You know, every Member of Congress is hearing from their constituents on it, but if you would just answer the question about any consideration of parent company guarantor, and also, have any other States set up these pup companies?

Mr. MCCARTY. I will just backtrack just a little bit.

In the immediate aftermath of Hurricane Andrew, as you know, the insurance commissioner, Tom Gallagher, at the time, implement a moratorium to prevent the cancellation of non-renewable policies, in particularly preventing the shedding of the policies through creation of a subsidiary. That was subsequently codified by the Florida legislature, allowing for a run-off of the moratorium over time, so that we can build some stability in the marketplace as we were ramping up some of the other programs, including the Florida Hurricane Catastrophe Fund and the creation of a residual market so that we could continue to have land sale contracts and bank could issue loans, etc., because it was critical to the stability of Florida to do that.

It was subsequent to that that the insurance industry argued, these companies, that in order to—particularly those that are traded in the stock market—that they needed to limit their exposure.

I was not privy to any conversations about the guarantees or any guarantees by those companies.

Legally, you set up a separate legal entity through corporate law to limit your exposure. That is the purpose of setting up a corporation, is to limit your exposure.

Ms. BROWN-WAITE. I would like the record to reflect that when you say "you" set it up, you did not mean the Florida legislature.

Mr. MCCARTY. Oh, no, the Florida legislature—

Ms. BROWN-WAITE. Okay.

Mr. MCCARTY. The Florida legislature—

Ms. BROWN-WAITE. I just want the record to clearly indicate—

Mr. MCCARTY. This was done through petitioning, through the department of insurance, at that time, and creation of those companies were licensed, then, by the insurance department at that time, and they were granted through a consent order, which is generally a mechanism for the agreements of the terms and conditions for establishing of these pup companies.

Ms. BROWN-WAITE. Do any other States have them? Yes or no?

Mr. MCCARTY. Yes, they do. Other States have had them.

Louisiana has subsequently had them. New York has historically had separate companies, separate entities.

It was because of the different regulatory framework that New York had that was separate and distinct for limitation of their exposure.

Ms. BROWN-WAITE. I thank the gentleman.

The gentleman from south Florida, Representative Foley, you are recognized.

Mr. FOLEY. Thank you very much.

Maybe if FEMA had not given away so many generators in Florida and so many gift cards, we probably could have created a reinsurance market.

Let me first thank Mr. Daniel for the comment about employees, because despite all of the tragedies we experienced in hurricanes, the one thing that became apparent, whether it was your agents, firefighters, police officers, linesmen for utility companies, who had their own damage at home, left their families to be of aid and assistance to fellow Floridians, and that is important to be noted. We all can complain.

There are a lot of reasons to be upset, but in our bleakest times, it was the average citizen who strode to the front of the line to say how can I help, and that is something I think is commendable.

As Mr. Shaw said, insurance rates are completely and totally out of control, and it is going to start having a dramatic impact on the economy of Florida.

I cannot underscore it enough, why the urgency of the situation is now, and I cannot underscore enough that it has to be a solution-based free market concept with some Federal entity.

Mr. Kanjorski mentioned a multi-peril—because that is the one oddity of the insurance business that I do not quite understand, because you know, flood and wind and this and that—everything is different. You have to buy a separate policy.

It is like going to a cafeteria to select from menu items, because you cannot buy a universal policy to cover, and a lot of people are finding out, well, the policy they have even spent a lot of money on does not cover it, because it came in through the wind—no, does not work. If it came up by flood, we can cover you.

If it is a flood resulting from the wind coming through your window, well, that is a flood that is not covered, because that is wind, and you did not have wind.

Even though there is 4 feet of water in your house, which would be typically thought of as a flood, the fact remains it came sideways through wind and is no longer coverable.

So we have to figure out some of these dynamics of the insurance markets, so there is a universality of coverage. I agree there has to be more competition. How do you bring it in?

$22 billion of losses in Florida alone makes it very untenable for an entity to say let us keep going through this based on projections that show for the next 20 years our exposure and experience may be comparable. So it is a difficult thing.

Mr. Heidrich, you mentioned this great miracle of New Jersey car insurance. How would that relate to homeowners insurance in Florida?

Mr. HEIDRICH. My point there is that, in New Jersey, you had a long history of highly regulated markets. You had a very difficult auto insurance market that was recognized generally across the Nation as one of the more difficult places to do business, and for years and years and years, the legislature was reluctant to try deregulation of that market and opening up that market.

That was done 3 years ago by Governor McGreevey and the legislature at the time, and the early results are very promising in terms of companies that previously were unwilling to commit capital being now willing to commit capital, insureds getting coverage that was not available to them before, in a number of cases at lower prices.

So my point simply is that these can be very difficult transitions. People in New Jersey certainly feared that it would be a very difficult transition, but we have seen successes, and so, it was really a point to say that we—that is among the policy prescriptions we ought to be looking at for Florida and other catastrophe-prone areas.

Mr. FOLEY. Do you see Florida as heavily regulated in the context of what New Jersey was?

Mr. HEIDRICH. Our members have told us that, historically, it has been heavily regulated. I want to comment on what Commissioner McCarty has done. We certainly passed rate relief last year, with the flex rating bill. Florida has taken very aggressive steps to improve its mitigation environment.

They are doing many, many things well, but historically, it has been a very difficult market to do business in, according to our member companies.

Mr. FOLEY. Can't that be, to some degree, some of the maybe fly-by-night insurance companies that set up, collect premiums, then do not pay, where the regulations have had to be strict in order to ensure fulfillment of obligation?

Mr. HEIDRICH. Let me be clear. We are not arguing for no regulation. We are arguing for not being very, very careful about the capital position of insurance companies, and I would certainly endorse Commissioner McCarty's comments earlier about the need for insurance regulators to always assure that the capital is available to pay the claims that are owed down the road.

So please do not misunderstand my comments to be arguing for no regulation.

We believe in solid, good, safe, sound regulation of insurance companies, but we also know that the answer to some of the more difficult availability and affordability problems are more free market solutions.

As I indicated in my testimony, not the only solution, but one of the solutions.

Mr. FOLEY. Let me make the final observation, because I think it is important relative to construction standards. Andrew proved to us that if building officials do not look for compliance with building codes, it does not matter, because the storm will blow down the house, and that seems to have been the huge casualty loss in Dade County, was that no one was watching.

Our roofs were strapped. You know, it was just a fly-by-night operation, and those were the areas of deep devastation.

When Governor Jeb Bush and I flew over Charlotte County, it was interesting to see almost pre-1970 construction that remained fairly intact, post-1994 construction after the new south Florida building codes took effect after Andrew, 1994–1996.

I mean the difference in how they weathered the storm was dramatic, and so, that has to be part of the equation.

It cannot be putting the onus all on insurance. It has to be both about building inspections that are significant and secure in the knowledge that they will achieve a thorough inspection and not allow for shoddy workmanship, but also the difference is the methodology that happened in the growth of Florida during those mid-years seemed to create homes that clearly would not withstand—never mind 150-mile-an-hour storm but possibly not even 40.

So that is something I think we also have to digest as we do a look at insurance opportunities. We have to look at the methodology by which construction takes place, and there is also give and take—what we find in Florida, because there are no longer overhangs allowed, because that allows the wind to come up and rip off the roof. That has created some energy efficiency issues.

So it is trade-offs and a lot of obvious different things that place us in a conundrum, but I am anxious to work with all of you to come up with some solutions, but it is the urgency that I cannot underscore enough, and not just for this election year. I have been working on this bill since 1999, I believe.

So it is not something I deduced in a hysteria of the moment. It is something that I knew was coming, a long time coming, and it is developing at a critical, critical pace.

Madam Chairwoman, thank you.

Ms. BROWN-WAITE. I appreciate your comments, and I certainly want to thank all of the witnesses who are here today, who contributed to make this a very successful hearing.

As the chairman said, we are going to be taking action next year. It cannot come a day too soon for so many homeowners and businesses who are really struggling to pay those increased costs, and today, if nothing else, we saw that from the testimony of the various members here today, and statements that are being submitted, that this is not just a Florida problem, and I look forward to working with each and every one of you to come up with a solution that helps everyone and helps to make insurance, a necessary component, more affordable.

With that, this meeting is adjourned. Thank you.

[Whereupon, at 12:49 p.m., the hearing was adjourned.]

A P P E N D I X

Septemberr 13, 2006

U.S. Congresswoman
Ginny Brown-Waite

Representing Citrus, Hernando, Lake, Levy, Marion, Pasco, Polk, and Sumter Counties

Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities
"Stabilizing Insurance Markets for Coastal Consumers"
September 13, 2006

Mr. Chairman, I cannot thank you enough for holding this hearing today. The insurance crisis that Florida is facing is eminent and we need to find solutions immediately.

I also want to thank the witnesses who are here.

As many of you know, I have introduced H.R. 4366, the *Homeowners' Insurance Protection Act,* with my colleague Mr. Shaw. As I have been meeting with industry groups and other Members, I hear claims that the market is stable, there is enough reinsurance, and that there is no problem.

Well, I would like the people making those claims to visit Florida. People living along the coasts, in the panhandle, and in central Florida – basically every person living in Florida – is a victim of a market that is no where near "stable." I am not just talking about millionaires who live on the beach, as the cliché goes. I am talking about retirees living on Social Security, young families just starting a business, and farmers who have been in Florida for a century.

Florida homeowners' premiums are increasing at double-digit rates, or their policies are dropped entirely and they have to get insurance from the state's insurer of last resort – Citizens. This "insurer of last resort" will soon become the largest insurer in Florida, which will spell even more disaster for our state.

However, if homeowners are facing affordability questions, business owners are facing a threat far worse – *availability*. Because there is no "Citizens Insurance" property coverage, Florida has moved passed the initial outrage stage and is now in a full-blown panic. Business owners are no longer just scared their rates will increase; they are closing their doors and leaving the state because they simply cannot get insurance. No area, including Florida, can withstand that type of economic meltdown.

Congress has to find a solution to this crisis, and I recognize that solution is multifaceted. The solution includes:

- States passing and enforcing strong building codes and mitigating disasters before they strike.
- Ensuring that companies are writing prudently, they are purchasing adequate amounts of reinsurance, and they aren't over exposing themselves.

- Relieving the market of unnecessary regulatory burdens and giving insurers the tools they need to enhance competition, such as allowing them to build up tax-free reserves.
- Making sure that the insurers of last resort are the private insurers, not the federal and state governments, as my bill, H.R. 4366 does by creating a federal catastrophe fund.
- Giving homeowners and business owners the tools they need to prepare for disasters themselves, like my colleague Mr. Feeney does by creating Catastrophe Savings Accounts.

I hope that all the panelists here today have some innovative suggestions as to what Congress can do to help you provide a better, more affordable product to our constituents. Because I refuse to wait until the next big disaster hits, whether it's a hurricane, earthquake, or tsunami, before Congress wakes up and enacts a solution to a crisis that already exists.

Thank you Mr. Chairman, and I yield back the balance of my time.

STATEMENT OF THE HONORABLE WM. LACY CLAY
Before
The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
"Stabilizing Insurance Markets for Coastal Consumers"
September 13, 2006

Good morning Chairman Baker, Ranking Member Kanjorski, Member of the Committee, and witnesses.

Mr. Chairman, I am concerned about the limitations of insurance polices and the payouts that are left for the government to make because of the shortfall in insurance coverage from the private sector. These shortfalls can be for various reasons: denial of claims, lack of coverage offered; no insurance coverage; to name a few.

I am especially concerned by the dismissal of claims by companies because of disagreements of whether the property was damaged by wind or water. We have catastrophic losses because of hurricane force winds and the accompanying rains and floods, yet, families have problems getting insurance settlements although they have insurance for these occurrences.

I am deeply concerned with the methods of reducing losses employed by the insurance industry. We have policies that are being issued that settle the water damage versus wind damage dispute by stating that if the property was damaged by both, the losses are not covered even if there was wind damage as well as flooding and even if the wind damage occurred prior to the flooding. However, I guess that I should feel better about this type of policy because families are told up front that they will be left up the creek.

Mr. Chairman, I ask unanimous consent to submit my statement to the record.

STATEMENT OF THE HONORABLE WILLIAM D. DELAHUNT

HOUSE SUBCOMMITTEE ON CAPITAL MARKETS

HEARING ON "STABILIZING INSURANCE MARKETS FOR COASTAL CONSUMERS"

SEPTEMBER 13, 2006

I would like to take this opportunity to commend the Committee for holding hearings today on this important issue and to thank you for allowing me to present my views in writing.

In recent years, we've watched as the remnants of hurricanes and tropical storms have battered our coasts and eroded our beaches. We've crossed our fingers that century-old dams and sea walls wouldn't burst and flood vital downtown economic areas. While my district has been extraordinarily lucky in terms of natural disasters, it has by no means escaped unscathed.

In recent months, thousands of my constituents, homeowners and businesspeople alike, have received the news that their insurance premiums have gone up, or worse, that they've been dropped altogether – all because some bureaucrat has decided that they're too much of a risk to insure simply because of their address. Today, it is harder than ever before for coastal homeowners to obtain the insurance coverage they need in order to protect themselves.

This reality has hit home in a very real way for the people of the Tenth District of Massachusetts. My district, encompassing the entirety of Cape Cod, has as much or more coastal exposure as any in the country. The typical homeowner living in a coastal area today faces higher costs for coverage than ever before, in addition to the real risk that coverage will be unavailable to them altogether. These problems aren't unique to the people of the Tenth Congressional District of Massachusetts. From the Gulf Coast to the Outer Banks, from the Atlantic to Pacific Ocean, homeowners are faced with the same choice; stay and risk losing everything or sell because they cannot pay their insurance premiums.

Today, the average premium on Cape Cod is $1,306. Thousands of area homeowners, living along the coast, have been confronted with double-digit hikes in their home insurance premiums due to growing fears that the Northeast is overdue for a major hurricane. A woman from Eastham in my district recently saw her premium rise from about $800 to nearly $1,600 and expects her bill to go up even more, to about $2,000. All this despite the fact that she has gone 20 years without an insurance claim.

In Massachusetts, there is a mechanism to reimburse companies for losses from coastal damages, called the FAIR plan. The FAIR Plan was designed to be the state's insurer of

last resort, a "backstop" to the private insurance market. But today it has become a primary insurer because there is simply no other option. As private insurers have withdrawn from our coast, the FAIR Plan has grown into the principal insurance carrier for the southeastern coastal region. The FAIR Plan insures some 175,000 Bay State homes that other insurers refuse to cover - including one-third of all Cape residences.

Unfortunately for my constituents, the Massachusetts State Insurance Commissioner earlier this summer approved a FAIR plan that would significantly boost the price of homeowner's insurance policies of last resort. So, even these state level plans are being strapped or overburdened. This system is not working in Massachusetts, any more than it is working in other areas of the country that have experienced devastating hurricanes and other natural disasters.

Clearly, the industry needs to examine ways that it can leverage its considerable equity and build up reserves – just like any other business. Foul weather is a fact of life. Hurricanes, tropical storms, floods are not going away anytime soon. When disaster strikes, people have come to expect that after years of paying faithfully on time and being a good customer, that their insurance provider will pay them back for their losses – especially those families and individuals that don't have the financial resources to start all over again.

Congress can, and should, send a clear message to the states that we too, will be there when the time comes. We can establish re-insurance funds to ensure that the industry doesn't collapse under the weight of a catastrophic event, like Hurricanes Rita and Katrina. We can invest in rebuilding our beaches and marshes – natural barriers that protect low-lying areas from flooding; and, we can repair our aging infrastructure – levees, dams and seawalls – that so often fail as a result of years of unrelenting pounding by Mother Nature. The small price we'd pay for investing in these preventative measures pales in comparison to the billions we'd lose in lost wages, property, tourism – even human life.

We should explore a variety of different options and listen to a wide group of stakeholders, including homeowners, consumer advocates, local officials, and the insurance industry itself. I look forward to hearing the insights of other members and knowledgeable parties as we look for solutions to this critical problem facing coastal homeowners.

Testimony of the Honorable Mark Foley
Financial Services Capital Markets Subcommittee
September 13, 2006
H.R. 2668 – Policyholder Disaster Protection Act

Thank you for holding this hearing today and allowing us to testify on an issue we believe Congress has to address – ensuring that disaster insurance policies remain affordable and accessible.

In the past 2 years, Florida has been hit by nine hurricanes – four of them back-to-back causing $22 billion in insured losses. Together, they accounted for 201 hurricane-related deaths.

The most recent hurricane was Wilma, which ripped through Florida causing at least $10 billion in insured losses. And, of course, it came on the heels of Hurricane Katrina, which ravaged the Gulf States causing horrible death and destruction.

When Hurricane Andrew tore through south Florida in 1992, it left 58 people dead and more than $15 billion in insured losses alone. Ten Florida insurance companies went belly-up because they could not absorb the losses. Had Andrew hit the nearby city of Miami directly, the losses would have approached $50 billion, the loss of life even more significant and an estimated third of all insurers in Florida would have been forced into insolvency.

I only mention these as examples of how the destruction of these storms alone – not to mention the destruction from other disasters like tornadoes and earthquakes – are overwhelming the ability of insurance companies to cover these losses under traditional methods.

The Policyholder Disaster Protection Act would correct that. It would give insurance companies the option of building up reserves over a 20-year period on a tax-deferred basis -- much like an IRA -- so that the resources will be there down the road to cover insured losses from a catastrophic natural disaster.

Mr. Chairman, the idea behind this legislation – though complicated as a bill -- is very simple. We currently have no incentives built into our tax laws that would help insurers build up reserves they can use later to cover future catastrophic losses. As a result, they lean largely on premiums to cover disasters as they occur – and as the State of Florida can attest, that almost always leads to insurance premium increases for homeowners.

The United States is almost alone among industrialized nations in not allowing insurance companies to plan ahead with tax-deferred reserves. What that means is that, barring government assistance, there is no real protection for insured homeowners should they fall victim to a mega-disaster that overwhelms both individual company resources and state insurance pools.

This bill is not an immediate fix. It cannot help with whatever losses another disaster this year or the next may inflict on our communities. But it can prepare us for future mega-disasters down the road, which is why it has been endorsed over the years by a wide range of groups, from the United Homeowners Association to the National Taxpayers Union.

We can start allowing insurance companies the ability to remain solvent to cover catastrophic losses – or we can start getting used to writing checks from the U.S. Treasury to cover those losses at the expense of all taxpayers.

Congress has done a lot by way of encouraging individual savings – particularly retirement savings so that people can help themselves in their retirement years rather than having to lean heavily on government for resources to survive. But we have not taken that same principle and applied it to insurance companies, which deal in losses created by natural disasters.

It is my hope, Mr. Chairman, that this subcommittee will take a hard look at this issue so that we can start planning ahead for disasters we know will occur rather than scrambling to react in their wake.

Thank you, Mr. Chairman.

OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS
HEARING ON
"STABILIZING INSURANCE MARKETS FOR COASTAL CONSUMERS"

Chairman Baker and Ranking Member Kanjorski,

I would like to ask unanimous consent that the following materials from the Texas Department of Insurance be submitted for the hearing record:

1. Summaries of the Texas Seacoast insurance market for residential property and commercial property and lists of the following:

2. A list of: casualty companies, Fire and Casualty Companies, risk retention groups, and Title companies licensed in Texas since January 2005 to August 2006;

3. A list of withdrawal plans filed in Texas since Hurricane Rita; and

4. A list of Property & Casualty carriers operating in Texas from the 2005 year-end available data.

Mr. Chairman, I am very concerned that certain insurance companies have decided not to issue new property and casualty insurance policies in certain areas of my district.

I am particularly concerned about the insurance industry's approach to issuing property and casualty insurance in what are known as Tier 1 and Tier 2 areas.

According to the Texas Department of Insurance, the following counties in my district fall in Tier 1 areas: Refugio and San Patricio. Tier 2 areas include: Bee, Brooks, Goliad, Hidalgo, Jim Wells, and Live Oak.

I respectfully request that each witness provide in writing an explanation of their understanding of the definition of Tier 1 and Tier 2 areas; an explanation as to why the counties I have mentioned fall in either the Tier 1 or Tier 2 category; and the impact this designation will have on the constituents in my county, both financially and in terms of insurance coverage.

Mr. Chairman, my goal here is not to punish the companies that have decided either not to issue new policies in certain areas of my district. Nor is it to punish them for deciding to restrict the issuance of new policies in TX-15.

I merely seek an explanation for their decision. I seek a better understanding of the impact Hurricanes Katrina and Rita had on their bottom line; and ways to ensure that the insurance companies operating in Texas have the ways and means to provide property and casualty insurance to all my constituents.

Thank you very much Chairman Baker and Ranking Member Kanjorski.

I yield back the remainder of my time.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON STABILIZING INSURANCE MARKETS FOR COASTAL CONSUMERS

WEDNESDAY, SEPTEMBER 13, 2006

Mr. Chairman, this morning the Capital Markets Subcommittee returns to an issue that we have often reviewed in the past: the availability and affordability of insurance in coastal areas.

From our past work on these matters, we know that the cost of reinsurance typically rises after major events, particularly as providers reassess risk. Most recently, this contraction has led to problems in rebuilding along the Gulf Coast after Hurricane Katrina. In addition, seven of the twelve most costly disasters in our nation's history occurred in 2004 and 2005. So, others are also affected.

I share the concerns of my colleagues about helping the communities affected by these catastrophes. I also want to ensure that we take effective steps to ensure that the people who live in less risky areas pay appropriate and reasonable rates for their insurance policies.

While today's hearing will allow us to gather the additional views of a number of experts on these matters, we are still awaiting the results of the 3 catastrophic insurance studies being prepared by the Government Accountability Office. In the next Congress, we should hear from the GAO about their findings on these matters. In the meantime, today's hearing will help us to better discern the quality of the adjustment process and consumer confusion in the insurance products that they should purchase and at what levels.

We will additionally look into what, if any, role the federal government should play in providing natural catastrophe insurance. I have, however, long had deep reservations about inserting the federal government into the private markets.

Finally, I hope that we will explore the interest in creating an "all-perils policy" that would protect homeowners regardless of the cause of the damage. This product would cover perils like floods, fire, hurricanes, wind damage and earthquakes in just one policy. While this type of product would end consumer confusion about what coverage they need and likely result in less litigation about insurance settlements, it would also come at a considerable cost.

In sum, Mr. Chairman, I look forward to hearing from our witnesses. This is a topic that deserves congressional attention and review.

Committee on Financial Services
Opening Statement of Representative E. Clay Shaw, Jr.
Hearing on Stabilizing Insurance Markets for Coastal Consumers
September 14, 2006

Chairman Baker, Ranking Member Kanjorski, members of the subcommittee, I would like to thank you for holding this hearing today on insurance markets for catastrophe prone coastal areas. This issue is of extreme importance to my constituents and to the entire nation. I'd also like to thank the subcommittee for letting me participate today. I appreciate the indulgence of everyone here as we examine this complex issue that will no doubt require a well considered solution, one that may span the jurisdiction of multiple Committees.

The devastation caused over the last two years by Hurricanes Wilma, Rita, Charlie, Frances, Ivan, and Jeanne in South Florida highlight the risk of hurricanes, wind storms, and flood hazards faced on coastal areas. However, catastrophe insurance includes earthquakes, tsunamis, and volcanic eruptions that affect other areas of our nation as well.

As a result, the insurance situation for businesses and homeowners has reached a critical point. I receive countless letters and emails from my constituents in South Florida who are unable to afford the high premiums that are continuously increasing for wind, flood and hurricane insurance. While the average home in my congressional district currently costs $380,400, our most recent numbers show that insurance premiums for only a $250,000 home average over $5,000. This state of affairs is untenable. Sadly, often the hardest hit are the large number of retirees who live on fixed incomes. This financial bind has become a massive crisis in the state of Florida.

It is imperative that Congress focus on the national issue of catastrophe insurance. We must pass comprehensive federal legislation that will address this problem.

In November of last year, Representative Ginny Brown-Waite and I introduced the Homeowners Insurance Protection Act of 2005. This bill would create a Federal backstop for natural catastrophic losses. By creating this backstop and spreading the risk of these disasters, we can reduce the pressure that is currently driving up homeowners' insurance rates. Additionally, by establishing this fund, we can ensure that future reconstruction projects are funded by insurance premiums and not taxpayer dollars. The bill would also create the National Commission on Catastrophe Preparation and Protection.

I am also a co-sponsor of the Policyholder Disaster Protection Act of 2005 sponsored by Representative Mark Foley. This bill would create tax-deductible contributions for insurance companies to a tax-exempt policy-holder disaster protection fund established for the payment of catastrophic events.

In resolving this issue, we must accomplish two goals:

FIRST, we must reduce insurance premiums to policy-holders.

SECOND, we must assure that financial recovery and rebuilding occur following the inevitable natural catastrophe. These bills offer two ways to deal with the crisis of assuring that the insurance industry has the capacity to continue to underwrite catastrophe risks.

Again, I appreciate your willingness to allow me to participate in today's hearing and I am looking forward to working with this Committee in solving this problem.

STATEMENT OF WENDY BAKER
PRESIDENT, LLOYD'S AMERICA, INC.

BEFORE

THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES

REGARDING

STABILIZING INSURANCE MARKETS FOR COASTAL CONSUMERS

September 13, 2006

Mr. Chairman, Mr. Kanjorski, Members of the Subcommittee, thank you for inviting me to testify today on behalf of Lloyd's of London, the world's leading specialist insurance market. Last year's record-breaking storm season presented significant challenges to the global insurance market. Although the first half of this year's Atlantic storm season has not proven as deadly or as costly as the early part of the 2005 season, it is nevertheless important to continue the dialogue on protecting the US economy from large-scale catastrophic losses. Lloyd's is very pleased to participate in today's hearing and commends the Subcommittee for recognizing the continuing need for stability in coastal markets.

Lloyd's is the world's best known -- but perhaps least understood -- insurance brand. This is because Lloyd's is not an insurance company, but an insurance market made up of underwriting members. Members of Lloyd's, or "capital providers" as they are often known, are companies, individuals, and limited partnerships that accept insurance business through syndicates on a separate basis for their own profit and loss. In other words, members of Lloyd's are not jointly responsible for each other's losses. Collectively, however, Lloyd's has established a Central Fund, which can be made available to meet any portion of any member's liabilities that the member is unable to

meet in full. These assets are held on a mutual basis. Thus, policyholders at Lloyd's are protected by a chain of security that is unrivalled in the global insurance market.

Although Lloyd's Underwriters write business on a non-admitted basis in all US markets, Lloyd's is licensed only in Illinois, Kentucky and the US Virgin Islands. Therefore, in Florida and the Gulf States, Lloyd's functions as an eligible surplus lines insurer and a reinsurer. In this region, Lloyd's is a significant direct insurer of industrial and utility property, particularly in the offshore oil and gas sector. Lloyd's also insures many other businesses and high-value residential properties.

Within hours after Hurricane Katrina hit the coast, Lloyd's established an emergency hurricane response team in London and the US. We also launched a toll-free helpline to deal with urgent policyholder concerns, which took thousands of calls and helped more than 99 percent of policyholders initiate contact with the right people in our marketplace. And Lloyd's syndicates were the first to pay claims to the offshore energy industry after Katrina decimated the Gulf.

More importantly, Lloyd's continued its 318 year record of paying claims on tough risks. We first made our reputation in the US a century ago when we paid out more than $50 million ($1 billion in today's dollars) to meet all claims in the wake of the 1906 San Francisco earthquake. This decade has been a challenging one for all insurers, Lloyd's included. But we have proven that we are up to the challenge. We paid more than $3 billion in claims after the 9/11 attacks, $2.7 billion relating to the 2004 Florida hurricanes, and almost $6 billion related to Hurricane Katrina and other US hurricanes last fall. But despite these record-making catastrophes, Lloyd's scored "A" grades from both Standard & Poor's and Fitch after the 2005 hurricane season, and these ratings were affirmed at the end of the year.

The US is the largest overseas market for Lloyd's underwriters, accounting for over one-third of all Lloyd's premium income in 2005. We insure 56 of the 65 businesses that comprise the Dow-Jones index. In addition, we maintain approximately

$13.7 billion in US trust funds to secure our liabilities to US policyholders. The US is a vitally important market for us.

We thank the members of this Subcommittee, as well as the other members of the House Financial Services Committee, for leading the way in promoting serious analyses and dialogue on the tough issues, such as catastrophe mitigation and regulatory efficiency and uniformity, which necessarily impact the stability of both the US economy and our global industry.

Addressing the Potential for Future Catastrophic Losses

Researchers have estimated the chance of a Category 3 or stronger hurricane making landfall on the East Coast this year at 64 percent. So far, this year's hurricane season has not yet proven as devastating as 2005—but the second half of the season has just begun. We are proud of our record, but our responsibility to our US policyholders going forward is to avoid complacency. We realize that we must ensure that we can continue to meet the future challenges that the marketplace and Mother Nature will present. We commend you, Mr. Chairman, Ranking Member Kanjorski, and the members of the Subcommittee for recognizing that, although markets have recently responded to large-scale disasters, the Federal government must also avoid complacency and anticipate future challenges.

Specifically, you have recognized that the Federal government's role is broader than simply providing immediate relief for losses and that policy initiatives and mitigation measures play a crucial role in stabilizing markets. Regulatory and litigation reform for the underlying direct market can have a material beneficial impact on the availability of reinsurance capacity. Likewise, land-use planning and public policies which affect the changing concentration of exposed values in coastal states may be an important component of long-term stability.

While the insurance and reinsurance markets tend to adjust to dislocations on their own in time, public policy can and should play a role in improving that market response. For example, most of the natural disaster bills which have been introduced by members of the Financial Services Committee over the past year have included mitigation measures, such as encouraging the development of mitigation programs by States as well as standards for the construction and maintenance of buildings to protect against future disasters. Reinsurers and direct insurers alike are interested in the efficacy of these measures. As a major US income taxpayer, Lloyd's also notes the dialogue initiated by this Subcommittee and in the tax-writing committees regarding the use of tax policy to encourage expansion of natural catastrophe risk capacity.

At Lloyds, we have our own initiatives to meet future challenges while continuing to protect our central assets and reputation. Part and parcel of that is to ensure that all underwriting syndicates perform to Lloyd's standards, which is the responsibility of the Lloyd's Franchise Performance Directorate. We will also continue to refine our Realistic Disaster Scenarios, which help us anticipate potential losses and ensure that both syndicate-level and market-level exposures will permit us to handle catastrophic losses.

Last year, one of our Realistic Disaster Scenarios asked underwriters to analyze their ability to handle a windstorm in the Gulf of Mexico resulting in losses of $60 billion. Hurricane Katrina proved that scenario to be realistic indeed. The severity and frequency of catastrophic events is increasing and we must make sure that we stay ahead of them. This year, Lloyd's will add two new scenarios with losses of up to $100 billion.

What role global climate change plays in recent or future losses may be subject to debate, but Lloyd's has taken several steps to contribute to worldwide efforts to find some answers. We have joined a U.K. organization that aims to connect business with the latest science and which also participates in a range of specific climate change action groups. We have also agreed to sponsor two Ph.D. climate change research

posts in leading universities. Finally, but importantly, we have set an example by working to reduce energy usage in our own building in London.

Positioning the Global Insurance Market to Respond to Potential Catastrophic Losses

As we consider our responsibilities to our policyholders and how to continue meeting them, US lawmakers and regulators might also consider their responsibilities to help ensure that the global insurance market is well-positioned to handle increasingly severe and costly natural disasters in the US. In this regard, we would like to raise two specific issues with you today.

First, we believe it to be important to create greater uniformity, simplicity and efficiency in State regulation of surplus lines insurance, to streamline placements for large commercial policyholders, and to modernize State regulation of reinsurance. We, therefore, commend your leadership, Chairman Baker, and that of Mrs. Brown-Waite, and all cosponsors and supporters of H.R. 5637, the Nonadmitted and Reinsurance Reform Act of 2006. We were gratified to see the Financial Services Committee take such a strong bipartisan stand in favor these goals, with invaluable leadership from you and Chairman Oxley. We pledge to continue to work with you and your colleagues on both sides of the aisle in Congress, state insurance regulators, and other interested stakeholders to continue to build consensus for creating greater uniformity in surplus lines and reinsurance regulation as well as in other aspects of insurance regulation.

We also recognize the efforts of Representatives Shaw and Foley and other members of the Ways and Means Committee to examine how tax policy might be used to address capacity issues.

Second, it is important to recognize that most of the reinsurance protection provided to the United States market comes from reinsurers based outside the United States. It is altogether appropriate to use global capacity as this provides a buffering

effect to a blow that would otherwise have to be sustained entirely by the local economy. Such reinsurance provided substantial benefits to US insurers in the face of large-scale catastrophic losses resulting from September 11 and the 2004-2005 hurricane seasons. Global reinsurance protection continues to be a vital element in the US insurance industry's ability to meet the challenges of the future.

Data from the Insurance Information Institute demonstrates the significance of the foreign reinsurance market to economic recovery in the Gulf and Southeast coasts in particular. In 2005, some primary insurers with exposure in those regions had up to 60 percent of their gross losses covered by reinsurance. Approximately one-third of the insurance industry's $60 billion loss from last year's hurricanes was paid by reinsurers based outside the US, including Lloyd's.

One way to address the capacity issues before us today is to maximize the participation of the world's strongest and most stable reinsurers in the US catastrophic risk market. This can be accomplished by reorienting US credit-for-reinsurance rules to focus on soundness and security. Specifically, the rules should focus on the financial quality of reinsurers and the security that they provide rather than the geographic locations of the reinsurers' headquarters. Appropriate weight should be given to external valuators such as the financial ratings assigned to reinsurers by third party rating services and the actual claims paying records of reinsurers.

Conclusion

Once again we thank you for your leadership. We also urge you to continue your efforts to ensure that the global reinsurance market as a whole is in the best position to meet the insurance needs of US consumers, especially in high-risk coastal areas where specialist overseas insurers such as Lloyd's provide such a critical source of insurance and reinsurance capacity.

Thank you for the opportunity to testify today.

TESTIMONY OF CHARLES CHAMNESS
ON BEHALF OF
THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES
BEFORE THE
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTITIES
CONCERNING
"STABILIZING INSURANCE MARKETS FOR COASTAL CONSUMERS

SEPTEMBER 13, 2006

Good morning Chairman Baker, Ranking Member Kanjorski, and members of the Committee. My name is Chuck Chamness, and I am the president and CEO of the National Association of Mutual Insurance Companies (NAMIC). Founded in 1895, NAMIC is the nation's largest property and casualty insurance association, underwriting more than 40 percent ($178 billion) of the property/casualty insurance premium written in the United States.

Let me first start off by saying that NAMIC is pleased that you, Mr. Chairman, and the members of this Committee are making a serious effort to understand the nature of catastrophic risk, and the role that the insurance industry and the federal government can and should play to better prepare for and manage future large-scale natural disasters.

With respect to the subject of this hearing—which is encapsulated in its title, "Stabilizing Insurance Markets for Coastal Consumers"—I have good news and bad news. The good news is that despite the enormous challenges property insurers have faced in the wake of last year's hurricanes, I can report that almost all claims have been paid, take-up rates for the flood insurance program have increased significantly, people in the affected regions are rebuilding at record rates, and a recent study found that nearly 90% of those who filed claims in Mississippi and Louisiana are satisfied with their insurance company. The bad news is that most forecasters predict that the 2005 storms cycle will be the norm for the next several years. The future stability of these markets will be threatened by the increase in storms, state suppression of rates, and litigation that seeks to rewrite regulator-approved insurance contracts that have been in force for decades.

First, let me elaborate on the good news. As this Committee is aware, 2005 was one of the worst years for natural disasters in American history. According to the latest estimates from the Insurance Information Institute, Hurricane Katrina alone caused approximately $40.6 billion in insured losses arising from 1.7 million claims. Yet one year later, roughly 95 percent of homeowners claims and 99 percent of auto insurance claims have been settled. As a result, while residential building permits declined by four percent nationwide, the two states hit hardest by Katrina—Louisiana and Mississippi—saw building permits increase by four percent and 32 percent, respectively. That is very good news, indeed. Even more encouraging is that despite the magnitude of insurers'

losses in 2005, their prudent risk management strategies have enabled them to stand ready to respond to future catastrophes.

That is all the more remarkable when one considers that according to hurricane forecasters, the increases we have seen in hurricane frequency and severity are expected to continue for at least another decade. Forecasters have predicted that during the 2006 hurricane season, there will be 13 tropical storms and 5 hurricanes, 2 of which will be major events. Earlier this year, the catastrophe modeling firm AIR Worldwide estimated that a level five hurricane hitting Miami, Florida, would cause over $130 billion in insured losses. According to AIR, there is a 20 percent chance that a $100 billion event will occur within the next 10 years.

Yet despite these dire forecasts, NAMIC believes that the private insurance market is well equipped to provide coverage for most types of natural disasters under most circumstances. That said, we also recognize that a *true* mega-catastrophe comparable to the 1906 San Francisco earthquake, or a high-category hurricane striking heavily populated areas such as Miami, Houston, or New York City, could potentially exceed private market capacity. Therefore, it is appropriate for policymakers and others to study whether government programs should be created to help assist policy holders and insurance companies to prevent, and prepare to such mega-events in those states or regions that are particularly vulnerable. Such programs, should they prove necessary, must be carefully designed so as not to distort private insurance markets.

That is a very important caveat, because the temptation will be to create government-subsidized insurance and reinsurance entities whose ostensible purpose will be to "stabilize" insurance markets by increasing the "affordability" and "availability" of insurance in catastrophe-prone areas.

While NAMIC does support several federal proposals that would help stabilize the market, we must also be careful not to create government programs that subsidize property owners in high risk areas. In fact, the general public is critical of government policies and programs designed to subsidize property owners in high-risk areas, although the public's objection is rooted more in notions of fairness than economic rationality. An August 2006 opinion survey by the Insurance Research Council found that 68 of those surveyed disagreed with the notion that taxpayers should subsidize insurance costs for people who want to build in coastal areas vulnerable to hurricanes. Sixty-one percent believe policyholder subsidies for wind damage to homes in coastal areas are "somewhat unfair" or "very unfair."

With that cautionary note about the use of government interventions to stabilize insurance markets out of the way, I'll offer a few observations:

First, it is an unfortunate but undeniable fact that state lawmakers and/or regulators sometimes impose rating and underwriting restrictions on property insurers that allow high-risk property owners to pay artificially low premiums, forcing low-risk property owners to subsidize the insurance costs of high-risk buyers by paying inflated premiums.

In my view, using the insurance pricing mechanism to create hidden cross-subsidies among risk classes is deceptive and unfair. NAMIC believes that a flexible regulatory environment, in which insurers are free to price coverage based on risk, will create incentives for property owners in high-risk areas to invest in loss mitigation measures.

Second, as I suggested above, government-imposed rate suppression can have the effect of distorting public perceptions of risk. Federal and state governments must bear the cost of the economically irrational decisions that result by paying for disaster aid to repair properties that should not have been built in the first place. Risk-based insurance pricing alleviates this problem by sending accurate signals to consumers about the relative level of risk associated with particular regions and types of structures.

Third, managing catastrophe risk in coastal areas is not simply an insurance availability and affordability problem. Numerous studies suggest that property owners as well as government officials tend to underestimate catastrophe risk and fail to prepare adequately for natural disasters. Other studies point to public misconceptions about the nature and purpose of insurance; for example, many consumers view insurance as a financial investment rather than as a protective measure, so that those who purchase insurance and do not collect on their policies over a period of time feel that their premiums have been wasted, leading them to discontinue coverage.

Fourth, the use of the term "actuarially sound" in discussions of insurance price regulation often lacks precision and can therefore be misleading. There is a tendency to use the term to refer to prices that reflect only the expected value of future loss costs. It is important to understand that "actuarially sound" pricing for catastrophe-exposed coverages must also include compensation for the unusually large "call on capital" that is required to pay catastrophic losses. The call on capital that results from the large-scale losses typically associated with extreme events may well be several times greater than the total annual "expected loss" of the coverage. In other words, the term "actuarially sound" should be understood to include an adequate "risk load" that takes into account the call on capital, rather than just the insurer's expected loss costs and expenses based on yearly averages.

Fifth, it is important for lawmakers, judges and the general public to understand the cyclical nature of property insurer profits, how profits relate to surplus, and the role of surplus in ensuring that insurers are able to meet their contractual obligations to policyholders. Economists who use return on equity as the universal benchmark for measuring company profitability have found that property/casualty insurance is less profitable than most other industries.

Finally, the nation's courts must preserve the sanctity of contracts. With respect to insurance contracts, this often means deferring to the authority of the state insurance regulator that approved the contract language as part of the rigorous "form filing" process that insurers must follow in all 50 states. Insurers who relied in good faith on the decision of a state insurance department that their policy language was clear and unambiguous must not be ordered by a judge to pay claims for which the insurer

collected no premiums simply because, in the court's view, the insurance department erred in approving the contract language. If trial lawyers or others succeed in retroactively rewriting insurance contracts because of the supposed "ambiguity" in contract language that was approved by insurance regulators, they will have introduced a degree of legal capriciousness that will undermine the predictability upon which a healthy insurance system is based.

These observations aside, we believe there are several measures that Congress should consider immediately to address certain problems associated with natural disaster risk management and insurance.

Policy Proposals that Deserve Immediate Consideration

First, NAMIC supports federal legislation that would create financial incentives to encourage states to adopt and enforce strong, statewide building codes. Strong building codes as well as responsible land-use planning have been shown to greatly reduce the level of property damage and human suffering caused by natural disasters. With respect to existing properties, we support government initiatives to create mitigation grant programs to enable homeowners in high-risk areas to invest in risk mitigation measures.

Second, we support the concept of amending the federal tax code to allow insurers to set aside a portion of premium income in tax-exempt policyholder disaster protection funds. We also support the concept of allowing homeowners to create tax-free catastrophic savings accounts similar to health savings accounts which could be used to pay hurricane deductibles and costs associated with retrofitting properties.

Third, we recognize that a market-based insurance pricing system in which premiums reflect the actual cost of insuring against catastrophic risk could result in significant premium increases for some property owners in high-risk regions. Policymakers may therefore consider creating programs to provide direct government assistance, funded from general revenue, to low-income and other groups according to criteria established by the unit of government providing assistance. However, in designing such programs, care must be taken to avoid reducing incentives to mitigate risk.

Fourth, we believe that the National Flood Insurance Program (NFIP) should be subject to substantial reform. This is an area in which NAMIC strongly praises the work that this committee has accomplished. We believe that H.R. 4973 goes along way in addressing some of the shortcomings that currently exist within the NFIP. Specifically we strongly support moving all second homes to actuarial rates, and stronger enforcement measures in the bill. NFIP premiums must be actuarially sound for all covered structures. The current method for setting premiums, which is based on average annual losses, has been called "unsustainable" by the Congressional Budget Office. This approach has prevented the NFIP from accumulating the surplus necessary to pay claims during periods when loss costs are above average. We also support stiffer penalties to be imposed on financial institutions that either fail to require flood insurance coverage for mortgages on properties in flood-prone areas, or allow the policies to lapse. Greater effort should be

made to ensure that more people are aware of the program and the benefits of having flood insurance coverage to protect their properties.

In conclusion, NAMIC realizes that property owners, insurers, mortgage lenders, realtors, and home builders that live and do business in catastrophe-prone areas will face serious challenges in the years ahead. We believe that the most effective mechanism for addressing these challenges is a private insurance market whose defining characteristics are open competition and pricing freedom. Congress can play a constructive role by reforming the National Flood Insurance Program, offering tax incentives for companies to reserve funds for future disasters, and providing incentives for states to enact and enforce effective statewide building codes.

Thank you for giving me the opportunity to testify on this issue of vital importance to NAMIC member companies and the U.S economy. I look forward to working with you and the Congress to help meet the challenges involved in effectively managing the risk of natural catastrophes.

Independent Insurance Agents
& Brokers of America, Inc.

STATEMENT OF DAVID DANIEL
ON BEHALF OF THE
INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

September 13, 2006

Good morning Chairman Baker, Ranking Member Kanjorski, and Members of the Committee. My name is David Daniel, and I am pleased to be here today on behalf of the Independent Insurance Agents & Brokers of America (IIABA) to provide my association's perspective on efforts to reform how our nation insures against natural disasters. I currently serve on our national association's Executive Committee. I am also the head of the Daniel & Eustis agency in Baton Rouge, LA, a full-service office that serves clients in Baton Rouge and the surrounding area with commercial and personal insurance, as well as employee benefits programs.

IIABA is the nation's oldest and largest trade association of independent insurance agents and brokers, and we represent a nationwide network of more than 300,000 agents, brokers, and employees. IIABA represents independent insurance agents and brokers who present consumers with a choice of policy options from a variety of different insurance companies. These small, medium, and large businesses offer all lines of insurance – property, casualty, life, health, employee benefit plans, and retirement products. It is from this unique vantage point that we understand the capabilities and challenges of the insurance market when it comes to insuring against catastrophic risks.

Background

In 2005, our country faced several devastating and record-setting natural disasters, including 27 named hurricanes, which left the lives of many Americans in ruins. These disasters also roiled the insurance marketplace and our overall economy. Estimates for 2005 hurricane losses are approximately $50 billion, greatly exceeding the previous record set in 2004 when 22 events caused $27.5 billion in insured losses. Six of the top 10 most costly catastrophes on record in the United States occurred in the 2004-05 hurricane seasons.

The high costs of recent natural disasters (hurricanes Katrina, Wilma, etc.), combined with the fear of future catastrophes (particularly with another difficult hurricane season being forecast for 2006), have restricted homeowners' insurance availability in many markets. These multibillion-dollar events have created exposure and solvency issues for companies that write homeowners insurance in disaster-prone areas. As a result, many insurance companies have stopped writing new business in or withdrawn from at-risk markets, making it difficult for residents to find homeowners' coverage.

While our members and their consumers have experienced varying types of natural disasters across the country, this problem has been compounded by the fact that an ever-increasing number of people reside in areas where they are exposed to natural disasters. For example, in coastal areas alone we have seen tremendous growth in population. In fact, according to AIR Worldwide, a leading risk modeling and technology firm, in 2004 the value of insured coastal properties in the 18 East Coast and Gulf states exposed to hurricanes totaled $6.9 trillion, or 16 percent of insurers' total exposure to loss in the United States. Not unlike other disaster-prone areas, AIR also estimates that property values in coastal areas of the United States have doubled over the last decade.

IIABA Perspective

As a Louisianan, I first would like to thank you, Chairman Baker, Ranking Member Kanjorski and Members of the Committee, for holding this important hearing on an issue that has impacted my own family, friends and coworkers, not to mention millions of Americans and many other communities across the country. The IIABA is extremely grateful for your work on this issue and for the opportunity to share its views on what we feel is a matter of critical importance.

Our members approach the issue of natural disaster insurance from a very simple perspective: we are here to serve consumers' needs, whether it is helping them secure coverage to protect their families and their homes prior to an event, or assisting consumers after an event to ensure that claims are paid quickly and fully. As the intermediaries between consumers and their insurers, our members cannot and will not walk away from consumer needs as long as they demand coverage for these risks. We strongly believe our industry must come together with policymakers to find a common solution that will encourage participation in at-risk markets. For this reason, the IIABA is grateful to you, Mr. Chairman, for calling this important hearing to explore these issues, and we look forward to working with the Committee in the future on this issue. We also thank the many other Members of Congress who have proposed legislative solutions to address these difficult issues.

In short, we welcome all proposals and are for any and all reasonable ideas and plans that lead us to a healthy and competitive insurance marketplace in which consumers have choices and companies are vying for their business.

When natural disasters strike, independent insurance agents and brokers are on the front lines with devastated policyholders who need to rebuild their lives. In fact, our members live in the communities that they serve, and they and their families are also impacted by many of the same issues facing other consumers. As such, independent insurance agents and brokers understand the challenges that consumers face and their concerns about the availability of affordable coverage for losses from natural disasters.

Over the last several years, our members have witnessed how substantial insured losses from severe hurricane seasons have diminished the insurance industry's capacity, and more importantly their appetite for catastrophic losses in general. Meanwhile, the cost of coverage has increased. Insurers are currently under pressure from rating agencies to limit exposure, and they are reevaluating their exposure to all types of catastrophic losses. As underwriters continue to focus on the aggregation of losses, there is a definite strain on the insurance industry's willingness to cover catastrophic losses—whether they result from natural disasters, such as hurricanes and earthquakes, or man-made threats, such as acts of terrorism.

Any discussion concerning the solution to insuring against future natural disasters starts with admitting there is a problem. The IIABA believes it is no longer enough to say that the private market can handle catastrophic risks, when coverage is not sufficiently available at affordable rates. In fact, it is our experience that private market coverage is scarcely available at any rate in some areas – this is fast becoming an availability problem rather than an availability AND affordability problem. The reality is that many insurers have either stopped writing new homeowners' business in or withdrawn completely from at-risk markets. With the prospect of another difficult hurricane season upon us, something needs to be done to ensure that residents of these areas can find adequate homeowners' coverage.

National Issue

With these experiences in mind, I would like to stress that this issue is not simply a Gulf Coast problem – it is a national problem. Our members live across the country, serving and living in a wide variety of communities – large and small – and so many of them have been impacted by natural disasters. Certainly, the most devastating natural disasters in recent years have resulted from hurricanes, which have had the greatest impact on the homeowner's insurance market. However, hurricanes are only one of the many catastrophic risks our nation faces. Whether it is tornadoes in the Midwest, earthquakes in California, or ice storms in the Northeast, we all face some risk of natural disaster, and it often takes only one or two events in a particular area for the homeowners' insurance market to be dramatically affected.

In some cases, of course, states have set up entities in an effort to prevent insurance availability crises, such as the California Earthquake Authority and the Florida Hurricane Catastrophe Fund. These programs are certainly useful, but ultimately, even if they are carefully constructed and managed they may not be enough to handle the particularly severe events. The plain truth is that some natural disasters will exceed the financial capacity of state catastrophe funds – only a program that is national in scope will be able to generate enough capacity to cover the most devastating events.

Put simply, insuring against natural disasters is a national problem that requires a national solution. Despite our longstanding position that the insurance market is best served by limited federal involvement, we believe that a federal solution is necessary to help provide capacity and

fill a void that the private market cannot and will not service. However, it is important that the day-to-day regulation of insurance remain at the state level, where state insurance departments are best equipped to serve the special needs of local consumers in local markets. As such, given the absence of affordable coverage and the exposure to consumers and taxpayers, we believe that there is a very limited and appropriate role for the federal government, and we are open to supporting proposals that increase insurance availability and affordability in catastrophe-prone areas.

Federal Solutions

In our view, a simple cost-benefit analysis suggests that it is more efficient and less costly for the federal government to address this issue in advance of a natural disaster in a way that maximizes private sector capacity, as opposed to through post-disaster relief on an ad-hoc basis. Members of this Committee are well aware of the recent GAO revelations regarding misuse of FEMA disaster funds disbursed following Katrina, and while we do not suggest that this would be a common occurrence, it does highlight some of the problems with ad-hoc relief efforts. The Big "I" believes the best solution is for a federal role to be in place before the events happen – to have a clear, well-structured mechanism that encourages the private sector to handle as much of the risk as possible, and only trigger federal involvement as a last resort upon private marketplace failure. We believe that such a structure will protect both consumers and taxpayers living in all areas across the country – especially when history has proven that more tax dollars are going to be spent on disaster assistance without a structure to encourage the private sector to take on additional risk.

It is with these sentiments that we approach the legislative proposals pending in Congress. Specifically, we support H.R. 846, the Homeowners' Insurance Availability Act, which was introduced by Congresswoman Ginny Brown-Waite last year. The legislation would allow private insurers to purchase, at auction, reinsurance contracts directly from the U.S. Treasury to cover natural disasters that are equal to or greater than a one-in-100-year event. We believe this is a strong proposal because it will encourage more companies to enter at-risk markets, thus increasing availability and market stability, while limiting federal involvement to only the most devastating catastrophes.

In addition to H.R. 846, the IIABA is examining other proposals that would create a federal catastrophe reinsurance program, such as H.R. 4366, the Homeowners Insurance Protection Act of 2005, introduced by Reps. Ginny Brown-Waite (R-Fla.) and Clay Shaw (R-Fla.), and H.R. 4507, the Natural Catastrophe Insurance Act of 2005, offered by Rep. Carolyn Maloney (D-N.Y.). Under these proposals, states that have their own catastrophe funds could be eligible to purchase reinsurance from the federal government. Both bills seek to encourage states to establish catastrophic funds to protect against natural disasters and reduce costs to homeowners. Our association has not, however, taken a formal position on these bills at the present time.

IIABA is also looking beyond federal reinsurance proposals to other possible solutions, and in that vein we are encouraged by the introduction of H.R. 2668, the Policyholder Disaster Protection Act, introduced by Congressman Mark Foley (R-Fla.). This bill would permit insurers to create tax-free reserve funds for natural disaster claims. We support the goal of this legislation, which is to build up insurance capacity in at-risk markets, although we are somewhat concerned that doing so through the tax code may take a significant amount of time.

We also have noted with interest the introduction of legislation that would create tax-free personal "Catastrophic Savings Accounts" similar to the Health Savings Accounts that have been successful

in the health care market. H.R. 4836, introduced by Congressman Tom Feeney (R-Fla.), enjoys bipartisan support from members of the Florida Congressional delegation as well as from Florida Insurance Commissioner Kevin McCarty.

In addition to the above proposals, our members support exploring ways to reduce the costs of disasters, such as mitigation efforts. For instance, enhancing building codes and using financial incentives to mitigate risk are among proposals worth exploring in order to protect both consumers and taxpayers across the country.

Along these lines, we thank Reps. Debbie Wasserman-Schultz (D-Fla.), Mike Castle (R-Del.), Rep. Patrick McHenry (R-N.C.) and Rep. Charlie Melancon (D-La.) for introducing H.R. 5891, the Catastrophic Disaster Risk and Insurance Commission Act. H.R. 5891 would help Congress address these issues by establishing a national commission to examine proposals and to make recommendations to help the federal government prepare for and manage natural disasters.

Finally, we thank you, Mr. Chairman and Members of this Committee, for unanimously approving and reporting out H.R. 5637, the Nonadmitted and Reinsurance Reform Act, introduced by Rep. Ginny Brown-Waite (R-Fla.) and Rep. Dennis Moore (D-Kan.). We appreciate your efforts and those of a number of bipartisan cosponsors who have worked together to craft a product that enjoys overwhelming support from the insurance community and that will allow us to better serve commercial policyholders, who are also beginning to feel the strain of limited capacity for natural disaster risk. Since many of the current natural disaster proposals primarily focus on homeowners insurance, we believe that H.R. 5637 is a good first step that will help provide efficiency to the surplus lines market that serves commercial policyholders throughout the country, including at-risk markets.

Congressional Attention Is Needed

Achieving a consensus within the insurance industry for a solution to this growing problem has been elusive, which has complicated public and private efforts to address this issue. However, as some parties express concern with some of the above proposals, consumers still need and demand coverage to protect their homes, their families and their communities.

We thank this Committee and the Members of Congress mentioned above for their leadership on these issues, and we would strongly urge you to continue to shed light on this important topic. We encourage Congress to be realistic, but also ask tough questions and demand responses. Congress can be very helpful in challenging the private sector to engage in this process. In our view, Congressional attention will spur greater insurance marketplace involvement in exploring potential solutions, perhaps leading to even more innovative proposals.

Conclusion

In conclusion, we commend you, Mr. Chairman, for convening today's hearing, and we hope that it will mark the beginning of a thorough examination of legislative solutions for the catastrophe insurance availability crisis.

The Big "I" does not pretend to have the answers to these questions, but we are committed to an open dialogue with all interested parties in the public and private sector to begin to address these important issues that consumers face. We are open to a number of potential solutions with limited

federal involvement, including federal catastrophe funds, insurer tax-free reserving, consumer-driven catastrophe savings accounts, etc.

We stand ready to assist your efforts in any way we can, and we urge you to see this fight through to the finish.

TESTIMONY OF GREGORY W. HEIDRICH
ON BEHALF OF
THE PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES FINANCIAL SERVICES COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

SEPTEMBER 13, 2006

My name is Gregory W. Heidrich and I am Senior Vice President – Policy Development and Research for the Property Casualty Insurers Association of America (PCI). 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 ways in which we can better prepare our industry and our nation to respond to future natural catastrophes. Thank you for the opportunity to appear before you today and to present our thoughts on these issues.

Introduction

As we testified in June before the Subcommittee on Housing and Community Opportunity, PCI believes that developing effective public policy solutions regarding natural catastrophes is one of the most significant issues facing the nation and the insurance industry today. Climate experts agree that America faces the prospect of more frequent and severe natural disasters in the coming decade. Moreover, significant development, population growth, and rapidly rising real estate prices in areas prone to natural disasters exacerbate the potential for larger human and economic losses, requiring stronger loss prevention and mitigation and greater financial resources for recovery.

We commend you and your colleagues for your attention to and leadership on this issue and for your efforts to find innovative solutions to the problem of catastrophe risk. Over the past year, members of Congress have introduced several important legislative proposals, including H.R. 4366, the Homeowners Insurance Protection Act, introduced by Rep. Brown-Waite; H.R. 2668, the Policyholder Disaster Protection Act of 2005, introduced by Rep. Foley; H.R. 4836, the Catastrophe Savings Accounts Act of 2006, introduced by Rep. Feeney, and H.R. 5891, the Catastrophic Disaster Risk and Insurance Commission Act, introduced by Rep. Wasserman-Schultz. You have also been vigorous in pursuing important reform of the National Flood Insurance Program, for which we commend you. We urge final passage of flood reform legislation and pledge to work with you and your colleagues in the Senate in this effort.

Comments on the Catastrophe Problem

PCI members play a pivotal role in protecting American homeowners and supporting our nation's housing markets by providing the products and services needed to protect homeowners, lenders, businesses, and communities against exposure to natural catastrophes. Our members are proud of the work they do in these markets.

Over the past two years, property insurance markets have been tested as never before. Catastrophe losses in 2005 totaled some $57 billion, nearly doubling the previous record losses in 2001. Hurricane Katrina itself caused some $40 billion in insured losses, surpassing the roughly $32 billion from 9/11. The vast majority of claims from last year's storms have been paid and the market has the financial capacity to meet its obligations. In our view, the most important catastrophe issue facing us today is whether the market has, or is building, the capacity to pay for catastrophes the nation will face in the future.

Given the very serious catastrophe losses we've seen over the past several years and the significance of this issue for our membership, our organization has devoted considerable time and effort to develop sound public policy solutions that we can recommend.

There are several fundamental issues that have to be addressed:

- First, America clearly faces the prospect of increased frequency and severity of major hurricanes and the continuing threat of other major natural catastrophes including earthquakes, floods, tsunamis, and volcanic eruptions. Catastrophe modelers tell us that we are in a prolonged period of increased severe storm activity. Seven of the ten most costly natural disasters in U.S. history have occurred since 2004. We can't afford to ignore this reality.

- Second, America is experiencing significant development, population growth, and rapidly rising real estate prices in areas that are highly prone to natural disasters. AIR Worldwide, one of the leading risk modelers for our industry estimates that there is currently some $7 trillion in property values exposed to catastrophe risk along America's coastlines; some $3 trillion of it is personal property, rather than commercial property. Even if storms were no more frequent or severe than in the past, this fact would mean that future storms will be more damaging and more costly to insure. As a result, the nation faces growing exposure to significant catastrophe losses and increasing costs of recovery.

- A growing number of Americans have a significant portion of their net worth exposed to catastrophic loss. The impact of future major natural catastrophes on the economy will be larger and will likely lead to significant public policy debates over how best to address this risk.

- As insurers, we would like to rely on private markets alone to solve this problem, with prices and products tailored to match the risks freely assumed. We think that such an approach would, over time, establish appropriate economic incentives for those who live and work in catastrophe-prone areas and would attract badly-needed private capital for risk protection. However, we must also recognize that our industry does not operate in an unregulated market. Our members work in a world where prices and coverage terms are highly regulated and generally are not allowed to respond freely and in an immediate fashion to changing risks or conditions. This is the opposite of the structure in which world catastrophe reinsurance markets operate. Indeed, a report just released by the international

reinsurance brokerage firm, Guy Carpenter, notes that U.S. catastrophe reinsurance rates have increased on average 76 percent in 2006 over 2005, compared to an average increase of 32 percent worldwide over the same period. The cost of catastrophe reinsurance is an economic reality our members face, as they decide how much and where they can assume this risk. We also recognize, as we must, that people do not simply pick up and move from one place to the next, irrespective of their homes, families, and community ties. Any set of realistic policy options must take this into account.

- Finally, with respect to prevention and mitigation of losses, states frequently have outdated and inconsistent requirements for building codes, code enforcement, and other prevention/mitigation tools in areas dangerously exposed to disasters. These weaknesses imperil lives, property, and policyholder resources.

In summary, we agree with you that this is a major public policy issue that must be addressed; we believe the problems posed by catastrophe risk are growing more severe, not less; and we believe a range of potential solutions must be considered, including market reforms, stronger loss prevention and mitigation, and new approaches to financing catastrophe risk. At the end of the day, we believe there will not be one "silver bullet" solving this problem, but rather a full range of policies that will have to be used.

Policy Options to Consider

As we look at the issue, PCI suggests four major areas for consideration.

Reduce Exposure to Catastrophe Losses

First, we need to do more to control and reduce catastrophe exposure. PCI suggests the following:

- State and local governments should urgently and immediately review their building codes in catastrophe-prone areas. Wherever needed, they should upgrade their codes. Stronger building codes protect lives and significantly reduce property damage and repair costs. In a highly competitive insurance market, those savings will be passed directly back to consumers. Some have argued that it costs too much to rebuild to meet modern building code standards. Louisiana State University's Hurricane Center has estimated that the marginal cost of building a structure to meet higher wind-borne debris requirements in the International Residential Code is between 1.5 and 4.5 percent of additional cost. On a single-family home with a $100,000 mortgage, that works out to about $27 extra dollars per month. We think such investments are vital. PCI supported passage of minimum building code legislation in Louisiana and Mississippi this past year, as well as an unsuccessful effort to extend stronger building codes into the Florida panhandle. As we look forward, we believe more work is needed to prepare an inventory of where our states' building codes are most in need of strengthening so that we can better target our efforts to strengthen the codes. And, finally, as much as we supported and are proud of our work to enact

stronger codes in Louisiana and Mississippi, we know that much work needs to be done to implement and enforce these new standards.

- A second idea is the establishment by the federal government of incentives for greater investment in loss prevention and mitigation. We suggest consideration of several ideas. First, the insurance industry's Building Code Coalition has recommended that enhanced disaster mitigation grants under the Stafford Act be provided for states that adopt stronger state-wide building codes. We strongly endorse this approach and urge Congress to enact legislation for this purpose. Second, Rep. Feeney has proposed legislation (H.R. 4836) to create a special catastrophe savings account for purposes of allowing homeowners to build up, tax-free, funds for payment of qualified catastrophe expenses. While we have not established a position on this bill, we are encouraged to see this type of creative thinking underway. Third, Congress could consider whether to grant special tax credits for qualifying expenditures by homeowners to retrofit their homes to better protect against disasters (as is being done in Florida now). Clearly, one of the major limitations of any new building code enactment is the fact that it typically can't address improvements needed in the existing housing stock. One approach to solving this problem is to give homeowners themselves additional incentives to make these improvements. An investment such as this could save many dollars later in disaster assistance and other government programs.

- We believe state and local governments must take seriously the need to restrict development in catastrophe-prone areas. Professor Roger Pielke, Jr. of the University of Colorado at Boulder is on point when he says, "More storms like Katrina are inevitable. And the effects of future Katrinas and Ritas will be determined... by the decisions we make now about where and how to build and rebuild in vulnerable locations."[1] This is not only an issue for single family homes. Ongoing commercial development on our nation's barrier islands or in the wetland marsh areas also significantly increase these risks.

- We believe greater steps can be taken for preparedness. As a first step, PCI has recently completed and distributed to more than twenty state insurance departments a new PCI Regulators' Kit, containing recommendations for disaster preparation and response. This kit contains model regulations covering five critical areas, including: establishing an Insurance Emergency Operations Center; disaster claim reporting requirements; cancellation and non-renewal of insurance under disaster conditions; suspension of premium payments under disaster conditions; and mediation of disputed claims. If adopted, these regulations could improve the necessary coordination and communication after a catastrophe and help those whose lives and property are at stake.

[1] "Managing the Next Disaster," Roger A. Pielke and Daniel Sarewitz, The Los Angeles Times, September 23, 2005.

Fix the Flood Program

Second, we believe Congress should complete its efforts to reform the National Flood Insurance Program (NFIP). When we testified in June, we strongly endorsed your reform efforts and we continue to do so. The NFIP is a necessary policy response to an uninsurable peril and must be continued. However, the program needs numerous reforms, the majority of which are contained in the reform bills today. As currently structured, the NFIP does little to discourage development in high risk areas, does not provide the level of protection needed by consumers and has not achieved the breadth of participation needed. PCI has been encouraged by the passage of H.R. 4973. Although we do not support all of the amendments made at the last minute, we believe that the Senate should act and pass its pending NFIP legislation, so a conference can begin and common sense reforms can be enacted.

Expand Private Sector Capacity

Third, a key part of the long-term solution to natural catastrophe exposure is to expand private sector capacity to handle the risk. PCI strongly supports efforts to make markets more responsive to the risks we face. Prices and terms of coverage that are openly and freely established in competitive markets will create essential incentives for property owners and attract new capital to these markets. As you know, homeowners insurance markets are heavily regulated in virtually all aspects of their operations. We face significant regulatory constraints, particularly in rating, but also in other areas, that inhibit effective market responses and discourage capital from entering these markets. There are several things we think policymakers at several levels of government can do to address this problem:

- First, state legislators should give insurance markets greater freedom to respond to the exposures we face. In free markets, prices and terms of coverage tell consumers the true cost of insuring against catastrophes and the most efficient means of funding exposures. Regulators often fear that giving up regulatory control will make the problem worse and invite consumer backlash. However, based on the experience we've seen in states that have taken this approach, including South Carolina and New Jersey most recently, we believe the results would be just the opposite. Free markets encourage new capital to enter where insurance protection is needed and develop more capacity, not less. PCI will support state legislative initiatives intended to remove regulatory barriers to free markets for catastrophe insurance and will oppose enactment of new barriers. We will be working with our partners in the states to develop specific proposals that can be enacted in key state legislatures beginning in next year's legislative sessions.

We also encourage your review of two additional proposals:

- First we are very interested in, and are examining the potential benefits of, establishing voluntary, tax-deferred catastrophe reserves. We are looking particularly at the legislation introduced by Rep. Foley (H.R. 2668). We find his

bill to be an intriguing concept and are working with our members to prepare specific comments on his approach. We urge your review of this bill as well.

- Second, we will be examining specific steps that might be taken to remove regulatory, legal, accounting, or tax barriers to further growth in the catastrophe bond market. This market provides another outlet for catastrophe risk financing and introduces new sources of capital and competition. A report earlier this year from Guy Carpenter described the growing importance of this market for financing catastrophe risk. While we certainly don't see the cat bond market displacing traditional reinsurance, market participants tell us that bringing more of these deals "onshore" in the U.S. and reducing a variety of regulatory barriers would permit the market to grow. In principle, PCI strongly supports steps that will attract more private capital to address catastrophe risk and we are very interested in how this might be done in the catastrophe bond market.

State and Federal Government Involvement

Finally, with regard to government involvement:

- First, based on our review of this issue, we believe the growth in natural catastrophe exposures is of sufficient magnitude in some states that they may require consideration of state natural catastrophe funding facilities. Recent events show that the industry can respond to very severe catastrophe events, but private markets may not always have the capacity to fund increasingly more frequent exposure to "mega catastrophes" or to a series of very large events in a single season. Given this, our approach will be to look at specific conditions in each state to determine whether a catastrophe fund, or other financing mechanism, might be helpful.

  When we consider whether a state needs a catastrophe fund, we look also to see: (1) whether private markets have freedom to respond to market conditions; (2) whether care has been taken to prevent a catastrophe fund from damaging private markets or preventing new capital from entering the market; and (3) that their funding doesn't rely on cross-subsidies across lines of business. By their nature, cross-subsidies damage the ability of markets to provide strong price signals and incentives for behavior. Having said that, we believe there may be cases and states where a catastrophe fund can be part of a well-rounded solution and must be considered. We believe they can be structured to avoid crowding out private market capacity while still offering benefits to consumers in some cases.

- Second, we would also suggest that there may be some mega-catastrophe exposures that are beyond the capacity of the private market and even of an individual state catastrophe fund to address. In these instances, it may be necessary for the federal government to offer liquidity protection to state catastrophe funds at a very high level, consistent with the maintenance of stable markets and avoidance of widespread insurer insolvencies. Federal involvement may also be essential if the nation suffers repeated mega-events within a short

time period. Lest anyone thinks that scenario is impossible, we would remind you of how close Hurricane Rita came to hitting Houston last year, only a few weeks after Katrina devastated New Orleans and the Mississippi coast. It is not inconceivable that several of our major cities could be struck by Category 4 or 5 storms within a single season, or that a major earthquake could strike in the same year as a significant hurricane.

There are many ideas for how a federal role could be structured, but we would suggest that one idea worth considering is whether a federal catastrophe financing facility could offer credit financing to state catastrophe funds, intended to provide access to liquidity to meet immediate claim requirements in the event of a mega-catastrophe or a series of very large events. One key advantage of this approach would be to offer important financing benefits while limiting the offer to state catastrophe funds and thus helping to minimize any potential disruption in private markets.

We are very mindful of the need to be extremely careful in structuring any federal role and of the overriding need to attract new private capital to the market. Accordingly, we also believe that any federal financing role should include measures intended to promote freedom for markets to respond to these exposures, including support for greater rating freedom, support for actuarial soundness or private market rates, freedom for product innovations, use of sound underwriting tools, and lower market barriers. The point of connecting standards for market freedoms to the creation of a federal financing facility is to provide incentives for the states themselves to do everything they can to attract private capital before asking for federal assistance. In addition, we believe any federal credit should be specified in advance, as private sector lines of credit are, in order to prevent political pressure from influencing what should be a market-based credit agreement. We would have the same concern about the need for a federal program to avoid cross-subsidies and other negative design elements as we have for state programs.

However, PCI thinks there may be a role, properly structured, for the federal government to play in assisting the financing of mega-catastrophe risk and we believe it should be given further review by Congress.

Conclusion

Again, let me thank you on behalf of PCI and our members for the opportunity to appear before you today, respond to your questions, and provide you with our input on possible solutions to the catastrophe problem. Let me thank you also for the work you are already doing to identify and explore constructive policy solutions. We believe this is one of the most serious public policy issues facing our nation and is deserving of your time and continued thoughtful attention. PCI and its members look forward to working with you in the future on this very important issue.

Testimony of
The National Association of Insurance Commissioners

Before the
Subcommittee on Capital Markets, Insurance and Government
Sponsored Enterprises
Of the
House Committee on Financial Services

Regarding:
Stabilizing Insurance Markets for Coastal Consumers

September 13, 2006
Room 2128
Rayburn House Office Building

Kevin M. McCarty
Florida Insurance Commissioner
Chairman of the NAIC Catastrophe Insurance Working Group
Chairman of the NAIC Property & Casualty Insurance Committee

Testimony of Kevin McCarty
Florida Insurance Commissioner
On Behalf of the National Association of Insurance Commissioners

Chairman Baker, Ranking Member Kanjorski, and members of the Subcommittee, I thank you for the opportunity to testify here today on the role of insurance commissioners in stabilizing the coastal insurance market, and thank you for your leadership on this important issue.

My name is Kevin McCarty, and I am the Insurance Commissioner for the State of Florida. I am also the Chairman of the Property & Casualty Insurance Committee of the National Association of Insurance Commissioners (the "NAIC") as well as chair of the Committee's Catastrophe Insurance Working Group.

Today I would like to provide my perspective by answering a few questions that must be considered before we can set about developing a local, regional, or national plan for managing natural catastrophes:

- First, what are the factors that contribute to the availability and affordability of insurance in coastal areas?
- Second, what is the current state of the insurance market in these high-risk areas?
- Third, what types of mechanisms exist in the states to manage catastrophic risk and to make insurance available and affordable?
- Finally, what are the merits of pre-disaster concepts like tax-deferred catastrophe reserving, mitigations tools, catastrophe savings accounts, and state and federal reinsurance programs?

1. Insurance Availability and Affordability in Coastal Regions

The ability of regional economies to withstand and recover from the next natural catastrophe depends critically on the availability and affordability of insurance. In high-risk coastal areas, we typically see greater fluctuations in these factors than in more stable areas, but we must not overlook the possibility of large-scale natural disaster that have little to do with coastlines. The recent hurricanes of the 2004 and 2005 season

have focused our attention in these areas, but the threat of natural disaster on a massive scale exists in virtually all states. Inland flooding and earthquakes are capable of widespread devastation that can span multiple states, and wild fires and winter storms can cripple states with no coastline to speak of. The problems and solutions we discuss today are in the context of the coast because of the last catastrophe, but they are every bit as relevant for the next catastrophe, regardless of what it is or where it occurs.

The availability of insurance is impacted by the perceived risk and historical experience of the region. Simply put, insurers have an expectation based on modeling, actuarial judgment, and past experience of the type, scope, and likelihood of risks they will face in a given area. They use that information to price their products. When an event comes along that falls outside of those expectations, or at least at the far end of that spectrum, whether for severity and likelihood (such as Hurricane Katrina) or frequency (such as the four consecutive hurricanes that hit Florida in 2004), insurers must rethink the expectations they have and typically respond by making their products less available, introducing coverage limitations, and/or by raising prices. Following the devastation of hurricane Andrew in 1992, the availability of insurance in Florida became a serious concern as insurers began to question their exposure in a market with volatility they did not fully anticipate. That being said, when the four hurricanes hit Florida in 2004, and when Katrina and Rita hit the gulf coast in 2005, given their size, severity, and frequency, a certain amount of constriction in the insurance market was inevitable. This constriction also was exacerbated because of the recent development boom, which created greater levels of exposure in areas where the risk is highest.

Impact of Regulation on Insurance Pricing and Affordability

Much has been written about the impact of regulation on the affordability and pricing of insurance. The term "price controls" has been widely used by those who prefer total deregulation of the insurance market to refer to rate regulation. The term implies heavy-handed control by insurance regulators over what an insurer can charge. *In actuality, insurance companies, not regulators, develop the rates and rating systems in 49 of the 50 states.* Insurers look at historical experience, future expected losses, reinsurance and operational costs, anticipated profit, and then apply actuarial judgment to help them select a price. The role of state regulators is to review the rates to ensure they are actuarially sound. Their goal is not to tell an insurer what to charge, but rather to verify that consumers are not being charged rates that are excessive, inadequate, or unfairly discriminatory.

There are a few types of systems that states use to review rates for personal lines insurance (homeowner's insurance, auto insurance, etc.), simplified here for the sake of this testimony. Only one state, Massachusetts, has regulatory control of insurance rates. Eighteen states have a "prior approval" system, where the insurance company develops a product, looks at various risk factors and the market, and then files to sell the product at a particular price. The state insurance department then reviews the rate to make sure it complies with statutory regulatory requirements, and is actuarially sound. Thirty-two jurisdictions use some type of flexible or competitive rating system. In some cases, this is a "use-and-file" system where the insurer begins selling a product and files with the regulator. The regulator then can review the rate to make sure it is compliant and actuarially sound, but the insurer does not have to wait for regulatory approval. Some states, including Louisiana and South Carolina, utilize a "flex-band" system where an insurer files to sell a product at a particular rate and can raise or lower that price immediately by a certain percentage, for example five or ten percent, to respond to competitive needs, changes in the market, or changes in their perceived risk. Regardless of the system, the state regulator is there to review the rate, not determine it.

Some in the insurance industry are in favor of total rate deregulation to let the "competitive market" arrive at a price. In most cases, the rates under rate regulation ARE competitive because insurers pick them and do not turn a blind eye to what their competitors are charging. One auto insurance provider has even built an ad campaign around comparing competitors' rates. In most markets, there are multiple companies vying for business and they compete aggressively on price and service. Some have also asserted that a lack of regulation will lead directly to lower insurance costs and greater availability, although as will be discussed later, that's not necessarily the case. In Florida and elsewhere, surplus lines carriers whose rates are not regulated provide much of the available capacity. Even in this situation, carriers are pulling out of the market, so it is inaccurate to think that availability disruptions are the result of regulation. Healthy competition and efficient regulation are not mutually exclusive. This distinction is important because, as prices in coastal areas have risen in response to the recent spate of hurricanes, it is up to regulators to allow companies to accurately price the risk so that those companies can continue paying claims. It does a regulator no good to suppress rates to the point where an insurer is not profitable, has no desire to remain in his or her state, or is not retaining enough money to pay claims. In the state of Florida, I face the direct results of back-to-back storm seasons that are driving the price of insurance up to levels we have never seen, because the newly demonstrated potential for catastrophic loss to a coastline with $1.9 trillion in exposure is at a level we have

never seen. As for claims that insurance rates are suppressed, I think any member of this subcommittee, or any member of the insurance industry, would be extremely hard-pressed to find a policyholder in the state of Florida, and likely anywhere else in the near-coastal counties and parishes of the Gulf of Mexico, who feels his or her insurance rates are being suppressed.

Costs in the Current Market

As insurers raise rates for individuals and businesses across the coastal market and in some cases pull back from those markets entirely, they cite a few key reasons. The first is the anticipation of exposure to future losses. Anticipating future losses is the main factor that adds volatility and subjectivity to insurance pricing. To better estimate future losses, insurers turn to risk modeling companies that attempt to predict and quantify future catastrophic activity. Those modeling companies have revised their models and are showing a greater risk of storm activity in the years to come. Regardless of improved models, no one can predict with total certainty what the future holds for natural catastrophic events, and having witnessed two devastating storm seasons in consecutive years, insurers are pulling back from markets on the coast where the risk of loss is high and the value of property has skyrocketed. For example, in terms of dollars, New York has roughly the same amount of coastal property exposure as Florida: about $1.9 trillion. Yet, it has about one tenth the coastline. Despite the fact that New York has not been hit with a significant catastrophe in decades, some insurers are recognizing the potential in such a concentrated area and are not renewing policies. It is worth noting that while we read in the newspaper about how these increases or cancellations impact individuals, the situation for commercial properties in many cases is far worse. Where will people work when businesses close their doors not because they can't turn a profit but because they can't afford insurance?

The second reason insurers are charging more is the rising cost of reinsurance. Reinsurance is an unregulated market where insurance companies purchase insurance to better spread the risk they've assumed. Affordable reinsurance options allow private insurers to limit their own exposure by diversifying risk, which in turn, allows private insurers to write more business at a more inexpensive rate. I personally have spoken to representatives of the global reinsurance markets in the Caribbean and in Europe to encourage more investment in Florida and the Gulf Region. Frankly, it is a difficult sell. Given the current situation, there is little interest in expanding investment to insure against mega-catastrophes. I suspect that if Katrina and Rita were names given to

earthquakes in California or along the New Madrid fault in Missouri or Kentucky, those states would see a similar response from the reinsurance markets there.

For reinsurance contracts that have been written, private insurers are finding that costs have risen dramatically, and reinsurers are changing the conditions of their reinsurance treaties *(or contracts)* forcing insurance companies to retain more of the risk. Compounding this problem are rating agencies *(e.g. Standard & Poor's, Moody's and Fitch)* that have begun requiring higher capital retention for insurers and reinsurers to maintain their bond ratings. All of these developments have caused capital to "dry up," meaning higher prices and less availability for the average American.

A recent report by Guy Carpenter and Company indicates that in 2006 reinsurance rates across the United States have risen 76 percent on average, and this while insurers and reinsurers are covering less and less. However, as is the case with direct insurance, the numbers are much more dramatic in coastal regions where insurers cite reinsurance rates doubling, tripling and, in at least one case, going up ten fold. In some areas in Florida, companies cannot purchase reinsurance at ANY price. Affordable reinsurance is a crucial risk transfer tool that insurers use to spread risk, particularly in catastrophe prone areas. As those rates go up exponentially, direct insurers have no choice but to raise rates and pass those costs on directly to policyholders.

2. Current State of the Insurance Market in Coastal Areas

Nationwide, the property and casualty insurance market for individuals and businesses is healthy and competitive. It has been well recorded that despite record catastrophic losses, the industry is also enjoying record profits. However, there are some coastal regions of the country where the insurance market is in crisis, due largely to insurers' reluctance to provide insurance in areas of perceived high risk and, subsequently, the reinsurance costs associated with those areas. It is important for you to know that insurance costs are not going up directly to recoup the losses of 2004 and 2005. They are going up because the losses of 2004 and 2005 have demonstrated a level of risk potential for the future that has insurers rethinking what their prospective losses will be going forward. When an insurer suffers a 1-in-500 year event in consecutive years, it rightly begins to question the validity of its models and risk management assumptions, and adjusts its future expected losses accordingly. At the same time, reinsurers are drawing those same conclusions, which adds to the overall price increase.

In terms of what areas of the country are suffering an insurance crisis, another important distinction is the difference between coastal states, and coastal regions within those states. Most coastal states, perhaps with the exception of Florida, have a relatively healthy property and casualty market in the vast majority of the state. In Alabama, only 2 of the 67 counties are having insurance issues, and even within those counties, the problems are limited largely to within just a few miles of the coast. In Mississippi, 6 of its 82 counties are directly experiencing problems. Louisiana, which took the brunt of hurricane Katrina, only has experienced troubles in the 24 coastal parishes of its 62 total parishes. These trouble spots are somewhat limited, but they comprise the bulk of the cases we've all heard about on the news, where insurance costs are skyrocketing, building has come to a standstill, and mortgage defaults are on the rise.

In some areas of the country however, the lack of availability and affordability is impacting the entire state – as is the case in Florida and South Carolina. The Florida market has been battered by 8 storms in 2 years resulting in $38 billion in losses, and the impact spans virtually the entire state. For those living in Florida's high-risk areas, the real tragedy occurred after the storms as policyholders experienced displacement, shortages in building supplies, shortages in homebuilding labor, rising insurance premiums, mortgage defaults, and the unavailability of private insurance. Even today, during a recent trip to South Florida, I saw blue tarps covering homes that have not been fully repaired from the last hurricane season.

Although the voluntary market recapitalized by infusing approximately $1 billion of new capital into the private market, this situation is not self-sustaining. There are a far greater number of insurance companies exiting the homeowners insurance market than there are new companies entering. Even for those companies staying in the market, there has been a significant retrenchment. Companies are enforcing stricter underwriting standards to limit their exposure in certain high-risk areas or limiting types of property they select to insure.

In stark contract to Florida, South Carolina has not had a major storm since Hurricane Hugo in 1989. South Carolina adopted the 1996 International Building Codes in 1997. South Carolina has been at the forefront of regulatory modernization and is considered a model regulatory environment by many insurers. Yet, South Carolina is experiencing a near meltdown in its coastal insurance market similar to Florida. Admitted carriers are increasing rates by 100 to 200 percent, decreasing coverage by requiring 5 to 10 percent deductibles, non-renewing long-term policyholders and discontinuing writing new

business in certain areas. Surplus lines carriers are increasing rates even more, as much as 700 percent. Condominiums are particularly hard hit as insurers seem to have just realized that condo projects represent a significant concentration of risk in a confined area. One condominium development saw its premium increased from $126,000 to $879,000 and it took 5 different insurers to piece together the coverage. Many condominium owners in South Carolina are retirees and senior citizens on fixed incomes so, again, this problem is having a disparate impact on a large segment of the population who don't have many options. South Carolina has already done everything the insurance industry says needs to be done to create the kind of free-market environment that would enable the private sector to handle this problem, and yet, we are not seeing any relief from the lack of availability and affordability.

Outside of Florida, those markets are absorbing the impact of recent catastrophic events, but in areas that were hit hardest, insurers are responding as if the next big catastrophe is certain to be a hurricane that hits the exact same region in the gulf coast, and pricing coverage accordingly. This begs the question, what happens if the next catastrophe is an earthquake in the Midwest or a massive Nor'easter in New England? Will those policyholders see a doubling and tripling of their rates because insurers are not adequately hedging their risk, and we as a nation are not doing the pre-event building, planning, and mitigation steps that limit those losses? Clearly, people who build and buy homes or operate businesses directly in harms way, whether that is on a coastline or a fault line, should pay insurance costs that reflect that risk, but they should not be the scapegoats for insurers, reinsurers, risk modelers, regulators, and legislators, who fail to learn the lessons of 2004 and 2005.

3. State Insurance Mechanisms to Manage Natural Catastrophes

There are a number of initiatives that states employ when responding to natural catastrophes, but I want to focus on just a few of those we use to manage the availability and affordability of insurance prior to an event. When the private insurance market refuses to provide coverage for a particular risk in a particular area, the states have responded to fill that need through a variety of tools. One of these tools in place in coastal regions of the Gulf prior to Katrina and Rita were state residual markets referred to generally as "wind pools." These are state-run insurers-of-last-resort that take on customers the private market will not insure. If not for these wind pools, the financial and social impact of the 2004 and 2005 storm season would have been far worse. These pools are run as non-profit entities, and rates are set significantly above the

private market so as to not compete with private insurers. Following hurricanes Katrina and Rita, these pools grew dramatically as private insurers began to pull back from the coastal market. As with regular insurers, these wind pools typically purchase reinsurance and are finding similar problems with rising reinsurance costs as more and more policyholders at the highest level of risk are entering the wind pool programs. When the losses to the wind pools exceed the retained premiums, as they did following 2004 and 2005, they often issue bonds or assess policyholders statewide to cover the deficit.

In Florida, the sheer severity and frequency of storms in 2004 and 2005 has pushed our insurer-of-last resort, the Citizen Corporation, to the breaking point. Eight storms inflicted $38 billion in damage and have placed a tremendous strain on the state's resources and, ultimately, the citizens of Florida. As private insurers limit their exposure, the Citizens Corporation has experienced an explosion of growth. Currently Citizens has 880,000 policies and insures over $217 billion in structure exposure. Moreover, it is on pace to become the largest insurer in the state of Florida. In 2005, Citizens Corporation ran a deficit of $1.7 billion that had to be financed through premium increases and a state-government bailout.

Another tool that Florida in particular has used is the creation of the state CAT Fund in 1993. The CAT fund was created to provide a stable and ongoing source of reimbursement to insurers for a portion of their catastrophic hurricane losses in order to provide additional insurance capacity. This program supports the private sector's role as the primary risk bearer. The CAT Fund currently provides $15 billion of reinsurance capacity for insurers in the state of Florida. The cost of CAT fund coverage is significantly less than the cost of private reinsurance due to its tax-exempt status, low administrative costs, and lack of a profit or risk-load. As a result, the CAT Fund has helped stabilize the market; it has enabled more insurance to be written in the state; and it has helped keep business out of the residual market.

Louisiana, which took the brunt of Hurricane Katrina, points to a different tool that has kept its market functioning. In addition to an effective wind pool, they have a statute in place, which says that if a policyholder has homeowners insurance from an insurer for at least three consecutive years, the insurer cannot cancel the policy unless they have had more than two non-act-of-God events. This mechanism provided stability in a market that likely would have seen a wave of companies abandon it in the most difficult of times.

Innovations such as these are possible at the state level where local needs require the creation of local solutions.

4. Pre-Disaster Concepts to Managing Natural Catastrophes

As we observed from Hurricane Katrina, the Indian Ocean tsunami, and the 2005 earthquake in Pakistan, federal governments will always need to become involved if there is a national catastrophe that affects its citizens. In the instance of Katrina, our federal government eventually appropriated $120 billion to help those in need, and to help rebuild the storm-ravaged region. However, it is like the old television commercial featuring the auto mechanic – "You can pay me now, or you can pay me later." It is always more inexpensive to finance disaster recovery before a catastrophe occurs, than after-the-fact. This is precisely the purpose of insurance --- to pay prior to the accident, to provide an economic cushion to survive the adverse event.

In testimony I gave to Housing Subcommittee in June, I highlighted some of the broader initiatives underway, both in the state of Florida, and in the NAIC, to develop practical and effective solutions to managing and planning for natural catastrophic risk. The NAIC has been involved in research and analysis of the effect of natural disasters on our society for a number of years, and is currently heavily engaged in developing a comprehensive national plan for managing the economy wide risk of catastrophic natural disasters. In addition, the NAIC has adopted resolutions, both in December of 2005 and most recently in June of 2006, supporting a national disaster plan and calling for a Federal Commission to further study the issues and any alternative solutions.

Although I believe this Subcommittee should consider all options for federal involvement, it is important to stress the solution to handling natural catastrophes, and ensuring a stable insurance market, does not necessarily begin or end with a massive federal program. In its Constitutional powers of taxation and interstate commerce, Congress' powers directly and indirectly affect state insurance markets. The loan conditions put on federal mortgages, the tax treatment of insurance company's reserves, economic incentives for individuals to retrofit their homes, improved building codes, and even upgrading our nation's infrastructure are all areas Congress can address to positively

impact the insurance marketplace. In the following section, I will attempt to summarize a few of the key ideas currently being considered.

Improve Disaster Preparedness and Disaster Response

Disaster planning and disaster response are the very first steps to saving lives and protecting communities. The sad evidence from Hurricane Katrina bears solemn testament to this fact. The recently released study of community disaster preparedness by the Department of Homeland Security suggests there is still much to be done around the country. The report states the "current catastrophic planning is unsystematic and not linked within a national planning system." It states that, "this is incompatible with 21st century homeland security challenges..." It goes on to suggest, "the need for a fundamental modernization of our Nation's planning processes." The NAIC has endorsed disaster planning as a top priority and maintains disaster preparedness manual for use by all states.

Build Better Homes

We cannot stop natural disasters, but there are measures we can take to mitigate damage. The first component of any comprehensive national strategy must be mitigation. By mitigation I mean preemptive measures taken to reduce or eliminate risk to property from hazards and their effects. In practical terms, this involves toughening building codes for new structures by making them more resistant to hazards such as wind, flood, and earthquakes. It also means stricter state and local guidelines to limit construction in highly hazardous areas.

In Florida, we are implementing rules mandating that insurance companies provide appropriate insurance premium discounts for homes that employ mitigation measures. In 2002, the Department of Community Affairs commissioned a study by the Applied Research Associates that calculated potential savings based on mitigation procedures. Shortly thereafter, the Florida Legislature passed a law that required companies to implement mitigation credits. Initially the Florida Office of Insurance Regulation adopted one-half of the recommended credits, but after two years of hurricane damage related data, we are asking the Florida Cabinet to approve the full ARA credits, and make these credits mandatory for the insurance industry in Florida. The message is clear: we must provide economic incentives for private citizens to protect themselves from catastrophic loss.

Some building techniques include reinforcing roof-to-wall connections, reinforcing roof systems, use of superior roof material attachment methods, placement of secondary water barriers on roof decking, and protection of all openings (windows, doors, garage doors and gable vents) by either installing shutter systems or using wind and impact-resistant window and/or door systems.

The federal government can positively impact these decisions by predicating federal loan decisions through the Federal Home Association (FHA) and Rural Development Home Program to only allow the purchase of homes that meet the most stringent building code standards. If a home does not meet these standards, a procedure for requiring the retrofitting of the home must be enforced.

These techniques work, and we have seen their successful utilization in Florida. The Florida Department of Financial Services provided $2.3 million to develop four model "hurricane houses" with advanced building techniques to withstand 140mph winds. In 2004, the eye of Hurricane Frances, a category 2 hurricane, passed over one of these houses located in Ft. Pierce. The house survived with no appreciable damage.

Although strengthening building codes for new structures will improve the housing stock on a going-forward basis, this will have a minor impact on the entire book of business in the short-run. According to the Shimberg Center at the University of Florida, the average age of a house in Florida is 24 years. Other states probably have similar age in their housing stock. Many of these houses were built prior to new building standards promulgated in 2001 or even the revised standards in 1994 following Hurricane Andrew. According to a study by the International Hurricane Research Center at Florida International University, over 85% of mobile homes were constructed prior to 1994 --- which is a particularly vulnerable segment of our housing stock.

I am glad to report that in this year's legislative session, the Florida Legislature passed the Florida Comprehensive Hurricane Mitigation Program, which provides for free home inspections, as well as 50% matching grants of up to $5,000 to encourage single-family homes to reduce vulnerability to hurricane damage. The response has been overwhelming. The Florida Department of Financial Services has already received 65,000 applications for the free home inspections that will alert consumers how to harden their homes. Regrettably the target for this year is to inspect 12,000 homes based on resource constraints, but this illustrates the interest homeowners have in protecting their homes when the proper financial incentives are provided.

Mitigate by Improving Infrastructure

Another element of improving the homeowners market is to improve our nation's infrastructure. This includes dikes, levees, tunnels, bridges, solid waste facilities, transportation facilities, and roads. Let us recall during the Hurricane Katrina tragedy in New Orleans, many of the structures withstood the initial damage of the storm, only to be destroyed due to the failed levee system. The American Society of Civil Engineers' March 2005 Report Card showed deteriorating conditions in 13 of the 15 infrastructure areas surveyed. Insurers are becoming reluctant to insure structures in areas with outdated or outmoded infrastructure risks. A commitment to improving our infrastructure, especially as it relates to structures that place homes in greater risk during a catastrophic event, will help prevent or mitigate damages to homes.

Expand the Capacity of the Insurance Marketplace

The current system of insurance is very good at handling the "normal" disasters ranging from car accidents, to storms, and even to large hurricanes. Catastrophic natural disasters, especially the prospect of mega-catastrophes (i.e. the "big one" hitting California, a category 3 or 4 hurricane hitting New York, the New Madrid Fault leveling the Midwest), create risks that could simply destroy an insurance company or potentially the entire industry. This risk of ruin will likely keep the private sector from offering sufficient capacity for entirely rational reasons. No potential rate of return is going to be worth the risk of losing the entire company.

Natural Catastrophe Reserves

In order to expand the capacity base, both the quantity available and the terms at which coverage is offered, several things can be done. One concept is to develop a catastrophe reserve for individuals. This has also been articulated as a Catastrophe Savings Account (CSAs). Modeled after the success of the Health Savings Accounts (HSAs), this would allow individuals to set aside money on a yearly basis that would accumulate tax free, and could only be withdrawn for specific purposes such as paying their hurricane deductible, or perhaps, to take mitigation measures to the homes to lessen hurricane damage. Although originally envisioned for the hurricane risk, it is sensible this concept could be expanded to include all catastrophe risk pertaining to the insurance of one's home.

Another concept is to overhaul the IRS tax code to provide incentives for individual insurance companies to set aside reserves for catastrophic losses on a tax-deferred

basis. Current tax laws discourage property & casualty insurers from accumulating assets to pay for future catastrophe losses. Payments for catastrophe losses are made from unrestricted policyholder surplus after losses have incurred. Current tax law and accompanying accounting standards require insurers to limit the recording of loss reserves which have already occurred, and require the recognition of catastrophe premiums in prior periods.

Currently if a company obtains higher than average profits, and creates an excess reserve, these reserves would be taxed at an ordinary tax rate, as well as negatively impact future rate requests. These limitations are not necessarily true for alien (overseas) insurers. Some non-U.S. insurers are able to deduct reserves for future catastrophe losses tax-free, which potentially gives them a competitive advantage over their U.S. counterparts. The inability to build catastrophe reserves forces insurers to prepare financially as if they were going to have a major storm in multiple locations every year. This necessitates annual reinsurance purchases with no credit or residual benefit toward next year if no losses occur. Allowing U.S. companies to join companies in most other industrialized nations, and granting them the ability to set aside tax-deferred reserves specifically for catastrophes, when structured appropriately so as not shelter income, could provide additional capacity for the market.

Another concept would be to have the federal government, through the U.S. Treasury Department, implement a reinsurance program offering reinsurance contracts sold at regional auctions. One variation of this proposal would be to allow private insurers to obtain reinsurance contracts. Other proposals would restrict these reinsurance funds to authorized state catastrophe funds, similar to our Florida Catastrophe Fund, or the California Earthquake Authority.

National Catastrophe Reinsurance

Currently, the United States is one of the only industrialized nations in the world not to have a federal comprehensive catastrophe plan. The Office of Insurance Regulation staff has not concluded its review of the details of the pending federal legislation outlined in HR 4366, and HR 846, but I think these ideas deserve strong consideration.

A multi-layered approach, with the federal government's commitment to reinsure state entities against a mega-catastrophe as its capstone, will not only proactively help in any catastrophe recovery effort, but also provide stability in the housing insurance market by allowing state agencies to diversify their risk. If we can accomplish this goal it will likely

lure additional private capital to the insurance market, stimulating more availability, more competition, and ultimately lower premiums.

Given the variety and complexity of concepts under consideration, I strongly endorse the concept of a National Commission on Catastrophe Preparation to weigh the merits of each and develop the best mix of solutions. Clearly there are a number of forward thinking ideas that need further consideration, but they should be framed to answer the question, "Will this make insurance for individuals and businesses more available, and more affordable?" We will work with this Subcommittee to find the right answers to that question. The lessons of recent catastrophes may be the only warning we get to start making those decisions, so I thank you for holding this hearing, for inviting me here today, and for your continued interest and leadership on this crucial issue. I'd be happy to answer any questions you have.

RAA
REINSURANCE
ASSOCIATION
OF AMERICA

STATEMENT

TESTIMONY

OF

FRANKLIN NUTTER
PRESIDENT
REINSURANCE ASSOCIATION OF
AMERICA

STABILIZING INSURANCE MARKETS FOR COASTAL CONSUMERS

BEFORE

THE SUBCOMMITTEE ON CAPITAL
MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTITIES

SEPTEMBER 13, 2006

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Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee:

My name is Franklin Nutter and I am President of the Reinsurance Association of America (RAA). It is an honor to appear before you on behalf of the RAA. I would like to thank you Chairman Baker, and many of the members of the House Financial Services Committee and Ways and Means Committee for the strong leadership on the issue of natural disaster financing. This is an issue of upmost importance to the RAA and we greatly appreciate the Members' commitment to this issue and look forward to working with Members on both Committees on market-based solutions.

The RAA is a national trade association representing property and casualty organizations that specialize in reinsurance. The RAA membership is diverse, including large and small, broker and direct, U.S. companies and U.S. subsidiaries of foreign companies. Together, RAA members write nearly 2/3 of the gross reinsurance coverage provided by U.S. property and casualty reinsurers and affiliates.

Reinsurance is commonly referred to as the insurance of insurance companies. Reinsurance plays a critical role in maintaining the financial health of the primary insurance marketplace and ensuring the availability of property and casualty insurance for U.S. consumers and businesses. Reinsurance is used for several reasons. One of the most common purposes is for a primary insurance company to transfer the potential risk of losses from catastrophic events such as hurricanes, earthquakes, and in the case of September 11, 2001, acts of terrorism. To that end, reinsurers have assisted in the recovery after virtually every major U.S. catastrophe over the past century. For natural disasters typically one-third of the insured losses are passed on to reinsurers and in the

events of September 11, two-thirds of the losses were absorbed by the reinsurance industry.

As cited in an August 2006 A.M. Best Report: "Several factors...contributed to the insurance industry's stability in 2004-2005:

- Transference of risk to the growing global reinsurance market
- Greater use of capital market solutions"

The resilient private insurance market system worked as it should to absorb losses from extreme natural events in 2005 through retained losses by insurers (37%) and substantial risk transfer to global reinsurers (63%).

Reinsurance Role in 2004-2005 Hurricane Seasons

There are many factors that affect the stability of insurance in coastal areas, reinsurance being a key factor. The important role reinsurance plays in coastal areas and in our nation's economy was demonstrated during the 2004 and 2005 hurricane seasons. As you are aware, in 2004 there were four major hurricanes that hit Florida resulting in $30 billion of damage. The global reinsurance industry paid approximately one-third of those losses, enabling insurance companies who purchased reinsurance to honor their obligations to their homeowner policyholders. Despite the huge financial impact to reinsurers, there were no reinsurer insolvencies and the reinsurance market was able to meet the primary insurance community catastrophe demand for the 2005 hurricane season.

As has been well documented the hurricane season of 2005 turned out to be a year of unprecedented losses in terms of frequency and severity. The insurance/reinsurance industry weathered the single largest loss in the industry's history (Katrina). Insured Katrina losses were an estimated $45 billion, even greater than the projected $35 billion

in 9/11 losses. The 27 named hurricanes and tropical storms in 2005 set a new record, an aggregate total of $80 billion in insured losses. The Big Three: Katrina, Rita and Wilma produced losses estimated to be as high as $60 billion. The reinsurance industry once again played a critical role, providing stability to the insurance market, by paying approximately 60% of all of these losses. The 2005 hurricane losses were spread well throughout the global reinsurance markets: Bermuda $11 billion; U.S. reinsurers $7 billion; London/Lloyds $6 billion; European reinsurers $6 billion.

The 2004-2005 hurricane seasons are indicative of risk transfer from insurers to reinsurers. Notwithstanding nearly $30 billion in catastrophe losses in 2004, U.S. primary companies had their first underwriting profit since 1978 and net income of $41.7 billion. In 2005 U.S. insurers had record net income of $49 billion and growth in surplus to $433 billion notwithstanding U.S. catastrophe losses of $58 billion. Reinsurers in the U.S., on the other hand, incurred $1.44 in loss costs and expenses for every $1 of premium. Global reinsurers in 2005 lost $1.20 for every $1 in premium. In 2005 the Bermuda reinsurance market, which provides nearly 40% of U.S. property catastrophe reinsurance, lost 25% of its capital base due primarily to U.S. catastrophe risks.

Reinsurance Capacity Today and its Impact on Coastal Insurance Stabilization

What does that mean for reinsurance capacity to provide natural disaster protection for primary insurance companies in coastal areas for 2006? Despite the unprecedented losses in 2004 and 2005, private market reinsurance capacity increased in 2006. Estimates are that the reinsurance capacity in place increased nearly 30%.

As it has following all recent catastrophe events, the free market responded to the increased demand for reinsurance. As in 1993 after Hurricane Andrew and 2001 after the terrorism losses of 9/11, the capital markets promptly provided new reinsurance capital

and capacity. The same dynamic occurred after 2005. Since Hurricane Katrina, approximately $24 billion in new capital has been raised to support underwriting needs notably for U.S. catastrophe risk. Of that capital, $7.780 billion was invested in new start up reinsurance companies; the remainder replenished the capital positions of existing (re)insurers. In addition to that new capacity, an additional $4 billion has been invested in special purpose vehicles, whose investors, such as hedge funds, collaborate to provide extra underwriting capacity to existing reinsurers for property and catastrophe retrocessions and other short tail lines of business. Reports are that $4 to $6 billion (estimated) of catastrophe bonds was invested in U.S. catastrophe exposure.

Despite this new capacity, there are still insurance market dislocations in Florida and in some areas of the Gulf Coast. Demand increased in some peak zones in 2006, notably the Gulf Coast and Florida, at a greater rate than the reinsurance supply increase due to: rating agencies requiring greater capital to support catastrophe exposure, catastrophe modelers increasing loss predictions; growth in both population and property values in certain high-risk areas; changed perspectives on frequency and severity of storms and insurance company managements' desire to purchase more protection. Rating agencies such as A.M. Best and Standard & Poors determined that insurers and reinsurers with catastrophe exposures needed additional capital to support their ratings. Insurance catastrophe modelers revised their models following the hurricane seasons in 2005 due to new data and a belief that we are entering into an era of increased hurricane frequency and severity. Reports are that Florida catastrophe models increased 60% for frequency and 40% for severity. The Gulf Coast models were revised for a 20% increase in frequency and 15% for severity. Insurance company managements also have reacted due to a changed perception of risk. Such managers have seen the impact of increased hurricane frequency and severity on their losses and seek to purchase more reinsurance

protection. The confluence of these events has resulted in demand for catastrophe protection in peak catastrophe zones greater than the supply.

The RAA believes this imbalance will be temporary, however. As the events after Hurricane Andrew suggest, typical insurance and reinsurance cycles involve temporary spikes in pricing, followed by new market participants, leading to increased competition and price moderation. Ultimately, free markets will create a more diversified insurance and reinsurance market that will spread risk widely, increasing capacity and price competition.

Conclusion

Reinsurance plays a critical role in the stabilization of insurance markets. We recognize that after some hurricane seasons, there will be temporary market dislocations as reinsurance demand exceeds supply. The RAA looks forward to working on market-based solutions with you Chairman Baker and other Members of Congress who have already demonstrated leadership and commitment to this most important issue.

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
CAPITAL MARKETS SUBCOMMITTEE
STABILIZING INSURANCE MARKETS FOR COASTAL CONSUMERS
SEPTEMBER 13, 2006

GOVERNOR MARC RACICOT, PRESIDENT
AMERICAN INSURANCE ASSOCIATION

Good morning. My name is Marc Racicot. I am president of the American Insurance Association (AIA). AIA represents major property and casualty insurers doing business across the country and around the world.

I appreciate the opportunity to testify this morning on a matter of utmost importance to AIA and the nation as a whole: insuring natural catastrophe risk. I commend the Committee for your leadership in examining proactive approaches to the management of this risk.

The first anniversary of Hurricane Katrina devastating the Gulf Coast was just two weeks ago. While we commemorate Katrina and remember her victims, we should also seize the opportunity to apply the lessons learned in a forward-looking, positive way – to better secure our nation against future disasters.

Fortunately, despite last year's record-breaking losses, the insurance industry is well positioned financially to manage this risk. However, to do so effectively, insurers must have the tools to measure and reduce catastrophe risk, and the insurance regulatory system must allow rates to reflect the real costs of coastal exposure.

Recent Experience

The 2005 hurricane season was, by far, the worst year on record. Records were set for the number of named storms (28), the number of hurricanes (15), and the number of hurricanes reaching category 5 status (4). The season also was remarkable for its early beginning and late end.

Beyond these statistics, the hurricanes of 2005 underscored the human toll of catastrophes. One year after Hurricane Katrina, thousands of former Gulf Coast residents remain homeless. The City of New Orleans has yet to rebuild its infrastructure or housing stock, recover its economic base, or reclaim its unique spirit. Some experts believe it will take years, if not decades, for the recovery process to be complete.

For insurers, 2005 was the most costly year on record, with insured losses from Hurricane Katrina estimated to reach $40 billion, and total catastrophe losses for the year totaling more than $70 billion, taking into account property insurance losses as well as automobile, marine, energy, commercial liability, workers' compensation and other insurance losses. Insurers adjusted more than three million hurricane claims, 1.6 million claims from Hurricane Katrina alone. The historic devastation from the 2005 hurricanes was met with an unprecedented deployment of insurance industry resources, including more than 10,000 claims adjustors. Despite tremendous logistical challenges, insurers were providing compensation to policyholders within hours of the storms making landfall. The good news is that well over 90 percent of the Katrina-related claims in Louisiana and Mississippi have been settled. AIA member companies will not be satisfied until every single claim is resolved. Insurers are committed to paying all damages that fall within their insurance contracts with customers.

Insurers are fully committed to working with local, state, and federal policymakers to "bring back the Gulf." We recognize that the insurance mechanism plays a vital role in preparing for, and responding to, future natural catastrophes. At the same time, we believe that long-term solutions must look beyond insurance. As a nation, we must make sure we are prepared for, and can respond quickly to, the spectrum of losses that may flow from a major catastrophe. We welcome the opportunity to be fully integrated into the planning process, in terms of logistics, communications, and coordination with relevant government agencies and private groups.

Needed Reforms

Although the property insurance market currently is under stress in several Atlantic and Gulf Coast states, the solution rests in improving, not displacing, private sector ability to serve homeowners and businesses in the path of potential storms. The challenge is to identify and advance positive system changes that will allow markets to manage natural catastrophe risk without establishment of new government programs or a bail-out from taxpayers living in less-risky areas. Beyond their benefits to the insurance system, many of these reforms will help prepare individuals and communities for future catastrophes, educate them about the benefits of risk management, and, most importantly, reduce the personal and economic toll of hurricanes and other natural catastrophes.

AIA's reform agenda includes both federal and state initiatives that could provide short- and long-term benefits. All should be put in place as quickly as possible. The agenda we have developed consists of four major components:

- *protective measures* to keep people out of harm's way and strengthen their ability to withstand future hurricanes;
- *regulatory and legal reforms* to improve the stability of insurers' operating environment;
- *tax incentives* to encourage residents to take more responsibility for hurricane preparation and response; and,

- *National Flood Insurance Program (NFIP) reforms* to assure that NFIP continues to play a vital role in protecting the region from the generally uninsurable risk of flood.

Although some of these reforms relate specifically to hurricanes, many of the tools described here can be modified to address earthquake risk and other natural perils.

I. *Protective Measures*

Natural catastrophe losses can be reduced through mitigation, including effective building codes, policies that encourage retrofitting of existing buildings, and sensible land use planning. From a community perspective, mitigation can make the difference between a community recovering relatively quickly from disaster – with citizens returning to homes and jobs – and a community remaining devastated and economically stagnant for many months or longer. From an insurance perspective, mitigation helps preserve market capacity, reduce solvency risk, and enhance insurer ability to cover more risks (assuming a flexible regulatory environment and stable legal environment).

- **Strong building codes help reduce deaths, injuries, and property damage from natural catastrophes and more routine property losses.** Building codes set minimum safety standards for design, construction, and maintenance of residential and commercial buildings. They are based on established scientific and engineering principles that have been thoroughly tested to ensure safe, predictable building performance in wide-ranging situations. Recent benefit/cost studies indicate that each dollar spent to comply with stronger natural hazard focused code provisions results in long-term savings of $3 to $16. Strong statewide building codes, with no opt-out features, are needed in every state, particularly those with significant catastrophe risk. Statewide building codes also must stay current and consistent with the latest mitigation technologies.

- **Enforcement of, and compliance with, building codes is critical.** Enforcement of building codes is as important as their enactment. Independent studies following Hurricane Andrew revealed that lax code enforcement contributed to total damage. Clearly, training for many new inspectors, as well as contractors, will be needed during the post-hurricane building booms and to implement/enforce new codes.

- **Land use planning can help make communities more disaster resistant.** Hurricane and other catastrophe risk should be factored into land use planning decisions in order to protect lives and property. Research shows that effective land use planning also helps reduce insured hurricane losses. States should enact laws to require local governments to prepare comprehensive plans, specifically taking natural disasters into account in local planning and zoning decisions. Even in jurisdictions without such mandates, the state could offer guidance to local governments on land use planning, even as a voluntary guideline.

- **Disaster awareness and preparedness can mitigate the negative personal and financial impact of a catastrophe.** Natural disasters present a real threat to all individuals and businesses. Having a disaster preparedness plan in place before a disaster strikes can reduce losses, as well as potentially save lives. It can also make the difference between a business continuing its operations after a disaster and closing down temporarily or permanently, and whether residents return to their communities or move to another location.

II. *Regulatory Modernization*

Central to insurers' ability to manage hurricane risk is their ability to predict risk and charge appropriate premiums for bearing such risk. Unfortunately, the political climate in many states includes arbitrary rate suppression, expensive and unpredictable regulatory mandates, and other regulatory and legal burdens. These must be addressed in order to create a more stable business environment for insurers making a capital commitment to the region.

- **Risk-based pricing is critical to *any* viable insurance system.** Property insurance rates must be based on insurer evaluation of underlying catastrophe risk in hurricane-prone areas. Risk-based pricing, utilizing the best possible scientific information, is essential to insurers' ability to provide protection against hurricanes. Equally important, appropriate pricing encourages loss prevention, thus reducing the individual and societal costs of disasters.

  Given the opportunities for politically influenced government rate suppression, all states should repeal requirements for rate approval by state insurance regulators. If a free market system cannot be achieved in the short-term, interim incremental measures are essential. One way this might be achieved is by shifting the burden of proof, so that the insurance department must prove that a filed rate is excessive; another is by allowing insurers to raise or lower rates by a specified percentage (within a "flex band") without regulatory approval.

- **Computer-based disaster models help insurers measure catastrophe risk and reduce likelihood of insurer insolvency.** Since Hurricane Andrew in 1992, the insurance industry has significantly improved its ability to monitor natural catastrophe accumulations through computer-based models that measure risk on a probabilistic basis using sophisticated simulation techniques. The models are not perfect; Hurricane Katrina prompted some improvements, which recently were announced by the major modeling firms. Just as insurers use models to manage catastrophe risk, states should accept their use in the ratemaking process, and protect the confidentiality of proprietary models. However, some states remain opposed to models, particularly if they indicate that higher rates are needed for actuarial soundness. Ignoring scientific models is another form of artificial rate suppression that increases subsidization, reduces incentives for mitigation, and ultimately undermines the role of the private sector in managing catastrophe risk.

- **Higher deductibles can make insurance more affordable; tax incentives can help policyholders pre-fund their deductible obligations.** Higher deductibles reduce the cost of insurance, conserve insurance capacity, and help focus post-event attention on homeowners who have had a major loss. They also encourage residents to take personal responsibility to mitigate loss (prior to and following a storm) and reduce cross-subsidization by shifting a portion of the risk back to policyholders likely to incur the loss.

- **Broad-ranging and shifting post-event regulatory mandates increase insurer uncertainty and divert attention needed to respond to claims.** Insurers must have some certainty that, if a major hurricane strikes, they will not be hit with shifting, wide-ranging regulatory mandates of questionable legality. Following Hurricane Katrina, for example, insurers were confronted with literally hundreds of legislative and regulatory mandates and proposals that impacted premium collection, underwriting, claims handling, and claims data reporting; most of these mandates varied from state to state. Recent legislation in Florida recognized the harm these mandates have on the insurance environment. As a result, Florida law now obligates regulators to adopt (through administrative rulemaking) standardized requirements *before* the event that may be applied to insurers *after* a catastrophe. Other states should do the same.

- **States also should facilitate post-event claims adjustment.** While every major hurricane is somewhat unique, a common theme is the need for insurance adjusters to get in quickly and settle claims expeditiously. Yet, there are usually many obstacles in place, such as licensing and establishment of procedures to facilitate payments. In addition to removing specific obstacles, there should be improved integration of insurers into the planning of post-event responses, in terms of logistics, communications, and coordination with relevant federal and state agencies.

III. *Legal Reform*

- **The legal system must preserve the sanctity of contracts.** Insurers must have confidence that the insurance policies they write will be upheld following a major catastrophe. Pending "wind versus water" litigation brought by the Mississippi attorney general and private plaintiffs epitomizes the problem that insurers face in an uncertain legal environment, particularly where cases are tried by "hometown" juries. Insurers should not be made to pay claims for losses that are beyond the scope of an individual's policy, and for which the policyholder did not pay premiums. If trial lawyers or others are successful in retroactively re-writing insurance contracts, the predictability upon which a healthy insurance system is based is undermined.

- **Statutes of limitations should not be extended.** Post-hurricane extension of the statute of limitations on hurricane claims raises fundamental fairness and due process concerns. Moreover, it becomes harder to settle claims equitably as the parties become farther removed from the event which caused the loss. All

insurance policies provide ample time for the filing of hurricane damage claims. Extending the statute of limitations is another attack on the sanctity of contract, in this case, by state legislatures.

IV. *Tax Incentives*

Although such a change may not precipitate substantial capacity in the short term, amending U.S. tax laws to permit insurers to establish tax-deferred catastrophe reserves, if designed properly, would have a positive impact on present and future recovery efforts. There are also other ways that federal and state tax policy can enhance affordability and encourage the use of protective measures. These include:

- federal legislation to establish tax-exempt Catastrophe Savings Accounts (CSAs) for individuals (similar to health savings accounts) as introduced by Rep. Tom Feeney (R-FL);
- federal or state income tax credits (similar to tax credits formerly provided to encourage energy efficiency) to encourage homeowners and business owners to invest in protective measures that go beyond building code requirements; and,
- state sales tax holidays for hurricane mitigation and preparedness purchases, or exempt certain items from state sales tax.

V. *National Flood Insurance Program (NFIP) Reforms*

The NFIP plays a critical role in hurricane preparedness and response. However, the program as currently structured does not cover enough people or provide the level of protection needed by many policyholders. The NFIP must be reformed so that it provides an effective safety net, while encouraging homeowners and businesses to take personal responsibility. Among needed NFIP reforms are:

- expansion of risk-based premiums;
- expanded program mandates to cover more homeowners in more locations;
- increases in maximum coverage limits and deductibles; and,
- policy terms that are more consistent with private insurance. Insurers have developed a comprehensive list of reforms.
- Additionally, NFIP must complete its map modernization initiative as soon as possible.

Comparisons to Terrorism Risk

The tools that I have outlined would improve the ability of private insurers to manage natural catastrophe risk, while at the same time making individuals and communities more disaster resistant and resilient. In doing so, they should obviate the need for new federal or state governmental insurance or reinsurance mechanisms for natural catastrophe risk.

However, these tools are insufficient for managing the complex, man-made risk of catastrophic terrorism. While both natural catastrophes and terrorism are capable of causing extreme loss, they are fundamentally different from an insurability perspective. For terrorism, private sector reinsurance or other risk-sharing capital remains woefully inadequate and shows no signs of robust growth in the near future. This is a strong indicator that the capital markets have reached the same conclusions about the private insurability of terrorism risk. Moreover, there is no reliable method for determining the likelihood of a terrorist attack (event frequency) within the United States, a critical component in determining the insurability of a risk. This is complicated by the fact that terrorism is a deliberate act committed by individuals bent on doing the worst possible harm. Additionally, the interdependence of terrorism risk also limits the potential effectiveness of mitigation. Finally, for national security reasons, vital information necessary to assess the terrorism threat is strictly classified and unavailable to insurers as they attempt to manage this risk.

Because of these factors, a federal reinsurance backstop for terrorism risk must remain in place after the December 2007 expiration of the Terrorism Risk Insurance Act Extension Act, and we appreciate the opportunity to work with this committee to develop long-term solutions to the ongoing problem of managing the nation's economic exposure to terrorism risk.

Conclusion

Thank you very much for giving me the opportunity to appear before you today. On behalf of AIA and our members, I look forward to working with you to address the challenges facing the insurance industry, and our nation as a whole, in preparing for, and responding to, natural catastrophes.

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Testimony of Mark Drennen
President and CEO
Greater New Orleans, Inc.

Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee
of the House Financial Services Committee

"Stabilizing Insurance Markets for Coastal Consumers"

On behalf of Greater New Orleans, Inc. (GNO, Inc.), the economic development organization for 10 parishes in the New Orleans region, I would first like to thank Congressman Richard Baker of Louisiana and his colleagues from the Financial Services Sub-Committee for holding this special hearing to address this vital issue of insurance instability caused by the damaging hurricanes in recent years. We hope that through these Congressional deliberations that awareness can be raised about the magnitude of the problem and the impact on coastal communities, and ultimately that federal policy solutions can be considered for short term and long term interventions desperately needed.

In 2005, Hurricanes Katrina, Rita and Wilma created an obstacle course of challenging road blocks for the businesses struggling to rebuild as well as new ones trying to invest in the greater New Orleans region in Southeast Louisiana and our counterparts in Southwest Louisiana. The same challenges of economic recovery are being felt throughout the Gulf States. In our region, the first major obstacle was levee protection and community safety, then it was the lack of housing, then it was the disruption of healthcare services and the untenable utility rate increases and now the critical issue of access and affordability of insurance for both homeowners and businesses—the latest impediment to the recovery effort as we try to bring back a population loss of 300,000, over 200,000 homes and 18,000 businesses.

As we just marked the anniversary of Hurricane Katrina on August 29, one of the major issues of increasing concern in recent months is the runaway costs of commercial insurance for those businesses that can even find insurers at all for property and casualty coverage. Businesses are stressed with the reality brought forth post-Katrina that many insurers are no longer writing new policies and those renewing policies are raising premiums and deductibles to unprecedented levels, putting the cost of coverage out of reach for many. In repeated cases, annual premiums have increased five fold and

deductibles as much as ten fold. Thus, for companies willing and capable of paying the high premiums to maintain property coverage, there is still the financial exposure of deductibles that may not be met if another hurricane type event is triggered.

The insurance access-cost issue is affecting all sized companies in all sectors, including real estate development, housing construction, multi-family rental projects, the tourism industry and banking just to name a few. Convention events are at stake, apartment units can not be refurbished, and lenders are having to bend some long standing insurance requirements in order to maintain commercial clients and absorb some of the risk. Insurance is now holding up many of the development deals that were originally attracted by the federally enacted GO Zone incentives. Without insurance solutions, such incentives will not realize their potential for economic recovery and investment.

The insurance industry justifies the increases based upon revised risk assessment computer models that attempt to predict future losses due to catastrophes. According to the Insurance Information Institute, 8 out of 10 of the most expensive natural disasters in US history occurred within the past four years. The National Hurricane Center predicts more named hurricanes in the next 10 to 15 years. Insurers are utilizing this information to significantly adjust premium and deductible rates and businesses are suddenly absorbing the costs or forced to opt out of purchasing insurance all together. This creates a short term insurance crisis that may be eased in the future if the storm seasons are quieter than predicted and the market dynamics respond favorably. In the interim, in order to retain and build current economies, the federal and state governments must partner with the private sector to devise temporary and permanent strategies to address ways to make insurance stabile and accessible for businesses who operate in the coastal areas of the United States, where according to the National Oceanic and Atmospheric Administration (NOAA) is currently home to a combined population of 153 million people, 53 percent of the nation's total population. NOAA also

predicts that by the year 2008, coastal county population is expected to increase by approximately 7 million, a trend that has tremendous policy implications.

After hearing countless insurance war stories from business and industry in the greater New Orleans region, GNO, Inc. quickly pulled together an Insurance Task Force with representatives of the insurance industry, real estate, banking and other private sector leaders from the community. The goal is to develop a comprehensive strategy to address the insurance issues for businesses in the surrounding 10 parish region. The task force will approach the problem by developing three tracks: Federal Relief and Intervention, State Policy and Legislation, and Private Sector Initiatives. The task force plans to meet with insurance companies and their CEOs throughout the US not currently doing business in the state and will work to attract more supply and competition into the local insurance market. The group will also look at potential solutions that can be aligned with other advocacy groups working to increase access and reduce the cost of commercial property insurance. Lastly, the task force will work at the state and federal level toward public policy initiatives to provide relief to hurricane impacted businesses already coping with a high cost environment due to labor pressures, increased utilities, housing rates, tight supplies, and other negative market factors.

The GNO, Inc. Insurance task force is in its early stages of policy formation but there is a growing list of legislative options for consideration. We are trying to benchmark best practices from other states, such as wind pools and reinsurance programs, as well as identify mitigation policies that will reduce risks. Our Task Force will assess what practices would influence the supply of insurance companies and policy writing activity. Although GNO, Inc. is a regional organization, our task force will join forces with other states and stakeholders where appropriate to consider short term federal relief to bridge the insurance gap in the short run until more permanent solutions can be developed and implemented through government actions and private sector response.

In closing, Greater New Orleans, Inc. urges the White House, Congress and the Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee to come together to provide short term measures that can provide the businesses in the coastal states insurance accessibility while we all continue to work toward longer term strategies at the state and federal levels. Congress has addressed other post-Katrina rebuilding issues such as housing, infrastructure and economic development by providing targeted grant resources like the Community Development Block Grants (CDBG funds) based on sound needs and sound allocation of resources. In this same spirit, GNO, Inc. asks this committee to closely examine the immense insurance needs and consider additional resources on a short term basis for the sake of comprehensive recovery in the Gulf Coast states and for the sake of insurance stabilization for all coastal states faced with the continued threat of catastrophe to lives and property. Hurricane Katrina devastated thousands of homes, businesses, families and employees. Congress has done much to provide resources for the areas of greatest need. Finding an interim insurance solution is the next area of great need in this long rebuilding effort.

GNO, Inc. would like to offer its expertise, energy and resources to Congressman Baker and the committee, with a firm commitment to work with he and his staff to narrow the federal relief options for consideration this Congressional session, which is ambitious but necessary from the perspective of those of us on the ground. We would also like to offer to testify before the committee in subsequent hearings regarding our Insurance Task Force's early findings and recommendations.

Thank you for your time and consideration.

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Appendix I - Post-Hurricane Case Studies of Business Insurance Issues

a) Commercial Printer with $7million of property. Expiring premium of $25,000. Expiring policy included equipment breakdown coverage and Business Interruption for up to 12 months. Very small wind deductible. Renewal required several policies with a wind deductible of 5% ($350,000), significantly reduced Business Interruption, Significantly reduced equipment breakdown coverage and double premium using four policies instead of one.

b) Property insurance for a large shopping center renewed where the premium went from $70,000 to $250,000 and the wind deductible went from 1% to 5% ($1,700,000 deductible up from $350,000 deductible.)

c) A local golf and country club paid through a business owners package approximately $60,000 in 2005. This included a $10,000 deductible per all risk. The renewal for the property alone was $100,000 and included $250,000 deductible for a named storm, a $100,000 deductible for any other wind damage and a $25,000 deductible for all other perils.

d) A fine dining restaurant located in the French Quarter paid $27,000 for their property insurance in 2005 which included a 2% wind/hail deductible with a minimum of $25,000. The 2006 renewal for the property with the same limits is $242,000 and includes a 5% wind/hail deductible.

e) French Quarter Hotel with Property Values at $3,000,000. The expiring premium was $17,000 and included a windstorm deductible of $25,000. Renewal policy had a premium of $84,000 and wind deductible increases to $400,000.

f) Door Manufacturer - Total Property Values of $5,000,000 including Business Interruption. Expiring premium $26,000. Renewal premium from incumbent carrier was $54,000 with a $750,000 windstorm/hail deductible. Alternative quotation was produced at an $83,000 premium with a 5% ($250,000 deductible).

g) Landscape Contractor with a $400,000 property exposure and an $800,000 business interruption exposure. All buildings are frame. The contractor could not find a single market to insure the buildings. The insured had to buy his wind/hail insurance through the State residual plan, Citizen's Insurance Company. As a result he is now self insured for any business interruption arising out of a wind event since Citizen's does not offer such coverage.

h) Ship Supply Company - Total insurable values of $9,500,000. Deductible increases from $50,000 aggregate last year to 5% ($475,000) this year. The company was too large to qualify for the Citizens plan and has too great of a business interruption exposure to move to Citizens plan. Cost to buy the windstorm deductible down to $100,000 was $80,000 ($375,000 of coverage).

i) Healthcare provider with over $1.5 billion property value. Previous property policy had a wind limit of $200 million. Total premium was about $1.3million. Renewal had a wind limit of $25 million at about the same premium. The provider secured another $50 million of coverage for $5 million of premium.

j) Local hotel owner and operator faced major changes when renewing coverage in 2006. Last year, asset coverage was $150 million (including wind), the annual premium was $380,000, and there was a one percent deductible. At renewal in 2006, coverage was still offered at $150 million, but with significant changes. First, the premium increased to $720,000. Second, the deductible increased to five percent. Third, the wind coverage was specifically limited to $25 million. When the lender tried to force an additional $50 million of wind coverage, the best deal in the market for $50 million in coverage would cost an additional $10.8 million ($20 per $100 of coverage). The company is currently in default of its loan agreement with its lender and is in active negotiations regarding this issue.

k) Local manufacturing company experienced dramatically higher quotes and lower coverage at renewal of its insurance. The prior structure was for $26 million in primary asset coverage at an annual premium of $438,000 per year. In addition, there was a secondary umbrella policy for $73 million with an additional cost (unsure of cost of last layer). Quotes came back at $1.285 million for $11 million in primary coverage. In addition, certain insurance companies shortened their policy terms from 12 months to quarterly, and even monthly. The deductible was increased from 1% to 5%. Also, the umbrella coverage is based on the primary coverages being in place. Without primary coverage, the last layer of $73 million is unavailable. The company decided to use State Department of Insurance, Rule 23 to force the insurance companies to maintain prior terms and conditions until December 31, 2006. After December 2006, the company expects to be subject to dramatic changes in premiums and coverages.

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October 10, 2006

The Honorable Richard H. Baker
Chairman
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
House Financial Services Committee
2129 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Paul E. Kanjorski
Ranking Member
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515-3811

Dear Chairman Baker and Ranking Member Kanjorski:

On September 12, 2006, the Commercial Mortgage Securities Association ("CMSA") convened a panel to discuss the current availability and affordability of windstorm insurance. The following day, Wednesday, September 13, the Capital Markets Subcommittee held a hearing to assess the current natural catastrophe insurance marketplace entitled "Stabilizing Insurance Markets for Coastal Consumers." While it was unfortunate that the timing of the panel discussion prevented CMSA from participating in the hearing, we submit this executive summary and the attached transcript of the panel discussion to be a part of the official record of that hearing.

Summary of Panel Findings

The Association found that the lack of available and affordable windstorm insurance, particularly in the hurricane prone metropolitan South-Atlantic and Gulf Coast regions, has affected each layer of commercial mortgage-backed securities ("CMBS") market participants, and, unless the dearth of coverage is resolved, will cause not only a contraction within the CMBS market, but within the larger U.S. economy as well. Moreover, if not corrected, this lack of available and affordable windstorm insurance could have a crippling effect on the CMBS market if coupled with the potential loss of terrorism risk coverage should the Terrorism Risk Insurance Act ("TRIA") program be allowed to expire in 2007.

Panelists included CMBS market participants experienced in windstorm insurance coverage: Stephanie Petosa of FitchRatings; Stacey Berger of Midland Loan Services; Deb Schiavo of Bear Stearns; Reggie Leese of Blackrock; Jan Sternin of Midland Loan Services; Michael Liebowitz of Harbor Insurance; Kathleen Dufraine of Wachovia; Lawrence Ceriello of Dechert; Peter Mardinly of Belmont Investments; John Kurtz of Marsh; Keith Belcher of J.E. Roberts; Lauren Cerda of FitchRatings; Joe Kelly of FitchRatings; Jim Palmisano of Standard and Poor's; and Dan Rubock of Moody's.

About CMSA & CMBS

CMSA is the international trade association for the $695 billion CMBS industry and the collective voice of the lenders, issuers, investors, loan servicers, rating agencies, trustees and other service providers that comprise its membership. CMBS are investment vehicles that pool commercial mortgages and issue bonds that are backed by the individual loans. These vehicles have been developed to increase the amount of capital available for commercial real estate finance and to increase the liquidity of commercial mortgages. They are favored by investors for their superior bond performance.

Windstorm Coverage Vital Component of Robust CMBS Market

The 2004 and 2005 hurricane seasons and the resulting property damage continue to ripple through the CMBS market. The increased frequency and severity of these natural disasters has affected investors and lenders alike. Commercial mortgage banks struggle to meet new windstorm insurance coverage requirements for new loans, and servicers, special servicers and rating agencies are now faced with the daunting task of ensuring that adequate property and casualty insurance is in place to protect the interest of the CMBS investors on existing loans and portfolios.

Lack of Available and Affordable Windstorm Coverage

CMSA's windstorm panelists and other market participants revealed critical findings: The unavailability and unaffordability of a single line of coverage – wind – posed a multifaceted attack on each layer of the CMBS marketplace, reducing cash flow for developers and lenders, restricting new loans for and reducing new commercial real estate development and subjecting existing loans to significant premium increases with the threat of default. Taken together this lack of availability and affordability of windstorm coverage, particularly in the South-Atlantic and Gulf States regions, undermines the CMBS as investment vehicles.

Since the major hurricane season of 2005, the market for windstorm insurance in Gulf Region states has deteriorated precipitously. Borrowers seeking windstorm insurance are faced with a contracted marketplace – the capacity is simply not there to insure. The lack of capacity has presented a two-fold problem for developers: 1) inadequate windstorm coverage for their properties; and, 2) cash flow problems. Because of this lack of capacity, borrowers seeking $100 million worth of property insurance are often only able to purchase $20 to $30 million worth of coverage. And, as they struggle to obtain the necessary coverage, borrowers have turned to alternative means of insuring, such as self-insuring, to the great consternation of lenders who are demanding recourse and collateral on properties that are self insured.

In addition to the lack of availability, the windstorm insurance that is generally available in the Gulf States for commercial mortgage lending is often unaffordable. Because borrowers are not able to obtain the windstorm insurance required to cover their properties, they must frequently shoulder the increased cost of that coverage themselves. In fact, borrowers who have pass-through provisions in lease agreements with their tenants are facing the stark realization that the market is only able to bear limited rent increases. There is only so much rent that can be passed through to tenants currently in place – some of them have problems making payments and others will have problems as the additional costs are passed through.

The lack of availability and affordability of coverage for borrowers also has a significant impact on lenders, impeding the issuance of new loans for commercial real estate. If borrowers do not obtain sufficient insurance coverage as required within the loan documents, the lender has required the servicer of the loan to obtain the insurance necessary to protect the lender's interest in these loans. The lender has been able to securitize these loans, and sell the bonds, because the investors have bought the bonds based on this risk being mitigated through this required "force-placement" of insurance. With fourfold increases for such insurance coverage, as well as actual moratoriums by insurance carriers as to providing this coverage, servicers are unable to meet this "force placement" requirement forcing lenders to take the risks, which in turn flow through to the investors of the bonds. The shifting of risk to the investor diminishes the attractiveness of the bonds as investments and impairs the creation of capital for new commercial real estate loans.

Probable Maximum Loss Studies Are Unreliable

The CMBS market is also adapting to the new use of probable maximum loss ("PML") studies. PML studies are financial assessments of the vulnerability of a commercial real estate project. Lenders and insurers are increasingly looking to this tool – historically used to measure the adequacy of earthquake insurance primarily on the West Coast - to accurately estimate the damage resulting from windstorm in the Southeast. Unfortunately for CMBS market participants, PML's application to windstorm coverage has required new methodologies for calculating potential losses which, to date, are unreliable. Barriers to consistently reliable PML studies are the lack of an industry standard and their cost.

Windstorm Insurance Crucial to Essential Driver of U.S. Economy

The lack of affordable and available windstorm insurance poses a very real threat to the CMBS market – an important driver of the U.S. economy. Of the $238.6 billion of new CMBS issued in 2005, $169.2 billion were issued in the U.S. This year's growth is even greater. Over $161 billion in new CMBS has been issued through August 31, 2006, of which, $110 billion was issued in the U.S. New issuances of CMBS mean new capital for commercial real estate development.

We appreciate the opportunity to add this summary and the attached transcript to the official record of the September 13 hearing. We look forward to working with the Committee to ensure that there is adequate availability and affordability of windstorm insurance for commercial real estate development as it is essential to the continued vibrancy of the commercial mortgage backed securities marketplace and the steady creation of new capital for commercial real estate investment.

On behalf of CMSA and its members, we thank you for leadership on this issue.

Sincerely,

Dottie Cunningham
Chief Executive Officer

Windstorm Conference Call

Moderator:	Stephanie Petosa	FitchRatings
Moderator:	Stacey Berger	Midland Loan Services
Panelists:	Deb Schiavo	Bear Stearns
	Reggie Leese	Blackrock
	Jan Sternin	Midland Loan Services
	Michael Liebowitz	Harbor Insurance
	Kathleen Dufraine	Global Realty Outsourcing (Wachovia)
	Lawrence Ceriello	Dechert
	Peter Mardinly	Belmont Investments
	John Kurtz	Marsh
	Keith Belcher	J.E. Roberts
	Lauren Cerda	FitchRatings
	Joe Kelly	FitchRatings
	Jim Palmisano	Standard & Poor's
	Dan Rubock	Moody's

Audio:

Operator: Good afternoon, ladies and gentlemen. My name is Coretta, and I will be your conference operator for today's conference. At this time, I would like to welcome everyone to the CMSA Windstorm conference call.

All lines have been placed on mute to prevent any background noise. After the speaker's remarks, there will be a question and answer period. If you would like to ask a question during this time, press star, then the number one on your telephone key pad. If you would like to withdraw your question, press the pound key. Thank you.

It is now my pleasure to turn you over to your host, Mr. Shane Beeson. Sir, you may begin your conference.

Shane Beeson:
Great, thank you. Hi, everyone. It's Shane Beeson with CMSA. Thanks for joining us this afternoon for our windstorm discussion. Without further ado, I will turn this over to our moderators for the afternoon, Stephanie Petosa with FitchRatings and Stacey Berger with Midland Loan Services.

Stephanie Petosa: Good afternoon. I'd like to thank you all for participating in this discussion. We're very fortunate today to have assembled a panel that is well-versed and very experienced with Windstorm insurance, though they might not think themselves so fortunate. We have insurance reps, we have an issuer, investors, servicers, rating agencies, and that rarely seen or heard entity known as the borrower. We also have a very ambitious agenda, so I'm going to ask your patience in letting us get to the topics and then, as was described, we will start our question

and answer period. There's another way to ask a question and that is you can email me, and that address was on the invitation; and I'll just repeat that right now. It's stephanie.petosa@fitchratings.com.

I'd like to introduce the panel, and then I'm going to turn it over to Stacey to frame the issue, and then we're going to hear from a borrower. Then, we're going to talk to some of the insurance people, and then, we're going to talk about pre-securitization issues and post-securitization issues.

Our panel—and I'll start with our borrower, Peter Mardinly. He's representing Belmont Investment Corp. They have a concentration in real estate, and they have had the fortunate experience of trying to do loans in Florida—one of the hardest hit hurricane areas. For an issuer, we have Deb Schiavo, she's managing director here at Bear Stearns, graciously hosting the calls. She is in charge of CMBS loan closings, post closing, and post-securitization matters. We also have several insurance experts with us. We have Kathleen Dufraine. She is from GROW, and she works with Wachovia, and she has been in the industry for twenty some-odd years.

We have Michael Liebowitz who is President of the Harbor Group, one of the leading national insurance consulting firms; and he represents many of the largest lenders. We also have a representative from Marsh, John Kurtz, and he is a southeast real estate industry practice leader. They are a leading insurance broker, I'm sure most everyone on the phone is familiar with Marsh. And again, he has been with the industry over twenty years.

We have several representatives from the rating agencies. We have Dan Rubock who is a senior credit officer at Moody's, and has participated on most of the MBA calls addressing this. We have Jim Palmisano who is the managing director also at Standard & Poor's in the real estate finance group. And, with me from Fitch, I have Joe Kelly, who is a senior director who works on deals, and Lauren Cerda, who works in the surveillance group. And we have two people that this business doesn't operate without, and that is investors. We have Reggie Leese from Blackrock, and we have Keith Belcher who is the managing director for JE Roberts representing the B piece buyers. And to keep us all honest, we have Larry Ceriello from Dechert who is an attorney and is going to make sure we don't cross any lines. And co-moderating with me is Stacey Berger; he's executive vice-president at Midland. He's responsible for corporate strategy, business development, and marketing activities, and Stacey is going to start the call out by framing the issues for us. Stacey?

Stacey Berger:
Thanks, Stephanie. As a result of the extensive property damage caused primarily by hurricanes over the past *few* years, the cost and availability of windstorm coverage has become a major issue for commercial prop owners. The frequency and severity of hurricanes have increased. Seven of the ten most destructive hurricanes occurred in the last two years—2004 and 2005. This has directly impacted secured lenders, including commercial mortgage banks, security originators, issuers, investors, servicers, and special servicers. CMBS originators and issuers are struggling with windstorm insurance standards for new loans; and servicers responsible for insuring the adequate property and casualty insurance is in place to protect the interest of CMBS investors on existing loans and existing portfolios.

The problem in terms of the availability and cost of windstorm insurance is most acute in the hurricane-prone metropolitan areas in the mid- and south-Atlantic and Gulf Coast areas. It is affecting other areas on the east coast and all the way through Texas. Florida, which has the highest value concentrations of commercial property in high-risk areas appears to have the most issues. The basic issue is the availability of windstorm insurance, the amount of coverage, and the associated deductible, the cost of such coverage, and the acceptability of the insurance companies. Our experts will go into all of those topics in detail. The challenge for CMBS servicers and special servicers on existing loans is: how, within the constraints of a very dynamic environment, to manage the conflicting interests of borrowers, lenders, investors, and ultimately, the CMBS trust; how to make relatively subjective decisions as to what windstorm coverage is adequate; and the most difficult question of all is: at what point is available coverage too expensive to require a borrower to secure?

One of the issues that we'll talk about is PML—probable maximum loss—and whether PML studies offer some relief to originators and servicers over the adequacy of coverage. PML studies are standard practice in establishing the adequacy of earthquake insurance requirement primarily on the West coast.

There is litigation around windstorm versus flood. This is an issue that has opened up a number of times, and the topic may have an impact on the availability of and affordability of windstorm insurance based on the adjudication of claims surrounding primarily Hurricane Katrina. The last topic that we'll address is: how the issues associated with windstorm compare with terrorism trends that we dealt with subsequent to 9/11, 2001. And the basic issue, with respect to CMBS originators and issuers for new loans and for servicers and special servicers for existing loans, is again the evaluation of availability and affordability against the interests of ultimately, the investors and the rating agencies. The major difference between terrorism insurance and windstorm is the higher likelihood and potentially *lower* loss severity of a casualty caused by windstorm damage versus acts of terrorism--loss severity in an individual property not necessarily against a much broader metropolitan area.

With that, I will turn it back to Stephanie.

Stephanie Petosa:
I knew when I was making those introductions I forgot somebody, and I did, and I can't believe it, and I apologize. Jan Sternin is also joining us, representing the whole servicer constituency. Jan's a senior vice president at Midland and responsible for managing the portfolio management and CMBS surveillance group. Sorry about that, Jan.

I thought a good place to start would be with the borrower, and that's who's trying to get this insurance; and then, we are going to hand it over to the insurance experts and have them comment on kind of the road and the path that Peter has had to take and what he's found out there. And addressing some of the issues that Stacey outlined. So, Peter, could you just describe for us where in the country you're trying to get insurance and the difficulties or the experiences you've had as a borrower trying to secure windstorm insurance?

Peter Mardinly:
The concentration of the real estate that we have is in Broward County, Florida which is the Ft. Lauderdale area. And we're talking about office buildings, single-tenant banks, shopping centers, no apartments. Our portfolio came up for re-bidding fortunately in April of this year. We generally try to push our people to try to have estimates in at least a couple of weeks, preferably a month. We made a number of different inquiries trying to get competitive bids and ultimately, literally, at the eleventh hour, we finally got a bid; and instead of it being projected at two times the increase from the prior year, it came in at basically three times the prior year for less coverage. The coverage decreased from a minimum $100,000 deductibility, or 3% per building, increased to 5%. We were fortunate--because I've been informed at this time that there's simply not enough capacity in the marketplace—we were able to get enough windstorm coverage and lost rent coverage that we did not have a severe impact with the servicer.

It did take us about three weeks after our technical insurance expiration deadline to get all the documentation in place, during which time I thought the servicers were very patient. They confirmed to us that they understood that the market was crazy. We have since that time placed an additional loan in that area and because we had an existing relationship layered with seven different carriers, we were able to obtain adequate coverage there; although, in our loan documentation, we've certainly looked a lot more closely at the language going in… in terms of windstorm and market capacity and what was reasonably available, and that's a standard that some servicer, I hope, is not going to need to interpret in the future. We hope that this season we dodge a couple more bullets and don't have the type of catastrophic losses that occurred in the prior two years.

Our properties were impacted by Hurricane Wilma, but since—with one exception—they were all built to the building standards post-Andrew, we have not suffered any significant losses that resulted in claims against the insurance. We have suffered, primarily in Wilma… The city that we're in is Westin—and I kind of joke about them—they have "Plant Police" so that every year they renew your landscaping plans and make sure that everything is planted, is healthy, etc… When Wilma hit, a lot of the things that had been healthy were ripped to shreds, so we had a large replacement landscaping bill, but that is not covered under the insurance. We also had a moderate amount of damage to the roof tiles—the barrel tiles on the roofs. Again, on a per building basis, there was not enough to arise….. to the extent of needing to submit a claim to the insurance companies.

The on-going nature of the increase has been such that we've had tenants calling us. One of our tenants is a subsidiary of the Berkshire Hathaway Group, Warren Buffet's company. It's a real estate brokerage firm. They said, "Our insurance did what?!" And they said, "Well, we've been acquired by Berkshire Hathaway, let me see what we can do about it," but they came back pretty much saying there's some people we can talk to, but you seem to be about where the market is. I've since then confirmed with other people, and it's a wide variety of variability. It seemed to me that some of the companies, if it's a single property and a single tenant, are not getting hit with large increases—where there was already factored in if they bought it. Others are. I've heard as high as four times the prior year's insurance cost. At this point, what I'm being told, shortly after our experience in April 2006, that the market deteriorated further, and there simply wasn't enough capacity so that if you were buying, for example, $100 million worth of property

insurance, you might end up only being able to purchase $20 or $30 million of wind coverage. You could get the other property coverage, but the wind coverage just simply wouldn't be there. If you already have a program, and you're re-bidding it, you're going to get first crack at it next go-round. So, part of this may be just sort of luck-of-the-draw in where you are in terms of your renewal date, and how the forecasters are forecasting your particular weather for the year coming up.

The other factor that we're looking at, obviously, is whether or not there's going to be any kind of help from the state of Florida . I've spoken to some members of the Florida legislature and the probability that they have is that their state fund—which is for homeowners—was so badly hit that they're still trying to rebuild that, and there's nothing that I've been made aware of at this point, as far as legislature, that would help with any type of commercial ins risks; even though what they're experiencing is with the apartments and condominiums—that insurance market has also gone through the roof as they say.

So, the issues that I think that we're looking at is what can we do to decrease our insurance costs by using probable maximum loss types of analysis that we need to persuade the servicers are adequate given our post-Andrew building code. What type of availability is there out there in the market? Just simply, can you buy it? Not is it reasonably available. If the hurricane season stays good, and the rates are staying where they are, there may be other people who open up a little bit; but right now, the insurance people are telling me that it's a very much contracted marketplace, that the capacity is not there to insure, that there's going to be more issues of self-insurance, and possibly situations where, in order to acquire insurance, that this is not something the servicers are going to be happy with perhaps without having somebody become recourse on this, to a certain extent, or posting some other type of collateral if there's going to be self-insurance issues.

Our particular business model, with the types of properties that we have, have leases with pass-throughs, so the big hit on the insurance, at least theoretically susceptible at pass-through. There's only so much rent that you can charge for those tenants in place; some of them are having problems making payment—or will have problems—as the additional costs are passed through. The other issue that we get from a cash flow point of view, is that you need to pony up the cash up front to buy the insurance. All of our loans have a prohibition against financing insurance. Or have insurance escrows. We will be knocking on—to the extent that we end up needing to put a huge amount of cash that was unexpected in escrow for the servicer—we will be knocking on their doors indicating that there was a change in circumstances unreasonably,...or reasonably not foreseeable at the time of the loan because many of these escrows are non-interest bearing escrows, and negotiating out those types of circumstances with the servicers. It would otherwise be a windfall not anticipated as the servicers come around to figuring out that the insurance costs have increased dramatically and start increasing the escrow amounts, you're going to find that your cash flow suffers because: a) you had to buy the insurance, and b) you have to pay for it. So it's like going to the closing table and ponying up your escrows again. That's significant in our case.

Stephanie Petosa: Peter, because you touched on a lot of topics that I know the insurance folks are going to comment on, did you want to wind that up, or can we ask them to respond to some of them?

Peter Mardinly: No, I've basically pretty much covered the points that I wanted to make.

Stephanie Petosa: Well, thank you very much. I wanted to talk to Kathleen and John. I know that you guys said that you were going to split up some of this, and I know one of the first questions that Peter brought up was availability. I'd like to ask that you make sure before you start speaking to tell us who you are so that the rest of us can follow along.

Kathleen Dufraine: Did you want to start?

Kathleen Dufraine: Actually, John do you want to start with availability?

John Kurtz: Sure. I can start with kind of the pricing issues and the availability issues because they're somewhat linked.

I'm John Kurtz with Marsh. It used to be that property markets, property insurance markets would cycle every 18 months. They would harden up, prices would go up, coverage would become restrained, and then soften up. What we've seen in this last cycle is a set of circumstances that are likely to create a stickiness to what's going on. That really derives first from two events that took place prior to Katrina. The loss models that the underwriters use to estimate their expected losses from any given storm event or any event, and really this issue is windstorm *and* earthquake based … But the loss models were revised following Katrina because it was determined that the loss models inadequately estimated the loss potential or the loss expectancy in the storm. They were revised upward *dramatically*, in some cases 40%. In the cases of hotels, cost of hotels, perhaps as much as 100% in the loss expectancies. So what this did to the underwriters, is say, "Oh, my gosh. We have a lot more at risk than we thought we did."

That, then, secondarily created pressure from regulators and rating agencies as loss expectancies grew, the financial solvency question came up, and everybody has been very, very concerned about whether or not an insurance carrier can actually meet its obligations if the worst happens. There's been a great deal of pressure on increasing reserves for losses, making sure that you're adequately capitalized to meet your obligations under the insurance contract, and the purpose—and to put a little bit of perspective on it right now—most of the insurance market is underwriting not to the scenario of a single loss—a single loss doesn't necessarily scare them a great deal. What they're underwriting to is essentially two storms and an earthquake in the same fiscal year for them. So there's a lot of pressure on the underwriters to get adequate pricing and to restrict their capacity; and this comes to the capacity issue.

We've seen carriers try to reduce their exposure—the number of policies they're writing and the limit they're putting out on any single policy—because of this recognition that they might be overexposed, or overexposing they're capital—in any given geography. We've seen substantial

capacity directed away from Florida, away from the Gulf Coast, to a lesser degree away from Cal-quake exposure, and into the Midwest where people are a lot less concerned about the catastrophic loss exposure. Right now it's fairly easy to get a pretty decent deal on insurance in Des Moines. You generally can't say that, as Peter has pointed out, in Ft. Lauderdale, Broward County area.

The new capacity that has showed up in the market place *has* been re-insurance capacity, and it's been used up feeding the hunger that insurance carriers have to get rid of risk in their own books so it hasn't bled through to the ultimate consumer, buyer of insurance. They're not seeing increased capacity in the marketplace yet because that capacity is just not getting beyond the re-insurance transaction. Capacity—Peter alluded to it in his comments earlier—he renewed in April of this year, when the full effects of Katrina had only really started to be felt, and capacity has continued to erode during the year. Carriers have basically filled up their buckets and said, "I've had enough. I'm done for the rest of the year writing insurance in Florida or in the Tampa area." And some of that capacity will get freed up at the first part of the year, but we'll likely see the same event take place; capacity will get more restricted as the year progresses.

Bottom line, we're liable to see this market continue for a period of time, these conditions continue for a while. We may see more capacity return to the marketplace at the retail level at the prices that are being asked right now. People may begin to—underwriters may begin to believe that they can make a profit and start to commit more capacity at the rates that are available right now. If we had a crystal ball, our estimate is that we're probably looking at a two- to four-year period before this market stabilizes, probably a one- to three-year pd before capacity problems start to be alleviated in the marketplace. On the bottom side with deductibles: probably not a lot of relief in deductibles unless the loss models start to prove more accurate. Then, we might see some practical relief on the deductibles side.

It's something that's not going to go away quickly. It's a very difficult time for the underwriters right now to try to figure out what to do next, and no underwriter is being criticized right now by their manager for not doing Florida business.

Stephanie Petosa: Thank you, John. Kathleen?

Kathleen Dufraine: Yes. This is Kathleen Dufraine with Global Realty Outsourcing. I am an insurance professional and I also work in a CMBS servicing shop. Interestingly enough, lenders and servicers have actually been battling the same issues with availability and affordability with our forced placed program primarily in Florida and in the Gulf states. This really is the first year that we've seen such drastic measures.

Just to explain, forced placed coverage is actually obtained by the lender/servicer, and it's obtained to protect their security interest in the property when the borrower has failed to do so; and because of what you've been hearing, the borrowers have had difficulty in securing this coverage so a lot of risks have been force-placed. This is coverage that is protection for the lender only, and it is at the borrower's expense. Of course, there is provisions in the loan documents that obviously allow for this transaction. With lenders and servicers, this really is our safety net. Most of the major servicers have seen very large triple-digit rate increases. I'm

talking 400%. This obviously affects the financial performance of the property, and it is right in line with what we're hearing from the borrowers in trying to obtain coverage. Some lenders and servicers have actually experienced moratorium where there carriers were not writing in certain pockets. Some carriers even pulled out of the Florida market entirely in the middle of this season. It's really been a challenging season for lenders and servicers that use forced-placed insurance programs.

Another important point that I'll point out on that program is that many of the servicers have a $25 million total insurable value limit; and we've really not had an issue with this limit outside of this year. Historically, most loans forced-placed are in the million to $10 million TIV range, but this year we've seen very large props not be able to secure proof of coverage. So our force-placed agents have had to go out to the external market to try and find coverage for these exposures; and you can imagine that paints the picture of adversity. These are large exposures, and it's nearly impossible to get the coverage. Even if they can get the coverage, many times it's cost-prohibitive. We've really felt the pain this year in our forced-placed program. This really was the first year, and I think it's just indicative of coming off of two very bad hurricane years.

Just to change gears, just for a brief minute, I'd also like to point out that Citizens have been used quite a bit for commercial properties this season, and that is because of the capacity issues that we've heard so far in this call. There are generally a lot of questions about citizens. They are the residual market group in Florida, aka, the windpool. And a couple of things I'll point out: 1) they are not rated; 2) they can be named perils only, so the borrower has to purchase wrap coverage to get all of the loan doc. requirements covered, and it generally take six to eight weeks to get certification of bound coverage. So, I'll leave you with their website. There's a lot of really good information on this facility on their site, and that is: www.citizensfla.com.

[Unidentified speaker]: They don't offer loss of rent or business interruption coverage…

Kathleen Dufraine: That's correct. It needs to be wrapped. That's one of the challenges with Citizens, and that's not the only coverage. A lot of times you can't get ordinance and law, a lot of times you can't get all the types of risk that you need, so…

[Unidentified speaker]: You need to build wrapped insurance into their form.

Kathleen Dufraine: Exactly. So it needs to be wrapped. There are companies in Florida that actually specialize in wrapped coverage, if you will, and that's what they do. They'll wrap all the different other aspects that you need around that Citizens policy.

Peter Mardinly: When do you find something is cost-prohibitive? I heard you use that term. This is Peter Mardinly. What is the standard that's used to look at that?

Kathleen Dufraine: Actually, Peter, a lot of times we work with the special servicer in the deal…

Peter Mardinly: Right.

Kathleen Dufraine: ...and we look at the financials of the properties. It's *really* handled on a case-by-case basis.

Stephanie Petosa: Okay, thank you, Kathleen. And we have one more insurance expert that we're going to hear from, and that's Michael Liebowitz. We've kind of covered cost and availability...

Michael Liebowitz: I think one of the interesting points is to hear from the marketplace from Marsh, you know, what's going on in the sense of what coverage is available, what the insurance marketplace is doing with respect to limiting what they're putting out...the market pretty much being at a place where they say, "We're pretty much filled to capacity for the year." I think that, based upon the picture that was painted, you know, it's a kind of scary time for the lenders; and I think that the one thing that lenders have to do on the origination side should, in turn, help the servicing side because, I think—while it may be painful now—I think you should put a clearer picture on what the market can take and what they can expect in the loan docs. I think it needs to be crafted in such a way that the servicer is in a good position and not in a position like they were post-9/11. Terrorism was obviously not discussed prior to 9/11, and then we had a whole different world which really put services in a terrible position.

Actually, to take a step back to Peter, from the borrower's perspective, he actually sounded like a pretty rational borrower. And he actually is *very* rational compared to many of the borrowers that I deal with on a day-to-day basis. In understanding, he brought up one key point and that was some other enhancement if full wind isn't available, you know, whether that be some type of recourse or that be a possible letter of credit... something of that nature to basically, you know, put the lender in a situation where, you know, the lending market a year ago was used to basically having full limits on wind and full coverage, and now the lending market is looking at being in the position where you have, just for arguments' sake, a $50 million building where our borrower is coming back and saying, "Hey, the only thing I can buy is $10 million or $20 million worth of coverage."

And just the reality of that risk profile has just changed. It's unlikely a building actually being totally destroyed by a hurricane; you're in a position now where a lender is in the business of taking risks that insurance companies are afraid of, and that's really a scary thing for a lender to, you know, basically deal with, and really why you have to really take every deal that a lender is doing today on a case-by-case basis.

I think you've got to factor in, take a lot of factors into it, you have to basically look at: 1) how much coverage are you going to get; what is the land possibly worth, and you know, is that going to give you some comfort that you've got a great location, and even if you've got damage to a building, you do have land that's valuable,... and you have to look at the sponsor and, you know, what is their situation in terms of are they deep-pockets and you know, are we going to recourse this, and does that make sense? Or if their pockets are not deep, are we going to take a lot of our credit? Well, a borrower that doesn't have deep pockets, probably is going to have people do a letter of credit anyway .

So you've got a lot of these scenarios that we're really looking at today that we're looking at on a case-by-case basis, and frankly, what's really a little unusual, we've actually had some deals with some of our lenders where we haven't done them. Where we've basically looked at all the factors, and we just could not get to a point where we were comfortable where we were 1) doing what was right as a prudent lender which is always how you have to think; and 2) that we thought that we would have a problem when we went to market where we'd have either where we'd be buyers or rating agencies looking at the deal and saying, "You know, you have a $100 million building, and the borrower wants you to take $10 million or $15 million of wind coverage which includes business interruption but then, that limit, what do you really have?" So, you know, we're in a really tough position now, and unfortunately, I don't have all the answers.

I get this call every day - at least that's what it feels like, whether I've got a deal in Florida or we're looking at deals in Mexico, the Caribbean, in very difficult places - and you know, I don't have an answer for them. The borrowers are getting smart. The borrowers are basically shopping their deals, in a lot of respects, on what a lender is going to do on insurance for them. The borrower will say, "Hey, listen. I've got Lender A that's going to allow me to, you know, have $25 million wind on a $100 million building, and they're going to allow a 10% deductible…," or whatever it may be; and they're shopping deals that way. We've tried to stay tough, …. I would say responsible and prudent, in terms of what kinds of conversation we're going to get into; and then you get into, which is another topic that I know others are going to speak about, and that's the PML, which is, you know, of course a totally new, I guess methodology to use in terms of how much windstorm coverage we're going to take.

Obviously, in the quake market that's been a standard, and it's been a good standard, and it has worked, and it's just a matter of whether the PML's—how qualified they are, how good they are, and you know, how much credence you want to give to a PML with respect to the wind. I haven't seen a lot of good PML studies, but I think there's something…that you've got to use something as a basis. I would not.. I'm not going to be an advocate for, "Okay, we'll take the PML;" but I think if you use multiples of PML's, to be conservative, and you say, "Okay, if I have a problem, that's a loss of $5 million, and last year the property incurred $3 million dollars worth of damage, and I guess that $5 million sounds pretty credible… but insurance is about the unknown, so I think you've got to basically use multiples of those PML's to show the market and show the investors you're being very conservative and that you're really putting yourself in a position where you've got to have something, and Katrina was something we never thought was going to happen, and it happened. And 9/11 was something we never thought would happen, and it happened. So, I think you've got to use multiples for that and you've got to be conservative, but I think the market can get to a point—and this is purely my opinion—where it doesn't have full wind, but it doesn't also have, what I think some of the borrowers think that they should have.

And I think you always need to be in that conversation of, you know, going back and forth, and trying to figure out, you know, what's logical, and what makes sense, and I think when responsible heads get together and come up with a scenario, and everybody sits around and thinks about it, and it makes sense to someone, I think it can happen without it being full coverage. But I think you really have to go through the exercise, and I think every case will have its own merits, and I think that's the only way to determine it.

Just one other point I want to bring up on premium finance agreements because I think, that's a ...Peter might have even brought it up before, talking about the cash flow, and it's an understandable issue from a borrower's standpoint to say, hey, if my premium was $100,000, and today it's $400,000, and you as a lender are going to say I have to come up with $300,000 out of nowhere,...I think it's a fair point for them to have that request; I think the problem is that the finance agreements basically give power of attorney to the finance company to basically go and cancel that policy. They can even do it on a retro-active basis to protect themselves, and they have no obligation to notify a lender at all. So, I think that's a big prob. I can tell you, we've done thousands and thousands of deals, and maybe 1 or 2 with a lot of financing, and we had a lot of triggers associated with it where we thought we were protected, you know, had them put down a lot of money, we had some borrowers that maybe had a relationship with the finance companies, and they agreed to notify the lender—things of that nature—so I think that again, it gets back to a case-by-case basis, but to say that finance cases are not a slam dunk to say, "Okay, we can take it." We have to understand the need and why it is there, but you have to understand the downsides are real, so...I think everyone just needs to think about them before they allow them.

Stephanie Petosa: We've heard that from servicers, or that's being suggested. Perfect segue—they keep talking about the lender, and that's you Deb. What are you finding?

Deb Schiavo: Michael's actually done a great job of summarizing everything that we're experiencing and how we're trying to box all these issues. I think everybody is dealing with a lot of patchwork solutions. Michael mentioned putting up cash reserves, letters of credit to supplement higher deductibles and lower coverage limits,...so we're looking at that. You look at the significant land value that you have to allow less than replacement cost which is something we've done, as well.

We've had some pretty good success on acquisitions where you've got motivated buyers and sellers where you've gotten the seller to agree to keep the insurance on a property after the buyer purchases it which at least gives you a little bit of breathing room, and that's helpful. We've had some large institutional buyers which are trying to establish captive insurance companies that will carry some limited exposure in a blanket policy to reduce premium costs. There's a lot of creative solutions that people are trying to work towards, and the question is what's going to work when you go to try and execute on your deal and what's accessible to investors.

We have taken a look at some PML studies. We've got one that is in the works, getting approval by the senior lender, a bunch of "mezz" lenders, we've got a master servicer taking a look at one. It's a little bit easier to get your arms around it because we closed with a huge blanket policy and basically agreed that we would consider lower limits subject to a PML, and as Michael mentioned, the limits that are being proposed are a significant multiple of the results of the PML study.

I'm much more concerned about the individual property PML studies—trying to get behind them; trying to understand what's been built into the analysis; how they really factored in the engineering report; you know, the actual property components. And so far, that's something

we've really only considered for some balance sheet loans and have not gone down the road on securitizing a loan with that kind of a profile.

I think we're all hoping that it's going to be a much better market once this hurricane season ends, but I think we're still going to have to work on patchwork solutions to try to minimize the impact on our execution.

Stephanie Petosa: Have there been any deals that, you know, as Michael explained, that they just couldn't get to, they couldn't get the coverage?

Deb Schiavo: Not so far, but I think we've been fortunate in that we're dealing with large portfolios where you already have significant blanket limits, and we're really talking about using a PML to justify a lower limit; but it's not the *same* as when you're talking about an individual property, and you've got a much higher risk profile there. But I am sure that we're going to come across a deal that we can't do.

Peter Mardinly: Are there any servicers who have had a large portfolio where, after the fact, they're dealing with a PML and a borrower coming to them saying, "I'd like you to come and take a look at this," where it's not written into the documentation?

Stephanie Petosa: That's Peter, right?

Peter Mardinly: Yes, it is.

Stephanie Petosa: Jan, Have you had any? Jan Sternin with Midland.

Jan Sternin: Hi, it's Jan Sternin with Midland. We have not yet had an opportunity to deal with a PML coming in where in a prior life we had coverage. In fact, we really haven't had an opportunity in any level to work one-on-one with any of the PML studies.

Deb Schiavo: And this is Deb, again. And one of the problems, you know, I think we saw was when we looked at one of the PML studies—well, it was called a PML study, but it looked like it had been produced for the benefit of the insurance company to insure that they were not going to blow through their deductible. So, you know, and maybe some of the insurance folks can comment on that. It really did not appear to be the kind of study that I would have expected as a lender.

Michael Liebowitz: Yeah, no. You obviously have to read the PML and see what it was.... Who did the PML, number one, and number two, what it was for, and that is true that insurance carriers will basically look at that. You've got to really get a third party, and I think the evolution of using a PML for wind is probably going to have to go the way of quake; we've basically have dedicated third parties that are going to do these PML's.

We had...interestingly enough, we actually had a deal recently with the lender, and the lender said to me, "What do you think about taking a PML?" And it was a hundred million dollar property in Florida on a hotel, and I said, "Well, my problem is that the PML is probably going

to come back with like a $3 million number because they all come back low." The PML actually came back at about thirty million; and I was shocked. Then I read through the PML, and it was a very well done PML, and they basically used the methodology of—I forget how they categorize the… and actually that's of a category five hurricane, so you know, the qualifying points of how they used it were terrific, and I think it was very conservative. The funny thing is I was actually at that property before; it's a hotel, and I stayed there, and I think they were very conservative, so I think it was a very good PML. The only thing that worries me is that I had been preaching for the last three or four months that you had to use multiple PML's, and then all of a sudden I found a PML that I liked , so… (laughs from audience)

Reggie Leese: This is Reggie Leese, and from an investment perspective, can you just give me a sense of the PML process, and how it works in a wind situation? And is there a consistent approach in the marketplace today for looking at those studies and are they being, you know, are the PML's—essentially looking at the same type of risk per study? Or is it different risks? Are we looking at category five versus category three? Can you shed some more light for the investor on how the PML would work in this case?

Dan Rubock: Yeah, this is Dan Rubock from Moody's. We've actually seen a number of PML's on proposed on a wide variety of loans in properties located from different area—from the Caribbean to Florida to other areas of the Gulf Coast; and almost invariably they have been problematic and quite deficient, although—just like any bell curve—there are some that are below the median and some that are above the median, but we're really looking for quality that's a number of standard deviations above the median *if* we decide to go this approach.

The thing about PML's, even for earthquakes,…Even earthquake PML's do not have a solid industry standard. The MBA, for instance, has been working for a couple of years actually on this very issue, and there's been some very vigorous debate on even earthquake PML's. Now, I can go into why earthquake is substantially different from hurricane.

The earthquake PML's are a legacy from many, many years or decades ago. Many dollars, federal dollars, were put into some quite interesting studies, studying exactly how buildings react to earthquake forces, but yet the very definitions that are used in PML's are very variable. And PML's that we use can serve a function in earthquake, but it's not the end-all and be-all; and we do not say, "Nothing is required," or with a PML, with a concentration of properties in California does not mean we won't somewhat adjust the levels to reflect the risk. But PML's, even for earthquakes, do not address all the problems.

PML's for earthquake could be even better. For instance, they use a 475/year standard, but if you overlay the rating grid over a 475, that may not be adequate. For instance, the default grids on a double-A bond or a triple-A bond are 1 in 10,000 in ten years, but if you're using a 1 in 475 type of test with an expected loss at the median instead of a 90% confidence level, you have some issues.

For instance, one of the debates in the MBA committee is we may want information embedded elsewhere where the maximum credible earthquake rate—which is sort of like the 1 in 5,000 a

year rate—which might be more consistent with a high double-A, triple-A type of risk that we really want to look at.

The issue that we have seen in PML studies is that there are sometimes, first of all, there's very little data to support loss figures…

Stephanie Petosa: That was the question that we got from the audience, too: how much empirical data is there to support PML's.

Dan Rubock: There really isn't, and sometimes, some of the PML's use non-generic construction data rather than property specific construction data. An issue for borrowers is going to be to get a PML that a rating agency, or that a prudent lender, can trust; and they cost a lot of money. So it's going to be a cost issue, we also have an issue of staffing within the various lender—who is going to review all of these PML's in an area that yet… does not yet have industry standards? I think, you know, looking at some of the PML's that we've looked at, for instance, you could hide a lot behind lack of definitions and lack of clarity in definitions.

For instance, …there's the short-term versus the long-term hurricane view. If you use some of the modeling firms recent bump-up in expected losses, we've got …we've seen some of these PML's that have been proposed that use the long-term view which is based on the forty-year or fifty-year history, but it could be—and I'm trying not to get too political here—but maybe global warming is changing the figures, and that's why various modeling firms have a… use a more conservative—what they call—the short-term view.

Some of the PML's don't consider storm surge or demand surge for construction costs. There are all kinds of things that you really have to question, as they say, "The devil's in the details;" and these are extremely detailed things. And what happens, really, is that our ratings have been based traditionally on market volatility, real estate fundamentals, you know, dirt kind of things—not insurance things. Insurance guys traditionally have worn their insurance hats, and we've completely relied on them.

Now, that's not to say we don't have to adjust to the times and be flexible. Of course, we do, and that's what we will be working with the industry to perhaps go down this path and look at the kind of standards that would be solid and acceptable to us, but we really have to think long and hard before we sort of take any kind of study off the shelf that we don't really know what goes into it.

For instance, it would be interesting to have studies do back-studies of seeing how the predictive methodology works. Now, most PML's use a probabilistic approach rather than a deterministic approach, and so, with a probabilistic approach, you know, you have to maybe back-test the particular storm that is one of the things like the cat. 3 storm that may have hit rather than the category 5 because probabilistic approaches have a whole almost Monte-Carlo kind of array of things that go into it.

So, you know, we have, to summarize, for PML: there are no industry standards—we really have to firm that up; there's little data to support some of the PML's of great questionable values; it

really depends on what kind of firm you use—we've talked to some very, very leading firms. PML's do have their use. For example, insurance groups, I think in many rating agencies, use them, but the reason that they're okay in the insurance field is that you have the law of large numbers.

When you're using a huge portfolio, it's a little different and maybe you can be a little more fuzzy on the numbers. When you're dealing with a binary one property, you have the sort of measure of the, uh, measure of error can be very, very great. It could be, as Michael was saying, a multiple, but you know, like Bob Dylan said, "How many multiples are blowing in the wind?" (laughs from audience) And you really have to say, if something comes in at three million, is it five times the correct multiple, or should it be even fifty?

And so there are a lot of issues. I think, you know, when a lot of people, smart people, put their minds together they can come up with a solution, but a lot has to be done.

Stephanie Petosa: I think we're getting some comments from the audience, too, you know. I don't think there's a lot of trust, and I think it goes hand-in-hand with the knowledge and education about PML's.

And one of the questions that's come up, that I was hoping one of the insurance folks could field, is: what happens if you are under covered? I will read the question exactly how it came across:

> Explain the implications of having insurance coverage *below* replacement cost if there is total casualty. Example: if the replacement cost is twenty-five million but the property only bound ten million of windstorm coverage, how much will the insurer pay if there is a total casualty?

Stephanie Petosa: John or Kathleen do you want to try?

Kathleen Dufraine: Sure, this is Kathleen from Global Realty.

It all depends on, first of all, if there is a co-insurance clause, obviously, on the policy; but also, if you are drastically under-insured, you may not even be able to get to replacement cost. All claims are settled on an actual cash-value basis, okay? The insurance company does not settle the claim with you on a replacement cost because they don't want you to put the money in your pocket and not restore the property.

The object of the game is to put the insured back in the position they were in prior to the loss. So once the property is ninety, ninety-five percent restored, you can make the claim for the replacement cost, but that's the key element there. If you don't have enough money to restore the property up to ninety to ninety-five percent, you're not going to be able to replace your claim for replacement cost.

Now, you know it's hard to answer hypothetical questions because you're not on the ground, you know, I can't tell you where you are on a claim or what aspect of the claim will not provide coverage, but theory-wise that is the answer to that question.

Go ahead.

John Kurtz: I'm sorry, this is John Kurtz at Marsh.

The most basic level in answering that question, if you are severely underinsured, and there's not a co-insurance claim, and there's not a question about the validity of the client, you're basically looking at policy limits payment. That will be all that the carrier is going to pay, and they'll basically wash their hands of the event, and walk away; and they're…

Kathleen Dufraine: Right.

John Kurtz: You've got to cash in on that check.

Kathleen Dufraine: Which is exactly my next point, was that in the event of a catastrophe, the insurance companies will settle, and that's very problematic to a lender because as you know the loan documents say that the lender has control of the proceeds.

If the insurance company and the lender end up settling, either because they don't have enough funds to restore the property or because they're arguing about the amount to restore the property, now, suddenly, there's a lump-sum distribution, and the servicer or the lender has to decide what to do from that point on. So it could be very problematic.

Michael Liebowitz: Yeah, I think the root of the question was also geared towards, you know, the exact scenario of wind. Let's say I've got a $25 million building, and I decide to buy less. I decide to buy $10 million. The policy is properly set up without a co-insurance clause, and it's pretty much set up on a loss limit basis, the carrier will pay up to that limit of liability without a penalty as long as it's set up correctly where the carrier understands that it's a $25 million property, they've rated it based on that, and the borrower elected to buy less on the loss-limit basis.

Then, if you do restore, they'll pay up to the maximum available under that policy that you've purchased, and if you obviously want to walk away with proceeds, all claims are adjusted on an actual cash-value basis. And I think that that's probably what scenario borrowers are going to have in the end when they're basically electing to purchase less. We obviously on the origination, on the servicing side, the lender—in the event that they choose to allow purchasing less—will of course make sure that there's co-insurance, a waiver of co-insurance is provided, so you don't have a co-insurance penalty and aren't in violation of insuring for value.

Stephanie Petosa: Keith, can you tell us from a B buyer's perspective, what you're looking at when you're looking at the deals?

Keith Belcher: I sure can. Again, this is Keith Belcher with J.E.R., but first, if I could go back just quickly to the PML discussion because I think, as Reggie started to touch on, the investors and the B piece side have an opinion on this, and I'm afraid that it's not necessarily going to be the cure-all—and in fact, from our perspective may be a negative development if it certainly

follows the path of quake coverage where we end up with study levels coming in at a certain threshold that allow the waiver of insurance entirely.

And aside from all the technical aspects, I just think the concept is problematic as it only leads to shifting risk that the insurance companies have priced effectively, in some cases, to the lenders on the basis of a study. And on one hand, you have insurance company professionals pricing this risk; and on the other hand, a service provider providing a study that allows manipulation of coverage levels and shifting of risk to lenders. So, I guess that's my editorial on the PML side.

Stephanie Petosa: And just to let you know, because I'm getting a fair amount of emails—and I'm hearing consensus out there, too—people out there are either not trusting it, or you know, just not understanding it, but just not having a great deal of trust.

Keith Belcher: Right.

Joe Kelly: This is Joe Kelly with FitchRatings. I agree with that point.

One of the things that we came across—over the past few months we've done extensive research on PML studies, and we've read many of them—and I'll echo a lot of what Dan said. They vary greatly in terms of how they're done, and you can tell a good report just by the first page when they list out their scope limitations, and Dan touched on a few of those things like demand surge and storm surge, you know. I've seen reports where demand surge and storm surge are not part of the report, and to me, that's absolutely meaningless without.

Demand surge, for those of you who don't know, is basically the fluctuation in construction costs, materials, labor,... that could be experienced in a certain area given a run on that type of material and labor. And also, the storm surge aspect of it for those properties that are directly on the coastal area—I mean, that's where a great deal of the damage can come from.

So, that said, there's a varying degree of, I think, quality in the reports, and what I think the industry needs is some type of standardization—or movement towards standardization—if we are in any limited capacity going to accept these reports.

An example of that would be what the Florida Hurricane Commission does for the residential market. There are four, currently four vendors who are approved by that commission, and in order to be on that approved list, they have to submit their models on an annual basis. So they're constantly tweaking their loss models based upon real data, and unfortunately for hurricanes, but fortunately for this exercise, there is a lot of new fresh data that can be imported into these models to make them more accurate. So that is the positive on the horizon, but I think we all agree right now that it's certainly very early in the process, and I don't think we could get totally comfortable with accepting PML's across the board. It's certainly a case-by-case kind of thing.

Peter Mardinly: This is Peter Mardinly. On just a quick note: the experience we had with the Florida Bartley barrel tiles,... Basically, there was so many tiles ripped off of so many properties in Florida that you just couldn't get them, no matter what the price. And here we are

about a year after Wilma, which was our event, and we had finally secured them at a rational price; it's still a high price, but it's just taken that long.

Stephanie Petosa: Keith?

Keith Belcher: Yeah, I'm sorry. I didn't mean to extend it overly long, but I just think that conceptually at the end of the day, it's going to lead down a path of shifting more risk to the lenders based on a service provider as opposed to insurance company professional prices. I'll move on.

With regard to our underwriting requirements in talking to other B piece buyers, as well, I think we've had two issues come up. One is on the new transactions where we're seeing some, not a tremendous amount of wrap variances being requested for certain properties with compromises on the level of insurance deductibles, etc., and those clearly have to be considered on a case-by-case basis; and I think people have done that. Nobody is anxious to agree to a variance from the full coverage, but up front on new pools, that is becoming part of the process to a very limited degree.

A second is in the actual underwriting process for properties that have yet to be fully re-priced, and our analysis in obtaining the current insurance certificates and coverage and re-underwriting that asset to provide for the 200, 300% increase and the impact that that has in our underwriting of that asset and the pricing of the transaction. That has led to, as you would expect, higher stress on certain assets and the loan kick-outs that you usually see, I think, have included a number of these loans that have yet to be re-priced. And the discussions with the issuers and ultimately down to the borrower have… those discussions have increased. I don't think that B piece buyer community at this point has a manual with a matrix of exactly what the agreed upon requirements are with respect to any variants. Obviously the strong preference is: we're not in the equity position, we're not getting rewarded on the equity basis, and we shouldn't be taking any of the insurance risk.

Stephanie Petosa: I think you'll get a lot of agreement. I'm getting that through my emails, that's for sure.

We were going to move to post-securitization. I know we still have a bit of pre-securitization, but we're kind of running out of time. I wanted to pose a question that can be fielded, …we're moving into the servicing area, so I think this is where servicers are going to find that. And the question is:

> How are others dealing with blanket coverage? Are borrowers disclosing all the information about what else is covered in the blanket? How do you know after accepting a blanket that the borrower has not added more properties under the blanket that would have affected your decision?

I'm seeing a nod across the table from Deb. Have you..?

Deb Schiavo: Oh, well,…

Stephanie Petosa: How you feel about blankets, and then, Jan, what do you… You guys are going to find that out after you get that loan in the house.

Deb Schiavo: I guess on account of pre-securitization, it's very difficult to get borrowers to release a schedule of all of the policies that are covered by a blanket policy. They resist that all the time. So, you know, some plans we get; sometimes we get something not quite like a full schedule, but maybe we'll get them to tell us how many properties are in a tier one zone and what the insurable values are. It's not easy to get that information.

[Unidentified speaker]: Pre-securitization. I can't even imagine what kind of luck you're having…

Deb Schiavo: Yeah, so what kind of luck are you having post-securitization?

Michael Liebowitz: It's Michael Liebowitz. I concur with, you know, what Deb said. The only thing that we've done in some larger fields where we've had concern about knowing the borrower, knowing the other assets that they have, we've put in some proximity language within the loan agreement that basically says that if they purchase assets with certain radiuses that they've got to get approval from the lender. So that's something you can think about to protect yourself.

Deb Schiavo: And we had one situation where we gave them, you know, I think a ten percent increase above what they closed with before they would need lender approval to add any other properties in a tier one zone, so….

Stephanie Petosa: Jan?

Jan Sternin: Stephanie, we have also seen situations as the blankets have been coming in with greater frequency, that it is difficult as everybody mentioned to get the detail of the properties that have been covered under the blanket. So what happens is two-fold: first of all, it's a big give and take back between us and the borrower which kind of butts you up against your insurance due date and your renewal date, and it gives us pause and a lot of concern.

Secondly, we quite often have to come up with an agreed upon value that basically governs the blanket because, up to this point, you don't always know what's included in the blanket underneath it. And to that point, we are seeing more and more of these just as we did back when we went through the terrorism thing. It's a very similar situation.

Stephanie Petosa: What about also finding that the borrower has agreed, you know, I'm going to get this much coverage, but then, by the time the loan closes, they haven't gotten that much coverage? I mean, 'cause that's another time, when you're going to find that.

Deb Schiavo: Basically,….

(in-room comment)

Stephanie Petosa: That's not *finalized* though.

Deb Schiavo: Right, and…

Stephanie Petosa: … said they won't close the loan.

John Kurtz: We won't close the loan unless we've got satisfactory insurance coverage.

Deb Schiavo: Right, and… Stephanie, we won't be considering the renewal process completed until we get what we've agreed upon with the borrower and the appropriate documentation.

Stephanie Petosa: What else are you contending with out there? As a servicer? You mentioned a lot during the course of the conversation.

Deb Schiavo: Right, and I don't want to be redundant in what we've already discussed 'cause I know time is valuable right now, but let me just say that if you take all of the issues that all of the experts have discussed previously—whether it be the deductible limits, cost of the coverage, availability, blankets, financing, effects on properties, NOI—we're dealing with that whole combo platter of issues from a servicer perspective, and what the servicers are having to do is basically evaluate each loan renewal on a one-off basis because you're usually contending with multiple issues. How we address this, and what we.. And we're not getting the coverage we'd like to see, and we're not getting the coverage that was in place last year at this same point in time.

So what happens at that point with those one-off loans where the coverage is not meeting the prior requirements, and certainly then doesn't meet the loan requirements, *is* we're becoming interactive with our specials and with our deed holders to try to come to some medium of where we can come to some level of comfort. And there's a lot of discretion in loan documents these days post the terrorism issues we faced that put some of that responsibility on the special servicer now.

And even though the loans aren't being transferred—I'm not saying that—the conversations are heightened, and they're often. And that, kind of in a nutshell, is what we're seeing and how we're handling what we're seeing.

Stephanie Petosa: Thank you, Jan. One constituency that we haven't heard from officially. I mean, Dan talked about PML, but I wanted to get the opinion of rating agencies and what they're looking at when they're rating the deal. Jim can you comment?

Jim Palmisano: Well, I mean, our criteria has not changed with regard to windstorm insurance. We still expect to see it.

Stephanie Petosa: And this is Jim…

Jim Palmisano: Oh, I'm sorry. Jim Palmisano from Standard & Poor's.

And we still do expect to see it; although we are realistic, and we understand the problems people are having. PML's may be one of the solutions that we'll look at, but as my counterparts have pointed out, the reports are kind of spotty in quality and inconsistent.

The other thing that we're looking at is sizing it into the loan itself. When we see a loan that doesn't have adequate insurance, we may deduct what we believe the deficiency to be from the value of the property before we size it so that we are basically in a liquidation, there would be money to restore the property if it was destroyed in a catastrophe.

Stephanie Petosa: Thank you. Joe?

Joe Kelly: This is Joe with Fitch. A lot of what we're dealing with here in terms of new deal securitization obviously, you know... starts with the NOI. We have to make sure the modeling reflects the proper NOI as it relates to the actual expense that they're going to be paying because quite often—well not quite often, all *too* often—a lot of the underwritings that we've been looking at might have been formulated months ago before this issue really came into play.

And even if they don't have this issue from the point of securitization, if they're two, three, four months from renewal, they're going to run into this so we have to ask a lot of pointed questions from a lot of different angles to make sure that this issue—whether it is dealt with up front—has been thought about going forward. And if it has, we have to adjust our underwritings to reflect that.

The other thing that, you know, that we sort of touched on here, that we spend… we always spend a lot of time looking at, especially as it relates to credit assessments and large loan securitizations, is really digging into the loan documents and really understanding when they say they have coverage, what is that coverage? And what does it really mean? And what are the definitions and variables that go into that coverage? 'Cause there are a lot of different ways to, you know, spin your coverage as being adequate when if you really drill down and look at, you know, what the representations are in the loan documents, you may not be adequate. So, we're spending a lot more time understanding those documents.

And also just in volatility scoring for our model overall—given the volatile nature of this issue and not knowing where it's going--we're certainly adjusting levels from that standpoint 'cause, again, this is an evolving issue that we all *hope* will normalize itself, but we certainly know there's no guarantees on that front.

And to accept the PML reports, as, you know, I think we've hit this point quite often, it's something that's very difficult and is going to take some time and education for us to get more comfortable with.

One other point that I didn't make before is: I was shocked to find out that in some of these reports for very sizeable loans—loans that you'll find in large loan securitizations or credit assessments in fusion deals—they've done essentially what we would call a desktop review. They haven't even visited the property. They haven't examined the site plans and really

understood what the materials are that have gone into the construction. So, I don't know—I'm not an engineer—but to me, I don't know how you could *possibly* formulate that side of the equation without actually looking at the plans, understanding the materials involved, walked the topography of the area, and really understand the property. I mean, all of us as real estate professionals know the value of a site visit, and I think this holds true for this issue, as well.

But again, Dan said before, "The devil's in the details." We're trying to pay a lot closer attention to those.

Dan Rubock: This is Dan Rubock at Moody's. A couple of perspectives: this windstorm *crisis*, I'd put it, is not like Yogi Berra would say, "Déjà vu all over again." It *is* different. But the scope of it is very different.

There are a couple of statistics from an upcoming report—the MBA. Interesting: from '85 to 2005, hurricanes accounted for almost 44% of catastrophic losses, earthquakes accounted for 5%, and man-made was around the same total amount. And the difference is that this affects wide swaths of property so it… It's a very, very… It's a broader issue than even terrorism; so some of the lessons we learned from terrorism are applicable, you know, but the quantity is so different that in some senses it changes the *quality* of the problem as well.

The things that we kind of look for is, you know, movement away from full coverage can have—in certain cases, especially when you're dealing with concentrations of loans in tier one areas or large, chunky kind of loans that don't have issues—could have serious, you know, credit effects. And you know, we look at things, like we would look at things if we get inadequate coverage, of alternative approaches—letters of credit, cash collateral, perhaps guarantees—to the extent that they don't violate non-consolidation issues—you know, could be some kind of mitigants. How much of an equity cushion do you really have? Land value, of course, for the higher tiers, could be an issue, but in urban areas, dense urban areas, you have great land value and some outlying areas, like in Florida, you might not have great residual land value. You have to look at….

Sorry?

[Unidentified speaker]: The land could be gone.

Jim Palmisano: The land could be gone (laughs). The sands… shifting sands.

[Unidentified speaker]: If it's underwater it could be…

Jim Palmisano: The shifting sands of time and wind, so you know…

Beware any kind of insurance caps whatsoever, we sort of have gone through that and written about that, and , you know… If there is inadequate insurance, our approach would be to taper down the effect, down… the capital stack.

In terrorism, we sort of looked at it as a double-A and triple-A kind of thing, and it really didn't affect levels below, like, double-A, but windstorm began because of the broadness of the policy, of the issue, may dig down a little deeper—somewhat deeper—into the capital stack.

There've been a couple of adjustments that we've made to some large loans, both, as Joe was saying, in the underwriting—we have to assume, somewhat, that going forward, underwriting for the cash flow can be stressed by increased premiums in the 16, 17% of the property values that are in the Gulf Coast and Eastern seaboard. And so we may have to apply that, and also, ...there are other effects that inadequate insurance will have, as well.

One thing that I do want to say is that one lesson we learned from the terrorism is that servicer flexibility, we think, is a good thing. And so, you know, we think that they'll have to be mindful of their fiduciary obligation to the bondholders.

Ratings are a little different because to the extent that a $2 million loan doesn't have insurance, proper insurance, it's not going to affect the rating; but they may have a fiduciary obligation that may be different from ratings effect. But servicer flexibility is a good thing, and we think it's good to have clauses that would mitigate some of the terrible effect that litigation cost had on pools, but it's got to be drafted sort of the right way. So, we're going to be looking again, as Joe said, at closely—especially larger loans because the larger the loans, the bigger the effect—closely at loan document language and what requirements there are. So we're going to proceed very carefully and cautiously on this evolving crisis.

Stephanie Petosa: I'd like to ask the investors, Reggie or Keith: get any comfort from that knowledge, or...any comments on that?

Reggie Leese: Well, I'll start on the investment grade to mezzanine investment,...the bottom line, what investors don't like are surprises; and I think that we've got to look, there are two different issues to look at here. And firstly, then, is the new issue: environment. How is this risk being viewed? How is it being underwritten? Are the rating agencies looking at it? And what is the impact on us as the investors? ...Of various traunches off of a deal on loan level probability of default? And in the case of default, loss severity, and I think that clearly that's a reporting issue, it's an educational issue,... for the investment community to be exposed to, and I think that if the exposure,...

If the risks are identified and fully understood, I think the investment community has shown over time it has the ability to price that into a deal...and make an appropriate credit decision.

I think also, just listening to some of the conversations we've had this afternoon, is a) the complexity, but also the impact on, you know,... on the secondary...on the existing market. And I, you know,... we heard that there's been forced placed insurance on loans, and my immediate question and response to that was: how big? What's that extent of that issue in existing transactions in the marketplace? Where that has occurred are the servicers aggressively pursuing remedies? In the case of inadequate insurance per loan documents being, in event of default, in trying to pursue remedies... In the case of those little events of default, rather than the payment default, and then, taking that one step further is, where we saw in the very worst cases in the

terrorism insurance placement, where, you know, those expenses when they're recouped had the ability… had the risk of creating interest shortfalls in investment grade securities, and so…

I don't know if I can expect to have the answers to those by today, but clearly, those are the type of things I think the investment community will want to hear and understand.

Keith Belcher: Yeah, just to follow on that, this is Keith.

I think from the B buyer standpoint, the very bottom, it's very simple in that we have to have the proper coverage. We cannot be in a position where we are insuring a loan pool through our investment. I don't think that's the intent of the process. We can certainly underwrite higher premiums and stress loans on that basis which is either going to lead, potentially, to a re-sizing of certain loans, or a removal of certain loans; but at the end of the day, we have to have the proper coverage there as we are not the insurance company for this pool.

Jan Sternin: Keith and Reggie: it's Jan.

To both of your points, I think… There's a couple things we need to keep in mind here. First, documents that were drafted post-9/11 provides the servicer, and this goes to Dan's flexibility comment, as well, the opportunity to discuss insurance options with the special, and in most cases these days on a lot of the newer deals, allow the special to have an approval authority that changes the construction of the insurance requirements vs. the way they were when the loan was approved and came to us. So we're not sitting out there.

Additionally, we're well aware that we need to make sure that the insurance requirements are in place. I mean, that's our job as a servicer, as well, to as much as the insurance is available and it can be procured in the marketplace because we don't want to add any increased risks to the pool either. That's not what we're there to do.

Keith Belcher: Right. Well, I think the documents, as you point out, provide for the consultation process adequately; and I think the B buyer's interaction so far with the master servicers has been good, and the communication has been there.

That being said, we're possibly in the early stages of this. I don't think there's been a tremendous amount of instances where we've had to have these discussions, but the documents, I think, work.

Stephanie Petosa: Right. This leads to one of the last things that we wanted to talk about, and to Reggie's point about not wanting any surprises, if I could get the rating agencies to comment on, from a surveillance standpoint, what do you anticipate? What kind of rating actions do you think, and I know it's, you know, …we haven't had a lot to deal with, but… And I'll start with Lauren?

Lauren Cerda: Sure. Well, you know, I think at this time…

Stephanie Petosa: This is Lauren Cerda with Fitch.

Lauren Cerda: ...to see some borrower requests come in to the house where we've had loans that have not necessarily been able to get the same type of coverage that they had at issuance. We've seen things come in like higher deductibles, a relaxation of the insurance rating requirement—which we really *haven't* talked about much today, but we're starting to see a lot more of that come in. So a lot of just the things we've come in today, and I think at this point in time, we're still looking at everything really on a case-by-case basis, and we need to look at, you know: what the implications are of lessening this coverage for this loan, how severe is the impact, how great is it, who is the borrower, you know, what kind of money do we have behind it?

All these kinds of things we've really been talking about today, we're looking at do we want to relax some of these standards or let them get away with it. What do we think the impact is going to be on the pool? And we also really have to keep in mind that we're still kind of governed by the loan documents, as well, from a surveillance standpoint. And also, there's the concern: if we're not comfortable, maybe, signing off on something, and the borrower is unable to do anything else, do we then make the pool worse by, you know.. maybe there's a higher likelihood of default, or maybe we start having advances coming through, we have shortfalls in the trust and the bonds are being hit in other ways. So, we really have to look at everything on a case-by-case basis and try to determine all the different scenarios for what we're going to do before we issue any letters on it.

Stephanie Petosa: Dan, anything different? Anything to add?

Dan Rubock: No, not much different. The challenge is, of course, to size the possible threat, if there is, depending of how much possible inadequate insurance might have. I mean, you could take a complete blunderbuss approach and say, "Zero insurance." No insurance is not good. Or do we have to do a on-the-sly lump, effectively, to sort of size the effect on how we might have to downgrade the pool if a large loan comes in on renewal without adequate insurance. That's going to be the interesting challenge—how we size the risk.

And of course we tried to do our best when it came to terrorism insurance issues which are, you know, *notoriously* difficult, even for any modeler, to get the probability of default here. So the challenge will be, if issues do arise, trying to size the possible effect and how conservative or... you know, where do we draw the line? That'll be the issue. And so, yes, I do agree. We will be in the position of constantly inventing the wheel, on each deal, each deal is so different, each deal has its own story, and that's what makes real estate interesting, and that's what makes our challenge hard.

Stephanie Petosa: Jim, anything different? Anything to add from S&P perspective?

Jim Palmisano: Well, we're seeing the same types of things that were mentioned earlier: less coverage, higher deductibles, lower rated carriers... So what we try to do is maintain a flexible attitude towards this stuff. We look and see how this one particular loan really impacts the pool and the diversified pool of each loan obviously has less of an impact and a more concentrated one. To the extent that we do believe it's a material deviation, we will, you know, re-underwrite

that loan, size in what we believe is the effect of the insurance, and then re-evaluate where the pool comes out.

Stephanie Petosa: We've been receiving some questions via email that I've been sprinkling throughout the conversation. Shane, I'm not sure if we've got any questions from over the phone. It's going to take the last few minutes that we have to open them up, if we have any other questions, if we wanted to ask our experts. We have the phone line actually open until five so we have plenty of time, and if nobody has any further questions then we'll thank everybody for participating, but I'll give it a minute. Anybody got anything?

Operator: At this time I would like to remind everyone: if you would like to ask a question, press star , then the number one on your key pad.

Our first question is coming from Sharol Collins of Bridger Commercial.

[Sharol L. Collins—Senior Vice President, Securitization and Closing, at Bridger Commercial Funding]

Sharol Collins: Yes. I have a question in regards to how the secondary market would look at captive insurance companies. We have a deal that I'm looking at right now where that's what one of the borrower's proposal is, is capitalizing a to-be-formed captive insurance company with a letter of credit. The question I have on that is.... My concern is if that letter of credit capitalizes more than the subject property, then how does the secondary market look at the risk of the potential loss for that if the...that company has properties that are in one area; in other words, one...event could impact more than one of the properties that the company would ... So my question is more of a b buyer ....

Michael Liebowitz: What risk has the captive taken? What type of risk?

Sharol Collins: Well, I guess that's what I'm still trying to understand that part in the fact they have,... They're creating this company, and they do have a letter of credit that capitalizes it. There's additional premiums, and I guess they're insuring ... I don't know that there is additional risk involved...

Michael Liebowitz: This is Michael Liebowitz. There's a difference that the captive is taking property risks, if they're taking liability risks... liability risks if it's a living company or something like that... nursing home.

I think, personally, I think a lender would look at it negatively because you want credit ratings behind it so I wouldn't look at the captive positively at all, but I'd be curious to know what kind of risks because there are certain things a little outside the box you listen to and see if it makes any sense.

Sharol Collins: So, is there something that is available that we can look at? But it depends on the structure, is what I'm hearing. Is that correct?

Michael Liebowitz: I can't give a simple yes to it because a lot of factors play. The *major* negative of the captive is that you need credit ratings . We always want to have carrier ratings that fit the profile of the deal, so...

Let's say it's a S&P rating, or a Moody's rating, or Fitch, whatever that may be, captives typically don't have that type of rating; they have much lower ratings. So that would be a problem where we typically would not accept it; although, if the captive was set up purely for the reason of a deductible, higher deductible, or--something that we're seeing now--is that sophisticated, large bars are setting up captives purely for the reason of getting access to the TRIA [Terrorism Risk Insurance Act] backstop for terrorism, where if you've got a qualified captive, they can get the benefit of the ninety percent reimbursement for the terrorism. So, there are things you have to do in addition to that like reinsure the remaining ten percent or the deductible piece that's part of the TRIA; but that's a way that you can possibly use a captive, but it's certainly no simple yes that captives are okay because I would say that typically, they're not.

Sharol Collins: Right.

Deb Schiavo: This is Deb Schiavo. You might want to find a situation where you could see a captive way out in the layers of the blanket policy so maybe the captive is dealing with some of the reinsurance, the lack of reinsurance, way out there--say twenty-five million in excess of 200 million, where you might not be as concerned about it.

Sharol Collins: I see. I guess mine's on a smaller level. I have a... The transaction I'm looking at is where the... What they're trying to do is this captive is being formed by the sponsor of this transaction to cover the risk due to the deductible; there's a $5 million deductible and so, they're creating a captive insurance company to handle that risk and the capitalization of the company is coming through by the way of a letter of credit. That is going to be issued by a press rated financial institution. Does that change any of this discussion?

Deb Schiavo: It's probably still hard to answer the question without knowing what risk that captive is going to be writing.

Sharol Collins: Okay, that's what I need to know. Okay, thank you.

Operator: Thank you. Our next question is coming from Michelle Moore at GE.

Michelle Moore: Yes, I have a question. What are lenders doing with respect to... Now are they buying any gap coverage, and if so, what methods are they using to determine that gap coverage?

Michael Liebowitz: When you say gap coverage, do you mean for the purpose of wind?

Michelle Moore: Yes, for the purpose of wind.

Michael Liebowitz: The problem is that every, you know... Gap insurance, property insurance, flood insurance--you're all going... Everyone's going to the same source for it; so the gap market--which really is basically non-existent, with some specialty products, have the same issues. If

you're trying to buy lease enhancement policies, and things of that nature, they have wind problems. If you want to buy one in Florida, they've got the same wind problems that the standard property market has. So there's not a solution out there to say a borrower needs a hundred million dollars of wind coverage, and they can buy 40 million from Marsh who's their broker. We're going to have a lender buy some product for some 60 million gap that's really not there. At least I haven't seen it.

Michelle Moore: Okay, thank you. Has anyone else seen it? Or do they have a comment? Or what has been anybody else's personal experience?

Stephanie Petosa: I think that's all we're going to get on that. Thank you, Michelle.

Operator: Thank you. There are no further questions in the queue.

Stephanie Petosa: I've got one question here on email.

Do any of the insurance companies plan on issuing a requirement or scope for work for wind PML's?

Joe Kelly: It's right now the carriers that drive that, so... That's a good question for the lenders and the rating agencies. Are they going to keep going? And that's, what Dan said very well, is I think that's the point we need to get to some kind of standardization where we have a qualifier for what scope is going on out there.

Dan Rubock: Let me make sure I understood the question . Are the carriers issuing any requirements for PML studies?

Joe Kelly: I imagine they mean like requirements of scope, you know, I imagine in terms of who is an accepted firm to perform that PML.

Right.

Dan Rubock: Most of the carriers are utilizing the LMS model to...to determine their own loss expectancies and the same model that's generally available to a borrower or an insured who run their own PML studies.

Joe Kelly: Right. Just to reiterate, I think that question's probably more relevant to the lenders and the rating agencies in terms of... because they're the ones who are going to be relying, or not relying, on those reports.

And as we've well-documented today, there's a lot of variables that we understand a little bit and some variables that we don't; and we're certainly in the fact-finding process of trying to understand what we can and can't do with these PML reports. So there's certainly limitations, and I think we've laid those out in terms of the limitations of the report. Quite honestly, in looking at the last year, there's a lot of PML studies that we've done on a lot of the properties that sustained damage, and by and large, a lot of them were very inaccurate.

Dan Rubock: And that was evidenced by the revising of the model.

Joe Kelly: Exactly but that is one good thing--just that, you know, to look at a positive that something like the Florida Hurricane commission can bring to the table 'cause they're constantly updating the models that are employed in the residential market. And one side of that equation relates to hurricane scenarios, and intensities, approaches--that's all the same whether it's commercial or it's residential. So the more that that is tweaked with the frequency of storms, the more accurate the model can be. Their bend is not necessarily towards the commercial market; they're more concerned with residential structures, but to the extent something like that could become a little more standardized, we might be able to see a little bit more confidence in beginning to find its way into the market for PML studies.

Dan Rubock: The last two years have been very, very instrumental in increasing the data pool underlying those models which obviously the revision took place this year. And the one thing I've heard throughout the entire PML discussion--which I think is a proper recognition--is the old adage, "Garbage in; garbage out."

There are varying levels of data input available to construct the model, and a lot of the models are done basically looking at the first page of the inputs, and that's a very cursory look at a PML. You have to get kind of behind that, into the page two of the inputs, before you build any kind of credibility of the model.

Joe Kelly: Dan hit on it before, in terms of... A lot of the data as it relates to hurricanes in what's in a hundred years of what's really meaningful data, and the long-term or the short-term view can have very different outputs for the report.

I mean, obviously, the frequency that we've seen over the last five to ten years is very different than what it was thirty years ago so depending upon what you think is the true cycle of hurricanes, you can have a very different report.

Stephanie Petosa: I think one of the things I'd like to make sure we point out is, the MBA has had a number of calls, and Jan, I believe you had that up. Are there task forces going on right now? Are there parts that we could, at CMSA, come up with something different? Or a complement possibly?

Jan Sternin: One on the insurance side, and again, we--as Stephanie mentioned,-we have called and said we're having one tomorrow, so if anyone is interested in dialing in, the information, the dial-in number, is all available on the MBA website. And those calls are in conjunction with the origination committee as well as the asset administration committee, and we're interfacing with the insurance company, as well. And we've had a huge participation on these calls, and the offshoot of this is always one industry works in groups to interface. So we encourage everybody on this call to join that call tomorrow as well. I believe it's eleven or noon, eastern time.

Stephanie Petosa: If anybody ... If there are no more questions, I'm going to thank everybody for participating. I think this was extremely informative, and definitely thank my panel for participating and letting us pick your brain.

Jan Sternin: Thanks for having us, Stephanie.

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STATEMENT OF THE NATIONAL ASSOCIATION OF REALTORS®

THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES

"STABILIZING INSURANCE MARKETS FOR COASTAL CONSUMERS"

Wednesday, September 13, 2006

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

Thank you for the opportunity to present the views of the NATIONAL ASSOCIATION OF REALTORS® (NAR) on the topic of insurance markets for coastal consumers. NAR applauds Chairman Baker for holding this hearing and thanks him for his leadership on this important issue. Homeowners and commercial property owners are increasingly being put at risk because options for obtaining and maintaining insurance coverage are dwindling.

Homeowners and commercial property owners need insurance to cover themselves in cases of emergencies and disasters. Events of the past few years have left many homeowners and commercial property owners with inadequate or, in some cases, no insurance for a variety of reasons: high cost of insurance, high deductibles, and lack of available insurance products in the competitive marketplace. Recent natural disasters have led a number of insurance companies to cancel policies, not renew policies, and pull out of markets because they fear that a significant event could severely impact them.

Recent research conducted by NAR in Florida concluded that the lack of affordable or available homeowners' insurance in that state contributed to a slowdown in Florida real estate markets, which can presage a slowdown in overall economic activity in the region. A strong real estate market is a linchpin of a healthy economy, generating jobs, wages, tax revenues and a demand for goods and services. In order to maintain a strong economic climate, the vitality of residential and commercial real estate must be safeguarded.

This deterioration in the availability and affordability of insurance in disaster-prone areas is an issue of very real concern to NAR. NAR members specialize in the business of facilitating real estate transactions, but when a young family is precluded from owning a home, or a tenant is unable to lease space because insurance is too difficult or too costly to obtain, we all suffer the

consequences. We cannot emphasize enough that the ultimate victims of this insurance crisis – and let us assure you that in many states in the Southeast, it is a crisis – are consumers frustrated in their attempt to realize the American Dream of homeownership.

The insurance availability and affordability crisis in the Gulf Coast region extends beyond homeowners' insurance and touches virtually every aspect of the real estate market. Many of NAR's commercial members have reported problems obtaining commercial property and casualty insurance during the brokerage of commercial real estate. Insurance is a key component to financing the purchase real estate. The lack of availability of insurance threatens to slow the investment in commercial real estate in these areas -- which is so crucial to rebuilding our storm ravaged coasts.

The inability to obtain affordable homeowners' insurance is a serious threat to the residential real estate market. Not only does it imperil the market for single family detached homes, but condo, co-op and rental markets are affected as well. New home purchases, resale transactions and housing affordability are impacted in the following ways:

- **Homeowners' insurance is a necessary component in securing a mortgage and buying and selling a home.** If a potential homebuyer is unable to obtain or afford the required insurance, the sale will not be completed. As a result, potential homebuyers are priced out of the market.
- **Homeowners' insurance is tied directly to the cost of owning a home.** If a homeowner is unable to maintain insurance required by a mortgage lender, the mortgage is in default. If disaster insurance coverage is optional, potential buyers may choose not to purchase a home because the insurance they need is too expensive. Others may choose to go unprotected.

- **Insurance costs impact rent levels.** Insurance costs incurred by multi-family property owners are ultimately passed on to tenants through higher rents. This impacts housing affordability, particularly for low-income renters and buyers.

The National Association of Realtors ® is pleased that Congress is discussing ways to address the need for a comprehensive natural disaster policy that will ensure that homeowners insurance is available and affordable to all who wish to purchase it. NAR encourages Congress to develop a comprehensive natural disaster policy that will help homeowners protect their most valued asset – their homes.

Congress has, with varying levels of interest, debated and voted on natural disaster policies during the past two decades. In this Congress, a number of bills have been introduced that take different approaches to addressing this problem. No one approach has emerged as a front-runner, but NAR is glad that the debate is beginning again. We applaud the efforts of those members of Congress who have introduced and co-sponsored legislation to address this critical issue.

NAR encourages this Subcommittee to examine the several approaches that exist and contemplate those that have not yet been thought of. The issue for NAR is simple: homeowners need insurance to protect themselves, their families and their property in case of catastrophe. Unless insurance is available and affordable, many may choose to go without insurance – precisely the decision many Californians have made due to the high cost of earthquake insurance. If "the big one" hits, and people are not insured, then the American Taxpayer, that is to say everyone in the country, will pay. NAR believes that people who bear risk should pay a fair share – that is through insurance. However, if insurance is not available or affordable,

people may decide to go without and rely on the federal government to assist them in their time of need.

In conclusion, NAR believes that some markets are better prepared than others, but not a single one can handle the burden of a major catastrophe on their own. It is in the best interests of all Americans to have a comprehensive federal natural disaster policy that includes aggressive mitigation, assumption of risk, and affordable and available insurance for homeowners and commercial property owners.

This issue is an extremely important one to NAR, REALTORS®, homeowners, commercial property owners, and taxpayers. NAR looks forward to working with this subcommittee, the Committee on Financial Services, and all members of Congress to achieve this goal. Thank you.

Summary – Texas Seacoast

Residential Property Insurance Market

On July 26, 2006, the Texas Department of Insurance resurveyed (original survey was sent April 28, 2006) 19 groups of insurance companies to determine the current market and availability of residential property insurance along the Texas seacoast.

Eighteen of the 19 groups indicated that they are accepting new business in Tier 1 counties. Of those 18 groups that are accepting new Tier 1 business, nine (9) are providing windstorm coverage subject to individual company underwriting guidelines. Examples of individual company restrictions are: no wind coverage provided for property on the barrier islands or risks that are within 1000' of salt water; no wind coverage provided for property on Galveston Island or in Galveston County, and parts of Brazoria County; no wind provided if within 15 miles of the gulf or bay waters; minimum 2% deductible.

All 19 groups are renewing current policyholders in Tier 1. Fifteen of those 19 groups are renewing with windstorm coverage. Four (4) groups out of the 19 surveyed are **not** renewing with windstorm coverage in Tier 1.

Eighteen groups are writing new business in Tier 2. A few groups have restrictions for homes located in Ft. Bend, Harris, and Orange Counties. One (1) group requires a 2% deductible on wood roofs while another group requires that homes meet certain building standards. All 19 groups are renewing current policyholders in Tier 2.

Tier 1 includes:
Aransas, Brazoria, Calhoun, Cameron, Chambers, Galveston, Jefferson, Kenedy, Kleberg, Matagorda, Nueces, Refugio, San Patricio, Willacy

For the purposes of this survey, Tier 1 also includes certain specifically designated communities in Harris County that are east of State Highway 146. These communities are Pasadena, Morgan's Point, Shoreacres, Seabrook and La Porte.

Tier 2 includes:
Bee, Brooks, Fort Bend, Goliad, Hardin, Harris - except as noted in Tier 1, Hidalgo, Jackson, Jim Wells, Liberty, Live Oak, Orange, Victoria, Wharton

Residential Property Insurance

Residential property groups who are writing new and renewal business in Tier 1 and Tier 2 are:

Groups Writing New Business In Tier 1*		Groups Renewing In Tier 1*		Groups Writing New and Renewal Business in Tier 2
	Wind Available Y or N		Wind Available Y or N	
AMICA	Y	AMICA	Y	AMICA
Allstate	N	Allstate	Y	Allstate[1]
American National	N	American National	N	American National
ASI Lloyds	N	ASI Lloyds	N	ASI Lloyds
Balboa	Y	Balboa	Y	Balboa
Beacon	N	Beacon	Y	Beacon
Central Mutual	N	Central Mutual	Y	Central Mutual
Cypress Texas Lloyds	Y	Cypress Texas Lloyds	Y	Cypress Texas Lloyds
Farmers	Y	Farmers	Y	Farmers
Hartford	Y	Hartford	Y	Hartford
Liberty Mutual	N	Liberty Mutual	Y	Liberty Mutual
National Lloyds	N	National Lloyds	N	National Lloyds
Nationwide	N	Nationwide	N	Nationwide
Republic	Y	Republic	Y	Republic
Safeco	N	Safeco	N	Safeco
[2]	N/A	State Farm	Y	State Farm
Texas Farm Bureau	Y	Texas Farm Bureau	Y	Texas Farm Bureau
Travelers	Y	Travelers	Y	Travelers
USAA[3]	Y	USAA	Y	USAA

Tier 1 includes:
Aransas, Brazoria, Calhoun, Cameron, Chambers, Galveston, Jefferson, Kenedy, Kleberg, Matagorda, Nueces, Refugio, San Patricio, Willacy. For the purposes of this survey, Tier 1 also includes certain specifically designated communities in Harris County that are east of State Highway 146. These communities are Pasadena, Morgan's Point, Shoreacres, Seabrook and La Porte.

NOTE: Wind coverage may be available through the Texas Windstorm Insurance Association.

Tier 2 includes:
Bee, Brooks, Fort Bend, Goliad, Hardin, Harris - except as noted in Tier 1, Hidalgo, Jackson, Jim Wells, Liberty, Live Oak, Orange, Victoria, Wharton

* New business written subject to individual company underwriting guidelines. Those companies that are shown to provide wind in Tier 1 may not provide wind in all areas within Tier 1. Other limitations may apply.

[1]Allstate is renewing but, not writing new business in Tier 2.
[2]State Farm is renewing, but not writing new business in Tier 1.
[3]USAA Group insurance is only available to persons eligible for membership.

Summary – Texas Seacoast
August 2006 Survey

Commercial Property Insurance Market

On August 14, 2006, the Texas Department of Insurance resurveyed (original survey was May 5, 2006) 25 groups of insurance companies to determine the current market and availability of commercial property insurance along the Texas seacoast.

As of September 9, 2006, 22 of the 25 groups had responded. One of the 22 groups has withdrawn from writing and 5 reported changes in underwriting since the survey conducted in May 2006. Changes include: increase in minimum deductible, limitations on the amount of new business being written in specific geographic areas of Tier 1 and Tier 2, and new business limited to masonry non-combustible or better construction (no frame construction) in Tier 1 and 2.

Twenty-one of the 22 groups indicated that they are accepting new business in Tier 1 counties. Of those 21 groups that are accepting new Tier 1 business, 12 are providing windstorm coverage subject to individual company underwriting guidelines. Examples of individual company restrictions are: no property written within a certain distance of the gulf or bay waters – within 1500' of coastal waters or within 30 miles of gulf; no coverage provided for property on the barrier islands; minimum 2% deductible.

Twenty-one of the 22 groups are renewing current policyholders in Tier 1. Sixteen of those 21 groups are renewing with windstorm coverage. Five of those 21 groups are **not** renewing with windstorm coverage in Tier 1.

Twenty of the 22 groups are writing new business in Tier 2. Fourteen of those 20 groups have some restrictions applicable to new business. Twenty-one groups are renewing current policyholders in Tier 2. Eight of those 21 groups are renewing with some restrictions.

Tier 1 includes:
Aransas, Brazoria, Calhoun, Cameron, Chambers, Galveston, Jefferson, Kenedy, Kleberg, Matagorda, Nueces, Refugio, San Patricio, Willacy

For purposes of this survey, Tier 1 also includes certain specifically designated communities in Harris County that are east of State Highway 146. These communities are Pasadena, Morgan's Point, Shoreacres, Seabrook and La Porte.

Tier 2 includes:
Bee, Brooks, Fort Bend, Goliad, Hardin, Harris - except as noted in Tier 1, Hidalgo, Jackson, Jim Wells, Liberty, Live Oak, Orange, Victoria, Wharton

Commercial Property Insurance
As of September 9, 2006

Commercial property groups who are writing new and renewal business[1] in Tier 1 and Tier 2 are:

Groups Writing New Business In Tier 1		Groups Renewing In Tier 1		Groups Writing New and Renewal Business in Tier 2
	Wind Available Y or N		Wind Available Y or N	
Church Mutual[1]	N	Church Mutual	N	Church Mutual
CNA Insurance[1]	Y	CNA Insurance	Y	CNA Insurance
Fireman's Fund[1]	Y	Fireman's Fund[1]	Y	Fireman's Fund[1]
Hartford[2]	N	Hartford[2]	N	Hartford[2]
RSUI[1]	N	RSUI	Y	RSUI
Safeco[3]	N	Safeco[3]	N	Safeco[3]
		State Farm	Y	State Farm[1]
Texas Farm Bureau[1]	Y	Texas Farm Bureau[1]	Y	Texas Farm Bureau[1]
United Fire[1]	N	United Fire	Y	United Fire
Unitrin[4]	N	Unitrin[4]	N	Unitrin[4]

Tier 1 includes:
Aransas, Brazoria, Calhoun, Cameron, Chambers, Galveston, Jefferson, Kenedy, Kleberg, Matagorda, Nueces, Refugio, San Patricio, Willacy

For purposes of this survey, Tier 1 also includes certain specifically designated communities in Harris County that are east of State Highway 146. These communities are Pasadena, Morgan's Point, Shoreacres, Seabrook and La Porte.

Tier 2 includes:
Bee, Brooks, Fort Bend, Goliad, Hardin, Harris - except as noted in Tier 1, Hidalgo, Jackson, Jim Wells, Liberty, Live Oak, Orange, Victoria, Wharton

[1]New business written subject to individual company underwriting guidelines. Those companies that are shown to provide wind in Tier 1 may not provide wind in all areas within Tier 1.

[2]Subject to detailed underwriting guidelines, aggregation controls, deductible limits and certain policy exclusions, The Hartford offers new business and renewal quotes for selected commercial properties within Tier 1 and Tier 2. To determine if your property is eligible for coverage, you should contact a Hartford agent for assistance.

[3]Safeco Insurance companies do not write new or renewal business with hail and windstorm coverage in any Tier 1 area. Windstorm and hail coverage is available in portions of Tier 2 subject to company underwriting rules. Moratoriums for all property coverages exist in portions of Tier 2 (sections of Harris, Liberty and Orange Counties).

[4]Unitrin Business Insurance Company does write both new and renewal business in Tier 1 and Tier 2 on a limited basis. Windstorm, hurricane and hail coverage is not available to most of Tier 1 subject to company underwriting rules.

As of September 9, 2006, the following companies have not responded to TDI's request to make information available to the public:

Allstate	Beacon Insurance	Crum & Forster

The following companies declined TDI's request to make information available to the public:

AIG	Chubb
CMI Lloyds	Federated Insurance
FM Global	Hanover
St. Paul Travelers	Union Standard

Archives Article View

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Carl Hiaasen

Just say no to stronger building code

By CARL HIAASEN, columnist for the *Miami Herald*

They think that they shall never see
An alibi lovely as a tree.
- with apologies to Joyce Kilmer

The Florida Building Commission, seeking cover in the woods, has voted to keep a prime coastal corridor of the Panhandle exempt from stiff wind protections in the state hurricane codes.

It's another signature copout for an industry-stacked panel that was formed after Hurricane Andrew with the unstated mission of preempting tough local construction codes.

In this case, the commission rebuffed by an 11-9 vote pleas from Gov. Jeb Bush and insurance regulators to require Panhandle builders to adhere to the same regulations as those in the rest of the state.

Citing an oddly self-contradictory study, a majority of commissioners ruled that most new homes in Northwest Florida will be safe from windblown debris because they're shielded by tall trees.

Seriously.

Be at peace, brothers and sisters, for the sycamore and oak shall save ye. Covet not storm shutters nor impact-resistant glass, for the dogwood and slash pine shall deflect all windblown tribulations.

Pick any substantial hurricane - Donna, Andrew, Katrina, Wilma - and check out the pictures of the aftermath. You'll see plenty of trees, all right. Tons and tons of 'em.

Flattening houses and cars.

Sticking through walls and roofs.

Blocking roads, tangling with power lines.

Ask the folks along the Mississippi Gulf Coast how well their pretty old loblollys protected them from Katrina. Ask the folks in Cutler Ridge what Andrew did to all those regal Dade County pines.

The trees didn't shield anybody from wind-borne debris; they were the windborne debris.

The best natural buffer against hurricanes are red mangroves which, unfortunately, don't thrive north of Cedar Key. So, with the sobering anniversaries of both Andrew and Katrina upon us, it's only reasonable to wonder about the Florida Building Commission:

Are these guys really that stupid, or are they just shameless?

I vote for shameless. Here's commission chairman Raul Rodriguez, a Coral Gables architect, defending the panel's action: "We don't want to drag the builders by the nose to do something they think is wrong."

Heaven forbid.

Because everybody knows that the building lobby would never ever put profits ahead of public safety. That's why it fought tooth and staple-gun against every significant reform proposed after Hurricane Andrew - including mandatory shutters for all new coastal housing.

The Florida Home Builders Association always whines that storm-proofing houses pushes the price too high for many buyers. That's a crock. Amortized over a 30-year mortgage, the cost of shutters or impact windows is absurdly inexpensive, especially since they can save your life.

Andrew leveled acres of crackerbox subdivisions that the industry had previously asserted were of first-rate construction. During the ensuing uproar, panicky Panhandle builders leaned on lawmakers to spare them

from the tougher construction standards that had begun sweeping the state.

Obligingly, the Legislature exempted the region from key parts of the state code. Recently, the governor persuaded lawmakers to let the Building Commission review that exemption. Some members of the panel say it took a huge step last week by requiring impact-resistant windows for new homes in areas of the Panhandle facing projected hurricane winds of 130 mph-plus.

However, the standard for the rest of coastal Florida is only 120 mph, and it extends to construction several miles inland.

Citing a study by a New Mexico-based outfit called Applied Research Associates, opponents of the 120-mph rule came up with this beaut: The trees in northwest Florida will buffer houses against hurricane winds, negating the need for a stricter building code.

The theory has drawn scorn from storm experts, and ominous skepticism from the insurance industry. Strangely, the same ARA study conceded that many subdivisions in the Panhandle have limited tree cover, and predicted that 60 to 98 percent of the homes would still suffer wind damage from a hurricane.

One reason that Gov. Bush has pushed so hard to remove the Panhandle's loophole is to demonstrate Florida's commitment to building safer structures, and to lure major insurers back into the state.

The vote of the Building Commission sends the opposite message: Hey, Bubba, look at us! We didn't learn a blasted thing from all them hurricanes, did we?

Thanks to those geniuses, all Floridians - at least the ones who can still find insurance - will pay increasingly outlandish windstorm premiums. Watch what happens to your rates in Miami if a big hurricane smacks Pensacola.

As for the hapless souls buying those shutterless homes in the Panhandle, don't count on your sweetgums to save you when the next Cat 4 comes roaring through.

A tree that looks at God all day

And lifts her leafy arms to pray . . .

Please don't blow my house away!

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STATEMENT OF

PROTECTINGAMERICA.ORG

Before the
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives

September 13, 2006

ProtectingAmerica.org is a non-profit organization committed to finding better ways to prepare for and protect American families from the devastation caused by natural catastrophes. Led by national co-chairmen ADM James M. Loy, USCG (Ret.) and Mr. James Lee Witt, the former director of the Federal Emergency Management Agency, our coalition members include first responders, emergency management officials, insurers, municipalities, small businesses, Fortune 100 companies and private citizens. The membership is broad and diverse and includes members from virtually every state in the nation.

ProtectingAmerica.org was formed to raise the national awareness about the important responsibility we all have to prepare and protect consumers, families, businesses and communities from natural disasters. We are building a campaign to create a comprehensive, national catastrophe management solution that protects homes and property at a lower cost, improves preparedness, and reduces the financial burden on consumers and taxpayers – all in an effort to speed recovery, protect property, save money and save lives when a significant natural disaster strikes.

Though we come from all walks of life, we share a common belief that the current system of destroy, rebuild and hope in the aftermath of extraordinary natural disasters is fatally flawed in two significant and dangerous ways.

First, we as a country simply do not prepare well enough in advance for natural catastrophes.

Fundamental to the current system is the vain belief that "it won't happen here." This denial, which is pervasive from homeowners to officeholders, has provided us all with the false comfort that, while we would like to prepare for the possibility of catastrophe, the likelihood of an event actually happening "here" is so remote that we should spend our time and resources on other more immediate and pressing problems.

This denial undermines efforts to prepare in advance of catastrophe which, naturally, leads to the other sweeping shortcoming which is that the current system is a patchwork of after-the-fact responses with all of the inefficiencies that are inherent in a system dominated by crisis and confusion.

The simple fact is that natural catastrophes can and do occur virtually anywhere in this country.

Some quick facts that should crystallize the urgent threat posed by natural catastrophe in America:

- The majority – in fact 57% -- of the American public lives in an area prone to catastrophes like major hurricanes, earthquakes or other natural disasters, and more move toward those areas every day.

- Seven of the 10 most costly hurricanes in US history occurred in the last 5 years.

- Some of the most valuable real estate in this country is squarely in the path of a natural catastrophe – on the Atlantic, Gulf and Pacific coasts and on top of the New Madrid fault in the greater Mississippi Valley.

Natural catastrophe preparedness, prevention and recovery are not a challenge limited only to Florida and the Gulf Coast, nor to the earthquake zone of northern California.

- In the past 100 years, 11 hurricanes have made direct hits on New England; 6 have made direct hits on Long Island.

  The most famous of those hurricanes hit in 1938 and is known as the Long Island Express. It hit Long Island and ripped up into New England. 700 people were killed; 63,000 were left homeless. Had it landed a mere 20 miles west, New York City would have been inundated.

- Although the Great San Francisco Earthquake of 1906 is the best known earthquake in America, in fact, the New Madrid series of earthquakes in the early 1800s covered a far greater area with a force every bit as strong as San Francisco's earthquake.

  The New Madrid Earthquakes emanated from New Madrid, Missouri and struck over a three-month period in 1811 and 1812. They changed the course of the Mississippi River, shook the ground from Mississippi to Michigan and from Pennsylvania to Nebraska. Structures were damaged throughout the Mississippi Valley, landslides occurred from Memphis to St. Louis. These earthquakes are largely unknown today because they struck at a time when the earthquake zone was largely wilderness. What was essentially the bulk of the Louisiana Purchase now encompasses major population centers across the Mid-West.

Climatologists are united in their observation that surface water temperatures are up and that we are in a weather cycle that is likely to last for many years, possibly several decades, and will include hurricanes with greater force and frequency than even those we have experienced in recent years.

Seismologists are similarly united in their observation that we are overdue for a major earthquake along many of the fault lines that run along our Pacific Coast or, as in the case of the New Madrid Fault, transect the very heartland of this nation.

There should be no comfort in the notion that the great earthquakes and hurricanes that previously ravaged our country seem to have occurred in such a vastly different age and time that they are not likely to repeat.

Is our modern society so sophisticated and our cutting-edge technology so advanced that Mother Nature will choose to strike in some remote and distant land?

To wager our families' futures on that sort of conceit is a fool's bet.

Simply put, catastrophe can happen here, it has happened here and there is no doubt that it will happen again. It is a question not of "if" but "when" and "how bad."

The costs of any of those catastrophes repeating themselves would be enormous.

- Disaster experts project that a replay of the San Francisco earthquake – same force at the same location – could result in more than $400 billion in replacement and rebuilding costs.

- Were we to experience a replay of the 1938 "Long Island Express" hurricane, the damages could exceed $100 billion. If that hurricane made landfall smack in the middle of Manhattan, the damages would be even more staggering.

The effect of such tremendous losses would be felt through our entire national economy.

When catastrophe strikes, our after-the-fact response programs and protocols do a remarkable job in getting victims into shelters and in mobilizing emergency supplies and personnel so that the situation does not worsen.

All Americans, regardless of whether or not they have been victimized by catastrophe, owe our first responders an enormous debt of gratitude and thanks. We are equally indebted to the people behind the scenes – the government employees who work around-the-clock to see that logistics are worked out, that supplies are ordered and that funding is delivered. These men and women are too often overlooked. Their service is invaluable.

The first responders in harm's way and the government workers in makeshift outposts perform exceptionally well in this crisis mode. But, as we all know, the crisis mode is

hyper-stressful both on a human level and on a system-wide level. It requires split-second triage and prioritization that can lead to inefficiencies and unfairness.

While little can be done to completely eliminate the crisis mode, ProtectingAmerica.org believes that it can, and must, be mitigated. Clearly, programs that would improve preparedness, increase public education, enhance prevention and mitigation programs, and augment support for first responder programs would improve our national capability to prepare and protect those of us who live in harm's way.

Public education programs would help homeowners to make necessary plans and be prepared in advance of an emergency. Mitigation programs such as strong building codes and effective retrofitting programs would improve the integrity of catastrophe-prone structures so that damage would be minimized if catastrophe strikes. Experts tell us that for every dollar spent on mitigation, we save $5 to $7 in future losses. An increase in first responder funding would help finance these critical programs that too often get shortchanged in the give-and-take of local budgeting.

Studies in the aftermath of Hurricane Katrina suggest that the current after-the-fact recovery funding for catastrophes results in an enormous taxpayer subsidy for uninsured and underinsured properties. In fact, a Brookings Institution study published in March of this year found that of the first $85 billion in taxpayer dollars spent on Katrina recovery efforts, more than $10 billion went to cover losses for uninsured or underinsured properties.

ProtectingAmerica.org believes that in addition to minimizing the extent of catastrophic losses through prevention and mitigation programs, we should also reduce the taxpayer subsidy of recovery efforts, ensure the adequacy of recovery dollars, and improve the delivery of those critical funds to homeowners.

ProtecingAmerica.org supports the establishment of a stronger public-private partnership as part of a comprehensive, integrated solution at the local, state and national levels. The

solution would include privately funded natural catastrophe funds in catastrophe-prone states that provide more protection at lower cost to consumers. These funds would serve as a backstop to the private insurance market and would generate investment earnings that, in addition to helping to pay claims in the aftermath of a mega-catastrophe, would be used for mitigation, prevention, preparation and first responder programs in each state.

We also support the creation of a national catastrophe fund that would serve as a backstop to participating state catastrophe funds in the event of a natural mega-catastrophe.

Those state catastrophe funds would be financed through mandatory contributions by insurance companies in each of those states in an amount that reflects the catastrophe risk of the policies that they write in each state. These are private dollars, not taxpayer funds.

The state funds would be required to set aside a minimum of $10 million up to a maximum of 35% of investment income for prevention, mitigation and public education programs.

Those states that choose to create a natural disaster funds would be able to purchase re-insurance from the national program. Rates for this coverage would be actuarially based and self-sufficient and would only be available to state programs that have established the prevention and mitigation funding as described above.

In the event that a catastrophe strikes, private insurers would be required to meet all of their obligations to their policyholders. Should catastrophic losses exceed those obligations, the state catastrophe fund would be utilized. In the event of an extraordinary mega-catastrophe, the national backstop program would provide benefits to the state and help pay remaining claims.

Because this is a state-by-state program based entirely on risk, the likelihood of a taxpayer subsidy is virtually eliminated. This approach requires pre-event funding and

relies on private dollars from insurance companies in the states that are most exposed to catastrophe.

Because this program relies on the traditional private market for paying claims, the inherent inefficiencies and bureaucracy in a government-run program are eliminated.

Because this program requires states to fund meaningful prevention and mitigation programs, catastrophe planning, protection and preparation will take place before the onslaught of catastrophe and will be in a state of continuous and rigorous improvement.

All of these elements are contained in HR 4366 and in companion legislation S. 3117 pending in the US Senate. We commend Rep. Ginny Brown-Waite and Senator Bill Nelson and the growing number of co-sponsors for their foresight on this very important issue.

This needs to be a top national priority. It reflects strong leadership to act before the next crisis. There is urgency and opportunity to act. We urge you to join us in our campaign to better prepare and protect America from natural disasters.

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