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AN EXAMINATION OF THE AVAILABILITY AND AFFORDABILITY OF PROPERTY AND CASUALTY INSURANCE IN THE GULF COAST AND OTHER COASTAL REGIONS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

THE AVAILABILITY AND AFFORDABILITY OF INSURANCE IN COASTAL REGIONS TO ADEQUATELY PROTECT AMERICANS' HOMES, BUSINESSES, AND THEIR FAMILIES FROM NATURAL DISASTERS

WEDNESDAY, APRIL 11, 2007

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WEDNESDAY, APRIL 11, 2007

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:30 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order.

I want to welcome everyone to today's hearing, "Availability and Affordability of Property and Casualty Insurance in the Gulf Coast and Other Coastal Regions." Let me first of all thank the witnesses who are appearing before the Committee today. I want to particularly thank my colleague from Florida, Senator Nelson, and Governor Crist for appearing at the hearing today, and also Senator Landrieu, who was planning to testify this morning but was unexpectedly called back to her State on an emergency and will be unable to attend the hearing this morning. But her statements and supporting information she wants the Committee to be aware of will certainly be included in the record.

Today's hearing is on an important and timely topic: insurance in our Nation's coastal regions. Although coastal areas comprise only 17 percent of the contiguous land area in the United States, 55 percent of the Nation's population lives within 50 miles of the coast; and by next year over 160 million Americans, more than half our population, will live and work along America's expansive coastlines. It is critical that these Americans are able to adequately protect their homes, their businesses, and their families from natural disasters.

We have all witnessed the devastation that nature can wreak across our country in the form of hurricanes, floods, tornadoes, and earthquakes. In 2005, Hurricanes Katrina, Wilma, and Rita destroyed hundreds of thousands of homes and businesses along the Gulf Coast. In 2004, Hurricanes Frances, Charley, and Ivan devastated parts of Florida. In the 1990's, the worst natural disasters were geographically diverse: Hurricane Andrew in Florida in 1992, and the Northridge earthquake in California in 1994, and the Red

River floods in North Dakota in 1997. Each of these caused billions of dollars in destruction.

In order to rebuild homes, businesses, and lives, Americans looked to, among other things, their insurers as well as their National Government for disaster assistance. Unfortunately, insurance coverage is becoming increasingly difficult to secure and afford. In many coastal areas from Texas, along the Gulf, and up the East Coast, insurers are pulling out of high-risk areas. Others are dropping certain coverages, such as wind storm coverage. Others are drastically raising rates and deductibles. Let me just read two examples from recent press articles of how these actions are affecting Americans' lives and their livelihoods.

A *Chicago Tribune* article on March 20, 2007, detailed the situation of Jeffrey O'Keefe, President of the Bradford-O'Keefe Funeral Homes in Mississippi, on Mississippi's Gulf Coast, who has scaled back his insurance coverage. Before Katrina, Mr. O'Keefe paid $61,224 in annual premiums to insure his business, and now renewing that $7 million in coverage would have cost about $781,000. So he reduced his coverage from $7 million to $2 million, but he is still paying $122,000 in premiums—twice as much as before the storm. So he is paying much more for a lot less coverage in his business.

A *Palm Beach Post* article from May 29, 2006, tells of Tracy Casper, who dropped her homeowners' insurance after her premiums became unaffordable. The article, entitled "Insurance premiums force tough choices," says, and I quote, "Tracy Casper felt ill Mother's Day weekend. While plenty of people will remember opening sentimental cards, Casper remembers opening her wind storm insurance renewal notice. Her premium had skyrocketed 194 percent to $7,443.

Today, appearing on our second panel, we have with us homeowner Harold Polsky, who was forced to sell his and his wife's home in Florida because of rising insurance costs. We are also joined by a small business owner from the Greater New Orleans area, David Guidry, who has seen his insurance costs rise and faces great uncertainty about his ability to shoulder further increases.

I would like to take a moment to personally thank the Polskys and Mr. Guidry for taking the time out of their schedules and time out of their work to come and speak with us at this public hearing this morning. It is critical that this Committee understand what this issue means to people around our country, and their testimony is going to help us do just that this morning in real terms with real faces.

The lack of affordable insurance is a serious problem for millions of Americans across our country. Many States have attempted to address the lack of available and affordable insurance by taking measures such as setting up State insurance pools to cover wind and other damages. However, these States cannot be expected to shoulder the burden alone given the magnitude of the losses that have occurred over the past few years and that may occur in the years to come. This is a national problem—a national problem that demands national attention. As such, it deserves examination by us as national leaders, and it is an appropriate area in which to consider national solutions.

Let me be clear at the outset that any Federal actions must be carefully crafted to ensure not only that Americans have access to affordable insurance but also that taxpayers are not overly burdened by the risk of losses that are properly borne by insurers and reinsurers. With that in mind, I believe we can and should consider a number of steps to help Americans find affordable insurance, because without insurance, their homes, their businesses, their very futures will be put at unacceptable risk.

There are four steps that I propose today that Congress and the administration take to provide relief for homeowners and businesses in the coastal areas of our Nation.

First, given the acute challenges faced by working families and working business owners, I believe that we ought to provide relief in the form of tax deductions for homeowners' insurance premiums in areas where premiums have been significantly increasing. Any deduction should be targeted to working and middle-income families who need it most and should be capped, both individually and on a national basis, so as not to exceed $100 million for the year. This homeowner's insurance deduction can give homeowners some desperately needed short-term relief from skyrocketing premiums, and it could also help ensure that families in hard-hit areas are not forced to move while they seek longer-term solutions. I am not talking about a permanent program here, but one that could provide some immediate, short-term relief to get people on their feet and avoid the kind of problems that I mentioned already in this statement.

Second, I believe that our Nation should increase our investment in mitigation activities so that communities, families, and businesses can protect against future losses. The current FEMA Mitigation Program provides $100 million in fiscal year 2007. This is, in my view, not enough to assist communities around the country to truly address the risk of loss to their residence. Mitigation efforts are critical, and we should at least double the amount of funding so that communities can assist individual homeowners to strengthen their homes, can find larger-scale mitigation projects to protect whole blocks of communities, and can help people relocate to safer ground. Additional funds should be used for revolving loans and grants to directly assist homeowners and business owners who want to make needed upgrades to help protect their properties. Increased mitigation efforts can help to decrease insurance costs, and they can also protect Americans from future devastation caused by natural disasters. I talked about a revolving fund here. I think if you have a vested interest, an equity interest in your home, then you ought to bear some responsibility for paying back those resources that helped you strengthen your residence or your business.

Third, we must strengthen the National Flood Insurance Program. The National Flood Insurance Program is essentially the only insurer of flood risks in this country. As a result of Hurricane Katrina, this program has borrowed funds from the U.S. Treasury and is now over $20 billion in debt. Most of that, I would point out to all of you here, occurred as a result of Katrina. Actually, the

Flood Insurance Program is running fairly well. It ran into some debt problems but nothing of the magnitude that I have just described until we were hit by Katrina. These numbers now, the premiums alone on this, could reach $1 billion a year fairly quickly. And, again, I will point out here the Committee also dealt with this legislation in the last Congress under the leadership of Senator Shelby and Senator Bunning. We need to get back to this right away, in my view, and deal with the Flood Insurance Program in the country. The interest alone on this, as I said, will reach $1 billion annually, close to half of the premium generated in the program each year. Clearly, this program was not designed to handle a catastrophe of the magnitude of Katrina, as I mentioned. In order to ensure the future availability of flood insurance, we must strengthen this program and put it on a sound financial footing, as Senator Shelby, Senator Bunning, and others on this Committee worked so hard to do last year.

Last, we need to gather additional information as we consider longer-term solutions here. Today's witnesses offer a range of views and a number of proposals on what, if anything, should be done at the Federal level to improve the long-term availability and affordability of property and casualty insurance. This diversity of opinion is on one level healthy and positive, and I welcome it. On another level, however, it underscores the fact that there is a lack of consensus among stakeholders and policymakers about what national action, if any, is appropriate in the long term to help homeowners and businesses contend with rising property and casualty premiums. For that reason, I believe we ought to establish a short-term national commission of insurance experts and other leaders to make recommendations to the U.S. Congress and to the executive branch in very short order. I look forward to working with my colleagues Senators Nelson and Martinez, Senators Landrieu, Lott, and others on this effort.

The issues before us today are critically important to millions of Americans. Recent analysis predicts that the 2007 hurricane season will be unusually active, with 17 possible named storms, 9 possible hurricanes, and much higher than average likelihood of a major storm hitting U.S. shores. Today's hearing is the first step toward looking at how we can assist in protecting Americans from natural disasters and assuring them that when disaster strikes, they will be able to rebuild their homes, their businesses, and their lives.

I look forward to hearing from all of our witnesses today and to working with Ranking Member Shelby and my colleagues on this very important issue.

With that, let me turn to Senator Shelby for any opening comments he wants to make. Then I will turn to our two colleagues from Florida, and to welcome Governor Crist for being here, and I thank you this morning for joining us as well.

Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Chairman Dodd.

Hurricanes Katrina, Wilma, and Rita caused more damage than any other natural catastrophes in U.S. history. The aftermath of these storms is still being felt even in my State of Alabama and across the entire Gulf Coast. Both homeowners and businesses are struggling to rebuild and to get back on their feet. Available and affordable insurance is a critical part of that effort.

In the case of the Gulf Coast, insurance has served this function for many people. It has protected them from financial ruin and has aided the recovery effort by injecting billions of dollars into the region from the payment of claims on insurance policies. Unfortunately, many were under- or uninsured, and the increasing cost of insurance in the region has slowed the economic recovery.

As we examine the question of the availability and affordability of catastrophic insurance, I believe that there are several considerations that we should keep in mind.

First, private markets are far more innovative than Government programs. The private sector is rapidly developing new ways to manage catastrophic risk, including the use of catastrophe bonds, catastrophe futures products, and securitization of insurance risk. Already, newly designed sidecar transactions have allowed the market to significantly expand its capacity for catastrophic risk over the past 2 years.

Second, the market is a better risk manager than the Government always. It is worth noting that we have yet to have a catastrophic situation inflict losses that our insurance markets were not able to absorb. Certainly there could be a catastrophe that our markets would not be able to handle, and we should consider how to address such a catastrophe for the future. In the overwhelming number of cases, however, our insurance markets can, and they do, effectively manage the risk.

While some in the insurance industry may favor the idea of the Government covering the most expensive risk, I doubt taxpayers would look favorably on paying for losses that insurance companies can and should bear. Our experience has shown that the Government-operated insurance programs have a record of financial mismanagement. The program most familiar to the Members of this Committee is the National Flood Insurance Program. This program is not actuarially sound, was never actuarially sound, and is currently in debt in excess of $20 billion, as the Chairman noted. Based on this experience, any consideration of a national catastrophic insurance program should have to address several key questions.

One, how would it ensure that its pricing is actuarially sound and not influenced by political considerations?

Two, what types of coverage would it provide?

Three, would it cover $1 million vacation homes?

In a time of fiscal constraint, what impact would it have on the Federal budget?

And, finally, if it is truly for catastrophic events, is it likely that it would benefit only citizens living in one State and a few other select areas at the expense of all Americans?

Recent events have demonstrated once again diversification is essential in managing catastrophic risk. As devastating as Katrina was, it would have been far worse had it resulted in a wave of insurance company insolvencies. One of the primary reasons insurance companies remained solvent was because they diversified their risk. Some estimates show that around half of the insured losses from Katrina, Wilma, and Rita were ultimately absorbed by insurers outside the United States. This diversification appears to have enabled U.S. insurers to bear the financial losses inflicted by the storms. As a result, policyholders could turn to solvent companies to pay their claims, and they did. Some policyholders, however, were not made whole, and we should focus on where the market failed and examine whether the market or the Federal Government is best positioned to fill those gaps.

As always, I support a comprehensive examination of every facet of this very complex set of issues. This Committee has a rich history of doing just that on a number of very difficult topics, and I believe, Mr. Chairman, that is where that examination should take place.

Thank you.

Chairman DODD. Thank you very much, Senator Shelby.

We have been joined by Senator Martinez—excuse me, Senator Menendez, although Senator Martinez is here as well.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. You are in good company, Mr. Chair. The President did that to me, too.

[Laughter.]

Mr. Chairman, let me—and I never mind being confused with Senator Martinez, by the way. You know, the other day I voted for him.

[Laughter.]

Let me thank you and Senator Shelby for holding an important hearing on the availability and affordability of property and casualty insurance in coastal regions. We all remember the Gulf Coast and how it was struck by several hurricanes in 2004 and 2005, and Katrina alone caused more than $40 billion in insured losses, including approximately $16 billion from homeowners' claims.

However, the availability and affordability of such insurance is not just a Gulf Coast problem; rather, it is a national problem. People in States from Massachusetts to my home State of New Jersey, to Florida and to Texas are facing similar situations because of hurricanes, and residents of other States across this country face similar challenges, whether they come from tornadoes, fires, earthquakes, or floods.

In my State of New Jersey, we have 127 miles of Atlantic coastline and more than 80 miles of bay side coastline. More than 51 percent of New Jerseyans live in counties that the National Oceanic and Atmospheric Administration lists as exposed to hurricane risk. And as of 2004, New Jersey ranked fifth in the Nation with $506 billion worth of insured coastal property that is vulnerable to hurricanes. While we were not directly hit by the hurricanes of 2004 and 2005, all we have to do is look back to 1999 when Hurricane Floyd damaged 76,000 homes, 4,000 businesses, and 9 New Jersey counties were declared disaster areas.

So as the Committee that is responsible for housing issues, we all know that the American dream of owning a home has been a powerful force throughout our history. The average family invests more in their homes than they invest in the stock market, the money market, or their retirement savings plans.

Unfortunately, skyrocketing insurance premiums and insurance availability are posing real threats to the American dream of homeownership. According to the Department of Banking and Insurance, last year rates increased 8 to 12 percent in New Jersey, or up to about 15 percent on average in coastal areas. And that is for those who can get coverage, Mr. Chairman. The fact of the matter is that several insurance companies in New Jersey have made a business decision to stop offering coverage in our coastal areas, and I am certainly not happy with that.

More and more homeowners in my State have been dropped or are slated for nonrenewal by their insurance companies. A recent report in the Asbury Park Press had Richard Ray, a 72-year-old retiree, who lives six blocks from the ocean in Bellmawr, receiving a letter from his insurance company in January informing him that his homeowner's insurance policy would not be renewed in February. The property insurance crisis is clearly a major one. It is not isolated just to New Jersey. Mr. Ray is one of many Americans who are now facing owning a home without the proper and much needed insurance, and without that, the single biggest asset that he has is exposed to enormous risk.

So, Mr. Chairman, I look forward to working with you and the Ranking Member to make sure that we ensure the dream of most people, their retirement security, the essence of their financial security, and that we can do so in a way that is thorough and efficient and make sure that that dream remains alive.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Menendez.

We have been joined by our colleague from Florida, Senator Nelson, as well as a Member of the Committee, Senator Martinez. I will begin with the Member of the Committee, and then I will turn to Senator Nelson before we hear from the Governor.

Senator Martinez.

STATEMENT OF SENATOR MEL MARTINEZ

Senator MARTINEZ. Well, thank you, Mr. Chairman. I appreciate so very much you and Ranking Member Shelby holding this very, very important hearing. I am a little under the weather this morning, but I could not pass the opportunity to be here with our Governor and an opportunity to introduce him before the Committee as well.

As has been noted, the skyrocketing cost of property insurance is a problem that has been largely driven by the devastating hurricanes that we have seen in the last couple of years. And let's be clear from the outset that the skyrocketing property insurance rates are a national concern and have the potential to become a national crisis.

It is a national problem because 90 percent of the people in our Nation live within 200 miles of a coastline. There is the risk crisis because insurance companies in my State and others have already shown that the current marketplace is not working for them. State Farm has chosen to stop writing business in Mississippi. This year, Allstate Floridian will send notices to an additional 100,000

Floridans that their homeowners' policies will not be renewed. Even in Northeast States that have not seen recent hurricane activity, we are witnessing a constricting of the market. We are indeed facing a crisis in both the availability and affordability of property insurance, and I believe the Federal Government can play a reasonable and responsible role in helping the marketplace better address the needs of our consumers.

We live in a world that will always have risk. In light of past disasters and in expectation of future ones, we have got to find a better way to spread and finance the risk. I support the creation of a national catastrophic fund in order to stabilize and strengthen the insurance market and encourage proper disaster mitigation. The economic distress brought by disasters affects us all. With a national catastrophic fund, we have an opportunity to minimize risk nationwide and ensure our economy is able to absorb losses from large and small disasters.

But the looming insurance crisis will not be fixed with a national backstop alone. This is a multilayered problem that requires a multilayered approach. Among other things, I believe we should provide tax incentives that encourage homeowners and businesses to prepare for disasters. I also support increased funding for hurricane research because, in order to better prepare for disasters, it is imperative that we know more about them.

I am so glad that we are meeting here today to discuss some of these initiatives, and I am also so proud to be able to introduce Florida's Governor, my Governor, to this Committee.

Charlie Crist is a public servant defined by his tireless devotion to the citizens of Florida. He has been a Florida State Senator, an Education Commissioner, and our Attorney General. In 2006, he sought and won the Governor's seat, and on January 2, 2007, was sworn in as Florida's 44th Governor. In his public career, Governor Crist has worked to pass laws that dramatically toughened penalties for the identity theft and counterfeiting and dealing of prescription drugs. He proposed and worked to pass Florida's landmark civil rights legislation, the Marvin Davies Civil Rights Act of 2003, to pursue those who engage in willful discrimination. He also won approval for legislation targeting those who distribute illegal spam on the Internet.

Since his first day in office, my good friend, Charlie Crist, has tackled the issue of property insurance affordability. One of the first things he did after becoming Governor was call our Florida legislature into special session to deal with the Florida insurance crisis. The State succeeded in addressing that issue in the best way that it could, and now Florida is rightly looking to the Federal Government to step in and play its appropriate role.

The Governor is working tirelessly with the entire Florida delegation in a bipartisan way to find a resolution, and I know I speak for all Floridians when I say we are proud to bring him before this Committee.

Before closing, I would like to add that in case you have not seen the hurricane predictions for this season, we could very well be in for a lot of activity. The forecast is calling for nine hurricanes, with a prediction that five will be major ones, Category 3 or higher. We dodged a bullet last year, but asking for the hurricanes to miss us 2 years in a row is like betting against the house.

Chairman Dodd, thank you for holding this hearing and tackling this very important issue this year.

Chairman DODD. Thank you very much, Senator Martinez. That is the reason we are holding the hearing now, is to try and get in front of this as early as we can and come up with some ideas. And no one has been more insistent upon that than the two Members from Florida in talking to this Committee, and no one more insistent within the delegation of Florida than my friend and colleague, Senator Nelson. I can see him coming almost on a daily basis to me. In addition to saying hello and wondering how my daughters are doing, he was also wondering when we could have a good hearing on the subject matter of the availability and affordability of property and casualty insurance. So I am pleased to welcome Senator Nelson here.

I would point out to the Committee, I know you have another Committee hearing in the Commerce Committee, but I want you to know if time permits, please come and join us here on the dais as we hear from other witnesses, and you are welcome to be a part of this hearing as well.

STATEMENT OF BILL NELSON, U.S. SENATOR FROM THE STATE OF FLORIDA

Senator NELSON. Thank you, Mr. Chairman, and thank you for permitting me to be a pest with you ever since our telephone conversation on November the 8th, the day after the election, when it became apparent that you were going to be Chairman of the Committee. I am grateful to you and Senator Shelby for your kindness in having this hearing, and indeed, Senator Martinez and I are quite honored to have our Governor here, who has to deal with this on a daily basis.

Mr. Chairman, the long and short of what is facing us is that the Big One is coming. In 2005, you may have thought that that was the Big One, and we in Florida in 2004 may have thought that four hurricanes within the span of 6 weeks, hitting virtually every county in Florida, might have been the Big One. But remember that Katrina was a Category 3, and it did to the Mississippi coast what you would expect a Category 3 to do. It just so happened on the back end of that hurricane and the winds coming counterclockwise from the north to the south in the city of New Orleans, that for reasons other than wind damage, the canals filled up, the drainage canals filled, and then emptied into the big drainage canals. The water rose. The pressure on the sides of those canals increased, and in two places they were breached, thus filling up the bowl of New Orleans with water, with the consequence that we are well in excess of that 2005 year, in excess of over $200 billion worth of damage, of which the Federal Government's share at the end of the day is going to be in excess of half of that. And that was a Category 3.

The Big One is coming, and it is a Category 4 or 5 hitting at a high-density, urbanized part of the coast, and it is not just Florida. It could be anywhere up that Atlantic seaboard. It could be anywhere on that Gulf Coast. Or it could be an earthquake in San

Francisco. It could be an earthquake in Memphis. And when the Big One hits, at the end of the day, just like Katrina, the Federal Government is going to pick up the tab.

So the question is: How can you rationally devise a system so that we know ahead of time and it gives certainty to the marketplaces that Senator Shelby was talking about so that the marketplaces can provide a commodity which is essential today? Insurance is not a luxury. If you want to own a home, you have got to have insurance because you cannot get a mortgage without insurance. And, oh, by the way, three major industries in this country—construction, real estate, and banking—all depend on homeownership and home building. So everything fits together.

So then when you look at it, you find out there is no consensus. The insurance industry is split nine ways to Sunday. The insurance industry is in a war with the reinsurance industry. The reinsurance industry is saying that the private marketplace can solve the problem, and it cannot on risk of this magnitude. When the Big One hits, it is a $50 billion insurance loss storm, minimum. The private marketplace cannot supply that. There is no one State that can withstand that kind of economic hit, and there is no one insurance company or reinsurance company or series of reinsurance companies that can withstand that kind of hit.

Therefore, that brings us to the table today. What is the appropriate role? Well, with everybody so split and with the fact that the Federal level of Government has discharged to the States ever since the 1930's, through the McCarran-Ferguson law, the responsibility of the regulation of insurance, then the question is begged to be answered: How do we build that consensus? And it is the bill that Senator Martinez and I and others—most of them the Gulf States, both Senators from Mississippi, Senator Landrieu are signed on—that takes the model of what we did in Florida in the mid-1990's, inheriting a paralyzed marketplace, not just in South Florida where Hurricane Andrew hit—-and it was a Category 4 that hit not the high-density, urbanized area. It hit South Dade County, a relatively lessened urbanized area. And yet the paralysis of that marketplace spread over the entire State.

The model that we used, we brought people together on a consensus-building—then it was called the Academic Task Force. It was headed by the presidents of the State universities. They went out, they hired the best staff. They sought people's opinions. They came together. They made 16 recommendations to me and to the Governor. We then went to the legislature, and we adopted 15 of those 16 recommendations and, indeed, restored the private marketplace.

What is that role? Senator Martinez and I have filed a six-pack. There is an additional bill that would be a seventh that we ought to look at, which is what is the Federal legislation that would incentivize the States to form a regional compact, a regional catastrophic fund. We tried that back in the 1990's. The rest of the States did not want to participate. Florida had to do it on its own. But Florida saw from the 2004 experience of four hurricanes that all of that catastrophic fund, which is a reinsurance fund, was depleted.

And so what we are facing is the question of what is the appropriate Federal role when, in fact, at the end of the day, on the experience of Katrina, the Federal Government is going to pay a lot of the tab. And I am just as pleased more than I can tell you, Mr. Chairman, that you have said that you support this consensus-building bill, because you will hear in the testimony today from all these experts there is no consensus. And there is no way, no idea of how you would even build a rate structure on a national catastrophic fund. We have got to determine that.

Should we change the Tax Code so that insurance companies can reserve for catastrophe without having to pay taxes on it and fence it off? But there is no consensus on that within the industry.

Should we change the Tax Code to reserve an individual person, a homeowner, to reserve for catastrophe without paying taxes on it? There is no consensus on that.

And all the other bills that Senator Martinez and I have filed in this six-pack, there has to be a high-level national emergency commission on catastrophe. And maybe at the end of the day you are not just looking at hurricanes, but you are looking at earthquakes. And who knows? Maybe at the end of the day, you might even be looking at the question of floods, all within what is the proper Federal Government role to backstop these huge natural catastrophes that, in fact, are so catastrophic economically as well as personally.

So it is my pleasure, Mr. Chairman, to introduce our Governor, who has taken a very strong leadership role in this, because people at home are hurting. They cannot afford their homeowner insurance premiums, and when that is combined with taxes in Florida, the homeowners' real estate taxes, people are being eaten out of their house and their home. And I wanted to, along with Senator Martinez, welcome our Governor, Governor Charlie Crist.

Chairman DODD. Well, thank you very much, Senator Nelson, for that, and Senator Martinez as well, both of you, for introducing your Governor. We are pleased to have him as our lead witness this morning.

Charlie Crist was elected in November 2006, served as the Attorney General of your State prior to that, and we are pleased that you are here this morning to talk about this issue as it affects your State and the Gulf States as well. So, Governor, welcome.

STATEMENT OF CHARLIE CRIST, GOVERNOR, STATE OF FLORIDA

Governor CRIST. Thank you very much, Mr. Chairman, and thank you, Senator Shelby as the Ranking Member, and Members of the Committee. I thank you for the opportunity to testify here today regarding the availability and affordability of property and casualty insurance, and I applaud you, Mr. Chairman, for your leadership on this critical issue. I want to thank my friends, Bill Nelson and Mel Martinez, for their leadership on this issue as well.

A few weeks ago, our Senators introduced an array of legislative options addressing insurance reforms. As you know, they call it the "six-pack," and it may have a seventh. I am so proud to work with Senators Nelson and Martinez, along with our Florida Members of the House of Representatives, to move toward the creation of a national catastrophic insurance fund.

The role of the Federal Government in protecting the American homeowner from skyrocketing homeowner's insurance has been debated for many years. Conceptually, the idea remains the same. The debate now focuses on the millions of Americans impacted by increased property insurance rates. Traditional insurance market mechanisms are not adequately managing catastrophic risk, and the financial strain on consumers can be felt from coast to coast.

Hurricane Katrina reminded us all of what a natural disaster can do, not only to a specific region but to our Nation as a whole. No specific area of our country is immune to natural disasters or exempt from paying the recovery costs thereof. In the past, congressional action created a bridge to homeowners in the form of national flood insurance. Congress has the opportunity once again to provide homeowners relief in the form of a national catastrophic insurance plan.

During my campaign for Governor last year, I traveled our great State, and I listened to the concerns of the people of Florida. Floridians are being forced to choose between paying skyrocketing insurance premiums or selling their homes. I have heard from many Floridians who are worried that soaring premiums are threatening their chance to raise their family in a Florida home. This is not the American dream.

The hurricane seasons of 2004 and 2005 produced eight named hurricanes that hit our Florida, costing the State $33 billion in property loss. As a result, the number of carriers providing property insurance coverage has been on the decline, and market concentration has diminished as well. Florida now relies on a greater number of carriers, often smaller, recently formed domestic insurers that provide coverage, rather than a handful of nationally known insurance companies. The dramatic increased cost of reinsurance, increased projected cost of building materials and labor, and projection of future catastrophes have all contributed to significant premium increases paid by Florida policyholders.

Commensurate with these issues, Florida's Office of Insurance Regulation, headed by Kevin McCarty, and in conjunction with our new CFO, Alex Sink, has received a substantial increase in the number of rate change requests from insurance providers. Floridians understand the risk of living in our beautiful State. Our State has made immense progress in reinforcement efforts and stricter building codes to protect our citizens when the next storm surely will come. However, these efforts are not enough to convince the insurance industry that Floridians are a worthy risk.

As Florida's new Governor, I have heard directly from our people that immediate insurance relief was needed. The people of Florida cried out. They needed help, and we answered their call. Earlier this year, the Florida Legislature did meet in a special session, seeking solutions to runaway property insurance rates. We worked together in a bipartisan way. We focused on results, not on politics or the process. Together, we achieved a momentous step forward in reducing property insurance rates for our people.

The legislature passed meaningful property insurance reform, providing much needed relief to the people of Florida, and I must at this time thank our Senate President, Ken Pruitt, and our Speaker, Marco Rubio.

The work of the Florida State Legislature has begun to address the insurance crisis in our State, but Federal action is also necessary. I implore Congress to take the next step to ensure the affordability and availability of property insurance. I know that each of you has chosen to serve the people of your State, with the end goal of improving their lives and their well-being. Like me, you want your citizens to have the opportunity to own a home without the worry of losing it to out-of-control property insurance rates.

Mr. Chairman, you have been a leader on consumer issues in Connecticut and in our country, and I applaud your efforts. Let me please be clear. This crisis is not an exclusive issue for Florida. Many other States are also facing insurance crises.

In February, I had the privilege of working with my fellow Southern Governors, including Governors Barbour, Riley, and Kaine of Virginia, in drafting a resolution urging our Congress to create a national catastrophic fund. Governors throughout our Nation deal firsthand with the impact of natural disasters, as do you. I am also proactively working with Governor Schwarzenegger of California, Governor Spitzer of New York, and Governor Perry of Texas to advance a national fund proposal. Governors understand, as you do, the need for such a program and look forward to working with you to formulate this legislation, much like as Senator Nelson and Senator Martinez have already done in their forward-thinking approach.

The problem of insurance availability and affordability in the Gulf Coast area has been widely publicized, but it is a problem that is now affecting other States as well. Mr. Chairman, as you probably know, the Connecticut Department of Insurance recently conducted a study of its homeowners' insurance market and determined that insurance availability within 1,000 feet of the shore is difficult to find in the traditional market today. Coverage that is available typically is 2 or 3 times more expensive now and often available only through a specialty market. Similar problems are being felt from Cape Cod to the Carolinas. The response from insurers is aimed at coastal exposure, but it ignores the very real possibility that the next major catastrophe will not even touch a coastline. Our country has a relatively brief history, but in that time virtually every region of the country has experienced some form of catastrophic event. The hurricanes in the Gulf are only our most recent reminder of the risk from natural disasters, but we would be naive to think that they are the last. We are all vulnerable to natural disasters. Most of the States you all represent have been impacted by hurricanes or tornadoes or wildfires or blizzards or drought. Whether you live in Connecticut, Alabama, New York, Hawaii, New Jersey, Ohio, Kentucky, North Carolina, or any other State, we are all at risk.

That is why it is time, I believe, for Congress to move forward and listen to the American people and create a national fund. A Federal catastrophe fund would provide protection for American homeowners throughout the country. A national program would spread the risk across our country, thus strengthening our insurance markets. Capital for the plan could come from a portion of the property insurance premiums already collected by insurance companies. The funds could grow tax free, provide the financial capability to cope with the catastrophic risk, and allow affected regions the ability to recover more quickly from the natural disasters they may suffer. This Federal backstop, as Senator Nelson refers to it, for insurers is an essential step to addressing our insurance crisis.

The situation is not just an issue of lowering insurance rates to our citizens. It is also an issue of using taxpayer dollars in the most efficient manner. Our current policy for managing the devastating effects of catastrophic natural disasters relies heavily on our Federal Government. Consider the $110 billion allocated so far to facilitate recovery and rebuilding following Hurricane Katrina. As generous as compassionate as the American people are, this current system leaves much to be desired.

The subject we are discussing today is not new. What are new are the insurance industry's record profits, to the tune of $68 billion in 2006 alone. That is according to a Wall Street Journal article from January 23, 2007. The insurance industry as a whole has enjoyed lavish prosperity in recent years. I believe it is time for the American people to participate in that prosperity by way of reasonable insurance costs.

Our Nation's response to natural disasters is one of defense. Mr. Chairman, the Committee has a unique opportunity to play offense by changing the mind-set within the Government. This change can be made by creating a national catastrophe fund that will ultimately protect our bosses—the American people.

The time is now to bring all the stakeholders to the table to do what is right. I ask you to refocus our national effort away from large-scale funded recovery after a disaster to proactive prevention. A national catastrophe fund will create this transition. Clearly, this practice makes the issue a national one, not only a local or a regional problem.

For example, it is estimated that the Great Lakes and Plains States will contribute approximately $26 billion to Katrina initiatives. However, these tax dollars are not risk based, and they will leave little legacy that guarantees relief for the next natural catastrophe, regardless of where that natural catastrophe would strike.

A national plan would also raise the bar for disaster preparedness and recovery. By encouraging States to adopt stronger building codes and emergency response capabilities, we would undoubtedly mitigate future economic damage while developing a cultural preparedness that will create a safer environment for all of the citizens of the United States.

Today, we must ask ourselves: What will make insurance more available and more affordable for the people that we all serve? I believe a national catastrophe fund will achieve that goal.

I thank you again for holding this hearing, Mr. Chairman and Senator Shelby, for inviting me here today, and for your continued interest and leadership on this crucial issue. I look forward to working with Congress to solving the insurance crisis facing our citizens. I thank you for your time and for your attention and for your compassion, and I want to again thank my colleagues and my friends, Senator Bill Nelson and Senator Mel Martinez, who serve the people of our State so ably and so well.

Thank you, sir.

Chairman DODD. Thank you very much, Governor, for your testimony. We thank our colleagues as well for their observations.

Let me just ask one question, if I can, of you, Governor, and that has to do with—and I think you referenced this in your comments. What has happened to the presence of private insurers as a result? Some have suggested that as a result of the Cat fund which was established in the State that the private industry has felt challenged by that and the result has been one of the contributing factors for them not staying in the State? What evidence do you have that that is the case?

Governor CRIST. Well, I think the opposite is the case now, Mr. Chairman. What is happening is we have expanded that catastrophe fund as it relates to Florida-specific. That is intended to encourage more insurers to come to the State, and they are coming.

As I mentioned in my prepared statement, many of them are domestic, and some of them are smaller companies. But it is creating greater competition and more choice for the consumers of the State of Florida.

Recently, one company offered new rates that are 34 percent lower than they were just a year ago. Two other companies' rates are more than 20 percent lower than they were just a year ago. And additional companies, one in particular wants to bring $100 million of coverage to our State that did not do so before this special session we had just in January.

Chairman DODD. So you actually think it is having the effect of attracting insurance companies.

Governor CRIST. I believe that it is, and we also have in Florida something that may be unique. We have a Citizens Property Insurance Company that is run by the State. This company came into being a number of years ago as a result of the catastrophes that we were facing. It offers greater competition. It was set up originally to be the insurer of last resort, required by law to only provide the highest rates. The special session changed that law. They now can compete. And what the old threat used to be in Florida by the insurance industry was, because the old mind-set used to be, the only way you can improve the insurance market in your State, Florida, is to allow rates to increase so you will attract more.

Well, that is exactly what was killing our citizens, were the increased rates. Senator Nelson was right in his comments, the double whammy of pocketbook issues in our State, our insurance premiums, as well as property taxes. And we are working on both.

But this insurance company that is run by the State now can compete, and what insurance companies used to say to us in the private market is, If you do not allow us to raise our rates, we will leave your State. Well, we do not want them to leave, but if they leave now, we have protection for our people, and we owe them that.

Chairman DODD. How much is in your fund in the State? And can it deal with the kind of situation that Senator Nelson described?

Governor CRIST. Not a $50 billion situation, but it is up to about $9 billion now, and we intend to increase it. That is why we feel that, you know, this is sort of a mosaic and there are lots of pieces to the puzzle across the board on this issue that will benefit Connecticut, that will benefit Florida, that will benefit Alabama, and every State in our country.

I had the opportunity—I guess you could put it that way—to be in California at a World Series game and witnessed the earthquake that stopped that game. Any State you are in in our country can suffer from a natural catastrophe. That is why I think it is so important that you have been kind enough to hold these hearings today.

Chairman DODD. Senator Shelby.

Senator SHELBY. Senator Nelson, one of the concerns I have about establishing a national catastrophe fund is that it may increase the chances of financial crisis following a natural disaster. Under your legislation, the national catastrophe fund would provide reinsurance to State insurance funds. Just as the Flood Insurance Program has failed to charge actuarially sound rates, the national catastrophe fund is very likely to underprice the reinsurance it would provide to State insurance funds. This is a concern of mine. This price break would likely be passed on by the State funds to their customers in the form of rates that are not actuarially sound. This could have two results.

First, because State insurance funds would charge below-market prices, they would underprice private insurers and obtain a significant share of the insurance market in their States. As a consequence, insurance risk could become concentrated in State insurance funds.

Second, the failure of the State insurance funds to charge actuarially sound rates, Governor, means that they would probably not collect enough premiums to cover their obligations. Accordingly, the net effect of a national catastrophe fund would be to concentrate insurance risk in undercapitalized State insurance funds. When a natural disaster hits a State—Florida, Alabama, or anywhere—risk will not be spread among numerous well-capitalized firms in the private market, but concentrated in one financially impaired State fund.

Senator Nelson, do you have any concerns that your legislation at this point—and I know it is subject to change—would concentrate too much risk in State insurance funds? Do you understand my concern?

Senator NELSON. Yes. Senator Shelby, I see problems with the national catastrophe fund, but not in the way that you have stated them, and——

Senator SHELBY. Why?

Senator NELSON. And I am going to answer that, but let me just say that the six-pack of bills that we have filed is purely to get the ideas on the table. What I have urged you for the last year, and the Chairman more recently, is to get that emergency commission going so that consensus can be built, because nobody has all of the answers and, in fact, if they do, they do not want to share them or they want to just protect their turf. And that is what is going on in the industry today.

Now, what I see, the biggest problem with a national catastrophe fund is not what you have said; it is the fact that you are going to have a Star Chamber up there setting rates that will not have the accountability to the people. And whenever you have that, that is not a good thing.

Senator SHELBY. Let me stop you, though. Do you believe that any fund we set up should be actuarially sound? You know the Flood Insurance Program is not actuarially sound. It is in debt of $25 billion now. Do you believe it should be actuarially sound?

Senator NELSON. In theory, yes.

Senator SHELBY. In theory? What about practice?

Senator NELSON. Well, in practice. Take, for example, the National Flood Insurance Fund. It would be great if you could have it actuarially sound, but that means you are going to have to hike all of the premiums, and politically that may not be available to you and to the rest of the Senate and to the Congress. Therefore, the Federal Flood Insurance Program has been subsidized by the Federal Government for the last number of years since its existence. That is a perfect example of a response to your question about these other funds.

Now, what these other funds do, if Florida had not had that catastrophe fund after the four hurricanes in 2004, it would be "Katy, Bar the Door"; the insurance companies would have fled the State of Florida. Is Florida's fund actuarially sound, to take your question back? The answer to that is technically no, because when the fund is drained, it under Florida law goes out to assess the people of Florida through the ratepayers of insurance policies.

Senator SHELBY. Well, my concern is that we should not dump everything, including the risk in my home State on the coast, on the taxpayers, as you well know.

Governor Crist, you recently enacted——

Senator NELSON. May I respond to that?

Senator SHELBY. Yes, go ahead.

Senator NELSON. But the fact is that your taxpayers from northern Alabama that do not have much of the risk that your people from the south coast of Alabama do, they are paying it because, remember, in excess of $100 billion for Katrina has been paid by the National Government.

Senator SHELBY. By the taxpayers.

Senator NELSON. By the taxpayers.

Senator SHELBY. I understand that.

Senator NELSON. So at the end of the day, the Federal taxpayer is paying it now. We ought to devise a system——

Senator SHELBY. Just because the taxpayer is paying it now, if we are looking at a future catastrophe fund, shouldn't we make that, the best we can, actuarially sound?

Senator NELSON. And that is the reason for the consensus commission.

Senator SHELBY. OK. I hope you are on the right track; otherwise, this legislation will go nowhere.

Governor Crist, your recently enacted insurance reforms greatly expanded the financial obligations of Florida's insurer of last resort and largest property insurer, Citizens Property Insurance Corporation. Citizens was allowed, as I understand it, to cover policyholders who could obtain insurance in the private market and to write additional lines of insurance. I think you mentioned this earlier.

Governor CRIST. Yes, sir.

Senator SHELBY. Your reforms also expanded the amount of reinsurance the State Hurricane Catastrophe Fund could provide to approximately $32 billion. Is that correct?

Governor CRIST. I think so.

Senator SHELBY. Yet despite the expansion of the financial obligations of Citizens and the catastrophe fund, your reforms did not increase the financial resources available to cover these obligations. Your reforms reduced the rate Citizens charges, and the catastrophe fund, as I understand it, has approximately $1 billion in cash. Critics have said that your insurance reform plan was not fiscally sound and that Florida has nowhere near enough money to cover all the promises made to insurers and taxpayers. The solvency of both Citizens and the catastrophic fund now depend on the levying of assessments on all Florida policyholders following a hurricane or an incident. However, a recent study found that the assessments that would have to be levied in the event of a real disaster on all policyholders in Florida to cover claims following a hurricane—not before, but following—would range from approximately $1,700 per household for a moderate hurricane to $14,000 per household for a major hurricane.

Governor, if faced with levying such assessments, is it possible that you would seek to waive them and look for other sources of funding, such as us, the Government, to cover the shortfall?

Governor CRIST. Thank you for the question, Senator. Some of your comment was not accurate. We have more in the fund. It is about——

Senator SHELBY. Correct the record if we were wrong.

Governor CRIST. Sir?

Senator SHELBY. You said it was not accurate. Correct the record.

Governor CRIST. I was about to.

Senator SHELBY. OK.

Governor CRIST. Yes, thanks. It is about $9 billion that we have in reserve.

Senator SHELBY. Not $1 billion?

Governor CRIST. Right.

Senator SHELBY. Not $1 billion in cash but $9 billion in reserves, that is your——

Governor CRIST. It is my understanding we have the ability to pay $9 billion, yes, sir.

Senator SHELBY. OK.

Governor CRIST. And it almost sounds like you are making my case for a national catastrophe fund by way of explanation of how at-risk many States, including yours, could be.

Senator SHELBY. Absolutely.

Governor CRIST. And that is why I think it is so important, Mr. Chairman, that we have this discussion. Florida has been responsible and we have responded to the needs of our people, just as you would respond to the needs of the people of Alabama. And what we have done in a responsible way is provide for a market and a climate and an opportunity to lower rates so that people do not have to sell their homes, that they can stay in the Sunshine State, if they wish, and not risk their homes as a result. We have done it in a way that is prudent, that is sound, that is responsible, but as I said earlier, there are many pieces to the puzzle. And we look to our friends at the Federal level because we are a union, we are a United States, and we all have a duty to each other. And that is what I am imploring you to do today, is give us a hand and help us, too, as we would help Alabama.

Senator SHELBY. Well, I think you are right in that regard. We are a union. We are in this together. But, on the other hand, if we have learned one thing from the Flood Insurance Plan—I think it came into being in 1968, more or less—it is insolvent today. It was always actuarially unsound. And if we are ever going to learn a lesson, we ought to learn a lesson there. And as we move forward in this area, whatever we do, we ought to make it as actuarially sound as we can, and we should look, I believe, at insuring million-dollar homes—a lot of times they are a third home—you know, at a cut rate, at a subsidized price, flood insurance, for example, and other things.

Governor CRIST. May I respond to that, Mr. Chairman?

Senator SHELBY. Yes.

Governor CRIST. Thank you. Well, I do not disagree with some of your comments, but I think it is important not only to look at the Flood Program but look at the Katrina experience and let us learn from it. As Senator Nelson ably pointed out, the Federal Government is giving the money anyway. It is already happening. And it just strikes me from a common-sense point of view that if we can do it proactively before the storm or disaster would hit, we can, you know, have premiums come in, we can earn interest in this fund, instead of shelling out the money that the taxpayers end up paying ultimately anyway. Wouldn't that be smart?

And the final point that I will make—and then I will be quiet, Mr. Chairman—is that we have a national defense in this country to protect us from foreign invasion. That makes sense, and it is right and it is just and it is appropriate. Wouldn't it make as much sense to have a fund to protect us from natural disaster as well? Don't we have a duty to protect our people, whether it is from a foreign invasion or from a natural or catastrophe? Our duty is to protect and serve, and I think we share that duty.

Senator SHELBY. I would just respond to that. I think we share a lot of views in this regard. My thought is to make it as actuarially sound as we can.

Governor CRIST. I do not disagree.

Senator SHELBY. Not open-ended for the taxpayers to take a hit.

Thank you, Mr. Chairman.

Senator NELSON. Mr. Chairman, if I could just add one comment, Senator Shelby, you may want to consider one of the other ideas that is out here on the table, which is a regional catastrophe fund, so that those who are most at risk on that particular natural catastrophe would create a regional catastrophe fund that would insure—in effect, a reinsurance fund insuring against that catastrophe. Then you pinpoint more the risks to the ratepayers and can make it, what you said, actuarially sound.

Senator SHELBY. Well, I think we should leave everything on the table as we go forward, but we should go forward.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Shelby.

Let me just make one additional comment. I see Senator Allard is here as well, and he may have some questions for the Governor and our colleagues.

One of the things that occurs to me, as I am listening to this idea of the national fund or regional fund, we have to be careful what we wish for in some cases, because certainly what will come with—one of the problems with the Flood Insurance Program was it was open-ended. Basically, it was a check-writing process, no matter what the circumstances were. And as I pointed out in the opening comments here, but for Katrina, actually the Flood Program was working relatively well. Katrina blew it out of the water, and for those reasons, we are probably going to have to do what the Committee did last year under the leadership of Senator Shelby, and that was to have a forgiveness with FEMA; otherwise, it is just never going to be paid, not at $20 billion, $25 billion.

But I can see when you come along with either a regional or national fund, all of a sudden watching a national regulator start dictating to States and localities where building can occur, under what circumstances, a variety of other steps that I suspect may run into a bit of a buzz saw when you get the National Government mandating now property needs to be managed and handled in a way that—I can just hear the reaction if that happens to some extent.

So as I think about this option, also be conscious of the fact that if you are asking for a national program to provide financial relief, expect as well that national entity to probably have some very rigid guidelines and standards that the States may find a little difficult to accommodate, particularly when you consider the attractiveness of some of our coastal States and the appetite to have homes and businesses located in some of the most beautiful areas but some of the most vulnerable areas as well to natural disasters.

And so as we look at this, we need to keep conscious of the possibilities of having some negative reactions to the kind of restrictions that may be placed on what happens under local zoning and planning.

Senator Allard, do you have any comments or questions you want to make?

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Well, Mr. Chairman, I have an opening statement I would like to make a part of the record, if I might, and then I do have one brief question.

Chairman DODD. Yes. Certainly, go ahead.

Senator ALLARD. You have talked about how property insurance rates are skyrocketing out of control. I guess you made that comment. Did we have some sort of artificial restrictions on how fast insurance rates could increase on property and flood insurance and whatnot prior to Katrina? Did we have any cap at all that restricted the increase in property rates at all?

Governor CRIST. Not that I am aware of, no.

Senator ALLARD. I just wanted to check and make sure of that because if we had some artificial restriction on how those rates increased prior to the floods and whatnot, then all of the—if those were removed for some reason, then you could have an artificially high increase. That is the point I am trying to get to.

Governor CRIST. That is a great question. No, sir.

Senator ALLARD. OK. So this is strictly just a market phenomenon that has occurred in that area down there, and the rates have increased, according to the insurance companies, based on the risk.

Governor CRIST. Dramatically. One of your colleagues—if I might, Mr. Chair, one of your colleagues, Senator Menendez, indicated that they have risen not only in Florida but in his New Jersey as well.

Senator ALLARD. And why has the increase—I can understand the increase in Florida, Louisiana, and whatnot. But why? Is it that New Jersey is along the coast?

Senator MARTINEZ. The next panel for that one.

Governor CRIST. Yes, the next panel will probably tell you, but my guess would be to make money.

Senator ALLARD. OK. But how do they justify that increase?

Governor CRIST. I have no idea, and I——

Senator ALLARD. OK. We will ask that of the next panel.

Thank you very much, Mr. Chairman.

Chairman DODD. Thank you very much. Governor, we thank you very much for your presence here today. It means a lot to us to have you here, and you have spoken eloquently on behalf of your State, and as your colleagues, the two Senators do, with great frequency, as I mentioned earlier. And the reason we are holding this hearing is because this is a national problem, and as you point out accurately here, natural disasters hit all of us at one point or another. I pointed out earlier that had some of these storms that you have described and Senator Nelson and Senator Martinez have described, had they moved a few degrees west as they went up the coastline, they could have had some devastating implications on the Northeastern States. I certainly recall back as a child growing up in Connecticut the huge storms that we had hit. The 1938 hurricane, I have a brother that was born in the middle of the 1938—they did not call it a hurricane in those days. They called it a sandstorm, I think, as they came through. We did not know how to predict them. It wiped out huge areas of the Northeast in 1938. In the 1950's as well, we had a number of big ones that came through. And you pointed out the natural disasters that hit other parts of the country as well.

So this is an important hearing, and obviously your State has been on the front lines of this given the devastation that has occurred in Florida, and, of course, Katrina and the devastation that occurred in the Gulf States. So we want to take some responsible actions.

The commission idea is one that I endorse, and I would like to have it move fairly quickly. As I mentioned to the former Chairman here, the possibility of combining that with the reform of the Flood Insurance Program, to mark up those bills in the next few weeks to be able to move aggressively so that we could get a commission to come back quickly with some recommendations as to how we might pursue this, on the assumption we can come up with some consensus here with responsible people from the insurance industry as well as others, to give us some ideas on what could be done.

So I thank you for the suggestions and ideas. I mentioned several other points that we could possibly move on, the tax relief as well as the issue of a mitigation program here, a revolving fund where people would have to pay back but, nonetheless, provide some low-cost loans to people to be able to take steps to protect their homes and businesses against the problems of natural disasters.

So there are a number of things that I think we would like to get moving on, and your testimony here today helps crystallize those ideas. So we thank you immensely for coming, and I thank both of my colleagues for their presence.

Senator Martinez obviously will be here. Senator Nelson, you are more than welcome to join us on the Committee as well.

Senator NELSON. Thank you, Mr. Chairman. Thank you all, Senator.

Chairman DODD. We will move to our next witness, Dr. Edward Lazear, who was sworn in as the Chairman of the Council of Economic Advisers in February of 2006. Before coming to the Council, Dr. Lazear was a member of President Bush's Advisory Panel on Tax Reform. He is on leave of absence from Stanford University, where he is the Jack Steele Parker Professor of Human Resources Management and Economics, and the Morris Arnold Cox Senior Fellow at the Hoover Institution. We thank Dr. Lazear for coming to the Committee.

Doctor, thank you, and I say this to all of our witnesses this morning. Your full statements and supporting documents and materials will be included as part of the record. If you can keep a bit of an eye on the clock here so that we try and stay within time here so we can get to some questions and get to our next panel. Thank you very much.

STATEMENT OF EDWARD LAZEAR, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. LAZEAR. Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to allow me to testify today. Your Committee is tackling an important and difficult set of issues in this hearing. I believe that we share similar goals. We all want homeowners and businesses to have insurance against events that are beyond their control. The question is how to provide it.

When Government gets into the insurance business, it undermines private insurance supply, and then individuals can only rely on the Government for insurance. Governments are not very good at providing insurance and should be wary about crowding out the private sector, leaving individuals with no recourse other than to rely on the Government.

The administration opposes legislation to create new Federal programs to backstop catastrophe insurance. There are a variety of forms that the backstop could take. We believe that none of these approaches would be helpful, nor are they warranted. They would create primarily three kinds of problems for the economy:

First, the Government insurance would displace insurance provided by the private market. For the most part, that market is healthy, and were it not for other forms of interference, the market could operate effectively to insure risks faced by homeowners and businesses.

Second, a Federal program would undermine economic incentives to mitigate risk because the program would likely distort rates from their actuarial values. Individuals would be encouraged to take on risks that are inappropriate, specifically putting themselves in harm's way because they do not bear the full expected cost of damages incurred.

Third, the Federal backstop would mean that all taxpayers nationwide would subsidize insurance rates for the benefit of a relatively small group of people in high-risk areas. The general taxpayer would pay for actions over which they have no control. Those who can avoid the risk would be passing the costs onto others, creating a system of distortion and inequity.

For the most part, the national insurance industry is healthy today, despite the record $57 billion estimated in insured losses incurred as a result of the 2005 hurricane season. Industry-wide capital available to cover future losses actually increased during 2005. Although it is true that Florida, North Carolina, and parts of Mississippi, Louisiana, and Alabama are experiencing difficulties with insurance availability, much of this can be traced to certain regulatory actions at the State level.

First, some States have used regulation to suppress prices, which has the effect of making insurance unavailable where it might be most needed. The role of State regulation should be to protect consumers from fraud and inadequate risk management by insurance companies, but States sometimes use their regulatory power to control prices. This discourages insurance companies from voluntarily providing insurance in those high-risk areas where unregulated rates would naturally be the highest. Insurers need to charge rates that are high enough to allow them to cover expected losses and purchase reinsurance or maintain surpluses to cover catastrophic losses.

Second, a national catastrophic risk insurance plan would likely distort rates and undermine economic incentives to mitigate risk. The experience of the National Flood Insurance Program and the steps needed to reform it illustrate some of the challenges that would likely arise in a broader Federal natural catastrophe insurance program. The National Flood Insurance Program plays an important role in helping homeowners insure against flood losses, but it needs to be further reformed and should not be expanded.

Reforms passed in the 2004 authorized a pilot program to remove some of the worst repetitive loss properties from the flood insurance rolls, and the President's fiscal year 2008 budget calls for doubling the funding of this program. Furthermore, the administration has proposed several principles for improving the National Flood Insurance Program, including making premiums more flexible and actuarially sound. We look forward to working with the Committee on developing these principles. However, the challenges of this program show it does not serve as a good model for broader Federal catastrophe insurance programs.

National catastrophe risk insurance would displace private insurance and undermine the economic incentives to mitigate risk. It would force all taxpayers nationwide to subsidize insurance rates for the benefit of a relative small group of people in high-risk areas. This would be both costly and unfair to taxpayers.

Returning to the example of national flood insurance, the financial consequences of passing claims on to the general Federal taxpayer is no minor issue. The National Flood Insurance Program has borrowed $16 billion from Treasury to cover the 2005 losses. The cost will in large part be borne by taxpayers nationwide, many of whom are not exposed to flood risk and do not receive coverage under the program. The insurance industry is healthy, and the private sector is well equipped to provide insurance for hurricanes and other natural catastrophes, but State regulators and the Federal Government must allow the private market to function. Therefore, the administration believes that a Federal program to provide catastrophe risk insurance at the Federal level, although well intentioned, would have significant adverse consequences to the economy and would be unfair.

I welcome your questions.

Chairman DODD. Thank you very much, Doctor, and we appreciate your being here today. I should point out you have very strong statements about the opposition to a Federal program to provide catastrophic risk insurance. Is there anything you believe the Federal Government should be doing in this area?

Mr. LAZEAR. I think that the Federal Government should encourage the private sector to be active in providing insurance, and to the extent that the Federal Government is involved in insurance—for example, through the National Flood Insurance Program—we have to be careful that we make sure that we charge the right rates and that we do not drive out other insurers who could be competitive. And let me be specific because I know Senator Shelby, who talked about this earlier, has strong views on this as well.

The last thing I think we want to do is create a structure where we induce people to locate in harm's way. The best way to avoid doing that is to make sure that we charge people the actuarially fair rates for being in those areas. That said, we have a program in place right now; the National Flood Insurance Program is in place right now. We certainly do not believe that we can pull the rug out from under people who have relied on that program, and as a result, we have thought about ways to reform this, and I think some of the positions that the Senator has taken on that are consistent with the way the administration is thinking about it as well.

Chairman DODD. Well, we were talking about it, and I hear what you are saying. Take Louisiana, for instance, New Orleans here. We are talking about people here, not all of them living in fancy homes on Bourbon Street here who were hurt. A lot of very desperate people were adversely affected by that. What is our answer to be? Is it sort of tough, that is the way things go? I mean, there is no insurance down there today. You have 300,000 homes in that city that are either uninhabitable or totally destroyed.

Mr. LAZEAR. Right.

Chairman DODD. There is little or no insurance available so you cannot get mortgages, you cannot get loans to rebuild. Things are absolutely stalled as they presently stand. Doesn't the National

Government—I mean, if that were my State here in devastation like that here, or someone else's State, I would expect my Government to want to stand up and help at a moment like that.

Mr. LAZEAR. What I would say is that we want to make sure that help is available. The question is whether it should be done by the National Government or whether it should be done by the private sector.

Now, that is why I distinguish between things that were done in the past and things going forward. If you have a system in place and people have relied on that system—you talk about New Orleans. I think that is a great case in point—you simply cannot change the rules on those people midstream and say, well, just tough. I mean, obviously, we have to have compassion for individuals who have bet on the coverage that was there in the past. And it is for that reason, I think, that the President felt strongly about the reauthorization of the National Flood Insurance Program in 2004. But it was also the case that he felt that as we look forward, as we go forward, as we think about new programs, we do not want to get ourselves into the same situation that we were in then. We want to try to take actions that will encourage the private market to come in and to take care of those risks that were previously covered by the Federal Government.

To the extent that we can do that, I think we move in a better direction, because I believe—and I think the President believes—that the private market will do a better job, actually, at insuring these people, at providing the kind of coverage—again, going forward, not talking about going backward—that we need to have. And it is extremely important that we do that.

I would be careful about getting in the way of the private sector in terms of providing——

Chairman DODD. You have made that point. I hear you saying that. I am curious as to whether or not you believe the administration takes the view, then, that the Flood Insurance Program—putting aside its obligations under the existing one, but do I hear you saying, in effect, that if you had your druthers, you would eliminate that program as well?

Mr. LAZEAR. No, that is not the position of the administration. Again, we did prefer reauthorization of that program, but, again, with——

Chairman DODD. Let me make a distinction between the reauthorization of that program as opposed to doing something like a national catastrophic risk——

Mr. LAZEAR. Well, again, I would——

Chairman DODD. Similar ideas here to deal with natural disasters.

Mr. LAZEAR. Similar, but one is new and one is old, and I would go back to that——

Chairman DODD. Aside from the newness and the oldness of it, what about the principle involved here?

Mr. LAZEAR. I think that is the key principle. The key principle is that when national flood insurance came in—that was about 30, 40 years ago.

Chairman DODD. 1968.

Mr. LAZEAR. 1968. Insurance markets were different. Capital markets were different. Now we have much more sophisticated both insurance markets and capital markets.

For example, we have national catastrophe bonds—catastrophe bonds which you can purchase on the market, which is a form of insurance that individuals can take. You can diversify risk that way. Those are a relatively new development.

What that means is that we have mechanisms available today, again, going forward, to deal with other kinds of risks that we did not have available when that program was first instituted.

Chairman DODD. I understand that. I am just trying to understand, putting that aside, then, if I was coming and proposing to you today a National Flood Insurance Program, the administration's view would be to oppose that idea.

Mr. LAZEAR. I do not know that the administration would necessarily oppose a new program. We would certainly oppose expansion of the National Flood Insurance Program right now. We believe that given the program as it stands—and, again, I am making the same point, so I hate to be——

Chairman DODD. I am just trying to understand the distinction here. I understand your point that you have made here, but the Flood Insurance Program has got some problems. We all admit that. It needs to be fixed.

Mr. LAZEAR. Right.

Chairman DODD. But I am trying to get at a deeper point here with you, and that is, whether or not the administration takes the view that even the National Flood Insurance Program is a program that probably is one that does not really deserve to be reauthorized, looking forward, again.

Mr. LAZEAR. That was not the position. Again, the position was that we favored reauthorization. We did so in 2004. So the answer to that question would be no.

Chairman DODD. All right. Senator Shelby.

Senator SHELBY. Thank you, Chairman Dodd.

Mr. Chairman, you are Chairman of the Council of Economic Advisers with the administration, and you have a deep background in economics. If a Federal bailout is required, what impact could it have on the Federal budget? And does your analysis provide any insight into the impact of a national catastrophic fund, what it would have on the Federal budget if it is not put together right?

Mr. LAZEAR. We do not have specific numbers to answer that because we would have to be thinking, obviously, about a specific plan. In order to score that, we would have to be quite specific about it. But the general impact is clear. If we were to have a bailout, then we would be passing the costs onto other taxpayers. And there is simply no doubt that that would have distortionary effects through the rest of the economy because you have to raise taxes in order to fund that, and that is the general principle.

Senator SHELBY. We understand that there are a lot of people in circumstances beyond their control. They live in certain areas. They are challenged economically. We have them in my State. We have them in Louisiana. We have them in Mississippi. We have them in New Jersey. Everywhere. And something ought to be—if we come with an insurance program or flood insurance reform, we would have to look into protecting those people to some degree.

But why do we have to continue to insure million-dollar homes, whether it is my State of Alabama, Florida, New Jersey, Louisiana, where people are in a flood-prone area and sometimes it is their third home, too? You understand what I am getting at.

Mr. LAZEAR. I do.

Senator SHELBY. Why should the average working person paying taxes in America have to do that?

Mr. LAZEAR. We believe that one of the major problems in terms of fairness associated with a national program is that it does pass the burden onto the general taxpayer. Sometimes the expenditures go to good purposes and go for things which we would all agree are important and fair. Sometimes they do not.

The point is that, no matter where we spend those monies, the cost will be borne by the general taxpayer, sometimes by people who are more needy than the individuals who receive those funds, and that is always a problem in terms of redistributing from one party to another. Sometimes it helps in terms of fairness, sometimes not.

Senator SHELBY. We have all referenced the Flood Insurance Program because we know it is not actuarially sound, was never actuarially sound. It is nearly 40 years old—1968. We tried to reform it last year. The whole Congress is aware of that. We had, I thought, a pretty good bill that came out of this Committee. It did not please everybody, but it came out of this Committee very strongly.

Doctor, I believe that we could be headed toward establishing a commission to review these issues. I think that if that is the direction that we take, we need to make sure that such a commission is appropriately comprised and put together—the taxpayer advocates, pro-market advocates, those familiar with the risks associated with coastal development, and others that would be able to participate in this commission. In other words, it would be broad-based and not slanted toward another so-called Flood Insurance Program that is actuarially unsound and does not work. Do you agree with that?

Mr. LAZEAR. I agree with that, Senator.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Could I just ask—I should have asked this question myself. We have talked about this commission idea. Does the administration support the idea of having a commission, sort of a 90- or 120-day brief window here to take these various ideas? I do not know if you heard Senator Nelson——

Mr. LAZEAR. I did, yes.

Chairman DODD [continuing]. Talk about the fact, and he is accurate in this. We are going to hear a lot of—in fact, in the next panel you will hear a lot of different thoughts on what ought to be done here, that we ought to try and pull some of this together so we get some clarity on this.

Does the administration support the commission?

Mr. LAZEAR. I think the administration would look forward to hearing from a commission that was broad-based, as Senator Shelby suggested, and that focused on providing new information. This is an area that is pretty well understood. The insurance area has been researched and researched for probably 50 years, so it is not a new problem. It is a problem that is pretty well understood in the economic literature. But there are certainly facts that could be uncovered by such a commission.

For example, some States have done things better than other States. Some States have run into difficult problems. It would be useful, I think, for a commission to perhaps unearth some of those problems and make those public, and we could learn from that. I think more information is always better. It is pretty hard to oppose getting more information.

Chairman DODD. Thank you very much.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman. I would like to follow up a little bit on a question that I posed to the Governor. You also referred to it in your remarks, and that is that some States, their Insurance Commission artificially held down insurance rates. Could you share with us which States that might have occurred in? Were they the coastal States that we are looking at and talking about now?

Mr. LAZEAR. I probably would defer to your next panel. I think the panel to which they referred was actually not this panel, but it was the one where you are actually having the experts from the industry.

Senator ALLARD. OK.

Mr. LAZEAR. I would prefer to have them testify on it in detail.

Senator ALLARD. But you do see that as a problem?

Mr. LAZEAR. It is certainly a problem because if you constrain the rates, then obviously insurance companies have a choice: either they produce the insurance, provide the insurance at rates that are below their actuarial costs, or they opt out. And most have opted out.

Senator ALLARD. Yes, and so it is supply and demand. If you cannot make a profit at a certain rate, you just discontinue providing the service. You do not have any choice. You cannot keep a business going and take a loss year after year.

Mr. LAZEAR. Simple economics.

Senator ALLARD. But your view is that the insurance companies have actually been doing relatively well in the last few years in many cases. Are you looking at it from a national basis, or are you looking at it on a State-by-State basis?

Mr. LAZEAR. Looking at it from a national basis, the insurance companies have been able to increase their solvency, increase the size of their funds available for paying off catastrophes.

Senator ALLARD. And that is probably by design, isn't it? Because the risks are getting greater, so you have to have larger pools out here. If you have any more Katrinas, you know, you are not in business any longer if you are insuring that. You have got to have a larger pool. So talk about that a little bit, if you would.

Mr. LAZEAR. Yes, in fact, the insurance—that is an excellent point. Insurance companies have redone their models of the risk, of the expected costs associated with disasters. In particular, what is important—and I will try to avoid economic jargon, but what is particularly important is the correlation among bad events. If lots of bad events happen at the same time, then that puts insurance companies in a worse situation than if these events are uncorrelated, if they are kind of random.

What happens is when you get populations moving to particular areas, so you have—for example, in Florida, as the population of Florida grows, you have more and more people who are at risk in an area that would be hit by one event. It tends to increase the correlation, and insurance companies have had to take that into account in adjusting their actuarial calculations, and that is what they have done.

Senator ALLARD. The question was posed by the Chairman: What is it the Government can do to help property and casualty insurance? In my view, they can get their act together as far as determining these floodplains. I mean, FEMA is not—they are not anywhere close to getting all these floodplains designated. In some areas, we have areas that are not in floodplains, but the maps show they are in it. We have other areas where they are shown out of a floodplain but in reality they are in floodplains that have heavily been built into.

So, you know, I think one of the reasons that the flood insurance is not working is because we have not done a good job of defining the floodplain.

Mr. LAZEAR. Again, that would be consistent with the view of basing costs on risk. So the floodplain is an extreme example of a very high-risk area, and the problem is we do not price it appropriately.

Senator ALLARD. Yes. Now, it seems to me if the Federal Government in flood situations, particularly Louisiana and Mississippi and those States that were impacted by Katrina, we have not been particularly hesitant about handing money over to those areas, and that has all gone to low-interest loans and whatnot, which is a way of providing, I guess, some insurance on a case-by-case basis to one locale that gets adversely impacted. So, in a way, the Government is already involved, would you say?

Mr. LAZEAR. That is correct. The block grant program that was associated with some of the recent disasters has put a significant amount of money into those regions. Mississippi got $5.4 billion, Louisiana $10 billion. Some of that has been used, by the way, for insurance, so, for example, in Mississippi, approximately $80 million went to purchasing reinsurance for that State.

So there are a variety of mechanisms that can be used, and I think some of the States have done a good job in using funds provided by the Federal Government to enhance the quality of the insurance—and, again, in cooperation with the private market, which, again, in my view, is probably the best way to do it.

Senator ALLARD. And how do you figure that into your rate setting? Or is that a factor?

Mr. LAZEAR. Well, it is certainly a factor in terms of the private companies figuring it in. If they get cheaper reinsurance, of course, that lowers the rate, and I suspect that some of that is going on in Florida as well, as the State provides cheaper reinsurance rates. So that does do that.

Now, again, one has to be very careful about doing that because to the extent that we subsidize reinsurance, either at the State level or the Federal level, again, what you are doing is you are saying you are essentially changing the true cost that the individuals see when they locate in an area. And so, again, you are giving an additional incentive by making that insurance cheaper than it otherwise would be to locate in harm's way.

I think we have to think carefully about any kind of reinsurance program as well.

Senator ALLARD. So your view is that the market is pretty well working, the free market is pretty well working at this particular point, with——

Mr. LAZEAR. My view—sorry.

Senator ALLARD. I mean, the insurance industry has traditionally relied on State regulation as avoiding Federalizing these programs, and I guess the market approach, feeling that States are in a competitive environment with each other—I mean, if you get insurance too high, an insurance company will not do business in your State. And it could have an impact on ownership and population in that State.

Could you talk about that some?

Mr. LAZEAR. Yes. The insurance industry is quite a sophisticated industry, obviously. It is sophisticated in many respects, but it is also a reasonably competitive industry. There are a number of large companies out there, some smaller ones, that can compete and do compete on the basis of rates and other kinds of services. As long as we have a well-functioning, competitive system—and what I mean by well-functioning, competitive system is that insurance companies can compete with one another and that they are not undermined by competition from the State or the Federal Government—then those companies can provide effective insurance and, I would argue, better insurance and better coverage to the average citizen of the State.

Again, I go back to my earlier statement. I am very uncomfortable when the State or the Federal Government comes in and provides cheaper insurance that, in the short run, looks like a better deal to the citizens, but then drives out the private market. And then what you find is that everybody has to rely on the Government and only on the Government. And then something happens and the Government is not there to pick up the slack.

So that is my big concern about having programs that are well intentioned but have the side effect of driving the private market out.

Senator ALLARD. And more Government control.

Mr. LAZEAR. More Government control.

Senator ALLARD. Yes. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

We have been joined by Senator Carper. Tom, do you want to submit some written questions here, or do you want to go to the next panel?

Senator CARPER. Let's go to the next panel. Thank you.

Chairman DODD. Well, thank you.

Senator SHELBY. Doctor, could you compare in any way or contrast, compare and contrast the national catastrophe proposal as we understand it at this point with TREA and its future?

Mr. LAZEAR. Yes. TREA, as you know, when the President authorized or suggested TREA, it was viewed to be a temporary program.

Senator SHELBY. Absolutely.

Mr. LAZEAR. And it came in as a temporary program and as a program to deal with a very new situation where the risks were not well——

Senator SHELBY. And it is working, is it not?

Mr. LAZEAR. I believe that it has worked because we have seen the private market actually increase in parallel to TREA.

Senator SHELBY. Absolutely.

Mr. LAZEAR. And it looks like now we——

Senator SHELBY. And we scaled it back some, did we not?

Mr. LAZEAR. We have scaled it back, and, in fact, private insurance is functioning and well developed. So we would expect that the temporary nature of TREA would be something that would give way in the future to the private market, and, you know, obviously you are thinking about those issues right now, and I think you will be exploring that with the administration.

That is a slightly different kind of issue than thinking about risks that are well known, that we have seen in the past, where there is the ability to diversify these risks and we can deal with that at the private level and can already deal with that at the private level. So I guess that would be the distinction that I would make.

Senator SHELBY. Thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Doctor. We appreciate your testimony, and we will leave the record open. Colleagues, I am sure, will have some additional questions for you. We would ask you to respond to them as quickly as you can.

Thank you very much.

Let me introduce our next and last panel here. We have a very distinguished group of panelists. I appreciate their patience this morning in listening to the earlier testimony.

Let me begin with Commissioner Walter Bell, who was named Alabama's chief insurance regulator in January of 2003, also President of the National Association of Insurance Commissioners, a position he was elected to in December of 2006. Commissioner, we welcome you. Thank you for being with us.

Governor Marc Racicot is with us this morning. He began his tenure as President of the American Insurance Association in August of 2005, joined AIA from the law firm of Bracewell & Giuliani, and he was a two-term Governor of Montana and someone whom I have come to know and respect immensely. Marc, we thank you for being with us here this morning.

Our third witness is Dr. Robert Hartwig, the President and Chief Economist of the Insurance Information Institute. He previously served as Director of Economic Research and Senior Economist with the National Council on Compensation Insurance in Boca Raton, Florida.

Mr. David Guidry is President and Chief Executive Officer of Guico Machine Works, located just outside New Orleans in Louisiana, and, Mr. Guidry, we thank you for being here with us this morning as well. Mr. Harold Polsky is with us, a homeowner who recently moved from Port Richey, Florida. I mentioned both of these individuals in my opening comments. We thank them for being with us.

Frank Nutter has been President of the Reinsurance Association of America since May 1991. He held the same position with the RAA from 1981 to 1984. Prior to becoming President in 1991, Mr. Nutter served as the association's general counsel.

Admiral James Loy is National Co-Chairman of *ProtectingAmerica.org*. Admiral Loy is the former Deputy Secretary of the Department of Homeland Security, former Administrator of the Transportation Security Administration, retired from the Coast Guard as its Commandant in 2002, and we are pleased to have you with us. And as someone who has represented that academy for a long time, I am delighted to have you be a part of the panel here this morning.

And, last, Mr. Chuck Chamness was appointed President of the National Association of Mutual Insurance Companies in September 2003. Prior to his appointment, he was Executive Vice President and served as Vice President of Public Affairs from 1995 to 2003.

We have a lot of you jammed in here. I apologize for that, but we wanted you all to get to know each other well here. So we have a little intimacy up here, elbow to elbow packed in. You look like you are passengers on one of our new airliners today here, jammed in here.

[Laughter.]

At any rate, let me begin with you, Commissioner Bell, and thank you for coming this morning. Then we will move right down the line in the order that I have introduced all of you here—at least the order I have introduced you rather than the order you are sitting here. And I will call on each one of you in case you fail to remember which number you were in the list.

Commissioner, we thank you. Keep your eye on the clock, by the way, so try and live within that timeframe for me here.

STATEMENT OF WALTER BELL, COMMISSIONER, ALABAMA DEPARTMENT OF INSURANCE, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. BELL. Thank you, Mr. Chairman, Ranking Member Shelby, and Members of the Committee. Thank you for the opportunity to testify here today on behalf of the National Association of Insurance Commissioners. My name is Walter Bell. I am the Insurance Commissioner, as you stated, for the State of Alabama, and I also serve as President of the NAIC. As a commissioner and citizen from the Gulf Coast, I commend you for holding this hearing today on this crucial national issue.

State insurance officials from coastal States are seeing significant problems near the water with the insurance availability and affordability. Rising rates near the coast are challenging many current homeowners. Retirees and those living on fixed incomes who have lived in their homes for years are now finding their insurance costs doubling, or worse. Likewise, rising rates are also challenging real estate development as more properties are going unsold because buyers cannot find affordable coverage. Some insurers are even reducing the number of policies they are willing to write at the coast, regardless of price, due to the exposure of Katrina-like events.

The uncertainty of anticipating future losses is the main factor that adds volatility and subjectivity to the insurance pricing. Insurers and reinsurers are becoming more conservative with where they place their business, and rating agencies are requiring these companies to retain more capital to maintain their ratings. Carriers are responding to changes in perceived risk by scaling back where they are willing to offer coverage, by reducing the number of policies they rate, and by raising prices.

A recent report by Guy Carpenter indicates that in 2006, reinsurance rates across the U.S. rose 76 percent on average, and that number is far higher near the water. This increased cost is passed on to consumers, and it is contributing to the growing gap between what they can afford and what insurers are willing to charge.

Property insurers are often licensed in 50 States, but the policies they sell, how they are underwritten, and how they are priced makes them an acutely local product. As part of my written testimony, we provided brief snapshots illustrating the challenges of insurability in a number of coastal States. The common theme in these snapshots is that most coastal states have a relatively healthy market, except for areas within a few miles of the water. In those areas, much of the coverage is provided by State-run insurers or surplus line carriers. What little coverage is provided by the market is typically expensive and often carries high-deductible and other coverage limitations.

The risk associated with large natural disasters is managed through a variety of means. Much has been talked about about the flood insurance. Floods are covered by the Federal programs. Earthquakes are largely uninsured or covered by a State entity. And wind is covered, but often augmented by a State wind pool. Very few areas of this country are not threatened by some form of devastating event, yet few people have comprehensive insurance coverage that fully reflects that risk.

There is no single solution to this problem. State governments and insurance officials are taking a variety of steps to manage the risk exposure in their State, but as Congress considers its own involvement in this challenge, there are a number of ideas that merit attention. Perhaps the biggest idea is a concept of an all-perils policy, a single policy for a single risk-based premium. A lesson learned from Hurricane Katrina is that consumers clearly expect all-perils coverage, and the current system of two or three separate policies just to cover one piece of property is ineffective and leads to gaps in coverage. All-perils coverage should be a private market solution, and any national insurance program should serve as a backstop to augment the private market, not supplant it.

We must also consider adopting mitigation efforts such as responsible land use policies, better building codes, and retrofitting programs to strengthen existing homes. Tax-deferred reserves for individuals and insurance companies should also be considered to increase market capacity and give consumers another option to manage the property risk.

The NAIC strongly endorses the concept of a national commission to analyze the problem and develop the best mix of solutions. State insurance commissioners look forward to working with this Committee to find the right answers to the problem.

Again, thank you for holding this hearing this morning and for inviting me to participate, and I will be pleased to answer any questions.

Chairman DODD. Thank you very, very much. That was very helpful testimony. We thank you for coming this morning.

Governor Racicot, thank you very much.

STATEMENT OF MARC RACICOT, FORMER GOVERNOR OF MONTANA, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN INSURANCE ASSOCIATION

Mr. RACICOT. Good morning, Mr. Chairman and Ranking Member Shelby. Thank you for the opportunity to appear in front of the Committee. Good morning as well to Senators Allard and Carper.

My name is Marc Racicot, and obviously it is an understatement to take note of the fact that Hurricane Katrina has focused renewed attention on the role of the private sector insurance industry in managing natural catastrophe risk. Fortunately, we believe very strongly that the insurance industry is well positioned to do that. However, insurers must have the tools available to them to measure, reduce, and fund those exposures. By contrast, in our judgment, quasi-governmental Cat Funds, draconian regulatory restrictions, and new legal liabilities not only fail to address the true problems but also threaten the viability of our Nation's private insurance mechanism.

In responding to Hurricane Katrina, just to put this in perspective, I believe that the insurance industry performed extremely well under very difficult circumstances. To date, claims payments have totaled about $40 billion. More than 95 percent of the claims have been successfully resolved. Less than 2 percent have been disputed, and less than 1 percent across the Gulf have ended in litigation. Those, however, even though they comprise a minority of the number of instances of dispute, nonetheless have received most of the attention.

As a Nation, we know that we have to make certain that we are prepared for and can respond quickly to future catastrophes, and insurers are fully committed to working with local, State, and Federal policymakers to make this happen.

I have had the chance to testify before Congress on this subject several times before, and I have shared our perspective with Southern Governors at their recent meeting in Washington in February. Each time that I have had the chance to talk with policymakers, I have strongly urged them to act carefully. Thankfully, last year's hurricane season was remarkably mild, but hurricane experts, as we all know, are calling for another active season in 2007, and each year more and more people populate our Nation's most vulnerable coastal communities, sometimes estimated those emigrating into Florida to be in the neighborhood of 1,000 to 1,400 people a day. And how are we advising them of the risks that are associated with the decisions they make?

At the same time, I am here today to urge appropriate scrutiny and care as this Committee sorts through the various Federal legislative proposals that have been introduced into this Congress. The reality is that there are no quick fixes or easy answers. However, I can assure the Committee that punitive measures directed at insurers, including recently introduced bills to repeal the McCarran-Ferguson Act, are wholly unrelated. They will do literally nothing to improve the availability or affordability of coastal insurance. In fact, the cruel irony is that they will have a serious and detrimental effect on the very markets that they purport to assist.

We have proposed a reform agenda that we believe in principled. It discards the path of least resistance and instead focuses upon sound financial, capital market, and environmental principles. It consists of four major principles: mitigation and land use planning, regulatory and legal reforms, tax incentives, and National Flood Insurance Program reforms. We are also working to identify other measures that can be put in place to address concerns expressed about the availability and affordability of natural catastrophe insurance. These measures would be designed to preserve the essential role that the private insurance sector plays in recovery and response, while at the same time recognizing the post-Katrina challenges that are still facing coastal communities.

As this Committee is well aware, several bills have been introduced this year to address different aspects of the natural catastrophe issue, but I would like to offer just a couple of thoughts about two of them.

The Homeowners Insurance Protection Act would create a Federal reinsurance mechanism to encourage States to establish Cat Funds based on the premise that large-scale natural catastrophes are uninsurable by the private sector. We respectfully but strongly disagree with the premise. Even after Hurricane Katrina, private sector capacity for natural disasters has increased. Ironically, the single greatest threat to private sector risk transfer mechanisms is not the force of hurricane winds, but legislation and regulations that displace available private capital or make it economically unfeasible for private companies to operate in coastal markets.

Despite their seeming promise of short-term relief, Cat Funds are no panacea for natural catastrophe risk, and they can lead to generational inequities among policyholders, unfair geographic and cross-sectional subsidization, and increased building in catastrophe-prone regions.

Another bill, the Homeowners Insurance Non-Coverage Disclosure Act, would require insurers to restate the terms of their private property insurance policies in plain language that may well be at odds with the actual contract language. It would increase complexity and the likelihood of litigation rather than address the issue at hand.

Unquestionably, these are tough and complex issues. The property/casualty insurance system, like any human enterprise, is not perfect, but it has been in place since the beginning of our Nation, and it takes good care of millions of Americans. It pays about $250 billion a year in damages that they sustain to their property, and I would suggest that is the threshold and most significant decision that will be made by policymakers. Do we want to preserve the private property protection system that, with its imperfections, has operated extremely well? Or do we want to move more and more toward the socialization of this protection system as we address these issues on an episodic basis? The last thing we want to do, it seems to me, that any Government can afford to do in the name of reform is to irreparably compromise the capacity of the private insurance industry to continue doing what it has done well over these last 150 years.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Governor, very much.

Dr. HARTWIG. And I understand you have some video.

STATEMENT OF ROBERT HARTWIG, PRESIDENT AND CHIEF ECONOMIST, INSURANCE INFORMATION INSTITUTE

Mr. HARTWIG. Yes, a bit of video here. Good morning, Chairman Dodd, Ranking Member Shelby, and members of the Committee. I would like to thank you for the opportunity to discuss the financial vulnerability of the United States to the real and growing threat posed by catastrophic hurricanes and the corresponding impacts on the availability and cost of insurance. My testimony today will address three major issues: the recent history of catastrophic hurricane losses in the United States; drivers of the increase in insured losses in coastal regions, including population growth, rising property values, and unsound land use decisions; and implications of increased hurricane risk on the price and availability of insurance.

Measured in dollar terms, the United States is arguably the most vulnerable country in the world to natural disaster risk. Catastrophic hurricanes, earthquakes, tornadoes, wildfires, and severe winter storms cost insurers $20 billion on an average annual basis. The record hurricane seasons of 2004 and 2005, however, spawned seven of the ten most expensive storms in U.S. history, as you see in the chart before you, resulting in payments to 5.5 million policyholders totaling $80 billion.

Tropical events now account for nearly half of all catastrophe losses over the past 20 years. Looking ahead, meteorologists are predicting that the 2007 hurricane season, which begins just 50 days from today, will be 85 percent more severe than average. Not only will more storms occur, but the likelihood of a powerful Category 3, 4, or 5 storm making landfall is estimated at 74 percent this year, well above the long-run average of 52 percent. More ominous is the fact that we may only be on the leading edge of a prolonged period of elevated hurricane activity, lasting perhaps another 15 to 20 years. Insurers today are actively planning for a $100 billion storm.

For the 53 percent of Americans today who live within 50 miles of the coastline, hurricanes represent a potentially life-altering economic threat. Yet despite increased awareness of the risk in the wake of Hurricane Katrina's destruction, people continue to be drawn to the coasts in records numbers. The U.S. Census Bureau predicts that the number of people living in hurricane-exposed States will increase by nearly 44 million, or 36 percent, between the years 2000 and 2030. Eight-hurricane exposed States will experience population gains equal to or exceeding the projected gain of 29.2 percent for the country overall. Florida, already the most exposed hurricane State in the country, will lead the way, with an expected population increase of 12.7 million people, or about 80 percent, by the year 2030.

Yet these trends are merely a continuation of growth trends that have been under way for some time, mostly in the years since the last period of intense hurricane activity ended about 1960. The following sequence of charts depicts population increases in a sampling of coastal counties from New England to the Gulf Coast. In each case, sharp population increases are noted in areas that are historically vulnerable to hurricane, although perhaps not recently.

Rising coastal populations drive increases in coastal development. In 2004, the insured value of all coastal property exposed to the threat of hurricanes totaled some $7.2 trillion, equivalent to 62 percent of GDP. It is expected that the value of insured coastal property will double within the next decade, as coastal populations and property values continue to soar. Again, Florida is the most exposed State in the country by far, with about $2 trillion in coastal exposure, about 27 percent of the total. The figure also shows how small States, like Mississippi, can sustain enormous losses and why the Northeast, with $3.7 trillion in insured coastal exposure, is so financially vulnerable. Indeed, a major landfalling hurricane in the Northeast could produce insured losses exceeding $100 billion.

Now, with respect to the issue of land use decisions, which has not been discussed too much, despite the fact of its well-known vulnerability to hurricanes and rapidly escalating property values, coastal development continues at a furious pace. The example of South Miami Beach is illustrative. In that narrow strip of land alone, 15 new condominium complexes will be completed by yearend 2009, offering a total of 2,111 individual units at prices ranging up to $16 million, with an average price of $3.7 million. Total insured exposure is likely to top $6 billion, much of it insured by the State at rates that are not actuarially sound, further burdening the State's already precarious property insurance markets. Rapid buildups are observed in many other coastal areas, from Galveston Island to Cape Cod.

The fact that so much coastal development continues to occur despite the lessons offered by the hurricane seasons of 2004 and 2005 suggests that builders, realtors, and buyers are entering into real estate transactions in these areas with their eyes wide open, fully cognizant of the risk. The bottom line is that coastal development is economically rational from the perspective of coastal stakeholders only because most of the benefits are retained locally while a high proportion of the hurricane-related losses are redistributed to others.

The price of insurance is determined primarily by the degree of risk assumed by the insurer. In the wake of the record hurricane seasons of 2004 and 2005, insurance prices have climbed sharply for many owners of coastal property as a direct result of this increasing risk. Deviations from risk-based pricing do lead to distortions or dilutions in the message that risk-based premiums do bring and do then encourage additional development in vulnerable areas. This is exactly what is happening in Florida today. The good news is that strengthening of building codes, encouraging mitigation, better land use policies can all help to reduce risk and lower insurance costs.

To conclude, I would like to say that the insurance industry is committed to working in partnership with public policymakers, consumers, and businesses in developing fact-based solutions to the formidable challenge posed by hurricanes and continuing our tradition of helping families, businesses, and communities wherever and whenever disaster strikes.

Thank you, Mr. Chairman.

Chairman DODD. Very good. Thank you very much. By the way, I do not know if we got copies of that.

Mr. HARTWIG. In my written testimony, there are these slides, and many others.

Chairman DODD. Oh, good.

Mr. HARTWIG. And a lot more detail.

Chairman DODD. They are very, very helpful. Thank you very much for that. It was very interesting and very helpful.

David Guidry, we thank you for coming this morning. We appreciate your being here.

STATEMENT OF DAVID GUIDRY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, GUICO MACHINE WORKS, INC.

Mr. GUIDRY. Thank you, sir. Mr. Chairman, Members of the Committee, I am David Guidry, President and Chief Executive Officer of Guico Machine Works. I appreciate the opportunity to appear before your Committee today on behalf of Greater New Orleans, Inc., a 10-parish regional economic development organization in southeast Louisiana, representing over 100 businesses in all major sectors of the local economy.

Mr. Chairman, as a small business man in the New Orleans area, I am truly grateful that you have called this hearing today to shine a national spotlight on one of the cruel realities of the post-Katrina Gulf South. Businesses both large and small simply cannot find affordable insurance. More than a year and a half after Hurricanes Katrina and Rita, with all the Federal dollars and tax incentives provided to our region of the country, many of you would expect to see the skyline of New Orleans crowded with cranes and bustling with construction activity. I am sad to report that, instead, very little of that activity is actually under way.

While many experts may have a number of explanations for the slow pace of the recovery in New Orleans, I can assure you that primary and significant factor is the unavailability of affordable insurance for business. I am told that in the Greater New Orleans area, not a single commercial property insurance policy has been renewed on an as-is basis and that most are simply not being renewed at all.

How can we possibly rebuild our great city under these circumstances? How can we expect capital to flow into our area when affordable insurance cannot be found? We must find a solution to this problem, and in the very near future. Indeed, if the insurance climate of the Gulf South does not materially improve in the next 12 to 18 months, many small business men and women will be forced to consider relocating to other regions of the country in order to obtain affordable insurance and maintain viable businesses.

Mr. Chairman, let me tell you a little bit about my business and what we have experienced during and after Katrina. My company, Guico Machine Works, is an oil and gas equipment manufacturer, a company that I founded over 25 years ago in the New Orleans area. Before the hurricane, my company had 55 employees, turning our wellheads and related products in our plant located on the Harvey Canal in Jefferson Parish. My business had accounts receivable of nearly $1 million from sales of $400,000 per month. However, after Katrina struck in August of 2006, our manufacturing output immediately dropped to zero. For nearly 6 weeks after the hurricane, we received no mail, no checks, no sources of income, yet customers continued submitting orders. We had a shop full of materials and machinery, but no workers, causing the shop to sit idle.

During Hurricane Katrina, the building next to my warehouse literally exploded, and parts of that building rained down upon my warehouse, causing extensive damage. Like most businesses in New Orleans, I had insurance coverage against storm and fire damage. I also had wind and hail protection on our warehouse, but not on its contents. My insurance company denied coverage for the damages to my building and its equipment. I have unfortunately been forced to litigate this claim and in the meantime have not received one dime from my insurer.

Without any insurance recovery, I have been unable to repair the damage, and, Mr. Chairman, on top of that, I have been notified that because the damage has not been repaired, my wind and hail policy will not be renewed. Moreover, the premium on the balance of my insurance policies has increased a whopping 55 percent for far less coverage than under my pre-Katrina policies, and my deductible has skyrocketed from $2,500 to $20,000. Furthermore, had I opted for the same coverage as my pre-Katrina policy, my deductible would have increased to $175,000 per occurrence. These are not costs and risks that my business can readily absorb.

To put it all in perspective for you, let me give the Committee just a few real-world examples of the experience that similarly situated businesses are facing in our area.

A local restaurant located in the French Quarter paid $27,000 for its property insurance in 2005, which included a 2-percent wind and hail deductible, with a minimum of $25,000. The 2006 renewal for the property with the same limits had been increased, believe it or not, to $242,000 and now includes a 5-percent wind and hail deductible.

A local shopping center experienced an increase in property insurance premium from $70,000 to $250,000 and an increase in its wind deductible from $350,000 to $1.7 million. Furthermore, when I visit with my colleagues in the business community in the New Orleans area, among other things, I am told almost all personal and commercial property policies are not being renewed or are renewed with severe restrictions regarding wind damage. Owners of vacant buildings are unable to obtain wind coverage of any sort. The wind provision in the typical policy will almost always have a 2- to 5-percent deductible. Business interruption coverage may not be provided if the wind coverage is placed with a different insurer.

Mr. Chairman, on behalf of the small business community in and around New Orleans, I urge you to address this crisis before it is too late. GNO Inc. is pleased to have joined the Natural Catastrophe Policyholders Coalition to address this very issue we are discussing here today. As taxpayers who have worked hard and played by the rules, we are counting on your and your colleagues in Congress to rescue us from this nightmare. We stand ready to work with you in any way we can. I am pleased to answer any questions that you may have or submit any additional information that you may require.

Thank you.

Chairman DODD. Mr. Guidry, thank you very much, and as I pointed out earlier, we appreciate your coming before us and telling us your story of what happened. Having been down there a few weeks ago, I know it is not an isolated case. As you point out, there are other businesses as well that are paying—if they can find any insurance at all, it is at prices they cannot afford. I suspect you are not going to—how long are you going to be able to hold on with your business? What is your sense?

Mr. GUIDRY. What was the last question?

Chairman DODD. How long can you hold out?

Mr. GUIDRY. Senator, the truth, I would like to say it is almost like I am playing this giant game of solitaire. Every day I pull a card, and I have to figure out where to put that card. You know, you guys have taught me a new word: "actuarially sound." With this new deductible, I have discovered my company is not actuarially sound today. So stability is what we need. As an entrepreneur and small business owner, managing risk is what I do for a living. But managing in an arena, in an environment where it is not stable—my insurance card comes due on September the 9th. That is my renewal policy. What that is going to look like, I have no idea yet, but we will figure out a place to put that card.

Chairman DODD. We will get back to you in a few minutes here. Mr. Polsky, thank you for being here.

STATEMENT OF HAROLD POLSKY, HOMEOWNER

Mr. POLSKY. Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. I want to thank you, first of all, on behalf of both myself and my wife, Barbara, for the opportunity to speak before you today. We appreciate this opportunity to add our voices to this very difficult but very important issue.

There are two issues here. We have only heard one side of it, and that is a very important side: the cost and availability of insurance. But there is another side, and Mr. Guidry talked to it briefly. Insurance companies are not paying the claims. They like to tell you, "We have paid 98 percent of all claims." They have not. They put money in a fund to pay off a future claim. They call that "claim paid" whether it has been paid or not.

Now, until November 2002, my wife and I rented a house in the city of Philadelphia, Pennsylvania. Around the middle of 2002, we discovered that we had the wherewithal to purchase a house. We did not want to live in Philadelphia, and on the advice of a relative, we looked into Florida. We found a perfect house for us: 1,500 square feet, concrete block, small lot. It was not a perfect house, but it was our house and that made it perfect for us. We moved in in December 2002. We had to carry three different kinds of insurance. We had to carry homeowner's insurance, wind insurance, and flood insurance. But the total of those three premiums was well within our budget.

The year we moved in and bought our first policies, all three policies had the same value for the property: $90,000. They were all identical. The homeowner's premium was $464, the wind premium was $443, and the flood premium was $851, and that is a total of $1,758. This was in November 2003. Remember that date, please—or November 2002.

In November 2003, when our first renewal came in, it was still a manageable cost. Our homeowner's premium was now $482 a month. The value of the house had changed. It was now $95,200. Our wind premium was $475 a month, and suddenly the wind policy value was $99,000, which was the same value that the National Flood Insurance Program put on the house with a premium of $935, for a total of $1,892. We could not understand why all of a sudden these three policies, two of them from the same insurance company, had different values for the house if it had to be replaced.

Then 2004 came. Hurricane Frances hit the East Coast of Florida and, like a slingshot, whipped across the peninsula. When it got to Port Richey, Tampa Bay area, on September 6th, it was a very strong tropical storm.

We suffered damage in our house. We do not know how it got in, but water somehow got into the house. We knew it was not flooding because there was no rising water. But all of a sudden all the carpeting in our house was soaking wet.

We were concerned about damage to our possessions. We moved everything into the middle of the rooms, and we are afraid the water was going to lead to mold issues. So we tried to contact our insurance company. We could not get a hold of them until September 10th, and that is understandable. A major storm had just come through.

We explained our damage. They gave us a claim number and told us that an adjuster would contact us within the next few days. They also gave us a telephone number to contact this adjusting company if we had not heard. Well, they did not contact us, and we tried to call every day, and they never answered their phone.

And then 20 days later, Hurricane Jeanne did her little whiplash out of the Atlantic Ocean, came right across, and again we had water on our carpeting. The day after that happened, we got two letters from our insurance company denying our claim. One of them said we did not have wind coverage, and the other one said our deductible did not cover the damage. Well, nobody had been to our house. How did they know what our damage cost was? They had no way of knowing it.

We also started to smell an odor in the house that we were convinced had to be mold because it was not there before. We contacted the insurance company on the 28th of September to file a claim for the damage from Jeanne. We were given a claim number and told that someone would contact us, told us, "Pull up all your carpeting, save a piece. Take pictures of your damage. Give it to your adjuster."

Then our telephone stopped working. We called the local phone company. They came out. The technician found that the main jack in the wall was soaking wet. He said, "There are only two ways that could have happened. Either water came down the walls and soaked the jack, or you had 18 inches of flooding in your house." And we had no flooding.

We pulled up the carpet. There was mold underneath it. We were worried we had not heard from anybody. We finally got a call from an adjuster. He inspected everything and said, "The wind blew the shingles up on your roof. The water got under the shingles, came down the walls. That is why you have wet carpeting." He agreed that there was mold and said we should have a payment within 2 weeks from our insurance company. We did not hear anything.

Then in November of that year, for 2004, our policy was renewed again, this time with a $100,700 value of the property for homeowner's insurance with a $504 premium. Wind had a $97,000 value with a $538 premium, and $99,000 value for flood with $992, which was still manageable, $2,034.

Then on December 21st of that year, we called our insurance company, and they said, "There is no insurance claim for you."

Senators, to put it bluntly, my wife and I went absolutely ballistic. This went on for all of 2005 and all of 2006, over and over and over. We had cleaned up all of our wet carpeting and the mold, which we were later told, "You should not have gotten that close to that much mold." But we did because somebody had to do it.

We got sent to mediation to try to settle this, and the only thing that happened there was the representative for our insurance company said, "You had a flood, and you have to file a flood claim." And we said, "We cannot file the flood claim. There was no flooding. If we file a flood claim, that is insurance fraud." He said, "I do not care. You have to file a flood claim. You had a flood."

The policies kept going up and up and up. I mean, you have my written testimony with all of it. I am just going to skip to a few facts because I have gone over, and I am sorry.

We were living in a house with bare concrete floors, boxes everywhere. We felt like we were living in a warehouse. The stress of having to live in these conditions was affecting us both physically and emotionally. The financial burden from the increased premiums plus the increased electrical costs—have you tried to heat or cool a house with wet insulation in the walls? It cannot be done. Our electric bills doubled.

Between losing our claim, misfiling it, jumping us from one adjusting company to another, and then putting us in a class action lawsuit of a wind versus flood claim without our knowledge and without our consent, we felt like we were living on a roller coaster. It put such a strain on our marriage that my wife and I almost split up over this. There is no way to understand what happened without seeing a timeline, and I have one of those here that I will give to you. We had to hire a lawyer to get the claim settled. Eventually, we could not afford to live in Florida. We settled our claim for half of what we should have received, sold the house at a loss—and by a loss, I mean we got $35,000 under market value. And then we left in September 2006 and moved to Virginia.

Now, in 2006, the original value of our house and premium for homeowner's insurance, the premium was $1,092 on a value of $108,000. In October of 2006, we got a revised statement, 1 month before that policy expired, and that revised statement said your home value is now $215,475 and your premium is $2,063. That is a 100-percent increase. Our mortgage jumped up by almost $200 all through insurance. We had already moved to Virginia when we got that. Heaven only knows what would have happened to our mortgage costs if we had not already moved.

Right now, in the Pasco County record, the house that we were living in has been assessed by the county as a value of $124,856. The insurance company for 2006–2007 valued it at $231,000. Our renewal that we would have had to pay if we stayed in Florida—we had a $2,700 premium. Right now the premium in that zip code is $3,491. That is just homeowner's insurance.

Senators, our case may be extreme. It is not uncommon. Thousands of people in Florida and throughout the Gulf States can tell you similar stories. The outrage here is not just the cost. It is what everybody who has a claim goes through, and they are intertwined. How many more people have to go through what Barbara and I went through or, even worse, lose their home to foreclosure, because they are. Thousands of people every day are losing their homes to foreclosure. The insurance industry along the Florida and Gulf Coast is out of control. It is a pattern that is repeating itself. If you do not believe that, ask people who live on Long Island, New York, why they cannot get insurance. Ask people on the Jersey shore why they cannot get insurance. It is happening, and it is going to hit every single State in this union if we do not do something about it. How long can we wait?

I am sorry I took more time. Thank you for the opportunity, and I would be happy to answer any questions you may have.

Chairman DODD. Thank you very much, Mr. Polsky. We are deeply sorry about what you have gone through and your family has gone through. But we appreciate your testimony here this morning.

Let me turn to Mr. Nutter, if I can, Frank Nutter. Thank you for being here.

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

Mr. NUTTER. Chairman Dodd, Ranking Member Shelby, and Members of the Committee, my name is Frank Nutter. I am President of the Reinsurance Association, which is the national association representing property and casualty organizations that specialize in assuming reinsurance. Reinsurance is commonly referred to as the insurance of insurance companies, and one of its most common purposes is for the transfer of risk associated with catastrophic events, such as hurricanes, earthquakes, and in the case of September 11th, acts of terrorism. Any debate about the role, if any, that the Federal Government should have with respect to financing recovery from natural disasters should include an analysis of what the reinsurance capacity is, as well as what the insurance companies' capacity is to write.

Global reinsurers view U.S. catastrophe risk as an essential component of their diversified assumed risk portfolios. Evidence of this is that in 2004 the four major hurricanes that hit Florida resulted in a little over $30 billion of insured damage. The global reinsurance industry ultimately paid approximately one-third of those losses.

The hurricane season of 2005 produced losses estimated to be as high as $60 billion to $65 billion. The reinsurance industry will ultimately pay approximately one-half of all of those losses.

The industry finances natural catastrophe risk by spreading the losses among market segments. For 2005 hurricane losses, insurers retained 39 percent of the loss, Bermuda reinsurers 29 percent of the loss, U.S. reinsurers 10 percent of the loss, European reinsurers 13 percent of the loss, and Lloyds of London 9 percent.

Notwithstanding this loss experience, the reinsurance market has adapted to increase natural catastrophe risk. The capital markets have greatly enhanced reinsurance capacity following Hurricane Andrew, as they did following Hurricane—following Hurricane Katrina, as they did in 1983 after Hurricane Andrew, and in 2001 after the terrorism losses of 9/11.

Since the fall of 2005, approximately $32 billion of new capital has been raised and committed to the reinsurance market. $10.4 billion was invested in new startup companies, $10.3 billion in replenishing the capital positions of existing reinsurers, an additional $5.6 billion was invested in special purposes vehicles. In addition, $5.3 billion was raised in the capital markets for catastrophe bonds for U.S. catastrophe risk. And in the last 6 months both the Chicago Mercantile Exchange and the New York Mercantile Exchange have launched catastrophe trading platforms.

Private reinsurance capacity increased in 2006 by approximately 30 percent, and reports of the January 2007 renewals indicate reinsurance capacity has grown an additional 14 percent in a moderating price environment. Broker reports reflect that flat to declining reinsurance rates for 2007 renewals. In our view, the free market works.

The RAA believes that the natural disaster risk are insurance in the private insurance and reinsurance market and that State Cat funds significantly displace the private market. The RAA believes there are many flaws with the concept of State catastrophe reinsurance fund, and only Florida has such a fund in place.

The first is that politically charged rate-setting does not affect the underlying risk of loss or cost of recovery. If premiums are set below actual risk either losses are not funded, someone else is subsidizing the losses, or insureds are led to expect a Government bailout.

Second, there is no evidence that State reinsurance catastrophe funds result in greater availability or affordability of homeowner's insurance.

Third, State catastrophe funds also violate one of the fundamental tenets of insurance, and that is spreading the risk among various risk bearers. State funds concentrate the risk.

State reinsurance funds, particularly as it exists in Florida, are merely a cost-shifting mechanism financed by debt. They rely on cross-subsidies to pay for hurricane risk rather than relying on current affected property policyholders paying those costs. In Florida, car owners, small businesses, school districts, daycare centers, churches, hospitals, renters, professionals, and business owners, anyone with a property and casualty insurance policy, is required by law to pay the billions in dollars in bonds authorized by the Florida Hurricane Cat Fund due to its shortfalls.

When hurricane occurs it requires the Florida Catastrophe Reinsurance Fund to pay losses in excess of its cash balance, as in the case in 2004 and 2005, the Cat fund issues bonds. The bond debt is not paid by insurance companies who receive the cheap reinsurance. It is paid by assessing or taxing Florida policyholders.

The irony of Florida is that the people who vilified insurers are, together with other policyholders, now their reinsurers.

We believe that preferred solutions include removing regulatory constraints from the private insurance market's ability to willingly insure risk, encourage private insurers to enter the market, and enforce building codes.

If policymakers follow competitive free market principles, a Federal natural disaster or reinsurance fund is unnecessary. Some have suggested that a Federal program is appropriate because we all pay for disaster recovery now, implying that Federal taxpayers are on the hook for disaster losses. While natural disasters may occur in all States, most are modest insurance costs compared with a few regions.

For instance, since 1950, with the exception of Louisiana in 2005, all other States combined had less insured hurricane losses than Florida. The potential natural disaster related losses in other States are notably less than potential costs, particularly in light of very low probability for the most severe events, and are paid for by insureds based upon their own risk premiums. Even with a Federal Cat fund, the reality is that only a few states would draw on its resources.

Mr. Chairman, we look forward to working with the Committee with respect to ideas to address this problem and to addressing any issues that we might help and of focusing on Federal catastrophe funds.

Thank you very much.

Chairman DODD. Thank you very much. Thanks very much and we appreciate it very much.

Admiral Loy, thank you for being here.

STATEMENT OF ADMIRAL JAMES M. LOY (USCG–RET.), CO-CHAIR, PROTECTINGAMERICA.ORG

Admiral LOY. Good morning, Mr. Chairman. Good morning, Mr. Shelby, members of the Committee.

I appreciate the opportunity to testify today in my capacity as Co-Chairman of *ProtectingAmerica.org*, an organization committed to finding better ways to prepare and protect American families from the devastation caused by natural catastrophes.

My fellow Co-Chairman is James Lee Witt, the former Director of the Federal Emergency Management Agency. Our coalition of over 200 members include first responders like the American Red Cross emergency management officials, insurers including State Farm and Allstate, municipalities, small businesses, Fortune 100 companies, and thousands of private citizens. We like to think we are becoming a bit of a voice of the people to help the Committee figure out which way forward is the right way to go.

ProtectingAmerica.org was formed in the summer of 2005 to raise the national awareness about the important responsibility we all have to prepare and protect our homes, families, businesses, and communities. And 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.

Mr. Chairman, in the 5 minutes available, let me make three critical points, I believe, from my full testimony, which I offer for the record.

The first is that the comprehensive nature of the solution I just mentioned really has four pieces. We have talked a lot this morning about a reformed insurance construct, which is certainly one of those pieces.

But the second is a serious public education effort with respect to preparedness that goes to the citizen level, it goes to the business owner level, and helps all of them understand how critical their personal role is to prepare.

The third is a serious commitment nationally to mitigation. We have heard good comments this morning, which is the beginning of I think the common ground even for the agenda for the commission that you have suggested. But efforts like land use policies and building codes and the enforcement of both of those are extraordinarily important to hopefully minimize the challenge on the front end that we have to deal with after the storm goes by.

And last, wherever it is appropriate for adequate support and resources to the first responders that we all count on, those four dimensions have to be woven together to design this comprehensive national solution. And all must be incorporated or we will fall short of the goal that we have.

The second point I would make is to recognize this current cycle that we are in of destroy, rebuild, destroy, rebuild, with hope in there somewhere, as hardly a very decent way of going forward. I believe that cycle to be fatally flawed and we have to find a way to interrupt it before the next major storm comes by.

I think the points at issue here are that complacency tends to reign. And the further away we get from Katrina, the less focused we will be on finding a solution to this problem. Denial of it happening to me is pretty pervasive. But invariably, as we have heard from testimony at the table already this morning, sooner or later it happens to us.

The current system is a Government system of bailout. Random, unplanned use of appropriated tax dollars as a bailout after the fact is a use of the Federal dollars at this point which is not what we should be doing. We should be planning in the front end for better utilization of those dollars.

Fifty-seven percent of our citizens live in catastrophe prone areas. More go there every day, as we have heard from other witnesses this morning. Climatologists predict several decades worth of big storms. Seismologists suggest that we are way overdue for a major earthquake.

The third point I would offer, sir, is the costs associated with these megacatastrophes are almost beyond imagination and certainly are not inside the envelope of what even actuarially sound policies can deal with.

For Katrina, for example, with a piece that was on the front page of the USA Today just on Monday, they are talking about $277 billion worth of claims, and I am mixing both flood and wind here. But at the other end of the day, this storm has the potential to get to the point of $500 billion by the time we are all done bailing this out.

If the 1906 earthquake in San Francisco happened exactly the way it did in 1906 again today, it would be a $400 billion event. If that 1938 storm, sir, that you cited in your commentary happened again today, it would be between $150 billion and $200 billion event.

And last, Mr. Chairman, more directly to the point of this hearing, *ProtectingAmerica.org* does advocate the establishment of a privately funded catastrophe funds in catastrophe prone States. Such funds will provide more protection at lower cost to consumers. Much like the 401(k)s retirement savings programs, these Cat funds would grow tax-free, able to generate higher levels of reserves to provide greater levels of coverage in a shorter timeframe.

These Cat funds would serve as a backstop to the private insurance market that we absolutely must continue to depend on as we have for the last 150 years. They would also generate investment earnings that, in addition to helping to pay claims in the aftermath of a catastrophe, would be used for those mitigation, prevention, education, preparation and first responder programs up front.

We also advocate the creation of a national catastrophe fund that would serve as a backstop to participating State funds in the event of a megacatastrophe. Those State funds would be financed through mandatory contributions by insurance companies in those States in an amount that reflects the exposure risk of the policies that they write in those States, to go back to Mr. Shelby's point about actuarially sound numbers.

Qualified State funds would be able to purchase reinsurance from the national program. Rates for this coverage would be actuarially based and would only be available to State programs that have established the prevention and mitigation funding as I have described above. In the event a catastrophe strikes, private insurers would be required to meet all of their obligations to their policyholders. Should catastrophe losses exceed those obligations, then at a threshold level first the State fund could kick in, and then the national fund, if it was appropriate.

Because this program relies on the traditional private market for paying claims, the inherent inefficiencies and bureaucracy in a Government-run program are virtually eliminated. Because this program requires States to fund meaningful prevention and mitigation programs, planning, protection, preparation will take place before the onslaught of a catastrophe and will be in a state of continuous and rigorous improvement over time.

ProtectingAmerica.org is cognizant of readiness and preparedness efforts underway by the Department of Homeland Security, by the Red Cross, by the Council of Excellence in Government, and we are working very hard to work with them, partner with them in that work.

All of these elements are contained in legislation currently pending in both the House and the Senate.

Mr. Chairman, I want to thank you again for taking the time to consider and discuss this important subject.

Before I close, reforming the insurance construct is a very important dimension of this work that we have in front of us. But Mr. Chairman, my final thought for your Committee is this: please recognize the opportunity we have to act before the next nightmare and provide the leadership to produce for America that comprehensive national catastrophe management solution with all the salient pieces.

Thank you, sir.

Chairman DODD. Admiral, it is great testimony and I suspect Senator Shelby might be asking a guy like you to serve on this commission when we get it going, and people with. You have got a good comprehensive view and you make some excellent points.

Admiral LOY. Thank you, sir.

Chairman DODD. We thank you very, very much.

Our last witness, and thank you for your patience in being the last witness to appear here.

Mr. CHAMNESS. Pleasure.

Chairman DODD. But thank you, Mr. Chamness.

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

Mr. CHAMNESS. Good morning, Chairman Dodd, ranking member Shelby, and members of the Committee.

My name is Chuck Chamness, and I am President and CEO of the National Association of Mutual Insurance Companies. I am grateful for the opportunity to testify before you this morning on a subject that poses an enormous challenge to the insurance industry and our Nation as a whole.

It is widely acknowledged that property insurance has become more expensive and less available in coastal regions of the U.S. While Government and the private sector can and should work together to address this problem, we believe that any actions taken must recognize the basic economic principles of supply, demand, and price.

A serious discussion of the issue at hand should begin by acknowledging three facts. One, the increased exposure of densely concentrated, high value property in certain geographic regions that are prone to elevated levels of a catastrophe risk means that property insurance in these regions will be relatively more expensive than regions that lack these attributes.

Two, as population growth and commercial development increases in these regions, high insurance costs are likely to continue to increase, as well. And three, the increased population growth and commercial development in the coastal regions is occurring at a time when the frequency and severity of catastrophe storms in these regions is increasing.

Simply put, the availability and affordability of property insurance in coastal regions is mainly a function of risk. But other variables, including actions taken by Government, can also reflect the supply and cost of risk.

I would like to comment on a few of the disaster-related proposals that have emerged this year. In Florida, the State recently removed restrictions on the ability of Citizens Property Insurance Corporation, the insurer of last resort, to compete with private insurers while canceling rate increases previously approved for Citizens to reduce the disparity between its level of risk and the relatively low premiums it charges.

Lawmakers also doubled the risk-bearing capacity of the Florida Hurricane Catastrophe Fund from $16 billion to $32 billion. As a result, the Fund has been given a legislative mandate to assume a level of catastrophe risk exposure more than 30 times its capital. Thus, if only one major storm hits the State this year, all Florida insurance consumers will face huge assessments and significant tax increases.

At the Federal level, NAMIC strongly opposes S. 618, which would almost certainly increase costs and decrease the availability of coastal property insurance. By repealing the limited insurance exemption from Federal antitrust laws created by the McCarran-Ferguson Act, S. 618 would prevent small insurers from sharing industry-wide historical loss data and using catastrophe models to predict loss costs. Without this data, small insurers will be driven from the marketplace. Their demise will decrease the supply and raise the cost of property insurance, particularly in catastrophe-prone regions.

With regard to a Federal catastrophe fund, NAMIC recognizes that a true megacatastrophe could exceed the capacity of the private insurance market. That is why it is appropriate for policymakers to consider solutions that could augment the capacity for the private market. However, any Federal catastrophe fund should have a high attachment point and only be triggered in the event of a megacatastrophe that the private market does not have the capacity to handle.

While we have reservations with some of the proposals that have either been introduced or enacted, we are encouraged by several bills that were recently introduced. NAMIC believes one of the best proposals to emerge so far is S. 930, which Senator Martinez recently introduced. It would lower costs by creating tax incentives to encourage property owners to mitigate wind-related risk.

NAMIC also supports two bills introduced by Senators Nelson and Martinez. S. 927 allows homeowners to create tax-free catastrophe savings accounts similar to health savings accounts, which could be used to pay hurricane deductibles and the costs of retrofitting properties. S. 926 would amend the Federal tax code to allow insurers to set aside a portion of premium income on tax-exempt policyholder disaster protection funds.

NAMIC also would support Federal legislation that would create financial incentives to encourage States to adopt and enforce strong state-wide 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.

Finally, NAMIC believes the National Flood Insurance Program should be substantially reformed. We supported the Senate bill passed by this Committee last year and we are hopeful that similar legislation is considered this year.

In conclusion, NAMIC recognizes that people who live and conduct business in coastal areas will face serious challenges in the years ahead. We believe the most effective mechanism for addressing these challenges is through the private insurance market. We also believe Congress can play a constructive role by enacting some of the positive reforms mentioned above.

Thank you.

Chairman DODD. Very good and I thank all of you for being brief in your statements. It has been very helpful to have us hear from all of you.

I am going to apologize to our witnesses in stepping out of the room and ask Senator Carper to take the gavel.

I have a series of questions I would like to ask all of you that I will submit in writing to you and then ask you if you could, in a prompt fashion, respond to the Committee. I would be interested in your reactions to a commission. I would be interested in your reactions to the tax proposal, the temporary one we have talked about to give some relief on premiums, as well as the flood insurance reform program. Many of you may have already commented on this in the previous Congress, when Senator Shelby struggled to get that adopted. We got it out of Committee but it did not go any further than that.

As well as the mitigation. I am particularly pleased that all of you have had positive comments about the mitigation ideas. That is $100 million we are talking about there.

I want to include a revolving idea there. I think the notion of homeowner responsibility, business responsibility of paying something back on this increases the likelihood you will get more responsiveness from the program than if it is just a fund you can draw down on without some commensurate responsibility.

So I would be interested in those and comments on those ideas for the Committee, and any other suggestions you might have in response to these questions.

And I apologize to the witnesses here for stepping out before I have a chance to ask the questions directly. But let me turn to my colleague, Senator Shelby, and turn the gavel over to Senator Carper. And I thank Senator Carper immensely for taking responsibility.

Senator SHELBY. Thank you, Chairman Dodd.

Mr. Polsky, I know you are frustrated with what you went through that you related. Who was your insurer that you had so much trouble with?

Mr. POLSKY. OK. My insurer was the only insurer in the State of Florida that would insure in my ZIP code, and that is Citizens Property Insurance Corporation, an arm of the government of the State of Florida.

But Citizens was the only option we had because nobody else would sell. Because they were told you do not have to sell. Because the regulators in the State of Florida caved on their demands to let them do it their way. That is why it was Citizens.

But Mr. Shelby, let me tell you, I spoke to many hundreds of people just in my area, and there were thousands across the State, who had the exact same problem with State Farm, with Allstate, and with Nationwide. So it was not a Citizens Insurance issue——

Senator SHELBY. Pretty uniform, was it not?

Mr. POLSKY. It was very uniform. There were more issues with Citizens because the regulations did not apply equally to them because they were a Government-funded agency. But the problems were the same, regardless of who the insurance company was.

Senator SHELBY. OK.

Admiral Loy, you propose a private—a public/private partnership to address the rising cost of catastrophe insurance. I worry myself when I hear the word public/private partnership because such partnerships usually involve a lot of public money, a lot of private profit, and not much partnership. That has been my concern for many years here.

Admiral Loy, in theory, a national catastrophe fund should—I say should—should be actuarially sound——

Admiral LOY. Yes, sir.

Senator SHELBY [continuing]. And thereby self-financing. Is that correct? Do you agree with that?

Admiral LOY. That is correct.

Senator SHELBY. However, our experience with the Federal Flood Insurance Program's inability to adequately price flood insurance leads me and others to doubt whether any Federal insurance program would be able, would be able to charge actuarially sound rates over the long term. That is what we would hope to do.

Would you discuss the scenarios under which you realistically foresee taxpayers having to pay to cover the obligations of a national catastrophe program?

Admiral LOY. A national catastrophe fund at the national level.

Senator SHELBY. Right.

Admiral LOY. Sir, first of all, let me establish my credentials as not an actuary.

Senator SHELBY. We know that.

Admiral LOY. There are folks on this panel that are dramatically better equipped to——

Senator SHELBY. But we know you know a lot about water, though.

Admiral LOY. Yes, sir, I do know a bit about water.

First, I would offer that we should learn lessons from the National Flood Insurance Program that has gone by. We have actually, in the *ProtectingAmerica.org* agenda, attempted to leave that over here, learn lessons from it, make those lessons become realistic for us as we think our way through what might be the proper construct of a national catastrophe fund keyed to those participating States that would meet the obligations——

Senator SHELBY. Should the No. 1 thing be actuarially sound?

Admiral LOY. Yes, sir, I do believe that to be the case.

Senator SHELBY. It has got to be, does it not?

How likely is it that actuarially sound prices will ever be achieved under the Flood Insurance Program, the proposed natural catastrophe program, or any other insurance program absent, Admiral, the use of neutral mechanisms to assign rates to risk?

In other words, you are managing risk. That is about insurance, is it not?

Admiral LOY. Exactly.

Senator SHELBY. And if you do not, if you do not assign a rate to a risk, somebody is getting a free lunch, are they not?

Admiral LOY. Well again, sir, I am not a student of the insurance business as it relates to the——

Senator SHELBY. But just use your own common sense.

Admiral LOY. Precisely. My common sense suggests that with thresholds established, as has been commented on by a couple of other witnesses, where a State fund—first of all, the first and primary provider of the insurance capability must remain the private insurer. And to the degree they find themselves overwhelmed in the aftermath of a storm, to have in advance the designed intent of allowing a State fund to kick in, so to speak, and address the shortfalls, as Mr. Polsky and others have described, that seems to be an appropriate thing to do.

And in my mind, the last court of resort can be that national fund where those very few, once in 100 years, maybe even once in 200 years, catastrophes come by that the national fund can, in all intents and purposes, be that reinsurer for the State fund to allow people and businesses not to have to suffer through what we have heard in testimony this morning.

Senator SHELBY. Mr. Nutter, what is your estimate of the maximum losses that the insurance industry could, could suffer in a year from a natural disaster before it would face widespread insolvencies? We know you have a tier of insurance and you sell off a piece of the risk here and there. That is managing risk.

But what are the probabilities of an event occurring that would inflict such losses?

Mr. NUTTER. It is a challenging question. Let me give you my best answer.

Our estimate of the reinsurance contacts in place in 2006, in other words not necessarily the total capacity available but the capacity in place, is probably $70 billion to $75 billion of reinsurance capacity.

You could add to that the capacity that the Florida Hurricane Cat Fund added, which is probably another $15 billion, looking at 2006, of $90 billion. And that sits on top of whatever the insurance companies retain by way of risk. So if you use some percentage of capital and surplus, you would add multiple billions of dollars of that.

So our estimate is that, indeed, there is satisfactory capacity for the catastrophe risk based on the probabilities of losses.

Senator Dodd mentioned the—and Admiral Loy mentioned the 1938 storm and the numbers were $100 billion or something. The insured exposure, even adjusted to today's cost, is about $38 billion. If that same storm happened today and today's exposures, that is considerably lower than what the industry paid by way of Katrina, Rita and Wilma.

The Miami hurricane of 1926 is often cited as perhaps the worst case scenario. And while it is no longer insured mostly in the private market because of the State of Florida's actions, that storm would be estimated at $80 billion.

To us those are numbers that suggest the industry is fully capable, in terms of capacity and handing a major natural catastrophe in this country. Admiral Loy mentioned, validly, numbers considerably in excess of that. But I am sure that includes infrastructure, disaster assistance, probably includes the Flood Insurance Program, none of which would be replaced by any Federal cat fund as currently proposed.

Senator SHELBY. Dr. Hartwig, would a natural catastrophe fund have any impact on the long-term availability and affordability of insurance?

Mr. HARTWIG. In terms of the long term availability and affordability, potentially for the highest level events that we can talk about, the sorts of events that Mr. Nutter has outlined, events that go beyond that, events that exceed that, events that would have required some Government involvement on the back end anyway.

To the extent that various funds are being discussed today or the legislation in Florida which was sold as a savings to individuals, most of those savings are illusory and they are illusory because while you can promise to cut rates today, the reality of it is the deficits that will be incurred both by the State-run insurer and the State-run reinsurer, have to be recovered on the back end.

Senator SHELBY. So there is no realistic price mechanism here?

Mr. HARTWIG. Right. Definitely with respect to Florida, there is no realistic pricing mechanism at all. And in fact, I would go so far as to say that the vast majority of State-run markets of last resort tend to operate in a deficit position or at very thin margins and are on the razor's edge of going bankrupt at any given point in time.

Senator SHELBY. Doctor, regarding Florida's catastrophe fund, regarding their—it replaces pre-event premiums with post-event assessments. That is an unusual kind of way to finance insurance, is it not?

Mr. HARTWIG. Well, there are some financing mechanisms that are post-event and some bonds can be triggered post-event. But what is unusual in Florida is to basically displace the private sector, promise a big, big savings for everybody in the State, and then to replace them with what many people do not understand is a huge tax increase on the back end. Just many people are unaware of it.

We are talking about literally, in some of the scenarios Mr. Nutter mentioned, a repeat of the Great Miami Hurricane of 1926. We do not need to go to fiction. We can just look at old events occurring today. We are talking about assessments in the vicinity of $40 billion that threatened the State's credit rating, that will cause all sorts of assessments on policies on people who do not even live near the coast.

Senator SHELBY. Mr. Nutter, I am sure you have reviewed Senator Nelson's legislation to establish a national catastrophe fund. What is your opinion on the likely impact of the affordability of insurance, if that were to become law in its present form?

Mr. NUTTER. It is hard to see how it would help. If, as has been suggested by proponents of a Federal cat fund, that it is to be actuarially sound at the Federal level, requiring the State fund to be actuarially sound, then ultimately you still have to have the consumer pay an actuarially sound rate in order to fund the mechanism. If you do not do that, there has to be a subsidy or some sort of taxpayer assistance, as Florida is doing now.

It is hard to see how that trickle-down effect of that fund is actually going to affect the affordability or availability of insurance.

Senator SHELBY. Dr. Hartwig, you just said that there are billions of dollars available for reinsurance in the marketplace, as I understand it. Would we chase that money away if we got the Federal Government in as the backstop business here?

And if it would be driven away, would it go away perhaps permanently?

Mr. HARTWIG. Well again, I think that everything needs to be done to encourage capital to flow into insurance in reinsurance markets. And if there is a need that is beyond what can be satisfied by any elements in the private market, including the capital markets, there you might see that there is some role of Government.

But to use Florida as a bit of a microcosm of this, it is true that reinsurers were chased out of Florida. And if you have the belief that each time you make a little money or each time you get to a year that there are no cat losses that the Government is going to step in and displace you, you are not going to come back in. So they are looking for somewhere else to go.

Senator SHELBY. Mr. Chamness, Chamness?

Mr. CHAMNESS. Chamness.

Senator SHELBY. One of the biggest problems we had following Katrina that we have heard a lot, over and over——

Senator CARPER. Senator Shelby, I am going to just wrap it with this one, if you would, please.

Senator SHELBY. I am getting toward the end, if you will let me.

Senator CARPER. OK, good. So am I.

Senator SHELBY. I always let you, remember?

One of the biggest problems we have had following Katrina was the failure of some companies to pay claims in an equitable manner. We have heard some of that today.

There are many reports of companies failing to adequately assess claims and being willing to litigate claims rather than to pay them. Do you think that the insurance industry could have done a better job settling claims in the aftermath of Katrina? And what are your members doing to make sure that they will do a better job in the future? You know, they have had a lot of bad publicity, not just in Louisiana, Mississippi, but everywhere.

Mr. CHAMNESS. Well, thanks for the question, sir.

The fact is, Katrina was unprecedented in the number of claims paid, the cost, the number of lives lost. And I think the insurance industry has learned lessons from the unprecedented claims handling that was required after that storm.

We certainly have looked at a lot of issues that Congress can do today that will help improve the next storm and the insurance industry's reaction to it.

I would respond, and I am sorry about the experience of Mr. Polsky in Florida. He was a panelist here and so to address—well, I cannot address his specific——

Senator SHELBY. He is probably speaking for a lot of people, though.

Mr. CHAMNESS. Well, I would just say that the experience with Citizens and his claims handling particularly, I think was well documented in that various period where Citizens had, I think, twice as many complaints in Florida as any other private insurer. So unfortunately, his experience perhaps was not an exception.

Senator SHELBY. I have one last question.

Governor, over the past few years, there has been tremendous growth in the use of alternative insurance mechanisms, including catastrophe bonds and sidecar transactions. Could you offer any insight as to why there has been so much innovation and what impact a national catastrophe fund would have on these incentives in the private market now for future innovation?

You might want, just for the audience, explain what you mean by catastrophe bonds and sidecar transactions. These are new developments.

Mr. RACICOT. They are, Senator Shelby. And frankly, they are a revelation of a notion that I believe you subscribe to. And that is the incredible imagination and creativity of capital markets when they are allowed the opportunity to function and operate because they are built upon the ingenuity and the competitiveness of the American people driving toward the best bargain they can drive to a consumer, thereby rendering a profit.

And clearly, there have been——

Senator SHELBY. But in doing that, they are assessing real risk, are they not?

Mr. RACICOT. They are. And frankly, at its core what this argument to me about is this, that there are some forms of insurance whereby a partnership with a governmental entity is unavoidable, for instance with terrorism. And that is for a very logical reason, because you cannot be advised—you have no history, first of all, to set a premium, to do it actuarially. You have no presently existing information to make an assessment on a daily basis. So how, in the name of God, can you go about setting a premium when you cannot assess the risk? That is unavoidable.

Our belief is that this system has operated exceptionally well for 150 years. Not perfectly, but exceptionally well. And when you talk about the number of failures with processing cases, really you are talking about in the neighborhood of 17,000 out of 1.75 million cases across the Gulf. I would say that is a pretty good record in any venue.

Those are the ones, of course, that receive the attention because they are so tragic and they are so difficult and they are so challenging personally to people, and our empathy goes out to them. But at the same time, we have got to keep an eye on principle.

If you establish a cat fund, I think you are tearing at the fabric of this infrastructure. And you can compromise it irreparably and you cannot restore it. And that is why our caution is to be very, very careful here. Because if we get to the point of socializing property casualty insurance in this country any more vastly than what is absolutely necessary, for instance with terrorism, we I think augment substantially the risk of decimating the system, which then means the Federal Government to this day has to be prepared to pay out about $250 billion more in damages to the American people.

Senator SHELBY. Thank you, Governor.

Thank you, Mr. Chairman.

Senator CARPER. Senator Shelby, I remember all those years when you were our chairman and you were patient with me and let me go on and on. And I thought how will I ever repay him? [Laughter.]

I think I owe you one less, my friend.

To our panel, sometimes I say when we have folks before us, we just have a couple of witnesses on that particular day would be quality, not quantity. Today we have quantity. But I would also observe we have quality. This is a good panel and good perspectives, a lot of different perspectives. They are of real value.

Governor Racicot and I served as Governors together for 8 years. I believe he once had an idea of—I want to call it a consensus commission or compromise commission. In a day and age when we do not get a lot done here in our Nation's Capitol and maybe we disagree more than we should. It was a different approach and, I thought, an intriguing approach.

As we listened to this back and forth here today, I think we may want to dust that off, that idea off, and see if we cannot apply it here in this regard as well.

I think it was a Republican, a great Republican, Abraham Lincoln, who used to talk about the role of Government. Do you remember what he used to say? To paraphrase him, the role of Government is to do for the people what they cannot do for themselves.

We have responsibility, really shared responsibility that involves States, involves Governors, insurance commissioners, legislators, that involve the private sector insurance companies, reinsurers, that involve the Federal Government as well, not only through outfits like the Coast Guard that respond to these emergencies and FEMA and others, but also, to those of us who keep looking at this flood insurance program, the Federal Flood Insurance Program, to decide is it appropriate or not.

Mr. Chairman, Chairman Shelby and I used to serve together on the House Banking Committee. And one of the things I worked on, actually I think we were on that committee together, was the National Flood Insurance Program. It seemed to me we almost incentivized people to move into harm's way.

I think it was Dr. Hartwig who said over half the people in our country live within 50 miles of one of our coastlines. We do not have 1,400 people a day coming to Delaware, but we probably have 1,400 people maybe every other month, that are moving, especially to Sussex County, which is where we have some terrific, terrific beaches.

What I want to do today is ask two different questions. I will tell you what both of them are. One of them deals with sea level rise, something that we are concerned about in my little State. The highest point of land in Delaware is a bridge and it is not very high.

We have a lot of folks who come to places like Rehoboth Beach and Dewey Beach and Fenwick Island and Lewes and Cape Henlopen and all kinds of places up and down our little shore.

But I kid people and say, Senator Shelby, we are going to have people buying beachfront property not in those places in Delaware, but if we are not careful in like Dover, Wilmington, or places far inland. Hopefully, that will never happen.

But last week the U.N.'s Intergovernmental Panel on Climate Change released a report. You probably heard about it. They concluded that climate change—yet another report concluding that climate change is going to have a significant impact on the environment. They talked about winners and losers in different parts of the world and how climate change was going to affect them.

One of the specific impacts they cited though in the report, and it states, and I quote "Sea level rise and human development are together contributing to losses of coastal wetlands, and mangroves and increasing damage from coastal flooding in many areas." That is their quote.

We know that climate change is presenting an increasing amount of risk to our lives and to our property around the globe, especially in coastal regions.

I would just ask, particularly for the insurance companies that are here or their spokesmen, if you would, how are the insurance companies calculating the risk of climate change impact when issuing policies? That is my first question.

And sort of as a follow-in, are insurance companies taking any specific risks or steps to incentivize actions that would reduce greenhouse gas emissions that cause global warming and contribute to sea level rise and just exacerbate the situation we are talking about here today?

Mr. NUTTER. Senator Carper, I will take a shot at that.

Senator CARPER. Mr. Nutter, you are on. Thanks.

Mr. NUTTER. The scientists who look at the evidence of climate change have concluded that the likely effect on hurricanes, which is how the industry would tend to translate climate change into its business, is that it will increase the intensity of storms, that there is no conclusive evidence that the number of storms will be increased by the intensity of storms. It does not take much to increase the intensity of the storms that have hit the Gulf Coast or Florida to understand that it will exacerbate the damage greatly.

The insurance mechanism that attempts to translate this scientific information is largely through catastrophe modeling companies. These companies try to assimilate scientific information together with the actuarial information. And the modeling companies then submit information to insurance companies and, in some cases, to insurance regulators.

Regulators have had difficulty, as you might expect, in accepting what maybe some consider subjective assessment of the likely impact of climate change. But it is an effort on the part of the industry to try and assimilate its actuarial expertise with the scientific expertise. But some conclusive information would suggest that not only are we going to see more activity, as Dr. Hartwig suggested, but the intensity of these storms are likely to be far more severe.

Senator CARPER. It would seem to me, before I yield to others to respond to the question, it seems to me that the intensity of the storms is sort of the near term threat. The longer term threat is sea level rise. That is just an observation.

Others, please?

Mr. RACICOT. Well, Senator Carper, I think it is important to note and for everyone to clearly understand that it is not insurance companies that do this actuarial analysis independently on their own, in private, with visors on. These analyses are conducted by independent entities that receive data from virtually every insurance company in the United States of America.

It actually, parenthetically, is a good reason why the bill that sets about to diminish or derail the application of McCarran would be a disaster for people because you would steal away the opportunity to get as much information as possible into these distilleries of knowledge and analysis allowing for an actuarially sound premium ultimately to be suggested.

At the end of the day, I think for our members, when it comes to climate change, it is not an issue that they denounce nor dismiss. It also, at the same point in time, is an issue, I think, that the jury still retains some doubt about. And as a consequence they are planning, looking to the modeling agencies, contemplating and trying to analyze virtually all of the new data that comes in on a daily basis. But frankly, it has not risen to the level that would allow for them to be able to draw a conclusive presumption about proceeding in the future.

Senator CARPER. All right. Others?

Mr. NUTTER. Senator Carper, can I just supplement it, since you——

Senator CARPER. Mr. Nutter, sure.

Mr. NUTTER [continuing]. Made the point about sea level rise.

As you would expect, gradually rising sea level is not going to be an insured event. On the other hand, increased storm activity or increased intensity is clearly going to drive a wave wash onto shore and affect property.

So it clearly is a problem, both with respect to what I mentioned earlier, the increased intensity of the storms, but also the likelihood that properties are now going to be subjected to a greater extent of the wave wash that comes with the storms when they come onshore.

Senator CARPER. All right, thank you.

Mr. Chamness.

Mr. CHAMNESS. Mr. Carper, I agree with the comments of the other insurance company participants.

I would add that it is something that our industry is beginning to pay quite a bit of attention to. Indeed, our own trade association has rolled out a website called InsuranceandClimate.org that is starting to track some of the information, some of the studies that have been published, most of them from Europe, mostly be reinsurers that are examining the issue. I might hold it out as a resource for you as you look into it and the insurance industry.

Senator CARPER. Anyone else? Please.

Mr. HARTWIG. Yes, Senator Carper.

I would like to get back to one point in my testimony also about land use.

Senator CARPER. By the way, I really enjoyed the visuals that you had there. You do not see that every day. That was good, good tool.

Mr. HARTWIG. Thank you for putting up the videos for me.

But the issue about land use, while there is a tendency to often think about these issues as forming part of elements of an insurance crisis, per se, as my example with South Miami Beach, every bit of which would disappear were sea levels to rise just a bit, we can see that clearly. While insurers may be looking at modelers and a variety of other researchers to help discern the risk, somebody in South Miami Beach is not looking at this. And so those structures are no doubt intended to stand a long time.

So we are seeing different things going on here. We see insurers taking this very seriously. But because land use decisions are local, but they do not appear to be thinking big picture.

Senator CARPER. Thanks.

Dr. Loy—not Dr. Loy, Admiral Loy. You may be a doctor, too, I do not know.

Admiral LOY. I guess I would just like to offer that your question allows us to sort of step back a bit from the conversation that we have had for the most part this morning. For this Committee, as you represent the people of this country, this has to be about saving lives and protecting people at the other end of the day.

And to the degree we are able to do that, we can recognize that insurance and the construct associated with it is not "the" solution. It is a part. It is a dimension, a serious, an important dimension of the solution.

But we need systemic changes, I believe, in the way our country is prepared and protected against these kind of things.

And so the multiple dimensions associated with truly a comprehensive national solution to this challenge is, unfortunately, what the Committee has to try to get its arms around while concentrating in each of those dimensions, including the insurance construct.

Senator CARPER. Second area I want to explore, I want to go back to Senator Shelby's questions with respect to the National Flood Insurance Program. Mr. Chamness, I think you were the one who said what we tried to do here in this Committee and in the Senate last year was worthy or was meritorious.

As I recall our efforts sort of foundered. I do not believe the House ever acted and I do not believe we ever ended up with final legislation.

But for about 20 years, when Senator Shelby and I were together in House Banking, we started working on national flood insurance, looking at the National Flood Insurance Program, and trying to make sure we were not somehow inadvertently incentivizing people to move into harm's way. Spend a lot of money, invest a lot of money, and ended up putting themselves and their families, and frankly insurance companies and taxpayers, at risk.

I do not care who starts off. Mr. Chamness, you mentioned the issue so you may want to start. If you want to give me just one thing we should do with respect to national flood insurance. Use last year's legislation. Just one important principle that we should adhere to in that legislation. I would welcome any advice you all have for us, because I think we are going to take it up again. I believe the Chairman mentioned that before I got here today.

Mr. CHAMNESS. Thank you, Mr. Carper.

You are right. I think the Congressional Budget Office called the current program unsustainable. Basically, as it was pointed out earlier, it takes in approximately $2 billion in premium each year and pays out, in a regular year, about that amount. Of course, when we reach the events of 2005, it pays out many times that amount.

So if there is one thing, I think it would be to make it more, and it is a Government program, more actuarially sound, allow it to build up a reserve, a reserve that can be called upon in those times of great need. And we just experienced one and the Committee is well aware of the challenges that that posed.

Senator CARPER. Thank you.

Any other counsel? Yes, Governor.

Mr. RACICOT. Senator Carper, would you permit me to add one footnote to your previous discussion?

Senator CARPER. Add that footnote.

Mr. RACICOT. That is that if we set about to—when you talk about climate change and sea levels—to create a natural catastrophe fund, perversely it seems to me we are contributing significantly to your rising concern.

What do I mean by that? You are still providing the same incentives for people to migrate wherever they choose and make whatever decisions they wish because at the end of the day they know that they will be taken care of. The value proposition that our forebears built into this system is somehow, I think, eviscerated.

I just thought it might be worthy of your consideration.

Senator CARPER. Thank you. Sure.

How about that second question?

Mr. RACICOT. In reference to the second question, frankly, if you really think about it, the National Flood Program was an effort to optionally federally charter a risk and allow it to be managed by the Federal Government. And frankly, had it been required to charge actuarially sound premiums and had it had accurate maps to be able to determine where the flood zones were, and had it the ability to react like a private company, it could very well have done exceptionally well.

And at the end of the day, when you think about it, if you are going to require something to be actuarially sound, there is already the private capacity to do that. So why are you creating that redundancy to create a Government program that already allows for that function to be performed by the private sector?

And so I think there are things that ought to be done with the National Flood Program. I would not agree with Dr. Lazear that somehow the difference is one is old and one is new. That has to do with justice. It does not have to do with economics.

And from an economic point of view, it seems to me, what we ought to be considering is how to make it work. And I think you can make it work and bridge to the future to an actuarially sound national pool by charging adequate premiums, having accurate maps, and having expanded coverage.

Senator CARPER. Good. Commissioner Bell.

Commissioner Bell, sitting back here, you are about a head taller than everybody else on this panel. When you stand up, how tall are you anyway?

Mr. BELL. I have been that way most of my life, Senator.

Senator CARPER. Do you just have really short legs?

Mr. BELL. I am 6′6″.

Senator CARPER. I could tell. We should sign you up for the University of Delaware. We could use another Fighting Blue Hen like you.

Senator SHELBY. We are going to keep him in Alabama.

[Laughter.]

Senator CARPER. I was afraid of that.

Mr. BELL. Thanks, Senator. That is my State of choice and birth.

When we look at the flood insurance program, it goes beyond what is sound in terms of actuarially. The big question from Katrina was was it wind or was it flood? And that is what has caused all of the issues in the State of Mississippi, in Louisiana, and in the entire program.

So until we come up with some way that is going to say and determine what happened first, unless we get rid of the anti-concurrent clauses. What happened first? To be able to determine that with an adjuster going out after the fact is going to be very difficult and it is still going to give room for much litigation going forward in another Katrina-type of event.

So I caution you going forward to make sure that that is a huge issue that you look forward to going forward because from day one that was going to be the big issue with the Katrina situation.

Senator SHELBY. Mr. Chairman, I think Mr. Guidry——

Senator CARPER. Mr. Guidry, I am going to ask you to really have the last word here and we will wrap this up. But I am going to ask the other witnesses to respond for the record, because I am very much interested in your thoughts.

If you were in our shoes, if you were in our shoes, not running a small business in Louisiana, and not being commissioner of insurance, not running a major trade association. If you were in our shoes, what would you do about the National Flood Insurance. I would welcome that. Thank you.

Mr. Guidry, the last word.

Mr. GUIDRY. I just wanted to comment on the notion of incentivizing people to move in harm's way with flood insurance.

I service the offshore oil and gas industry. I am not down there for the view. We are there because that is where the pipelines are. We are down there because that is where the oil ports are, the heliports are. And then obviously, to service that industry I have to be in proximity to that industry.

In turn, the people I employ comes down to that area and survive. So we are not exactly on the same par with Florida where we are there to build million dollar houses, third and second houses.

And finally, the comments that the Admiral said. I am a firm believer that the profit motive is the most efficient way to be able to deliver a service. So the private sector thing, I am in total agreement with that.

When I look at our particular case, the education piece, we do accept our responsibility in our insurance coverage and looking at it. Obviously, the term "in good hands" does not mean what I thought it meant. That is a part of it.

And then second, the mitigation piece. I mean, there is a lot of it that we just feel that we are just being held hostage because these guys got the lawyers and we do not. And the deal is just to hold us out, hold us out as long as possible for us to just come in and finally settle. Because we think the insurance companies are actually going to do that.

But what I do caution you with is you can come in here and you can spout all these wonderful statistics. But we, as small business people, what we are thinking today are going to be the statistics that you are going to be debating, you know, in the next year and the next year. When you take it and you make my company have a $200,000 deductible, what you have done is you have taken the risk from the insurance company and you have put it on me.

In turn, I will put it on my banker. And if something were to happen to just me, I will just have to deal with it. But if it happens as large as it has happened in my community, then my banker is going to have to deal with it. And on the back end, you are going to come right back from the insurance side of your committee to the banking side of your committee and you are still going to have to deal with the issue.

And if Katrina has taught us one thing, being proactive on a situation is always less costly than being reactive on a situation.

Senator CARPER. That is a good note to end on.

Mr. Guidry, the committees here are always jealous of their jurisdiction. When you say whether it is banking or whether it is insurance, we are your committee, that is something that is probably music to the ears of most members of this Committee.

I am sort of speaking on behalf of Chairman Dodd, and I will not pretend to speak for Senator Shelby. But we are grateful that you stuck around with us today and testified and provided some real good thought.

I think the hearing record will be open for a week or two after this and you will get a couple of questions, further questions in writing. If you all could respond to them, we would be deeply grateful.

Again, it is good to see all of you. Especially good to see my friend and colleague, Governor Racicot.

And Admiral Loy, we are always grateful to you for your service to our country.

With that, this hearing is adjourned.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follows:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank Chairman Dodd and Ranking Member Shelby for holding this important hearing to examine the availability and affordability of property and casualty insurance in the Gulf Coast and other regions.

I want to say from the outset that I remain highly skeptical of the necessity of federal catastrophe insurance. Although the property/casualty insurance industry paid $57.7 billion in catastrophe losses in 2005, the last three years have been their most profitable ever, rising to unprecedented levels.

If there is a problem, it is that the companies no longer want to take on any risk. After one claim, many homeowners are dropped by their insurance companies. After dropping anyone they perceive as risky, the insurance companies now want the taxpayers to shoulder the remaining risk? That doesn't make much sense to me.

While it may be necessary to make some adjustment in the insurance markets, I am unconvinced that the necessary "adjustment" is federal insurance. After all, the flood insurance program provides a fairly shameful record of federal involvement in insurance. While proponents would disagree, pointing out that this program will be actuarially sound. I would remind them that federal flood insurance started with the same promise.

Terrorism risk insurance provides another instructive example. Although we were repeatedly promised that the markets only needed time to adjust. GAO and others found that the federal presence has served to stifle private sector innovation and involvement.

So, despite the many promises we might hear surrounding current proposals, I am reminded of the saying that those who don't know history are doomed to repeat it.

While I don't think it is a good idea for the federal government to get in the insurance business, I do recognize that some changes may be necessary to help foster a healthy private market. I will be interested in any suggestions our witnesses today may have along those lines, so I will be listening carefully to their testimony.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR JACK REED

Thank you Chairman Dodd and Senator Shelby for holding this hearing on the availability and affordability of property and casualty insurance.

In many catastrophe-prone coastal areas, some insurance companies have stopped writing new homeowner policies and have dropped existing customers or decreased coverage. Homeowner premiums for customers in several coastal states have increased sharply despite several years of rising industry profits and a less costly 2006 hurricane season in the East. In my state of Rhode Island, property owners have been greatly impacted and are frustrated by fewer options and significant increases in insurance premiums; reportedly, some homeowners are paying over twice their premium. Even though they have been loyal customers for years and have never filed a claim, some Rhode Islanders have received non-renewal notices from their insurance company. According to the Newport County Board of Realtors, 4,500 homeowners' policies have been cancelled in the Newport area. Other Rhode Islanders have been forced to accept higher deductibles in order to receive coverage.

Rhode Islanders are experiencing these difficulties in obtaining insurance and are paying higher premiums even though insurance companies are reporting rising profits. According to a Wall Street Journal article, the insurance industry has had three straight years of rising profits, which factors in the cost of 2005's Hurricane Katrina. Profits from the property and casualty industry rose to $68.1 billion in 2006 compared to $49 billion in 2005. However, home insurance rates along the Gulf and Atlantic coasts rose between 20 and 100 percent during 2006; outside coastal areas, rates rose 2 to 4 percent over the same period.

At the national, state, and local levels we must evaluate how we plan, mitigate, and respond to natural hazards. Hurricanes and floods have occurred throughout history and will continue to occur. We have to engage in an honest discussion about how to rebuild in a way that protects people, property, and the environment.

I believe the federal government needs to provide Americans with the most accurate data that reflects flooding hazards from hurricanes and other natural events. Currently, FEMA's flood maps do not reflect the real flood hazard risks. Over 70 percent of FEMA's maps are over ten years old. In the case of Rhode Island, the maps are over 20 years old. New development, community growth, erosion, and a variety of other factors altered watersheds and floodplains. This new development and its affects on floodplains are not accurately reflected in FEMA flood maps. As a result, I plan on reintroducing my flood mapping bill, the National Flood Mapping Act.

I am interested to find out from today's witnesses the reasons why insurers are exiting the property and casualty insurance market and why homeowners are being cancelled or having to pay substantially higher insurance premiums to protect their homes. Furthermore, I am interested in what states are doing to address the impact exiting insurance companies and rising insurance premiums will have on homeowners and competition. Lastly, I would like the witnesses to address what role the federal government might be able to play in providing homeowners with needed relief.

Testimony of Charlie Crist, Governor of Florida
Senate Committee on Banking, Housing and Urban Affairs
An Examination of the Availability and Affordability of Property and Casualty Insurance in the Gulf Coast and Other Coastal Regions
April 11, 2007

Chairman Dodd, Ranking Member Shelby and Members of the Committee, I thank you for the opportunity to testify here today regarding the availability and affordability of property and casualty insurance. I applaud you for your leadership on this critical issue.

I want to thank my friends Bill Nelson and Mel Martinez for their leadership on this issue. A few weeks ago, our senators introduced an array of legislative options addressing insurance reforms. I believe they call it a Legislative Six Pack. I am so proud to work with Senators Nelson and Martinez, along with our Florida members in the House to move towards the creation of a national catastrophic insurance fund.

The role of the federal government in protecting the American homeowner from skyrocketing homeowners insurance has been debated for many years. Conceptually, the idea remains the same; however, the debate now focuses on the millions of Americans impacted by increased property insurance. Traditional insurance market mechanisms are not adequately managing catastrophic risk, and the financial strain on consumers can be felt from coast-to-coast. Hurricane Katrina reminded us all of what a natural disaster can do, not only to a specific region, but to our nation as a whole. No specific area of our country is immune to natural disasters or exempt from paying for the recovery costs. In the past, Congressional action created a bridge to homeowners in the form of national flood insurance. Congress has the opportunity, once again, to provide homeowners relief in the form of a national catastrophic insurance plan.

During my campaign for governor, I traveled our great state listening to the concerns of the people of Florida. Floridians are being forced to choose between paying skyrocketing insurance premiums or selling their homes. I've heard from many Floridians who are worried that soaring premiums are threatening their chance to raise a family in a Florida home. This is not the American dream.

The hurricane seasons of 2004 and 2005 produced 8 named hurricanes that hit Florida, costing the state $33 billion in property loss. As a result, the number of carriers providing property insurance coverage has been on the decline and market concentration has diminished as well. Florida now relies on a greater number of carriers – often smaller, recently formed domestic insurers – to provide coverage, rather than a handful of nationally known insurers.

The dramatic increased cost of reinsurance increased projected cost of building materials and labor and the projection of future catastrophes have all contributed to significant premium increases paid by Florida policyholders. Commensurate with these issues, Florida's Office of Insurance Regulation has received a substantial increase in the number of rate change requests from insurance providers.

Floridians understand the risk of living in our beautiful state. Our state has made immense progress in reinforcement efforts and stricter building codes to protect our citizens when the next storm comes. However, these efforts are not enough to convince the insurance industry that Floridians are a worthy risk.

As Florida's new governor, I have heard directly from our people that immediate insurance relief was needed. The people of Florida cried out for help and we answered their call. Earlier this year the Florida Legislature met in special session, seeking solutions to runaway property insurance rates. We worked together in a bipartisan way. We focused on results – not on politics or process. Together we achieved a momentous step forward in reducing property insurance rates for our citizens. Our Legislature passed meaningful property insurance reform, providing much needed relief to the people of Florida.

The work of the Florida State Legislature has begun to address the insurance crisis in our state, but federal action is also necessary. I implore Congress to take the next step to ensure the affordability and availability of property insurance. I know that each of you has chosen to serve the people of your state with the end goal of improving their lives and well being. Like me, you want your citizens to have the opportunity to own a home without the worry of losing it to out-of-control insurance rates.

Let me be clear, this crisis is not an issue exclusive to Florida. Many other states are also facing insurance crisis. In February, I had the privilege of working with my fellow Southern Governors, including Governors Barbour, Riley and Kaine, in drafting a resolution urging the Congress to create a national catastrophic fund. Governors throughout our nation deal first hand with the impact natural disasters have on our state economies and industry. I am also pro-actively working with Governor Schwarzenegger, Governor Spitzer and Governor Perry to advance a national fund proposal. Governors understand the need for such a program and look forward to working with you as you formulate legislation.

The problem of insurance availability and affordability in the Gulf Coast areas has been widely publicized, but it is a problem that is now affecting other states as well. Mr. Chairman, as you may know, the Connecticut Department of Insurance recently conducted a study of its homeowner's insurance market and determined that insurance availability within 1,000 feet of the shore is difficult to find in the traditional market. Coverage that is available is typically two to three times more expensive and often available only through the specialty market. Similar problems are being felt from Cape Cod to the Carolinas.

The response from insurers is aimed at coastal exposure, but it ignores the very real possibility that the next major catastrophe will not touch a coastline. Our country has a relatively brief history, but in that time virtually every region of the country has experienced some form of catastrophic event. The hurricanes in the Gulf are only our most recent reminder of the risk from natural disasters, but we would be naïve to think they are the last. We are all vulnerable to natural disasters. Most of the states you represent have been impacted by hurricanes, tornadoes, wildfires, blizzards and drought. Whether you live in Connecticut, Alabama, New York, Hawaii, Colorado, Ohio, Kentucky or North Carolina; we are all at risk. That is why it is time for Congress to move forward and listen to the American people and create this national fund.

A federal catastrophe fund would provide protection for American homeowners throughout the nation. A national program would spread the risk across the country, thus strengthening our insurance markets. Capital for the plan could come from a portion of the property insurance premiums already collected by insurance companies. The funds could grow tax-free, provide the financial capability to cope with the catastrophic risk and allow affected regions the ability to recover more quickly from natural disasters. This federal backstop for insurers is an essential step to addressing the insurance crisis.

This situation is not just an issue of lowering insurance rates for our citizens. It is also an issue of using taxpayers' dollars in the most efficient manner. Our current policy for managing the devastating effects of catastrophic natural disasters relies heavily on the Federal government. Consider the $110 billion allocated so far to facilitate recovery and rebuilding following Hurricane Katrina. As generous and compassionate as the American people are, this current system leaves much to be desired.

The subject we are discussing today is not new. What are new are the insurance industry's record profits – to the tune of $68 billion in 2006, according to a report from *Wall Street Journal,* January 23, 2007. The insurance industry as a whole has enjoyed lavish prosperity in recent years. I believe it is time for the American people to participate in that prosperity by way of reasonable insurance costs.

Our nation's response to natural disasters is one of defense. Mr. Chairman, the committee has a unique opportunity to play offense by changing the mindset within the federal government. This change can be made by creating a national catastrophe fund that will ultimately protect our bosses – the American people. The time is now to bring all stakeholders to the table to do what is right. I ask you to refocus our national effort, away from large-scale funded recovery after a disaster, to proactive prevention. A national catastrophe fund will create this transition.

Clearly, this practice makes the issue a national one, not only a local or regional problem. For example, it is estimated that the Great Lakes and Plains states will contribute approximately $26 billion to Katrina initiatives. However, these tax dollars are not risk-based, and they will leave little legacy that guarantees relief for the next natural catastrophe, regardless of where it strikes.

A national plan would also raise the bar for disaster preparedness and recovery. By encouraging states to adopt stronger building codes and emergency response capabilities in order to participate in the plan, we would undoubtedly mitigate future economic damages, while developing a culture of preparedness that will create a safer environment for all citizens of the United States.

Today, we must ask ourselves, "What will make insurance more available and more affordable for the people we serve?" I believe a national catastrophe fund will achieve this goal.

I thank you for holding this hearing, for inviting me here today, and for your continued interest and leadership on this crucial issue. I look forward to working with Congress to solve the insurance crisis facing our citizens today.

Thank you for your time and attention today. I would request my full statement be included in the record, and I am happy to respond to any questions that you may have.

* Embargoed for Release at 9:30am 4/11/07 *

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, DC 20502

Testimony of Edward P. Lazear
Chairman, Council of Economic Advisers

Before the Senate Committee on Banking, Housing, and Urban Affairs
Hearing on "An Examination of the Availability and Affordability of Property and Casualty Insurance in the Gulf Coast and Other Coastal Regions"

Wednesday, April 11, 2007

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today. Your committee is tackling an important and difficult set of issues in this hearing. I believe we share similar goals, but we must be mindful of unintended consequences that may arise from some government actions.

Insurance plays a vital role in America's economy by helping households and businesses manage risks. Individuals purchase insurance so they can sleep well at night; they gain comfort from the knowledge that they and their families are protected from some of the adverse effects of future events beyond their control. Businesses purchase insurance for much the same reason. It allows them to reduce the uncertainty associated with future costs and revenues, which enables them to plan for the future more effectively. Today, one can purchase insurance protection against a myriad of economic hazards, from poor health to motor vehicle accidents to legal liability to lightning strikes. Insuring economic losses arising from large-scale catastrophes pose special challenges for the insurance industry and for federal and state governments.

The Administration opposes legislation to create a new federal program to backstop catastrophe insurance. There are a variety of forms that the backstop could take. The federal government could directly subsidize the purchase of insurance in the private market, it could provide primary insurance directly to homeowners and others, or it could enter the reinsurance business allowing private companies to sell their insurance policies to the government at subsidized rates. We believe that none of these approaches would be helpful nor are they warranted. They would create primarily three kinds of unintended consequences and problems for the economy. First, government insurance would displace insurance provided by the private market. For the most part that market is healthy, and were it not for other forms of interference, the market could operate effectively to insure risks faced by homeowners and businesses. Second, a federal program would undermine economic incentives to mitigate risks because the program would likely distort rates from their actuarial values. Individuals would be encouraged to take on risks that are inappropriate, specifically putting themselves in harm's way because they do not bear the full expected costs of damages incurred. Third, a federal backstop would mean that all taxpayers nationwide would subsidize insurance rates for the benefit of a relatively small group of people in high-risk areas. The general taxpayer would pay for actions over which they have no control. Those who can avoid the risk would be passing the cost on to others, creating a system of distortion and inequity.

For the most part, the national insurance industry is healthy today. Despite the record $57 billion estimated insured losses incurred as a result of the 2005 hurricane season, industry-wide capital available to cover future losses actually increased during 2005. As a result of lessons learned in 2004 and 2005, insurers have increased their estimates of probable losses from future hurricanes. They have upwardly adjusted the actuarial weights necessary to cover future losses and enhance solvency – which in turn implies higher rates. Although it is true that Florida, North Carolina and parts of Mississippi, Louisiana and Alabama are experiencing difficulties with insurance availability, much of this can be traced to certain state regulatory actions.

First, some states have used state regulation to suppress prices, which has the effect of making insurance unavailable where it may be most needed. The role of state regulation should be to protect consumers from fraud and inadequate risk management by insurance companies, but states sometimes use their regulatory power to control prices. This discourages insurance companies from voluntarily providing insurance in those high-risk areas where unregulated rates would naturally be highest. For example, a new Florida law includes a number of provisions that are likely to deter private sector insurers from operating in the state. The law suspends "rate-flex" rules that had previously allowed residential property insurers to increase or decrease rates (within a band) without prior approval by regulators. Insurers must now file a request for review with regulators 90 days in advance of increasing rates, and new rate reviews have been temporarily suspended – effectively freezing insurance rates. Insurers need to charge rates that are high enough to allow them to cover expected losses and purchase reinsurance or maintain surplus to cover catastrophic losses. When premiums are not permitted to rise in tandem with loss forecasts, insurers have a very strong incentive to limit their catastrophe risk exposures by withdrawing from high-risk markets and product lines; to do otherwise would jeopardize their financial soundness.

Some states are already beginning to recognize that their well-intentioned attempts to keep insurance prices low have had the unintended consequence of making insurance less available. In Louisiana an advisory committee is considering proposals that would disband the state's insurance rating commission and allow insurers to set hurricane deductibles on the basis of risk rather than requiring one deductible for all policy holders state-wide. The Governor of

South Carolina has called for market-based solutions to insuring coastal homes against storm damages by imposing the costs of those damages directly on those who build in risky areas.

Second, through regulation some states have created state-sponsored insurance programs, which can further drive out private market participants. For example, in Florida, the state-sponsored Citizens Property Insurance Corporation (Citizens) sells property insurance to cover wind storm losses, and the Hurricane Catastrophe Fund provides reinsurance to cover private insurers at below-market rates. Citizens was designed to be the insurer of last resort, but is now the largest insurer in the state. Florida's insurance law passed earlier this year makes it easier for Citizens to compete with private insurers by charging competitive rates and by offering a broader array of coverage. The law also expands reinsurance coverage available through the Florida Hurricane Catastrophe Fund. Florida's Office of Insurance Regulation reports that neither program has sufficient funds to cover losses from a severe hurricane, so the next major storm could result in significant taxes or assessments on policyholders in order to cover any shortfalls by Citizens and the Hurricane Catastrophe Fund. A private insurance market that was allowed to appropriately price risk would build up the financial resources necessary to remain solvent even when faced with very large claims. Reinsurance, which is a common feature of the industry, helps diversify risk among a very large number of investors. Unfortunately, the Florida Hurricane Catastrophe Fund displaces private reinsurance that would have spread the cost of covering future storm losses to investors worldwide with a state program under which costs will ultimately be borne by Florida residents and businesses.

A national catastrophic risk insurance plan would likely distort rates and undermine economic incentives to mitigate risk. The experience of the National Flood Insurance Program and the steps needed to reform it illustrate some of the challenges that would likely arise in a broader federal natural catastrophe insurance program. The National Flood Insurance Program plays an important role in helping homeowners insure against flood losses, but it needs to be further reformed and should not now be expanded. Currently the program is required to provide insurance to some older properties at rates that are not sufficient to cover expected claims. In many cases the program cannot deny coverage to high-risk properties, so it continues to provide insurance for properties that have been damaged numerous times by floods. An October 2005 study by the U.S. Government Accountability Office found that while repetitive loss property claims were only 1 percent of all properties insured, they account for 25 to 30 percent of program losses from the National Flood Insurance Program. By making insurance available at below-market rates for some structures, the Flood Program allows homes and commercial properties to be located in areas that are extremely risky. Were the owners required to pay market rates for insurance, they would be less likely to be in those areas and more likely to build on safer ground. Reforms passed in 2004 authorized a pilot program to remove some of the worst repetitive loss properties from the Flood Program rolls, and the President's FY2008 budget calls for doubling the funding of this program. Furthermore, the Administration has proposed several principles for improving the National Flood Insurance Program, including making premiums more flexible and actuarially sound. We look forward to working with the Committee on developing these principles. However, the challenges of this program show it does not serve as a good model for a broader Federal catastrophe insurance program.

National catastrophe risk insurance would displace private insurance and undermine the economic incentives to mitigate risk. It would force all taxpayers nationwide to subsidize insurance rates for the benefit of a relatively small group of people in high-risk areas. This would be both costly and unfair to taxpayers. Indeed my personal experience is a case in point.

I own a home in the San Francisco Bay area, which is known for its beauty and lovely climate but which is also famous for its earthquake potential. My house is located a very short distance from the San Andreas Fault which runs along the coastline of California. It would certainly be possible for the federal government to subsidize my earthquake insurance and to pass the burden on to the general U.S. population. Passing the burden to taxpayers in Indiana and New Jersey is inappropriate both because I have the ability to avoid locating in an earthquake prone area, and because those who live in other states do not reap the benefits of the location and climate that I have chosen.

Returning again to the example of the National Flood Insurance Program, the financial consequences of passing claims on to the general federal taxpayer is no minor issue. The National Flood Insurance Program has borrowed $16 billion from the Treasury cover 2005 losses. The cost will in large part be borne by taxpayers nationwide, many of whom are not exposed to flood risks and do not receive coverage under the program.

The insurance industry is healthy and the private sector is well equipped to provide insurance for hurricanes and other natural catastrophes, but state regulators and the federal government must allow the private market to function. Therefore, the Administration believes that a federal program to provide catastrophe risk insurance at the federal level, although well intentioned, would have significant adverse consequences to the economy, and would be unfair.

I welcome your questions.

Testimony of
The National Association of Insurance Commissioners

Before the
U.S. Senate Committee on Banking, Housing, and Urban Affairs

Regarding:
The Availability of Property and Casualty Insurance in Coastal Areas

April 11, 2007
Room 538
Dirksen Senate Office Building

Walter A. Bell
Alabama Insurance Commissioner
President of the National Association of Insurance Commissioners

Chairman Dodd, Ranking Member Shelby and Members of the Committee, thank you for the opportunity to testify here today on behalf of the National Association of Insurance Commissioners (NAIC) regarding the availability and affordability of property and casualty insurance in coastal regions.

My name is Walter Bell, and I am the Insurance Commissioner for the State of Alabama. I also serve as the president of the National Association of Insurance Commissioners. As an insurance official from the Gulf Coast, I commend you for holding today's hearing on this crucial, national issue.

When I became president of the NAIC, I pledged that examining the role of insurance in managing natural catastrophes would be our top priority. And indeed, in January of this year, we held a natural catastrophe symposium to bring together not only the insurance industry, but many of the stakeholders who have a role and a voice in this debate. We brought together representatives from the insurance and reinsurance community, agents, adjusters, realtors, NOAA, FEMA, and risk modelers for a significant discussion of the range of issues that must be contemplated. The symposium was a significant event, but that effort and my pledge is merely the continuation of an ongoing commitment that insurance commissioners, individually, and collectively through the NAIC, have made to examine how our nation manages this national threat.

Insurance regulators and the NAIC have been actively engaged in research and analysis on the impact of natural disasters on our society for a number of years. Insurance Commissioners across the country are working to find solutions to manage the catastrophic risk exposure in their respective states – exposure that grows with increased real estate development, rising property values, and expanding commercial operations in catastrophe prone areas. The NAIC currently is 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 Commission of experts to further study the issues, weigh the alternatives, and focus the debate.

1. Insurance Affordability and Availability in Coastal Areas

The ability of individuals, businesses, and regional economies to withstand and recover from the next natural catastrophe depends critically on the availability and affordability of insurance. From the perspective of insurance regulators, the key component is affordability, because if consumers in our states can't afford to buy the coverage, its availability becomes irrelevant. However, it's worth noting that in some cases, insurance has become less available regardless of the price. For example, surplus lines companies (a largely unregulated segment of the market with no rate regulation) in hard hit areas of Florida have dropped commercial policies, requiring the state to activate a commercial pool to provide coverage.

In coastal areas where catastrophic risk is perceived to be higher, we typically see greater fluctuations in availability and affordability than in other areas. The problem with this perception is that it focuses on what happened last, rather than on what could happen next. We must not overlook the possibility of a large-scale natural disaster that has little to do with coastlines. The threat of natural disasters 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.

Factors Affecting Availability and Affordability

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 help 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 (such as Hurricane Katrina) or frequency (such as the four consecutive hurricanes that hit Florida in 2004), insurers must reexamine the risk profile for their book of business, and typically respond by scaling back where they write new policies, introducing coverage limitations, and/or by raising prices. Anticipating future losses is the main factor that adds volatility and subjectivity to insurance pricing.

Another major factor in affordability of insurance is the rising cost of reinsurance. Reinsurance is a largely 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. Following the catastrophic 2004 and 2005 hurricane seasons, reinsurers began to scale back the coverage they are willing to offer in coastal areas and what coverage they are willing to provide is coming at significantly higher rates. A recent report by Guy Carpenter and Company indicates that in 2006 reinsurance rates across the United States rose 76 percent on average, and this while insurers and reinsurers scaled back coverage and exposure. 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. The state of Florida estimates that the cost of reinsurance accounts for nearly 45% of the consumer's premium in that state. 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. 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," following hurricane Katrina, meaning higher prices and less availability. However, as we move farther from that event, in the last six months or so there has been a moderate softening of the reinsurance market as more capital has been raised, and it is becoming somewhat more available. This improvement has not had a significant impact on rates at this point.

<u>Current State of the Insurance Market in Coastal Areas</u>

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, but it is important to note the distinction 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 trouble 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.

A Sampling of the States

Insurance companies are often global enterprises, but in terms of the property insurance market, the policies they sell, how they are underwritten, and how they are priced makes them an acutely local product. It is important to illustrate how the problem of affordability and availability has manifested in various regions of coastal states.

In Connecticut, there is a tightening in the coastal market (which is edging toward nearly a half trillion dollars of exposure) particularly with 1000 feet of the shore. In this area, there are some home owners who can only find coverage through the surplus lines market. Some insurers are also requiring hurricane deductibles and encouraging mitigation efforts, such as storm shutters and roof-strapping. No companies appear to be leaving the coast entirely, though Allstate has announced that they will not write new policies. However, they are maintaining the business they currently have. Smaller mutual companies appear to be more adversely impacted by financial rating agency actions in light of coastal exposure. These smaller mutual companies also tended to react more slowly to changing market conditions following hurricane Andrew in 1992 and appear to have become slightly over-concentrated along the CT shore. In general, rates along the Connecticut coast have increased from 30% to 100%. Connecticut's residual market, the state-run FAIR plan, only allows limited dwelling coverage for fire, but the Department of Insurance has asked that the plan develop a Coastal Market Assistance Program (CMAP), similar to the program in New York, to provide wind coverage as well.

South Carolina has been at the forefront of regulatory modernization and is considered a model regulatory environment by many insurers. The state also adopted the 2003 International Building Codes, and has not had a direct hit from a major hurricane (e.g., Category 3 or better) in nearly two decades. Yet, South Carolina is experiencing many of the same problems that the gulf coast states are experiencing. Shortly after hurricane Katrina, admitted carriers were seeking to increase 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 were increasing rates even more, by as much as 300-400 percent. Condominiums were particularly hard hit as insurers recognized the risk concentration they presented. One 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 implemented many of the measures the insurance industry says need to be in place to create the kind of free-market environment that would enable the private sector to handle this problem, and yet, the state is seeing only scattered relief from the lack of available and affordable property insurance. In South Carolina's coastal counties, the number of policies written by admitted insurers has only increased 3%, while population has grown 9%, building permit activity has increased 27%, and property values have increased 28% since 2000. Like other coastal states, South Carolina also has a wind pool to pick up policies that the private market won't cover. From 2001 through the third quarter of 2006, the written premiums for the Wind Pool increased 88% for residential lines and 448% for commercial lines. In the past several months, however, there are indications that the coastal property insurance market may be improving. Insurers are not reporting the same problems acquiring reinsurance as they did in 2006. Other insurers and producers have indicated that capacity within the reinsurance market has increased and that reinsurers are looking at deploying that increased capacity in the coastal property insurance market in South Carolina and other southeastern states. Additionally, the Wind Pool has reported that it is losing some of the condominiums that it insured in 2006. These condominiums are canceling coverage with the Wind Pool because they are finding better coverage and/or better rates elsewhere. Recently, the Wind Pool indicated that it has had some days with negative written premium. All are indications that there is more capacity within the market.

In Texas, the property insurance market generally is as healthy as it has been in recent years; however, recent hurricane experience is affecting the personal and commercial property market along the coast. Approximately 30 percent of Texas's population resides in counties along the Texas Coast and the counties adjacent to them. The insurance industry estimates that in 2004, about $750 billion in insured properties, both residential and commercial, in the state were vulnerable to hurricane losses. In 2005, Hurricane Rita came ashore and caused an estimated $2.6 billion in insurance losses in the state. Texas's wind pool, the Texas Windstorm Insurance Association (TWIA), has seen its exposure growing rapidly in recent years. In 2001, TWIA had 68,758 policies. As of December 31, 2006, TWIA insured 143,999 policies with liability in excess of $38 billion with approximately $20 billion of liability concentrated in Galveston and Brazoria Counties. TWIA's exposure, including miscellaneous coverages such as business interruption, exceeded $43 billion by the end of 2006. Increasing reinsurance has also been an issue in Texas. The 2006 cost for TWIA to purchase the same amount of reinsurance that was purchased in 2005 was almost double, or approximately $38 million dollars higher. TWIA ultimately purchased a lower level of reinsurance in 2006 at a cost that was approximately $7 million higher than the 2005 reinsurance program. By and large, rates have gone up in the coastal regions, though the increases are not as severe as those experienced in some other coastal states.

In Florida, while the number of policies in force actually declined by 0.75%, the amount of insured exposure rose by 17.66% and the aggregate premium paid in the Florida residential market rose by 38.1%. Florida's unique geography is such that the entire state is considered coastal exposure using traditional definitions; the entire state is subject to the risk of hurricane. Over the last year, Florida policyholders have not only seen remarkable rate increases, increases of 200% to 400% are not infrequent, but have also faced growing uncertainty regarding the availability of property insurance at any price. A number of firms, large and small, are retreating from the Florida marketplace. For example, at year end 2005, 122 companies were writing homeowners insurance (with or exclusive of wind coverage). By year end 2006, that number had dropped to 111 companies, a 9.0% decline in the number of carriers. In 2005, the largest 20 insurers wrote 72% of the residential market, by 2006 that concentration had risen to 78%. Reports to date show that trend continuing.

In Massachusetts, rates in the southern coastal communities have risen significantly over the past three years as the companies in that market react to new hurricane models that project substantially higher probable maximum losses in these areas. As such, several companies are requiring wind or hurricane deductibles of up to 5% of insured value. Companies offering coverage in these southern coastal communities have had to buy more reinsurance and more expensive reinsurance in order to maintain their financial ratings. Of the 43,000 policyholders who were non-renewed over the last three year in the Cape Cod and Islands area, the vast majority of those policyholders obtained replacement coverage in the Massachusetts FAIR Plan (the residual market mechanism). The FAIR Plan now represents well over 40% of the homeowners insurance market in the Cape and Islands area at this time.

In Maryland, the property insurance market remains healthy and there is not a lack of insurance availability. However, Allstate announced that it would no longer be writing new homeowners insurance policies in various areas located near water, though this is an improvement compared to states like South Carolina, North Carolina, Texas and New

York where Allstate is neither writing new business nor renewing existing accounts. Nationwide is only picking up policies as others accounts do not renew, and State Farm has changed its underwriting guidelines to not write within 2500 feet of the ocean. Two backstops for property insurance availability remain in place should a problem arise: the surplus lines market and the Joint Insurance Association, Maryland's FAIR Plan. Lloyds of London has lowered rates on surplus lines policies and is seeking to attract new business across the shore. No insurance agent has reported consumer or business alarm from the underwriting changes described above. They generally see this as a normal market correction, relative to the problems in other states.

In North Carolina, the coastal market is doing well. Some of this may be due to geography that puts the major urban areas of Charlotte and the research triangle, and therefore the greatest risk concentrations, farther inland than in other coastal states which tend to have the greatest amount of development near the coast. However, the immediate coastal area is still somewhat difficult to insure, and is predominately served by the residual market mechanism called the North Carolina Insurance Underwriting Association (Beach Plan). While not as dramatic as in other regions, recent homeowner's rate increased 15% in 2003, 15% for beach areas and 10% for coastal areas in 2005, and 25% for both beach and coastal areas in 2007.

In Mississippi, the coastal market is having significant problems, particularly right on the beach, where surplus lines companies are virtually the only option for consumers. Rates in the admitted market are increasing about 14% through the whole state, but in some near-coastal areas, particularly south of interstate 10, the rates have gone up roughly anywhere from 20% to 90%. Similarly, the state-run insurer of last resort, or "wind pool", has seen rates increase nearly 90%, with an initial rate increase request of nearly 400% (a recent infusion of Federal funds has helped to keep the program's rates from going higher). As larger companies are buying up what little reinsurance capacity there is, the wind pool is finding its reinsurance costs escalating nearly 500%. Since hurricane Katrina, the wind pool has also seen its total insured value climb dramatically from $1.8 billion to roughly $6 billion today. While many insurers have stepped up to serve their customers quickly and fairly (over 90% of claims are settled), a few companies have had serious complaints filed against them, and the state is conducting market conduct exams to look into their business operations. Overall, from September of 2005 through December 2006, the Department's Consumer Services Division processed over 17,000 complaints and recovered a record amount of $11,536,970 for consumers.

2. Key Affordability/Availability Issues for Consideration

Discrepancy between economic losses and insured losses

There is a growing discrepancy between total economic losses following a catastrophic event, and total insured losses. For example, insurers paid out a record amount for Hurricane Katrina of roughly $40 billion. And yet, the federal government authorized well over $100 billion in additional aid, and roughly $20 billion in additional funding for the flood program. Private insurance covered only one third of the total economic response, with taxpayers covering the remaining seventy percent. When Hurricane Andrew hit, those percentages were effectively reversed, with the majority of losses covered by insurance. Taxpayers across the country are paying for the natural catastrophes that hit this country, and this illustrates the need for a national response to close the gap between insured losses and economic losses.

Wind vs. Water: A Call for All-Perils Coverage

There are many lessons to be learned from hurricane Katrina, but perhaps the greatest insurance lesson we can take from that tragic event is that many consumers are confused about what their property insurance policy covers, and what it does not. Consumers have made it clear that they have an expectation that if they are paying a premium, they want their property to be covered and they don't care what the cause of loss is or what the mechanics of covering that loss is. They simply want to be made whole and begin rebuilding their lives as quickly as possible. As Congress considers its role in our nation's evolving approach to managing natural catastrophes, we think serious consideration should be given to offering consumers what many wrongly expected they already have: an all-perils insurance policy. The offer of a single policy for a single risk-based premium, where the only natural catastrophe-related exclusions are dictated by the consumer, is in the best interest of consumers, maximizes personal responsibility, and eliminates confusion over what is and is not covered.

Anti-Concurrent Cause

Much has been made of the anti-concurrent cause language in a standard property insurance policy. This provision is a direct result of the bifurcated insurance system we have, and was developed by the insurance industry to protect insurance companies from having to pay for losses (in this case, flood losses) which are excluded from coverage and for which they did not collect a premium. It is a provision that frankly had not been tested at the magnitude of a storm like Hurricane Katrina where wind and water losses were so wide spread. Some have suggested that this provision allows companies to avoid paying their obligations of coverage when flood damage is present. This is not the intent of that language, and the vast majority of companies do not distort the provision to shirk their obligations. In Mississippi, for example, where this issue has become the subject of much debate, Commissioner Dale put out a bulletin (attached to this testimony) immediately following hurricane Katrina to all property and casualty insurers instructing them that the burden of proof for determining the cause of loss is on the insurers, not the policyholders. Furthermore, Commissioner Dale advised companies that when there was doubt as to whether damage was caused directly by flood or wind, the insurers were to ere in favor of covering the insured.

Despite this, there have been serious allegations that some companies or adjusters have wrongly denied claims while misconstruing this provision, and they are now being forced to defend that contention to their insurance department or in the courts. The fact that insurers feel compelled to structure their policies to create legal barriers to segregate various perils (with the cost to defend these legal barriers often factored into rates), and those barriers add confusion and uncertainty for policyholder who are now challenging those barriers in courts, begs the question: Why shouldn't we offer consumers an all-perils policy that covers wind and water and eliminates the need for this provision along with any possible distortion or manipulation of its intent?

3. Our Current Insurance System for Natural Catastrophes

As we meet today, the ability of housing markets and local and regional economies to withstand and recover from the next natural catastrophe depends critically on what type of peril creates the disaster, where the disaster occurs, and the severity of the disaster event. The varying types of catastrophic natural disasters are managed very differently within our current insurance framework. This, in turn, can lead to highly different outcomes.

Wind events, including tornados and hurricanes, are considered a basic covered peril in the vast majority of homeowner's insurance policies. Flood, on the other hand, is written only rarely by the private insurance industry for residential property; since 1968 the National Flood Insurance Program (NFIP) has been the public solution to managing this risk. Finally, seismic events, particularly earthquakes, are not considered a standard covered peril, and aside from the California Earthquake Authority (CEA), there is no public mechanism to underwrite the risk; therefore, coverage is restricted to being an optional coverage, where available, in the private insurance market. It also is worth noting that the coverage provided by the CEA is somewhat limited (the standard policy carries a 15 percent deductible and offers $5,000 for contents coverage and $1,500 for additional living expenses due to loss of use).

If the next natural catastrophe is a significant flood event, the ability of the affected areas to recover is going to depend critically on the degree to which affected properties were insured with the NFIP. Unfortunately, recent evidence from 2004 and 2005 suggests that far too many properties damaged by flood were uninsured; either they were outside of the mandatory flood plains as dictated by antiquated maps, or they were in the mandated flood zones but were uninsured anyway. A recent study by the Rand Corporation provides evidence that suggests that the rate of take-up (that is how often the coverage is purchased) outside of the mandated zones is around 5 percent, and the take-up rate in mandated zones is only about 75 percent.

If the next natural catastrophe is an earthquake, the ability of the affected regional economy to recover will depend on the degree of disaster relief that comes from the federal government. The reason is really quite simple: the majority of residential property in earthquake prone areas is not insured for this very real risk. In California, for example, it is estimated that the take-up rate for optional earthquake insurance has fallen to about 12 percent or less. The same take-up rate is frequently suggested to be true in the earthquake prone areas in the Midwest's New Madrid area and along the eastern seaboard's seismically active areas.

As you can see, our current system lacks a comprehensive approach to managing the devastating effects of catastrophic natural disasters. Our current policy is inefficient and discourages personal responsibility and risk avoidance by relying too heavily on the Federal government. For example, the federal government so far has allocated $110 billion to facilitate recovery and rebuilding following hurricane Katrina. As generous and compassionate as the American people are, this current system needs improvement. Although our current reliance on federal payments for large-scale disaster spreads the cost of these events across a broad pool – the American taxpaying public – it does so without the efficiency and risk-based structure of the insurance market.

A Problem Paid for by the Nation is a "National" Problem

One of the arguments against a comprehensive national approach to manage this nation's natural disasters is that people in areas with lower perceived levels of risk do not want their money paying for events in other areas. This argument ignores the reality that, in the context of a major catastrophe, those areas already pay for risk in other areas – in the most ineffective way and with little tangible benefit going forward. Attached to this testimony, you will find some estimates prepared by the Florida Office of Insurance Regulation on the federal tax burden, by state, of the Katrina allocation of $110 billion. This analysis highlights one important truth about the consequences of large-scale natural disasters: they are a national issue rather than local or regional problems. As the estimates show, the Great Lakes and Plains states will contribute, based on their proportionate percentage of individual federal tax filers, approximately $26 billion to Katrina initiatives. These tax dollars are not risk-based, and they leave little legacy that guarantees relief for the next natural catastrophe, regardless of where it strikes. Precious little of the money that we spend collectively on catastrophes is invested in lasting solutions or efforts to limit losses. Our current system is based largely on a post-event reaction. The NAIC believes that a more proactive system, which prepares the public and mitigates the potential for catastrophic damage following such an event, is more practical and less expensive in the long run to both affected individuals and the public at large.

4. Improving Our Natural Catastrophe Approach

Although I believe this Committee should consider all reasonable options, it is important to stress that the solution to handling natural catastrophes, and ensuring a stable insurance market, does not begin or end necessarily 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 addition to the development of all-perils insurance coverage, the following ideas should also be 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 (DHS) suggests that there is still much to be done around the country. The report states that the "current catastrophic planning is unsystematic and not linked within a national planning system." It continues that, "this is incompatible with 21st century homeland security challenges," and suggests the need for a "fundamental modernization of our Nation's planning processes." The NAIC has endorsed disaster planning as a top priority and maintains a disaster-preparedness manual for use by all states.

Build Better Homes

Although we cannot stop natural disasters, there are measures that we can take to mitigate damage. The first component of any comprehensive national strategy must be mitigation – meaning 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.

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. During the Hurricane Katrina tragedy in New Orleans, many 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. In California, low lying areas around the Sacramento and San Joaquin rivers are protected by thousands of miles of earthen levees, many that date to the Gold Rush era. These levees protect a delta that provides freshwater to nearly 25 million Californians. If those levees break, either from disrepair or seismic activity, the consequences could be devastating.

Insurers are factoring in these aspects of infrastructure, and they 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 and Encourage Insurance Coverage

One of the unfortunate truths revealed after every large-scale natural disaster is that a number of affected citizens did not have insurance in place to protect themselves. As Congress considers the challenges of insuring natural catastrophes, care must be given to ensure that any solution has the ability to encourage participation. Part of this is accomplished through affordability of any insurance solution, but this must be weighed against providing a subsidy that encourages building in risk prone areas or offers post-event assistance that encourages people not to buy insurance to manage their risk.

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 being discussed 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 that only could 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 hurricane risk, it is a concept that could be expanded to include all catastrophe risk for homeowners.

Another concept is to amend 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 to events which already have occurred, and require the recognition of catastrophe premiums during the periods in which they are written.

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 affect 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 those in most other industrialized nations by setting aside tax-deferred reserves specifically for catastrophes, when structured appropriately as not shelter income, could provide additional capacity for the market. Tax-free catastrophe reserves also could help mitigate some of the "boom or bust" cycle in the property insurance market to everyone's benefit.

A National Catastrophe Backstop

For the creation of a federal backstop, a number of innovative ideas have been proposed. One concept is to have the federal government, through the U.S. Treasury Department, implement a reinsurance program to offer reinsurance contracts sold at regional auctions. A variation of this proposal would be to allow private insurers to obtain reinsurance contracts directly from a national backstop. Other proposals would restrict these reinsurance funds to authorized state catastrophe funds, similar to our Florida Catastrophe Fund, or the California Earthquake Authority. More recently, there has been discussion of limiting the role of the federal government to providing "credit lines" to state or regional funds, which would be repaid over an intermediate term after a qualifying event.

Currently, the United States is one of the only industrialized nations in the world not to have a comprehensive catastrophe plan. A multi-layered approach, with the federal government's commitment to reinsure state entities against a mega-catastrophe as its capstone, will proactively help in any catastrophe recovery effort, as well as provide stability in the housing insurance market by allowing state agencies to diversify their risk. Accomplishing this goal likely will lure additional private capital to the insurance market, thereby stimulating more availability, more competition, and ultimately lower premiums.

A Commission Can Focus The Debate

Given the variety and complexity of concepts under consideration, the NAIC strongly endorses 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 require further consideration, but they should be framed to answer the question, "Will this make insurance for individuals and businesses more available and affordable?" State insurance commissioners look forward to working with this Committee to find the right answers to this question.

Thank you for holding this hearing, for inviting the NAIC here today to participate, and for your continued interest and leadership on this crucial issue. I am pleased to answer any questions that you may have.

GEORGE DALE
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State Fire Marshal

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Mississippi Insurance Department
Bulletin No. 2005-6
September 7, 2005

This Office has been working with Mississippi consumers and the insurance industry to ensure that Mississippians impacted by Hurricane Katrina are treated fairly and receive compensation in a timely manner. While a lack of housing, communications and fuel has made it difficult in many cases for adjusters to get with insureds, this situation is improving daily and the claims adjustment process is moving forward.

My Office has been contacted by Mississippians who advise that their adjusters allegedly denied their homeowners' claims without inspecting the damaged property. While there was significant water damage on the Mississippi Gulf Coast, and homeowners' policies offered throughout the United States generally contain a water damage exclusion, an adjuster cannot summarily determine the cause of damage without inspecting the damaged property. Consequently, I am instructing all companies to be aware of these issues and to fully inspect any damaged property before a coverage decision is made.

In some situations, there is either very little or nothing left of the insured structure and it will be a fact issue whether the loss was caused by wind or water. In these situations, the insurance company must be able to clearly demonstrate the cause of the loss. I expect and believe that where there is any doubt, that doubt will be resolved in favor of finding coverage on behalf of the insured. In instances where the insurance company believes the damage was caused by water, I expect the insurance company to be able to prove to this office and the insured that the damage was caused by water and not by wind.

These are very difficult times for our State and region, and I ask that the insurance industry construe coverage issues in a manner that will afford coverage to as many of our citizens as possible. We will continue to work with Mississippi consumers and the insurance industry to ensure that all claims are fairly and promptly processed.

This the 7th day of September, 2005.

Sincerely,

George Dale

GEORGE DALE

Allocating the Federal Cost of Katrina

United States	# of Individual Returns	% of Individual Tax Returns	Tax Burden For Individual Return*	% Share of Total Tax Burden	Gross State Product (GSP)	Tax Burden/ GSP
New England	**6,785,928**	**5.17%**	**$5,684,164,730**	**5.17%**	**$690,689,000,000**	**0.82%**
Connecticut	1,663,080	1.27%	$1,393,062,331		$194,469,000,000	0.72%
Maine	618,210	0.47%	$517,837,424		$45,070,000,000	1.15%
Massachusetts	3,057,144	2.33%	$2,560,786,100		$328,535,000,000	0.78%
New Hampshire	642,173	0.49%	$537,909,792		$55,690,000,000	0.97%
Rhode Island	499,781	0.38%	$418,636,557		$43,791,000,000	0.96%
Vermont	305,540	0.23%	$255,932,526		$23,134,000,000	1.11%
Mideast	**21,820,285**	**16.62%**	**$18,277,543,527**	**16.62%**	**$2,263,452,000,000**	**0.81%**
Delaware	394,909	0.30%	$330,791,575		$54,354,000,000	0.61%
District of Columbia	276,974	0.21%	$232,004,501		$82,777,000,000	0.28%
Maryland	2,630,345	2.00%	$2,203,282,186		$244,899,000,000	0.90%
New Jersey	4,099,869	3.12%	$3,434,214,269		$430,787,000,000	0.80%
New York	8,613,865	6.56%	$7,215,317,879		$963,466,000,000	0.75%
Pennsylvania	5,804,323	4.42%	$4,861,933,118		$487,169,000,000	1.00%
Great Lakes	**21,224,096**	**16.16%**	**$17,778,151,773**	**16.16%**	**$1,836,746,000,000**	**0.97%**
Illinois	5,756,784	4.38%	$4,822,112,550		$560,236,000,000	0.86%
Indiana	2,848,276	2.17%	$2,385,829,909		$238,638,000,000	1.00%
Michigan	4,560,071	3.47%	$3,819,697,872		$377,895,000,000	1.01%
Ohio	5,439,800	4.14%	$4,556,594,072		$442,440,000,000	1.03%
Wisconsin	2,619,165	1.99%	$2,193,917,371		$217,537,000,000	1.01%
Plains	**9,027,463**	**6.87%**	**$7,561,764,107**	**6.87%**	**$794,607,000,000**	**0.95%**
Iowa	1,333,959	1.02%	$1,117,377,417		$114,291,000,000	0.98%
Kansas	1,228,885	0.94%	$1,029,363,231		$105,448,000,000	0.98%
Minnesota	2,405,900	1.83%	$2,015,278,076		$233,292,000,000	0.86%
Missouri	2,583,130	1.97%	$2,163,733,013		$216,069,000,000	1.00%
Nebraska	808,565	0.62%	$677,286,387		$70,263,000,000	0.96%
North Dakota	304,992	0.23%	$255,473,499		$24,178,000,000	1.06%
South Dakota	362,032	0.28%	$303,252,484		$31,066,000,000	0.98%
Southeast	**32,187,001**	**24.51%**	**$26,961,119,518**	**24.51%**	**$2,779,264,000,000**	**0.97%**
Alabama	1,906,296	1.45%	$1,596,789,781		$149,796,000,000	1.07%
Arkansas	1,134,378	0.86%	$950,200,388		$86,802,000,000	1.09%
Florida	8,115,915	6.18%	$6,798,215,041		$674,049,000,000	1.01%
Georgia	3,775,196	2.87%	$3,162,255,177		$364,310,000,000	0.87%
Kentucky	1,755,511	1.34%	$1,470,486,234		$140,359,000,000	1.05%
Louisiana	1,886,871	1.44%	$1,580,518,624		$166,310,000,000	0.95%
Mississippi	1,174,560	0.89%	$983,858,438		$80,197,000,000	1.23%
North Carolina	3,762,836	2.87%	$3,151,901,947		$344,641,000,000	0.91%
South Carolina	1,839,987	1.40%	$1,541,246,711		$139,771,000,000	1.10%

Tennessee	2,603,548	1.98%	$2,180,835,947		$226,502,000,000	0.96%
Virginia	3,484,282	2.65%	$2,918,573,974		$352,745,000,000	0.83%
West Virginia	747,621	0.57%	$626,237,254		$53,782,000,000	1.16%
Southwest	**14,095,441**	**10.73%**	**$11,806,905,199**	**10.73%**	**$1,388,035,000,000**	**0.85%**
Arizona	2,365,284	1.80%	$1,981,256,490		$215,759,000,000	0.92%
New Mexico	824,600	0.63%	$690,717,944		$69,324,000,000	1.00%
Oklahoma	1,474,272	1.12%	$1,234,909,198		$120,549,000,000	1.02%
Texas	9,431,285	7.18%	$7,900,021,567		$982,403,000,000	0.80%
Rocky Mountain	**4,376,074**	**3.33%**	**$3,665,574,625**	**3.33%**	**$410,351,000,000**	**0.89%**
Colorado	2,106,319	1.60%	$1,764,337,047		$216,064,000,000	0.82%
Idaho	592,912	0.45%	$496,646,808		$47,178,000,000	1.05%
Montana	439,213	0.33%	$367,902,377		$29,851,000,000	1.23%
Utah	994,387	0.76%	$832,938,327		$89,836,000,000	0.93%
Wyoming	243,243	0.19%	$203,750,067		$27,422,000,000	0.74%
Far West	**21,805,660**	**16.60%**	**$18,265,293,042**	**16.60%**	**$2,239,824,000,000**	**0.82%**
Alaska	344,971	0.26%	$288,961,508		$39,872,000,000	0.72%
California	15,311,402	11.66%	$12,825,442,771		$1,621,843,000,000	0.79%
Hawaii	604,667	0.46%	$506,493,266		$53,710,000,000	0.94%
Nevada	1,088,156	0.83%	$911,482,992		$110,546,000,000	0.82%
Oregon	1,602,105	1.22%	$1,341,987,232		$145,351,000,000	0.92%
Washington	2,854,359	2.17%	$2,390,925,273		$268,502,000,000	0.89%
	131,321,948	1	$110,000,516,523	100.00 %	12,402,968,000,000	0

Region	# of Individual Returns	% of Individual Tax Returns	Tax Burden	% share of total Tax Burden	GSP	Tx Burden/ GSP
Southeast	**32,187,001**	**24.51%**	**$26,961,119,518**	**24.51%**	**$2,779,264,000,000**	**0.97%**
Plains	**9,027,463**	**6.87%**	**$7,561,764,107**	**6.87%**	**$794,607,000,000**	**0.95%**
New England	**6,785,928**	**5.17%**	**$5,684,164,730**	**5.17%**	**$690,689,000,000**	**0.82%**
Far West	**21,805,660**	**16.60%**	**$18,265,293,042**	**16.60%**	**$2,239,824,000,000**	**0.82%**
Great Lakes	**21,224,096**	**16.16%**	**$17,778,151,773**	**16.16%**	**$1,836,746,000,000**	**0.97%**
Rocky Mountain	**4,376,074**	**3.33%**	**$3,665,574,625**	**3.33%**	**$410,351,000,000**	**0.89%**
Mideast	**21,820,285**	**16.62%**	**$18,277,543,527**	**16.62%**	**$2,263,452,000,000**	**0.81%**
Southwest	**14,095,441**	**10.73%**	**$11,806,905,199**	**10.73%**	**$1,388,035,000,000**	**0.85%**

* - Individual Tax Return burden = $110,000,000 authorized divided by 131,321,948 tax returns filed in 2005

Data: Bureau of Economic Analysis, Internal Revenue Service, 2005 (latest data available)

American Insurance Association

UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

"AN EXAMINATION OF THE AVAILABILITY AND AFFORDABILITY OF PROPERTY AND CASUALTY INSURANCE IN THE GULF COAST AND OTHER COASTAL REGIONS"
APRIL 11, 2007

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.

Hurricane Katrina and the difficult rebuilding in its aftermath focused renewed attention on the role of the private sector insurance industry in managing natural catastrophe risk. To effectively manage this risk, insurers must have the tools to measure, reduce, and fund these exposures. Those tools include protective measures, legal reforms, and regulatory reforms at the state and federal level. There are no shortcuts to addressing these problems, and all of us must remain committed to solutions that guarantee long-term stability in the private markets to protect our economy and, more importantly, to provide certainty to the nation's insurance consumers.

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. Insurers are fully committed to working with local, state, and federal policymakers to make this happen. Thank you for the constructive role you are playing in the search for solutions.

Recent Experiences

Hurricane Katrina was the largest, most expensive insured disaster in our nation's history. Approximately 1.75 million claims were filed across six states. Some 15,000 insurance claims adjusters were called in from across the country to begin the process of recovery. To date, claims payments to restore homes, businesses, and vehicles have totaled about $40 billion.

As of the first anniversary of Katrina in August 2006, more than 95 percent of the 1.1 million homeowners' claims in Mississippi and Louisiana had been resolved, with fewer than 2 percent of such claims disputed. Approximately half of these disputed claims were referred to no-cost mediation programs established by the Mississippi and Louisiana insurance departments, leading to successful resolution of approximately 80 percent of the cases heard. Across the Gulf, less than one percent of homeowner's claims have resulted in lawsuits. Yet, these are the claims that have received most of the public attention.

Beyond the industry's response mechanism, we must also consider the role of mitigation and land use planning in reducing the tangible and intangible losses that occur after a major catastrophe. Additionally, the planning process, in terms of logistics, communications, and coordination with relevant government agencies and private groups, must be significantly improved.

The Need for Meaningful Reform

In the aftermath of Hurricane Katrina, AIA began the process of identifying ways to improve the insurance industry's ability to serve homeowners and businesses in the path of potential storms, in particular, 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.

I have testified before the House Financial Services Committee about AIA's reform agenda on three previous occasions and also have shared our perspectives with southern governors meeting under the auspices of the National Governors Association. On each occasion, I have urged policymakers to act carefully. Thankfully, last year's hurricane season was remarkably mild. But hurricane experts are calling for another active season in 2007, and each year, more and more people populate our nation's most vulnerable coastal communities.

I have consistently cautioned against short-term fixes that create long-term problems for states or the national economy. Unfortunately, that was the approach taken by Florida in its recent short and chaotic special session—a deeply flawed bill aimed at lowering property insurance rates by transferring billions of dollars of hurricane risk from private sector (re)insurers to "post-event" bonding that will be paid for by assessments on policyholders and, ultimately, taxpayers throughout the state.

I am here today to urge appropriate restraint as this Committee sorts through the various federal legislative proposals that have been introduced in the 110th Congress. The reality is that there are no quick fixes or easy answers to the very difficult challenges we face. Moreover, punitive measures directed at insurers, including recently introduced bills to repeal the McCarran-Ferguson Act's limited antitrust exemption for the business of insurance, while couched in the language of the current natural catastrophe insurance debate, are wholly unrelated. They will do nothing to improve the availability or affordability of coastal insurance and instead will have a serious and detrimental effect on the markets they purport to assist.

AIA's Reform Agenda

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 we have identified can be modified to address earthquake risk and other natural perils.

In addition to the ideas that we already have developed, we are working to identify other measures that can be put in place at the federal or state level to address concerns expressed about the availability and affordability of natural catastrophe insurance. These measures would be designed to preserve the essential role that the private insurance sector plays in response and recovery, while at the same time recognizing the post-Katrina challenges that are still facing some coastal communities.

Recent State Activity

In addition to Florida's special session legislation, natural catastrophe insurance issues are on the agenda this year in almost every coastal state from Texas to Maine. They cover a spectrum that includes regulatory reform (under consideration in Louisiana); restructuring of residual market mechanisms (enacted in Mississippi and under consideration in Massachusetts and Texas); tax incentives to encourage mitigation (under consideration in South Carolina); quasi-governmental Catastrophe Funds (introduced in Louisiana, Texas, New Jersey, New York, Connecticut, and Massachusetts); and anti-insurer regulatory mandates (under consideration in various forms in several states).

I would like to call the Committee's attention to two recent and very promising developments.

Last month, Mississippi enacted legislation reforming the state's wind pool, which had been under stress since Hurricane Katrina resulted in a $545 million deficit, paid by private insurers in the state. The new legislation allows these deficits to be recouped through a surcharge on property insurance policyholders throughout the state and gives the wind pool the authority to issue bonds if the amount assessed is not sufficient to pay claims. There is also a four-year, $20 million-a-year subsidy to the wind pool to reduce policyholder premiums, thus providing immediate relief without endangering the program's claims-paying ability.

In South Carolina, the goal of Governor Sanford's coastal insurance relief plan is to encourage, rather than discourage, insurers to write policies along the coast. The proposal includes a number of tax incentives, such as catastrophe savings accounts established by homeowners who choose to carry large deductibles or create accounts to "self insure;" deductions for disaster mitigation measures and for lower-income property owners who pay more than five percent of their incomes towards insurance premiums; and tax credits for insurance companies who write full coverage for property owners along the coast.

Less positively, as I noted earlier, Florida's special session legislation will result in much higher costs when hurricanes happen, which is inevitable in Florida. According to a report released by the Associated Industries of Florida, per household, total assessment costs to finance the deficits resulting from this legislation could range from $1,700 after a moderate hurricane to $14,000 following a major hurricane, in comparison to average savings this year of $265. Thus, the long-term cost of this legislation could be more than 50 times the short-term savings for the average Florida household.

Moreover, the punitive regulatory restrictions imposed on insurers, while striking a populist chord, only add to the cost of providing insurance and send another message that Florida is a hostile business environment for insurers. Despite its flaws, the legislation did include several important provisions on mitigation, which is an essential part of the long-term solution.

Federal Approaches

As this Committee is well aware, several bills have been introduced this year to address different aspects of the natural catastrophe issue. I would like to take a few minutes to comment on several of these bills.

S. 928 - The Homeowners Insurance Protection Act: This legislation would create a federal reinsurance mechanism to encourage states to establish catastrophe funds (Cat Funds) for homeowners insurance. We believe this is based on the premise that large-scale natural catastrophes are uninsurable by the private sector, and that the government should step in to provide capacity.

AIA respectfully disagrees with this premise. Even after Katrina, private sector capacity for dealing with natural disasters has grown – with approximately $28 billion in new capital entering this market last year – and is adequate to spread and manage this risk. Even the leading insurance industry proponents of Cat Funds have secured significant amounts of private reinsurance coverage. Ironically, the single greatest threat to private sector risk transfer mechanisms is not the force of hurricane winds, but legislation and regulations that displace available private capital, or make it economically unfeasible for private companies to operate in coastal markets.

Despite their seeming promise of short-term relief, Cat Funds are no panacea for natural catastrophe risk, and such programs can encourage and lead to generational inequities among policyholders, unfair geographic subsidization, and increased (and unwise) building in catastrophe-prone regions. Insurance mechanisms should not mask the true cost of living in risky coastal areas, although some bridge mechanisms (such as the recently enacted subsidy to the Mississippi wind pool) might be necessary for the immediate future.

Tax legislation: 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 tax policy can enhance affordability and encourage the use of protective measures. These include: legislation to establish tax-exempt catastrophe savings accounts (CSAs) for individuals (similar to health savings accounts) as introduced by Senator Bill Nelson, S. 927; and federal income tax credits to encourage homeowners and business owners to invest in protective measures as introduced by Senator Mel Martinez, S. 930.

S. 1061 - The Homeowner's Insurance Non-coverage Disclosure Act: This legislation would require insurers to restate the terms of their property insurance policies in "plain language" that may be at odds with the actual contract language, thus increasing complexity and the likelihood of litigation, while discouraging homeowners from reading their policies. The overwhelming majority of states, including those in the Southeast and along the Gulf, subject companies to regulatory review of their policy language and conditions. This process recognizes the importance of technical accuracy over language that is so simple as to be misleading to the consumer. Simplifying and re-characterizing existing language would undercut the regulatory process and long-standing judicial interpretations of contract terms.

Moreover, imposing new regulatory requirements, and increasing the litigation risk facing insurers, is counterproductive to the goal of encouraging the growth and development of private sector capacity to manage catastrophe risk. There are ample safeguards in state systems, including market conduct regulations and unfair claims practices laws, to make sure that insurers do not mislead their policyholders or shirk their responsibilities to pay covered claims. The addition of new disclosure requirements that are at odds with existing contract terms will make catastrophe exposures more difficult to measure and add to the cost of providing coverage.

Conclusion

Thank you very much for giving me the opportunity to appear before you today. On behalf of AIA and our members, I appreciate this opportunity to continue to engage with you to address the challenges facing the insurance industry, and our nation as a whole, in preparing for, and responding to, natural catastrophes.

An Examination of the Availability and Affordability of Insurance in the Gulf Coast and Other Coastal Regions

Written Testimony of

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Good morning Chairman Dodd, Ranking Member Shelby and members of the Committee. Thank you for the opportunity to discuss the financial vulnerability of the United States to the real and growing threat posed by catastrophic hurricane losses and its impact on the availability and cost of insurance.

My name is Robert Hartwig and I am President and Chief Economist for the Insurance Information Institute, an insurance trade association based in New York City whose primary mission is to improve the public's understanding of insurance: what it does and how it works. Our members consist of insurers and reinsurers that operate on a global scale and account for more than 60% of the premiums written in the United States.

Measured in dollar terms, the United States is arguably the most vulnerable country in the world to natural disaster risk. Hurricanes, earthquakes, tornados, wildfires, floods and severe winter storms on average cost insurers $14.5 billion annually over the 20-year period from 1986 through 2005. The cost to the overall economy is at least twice that amount. But the toll in recent years has begun to rise rapidly—to $20 billion annually since 2000 with virtually all of that increase due to hurricane damage. The hurricane seasons of 2004 and 2005 alone produced record insured losses exceeding $80 billion. Already, leading meteorologists are predicting that the 2007 hurricane season will be 85 percent more severe than average. More ominous is the fact that we may only be on the leading edge of a prolonged period of elevated hurricane activity—lasting perhaps another 15 to 20 years—during which hurricanes will not only be more frequent but also more intense. Today the active planning hurricane event scenario for insurers is now $100 billion.

These staggering numbers and dire predictions illustrate the magnitude of the threat posed by hurricanes to people who live and businesses that operate in coastal regions as well as the need for a financially strong and resilient insurance industry.

The enormous challenge posed to the nation by natural catastrophes calls on all of us to address the problem as partners in order to find sustainable solutions to protect the millions American home and business owners in harms way.

My testimony today will address four major issues:

- The recent history of catastrophic hurricane losses in the United States;
- Drivers of the increase in insured losses in coastal regions exposed to tropical cyclones;
- Implications increased hurricane risk associated on the price and availability of insurance; and
- Current regulatory, legislative, and litigation-related obstacles that are raising costs and reducing choices for insurance consumers in hurricane exposed areas.

Recent Hurricane Activity & Impacts on Insurance Markets

The hurricane seasons of 2004 and 2005 resulted in insured losses totaling $81 billion arising from 5.5 million claims across a vast, 1,400 mile arc from East Texas to the Florida Keys. Flood losses paid by the National Flood Insurance Program (NFIP) came to an additional $20 billion. Hurricane Katrina, of course, was the most devastating of these storms. Katrina was not only the largest, most expensive disaster in the history of the United States—it was also the most costly event in the global history of insurance. Claims payments to restore homes, businesses and vehicle losses totaled $40.6 billion on some 1.74 million claims filed by policyholders across six states **[Figure 1]**. It is a similarly remarkable fact that seven of the ten most expensive hurricanes ever to strike the United States occurred in the 14 month interval from August 2004 through October 2005 **[Figure 2]**. The sharp increase in hurricane activity has also caused a shift in the distribution of catastrophe losses **[Figure 3]**. Tropical events now account for nearly half of all catastrophe losses over the past 20 years. Prior to 2004, tornados had been the leading cause of catastrophic loss in the United States.

Past as Prologue: Lessons Learned from Katrina

Hurricane Katrina was a storm without precedent in scale or scope, occurring amid a hurricane season that itself was without precedent. But the lessons of Katrina and the unparalleled destruction of the 2004 and 2005 hurricane seasons also include a very stark reminder—that living along the hurricane-exposed coastline of the United States is an increasingly risky proposition. Meteorologists predict that the number and intensity of hurricanes will remain at elevated levels for the next 15 to 20 years, even before accounting for any possible effects associated with global climate change.

Hurricane Forecast for 2007 and Beyond

Hurricane forecasters are predicting a severe hurricane season for 2007, which begins just 50 days from today. The latest forecast, announced just last week at the National Hurricane Conference in New Orleans by renowned Colorado State University hurricane forecaster Dr. William Gray and his associate Philip Klotzbach, calls for hurricane activity this year to be 85 percent above normal **[Figures 4 and 5]**. This implies not only that more storms are expected, but also that those storms that do occur will be more powerful. The forecast also calls for an increased probability of a major (Category 3, 4 or 5) landfalling hurricane. The likelihood of a Category 3, 4 or 5 storm making landfall anywhere along the United States coast is estimated at 74 percent this year, well above the long-run average of 52 percent.

The Gray/Klotzbach forecast is consistent with conditions that many meteorologists will hold for years to come—a cyclical increase in tropical activity known as the multi-decadal oscillation **[Figure 6]**. Already during this decade there have been six major landfalling hurricanes and it is likely that there will as many as 9 or 10 by decade's end. The emerging pattern of intense tropical activity appears similar to the last manifestation of the multi-decadal oscillation that occurred in the period from the 1930s through the 1950s.

Population Trends in Coastal Areas

For the 53 percent of Americans today living within 50 miles of the coastline, hurricanes represent a potentially life-altering economic threat for which many are ill-prepared. Hurricane Katrina and the other storms of the 2004/2005 hurricane season vividly illustrated the risks of owning coastal property. Yet despite increased awareness of the risk, people continue to be drawn to the coasts in record numbers. According to the US Census Bureau, the population in hurricane exposed states will increase by 43.8 million or 36.3 percent between 2000 and 2030, accounting for 53 percent of the increase in population for the entire United States. As Table 1 indicates, eight hurricane exposed states will experience population gains equal to or exceeding the projected national gain of 29.2 percent. Florida, already the most hurricane vulnerable state in the country, will lead the way with an expected population increase of 12.7 million or 79.5 percent by 2030.

Table 1 (see page 6) indicates that the number of people and businesses threatened by hurricanes will rise rapidly in the future. Yet these trends are merely a continuation of population growth trends that have been underway for some time—mostly in the years since the last period of intense hurricane activity ended about 1960 **[Figures 7, 8, 9 and 10]** illustrate population increases in a sampling of coastal counties from New England to the Gulf Coast. In each case, sharp population increases are noted in areas that are historically vulnerable to hurricanes. Each figure shows hurricane activity that is far more intense during the period from 1930 through 1960—which was the most recent manifestation of the natural cyclical phenomenon known as the multi-decadal oscillation—which reappeared in the mid-1990s and is expected to last another 15 to 20 years. Because populations in many coastal counties are presently 4 to 6 times what they were in 1960, extremely large numbers of people, their property and the communities in which they live and work are at risk. A recurrence of the frequency and intensity of hurricanes observed during the last oscillation would result in frequent large-scale losses and significant displacements of populations and economic activity.

Table 1. Population Growth Projections for Hurricane Exposed States

Change: 2000 to 2030 State	Change: 2000 to 2030 Number	Change: 2000 to 2030 Percent	Change: 2000 to 2030 Rank in percent change
United States	**82,162,529**	29.2	(x)
.Florida	12,703,391	79.5	3
.Texas	12,465,924	59.8	4
.North Carolina	4,178,426	51.9	7
.Georgia	3,831,385	46.8	8
.Virginia	2,746,504	38.8	11
.New Hampshire	410,685	33.2	15
.Maryland	1,725,765	32.6	16
.Delaware	229,058	29.2	18
.South Carolina	1,136,557	28.3	19
.Hawaii	254,509	21.0	22
.New Jersey	1,388,090	16.5	24
.Maine	136,174	10.7	32
.Massachusetts	662,912	10.4	33
.Rhode Island	104,622	10.0	34
.Alabama	427,143	9.6	35
.Mississippi	247,752	8.7	37
.Connecticut	283,065	8.3	38
.Louisiana	333,657	7.5	41
.New York	500,972	2.6	46
TOTAL	**43,766,591**	**36.3**	**(x)**

Source: US Census Bureau; Accessed at http://www.census.gov/population/projections/PressTab1.xls.

Insured Exposure: Homes & Businesses

Rising coastal populations necessarily imply corresponding increases in coastal development. In 2004, the insured value of all coastal property exposed to the threat of hurricanes totaled $7.2 trillion—equivalent to 62 percent of the US gross domestic product (GDP) **[Figure 11]**. It is expected that the value of insured coastal property will double within the next decade as coastal populations and property values continue to soar.

Figure 11 shows that Florida is the most exposed state in the country, by far, accounting for 27 percent of all hurricane exposed property in the United States.

Adjusting for growth since 2004, insured coastal exposure in the state now exceeds $2 trillion. Although New York is a close second, it is statistically less likely to be hit by major hurricanes than Florida. Many interesting lessons can be learned from the distribution of insured exposures in **Figure 11**. The first is that even small states with relatively small amounts of exposure can sustain very heavy losses. Mississippi, with $44.7 billion in insured exposure in 2004, sustained $13 billion in property losses arising from some 410,000 claims. The second is that states in the Northeast account for $3.73 trillion or 52 percent of hurricane exposed property in the United States. Thus while the Northeast is statistically less likely to be struck by hurricanes than the Southeast or Gulf Coast regions, the loss potential is nevertheless considerable. A major landfalling hurricane in the Northeast could produce insured losses exceeding $100 billion **[Figure 12]**. Of related interest is the surprisingly high percentage of statewide insured exposure that is coastal. Unsurprisingly, nearly 80 percent of all insured value throughout the state of Florida is coastal, but the fact that more than 60 percent of all insured property in Connecticut and New York is coastal is startling and further highlights the vulnerability of the Northeast to major hurricanes **[Figure 13]**.

Land Use Decisions: A Major Driver of Vulnerability, Loss & Insurance Costs

Despite the well-known vulnerability to hurricanes and rapidly escalating property values, coastal development in vulnerable areas continues at a furious pace. The example of South Miami Beach is illustrated in **Figure 14**. In that narrow strip of land alone, 15 new condominium complexes will be completed by year-end 2009 offering a total of 2,111 individual units at prices ranging up to $16 million. The average price of the least expensive units exceeds $940,000 while the average price of the most expensive units is $6.46 million. The aggregate additional insured exposure is likely to top $6 billion, further burdening the state's already precarious property insurance market. Rapid build-ups are observed in many other coastal areas, including Galveston Island, Texas, Hilton Head and Myrtle Beach, South Carolina, the Maryland shore, eastern Long Island and Cape Cod.

The vulnerability of communities such as these to catastrophic damage from hurricanes is common knowledge among residents. South Miami Beach, for example, is only 20 miles from where Hurricane Andrew made landfall as a Category 5 storm in 1992, causing more than $22 billion in damage in current dollars. The same storm striking Miami directly today, or a repeat of the Great Miami Hurricane of 1926, could cause upwards of $80 billion to $100 billion in insured losses. Likewise, Galveston Island's seawall and memorials to the 8,000 people who perished in a 1900 hurricane—to this day still the deadliest natural disaster in United States history—serve as stark reminders of the danger.

The lure of warm, sunny oceanfront property is understandable. But the fact that so much coastal development continues to occur despite the lessons offered by the hurricane seasons of 2004 and 2005 suggests that buyers of such property are buying and building in these areas with their eyes wide open, fully cognizant of the risk. Another key to understanding the paradox of rapid coastal development in hurricane vulnerable areas is traceable to land use decisions such as zoning and permitting, which in the United States are largely under the control of local officials. It is in the economic interest of these and other officials to approve continued development in high-hazard zones for many reasons: job creation, inflow of wealth, infrastructure development and increased tax revenue to name just a few. Virtually all of these economic benefits accrue locally. In the event a major hurricane strikes, however, most of the costs are shifted to others elsewhere in the state or country. Depending on the state, the redistribution of costs is commonly achieved via laws that allow state-run insurers (which are often the largest insurer in the most hazardous areas) to recover their losses in excess of their claims-paying resources by assessing (effectively taxing) the insurance policies of home and business owners throughout the state, including those well away from the coast and those who have never filed a claim. In some cases, even unrelated types of insurance such as auto insurance and commercial liability coverage can be assessed. States have also diverted general tax receipts and used federal relief funds to subsidize the cost of insurance for coastal dwellers. The bottom line is that coastal development is economically *rational* from the perspective of coastal stakeholders only because most benefits are retained locally while a high proportion of costs are redistributed to others.

Impacts of the Price and Availability of Property Insurance

The price of insurance is determined primarily by the degree of risk assumed by the insurer. Therefore, from an insurance perspective, the prospect of a long-term crescendo in coastal risk is a paramount concern. Key risk-related lessons revealed in the aftermath of Katrina include the following:

- Many, if not most, coastal structures in the United States today are insufficiently well constructed to withstand the forces of a major hurricane, either in terms of wind or flooding;
- The risk and related cost associated with offering insurance in hurricane-prone areas will continue to escalate as coastal populations and property values continue to soar and more and more vulnerable areas are opened to development; and
- Insurance is by far the fastest, most efficient means of recovery for communities affected by disasters large and small. Only an insurance industry that is financially strong, sound and secure can deliver the financial relief necessary to help communities recover from major catastrophic events.

Risk: The Basis of Insurance Pricing

The price of insurance must ultimately reflect the risk of the property insured and insurance premiums are nothing other than messengers of risk. Any deviation from risk or cost-based pricing leads directly to distortions or dilutions in that message which, in turn, encourages additional development in vulnerable areas. This is exactly what is happening in Florida and many other coastal area today.

Hurricane Katrina and the other storms of 2004 and 2005 provided for insurers and public policymakers with valuable insights into risk/loss reduction and mitigation. The insurance industry's decades-long support of tougher building codes and mitigation technologies, for example, bore fruit throughout the Gulf Coast, with homes built to industry-supported standards faring far better than structures built to less stringent standards. Insurers will continue to invest millions of dollars annually through organizations such as the Institute for Business and Home Safety in order to fund additional research that will save lives and reduce property damage from future disasters.[1]

In the wake of the record hurricane seasons of 2004/2005, insurance prices have climbed sharply for many owners of coastal property. The increase in cost of insuring properties in coastal areas is the direct result of increasing risk. Higher risk means that insurers need to compensate investors/owners of capital with a higher rate of return than is required in less exposed areas. Insurance ratings agencies will also downgrade an insurer if its rates are inadequate for the risk assumed. The increase in the price of homeowners and business property insurance offered by *state-run* insurers in Louisiana and Mississippi are displayed in **Figure 15** and **Figure 16**.

The availability of insurance has also decreased in some areas. Diminished availability is potentially the result of several factors. Insurers that are too exposed to hurricane-related losses could be compelled to reduce their exposure by regulators and/or ratings agencies, for example.

In some coastal areas punitive, burdensome legislation and regulation accompanied by rigid price controls and a surge in litigation are driving-up costs and reducing choices for consumers. Worse still, these measures do nothing to reduce the actual risk faced by people living in harm's way. Put simply, neither laws nor lawsuits can diminish the real, formidable risk associated with catastrophic hurricanes or any other type of disaster.

[1] The Insurance Information Institute has produced free, home inventory software available for download at www.iii.org, that allows homeowners to create an electronic archive of their possessions and then email that file to a location that is out of harm's way.

Regulatory, Legislative and Litigation-Related Obstacles Impacting Insurance Costs and Availability of Coverage

A state's regulatory, legislative, and tort environment establish the parameters under which insurers operate and compete. The requirements for competitive insurance markets are modest, centering primarily on the ability to (i) price policies that reflect the actual risk or cost; (ii) a judicial system that upholds contract language in policies which have been approved by state insurance regulators, and (iii) a regulatory and legislative environment that is supportive of both requirements.

In most states and for most types of insurance, insurance markets are highly competitive, with dozens of insurers competing for the business of auto, home and commercial policyholders. Indeed the cost of auto, home and business insurance is actually *declining* today. Recently, however, regulatory and legislative actions in a number of states and proposed legislation at the federal level threaten to stifle competition thereby increasing costs for insurers and reducing choices for consumers.

Florida's recent legislative changes illustrate this point. Insurance rating agency A.M. Best in February issued the following ominous statement about recent legislative changes in the state: *"A.M. Best views the recent legislative changes as weakening the business profile of companies with significant concentration of Florida business."*

In other words, insurers with significant exposure to hurricane risk in the state could see their financial strength ratings downgraded, potentially impairing their ability to operate nationwide. The only way for the insurers to maintain their ratings is to increase rates or non-renew current policyholders. Infusing additional capital could also preserve the insurer's rating, but such an infusion would be tantamount to throwing good money after bad.

That's because the recent actions in Florida also cancelled even previously approved rate changes even though the state's homeowners insurers are already more than $10 billion in the red since 1992.

Mississippi is another example, with its homeowners insurance market in a freefall, especially in the state's southern tier of counties. Operating in coastal

Mississippi is an extremely risky proposition. The state has been the target of some of the most destructive storms in history, including mega-storms like Hurricanes Camille and Katrina.

Claims from Katrina in Mississippi alone totaled $13.6 billion. Homeowners insurance losses in the state wiped out approximately 17 years worth of premiums and every dime of profits those insurers had ever earned in the history of the state. In Louisiana, the $10.9 billion dollars in insured homeowners losses were equivalent to 25 years worth of premiums.

Expectations of an increase in the number and intensity of storms for the next 15 to 20 years compound the risk. These factors mean that property insurance in coastal Mississippi is relatively expensive—but it has nevertheless generally been regarded as a *priceable* risk. It is the actions of men, more than nature, which have crippled the market for insurance in Mississippi.

Litigation is another factor that leads unambiguously to higher costs and reduced availability of insurance. Although the actual number of lawsuits following Katrina is very small relative to the total number of claims filed—estimated at approximately 1 percent of homeowners insurance claims—these claims have an inordinate impact on the health of the marketplace. The litigation in Mississippi, initiated just 17 days after Katrina by the Mississippi Attorney General's Office, followed by civil actions from trial lawyers and compounded by court decisions that have retroactively rewritten the terms of regulator-approved insurance contracts, constitute an *unpriceable* risk. Litigation has pushed uncertainty past the tipping point, leaving insurers with no alternative but to reduce their presence in the state. Litigation in Louisiana is threatening to impair insurers' ability to operate in that state as well.

Remarkably, litigiousness in Mississippi may have accomplished what Katrina did not—delivery of a potentially lethal blow of uncertainty to the viability of a private homeowners insurance market in the state. Today, the only choice for an increasing number of Mississippi homeowners is the state-run insurer of last resort, which itself went broke in 2005, forcing it to make an initial rate hike request of nearly 400 percent.

Summary

Population growth, rising property values and continued development in vulnerable areas are the primary driving factors behind the rising cost of property damage inflicted by hurricanes. Cyclical changes in the frequency and intensity of hurricanes have also increased risk. Litigation has also increased uncertainty for insurers, further driving up costs and reducing consumer options. Insurance premiums necessarily reflect the increased costs and risks.

Looking ahead, insurers must operate under the assumption that Hurricane Katrina and indeed the entire 2004/2005 hurricane seasons were not aberrations. If history is any guide, a disaster that will dwarf hurricane Katrina may be just a few months to a few years away. Catastrophic losses associated with hurricanes will almost certainly rise in the years ahead as coastal populations and property values continue to swell. Few communities appear to have heeded the warnings of Katrina, Rita, Wilma and the other major storms of the 2004/2005 hurricane seasons.

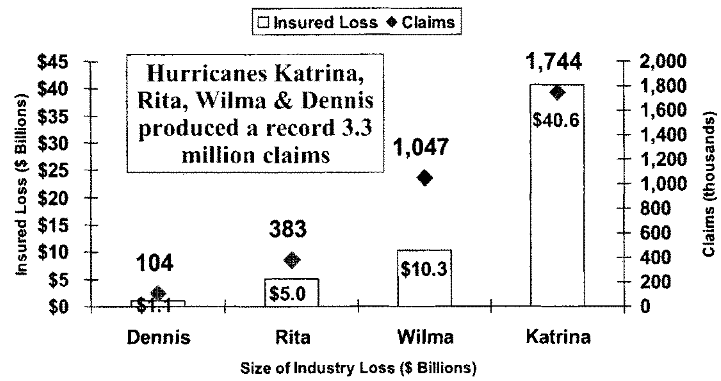
The record $41 billion insurers paid by more than 100 insurers and their reinsurers to more than 1.7 million Hurricane Katrina victims and the $81 billion paid to 5.5 million policyholders over the course of the 2004/2005 hurricane seasons are vivid and tangible demonstrations of the vital and important role played by insurers in helping families, businesses and entire communities recover the devastation wrought by major disasters.

To conclude, the insurance industry is committed to working in partnership with public policymakers, consumers and business in developing fact-based solutions to the formidable challenge posed by Hurricane Katrina and the other disasters and continuing our tradition of helping families, businesses and communities wherever and whenever disaster strikes.

Thank you for the opportunity to address the Committee today. I would be happy to address any questions you might have.

Figure 1.

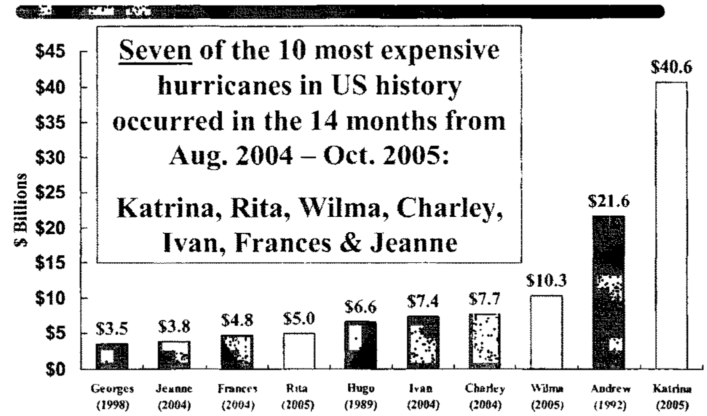
*Insured Loss & Claim Count for Major Storms of 2005**



*Property and business interruption losses only. Excludes offshore energy & marine losses.
Source: ISO/PCS as of June 8, 2006, Insurance Information Institute

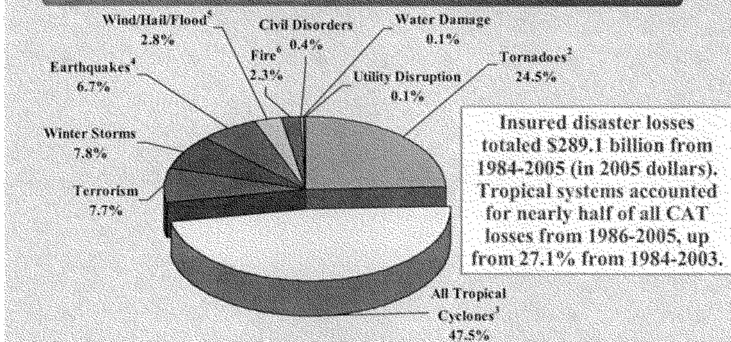
Figure 2.

Top 10 Most Costly Hurricanes in US History, (Insured Losses, $2005)



Sources: ISO/PCS; Insurance Information Institute.

Figure 3. *Inflation-Adjusted U.S. Insured Catastrophe Losses By Cause of Loss, 1986-2005*[1]



[1] Catastrophes are all events causing direct insured losses to property of $25 million or more in 2005 dollars. Catastrophe threshold changed from $5 million to $25 million beginning in 1997. Adjusted for inflation by the III. [2] Excludes snow. [3] Includes hurricanes and tropical storms. [4] Includes other geologic events such as volcanic eruptions and other earth movement. [5] Does not include flood damage covered by the federally administered National Flood Insurance Program. [6] Includes wildland fires.

Source: Insurance Services Office (ISO).

Figure 4. *Outlook for 2007 Hurricane Season: 85% **Worse Than Average***

	Average*	2005	2007F
Named Storms	9.6	28	17
Named Storm Days	49.1	115.5	85
Hurricanes	5.9	14	9
Hurricane Days	24.5	47.5	40
Intense Hurricanes	2.3	7	5
Intense Hurricane Days	5	7	11
Accumulated Cyclone Energy	96.2	NA	170
Net Tropical Cyclone Activity	100%	275%	**185%**

*Average over the period 1950-2000.
Source: Philip Klotzbach and Dr. William Gray, Colorado State University, April 3, 2007.

Figure 5.

Probability of Major Hurricane Landfall (CAT 3, 4, 5) in 2007

	Average*	2007F
Entire US Coast	52%	74%
US East Coast Including Florida Peninsula	31%	50%
Gulf Coast from FL Panhandle to Brownsville, TX	30%	49%
ALSO…Above-Average Major Hurricane Landfall Risk in Caribbean for 2007		

*Average over the period 1950-2000.
Source: Philip Klotzbach and Dr. William Gray, Colorado State University, April 3, 2007.

Figure 6.

Number of Major (Category 3, 4, 5) Hurricanes Striking the US by Decade

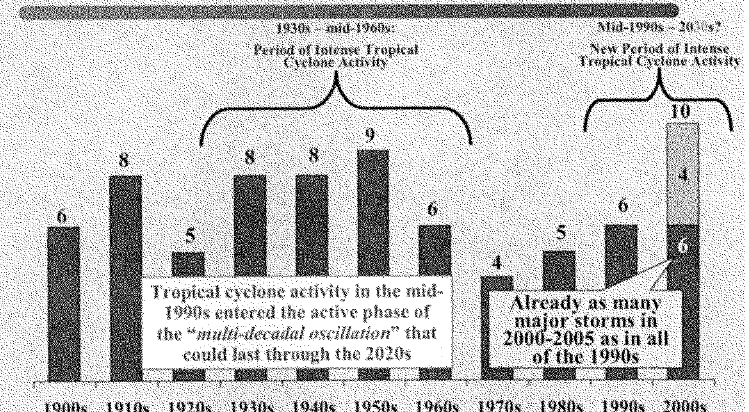


*Figure for 2000s is extrapolated based on data for 2000-2005 (6 major storms: Charley, Ivan, Jeanne (2004) & Katrina, Rita, Wilma (2005)).
Source: Tillinghast from National Hurricane Center: [illegible]

Figure 7.

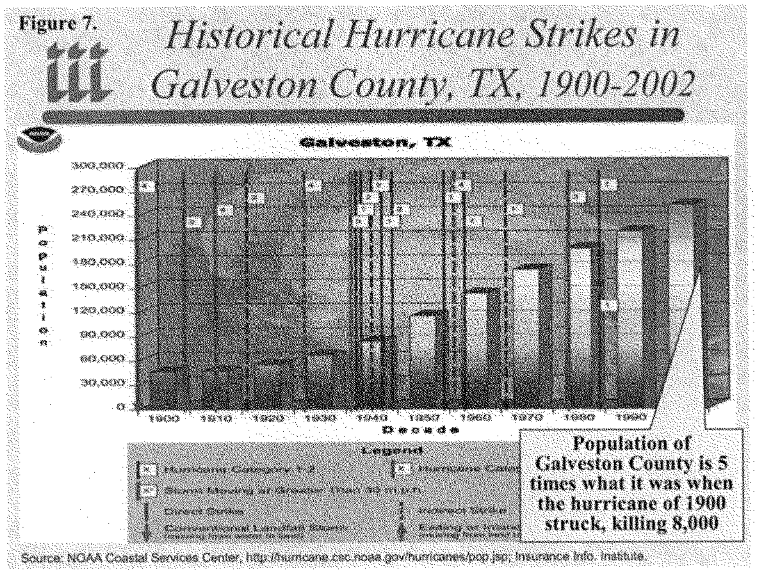
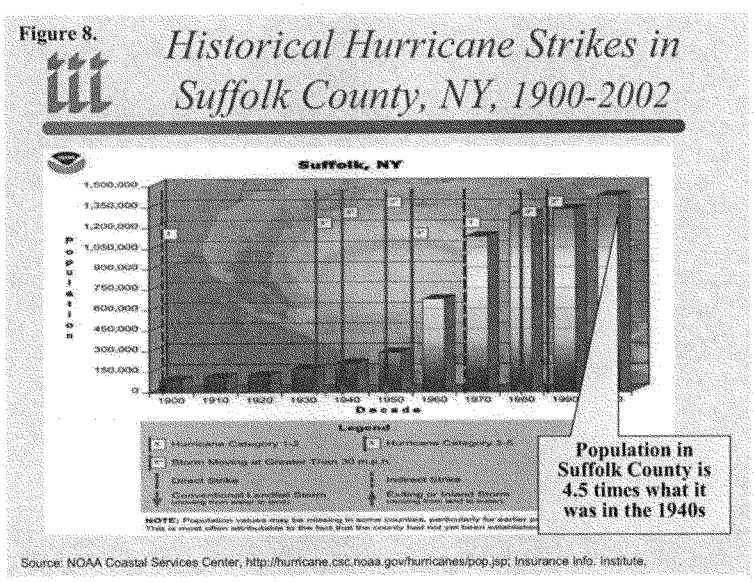


Figure 8.



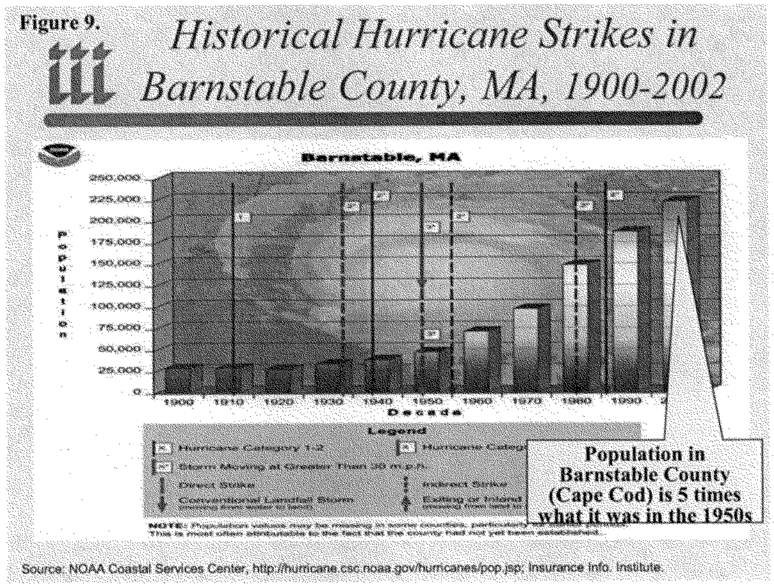


Figure 9.
Historical Hurricane Strikes in Barnstable County, MA, 1900-2002
Barnstable, MA
Population
Decade
Legend
Hurricane Category 1-2
Storm Moving at Greater Than 30 m.p.h.
Direct Strike
Conventional Landfall Storm
Indirect Strike
Population in Barnstable County (Cape Cod) is 5 times what it was in the 1950s
Source: NOAA Coastal Services Center, http://hurricane.csc.noaa.gov/hurricanes/pop.jsp; Insurance Info. Institute.

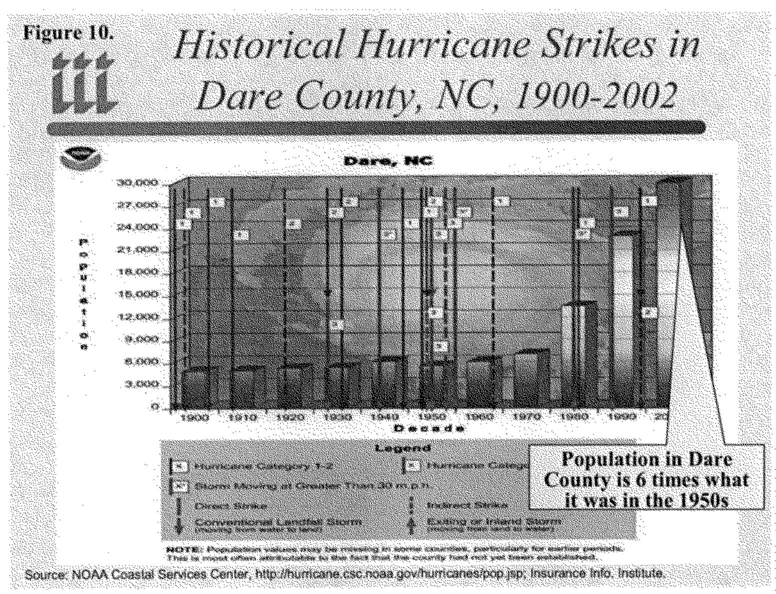


Figure 10.
Historical Hurricane Strikes in Dare County, NC, 1900-2002
Dare, NC
Population
Decade
Legend
Hurricane Category 1-2
Storm Moving at Greater Than 30 m.p.h.
Direct Strike
Conventional Landfall Storm
Indirect Strike
Exiting or Inland Storm
Population in Dare County is 6 times what it was in the 1950s
Source: NOAA Coastal Services Center, http://hurricane.csc.noaa.gov/hurricanes/pop.jsp; Insurance Info. Institute.

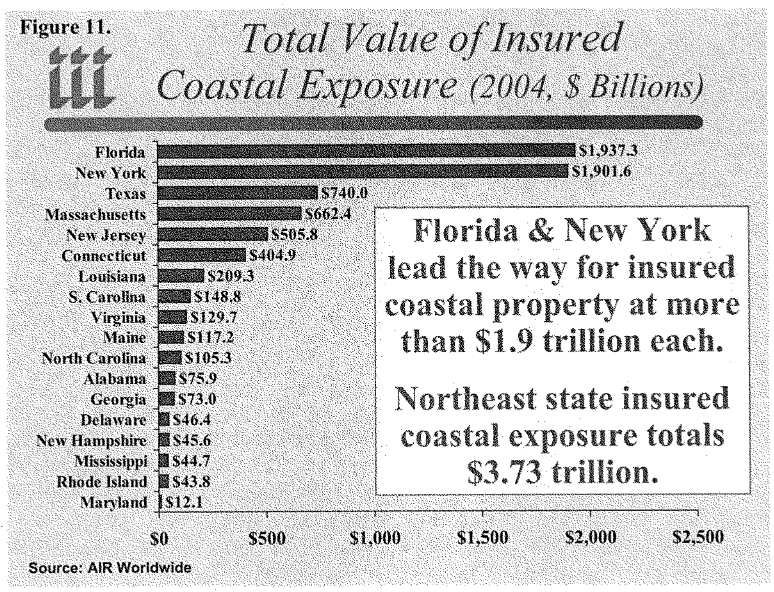


Figure 11.
Total Value of Insured Coastal Exposure (2004, $ Billions)
Florida $1,937.3
New York $1,901.6
Texas $740.0
Massachusetts $662.4
New Jersey $505.8
Connecticut $404.9
Louisiana $209.3
S. Carolina $148.8
Virginia $129.7
Maine $117.2
North Carolina $105.3
Alabama $75.9
Georgia $73.0
Delaware $46.4
New Hampshire $45.6
Mississippi $44.7
Rhode Island $43.8
Maryland $12.1
$0
$500
$1,000
$1,500
$2,000
$2,500
Florida & New York lead the way for insured coastal property at more than $1.9 trillion each.
Northeast state insured coastal exposure totals $3.73 trillion.
Source: AIR Worldwide

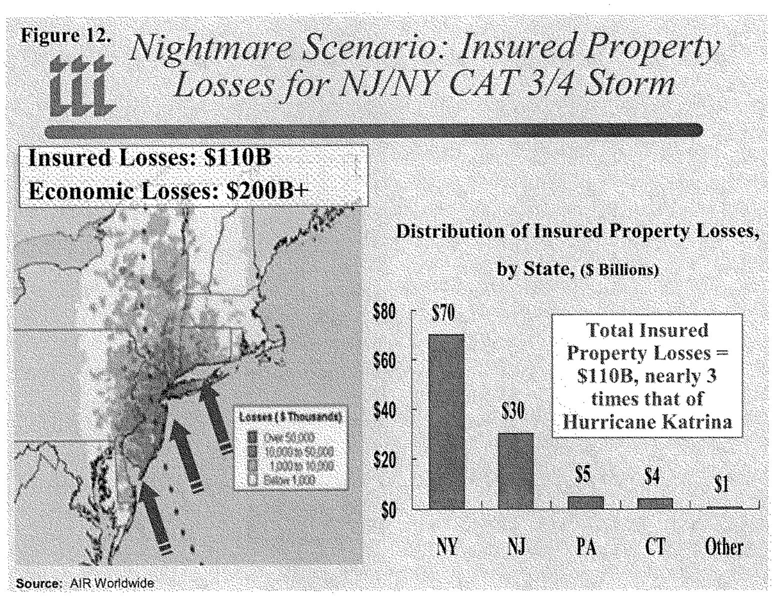


Figure 12.
Nightmare Scenario: Insured Property Losses for NJ/NY CAT 3/4 Storm
Insured Losses: $110B
Economic Losses: $200B+
Distribution of Insured Property Losses, by State, ($ Billions)
$80
$60
$40
$20
$0
$70
$30
$5
$4
$1
NY
NJ
PA
CT
Other
Total Insured Property Losses = $110B, nearly 3 times that of Hurricane Katrina
Source: AIR Worldwide

Figure 13.

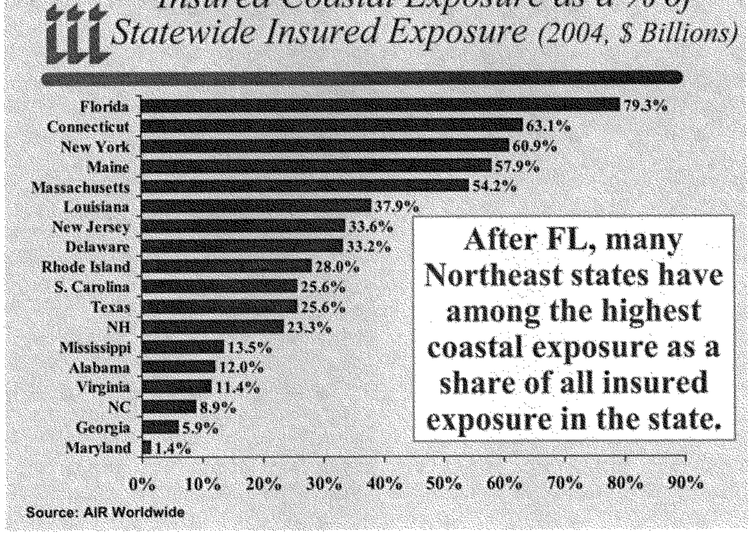


Figure 14.

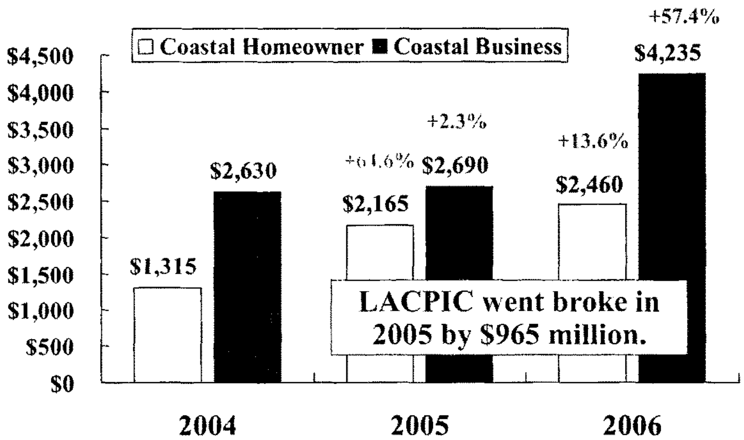
New Condo Construction in South Miami Beach, 2007-2009

- **Number of New Developments: 15**
- **Number of Individual Units: 2,111**
- **Avg. Price of Cheapest Unit: $940,333**
- **Avg. Price of Most Expensive Unit: $6,460,000**
- **Range: $395,000 - $16,000,000**
- **Overall Average Price per Unit: $3,700,167***
- **Aggregate Property Value: At least $6 Billion**

*Based on average of high/low value for each of the 15 developments

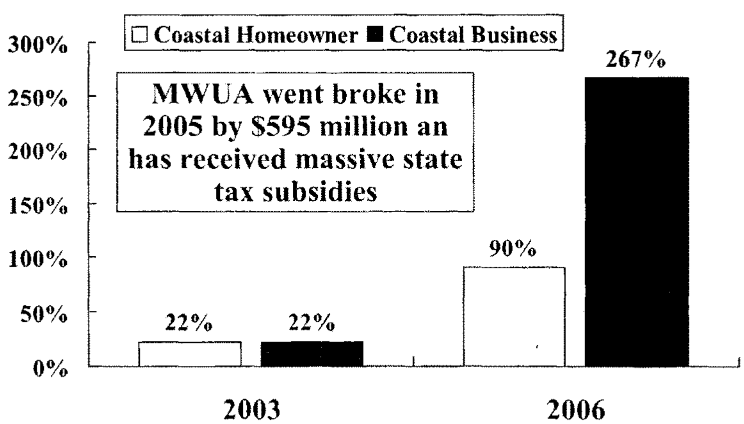
Source: Insurance Information Institute from www.miamicondolifestyle.com accessed April 5, 2007.

Figure 15. *Price Increases for Louisiana Citizens—State's High Risk Insurer of Last Resort*



Source: Louisiana Citizens Property Insurance Corp. from *USA Today*, April 3, 2007, p. 1A..

Figure 16. *Price Increases for MS Windstorm Underwriting Association—State's Insurer of Last Resort*



Source: Mississippi Windstorm Underwriting Association from *USA Today*, April 3, 2007, p. 1A..

STATEMENT OF DAVID GUIDRY
PRESIDENT/CEO
GUICO MACHINE WORKS, INC.

ON BEHALF OF GREATER NEW ORLEANS, INC.

SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

HEARING ON "AN EXAMINATION OF THE AVAILABILITY AND AFFORDABILITY OF PROPERTY AND CASUALTY INSURANCE IN THE GULF COAST AND OTHER COASTAL REGIONS"

APRIL 11, 2007

Mr. Chairman and Members of the Committee, I am David Guidry, President and Chief Executive Officer of Guico Machine Works. I appreciate the opportunity to appear before your Committee today, on behalf of Greater New Orleans, Inc. (GNO, Inc.), a ten parish regional economic development organization in southeast Louisiana representing over 100 businesses in all major sectors of the local economy. Almost immediately after Hurricanes Katrina and Rita, GNO, Inc. began to work with the regional business community and Federal, state and local officials to address the myriad of insurance issues facing the greater New Orleans area.

Mr. Chairman, as a small businessman in the New Orleans area, I am truly grateful that you have called this hearing today to shine a national spotlight on one of the cruel realities of the post-Katrina Gulf South: businesses, both large and small, simply cannot find affordable insurance. More than a year and a half after Hurricanes Katrina and Rita, with all of the Federal dollars and tax incentives provided to our region of the country, many of you would expect to see the skyline in New Orleans crowded with cranes and bustling with construction activity. I am sad to report that, instead, very little of that activity is actually underway. While the experts may have any number of explanations for the slow pace of the recovery in New Orleans, I can assure you that a primary and significant factor is the unavailability of affordable insurance for businesses.

I am told that in the greater New Orleans area, not a single commercial property insurance policy is being renewed on an "as is" basis, and that most are simply not being renewed at all. How can we possibly rebuild our great City under these circumstances? How can we expect capital to flow into our area when affordable insurance cannot be found? We must find a solution to this problem in the very near future. Indeed, if the insurance climate in the Gulf South does not materially improve in the next 12-18 months, many small businessmen and women will be forced to consider relocating to other regions of the country in order to obtain affordable insurance and maintain viable businesses. Unfortunately, many businesses already have relocated.

Mr. Chairman, let me tell you a little bit about my business and what we experienced during and after Hurricane Katrina. My company, Guico Machine Works, is an oil and gas equipment manufacturer that has been in business in the New Orleans area for over 25 years. Before the hurricane, our company had 65 employees churning out wellheads and related products in our plant located on the Harvey Canal in Jefferson Parish, Louisiana. Our business had accounts receivable of nearly $1 million from sales of $400,000 per month. However, after Hurricane Katrina hit in August of 2005, our manufacturing output immediately dropped to zero. For nearly six weeks after the hurricane, we received no mail or checks, yet customers continued submitting orders. We had a shop full of materials and machinery, but no workers, causing the shop to sit idle.

During Hurricane Katrina, the building next to my warehouse literally exploded and parts of that building rained down on my warehouse, causing extensive damage. Like most businesses in New Orleans, I had insurance coverage against storm and fire damage. I also had wind and hail protection on our warehouse, but not on its contents. My insurance company denied coverage for the damages to my building and its equipment. I have unfortunately been forced to litigate this claim, and, in the meantime, have not received one dime from my insurer.

Without any insurance recovery, I have been unable to repair the damage. And, Mr. Chairman, on top of that, I have been notified that because the damage has not been repaired, my wind and hail policy will not be renewed. Moreover, the premiums on the balance of my insurance policies have increased a whopping 55% with far less coverage than under my pre-Katrina policies and my deductible has skyrocketed from $2,500 to $20,000. Furthermore, should I have opted for the same coverage as in my pre-Katrina policy, my deductible would have increased to $175,000. These are not costs and risks that my small business can readily absorb. In fact, these increases threaten my ability to remain in business.

Without proper insurance coverage, I cannot obtain financing from local banks for my business. The banks may want to loan me money, but Federal regulations prohibit them from making loans on most uninsured assets.

Mr. Chairman, I am struggling to keep my business afloat. And, I am not alone. Most small businesses in our region are struggling. Struggling to rebuild, struggling to operate, struggling to obtain affordable insurance. For so many of the 18,000 businesses impacted by the 2005 hurricanes, obtaining adequate insurance coverage remains a major obstacle.

To put this all in perspective for you, let me give the Committee just a few real world examples of the experiences that similarly-situated businesses are facing in our area:

1. A local restaurant located in the French Quarter paid $27,000 for its 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 has been increased, believe it or not, to $242,000 and now includes a 5% wind/hail deductible.

2. A French Quarter hotel with a property value of $3 million had an expiring premium of $17,000 with a policy that included a windstorm deductible of $25,000. Its renewal policy significantly increased the premium to $84,000 and the wind deductible increased to $400,000.
3. A local shopping center experienced an increase in its property insurance premium from $70,000 to $250,000 and an increase in its wind deductible from $350,000 to $1.7 million.

Furthermore, when I visit with my colleagues in the business community in the New Orleans area, I am told that:

1. Almost all personal and commercial property policies either are not being renewed or are renewed with severe restrictions regarding wind damage.
2. Owners of vacant buildings are unable to obtain wind coverage of any sort.
3. Standard Business Owner's Packages (BOP), which had been a common form used for small businesses and provided broad property coverage, general liability, crime, umbrella, and automobile liability coverage, are no longer available in our area, with a few exceptions for offices in the larger buildings.
4. Commercial policies are now moving from a standard, admitted policy with a well-known carrier to a surplus lines policy.
5. Often the replacement policy will employ a layered structure, using two to more than five insurers to provide the full limit.

6. The wind provisions in the typical policy will almost always have a 2% to 5% deductible.
7. Business interruption coverage may not be provided if the wind coverage is placed with a different insurer.

These types of increases are simply unsustainable, particularly for small businesses like mine. Stories like these of annual premiums increasing five-fold or more and deductibles increasing over ten-fold are all too common. Even if companies are willing and capable of paying the high premiums to maintain property coverage, there remains the financial exposure of significant deductibles that may not be met if another hurricane-type event occurs. And, I am sure the Committee is aware that the upcoming hurricane season is predicted to be very active.

Addressing this insurance crisis will not be easy. But, I am certain of this: if I cannot operate my company in a stable environment, with reasonable and affordable insurance to protect my company and its employees, then I will be forced to move. In the end, the community that I love and worked so hard to help will suffer yet another loss.

Mr. Chairman, on behalf of the small business community in and around New Orleans, I urge you to address this crisis before it is too late. I know that many suggestions and alternatives have been put before you. In order to coordinate more fully with other stakeholders in this debate, GNO, Inc. is pleased to have joined the Natural Catastrophe Policyholders Coalition to address the very issues we are discussing here today, namely the availability and affordability of insurance. We fully understand the difficulty in reaching consensus on these complex issues. But my hope is that this Committee moves aggressively to provide appropriate relief to all of us who are fighting each and every day to run our businesses and be a positive part of the recovery of the Gulf South. As taxpayers who have worked hard and played by the rules, we are counting on you and your colleagues in Congress to rescue us from this nightmare. We stand ready to work with you in any way that we can.

Thank you for the opportunity to appear before you today. I would be pleased to answer any questions that you may have or submit any additional information that you may require.

Testimony of Harold Polsky before the Senate Committee on Banking, Housing and Urban Affairs
April 11, 2007

Chairman Dodd, and Members of The Senate Banking, Housing and Urban Affairs Committee.

First, let me thank you on behalf of my wife, Barbara, and me, for the opportunity to appear before you today. We appreciate the opportunity to add our voices to this very difficult and important issue.

As you already know, our names are Harold and Barbara Polsky. Until November 2002, we lived in the city of Philadelphia, PA.

Near the middle of 2002, we found ourselves in a position to purchase a house. However, living in Philadelphia was not what we wanted. On the advice of a family member, we looked into Florida. We purchased a modest, 1516 square foot house in Port Richey, FL. The house wasn't perfect, but it was ours. We moved into the house in December 2002.

We knew that we would be required to carry three different types of insurance on our house, but the total of the three premiums was within our budget. Our first year in the house, all three policies had the house valued at $90,000.00. The homeowner's premium was $464.00, the wind premium was $443.00 and the flood premium was $851.00, for a total of $1,758.00.

When our renewal came due in November 2003, the cost was still manageable. Our homeowner's premium was now $482.00 with a value of $95,200.00, our wind premium was $475.00 on a value of $99,000.00 and our flood insurance premium was $935.00 on a value of $99,000.00, for a total of $1,892.00.

In 2004, Hurricane Frances hit the east coast of Florida, and moved across the peninsula. It came through the Tampa Bay area as a very strong tropical storm on September 6, and we suffered damage from water soaking our carpeting. We had to move everything into the middle of the rooms to keep our furniture and possessions from getting soaked. Concerned about the damage, and afraid all the water would lead to mold, we tried to contact our insurance company for help. We were unable to reach them until September 10. We explained our damage, and were given a claim number, and advised that an adjuster would contact us within the next few days. We were given a telephone number for the adjusting company, and when no one called us, we tried to contact this company. They never answered their phone.

When Hurricane Jeanne came through our area on September 26, we had more damage, with water again soaking our carpeting. The next day, we received two letters from our insurance company denying our claim. One stated we did not have Wind insurance, and the other stated our damage was less than our deductible. We could not understand this, since no one had been to our house to assess the damage. We were also starting to notice an odor that we were afraid was mold.

We contacted our insurance company on September 28 to to file a new claim for the damage from Hurricane Jeanne. Again, we were given a claim number, told we would be contacted by an adjuster, and were advised to pull up all the wet carpeting and save one small square, take pictures of the damage and give this all to the adjuster.

We started having trouble with our telephone. The technician said that the main phone line in the wall was soaking wet. He said the only way this could have happened was either water came down the walls, or we would have had to have eighteen inches of flooding. There was no flooding in our area.

We started pulling up carpet, and discovered mold was growing on the floor underneath. We still had not heard from an adjuster, and were starting to worry.

We finally got a call from a different adjuster. He inspected everything, said we had damage from water coming down the walls, agreed there was mold growing, and said we should have our payment from the insurance company within two weeks. We did not hear anything in those two weeks, and began to wonder if we ever would.

In November 2004, our homeowner's policy was for a value of $100,700.00 with a premium of $504.00, our Wind policy had a value of $97,000.00 with a premium of $538.00, and our Flood policy had a value of $99,000.00 with a premium of $992.00, for a still manageable total of $2.034.00.

On December 21, we called our insurance company and were told we had no open claim. This type of action continued for all of 2005 and 2006. We were sent to mediation to try to resolve this issue, but all that happened was the representative from our insurance company told us we had flood damage, and we should file a flood claim. When we advised him there was no flooding in our area, and that to file a flood claim would be insurance fraud, he still insisted that was what we should do. The mediation ended as an impasse, and nothing happened.

Our November 2005 insurance renewal was now becoming a concern. Our homeowner's policy had a value of $108,000.00 with a premium of $1,093, our Wind policy had a value of $104,000.00 with a premium of $772.00, and our Flood policy had a value of $99,000.00 with a premium of $994.00 for a now difficult total premium of $2,859.00. We managed to find a way to make the payments, but our monthly mortgage payment jumped from $651.42 to $821.61.

We had to hire a lawyer to try to get the insurance claim resolved. Eventually, because we could no longer afford to remain in Florida, we settled our claim for about half of what we should have received, sold our house at a loss, and, in September 2006, moved to Virginia.

In October 2006, we received a revised statement for our 2005-2006 homeowner's policy, with a value of $215,475.00 and a premium of $2063.00, an increase of almost 100%. This was more than our total insurance premium when we purchased the house in November 2002. We received this revised notice after we had already moved to Virginia.

Senators, while our case may be extreme, it is by no means uncommon. Many thousands of people in Florida, and throughout the Gulf states, can tell similar stories. These issues must be addressed, and these outrages cannot be allowed to continue.

Thank you. We would be happy to answer any questions you may have.

RAA
REINSURANCE
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STATEMENT

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TESTIMONY

OF

FRANKLIN W. NUTTER
REINSURANCE ASSOCIATION OF AMERICA

An Examination of the Availability and Affordability of Property and Casualty Insurance in the Gulf Coast and Other Coastal Regions

BEFORE

SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

April 11, 2007

Chairman Dodd, Ranking Member Shelby and Members of the Banking, Housing and Urban Affairs Committee:

My name is Frank 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. The RAA is a national trade association representing property and casualty organizations that specialize in assuming reinsurance. Together, RAA members write nearly 2/3 of the 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 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. Fifty percent of 2005 losses associated with hurricanes Katrina, Rita and Wilma ultimately were borne by reinsurers.

As the Committee has called this hearing to address the question of "Perspectives on Natural Disaster Insurance," I am here to share with you the reinsurance perspective on this most important matter. My testimony will focus on: 1) status of the 2007 reinsurance marketplace and 2) the RAA's general concerns with the creation of state and federal catastrophe reinsurance funds.

The Property and Casualty Reinsurance Marketplace Today

An important component of ensuring the availability of homeowners' insurance is the reinsurance market and its capacity, that is, the amount of reinsurance it is able to provide to primary companies. Any debate on whether there should be a federal catastrophe fund should include an analysis of the ability of the private reinsurance market to provide catastrophe capacity to insurance companies as well as the capacity of insurers to underwrite and retain this risk.

The U.S. attracts reinsurance capacity from all over the world. Global reinsurers view U.S. catastrophe risk as an essential component of their diverse assumed risk portfolios. The important role reinsurance plays in our nation's economy is best demonstrated by evaluating the 2004 and 2005 hurricane seasons (since 2006 did not result in any significant hurricanes).

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 this huge financial hit to reinsurers, there were no reinsurer insolvencies and the reinsurance market was able to meet the primary insurance community demand for the 2005 hurricane season.

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 alone 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 one-half of all of these losses. Even with these unprecedented losses there were no resulting reinsurer insolvencies.

Notwithstanding that 2005 was the worst year on record for insured natural catastrophe losses in the U.S., the insurance industry reported its best ever profitability which can be attributed in large part to the industry's reliance on reinsurance to moderate the losses. In fact, the U.S. insurance industry surplus grew from $356 billion at December 31, 2003 to $439 billion at December 31, 2005. As of December 31, 2006 the industry's claims paying ability and capital base have never been better.

Despite the resilience of the reinsurance industry to respond to these record breaking financial losses, a few primary insurance companies in the industry are suggesting the 2005 hurricane season has demonstrated the need for a federal reinsurance program for natural disasters. The RAA does not believe market conditions warrant the creation of a federal program.

Indeed the capital markets have greatly enhanced reinsurance catastrophe capacity following hurricane Katrina. As they did in 1993 after Hurricane Andrew and in 2002 after the terrorism losses of 9/11, 2001, the capital markets promptly provided new reinsurance capital and capacity in response to the 2005 hurricanes. Since late fall 2005, approximately $32 billion in new capital has been raised and committed to the reinsurance market. Of that capital, $10.4 billion was invested in new start up reinsurance companies; $10.3 billion replenished the capital positions of existing reinsurers; and an additional $5.6 billion was invested in special purpose vehicles, whose investors collaborate to provide extra underwriting capacity to existing reinsurers for property and catastrophe retrocessions and short tail lines of business. Thus over $26 billion in new capital has been raised in the reinsurance industry since Hurricane Katrina. An additional $5.3 billion was raised in the capital markets in catastrophe bonds for U.S. catastrophe risk.

So what does that mean for actual reinsurance capacity to provide natural disaster protection for primary insurance companies for 2007? Despite the unprecedented losses in 2004 and 2005, private market reinsurance capacity increased in 2006 by approximately 30%. The reports of January 2007 renewals indicate reinsurance capacity for 2007 has grown by 14% even in a moderating price environment. The private reinsurance market is financially strong and diverse. Reinsurance capacity is adequate even for peak catastrophe markets. Thus, RAA does not believe a federal role is appropriate.

Looking back at 2006 and the issues raised by some regarding reinsurance market dynamics, several factors external to the reinsurance market affected the market. Demand increased in some peak zones at a greater rate than the supply increased due to: rating agencies (such as AM Best and Standard & Poors) requiring more capital of insurers and reinsurers to support catastrophe risk; reinsurance modelers increasing loss predictions; and insurance company managements' desire to purchase more protection. Rating agencies determined that companies with catastrophe exposures needed additional capital or needed to buy more reinsurance to support their ratings. Insurance catastrophe modelers revised their models due to new data following 2005 and a belief that the country is entering into an era of increased hurricane frequency and severity. Insurance company managements also have reacted to a changed perception of risk. Such managers have seen the impact of increased hurricane frequency and severity on their losses and want to purchase more reinsurance protection. At the same time as demand was increasing, reinsurers were re-evaluating the losses that their ceding insurers could suffer.

The confluence of these events resulted in reinsurance prices increasing in some peak catastrophe zones dramatically.

In classic supply/demand economics, this period of re-evaluation and re-underwriting by reinsurers and the addition of new capital sources appears to have moderated the market. The RAA stated it believes that the imbalance between demand and supply of reinsurance is temporary. 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.

That process appears to be well underway. Capacity is adequate and reinsurance rates for January 1, 2007 renewals are below the market highs at July 1, 2006 according to reinsurance brokers.

> "Aon Re expects a slight excess of capacity….." *Aon Re Global Analysis March 30, 2007.*

> "The reinsurance industry is in robust shape. April 1 (2007) pricing remained flat or fell. We fully expect this global trend……to accelerate with the July renewals across all lines of business." *Willis Re Reinsurance Renewal Review. April 2, 2007.*

> **"Reinsurance capacity at the end of 2006 was more than adequate, even for most peak exposures** … Strong earnings were driven by low catastrophe losses. Normal dividend payments were maintained, and capital was boosted during the year. **New entrants were eager to join."**
> *Benfield, "Global Reinsurance Market Review Pick 'n' Mix," January 2007*

> **"[R]ates** at January 1, 2007 renewals for US property catastrophe **were below** the levels of July 1, 2006 renewals. Given that nearly all other lines are experiencing rate decreases or renewing at expiry, **we can now conclude that the U.S. reinsurance market overall has entered the soft phase of the cycle**. If history is a guide, **we can expect soft market conditions to persist for many years.** This will be the 'normal' state of the market."
> *Guy Carpenter, "U.S. Reinsurance Renewals at January 1, 2007 Smooth Sailing Ahead?"*

RAA's Position on State and Federal Catastrophe Funds

Some have called for the creation of a federal catastrophe reinsurance fund. At the core of these proposals is the creation of federal catastrophe funds to provide reinsurance to state catastrophe funds. The state catastrophe funds would then sell reinsurance to insurance companies. The stated intent is that this would result in insurance companies providing more homeowners with insurance in high-risk areas.

The RAA believes that there are many flaws with state catastrophe funds. There is no evidence that they result in greater availability or affordability of homeowners' insurance. Insurers must still manage their accumulated catastrophe exposure and in some cases, limit writings, cancel existing policies or seek premium increases. It is an essential element of solvency regulation and financial management that insurers (or those required to subsidize them) maintain adequate resources to cover losses. Politically charged rate setting does not affect the underlying risk of loss. Premiums (or in the case of Florida, premiums combined with later assessments on policyholders) must still cover catastrophe losses.

The RAA believes that natural disaster risks are insurable in the private insurance and reinsurance market and that state catastrophe funds significantly displace the private market. State catastrophe funds are not a long-term solution. The catastrophe fund concept as applied in Florida for example is one that relies on public subsidies or cross-subsidies from other insurance lines to pay for natural disaster risk, rather than relying on affected property policyholders paying the costs of their own risk exposure.

Florida's Catastrophe Reinsurance Fund meets the standard of proposed legislation, therefore it seems appropriate to examine its structure and its experience.

The Florida Hurricane Catastrophe Fund does not rely on its premiums to pay its hurricane losses. The model of the Florida Catastrophe Fund is one that offers insurers inexpensive reinsurance premiums up front, because it is back loaded. When a hurricane occurs that requires the Florida Catastrophe Fund to pay losses in excess of its cash balance (as in 2004 and 2005), the Catastrophe Fund issues bonds. The bond debt is not paid by the insurance companies who received the cheap reinsurance. Instead, it is paid by assessing/taxing Florida policyholders of other lines of insurance, such as automobile insurance and commercial insurance such as municipalities, daycare centers, school districts and small businesses. The effect is that insurers have off loaded a substantial part of their property risk to a government catastrophe fund, and that government fund assesses its citizens to make up for the revenue shortfall caused by the low upfront catastrophe fund reinsurance premiums. Policyholders from all lines of insurance, including those at low risk to catastrophes are being required to insure insurance companies. In essence the Florida Catastrophe Fund has disintermediated the reinsurance market and in its place, put the insured public, commercial and residential. The irony of Florida is that, those citizens who vilified insurers are, by virture of Florida law, now their reinsurers.

State catastrophe funds also violate one of the fundamental tenets of insurance-spreading the risk among various risk bearers. Government funds concentrate risk. The Florida Hurricane Catastrophe Fund, for example, has $1.8 trillion of insured values with $1 billion of cash and $980 million of expected 2007 revenue. Private insurance and reinsurance however spreads the risk globally. Of the losses caused by Hurricanes Katrina, Rita and Wilma, reinsurers paid approximately 50% through markets in London, Bermuda, Europe and the U.S. Through bond indebtedness a state catastrophe fund concentrates risk in one jurisdiction and shifts the financial cost of paying catastrophe losses from the private sector insurers to insurance buyers including those not covered by the fund itself. Effectively low risk policyholders insure high risk policyholders.

State funds like the Florida Hurricane Catastrophe Fund do not reduce the vulnerability of people to natural catastrophes. They are not a proactive, disaster planning approach. Rather, they are a cost shifting mechanism. There is no free lunch-someone will pay for the losses. Private reinsurance is a proactive, "pay for the risk up front" by those insured at risk. The "pay me later" approach of state catastrophe funds costs homeowners and businesses, not insurers, since policyholders are essentially obligated to pay insurers for any shortfalls in the state catastrophe fund claims paying ability. For example the Florida fund is currently assessing policyholders for the 2004-2005 hurricane seasons.

State catastrophe funds also create cross-subsidies. First, coastal properties are subsidized by policyholders that have a lower risk to catastrophes, cannot afford or choose not to live in such hazard zones. In addition to property policyholder subsidies, the catastrophe funds rely on cross-subsidies to pay for hurricane risk rather than relying on current affected property policyholders paying those costs. For instance in Florida, car owners, small businesses, school districts, day care centers, churches, hospitals, renters, professionals, and business owners – anyone with a property and casualty insurance policy (other than medical malpractice and workers' compensation) – is required by law to pay the billions of dollars in bonds authorized for the Florida Hurricane Catastrophe Fund due to its shortfalls. These policyholders, even those far from the coast, will pay annual assessments needed to pay off the hurricane bonds that will benefit the coastal property owners.

The experience with state catastrophe funds is that they are susceptible to suppression of insurance rates for those at risk. The effect of this is to mislead high risk insureds about the financial consequences of living in high risk areas, encourage continued development in those areas and shift the cost of disaster losses to others who may be less at risk and equally less willing to pay the subsidy.

The current Florida fund is riddled with debt and is likely to become worse. What incentives do states have to be fiscally responsible if a Federal fund were to provide financial backing? We urge Members of the Committee to take a serious look at the inherent problems with state catastrophe funds and whether they would actually create an improved homeowners' insurance market. We strongly suggest that such funds do not.

RAA's Concerns with Federal Catastrophe Funds

Over the last 15 years, the RAA has worked with Members of Congress and their staffs on many different legislative proposals to create federal reinsurance programs. We believe that natural catastrophe risk is insurable in a free market. We do not believe the creation of a federal reinsurance program solves the homeowners' insurance availability problem. It ignores the many constraints that are now imposed upon the private market. We believe public policymakers should make it their top priority to remove regulatory constraints from the private insurance market's ability to willingly insure risk. By removing regulatory constraints policymakers will maximize private sector risk bearing. These regulatory constraints include: price controls, coverage mandates, and involuntary residual market facilities and associated assessments. If policymakers follow competitive, free market principles, a federal natural disaster reinsurance fund is unnecessary.

The RAA offers the following observations regarding federal catastrophe funds:

1. Often, the proposed trigger levels for the federal reinsurance program are too low and will interfere with the private marketplace. These are levels of losses where the private reinsurance marketplace is currently providing capacity. If the federal fund had provided reinsurance at low attachment points as some have proposed, rather than the private insurance and reinsurance markets paying for the insured losses associated with Katrina, Rita and Wilma, the federal government through its reinsurance fund would have paid for these insured losses.
2. There is no assurance that a federal reinsurance program will result in more availability of homeowners' insurance. Unlike the Terrorism Risk Insurance Act where the quid pro quo for the federal reinsurance is that insurers must offer terrorism insurance on the same terms and conditions as they offer other lines, there is no requirement that insurers who benefit from the federal reinsurance of state funds offer more homeowners' insurance. The experience of Florida is that cheap reinsurance has not resulted in greater private sector insurance.
3. To be fiscally responsible any federal reinsurance must include a requirement that the federal government and the state fund add a risk load reflecting the true cost of catastrophe exposure when pricing the reinsurance. In the private insurance and reinsurance market a catastrophic risk load is required on all pricing. Without such a requirement the private reinsurance and insurance market would be further disenfranchised from the market it now serves.
4. It has been suggested that a federal program is necessary because reinsurance prices are too high. The RAA believes that a free market should be allowed to work and that it is totally inappropriate to create a federal program simply based

on complaints by some insurers over reinsurance prices at a single point in time. The concepts of supply and demand are playing out in the free market. As we learned following Hurricane Andrew in 1992, after 9/11 terrorism losses and now post-hurricane Katrina, reinsurance markets adjust. They are resilient, they attract capital and capacity after major events and the supply/demand equation will come back into balance.

5. A federal fund that sells reinsurance to state catastrophe funds concentrates all of the risk associated with natural disasters in government. A private market diversifies this risk, spreading it globally. A classic example of the importance of a diversified insurance/reinsurance market occurred in 2005. Of the total reported losses, U.S. insurers paid (all approximate) 41%: U.S. reinsurers paid 11%, Bermuda reinsurers 24%, European reinsurers 13%, Lloyds 9%, and all others 1%. If H.R. 91 were to become law, most of this risk would no longer be spread across the global insurance/reinsurance market; instead it would be concentrated in the State and Federal governments.

Would a Federal reinsurance program replace government disaster assistance? Some have suggested that a Federal program is appropriate because "we all pay for disaster recovery now" implying that Federal taxpayers are on the hook for disaster losses. First it must be understood that, while natural "disasters" may occur in all states, most are modest potential costs compared with a few regions. Because of unusual risk exposures and concentrative of insured values, 97% of all earthquake losses have occurred in California and since 1900, 75% of all hurricane losses have occurred in Florida, Louisiana and Texas. The natural disaster related losses in other states are notably less and paid for by insureds based on their own risk premium. Secondly, an analysis of

Federal disaster assistance indicates that it primarily goes to immediate and temporary shelter and food, infrastructure repairs and emergency responses. These losses would not be covered by a proposed Federal reinsurance program and therefore it would be expected that taxpayers would continue to support them. Third, a high percentage of catastrophe loss occur to commercial businesses, none of which are covered under existing programs or by any proposed Federal program.

The Role of Government

Government does have a critical role related to natural catastrophes. States should impose appropriate hazard mitigation through sound building codes and land use. With respect to insurers, state government should ensure sound financial management of insurers by seeing that premiums are appropriate for the risk and that insurers remain financially vibrant and solvent. At the Federal level government provides appropriate disaster assistance in times of need. It also provides financial support for research and repair of infrastructure damage such as rebuilding of levees, dams, bridges and roads.

Conclusion

The reinsurance industry has responded well to every major catastrophe in the United States over the past decade. Reinsurers have served a vital purpose in providing insurers with the necessary capacity to ensure that homeowners are able to obtain insurance. A federal reinsurance program created to enhance state reinsurance programs would displace the vibrant private reinsurance market to the detriment and cost of the U.S. taxpayers. The RAA believes that natural disaster is an insurable risk in the private sector if the free market is allowed to work. A free market will give insurers the tools they need to better provide homeowners' insurance at an appropriate risk-based cost.

PROTECTING AMERICA.org
PREPARING FOR AND PROTECTING AMERICA FROM CATASTROPHE

Admiral James M. Loy, National Co-Chair
Former Deputy Secretary, Department of Homeland Security
Commandant, U.S. Coast Guard (Retired)

James Lee Witt, National Co-Chair
Former Director, Federal Emergency Management Agency
Chief Executive Officer, International Code Council

STATEMENT OF

JAMES M. LOY
ADMIRAL, USCG (Ret.)

NATIONAL CO-CHAIRMAN
PROTECTINGAMERICA.ORG

Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

April 11, 2007

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Thank you Mr. Chairman, Ranking Member Shelby and members of the committee. My name is James M. Loy. I appreciate the opportunity to appear before you today in my capacity as co-chairman of ProtectingAmerica.Org, an organization committed to finding better ways to prepare and protect American families from the devastation caused by natural catastrophes.

My fellow co-chairman is James Lee Witt, the former director of the Federal Emergency Management Agency. Our coalition's over 200 members include first responders like the American Red Cross, emergency management officials, insurers like State Farm and Allstate, municipalities, small businesses, Fortune 100 companies and thousands of private citizens. The membership is broad and diverse and includes members from virtually every state in the nation.

ProtectingAmerica.org was formed in the summer of 2005 to raise the national awareness about the important responsibility we all have to prepare and protect consumers, families, businesses and communities. We hope to build 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.

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.

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.

The simple fact is that catastrophe can and does occur virtually anywhere in this country.

Let me give you some quick facts that should crystallize the urgent threat posed by natural catastrophe in America:

- The bulk – 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 catastrophe's path – on the Atlantic, Gulf and Pacific coasts and on top of the New Madrid fault in the greater Mississippi Valley.

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.

- 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.

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 a mere 20 miles to the west, 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. Their service is invaluable.

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, enforceable building codes and effective retrofitting programs would improve the integrity of catastrophe-prone structures so that damage would be minimized if catastrophe strikes. 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 last 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 must 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 has been advocating 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 catastrophe funds in catastrophe-prone states that provide more protection at lower cost to consumers. Much like the 401k retirement savings program, these CAT funds would grow tax-free, thus able to generate higher levels of reserves to provide greater levels of coverage in a shorter timeframe. These CAT 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.

We have also been advocating the creation of a national catastrophe fund that would serve as a backstop to participating state catastrophe funds in the event of a 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.

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 and mitigation programs.

Qualified state funds would be able to purchase re-insurance from the national program. Rates for this coverage would be actuarially based 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 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 areas 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 <u>before</u> the onslaught of catastrophe and will be in a state of continuous and rigorous improvement. ProtectingAmerica.org is cognizant of readiness and preparedness efforts underway by DHS, the Red Cross and the Council on Excellence in Government and is working hard to compliment that work.

All of these elements are contained in legislation currently pending in both the House and Senate.

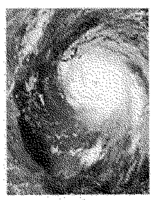
This needs to be a top national priority. It reflects strong leadership to act before the next crisis. There is urgency and opportunity to act.

Mr. Chairman, I want to thank you, again, for taking the time to consider and discuss this important subject. I would be happy to answer any questions that you may have.

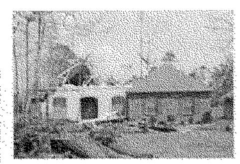
PROTECTING ★★★ AMERICA.org

PREPARING FOR AND PROTECTING AMERICA FROM CATASTROPHE

Hurricane Katrina exposed America's vulnerability to natural catastrophes as never before. The tragic loss of life and massive devastation of property touched the hearts of every American.



The world was stunned by the lack of preparedness evident in the aftermath of the storm. We know catastrophe will strike again. What have we learned since Katrina? Is America prepared today?



Congress must act ... before catastrophe strikes again.

"The time to repair the roof is when the sun is shining."
President John F. Kennedy
1962 State of the Union

A major hurricane or earthquake in a highly populated area could kill thousands and have a devastating impact on the economy of the entire nation. A repeat of the 1906 San Francisco earthquake could cause economic damages of $400 billion or more. The 1938 "Long Island Express" could cause $100 billion in damages if it struck today and much more if it hit Manhattan with the force it struck Long Island and parts of New England.

As presently structured, our catastrophic management system is ill-equipped to respond to major events, leaving too many consumers to fend for themselves or turn to the government for financial assistance. No state alone can adequately prepare and protect its citizens and the economy from a major catastrophe.

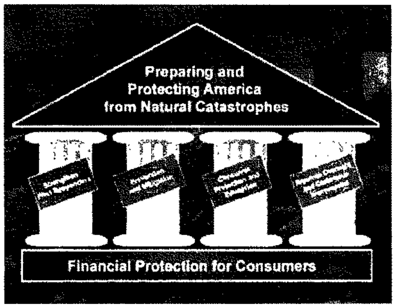
Leaders of both houses of the 110th Congress have pledged to develop a national homeowners protection program that will make catastrophe insurance more available and more affordable for consumers. The time to act is now.

- According to risk assessment experts, 57 percent of the American public resides in areas that are prone to earthquakes, hurricanes or other disasters.
- Twenty states, including Hawaii and every state that borders the Atlantic Ocean and Gulf of Mexico, face the threat of hurricanes every year.
- The largest earthquake to strike the continental U.S. was centered in New Madrid, Missouri in 1811 and affected an area stretching from Mississippi to Michigan, from Pennsylvania to Nebraska.
- Eight of the 11 most costly U.S. natural catastrophes have occurred since 2001.

Outlook for 2007 Hurricane Season: 85% Worse Than Average

	Average*	2005	2007
Named Storms	9.6	28	17
Named Storm Days	49.1	115.5	85
Hurricanes	5.9	14	9
Hurricane Days	24.5	47.5	40
Intense Hurricanes	2.3	7	5
Intense Hurricane Days	5	7	11
Accumulated Cyclone Energy	96.2	NA	170
Net Tropical Cyclone Activity	100%	275%	185%

*Average over the period 1950-2000.
Source: Philip Klotzbach and Dr. William Gray, Colorado State University, April 3, 2007.



A Comprehensive, Integrated Solution

ProtectingAmerica.org, a national coalition of emergency management officials, first responders, disaster relief agencies, non-profits, businesses and insurers, believes that a comprehensive solution is needed to prepare and protect America from future catastrophes. Making it possible for more people to afford adequate insurance protection is one critically important element of the solution, but our nation must also do more to:

- Prevent unnecessary loss of life and property by encouraging state and local governments to enact sensible building codes, land use policies and retrofit programs that address the threat of natural catastrophes.

- Support first responders with the equipment, training and personnel needed to save lives and reduce property damage.

- Educate consumers and provide the tools they need to prepare for catastrophes and protect their families and homes from harm. Warn catastrophe victims about scam artists and enforce tough anti-gouging laws.

- Create a rigorous process of continuous improvement by establishing a commission of local, state and federal officials to work with the private sector to review and assess recovery efforts after every disaster to identify ways to continually improve our ability to recover from catastrophes.

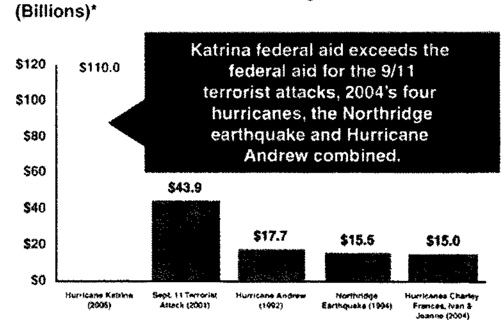
Financial Protection

"Without policy solutions, federal taxpayers in particular face unnecessarily large burdens for future disaster relief. The time has come for the federal government to convert what is de facto ***insurance—relief provided 'after the fact'—into a formal reinsurance system that assesses the cost of such catastrophic risks before such events occur."***

The Brookings Institution
March, 2006

The national catastrophe fund envisioned by ProtectingAmerica.org would reduce insurance costs for consumers by serving as a financial backstop for state catastrophe funds. The backstop will protect the private market from collapse and help ensure resources are available to rebuild after a major catastrophe. It will augment private reinsurance and provide more insurance protection to consumers at lower cost.

Government Aid After Major Disasters
(Billions)*



*In 2005 dollars.
Source: United States Senate Budget Committee, Insurance Information Institute as of 12/31/05.

Here's how it works:

- A portion of private insurance company revenues would be deposited into the national catastrophe fund, which would provide reinsurance to state catastrophe funds for losses above a specified amount. The fund would be self-supporting except for $10 million in start-up costs, which would be recouped from the premiums deposited into the fund during its first year of operation.
- The U.S. Treasury Department would administer the Fund and, like the premiums collected for federal bank deposit insurance, protect the fund from being raided for other purposes.
- The fund would be operated on a tax-exempt, not-for-profit basis.
- Premiums would be actuarially sound to ensure that rates reflect the actual risk that consumers face and to avoid subsidization of consumers in high-risk areas by consumers in lower risk areas.
- State catastrophe funds that purchase reinsurance from the national fund would be required to allocate up to 35 percent of investment income from the state fund for prevention, mitigation and public education programs.

Private insurance companies would be required to meet their obligations to utilize the state catastrophe fund. Likewise, the state catastrophe fund must discharge its financial obligations to access the national fund. This ensures that the national fund covers losses from mega-catastrophes that cause damage of such magnitude that private insurers and state catastrophe plans are at a significant risk of financial collapse.

Exempt from taxation and with no investors to satisfy, the national catastrophe fund could charge lower rates than the private market. The savings would be passed on to consumers, making homeowners coverage more affordable and available.

At the end of a year when there are no catastrophes, the national fund would continue to grow to protect consumers from future catastrophes. In contrast, a year without catastrophes under the current system means higher earnings for insurance and reinsurance companies, but little can be done to prepare for catastrophes that may occur in future years.

Reinsurance

"They (reinsurers) control the whole market."
Former Florida Governor Jeb Bush
September, 2006

Few consumers know or care about the arcane world of reinsurance, but those who live in the Gulf States and other catastrophe-prone regions have learned that foreign reinsurance companies can have a profound effect on the price and availability of homeowners insurance. Simply stated, insurance companies buy reinsurance – typically from companies located in Europe, Asia and Bermuda – to spread the risk of catastrophe losses that might otherwise put the company in financial peril. Insurance companies pay for reinsurance, but the cost is factored into the premiums consumers pay.

Foreign reinsurance companies collect about 85 percent of the reinsurance premiums paid in the U.S. More than 2,300 "alien" (offshore) reinsurers do business in this country, according to the Insurance Information Institute.

In the aftermath of the 2004 and 2005 hurricane seasons, reinsurance prices increased dramatically, while the amount of coverage shrank, especially in states where it was needed most.

- In its annual study of the international reinsurance market, Guy Carpenter & Company, Inc. reported that reinsurance rates in the United States increased 76 percent in 2006.
- In 2006, the *New York Times* reported that higher reinsurance costs contributed to steep premium increases along the coast from Texas to Maine; homeowners face premiums up to ten times as much as they paid in 2005. Rates on Cape Cod have tripled, and they're up 50 percent on Long Island even as deductibles have increased.
- Homeowners' insurance rates in Gulf Coast states increased dramatically in 2006 after reinsurance rates doubled.

Several factors have contributed to increase the demand for reinsurance and a decrease in supply, causing the upward pressure on rates:

- The catastrophe reinsurance market experienced record losses and at least four reinsurance company failures in the aftermath of the 2004-05 storm seasons.
- Predictions of increased storm activity in the Atlantic, including more frequent and intense storms in the Northeast;
- Pressure from regulators and rating agencies on homeowners' insurance companies to increase the capital available to pay catastrophe claims;
- Increased projected loss estimates due to rapid development and rising home values in coastal areas.

Even the most optimistic estimates of private reinsurance capacity fall well short of the magnitude of losses that will occur some day, according to many experts. A major hurricane or earthquake in a densely populated urban area could cause well over $100 billion in damage and totally exhaust the capacity of the private reinsurance market. Will claims be paid? Will the market collapse as it did in Florida after Hurricane Andrew and in California after the Northridge earthquake? At the present time, there is no guarantee that private capital will be available after a major catastrophe to restore the market and protect consumers so they can repair, rebuild and recover.

The national catastrophe fund will provide market stability, and its tax-exempt, not-for-profit status will mean more protection at lower prices for consumers.

Estimated Savings from a State Catastrophe Fund and National Backstop Mechanism

State	Estimated Cost Savings	Average Savings per Household
Florida	$ 4,131,700,174	$ 538.92
South Carolina	567,528,371	308.27
California	3,286,246,611	256.28
Washington	597,503,522	232 21
Louisiana	435,330,364	224.49
North Carolina	491,380,168	132.83
Oregon	194,239,763	127.37
Alabama	187,190,321	90.80
Texas	735,302,881	85.86
Mississippi	76,919,094	63 06
Massachusetts	158,806,604	57.69
New York	452,387,200	56.12
New Jersey	146,074,947	42.03
Connecticut	34,624,951	23 80
Virginia	57,180,999	18.76
Georgia	11,372,585	3.30
TOTAL	**$ 11,563,788,558**	**$ 174.81**

Source Milliman, Inc.

How Much Can Consumers Save?

"...our analysis indicates potential annual reductions in homeowners' premiums of over $11 billion."
Milliman, Inc.
May, 2007

Milliman, Inc, the international actuarial consulting firm, analyzed the potential impact of a national catastrophe fund such as that proposed by ProtectingAmerica.org and concluded that reductions in homeowners' insurance premiums could exceed $11 billion a year. The estimate is based on the savings consumers can expect with state and national catastrophe funds that serve as a backstop to private insurance.

Milliman's analysis assumes the national catastrophe fund would provide reinsurance coverage up to the aggregate annual catastrophic losses expected to occur once every 250 years. Additional savings to consumers can be expected if the fund is structured to pay claims up to annual losses that can be expected once every 500 years.

Consumer savings are attributed to the fact that rates charged by the state and national funds will not require the significant margin for return on capital that investors expect for a high-risk investment like catastrophe reinsurance. The tax-exempt status of the funds produces additional savings that will be passed on to consumers. Milliman also suggests the expense of administering the catastrophe funds will probably be less than the expense factor that reinsurance companies build into their rates.

Implementation of the other elements of a comprehensive catastrophe plan – preparedness, prevention and mitigation – will produce indirect savings for consumers, although these are difficult to quantify.

Savings differ from state to state depending on each state's exposure to catastrophes. Consumers who live in catastrophe-prone areas should experience greater savings than those who live in other states.

Will Low-Risk States Subsidize High-Risk States?

No. Critics of a national catastrophe fund allege that consumers in low-risk areas will subsidize those who live in states threatened by earthquakes and hurricanes.The speciousness of this argument is apparent by virtue of the fact that the national catastrophe fund provides reinsurance only to state catastrophe funds. Consumers in states without catastrophe funds won't pay anything into the national catastrophe fund. This is consistent with the basic tenets of insurance and cognizant of the political reality that legislators from low-risk areas will make sure their constituents are protected from paying for those who live in high-risk areas.

The legislation supported by ProtectingAmerica.org requires rates to be actuarially sound. This applies not only to the rates charged by the national catastrophe fund, but to state catastrophe funds that are protected by the national fund. Both on a national basis, and within different regions of high-risk states, rates would be required by law to be based on actual risk. Hence, the argument that those who live on Florida's beaches or California's earthquake faults will get cheaper insurance at the expense of consumers in less perilous areas doesn't withstand scrutiny.

Moreover, ProtectingAmerica.org supports the creation of a National Commission on Catastrophe Protection and Preparation, which will provide better oversight and act as a catalyst for continuous improvement in how our nation responds to the threat of natural catastrophes. The legislation reserves a seat on the commission for an actuary, who will monitor rates charged by the national catastrophe fund as well as participating state catastrophe funds to ensure the rates accurately reflect the risks insured.

Taxpayers across the nation will spend over $100 billion to help recover from Hurricane Katrina. With a cost-effective, privately financed catastrophe management system in place, more people in catastrophe-prone areas will be able to protect themselves, thereby cutting the "catastrophe tax" that all Americans pay to rebuild after natural catastrophes.

Prevention and Mitigation

"Economic losses, which include damage to buildings and contents, would be reduced an estimated 68%, from $4.8 billion to $1.5 billion. The loss reduction estimate does not include such additional benefits as reduction in loss of life, human suffering, reduced disruption of communities and local economies, reduced emergency response costs, reduced post-storm sheltering and housing costs and other very significant but difficult to quantify losses."

Louisiana State University Hurricane Center
Residential Wind Damage in Mississippi: Potential Hurricane Loss Reduction Through Improved Building Codes and Construction Practices
December, 2005

Living on known faults without earthquake insurance, building in a flood plain without flood insurance, allowing brush to grow unchecked in areas prone to wildfire and building homes in coastal areas that cannot withstand hurricane force winds are among the threats that confront America.

Stronger building codes, vigorously enforced, combined with sensible land use policies are needed to reduce the impact of catastrophes on consumers and taxpayers. One study estimated the damage from Hurricane Andrew would have been $8.1 billion less if the building code now in Miami-Dade had been in effect in 1992.

After Hurricane Charley - Home built to newer Florida code

After Hurricane Charley - Home across the street built to older code

Source: Institute for Business & Home Safety

ProtectingAmerica.org believes a comprehensive approach to catastrophe management includes incentives for local communities to enact and enforce tough building codes and land use policies, which recognize the area's exposure to natural catastrophes. Moreover, consumers should receive the help they need to make their homes stronger and safer with affordable and effective retrofits.

As Brookings notes: "By explicitly tying premiums to risk and to the implementation of effective loss mitigation programs at the state and local levels, the program would provide an important, and potentially powerful incentive for state and local officials and for individual homeowners to take cost-effective steps to minimize their exposure to catastrophe losses."

Strengthen First Responders

When catastrophe strikes, first response is the most immediate concern. Firm command and control of emergency situations, aided by adequate information sharing and clarity of roles between local, state, and federal officials is imperative to minimize human suffering.

As evident from the aftermath of Hurricane Katrina, a well-defined, cohesive plan for response and an accompanying financial backstop must be in place to best respond to large-scale catastrophes. Catastrophes are inevitable, and our first responders, who are charged with saving lives and protecting critical infrastructure, must be prepared and coordinated for a worst-case scenario.

At the local level, additional capacity should be built into emergency management, law enforcement, and firefighting. There are insufficient numbers within these incident management disciplines to deal with major catastrophes. Because of this, an effort involving all levels of government is essential to prevent, prepare for, respond to, and recover from any emergency or catastrophe.

The solution supported by ProtectingAmerica.org requires that a portion of the investment income earned by state catastrophe funds be allocated to local communities to help support the training, equipment and personnel needs of first responder agencies.

Consumer Education and Protection

Public and private sector resources should be dedicated to inform the public about how to protect themselves and their property as well as tips to help them recover quickly after a disaster strikes. Banks, insurers, social service agencies and emergency preparedness officials are all in a position to educate the public and help save lives and property.

Consumers must also be alert for scam artists and other criminals who descend on catastrophe areas and prey on those who are at their most vulnerable.

The state catastrophe funds supported by ProtectingAmerica.org would be required to dedicate a portion of the investment income earned by the fund to consumer education and protection programs.

Continuous Improvement

A commission of state, local and federal officials, together with representatives from insurers, banks, builders, medical providers and others should be appointed to study ways in which America might better prepare for catastrophic events. We should learn both from our mistakes and our accomplishments to alleviate suffering and economic damage from future catastrophes. The Commission will strengthen the pubic-private partnership at the local, state and national levels.

About ProtectingAmerica.org

At the core of ProtectingAmerica.org's mission is the establishment of a comprehensive, integrated national catastrophe management solution that will better prepare and protect American families, communities, consumers and the American economy from catastrophe. ProtectingAmerica.org is working to increase public awareness and enhance consumer education; advocate for better coordination with local, state and federal mitigation and recovery efforts, and strengthen emergency response and financial mechanisms to rebuild after a major catastrophe.

Chaired by former FEMA Director James Lee Witt and former Deputy Secretary of Homeland Security Admiral James M. Loy (USCG, ret.), ProtectingAmerica.org was formed in 2005 to lead a concentrated effort to improve the way America prepares for and protects its families, communities, consumers and economy from catastrophe.

For more information, please visit us at www.ProtectingAmerica.org

NAMIC®
NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

STATEMENT OF CHARLES CHAMNESS

ON BEHALF OF

THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

BEFORE THE

U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

"AN EXAMINATION OF THE AVAILABILITY AND AFFORDABILITY OF PROPERTY AND CASUALTY INSURANCE IN THE GULF COAST AND OTHER COASTAL REGIONS"

APRIL 11, 2007

**STATEMENT OF CHARLES CHAMNESS
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THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES
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"AN EXAMINATION OF THE AVAILABILITY AND AFFORDABILITY OF PROPERTY AND CASUALTY INSURANCE IN THE GULF COAST AND OTHER COASTAL REGIONS"

APRIL 11, 2007

Good morning Chairman Dodd, Ranking Member Shelby, and Members of the Committee. My name is Charles Chamness, and I am the president and CEO of the National Association of Mutual Insurance Companies (NAMIC). Founded in 1895, NAMIC is a property and casualty insurance association, whose 1400 members underwrite more than 40 percent ($178 billion) of the property/casualty insurance premium written in the United States. I am grateful for the opportunity to testify this morning on a subject that poses an enormous challenge to the insurance industry and our nation as a whole.

It is widely acknowledged that property insurance has become more expensive and somewhat less available in the Gulf and Atlantic coastal regions of the U.S. While government and the private sector can and should work together to address problems of insurance availability and affordability in these areas, we should not delude ourselves into thinking that economic principles affecting the complex relationship between supply, demand, and price can be erased by government regulation and programs.

Understanding the Nature of the Problem

Any serious discussion of the issue at hand should begin by acknowledging three simple facts:

1. The exposure of densely concentrated, high-value property to elevated levels of catastrophe risk in certain geographic regions means that property insurance in these regions will be relatively expensive compared to regions that lack these attributes.

2. As population growth and commercial development in catastrophe-prone regions increases, the number of people and businesses faced with relatively high insurance costs will naturally increase as well.

3. The Gulf and Atlantic coastal regions of the U.S. have experienced increased population growth and commercial development at a time when the frequency and severity of catastrophic storms in these regions is increasing.

Simply put, the availability and affordability of property insurance in coastal regions is mainly a function of risk. But other variables, including actions taken by government, can also affect the supply and cost of insurance. The availability and affordability of coastal property insurance are particularly influenced by the following factors.

Frequency and Severity of Major Coastal Storms

Higher property insurance prices in coastal areas have come in the wake of the three 2005 Gulf Coast hurricanes that killed more than 1,400 people and cost more than $180 billion in insured losses and federal disaster relief. But the trend was not caused by those hurricanes per se. Rather, insurance prices have increased because of what the 2005 hurricane season portends for the future.

Whether because of global warming or cyclical climate change, a consensus has emerged among hurricane experts that the frequency and severity of major storms will increase during the next several years. During the 2007 hurricane season, which begins 50 days from today, hurricane experts anticipate 17 tropical storms, nine of which will become hurricanes and four or five of which will be classified as Category 3 or above. According to Joe Bastardi, Chief Forecaster at the AccuWeather.com Hurricane Center, "The Gulf and Florida face a renewed threat, and we will see more powerful storms across the board." Mr. Bastardi, who correctly predicted last year's anomalous dearth of hurricane activity, believes that the northern Atlantic Coast is "in a pattern similar to that of the late 1930s, when the Northeast was hit by two major storms."

Coastal Development and Population Growth

Greater frequency and severity of coastal storms would matter less if the affected areas were sparsely populated and contained few valuable assets. But in fact the areas most at risk of increased storm activity contain a disproportionate share of the nation's population, as well as its most valuable real estate. What is more, the movement of people and wealth from interior regions with relatively little catastrophe risk to coastal regions with the highest levels of catastrophe risk is increasing even as the likelihood of severe coastal hurricane activity increases. According to the U.S. Census Bureau, Florida will experience significant population growth every year between now and 2030, by which time the state will have added more than 11 million new residents. That is equivalent to the entire current population of Ohio moving to Florida over the next 23 years. In 2015—just eight years from now—Florida will surpass New York as the nation's third most populous state.

Regulation

Many states in catastrophe-prone coastal regions impose rating and underwriting restrictions on property insurers that act as price ceilings on coverage. Government rate suppression, which allows high-risk property owners to pay artificially low premiums, is the preferred solution of many regulators and state legislators to the property insurance "affordability problem" in catastrophe-prone areas. But rate suppression masks the real problem—the growing concentration of people and wealth in high-risk regions—by forcing insurance buyers in low-risk regions to pay inflated prices in order to subsidize the insurance costs of those in high-risk regions.

Insurance rate suppression also removes a powerful disincentive to further population growth and economic development in these areas. That may seem like a good thing to government and private businesses that thrive on growth and development. But unfortunately, government rate suppression distorts the public's perception of risk, thus encouraging the very phenomenon that created to the problem in the first place. Federal and state governments must then end up bearing the cost of the economically irrational decisions that result from rate suppression by paying for disaster aid to repair properties that should never 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.

Rate suppression and underwriting restrictions are also largely responsible for insurance availability problems in coastal areas. Like any other business enterprise, insurers must charge a price that covers the cost of the good or service they provide and allows them to make a profit. Historically, profit margins in the highly competitive property/casualty insurance industry have been quite modest compared to other business sectors. But if government rate regulation prevents insurers from covering their claim costs, replenishing surplus reserves to pay future claims,and making a profit, they may have no choice but to exit the market. The surest way to increase the supply of insurance in catastrophe-prone coastal regions is to remove government restrictions on pricing and underwriting.

Human Psychology

Numerous studies have shown that property owners and 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 those who purchase insurance and do not collect on their policies over a period of time feel that their premiums have been wasted, and often discontinue coverage.

Litigation and the Viability of Insurance Contracts

For more than 30 years, the standard American homeowners insurance policy has contained a provision that excludes coverage for damage caused by flooding. Throughout this period, flood coverage has been provided almost exclusively by the federal government through the National Flood Insurance Program (NFIP).

Nevertheless, after every major disaster involving extensive flooding, attorneys take aim at the flood exclusion in homeowners policies, looking for ways to overcome decades of legal precedent behind that part of the insurance contract. Sometimes they succeed, causing insurance companies to re-examine their policies and make adjustments so that the policy language is as clear and unambiguous as possible in stating that damage due to flood is not covered. They then file those policy contract forms with state insurance regulators and negotiate the terms until they can obtain official approval and issue them to policyholders.

Such was the case in Mississippi, Louisiana, and the other states hit by the 2005 hurricanes. And when it developed that many homeowners whose properties were damaged or destroyed by hurricane-related coastal flooding had not purchased federal flood insurance (or had not purchased enough to cover their losses), class action attorneys, joined in this instance by the Mississippi Attorney General, descended on the courts, trying to persuade judges to abrogate the flood exclusion and force insurers to retroactively provide coverage for which they collected no premium.

The sanctity of contracts is a cornerstone of the free enterprise system. With respect to insurance contracts, this often means deferring to the state insurance regulator that approved the contract language as part of the rigorous "form filing" process that insurers must follow. 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 because, in the court's view, the insurance department erred in approving the contract language.

The unfortunate lesson that insurers may already have learned from the Katrina-related lawsuits still working their way through the court system is that "juridical risk"—the risk that courts will fail to uphold insurance contracts—is a risk factor that must be taken into account in setting property insurance premiums no less than the risk of loss due to fire, theft, or wind. And just as an inhospitable regulatory climate can cause an insurer to exit a market, a legal system that fails to honor the sanctity of contracts may produce the same result.

Recent Government Action Affecting Natural Disaster Insurance

I would like to comment on a few of the disaster insurance-related proposals that have emerged thus far from the 110th Congress, as well as the legislation recently enacted in the state of Florida. With respect to the topic of today's hearing, no state figures more prominently than Florida. In crafting solutions to coastal insurance availability and affordability issues, it is especially important for Members of Congress to carefully examine the Florida model of disaster insurance reform.

Florida

During a special seven-day legislative session in January, Florida lawmakers removed restrictions on the ability of the Citizens Property Insurance Corporation—originally conceived as the state-run property "insurer of last resort"—to compete with private insurers, while canceling rate increases that had previously been approved to reduce the disparity between the level of risk assumed by Citizens and the relatively low premiums it charges. Citizens was also encouraged to explore writing additional lines of insurance.

Lawmakers also doubled the risk-bearing capacity of the Florida Hurricane Catastrophe Fund from $16 billion to $32 billion, thus ensuring that the state's disaster reinsurance mechanism will become the predominant reinsurer for public and private insurers doing business in Florida. At the same time, property insurers were ordered to roll back their rates to reflect savings they would realize by having the ability to purchase cheaper reinsurance from the state catastrophe fund. Although there is currently only $1 billion in the fund, it now has a legislative mandate to assume a level of catastrophe risk exposure more than 30 times that amount. Thus, if even one major storm hits the state this year, all Florida insurance consumers—not just property insurance policyholders—will face huge assessments and significant tax increases. Indeed, according to a recent report by the Associated Industries of Florida, total assessment costs to finance the deficits that will inevitably result from this legislation could range from $1,700 per household following a moderate hurricane to as much as $14,000 per household following a major hurricane.

Current Federal Proposals

A highly critical editorial in the *Washington Post* noted that in their misguided attempt to artificially reduce the cost of property insurance, Florida lawmakers "not only are gambling with the state's fiscal future but are also giving people an incentive to keep putting themselves in harm's way." That observation speaks directly to the Senate, which is considering **S. 928, The Homeowners Protection Act of 2007,** a bill that would create a federal reinsurance mechanism to encourage states to establish catastrophe funds for homeowners insurance.

NAMIC readily acknowledges that a genuine 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. To prepare for a disaster of this magnitude, it is appropriate for policymakers to consider whether government programs should be created to supplement the supply of private sector capacity. At the same time, we believe the Florida example should serve to caution lawmakers against creating a national catastrophe reinsurance program that unintentionally creates incentives for Americans to migrate from regions with relatively little exposure to disaster-related risk to coastal regions with the most frequent and severe hurricanes. The federal government should not reward states that enact politically expedient disaster insurance "reforms" by promising to transfer the cost of such measures to federal taxpayers.

We have similar concerns about HR 920, **The Multi Peril Insurance Act of 2007**, which would add wind hazard to the coverage available to purchasers of flood insurance through the troubled National Flood Insurance Program. Through its chronic failure to charge risk-based premiums for flood insurance, the NFIP has operated for decades in a manner that is both fiscally unsound and environmentally irresponsible. The proposed legislation would make wind coverage contingent on responsible land use planning and zoning by state and local governments, which NAMIC strongly supports. But it is questionable whether the standards developed by the Federal Emergency Management Agency (FEMA) will be sufficiently stringent, whether enforcement will be sufficiently vigorous, and whether the premiums charged for wind coverage will be sufficient to pass the test of true actuarial soundness. A National Flood Insurance Program that was expanded to include wind coverage would need to build up a very large loss reserve very quickly to avoid the under-reserving problem that has plagued the NFIP. Otherwise, the plan would amount to little more than a massive risk transfer from private insurers to federal taxpayers.

NAMIC believes that one of the best proposals to emerge from Congress this year is **S. 930, The Hurricane and Tornado Mitigation Investment Act of 2007**. Instead of interfering with the pricing mechanism or creating taxpayer-subsidized government substitutes for private insurance and reinsurance, this bill would lower costs by creating tax incentives to encourage property owners to mitigate wind-related risk by investing in such measures as more durable roofs, reinforced connections between roofs and supporting walls, protections against wind-borne debris, and enhanced protection of exterior doors and garages. Investing in these proven risk mitigation measures will allow property owners to cut their insurance costs by opting for higher deductibles.

At the other end of the spectrum is **S. 618, The Insurance Industry Competition Act of 2007**, which would almost certainly increase the cost and decrease the availability of coastal property insurance. By repealing the limited insurance exemption from federal antitrust laws created by the McCarran-Ferguson Act of 1945, S. 618 would prevent insurers from sharing historical loss data and utilizing catastrophe models to predict future loss costs. Small insurers whose own book of business is not large enough to allow for independent loss projections depend upon their ability to access this critical industry-wide information. Without it, they would be driven from the marketplace. Their demise would decrease the supply and raise the cost of property insurance, particularly in catastrophe-prone regions.

Taking the Affordability Problem Seriously: A Different Approach

In February, the Wharton Risk Center at the University of Pennsylvania issued a report that identified the "two key principles" that should guide insurers and policymakers as they grapple with natural disaster insurance availability and affordability issues. NAMIC believes that these principles provide Congress with a solid foundation from which to develop innovative solutions and avoid costly mistakes. As stated in the report, the two principles are:

- *Risk-based Premiums*: Insurance premiums should be based on risk to provide signals to individuals as to the hazards they face and to encourage them to engage in cost-effective mitigation measures to reduce their vulnerability to catastrophes.

- *Dealing with Equity and Affordability Issues*: Any special treatment given to lower income residents in hazard-prone areas who cannot afford the cost of living in those locations should come from general public funding and not through insurance premium subsidies.

The Wharton catastrophe risk management experts understand, as does NAMIC, 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. We agree with their recommendation that in lieu of cross-subsidization through rate suppression and taxpayer-funded government insurance schemes, policymakers should consider creating programs to provide direct government assistance, funded from general revenue, to particular consumers based on criteria established through a transparent decision-making process.

This should not be all that difficult. The federal government has a long history of designing and administering programs that provide grants and other forms of direct financial assistance to individuals on a means-tested basis for the purchase of essential goods such as food and shelter. For example, government responds to the inability of some individuals to afford basic food staples, not by capping the price of groceries or creating government-run food stores, but by providing food stamps to low-income individuals that can be used to purchase food items from private vendors.

There is no reason why Congress could not provide a similar form of aid to selected property owners for the purchase of insurance. Such an approach would have many advantages over the current system of generalized rate suppression and cross-subsidization, not the least of which is that the assistance could be targeted to particular individuals based on financial need. Moreover, its availability could be limited to those currently residing in disaster-prone areas, and would thus avoid creating incentives for people not currently living in those areas to move into harm's way.

NAMIC's Reform Agenda

In testimony before the House Financial Services Committee last September, I laid out an agenda for improving the ability of insurers, property owners, and government to manage and finance future natural disasters. I am happy to report that several coastal states are considering or have recently enacted legislation consistent with that agenda. I believe that some of these measures could be emulated or reinforced by federal legislation. Here are some examples:

- NAMIC supports federal legislation that would create financial incentives to encourage states to adopt and enforce strong, statewide building codes. In the aftermath of Hurricane Katrina, Louisiana lawmakers enacted a statewide building code. Mississippi lawmakers followed suit in 2006 with a building code covering its six most southerly counties. In both instances, implementation of the codes was delayed, due in part to a lack of funding. Thanks to the persistence of Governors Barbour in Mississippi and Blanco in Louisiana, both states eventually obtained federal funding to help counties hire and train building inspectors. 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. Florida created the first such program in 2006; lawmakers there are now considering a proposal (H.B. 7057) to expand the "My Safe Florida Home Program," under which it would inspect 400,000 residential properties and provide 35,000 grants before June 30, 2009. Mississippi has enacted a similar program (H.B. 753), but is still trying to develop a funding mechanism. Recently-introduced legislation in South Carolina would partially fund that state's new mitigation grant program with premium taxes from its wind pool and by reducing the commissions that agents receive for placing business with the pool.

- 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. South Carolina's governor, Mark Sanford, recently proposed a similar amendment to his state's tax code. 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. This idea has been incorporated into the South Carolina legislation as well.

- The National Flood Insurance Program should be subject to substantial reform. 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. Some of these reforms are included in **H.R. 1682, The Flood Insurance Reform and Modernization Act of 2007**. NAMIC supports this legislation and hopes that a companion bill will soon be introduced in the Senate.

In conclusion, NAMIC realizes that property owners, insurers, mortgage lenders, realtors, and home builders that live and do business in coastal 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, creating incentives for states to enact and enforce effective statewide building codes, and providing targeted grants that would enable low-income property owners to pay risk-based property insurance premiums.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM EDWARD P. LAZEAR

Q.1. All of the witnesses appear to support the proposition that mitigation efforts are an important part of preparing Americans to withstand and hopefully minimize damage from a large-scale natural disaster. I agree, which is why I have called for at least doubling the federal investment in mitigation efforts. What do you see as the current barriers to mitigation efforts and what can be done to remove those barriers?

A.1. First and foremost, the government should not take actions that discourage loss mitigation such as providing subsidized insurance against catastrophe risk at below actuarial rates or preventing private insurers from charging premiums commensurate with risk. In a well functioning insurance market, those businesses and homeowners who chose to locate in dangerous areas or fail to adopt measures to reduce losses may be charged higher insurance premiums, which gives them a financial incentive to change their behavior.

The Administration strongly supports disaster risk mitigation. The FY 2008 Budget proposes $100 million for FEMA's Pre-Disaster Mitigation Program which provides funds to states and communities for hazard mitigation planning and the implementation of mitigation projects prior to a disaster event, and $34 million for FEMA's Flood Mitigation Assistance Program which provides funding for measures that reduce the long-term risk of flood damage to buildings. The FY08 Budget also proposes to double the funding for the Severe Repetitive Loss Pilot Program, from $40 million to $80 million. Funding is provided for the acquisition of the structure and underlying real property for the purpose of creating open space uses in perpetuity; relocation of flood prone residential structures to areas outside the hazard area; elevation of existing residential structures; demolition and rebuilding of structures; construction of minor localized flood control projects that provide protection to severe repetitive loss properties; and certain flood-proofing techniques for historic structures. Although federal programs such as these can help to encourage community mitigation efforts, responsibility for establishing and enforcing prudent building codes, zoning, and land use planning rests mainly with the states and local communities.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM EDWARD P. LAZEAR

Q.1. Are you familiar with the experiences other countries have had with establishing national catastrophe funds? If so, are there any lessons that we should learn from their experiences?

A.1. In February 2005 the Government Accountability Office submitted *U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risks*, to the House Financial Services Committee. This report, which reflects information gathered from a diverse array of stakeholders, looked at practices in six European countries and found a mix of government and private-sector approaches to dealing with natural catastrophe risk. The governments of France and Spain mandate natural catastrophe coverage and backstop private insurers with state-backed entities or government guarantees. Conversely, the national governments of Germany, Italy, and the United Kingdom do not provide natural catastrophe insurance. All six countries, however, allow insurers to establish tax-deductible "reserves" for future catastrophe events.

Q.2. If a mega-catastrophe did occur that threatened the solvency of the entire insurance industry, what actions could the federal government presently take to stabilize insurance markets and ensure that policy holders' claims were paid, and would the existence of a national catastrophe fund improve the federal government's ability to respond to a crisis in U.S. insurance markets caused by a mega-catastrophe?

A.2. Currently, the Stafford Act provides for post-event federal disaster assistance and state guarantee funds protect policyholders when individual insurers are unable to pay claims. A mega-catastrophe large enough to threaten the solvency of the entire insurance industry would require an aggressive federal response, regardless of whether or not a federal natural catastrophe backstop program were in place. An insurance industry crippling event would necessarily be much larger than 9/11 or Katrina, but, if those events are any guide, only a fraction of the overall economic costs of the mega-catastrophe would actually be covered by insurance. After the event, Congress would need to make difficult choices about how to allocate scarce federal aid dollars and federal budgetary resources. One problem with a natural catastrophe backstop program is that it would effectively pre-commit a share of those scarce aid dollars to pay loss claims. A post-event insurance bailout could be beneficial, but after a true mega-catastrophe, other needs might be more pressing.

Q.3. Do you have any concerns that Florida's recently enacted insurance reforms have undermined its insurance market and make it likely that a federal bailout will be needed in the near future?

A.3. As discussed in my prepared remarks, I believe that Florida's recent insurance legislation is, in important ways, a step in the wrong direction. States need to allow markets to function. When insurance premiums reflect underlying risk, they provide valuable signals to those seeking insurance about the costs of their decisions, so people have incentives to take actions to mitigate risk. Moreover, basic economic theory and evidence shows that if premiums are suppressed through regulation, less insurance will be available. Unfortunately, rather than allowing market forces to operate, key provisions of Florida's recent insurance legislation tighten constraints on insurer's ability to adjust the premiums they charge. Furthermore, the state has substantially increased coverage of its property insurer of last resort while lowering its rate of coverage threshold, and has nearly doubled the size of its reinsurance facility, the Florida Hurricane Catastrophe Fund. When a state provides insurance and reinsurance at below market rates, it crowds out private insurance and reinsurance. By expanding coverage provided by the Florida's reinsurance backstop, the Florida Hurricane Catastrophe Fund, without appropriating sufficient capital to cover potential near-term losses, the new law increases the odds that the Fund or the state will need to borrow heavily to cover claims if a severe catastrophe strikes.

Every state need to take responsibility for keeping its own financial house in order, so I would not want to speculate on the possibility of a federal bailout for Florida. I would note, however, that it is reasonable to have concerns about the financial risks posed by expanding state insurance obligations. Florida's legislative changes to its property insurer of last resort had made the carrier actuarially unsound, according to the state's chief financial officer. It is telling that shortly after Florida's insurance legislation was passed, major rating agencies lowered credit ratings for bonds issues by the Florida Hurricane Catastrophe Fund. The insurance strength rating agency A.M. Best Company also cautioned that insurers with large exposures in hurricane-prone areas of Florida could have their ratings downgraded because of concerns over the financial strength of the Florida Hurricane Catastrophe Fund.

Q.4. If a national catastrophe fund was established and it increased the supply of reinsurance, would it result in lower insurance prices for consumers?

A.4. A national catastrophe fund would likely result in taxpayer-subsidized government reinsurance crowding out some private reinsurance. We have already seen an example of this in Florida. Guy Carpenter and Company has reported that expansion of the state-sponsored Florida Hurricane Catastrophe Fund could cause Florida insurers to purchase $1.5 to $2.0 billion less private reinsurance than they otherwise would.

To the extent insurance prices would decline under a national scheme, it would likely be due to taxpayers taking on some of the risk instead of insurance companies and policy holders.

Replacing private reinsurance with government reinsurance is both unfair and inefficient. It is unfair because it forces taxpayers nationwide to bear the costs of subsidizing insurance in high risk areas. Why should the residents if Iowa or Nebraska, who don't enjoy the amenities of living on a coast, have to pay higher taxes so that the insurance rates of those living in high-risk coastal areas can be lower? It is inefficient because it means that the costs of covering catastrophic losses will be contained within the United States instead of diversified internationally. Insurance exists to spread risk. When a primary insurer buys reinsurance cover, it is effectively spreading the risk of covering catastrophic losses to investors around the world. One of the reasons the U.S. property/casualty insurance industry emerged from the devastating 2005 hurricane season in sound financial condition is that a significant fraction of insured hurricane losses were borne by reinsurance companies backed by capital from investors in Europe and Asia as well as North America. In contrast, when insurance or reinsurance is provided by the U.S. government, all of the costs will ultimately be borne by U.S. taxpayers, so risk is not spread as widely as it could be.

Q.5. In your testimony, you stated that a national catastrophe program would "undermine economic incentives to mitigate risk because the program would likely distort rates from their actuarial value." Could you elaborate on this statement and discuss further whether a national catastrophe program could increase the financial losses incurred by natural disasters by reducing incentives for risk mitigation?

A.5. In insurance markets, as in other markets, prices affect the way people weigh costs and benefits. Insurance prices that are artificially low can discourage people from adequately protecting against future losses. If we introduce a taxpayer-backed backstop program designed to keep insurance premiums in high-risk coastal areas artificially low, we effectively make it cheaper for people to locate in those high-risk areas. Since people consider insurance costs when deciding where to live and do business, such a policy risks encouraging excessive development in places where catastrophes are most likely to strike. Similarly, a subsidized catastrophe insurance program would mean that owners of properties already in place would not bear the full cost of their risk exposure, so they would have less incentive to take actions such as installing storm shutters that might reduce future losses.

Q.6. What impact could alternative insurance mechanisms, such as catastrophe bonds, insurance derivatives, and the securitization of insurance risks, have on the availability and affordability of insurance in the future? Also, what impact would a national catastrophe fund have on the development of these new products?

A.6. Through catastrophe bonds, sidecar deals, and other innovative financing mechanisms, insurers and private investors are finding new ways to spread the risks posed by large-scale catastrophes. These financing mechanisms currently contribute only a relatively small share of the total capital available to cover catastrophe losses, but the volume of capital they have raised has grown rapidly in recent years. It is likely that as these markets mature, the base of investors willing to bear some catastrophe risk will continue to expand, ultimately lowering the costs of insuring catastrophe risk. However, a government-sponsored national catastrophe backstop program would likely undermine market innovation in catastrophe risk finance because government-subsidized reinsurance provided at less than actuarial prices would crowd out private sector alternatives. It is reasonable to assume that the greater the government's involvement in the catastrophe risk reinsurance market, the less time and money will be spent looking for innovative alternatives.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM WALTER BELL

Q.1. Mr. Nutter says in his testimony, "The insurance industry surplus grew from $356 billion at December 31, 2003 to $439 billion at December 31, 2005. As of December 31, 2006, the industry's claims paying ability and capital base have never been better." This statement suggests that despite Katrina, the largest natural disaster in American history, insurance companies have had no problems paying claims, and in fact, have a better ability to pay claims now than before that disaster. In addition, Mr. Nutter says that "reinsurance capacity is adequate even for peak catastrophe markets."

At the same time, Americans around the country are finding it increasingly difficult to secure sufficient and affordable insurance. We hear reports that people from Texas through the Gulf and up the Eastern seaboard are seeing their insurance dropped and their rates and deductibles increased.

How can this disconnect be explained? There appears to be sufficient insurance capacity, yet working families and business owners are unable to afford sufficient coverage. What do we do for these people, so that they can afford needed insurance coverage?

A.1. The capacity of the insurance industry is an important indicator of the collective industry's ability to withstand a catastrophic event, but capacity alone does not dictate affordability and availability. All the capacity in the world becomes meaningless to the public if an insurer is not willing to make that capacity available at an affordable price to cover their home or business. Insurers are reluctant to expose their capital to catastrophic risk—risk that if not carefully managed could result in insolvency—particularly when there are other lines of business that are potentially more profitable and less catastrophe prone. While this makes good economic business sense from their perspective, it does not solve the regulators' and legislators' public policy concern of making coverage available to those deemed in a high-risk area. The perception of catastrophic risk exposure, particularly to an event that would result in the risk of certain insolvency, is what has led to the coastal market problems.

Insurance companies, risk modelers, meteorologists and regulators agree that there are naturally occurring catastrophic events that could produce insured losses of $100–200 billion, or perhaps more. A massive earthquake in the new Madrid fault area or in downtown San Francisco, or a category 5 hurricane hitting Miami, veering out to sea, and then traveling up the eastern seaboard, are such events. While the statistical likelihood is relatively low, insurers are factoring such potential into their risk management and decision making. Therefore, despite a large amount of aggregate financial capacity, only a fraction of that capacity is available to any one company. Further, they are unwilling to put much of that capacity at risk to catastrophic exposure when there are other more profitable and less risky lines of business that they could write. When they do expose their capital to the risk of catastrophic loss, the cost to policyholders can be rather expensive.

There are no easy solutions or overnight fixes, but there are a series of steps that collectively would address this issue:

- In the long term we can limit catastrophic risk by strengthening building codes and making informed land use plans. A first step in achieving this would be a commission, like the one you have proposed, to partner states, localities, the federal government, and the private sector. Lowered risks stemming from these improved codes and land use plans should be reflected in the pricing by insurers.
- The tax code could be modified to support mitigation and loss prevention. For example, deductions or credits for risk reduction measures would encourage mitigation. Allowing for tax-free IRA-like vehicles to save for deductibles would incentivize

families to save up funds to have higher deductibles and lower rates.

- Another concept is to amend 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 and 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 to events which already have occurred, and require the recognition of catastrophe premiums during the periods in which they are written. 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 affect future rate requests. 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 those in most other industrialized nations by setting aside tax-deferred reserves specifically for catastrophes, when structured appropriately as not shelter income, could provide additional capacity for the market. Tax-free catastrophe reserves also could help mitigate some of the "boom or bust" cycle in the property insurance market to everyone's benefit.
- A better system of integrating the federal flood insurance program with the state regulated property insurance and wind pools could reduce the litigation risk that is causing insurance companies to view coastal insurance as riskier than other lines of business. for example, Congress could partner with the states to move to a mandatory offer of an all-perils policy.
- A dedicated reinsurance fund, whether single state, multi-state or national in scope, could help manage the timing risk associated with catastrophic losses.
- A "line of credit" or some other access to a short term funding mechanism could limit the timing risk associated with large scale catastrophes that would otherwise overwhelm the immediate capital capacity of a company. In other words, the risk of total ruin would be reduced because the insurance company would be able to handle larger than expected losses by tapping additional funds and being able to pay back these funds over time.

Q.2. All of the witnesses appear to support the proposition that mitigation efforts are an important part of preparing Americans to withstand and hopefully minimize damage from a large-scale natural disaster. I agree, which is why I have called for at least doubling the federal investment in mitigation efforts. What do you see as the current barriers to mitigation efforts and what can be done to remove those barriers?

A.2. You are right to focus on the important role of increased mitigation. The primary barrier to mitigation is the upfront cost and the fact that the benefits may not come during a homeowner's time in the house. Although there are some inexpensive things that a homeowner can do to harden a dwelling, to completely retrofit a home to a stronger building code can be expensive. For example, elevating a home to reflect changes in the flood plain can be extremely expensive, but it is estimated that $1 of mitigation can result in $4–5 of savings from reduced loss. Similar mitigation efforts like more securely attaching walls to roof and walls to foundations pay off for both hurricane risk and earthquakes. Mitigation takes foresight but it is good public policy that not only saves money, but saves lives.

If there is little perception of risk then there is little incentive for mitigation. As Congress considers its role in managing natural catastrophes, any federal involvement should find ways to provide information and incentives to homeowners, state governments, insurers, builders and other stakeholders to include mitigation efforts in their decision making process. Flood plain maps that accurately reflect the risk of flood would help the public have a true understanding of the risk empower them to make informed decision about where to build and how to build. The tax code could be used to provide tax credits to homeowners that take specific steps to improve the likelihood that their home could withstand a catastrophic event to which they are exposed. Congress could authorize funds to provide grants or low-interest loans to encourage people to take steps to harden their homes. State legislatures could encourage mitigation by requiring insurers to offer discounts or credits that recognize efforts of the homeowner to strengthen the house against the risk of catastrophic loss. Also, efforts to educate the public about the positive benefits of mitigation could be undertaken. Efforts to either encourage or mandate the adoption and enforcement of strong building and land use codes could be considered.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ROBERT HARTWIG

Q.1. During the hearing, testimony was given on how the high cost of insurance in the Gulf Coast is hindering the region's recovery from Katrina. What measures would you recommend to help reduce the cost of insurance in the region?

A.1. There are a variety of recommendations that will reduce the cost or limit the magnitude of future increases. All are related to risk reduction.

- Further strengthen building codes throughout vulnerable states.
- Allow insurance prices to move to their full actuarially-sound (risk-based) level. Risk-based pricing is critical because it is a signal to buyers and developers about the relative riskiness inherent in coastal areas. Federal and state programs that provide insurance subsidies on coastal property obscure and dilute the informational value that risk-based insurance premiums bring to the market. Risk-based pricing will compel more stringent building designs and make building in highly vulnerable areas less economically viable, thereby reducing potential

losses and future levels of exposure while at the same time reducing the exposure of taxpayers.

- Provide incentives for mitigation using federal and state tax policy, low interest loans and grants. Insurance discounts can be used if rates are allowed to first move to their full actuarially sound level.
- Require disclosure of property's hurricane resistance in real estate transactions. If market participants are made aware of the strengths and vulnerability of a property before a real estate transaction, then this will become an element upon which price is determined. All else equal, a home with better resistance will be more valuable so long as this fact is known by all parties. A hurricane resistance index could be developed (*e.g,* using a scale of 1–10) that would incorporate a variety of factors. This could be similar to what is done now for automobile and crashworthiness. People actually shop for cars based on safety considerations and will pay more for safety. Why wouldn't they do the same for homes? I believe real estate transactions in Japan use such an index to gauge seismic risk.

Q.2. Are you familiar with the experiences other countries have had with establishing national catastrophe funds? If so, are there any lessons that we should learn from their experiences?

A.2. Numerous countries have funds to deal with terrorism risk. I believe few, if any, have comprehensive national catastrophe funds for natural disasters. I will research this and report to you on my findings.

Q.3. Would a natural catastrophe fund have any impact on the long-term availability and affordability of insurance?

A.3. The answer to this question depends entirely on how the plan is managed. If, as proposed, the plan is actuarially sound and is prohibited from receiving any form of taxpayers subsidy, the answer is that what savings do emerge will be nominal (limited primarily to the profits that would have gone to private reinsurers, as well as other costs incurred by private reinsurers such as taxes). This amount is only a small fraction of the total cost of insurance at the retail level. Reinsurance markets have historically been able to bring capacity to market, as needed, after mega-catastrophes (excluding terrorism). Price often rises because risk is elevated and demand goes up, but this incentivizes new capital to enter (at least $34 billion post-Katrina).

If the natural catastrophe fund is not operated on an actuarially sound basis, as is the case in the Florida Hurricane Catastrophe Fund, large discounts are possible, but only because funds are collected via post-event assessments, taxes and borrowing and because non-exposed types of insurance (*e.g.,* auto and liability insurance, are often assessed as well).

Q.4. The states are primarily responsible for regulating insurance. What steps can state insurance commissioners take to improve the availability and affordability of catastrophe insurance?

A.4. The most important tool at the disposal of commissioners is to allow price to be fully reflective of risk. This provides the correct economic incentives to people and businesses living/building/buying in disaster-prone areas and would be the most effective, long-run solution to healthy insurance markets with minimal government intervention. Coverage would generally be available, with prices tied directly to risk. Markets even in risky areas could be competitive, providing premiums that are affordable given the risk that must be assumed.

State insurance commissioners can work to educate the public on the risks they face living in disaster-prone areas. They can develop their own initiatives and work with insurers, disaster-relief organizations and the federal government. Commissioners cannot under present law require people to buy coverages such as flood or earthquake, consequently take-up rates for these optional coverages is low. Commissioners may be able to raise awareness, however, by forcing a signed waiver in the event the policyholder declines such coverage. Perhaps in working with partners at the federal level, such a waiver could have some real teeth in it (e.g., if you decline flood coverage and live in a flood zone, you lose eligibility for federal aid).

Commissioners can also push other state agencies charged with building codes, zoning and land use into making decisions that reduce or limit vulnerability.

Commissioners might also seek funding for their departments that could be used to award grants for mitigation/retrofitting, etc., or to help pay the incremental cost in building a “fortified” home.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM ADMIRAL JAMES M. LOY (USCG–RET.)

Q.1. Mr. Nutter says in his testimony, “The insurance industry surplus grew from $356 billion at December 31 2003 to $439 billion at December 31, 2005. As of December 31, 2006, the industry’s claims paying ability and capital base have never been better.” This statement suggests that despite Katrina, the largest natural disaster in American history, insurance companies have had no problems paying claims, and in fact, have a better ability to pay claims now than before that disaster. In addition, Mr. Nutter says that “reinsurance capacity is adequate even for peak catastrophe markets.”

At the same time, Americans around the country are finding it increasingly difficult to secure sufficient and affordable insurance. We hear reports that people from Texas through the Gulf and up the Eastern seaboard are seeing their insurance dropped and their rates and deductibles increased.

How can this disconnect be explained? There appears to be sufficient insurance capacity, yet working families and business owners are unable to afford sufficient coverage. What do we do for these people, so that they can afford needed insurance coverage?

A.1. The assertion that sufficient capacity exists to defend the status quo misses the point. The fact is the traditional insurance model is not serving consumers well. Reform is needed, and the time to act is before the next crisis.

Moreover, the assertion about capacity is dubious at best. While the industry’s surplus and capital base may be in a strong position generally, that surplus and capital is dedicated to risks across many different lines of insurance and supports risks in every state. There is not $439 billion of surplus and capital available to cover wind damage to homes along the Gulf Coast. Even reinsurers limit their coverage by line and geography. Last Fall, reinsurance industry leaders acknowledged that there is a sizable gap between the supply and demand for reinsurance coverage in the southeast U.S.[1] This gap demonstrates why the reinsurance market is not a complete solution for U.S. catastrophes needs. Absent a new model, the most catastrophe-prone areas, where higher levels of capital are needed most, will always have trouble attracting capital.

The fact is the homeowner's insurance market is contracting for primary insurers because they do not enjoy the same ability to cap losses that reinsurers enjoy. Moreover, the rates of returns have been historically low. When one lays on top of these facts the reality that the risk has risen, it is easy to see why the primary market has contracted. The risk has risen because more people live in harm's way, property values have risen significantly, especially in most of the highly exposed areas, and the forecast calls for more frequent and ferocious storms and the reality is that major earthquakes are likewise inevitable.

The disconnect between the reports of industry surplus and capital and availability issues along the Gulf Coast is also the result of a misunderstanding of state regulation and the competitive environment of the insurance marketplace. State regulation requires insurance rates in each state to reflect the actual and expected losses in that state. Furthermore, for a multi-line insurer to remain competitive, each line of insurance, such as auto and homeowners coverage, needs to stand on its own in terms of profitability. Profits in auto insurance or workers compensation coverage, for example, cannot be used to subsidize losses in homeowners insurance that arise from hurricanes or other natural disasters. Likewise, insurance markets in each state must be profitable in their own right and cannot be subsidized by profits in other states. Hurricane-related losses to homes in a state like Louisiana, for example, cannot be subsidized by profits generated by homeowners insurers in Montana. Conversely, Louisiana homeowners cannot and should not be called upon to subsidize severe earthquake losses in California.

These realities clearly present challenges for consumers in the homeowners insurance market along the coast. The traditional insurance model does not work well for those consumers. Consumers exposed to low frequency and severely high severity events need a new model. The market has contracted and costs for the available insurance have increased significantly. The residual market (so-called market of last resort for consumers) is growing in a dangerous way. The status quo is unacceptable for consumers, and there is urgency and opportunity for Congress to act in a way that will address the challenge. An innovative public-private partnership as part of a comprehensive, integrated solution provides a better way for consumers.

A comprehensive solution that includes an integrated state and national financial backstop model can provide more protection at

[1] *Business Insurance*, September 25, 2006 (quoting David Priebe, CEO-Europe for Guy Carpenter & Co. Inc.)

lower cost. Milliman, Inc, the international actuarial consulting firm, analyzed the potential impact of a national catastrophe fund such as that proposed by ProtectingAmerica.org and concluded that reductions in homewoners' insurance premiums could exceed $11 billion a year. The estimate is based on the savings consumers can expect with state and national catastrophe funds that serve as a backstop to private insurance. Consumer savings are attributed to the fact that rates charged by the state and national funds will not require the significant margin for return on capital that investors expect to earn for a high-risk investment like catastrophe reinsurance. The tax-exempt status of the funds produces additional savings that will be passed on to consumers. Milliman also suggests the expense of administering the catastrophe funds will probably be less than the expense factor that reinsurance companies build into their rates. Implementation of the other elements of a comprehensive catastrophe plan—preparedness, prevention and mitigation—will also produce meaningful savings for consumers and must be part of a comprehensive, integrated solution.

The private reinsurance market is too volatile to provide a reliable, predictable and enduring solution to the problems facing consumers along the Gulf Coast. It was no surprise that in the aftermath of the 2004 and 2005 hurricane seasons, reinsurance prices increased dramatically, while the amount of available coverage shrank, especially in states where it was needed most.

- In its annual study of the international reinsurance market, Guy Carpenter & Company, Inc. reported that reinsurance rates in the United States increased 76 percent in 2006.
- In 2006, the New York Times reported that higher reinsurance costs contributed to steep premium increases along the coast from Texas to Maine; homeowners face premiums up to ten times as much as they paid in 2005. Rates on Cape Cod have tripled, and they're up 50 percent on Long Island even as deductibles have increased.
- Homeowners' insurance rates in Gulf Coast states increased dramatically in 2006 after reinsurance rates doubled.

Several factors have contributed to increase the demand for reinsurance and a decrease in supply, causing the upward pressure on rates:

- The catastrophe reinsurance market experienced record losses and at least four reinsurance company failures in the aftermath of the 2004–05 storm seasons.
- Predictions of increased storm activity in the Atlantic, including more frequent and intense storms in the Northeast;
- Pressure from regulators and rating agencies on homeowners' insurance companies to increase the capital available to pay catastrophe claims;
- Increased projected loss estimates due to rapid development and rising home values in coastal areas.

Even the most optimistic estimates of private reinsurance capacity fall well short of the magnitude of losses that will occur some day, according to many experts. A major hurricane or earthquake in a densely populated urban area could cause well over $100 billion in damage and totally exhaust the capacity of the private reinsurance market. Will the market collapse as it did in Florida after Hurricane Andrew and in California after the Northridge earthquake? At the present time, there is no guarantee that private capital will be available after a major catastrophe to restore the market and protect consumers so they can repair, rebuild and recover, and if it is available, at what cost. A national catastrophe fund will provide market stability, and its tax-exempt, not-for-profit status will mean more protection at lower prices for consumers.

The bottom line is that unless America rethinks its approach to better preparing and protecting its citizens with respect to natural catastrophes, the era of readily available and affordable homeowners coverage in the private market for such losses is behind us. Today, the homeowners insurance coverage that people need every day is tied to coverage for natural catastrophes. When insurance companies can no longer write catastrophe coverage because of the enormous unpredictable risk it presents, they are often forced to also drop the non-catastrophe coverage too—even though we believe companies would be willing to compete vigorously for non-catastrophe homeowners policies in every state.

Q.2. All of the witnesses appear to support the proposition that mitigation efforts are an important part of preparing Americans to withstand and hopefully minimize damage from a large-scale natural disaster. I agree, which is why I have called for at least doubling the federal investment in mitigation effort. What do you see as the current barriers to mitigation efforts and what can be done to remove those barriers?

A.2. Doing more to save lives and to prevent and mitigate losses must be a part of a comprehensive, integrated solution. The solution should force policymakers to make this component of the solution a top national priority, including do more research and development of ways to help consumers build stronger, safer homes and strengthen their existing homes with effective, affordable retrofits.

One of the largest barriers to mitigation efforts is the demand for housing in catastrophe-prone areas. There has been, and continues to be, a significant population migration to hurricane exposed areas. Property values along the coast are also rapidly increasing. In addition, all forecasts predict an increase in the frequency and strength of hurricanes for the foreseeable future. These factors mean that the future holds more devastating storms. In fact, a repeat of the great Miami hurricane of 1926 could cause $500 billion in damage by 2020, given current demographic trends.[2] A direct hit by a Category 5 hurricane on Miami could cause $130 billion in commercial and residential damages according to AIR Worldwide. Yet, people continue to build along the coast and those living inland continue to subsidize them. Unless and until the cost of living along the coast reflects the true risk of living there, the coastal migration will continue.

Another more significant obstacle is the perception that prevention and mitigation can only be accomplished at a substantial cost.

[2] Hurricane Season of 2005: Impacts on U.S. P&C Markets in 2006 and Beyond, Insurance Information Institute, March 2006, page 12.

In reality, it is only marginally more expensive to build a home with storm-resistant features. The same is true for retrofits. What we have to do is make it a higher priority to bring into this work the best and the brightest to help consumers. In doing so, we can leverage consumer education and drive consumer demand in this area. An analogy we would offer is to automobile safety. Some manufacturers for years fought efforts to require automobiles to include passive restraint systems and air bags. Before long, consumers demanded more safety features, and the manufacturers responded in a competitive way to meet the demand. Now, you see active efforts to market safety to respond to the consumer demand. The same will happen for home safety as well if we make this a priority and knock down or overcome the obstacles.

The public-private partnership model again has perfect application in this area. A recent Wall Street Journal article detailed insurance industry efforts to encourage mitigation, such as shutters and fire-resistant roofs, and the complaints and resistance they encountered from politicians and consumer groups.[3] More specifically, we recommend the following actions as part of the comprehensive solution:

- (1) Congress should consider amendments to the Stafford Act to provide additional funding for states that adopt and enforce a strong state-wide building code.
- (2) Community Block Grant funds could be given to communities to provide the funding to offer incentives for disaster-resistant construction or retrofitting, especially for low-income families.
- (3) Congress could amend the National Earthquake Hazard Reduction Program (NEHRP) to give greater emphasis to construction and retrofitting to mitigate earthquake risks.
- (4) Federal tax credits could be offered to home owners and business owners for cost of retrofitting, such as the cost of installing shutters or the incremental cost of installing a hail-resistant roof.
- (5) The state sales tax could be waived for disaster-resistant products.
- (6) States and/or local governments should consider discounting the value of disaster mitigation in property tax assessments.
- (7) The Federal government should encourage Freddie Mac and Fannie Mae to offer mortgage discounts for disaster-resistant homes.

A key point to remember is that the comprehensive, integrated solution that includes the financial backstop will also provide seed money to help finance and facilitate (and continuously improve) the prevention, mitigation and consumer education that will help drive this component of the solution.

[3] Bracing for Disaster: Insurers Require Homeowners to Make Expensive Upgrades to Protect Property: Using Google Earth for Inspections, Wall Street Journal, June 7, 2007.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ADMIRAL JAMES M. LOY (USCG–RET.)

Q.1. If a national catastrophe fund was established, what in your view should be the minimum amount of losses that would trigger coverage by the fund? In other words, if the national catastrophe fund aims to provide a backstop for only truly catastrophic events, what would be the minimum amount of losses that a catastrophe would have to inflict for those losses to be covered by the fund?

A.1. The fund should extend protection to maximize consumer benefits and provide meaningful relief given limitations in the private market and to take into consideration the level of current capacity that state funds have or would have. In setting the trigger at some level, Congress should realize that there is a trade off, the higher the trigger the lower the consumer benefit. The proposals to set a trigger at a 1 to 50 year event seem reasonable, such as Senator Nelson's bill that was pending last session.

Milliman, Inc., the international actuarial consulting firm, analyzed the potential impact of a national catastrophe fund such as that included in H.R. 91 (currently pending in the 110th Congress) and concluded that reductions in homeowners' insurance premiums could exceed $11 billion a year. For the study, Milliman assumed a flat trigger of $10 billion. The savings estimate is based on the savings consumers can expect with state and national catastrophe funds that serve as a backstop to private insurance. Consumer savings are attributed to the fact that rates charged by the state and national funds will not require the significant margin for return on capital that investors expect to earn for a high-risk investment like catastrophe reinsurance. The tax-exempt status of the funds produces additional savings that will be passed on to consumers. Milliman also suggests the expense of administering the catastrophe fund will probably be less than the expense factor that reinsurance companies build into their rates.

It is important to note that the financial backstop model would augment private capital. Private capital, including private reinsurance capital, would continue to be important. This approach would provide additional capacity to protect consumers and much needed stability to the market. It would also provide the predictability and certainty that the market will survive major events and will continue to extend protection year after year.

Q.2. In your written testimony, you stated that a national catastrophe fund would "provide more protection at lower cost to consumers." Please explain how a national catastrophe fund would provide more protection at lower cost and whether such cost reduction would be financed through subsidies from other policyholders, direct federal appropriations, or tax-breaks financed by the taxpayer, or other funding mechanisms?

A.2. Critics of a national catastrophe fund allege that consumers in low-risk states will subsidize those who live in states threatened by earthquakes and hurricanes. The speciousness of this argument is apparent by virtue of the fact that the national catastrophe fund provides reinsurance only to state catastrophe funds. Consumers in states without catastrophe funds won't pay anything into the national catastrophe fund. This is consistent with the basic tenets of insurance and cognizant of the political reality that legislators from low-risk states will make sure their constituents are protected from paying more to subsidize those who live in high-risk states.

The legislation supported by ProtectingAmerica.org requires rates to be actuarially sound. This applies not only to the rates charged by the national catastrophe fund, but to the state catastrophe funds that are protected by the national fund. Both on a national basis, and within different regions of high-risk states, rates would be required by law to be based on actual risk. Hence, the argument that those who live on Florida's beaches or California's earthquake faults will get cheaper insurance at the expense of consumers in less perilous areas doesn't withstand scrutiny.

See also the answer to item 1 above. While there are many ways to structure a fund, the cost reductions would not have to be financed through subsidies from other policyholders, direct federal appropriations, or tax-breaks financed by the taxpayer, or other funding mechanisms. We have attached a report that shows American homeowners will save $11.6 billion annually if privately funded catastrophe protection programs are established in disaster-prone states and backed up by a similar national program, according to Milliman, Inc., one of the nation's leading actuarial and consulting firms. This report explains in detail how the savings would be generated.

More protection would be provided because coverage would be more widely available and consumers could afford more coverage. Insurers in a competitive market may also lower deductibles or take other steps to increase coverage knowing that the state and federal backstop is in place. Very importantly, as stated above, the public-private partnership model will provide additional capacity to protect consumers and much needed stability to the market. It would also provide the predictability and certainty that the market will survive major events and will continue to extend protection year after year.

Q.3. In your written testimony you stated that "we must also reduce the taxpayer subsidy of recovery efforts" and noted that "of the first $85 billion in taxpayer dollars spent on Katrina recovery efforts, more than $10 billion went to cover losses for uninsured and underinsured properties." Your statements suggest that a national catastrophe fund would provide funds to cover uninsured and underinsured persons. The national catastrophe fund you proposed in your testimony, however, would provide reinsurance only to state catastrophe funds to assist them in paying claims of policyholders in the event of a natural disaster. Accordingly, how would a national catastrophe fund, using actuarially sound rates as you proposed in your testimony, provide funds to uninsured and underinsured persons following a natural disaster? In addition, would you please identify the specific federal appropriations for the disaster recovery in connection with Hurricane Katrina that would have been unnecessary had a national catastrophe fund, as you proposed in your testimony, been established and functioning at the time Hurricane Katrina hit the Gulf Coast?

A.3. A national catastrophe fund would not provide funds to cover uninsured or underinsured persons. However, as the Milliman study concluded, a national catastrophe fund could help reduce the cost of insurance for consumers. The study estimates an average savings of $174.81 per household. These savings increase in more catastrophe-prone areas—up to $538.92 per household in Florida. We believe that these savings would reduce the number of persons who would otherwise be uninsured or underinsured.

In addition, our plan addresses stronger building codes and improving mitigation efforts. Living on known faults without earthquake insurance, building in a flood plain without flood insurance, allowing brush to grow unchecked in areas prone to wildfire and building homes in coastal areas that cannot withstand hurricane force winds are irresponsible actions, which should not be subsidized by tapayers when the inevitable occurs.

Stronger building codes, which are vigorously enforced, and sensible land use policies are needed to reduce the impact of catastrophes on consumers and taxpayers. Successful mitigation efforts can have dramatic impact on reducing damages caused by these storms. One study estimated the damage from Hurricane Andrew would have been $8.1 billion less if the building code now in Miami-Dade had been in effect in 1992. Further, Louisiana State University noted:

> Economic losses, which include damage to buildings and contents, would be reduced an estimated 68%, from $4.8 billion to $1.5 billion. The loss reduction estimate does not include such additional benefits as reduction in loss of life, human suffering, reduced disruption of communities and local economies, reduced emergency response costs, reduced post-storm sheltering and housing costs and other very significant but difficult to quantify losses.[4]

Prior to Hurricane Katrina, had cost savings measures, better land use policies and mitigation incentives been in place, we believe that there would have been fewer uninsured and underinsured persons and less property damage. While we are not familiar with every post-Katrina federal appropriation, it is our understanding that H.R. 2863 provided $11.5 billion to pay for uninsured and underinsured losses incurred as a result of Hurricanes Katrina and Rita through HUD's Community Development Block Grant Program, If the comprehensive plan we propose was in place prior to Katrina, we believe that the need for such a large appropriation would have been reduced.

The comprehensive, integrated solution we support would also include better consumer and public education to make sure consumers are aware of the steps they can and must take to protect themselves. The financial backstop model can help finance and facilitate those initiatives. Moreover, policy makers should examine the system of mandates that apply in some areas but not in others. For example requirements that apply to flood coverage do not seem to be uniformly enforced. Moreover, it seems incongruous to apply such requirements to flood but not for earthquake exposure. ProtectingAmerica.org is not proposing more mandates, but the issue in this regard should be reviewed and better understood by policy makers. We would be happy to assist in that process.

[4] Louisiana State University Hurricane Center Residential Wind Damage in Mississippi: Potential Hurricane Loss Reduction Through Improved Building Codes and Construction Practices (December, 2005).

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REPORT ON THE IMPACTS ON CONSUMERS FROM POTENTIAL STATE & NATIONAL LEGISLATION DESIGNED TO PREPARE AND PROTECT CITIZENS FROM NATURAL CATASTROPHES

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REPORT ON THE IMPACT ON CONSUMERS FROM POTENTIAL STATE & NATIONAL LEGISLATION DESIGNED TO PREPARE AND PROTECT CITIZENS FROM NATURAL CATASTROPHES

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REPORT ON THE IMPACT ON CONSUMERS FROM POTENTIAL STATE & NATIONAL LEGISLATION DESIGNED TO PREPARE AND PROTECT CITIZENS FROM NATURAL CATASTROPHES

INTRODUCTION

ProtectingAmerica.org advocates for a comprehensive, integrated approach to the complex issues involved in dealing with natural catastrophes. This approach, which is based on a stronger public-private partnership at the local, state and national levels, will better prepare and protect America from the consequences of natural catastrophes. Federal and state legislation is recommended to accomplish this goal. H.R. 91 captioned the "Homeowners Insurance Protection Act of 2007," introduced in the U.S. House of Representatives in January, 2007, is one example of this type of Federal legislation. Legislation has been introduced in several states that is based upon a model bill adopted by the National Conference of Insurance Legislators. Milliman, Inc. was retained by ProtectingAmerica.org to provide actuarial and economic analysis of this type of legislation.

SCOPE OF REPORT

Background

Insurance that provides dwelling and contents coverage in catastrophe prone geographic areas is subject to enormous risk. Since "mega-catastrophic" events are characterized by very low frequency and extremely large potential severity, insurance that provides coverage for such events is subject to large potential variation in underwriting results from year to year. In order to have sufficient resources to respond to these exposures, insurance and reinsurance companies must hold extremely large amounts of capital. Because it is exposed to substantial risk, the costs associated with providing this capital are significant. Indeed, shortages of capital and a declining appetite for bearing catastrophic risk, have led to a lack of availability of homeowner insurance by private market insurers in catastrophe prone areas.[1]

Major Features of Legislation

Milliman has been asked to identify and quantify any potential impacts on consumers resulting from possible state and national legislation protecting citizens from natural catastrophes. Legislation enacting a national backstop for natural catastrophes would include provisions in three areas that would impact the price consumers pay for property insurance coverage.

First, state or regional catastrophe funds could be established to add capacity for homeowner insurance coverage against large catastrophic events. The Florida Hurricane Catastrophe Fund

[1] It is well known that when insured exposures are highly correlated, it is considerably more difficult for traditional insurance mechanisms to efficiently provide coverage Indeed, some have argued that for events with extreme severity and relatively low frequency, such as major hurricanes or earthquakes, the private sector cannot effectively provide adequate insurance coverage Mr Robert E Litan asserted in the Brookings Institution, Policy Brief #150, Preparing for Future Katrinas, "Portions of the Gulf Coast and East Coast are now seeing evidence of insurance market failure in the wake of the 2004 and 2005 hurricane seasons"

("FHCF") and the California Earthquake Authority ("CEA") are examples of existing state catastrophe funds.

Second, a national backstop mechanism could be created that provides additional capacity for higher layers of loss, improves liquidity and addresses timing risk. (These are all issues that have been identified by Robert E. Litan of the Brookings Institution).[2] The national backstop would be coordinated with the state or regional catastrophe funds.

Third, various provisions designed to further prepare and protect consumers and to prevent or reduce the potential property damage from large catastrophic events could be funded through state, regional or national mechanisms. Examples of these other provisions include mandates and resources:

- To improve preparedness;
- To strengthen first responders;
- To educate consumers about catastrophe preparedness;
- To facilitate research, development and implementation of mitigation and prevention initiatives;
- To assist in recovery and rebuilding from natural catastrophes;
- To provide a more rigorous and integrated oversight, coordination and continuous improvement process; and
- To better assist in the financial recovery from natural catastrophes.

[2] The Brookings Institution, Policy Brief # 150, Preparing for Future "Katrinas", March 2006, www.brookings.edu.

Milliman's Role

The focus of Milliman's actuarial and economic analysis is on the provisions of the proposed legislation relating to the state/regional catastrophe funds and the national backstop. Of course, there are many possible ways to structure the coverage, funding and capacity of the state and national catastrophe funds. For purposes of this analysis, we have assumed specific structures for a state catastrophe fund mechanism (based on a structure similar to the FHCF), and a national backstop mechanism (based on a structure similar to the one contained in HR 91). Some possible variations in the design of these funds will also be discussed later in this report.

Our report will also analyze and discuss the indirect savings to consumers resulting from the other provisions of the legislation listed above.

EXECUTIVE SUMMARY

Milliman was engaged by ProtectingAmerica.org to identify, evaluate and provide an independent analysis of the cost impacts on consumers resulting from the enactment of proposed state and national legislation to protect citizens from natural catastrophes.

This work is intended to help policymakers and the public understand some of the complex issues involved with catastrophe management. In particular, this report is intended to help policymakers and consumers better understand how a stronger public-private partnership with a financial backstop can provide more protection at lower cost for consumers (as we have demonstrated through our analysis). It is important to emphasize at the outset that our analysis confirms that the financial backstop would not replace, but would supplement, the private insurance and reinsurance markets. The approach would generate substantial additional capacity, provide more stability and certainty, and generate significant savings for consumers.

If a national backstop mechanism is enacted and a state catastrophe fund is created in every state included in our analysis, the aggregate direct reductions consumers can realize in their homeowners premiums would exceed $11 billion annually.[3]

Homeowner insurance premiums contain provisions to cover losses to buildings and contents resulting from natural disasters. However, because of the potential for highly correlated losses due to natural catastrophes, insurers must hold large amounts of capital to support their promise to pay claims. Of course, insurance premiums include the costs of exposing these large amounts

[3] This estimate of consumer savings is based on the specific assumptions and calculations documented in this report. Other assumptions regarding the structure and operations of these new mechanisms would produce different estimated savings.

of capital to catastrophic events, as well as the costs of purchasing reinsurance from private reinsurers for layers of catastrophe coverage.

The legislation we have evaluated essentially supplements, at the higher levels, the reinsurance protection related to catastrophic natural disasters through public sector, non-profit mechanisms. The public sector mechanisms charge an actuarially estimated loss cost plus a modest expense load for the layer of coverage, but do not charge for the risk of exposing capital to catastrophic events. For our analysis, we have defined a structure where each state has a state catastrophe fund with a national backstop mechanism which together provides coverage up to each state's 1 in 250 year event. Under this structure, our analysis indicates potential annual reductions in homeowners' premiums of over $11 billion.[4]

Other state catastrophe fund and national backstop structures are also possible. The related consumer savings will move up or down depending on the structural changes, but under virtually any structure that provides meaningful coverage, the potential saving will remain significant.[5]

Either state catastrophe fund or national backstop legislation can authorize funds from the public sector mechanism be used in efforts to further prepare and protect citizens from natural

[4] "Accordingly, the federal program can charge risk loads that are well below those in the private sector, with the savings passed on to consumers, making catastrophe coverage more affordable and ensuring its availability." See Robert E. Litan, Brookings Institution Policy Brief #150, Preparing for Future Katrinas.
[5] For example, one of our assumptions is that the national backstop coverage limit is a 1 in 250 year event. Raising the national backstop coverage limit to a 1 in 500 year event would increase the overall consumer savings estimates significantly.

catastrophes. We have discussed the general effects of these efforts in the Indirect Savings of Legislation section of this report. Mitigation or retrofitting efforts will produce additional saving to consumers in the form of lower homeowners' insurance premiums by decreasing the underlying loss costs. Strengthening and enforcing building codes and improving land use policies and practices can also have a measurable effect on decreasing the underlying loss costs associated with insuring against losses from natural catastrophes.[6]

[6] AIR Worldwide Corporation ("AIR") has studied the effectiveness of building codes designed for hurricane prone areas and concluded that the estimated impact on losses from applying building codes to all buildings in hurricane prone areas is an approximate 30% reduction in average annual loss.

STRUCTURE OF A STATE CATASTROPHE FUND AND NATIONAL BACKSTOP MECHANISM

To estimate consumer cost savings, we have made certain assumptions about how the state catastrophe fund/national backstop mechanism might be structured. These assumptions are based on some of the concepts contained in HR 91 and the current structure of the FHCF. In this section we address the major issues that arise in designing such mechanisms, discuss some variations in the potential structure of the state and national catastrophe funds, and document the structure that was used in our cost savings analysis.

Perils

The catastrophe fund mechanism can be designed to cover some, or all, naturally occurring perils as defined in the legislation. We have focused on the perils of hurricane and earthquake because these are the perils that will result in the most severe insured losses. In our analysis, we have assumed that the catastrophe funds would provide layers of catastrophe coverage for specific events. The specific events covered would be named storms designated as hurricanes and all earthquakes.

Covered Dwellings

The catastrophe fund mechanism can be structured to cover all residential and commercial buildings, or some subset of these buildings. Residential dwellings would include private homes, multi-family homes, and mobile homes. Commercial residential buildings would include rental units and large condominium buildings. Commercial buildings would include all structures used for commercial purposes, such as retail outlets, office buildings and governmental buildings (e.g., schools and municipalities).

Homeowner policies generally cover damage to the building, damage to contents and additional living expenses when the dwelling is not habitable after an event. Commercial policies generally cover damage to the building, damage to contents and inventories, and business interruption. The types of buildings and types of losses that would qualify for coverage under the state or national catastrophe fund would be defined in legislation.

In our analysis, we have assumed that the state and national catastrophe funds would cover insured losses to the building, contents and additional living expenses. We have further assumed that these catastrophe funds would cover policies for homeowners, renters, condominium owners and mobile homeowners.

Participation Level

Currently the FHCF has participation percentage options of 45%, 75% and 90% which primary insurers can choose at their own discretion. Under the 90% participation option, for example, the state catastrophe fund would reimburse the primary insurer for 90% of the covered losses in the covered layer. Currently, the vast majority of Florida primary insurers elect the 90% participation option.[7] In our analysis we assumed a 90% participation level in the state funds and a 100% participation level in the national backstop.

[7] This is not surprising in light of the fact that the FHCF provides reinsurance at significantly lower cost compared to private reinsurance.

Funding

The state and national catastrophe funds' primary source of revenue would be charges to primary insurers related to the reinsurance coverage being offered. Using one or more catastrophe models, the actuarially indicated pure premium or loss cost for the coverage layer can be calculated. Another potential source of revenue for the catastrophe funds is an allocation from general revenues of the government entity. A third source of revenue is the investment income earned on the cash balances held by the catastrophe funds. Other sources of revenue such as extra sales tax revenue due to rebuilding after a catastrophic event, a real estate transaction tax, etc. could be included in potential state catastrophe fund legislation. In addition, if there is perceived to be a need for an initial cash infusion, a provision for a rapid cash build up could be included in the legislation, as was the case in the Florida legislation regarding the FHCF. This additional revenue could be obtained by initially charging primary insurers more than the actuarially indicated loss and expense costs for the catastrophe coverage. Primary insurers could be charged 110%, 125% or even 150% of the indicated cost.

The funding of a catastrophe fund must also contemplate the expenses of administering the fund and any legislative provisions allocating funds for mitigation or other catastrophe preparation efforts.

An actuarially estimated charge to primary insurers for the catastrophe coverage, the expenses of running the fund and the costs of any mitigation or catastrophe preparation efforts would, in the long run, generate enough revenue for the fund to achieve a break-even operating result. In particular, over a long period of time, the investment income in years when the fund has a positive balance will be offset by interest paid on bonds when the fund is in a deficit position.[8] However, significant potential annual variation in covered losses creates some probability that the fund, especially in the initial years of operation, may not have adequate resources to pay all covered losses. This eventuality can be covered by the ability of the fund to issue bonds which would ultimately be retired through future charges to primary insureds and/or emergency assessment provisions. The emergency assessment provision can be structured in the legislation to apply similar to a premium tax for the property lines of business as well as other lines of business.

In our analysis, we have assumed that the primary insurer will be charged the actuarially indicated loss cost generated from the AIR model plus a provision to cover the administrative expenses of the fund.[9] The administrative expenses of the FHCF have been slightly less than 1% of premiums, or approximately $5 million annually. However, the annual premiums for catastrophe funds in other states will be substantially less than in Florida; hence, the administrative expenses will likely be a slightly higher percentage of premiums than in Florida.[10] In our analysis, we have assumed that the expenses necessary to cover the administrative expenses of a state fund will be the greater of $3 million or 1% of premium. The

[8] This conclusion depends on several conditions including the assumptions of perfect capital markets (i.e., the fund has the ability to borrow and lend unlimited amounts at a constant rate) and complete participation by all entities in all years.
[9] AIR Worldwide Corporation ("AIR") is one of the world's largest providers of catastrophe modeling services to insurers, reinsurers and others.
[10] The larger is the premium base, the greater the volume of business over which to spread the fixed costs of administration. If premium volume is substantially lower than in Florida, it is probable that the total administrative costs will exceed 1% of premium but would still likely remain small.

provision to cover administrative expenses of the national fund has been assumed to be 1% of premiums, although it could be less, especially over time.

We have further assumed that the cost for mitigation programs and catastrophe preparation would be covered by investment income earned by the catastrophe funds and any other investment income earned would remain in the fund to cover losses. In the FHCF, premiums are increased by 5% to cover loss adjustment expenses and loss payments by the fund are increased by 5% to cover the expense of adjusting covered claims. For simplicity, we have not included a loss adjustment expense provision in our calculations.

While the assumptions above form the foundation of our analysis in this report, many other funding variations are possible. Additional calculations can be made for specific legislative provisions for variations in funding, bonding and expenses of a catastrophe fund.

Layers of Coverage

For simplicity, we have assumed that the state and national catastrophe funds will provide catastrophe reinsurance to primary insurers only. In actual practice, each primary insurer will have a different layer of catastrophe reinsurance based on its exposure in a state. However, rather than attempting to model every primary insurer individually, our model assumes that there is a single primary insurer in each state. As to the coverage provided, the actual layer of catastrophe losses covered by a state's fund will be defined by legislation, with many possible industry-wide attachment points and limits. To make our analysis tractable, we have assumed what we believe is a reasonable layer of coverage for each state in the study. In addition, we have assumed that the national backstop mechanism would provide coverage from the state catastrophe fund limit or capacity up to a predetermined limit.

We have constructed a simple example to illustrate the layers of coverage for a catastrophic event under a state catastrophe fund and national backstop model. The charts contained in Attachment A are based on a hypothetical State x, where the state fund provides coverage from \$5 billion to \$10 billion at a 90% participation level and the national backstop facility provides coverage from \$10 billion to \$50 billion. Page 1 of Attachment A displays the layers of coverage provide by the primary insurer, the state cat fund and the national backstop. We assumed that a catastrophic event occurs in State x producing covered losses of \$15 billion. Page 2 of Attachment A displays the amount of loss covered by each of these entities.

The layers of loss exposure covered by each state catastrophe fund used in our analysis are displayed in Attachment B. The national backstop attachment point is the limit of the state fund coverage. The limit of the national backstop coverage is the 1 in 250 year aggregate loss. The national catastrophe fund attachment points and limits used in the analysis for each state are also listed in Attachment B.

To place these assumptions in context, consider the experience of the FHCF during its brief history. The FHCF coverage layer has varied over its existence, for many reasons. Throughout its history the fund has provided a layer of coverage close to the layer of a 1 in 10 year event to a 1 in 50 year event. Based on the latest AIR model, the layer of coverage in Florida from the 1 in 10 year event to the 1 in 50 year event is approximately from \$5.8 billion to \$27.8 billion.

We have analyzed the 1 in 10 year to 1 in 50 year event layers in other states, and have concluded that in many states the catastrophe fund would start providing coverage at fairly low levels. For example, in Louisiana, the 1 in 10 year event is a catastrophe producing $523 million of covered industry losses. For an individual insurer with a 10% market share, reinsurance coverage from the state catastrophe fund would begin at a loss of about $52 million. This is a much lower attachment point than most primary insurers would use for their own private reinsurance coverage. As a result, for our analysis, we have chosen a minimum of $2 billion for the attachment point of any state catastrophe fund.[11]

HR 91 defines the limit of the national backstop to be the 1 in 500 year event, with an overall limit across all states and regions of $200 billion. Companies that purchase reinsurance generally buy layers of coverage somewhat lower than the 1 in 500 year event. For example, it is not unusual for a company to purchase catastrophe reinsurance up to the 1 in 250 year event. For our analysis we have chosen to limit the national backstop coverage at the 1 in 250 year event. Consumer savings for a higher national backstop coverage limit will be greater than those quantified in our analysis.

HR 91 contains provisions to lower the attachment point of the national backstop layer in various situations including the start up of a new state catastrophe fund and a decrease in the capacity of a state fund due to a covered event. We have assumed the national backstop layer over each state catastrophe fund will be established annually so that no gap in coverage will exist between the state fund and the 1 in 250 year event.

[11] Lower attachment points are certainly possible, and further analysis can be done to quantify consumer cost savings for other layers of coverage. Our preliminary assessment suggests that these savings would be significant.

In addition, the national backstop coverage in HR 91 is designed to cover the aggregate losses from multiple events in the same year. A state catastrophe fund can also be structured to cover multiple events in the same year or, as was the case with the FHCF, have an aggregate limit subject to separate retentions for each event. Other variations are also possible. According to HR 91, the national backstop layer would begin when coverage for the state catastrophe fund reaches its capacity (either from a single event or from multiple events). Thus, for each event, aggregate losses will all be covered by either the state or national funds. For simplicity of the calculations, our analysis is based on aggregate annual losses, as opposed to occurrence or event losses. Our model applies the state catastrophe fund limits and the national backstop limits based on annual losses for all covered events combined.[12]

The national backstop coverage in HR 91 is designed to attach at the capacity of each state catastrophe fund. During the initial years of a state catastrophe fund and after an event consumes the capacity of a state fund, the national backstop is designed to attach at a lower layer of coverage. When a state catastrophe fund has reduced capacity, the layers used in our calculations will overstate the savings arising from the state catastrophe fund and understate the savings arising from the national backstop. In our analysis, we have intended to capture the long term split between state and national funds contemplated by HR 91. In short term situations where the capacity of a state fund is reduced, some of the cost savings is shifted from the state fund to the national backstop, however the total cost savings is not affected.

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[12] If a state catastrophe fund offers reinsurance under a structure other than aggregate annual losses, our cost savings calculations may somewhat overstate the actual savings due to the state catastrophe fund.

CONSUMER COST SAVINGS CALCULATIONS

Overview

Our analysis includes states where the 1 in 250 year event from a hurricane or earthquake is measurably greater than $2 billion. For each state, we have selected the layer of coverage for the state catastrophe fund and for the national backstop mechanism as displayed in Attachment B. In the state catastrophe fund analysis, we have estimated the cost the primary insurer would pay for reinsurance provided by the state catastrophe fund. We have also estimated the cost of this coverage if primary insurers purchased this reinsurance from reinsurers. The difference is the estimate of statewide premium savings resulting from implementation of a state catastrophe fund with the structure discussed in this report.

The national catastrophe fund analysis was performed in a similar manner. The cost of reinsurance paid by primary insurers for the national backstop layer of coverage was estimated based on the AIR model results. We also estimated the cost of this layer of coverage if purchased from reinsurers. The difference is the estimate of premium savings resulting from implementation of a national backstop catastrophe fund.

The savings to consumers arises from the fact that the state and national catastrophe funds are assumed to set prices as the sum of the actuarially indicated pure premium plus a very modest expense loading. This cost is then compared to the cost of private reinsurance, which is comprised of the actuarial pure premium, a substantially higher expense load, plus, most notably, a significant risk margin applied to losses. This risk margin is the provision in the premium that provides for a return on the capital required to support the catastrophe exposure. Because the amounts of required capital are extremely large, and the required return is high (given the risk of the exposure), the indicated risk margin or underwriting profit factor in reinsurance prices is quite high. Since the state and national catastrophe funds are assumed to impose no charge for this risk, the resulting premium will be substantially lower, generating significant savings for consumers.[13]

Loss Cost Data from AIR Worldwide Corporation ("AIR")

AIR provided an analysis of potential industry-wide losses by state for the hurricane and earthquake perils. The AIR output provides aggregate annual losses as if all residential insurance policies were written by a single primary insurance company. Included in the output from AIR were the average annual aggregate losses for various layers of coverage in each state. The average annual aggregate losses were used in our analysis. The industry residential exposure database used by AIR represents amount of insurance values as of December 31, 2005.[14] The aggregate annual losses from catastrophic events will increase each year due to population growth and inflationary impacts on the replacement cost of dwellings and contents. We have not made any adjustments in our analysis for the impact of these factors. However, both the pure premium in the state catastrophe fund layer and the cost of reinsurance for the same layer will be impacted by population growth and inflation. Therefore, the impact of these factors on our analysis will be a modest understatement of consumer savings.

[13] Another factor that gives rise to savings from a public-sector reinsurance mechanism is the fact that such funds are assumed to be tax exempt. Private sector reinsurers must charge a price that provides for a fair and reasonable after-tax return on capital, which increases the required risk margin, and ultimately the price of reinsurance, relative to a tax exempt alternative.

[14] For the earthquake peril, the client has asked us to quantify the potential savings due to the legislation assuming all consumers in earthquake prone areas purchase the coverage. Not all consumers in these areas purchase earthquake coverage today. Our quantification of savings for the earthquake peril includes current savings for consumers purchasing the coverage and potential saving for consumers deciding to purchase the coverage in the future.

Appendix I provides some background on the construction and output of catastrophe models.

Rates on Line for Catastrophe Reinsurance Coverage

The premium charged for reinsurance coverage is generally quoted using a concept known as "rate on line" ("ROL"). For example if the layer of coverage provided is $5 billion in excess of $2 billion, the primary insurer would retain the first $2 billion of losses and the reinsurer would cover the next $5 billion of insured losses up to a total of $7 billion. If the ROL for this coverage was 10%, then the reinsurance premium would be the layer of coverage ($5 billion) times the ROL (10%), or $500 million.

We obtained current and historical ROLs for catastrophe reinsurance from several different sources. The ROLs vary depending on the expected value of losses in the covered layer and the probability of having a loss in the covered layer. Generally, as the probability of loss increases, the ROL will also increase. The ROL for catastrophe reinsurance also varies by state because the expected value of losses in a covered layer varies by state.

Benfield provided current ROLs for each state for various layers of coverage based on their knowledge of the reinsurance market. Benfield also provided ROLs for comparison from 2003. Other publicly available ROL data was obtained from reports published by Guy Carpenter and Lane Financial, LLC. All of our data sources indicate that ROLs available in the private insurance market increased significantly between 2003 and early 2007. In our analysis, our calculations of the impact of introducing state catastrophe funds and a national backstop are intended to reflect a long-term average. In order to approximate the long term average ROLs, we selected ROLs for each state between the 2003 and current values provided by Benfield.

The Guy Carpenter data can be found in their September 2006 report titled, "The World Catastrophe Reinsurance Market: Steep Peaks Overshadow Plateaus." Within this report, catastrophe reinsurance ROLs are compared to the likelihood of a covered loss. The Lane Financial data can be found in their April 2006 report titled, "How High Is Up? The 2006 Review of the Insurance Securitization Market." This report contains catastrophe bond yields for securities issued by several different corporations.

All three data sources (Benfield, Guy Carpenter, and Lane Financial) contain information that allows us to evaluate the ROLs for different layers of coverage, the probability of incurring a loss in that layer, and the type of loss being covered. Benfield's data was the most detailed, providing ROLs separately for individual states and for numerous layers of coverage within each state. The data from Guy Carpenter was extracted from a chart that plotted the 2005 and 2006 ROLs for U.S. catastrophes against the likelihood of loss. In evaluating the data from Lane Financial, we selected the ten catastrophe bonds issued after Hurricane Katrina that cover losses caused by U.S. earthquakes or windstorms, including hurricanes.

A catastrophe bond (cat bond) securitizes a layer of loss when an investor provides an amount of capital equal to the entire layer that is being covered. The funds are deposited into an account that yields the risk free rate (LIBOR). The return the investor receives is LIBOR plus a risk premium; however, the investor is subject to loss if a covered catastrophic event occurs during the term of the security. The expected "profit" on this investment is the difference between the risk premium and the expected value of loss in the layer being covered. The details of the ten securities we evaluated are listed in a table found in Attachment F, including the expected annual loss and risk premium above LIBOR, as discussed above. In order to compare cat bonds to the data from Benfield and Guy Carpenter, we used the Probability of First Dollar Loss and a Rate on Line equivalent to an adjusted Risk Premium above LIBOR (adjusted from a 360-day rate, which is typical for LIBOR, to a 365-day rate). These two statistics are comparable to the probability of loss and ROL found in catastrophe reinsurance contracts, respectively.

The ROLs from Benfield, Guy Carpenter, and Lane Financial are summarized in the chart included as Attachment G. For simplicity and clarity, we chose to include Benfield data from a single sample state (Louisiana) rather than data for each state in this chart. The ROLs from all three sources of data consistently increase as the probability of loss increases. The Louisiana ROLs provided by Benfield are lower than the ROLs from the other sources. The variation in the ROLs at various probabilities of loss among the three sources of data can be attributed to such things as differences in the types and locations of risks being covered, differences in when the ROLs were issued, and differences in the duration of the coverage.

The ROL data provided by Benfield was the most detailed of the three sources. Since the ROLs provided were state specific, Benfield was able to identify the potential peril in each state. For most of the Gulf and East Coast states, the coverage was specific to hurricanes; for states like California, Washington, and Oregon, the coverage was specific to earthquake; and for a state like South Carolina, the reinsurance coverage underlying the ROL reflected both hurricane and earthquake perils.

Not surprisingly, the ROLs at various probabilities of loss vary by state and peril. ROLs provided by Benfield from six states are included in a chart labeled Attachment H. This chart includes states with both the hurricane and earthquake perils and includes the range of ROLs by state.

The Lane Financial data used in our analysis is contained in Attachment F. In most cases the cat bonds cover multiple perils and apply in multiple states. In contrast to this, the Guy Carpenter data was a more global perspective of all U.S. property catastrophes.

Another difference in the three data sources that contributes to the variation in the ROLs is the timing of the coverage. Benfield provided ROLs from both 2003 and late in 2006, the data from Guy Carpenter included information from 2005 and 2006, and the cat bonds from Lane Financial included securities issued from 2002 to February, 2006. All three sources of data showed significant increases in the market ROLs after Hurricane Katrina in August of 2005. As previously discussed, to better reflect a long-term average ROL, we selected a ROL for each state between Benfield's current and 2003 ROLs.

After considering the expected differences in ROLs discussed above we believe the Lane Financial and Guy Carpenter data corroborates the selected ROLs used in our analysis. These other sources indicate that our selections are conservative on the low size.

Typically, private catastrophe reinsurance is purchased to cover the first event, and a reinstatement limit is offered at additional premium if any of the first event coverage is used. In our model, we selected ROLs that contemplate coverage for aggregate annual losses from covered events to be consistent with the coverage contemplated by HR 91. The cost of private catastrophe reinsurance for aggregate annual coverage could be estimated by first estimating the cost of the first event cover and then estimating probabilities of the need to purchase second event covers. Instead, we have chosen to estimate aggregate annual coverage directly by contemplation of the higher expect loss value (aggregate vs. single event) in our selection of ROLs for the layers covered by the state catastrophe funds and national backstop.

State Fund Analysis (Attachment C)

Our analysis of consumers' savings from state catastrophe funds is included in Attachment C. The calculations are based on the attachment point and state catastrophe fund limit from Attachment B. The ROL for the layer of coverage offered by each state catastrophe fund was selected based on data provided by Benfield and other publicly available information discussed above. In the state fund analysis, we have assumed that the fund will only offer coverage for 90% of the layer. The estimated cost of reinsurance is calculated by taking 90% of the product of the ROL and the amount of coverage. The pure premium for the layer of coverage offered by the state catastrophe fund obtained from AIR analysis is shown next. The estimated cost of state catastrophe reinsurance is calculated from the pure premium, adding a provision for administrative expenses the state catastrophe fund, and assuming a 90% participation level. The difference between the premiums for private reinsurance coverage and the premiums for the state catastrophe fund coverage is the statewide savings realized by consumers.

A version of a state catastrophe fund already exists in both Florida and California. These states were included in Attachment C for illustrative purposes. The last row on Attachment C shows the total for all states excluding Florida and California, which reflects the potential savings for consumers purchasing homeowner insurance, if a state catastrophe fund is implemented in the remaining states included in the analysis. Additional consumer savings are possible in Florida and California from a national backstop mechanism.

National Backstop Analysis (Attachment D)

Our analysis of consumers' savings from the national backstop is similar to the state fund analysis and is included in Attachment D. The participation level is assumed to be 100%, instead of the 90% used in the state fund analysis. Otherwise all other calculations are identical.

Total Savings (Attachment E)

The estimated consumer savings by state for both the state and national funds is included in Attachment E. In addition, we have estimated the number of residential dwellings in each state from census data. The total savings is divided by the number of dwellings to calculate an average savings per consumer in each state.

OTHER STATES AND CATASTROPHE FUND STRUCTURES

As discussed earlier in this report many variations of catastrophe fund structures are possible. The attachment point of a state fund would be established by legislation. Several states were not included in our original analysis because the projected 1 in 250 year event was less than $2 billion. This was done for convenience and simplicity of the analysis and is not intended to imply that states with smaller amounts of potential loss from natural catastrophe cannot establish a state catastrophe fund and benefit from a national backstop mechanism.

We have included an example of how a state catastrophe fund with a national backstop mechanism could be structured for the state of Rhode Island, one of the states excluded from our analysis because the 1 in 250 year event was less than $2 billion. The attachment points and limits were selected based on the potential state losses from hurricanes. In our example, the state catastrophe fund would cover industry losses between $321 million and $686 million. The national backstop would provide coverage for industry losses from $686 million to $1.96 billion. The potential consumer cost savings was derived in the same manner as for other states included in our analysis and is shown on Attachment I.

We assumed that the Rhode Island fund would attach at a much lower probability of occurrence (2%) and the upper limit of the national backstop would be extended to the 1 in 500 year event. This fund would operate the same as state funds illustrated in our original analysis, but would have the advantage that a major event in the initial years of the fund would be less likely in Rhode Island than in other states.

A similar state fund/national backstop structure could be used in Pennsylvania, Maryland, Delaware, New Hampshire, Maine, Missouri, Arkansas, Tennessee and Kentucky.

HOW DOES A CONSUMER SAVE?

The premiums charged by the primary insurers should be lower if catastrophe coverage is available from a state fund and a national backstop as opposed to retaining the risk or purchasing private reinsurance. Primary insurers file rates with state regulatory agencies in each state. Although the methodology used varies by company, rate filings follow the ratemaking principles established by the Casualty Actuarial Society ("CAS") -- most importantly, the principle that the rate include all costs associated with the transfer of risk. In the case where a primary insurer purchases reinsurance, the cost of reinsurance in excess of the pure premium is built into ratemaking methodology. Also, a relatively small number of companies do not buy catastrophe reinsurance; however, in such cases these companies retain the risk of exposing their surplus to catastrophic events and this additional risk is generally built into their rates. The risk of providing homeowner insurance in catastrophe prone areas is the same whether it is reinsured or retained by the primary insurer. The reinsurers include a provision in the reinsurance premiums to cover the risk of exposing their capital to large catastrophic events. In our analysis, we assumed that the risk margin included by reinsurers in their reinsurance premiums is an estimate of the additional risk retained by the primary insurers that do not buy catastrophe reinsurance for the layers included in our analysis.

We have reviewed recent rate filings made by primary insurers in catastrophe prone states. Although the exact methodology varies by company, almost all filings include provisions for the additional risk associated with large catastrophic events in the higher layers of coverage. Using the risk load inherent in reinsurance premiums is a reasonable proxy for the cost that will be paid by consumers in their homeowners premiums in the long term.

When legislation creating a state catastrophe fund or the national backstop is enacted, primary insurers could be required to make rate filings to reflect the changes to their expected costs. The costs of the reinsurance premiums and additional risk associated with catastrophe events are replaced by the reinsurance premiums charged by the state fund and national backstop. Our analysis calculates the difference in these costs on a statewide basis, and this represents an estimate of the aggregate statewide long term premium difference for consumers when a state catastrophe fund and national backstop mechanism is implemented in a state. Ratemaking methodologies usually account for variable expenses (such as premium tax and commissions) by applying a multiplicative factor to the loss and non-variable expense provisions. Consumers will potentially realize more reduction in their premiums than contemplated in our calculations since variable expenses will be reduced in the same proportion as the decrease in the cost of reinsurance and risk charge for the layers reinsured by the catastrophe funds.

The pure premiums associated with catastrophes vary significantly by geographic location of the dwelling. Insurance rates also vary by geographic location based on the methodology used by the primary insurers in the ratemaking process. Ultimate premium savings will therefore vary for individual consumers in proportion to the underlying costs of catastrophe coverage included in their current premiums. We have provided estimated average premium savings per consumer on a statewide basis in this report. We have not attempted to estimate the cost savings in a finer geographic breakdown because of the complexity of such calculations. On average, consumers that live in coastal counties should realize the largest savings, while consumers that live in inland counties should realize less savings.

CONCLUSIONS OF DIRECT SAVINGS

A summary of the potential consumer savings resulting from creation of a state catastrophe fund with a national backstop mechanism is included in Attachment E. If a national backstop mechanism is enacted and a state catastrophe fund is created in all the states included in our analysis, the aggregate reductions consumers can realize in their homeowners premiums would be in excess of $11 billion. The estimated savings amounts do vary by state in proportion to the underlying average loss costs for the natural disaster perils. The largest impact would be the creation of a national backstop mechanism for Florida and California.

OTHER POTENTIAL CONSUMER COSTS

It is true that the cost of replacing buildings and contents damaged in a natural catastrophe event does not change as a result of simply enacting legislation described in this report. Under this type of legislation, a layer of the losses from large events are covered by the state catastrophe funds and the national backstop mechanism instead of by the surplus of direct insurers and private reinsurers. The risk under a state catastrophe fund and national backstop structure is the potential for a large event to occur early in operation of the new mechanisms, when there are not enough accumulated funds to pay for covered losses.

Currently, the FHCF legislation covers this risk by allowing the fund to issue bonds. The bonds are backed by future assessments on Florida insurance policyholders for most property/casualty insurance policies. The Florida law limits the annual assessment to 10%. The surcharge mechanism is what enables the fund to secure financing through bond issuance.

As mentioned previously, theoretically in the long run, you would not need to surcharge other policyholders[15]. However, the long term is over thousands of years and there is a probability that a large natural disaster in the early years of the legislative structure will occur and will need to be funded. There are options on how to structure the funding mechanism of the state catastrophe funds. The probability that a state catastrophe fund will not have enough funds to pay losses in a covered layer can be reduced by state contributions to the fund, by including a

[15] In the long run, the investment income in years when the fund has a positive balance will be offset by interest paid on bonds when the fund is in a deficit position. This conclusion depends on several conditions including the assumptions of perfect capital markets (i.e., entities can borrow and lend at the same interest rate) and complete participation by all entities in all years.

rapid cash build up factor in the state catastrophe premium, and by effectively using appropriations for mitigation to reduce the damage to buildings from future natural disasters.

The national backstop can be structured to provide financing to state catastrophe funds, and eliminate or reduce the need for bonding and assessments by the state catastrophe fund. If the national backstop were functioning in all the states included in our analysis, the probability of the national backstop operating in a deficit position would be reduced because of the pooling across all states of the higher layer of coverage. An event would be funded by national backstop funds collected from all states, and paid back over time. In the long run the consumers who benefit from the coverage would pay the costs of the coverage, but the costs of the coverage would be lower than if insurers purchased catastrophe coverage from the private reinsurance market.[16]

[16] Milliman is available to work with ProtectingAmerica.org to assist policymakers in quantifying and understanding any potential structural options for state catastrophe funds or the national backstop mechanism.

INDIRECT SAVINGS OF LEGISLATION

As noted earlier, an important component of the proposed legislation is the allocation of funds to support various forms of catastrophe preparedness, including strengthening first responders, improving prevention and mitigation programs, and mandating continuous improvement in consumer education. These activities are intended to reduce the real societal costs of catastrophic events, as opposed to just reducing the cost of insuring against the losses from such events. This approach is consistent with basic theories of insurance economics, which identify loss prevention, loss mitigation and the purchase of insurance (in effect, loss transfer) as different methods of managing risk. Obviously, it is in society's interest to incur the smallest aggregate cost possible to control the risks it faces from natural catastrophes.

To that end, the legislation mentions certain specific measures, as shown below:

- Instilling a new culture of preparedness
- Funding new research and development for better prevention and mitigation including retrofitting, helping consumers build stronger and safer homes;
- Achieving a new level of public education and making sure consumers not only know how to be better prepared but also how to make sure they have adequate insurance;
- Mandating more appropriate land use management;
- Advancing improved construction standards;
- Mandating stronger, modern building codes; Enforcing those codes; and
- Developing new building materials and/or building techniques.

Any of these measures that can be undertaken at a cost less than the loss cost savings resulting from the initiative should clearly be encouraged; in the long run the social costs of catastrophic events will be lower as a result. Therefore, to the extent that these measures are demonstrated to produce aggregate cost savings, the legislation will provide a mechanism for implementing such measures on a broad scale.[17]

[17] There is another important consideration relating to this aspect of the legislation that should be noted. Since the primary purpose of the state and national legislation is to reduce the cost of insurance, there is a legitimate concern that the program could reduce the incentives to undertake loss prevention and control activities. Generally speaking, the lower are insurance costs, the more consumers will prefer the purchase of insurance to other forms of risk management such as mitigation. To minimize this possible problem, it is useful to specifically target measures such as these.

LIMITATIONS AND QUALIFICATIONS

LEGEND: This work product was prepared solely to provide assistance to ProtectingAmerica.org. Milliman does not intend to benefit and assumes no duty or liability to other parties who receive this work. Milliman recommends a third party recipient be aided by its own actuary or other qualified professionals when reviewing the Milliman work product.

Data Reliances:

In performing this analysis we have relied on data and other information provided to us by AIR Worldwide Corporation, Benfield, Inc., and reports publicly available produced by Guy Carpenter and Lane Financial. We have not audited or independently verified this data and information for accuracy. Such a review is beyond the scope of our assignment. If the underlying data or information is inaccurate or incomplete, our analysis may likewise be inaccurate or incomplete.

We performed a limited review of the data used directly in our analysis for reasonableness and consistency. We did not find material defects in the data. If there are material defects in the data, it is possible that they would be uncovered by a detailed, systematic review and comparison of the data to search for data values that are questionable or relationships that are materially inconsistent. Such a detailed review was beyond the scope of our assignment.

Our estimates of cost savings derived in this report are based on a specific fund structure and the assumptions described in the report. Actual savings may differ due to different fund structure and market conditions at the time a fund or national backstop is introduced.

Distribution:

Milliman's work is prepared solely to provide assistance to ProtectingAmerica.org. Milliman does not intend to benefit and assumes no duty or liability to other parties that receive this report. In the event this report is distributed to third parties, the report must be provided in its entirety. We recommend that any such party have its own actuary review this report to ensure that the party understands the assumptions and uncertainties inherent in our estimates. This report may not be filed with the SEC or other securities regulatory bodies.

It has been our pleasure to assist ProtectingAmerica.org on this important project. If you have any question please call us to discuss. We would be glad to assist you with any further analysis.

Sincerely,

David R. Chernick

David R. Chernick, F.C.A.S., M.A.A.A.
Consulting Actuary

David Appel

David Appel, PhD
Principal and Director – Economics Consulting

DRC/DA/sbs

May 14, 2007

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Attachment A
Page 1

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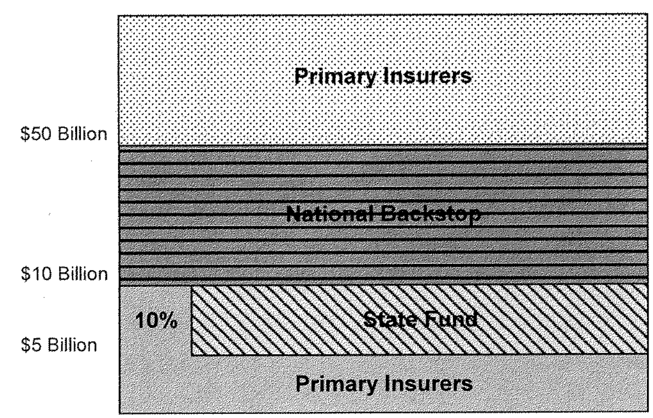
REPORT ON THE IMPACTS OF POTENTIAL CATASTROPHE-RELATED LEGISLATION

Hypothetical State X
Illustration of Layers of Catastrophe Coverage



90% Participation Level for State Fund

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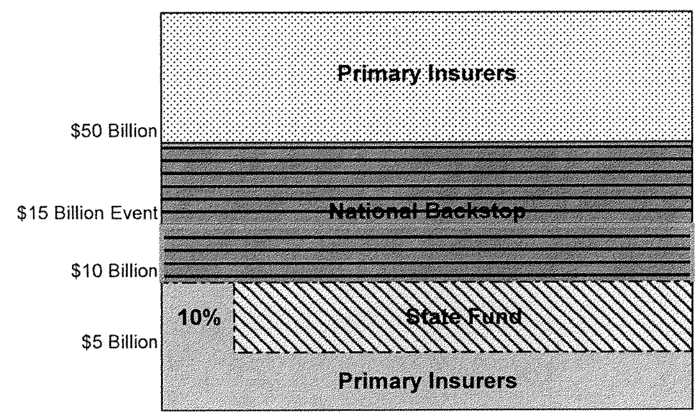
Hypothetical State X
$15 Billion Event Example



Event Losses	
Primary	$5.5 Billion
State	$4.5 Billion
National	$5.0 Billion

Attachment B

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REPORT ON THE IMPACTS OF POTENTIAL CATASTROPHE-RELATED LEGISLATION

Cat Fund Coverage Assumptions

State	State Fund Attachment Point	State Fund Limit/National Fund Attachment Point	National Fund Limit (1 in 250)
Texas	$2,000,000,000	$7,000,000,000	16,000,000,000
Louisiana	2,000,000,000	7,000,000,000	8,400,000,000
Mississippi	2,000,000,000	4,500,000,000	5,600,000,000
Alabama	2,000,000,000	4,500,000,000	5,900,000,000
Florida	5,800,000,000	27,800,000,000	73,100,000,000
Georgia	2,000,000,000	3,200,000,000	
South Carolina	2,000,000,000	7,000,000,000	12,700,000,000
North Carolina	2,000,000,000	7,000,000,000	9,800,000,000
Virginia	2,000,000,000	4,000,000,000	
New Jersey	2,000,000,000	4,500,000,000	7,200,000,000
New York	2,000,000,000	10,000,000,000	12,000,000,000
Connecticut	2,000,000,000	3,500,000,000	
Massachusetts	2,000,000,000	4,500,000,000	6,400,000,000
Washington - EQ	2,000,000,000	7,000,000,000	19,600,000,000
Oregon - EQ	2,000,000,000	7,000,000,000	9,600,000,000
California - EQ	5,000,000,000	12,000,000,000	59,800,000,000

States Not Included in the Analysis - 1 in 250 Year Aggregate Annual Losses Less Than (or Close to) $2 Billion

State	1 in 250 Year Loss
Missouri - EQ	1,300,000,000
Arkansas - EQ	1,700,000,000
Tennessee - EQ	2,100,000,000
Kentucky - EQ	700,000,000
Pennsylvania	1,900,000,000
Maryland	1,200,000,000
Delaware	300,000,000
Rhode Island	1,400,000,000
New Hampshire	500,000,000
Maine	700,000,000

Attachment C

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Consumer Savings From Formation of New State Funds

		(1)	(2)	(3)	(4) = [(2)-(1)]*(3)*.9	(5)	(6) = (5)+expenses	(7) = (4)-(6)
State	Peril	State Fund Attachment Point	State Fund Limit	Selected Rate On-Line	Estimated Annual Reinsurance Premium for Layer	Modeled Pure Premium for Layer	Estimated State Cat Fund Premium	Estimated Cost Savings
Texas	HU	2,000,000,000	7,000,000,000	14.6%	658,968,750	165,835,151	168,835,151	490,133,599
Louisiana	HU	2,000,000,000	7,000,000,000	10.5%	470,571,429	71,125,889	74,125,889	396,445,539
Mississippi	HU & EQ	2,000,000,000	4,500,000,000	3.5%	78,750,000	18,014,402	21,014,402	57,735,598
Alabama	HU	2,000,000,000	4,500,000,000	7.9%	177,187,500	25,476,969	28,476,969	148,710,531
Florida	HU	5,800,000,000	27,800,000,000	23.6%	3,534,413,829	844,790,883	853,238,792	2,681,175,037
Georgia	HU	2,000,000,000	3,200,000,000	1.8%	19,938,462	5,565,876	8,565,876	11,372,585
South Carolina	HU & EQ	2,000,000,000	7,000,000,000	10.5%	472,500,000	69,187,537	72,187,537	400,312,463
North Carolina	HU	2,000,000,000	7,000,000,000	11.0%	496,323,529	73,129,130	76,129,130	420,194,399
Virginia	HU	2,000,000,000	4,000,000,000	4.0%	72,000,000	11,819,001	14,819,001	57,180,999
New Jersey	HU	2,000,000,000	4,500,000,000	5.0%	113,303,571	18,544,658	21,544,658	91,758,914
New York	HU	2,000,000,000	10,000,000,000	6.3%	453,600,000	61,587,831	64,587,831	389,012,169
Connecticut	HU	2,000,000,000	3,500,000,000	3.3%	45,041,667	7,416,716	10,416,716	34,624,951
Massachusetts	HU	2,000,000,000	4,500,000,000	6.1%	137,812,500	24,524,530	27,524,530	110,287,970
Washington	EQ	2,000,000,000	7,000,000,000	7.0%	313,333,333	56,870,701	59,870,701	253,462,632
Oregon	EQ	2,000,000,000	7,000,000,000	3.5%	157,500,000	28,156,656	31,156,656	126,343,344
California	EQ	5,000,000,000	12,000,000,000	31.0%	1,956,048,387	435,428,405	439,782,689	1,516,265,698
Total					9,157,292,957	1,917,474,334	1,972,276,527	7,185,016,430
Total Excluding FL & CA*					3,666,830,741	637,255,046	679,255,046	2,987,575,695

(1), (2) State Fund covers 90% of the layer
(5) Layer Pure Premium obtained from AIR
(4), (5) Assumes participation level is at 90%
(6) Expense = maximum of 1% pure premium or $3 million

* State Fund savings for Florida and California are not included since those State Funds already exist.

Attachment D

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REPORT ON THE IMPACTS OF POTENTIAL CATASTROPHE-RELATED LEGISLATION

Consumer Savings From Formation of National Backstop

		(1)	(2)	(3)	(4) = [(2)-(1)]*(3)	(5)	(6) = (5) * 1.01	(7) = (4)-(6)
State	Peril	National Fund Attachment Point	National Fund Limit	Selected Rate On-Line	Estimated Annual Reinsurance Premium for Layer	Modeled Pure Premium for Layer	Estimated National Backstop Premium	Estimated Cost Savings
Texas	HU	7,000,000,000	16,000,000,000	3.6%	327,487,500	81,503,186	82,318,218	245,169,282
Louisiana	HU	7,000,000,000	8,400,000,000	3.3%	45,750,000	6,797,203	6,865,175	38,884,825
Mississippi	HU & EQ	4,500,000,000	5,600,000,000	2.2%	24,062,500	4,830,697	4,879,004	19,183,496
Alabama	HU	4,500,000,000	5,900,000,000	3.3%	45,937,500	7,383,871	7,457,710	38,479,790
Florida	HU	27,800,000,000	73,100,000,000	10.1%	4,560,025,647	424,084,627	428,325,473	4,131,700,174
Georgia	HU	3,200,000,000	N/A		-	-	-	-
South Carolina	HU & EQ	7,000,000,000	12,700,000,000	3.5%	199,500,000	31,964,448	32,284,092	167,215,908
North Carolina	HU	7,000,000,000	9,800,000,000	3.1%	86,470,588	15,133,484	15,284,819	71,185,769
Virginia	HU	4,000,000,000	N/A		-	-	-	-
New Jersey	HU	4,500,000,000	7,200,000,000	2.5%	67,982,143	13,530,802	13,666,110	54,316,033
New York	HU	10,000,000,000	12,000,000,000	3.6%	72,000,000	8,539,573	8,624,969	63,375,031
Connecticut	HU	3,500,000,000	N/A		-	-	-	-
Massachusetts	HU	4,500,000,000	6,400,000,000	3.1%	58,187,500	9,573,135	9,668,866	48,518,634
Washington	EQ	7,000,000,000	19,600,000,000	3.3%	411,250,000	66,543,673	67,209,110	344,040,890
Oregon	EQ	7,000,000,000	9,600,000,000	3.1%	79,625,000	11,612,456	11,728,581	67,896,419
California	EQ	12,000,000,000	59,800,000,000	8.6%	4,090,846,328	796,633,383	804,599,717	3,286,246,611
					10,069,124,706	1,478,130,538	1,492,911,844	8,576,212,863

(5) Layer Pure Premium obtained from AIR
(6) = Expense = 1% of pure premium

Attachment E

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REPORT ON THE IMPACTS OF POTENTIAL CATASTROPHE-RELATED LEGISLATION

Total Consumer Savings Resulting from State Cat Fund and National Backstop Mechanism

State	Peril	Estimated State Fund Savings	Estimated National Fund Savings	Total Estimated Cost Savings	Estimated Housing Units	Savings per Household
Texas	HU	490,133,599	245,169,282	735,302,881	8,563,822	$85.86
Louisiana	HU	396,445,539	38,884,825	435,330,364	1,939,171	224.49
Mississippi	HU & EQ	57,735,598	19,183,496	76,919,094	1,219,818	63.06
Alabama	HU	148,710,531	38,479,790	187,190,322	2,061,504	90.80
Florida	HU	-	4,131,700,174	4,131,700,174	7,666,634	538.92
Georgia	HU	11,372,585	-	11,372,585	3,445,168	3.30
South Carolina	HU & EQ	400,312,463	167,215,908	567,528,371	1,841,003	308.27
North Carolina	HU	420,194,399	71,185,769	491,380,169	3,699,436	132.83
Virginia	HU	57,180,999	-	57,180,999	3,048,821	18.76
New Jersey	HU	91,758,914	54,316,033	146,074,947	3,475,127	42.03
New York	HU	389,012,169	63,375,031	452,387,201	8,061,736	56.12
Connecticut	HU	34,624,951	-	34,624,951	1,454,997	23.80
Massachusetts	HU	110,287,970	48,518,634	158,806,603	2,752,564	57.69
Washington	EQ	253,462,632	344,040,890	597,503,522	2,573,139	232.21
Oregon	EQ	126,343,344	67,896,419	194,239,764	1,525,054	127.37
California	EQ	-	3,286,246,611	3,286,246,611	12,822,834	256.28
Total		2,987,575,695	8,576,212,863	11,563,788,558	66,150,828	$174.81

Note: State Fund savings for Florida and California are not included in the total since those State Funds already exist.

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Sample of Post-Katrina Catastrophe Bonds Covering U.S. Earthquakes & Windstorms

Security	Amount of Coverage ($ Millions)	Issue Date	Issuer	Covered Losses	Exposure Term (Months)	Probability of 1st $ Loss	Expected Annual Loss (% of Layer)	Risk Premium Above LIBOR	**Equivalent Rate on Line**
Arbor I - X	18	Dec-05	Swiss Re	Multi-peril (primarily Wind)	12	6.0%	4.9%	14.50%	**14.70%**
Atlantic & Western Re A	100	Oct-05	PXRE	Wind: East Coast & Europe	60	1.2%	1.0%	5.75%	**5.83%**
Atlantic & Western Re B	200	Oct-05	PXRE	Wind & California EQ	60	3.4%	2.5%	10.00%	**10.14%**
Atlantic & Western Re II A	125	Dec-05	PXRE	2nd event - Wind & EQ	12	0.7%	0.7%	6.00%	**6.08%**
Atlantic & Western Re II B	125	Dec-05	PXRE	2nd event - Wind & EQ	36	0.7%	0.7%	6.25%	**6.34%**
Champlain Ltd A	75	Dec-05	Montpelier Re	U.S. & Japan EQ	36	3.4%	3.4%	13.50%	**13.69%**
Champlain Ltd B	75	Dec-05	Montpelier Re	2nd event - Wind or EQ	36	4.0%	3.6%	12.75%	**12.93%**
Foundation Re Ltd D	105	Feb-06	Hartford	Wind: Gulf & East Coast; EQ	48	1.6%	1.2%	7.25%	**7.35%**
Redwood VII	160	Feb-06	Swiss Re	California EQ	24	0.7%	0.6%	5.25%	**5.32%**
Redwood VIII	65	Feb-06	Swiss Re	California EQ	24	0.8%	0.6%	5.25%	**5.32%**

Attachment G

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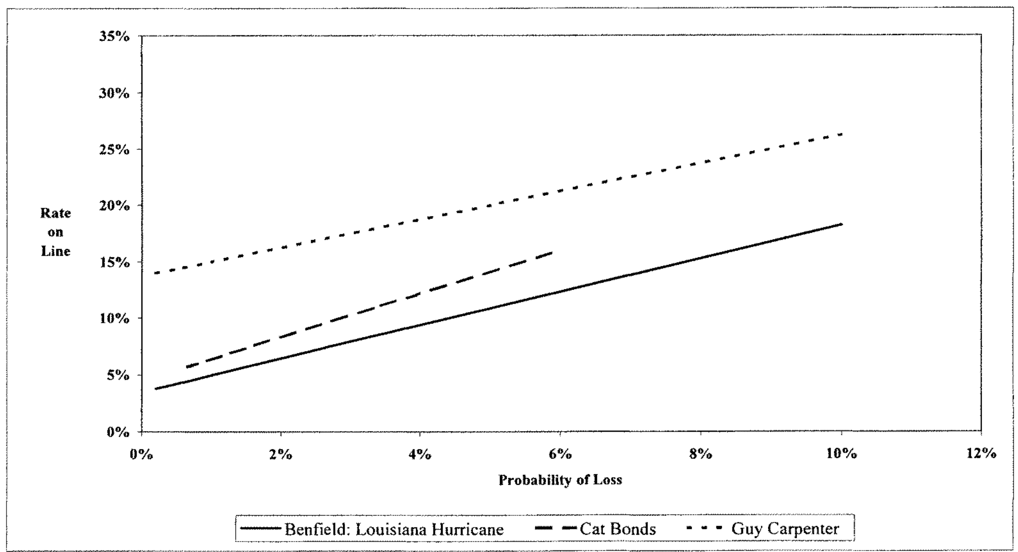
Summary of Rates on Line from 3 Different Sources



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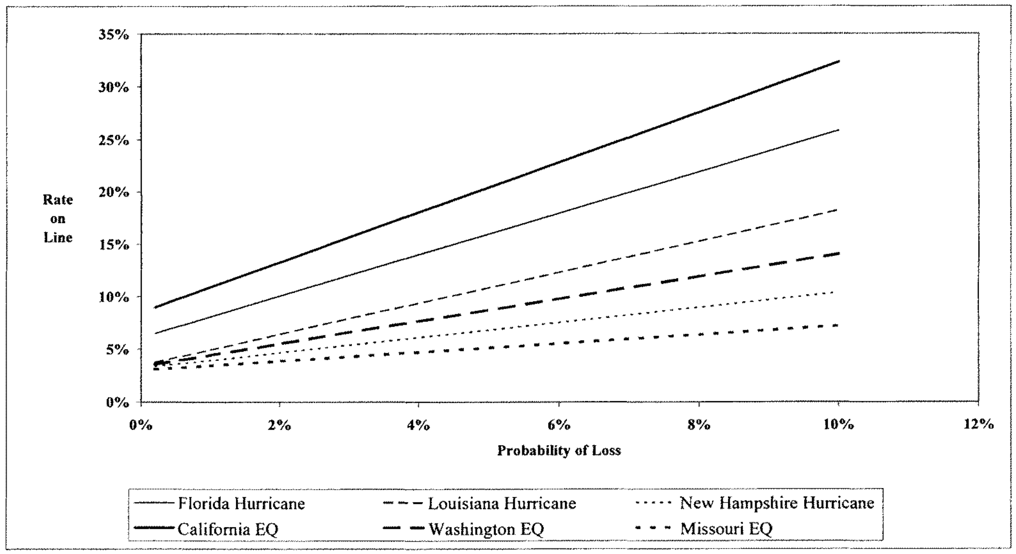
Rates on Line by State and by Coverage



Attachment I

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REPORT ON THE IMPACTS OF POTENTIAL CATASTROPHE-RELATED LEGISLATION

Estimated Savings for Rhode Island

State Fund Savings

State Fund Attachment Point	State Fund Limit	Selected Rate On-Line	Estimated Annual Reinsurance Premium for Layer	Modeled Pure Premium for Layer	Estimated State Cat Fund Premium	Estimated State Fund Savings
321,000,000	686,000,000	7.2%	23,652,000	4,592,427	5,051,670	18,600,330
(1 in 50)	(1 in 100)					

National Backstop Savings

National Fund Attachment Point	National Fund Limit	Selected Rate On-Line	Estimated Annual Reinsurance Premium for Layer	Modeled Pure Premium for Layer	Estimated National Backstop Premium	Estimated National Fund Savings
686,000,000	1,960,000,000	3.1%	39,494,000	6,170,237	6,231,939	33,262,061
(1 in 100)	(1 in 500)					

Total State and National Fund Savings

Estimated State Fund Savings	Estimated National Fund Savings	Total Savings	Estimated Housing Units	Savings per Household
18,600,330	33,262,061	51,862,391	461,741	$112.32

State Fund expenses are 10% of premium
National Fund expenses are 1% of premium

About Catastrophe Models

Natural catastrophes such as earthquakes, hurricanes, tornadoes and floods can jeopardize the financial well-being of an otherwise stable, profitable company. Hurricane Andrew, in addition to causing more than $16 billion in insured damage, left at least 11 insurers insolvent in 1992. The 1994 Northridge earthquake caused more than $12 billion in insured damage in less than 60 seconds.

Fortunately, these sorts of occurrences are rare. But it is exactly their rarity that makes estimating losses for future such catastrophes so difficult. Standard actuarial techniques are insufficient because of the scarcity of historical loss data. Furthermore, the usefulness of the loss data that does exist is limited because of the constantly changing landscape of insured properties. Property values change, along with the costs of repair. Building materials and designs change, and new structures may be more or less vulnerable to natural catastrophes than were the old ones. New properties continue to be built in areas of high hazard. For all of these reasons, the limited historical loss information that is available is not suitable for directly estimating future catastrophe losses.

AIR Worldwide Corporation was the first company to develop catastrophe modeling as an alternative to the traditional actuarial and "rule of thumb" approaches that had previously been used for estimating potential catastrophe losses. AIR's highly trained staff of seismologists, meteorologists, hydrologists, wind and earthquake engineers, mathematicians, statisticians, actuaries, and computer technology specialists is augmented by the many years of experience that the company has accumulated in this field. The result is the delivery of reliable and credible loss estimates needed to make informed risk management decisions.

How are Catastrophe Models Constructed?

In 1987, AIR developed the first catastrophe model for use by the insurance industry. The model relied on sophisticated simulation techniques and powerful computer programs of how natural catastrophes behave and impact the man-made environment. Today, AIR offers models for 50 countries and a wide variety of perils. Over the course of the last 20 years, the models have undergone a continual process of review, refinement, enhancement, and validation. New models continue to be developed for new perils and regions of the globe. Ongoing research ensures that the models incorporate the latest advances in the science and engineering.

Catastrophe models are complex computer programs that mathematically represent the physical characteristics of natural catastrophes. Large catalogs of simulated catastrophes are generated, representing the entire spectrum of plausible events. For each simulated event, the model calculates the intensity at each location within the affected area. For hurricanes, intensity may be expressed in terms of wind speed or the height of the storm surge; for earthquakes, intensity may be expressed in terms of the degree of ground shaking or the number and intensity of fires spawned by the earthquake.

These measures of intensity are then applied to highly detailed information about the properties that are exposed to them. Mathematical equations called damage functions calculate the level of damage and monetary loss for different types of construction and occupancy (building usage). Losses are calculated for the structure, its contents and for the loss of use (such as lost business income). These damage functions are developed by wind and earthquake engineers and incorporate a wide body of published literature and the results of laboratory tests.

Models produce the full range of potential outcomes expressed in terms of monetary loss. Probabilities are assigned to each level of loss. This loss distribution, called an exceedance probability curve, reveals the probability that any given level of loss will be surpassed in a given time period. The probabilities can also be expressed in terms of return periods. For example, the loss associated with a return period of twenty years is likely to be exceeded only 5% of the time or, on average, in one year out of twenty. Loss probabilities can be provided at any geographic resolution for the entire insurance industry, for a particular portfolio of buildings, or for an individual property.

How are Catastrophe Models Used?

The purpose of catastrophe modeling is to help companies (or public entities) anticipate the likelihood and severity of potential future catastrophes *before they occur* so that they can adequately prepare for their financial impact. Catastrophe models can be used to address a number of questions, such as: Where are future catastrophes likely to occur? How big are they likely to be? How often are they likely to occur? What level of loss can my company expect to incur on average each year over the long term? What is the probability of incurring a large loss this year?

Insurers and reinsurers employ catastrophe models to estimate the loss potential to their books of business and to give them the tools and information they need to choose between alternative strategies for managing that risk. Model output is used to develop appropriate insurance rates and underwriting guidelines, analyze the effects of different policy conditions, and make sound decisions regarding the purchase of reinsurance. "What if" analyses can be performed to measure the impact on loss potential of various mitigation strategies, such as adding storm shutters or retrofitting with cross bracing in earthquake-prone areas. In addition to estimating potential future property damage and losses, models can be used to estimate the number of insurance claims, and the number of injuries and fatalities.

Increasingly, organizations outside the insurance industry are employing catastrophe models to assess and manage their catastrophe risk, including government agencies, mortgage lending and other financial services companies, risk pools, and corporations and other owners of high-value real estate.

Catastrophe modeling offers enormous value—value that continues to increase as the technology continues to evolve. Catastrophe modeling enables proactive decision-making and strategic planning and is an essential component to any company's or organization's efforts to assess and manage risk.

The Limitations of Catastrophe Models

Although AIR's simulation methodology is a superior technique for estimating potential catastrophe losses, the methodology does have certain limitations. It is based on mathematical/statistical models that represent real-world systems. As with all models, these representations are not exact. The simulated events generated by the AIR models do not represent catastrophes that have occurred, but rather events that could occur. The AIR models rely on various assumptions, some of which are subject to uncertainty. Accordingly, the loss estimates generated by the models are themselves subject to uncertainty. As a result of its ongoing process of internal review, AIR refines and updates model assumptions in light of new research findings as such information becomes available. Such refinements and updates may materially alter the loss estimates generated by the AIR models.

The loss estimates and their associated probabilities are estimates of the magnitude of losses that may occur in the event of natural and man-made hazards; they are not factual and do not predict future events. Actual loss experience can differ materially. Also, they are intended to function as one of several tools for use in analyzing estimated expected and potential losses from such hazards. The assumptions that AIR uses in generating loss estimates may not constitute the exclusive set of reasonable assumptions and methodologies, and different assumptions and methodologies could yield materially different results.

Modeling Assumptions and Conditions

The loss estimates contained in this report reflect industry loss estimates for the United States. These estimates are dependent upon the data used in the analysis, the assumptions and conditions applied in the analysis, and the models and perils used in the analysis. Details outlining these factors as they relate to the loss estimates contained herein are outlined below.

Modeled Data

The exposure data used in the analysis is the AIR database of industry exposures and associated policy conditions as of December 31, 2005. The AIR database of industry exposures is compiled from a variety of sources, which include the U.S. Census Bureau, U.S. Bureau of Economic Analysis, Dun & Bradstreet, R.S. Means, American Housing Survey, CLARITAS, and HAZUS®. In addition, the industry exposure data also leverages the detailed data available in ISO HomeValue™ for residential structures and, for commercial structures, the ISO's SPI℠ database.

AIR generated industry loss estimates for the perils of U.S. hurricane, U.S. earthquake, and U.S. fire following earthquake by modeling the database of industry exposures at a postal-code centroid level against the 10,000-year standard stochastic hurricane catalog, and the 10,000-year earthquake and fire following earthquake catalog. The resulting industry losses include losses to residential, commercial, mobile home, and auto lines of business for on-shore building, appurtenant structure, contents, and direct business interruption coverages. These postal-code centroid level losses by line of business and coverage are then aggregated into a single combined coverage loss estimate by county and line of business.

The loss estimates contained in this report represent only the residential and mobile home lines of business. The losses exclude commercial and auto lines of business. For the hurricane and fire following earthquake perils, the loss estimates reflect insured losses. For the earthquake peril, the loss estimates reflect insurable losses net of average policy conditions before the application of take-up rates.

Modeling Assumptions

Storm Surge

All hurricane loss estimates in this report include storm surge. AIR loss estimates include 10% of the losses generated from its storm surge model. For residential lines of business, it is assumed that 10% of the storm surge loss is paid as wind losses.

Demand Surge

All loss estimates in this report include aggregate demand surge. The AIR aggregate demand surge function reflects increases in labor and materials prices as a result of the aggregation of catastrophic events that occur in close proximity of both space and time.

Model Details

The following models were used in to produce these loss estimates:

Perils/Regions:	U.S. Hurricane (Atlantic and Gulf Coasts)
Models:	2006 Atlantic Hurricane Model, v 8.0
Catalogs:	10,000-year standard catalog (based on the long-term view of expected risk)
Perils/Regions:	U.S. Earthquake and Fire Following (48 contiguous states)
Models:	2006 U.S. Earthquake Model, v 7.2
Catalogs:	10,000-year catalog

All loss estimates were generated using the 10K World All Perils (10K Hybrid) event set in CATRADER version 8.0

Probabilities of Exceedance

The estimates contained in this report reflect the estimated probability distributions of annual aggregate losses. These distributions represent the range of possible losses and the relative likelihood of various levels of loss.

An annual aggregate loss is the sum of the losses caused by all simulated events in a given single year. The probability distribution of annual aggregate losses displays the probability of experiencing aggregate losses of specified amounts resulting from all events in a given single year.

Probabilities of exceedance are stated in this report as return periods, which represent the inverse of the probabilities of exceedance. As an example, the 250-year return period loss equates to a .4% probability of exceedance: this mean that there is a .4% chance that this loss amount will be equaled or exceeded in any given year. State level return period losses are calculated independently for each state.

Unless otherwise indicated, all loss estimates in this report are annual aggregate losses.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM CHARLES CHAMNESS

Q.1. Mr. Nutter says in his testimony, "The insurance industry surplus grew from $356 billion at December 31, 2003, to $439 billion at December 31, 2005. As of December 31, 2006, the industry's claims paying ability and capital base have never been better." This statement suggests that despite Katrina, the largest natural disaster in American history, insurance companies have had no problems paying claims, and in fact, have a better ability to pay claims now than before that disaster. In addition, Mr. Nutter says that "reinsurance capacity is adequate even for peak catastrophe markets."

At the same time, Americans around the country are finding it increasingly difficult to secure sufficient and affordable insurance. We hear reports that people from Texas through the Gulf and up the Eastern seaboard are seeing their insurance dropped and their rates and deductibles increased.

How can this disconnect be explained? There appears to be sufficient insurance capacity, yet working families and business owners are unable to afford sufficient coverage. What do we do for these people, so that they can afford needed insurance coverage?

A.1. It is important to understand the relationship between insurance and reinsurance capacity, and the price insurers and reinsurers charge for their products. The price of global catastrophe reinsurance rose after the 2005 Gulf Coast hurricanes in response to forecasts by climate scientists and catastrophe risk modelers that coastal regions of the U.S. would experience more frequent and severe storm activity for the next several years. The ability of reinsurers to increase premiums served to attract new capital to the global reinsurance market, which explains Mr. Nutter's observation that "reinsurance capacity is adequate even for peak catastrophe markets."

Primary insurers, for their part, have responded to the rising cost of reinsurance by seeking rate increases for property insurance coverage in catastrophe-prone regions. Some primary insurers have withdrawn from, or stopped writing new policies in, certain catastrophe-prone regions, either because state regulators refused insurers' requests to raise premiums to a level commensurate with the prevailing risk of loss, or to reduce their exposure levels to ensure their ability to pay future claims. This accounts for the fact that some consumers in catastrophe-prone regions "are seeing their insurance dropped and their rates and deductibles increased."

In short, catastrophe insurance capacity has remained adequate to the extent that the price of insurance and reinsurance coverage has risen sufficiently to attract new capital. Understood in this context, there is no "disconnect between sufficient reinsurance capacity and rising primary insurance rates or reduced availability of coverage in markets where rates have been suppressed through regulation.

The last part of your question—"What do we do for these people, so that they can afford needed insurance coverage"—poses what I believe is the central challenge for government policy makers. In response, I can do no better than reiterate the follow statement from my written testimony: "The federal government has a long history of designing and administering programs that provide grants and other forms of direct financial assistance to individuals on a means-tested basis for the purchase of essential goods such as food and shelter. There is no reason why Congress could not provide a similar form of aid to selected property owners for the purchase of insurance. Such an approach would have many advantages over the current system of generalized rate suppression and cross-subsidization, not the least of which is that the assistance could be targeted to particular individuals based on financial need. Moreover, its availability could be limited to those currently residing in disaster-prone areas, and would thus avoid creating incentives for people not currently living in those areas to move into harm's way."

Q.2. All of the witnesses appear to support the proposition that mitigation efforts are an important part of preparing Americans to withstand and hopefully minimize damage from a large-scale natural disaster. I agree, which is why I have called for at least doubling the federal investment in mitigation efforts. What do you see as the current barriers to mitigation efforts and what can be done to remove those barriers?

A.2. NAMIC believes mitigation efforts can play an integral part in protecting homes and businesses from a large-scale natural disaster. As I testified before the committee in april, NAMIC endorses strong statewide building codes and responsible land-use planning.

We applaud your efforts to double the federal government's investment in mitigation efforts. Our recent experience in Louisiana and Mississippi suggests that a major impediment to enacting stronger building codes is the perception by local government officials that the codes effectively create unfunded mandates. Governors Blanco and Barbour were eventually able to secure funding from the Federal Emergency Management Administration to enable their county governments to hire and train building inspectors. We believe that building code legislation could be more readily enacted in other states if affected jurisdictions new in advance that FEMA funding was available to assist them in implementing new building standards.

Another barrier to effective mitigation is the fact that property owners currently lack sufficient incentives to invest in mitigation measures. Congress could encourage risk mitigation by offering property owners appropriate incentives. To that end, S. 930, the Hurricane and Tornado Mitigation Investment Act of 2007, would create federal tax incentives to encourage property owners to mitigate wind-related risk. Similar legislation at the state level has already been enacted in Florida and Mississippi, and is currently under consideration in South Carolina.

Q.3. Governor Racicot testified on behalf of the American Insurance Association that 95 percent of the 1.1 million homeowners claims in Mississippi and Louisiana have been resolved. Do you agree with that statement? If not, please explain the areas of disagreement. If you do agree, please clarify whether the 1.1 million figure includes claims where the insurance company determines that the damage is not covered under the policy. If it does not, please tell me how many claims were filed overall in Mississippi and Louisiana, both those which were determined to be covered by the homeowners policy and those which were determined not to be covered.

A.3. I agree with Governor Racicot regarding the number and dollar amount of the claims paid by the insurance industry as the first anniversary of Hurricane Katrina approached in 2006. These figures were based on information compiled at the time by the Insurance Information Institute. As for the additional statistics you request, I recommend that you contact the departments of insurance in Louisiana and Mississippi, as my trade association is not in a position to collect industry-wide data of this kind. The Louisiana and Mississippi departments issued bulletins in the immediate aftermath of Hurricane Katrina, ordering insurers in those states to regularly file several types of information related to claims handling. The data you seek should be available from these insurance departments.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM CHARLES CHAMNESS

Q.1. What role could mitigation efforts play in helping to reduce the price of insurance?

A.1. Research has shown that mitigation efforts can play an important role in helping to reduce the price of insurance.This is why NAMIC believes that strong statewide building codes are needed to reduce property damage caused by severe wind storms. However, this view is not universally shared by others, including some home builders who argue that stronger building standards result in higher home prices. While this may be true, the fact is that the use of fortified construction techniques and wind-resistant building materials, made mandatory by strong building codes that are vigorously enforced, is critical to mitigating catastrophe risk and reducing the cost of insurance.

In the aftermath of Hurricane Katrina, both Louisiana and Mississippi adopted stronger building standards. Louisiana's new building code applies to the entire state, while the Mississippi code applies to the state's six most southerly counties. It is worth noting that during the legislative debates that led to the enactment of these laws, many county commissioners in both states expressed reservations about the proposed building codes because, in their view, being forced to create building departments to administer and enforce the codes without proper funding sources constituted an unfunded mandate.

The county commissioners have a point. Fortunately, Governors Blanco and Barbour were eventually able to obtain funding from the Federal Emergency Management Administration to help the affected counties hire and train building inspectors to enforce the new building code standards. However, if local officials could be assured in advance that federal funds are available to assist in implementing new building standards, the resistance to new building codes might be lessened or even eliminated.

It is also important to consider ways to encourage catastrophe risk mitigation with respect to the existing housing stock, since building codes apply only to new structures. Following the 2005 hurricanes, three states considered legislation designed to create incentives for owners of existing properties to invest in risk mitigation measures. In 2006, Florida lawmakers created "My Safe Florida Home" disaster mitigation program, which was expanded earlier this year. The Florida program offers homeowners free home inspections and advice on how to make properties more wind resistant. In addition, the program offers grants to help defray the cost of purchasing risk-mitigation equipment and devices (such as storm shutters). A similar program was enacted this year in Mississippi, and another is currently being considered by the South Carolina legislature.

NAMIC believes disaster mitigation programs like the ones described above can and will help to protect properties, especially in catastrophe-prone states, and thus help keep insurance rates more affordable for homeowners. S. 930, the Hurrican and Tornado Mitigation Investment Act of 2007, appears to closely approximate the goals of the state disaster mitigation program and should be seriously considered by Congress.

In addition to mitigation, responsible land-use practices can also play a vital role in reducing insurance costs. Given the widespread concern among policymakers over the escalating cost of insuring properties in catastrophe-prone areas, it is difficult to understand why developers are allowed to build multi-million dollar luxury condominiums on coastal lands that are prime targets for hurricanes. Because insurers are often prevented by regulators from charging risk-based premiums for these properties, the cost of insuring them must be partially borne by property owners in less risky areas, driving up their insurance costs. Florida Chief Financial Officer Alex Sink apparently shares my dismay over this state of affairs. Speaking recently to a group of insurers, she lamented that "the state [of Florida] is doing nothing in the area of zoning codes to discourage building in coastal areas."

Q.2. It has been widely reported that in the aftermath of Hurricane Katrina, some insurance companies may have failed to adequately assess claims and may have chosen to litigate claims rather than pay them, with the expectation that policyholders would agree to smaller settlements. Could the insurance industry have done a better job settling claims in the aftermath of Katrina and what are the member companies of NAMIC doing to improve their claims payment procedures to prepare for the next natural disaster?

A.2. The managers and employees of NAMIC member companies know that they are engaged in a highly competitve business. They understand that they can never be totally satisfied with their performance and must always strive for improvement. Any insurance company that deliberately pursued a strategy of litigating legitimate claims in an attempt to force policyholders to agree to smaller settlements would stand to lose market share to companies known for treating their customers fairly.

The media reports to which you allude are largely anecdotal and are refuted by data released by the Louisiana and Mississippi insurance departments, which indicate that most claims were adjusted to the satisfaction of policyholders in a timely manner, with only two percent of claims going to mediation or litigation. This is not surprising, given insurers' desire to attract and retain policyholders in a highly competitive market. Another reason that insurance companies generally try to avoid litigating claims is that it is a costly option that does not always lead to an outcome favorable to the insurer, regardless of the merits of a particular case. If anything, insurers tend to err on the side of paying questionable or suspect claims to avoid litigation costs and potential harm to their reputations.

That said, it is important to note that no matter how well a claim is handled and how fair the settlement offer, some policyholders will not be satisfied. In those instances, insurance companies work diligently to try to resolve outstanding issues with their policyholders. Where a resolution is not possible, insurers often turn to mediation. In the aftermath of Hurricane Katrina, the insurance commissioners in Louisiana and Mississippi quickly implemented mediation processes that were successfully utilized by several hundred individuals.

In closing, I would note that the sheer magnitude of Hurricane Katrina—the largest natural disaster in the country's history—placed an enormous strain on the ability of several of our member companies to respond to this unprecedented event. Our member companies have taken the lessons of Hurricane Katrina to heart, and each in its own way has learned from that experience and is likely to respond differently when the next mega-catastrophe occurs.

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

WRITTEN TESTIMONY OF
THE PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA
SUBMITTED TO THE
SENATE BANKING, HOUSING AND URBAN AFFAIRS COMITTEE
APRIL 11, 2007

Property Casualty Insurers Association of America (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, PCI has a deep interest in natural disaster issues and the ways in which we can better prepare our industry and our nation to respond to future natural disasters.

Introduction

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 property 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.

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.

In 2004 and 2005, property insurance markets have been tested as never before. Catastrophe losses in 2005 totaled some $61.9 billion, nearly doubling the previous record losses in 2001. Hurricane Katrina itself caused nearly $40 billion in insured losses, surpassing the roughly $32 billion from 9/11. The vast majority of claims from 2005's events have been paid and the insurance market has met its financial obligations. In PCI's 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 in this country, reports 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 alone means that future storms will be more damaging and more costly to insure. As a result of migration and property development, 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, our members would like to rely on a free market environment to solve this problem whenever possible, 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. For example, the Florida legislature, in a special session held just to address the affordability of property insurance, passed landmark legislation that rolled back appropriate rate changes for the state's largest insurer, Citizens Property Insurance Corporation, removed its "market of last resort" status, and required insurers to modify their pricing based on reductions in the cost of reinsurance resulting from changes to the Florida Hurricane Catastrophe Fund. According to our analysis, the legislation also lowers current residential property insurance rates by: providing reinsurance that is less expensive than commercial insurance, which includes provisions for risk load and taxes; deferring some of the risk of paying catastrophic losses to future years, and transferring risk currently borne by property owners to insured motorists and businesses. Clearly there is a problem in the availability and affordability of homeowners insurance in this state and we hope to work with Florida legislators to effectuate long-term solutions to this issue.

In sharp contrast to the highly-regulated structure governing direct writers, the world catastrophe reinsurance markets operate under a regulatory structure that allows free competition with respect to price, underwriting and product. The cost of catastrophe reinsurance is an economic reality PCI's members and their customers 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 preventing and reducing 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 reduction and prevention, and new approaches to financing catastrophe risk. We do not believe there is one "silver bullet" to solve this problem, but rather a full range of changes that will have to be made.

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. However, the Florida legislature realized that this delay in applying its strong statewide building code in the panhandle was inappropriate and, in the special session legislation mentioned above, eliminated this exception. Yet we still hear that there are those in Florida that still would oppose or delay implementation of this provision. PCI also applauds NCOIL in taking a leadership position in adopting a statewide building code model. 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, including making sure there is enough funding for the training of building inspectors.

- A second idea is the establishment by the federal government of incentives for greater investment in loss reduction and prevention. 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 statewide building codes. This would address the funding issue mentioned above and PCI strongly endorses this approach and urge Congress to enact legislation for this purpose. Second, Sen. Nelson reintroduced legislation (S. 927) this Congress to create a special catastrophe savings account for purposes of allowing homeowners to build up, tax-free, funds for payment of qualified catastrophe expenses. Third, Sen. Martinez reintroduced S. 930, the *Hurricane and Tornado Mitigation Investment Act,* which grants special tax credits for qualifying expenditures by homeowners to retrofit their homes to better protect against disasters. Roughly one dollar spent to better protect a property results in four dollars saved following an event. 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. This approach gives homeowners themselves additional incentives to make these improvements. This would 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. Max Mayfield, who recently left his position as director of the National Hurricane Center stated in a *Los Angeles Times,* January 3, 2007 article that he is more convinced than ever that U.S. residents of the Southeast are risking unprecedented tragedy by continuing to build vulnerable homes in the tropical storm zone and failing to plan escape routes. 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 increases these risks.

- We believe greater steps can be taken for preparedness. As a first step, PCI has completed and distributed to forty eight state insurance departments a PCI Regulators' Kit, containing recommendations for disaster preparation and response. This kit contains model regulations covering five critical areas,

[1] "Managing the Next Disaster," Roger A. Pielke and Daniel Sarewitz, The Los Angeles Times, September 23, 2005.

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. When adopted, these regulations could improve the necessary coordination and communication after a catastrophe and help those whose lives and property are at stake.

Fix the Flood Program

Second, we believe Congress should complete its efforts to reform the National Flood Insurance Program (NFIP). PCI strongly endorsed reform efforts last year 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 recently introduced House bill, H.R. 1682, the *Flood Insurance Reform Act of 2007*. 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. We support efforts to pass a flood insurance reform bill this year and are willing to work with you to obtain passage of this important legislation.

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 can 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 are an 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 also encourage your review of two additional proposals:

- First we are very interested in, and in fact endorse, establishing voluntary, tax-deferred insurance company catastrophe reserves such as S. 926, which was reintroduced by Sen. Nelson. While there are provisions in this bill PCI believes should be modified, we urge your review and debate 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 state and federal 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 stable private markets or preventing new capital from entering the market; and (3) that the funding of the state program 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. PCI believes that the Florida Hurricane Catastrophe Fund, including its recent capacity expansion through the recently enacted special session legislation provides the basis for ongoing improvement to that program.

- 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 recommend, as we have suggested before, serious consideration of establishing a federal catastrophe financing facility. Such a facility would optimally offer credit financing only 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 that 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 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 serious consideration by Congress now - before the next crisis.

Conclusion

PCI appreciates the work this Committee is already doing to identify and explore constructive policy solutions. PCI believes 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.

NMHC National Multi Housing Council®

NAA National Apartment Association

"An Examination of the Availability, Affordability of Property and Casualty Insurance in the Gulf Coast and other Coastal Regions"

Statement of the
National Multi Housing Council (NMHC)
National Apartment Association (NAA)

U.S. Senate
Committee on Banking, Housing &Urban Affairs
Washington, DC

April 11, 2007

The American apartment industry...working together for quality, accessible, affordable housing.

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Chairman Dodd, Ranking Member Shelby and Members of the Committee, on behalf of the National Multi Housing Council (NMHC) and the National Apartment Association (NAA) we commend you for demonstrating leadership in holding this hearing to examine the availability and affordability of property and casualty insurance in the Gulf Coast and other coastal regions.

NMHC and the NAA represent the nation's leading firms participating in the apartment industry. Their combined memberships include apartment owners, developers, managers, builders and lenders. NMHC represents the apartment industry's largest and most prominent firms and its members are the principal officers of these organizations. NAA is the largest national federation of state and local apartment associations, with 190 affiliates representing nearly 50,000 professionals who own and manage more than six million apartments. NMHC and NAA jointly operate a federal legislative program and provide a unified voice for the private apartment industry.

Catastrophic events of 2005 continue to Impact the Apartment Industry throughout the U.S.

As you know the major catastrophe losses of 2005 from Hurricane Katrina had a devastating impact on the property insurance market in many states across the country. While many apartment owners expected the 2006 insurance renewal process to be challenging, apartment property risk managers experienced a reality that far exceeded their worst case expectations. Apartment portfolios with catastrophic (CAT) exposure to windstorms in the Gulf Coast, Florida, the eastern coastal states, and earthquakes in California saw 100-400 percent price increases for some layers of insurance. Because pricing seemed to increase daily and capacity was shrinking as quickly, many risk managers scrambled to move up their renewal dates in an effort to secure adequate coverage. It became widely accepted that even at the exorbitant cost and lower limits, a property owner was lucky to have obtained coverage at all.

In 2007 the market seems to be showing some signs of stabilization for some property owners but certainly not for all. Smaller property owners who cannot spread the risk among a large portfolio will continue to be challenged in this market. One Florida property owner reported paying as much as \$202,000 in premium for a 184 unit apartment community in which rents average \$850-900 per month. That translates into \$1098 of insurance cost per unit. Texas policyholders reported similar experiences in pricing and availability of coverage. Even in locations far from the Gulf coast, similar experiences are being reported. For a property owner in New Jersey insurance costs have jumped from \$85 per unit to \$250 per unit, a significant jump in cost. Even California continues to feel the ripple effect of skyrocketing premiums, reduced limits, and higher deductibles for earthquake insurance which is not included in property insurance policies but must be purchased separately. Many owners choose not to purchase earthquake insurance unless it is required by lenders, simply because it is cost prohibitive.

Impact on Affordable Housing

Apartment owners, especially those with older properties, are continually faced with the increasing operating costs required to maintain and upgrade properties so that residents can enjoy a safe, decent and affordable home. At some point a property owner must determine how much of the insurance cost increase he or she can absorb and how much must be passed on to the resident in the form of a rent increase. Unfortunately, many property owners have had to adjust rents upward to manage these increasing operating costs.

Even larger apartment owners with national portfolios face the same operating cost challenges as the smaller operators, especially when participating in government programs. For example it is not uncommon for apartment owners of properties utilizing the Low Income Housing Tax Credit (LIHTC) program to decline earthquake insurance coverage due to the cost unless it is required by the lender. One of the reasons is that unlike market-rent properties, these properties offer no rent adjustment option to offset the added cost because the rents are based on local household income levels. This is also true of other federally subsidized programs such as the Section 8 program. For the properties that purchase this insurance due to lender requirements, the owner assumes the additional cost, perhaps at the expense of property maintenance or improvements. The uninsured properties remain at risk to Mother Nature, leaving the owner as well as the lender exposed. In the event of a large-scale earthquake, many of these affordable assets would have no source of funds to rebuild. This underscores the fact that the costs of catastrophic insurance coverage for many property owners exceed a level that is business practicable and threatens the already dwindling supply of affordable housing.

Government v. Market Solution

It is not clear that a government solution exists to the current insurance crisis, or if one will come from the private market. What we do know is that the continued occurrence of catastrophic events, whether the result of a natural disaster or terrorism, will have a significant impact on the national economy. It seems clear that the private insurance market is losing its appetite to take on this significant risk for much longer. Anecdotal accounts of carriers pulling out of certain high-risk states worsen the already deteriorating situation.

It is very likely that in the event of a mega-catastrophe the federal government would step in and take whatever action is necessary to stabilize the markets, regardless of whether a role for them has been defined in legislation. This sentiment has prompted policymakers at the state and federal level to look at the viability of a public/private program. We recognize it will not be an easy task to identify a one-size-fits-all solution to this problem. Arguments against federal involvement are plentiful and generally caution against the government from direct involvement in providing insurance thus stifling the development of a private market solution. It is also opined that federal subsidies only encourage construction in areas that place people and properties in harm's way. These arguments may have merit but should be carefully weighed against the goal of creating continued stability in the marketplace. Therefore, we encourage Congress to fully consider the various proposals that advance this goal including but not limited to the creation of a federal backstop to state catastrophe funds, tax exempt cat reserves for insurers, National Flood Insurance Program (NFIP) reform, and

Risk Retention Act expansion. At the minimum we believe the establishment of a bi-partisan commission to examine these and other proposals has a lot of merit and should be pursued. However we strongly encourage this Commission work in tandem with Congress's efforts on a parallel track and does not merely serve to delay serious consideration of legislation.

The apartment industry has much at stake in this debate. Decreased capacity and pricing increases of insurance will result in higher prices for the consumers and ultimately reduce the level of available housing in certain areas. Especially hard hit will be the level of affordable housing, which is already in short supply. This is why we are encouraged by this hearing and the various legislative proposals that have been introduced or are in the planning stages to address the challenges facing the commercial property insurance policyholder.

NMHC and NAA are currently working with our industry partners through the newly created Natural Catastrophe Policyholder Coalition to identify and lend support to the legislative initiatives that offer long-term stability in the insurance market. In addition to multifamily property owners, our membership includes but is not limited to owners and managers of shopping centers, commercial office properties, hotels, industrial office parks, community bankers, resort developments, residential and commercial Realtors, mortgage bankers, economic development corporations, homebuilders, real estate investment trusts and many other groups representing real estate interests. .

Conclusion

We encourage Congress to move in a deliberative and thoughtful manner rather than react in a time of crisis after another future catastrophic event. Congress should consider the appropriate level of federal participation to ensure adequate coverage is available and at affordable prices to the policyholders of America.

Thank you for the opportunity to submit this statement on behalf of the National Multi Housing Council and the National Apartment Association. Please consider our organizations as resources to the Committee as you continue your important work

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STATEMENT OF THE NATIONAL ASSOCIATION OF REALTORS®

For the

U.S. Senate Committee on Banking, Housing and Urban Affairs Hearing

"An Examination of the Availability and Affordability of Property and Casualty Insurance in the Gulf Coast and Other Regions"

April 11, 2007

Introduction

The National Association of REALTORS® (NAR) appreciates the opportunity to present its views on the availability and affordability of property and casualty insurance in the Gulf Coast and other coastal regions to the Committee on Banking, Housing and Urban Affairs. We thank Chairman Dodd and Ranking Member Shelby for holding this hearing and beginning the discussion to address an issue of concern to homeowners and commercial property owners in the Gulf Coast and other regions of the country.

The National Association of REALTORS® is America's largest trade association, representing more than 1.3 million members involved in all aspects of the residential and commercial real estate business. Ensuring the availability and affordability of property and casualty insurance, therefore, is a top priority for members of NAR.

The storms that hit the Gulf Coast region in 2004 and 2005 have had a significant impact on the availability and affordability of property casualty insurance for homeowners and commercial property owners in the region. These effects have been felt up the Atlantic seaboard as far north as New England. In addition, as other witnesses will testify, the costs associated with the federal recovery efforts from these storms are being borne by taxpayers across the country.

It is for these reasons that NAR strongly encourages the members of this committee and Congress to develop a comprehensive policy that will protect property owners, address insurance availability and affordability, acknowledge the importance and limitations of markets, and recognize the respective responsibilities of property owners and all levels of government.

Overview

The catastrophic events of 2004 and 2005 have shown the need for a comprehensive, forward-looking natural disaster policy. Such a policy would recognize that property owners, private insurance markets, and all levels of government must work together in order to successfully address the problems (e.g., lack of available and affordable property insurance) currently plaguing disaster-prone areas.

The availability and affordability of property insurance is, at its core, a consumer issue. The importance of available and affordable insurance to homeowners, commercial property owners and those who would like to own their own home or place of business cannot be overstated. Unfortunately, it is also something that consumers nationwide – even those who are not in what have traditionally been considered "disaster-prone" areas – now know all too well.

The National Association of REALTORS® believes that any real solution to the insurance problems now facing this country must go beyond a discussion of natural disaster insurance and include a comprehensive natural disaster policy that addresses, but is not limited to, insurance availability and affordability. A comprehensive natural disaster policy also should take into account the responsibilities of multiple actors including property owners, insurance companies and each of the different levels of government in preparing and paying for future catastrophic events. Consequently, although this hearing is titled "An Examination of the Availability and Affordability of Property and Casualty Insurance in the Gulf Coast and Other Regions," our statement offers suggestions for what REALTORS® believe should be included in a comprehensive approach to addressing future catastrophic natural disasters.

Residential and Commercial Properties at Risk

A strong real estate market is the linchpin of a healthy economy, generating jobs, wages, tax revenues and a demand for goods and services. In order to maintain a strong economy, the vitality of residential and commercial real estate must be safeguarded.

Today, insurance availability and affordability concerns are not limited to the Gulf Coast region. We have heard from REALTORS® in numerous states, including New York, New

Jersey, South Carolina and North Carolina, expressing concerns about the availability and affordability of property insurance. Their insurance concerns extend beyond homeowners' insurance and include multifamily rental housing and commercial property casualty insurance.

Insurance is a key component to financing the purchase of real estate. Without property casualty insurance, lenders will not lend; without insurance, borrowers are typically in default of their mortgage terms. The limited availability and high cost of insurance, therefore, not only threatens the ability of current property owners to hold onto their properties, but also to slow the rate of housing and commercial investment in these communities. Either of these threats could, in turn, further delay the rebuilding of communities on our storm-ravaged coasts.

The inability to obtain affordable insurance is a serious threat to the residential real estate market, impacting not only single family detached homes, but condominiums, co-operatives and rental units as well. New home purchases, resale transactions and housing affordability are affected 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 excluded from the market.
- **The cost of owning a home is directly tied to insurance costs.** Homeowners are required by their mortgage lenders to maintain homeowners insurance, regardless of its cost. If the homeowner is unable to afford the cost of that insurance, the mortgage is in default and the lender may foreclose. If disaster insurance coverage is required, potential buyers may choose not to purchase a home because the insurance they need is too expensive. If disaster coverage is optional but expensive, owners 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.

Many of NAR's commercial members in the Gulf Coast and coastal regions have also reported problems with commercial insurance availability and affordability. Members have experienced large increases in premiums-- in some cases more than four-fold with concurrent increases in deductibles and decreases in coverage -- and in some cases, a complete lack of availability. These changes put the property owner at greater financial risk to recover from losses, while also affecting property values since dramatic insurance increases often cannot be passed on to tenants. For example, in the multifamily housing sector, the ability to pass on increased insurance costs in the form of higher rent is often limited by market conditions, rent stabilization laws and strict limits imposed on federally subsidized landlords. The commercial property owner faces similar problems because leases may cover more than one year and may include limitations on the amount of expenses that may be passed on to the tenant. Thus, when insurance costs rise from $0.10 to $0.50 cents per square foot, the landlord must absorb most of the increased costs.

Often it is the smaller property owner that suffers the greatest. Small owners cannot offset the increases in insurance costs for one property with lower insurance costs in other parts of the country; nor are they able to negotiate a lower multiple property rate. In commercial real estate, there is a point at which insurance becomes unaffordable -- when insurance expenses are so high that the property no longer generates sufficient income to cover expenses. This problem forces many owners to sell their property.

Catastrophic Natural Disasters are a National Issue

The catastrophic events of 2004 and 2005 should serve as a wake up call that highlights not only the importance of having insurance, but also that individual property owners, insurance companies, all levels of government, and taxpayers have a role in preparing for and recovering from future catastrophic events. The ongoing recovery from these storms shows that all taxpayers in the country have a stake in a federal natural disaster policy because their tax dollars are funding recovery efforts.

As a result of the 2004 and 2005 hurricanes, attention has focused on Florida and the Gulf Coast states, but other areas of the country are also susceptible to large-scale natural disasters. Damage caused by any of the following events could be as great as, if not greater than, that caused by Hurricane Katrina: a repeat of the 1906 San Francisco earthquake, another 1938 "Long Island Express" hurricane, or a significant seismic event along the New Madrid fault, which extends from northeast Arkansas, through southeast Missouri, western Tennessee, western Kentucky to southern Illinois. While it is true that not all areas of the country are susceptible to the large-scale disaster scenarios above, the effects of these disasters certainly would be felt by all taxpayers.

Elements of a Comprehensive Natural Disaster Policy

The National Association of REALTORS® encourages Congress to develop a comprehensive natural disaster policy that encourages personal responsibility, promotes mitigation measures, ensures insurance availability, and strengthens critical infrastructure (e.g., levees, dams, bridges, etc.). NAR supports the creation of a federal natural disaster policy that will promote available and affordable homeowners' insurance in disaster-prone areas.

NAR supports the creation of a federal policy to address catastrophic natural disasters that:

1) Protects property owners by ensuring that transparent and comprehensive insurance coverage is available and affordable, with premiums being reflective of the risk involved;
2) Acknowledges the importance of personal responsibility of those living in high-risk areas to undertake mitigation measures, including the purchase of adequate insurance;

3) Provides property owners adequate incentives to undertake mitigation measures where and when appropriate;
4) Acknowledges the importance of building codes and smart land use decisions while also emphasizing that proper enforcement of both is best left in the hands of state and local governments;
5) Recognizes the role of States as the appropriate regulators of property insurance markets while identifying the proper role of federal government intervention in cases of mega-catastrophes; and
6) Reinforces the proper role of all levels of government for investing in and maintaining critical infrastructure including levees, dams, and bridges.

NAR believes that now is the time for Congress to address a comprehensive natural disaster policy that includes natural disaster insurance. The lack of a national natural disaster policy has had a measurable direct impact on the availability and affordability of property casualty insurance in many parts of the country. The inability to obtain affordable homeowners' insurance is a serious threat to the residential real estate market – and thus, our economy.

Homeowners and commercial property owners need insurance to protect themselves, their families and their property in case of catastrophe. However, if insurance is not available or affordable, many make the unfortunate, but understandable, decision to purchase only the minimal amount or type of insurance required. This is precisely the decision many Californians have made - buying the required property casualty coverage but foregoing earthquake insurance due to its high cost. The problem with this rational economic decision is that if "the big one" hits, and people are not insured for that type of catastrophe, 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 – by obtaining and maintaining adequate insurance coverage.

Property owners should have confidence that their homes and businesses will survive future catastrophic events. Appropriate mitigation measures can help to create that confidence. Federal and state governments can provide incentives (e.g., tax credits, insurance rate reductions) to property owners to undertake appropriate mitigation measures for their homes and businesses. Research conducted by the Multihazard Mitigation Council of the National Institute of Building Sciences found that a dollar spent on mitigation saves society an average of four dollars.[1]

States are the appropriate regulators of property insurance markets, but there is a proper role for the federal government in addressing mega-catastrophes. Some disasters are just too large or unpredictable for the private market to deal effectively with the resulting damage. At some level, there may be an appropriate role for the federal government to intervene in insurance markets to prevent market disruption and insolvencies among insurance companies. The level of intervention, however, must be set at a level that will not interfere with normal market forces. The difficulty lies in determining the level at which such intervention would be appropriate

Finally, an essential part of a comprehensive natural disaster policy is the recognition of the basic responsibility of government at all levels to build and maintain infrastructure. Hurricane Katrina was not the largest hurricane to ever hit the Gulf Coast, but the failure of the levees protecting New Orleans contributed significantly to the loss of life and property from that storm. USA Today reported on January 29, 2007, "The Army Corps of Engineers has identified 146 levees nationwide [including five in Connecticut] that it says pose an unacceptable risk of failing in a major flood."[2] Last year, the city of Hartford, Connecticut spent $5 million to repair levees to protect thousands of properties worth approximately $2 billion – properties that otherwise would have been required to purchase flood insurance.[3] The cost of maintaining levees can prove very costly, but is a relative bargain when compared to the potential loss of life and property as shown by the failure of the levees in New Orleans. Moving forward, NAR

[1] Multihazard Mitigation Council, "Natural Hazard Mitigation Saves: An Independent Study to Assess the Future Savings from Mitigation Activities, Volume 1 – Findings, Conclusions and Recommendations," National Institute of Building Sciences, Washington, D.C. (2005), p.5.
[2] Peter Eisler, "146 U.S. Levees May Fail in Flood," USA Today, January 29, 2007. http://www.usatoday.com/news/nation/2007-01-28-levees_x.htm?POE=NEWISVA
[3] Ibid.

believes that all levels of government must do a better job of shouldering their respective responsibilities.

To summarize, NAR believes that it is in the best interests of all Americans to have a comprehensive federal natural disaster policy that includes aggressive mitigation and appropriate assumption of risk so that affordable insurance for homeowners and commercial properties is available. Having a comprehensive natural disaster policy is essential in the coming years. There is no guarantee that 2007 or any future years will be as benign for natural catastrophes as 2006. The question is not whether there will be another Katrina-like event in size and scope of destruction, but when. As we have learned, it is far less costly to prepare ahead of time than to fund recovery efforts.

Proposed Legislative Approaches

Congress has, with varying levels of success, debated and voted on natural disaster legislation since the 1990s. The National Association of REALTORS® encourages a healthy and vigorous debate during the 110th Congress that leads to sound and productive legislation. NAR supports the efforts of members of Congress, especially Senators Bill Nelson (D-FL) and Mel Martinez (R-FL), who have introduced and co-sponsored seven bills to address this critical issue.

Legislation introduced in the Senate during the 110th Congress takes different approaches to addressing the natural disaster insurance issue including: allowing insurance companies to accumulate tax-deferred catastrophic reserves (S. 926), allowing homeowners to create catastrophic savings accounts similar to health savings accounts (S. 927), offering mitigation tax credits (S. 930), streamlining regulations for "surplus lines" of insurance (S. 929), creating a federal fund to sell reinsurance to states with catastrophe funds (S. 928), funding hurricane research (S. 931), and creating a bi-partisan commission to study various insurance-related ideas and report back to Congress (S. 292).

NAR encourages the Committee to evaluate carefully each of these approaches and also consider the benefits that would be derived from providing additional funding for infrastructure needs. Mitigation has been proven to save money in the long-run. Ensuring that infrastructure is sound, as shown by the comparison of Hartford and New Orleans above, can also be life-saving. NAR believes that all reasonable proposals should be considered as part of a comprehensive solution to address future catastrophic events. The ultimate result of any legislation should be to ensure that property casualty insurance is available and affordable to homeowners and commercial property owners.

As a first step toward creating a comprehensive natural disaster policy, NAR strongly encourages the Committee to enact legislation to reform the National Flood Insurance Program in order to ensure its long-term viability.

Conclusion

Thank you again for offering the opportunity to present to the Committee the views of the National Association of REALTORS® on the need for a comprehensive natural disaster policy. NAR encourages Congress to develop a comprehensive approach to natural disaster preparedness that encourages personal responsibility, promotes mitigation measures, ensures insurance availability, and strengthens critical infrastructure (e.g., levees, dams, bridges, etc.).

Passage of an appropriate comprehensive national disaster policy is a top legislative priority for REALTORS® nationwide. We stand ready to work with the members of the Committee on Banking, Housing and Urban Affairs and others in Congress to develop a responsible natural disaster policy that addresses the needs of consumers, the economy and the nation.