S. HRG. 106–1109

S. 1361, THE NATURAL DISASTER PROTECTION AND INSURANCE ACT OF 1999

HEARING

BEFORE THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

APRIL 13, 2000

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SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

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CONTENTS

S. 1361, THE NATURAL DISASTER PROTECTION AND INSURANCE ACT OF 1999

THURSDAY, APRIL 13, 2000

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Committee met, pursuant to notice, at 2:52 p.m., in room SR–253, Russell Senate Office Building, Senator Ted Stevens presiding.

Staff members assigned to this hearing: Robert Taylor, Republican Counsel; and Moses Boyd, Democratic Chief Counsel.

OPENING STATEMENT OF HON. TED STEVENS, U.S. SENATOR FROM ALASKA

Senator STEVENS. I am pleased to be able to hold this hearing on one of the most overlooked and potentially devastating subjects, that I feel exist in this country, the issue of natural disaster insurance is not a new issue for this Committee of the Congress. Senator Inouye and I have tried to build a consensus to do something to protect homeowners from natural disasters for some time, starting with the 103rd Congress. There have been a total of 11 hearings, including today's.

I am not going to read this long statement; I'll put it in the record, but let me just close by saying I am sure that everyone realizes that one of the most powerful earthquakes ever to hit this continent was the one that hit Anchorage on Good Friday in 1964.

My family and I lived through that quake. It left a permanent impression on me and all of us in Alaska, and we believe that something must be done to encourage state and local governments to adopt litigation strategies, and provide them with the funds derived from private industry to develop those strategies in order to try and share the burden of the many, many disasters of that type.

We introduced this bill to secure affordable protection from natural disasters for homeowners; a resource pool to cover the cost of major catastrophes, and a way for the government, commercial insurance and consumers to participate in providing a hedge for homeowners, to industry and government if such a natural disaster occurs.

I appreciate the time that you have all allocated to come and help us make a record again this year. Again, I apologize for those three unexpected votes, but I look forward to your testimony. Stu, I know that you have been at this for a long time, too; so we welcome your comments.

[The prepared statement of Senator Stevens follows:]

PREPARED STATEMENT OF HON. TED STEVENS,
U.S. SENATOR FROM ALASKA

I'm pleased to hold this hearing to address one of the most overlooked and potentially devastating subjects facing this country.

The issue of natural disaster insurance is not a new issue to the Committee and Congress. It has been studied many times.

Senator Inouye and I have tried to build consensus to do something to protect homeowners from natural disasters.

Starting with the 103rd Congress, there have a been a total of eleven hearings, including today's.

During recent hearings on a similar measure in the House, there was considerable support for a government reinsurance program to deal with natural disasters.

Our witness, Deputy Secretary Mr. Eizenstat is aware that my staff is working with Treasury to address some of the Administration's concerns. They merit our attention and hopefully we will be able to accommodate some or all of them as best we can.

We will continue to work with the reinsurers. I believe that a provision to give the Treasury Secretary authority to set minimum trigger levels between $2 million and $5 billion as adopted in the House is possible.

In my judgment, the reinsurers should have the opportunity to match terms and conditions of reinsurance contracts sold to state programs. Having said that, we should review whether we should include some provision to accommodate smaller states and small programs such as the Hawaii Hurricane Relief Fund.

Every year, an area of our nation is devastated by a natural disaster and before we can recover from it, there is another tragedy in another area. I believe we must confront this issue and do all we can to protect the American people.

Over the past decade, hurricanes have caused billions in damage to property. In the past year, hurricanes Dennis and Floyd tormented the entire eastern seaboard of the United States.

Hurricane Floyd could have struck the mainland packing winds of 155 mile per hour. According to the Disaster Relief Organization "Floyd could have been the most powerful hurricane to strike the United States mainland this century" where Hurricane Andrew left 160,000 homeless and caused over $26 billion in damages, Floyd could have been much worse.

Alaska has three times more quakes than California. Alaska had at least nine quakes of 7.4 magnitude or more on the Richter scale since 1938.

The 1964 Good Friday quake was one of the world's most powerful at a magnitude of 9.2. My family and I lived through that quake. The earth shook for seven minutes.

Most quakes last under two minutes. For example, California's Northridge quake lasted about thirty seconds.

The Alaska quake destroyed the economic base of entire communities. Whole fishing fleets, harbors, and canneries were lost. The shaking generated catastrophic tidal waves. The effects of the quake were felt as far away as San Diego and Hawaii.

Experts predict that a quake this size in the lower 48 would kill thousands and cost up to $100 billion. This is not improbable, especially in California or in the new Madrid fault line.

When natural disasters have occurred, the federal government has had to bear much of the cost.

According to an article in the *Washington Post,*

> Recent federal research suggests that because of migration [to the coasts] and housing development trends, future storms and earthquakes have the potential to cause $20 billion or more per event in heavily urbanized areas . . . a powerful hurricane making a direct hit on the New Jersey-New York coastline could produce $52 billion in insured property claims. A New Madrid category earthquake near Memphis could cause $69.7 billion in claims.

I introduced a bill in order to secure affordable protection from natural disasters for homeowners, a resource pool to cover the cost of major catastrophes, and a way for government, commercial insurance, and consumers to participate in providing a hedge for homeowners, the industry and government if a natural disaster occurs.

S. 1361 establishes a program for state insurance pools, programs, private insurers and reinsurers to buy reinsurance for natural disasters from the federal government.

These entities would pay reinsurance premiums that are allowed to grow into a reserve to cover future losses if needed. The reinsurance is sold on a regional basis with the premiums based on risk.

This bill also encourages states and local governments to adopt mitigation strategies and provides them with funds derived from the private industry to develop them.

The $200 million mitigation figure at page 78 of the bill, as introduced, contains one too many zeroes—$20 million would be used from premiums for natural hazard mitigation.

[The prepared statements of Senator Hollings and Senator Inouye follow:]

PREPARED STATEMENT OF HON. ERNEST F. HOLLINGS, U.S. SENATOR FROM SOUTH CAROLINA

The underlying purpose of the legislation which is the subject of today's hearing is to reduce federal disaster costs by encouraging hazard mitigation and creating a mechanism to ensure the availability of property insurance for persons living in areas prone to natural disasters. I must say this is a laudable goal, and one that I can appreciate as a resident of a coastal state.

As I indicated at previous hearings on this issue, I can definitely appreciate the concerns about natural disasters. Over a decade ago, South Carolina was struck by one of the costliest storms of the century—Hurricane Hugo. Hugo caused approximately 29 deaths, and an estimated $6 billion in damages.

With respect to federal policy, I agree that efforts should be made to reform the manner in which the federal government currently handles natural disasters. I have always taken the position, however, that one of the most effective ways to deal with this issue is through mitigation. A sound mitigation program will result in the building of safer structures, which will help to reduce structural damage, and in turn, disaster costs. Title II of the legislation seeks to address this issue. I certainly would like testimony from the witnesses that will appear today, and from other experts, on whether the provisions in the bill effectively address the issue.

Of course, the most controversial part of the bill is Title III which provides for the creation of the insurance program. The legislation allows for the establishment of a special corporation—to be comprised of and managed by insurance companies, to provide reinsurance to companies and state insurance pools in natural disaster prone areas. The reinsurance is to be provided in the form of individual contracts. The contracts will be used to pay losses whenever total losses from a single event reaches a certain trigger—$2 billion is the operative number in the bill. The premiums on the contracts will be set by the corporation and are required to be actuarially sound. In situations where losses associated with an event exceed the assets of the corporation, the corporation is permitted to borrow funds from the federal treasury to cover losses. The Treasury Department is mandated to make these loans available. The agency is to determine the interest rates based on the rates of other government maturities. The corporation will have 20 years to repay each loan. The bill also includes provisions to encourage states to implement mitigation programs. States that failed to do so would be prohibited from receiving mitigation funds from the corporation that are provided for under the bill.

A number of groups have raised concerns about the legislation. These include the National Taxpayers Union, the Competitive Enterprise Institute, consumer groups, and small insurance companies. They argue that the Committee should approach the issue pursuant to the following questions:

1. Is there sufficient capacity in the insurance market to provide insurance companies reinsurance without federal involvement?

2. Should the federal government be in the business of providing favorable loans to an industry that has more than a trillion dollars in assets and does the program have the potential of exposing federal taxpayers to massive liability?

3. Should the federal government provide aid to an industry that is not subject to antitrust and regulatory federal laws?

These are legitimate questions to be raised and issues which today's witnesses have been invited to address. I must say for the record, however, that I am particularly sensitive to the issue concerning the federal regulation of insurance companies. For years, I have been a supporter of the McCarran-Ferguson Act and state regulation. It appears, however, that many in the insurance industry want it both ways—

preserve state regulation but support federal involvement when it's to the industry's benefit. That I cannot support. Nevertheless, I am open to trying to put together a good piece of legislation that will adequately address the important issues concerning this subject. I thank the witnesses for appearing and look forward to their testimony.

PREPARED STATEMENT OF HON. DANIEL K. INOUYE,
U.S. SENATOR FROM HAWAII

Mr. Chairman and Members of the Committee:

I deeply regret a scheduling conflict will not allow me to attend today's hearing. As many of you know, my interest in providing a federal program for hazard mitigation and insurance against the risk of catastrophic natural disasters stems from the hurricane disaster which struck the Island of Kauai in 1992. Both Senator Stevens and I have examined various disaster insurance measures for the last several Congresses. I wish to commend Senator Stevens for his continued efforts on this issue. I remain committed to working with Senator Stevens and the Chairman to see a bill favorably reported by the Commerce Committee.

Although S. 1361 will not completely eliminate the federal burden of disaster relief or the availability problems of disaster insurance, I believe the measure is a needed first step on which to build future efforts to provide affordable disaster relief coverage. S. 1361 will help to reduce the cost of natural disasters to federal taxpayers by promoting private funding of mitigation efforts at the state level and by promoting greater availability of private homeowner's insurance in areas prone to natural disasters.

There are several differences of opinion with respect to the $2 billion threshold established under S. 1361. For example, the $2 billion threshold is too high for smaller states such as Hawaii. As this measure moves through the legislative process, I hope we will examine possible alternatives for a lower threshold for smaller states either by region or by state population size. In this regard, I am pleased to share with you a copy of a letter from Mr. Amori R. Ogata, Executive Director of the Hawaii Hurricane Relief Fund.

I wish to extend a warm welcome to the witnesses and look forward to reading your testimony.

STATE OF HAWAII,
Hawaii Hurricane Relief Fund,
Honolulu, HI, March 20, 2000.

Hon. TED STEVENS,
United States Senator,
Washington, DC.

Dear Senator Stevens:

We were asked by Senator Daniel Inouye to provide comments on S. 1361, titled "Natural Disaster Protection and Insurance Act of 1999." We appreciate the opportunity to comment.

The Hawaii Hurricane Relief Fund (HHRF) is a State entity started in 1993 for the purpose of providing hurricane property insurance in Hawaii. This was necessary following a scarcity in property insurance following Hurricane Iniki in 1992. The HHRF was intended as a short term solution that would terminate when the insurance industry became strong enough to once again provide sufficient residential insurance including coverage for hurricanes. If the HHRF were to continue its operations, S. 1361 provides a framework for loss coverage above the level of coverage provided by the HHRF.

S. 1361 provides State operated insurance or reinsurance programs with reinsurance contracts above minimum retention limits of $2 billion.

Although the HHRF supports any legislation benefiting State-operated catastrophe insurers or reinsurers, the minimum retention limits proposed in the Act would make Hawaii's or any other smaller State program's participation precarious. For only one of the past seven years was the HHRF able to afford $2 billion in retention. Today, with the number of policyholders rapidly declining, the HHRF is unable to achieve a $2 billion retention. Additionally, modeling may not dictate that $2 billion is needed for the most likely loss scenarios. A possible solution to ensure that all States may participate is to have minimum retention limits actuarially determined. An actuarial report indicating retention levels could be submitted with the request to purchase reinsurance.

Another possible solution would be to make reinsurance from the Natural Disaster Insurance Corporation available to several distinct groups of States, with the entire group subject to a group retention. A geographical solution may not be appropriate since, for example, Hawaii would likely be linked to California, lumping together Hawaii's more limited hurricane risk with California's earthquake risk. An alternative might be to group States by actuarially determined risk levels pursuant to actuarial reports submitted by all States. This might allow for a lower retention for groups of States actuarially determined to have lower risks. Another alternative might be to group States so that each group contained roughly equal populations.

Also, to require these reinsurance contracts to be repaid if drawn upon moves this Act more towards a line of credit as opposed to traditional reinsurance. Given the size of the draw and limited finances of a State fund, the potential for a State to be perpetually in debt seems very possible. The HHRF would prefer to have these contracts maintain the characteristics of traditional reinsurance (full risk transfer). Alternatively, since the "Risk Load" component of the cost of these contracts appears to provide for profit, once the reserves built within the program reach certain limits, the repayment requirement of drawn amounts could be terminated. Relative to the requirement to continue to purchase reinsurance contracts following a drawing, the HHRF is unsure whether the premiums paid for the reinsurance contracts would be used to pay down any loans borrowed. If not, the requirement to continue to purchase reinsurance contracts would decrease the available cash to pay on any loans outstanding.

Finally, the HHRF is concerned that they would have been surcharged on the reinsurance contract should the payout on claims be prorated. Therefore, would there be any refund of premiums?

Attached, please find additional technical comments.

Very truly yours,

AMORI R. OGATA,
Executive Director.

Attachment

Technical Comments To S. 1361

1. Section 4. Definitions. Number (22)(A): It's not clear whether the state insurance pool must provide coverage for all listed perils or whether it can provide for one or more listed perils. That is, the "and" should be an "or."

2. Section 303. Program Authority. 303(c)(1): How can the reinsurance coverage avoid competing with the private insurance or reinsurance markets or capital markets? Perhaps this requirement should be deleted.

3. Section 305. Covered Perils: (1)(D). The "and" should be an "or," unless each reinsurance contract is to cover all listed perils.

4. Section 306(a)(6)(B): Depending on the way the regulations are worded, items (ii), (iii) and (iv) could change the way existing State programs are functioning. For example, State operated insurance entities may not be charging the optimum rates, or providing the optimum coverage, suggested by an actuary.

5. Section 306(b)(7): Are reinsurance premiums applied to loans or does the state entity have to repay loans and purchase reinsurance? We suggest a clarification on that point to the effect that premiums are applied against the loan amount.

6. Section 306(b)(8) INFORMATION: Should there be a requirement that the Corporation hold confidential certain types of information that may be in the possession of the State program (e.g. relating to private insurers book of business)?

7. Section 306(c) PRICE GOUGING PROTECTIONS: line 4: Can any laws or regulations be "sufficient to prohibit price gouging"? Maybe it should read "laws or regulations that prohibit price gouging" or "laws or regulations sufficient to deter price gouging."

8. Section 308(b)(3) ANNUAL ADJUSTMENT, last two lines: How can the reinsurance coverage avoid competing with the private insurance or reinsurance markets or capital markets? Perhaps this requirement should be deleted.

STATEMENT OF THE HON. STUART E. EIZENSTAT, DEPUTY SECRETARY, DEPARTMENT OF THE TREASURY

Secretary EIZENSTAT. Thank you, Mr. Chairman. It's always a privilege to be with you, and I want to compliment you, Senator Stevens, for your steady and consistent leadership on this issue. I mean that with all sincerity.

We look forward to continuing to work with you toward our shared objective of achieving a legislative outcome commensurate with the grave seriousness of the problem.

Disasters are of course a tremendously tragic occurrence; their costs can be astronomical not only in financial but in human terms as well. The administration has developed a comprehensive policy for dealing with natural disasters, under the leadership of James Lee Witt, the FEMA director; and we view well-functioning insurance markets as a compliment to that policy.

We believe there is in fact a role for the Federal Government to play with respect to the provision of reinsurance for the risk associated with the most severe, least probable disasters. And we believe that role should respect two principles, Mr. Chairman; one, that we should leave more than enough room for private market activity to grow and flourish, and second, the taxpayer should be adequately compensated for any financial risks they are asked to bear.

In line with those principles, we believe the Federal involvement should be strictly limited and on an interim basis, pending the more complete development of private market solutions.

We see the legislation now before the Committee which you've championed as a generally positive step forward, and as a solid foundation on which to build. In our view, the proposed legislation constructively and creatively responds to the difficulty faced by both state funds and private entities, in purchasing reinsurance against their potential large but low probability losses on homeowner's insurance.

The characteristics of natural disasters make the risk associated with them especially difficult for the private insurance market to handle. Natural disasters happen only infrequently, but when they do they can be exceedingly severe, as you reflected in your own experience in Alaska.

Reflecting this difficulty, prices for disaster reinsurance for homeowner losses can be very high, measured relative to expected losses; and prices have in the past spiked and markets have shrunk following such disasters for a considerable period of time.

Because of their tremendous capacity for absorbing loss, we view the capital markets in which disaster risk increasingly can be bought and sold like many other risks, as a crucial compliment to the traditional reinsurance industry. We very closely monitored the development of the private capital markets in this regard, and while progress has not come as fast as we had hoped, we still expect that insurance securitizations in capital markets will be a significant part of well-functioning markets for disaster risk in the long run.

But we are persuaded at the same time that a problem still remains at least for the short period of time, until the private market can fully take over while the volume of these securitizations builds, and that a well-designed transitional Federal program could be constructed.

Four considerations argue in favor of a prudent, interim participation by the Federal Government in the market for disaster risk management. First, it is better to undertake policy prior to a catastrophic event. Second, the Federal Government is uniquely capable of spreading risks across the population and over time. Third, the Federal Government would likely bear in any event costs associated with destabilizing distressed insurance markets if there were a true cataclysmic event, whether or not we have this legislation. And finally, prudent participation at this stage may enhance the ability of private markets to deal with these risks.

It is essential that any Federal involvement be guided by a sense of, we think common sense principals. First, that Federal involvement must support and not supplant private insurance markets. It must be partial, applying only to two true catastrophes that the private market is not capable of handling, it must be transitional, phasing down as private markets develop.

And second, Federal involvement must share and not subsidize risk. Federal involvement must create new capacity to absorb risk, but that involvement should be priced so as to compensate the taxpayer adequately for the financial risk involved. The pricing of this Federal involvement should be so robust that on a prospective probability rated basis, the program would impose no net cost to the taxpayer.

We believe, Mr. Chairman, that there are several ways in which the legislation can be improved so it better addresses the market problem we see and fulfills our public stewardship responsibility. And permit me to briefly summarize.

The first involves governance. S. 1361 would establish a new corporation, owned and operated by the purchasers of the disaster-related contracts sold under this program. That corporation would have special ties to the government, importantly including a limited ability to borrow from the U.S. Treasury.

Our concern is that it would create an entity that is charged with fulfilling a public mission, making public judgments, and having access to public benefits, but that would be owned and controlled by private purchasers. There's a risk that the entity may not carry out its charge appropriately and could use public benefits for private gain.

In our view, a preferable approach would be to lodge the authority squarely in the Federal Government. We believe this for several reasons, Mr. Chairman.

First, it would provide a very strong set of controls over operations that have to be in place to assure the taxpayers are adequately protected in assuming risks.

Second, a Federal entity is better suited, in our opinion, for making decisions of a truly public nature, such as are inherent in this program. To take just one example, pricing decisions have to reflect a balance of factors including fairness to taxpayers. And finally, a Federal entity could be focused narrowly upon the direct mission; it would be more easily sunsetted when there is no longer a need for Federal intervention.

At the same time we would be pleased to continue to work with you and the Committee to develop alternatives that set the entity properly within the Federal Government.

Next is the issue of caps. The proposed legislation would limit or "cap" payouts on the contracts sold by the corporation in the event the contractual obligations exceed the resources of the corporation. This cap would be implemented by limiting the corporation's borrowing from the Treasury to the amount it could repay within 20 years. If contractual obligations were to exceed the sum of all resources available to the corporation, then available resources would be prorated among entities holding the contracts and due a payment.

We obviously share your objective of developing a fiscally prudent piece of legislation. We share your belief that a limit on the potential draw on the Treasury is an essential item of fiscal prudence. But we are concerned about the robustness of a cap that would, in some circumstances, require proration of payments across claimants. The reason is, that in those circumstances Mr. Chairman, we believe there would be enormous pressure for full payment to be made on all contracts, despite the fact that the fees or premiums on the contracts had been set on the assumption that only partial prorata payments would be made. As a result, we believe it plausible that taxpayers would be exposed to financial risk for which they haven't been fairly compensated.

We believe that it's possible to design an approach to capping the Federal liability that would avoid such exposure. One possible approach would involve limiting the amount of insurance to be sold, not the amount of payoff to be made, and honoring the face amount of these contracts in all cases.

Briefly, Mr. Chairman, a mechanism would work along these lines, and we've enclosed a chart which I have here, and we'll go through in a minute.

Contracts sold under the legislation would cover 50 percent of losses above a deductible, up to an upper limit corresponding to the dollar amount that would be lost in the event of some more remote probability. For the sake of illustration, one could consider setting the upper limit at a dollar amount corresponding to a one in 500-year event.

Under this approach, the maximum theoretical draw on the Treasury would be calculated as the sum of the maximum obligations in each state and region. The probability that this draw would actually be made would extremely small. There would be certainty about what we could pay; we would pay out exactly what we said we would pay.

On this chart, Mr. Chairman, the Federal Government's liability again would be limited by capping the amount of insurance sold, rather than selling an unlimited amount and then capping payments.

In this chart, the deductible amount is set at a loss associated with a one in one hundred year event. For example, on the far left, Florida; a one in one hundred year event for Florida would inflict—for illustrative purposes, and these are of course rough figures—residential property damage of about $13 billion.

Again for purposes of illustration, the ceiling would be set at a loss associated with a one in 500-year event. The one in 500-year event for Florida would be shown and is shown at $26 billion. The coverage would be offered to Florida for half of that layer in between. Similarly, for California, next to Florida, the chart shows an one in 100-year event at $11 billion and a one in 500-year event at $14 billion.

The government's maximum exposure in each state is 50 percent of the difference between the ceiling and the deductible. For example, in Florida, there is again a $13 billion difference between the deductible level, which is around $13 billion, and the ceiling level, which is $26 billion. The U.S. Government would then pick up 50 percent of that difference, leaving the other 50 percent to the private sector.

That would therefore cap the U.S. Government liability at $6.5 billion if a $26 billion one in 500-year event occurred. Of course, if it was only a one in 300-year event, exposure would be less.

For California, the maximum exposure would be $1.5 billion. The private market would remain exposed for the remaining 50 percent. So again, the government's maximum exposure would be the sum of these amounts across states. A loss of this magnitude to be experience with all contracts offered to each state and region were actually purchased, and an event of sufficient size occurred in every one of them.

The aggregate amount of government exposure could be set in your legislation. The ceiling amounts in each state and region would follow as an implication of the desired aggregate exposure and deductibles. Separately, Treasury would adjust the level deductible after the first year, taking into account developments in private market and other factors.

This has the other advantage, Mr. Chairman, of leaving room for the private sector in two ways: First, in that first one in 100-year event; that is the deductible amount, that is all private. So for example in the Florida example, that would be that first $13 billion. And then even on the amount above it, where the Federal role will come in, the Federal Government would only pick up 50 percent, the $6.5 billion, leaving an additional amount for the private sector to be able to come in.

So under the approach we are proposing, the corporation would only sell a limited amount of coverage, but having sold it, would make good on all of it. We'd be happy to continue to work with you and the Committee to create a cap on Federal liability consistent with our mutual objectives of designing a fiscally prudent program.

Another issue is a sunset. We believe that this program should be sunset after some fixed number of years, and we would work with you on how long that should be. To preserve adequate incentive for the further development of private market. The goal should be to ensure that the proposed program supports rather than supplants the growth of the private market and sunsetting would be a way of achieving that.

Next is the continued purchase requirement in the legislation. The proposed legislation would require a state program participant to continue purchasing reinsurance in the even that the participant were to receive a payout from the corporation that caused the corporation to have to borrow or increase its borrowing from the Treasury. The participant must continue to purchase the reinsurance until the borrowed funds are repaid.

We have some problems with that provision, Mr. Chairman. For one, we think it could further burden an already stressed public or private entity in the aftermath of a disastrous event, raising the possibility of a scenario in which the requirement would be waived. In this case, the corporation would have been adequately compensated for the financial service that it would have.

An alternative approach, we think, is to provide for the option of offering multi-year as well as 1 year contracts, if market conditions indicate such contracts would be appropriate and desirable.

So just to go back to one more minute on the cap, because I know this is a crucial issue, we are concerned with the fact that in the cap that is provided in the bill, that there would just be enormous pressure when you are talking about prorated, to go ahead and make complete payments. And so we think therefore the risks would be higher than under our cap.

In conclusion, Mr. Chairman, all of our suggestions derive from two basic principles; that relief for insured homeowners not come at the expense of taxpayers, and that Federal intervention must share risk and support private markets. The current proposed legislation, your legislation, we believe provides a sound foundation for progress in this area. We look forward to working with you, Mr. Chairman and other members of the Committee, to resolve those concerns that we have, and we believe that that is something that is certainly possible.

So thank you for the opportunity. We look forward to working with you and we respect greatly the effort that you have put into this over the years.

Senator STEVENS. Well, thank you very much, Mr. Secretary. I have some problems, I had a conversation yesterday with Senator Gramm, who is chairman of the Banking Committee, probably has some jurisdiction over this bill, too; and I pointed out to him the House bill.

I am told that when you testified on the House bill concerning—H.R. 21—you said that the administration remains convinced that a well-designed reinsurance program could help provide the foundation for communities, individuals and the private markets on which they could depend, to a sound recovery and financial crisis.

And it went on to say—that's sort of paraphrased in one place. In our view, the proposed legislation, H.R. 21, constructively and creatively responds to the difficulty faced by both state insurance funds and private entities in purchasing reinsurance against their large but low probability losses on homeowner's insurance.

Now I do know that your staff and ours are working together, and hopefully we can come together.

Are you saying you prefer the form of the House bill over the Senate bill? Is it a matter of substance, or form?

Secretary EIZENSTAT. We think as a matter of substance that the House bill reflects our view on a variety of issues, including cap and repurchase and so forth, to a greater degree.

Again, we believe that your bill does provide a sound basis, but we believe that the closer one can come to the administration's views, many of which were incorporated in H.R. 21, the more enthusiastic we can be.

Senator STEVENS. Do you view it possible that we could work together and take the approach of the House bill and modify it to some extent by what we've developed over here, and have a bill that the administration could approve?

Secretary EIZENSTAT. Well, it obviously would depend on precisely what changes were made, but we certainly would like to work with you, Mr. Chairman. We would like to see, and I want to make this very clear; we would like to see legislation. We think this is an area in which legislation is needed; we think there is a market imperfection here; we believe that additional Federal reinsurance would improve the availability of homeowner's insurance, it would ameliorate market contractions and long-lasting price spikes following a disaster, and that it could encourage a reduction in insurance costs in many areas, and actually encourage private reinsurance.

So we think there is a need, and we would look forward to trying to work with you to produce legislation that we could accept.

Senator STEVENS. Our goal really is to try and deal with the homeowners problem, and as much as possible to take that out of the area where, in a normal—not 500-year, not 100-year, but a normal period of disasters, regional rather than national type, that the private sector could adequately deal with them.

Our experience is that in the smaller disasters that are enormous for one state but isolated in that state, requires a national mobilization, takes time to bring people from Washington or wherever they might be in the region; whereas the private sector can move in very quickly and help ameliorate the loss, and bring about recovery much faster under conditions that are a lot more flexible in terms of the basic instructions to those who are adjusting the losses, and that the whole nation would be better off with that.

We seem to be spending our time mostly on the extraordinary loss, which is the more than 300, up to 500-year projected possible loss. And that is what is holding us up. We are not really dealing with the $13 billion, we never get to that. We just assume that the industry will be capable of covering that without any basic assurance that if it goes in excess of that, that they wouldn't all be bankrupt. I would hope that we would find some way to get together. As I said, I think this is the 11th hearing that I've chaired or participated in on this subject in the last terms of my existence here in the Senate and Senator Inouye and I are sort of getting a little weary about pursuing it, because we get right down to the point where it's possible to move, but then something else comes up every time.

I think we ought to find some way to come to closure. I would urge you to do that. I think we can accommodate most of what you've just said in modification to this bill or the House bill and achieve our common goal with the House. But that never takes place.

Secretary EIZENSTAT. Well, we have absolutely no inclination to delay or forestall action. We would like to work with you. We've put frankly a lot of time and effort into it ourselves. We tried to come up, for example, with what I think is a fairly creative cap.

I want to stress to you that there is no magic to the one in 500 and the one in 100 levels; I understand for example that some in the reinsurance industry are saying, well they might like a different level so they have a greater opportunity to come into the market at the beginning. There is no magic level to it; what we want is a realistic program and one that protects taxpayers, and one that fills a market void—and there is a market void.

So we are, as we did with the House, willing to work with you sincerely, with your staff—our staffs, as you mentioned, have already been working—and nothing would please me more than this would be your last hearing on this issue.

Senator STEVENS. We want to work with you. The problem is without some reinsurance capability, an assurance that the government will be there, there is no—these policies are not being marketed at a price that they can be afforded, and as a consequence, we see an ever-increasing exposure of the taxpayers, witness the Rapid City exposure, the California earthquake, the recent hurricanes along the East Coast. Those dwarf in settlements—the settlement that took place in Alaska after that monstrous earthquake. Every year they get higher, and every year it gets more difficult to pass legislation that might limit the recovery, particularly in terms of the times when there's a repeated disaster to the same home.

I think we're going to have to find some way or ultimately the public is going to say it's a total Federal responsibility and not have any really private sector coverage on disasters of this type because of the fear that the next one might be the biggest one.

Secretary EIZENSTAT. Well, the GAO recently expressed concern over the ability of insurers to withstand the greater than one in one hundred event, and of course no one can know for sure, but if history is a guide, if you look at two recent huge events, Hurricane Andrew in 1992 and the Northridge earthquake in 1994, following each of those events, smaller companies became insolvent, insurers and reinsurers withdrew from the market to reassess their exposures, and markets went through frankly a surprisingly long period of turmoil; prices spiked, private insurance availability shrank, state risk pools expanded.

So there is a problem. We recognize that. We believe there is a Federal role; it should be limited and it should be sunset, but there is a role and we want to work with you to appropriately put that role in and protect taxpayers at the same time and not crowd out the private market. We think this cap mechanism does just that.

Senator STEVENS. Well, we look forward to our staff pursuing that avenue with you and your staff. We stand ready, those of us that have been involved here, to meet with you personally or anyone that you select, to see if we can bring this to a closure this year. If possible, we would like to see that happen.

Secretary EIZENSTAT. That would be our goal as well.

Senator STEVENS. Again I apologize for keeping you waiting. It was just beyond my control.

Secretary EIZENSTAT. Never a problem.

Senator STEVENS. Thank you.

I will print your full statement in the record in case you didn't read it all, and my opening statement.

Secretary EIZENSTAT. Thank you. I did not read it all, so that would be appreciated. And if the chart also could be put into the record, we'd appreciate it.

Senator STEVENS. It will be. It is a good chart. It's very self-explanatory, as a matter of fact.

[The prepared statement of Secretary Eizenstat follows:]

PREPARED STATEMENT OF HON. STUART E. EIZENSTAT, DEPUTY SECRETARY, DEPARTMENT OF THE TREASURY

I. Introduction

Mr. Chairman, Senator Hollings, Members of the Committee. Thank you for providing me the opportunity to discuss with you the important issue of natural disaster insurance. Let me begin by complimenting you, Senator Stevens, for your steady and consistent leadership on this issue. We look forward to continuing to work with you toward our shared objective of achieving a legislative outcome commensurate with the seriousness of the problem.

Disasters are of grave importance for all. Their cost can be astronomical, not only in financial terms but also in human terms. The Administration, under the leadership of James Lee Witt, the Director of FEMA, has developed a comprehensive policy for dealing with natural disasters, going beyond simply the response to them, to work with local communities to reduce their exposure to natural disasters. We view well-functioning insurance markets as a complement to that policy. While insurance cannot undo the costs of a natural disaster in human terms, it can provide the foundation for a sound recovery in financial terms.

We believe there is a role for the Federal government to play with respect to the provision of reinsurance for the risk associated with the most severe, least probable disasters. We believe that role should respect two principles—that we should leave more than enough room for private market activity to grow and flourish, and that the taxpayers should be adequately compensated for any financial risks they are asked to bear. In line with those principles, we believe the Federal involvement should be strictly limited, and on an interim basis, pending the more complete development of private market solutions.

In that regard, we see the legislation now before the Committee as a generally positive step forward. In our view, the proposed legislation constructively and creatively responds to the difficulty faced by both state funds and private entities in purchasing reinsurance against their potentially large, but low-probability losses on homeowners' insurance. Although we are concerned about some aspects of the bill, I understand that our respective staffs have begun a productive dialogue, and we look forward to working with Members on both sides of the aisle to explore means of resolving those concerns.

An important portion of the bill addresses issues related to mitigation. We respect and appreciate your interest in this topic. As you know, the Administration strongly supports efforts to encourage mitigation, an indispensable form of "preventive medicine" to protect communities against the ravages of natural disasters, and is placing increased emphasis on pre-disaster mitigation efforts. However, this vital area is not a province of Treasury, so I must defer to FEMA on questions that reach solely to mitigation policy and provisions. My testimony will therefore focus on the reinsurance aspects of the bill, and will touch on mitigation provisions only insofar as they affect those reinsurance aspects. However, let me say that we view insurance markets and pre-disaster mitigation initiatives as natural complements, and I understand, Senator Stevens, that you have spoken with Director Witt several times on mitigation.

II. Review of the Problem and Our Principles

The characteristics of natural disasters make the risk associated with them especially difficult for insurers to handle: natural disasters happen only infrequently, but when they do occur, they can be exceedingly severe. Reflecting this difficulty, prices for disaster reinsurance for homeowner losses can be very high measured relative to expected losses, and prices have in the past spiked—and markets shrunk—for a considerable time following a disaster.

Because of their tremendous capacity for absorbing losses, we view the capital markets, in which disaster risk increasingly can be bought and sold like many other risks, as a crucial complement to the traditional reinsurance industry. We have closely monitored the development of capital markets. While progress has not come as fast as we had hoped, we still expect that insurance securitizations in capital markets will be a significant part of well-functioning markets for disaster risk in the long run. But we are persuaded that a problem still remains at least for a time—while the volume of these securitizations builds—and that a well-designed transitional Federal program could be constructive.

Four considerations argue in favor of a prudent, interim participation of the Federal government in the market for disaster risk management at this time. First, it is better to consider undertaking policy prior to a catastrophic event; surely, if we can do it, the time to fix the roof is when the sun is shining. Second, the Federal government is uniquely capable of spreading risk across the population and over time. The capacity of the Federal government to gather resources from a wide base for the purpose of meeting short-term contingencies dwarfs that of any single private-sector entity. Third, the Federal government would likely bear part of the cost associated with stabilizing distressed insurance markets in a truly cataclysmic event regardless of whether legislation of the type now before the Committee is enacted. Finally, prudent participation at this stage of development may enhance the ability of private markets to deal with these risks.

It is essential that any Federal involvement be guided by a set of common-sense principles. Let me enumerate those principles.

- Federal involvement must support, not supplant, private insurance markets.
  - —It must be partial, applying only to true catastrophes that the private market is not capable of handling.
  - —It must be transitional, phasing down as private markets develop.
- Federal involvement must share, not subsidize, risk.
  - —Federal involvement must create new capacity to absorb risk, but that involvement should be priced so as to compensate the taxpayer adequately for the financial risk involved. In particular, the pricing of this Federal involvement should be sufficiently robust to ensure that—on a prospective, probability-weighted basis—the program will impose no net cost on the taxpayer.

III. The Bill Before the Committee

Let me now turn to the specifics of the proposed legislation before you. In brief, S. 1361 would establish a new not-for-profit Corporation that would sell excess-of-loss reinsurance to qualifying state funds, and auction industry excess-of-loss contracts to interested State or private purchasers for losses above certain threshold "deductible" amounts, incurred on residential policies. The Corporation would establish a Trust Account into which a portion of contract payments and associated investment earnings would be placed; and would disburse monies from that Trust as well as proceeds from its own borrowings, if any, to holders of its contracts in the event of a qualifying disaster. The Corporation would be able to borrow from private markets; in addition, it would be eligible to borrow from the Treasury in the event that its other resources proved insufficient to make promised payments. The bill would establish an Independent Board of Actuaries that would approve the initial operating plan, and help ensure that the pricing of the contracts sold by the Corporation offered sufficient protection for taxpayers.

The bill would require that states develop and undertake mitigation plans approved by FEMA to reduce the hazards of covered disasters, with progress to be evaluated periodically by FEMA. It would also establish in Treasury a separate Mitigation Account, consisting of required annual payments by the Corporation and appropriated funds, to be distributed to participating state programs that have satisfied the mitigation plan requirement.

IV. Suggested Improvements

We believe there are several ways in which the legislation can be improved so that it better addresses the market problem as we see it and fulfills our public stewardship responsibility. Let me enumerate here the most important of these suggested improvements.

Governance

S. 1361 would establish a new Corporation, owned and operated by the purchasers of the disaster-related contracts sold under this program. This Corporation would have special ties to the government, including importantly a limited ability to borrow from the Treasury. Our concern with this aspect of the bill is that it would create an entity that is charged with fulfilling a public mission, making public judgments, and having access to public benefits, but that would be owned and controlled by purchasers. There is a risk that the entity may not carry out its charge appropriately, and could use its public benefits for its own private gain. In our view, a preferable approach would be to lodge the authority for this program squarely within the Federal government, for several reasons. First it would provide the very strong controls over operations that must be in place to assure that taxpayers are adequately protected in assuming risks such as these. Second, a Federal entity is better suited for making decisions of a truly public nature, such as are inherent in the operation of this program. To take just one example, pricing decisions must reflect considerations of fairness to taxpayers. Finally a Federal entity could be focused narrowly upon the direct mission, and would be more easily sunsetted when there was no longer a need for Federal intervention. The House bill, H.R. 21, embodies a concept along the lines we prefer. We have had productive discussions with your staff on this topic, and would be pleased to continue to work with the Committee to develop alternatives that set the entity within the Federal government.

Cap

The proposed legislation would limit or "cap" payouts on the contracts sold by the Corporation in the event that contractual obligations exceed the resources of the Corporation. This cap would be implemented by limiting the Corporation's borrowing from the Treasury to the amount the Corporation could repay within 20 years. If contractual obligations were to exceed the sum of all resources available to the Corporation, available resources would be prorated among entities holding the contracts and due a payment.

We share your objective of developing a fiscally prudent piece of legislation. And we share your belief that a limit on the potential draw on the Treasury is an essential component of fiscal prudence. But we are concerned about the robustness of a cap that would, in some circumstances, require proration of payments across claimants. In those circumstances, we believe there would be enormous pressure for full payment to be made on all contracts despite the fact that the fees or premiums on the contracts had been set under the assumption that only partial payment might be made. As a result, we believe it plausible that taxpayers would be exposed financial risk for which they had not been fairly compensated.

We believe that it is possible to design an approach to capping the Federal liability that would avoid such exposure. One possible approach would involve limiting the amount of insurance to be sold. Briefly, a mechanism along these lines could work as follows. Contracts sold under the legislation would cover 50 percent of any losses above the deductible, up to an upper limit corresponding to the dollar amount that would be lost in an event of some more remote probability. For the sake of illustration, one could consider setting the upper limit at the dollar amount corresponding to a one-in-500-year event. Under this approach, the maximum theoretical draw on the Treasury could be calculated as the sum of the maximum obligations in each state and region. The probability that this draw would actually be made would be extremely small. The attached chart illustrates our proposal.

Thus, under the approach we are proposing, the Corporation would sell only a limited amount of coverage, but, having sold it, would make good on all of it. We have had constructive discussions with your staff on this point, and we would be happy to continue to work with the Committee to create a cap on Federal liability consistent with our mutual objective of designing a fiscally prudent program. The appendix explains our proposal in more detail.

Sunset

We believe that this program should be sunsetted after some fixed number of years. A sunset-type provision is important in order to preserve adequate incentive for the further development of the private market. As we have said earlier, we continue to believe that private markets will ultimately be able to supply coverage for even huge natural disasters, given sufficient opportunity for growth. The goal should be to ensure that the proposed program supports rather than supplants this growth of the private market. Again we would be happy to continue our work with your staff on this issue.

Continued Purchase Requirement

The proposed legislation would require a state program participant to continue purchasing reinsurance in the event that the participant were to receive a payout from the Corporation that caused the Corporation to borrow or to increase its borrowing from the Treasury. The participant must continue to purchase the reinsurance until the borrowed funds are repaid.

This provision raises some difficult issues. For one, it could further burden an already stressed entity (public or private) in the aftermath of an event, raising the possibility of a scenario, not unlike the one that causes us concern over the annual cap, in which the requirement would be waived. In this case the Corporation would have been inadequately compensated for the financial service it would have, in fact, provided.

While this provision may serve a useful role within the Corporation governance structure, it would not be needed were the program to be lodged within a Federal agency and were the cap on Federal liability to be revised as we have suggested. An alternative approach that might meet the intention of this provision would be to provide for the option of offering multiple-year, as well as one-year, contracts, if market conditions indicate that such contracts would be appropriate and desirable. We have had useful discussions with your staff on this issue also, and would be pleased to continue to work with your staff.

V. Conclusion

The Clinton Administration has long recognized the importance of improving the nation's ability to deal with natural disasters. While our list of concerns may seem long, it does not imply any lack of interest in working with you, and all of our suggestions derive from our two core principles: that relief for insured homeowners not come at the expense of taxpayers, and that any Federal intervention must share risk and support private markets. We believe that we all share a clear recognition of the importance of moving forward. The current proposed legislation provides a sound foundation for progress in this area, and we look forward to working with you, Mr. Chairman, the other Members of this Committee, its staff, representatives of industry and of affected communities, and with other stakeholders, to resolve these issues.

APPENDIX

State Program Mitigation Requirement

With regard to the requirement that state programs commit a specified percentage of their investment earnings toward mitigation, we would suggest a wording change, to require that the mitigation activities undertaken by states to fulfill this provision be cost-effective, and consistent with general FEMA guidelines.

Tax Consequences of Buying Excess of Loss Contracts

The statute refers to the auctioned excess of loss contracts as "reinsurance coverage," and refers to the amounts paid by such contracts as "premiums." We should note that, as a technical matter, if an insurance company purchases an excess of loss contract where the amount payable does not indemnify the insurance company specifically for its actual losses, then the excess of loss contract would not be considered "reinsurance" for Federal income tax purposes. This, for example, will mean that insurance companies could not deduct amounts paid for excess-of-loss contracts as reinsurance premiums. Instead, insurance companies would have to account for these purchases using Federal income tax rules that apply to purchases of similar financial instruments. To avoid any potential confusion on this issue, we would recommend that the statute be revised so that excess-of-loss contracts are not referred to as reinsurance coverage.

Capping Payouts

After careful study, we have concluded that capping payouts is an imperfect mechanism for limiting the potential draw on the Treasury. We believe that an effective mechanism for limiting the total Federal liability and ensuring fiscal prudence is an essential feature of fiscally prudent legislation, and we are confident that such a mechanism can be devised. This section of the appendix provides additional detail relative to the discussion in the body of the testimony.

One approach we have been exploring would involve capping the amount of insurance to be sold by the Corporation. Under this approach, the total amount of insurance offered to each state and region would equal 50 percent of the difference between (a) a threshold trigger level (essentially, a "deductible"), and (b) an upper limit loss. The bill sets the threshold trigger level at the greater of (a) the amount that would be lost in a 1-in-100-year event, or (b) $2 billion (or, for existing state programs, the claims paying capacity of the program). The bill also provides for certain transition trigger levels. The upper limit loss could be set similarly at the amount that would be lost in some less probable event, such as a 1-in-500-year event.

- For example, if the 1-in-100-year loss on insured residential property in Missouri were $4 billion, and the 1-in-500-year loss were $8 billion, then the total amount of coverage offered to Missouri would be half of the difference between $8 billion and $4 billion, or $2 billion.

Coverage would be allocated between the state programs and the regional auctions in proportion to the share of the industry risk in each state that the state program (if any) covers.

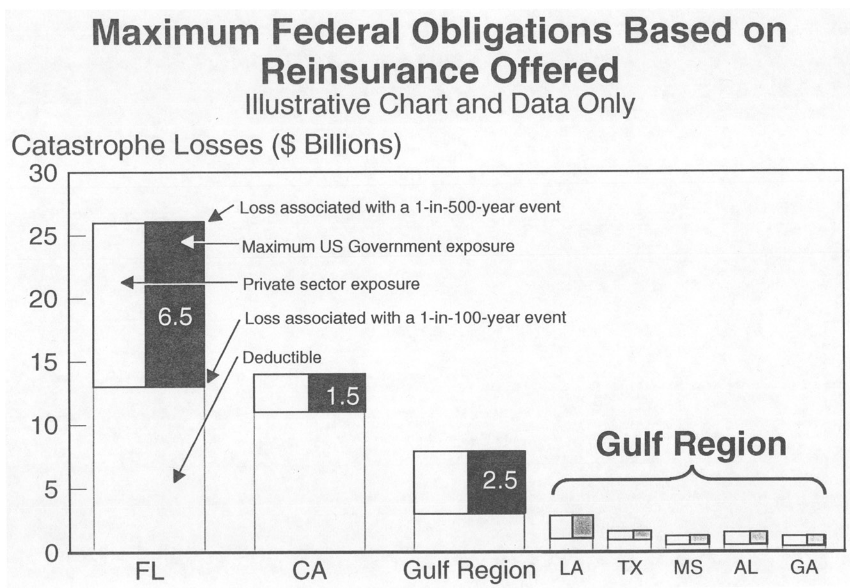
State with 100 percent state program: If a state elects to create a state program that, as a matter of policy, reinsures every insurance entity with exposure to residential property losses in the state for all its losses above the deductible, we propose to offer the full state allocation to the state program. Because the full amount of coverage for the state had been offered to the state program, nothing attributable to this state would be offered in a regional auction.

No state program: If a state elects not to create a state program, we would attribute the full amount of that state's allocation to the applicable regional auction. If Missouri chose not to establish a state program, we would add $2 billion in total insurance to the auction of contracts for the region covering Missouri.

The cap or aggregate maximum payout would then be defined as the sum of the maximum obligations in each state and region, and funds would be made available up to the amount of this payout. The probability of hitting this cap would be extraordinarily small; the cap would be hit only if every state and region bought its full allotment of contract protection, and huge events happened to every state and region in one year and caused the maximum payouts in each state and region to be made.

An ancillary benefit of the approach sketched here is that it provides a natural method of allocating coverage across states and regions. The legislation as currently drafted does not address that issue.

[The information referred to follows:]



Senator STEVENS. Our second panel includes Mr. David Keating, Senior Counsel, National Taxpayers Union; Mr. Frank Nutter, President of the Reinsurance Association of America; Mr. Jack Weber, President of the Home Insurance Federation of America; and Mr. Travis Plunkett, Legislative Director of the Consumer Federation of America.

Gentlemen, you can proceed in any way you wish. You can proceed in the way I have just read off from the schedule; but if you have any other order you would like to proceed in, be my guest.

Mr. Keating, you are first on this list. Is that all right with everybody?

Mr. KEATING. If it's fine with you, it's fine with us, Senator.

Senator STEVENS. Thank you very much.

STATEMENT OF DAVID L. KEATING, SENIOR COUNSELOR, NATIONAL TAXPAYERS UNION

Mr. KEATING. Thank you for inviting me to speak before the Committee today. We have appreciated the opportunity to work with you in previous years and with your staff to try to develop a consensus——

Senator STEVENS. Let me tell you—I have to interrupt you, Mr. Keating. An unexpected happening is we just voted the temporary adjournment resolution, and what is going on on the floor is the debate on the budget resolution that has just come over from the House, and that is going to go on the balance of the afternoon. But it is quite intense over there, so I don't expect to see any of my colleagues. Again, that's another thing I am sad about, but it's just the timing of this period right now.

I do know you all realize we need the record in order to proceed. Thank you.

Mr. KEATING. You're welcome. Thank you.

And I want to reiterate our interest in continuing to work with you and others on this Committee who would like to work on this issue.

While we hope that a consensus can be reached, we must state our opposition to the bill as it has been introduced, because we believe it would unnecessarily increase the potential liabilities to the Federal Government, displace well-functioning private insurance markets that exist today, and perhaps equally important, stifle innovations that are greatly increasing insurance capacity.

The way the proposed Natural Disaster Insurance Corporation is structured, and the management of this corporation, is unacceptable and very risky. There can be no doubt the legislation could be expensive. The bill itself says the Secretary of the Treasury shall provide direct loans in sufficient amounts to cover any shortfall.

As we heard earlier from the Treasury Department, there is no effective limit on the total potential liability. There is no real limitation on the number or dollar amount of all the contracts that may be sold by the NDIC.

We have also reviewed the House bill, H.R. 21, which is similar in many ways to S. 1361. CBO has said because of the frequency and severity of future catastrophic events that are exceedingly difficult to estimate, it's unlikely the Federal Government would be able to establish prices for disaster reinsurance that would fully cover the potential future costs of these financial obligations.

We are also very concerned about the NDIC board and how it would operate as a whole. The NDIC board would be composed almost entirely of insurance industry representatives. Now, they would be subject to review by an allegedly independent National Disaster Insurance board of actuaries, but we don't think this board would be terribly independent.

First of all, the private insurance industry representatives and member insurance companies of the NDIC are not liable—I'm quoting from the bill here—or in any way responsible for the obligations of the corporation.

Well, that leaves a question of who is. If they make a mistake, if they price things too low, the corporate members don't pay; the taxpayers do. This is something that frightens us; this is something the Treasury Department just alluded to in its statement—the idea of conferring access to public benefits, meaning the Federal borrowing authority, to people who are entirely in the private sector and making decisions that would affect the private sector.

We also think the NDIC board would face many political incentives to avoid charging the proper rates, one of which is that the industry greatly fears the whole spectre of Federal regulation. If actuarial soundness requires higher rates in politically sensitive areas, we think it's quite likely the board would avoid imposing such higher rates.

Even more surprising to us, the NDIC would essentially be selling insurance as allowed under one part of this bill, to state governments, or entities controlled by state governments. Yet these very same state governments regulate the insurance industry today. We don't think it is likely that the NDIC will negotiate a fair rate of return for reinsurance under such a clear conflict of interest.

As for the independent board of actuaries, there are a number of flaws we see with its potential independence. I'll just name a few of the seven that I identify in my statement. One is, the actuaries only have 90 days to review the business plan or rates, and we think this is much too short a period of time.

The actuaries apparently can also be removed at the will of the Treasury Secretary or the President, which we think would also reduce their independence.

The board of actuaries also has a very difficult burden of proof. We think the burden of proof is actually reversed. Here's the standard in the bill: The board may disapprove the prices or methodologies only if it presents compelling and substantial actuarial evidence on the record that the prices or methodologies are materially inconsistent with actuarial soundness. We think, if anything, the burden should be exactly opposite. The NDIC board should have to prove the compelling and substantial actuarial evidence to justify their prices and plans.

Finally, if there are any new developments or new information, the actuaries apparently have no power to reopen and reject current rates or business practices.

I think one of our key concerns with either this proposal or the House proposal is that the way things are structured for triggers on the contracts and payments. We think those triggers are much too low, and the NDIC would compete with the private sector. We believe that it would be better to set attachment points for Federal contracts at much higher levels, preferably $60 billion or more of losses, rather than the proposals in the House or Senate bills.

Low attachment points for contracts threaten to crowd out existing private sector mechanisms, and what worries us even more is this will completely kill off financial innovations that have the potential to further expand capacity from the private sector.

The bill addresses risk loads—now risk loads are charges that are meant to compensate for the riskiness of selling this type of insurance. The Congressional Budget Office notes that the risk load outlined in this bill and the House bill is about one-half to one-third the risk load seen in the private sector.

There is also little incentive here to charge the proper risk load to compensate taxpayers. There's some language about having fair compensation for the risk being undertaken by the Federal Government, but we don't see any real incentive to ensure that the risks are appropriately offset by the proper pricing.

We also think it's very important to limit the supply of contracts in any auction. Both House and Senate bills speak of auctions, but there's very little in the way of detail about how the auctions would run or how much would be supplied to the auction. As anyone who has followed auctions knows, you're not going to get a good, high price for something you sell if someone floods the market; and that's true whether it's on eBay or with the Treasury Department selling these types of contracts.

We also see very severe management risks to having an industry-run federally created corporation with virtually unlimited Federal borrowing authority.

I would also like to clarify that both the House and the Senate bills are not really selling reinsurance per se. What we have here is a contract that's actually a derivative instrument, not reinsurance. Now there's nothing wrong with a derivative in theory, but I think we should really know what we're talking about here. We have a contract that pays off, not based on the direct losses of any particular buyer of the contract, but pays off an amount based on losses in a certain area or region.

So we have recommended for many years, and we're disappointed to see that the Treasury Department hasn't done much work in this area to date; and that is, before undertaking what we see as a risky and perhaps expensive experiment selling Federal reinsurance derivatives, that we should identify and reform laws and regulations that have the effect of making catastrophe insurance less available and more expensive.

And your colleague, Senator Connie Mack, has identified one such area, and he's on the right Committee to try to do something about it, the Finance Committee. That is, the Federal tax laws have a huge implicit penalty on homeowners who attempt to purchase such insurance. His bill would fix that.

We believe actually there is an emerging consensus around that approach and that legislation among both taxpayer and consumer groups that have not been terribly enamored with the idea of setting the Federal Government in the business of guaranteeing the nation's insurance companies.

So again, Senator, thank you very much for your interest in this topic, and your continuing commitment to work with people of all views, and I think it's reflected in the panel that has been put together today. Again, thank you.

[The prepared statement of Mr. Keating follows:]

PREPARED STATEMENT OF DAVID L. KEATING, SENIOR COUNSELOR, NATIONAL TAXPAYERS UNION

On behalf of the 300,000-member National Taxpayers Union, thank you for the opportunity to present our views on the Natural Disaster Protection and Insurance Act of 1999.

We have appreciated the opportunity to work with Senator Ted Stevens, his staff, and Committee staff in the past in an attempt to develop a consensus among a number of associations in this important area of public policy.

While we hope that consensus can be reached, we must strongly state our opposition to S. 1361 because it would greatly and unnecessarily increase the potential liabilities of the government, displace well-functioning private insurance markets, and stifle innovations that are greatly increasing insurance capacity.

The legislation proposes to establish a federally-chartered private corporation that would have enormous access to federal loans. The corporation, consisting of member insurance companies and called the Natural Disaster Insurance Corporation (NDIC), would sell derivative contracts that resemble reinsurance directly to eligible state programs or through an auction to private and state insurers and reinsurers.

The NDIC would create many disincentives for the insurance industry to properly assume risks in a disciplined fashion at the right price. It would do little or nothing to encourage insurance companies to manage their disaster insurance risks well and it would likely reward companies that have been the least disciplined and the least professional in their accumulation of risks.

Given its virtually unlimited access to federal borrowing, the structure and management of the proposed NDIC is unacceptable and extremely risky. S. 1361 would require the Treasury Department to guarantee payments on the multi-billion dollars-worth of contracts that could be sold by this corporation.

The issue of an appropriate federal role in this area, if any, is highly complex and controversial. In our view, the Committee should legislate on this issue as carefully as it would if it were to create a new system of deposit insurance. There are very significant taxpayer, financial, public safety, consumer, insurance, and environmental risks involved, and all viewpoints should be heard. There are still a number of provisions in the legislation that are either unclear or pose a substantial risk of massive taxpayer losses.

S. 1361 Would Create Enormous And Unlimited Unfunded Liabilities

There can be no doubt that this legislation could prove to be enormously expensive. Section 7 would create a new Section 310 in the Earthquake Hazards Reduction Act of 1977 explicitly authorizing massive federal borrowing when it states:

> To the extent that the accumulated assets of the trust accounts described in subsection (a) or funds raised by issuing obligations in the private market pursuant to section 301(e)(3)(C), are insufficient to pay claims and expenses resulting from the primary insurance coverages or the reinsurance coverage, the Secretary of the Treasury shall provide direct loans from the Private Loss Account described in section 402 in sufficient amounts to cover that shortfall in accordance with this subsection.

The bill contains no effective limit on the total potential liability. There is no limitation on the number or the dollar amount of all the contracts that may be sold by the NDIC.

S. 1361 provides that if "claims under existing contracts for reinsurance coverage exceed the applicable maximum amount, each claimant shall receive a prorated portion of the amount available for payment of claims." Yet does anyone seriously believe that after a catastrophe Congress and the President would allow the federally-backed Natural Disaster Insurance Corporation to ration payments on claims and refuse to pass legislation making full payment on the contracts?

The Congressional Budget Office agrees that such a program is likely to lead to losses. In its analysis of H.R. 21 (in many ways similar to S. 1361), CBO said "because the frequency and severity of future catastrophic events are exceedingly difficult to estimate, it is unlikely that the federal government would be able to establish prices for disaster reinsurance that would fully cover the potential future costs of these financial obligations."

NDIC Has Overwhelming Incentives To Not Set Actuarially-Sound Rates

S. 1361 requires that the NDIC board shall develop a plan of operation, including the "guidelines, criteria, definitions, clarifications, and procedures necessary for the reinsurance coverage." The plan of operations and rates to be charged would be subject to review by an allegedly independent "Natural Disaster Insurance Board of Actuaries."

Despite the bill's language to the contrary, the rates will not be fiscally sound for several reasons. The NDIC corporate members are specifically excluded from any liability for the NDIC's debts; the board and actuaries will be subject to strong political pressures to minimize rates; and, the NDIC rates would not accurately reflect reasonable risk capital charges.

NDIC Members Are Not Liable For Its Debts, But Taxpayers Are

Like the other versions of this legislation, this bill would have the practical effect of subsidizing insurance companies while putting taxpayers at substantial risk. Section 301 explicitly says that its insurance company members "shall not be liable, or in any way responsible, for the obligations of the Corporation" created by the bill.

As noted earlier Section 310 makes it clear who is on the hook for perhaps tens or even hundreds billions of dollars: the American taxpayer, who is left without redress to those who took on the risk in the first place. This is moral hazard at its worst.

Since the NDIC is intended to be a nonprofit corporation that only writes disaster insurance policies, this leaves less of a cushion for financially sound rates. Profit-making concerns, which now provide such insurance, can absorb reductions in their profits or capital because their rates reflect the actuarial risk to their capital. Most of these companies also have diversified risks since they insure many events other than natural disasters. Profit-making companies have much more incentive to develop advanced forecasting tools for proper rate-setting and analysis of risks.

NDIC Board Likely To Become A Revolving Door, With Little Accountability

The rates would largely be set by the NDIC board, which would be composed almost entirely of insurance industry representatives. Of the 15-member board of directors, there would be nine insurance directors, and up to two insurance agents or brokers who can be elected to the board. Additionally, the other directors who might be elected will likely have close relationships with the insurance industry.

Such a board would probably develop into a revolving door for property and casualty insurance interests to move in and out of the NDIC board, making decisions with respect to the disaster insurance market. There is a time lag between establishment of a policy and the moment when the NDIC reports the losses from that policy. That time lag would permit such revolving door directors to be out of the NDIC when fiscal losses occur, allowing them to escape accountability.

Furthermore, the NDIC board would face many political incentives to avoid charging the proper rates. The property and casualty insurance industry greatly fears federal regulation, and if actuarial soundness requires higher rates in politically sensitive areas, it is entirely possible, and indeed likely, that the board will avoid imposing such rates. Of course the failure to set proper rates will not be felt until perhaps many years after those directors are no longer on the NDIC board.

A Shocking Conflict Of Interest

Even more surprisingly, the NDIC would essentially sell insurance to state governments. Yet these very same state governments regulate the insurance industry today. How can we expect the NDIC to negotiate a fair rate for reinsurance under such a clear conflict of interest?

Board Of Actuaries Would Not Be Independent

Proponents will claim that the "independent" board of actuaries must approve the NDIC's plan of operation and insurance rates. But this board would be a lap dog, not a watchdog.

First, the legislation gives the actuaries only 90 days to review the plan of operation or rates. This is a ridiculously short period of time. If it is not disapproved within 90 days, the plan "shall be deemed to have been approved and shall become final." Likewise if the board fails to disapprove within 90 days, the rate "methodologies shall be deemed to have been approved."

Second, the actuaries themselves are likely to be subject to political control in several different ways. Most of the actuaries must rely on selling their services to current property and casualty insurance companies in the United States. Remember that the NDIC board of directors will represent some of the largest property and casualty insurers in the country. If an actuary tried to veto rates being proposed by the NDIC board, he might find it difficult to either find employment or to sell his services to NDIC member insurance corporations.

Third, the terms of office make it easy for a President to appoint actuaries who will represent his wishes. The actuaries "shall serve staggered terms for a maximum of 6 years as determined by the Secretary at the time of appointment." This wording is unclear, and may mean that the Treasury Secretary could appoint a member for a three-year term or a six-year term. In any event, the Secretary could clearly appoint a majority of the board within a President's term, which is hardly enough to protect independence. The President may feel intense political pressure to hold down rates in politically-important states such as California and Florida.

Fourth, it appears that the commission members can be removed at the will of the Treasury Secretary or President, which would greatly reduce the already low chance of objective findings.

Fifth, given that the pressures on the actuaries may well be intense, it is especially unfortunate that the board would apparently make its decisions by a simple majority vote. A unanimous vote would better ensure a more rigorous review.

Sixth, the bill makes it very difficult for the actuaries to disapprove proposed rates. Here is the absurd standard: The board "may disapprove the prices or methodologies . . . only if [it] presents compelling and substantial actuarial evidence on the record that the prices or methodologies are materially inconsistent with actuarial soundness." If anyone should have the burden of proving compelling and substantial actuarial evidence, it should be the NDIC board.

Seventh, if new developments occur, the actuaries have no power to reopen and reject the current rates. Once the 90-day review period has been closed, that appears to be it. Certainly, the actuaries should have the power to reopen the rates or methodologies at any time and to declare them actuarially unsound. Yet the bill appears to prohibit such action by the actuaries.

Reinsurance Contracts

One portion of the proposal authorizes the NDIC to auction excess-of-loss-style reinsurance contracts. While such contracts can be designed and auctioned in a budget-neutral fashion, the legislation to authorize such contracts would likely lead to taxpayer losses, competition with the private sector, and distortions in the reinsurance markets.

In a paper by Christopher M. Lewis—who is credited with developing the concept of these contracts—entitled "The Role of Government Contracts in Discretionary Reinsurance Markets for Natural Disasters," he explains how to design a fiscally sound program for federal excess-of-loss reinsurance. He writes that "Only federal reinsurance proposals that provide coverage based on industry losses, offer capacity at levels above what is being provided in the private market, are capped and fully-funded, and are market neutral, are worthy of consideration."

Unfortunately, the bill as currently drafted does not meet these key tests. As already noted, the bill does not cap the amounts.

Following are some of the other flaws we have been able to identify at this time:

Crowding out the Private Sector. We fully agree with the comments made by many others that the triggers for payments on the contracts are much too low. The contracts could be structured to pay claims once losses exceed as little as $2 billion.

Last year the Reinsurance Association of America (RAA), citing highly credible industry reports, indicates that there is "approximately $20 billion of catastrophe reinsurance capacity available per region, per event."

That is just for reinsurance. As noted by RAA, "the primary insurers have paid two-thirds to three-quarters of catastrophic claims, passing the remainder through to reinsurers."

According to industry estimates, the overall industry surplus now exceeds $330 billion. If just 20% of that surplus were available to pay for a catastrophe, that alone would equal $66 billion.

There is even more capital available in the private sector. Thanks to recent financial innovations, increasing efforts have been made to securitize the financial risks of catastrophes. While still relatively small, the size of this market has dramatically grown in recent years. According to RAA, this securitization has "grown from one transaction in 1994 totaling $85 million to eighteen transactions in 1998 totaling approximately $2.5 billion." My understanding is that the total of all such transactions completed to date now exceeds $5 billion.

To stay out of the way of the private market, we believe any federal contracts should attach at points no less than $60 billion, and more likely $100 billion, under current conditions and should be increased based on the capacity of the sector.

Low attachment points for the contracts threaten to crowd out existing private sector mechanisms and completely kill off financial innovations that have the potential to further expand capacity from private sector sources.

Unless legislation is very carefully designed, it would seriously damage the private reinsurance markets and prevent financial innovators from entering this important sector.

Current laws and regulations already pose high risks for the private markets and S. 1361 would exacerbate the current situation.

Under current tax laws, state insurance pools have an enormous tax advantage over similar private sector funds in that all income to such pools is tax exempt (as are all earnings from capital in those pools.) This advantage alone has exerted substantial pressure for creation of state insurance pools. If low cost federally-backed reinsurance is made available, state pools will undoubtedly become more common, and those states with pools may well expand coverage limits.

The end result will be a greater reliance on politically-run insurance programs and less opportunity for private insurers.

Risk Loads. The legislation would set a price for state reinsurance contracts at the estimated annual losses, plus a risk load equal to those losses. A similar amount would be the basis of the minimum price for auctioned contracts.

While such pricing sounds sufficient, one has to remember who would be responsible for estimating the likely losses—a politically influenced NDIC that has no responsibility to bear any financial risk from a too-low estimate. Equally important is the fact that such estimates are highly uncertain to say the least. After all, who really knows the chances of an earthquake striking in California or Missouri next year, or a strong hurricane passing directly over a major metropolitan area on the coast?

The risk load is meant in part to compensate for, as CBO notes, "the likelihood that available historical data do not fully capture current catastrophe risks."

The reality is that the price for sale of such contracts may well be less than the actual cost of the contracts, and is certain to be less than the price that would be offered by true private sector firms. CBO notes that "risk loads observed in private transactions for disaster reinsurance against infrequent events, similar to those that would be covered under H.R. 21, are typically four to six times but sometimes exceed 10 times actuarially expected losses."

Cost of Capital. There is no provision requiring consideration of the cost-of-capital, except for some vague and unenforceable language requiring "fair compensation for the risks" being undertaken by the federal government. The NDIC should not compete with private reinsurers by charging less for the federal capital it has at risk. If it charges less, it will either drive out truly private firms or prevent them from entering the market.

A Limited Supply of Contracts Is Essential. The Lewis paper notes that the program should be "designed to enable the private sector to 'crowd out' the federal government. . . . Once the market for these contracts is established, private companies can offer similar contracts in competition with the federal government." This is an essential component of this concept, but the draft legislation would make it virtually impossible for the private sector to accomplish the feat.

In fact the legislation has no effective limitation on the supply of contracts, which would undercut the whole concept of an "auction."

If the supply of contracts is not limited, the bids will be too low and a private sector market would not emerge at higher levels of capacity, defeating one of the key points of such a proposal.

We strongly believe it would be a mistake for legislation to be completely silent on the auction process. While discretion is needed, guidance is essential.

One cannot have a true auction with real bidding if the market is oversupplied. A rule must be devised that would be easily enforceable on the NDIC and would protect against political manipulation of the auctions.

Taxpayer Standing. The bill appears to contain some provisions to protect the private sector and taxpayers. The reality is that these provisions are weak and unenforceable. Any such legislation creating enormous federal guarantees should allow taxpayers to have standing to sue to enforce any restrictions in the law protecting the private sector from NDIC competition or taxpayers from losses. There also may be enormous political pressure exerted in order to force the conclusion that a certain trigger has been reached, and that payouts should be made on the contracts. We believe in the principle of trust, but verify. Taxpayers should be given the standing in court to enforce the contracts if necessary in order to help ensure that they are honestly followed.

Protection for the Private Sector. The tendency for government is to expand and crowd out the private sector. Since one goal of the excess-of-loss contracts is to expand the capacity of the private market, any such legislation should give the private sector a right to expand (and demand that the NDIC shrink) its sale of such contracts. For example, if a qualified reinsurer is willing and able to sell a contract, then we see no reason for the NDIC to sell a similar contract at a lower or even equal price.

Political Risks of Reinsurance Contracts

The comments expressed above outline our technical concerns with the bill's description of the contracts as defined by the "Administration Policy Paper on Natural Disaster Insurance and Related Issues" and the Lewis paper. A discussion of these contracts would be incomplete without a review of the inherent political risks.

These political risks take two forms. First, and most important, are the political risks to prudent management of these contracts by the Congress, the President, and the Treasury Department and how payments are made. Second, and of legitimate concern to Members of Congress, is the public perception of the wisdom of offering these contracts should a disaster hit.

Management Risks. The legislative description of the contracts leaves much discretion to an industry run federally-created corporation with virtually unlimited federal borrowing authority.

While flexibility can be useful in designing a contract that would be accepted by the market, it can also be abused by a future Treasury Secretary who might be intent on granting back-door subsidies to the insurance market in a misguided attempt to increase capacity.

A future Treasury Secretary might act politically to keep the reserve price down by putting pressure on the NDIC and the Board of Actuaries to lower their estimations of the costs of various risks.

There may also be a great deal of pressure brought on the NDIC and Secretary to over-supply the market as early and for as long as possible. Please remember that the reserve price on auctioned contracts is at best an educated guess. We need a healthy, functioning auction market to incorporate more educated guesses—the guesses of those who wish to buy the contracts. If the auction market is flooded, that information will not be collected, nor will it be reflected in the bid prices for the contracts.

After a major disaster, there may be great pressure on the NDIC to err on the side of making payments under the contracts. After all, those who hold the contracts can be expected to bring intense political pressure for billions of dollars in payments. Holders of the contracts might hire public relations and lobbying firms to state that payments on homeowners' claims could be made more quickly or completely if the NDIC were to make quick payments on the contracts.

Clearly those who hold the contracts will have a court-enforceable right to force the NDIC to make the payments. But what would happen if the NDIC were to interpret the contracts and make payments that might not be clearly authorized? By contrast there is no legal recourse for taxpayers who will pay the bills—only a political recourse, which would likely come long after the improper payments were made.

Public Perception of Risk. There is also political risk to Members of Congress from public perceptions of these contracts before or after a disaster. Consider the public's reaction if it appeared that these contracts were sold at too low a price or without a prudent auction process that would under supply the market, thereby ensuring healthy receipts to the NDIC. After a disaster that would result in taxpayer losses, the public reaction might be intense because there could be a perception of a huge subsidy to the insurance business, which both sold and became the owners of many, if not almost all, of the auctioned contracts. It is very important to get the technical details correct in order to minimize these political risks.

Other Substantial Political Risks For Members Of Congress

Members of Congress who vote for this should know that these contracts are actually a derivative instrument, not reinsurance. In fact, under current state regulatory rules, these contracts would not be treated as reinsurance—they would be treated as investments because the losses that trigger the payment of the contracts are not the direct losses of the insurer. This means that an insurer may or may not have incurred losses in proportion to the regional losses that cause contracts to be paid. There is nothing theoretically wrong with a properly-priced derivative. Yet the public perception of derivatives is that they are inherently risky and were responsible for the massive losses in California's Orange County.

Even if the reserve price for the contracts is actuarially correct, which we doubt would happen, the federal government can still lose a lot of money very soon after passage of legislation. We could be unlucky. The first set of contracts could be sold in a year when a major disaster would cause the trigger to be reached and billions of dollars in payments to be made when receipts are merely in the millions. Such an event could immediately damage the fiscal reputation of the program.

After a disaster, new information might become available that would show the reserve price was based on incorrect information. This is to be expected. With each subsequent disaster, new information is learned and incorporated into pricing decisions by the market. That's not to say that people won't try to use hindsight to criticize the NDIC's actions, especially if it appears that political pressure was successfully brought to bear on the NDIC and the Treasury Department to set a low reserve price.

Fix Laws And Regulations First

Before undertaking a risky and perhaps incredibly expensive experiment in selling federal reinsurance, Congress should first examine and reform laws and regulations that have the effect of making catastrophe insurance less available and more expensive.

During our work over the last five years studying proposed legislation and public policy regarding natural disasters, we have found that a number of federal and state laws and regulations greatly hamper the ability of the private sector to provide insurance for catastrophes.

Perhaps the most important impediment to affordable catastrophe insurance is the federal tax law, which contains a huge implicit penalty on homeowners who attempt to purchase such insurance. These same laws also prevent insurance companies to deduct an amount equal to the risk of catastrophic natural disasters; amounts that we consider legitimate business expenses. Here is why.

When a taxpayer buys a homeowner's policy in a catastrophe-prone area, a large part of the premium represents the annual amount that needs to be saved over many years to cover the likely loss from a major catastrophe. Unlike normal fire or theft losses, which occur smoothly year to year and thus are deductible from income, losses from catastrophes are huge. An insurance company might go for many years or even decades before paying claims on a catastrophe.

A prudent tax law would recognize that premiums that represent the best estimate of the risk from catastrophe losses should be deductible as a cost of doing business. That is not the case. Under our current tax system, virtually all premium income that represents the risk of loss flows into taxable income. Effectively our tax laws have created a sales tax on risk premiums for catastrophe losses! This misguided tax exacerbates the problems of availability and affordability of homeowner's insurance in catastrophe-prone areas.

Of course, when the catastrophe comes, these claim payments can be deducted against an insurance company's income that year. Yet that does little good if the insurance company goes insolvent. For companies that remain solvent, loss carrybacks and carry-forwards are limited and the losses might never be fully recognized by the Tax Code. When it comes to catastrophes, we have created a tax policy that is not much different from the trick coin-toss choice: "heads we win, tails you lose."

We believe a consensus is emerging around legislation to fix this problem in the tax laws and urge Senators who are interested in this issue to support S. 1914, sponsored by Senator Connie Mack.

Conclusion

S. 1361 is both politically and economically risky and should be subjected to more extensive examination and comment before being enacted into law. We strongly urge the Committee to remember that even the best-intentioned programs can have budget-busting consequences. While legislation may be needed to reduce the impact of natural disasters, Congress must move carefully in this highly complex area to ensure that it does not create a fiscal disaster or unwisely interfere with private markets. We would be pleased to work with you in order to protect against taxpayer losses and improve federal disaster policies.

Senator STEVENS. All right. If it's all right with you, I'd prefer to hear all of the statements and then see if we can ask key questions of each one of you.

Mr. Nutter is next on our list, but Mr. Plunkett, you're sitting right there, why don't we just go down the table?

STATEMENT OF TRAVIS PLUNKETT, LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. PLUNKETT. Thank you, Mr. Chairman. We also appreciate the invitation to offer our comments today, and we very much appreciate the diversity of comments that you are receiving.

I am Travis Plunkett, I am the Legislative Director of the Consumer Federation of America, which is an association of 260 state and national organizations focused on education and advocacy. Unfortunately, our Insurance Director, Bob Hunter, is unable to be here today; he's out of the country. So I am offering his comments.

He is the former Texas State Insurance Commissioner. He also served as Federal Insurance Administrator under Presidents Ford and Carter, when he administered the National Flood Insurance Program.

As we all know, the 1990's were a decade of very high levels of disasters. However, we want to note that even with payouts to disaster victims by insurance companies approaching $70 billion over that decade, the surplus of property casualty insurance business has skyrocketed from $134 billion at the start of the Nineties to about $330 billion today. This is a growth of almost two and a half times.

The reinsurance industry is similarly rich. Further, new forms of private backup for primary insurance such as acts of God bonds and other forms of securitization have been developed in the last decade and are in the market now. All of this must be tapped, even stretched a bit before the taxpayer steps in to help.

Although the insurance industry has not been adversely affected by disasters, even disasters at record levels over the last decade, consumers have. They have been subject to coverage cutbacks in the form of much higher deductibles, and other cutbacks in coverage. The amazing thing is that while reinsurance prices for catastrophes are now readily available at very cheap prices, often half of what was being charged a few years ago, consumer prices have not fallen.

The proposals under consideration by this Committee today place too much emphasis on providing relief to the insurance industry rather than ensuring the availability of affordable insurance to consumers. I would note here that we also are not opposed to a Federal role if it meets the principles of sound public policy for handling disasters, and this bill just doesn't for several reasons. I'll touch on a few of them.

First, S. 1361 does not assure the taxpayer of any reduction in the cost of disaster relief. While mitigation is encouraged and funds made available to the states, there aren't minimum requirements in the bill.

I know from—this is Bob Hunter—having served at both the state and Federal levels, he knows that great pressure is brought to bear from developers on the states, and even moreso on local authorities to go easy on building codes. The Federal Government must bite the bullet on minimum standards, as in the Flood program, if mitigation is to be meaningful enough to cut costs.

Second, the bill does not encourage that consumers in high risk areas get adequate insurance coverage. There are no provisions in the bill requiring that one more policy of insurance be written by state pools or the private insurers in exchange for the Federal backup.

The Federal Government would be foolish to provide financial backup absent some guarantees of more coverage sales and the easing of the burdensome coverage restrictions now in use.

Third, this bill clearly interferes with and impedes the development of the private insurance market; and on this we agree with David's comments. A trigger of $2 billion is really far too low in comparison to what just the primary market can deliver. USAA, the fine insurer from Texas, has securitized backup for at least

$1.5 billion itself. The trigger should be tied to the industry's capacity and the capacity of new, innovative methods. A trigger below $50 billion, given today's market cap, is simply not needed.

Fourth, the bill does not set standards for state pools that the taxpayer would be backing up. Pools could be set up that actually increased taxpayer exposure, such as the California earthquake authority, what they have done. We would also agree with the comments you've heard about the domination of the board of directors of the corporation by insurance companies. They simply have too much power, given the way that it's written.

The 15-person board of directors of the corporation is dominated by the insurance industry; 9 of the 15 are from insurance companies and another is an insurance agent or broker. This industry organization will be empowered to provide the reinsurance and manage the trust. Members of the corporation will not be liable for corporation obligations, and members and directors shall not be liable for acts taken under these authorities.

Worse, the board gets to certify that state plans comply with regulations it issues. The bill goes so far to say that the corporation may require the state pool to give all information it asks for as it determines. This means that insurance companies are essentially regulating the government.

The bill includes requirements, finally, that the rates charged for reinsurance be very high, at least as high as the actuaries say it should be, and with at least a doubling of the price for the risk load.

In closing, I would just like to say that we do oppose this bill as written. However, we would note that we do need, this country does need an integrated plan that lowers the risk of death and property damage across the country with a national mitigation strategy. We do need to develop mechanisms that would assure that people can get insurance.

We can minimize both Federal involvement and taxpayer burden. We can also develop projections of how such a plan would work before Congress acts. So you, Mr. Chairman and others, know what you're getting into.

We can assure that over time the cost of choosing to live in high risk areas will be borne by those who choose to live there more and more, eliminating the high taxpayer burden currently necessitated by the lack of a proper plan for the nation.

So I would also say that we would look forward to working with you and your staff. Mr. Hunter would be available to anyone who would like to speak with him about how to construct a proper plan. Thank you.

[The prepared statement of Mr. Hunter follows:]

PREPARED STATEMENT OF J. ROBERT HUNTER, INSURANCE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Good morning. I am Bob Hunter, Director of Insurance for CFA. I served as Federal Insurance Administrator under Presidents Ford and Carter, during which time I administered the National Flood Insurance Program. I also served as Texas Insurance Commissioner in the early 1990s during which time I developed a comprehensive disaster response plan for insurance and, unfortunately, got to test it in terrible flooding in the Houston area and devastating tornadoes near Dallas.

Background

The 1990s have been a decade of very high levels of disasters. Of the ten most costly insured disaster events all but one of them occurred in the past decade. However, even with payouts to disaster victims by insurance companies approaching $70 billion over the decade, the surplus of the property/casualty insurance business has skyrocketed from $134 billion at the start of the decade to about $330 billion today, a growth of almost two and one-half times.[1]

The industry leverage (as measured by the ratio of net premiums written to surplus) has dropped from just over 1.5 to 1 at the beginning of the decade to about 0.8 to 1 today. The standard for the industry that is considered ideal is 2 to 1. Thus the property/casualty has gone from strongly capitalized prior to the rash of catastrophes to significantly overcapitalized today.

The insurance industry has not been adversely impacted by disasters, even disasters at record levels. The consumer, on the other hand, has been subject to coverage cutback in the form of gigantically higher deductibles and other cutbacks in coverage. The amazing thing is that, while reinsurance prices for catastrophes is now readily available at very cheap prices (often half of what was being charged a few years ago), consumer prices have not fallen at all.

Consider the state that took the brunt of Hurricane Andrew's wrath. The rate of return on home insurance in Florida was 29.3% in 1998, the latest year of profit data available.[2]

Insurers have insulated themselves from catastrophes in several ways. The raising of deductibles[3] shifts a significant part of the cost of disasters to consumers and to taxpayers. A clear example is the calculations of the California Earthquake Authority who estimated that the cost of future earthquakes in that state will be shifted so that 63% of the cost will be borne by consumers (and taxpayers).

Toward a Rational National Public-Private Disaster Policy

Before Congress acts to provide what is likely unnecessary assistance to the insurance industry for disasters, it must access the relationship between taxpayer-financed disaster relief and protection currently available from the private insurance market. Any program Congress enacts must ensure that the capacity of the private market is maximized and that claims against federal and state taxpayers from future disasters are reduced and, ultimately, eliminated through use of mitigation and private market mechanisms.

The relationship between insurance and taxpayer-funded relief is an important one. Chart 1 shows that insurance payouts for catastrophes are large for wind type claims. 73.9% of insured cat payouts are for wind related events such as hurricane, tornado and other wind loss. Only 9.1% of the payout is for earthquake. Nothing is paid out by private insurers for flood since flood insurance is a federal program.

Correspondingly, the chart at the bottom of Chart 1 shows that disaster relief payments are 35.4% for earthquake, 15.6% for flood and only 23.0% for hurricane.

Not surprisingly, it works like this: the better the insurance coverage, the less the taxpayer burden.

Charts 2 and 3 show the effect of private vs. tax-financed coverage. Chart 2 shows that people living in wind-prone areas pretty much pay their own way through high homeowner rates. Texas and Florida have among the highest homeowner rates in the country, for example.

Unlike insurance rates, disaster relief is not paid for on a risk-related basis. Taxpayer subsidy from state to state is very real and varies depending upon the level of insurance coverage in the particular state. Outrageously, the better the state does at paying its own way through insurance, the more the state pays in subsidy to states that do not pay their own way.

Chart 3 shows the household subsidy from state to state. California gets an average annual subsidy of $100 per family paid for by such states as Connecticut ($63), Nevada ($43), Michigan ($42), Massachusetts ($38), Texas ($23) and Arizona and Montana ($22 each).

It is not fair for a state like Texas, where I well know homeowner's rates are remarkably high to cover catastrophes, to have to kick in a subsidy for states that do not insure their risks more completely.

CFA's 1998 study, "America's Disastrous Disaster System" found that there is no real system in place in the United States to handle disasters from the insurance point of view. When a disaster strikes, there are times when there is almost complete insurance protection available from private sources. Other times there is par-

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[1] *Best's Aggregates and Averages*, 1999 Edition, Pages 250–252.

[2] *Report on Profitability by Line by State*, NAIC, November 1999.

[3] 5% along coasts, even higher along earthquake faults.

tial coverage, sometimes from private sources, sometimes from government sources. Sometimes when a disaster strikes very little insurance protection is in force from any source.

Mitigation and enforcement of codes is also spotty. Building codes for flood-prone buildings are set nationally, by FEMA. Wind and earthquake codes are set either at the state or the local level, with a wide disparity in code and in enforcement of code. You all know that, had the codes in Florida been enforced, Hurricane Andrew damage would have been 40 to 70% less.

Our research shows that mitigation, enforcement and maximization of private insurance and reinsurance can sharply reduce the tax burden of natural disasters and, eventually, can largely eliminate them (except for immediate shelter and other emergency needs). Congress should develop and adopt a plan to accomplish this prior to enacting any legislation, which further exposes taxpayers to risk of payments in the event of disasters. We are very concerned about moving ahead with any bill that has not been prepared with the necessary analysis of mid- and long-term impacts on taxpayers of implementation.

Principles to Guide National Disaster Policy

The nation needs a new system, an integrated system, to deal with disasters. The proposal under consideration by this Committee today places too much emphasis on providing relief to the insurance industry rather than ensuring the availability of affordable insurance to consumers. Congress should not pass legislation bailing out insurance companies unless the bill meets the following principles to ensure it benefits consumers and taxpayers as well as the industry:

1. Assuring Insurance Protection Occurs

- Any proposal must ensure that adequate insurance is available at adequate rates to all consumers, especially in high-risk areas. A transition plan may be needed to help current homeowners get through the "sticker shock" of changes in price for insurance in some areas.
- Low- and moderate-income homeowners should be protected from loss of insurance coverage.
- Deductibles, co-insurance and surcharges may all be ways to ensure that insurance is available but should not be used (as the California Earthquake Authority—CEA—does) to render coverage inadequate. Congress must also deal with the problem now extant where taxpayers pay the lower levels of costs of disasters under too-high private deductibles.
- Insurance rates on new construction must be based on risk; otherwise unwise construction is encouraged. The CEA cross-subsidizes rates for new construction in the highest risk areas of California. These subsidies will greatly increase cost and taxpayer burden over time.

2. Strong Mitigation Measures to Reduce the Cost of Disasters

- Any proposal to back up the insurance industry must have as its focus mitigation of risk to reduce losses. To back up insurance in the highest risk areas of the nation without controlling new building in predictable ways is an invitation to build improperly.
- All stakeholders must be included in mitigation efforts—federal, state and local governments, businesses and consumers, developers, the insurance industry and other stakeholders.
- The proposal should encourage and at times require building away from the most dangerous locations (which locations are often visually appealing).
- The proposal must include measures to encourage and assist homeowners, especially low-income homeowners, to implement damage reduction measures.
- The program should encourage reduction in risk in existing homes.[4]

[4] As an example of an innovation to encourage retrofitting: If a program could be established that offered insurance rate discounts for retrofitting that would be sufficient to lower monthly cost by an amount sufficient to pay off a loan to pay for the retrofitting, that would surely encourage action by homeowners, even low income homeowners.

Retention of Risk in the Private Market

- Any program must have a clear test to assure that as much risk as possible is served privately, taking into consideration the market's capacity and the type of risk involved.
- The property/casualty industry has over $325 billion in surplus today, 2 and ½ times what it had in 1989 despite the worst decade of catastrophes in history. The industry is, as all observers recognize, overcapitalized. The reinsurance industry is similarly rich. Further, new forms of private back-up for primary insurance, such as Acts of God Bonds and other forms of securitization have been developed and are in the market. All of this must be tapped, even stretched a bit, before the taxpayer steps in to help.

Appropriate State and Federal Oversight

- Federal oversight of the insurance industry is essential if the federal government provides financial back-up of the industry's writings. Are rates reasonable? Are consumers being underwritten in high risk areas?
- States must maintain proper protections such as rate review and approval, monitoring of availability of insurance, and so forth.

Demonstrated Benefits to the Federal Government's Disaster Relief Expenditures

- Any back-up plan must be shown to reduce projected disaster relief payments by the federal government. The quid-pro-quo for the taxpayer must be proven reductions in payments for disasters over time. That analysis must be rigorous and available to the public. Congress must show that the short-term investment made by taxpayers in mitigation and insurance back-up liabilities actually will work to reduce long-term disaster relief costs. Otherwise, the taxpayer is being asked to buy a pig-in-a-poke. Congress should have a year-by-year projection with and without any bill so the public and Congress itself can measure whether the program is working as intended.

The Natural Disaster Protection and Insurance Act Fails to Meet these Principles

S. 1361 establishes a federally backed reinsurance program administered by the insurance industry itself, through the creation of the Natural Disaster Insurance Corporation. Reinsurance would be granted to qualifying State Pools and to private insurance companies. The reinsurance program would cover homeowners against the perils of hurricanes, earthquakes, volcanic eruptions, tsunamis, windstorms and wildfires. There is no dollar maximum for federal back-up, only a limit based on the unknown "financial capacity of the Corporation to repay those loans not later than 20 years after receiving the loans." The Secretary of Treasury is authorized to borrow from the Treasury to make these loans.

The state pool and the private insurers would have slightly different triggers, amounts that must be exceeded for reinsurance to kick in. State Pools must sustain the greater of $2 billion, the claim paying capacity of the Pool (as determined by the industry members of the Corporation) and the cost of the 100 year event (also determined by the insurer/members of the Corporation).

Private insurers have cover triggered at $2 billion or the 100 year event cost (determined by the Corporation), whichever is greater.

The bill is flawed in almost every particular:

- *S. 1361 does not assure the taxpayer of any reduction in the cost of disaster relief.* While mitigation is encouraged and funds made available to the states, there is no minimum requirement in the bill. I know from having served at both the state and federal levels that great pressure is brought to bear from developers on states (and even more on local authorities) to go easy on building codes. The federal government must bite the bullet on minimum standards as in the flood program if mitigation is to be meaningful enough to cut costs. Just throwing money and platitudes at the need has not worked in the past to bring down taxpayer costs from natural disasters. You can and must be specific as to what is required to cut costs.
- *The bill does not ensure that consumers in high-risk areas get adequate insurance coverage*. There are no provisions in the bill requiring that one more policy of insurance be written by State Pools or the private insurers in exchange for the federal back-up. The federal government would be foolish to provide financial back-up absent some guarantees of more coverage sales and easing of the burdensome coverage restrictions now in use.

- *S. 1361 clearly interferes with and impedes the development of the private insurance market.* A trigger of $2 billion is really obscenely low in comparison to what even just the primary market can deliver. USAA, the fine insurer from Texas, has a securitized back-up for at least $1.5 billion itself! The trigger should be tied to the industry's capacity and the capacity of new innovative methods. A trigger below $50 billion given today's market cap is simply not needed.
- *The bill does not set standards for state pools that the taxpayer would be backing up*. Pools could be set up that actually increase taxpayer exposure, such as the California CEA has done.
- *The bill is a "wish list" of a few large insurance companies giving them too much power*. The 15 person Board of Directors of the Corporation is dominated by the insurance industry. 9 of the 15 are from insurance companies and another is an insurance agent or broker. This industry organization will be empowered to provide the reinsurance and manage the Trust. Members of the Corporation will not be liable for Corporation obligations and members and Directors shall not be liable for acts taken under these authorities. Worse, the Board gets to certify that State Plans comply with regulations it issues. It goes so far to say that the Corporation may require the State Pool to give it all information it asks for, as it determines. How delicious for the insurance companies; they finally get to regulate the government!
- *The bill includes requirements that the rates charged for reinsurance be very high* (at least as high as the actuaries say it should be and with at least a doubling of the price for "risk load"[5]).

There has been a history recently of insurers dumping good risks into State Pools, particularly in California and Florida. Now that they are flush with cash, with ample private reinsurance and other back-up available, many consumers still languish in these Pools. This bill could encourage more use of State Pools and give insurers more freedom to dump and avoid their responsibilities to serve all in the state in which they are licensed. This would arrest the fast developing securitization of catastrophic risk and cause imbalances in the working of the private market.

The private market handled Hurricane Andrew. It handled the Northridge earthquake. Through these things the private insurance and reinsurance market prospered and new markets from other disciplines developed. The nation does not need S. 1361. We do not need to bail out insurers. We do need to develop national minimum mitigation strategies. We do need to do the analysis we have been asking to be done now for the 12 years this bill and its predecessors have died up on Capitol Hill.

Good News on the Research Front

Wharton School has gone a long way toward answering many of the questions that must be answered before you design a bill that really offers benefits to more than one or two jumbo insurance companies. The Wharton research is being done in its Managing Catastrophic Risks Program. You can see a list of 14 papers to review on their web site at *www.fic.wharton.upenn/fic/wfic/riskinfo*.

The most important finding relative to need for federal back-up is this one:

- The industry has more than adequate capacity to pay for catastrophes of moderate size. E.g., based on both the national and Florida samples, the industry could pay at least 98.6 percent of a $20 billion catastrophe. For a catastrophe of $100 billion, the industry could pay at least 92.8 percent. . . . The results suggest that the gaps in catastrophic risk financing are presently not sufficient to justify Federal government intervention in private insurance markets in the form of Federally sponsored catastrophe reinsurance. However, even though the industry could adequately fund the "Big One" doing so would disrupt the functioning of insurance markets and cause price increases for all types of property-liability insurance. Thus, it appears that there is still a gap in capacity that provides a role for privately and publicly traded catastrophic loss derivative contracts.[6]

[5] This gouging is not justified in any way in the bill. As an actuary I say there is no such justification.

[6] *Can Insurers pay for the "Big One"? Measuring the Capacity of the Insurance Industry Market to Respond to Catastrophic Losses*, Wharton School, University of Pennsylvania, Cummins, Doherty and Lo, June 1999.

- Another remarkable Wharton finding is that securitizing the risk of catastrophes not only lowers the risk for the primary insurer, it lowers the portfolio risk for the investor as well since the catastrophe occurrences are not timed with market moves.

I recommend that the Committee invite Wharton to testify if you have not already done so.

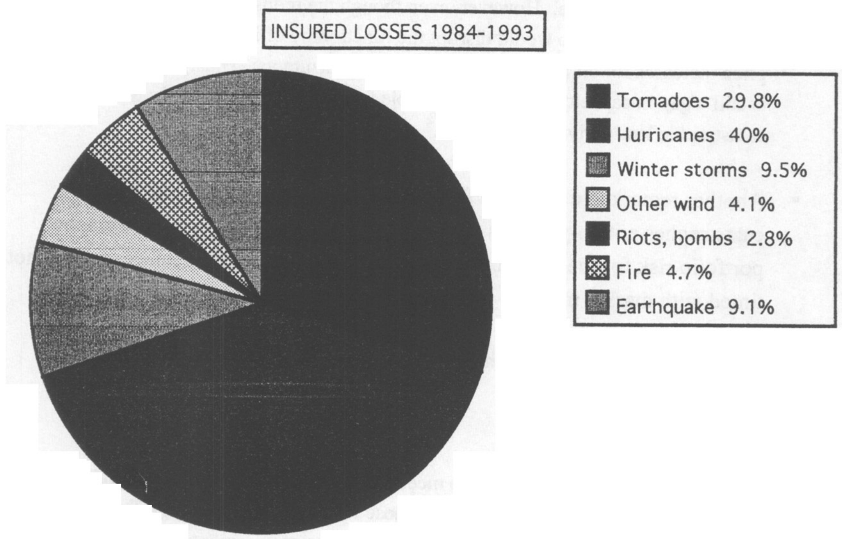
Conclusion

CFA strongly opposes S. 1361. The bill fails to meet the principles of sound public policy for handling disasters. It does not assure insurance for those who need it. It will interfere with existing and emerging private solutions to the financial back-up requirements of the primary insurance market. It will exacerbate the taxpayer burden because, absent sound mitigation requirements, the bill will encourage unwise construction. The trigger levels are way too low. There are inadequate incentives for insurance companies not to dump into State Pools and no incentives for insurers to take people out of such Pools. The insurance companies are delegated too much power, including regulatory rights over State Pools. Worst of all, there is no rigorous analysis establishing how the bill is intended to impact the disaster relief burden of taxpayers, no projection of long-term effects with and without the bill on subsidies so many states now pay for a few states that are inadequately protected from the cost of disasters.

Mr. Chairman, you can do much better. You should do much better. You can adopt an integrated plan that lowers the risk of death and property damage throughout the nation through mitigation. You can develop mechanisms that would assure that people could get insurance. You can minimize both federal involvement and taxpayer burden. You can develop the projections of how the plan would work before you act so you know what you are doing. You can see that, in time, the cost of choosing to live in high risk areas will be borne by those who choose to live there, eliminating the high taxpayer burden currently necessitated by lack of a proper plan for the nation

I would be happy to respond to any questions you may have for me at the appropriate time.

CHART 1


INSURED LOSSES 1984-1993
Tornadoes 29.8%
Hurricanes 40%
Winter storms 9.5%
Other wind 4.1%
Riots, bombs 2.8%
Fire 4.7%
Earthquake 9.1%

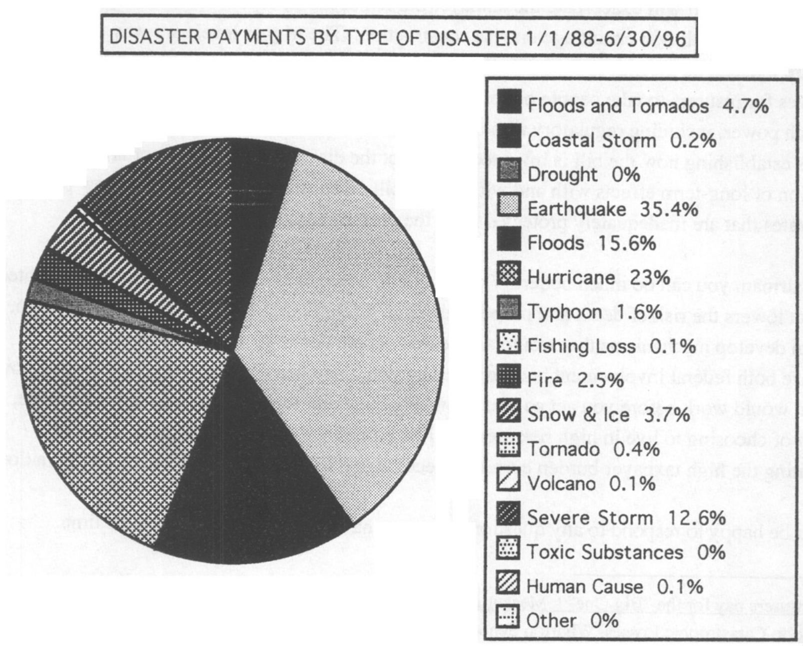

DISASTER PAYMENTS BY TYPE OF DISASTER 1/1/88-6/30/96
Floods and Tornados 4.7%
Coastal Storm 0.2%
Drought 0%
Earthquake 35.4%
Floods 15.6%
Hurricane 23%
Typhoon 1.6%
Fishing Loss 0.1%
Fire 2.5%
Snow & Ice 3.7%
Tornado 0.4%
Volcano 0.1%
Severe Storm 12.6%
Toxic Substances 0%
Human Cause 0.1%
Other 0%

CHART 2

The ten most expensive states in which to insure a home today are:

State [1]	Cost per $1,000	State	Cost per $1,000
1. Texas	$7.55	6. Florida	$4.98
2. Mississippi	6.60	7. Kansas	4.94
3. Louisiana	6.34	8. Wyoming	4.53
4. Oklahoma	6.23	9. South Carolina	4.35
5. Arkansas	5.00	10. Alabama	4.34

[1] The data from the national Association of Insurance Commissioners does not include California as of this survey. It will be included next year.

The ten least expensive states in which to insure a home today are:

State [2]	Cost per $1,000	State	Cost per $1,000
1. Virginia	$2.14	6. New Jersey	$2.48
2. Maryland	2.21	7. Ohio	2.55
3. Delaware	2.21	8. Oregon	2.64
4. Illinois	2.39	9. Washington	2.76
5. Wisconsin	2.46	10. Pennsylvania	2.81

[2] The data from the national Association of Insurance Commissioners does not include California as of this survey. It will be included next year.

The major reason for high prices is related to the degree of wind-related or hail-related natural disasters in the state.

This has important implications for public policy in the high cost states. Mitigation of damage through better roofing and wind protective devices can save significant dollars in home insurance costs. Savings of at least 50% may be possible in some jurisdictions. In Texas, for example, just moving the homeowners rate half way toward the countrywide average cat load would cut the homeowners premiums by more than 25%.

CHART 3

State	Disaster Relief Subsidy per Household	State	Disaster Relief Subsidy per Household
12 States Receive:		Other States Pay (continued):	
North Dakota	$104.32	Vermont	−20.60
California	99.56	Montana	−21.76
Hawaii	74.38	Arizona	−21.81
South Dakota	52.00	Illinois	−22.74
South Carolina	31.73	Texas	−23.41
Iowa	25.69	New Mexico	−25.92
Alaska	24.95	Tennessee	−27.40
Florida	21.62	Pennsylvania	−27.42
Louisiana	20.19	Wisconsin	−28.91
Missouri	4.57	Indiana	−30.32
Nebraska	3.31	Utah	−30.48
West Virginia	0.10	Rhode Island	−31.22
		Ohio	−32.62
Other States Pay:		Colorado	−34.66
Georgia	−0.09	Virginia	−35.57
Mississippi	−2.36	Delaware	−36.06
Alabama	−5.75	Wyoming	−37.88
North Carolina	−8.07	Massachusetts	−38.11
Kentucky	−11.83	New York	−39.20
Oregon	−12.22	Michigan	−41.60
Idaho	−13.11	Nevada	−43.41
Arkansas	−13.86	New Hampshire	−43.65
Washington	−15.36	Maryland	−43.99
Kansas	−15.40	Dist. of Col.	−49.73
Maine	−16.75	New Jersey	−51.71
Oklahoma	−17.39	Connecticut	−62.61
Minnesota	−17.73		
		Countrywide	$0.00

Senator STEVENS. Thank you, Mr. Plunkett.

Mr. Nutter.

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

Mr. NUTTER. Mr. Chairman, thank you very much. The Reinsurance Association of America represents the United States property casualty reinsurance industry.

As we have for some time we believe that there is an appropriate and necessary Federal component in any solution dealing with the financing of natural disaster risk. In our view, the states have done a lot to address this problem. They have provided insurers and consumers with coverage options, variable deductibles, and they have worked with insurers to find proper rates.

We are encouraged by the development of the capital markets, which have been mentioned as increasing capacity to deal with this risk. And frankly we're encouraged by the increasing focus that FEMA and many private sector organizations are placing on mitigation. Yet there remains in this country an extraordinary exposure to hurricanes, earthquakes and volcanic eruptions threatening lives and people's property.

We believe that S. 1361 is a sound foundation for a Federal role. We endorse the mitigation provisions of the bill, and we have offered to your staff certain technical amendments that were adopted by the House Banking Committee largely without controversy.

I would like to focus my comments on two particular proposals which we view as constructive in improving the legislation.

The first of these is the level at which the federally sponsored program assumes a financing role. Our philosophy is echoed very well in the Treasury testimony, that the Federal role should be a back-stop, it should be a safety net behind the industry. It should not compete with, replace, or provide disincentives for the private sector.

Because the capacity of the insurance, reinsurance, and capital markets is robust, has been for a number of years and we believe will continue to be, we do believe that high thresholds for the Federal attachment point, or triggers, are necessary.

We have recommended in our testimony that these minimum thresholds be a range of $5 billion or a 1 and 250-year event. Let me offer my perspective on each of those two numbers.

First the $5 billion number: Three distinct reinsurance organizations in 1999 issued reports looking at the available reinsurance capacity and found essentially the same number. About $20 billion of property catastrophe reinsurance is in place, covering actual risk in the United States per region.

Second, Louisiana and New York both issued reports stating that there was an overabundance of reinsurance in their markets. To this capacity in the reinsurance market, you need to add the capacity of the primary insurance market. Because the largest homeowner's insurers in the country buy very little reinsurance relative to their size, they offer capacity from their own balance sheets.

A.M. Best, which is the principal rating organization for the industry, has stated publicly that the industry is over capitalized by

$100 billion, even taking into consideration a 1-in-100-year catastrophe.

The Wharton School has issued a report stating that there is more than adequate capacity to deal with the risk in the United States. This capacity or surplus of the industry has risen even though the industry has paid $99 billion in catastrophe losses in the last 10 years.

Even the $5 billion number that we have recommended would seem low in the context of these numbers that I have given in capacity, but we believe if treated properly in the legislation as a threshold, they should be acceptable to all parties.

With regard to the 1-in-250-year threshold that we have suggested: that number may sound unreasonable to some people, a 1-in-250-year event. But it's merely a measure, a probability measure of what catastrophe exposure is. In fact, it is the standard being used in the industry. Again, A.M. Best, the rating organization that is independent of the industry, uses a 1-in-250-year event as a standard for insurers, for earthquake risk, wherever it is in the United States, and for Florida hurricane risk.

Insurance companies must already demonstrate to this rating organization that they have the risk management tools in place for a 1-in-250-year event.

So we encourage the Committee to increase the thresholds in the legislation to a $5 billion or 1-in-250-year event as a minimum trigger for the Federal role.

The second suggestion that we make relative to the legislation is that the Committee adopt improvements to an amendment offered and adopted by the banking committee from Representative Baker. Our proposal is that the federally sponsored program provide reinsurance but require the program first to request proposals from the private market to provide all or part of the proposed cover.

In this way, the Federal program will test the private market's capacity, it will test the pricing mechanism, and it will be protection against the intrusion of the Federal Government in the private markets.

In conclusion, Mr. Chairman, we support your initiative. We caution against a program that discourages private sector development. We believe that low triggers encourage state government programs to be created, and that those state government programs will pass along the risk to the Federal program. Low triggers will increase the federally sponsored exposure or loss.

Low triggers, like low deductibles in insurance, will lead to high consumer prices, and low triggers will encourage government approaches. Higher triggers, higher than those in this current bill, will in fact encourage and require private sector development and private sector approaches.

We believe that S. 1361 is a very sound foundation for proceeding, and we look forward to working with the Committee, members, and staff.

Thank you.

Senator STEVENS. Thank you, Mr. Nutter .

Mr. Weber.

[The prepared statement of Mr. Nutter follows:]

PREPARED STATEMENT OF FRANK W. NUTTER, PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA

Chairman McCain, Senator Stevens and Members of the Commerce Committee, it is an honor to appear before you on behalf of the Reinsurance Association of America. We commend you, Senator Stevens, in particular, for your leadership in promoting legislation to address the issue of natural catastrophe exposure and insurance.

The Reinsurance Association of America (RAA) represents U.S. domestic property casualty reinsurers.[1] The creation of a federal reinsurance program is of great importance to our member companies. Over the years, the RAA has supported efforts to create a federal role to address the issue of natural disaster catastrophe exposure in the United States. In fact, over the years we have worked closely with Senator Stevens and his staff on legislation to address this issue. Our members firmly believe that federal involvement is a necessary component of any ultimate solution to this very important issue.

S. 1361 is a sound foundation for addressing a federal role in financing natural catastrophe losses. However, the RAA would like the Committee to address the level at which the government-sponsored program assumes the cost and risk of a natural disaster. We urge the Committee to fully consider the capacity of both the primary and reinsurance marketplaces to bear catastrophic risk. We propose that higher attachment levels ("triggers") for the government role be incorporated to better reflect the private sector's risk bearing capacity. The RAA believes that such a change will help ensure that the private marketplace is not unnecessarily infringed upon and that the federal Treasury is not at risk by assuming too much of the cost of financing these disasters.

RAA Principles of Natural Disaster Policy

The reinsurance industry has maintained a consistent position on the need for a federal backstop when the costs of a natural disaster exceed the private market capacity. Such a federal role is crucial to protect the solvency of the insurance marketplace and maintain insurance markets for consumers.

Providing catastrophe insurance and reinsurance coverage should otherwise be preserved for private sector carriers. State government catastrophe funds[2] should only be employed as a last resort.

That position is rooted in the following principles, which we urge the Committee to adopt as its own:

(1) natural catastrophe exposures, hurricanes and earthquakes, are insurable risks in the private sector;

(2) government's role should only be to address insurer solvency in the event of a mega-catastrophe, hereby fostering private sector coverage and preserving the claims paying ability of insurers;

(3) the risk of natural catastrophes is best insured in a diversified marketplace which avoids concentration of risk in too few insurers or state programs;

(4) the private sector's role, including insurance, reinsurance and capital markets, should be maximized and such financing mechanisms fully exhausted before any government capacity is provided, state or federal;

(5) the government should encourage, and—where appropriate—fund pre-disaster hazard mitigation efforts; and

(6) any federal proposal should not put taxpayers' dollars at risk when the private sector is more than capable of financing the costs of a natural disaster.

These principles form the basis for the RAA's evaluation of all disaster-related legislation, whether they be federal or state proposals. They are founded solely in the belief that the private sector is the appropriate bearer of catastrophic risk, but

[1] Often described as "insurance for insurance companies," reinsurance is a sophisticated transaction by which one insurer indemnifies, for a premium, another insurer against all or part of a loss that it may sustain. The fundamental objective of insurance, to spread risk of loss, is thereby enhanced by the insurers ability to spread that risk through reinsurance.

The key reasons a primary company purchases reinsurance are: (1) to limit liability on specific risk; (2) to stabilize loss experience; (3) to protect against large losses; and (4) to increase capacity so they can write more policies. The degree to which each insurer will utilize reinsurance for one or all of these purposes is determined by each insurer after assessing its own exposure to losses and its own capital resources.

[2] A state run tax-exempt trust fund that provides reinsurance to insurance companies writing homeowners insurance in a particular state.

are tempered by the recognition that a natural event could occur, one greater than any which has occurred to date, which exceeds the resources of the U.S. insurance and global reinsurance industries.

Capacity to Finance Natural Disasters

At the heart of the debate on S. 1361 is what is the capacity of the insurance industry to finance natural disasters. It is critical in evaluating capacity of the industry that the Committee keep in mind that insurance capacity for natural disaster exposures is provided by insurers, reinsurers and the capital markets. The bulk of catastrophic risk is retained by primary insurers which provide coverage directly to the public. Such coverage represents the typical homeowners contract where an insurance company agrees to indemnify their customer, upon receipt of a premium, for a loss or damage to property. The primary insurance industry is in the business to pay claims and finance losses associated with a natural disaster. Reinsurers provide protection for insurers in the face of large catastrophe losses but our segment of the industry, by premium volume or surplus, is roughly one-tenth the size of the primary industry.

Although reinsurers assume the risk of a significant portion of most insurance companies' catastrophe losses, several of the largest national personal lines insurers, for example, purchase very little, if any, reinsurance, because their resources, as reflected in their capital and surplus, are large enough to retain risk and absorb shock losses.

A smaller or regional insurer, however, may rely more on reinsurance to spread its risk of loss. No insurer should, or wants to, expose its entire capital base to a threat of a single natural catastrophe or an accumulation of catastrophes. In addition, insurers have a responsibility to stockholders or, in the case of mutual insurers, policyholders, to see that their capital provides an adequate return on equity and is not exposed to a risk of ruin from natural catastrophes.

Thus, as this Committee deliberates this most important issue, it must not just look at the capacity of the reinsurance industry, but it must consider the capacity of the insurance industry as a whole to finance major catastrophes. In addition, the Committee must not ignore the ever growing capacity provided by the capital markets.

Reinsurance Capacity Abounds and Prices Continue to Fall

There is currently an abundance of catastrophe reinsurance available in the marketplace today. As the General Accounting Office reported in a February 8, 2000, correspondence to Members of the House, reinsurance is widely available and prices are low relative to historic levels. GAO's analysis is consistent with a Standard and Poors, Inc. 1999 report that concludes there is currently an overabundance of reinsurance in the marketplace and the "glut of capacity in the reinsurance marketplace will continue to hold back rate increases. Capital is very, very, strong in the reinsurance market."

In July 1999, a leading U.S. reinsurance broker, U.S. Re, wrote the Chairman of the House Banking Committee a letter that states that: (1) there is approximately $13–$15 billion of "excess of loss" catastrophe reinsurance capacity in place per region, per event in the U.S.; (2) an additional 40 percent of capacity is in place from other forms of reinsurance being purchased (facultative, per risk of loss and proportional); and (3) that an additional $1 billion of capacity per region is also available from capital markets products (see Attachment A). These factors would result in approximately $20 billion of catastrophe reinsurance capacity available per region, per event. This number does not include the capacity provided by the primary industry to finance catastrophes.

We believe the abundance of reinsurance in the marketplace as reported by many independent sources warrants the raising of the trigger levels in S. 1361.

- Consistent with the U.S. Re report, a July 1999, Renaissance Re report (see Attachment B) analyzing the reinsurance marketplace, concludes that: (1) there is approximately $14 billion in capacity, per event, per region of excess of loss reinsurance *purchased* by the primary marketplace at this time; (2) reinsurers are offering additional capacity in the excess of loss market, but many insurance companies have decided to retain the risk on their own balance sheet, rather than purchase reinsurance; and (3) in addition to the $14 billion of excess of loss reinsurance available per region, there is additional reinsurance catastrophe protection currently being purchased from other forms of reinsurance agreements including, proportional, facultative and per risk excess of loss contracts. This additional protection adds approximately 40 percent more reinsurance being purchased, resulting in approximately $20 billion of reinsurance sold per region. This number does not include the capacity of the primary industry to finance catastrophes. (Renaissance Re is one of the largest catastrophe writers in the world. It maintains an exhaustive database of all catastrophe offerings and is considered to have the most comprehensive database of catastrophe cover purchased in the U.S.).

- In February 1999, the Louisiana Property Insurance Task Force reported to the State Legislature that there is over capacity in the reinsurance market, without even counting capital markets capacity. The report concluded that in Louisiana alone, it is estimated that a market loss of over $13 billion alone would be needed to exceed the catastrophe reinsurance limits purchased.
- In February 1999, the New York State Temporary Panel on Homeowners' Insurance Coverage reported to Governor Pataki and the State Legislature that there is a current overabundance of reinsurance capacity in the marketplace and that "losses from a 250-year storm striking New York would be in a range of $6 billion. This amount is easily within the industry's current capacity to absorb."
- In August 1999, the Texas Insurance Commissioner wrote to Congress stating that the trigger levels of 1-in-100 or $2 billion would result in an infringement on the private marketplace in Texas. The Commissioner suggested that a trigger level of 1-in-250 year event may be more appropriate.
- In the fall of 1999, the California Earthquake Authority reported that the claims-paying capacity of the CEA is $7.3 billion. A 1-in-100 year event would result in $2.8 billion in losses. The CEA reported that it is expected to be able to easily pay losses resulting from a 1-in-100 year event, and to have approximately $4.5 billion left over to cover losses from subsequent earthquakes. CEA stated that it would take a single event on the order of 3 to 4 times the devastation of Northridge to deplete the CEA of its claims-paying capacity. (Last year before the House Banking Committee, the CEA Assistant Director testified the CEA could handle two 1-in-250 year events.)
- In the same Congressional correspondence, when asked if there was current adequate private sector reinsurance available for the CEA to purchase, the CEA answered as follows: Yes, in a very short time frame (approximately three years) the market situation involving the catastrophe reinsurance product best suited to the CEA's needs has changed such that the CEA is currently purchasing its reinsurance at rates more than 40% less than it did three years ago. The CEA has such reinsurance contracts in place through the 2001 calendar year.
- Guy Carpenter, a reinsurance broker, reported in November of 1999 that the reinsurance capacity has risen and insurance companies can now purchase traditional catastrophe excess coverage above $632.6 million per event, per insurer, as compared to $200 million in 1992.
- Evidence of this high level coverage came in January 1999 when State Farm and Renaissance Re announced the formation of Top Line Re which will provide $3 billion in high level excess catastrophe coverage for non-U.S. business. The marketing plan, according to press reports, envisions that Top Line Re will make $500 million in high layer, catastrophe aggregate excess coverage available per insurer. Even though Top Line Re will not make the coverage available for U.S. insurers, its creation means competition is increasing in this sector.

It has also been suggested by witnesses before a House Banking Subcommittee hearing on this issue that insurance agents are unable to sell homeowners insurance policies because "unnamed insurance companies" inform them that it is too expensive to buy reinsurance. The fact is, reinsurance prices are very low and have dropped for five years in a row. We urge the Committee to consider the following when addressing the catastrophe pricing issue:

- On June 1, 1999, Paragon Risk Management Services announced its Catastrophe Price Index (measure of domestic reinsurance catastrophe prices) and reported that reinsurance prices for renewals for January 1, 1999, had dropped for the ninth semi-annual period in a row. Paragon's report concludes that global catastrophe pricing remains under pressure as reinsurance capacity exceeds demands in all regions.
- Guy Carpenter Inc, a reinsurance broker, issued a 1999 report noting that its reinsurance placements on behalf of clients continue to indicate a decline in the cost of reinsurance, noting that the cost of reinsurance is now close to Pre-Andrew levels. The report also notes that the prices for catastrophe reinsurance contracts have declined for five years in a row.

- The GAO reports that the California Earthquake Authority (CEA) has obtained billions of dollars of reinsurance coverage at substantially reduced rates, and that in 1999, CEA received offers for more reinsurance coverage than it required. How much money the CEA saves with the new rate: a $47 million savings, a 23.4 percent reduction. For 2000/2001 the "rate on line" will decrease to 8.5 percent, reducing the CEA's premium cost by nearly 30 percent, thus reducing the CEA's reinsurance costs by approximately $39 million.

  The reinsurers also provided the CEA with a "no claims bonus" for 1999 and 2000. If the CEA treaty is loss free, reinsurers will return 12.5 percent of premiums collected in the three years of 1997 through 1999. According to the then CEA Chief Executive Officer Greg Butler, "the CEA was in a good position to negotiate, given the excellent loss experience (no claims), good operating performance, and excess capacity in the reinsurance markets. We asked a lot from the reinsurers, and a majority of them stepped up to the plate."

There are record amounts of reinsurance capacity available today. Ironically, this is due in part to the unprecedented insurer losses associated with Hurricanes Andrew ($15.5 billion) and Iniki ($1.6 billion) which prompted an assessment of conventional insurance and reinsurance risk. Insurers and reinsurers reviewed their insured exposures and risk management programs and decided to revise their business plans for the coming years. Since 1994, reinsurers, investment bankers, and financial market traders developed additional contingent capital, reinsurance, and derivative risk management products and added new capacity through newly capitalized companies. This has led to the over capacity in the marketplace.

It appears that the capacity will continue to grow in future years as well. In 1998 reinsurance broker Guy Carpenter made the following prognosis about the future of reinsurance during the Louisiana Coastal Task Force hearings: (1) there will be excess capacity, price reductions and continuity of market (the larger catastrophes are more easily absorbed by reinsurers without market concentration); (2) catastrophe reinsurance will continue to become more available and affordable; and (3) more sophisticated customized products will be developed and there will be lower transaction costs. The following contributing factors that cause this positive outlook on future market conditions were cited:

- Mergers and acquisitions, larger companies will assume larger amounts of risk;
- Strong investment returns;
- Entry of new players and new distribution channels including: (a) investment banks; (b) capital market investors; (c) alternative markets; and (d) strengthened Bermuda reinsurance capacity.

Primary Marketplace Also Well Prepared to Finance Natural Disasters

Historically primary insurers have paid ⅔ to ¾ of catastrophe losses, passing the remainder through to the reinsurance industry. The primary industry is also well-positioned to finance natural disasters. As previously stated, it is very important for this Committee to consider the capacity of the primary insurers (not just reinsurers) in its consideration of the trigger levels in S. 1361. Although S. 1361 is a proposal to create a federal reinsurance program, the primary industry plays just as critical of a role in financing these natural disasters.

- According to A.M. Best, the nations' insurance rating agency, "the industry remains overcapitalized by $100 billion, or 30%, relative to A.M. Best's minimum level for Secure-rated companies. This is true, even after accounting for a 100-year catastrophe." Best's Viewpoint, January, 10, 2000 page 6.
- RMS, a catastrophe modeling firm, reported in November 1999 that the U.S. property and casualty insurance industry is overcapitalized by as much as $100 billion.
- According to the GAO, the insurance industry has sufficient capacity to pay most or all claims from a 1-in-100 year event loss, without taking into account reinsurance. GAO notes that the insurance industry surpluses of the insurers operating in the most catastrophe-prone states have grown by 140% over the last 9 years. GAO reports that the insurance industry surplus currently stands at $427 billion, even though over the last ten years the industry has incurred $99.5 billion in catastrophe losses.
- According to a July 14, 1999, study by the Wharton School at the University of Pennsylvania entitled "Managing Catastrophe Risks," which analyzed the capacity of the U.S. property insurance industry's ability to finance major catastrophic losses, the insurance industry has more than adequate capacity to pay

at least 98.6 percent of a $20 billion loss. For a catastrophe of $100 billion, the industry could pay at least 92.8 percent. The report concludes that the gaps in catastrophic risk financing are presently not sufficient to justify Federal government intervention in private insurance markets in the form of catastrophe reinsurance.

- Not only have the primary market's capital and surplus rebounded since the disastrous effects of Hurricane Andrew and the Northridge Earthquake, most, if not all, insurers have taken steps to better assess their catastrophe exposure and put in place programs that mitigate the risk of financial impairment to their companies. These steps have included the establishment of subsidiaries devoted exclusively to high-risk markets, better management of the utilization of reinsurance, use of new capital markets products and special purposes vehicles, and catastrophe modeling to better evaluate and establish premium levels commensurate with risk.

Capital Markets Continue to Provide Capacity

The GAO reports that the potential for the capital markets to finance natural disasters is great. Over the last few years, the capital markets have developed and implemented products to securitize insured catastrophe risk and provide additional capacity to insurers (see Attachment C). The capital markets potential to provide capacity for natural disasters reaches into the trillions of dollars. Some of the nation's most prominent investment banking and securities organizations have actively securitized insurance catastrophe risk, including the Chicago Board of Trade, Goldman Sachs, Morgan Guaranty Trust, J.P. Morgan Securities, Credit Suisse First Boston, AON Re Services, Sedgwick Financial, and Merrill Lynch. The market for capital markets funding of catastrophe natural exposures has grown from one transaction in 1994 totaling $85 million to eighteen transactions in 1998 totaling approximately $2.5 billion. While it is still in its infancy, a lot of resources are being directed by capital markets intermediaries to encourage development of the market and to complete a growing number of transactions. This development could revolutionize catastrophe insurance funding and greatly expand the capacity of the U.S. insurance market to deal with the financial risks attendant to mega catastrophes. The potential capacity from the capital markets should not be ignored or underestimated during the Committee's consideration of S. 1361. This is particularly important in light of the likely convergence of the financial services industries if financial modernization is enacted into law.

State Solutions to the Catastrophe Exposure

The RAA believes that the state insurance departments play an important role in the issue of homeowners insurance availability in disaster-prone areas. State insurance departments have been working with insurers to allow changes in policy coverages and premiums that bring premiums in line with the risk of catastrophes in their markets and give consumers options in line with their resources. Together, the overcapacity of the primary and reinsurance markets have done much to address consumer level concerns about the availability and affordability of catastrophe insurance and have provided additional security to insurers against the threat of financial impairment. Evidence of this is reflected in two recent state reports. In February 1999, the New York State Panel on Homeowners's Insurance, chaired by the state superintendent of insurance, concluded that: the New York insurance market is resilient for the availability of homeowners' insurance in coastal communities, with few exceptions, has rebounded; and that the number of homeowners' insurance policies written by the New York Property Insurance Underwriting Association (a state-mandated market to ensure availability) has leveled off and the number of new policies is declining.

In Louisiana, after the Property Insurance Task Force issued its study in 1999, the Insurance Commissioner issued a letter to Congress noting that ". . . it is crucial that our homeowners are able to obtain affordable homeowners insurance to protect their property against a major catastrophe. In Louisiana, the private marketplace is doing just that, providing homeowners with affordable and adequate coverage to protect against such a catastrophe."

Recent developments in Florida also highlight the positive developments in the homeowners insurance markets. According to the state-run Joint Underwriting Association (JUA—insurer of last resort) in 1999 the number of policies dropped below the 200,000 mark. The policy count for the JUA peaked in the fall of 1996, when policies totaled nearly 937,000. The JUA issued a statement that "the steady decline in the JUA policyholders is a sign that Florida's property insurance market continues to grow healthier after collapsing in the wake of Hurricane Andrew in August of 1992. According to a May 5, 1999, Sun-Sentinel report, "reinsurance is playing a big role in breaking the logjam of policies stuck in the pools."

Hawaii has the Hawaiian Hurricane Relief Fund, created in 1993, which provides hurricane insurance directly, via a separate policy issued to the consumer. During the Fall of 1999, the Hawaiian Hurricane Relief Fund made plans to depopulate its fund and allow the private sector to issue some of these policies.

Looking at the primary, reinsurance and capital markets, as well as state initiatives, the RAA believes that the private marketplace is more than equipped to handle losses above the levels provided for in S. 1361.

Mega-Catastrophe Still Threatens the Marketplace

Notwithstanding these positive developments, a fundamental problem facing insurers and their policyholders remains: the threat of a mega-catastrophe that exceeds the resources of the insurance and reinsurance markets. An insured catastrophe that, for example, exceeds 20 percent of the aggregate surplus of the industry could have a significant negative impact on the solvency of some companies and their ability to provide coverage. Currently, according to GAO, industry surplus stands at $427 billion. Twenty percent of industry surplus would be a $84 billion event. As previously cited, the Wharton School concluded that for a catastrophe of $100 billion, the industry could pay at least 92.8 percent of the claims, however, a significant number of insolvencies would occur, disrupting the normal functioning of the insurance market, not only for property insurance but also for other coverages.

The best approach to improve insurance affordability and availability and to prepare for the losses and devastating effects of a mega-catastrophe should include:

- Consumers who live in catastrophe-prone areas should pay a premium for insurance in direct relationship to that risk. A key component to ensure availability of insurance for these consumers is the experimentation with deductible programs. Earthquake programs have long been written with a percentage deductible of 2 percent, 5 percent, or 10 percent of policy limits. Wind policies have typically stayed with a flat deductible. Many insurers today believe that creation of new deductible programs will provide an incentive for consumers to take steps to mitigate against property loss. Many states have taken action to approve such deductible programs.
- Consumer information programs should be enhanced. A well-publicized effort to provide consumers with information on how to obtain property insurance is necessary. If a consumer chooses not to purchase affordable insurance, there is not a lot a federal reinsurance program can do for the consumer.
- States and communities working with the federal government should institute pre-disaster mitigation programs, including appropriate building codes and hazard reduction measures. Hurricane Andrew has emphasized the importance of enforcement since the Dade County, Florida, experience indicates that little or no enforcement existed for compliance with building codes. The result was billions of dollars in additional damage.
- At the federal level, a federal safety net providing protection for insurers above which they cannot absorb catastrophe losses should be put in place.

With these measures, private sector competition and capacity will continue to flourish, damage to homes and lives will diminish and, in case of a mega-catastrophe, the financial infrastructure of the industry would remain intact, thereby averting wide dislocations throughout the economy. This combination of state regulatory action and federal legislation will solve this problem.

Evaluation of Proposed Federal Approaches

The RAA believes that S. 1361 is a sound foundation for addressing a federal role in financing natural catastrophes. The RAA supports the concept of a federal reinsurance backstop and the mitigation provisions in the legislation. The RAA's foremost concern in the legislation is the trigger at which the government sponsored program would provide reinsurance. In S. 1361, the program would provide reinsurance to state government-sponsored catastrophe funds once losses exceed $2 billion, a 1-in-100 year event or the claims paying capacity of the state cat fund, whichever is greater. The trigger levels for the regional contracts to be auctioned are $2 billion or 1-in-100 year event, whichever is greater. The RAA believes that S. 1361 would interfere with the private marketplace and encourage the creation of more state government programs. We are seeking to incorporate higher trigger levels for the federal reinsurance program to better reflect the private sector's risk bearing capacity. As evidenced in the material above, the RAA believes these changes will help ensure that the private marketplace is not unnecessarily infringed upon and that the federal Treasury is not at risk by assuming too much of the cost of financing these disasters. We believe that low trigger levels tilt the field toward government solutions while higher trigger levels promote private solutions.

The RAA urges the Committee to consider trigger levels that preserve the solvency of the insurance industry but do not supplant private market resources. The RAA has previously suggested trigger levels that are set based on losses to the insurance industry or insurance company surplus. Senator Stevens' bill in the 104th Congress, S. 1043, provided for the federal reinsurance program protection to trigger for insured losses which exceed 15 percent of industry surplus or losses by an insurer of 20 percent of its own surplus. If the industry was in a decline and surpluses were down, the trigger would be a lower number. If the industry continues to be robust, the triggers automatically rise. Therefore, the trigger level would adequately reflect the capacity of the insurance industry in good times and in bad.

If the industry surplus trigger is not a viable one, the RAA proposes that at a minimum, the trigger levels in S. 1361, for both the state programs and the auctions of be raised to: the greater of $5 billion, 1-in-250 year event or the claims paying capacity of the state cat fund. The House Banking Committee adopted part of our trigger language by incorporating a trigger that is in the range of $2 billion or $5 billion or in the range of a 1-in-100 year event or a 1-in-250 year event, whichever is greater. The RAA urges the Senate to go further and simply adopt the $5 billion or 1-in-250 year event trigger. It is important to note that a 1-in-250 year event is a standard for the insurance industry. In order to get a favorable rating from the nations' insurance rating agency, A.M. Best, insurance companies must demonstrate that they have the risk management tools in place to handle a 1-in-250 year event for earthquakes and Florida hurricanes. Additionally, as already stated, the states of Florida, Texas, Louisiana and California have reported that the industry can handle these size of events in their respective states.

The RAA also supports the concept of a private market amendment offered by Representative Baker that was adopted in the House Banking Committee. The Baker amendment provides that before the federal program sells the reinsurance to state catastrophe funds, the private sector must first be given the right to offer such reinsurance to the state program, in lieu of the federal government. The RAA believes that the concept of this amendment will further ensure that the private sector resources are fully utilized before implementing the federal program. We have drafted some technical amendments to the Baker amendment that we believe will improve the administration of this private market approach.

The RAA is also seeking to incorporate amendments that are more technical in nature that we believe will help increase the effectiveness and fiscal soundness of the new federal reinsurance program.

Finally, the RAA recognizes that S. 1361 is significantly different than H.R. 21 in that S. 1361 proposes to create a private insurance corporation to sell the reinsurance whereas the House bill provides that the Treasury Department sells the reinsurance. The RAA does not currently have a formal position as to which approach is preferable. The RAA understands that S. 1361 would require insurance companies who participate in the private insurance corporation to capitalize the corporation with start up loans for administrative costs. Additionally, participating insurance companies must repay the federal government within a reasonable period for any federal loans used to pay qualifying claims. The RAA believes that both S. 1361 and H.R. 21 potentially put taxpayer dollars at risk and thus would urge the Congress to adopt the approach that minimizes this risk and would result in the lowest cost to the U.S. Government.

Additional Concerns about Low Triggers

- The RAA believes that the lower trigger levels will encourage the creation of state catastrophe funds. More states would then be taking on more liability for catastrophe exposures, and seeking to pass the states' liability on to the federal government. Any legislation should allow the private marketplace to assume most of the liability, before a state or federal program subjects their taxpayers to the risk of these exposures.
- The RAA believes that, together with more state funds, low triggers for federal reinsurance, and the requirement that the program underwrite each state fund based on risk covered and the prices charged to consumers, a federal oversight mechanism would eventually have to be created. This federal regulatory entity would have to make an evaluation of underlying rates charged to consumers (required by S. 1361 to be actuarially sound) and oversee solvency of state funds. Higher trigger levels would negate the necessity of federal insurance regulatory oversight.

- Lower trigger levels lead to higher consumer prices. The state catastrophe funds will purchase the federal reinsurance, but in order to fund the purchase of it, will have to pass the cost down to the primary companies in the case of Florida, who in turn will pass the cost onto the consumer. In Hawaii and California, the cost of federal reinsurance will have to be directly incorporated in the cost of coverage paid directly by consumers. Low triggers mean higher cost to purchasers and consumers.

Closing Remarks

The RAA principles on natural disaster legislation are rooted in the belief that capitalistic incentives, operating within a flexible regulatory environment, provide ample motivation for the private sector to offer homeowners insurance in disaster-prone areas. However, they also recognize that the inherent nature of the risk associated with that coverage creates a high-capacity void that only the federal government can fill.

Those principles are further strengthened by a marketplace that has improved considerably over the last few years and is continuing to improve each passing day: insurance companies have surpluses that allow them to write more coverage; reinsurance capacity is abundant; the cost of reinsurance is at a five-year low; and new forms of reinsurance and capital markets are enhancing the catastrophe risk management market.

Combine these dynamic developments with the guidance exhibited by Congressional leaders as yourselves, and I am optimistic that we are approaching a private/public partnership that will help ensure the availability of homeowners insurance to consumers in disaster-prone areas, while maximizing the resources of the private sector.

I urge you to thoroughly evaluate both the capacity of the primary marketplace, the reinsurance marketplace and the capital markets. I believe doing so will result in your support for higher trigger levels which will minimize the risk assumed by the federal Treasury and maximize the resources of the private insurance industry.

Attachment A

U.S. RE CORPORATION,
New York, NY, July 28, 1999.

Mr. Franklin W. Nutter,
President, Reinsurance Association of America,
Washington, DC.

RE: Catastrophe Excess of Loss Reinsurance Availability in the U.S.A.

Dear Frank:

U.S. RE Corporation is pleased that it has been cited in the July 23rd, 1999 memorandum from the Majority Staff to the Legislative Assistants' Committee on Banking and Financial Services. This memorandum discusses catastrophe exposures and we presume data contained therein will be discussed at the hearing of July 30th, 1999 on H.R. 21, The Homeowners Insurance Availability Act of 1999.

In the fourth paragraph of the Memorandum, it mentions that U.S. RE has publicly stated that the total supply of available reinsurance in any single region of the United States is approximately $7 billion. We wish to point out that this information is now substantially outdated, as it was based on an analysis our company performed in 1995/96. Since then, the capacity for catastrophe reinsurance protection has grown dramatically. In fact, based upon an analysis we have just completed, we estimate that the catastrophe reinsurance capacity for four of the key regions of the U.S.A. has now more than doubled, as follows:

North East	$13.0–14.0 Billion
Carolinas	$12.5–13.5 Billion
South East	$13.0–14.0 Billion
Gulf & Texas	$14.5–15.0 Billion

We enclose copies of our exhibit which reflects this revised analysis for your convenience. We would also like to point out that based upon our estimate, the aforementioned amounts can be increased by as much as 40% when factoring the availability of the additional reinsurance capacity coming from proportional property treaty reinsurance, per risk excess of loss reinsurance and facultative reinsurance. Moreover, additional capacity is now available from the capital markets which began to emerge in 1994. This capacity has grown since 1994/95 to approximately $1 billion in any one zone. Consequently, the aggregate capacity is estimated to be more than $20 billion of limit for any one zone. We also further believe that catastrophe capacity from the capital markets will grow more significantly now that investors in the security sector have begun to actively support securitization products tied to the assetization of catastrophic risk

Considering that insurers themselves are generally prepared to retain a certain level of losses after deducting recoveries from reinsurance and other risk transfer devices, we believe that any legislation calling for a federal reinsurance mechanism should be formulated such that the federal program should not operate or trigger below an industry loss of between $25 to $30 billion. Furthermore, we believe that the trigger level established should be adjustable to meet future changes in capacity available from private sector mechanisms. With the foregoing in mind, U.S. RE Corporation urges the Committee and members of Congress to assure that H.R. 21 or any similar type of proposed legislation will not be formulated in such a way as to compete with private sector reinsurance capacity.

We understand that the RAA's position is consistent with our philosophy and are prepared to assist it and the House Committee with any clarification or further information and remain at your disposal.

Sincerely,

TAL P. PICCIONE,
Chairman, President & Chief Executive Officer.

Attachment B

RENAISSANCE REINSURANCE LTD.,
Hamilton HMGX, Bermuda, June 11, 1999.

Frank Nutter,
President, Reinsurance Association of America,
Washington, DC.

Re: Reinsurance Catastrophe Capacity

Dear Frank,

Thank you for inquiring about our views on the available catastrophe capacity by region in the United States. As you know, Renaissance Re is one of the largest catastrophe writers in the world. As part of this activity we maintain an exhaustive database of all catastrophe offerings we consider and pride ourselves in having the most comprehensive database of catastrophe cover actually purchased in the U.S.

We run a variety of probabilistic models against this database of catastrophe contracts to determine and understand the dynamics of the risk in the market. Up until now we have maintained this information as proprietary to ourselves, but at your request, we are willing to release a certain amount of the information we have assembled. It must be understood that the information is our best attempt to model the reinsurance business and is subject to some degree of interpretation.

Attached is an exhibit, which outlines the capacity available by major risk territory in the U.S.* To c1arify, this is the actual amount we calculate would be paid by the reinsurance market in very large events.

Total Maximum Recoverable in an Event

(millions)

Region	Cat XOL Purchased
Northeast	14,000
Southeast	13,000
California	11,000
New Madrid	14,500

*The information referred to has been retained in the Committee files.

CAT XOL—Natural catastrophe excess of loss reinsurance provides a defined limit of coverage that indemnifies the company above a specified loss amount.

As you can see, our data indicates there is about $14 billion in capacity per event by region currently purchased by the primary insurance market at this time. We also believe there is additional capacity available in the cat excess of loss market, but many insurance companies have decided to retain the risk on their own balance sheets. Also there is additional reinsurance protection that will be payable following a natural disaster from proportional, facultative and per risk excess of loss reinsurance agreements. More research needs to be done to ascertain the amount of additional reinsurance protection from these products, but we believe these products add about 40% more potential recovery.

Thank you for your inquiry and hope you find this information helpful.

Best regards,

WILLIAM I. RIKER,
President and COO.

Attachment C

Securitizing Natural Disaster Risk

Nationwide—Nationwide has the option to issue up to $400 million of 9.222% surplus notes to fund new business opportunities or as reimbursement to catastrophic losses. Contract with Morgan Guaranty Trust Company. (1995)

Arkwright—Arkwright has set up a trust to issue $100 million in trust notes to private investors. New proceeds of the notes will be used to buy government securities held by the trust. (1996)

AIG Combined Risks/Benfield—Placed 5 catastrophe-linked bonds with an investment fund managed by Mercury Asset Management. Bonds will pay out if a catastrophe exceeding an agreed trigger occurs in: U.S., Japan, Australia, Caribbean, Europe or Japan. (1996)

Hannover Re—Sold $100 million worth of catastrophe cover. The portfolio-linked swap is comprised of the following: Japanese earthquakes, U.S. natural catastrophes, Canadian natural catastrophes, North European storms, North European other catastrophes, Australia—all catastrophes and aviation excess of loss. (1996)

St. Paul Re—$68.5 million deal through Goldman Sachs & Co. to increase capacity. St. Paul Re will cede reinsurance business from five classes under a 10 year reinsurance treaty. Investors participate in excess-of-loss underwriting by investing in bonds or preference shares. Enables St. Paul to increase capacity in 5 excess-of-loss classes: U.S./Caribbean property-casualty, European property-casualty, other property-casualty, retrocessional/Lloyd's short-tail and marine and aviation. (1997)

Winterthur Swiss Insurance Group—Placed $282 million of catastrophe bonds in private capital market. The bonds cover Winterthur exposure to auto claims stemming from domestic summer hailstorms. Transaction managed by Credit-Suisse First Boston. (1997)

Swiss Re—Placed $137 million in two-year bonds tied to reinsurance losses from a potential California earthquake. Swiss Re and Credit Suisse First Boston were the placement agents for the notes. (1997)

Horace Mann Educators Corporation—Agreement allows Horace Mann to receive up to $100 million from Center Re, the transactions underwriter, in exchange for an equivalent value of its convertible preferred shared in the event of a mega-catastrophe. (1997)

RLI Corporation—Aon Re Services developed a $50 million catastrophe equity put (CatEPut) for the RLI Corporation. The deal was underwritten by Centre Re. In the event of a catastrophe which exhausts RLI's traditional reinsurance coverage, the CatEPut program allows RLI to sell up to $50 million in preferred shares to Centre Re. (1997)

USAA—Placed $477 million of hurricane bonds in the private placement market. The bonds will provide USAA with an excess-of-loss cover tied to a single hurricane producing losses of more than $1 billion during a one-year reinsurance period. The syndicate managers were Merrill Lynch & Co., Goldman Sachs & Co. and Lehman Bros. (1997)

LaSalle Re—Aon Re, Inc. and Aon Securities Corporation developed a $100 million multi-year Catastrophe Equity Put (CatEPut) option program for LaSalle Re. The option program allows LaSalle to issue up to $100 million in convertible preferred shares in the event of a major catastrophe or series of large catastrophes that result in substantial losses to LaSalle Re. (1997)

Reliance National Insurance Company—Completed a $40 million securitization of non-catastrophe coverage for its property, aviation, marine drilling and satellite launch exposure. The placement ties bond payment trigger points to a catastrophe index established by Swiss Re. Sedwick Lane Financial structured the deal. (1997)

Tokio Marine & Fire Insurance Co., Ltd—Tokio Marine has acquired earthquake risk coverage of $90 million purchased from capital markets investors through Parametric Re, Ltd. Parametric Re issued 10-year fixed income securities with principal reduction contingent on the occurrence and severity of earthquakes within an area centered on Tokyo. Goldman, Sachs & Co. and Swiss Re Capital Markets Corporation were co-leaders for the transaction. (1997)

Centre Solutions—Issued $83.5 million in catastrophe bonds. The bonds provide retrocessional catastrophe cover for natural and man-made perils which Centre Solutions has underwritten. The bonds have an expected maturity date of December 31, 1998. The bonds were placed by Goldman Sachs. (1998)

Mitsui Marine and Fire—Obtained $30 million in reinsurance cover backed by event-linked swap transactions. Payment is determined by the magnitude of earthquakes in and around the Tokyo area. The cover for risks is available for a three-year period which began April 1, 1998. Swiss Re Capital Markets served as the agent for the swap transaction. (1998)

Reliance National Insurance Company—Purchased an option to issue multi-peril-linked insurance notes, providing a guaranteed reinsurance cost. The deal gives Reliance the right to issue notes over a three-year period to fund reinsurance coverage provided through SLF Reinsurance LTD. The notes are tied to five classes of risk: U.S. property, property outside of the U.S., aviation, marine drilling rigs and satellite launch failure. Sedwick Lane Financial structured the deal. (1998)

USAA—Placed $450 million of hurricane bonds in the private market. The syndicate managers were Merrill Lynch & Co., Goldman Sachs & Co., and Lehman Bros. (1998)

Yasuda Fire & Marine, Aon Capital Markets and Munich Reinsurance Company—Private placement of $80 million of catastrophe reinsurance notes that provide protection against Japanese typhoon-related losses. The notes may be triggered by either one large typhoon or two, smaller separate typhoons. (1998)

F & G Re—F & G Re, in conjunction with Goldman Sachs and E.W. Blanche Capital Markets, completed a $54 million bond issuance that backs its property catastrophe excess-of-loss reinsurance contracts. The funding benefits Mosaic Re, an offshore firm that provides reinsurance on F & G Re's products. This is the first Cat bond deal to securitize multiple underlying reinsurance contracts sold to a variety of insurers. (1998)

CNA—Issued $200 million of 6.6 percent notes due December 2008. Goldman Sachs is the lead manager, and Lehman Brothers the co-manager for the issue. The net proceeds will be used for general corporate purposes. (1998)

Centre Re Solutions (Bermuda) Limited—Sponsors its second securitization of reinsurance coverage by purchasing retrocessional capacity against Florida hurricanes from capital market investors through special purpose vehicle. Trinity Re 1999, Ltd. has used $56.615 mm of fixed income securities due 12/31/99. The loss of principal on the bond is triggered when Centre Re Solutions (Bermuda) Ltd. incurs losses as the direct result of a hurricane under an excess of loss reinsurance policy the company has written for a Florida residential property insurer. Goldman Sachs is lead manager, with Chase Securities, Lufkin & Jenrette Securities Corporation, and Zurich Capital Markets Securities, Inc. as co-managers. (1998)

Allianz A.G. Holdings—Issued a $150 million catastrophe bond option to cover European catastrophe risks. The bond option gives Allianz the right to issue notes at a fixed rate any time over a three-year period to fund $150 million of reinsurance coverage through Gemini Re, a Cayman Islands special purpose reinsurer. The bond allows Allianz to hedge its future cost of reinsurance. If traditional reinsurance costs rise after windstorm losses, the company might find it more cost effective to exercise the option to issue notes. Goldman Sachs placed the notes. (1998)

Hannover Re—Secured commitments for $50 million in options for risk securitization of catastrophe losses. The option was placed with North American institutional investors and was amended to a November 1996 transaction. (1998)

XL Mid Ocean Re—Placed a $200 million retrocessional property catastrophe cover. The transaction covers the upper layers of XL Mid Ocean Re's hurricane and earthquake exposure in the U.S. and its territories and possessions in the Caribbean. The deal provides retrocessional cover in the form of a swap in which claims recovery is triggered by catastrophe losses incurred by XL Mid Ocean Re. (1998)

Horace Mann Educators Corporation—Agreement involving a $100 million transaction with Center Re. The transaction was managed by Aon Capital Markets. (1999)

Constitution Re—Transferred its East and Gulf Coast hurricane risk to Arrow Re. The risk was spread through a series of securitization and risk-transfer transactions. The transaction involved a $10 million risk transfer. Goldman Sachs, Swiss Re New Markets and E.W. Blanch Capital Markets served as advisors. (1999)

St. Paul—Completed a $45 million securitization transaction. The transaction provides additional capacity for a defined portfolio of U.S. property catastrophe excess-of-loss reinsurance contracts. Mosaic Re II issued the debt securities for the securitization. (1999)

Kemper—Acquired $100 million of earthquake coverage. The capital markets transaction funds a fully collateralized reinsurance agreement providing $100 million of Midwest earthquake coverage to the Kemper Insurance Companies. The transaction was managed by Aon Capital Markets. (1999)

Sorema—Issued a three-year $17 million deal to protect its European windstorm exposures and Japanese typhoon and earthquake risks. The bonds have an annually renegotiable interest rate and allow Sorema to adjust the size of the coverage and the premium to meet market conditions. Merrill Lynch and Aon Capital Markets arranged the transaction. (1999)

Oriental Land Company—The owner of Tokyo Disneyland, Oriental Land Company, placed two catastrophe bonds totaling $200 million to protect against earthquake risk. In the first bond, Concentric Ltd. would pay Oriental Land $100 million upon the occurrence of an earthquake that meets certain trigger conditions. The second bond provides Oriental Land with a $100 million post earthquake financing facility. Goldman Sachs and Company was the placement agent for both transactions. (1999)

USAA—Acquired $200 million in catastrophe reinsurance from Residential Reinsurance Limited. The proceeds of the sale of the bond were segregated into a trust to pay USAA's claims in excess of $1.0 billion arising from a category 3, 4, or 5 storm on the Saffir-Simpson index. The placement was co-managed by Goldman Sachs & Company, Lehman Brothers Holding and Merrill Lynch. (1999)

Gerling Global Re—has secured $80 million of cover in a three-year deal to protect the company against U.S. hurricane losses of more than $200 million. The securitized retrocession is provided by a special purpose vehicle, Juno Re, based in the Cayman Islands. The deal was managed by Goldman Sachs. (1999)

Marsh & McLennan—has completed a $50 million insurance-linked swap transaction covering losses in six states around the New Madrid fault line. (1999)

STATEMENT OF JACK WEBER, PRESIDENT, HOME INSURANCE FEDERATION OF AMERICA

Mr. WEBER. Thank you, Senator Stevens.

We'd like to thank you for the leadership that you have brought to this issue over the many years and we look forward to working with you on S. 1361.

We think it is a very good bill and one that's worthy of the Committee's support.

Natural disasters have received a tremendous amount of attention over the last few years. Two weeks ago, the Congress debated a supplemental appropriation bill containing funds to assist North Carolina regarding victims of Hurricane Floyd. And almost 1 year ago to the day, we are approaching the anniversary of Congress approving $1 billion of relief to the victims of Hurricane Mitch, which took place in Nicaragua and Honduras a little over 2 years ago.

What makes the Hurricane Mitch aid so remarkable is that the money was appropriated even though the victims were not our citizens, never paid U.S. taxes, and will never repay the money.

Americans are compassionate, and after a decade in which the Congress has appropriated more than $50 billion in disaster aid, there cannot be any doubt that whenever nature strikes, Congress will ride to the rescue.

I think the question before this Committee and the one that has been raised by the introduction of this bill, is whether the current system is the best way of dealing with natural disasters. Is it best to ask all Americans to cover the cost of the next big event regardless of where they live, or is it more just to assure that a properly functioning private insurance system covers the bulk of the losses?

Today, the private homeowners insurance marketplace is on shaky ground in the very places that it is most urgently needed. The availability, the quality, the affordability and the permanence of coverage is very much in doubt.

Just a few examples: In North Carolina, a residual pool for homeowners who cannot obtain traditional insurance coverage covers an area of 18 counties which stretch as far as 100 miles from the Atlantic Coast.

In Louisiana, a similar pool has grown by more than 800 percent in the last 9 years. According to A.M. Best, the insurance rating agency which published its findings about a month ago, the Florida insurance market is ill-prepared for the next major storm and will suffer a great number of insurance company failures.

In California, Washington State, and the New Madrid regions of Missouri and Tennessee, earthquake deductibles have been raised to as high as 20 percent, which means that the average homeowner will have to absorb $20,000, $30,000, or even $50,000 in earthquake damage before making an insurance claim.

As a result, the percentage of homeowners purchasing earthquake insurance has dropped precipitously to the lowest levels in a generation.

Ask residents in any of the regions I have just highlighted, and they can tell you about the problems personally. But you will not find these people in a caravan ready to block the entrances to the Capitol. This is not that kind of a crisis. No one ever complains about the lack of insurance before they need the coverage. It's only after the disaster that the magnitude of the problem sets in. Then, homeowners will be wondering why their policy was inadequate, why their policy didn't cover the loss at all, or why their insurance company failed.

They will ask quite rightly why the system failed, and they will demand relief and history shows that they will get it from this Congress or the next Congress just as they've gotten it from this Administration, and they will from any administration.

S. 1361 is an alternative to the above-referenced scenario. The Stevens bill stands for the premise that it is more desirable to fix the problems in the homeowners insurance market now rather than after the next mega-catastrophe, and then rely more heavily on supplemental appropriations to fix the mess.

We live in a time when the increasing frequency and severity of natural disasters is a near certainty. Just last year, the Southeast underwent the largest evacuation in history in advance of Hurricane Floyd. The storm lost most of its strength before making landfall, sparing billions of dollars in property and perhaps thousands of lives. However, it was not the reality of Floyd but would Floyd could have been that prompted USA Today to editorialize in its September 17th edition that the United States remains dangerously exposed.

According to USA Today, should a "big one" arrive as a hurricane on the East Coast or a massive earthquake out West or in the Middle States, insurers are almost certain to find themselves unable to make good on all claims, leaving homeowners in the lurch and taxpayers on the hook.

The only way to address such a debacle, according to USA Today, is with a national reinsurance program.

We agree and we're not alone. As you've already heard today, the Deputy Secretary of the Treasury has spoken favorably about a national reinsurance program. In addition, the General Accounting Office, in a report issued last month, concluded that the U.S. property insurance market, and I'm quoting here, "continues to be vulnerable to natural catastrophe losses despite efforts to contain potential losses since the 1990's."

Indeed, while the GAO found that the insurance industry's ability to pay the claims of events less than 100 years was likely, the ability to handle something greater than a 1-in-100-year event or a closely spaced series of smaller disasters could lead to a large number of insolvencies and reduce the availability of insurance in catastrophe-prone areas. Mr. Chairman, I'd like to, with your support, include the GAO report as part of the record at this time.

Senator STEVENS. I'm not sure we can include the whole report. We can include portions of it.

Mr. WEBER. Thank you. It is these events larger than 1-in-100 years that S. 1361 seeks to address, by providing a level of reinsurance protection which is neither available nor affordable in the private marketplace. Without it, insurers will continue to reduce their exposures in the areas where consumers need it most, which means inadequate coverage or no coverage for homeowners or coverage which is doubt in the wake of insurance insolvencies.

Perhaps this is why during the debate in the House Banking Committee, Federal reinsurance legislation was supported by groups as diverse as the National Association of Realtors, the Western League of Savings Institutions, the National Association of Home Builders, Fannie Mae, Freddie Mac and the Independent Insurance Agents of America.

Everyone loses if the homeowners insurance market fails, including consumers, lenders, stockholders, local and state governments and ultimately U.S. taxpayers.

S. 1361 includes important provisions to make sure that private insurance markets and private capital are used to their fullest capacity. As I mentioned, the bill limits reinsurance coverage from the Natural Disaster Insurance Corporation to events that are greater than 1-in-100 years. As the term implies, these events are extremely infrequent. A 1-in-100 year event in Florida, for example, would cause insured losses in excess of $20 billion. Under the Stevens bill, none of these losses would be covered by the National Reinsurance Program. Only losses greater than $20 billion would be eligible for coverage and then at a reimbursement rate of only 50 percent, leaving plenty of room for private capital and reinsurance markets to provide their own capacity.

It is clear that there is a scarcity of private reinsurance to cover worst case disasters. This "capacity gap" can best be described as an affordability problem. In simplest terms, the cost of capital, which governs the price of private reinsurance, is considerably higher than the premiums that can be collected from homeowners, based on the actuarial probability of loss. As a result, there is a limit to how much reinsurance primary insurers can realistically purchase.

S. 1361 helps to close this reinsurance gap, which in turn should assure a steady and predictable supply of insurance coverage for the homeowner.

While the precise threshold for this reinsurance would vary by region of the country based upon population and risk, the same 1-in-100-year principle would apply, thereby assuring that all regions and all states within a region were treated equitably.

And I would like to reference a point that one of the—actually two of the witnesses on this panel raised, which was to raise the threshold of reinsurance to somewhere in the neighborhood of a 40 or 60 billion dollar event. To put in some perspective, the worst natural disaster in terms of insurance loss in U.S. history was Hurricane Andrew, which was a $10 billion residential insured loss.

If we were looking at six times that amount, I can assure you that the entire insurance market in Florida would be in total failure. But for places like Hawaii and Alaska, $60 billion, I venture to say, is more than the entire town of Anchorage is probably worth. So that if we had that——

Senator STEVENS. Depends on who's bidding.

Mr. WEBER. That's true.

(Laughter)

Mr. WEBER. If we had those kinds of thresholds, we would probably render this program completely meaningless to virtually every state in the country with perhaps the exception of Florida.

Today, the fear of a mega-catastrophe and the inability of insurance companies to adequately reinsure their exposures, are forcing insurers to either withdraw from catastrophe-prone markets, reduce coverage, or place a moratorium on new writing.

S. 1361 can reverse this trend and do so in a way that is fiscally responsible. It is highly likely that the program will never require any infusion of Federal resources since the probability of a claim is so small, but this high-level reinsurance eliminates the possibility of the super event that poses the risk, however slight, of a financial meltdown. Only government can provide this assurance.

Private homeowners insurance paid for by the people who live in harm's way reduces the burden on taxpayers after a disaster and imposes costs on the homeowner which fairly reflect the risk of living in certain areas. It's in the public interest that the supply of this coverage is stable, predictable, and efficiently priced.

S. 1361 will go a long way to assuring such stability and deserves your support. I would add that in reference to the comments made by the Deputy Treasury Secretary, that the groups that supported Federal reinsurance legislation, worked very hard with the proponents of H.R. 21 to come up with a plan that was acceptable to the administration and the other major players involved in the debate. As a result, the bill that was reported out of the House emerged from the Banking Committee with a very strong bipartisan majority, and I think we can do the same thing working with you in the Senate, Mr. Chairman.

Thank you.

[The prepared statement of Mr. Weber follows:]

PREPARED STATEMENT OF JACK WEBER, PRESIDENT, HOME INSURANCE FEDERATION OF AMERICA

I would like to thank the Chairman and other members of the Senate Commerce Committee for this opportunity to appear before you to discuss S. 1361, the Natural Disaster Protection and Insurance Act.

This is a good bill, Mr. Chairman, and one that is worthy of the Committee's support.

Natural disasters have received a tremendous amount of attention from the Congress in the last few years. Two weeks ago, Congress debated a supplemental appropriation bill containing funds to assist the North Carolina victims of Hurricane Floyd. Exactly one year ago, Congress approved nearly $1 billion in aid to Nicaragua and Honduras to help in the clean-up of Hurricane Mitch. What makes the Mitch aid so remarkable is that the money was appropriated even though the victims were not our citizens, never paid U.S. taxes and will never repay the money.

Americans are compassionate. After a decade in which the Congress has appropriated more than $50 billion in disaster aid, there cannot be any doubt that whenever nature strikes, Congress will ride to the rescue.

The question before this Committee, however, which has been raised so eloquently by Senator Stevens and Senator Inouye, is whether this is the best way of dealing with natural disasters. Is it best to ask all Americans to cover the costs of the next big event, regardless of where they live? Or is it more just to assure that a properly functioning private insurance system covers the bulk of the losses?

Today, the private homeowners insurance marketplace is on shaky ground in the very places it is most urgently needed. The availability, quality, affordability and permanence of coverage is in doubt. In North Carolina, for example, a residual pool for homeowners who cannot obtain traditional insurance covers an area of 18 counties which stretch as far as 100 miles inland from the coastline. In Louisiana, a similar pool has grown more than 800% in nine years. According to A.M. Best, the insurance rating agency which published its findings last month, the Florida insurance market is ill-prepared for the next major storm and will suffer a great number of insurance company failures. In California, Washington state and the New Madrid regions of Missouri and Tennessee, earthquake deductibles have been raised to as high as 20%, which means the average homeowner will have to absorb $20,000 . . . $30,000 . . . or even $50,000 in earthquake damage before making an insurance claim. As a result, the percentage of homeowners purchasing earthquake coverage has dropped precipitously to their lowest levels in a generation.

Ask residents in any of the regions I have just highlighted and they can tell you about the problems. But you will not find these people in a caravan ready to block entrances to the U.S. Capitol. This is not that kind of crisis. No one ever complains about the lack of insurance before they need it. It is only after the disaster that the magnitude of the problem sets in. Then, homeowners will be wondering why their policy is inadequate, why their policy doesn't cover the loss at all, or why their insurance company failed. They will ask, quite rightly, why the system failed them. They will demand relief and history shows they will get it from this Congress or the next Congress, just as they will get it from this Administration or from any Administration.

S. 1361 is an alternative to the above-referenced scenario. The Stevens bill, which is co-sponsored in this Committee by Senators Inouye, Breaux, Lott and Frist, stands for the premise that it is more desirable to fix the problems in the homeowners insurance market now, rather than after the next mega-catastrophe and then relying more heavily on supplemental appropriations to fix the mess.

We live in a time when the increasing frequency and severity of natural disasters is a near certainty. Just last year, the Southeast underwent the largest evacuation in history in advance of Hurricane Floyd. The storm lost most of its strength before making landfall sparing billions of dollars in property and perhaps thousands of lives even while bringing enormous suffering to North Carolina, South Carolina, and southern Virginia.

It was not Floyd, but what Floyd could have been, that prompted USA Today to editorialize in its September 17th edition that the United States remains dangerously exposed. According to USA Today, ". . . should a 'big one' arrive—as a hurricane on the East Coast or a massive earthquake out West or in the middle states . . . insurer[s] are almost certain to find themselves unable to make good on all claims, leaving homeowners in the lurch and taxpayers on the hook."

The only way to address such a debacle, according to USA Today, is with a national *reinsurance* program.

We agree. And we are not alone.

Both Treasury Secretary Lawrence Summers and Deputy Treasury Secretary Stuart Eizenstat have testified favorably before the House Banking Committee. According to Deputy Secretary Eizenstat "the Administration remains convinced that a well-designed reinsurance program . . . could help provide the foundation for communities, individuals and the private insurance markets on which they depend to make a sound recovery in financial terms."

Moreover, the General Accounting Office, in a report issued last month, concluded that the U.S. property insurance market "continues to be vulnerable to natural catastrophe losses, despite efforts to contain potential losses since the 1990s." Indeed, while the GAO found that the industry's ability to pay the claims of a 1-in-100 year disaster was likely, the ability to handle something greater than a 1-in-100 year event or a closely spaced series of smaller disasters could lead to a large number of insolvencies and reduce the availability of insurance in catastrophe-prone areas.

It is these events larger than 1-in-100 years that S. 1361 seeks to address, by providing a level of reinsurance protection which is neither available or affordable in the private marketplace. Without it, insurers will continue to reduce their exposures in the areas where consumers need it most which means inadequate coverage or no coverage for homeowners or coverage which is in doubt in the wake of insurer insolvencies.

Perhaps this is why, during the debate in the House Banking Committee, federal reinsurance legislation was supported by groups as diverse as the National Association of Realtors, the Western League of Savings Institutions, the National Association of Homebuilders, Fannie Mae, Freddie Mac and the Independent Insurance Agents of America.

Everyone loses if the homeowners insurance market fails including consumers, lenders, stockholders, local and state governments and ultimately U.S. taxpayers.

S. 1361 includes important provisions to make certain that private insurance markets and private capital are used to their fullest capacity. As I mentioned, the bill limits reinsurance coverage from the Natural Disaster Insurance Corporation to events that are greater than a 1-in-100-year event. As the term implies, these events are extremely infrequent. A 1-in-100 year event in Florida, for example, would cause insured losses in excess of $20 billion. Under the Stevens bill, none of these losses would be covered by the national reinsurance program. Only losses greater than $20 billion would be eligible for coverage, and then at a reimbursement rate of only 50%, leaving plenty of room for private capital and reinsurance markets to provide their own capacity.

It is clear that there is a scarcity of private reinsurance to cover worst-case disasters. This "capacity gap" can best be described as an affordability problem. In simplest terms, the cost of capital—which governs the price of private reinsurance—is considerably higher than the premiums that can be collected from homeowners based on the actuarial probability of loss. As a result, there is a limit to how much reinsurance primary insurers can realistically purchase.

S. 1361 helps to close this reinsurance gap, which in turn should assure a steady and predictable supply of insurance coverage for the homeowner. While the precise threshold for this reinsurance would vary by region of the country based on population and risk, the same 1-in-100 year principle would apply, thereby assuring that all regions and all states within a region were treated equitably.

Today, the fear of a mega-castastrophe and the inability of insurance companies to adequately reinsure their exposures are forcing insurers to either withdraw from catastrophe-prone markets, reduce coverage or place a moratorium on new underwriting. S. 1361 can reverse this trend and do so in a way that is fiscally responsible. It is highly likely that the program will never require any infusion of federal revenues, since the probability of a claim is so small. But this high-level reinsurance eliminates the possibility of the super-event that poses the risk, however slight, of a financial meltdown. Only government can provide this assurance.

Private homeowners insurance, paid for by the people who live in harm's way, reduces the burden on taxpayers after a disaster and imposes costs on the homeowner which fairly reflect the risk of living in certain areas. It is in the public interest that the supply of this coverage is stable, predictable and efficiently priced. H.R. 21 will go a long way to assuring such stability and deserves your support. We look forward to working with members of the Commerce Committee as S. 1361 proceeds to mark-up.

Thank you.

Senator STEVENS. Thank you very much, gentlemen. It's an accident you arranged the table as you are, but you've got the Right and the Left at one table.

My mind goes back to a bill we had here earlier today, and that was the Olympics sports bill. I remember hearing similar testimony from Olympic athletes and the AAU and the NCA, and no one thought we could ever get together. It took us about 5 months, but we're in this room around those tables, and not listening to one another here but talking to one another at the table, and we finally reached a consensus, which is held solid now for almost 25 years.

If we don't make it this year, I'm going to do that next year with this bill, and we're going to have meetings and meetings and meetings until we find some way to agree, because I think we are reaching the point now, where the limits on us and the budget process are such that we could probably not respond to even the 100-year occurrence within the constraints of the budget we're debating on the floor right now.

I'm concerned to ask you, Mr. Keating, Mr. Plunkett, the GAO report indicates that if we have events in excess of the 100 years, there will be severe harm to the insurance markets. There will be a disastrous effect as far as availability of insurance covering for consumers. How do we get around that? The people that you speak for are the ones that are going to be harmed if we don't find a solution to the differences between your groups and the industry groups.

What do you think about GAO's conclusion? They really said that we do need—as I understand it—we do need to take some action to deal with future catastrophes. You seem to agree, but I don't see how we can get there from here and in comparing the comments that the four of you made, two on one side, two on the other, what do you two think? What do we need to bring you closer to Mr. Weber and Mr. Nutter?

Mr. KEATING. Well, first I guess I'll comment briefly on the GAO report. The GAO report I think was also notable for what it didn't include. It didn't look at the potential, and not only now but in the future, for securitization. We have to keep in mind our public capital markets are in the trillions of dollars. So what we're talking about here, even in terms of a worse case scenario, you know, 100, 150 billion dollars of losses to the insurance industry, when you compare that to the size of the capital markets in the trillions, obviously there's great potential there.

If we just tap a small sliver of the capital markets to back this type of insurance, we're talking about a huge capacity that could be tapped into, and this is something, at least my reading of the GAO report, they didn't examine.

I think the GAO report was also notable in that it definitely confirmed the numbers that Travis spoke of where the industry's surplus is much larger today despite record payouts during the 1990's. The surplus has actually increased.

Now obviously a general industry surplus is not available to any individual company that may have written its business poorly, but clearly there's an enormous amount of capital in the industry itself. Whether it's this reinsurance or some sort of derivative, we believe that private money should be relied upon to the extent possible rather than bureaucratic decisions being made at the Treasury Department, especially when you consider that the real risks to the Federal Treasury here are likely to come from California and Florida.

Now these two states are rapidly growing states, and that means politically they're growing in importance as well to any future administration. So we have to not only keep in mind whether a program is artfully designed from the beginning but whether there are sufficiently checks and balances on the political apparatus on a future administration that may seek to shovel subsidies to a state like California or Florida at the expense of the people around the country.

A reform that I think holds great potential is the idea of fixing a problem in the tax laws that penalize both the homeowners that try to buy insurance coverage as well as the industries, the companies that try to offer insurance.

The Federal tax laws treat putting aside money to paying for a mega-disaster as profit. This is ridiculous. If money is set aside to pay for that 1-in-100 or 1-in-250-year event, that's prudently putting aside the money so it's available, so when the big one does hit, the money's there.

Senator STEVENS. Ah, but what you don't see is if one hits in California all the small states are absolutely wiped out. It is a national system, Mr. Keating. That one earthquake in California, a 20-mile long earthquake costs 10 times as much as the total earthquake in Alaska and tidal wave in Oregon.

I don't see how you look at those surpluses and say other than that they are prudent, yes, and I understand what you're saying about the tax bill. I wish we'd go along with that. But you, yourself, point to the surpluses as being a reason not to have reinsurance.

Reinsurance for California is not going to do me any good if we have another earthquake in Alaska if they trigger first.

I don't think you're helping us on a national system for your comments, frankly.

Do you, gentlemen? Mr. Weber, do you have any comments? Mr. Nutter?

Mr. PLUNKETT. Mr. Chairman, since you asked me to could I put in something you haven't heard it?

Senator STEVENS. Yes. Quickly, though, because I do have an appointment at 4:30, and I have two other people I want to hear.

Mr. PLUNKETT. I'll ask Mr. Hunter to get to your staff our thoughts on the GAO report.

I would encourage you to get the folks in from the Wharton School and ask them to talk to you about their series of 14 papers on this issue.

Senator STEVENS. I've read the report, as a matter of fact, and I think a lot of that school, and I do know quite a few of them involved, and I understand what they're saying.

But I think they, too, are sort of oriented on the concept of the national reinsurances is all we need, but really it doesn't deal with a state-by-state analysis of that problem.

Mr. Nutter.

Mr. NUTTER. Mr. Stevens, if I could comment on what you said.

Your state is a good example of the point that you make. Your state is served by some of the best capitalized insurance companies in the United States—State Farm, AllState, USAA are the principal homeowners insurers. Fine companies, fully capable of handling a significant major earthquake in your state.

But if those companies are financially impaired as a result of a Los Angeles earthquake, or a Miami hurricane, but they will have problems serving a state such as your own. Standing alone they look like they're well within the resources to respond, yet this program is needed as a safety net behind those companies.

I would also like to offer the comment that the insurance tax laws, already take into consideration catastrophe losses. Insurance companies are free to carry back 2 years and carry forward 15 years any catastrophe losses they have against their future profits or the past profits. That there is a tax provision which takes into consideration the smoothing of catastrophe experience that the companies have.

Mr. WEBER. Senator Stevens, you had asked me for my comments. I want to get them in real quick.

The great irony of the GAO report is that it was the opponents of the legislation in the House of Representatives that were so eager and adamant to have the GAO study this problem. And the bottom line of the GAO report is that it corroborates the very point that the proponents of the legislation are trying to make, and that is that for events greater in 1-in-100, that we do have a problem that needs a role for the Federal Government.

That's where S. 1361 kicks in. That's where the GAO says there's a problem. That's also where the House bill kicks in.

As far as the capital markets are concerned, the GAO did take note of the capital markets, and what they said, and it's the absolute truth because we're dealing with the issue of capital markets everyday with the companies that I represent, is that the capital markets to date have not provided any large degree of new capacity.

The capacity that has been provided has been more expensive than what's available in the private reinsurance markets, and actually in the last 2 years the amount of business that has been done in the capital markets regarding catastrophes has declined by over 40 percent.

So we do not share the optimism of the taxpayer's union that the capital markets are the answer to everything.

And finally on the issue of the changes to the tax code, the Home Insurance Federation, is comprised of some of the largest homeowners insurance companies in the nation, and at this point we do not oppose the tax proposal.

But we would be remiss if we did not tell you that the changes that are being proposed with the tax code, would not make one bit of difference to our companies in terms of the amount of insurance that we write in risk-prone areas.

S. 1361 would. And the reason is because the tax changes do not provide the kind of catastrophic protection against the worst case event that we need in order to feel comfortable writing that business.

Senator STEVENS. Thank you very much. We normally limit witnesses to 5 minute statements. I decided that you all ought to hear one another as we hear you and try to see if there isn't some way to bring you together.

Now we represent consumers, Mr. Keating and Mr. Plunkett. I don't represent any of the insurance companies. I don't think there's an insurance company in Alaska or Hawaii, as a matter of fact, that writes this kind of insurance.

But we suffer more of these disasters, our two states, than all the rest of the Nation put together. That's what motivates us and I've seen the change here since the Alaska earthquake and the Hawaii tidal wave. The amount of money we're putting up for things like the hurricanes on the East Coast, and the California disasters, as I said before, just pale our past recoveries from our disasters and just they're insignificant, really, compared to the payments we're paying now.

You get paid for temporary housing. You get paid for recovery of rebuilding your home. Even if it's been built two or three times. You get paid to move it if it's in a newly defined zone of harm.

That just continues now, and if you're really protecting the taxpayers, Mr. Keating, you'd find some way to limit that by taking out of the zone that the smaller disasters that happen throughout the country, and you do that by reinsuring to make sure that not one of these big ones, if it goes off, destroys the insurance that all the rest of us in the country carry.

I don't see that we're coming together yet. I hope we get there, though. And I do thank you very much.

I've got one more panel, and then I've got to go vote at 4:30.

Thank you very much. If you have any additional information we'd be pleased to receive it. We'll put all the statements you gave us in the record as so given and we will put parts of the GAO report in the record.

Thank you all very much.

[The information referred to follows:]

NOTES FROM GAO REPORT

p. 2—Results in Brief

"We did not assess the extent to which a major catastrophe could have long-term affects on insurers and consumers. Catastrophes can disrupt insurance markets and harm insurance companies and consumers even in cases where all claims are paid. Therefore, determining whether insurance companies have resources to pay all claims arising from a given natural catastrophe may ignore other important aspects of insurer capacity."

"Although it appears that the insurance industry today as a whole may be able to pay for most or all claims arising from a 1-in-100 year catastrophe loss, the current level of insurer resources to pay catastrophe claims is unlikely to be stable over time. A catastrophe loss greater than a l-in-100 year loss or a closely spaced series of smaller disaster could temporarily deplete insurer resources, including the supply of reinsurance. Such disasters could lead to a larger number of insurer insolvencies than would result from a 1-in-100 year loss or reduce the availability of insurance in catastrophe-prone areas of the country. Other developments could also shrink insurer capacity. For example, after adjusting for taxes on realized capital gains on insurers stock and bond holdings, more than ¾ths of growth in the insurance industry's financial capital since 1995 was from capital gains. As a result, insurer resources could change with major changes in equities prices or interest rates."

p. 3

"Comparing the total available resources of the insurance industry to total potential catastrophe losses may, itself, not be the best way to measure capacity. A more thorough evaluation of the insurance industry's catastrophe capacity would also take account of the extent to which hypothetical disaster would erode the financial health of insurance companies and the degree to which individual insurers would react to those losses by restricting the supply of insurance after the event occurs. Historically, large natural catastrophe have disrupted insurance markets and harmed insurers and consumers. For example, in 1992, Hurricane Andrew caused more insured losses than any other catastrophe in U.S. history. Even though more than $15 billion in claims were eventually paid and few insurers became insolvent, insurance companies then restricted the supply of certain types of insurance—notably homeowners insurance—in catastrophe-prone areas."

p. 4—Scope and Methodology

"We generally defined a major natural catastrophe as one that would generate a 1-in-100-year loss. However, the approach we used had important limitations. For example, it did not factor in any reinsurance that insurance companies might have held because we were not able to obtain such information. Omitting reinsurance might lead us to underestimate capacity. On the other hand, our analysis may have overestimated capacity because it included the surpluses of some firms that either were in the same corporate family or that do not sell property insurance."

p. 5

"Our comparison of insurers financial capital to catastrophe loss estimates suggests that they probably would be able to pay all or most claims arising from a single 1-in-100 year catastrophe loss that strikes one of the 10 states we studied. However, important limitations reduce the usefulness of the results."

p. 6

"In our view, growth in the entire insurance industry's surplus is a fairly crude measure of its natural catastrophe claims-paying capacity because the insurance industry as a whole does not pay catastrophe insurance claims. Instead, individual insurance companies pay claims on the basis of the damage that particular catastrophe inflicts on the properties they insure. For any given catastrophe, only a portion of the industry's surplus is available to pay disaster claims."

p. 7

"Recent estimates of reinsurance available to finance catastrophic losses indicate that reinsurance coverage has increased significantly since the mid-1990s. . . . The estimates were prepared for the Reinsurance Association of the America and submitted for the record by the Association at a hearing of the House Banking and Financial Service Committee in July 1999. We could not independently verify these estimate of reinsurance capacity because the data on which the estimates were based are not publicly reported and are proprietary in nature. Still, these estimates have certain limitations that must be understood so that their meanings are not misconstrued. First, regional figures should not be added together to obtain multi-regional or national totals. This is because insurance companies tend to buy reinsurance to cover some share of their catastrophe exposure regardless of where the catastrophes occur. Therefore, a catastrophe in any one region would reduce the amount of reinsurance available to pay for additional catastrophes in that region or other regions."

"Second, these estimates are for the value of the reinsurance purchased by insurers, not the surpluses of the reinsurance companies supplying the reinsurance; that is, not for the resources that back up the reinsurance contracts. An ISO official said that in a major catastrophe, some reinsurance companies might become insolvent before they fully honor their reinsurance commitments. Therefore, the actual amount of reinsurance that would be used to cover insurer losses in a major catastrophe could be less than the estimates provided by the two reinsurance companies."

"A third financial resource—but by far the smallest—that insurance companies can use to transfer catastrophe risk is capital market products. These specialized products transfer some of insurers catastrophe risk to investors. Some sources with whom we talked told us that the potential for using capital market products may be great, but actual use of these products by the insurance and reinsurance industries has been very modest to date."

p. 9

[Note that Modeled Losses cited in the GAO Report include both residential and commercial losses. H.R. 21 applies only to residential losses.]

"The results of our analysis suggest that some insurers claims from a single major catastrophe in a single state could be large relative to their surplus. As table 2 indicates, in four states (Florida. California, Texas and New York) more than 20 percent of insurance companies might have claims that exceed 20 percent of their surpluses, the level of surplus loss from a catastrophe that could trigger a rating review by the AM Best Co. To the extent that these losses were not replaced, for example, by reinsurance payments, some of these companies could face serious financial difficulty. Moreover, markets in these states could be disrupted if insurers reduced the number of policies they issued after the event, as happened in the aftermath of Hurricane Andrew in 1992 and other past major catastrophes."

p. 10–11

"The above analysis suggest that, in the 10 states we studied, most insurance companies should be able to handle a major catastrophe, but that some firms could incur significant financial harm in paying their claims. However, this analysis has important limitations."

"Our analysis has other limitations as well. Two of these limitations may have led us to underestimate and two to overestimate insurance companies capacity to pay catastrophe claims."

. . . Our analysis only considered the impact that a single catastrophe that strikes a single state would have on insurer surpluses. In reality, insurance companies often must deal with catastrophes that cause damage in more than one state or that occur within a short span of time. To the extent this happens, our analysis overestimated capacity.

. . . We [also] included some insurer surpluses that may not be available to pay catastrophe claims.

p. 12

[in reference to 1997 Wharton Study on Insurance Industry Capacity]

"The Wharton analysis also found that, even if the insurance industry as a whole could pay all or most claims arising from catastrophes of these magnitudes, a significant number of insolvencies would result. . . . The Wharton study concluded that these insolvencies would disrupt the normal functioning of the insurance market, not only for property insurance, but also for other types of insurance. . . . Moreover, the Wharton study's model may overstate insurance industry capacity for two reasons. First, as our analysis did, the study assumed that the total resources of all property and casualty insurer in the respective samples would be available to pay catastrophic loss claims, even though some of those companies do not write policies that likely would be triggered by a catastrophe such as firms that write only liability insurance."

p. 13

"Although it appears that insurance companies today may be able to pay for most or all claims arising from a 1-in-100 year catastrophe. insurers current capacity may not be stable over time. Insurance companies remain heavily exposed to catastrophe losses despite effort to reduce their potential losses. . . . The U.S. property and casualty insurance industry continues to be vulnerable to natural catastrophe losses, despite efforts to contain potential losses since the early 1990s."

p. 14

"Insurance companies capacity to pay catastrophe claims can be affected by the occurrence of past catastrophes. In the event of a very large natural disaster or of multiple major disasters, insurer resources, including reinsurance, could be temporarily depleted. This occurred in the mid 1990s after Hurricane Andrew and the

Northridge earthquake. . . . Moreover, historically, the P&C insurance business has been cyclical in nature . . . A major catastrophe or series of catastrophe could occur near the peak of a cycle, when both demand for insurance and insurance premiums were high by historical standards. According to an ISO official, in such a case, consumers could be harmed more than if the catastrophe were to occur during a period when insurance was readily available and prices were low.”

p. 15–16 Conclusions

“Both the surplus of insurance companies and the amount of reinsurance they purchase have increased substantially during recent years. However, only a portion of these resources would be available to pay claims from any single catastrophe. Our analysis of insurance industry data suggested that the surpluses of insurance companies that operated in 1998 in each of the 10 states in our review exceed likely losses they would incur from a single 1-in-l00 year natural catastrophe. However, a simple comparison of the industry’s total resources available to pay catastrophe claims with the estimated losses that could result from a large catastrophe ignore the importance of maintaining functioning insurance markets in the aftermath.”

“. . . The insurance industry’s current capacity to pay disaster claims is not likely to be stable over time. A major catastrophe loss or a series of smaller disasters could temporarily deplete insurers resources.”

UNITED STATES GENERAL ACCOUNTING OFFICE,
GENERAL GOVERNMENT DIVISION,
Washington, DC, February 8, 2000.

B–284252

Hon. ED ROYCE,
House of Representatives.

Hon. PAUL E. KANJORSKI,
House of Representatives.

Hon. RICK HILL,
House of Representatives.

Subject: Insurers’ Ability to Pay Catastrophe Claims

The Homeowners’ Insurance Availability Act of 1999 (H.R. 21) would establish a federal program to sell reinsurance [1] (1) to state government programs and (2) at auction to cover some insured losses associated with certain natural disasters. The bill requires that the federal program not displace or compete with the private insurance or reinsurance markets, or compete in the capital markets. However, conflicting claims have been made concerning private insurers’ capacity to handle such disasters.

You asked us to evaluate current industry capacity to pay natural catastrophe [2] claims. To address this issue, we (1) compared available data on industry [3] financial resources to estimates of potential insured losses that would result from natural catastrophes of various magnitudes, (2) considered two recent studies of capacity,[4] and (3) evaluated factors that may affect the stability of insurer capacity over time.

[1] Reinsurance is insurance for insurance firms. Under a reinsurance contract, in return for a share of the premium it collects, an insurer is able to transfer a portion of its risk to a reinsurance entity, which, in turn, is obligated to reimburse the insurance company for an agreed-upon share of covered losses.

[2] The Insurance Services Office, Inc., a company that provides information on the insurance industry, defines a catastrophe as an event that causes at least $25 million in insured property losses and affects a significant number of property and casualty insurers and policyholders. Although some catastrophes are not nature-related (e.g., riots), this report focuses on natural catastrophes.

[3] The U.S. insurance industry can be divided into (1) an accident, life, and health insurance industry and (2) a property and casualty (liability) insurance industry. This report deals with the property and casualty insurance industry only.

[4] The studies are (1) *Can Insurers Pay for the Big One? Measuring the Capacity of the Insurance Market to Respond to Catastrophic Losses* (Wharton School, University of Pennsylvania), July 14, 1999; and (2) *P&C RAROC: A Catalyst for Improved Capital Management in the Property and Casualty Industry* (Risk Management Solutions, Inc., and Oliver, Wyman, and Company). Fall 1999.

Senator STEVENS. We now turn to Mr. Charles Brown, Vice President of Baker Welman Brown Insurance of Kennett, Missouri; Mr. Scott Gilliam, Director Government Relations, The Cincinnati Insurance Companies.

Gentlemen. Sorry to keep you. It should have been a very quick little hearing, but I decided to hear everybody.

Mr. Brown, are you prepared to go first?

Mr. BROWN. Yes, sir.

Senator STEVENS. We'll put your statements in full in the record, as I indicated. But you tell us what you think we ought to all hear.

STATEMENT OF CHARLES T. BROWN, VICE-PRESIDENT, BAKER, WELMAN, BROWN INSURANCE

Mr. BROWN. Mr. Chairman, I want to thank you for the opportunity to address the Committee on the need for natural disaster legislation.

My name is Charlie Brown and I'm Vice President of Baker, Welman, Brown Insurance in Kennett, Missouri.

I am an independent insurance agent in this community and have the privilege of representing hundreds of homeowners with all different types and values of home. Currently, I also serve as the Chairman of Missouri Agents Earthquake Task Force and Chairman of the Independent Agents of America's Natural Disaster Task Force.

I am here today to testify in support of S. 1361 on behalf of the hundreds of homeowners and all my clients, and the thousands of insurance agents across America that have and are experiencing problems with their homeowners' markets due to the threat of natural disasters.

Unfortunately, my town is located in what has been predicted to be one of the worst affected ares of the New Madrid fault. Those who unfamiliar with the fault, it crosses five state lines and the Mississippi River in at least three places. Damage estimates for a major earthquake on the New Madrid fault run into the billions of dollars. A major event would devastate St. Louis and Memphis and impact thousands of homeowners in Arkansas, Illinois, Kentucky, Tennessee and Missouri.

Senator STEVENS. As a matter of fact, Mr. Brown, during the last earthquake in Missouri, the bells from the churches in Boston rang.

Mr. BROWN. That's right. That's what I've heard ever since I was a little boy.

Ever since Hurricane Andrew and the North Ridge earthquake, we've seen our markets for earthquake coverage on homeowners policies dwindle at an alarming rate, even though we haven't experienced a major really since the 1800's.

This change has been less dramatic than the market problems in Florida or California, but I want to stress the changes in our market are no less real for my clients.

Let me further explain what has been happening in our Missouri marketplace.

First, we see many companies simply withdraw from the earthquake-prone area of out state. For example, one national direct insurance company canceled of their agencies in Southeast Missouri.

If all of the insurance companies in Missouri had done this, we would have seen an immediate crisis as we did see in California and Florida.

My agency has been visited by a major national insurance company, and during that visit the company told us that they could no longer justify their earthquake exposure in Southeast Missouri. It would take at least a 1,400 percent increase in the rates to justify their exposure.

The same company asked us to either take the earthquake coverage off our policies or to write it with a different company. Fortunately, we were able to find another company at that time to help us.

Most insurance companies have taken a different approach to eliminating, reducing, or maintaining their amount of earthquake insurance they write in my area.

Another insurance agency in Southeast Missouri was told by one of their companies they represented that they were being terminated because they had experienced too many losses. The owner of this agency didn't really believe this and so he checked into it himself and confronted the insurance company. The agent was then told he could keep his contract but he would have to non-renew all of his homeowners policies with the company. He was told that the real reason the company was canceling his agency and others in the area was to reduce the company's earthquake exposure.

The most widely used tactic of insurance companies to exit our homeowners insurance market has simply been price. By just increasing the cost of the homeowners policy, they can easily see their business cancel. Rates have climbed 100, 200 percent in the last several years.

The companies that increase their rates do not have to cancel any policies or withdraw from our area. Their price increases that form.

Our Missouri Department of Insurance have been monitoring the cost of earthquake insurance for homeowners and the percentage of homeowners that have this covering. When they released their first data in 1996, he headline of their press release read "Statewide earthquake insurance market relatively stable."

In 1997, the department issued a press release with the following headline: "Earthquake insurance rates sharply up in the Bootheel. Coverage there falls off."

The last press release in 1998 read: "Director Angoff orders examination of major increase in earthquake rate recommendations for Missouri businesses and homes." The press release went on to say that the residential rate hikes reached 266 percent for some homeowners policies in Southeast Missouri and metropolitan St. Louis.

The third manner in which insurance companies have handled their earthquake exposure in that area is by increasing deductibles and limiting coverage to just the home itself and providing no coverage for outbuildings, and none or only limited coverage for personal property.

The standard earthquake deductible used to be 2 percent, now we see deductibles starting at 10 percent, going up to 25 percent. One company our agency represents has stopped writing any new homeowners with earthquake and on their existing homeowners they have changed the coverage to just the home itself and a small amount on personal property.

They did not increase their earthquake rates but by reducing their coverage they, in fact, took 100 percent rate increase.

Some of the industry will tell you that companies increasing deductibles and limiting coverage is a partial solution to the problem with natural disasters. I just wonder where these homeowners are going to get the money for their personal property or to manage a 25 percent deductible. This is no solution for the average American but rather a prayer that somehow it will cost 25 percent less to rebuild their homes, or that when their home falls to the ground, that miraculously their furniture, clothes, and other items will remain useful.

In January 1999, my agency contacted over 20 companies to see if we find a company willing to come to our area and write homeowners policies. Only one company would seriously talk to us. We heard many excuses from these insurance companies on why they would not appoint our agency, but a few were honest enough to tell us that their company was just not interested in writing any earthquake coverage.

Missouri is by no means the only state that has been experiencing problems with their homeowners markets. Agents have testified on H.R. 21 from North Carolina, Louisiana, Massachusetts, Florida, New Jersey, and they all testified about the problems to that the homeowners face in obtaining adequate homeowners insurance.

If time will permit, the same message could be told by scores of other insurance agents from California, Texas, Arkansas, Tennessee, Georgia, and South Carolina, just to name a few. The stories are all similar as is the need for a solution to the problem. The fact is that homeowners across our great nation are not able to protect their homes in the manner that most of us take for granted.

In 1999, the Missouri Association of Insurance Agents, a group that represents independent agents in Missouri, introduced a bill on Missouri Senate to establish a fund similar to the Florida Hurricane Catastrophe Fund. All legislation was heard and unfortunately we did not have sufficient support to adopt the legislation at that time.

We were concerned that, as you know, Senator, this debate has been going on a long time and we haven't seen the solution. After our General Assembly adjourned, our Earthquake Task Force met again and decided that while we believed it was a good idea to establish a state plan in Missouri, the problem of availability was going to have to worsen further. Getting a state plan established is no easy task.

This brings me to one of the arguments against S. 1361. The bill encourages the proliferation of state plans to compete against the private market. If our effort in Missouri is any example of what it takes to implement a state plan, I cannot see how this argument against S. 1361 holds water. Because the threat that natural disasters pose to most states is that usually the entire state is not affected but usually certain areas.

Convincing state legislature in this states to implement a state plan is extremely difficult if not impossible unless our markets continue to worsen. States like California, and Florida and Hawaii, where the entire states have been affected, have implemented those plans. I believe it will take similar situations in other states for more state plans to be developed.

We don't really want to see the proliferation of state plans. We'd like to see a national solution as we believe it is a national problem.

We think this bill should, in fact, help curtail the creation of additional state plans. The need for state plans only exist when the market fails, and we believe this bill can revitalize the markets in our states that are currently worsening; and, even more importantly, prevent what happened in Florida after Andrew when the market fell apart and not only affected insurance but affected all segments of the economy.

The Independent Insurance Agents of America believes that the insurance marketplace has and will continue to have problems in dealing with mega-catastrophes like earthquakes and hurricanes.

Insurers and reinsurers are well equipped to handle the normal types of losses that occur everyday from fires, theft and lots of other types of losses. But the losses that an earthquake or hurricane can present to many regions of America are beyond our industry's capability to manage without assistance.

Some people have tried to paint this bill and the bill in the House as a bailout for the rich, for big beach houses, or for those that were foolish enough to build in areas where they shouldn't. Nothing could be farther from the truth. Most of my clients in Missouri live in modest homes ranging from $50,000 to $150,000. These homes are not mansions but they are most value asset that most Americans possess.

I also want to address another misconception about natural disaster legislation. Opponents will tell you that there is sufficient reinsurance to handle the problem, but I can tell you that will all the sufficient reinsurance being in the market after Andrew and North Ridge, we have continued to see our marketplace deteriorate.

I really question the availability of sufficient reinsurance now and fear that the inevitability of a mega-catastrophe will once again strict reinsurance to levels that will send thousands of homeowners scrambling for a policy to protect their home.

I also want to address the benefit of this legislation to the taxpayers in both disaster and non-disaster prone states.

Senator STEVENS. Mr. Brown, I hate to do this. I'm going to have to ask you to wind it up if you can. I have to get to a vote here.

Mr. BROWN. I really can't see the logic because we spend so much money in disaster relief. It makes more sense to me that we allow homeowners in those states that had the exposure to prepay for this by buying their homeowners insurance. That's what this bill will help us accomplish.

[The prepared statement of Mr. Brown follows:]

PREPARED STATEMENT OF CHARLES T. BROWN, VICE-PRESIDENT, BAKER, WELMAN, BROWN INSURANCE

Mr. Chairman, thank you for the opportunity to address the Committee on the need for natural disaster legislation. My name is Charlie Brown and I am Vice President of Baker Welman Brown Insurance in Kennett, Missouri. Kennett is a small town of approximately 11,000 people located in the extreme Southeast or "Bootheel" of Missouri. I am an independent insurance agent in this community and have the privilege of serving hundreds of homeowners with all different types and values of homes. Currently, I serve as the chairman of the Missouri Agents Earthquake Task Force and chairman of the Independent Insurance Agents of America's (IIAA) Natural Disaster Task Force. I am here today to testify in support of S. 1361 on behalf of the Independent Insurance Agents of America and the thousands of insurance agents and homeowners across America that have and continue to experience problems with their homeowners markets due to the threat of natural disasters.

Unfortunately, my town is located in what has been predicted to be one of the worst affected areas of the New Madrid fault. For those who are unfamiliar with the fault, it crosses five state lines and the Mississippi River in at least three places. Damage estimates for a major earthquake on the New Madrid fault run into the billions of dollars. A major event would devastate St. Louis and Memphis and impact thousands of homeowners in Arkansas, Illinois, Kentucky, Tennessee and Missouri. Still, my insurance agency, since its beginning in 1939, has never seen enough damage to a home from a minor tremor to pay an earthquake claim. However, the ripples and tremors from the potential for enormous damage in the New Madrid fault area, coupled with the financial impact of Hurricane Andrew and the Northridge Earthquake on insurance companies, have been felt by my clients and all homeowners in Eastern Missouri and other states that share this fault zone.

As you are well aware, after Hurricane Andrew and the Northridge Earthquake, all insurance companies, reinsurance companies, and their rating agencies began taking another look at the potential for loss that major natural disasters could have on an insurance company's ability to pay claims. Even though these specific disasters did not happen in my area, attention has been focused on the potential for any natural disasters. Most potential hurricanes from Florida to Massachusetts and earthquakes in California pale in comparison to the potential insured property damage estimates from a mega New Madrid earthquake.

As a result, we have seen our markets for earthquake coverage on homeowners policies dwindle at an alarming rate. This change has been less dramatic than the market problems experienced in Florida or California, but I want to stress that the changes in our market are no less real to my clients. We have seen insurance companies cancel their homeowners policies, invoke moratoriums on writing new homeowners policies with earthquake coverage, change earthquake coverage to exclude all contents of a home, and increase premiums on either the earthquake coverage or the entire homeowners premium forcing many homeowners to reduce or cancel their insurance.

Let me further explain what has been happening in our Missouri homeowners marketplace. First, we have seen many companies simply withdraw from the earthquake prone areas of our state. For example, one national company canceled all of their agencies south of Cape Girardeau, Missouri. If all the insurance companies in Missouri had done this we would have seen an immediate crisis like California and Florida experienced. Instead our problem has not drawn headlines, partly because it has mainly affected Southeast Missouri and, only recently, has it begun to spread to the St. Louis area.

My insurance agency was visited by a major national insurance company we represented. The regional vice president from Chicago came to see us and three other Southeast Missouri agencies that represented this company. He told each agency that the company had examined their earthquake exposure in Southeast Missouri and there was just no way to charge enough premium for that exposure. It would take a 1400% increase in the rates to justify the exposure. He asked us to either take the earthquake coverage off of our homeowners policies and write that coverage separately or to move the policies to another company. I was even more astonished when he offered to pay us to move the business! My agency did decide to move our client's policies. We did so not for the money but, because this same company official had told us that they would be limiting coverage and raising their earthquake rates to a level that would not be affordable for most homeowners.

Most insurance companies have taken a different approach to eliminating, reducing, or maintaining their amount of earthquake insurance that they underwrite in Missouri. We have seen several different approaches used: 1) Blaming some other factor for leaving the market, 2) limiting coverage and/or increasing deductibles, and 3) increasing either earthquake rates or rates on their basic homeowners policy until consumers can no longer afford the coverage.

An insurance agency in Sikeston was told by a company they represented that their contract with that company was being terminated because the agency had too many losses. The owner of this agency did not believe his agency had a loss problem with this company and, after reviewing the loss results himself, spoke with company representatives. The agent was told he could keep his contract but that he would have to non-renew all his homeowners policies with that company. He was told that the real reason the company was canceling his agency and others in the area was to reduce the company's earthquake exposure. This agency decided that he could not non-renew his client's policies and, fortunately, was able to find another market to take the business.

The most widely used tactic of insurance companies to exit our homeowners insurance market has simply been price. By just increasing the base cost of your homeowners policy, increasing their earthquake rates on your homeowners policy, or increasing both rates, a company can easily see their business canceled. An outside observer might think that the homeowner, knowing of the potential for an earthquake in our area, would not like his homeowners premium increased, but would still keep the policy because of the need for coverage. What if your homeowners insurance cost $500 last year and you received a bill for the renewal with a premium of $1100? Naturally, you would look for other coverage which is exactly what many of my clients have been doing and will continue to do. The companies that increased their rates did not have to cancel any policies or withdraw from our area. The price increase accomplished this de facto.

I will share another example of how my agency faced this price increase tactic. We represented a small regional insurance company that was purchased by a large national carrier. The company had agencies in almost every town in Eastern Missouri. The national carrier decided to absorb the smaller company. Previously, this national carrier had only a handful of agents in our area (mainly because they did not write earthquake insurance on their homeowners policies in the area.) With the absorption of the small company business, no homeowners policies were canceled by the company. However, they raised their homeowner's premiums on all renewals over 100%. The result was that almost all of our clients canceled their homeowners insurance with this company. Again, a price increase rid that company of its potential problem.

Our Missouri Department of Insurance has been monitoring the cost of earthquake insurance for homeowners and the percentage of homeowners that have this coverage. When they released their first set of data on December 11, 1996, the headline of their press release read "Stateside earthquake insurance market relatively stable." This was based on data from 1993–1995. On August 4, 1997 after they analyzed their data from 1996, the Department issued a press release with the following headline: "Earthquake insurance rates up sharply in Bootheel; coverage there falls off." The last press release concerning earthquake rates from the department was on February 2, 1998 where the headline read: "Angoff orders exam of major increase in earthquake rate recommendations for Missouri businesses, homes," This press release went on to say that the residential rate hikes . . . reach 266 percent for some homeowners policies in southeast Missouri and metropolitan St. Louis, including part of the urban core, north St. Louis County and eastern St. Charles County.

I agree with the department's last assessment on August 4, 1997 that rates are up sharply and more and more homeowners are deciding not to buy coverage. The MDI data does not take into account the many companies that have increased not only their earthquake rates but may have increased both their basic homeowners policies and earthquake rates to exit the market totally. Unfortunately the MDI's data does not include the number of homeowners that have had to change companies for this reason. Also, not included in the last data are the number of companies that have exited our market like the company in my agency that asked us to move the business or the company that terminated agents for high losses (when in fact the true reason was to reduce their earthquake exposure.)

The third manner in which insurance companies have handled their earthquake exposure in our area is by increasing deductibles and/or limiting coverage to just the home itself, providing no coverage for outbuildings and little if any coverage for personal property. The standard earthquake deductible used to be 2%. Now we see deductibles starting at 10%, going up to 25%. One company our agency represents has stopped writing any new homeowners policies with earthquake coverage and, on their existing homeowners, has changed the coverage to the home itself and $10,000 on personal property. They did not increase their earthquake rates because by reducing what was covered, they took a 100% rate increase. Once again, this type of action by a company has never been reflected in any MDI data.

Many in the insurance industry will claim that companies increasing deductibles and limiting coverage is a partial solution to their problem with natural disasters like earthquake. I just wonder where these homeowners are going to obtain the money for their personal property or to manage a 25% deductible. This is no solution for the average Missourian, but rather a prayer that somehow it will cost 25% less to rebuild their home or that when their home falls to the ground that miraculously their furniture, clothes, and other items will remain intact.

The final manner in which companies are dealing with the potential mega catastrophe presented by the New Madrid fault is by simply not appointing any agents in earthquake prone areas.

When our agency first witnessed company's restricting coverage and knowing that we faced the possibility of our companies pulling out of our market or increasing rates to unaffordable levels, my agency contacted over 20 companies to see if we could find a company willing to come into our area to write homeowners policies. Only one company would seriously talk with us. We offered to give all of these companies over $500,000 of profitable business and write all lines of insurance for their company. We heard many excuses from these insurance companies on why they would not appoint our agency. At least a few were honest enough to tell us that their company was just not interested in writing any earthquake coverage. This same search for companies has been repeated by almost every independent agency in Southeast Missouri with similar results.

Still, we do have markets available in Eastern Missouri. But how long can the few remaining companies keep writing more business as other companies use tactics I described earlier to eliminate their homeowners policies?

The Missouri Department of Insurance in analyzing their premium date also noted in their last earthquake study that coverage was falling off in our area. Why are fewer homeowners purchasing earthquake coverage? The answer is price. Several years ago the earthquake premium on an a $80,000 home in my agency was $70. Now the average premium for a home can cost $300, in addition to regular homeowners premium. Before the problems began in our marketplace, I was proud to say that approximately 90% of my homeowners clients had earthquake coverage on their homes. Now this percentage has declined to roughly 70%. I fear that this number will continue to fall. If nothing is done to strengthen our homeowners marketplace, I can see the day when the only homeowners that carry earthquake coverage will be those that are required to do so by their lenders, and even so these homeowners will probably only carry a small percentage of what they really need. All one has to do is to look at flood insurance to see how this can and will happen if something is not done.

Missouri is by no means the only state that has, and still is, experiencing problems with our homeowners insurance markets. A fellow independent insurance agent from Louisiana, Don Beery, who currently serves as the President of the Independent Insurance Agents of Louisiana testified last year before the House Committee on Banking and Financial Services. To explain the problem that homeowners face in Louisiana, the following is a quote from his testimony:

> After Hurricane Andrew "we began having trouble placing and renewing homeowners business. . . . Eventually, the Louisiana Insurance Department authorized that the business which insurance companies refused to write could be placed into an insurance pool . . . know as the Louisiana Fair Plan. . . . The number of applications soared almost immediately. Between 1993 and 1997, the Fair Plan grew by more than 750%. The growth continues today, nearly a decade after Andrew, at a rate of more than 1,000 policies every month.
>
> The Estis Agency (Mr. Beery's agency) lives with the insurance availability problem every day even though homeowner's insurance rates are considered adequate and are the second highest in the United States. Most of the companies we represent have placed severe restrictions on the number of new policies that we can place with them. Many insurers will only allow us to write one or two policies a month. Some will only allow us to write three or four new policies a year! Several insurers will not write any policies for homes valued at more than $100,000. Other will not write any policies on homes worth less than $400,000. Many of our customers are caught in between. It is not unusual, for example, that the only source of insurance coverage we can find for a $125,000 home is Lloyds of London. We do not feel that a homeowner with a $125,000 mortgage belongs with Lloyds. Nevertheless, we have no alternative but to place them there."

Another independent insurance agent, W. Cloyce Anders, who serves on the executive committee of the Independent Insurance Agents of America, also testified last year before the Housing and Community Opportunity Subcommittee of the House Banking and Financial Services Committee. Mr. Anders related the problems that North Carolina homeowners are facing. The following is quote from his testimony:

> "We have a facility in North Carolina for homeowners who are unable to obtain traditional homeowners insurance coverage called the North Carolina Insurance Underwriting Association. . . . In the last two years, the NCIU has grown 34%, the fastest rate in history. This is on top of double-digit increases nearly every year as far back as 1989. Demand is so great that the association can no longer keep up with the demand for applications. As a result, they now delay opening the office phone lines for two and a half hours every morning in order to process the previous days' business."

> Mr. Anders also stated that "It (the lack of homeowners markets) is also not a condition that is limited to beach communities and the affluent. In North Carolina, many insurance companies will not write hurricane coverage and many others will not write property coverage of any kind for any home which is located east of Interstate 95. In many places I–95 is as much as *150 miles from the Atlantic Ocean*. The NCIU accepts applications from residents in 18 counties. The vast bulk of the applications come from middle class families that live up to an hour's drive from the coast."

We are all aware of the problems faced by Florida homeowners because of the threat of future hurricanes. Mr. Alex Soto, an independent insurance agent and State National Director from Florida on the Independent Insurance Agents of America board, stated the problem succinctly in his testimony before the Housing and Community Opportunity Subcommittee of the House Banking and Financial Services Committee. The following is an excerpt from his testimony:

> "I am an independent agent and as such, represent numerous insurance companies. In fact, we work with more insurance companies than most of my peers. . . . Of all the companies . . . not one is openly writing homeowner's insurance policies in any of the communities I represent. Not a single company. . . . but it gets worse. Most companies are not only refusing new business; they are still actively non-renewing as many customers as possible, in order to reduce their exposure in Florida. This is not a trend which is reversing."

Mr. Chairman, other insurance agents from New Jersey and Massachusetts have also testified on the problems that homeowners in their states face in obtaining adequate homeowners insurance and if time would permit the same message could be told by scores of other insurance agents from California, Texas, Arkansas, Tennessee, Georgia, and South Carolina, just to name a few. The stories are all similar, as is the need for a solution to this problem. The fact is that homeowners across our great nation are not able to protect their homes in the manner that most of us take for granted.

I had the privilege to testify less than a year ago before the United States House of Representatives Committee on Banking & Financial Services as they were considering passage of the Homeowner's Insurance Availability Act (H.R. 21). In my testimony before that Committee, I was asked if I expected Missouri to enact a catastrophic fund. At that time I stated that my goal was for the introduction of legislation in the next session of the Missouri General Assembly.

In 1999 the Missouri Association of Insurance Agents had a bill introduced in the Missouri State Senate to establish a fund similar to the Florida Hurricane Catastrophe Fund. The main reason for our support of this legislation was that we were unsure that any federal natural disaster legislation would be passed. This legislation had a hearing in the Missouri Senate insurance committee, however because the problem of availability at this time is mainly in the Southeast part of Missouri, it was difficult to convince senators to adopt our plan and the bill was not voted on by the Committee.

After the Missouri General Assembly adjourned from that session, our agent's earthquake task force met again and decided that while we believe that our legislation was a good idea, the problem of availability of homeowners insurance would have to worsen further before we could see a bill passed. We were also encouraged by action in the U.S. House of Representatives Banking & Financial Services committee on H.R. 21 and thought our best course of action for our clients was to support federal legislation at this time. Since most of the major direct and independent agency companies writing homeowners insurance supported federal natural disaster legislation, we believe that this legislation will in turn help our clients.

This brings me to one of the arguments made against S. 1361; that this bill will encourage the proliferation of state plans that compete against the private market. If our effort in Missouri is any example of what it takes to implement a state plan, I cannot see how this argument against S. 1361 holds water. Because the threat that natural disasters pose to most states is usually not a state-wide concern, convincing a state legislature in most states to start a state plan will be extremely difficult—if not impossible—unless our markets continue to worsen. States like California, (where a large portion of the state is effected) and Hawaii and Florida (where virtually the entire state is at risk from a natural disaster) have already acted in forming state plans because their markets could not wait for a national solution. These states insurance markets were in a state of collapse. I believe that it will take a similar situation in other states for more state plans to be developed or expanded to handle our natural disaster exposure.

S. 1361 should in fact help curtail the creation of additional state plans as it offers a true national solution to this problem. The need for state plans only exists when the market fails and S. 1361 will revitalize the markets in our states that are currently worsening and, even more importantly, prevent what happened in Florida after Hurricane Andrew when the availability of homeowners insurance threatened every facet of the state's economy. Insurance companies and state departments of insurance do not lightly tread into state plans. If Congress fails to enact meaningful natural disaster legislation and we experience a 1-in-100 year mega catastrophe in any area of the U.S., cries from the citizenry will demand that states take action on their own and create more state specific plans.

The Independent Insurance Agents of America believe that the insurance market place has and will continue to have a problem in dealing with mega catastrophes. Insurers and reinsurers are well equipped to handle the normal types of losses that occur everyday from fires, theft and many other types of losses. But the losses that worst case 1-in-100 year can present to many regions of America are beyond our industry's capability to manage without assistance.

I am not here to testify on behalf of insurance companies. The insurance companies that support S. 1361 can tell you why they believe this legislation is necessary. This bill is not about helping insurance companies. I come here today to represent average Americans that just want to protect their most valuable asset, their homes. These taxpayers are not looking for a hand out from Uncle Sam. They want the ability to purchase homeowners insurance so that they will not have to come begging to Congress for help after a mega catastrophes in the form of ad hoc disaster assistance.

This is not just a Florida or California problem. While California and Florida have received the most press about the problems that earthquakes and hurricanes present, the disaster prone states are much larger. When studying a map of the catastrophe prone states we are looking at the entire east and west coast, states on the gulf of Mexico and the states surrounding the New Madrid fault in the center of the U.S. As the Carolinas witnessed last hurricane season, many states can suffer from natural disasters. The problem posed by mega catastrophes is truly national in scope and not limited to those few homeowners living in Miami Beach or on the San Andres fault.

Some insurance companies and taxpayer groups have tried to paint this as a bailout for the rich that have been foolish to build expensive homes on the beach or on a earthquake fault line. Nothing could be farther from the truth. Most of my clients in Missouri live in modest homes ranging from $50,000 to $150,000. These homes are not mansions, but they are the most valuable asset they possess. Also, the exact path of hurricanes and fault lines for earthquakes can and do change. In recent hurricanes, homes far from the coast or beach have been damaged. How can one say that a homeowner in South Carolina living 50 miles from the coast has been foolish to purchase a home in that area. Unfortunately many of the fastest growing areas in America face a threat from these mega catastrophes. I could go on to site numerous examples but the fact is that natural disaster legislation will help all facets of our society.

I also want to address another misconception that opponents of natural disaster legislation have been promoting. These opponents claim there is sufficient reinsurance to handle this problem and those insurance companies supporting this legislation are just not practicing prudent risk management. Again, I will let the insurance company representatives tell their story. I want to relate to you how this "sufficient" reinsurance has failed to help the situation of many homeowners.

I previously related to you how many insurance companies withdrew or found other ways to eliminate homeowners clients in my area. After a couple of years without the enormous natural disasters like Hurricane Andrew and the Northridge Earthquake and without a major earthquake along the New Madrid fault, we still have companies that will not sell homeowners insurance is my area. With all this "sufficient" reinsurance there are still many insurance companies that will not write homeowners insurance in Southeast Missouri. Other companies still have a moratorium on writing new homeowners. And we have many other companies that have continued to take the approach of avoiding writing homeowners insurance by making sure their premiums are too high to consider. I really question the availability of "sufficient" reinsurance now and fear that the inevitability of a mega catastrophe will restrict reinsurance to levels that will send thousands of homeowners scrambling for a policy to protect their home.

I also want to address the benefit of this legislation to the taxpayers in both disaster prone and non disaster prone states. When I testified before the House Banking Committee on a similar bill to S. 1361, I was shocked to hear testimony from some of the groups representing "the average American." Many of these groups say that S. 1361 is not good for the taxpayers. I find the logic on this debate hard to comprehend. They suggest that S. 1361 will cost the taxpayers millions of dollars. I tell you that history has shown that if taxpayers cannot purchase homeowners insurance it will cost the federal treasury many more millions, if not billions, in disaster relief after the fact. S. 1361 will give homeowners the opportunity to purchase insurance so they will not have to come begging to Congress for disaster aid. We have an opportunity with this bill to empower individual American homeowners in disaster prone states to exercise their responsibility to protect their property. What could be a more basic responsibility? I hope you can see my position that assuring the availability of homeowners insurance to taxpayers will help save the federal government millions of dollars in disaster aid, all of which comes out of the pockets of taxpayers.

Some would also argue that while this bill will help disaster prone states, why should a Senator from a non-disaster prone state support it? The reason is that when a disaster strikes any area of America, it is never just the taxpayers in that area that pay for the disaster aid. All American taxpayers contribute their tax dollars in disaster relief. Therefore any money that we can eventually save in future disaster relief will reduce the tax burden of taxpayers all across America. The best way for Congress to shift the burden of paying for disaster relief to those that receive it is by making sure that those Americans in disaster prone states have the ability to purchase homeowners insurance and thereby pre-pay for the assistance they will receive from their homeowners insurance companies.

Homeowners across America are being forced to abdicate their individual financial responsibility to provide insurance protection for their homes because of a lack of markets and a severe increase in the cost of coverage. What will be our country's future disaster relief costs if this trend continues unabated? Will we continue to make homeowners in disaster prone areas rely on what relief they can get from their state and the federal government when mega a hurricane or earthquake strikes?

I find the abdication of individual responsibility to be one of the greatest threats that our nation faces and that is why I want to see this legislation enacted. There will always be a need for a level of disaster aid and the assistance of FEMA, but we have an opportunity to allow individuals to help shoulder burden of the costs of worse case natural disasters by strengthening their homeowners markets. I am reminded of the old saying, "If you give a man a fish you feed him for a day. If you teach him how to fish you feed him for a lifetime." S. 1361 is that lesson in fishing that will help our homeowners insurance markets revitalize and survive the mega disaster.

Senator STEVENS. I do thank you for coming.

Mr. Gilliam, I'm sorry to do this but I'm going to have to leave here in about 11 minutes.

STATEMENT OF SCOTT A. GILLIAM, DIRECTOR, GOVERNMENT RELATIONS, THE CINCINNATI INSURANCE COMPANIES

Mr. GILLIAM. Thank you, Senator Stevens.

Again, my name is Scott Gilliam. I'm Director of Government Relations for the Cincinnati Insurance Companies. We are a group of property and casualty insurance companies headquartered in Fairfield, Ohio, just north of Cincinnati. We currently market property and casualty insurance in 30 states, and our premium volume is around $2 billion per year.

I am honored to be with you today to present the Cincinnati Insurance Companies' perspective on S. 1361. We commend you for holding this hearing and for you leadership over the last several years in raising awareness of the issues associated with natural catastrophe exposure and insurance.

We also particularly commend you for the balanced panels that you've had today. You're hearing all viewpoints, and I picked up during your own comments that you're looking for an opportunity for us all to work together and try and solve this. And while we do have some serious concerns, I would like to help in that process.

Let me now briefly summarize my written testimony.

We do not disagree that there may be a need for a high-level Federal involvement in excess of private market capacity to insure that Americans are provided with appropriate insurance protection for losses arising from hurricanes, earthquakes, and other natural disasters. However, we have several concerns with S. 1361 as presently drafted.

Our primary concern with the bill is its trigger for payment of losses, a trigger which is far below existing industry capacity. As currently drafted, the trigger for payment of losses is as low as $2 billion despite the fact that the industry paid insured losses of $15.5 billion for Hurricane Andrew in 1992 and $12.5 billion for the Northridge earthquake in 1994.

Why should the government step in at such low levels at a time when the industry continues to gain financial strength.

Since 1992, the industry's policyholder surplus has increased from $162 billion to over $330 billion today. Simply put, with a private market which is twice as prepared today to cover the back-to-back natural disasters it handled on its own in the early 1990's at a cost of $28 billion, the Federal Government should not be stepping in to pay for events with damages as low as $2 billion.

This is reinforced by the sentiments of Treasury Secretary Summers who told a New York forum for property-casualty insurers in January 1999, that a Federal reinsurance program like that proposed under S. 1361 should be limited to those risks that private markets currently have difficulty handling.

With the primary markets industry surplus at $333 billion, the private markets do not have any problems handling losses at the $2 billion level or as great as $5 billion, $10 billion, or even more.

In addition, as 1999 data from the Reinsurance Association of America reflects, there is approximately $20 billion of catastrophe reinsurance capacity available per region, per event in the U.S. and prices for catastrophe reinsurance have declined for 5 years in a row.

Equally distressing is the fact that we believe S. 1361 will expose taxpayers to new, unfunded Federal liability.

In its February 2000 Cost Estimate for H.R. 21, the House counterpart to S. 1361, the Congressional Budget Office concluded it is unlikely that the Federal Government would be able to establish prices for disaster reinsurance that would fully cover the potential future costs of these financial obligations.

This situation could be even worse under the Senate version of the bill, since it gives the program's governing body, the Natural Disaster Insurance Corporation, unlimited authority to borrow Federal funds to pay claims if the premiums collected are insufficient to pay those claims. This has the potential of creating a crisis similar to what we saw in the savings and loan industry not too many years ago.

Another major concern is the anti-competitive effect the Senate bill may have on existing markets. Most insurers act responsibly. They avoid large concentrations of risk and purchase adequate reinsurance or other otherwise develop adequate resources to absorb shock losses.

Under S. 1361, these responsible insurers would have to compete against irresponsible carriers who have over-concentrated their risk in catastrophe-prone areas and put themselves in a position of having to rely upon state insurance programs or other government mechanisms to absorb shock losses.

As one major insurer admitted in the letter it sent to its Florida policyholders after Hurricane Andrew, and I quote, “In the past, despite well-intentioned efforts to determine what our policy holders should pay for insurance, we greatly underestimated the cost of covering hurricane damages. Over the years, our policy providing insurance to everyone who qualified meant we sold our product at too low a cost to too many people. We now know that it is not good business for anyone to insure every third or fourth home in an area where natural disasters strike.” With the low level Federal backstop afforded to state insurance programs under S. 1361, such overexposed carriers will likely continue to rely on state programs to absorb shock losses and ignore the peril of risk concentration.

Clearly this gives those companies an unfair market advantage and rewards irresponsible behavior. S. 1361 would give these carriers further reason to write insurance at even greater concentrations in high-risk areas further exposing the Federal Treasury.

Now I would like to address the issue of the trigger and give you some thoughts on what you think the trigger should be.

The underlying goal of S. 1361 is very sound. To create a Federal reinsurance mechanism to buttress the solvency of the insurance industry in the rare event of a mega-catastrophe that seeks current or projected claims paying ability. With this goal in mind, it should not be difficult to determine appropriate trigger for Federal involvement.

As a starting point, we believe it makes sense to look at the magnitude of past catastrophe losses handled by the insurance industry. As already mentioned, the industry handled back-to-back cat losses of $15.5 billion and $12.5 billion in the early 1990’s.

With the industry’s current policyholders surplus at an all-time high of $333 billion, which is more than twice what it was at the time the industry paid combined losses of $28 billion for Andrew and Northridge, we believe the industry is more than equipped to handle a $35 billion catastrophe without Federal involvement.

For those who view the selection of a static trigger as problematic, another approach which has been given consideration, is a percentage trigger based on industry surplus or individual insurer’s surplus.

For example, Senator, under your bill in the 104th Congress, S. 1043, payments under the Federal Reinsurance Program would have been triggered when insured losses exceeded 15 percent of industry surplus, which under today's numbers would be $49 billion, or 20 percent of an individual insurer's surplus in certain cases.

By using surplus rather than a static number, the trigger will adjust based on the financial experience of the industry. This method of calculation and the accompanying dynamic trigger level, would take into account private insurance capacity and would avoid a major dislocation of private market capacity in favor of government intrusion of the marketplace.

We offer these comments on trigger levels as a starting point for determining an appropriate level under this bill.

To try and wrap this up quickly, I would echo the sentiments of Mr. Keating in regard to Senator Mack's bill, S. 1914, the Policyholders Protection Act. We are one of the only industrialized countries in the world that does not allow their insurers to put aside reserves to hold for future mega-catastrophes, and we think that could go a long way in insuring the solvency of the industry when the mega-catastrophe comes, which inevitably it will.

That's the basis of my remarks today. Just a couple of quick points I would make in regard to some of the other testimony——

[The prepared statement of Mr. Gilliam follows:]

PREPARED STATEMENT OF SCOTT A. GILLIAM, DIRECTOR, GOVERNMENT RELATIONS, THE CINCINNATI INSURANCE COMPANIES

Introduction

Chairman McCain, Senator Hollings, Senator Stevens, members of the Committee, my name is Scott Gilliam. I am Director of Government Relations for The Cincinnati Insurance Companies, headquartered in Fairfield, Ohio, just north of Cincinnati.

Our group of companies market property and casualty insurance in 30 states through an elite corps of fewer than 1,000 local independent insurance agencies. That group of companies has nearly one million policies in force insuring businesses and families. Our parent company, Cincinnati Financial, is among the top 20 publicly traded property and casualty insurers based on 1999 consolidated revenues of $2.1 billion.

I am honored to be with you today to present The Cincinnati Insurance Companies' perspective on S. 1361. We commend Chairman McCain and Senator Hollings for holding this hearing and Senator Stevens for his leadership over the last several years in raising awareness of the issues associated with natural catastrophe exposure and insurance.

The frequency and severity of natural disasters have created serious issues that the insurance industry and government need to address. In recent years there have been a number of attempts at the federal level to deal with the problems associated with insurance protection for losses arising from hurricanes, earthquakes and other natural disasters.

The catastrophe exposure we face from our own book of business has prompted us to engage in this important debate. For example, our hurricane exposure in Florida and Alabama alone is nearly $1.8 billion, representing over 10,000 homes. In the New Madrid earthquake region in the Midwest, our total insured values are $89.5 billion, based on the amount of earthquake coverage currently in force for homes and businesses. These are significant exposures for The Cincinnati Insurance Companies when considered in relation to the current level of assets for our property/casualty group ($5.9 billion).

We have been further motivated by several basic concerns which have presented themselves over the years as various legislative proposals, the most recent being S. 1361, have been presented to deal with the problems associated with insurance protection for losses arising from hurricanes, earthquakes and other natural disasters. These include:

- the need to preserve state regulation of insurance (McCarran-Ferguson Act);
- finding a solution that will enhance private markets and not compete against them;

- the need to oppose legislation that is detrimental to any segment of our industry or would unfairly favor one insurer over another.

The S. 1361 Proposal

Let me know turn to the legislation at hand, S. 1361, which would create a new federal agency, the "Natural Disaster Insurance Corporation" (NDIC), through which federal reinsurance contracts would be offered for purchase by state insurance programs and for auction to state insurance programs and private insurers to cover residential losses in the event of a natural disaster. The federal reinsurance contracts would provide natural disaster peril coverage on an excess-of-loss basis with a trigger as low as $2 billion. Pricing of the contracts would be established by the NDIC, in consultation with a new federal commission, the "Independent Natural Disaster Board of Actuaries." The NDIC would be authorized to make unlimited annual payments under the contracts and to engage in borrowing through the Secretary of the Treasury as necessary to pay claims and expenses under the contracts.

We do not disagree that there may be a need for high-level federal involvement in excess of private market capacity to ensure that Americans are provided with appropriate insurance protection for losses arising from hurricanes, earthquakes and other natural disasters. However, we believe that the following principles must be embodied in any legislation which endeavors to provide a federal safety net for catastrophe insurance:

1. The risk of natural catastrophes is best insured in a diversified marketplace which avoids concentration of risk in too few insurers or state programs.

2. The private sector's role, including insurance, reinsurance and capital markets, should be maximized and such financing mechanisms fully exhausted before any government capacity is provided, state or federal.

3. Government's role should be to address insurer solvency in the event of a mega-catastrophe and should not come at the expense of taxpayers.

4. Any federal proposal should include personal and commercial lines of insurance since both forms of coverage are affected by catastrophic events.

Unfortunately, S. 1361, in its current form, falls short in a number of these areas.

Low Trigger And New Unfunded Federal Liability

Our primary concern with S. 1361 is its trigger for payment of losses, a trigger which is far below existing industry capacity. As currently drafted, the trigger for payment of losses is as low as $2 billion, despite the fact that the industry paid insured losses of $15.5 billion from Hurricane Andrew in 1992 and $12.5 from the Northridge Earthquake in 1994. Why should the government step in at such low levels at a time when the industry continues to gain financial strength? Since 1992, the industry's policyholder surplus has increased from $162 billion to over $333 billion today. Fact of the matter is, the industry has handled all catastrophes to date regardless of their size and has handled them totally within the private sector.

Simply put, with a private market which is twice as prepared today to cover the back-to-back natural disasters it handled on its own in the early 1990s at a cost of $28 billion, the federal government should not be stepping in to pay for events with damages as low as $2 billion. This is reinforced by the sentiments of Treasury Secretary Larry Summers, who told a New York forum for property-casualty insurers in January, 1999 that a federal reinsurance program like that proposed under S. 1361 should be limited to those "risks that private markets currently have difficulty handling."

Equally distressing is the fact that S. 1361 will expose taxpayers to new unfunded federal liability. In its February 9, 2000 "Cost Estimate" for H.R. 21, the House counterpart to S. 1361, the Congressional Budget Office concluded "it is unlikely that the federal government would be able to establish prices for disaster reinsurance that would fully cover the potential future costs of these financial obligations," as a result of which "federal payments for disaster insurance claims would exceed the premiums collected" under H.R. 21. This situation will be even worse under S. 1361, since the Senate bill gives the program's governing body, the Natural Disaster Insurance Corporation, unlimited authority to borrow federal funds to pay claims if the premiums collected are insufficient to pay claims. This has the potential of creating a crisis similar to what we saw in the savings and loan industry not too many years ago.

Similar concerns were voiced by Secretary Summers in his remarks to the same property-casualty forum mentioned above, Mr. Summers telling the group that a federal reinsurance program like that proposed under S. 1361 "should impose no net cost on the taxpayer" since "the federal government cannot be the bill-payer of last resort" for such insurance. However, that is exactly what will happen if S. 1361 is enacted in its current form.

Government Competition With The Private Market

We are also very concerned that S. 1361 will supplant the private market and stifle private sector development of new and innovative approaches to the problem of protecting Americans against catastrophic risk. Despite what others may have said today, reinsurance is available and affordable through the private sector for those who properly manage their risk. As 1999 data from the Reinsurance Association of America reflects, there is approximately $20 billion of catastrophe reinsurance capacity available per region, per event in the U.S., and prices for catastrophe reinsurance have declined for five years in row.

The federal reinsurance program proposed under S. 1361 overlooks these important facts and invites the federal government to compete with and displace private markets for reinsurance. S. 1361 is a classic "government-knows-best" approach to public policy issues. By offering subsidized federal reinsurance to state insurance programs, S. 1361 displaces the private insurers and reinsurers already assuming risks in those markets. The likely result is markets that are dictated by government officials with no room for private sector ingenuity.

As the private reinsurance market continues to improve, we are also witnessing the introduction of innovative capital market approaches which are expanding the industry's risk-bearing capabilities for catastrophe exposures. An evolving form of securitizing risk through capital market instruments is providing significant new capacity to the insurance industry. In 1998, there were eighteen such transactions totaling $2.5 billion and similar approaches for securitizing catastrophe risk are in various stages of development. It is these types of approaches to catastrophic risk protection which Treasury Secretary Summers views as the most promising. As Secretary Summers told the property-casualty forum in New York:

> "Ultimately, we believe that the most efficient means for underwriting these risks may involve the capital market as an important complement to the traditional reinsurance industry."

Unfortunately, S. 1361 may stifle further development of such innovative free market approaches to catastrophe securitization since it encourages the shifting of catastrophe risk out of the private sector and displaces private market capacity in favor of federal capacity. The bill's stifling effect on private market development and innovation is exacerbated by the fact that S. 1361 does not contain a sunset provision, unlike its House counterpart, S. 1361, which provides for a sunset of the federal reinsurance program after 10 years.

Proliferation Of State Insurance Programs And Anti-Competitive Effects

S. 1361 will also encourage the development and proliferation of underfunded and overexposed state insurance programs by making low-cost federal reinsurance available to these programs at very low trigger levels. Providing subsidized federal reinsurance to state programs will supplant private risk capacity and foster the existence of these pools of last resort which are often underfunded and overexposed (they contain each state's most undesirable risks and suppress risk-based rates for insurance). If the federal government steps in and offers to indemnify state programs at the low levels contemplated in S. 1361, there is little incentive for insurance commissioners and state legislators to consider common sense alternatives to underfunded and overexposed state insurance programs, e.g., market driven solutions premised upon two of the most essential principles of insurance: spreading of risk and risk-based pricing.

Another concern is the anti-competitive effect S. 1361 may have on existing markets. Most insurers act responsibly, avoid large concentrations of risk, and purchase adequate reinsurance or otherwise develop adequate resources to absorb shock losses. Under S. 1361, these responsible insurers would have to compete against irresponsible carriers who have over concentrated their risk in catastrophe-prone areas and put themselves in a position of having to rely upon state insurance programs or other government mechanisms to absorb shock losses. As one major insurer admitted in a notice to its Florida policyholders after Hurricane Andrew:

> "In the past, despite well-intentioned efforts to determine what our policyholders should pay for insurance, we greatly underestimated the costs of covering hurricane damages. Over the years, our policy of providing insurance to everyone who qualified meant we sold our product at too low a cost to too many people. We know now that it is not good business for anyone to insure every third or fourth home in an area where natural disasters strike."

With the low-level federal backstop afforded to state insurance programs under S. 1361, such overexposed carriers will likely continue to rely on state programs to absorb shock losses and ignore the peril of risk concentration. Clearly, this gives those companies an immediate and unfair market advantage and rewards irresponsible behavior. Moreover, S. 1361 would give these carriers further incentive to write insurance in even higher concentrations in high risk areas, further exposing the federal treasury.

Commercial Risks

S. 1361 does not provide coverage for commercial losses despite the fact that both personal and commercial lines of insurance coverage are affected by catastrophic events. For example, our company's commercial hurricane exposures in Florida and Alabama are nearly as large as our personal lines exposure (personal lines exposure: $1.7 billion; commercial lines exposure: $1.5 billion). There is simply no logical reason why commercial risks should be excluded from S. 1361.

State Regulation

S. 1361 will further endanger state regulation of the business of insurance. Since 1945, the insurance industry in the United States has been regulated by the States under authority of the McCarran-Ferguson Act. State regulation of insurance has and continues to work well. S. 1361 would strike at the heart of McCarran-Ferguson and open the door for the federal government to enter into the business of insurance regulation.

If S. 1361 becomes law, it would not be long before the federal government took an active role in the insurance industry. As soon as significant federal dollars are spent to bail out the over-exposed insurers who seek S. 1361 as a solution to their balance sheet problems, an argument would be made for more federal control over these insurers, and ultimately over all insurers. The bill's provision for the creation of two new federal bureaucracies: the "Natural Disaster Insurance Corporation" and the "Independent Natural Disaster Board of Actuaries," would provide further impetus for full scale federal intrusion into regulation of the business of insurance.

McCarran-Ferguson has worked well and we need to do all we can to preserve it. The passage of S. 1361 would imperil McCarran-Ferguson.

Determining An Appropriate Trigger Level—Two Approaches For Consideration

While we have a number of concerns with S. 1361 as presently drafted, we see little chance for the bill to gain industry-wide support unless the unreasonably low triggers are addressed. The current triggers fall far below the actual claims paid by industry for our Nation's largest insured losses: Hurricane Andrew at $15.5 billion and the Northridge Earthquake at $12.5 billion. The $2 billion trigger significantly underestimates private insurance capacity and would likely lead to a major dislocation of private market capacity in favor of federal capacity.

We do not disagree that there may be a need for high-level federal involvement in excess of private market capacity to ensure that Americans are provided with appropriate insurance protection for losses arising from hurricanes, earthquakes and other natural disasters. The pivotal question remains: what is an appropriate trigger level for federal involvement?

The underlying goal of S. 1361 is sound—that is, to create a federal reinsurance mechanism to buttress the solvency of the insurance industry in the rare event of a mega-catastrophe that exceeds current or projected claims-paying ability. With this goal in mind it should not be difficult to determine an appropriate trigger for federal involvement.

As a starting point for determining an appropriate trigger level, we believe it makes sense to look at the magnitude of past catastrophe losses handled by the insurance industry. As already mentioned, the industry handled back-to-back catastrophe losses of $15.5 billion (Hurricane Andrew) and $12.5 billion (Northridge Earthquake) in the early 1990s. With the industry's current policyholder surplus at an all-time high of $330 billion plus, which is more than twice what is was at the time the industry paid combined losses of $28 billion for Andrew and Northridge, we believe the industry is more than equipped to handle a $35 billion catastrophe without federal involvement.

For those who view the selection of a static trigger as problematic, another approach which has been given consideration is a percentage trigger based on industry surplus or individual insurer surplus. For example, under Senator Stevens' bill in the 104th Congress, S. 1043, payments under the federal reinsurance program were triggered when insured losses exceeded 15 percent of industry surplus ($49 billion in today's dollars) or 20 percent of an individual insurer's surplus. By using surplus rather than a static number, the trigger adjusts based on the financial experience of the industry. This method of calculation and the accompanying dynamic trigger level would take into account private insurance capacity and would avoid a major dislocation of private market capacity in favor of government intrusion into the marketplace.

We offer these comments as a starting point for determining an appropriate trigger level under S. 1361.

S. 1914—The Private Sector Alternative to S. 1361

As a property and casualty insurer, we are concerned that some high-level catastrophes may be beyond the financial ability of our industry. However, there is a viable alternative to the perils of S. 1361. Under S. 1914, the "Policyholder Disaster Protection Act of 1999," property-casualty insurers would be permitted to set aside catastrophe reserves on a tax-deferred basis to better prepare for mega catastrophes, a bill introduced in the Senate last November by Senators Connie Mack and Kay Bailey Hutchison.

The intent of the S. 1914 is to motivate insurers, through the correction of a flaw in federal tax law, to establish reserves for future catastrophes on a voluntary basis and to hold the funds backing those reserves in a segregated account until they are released to pay for catastrophic losses. But the current U.S. tax/accounting system is flawed in that it only allows insurers to look backwards—insurers can set aside consumer premiums in reserves to pay for past disasters but not for future, predicted events. As a result, consumers' insurance payments are taxed up front as profits, discouraging insurers from providing insurance in high-risk areas and reducing capacity to deal with catastrophes.

The United States is one of the few countries in the industrialized world which does not allow insurers to prepare for future disasters by setting up pre-event catastrophe reserves. S. 1914 corrects this flaw by allowing and encouraging insurers to set aside part of the premiums they receive in special tax-deferred catastrophe reserves under strict regulation and oversight and dedicate them solely to pay for future major disasters. This will empower and encourage more insurers to serve markets in disaster-prone areas and encourage the insurers now serving those markets to remain. Policyholders will benefit from the resulting increase in competition in a number of ways, including the likely introduction of better insurance products and policy features and more competitive pricing.

S. 1914 will also reduce the possibility that a significant portion of the private insurance system would fail in the wake of a major natural disaster and that governmental entities would be required to step in to provide relief at taxpayer expense.

We strongly support S. 1914, as do the National Association of Professional Insurance Agents (PIA) and the Council of Insurance Agents and Brokers (CIAB), and believe it is a viable alternative to the federal reinsurance program proposed under S. 1361.

Conclusion

Regardless of which legislative proposal is ultimately adopted to deal with the problems associated with insurance protection for losses arising from hurricanes, earthquakes and other natural disasters, it is incumbent that we keep these basic principles and concerns at the forefront of the debate:

- The risk of natural catastrophes is best insured in a diversified marketplace which avoids concentration of risk in too few insurers or state programs.
- The private sector's role, including insurance, reinsurance and capital markets, should be maximized and such financing mechanisms fully exhausted before any government capacity is provided, state or federal.
- Government's role should be to address insurer solvency in the event of a mega-catastrophe and should not come at the expense of taxpayers.
- Any federal proposal should include personal and commercial lines of insurance since both forms of coverage are affected by catastrophic events.
- The need to preserve state regulation of insurance (McCarran-Ferguson Act).

We do not disagree that there may be a need for high-level federal involvement in excess of private market capacity to ensure that Americans are provided with appropriate insurance protection for losses arising from hurricanes, earthquakes and other natural disasters. But if this Committee and this Congress is serious about passing legislation to protect policyholders against the perils of natural catastrophes, the legislation ultimately adopted must not encourage government subsidization of catastrophe risk or supplant the private market for insurance and reinsurance.

Unfortunately, S. 1361, as presently drafted, does not satisfy these minimum criteria.

Thank you for your consideration of this important issue. I would be happy to answer any questions.

ADDITIONAL REMARKS

Introduction. At the conclusion of the presentation of my initial remarks, Senator Stevens adjourned the hearing due to the necessity of his attendance at another appointment. This prevented me from making comments on several points made by other witnesses earlier in the hearing. I was subsequently told by Committee staff that I could provide those comments in written form and they would be included in the record. Those comments follow.

Private Homeowner Insurance Market Not On "Shaky Ground." One witness commented during his testimony that S. 1361 is needed because the private homeowner insurance market is on "shaky ground." (Jack Weber, President, Home Insurance Federation of America). Simply put, nothing could be further from the truth.

In catastrophe-prone Florida, for example, major insurers are writing new homeowners coverage in most of Florida's 67 counties. (Testimony of Susanne Murphy, Deputy Insurance Commissioner, Florida Department of Insurance, before the U.S. House of Representatives Banking and Financial Services Subcommittee on Housing & Community Opportunity, July 12, 1999 [in Tampa, Florida]).

GAO Report Not Supportive of S. 1361. The proponents of S. 1361 suggest the GAO report supports their contention that the private insurance markets are not prepared to cover catastrophe losses expected to occur as a result of certain 1-in-100 year events, from which they conclude that a federal reinsurance program like that set forth in S. 1361 is therefore necessary. However, those who point to the GAO report as support for S. 1361 have overlooked several key limitations in the GAO report as well as several conclusions made in the report.

The GAO report acknowledges many limitations to its research. Elements not considered in the report, either at all or in depth, include:

- Multiple disasters
- Multi-state disasters
- Varying capacities of individual insurers to respond to disasters
- Reinsurance
- Capital markets
- State insurance funds
- Long-term effects on insurers and consumers
- The effects of fluctuations in our overall economy

The proponents of S. 1361 have also overlooked several of the most critical conclusions reached by the GAO in its report:

- The insurance industry has sufficient capacity to pay most or all claims from a major catastrophe loss using its own resources, without taking into account reinsurance.
- Most of the insurers in the top ten disaster-prone states would be able to easily pay off all of their claims after a major catastrophe, without even taking into account reinsurance.
- The surpluses of all U.S. insurance companies ($427 billion) are at an all-time high and have grown more than 140 percent over the last ten years.
- The surpluses of insurers operating in the most catastrophe-prone states—such as Florida, California, and Texas—have grown by more than 140 percent.
- Insurers currently have large surpluses despite suffering huge catastrophic losses over the years.
- GAO certifies independent studies that find that the insurance industry has sufficient capital to support its risk.
- Reinsurance is widely available and prices are low relative to historical levels.

- GAO acknowledges studies that report $20 billion of catastrophe reinsurance is currently in force in each of four U.S. regions, which is twice as much catastrophe reinsurance as was available in 1994.
- Reinsurance is cheap and plentiful for purchasers, including the California Earthquake Authority (CEA).
- The potential for the capital markets to finance natural disasters is great.

Since the report concludes that there is adequate capacity in the primary insurance marketplace to finance losses from a major natural disaster, we believe there is a need for further research into the need for a federal reinsurance program before the Senate decides to act or pass legislation like that embodied in S. 1361.

Senator STEVENS. I'm sorry to tell you I'm going to have to go. I appreciate it. I'll put your full statement in the record. I am due over there now.

I thank you all very much for coming to the hearing. I do hope we can get staff working with some of you people and your representatives as well as the other witnesses to see if we can work out something with the administration this year.

Thank you very much.

[Whereupon, at 4:26 p.m., the hearing concluded.]

APPENDIX

BOB GRAHAM, United States Senate,
Washington, DC, April 7, 2000.

Hon. STUART E. EIZENSTAT,
Deputy Secretary of the Treasury,
United States Department of the Treasury,
Washington, DC.

Dear Secretary Eizenstat:

As you prepare for your appearance before the Senate Committee on Commerce, Science, and Transportation on April 13, 2000, regarding the Natural Disaster Protection & Insurance Act (S. 1361), I would ask that you voice your support of this legislation, in consideration of the issues discussed below.

Increasing the availability and affordability of property and casualty insurance is very important to me and the over 15 million residents of the State of Florida. In the last two (2) sessions of Congress, numerous proposals to address this critical need have been forwarded by members of the House and Senate. Since the inception of these legislative proposals, Congress, the Administration, the insurance and reinsurance industries, consumer groups and other interested parties have worked diligently to come to an agreement on an acceptable mechanism to increase the availability and affordability of insurance in high-risk areas.

Given the fact that 112 members of the House of Representatives have co-sponsored the Homeowners Insurance Availability Act of 2000 (H.R. 21) and that Title III of S. 1361 contains provisions substantially similar to H.R. 21, I believe that we are rapidly approaching a compromise that will be accepted by both the House and the Senate. Secretary Summers' efforts in crafting this legislation were critical to the progress we have made thus far, and I would ask that you continue to work positively with Congress to pass legislation that will address the need for catastrophic disaster insurance.

The Treasury Department's long-standing decision to focus primarily on the insurance side of the natural disaster equation is a good one. Although I remain committed to the mitigation of losses from natural disasters—and have introduced separate legislation on this subject (S. 1691, the Disaster Mitigation Act of 1999)—combining insurance and comprehensive disaster mitigation into a single bill may confuse the issues and put both concepts in jeopardy. However, the insurance reforms contained in S. 1361 deserve careful consideration by the Treasury Department, and your support of the bill's approach will move us even closer to an acceptable compromise.

Once again, I believe that it is vitally important that you and the Administration remain engaged and supportive in the process if this complex legislation is to be enacted and its benefits made available to the million of our citizens who are vulnerable to the effects and economic reverberation of a catastrophic event.

I look forward to continuing to work with you on this important initiative.

With kind regards.

Sincerely,

BOB GRAHAM,
United States Senator.

PREPARED STATEMENT OF THE ALLIANCE OF AMERICAN INSURERS

The Alliance of American Insurers is a national property and casualty insurance trade association representing more than 300 companies. Alliance membership is diverse, representing large multi-line insurers doing business in all states as well as small regional and single state insurance companies. We offer the following comments on S. 1361, a bill to amend the Earthquake Hazards Reduction Act of 1977.

For more than two decades the Alliance has participated in discussions regarding a federal response to property losses from natural catastrophes. While we have supported congressional action for flood insurance and commend Senator Stevens for his effort in developing this legislation, we do not believe S. 1361 is either appropriate or necessary.

We believe the current capacity of the reinsurance industry, both domestic and offshore, is sufficient to meet the needs of our domestic property and casualty industry. Access to the capital markets via "securitization," as well as the development and use of other sophisticated risk transfer mechanisms, is functioning well to supplement traditional reinsurance. The successful placement of catastrophe bonds has expanded the industry's capacity to provide coverage. The legislation's encouragement of state programs and the creation of a federal reinsurance program strikes at the core of our belief that the private insurance market offers better, and more creative, responses to questions about the industry's ability to respond to natural disasters.

Creation of a Natural Disaster Insurance Corporation, as required by this act, would establish a private reinsurer that would have the ability to raise funds through the auspices of the Department of the Treasury. While the stated purpose in S. 1361 is not to compete or supplant private markets, this is exactly what the bill would do.

The bill allows state funds to collect reinsurance funds for loss occurrences not less that the greater of $2 billion or the "claims-paying capacity of the eligible State program." The Alliance believes S. 1361 would thereby encourage the creation of more state catastrophe programs in order to take advantage of federal reinsurance.

While S. 1361 does contain extensive provisions for mitigation, the Alliance is concerned that they do not adequately address the issue of overbuilding in catastrophe-prone regions of the country. The bill calls for a study of this issue by states, but does not require any action to limit the concentration of risk. Land use and zoning controls are needed, not increased exposures.

For example, modest coastal cottages along the eastern seaboard are being replaced with luxury homes and high rise condominiums. Following the construction of these properties, the owners of these properties expect the same continued access to inexpensive insurance coverage as though they were located in a far less hazardous area.

S. 1361 does nothing to address this continued expectation that people can build what and where they want with no consequences for this action. The bill does provide for the establishment of building code requirements and enforcement of those standards by states. However, we think that the funding incentive for these programs, 10% of investment income from the Corporation funds, is inadequate.

The Alliance believes that the creation of a federal reinsurance program and the likely growth of state pools will place a continued burden on the U.S. taxpayer and private insurance policyholder to subsidize property insurance rates for people who choose to locate in catastrophe-prone areas.

Under the Stafford Act, we continue to pay federal disaster relief to public entities that do not undertake mitigation activities to improve the survivability of their properties and often do not purchase insurance or set aside funds in a self-insurance program. This continued federal largesse acts as an incentive not to mitigate and not to insure. S. 1361 does contain provisions for a study of retrofitting of these properties. However, the level of mitigation funding makes it unlikely that improvement will occur.

The Alliance opposes S. 1361 because it would continue to perpetuate the cycle of insurance rate subsidization of residents in hazard-prone areas and the continued overbuilding in these same areas of the country. While we can support pursuing a national mitigation policy, in our opinion, the imposition of a federal reinsurance program would not be an equitable trade-off. The market place has responded to the perceived insurance capacity problems as they relate to natural disasters. Market solutions are almost always preferable when responding to a perceived problem. We believe this is clearly the case in this instance.

Prepared Statement of America's Community Bankers

America's Community Bankers (ACB) represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities. Establishing a federal approach to help maintain insurance coverage in areas subject to major natural disasters is a priority issue for ACB, and we appreciate this opportunity to provide a statement on this significant issue.

Mr. Chairman, S. 1361 is an excellent step toward developing an effective legislative remedy to the natural disaster insurance dilemma. ACB believes that it provides a good foundation on which to build a natural disaster insurance program that provides support for the private sector insurance industry without imposing an undue cost to taxpayers. The legislation helps to ensure that regional economic infrastructures are maintained and that financing availability for housing is not diminished.

ACB commends Senator Stevens for introducing this thoughtful legislation. ACB is committed to working with the Committee, the Administration, and the insurance industry in crafting an effective legislative solution. To make such a program effective, however, broad coverage is desirable. No type of improved property—whether residential, multi-family or commercial (mortgaged or unmortgaged)—is insulated from the effects of natural disasters, and none should be excluded from the natural disaster insurance program. However, we believe that adequate insurance coverage for residential property must have the highest priority.

Impact of Natural Disasters

The magnitude of the natural disasters that have plagued the United States recently has been staggering. For example, 119 natural disasters were declared from 1990 to 1994. From 1979 to 1993, the federal government provided assistance and loans of over $130 billion in connection with natural disasters. Prior to 1989, no natural disaster in the United States had caused more than $1 billion in insured losses. However, the losses associated with Hurricane Hugo, which followed shortly thereafter, totaled $4 billion.

The peak losses in the early 1990s increased precipitously in comparison with the earlier periods. In August, 1992, Hurricane Andrew inflicted $15.5 billion in insured losses. It is estimated by many that Hurricane Andrew inflicted another $15.5 billion in uninsured losses. In addition, the Northridge earthquake in southern California generated claims totaling $12.5 billion.

These natural disasters caused enormous suffering and massive property destruction, and a number of insurance companies sustained massive losses. In order to reduce risk exposure, certain national insurance companies withdrew totally, or severely restricted the availability of natural disaster insurance after these major disasters. Natural disaster insurance coverage in disaster-prone areas became significantly more expensive and contained larger deductibles. Under certain circumstances, these deductibles reached 15 percent of the value of the insured property. Without the creation of special state-sponsored, joint underwriting pools, even this scaled-backed coverage may not have been available.

The absence of adequate natural disaster insurance in disaster-prone areas represents an enormous risk factor for lenders extending credit in those areas. ACB members provide financing for one-to-four family and multi-family residential mortgages, and community and business development lending. Without adequate insurance coverage, these community banks could suffer severe losses and funds for disaster recovery and credit for new development in disaster-prone areas would be severely restricted.

Because our member institutions in the disaster-prone areas are subject to substantial risk, ACB is committed to the development of a prudent and effective natural disaster insurance program. Accordingly, ACB is working with state organizations and member institutions to obtain as much information as possible with respect to the financial risks related to natural disasters, and is exploring feasible solutions to the natural disaster insurance problem.

State Initiatives

After the devastation caused by these recent natural disasters, several state legislatures attempted to provide some degree of protection from natural disasters for their citizens. California, Florida, and Hawaii adopted disaster insurance programs that established a reinsurance fund for losses in excess of a specified amount per disaster. Unfortunately, these programs provide relatively limited protection. None of these programs have the capacity or resources to provide adequate protection against catastrophic losses resulting from major natural disasters.

The primary criticism of state natural disaster programs is that they lack adequate funding and they are limited geographically. For example, the state of California's program is arguably the most comprehensive. Nevertheless, it has been widely criticized as too limited in scope and is substantially undercapitalized.

Disaster Insurance on the Federal Level

ACB believes it is imperative that Congress develops a realistic and comprehensive federal solution to the natural disaster insurance problem. S. 1361 addresses a number of issues inherent in the operation of a federal disaster insurance program. It is clear that major natural disasters can substantially overwhelm the capacity of private and state-sponsored insurance and reinsurance programs within the individual states. Thus, the natural disaster insurance problem suggests a federal-level solution.

It should be emphasized that secured housing lenders are faced with a particularly acute problem since they underwrite loans in reliance on the physical collateral. Lack of adequate disaster insurance will reduce the availability of new loans and refinancings, and harm collateral on all outstanding mortgage loans. In the event of a major natural disaster, many community lenders would sustain severe losses on under-insured and uninsured loans.

Unless they have insurance that covers natural disasters, borrowers generally do not have the financial resources to meet financial obligations if their properties suffer severe damage. This is especially true for residences financed with high loan-to-value loans. Therefore, lending institutions would incur losses on many properties impaired by natural disasters.

The details of how a program is constructed are important and deserve close attention. For example, force-placing of insurance should be seriously considered. The use of tax incentives to encourage insurance industry involvement is worth exploring. Certainly, legislation should address support of state natural disaster programs, as well as the need to pool risks across a larger population. Logically, Congress should examine the merits of coordinating the existing federal flood insurance scheme with the new program, rather than establishing unrelated policies for flood and non-flood disasters.

Mandatory Mitigation

ACB is aware that an array of issues must be extensively scrutinized prior to promulgating an equitable program that would resolve the issue of natural disaster insurance availability. ACB believes that a committed and realistic loss mitigation program is an essential component of any federal disaster insurance effort. Under a mitigation structure, businesses and homeowners would be required to take adequate steps to reasonably fortify existing structures and new construction to mitigate the impact of natural disasters in high-risk areas. Although Section 6 of S. 1361 contains language relating to the development of state mitigation plans, ACB believes that the mitigation language should be more specific and provide more focused guidance in developing mitigation standards.

Conclusion

ACB supports a federal disaster insurance program such as the one proposed in S. 1361. We believe that the program must address the concerns of community banks and the borrowers they serve, and we believe this can be done in a manner that does not impose an undue burden on taxpayers or the federal budget. A natural disaster insurance program must also be structured so that it spreads the natural disaster insurance risk over a diverse geographic area. We believe that S. 1361 addresses these natural disaster insurance problems and warrants the support of this Committee and the Congress.

PREPARED STATEMENT OF JOHN HAGEMAN, TEXAS STATE EXECUTIVE OFFICER AND PRESIDENT, TEXAS FARMERS INSURANCE COMPANIES

I would like to thank Chairman and the other members of the Committee for the opportunity to discuss S. 1361, the Natural Disaster Protection and Insurance Act.

My name is John Hageman, and I am the chief officer of the Farmers Insurance Group in the state of Texas. I am also the current Chairman of the Texas Windstorm Insurance Association, which is a wind insurance pool for homeowners who cannot currently find coverage in the private market. By market share, Farmers Insurance is the third-largest homeowners insurance company in the United States, and the second largest homeowners insurance company in Texas.

Permit me to offer some observations from the perspective on an insurance executive who must make underwriting decisions everyday.

My company's most recent experience with major natural catastrophes was the Northridge Earthquake, which struck Southern California in 1994 and in 45 seconds generated $20 billion in claims. In that event, which was considered modest by seismic standards, Farmers paid claims to 23,651 of our customers in the San Fernando Valley and parts of Santa Monica, in the amount of $1,227,510,846.

To put this loss in perspective, consider that Farmers sold earthquake insurance for more than 23 years in California and other states. Our loss from Northridge exceeded the total premium collected over those 23 years by a factor of nearly 400%. In other words, one event wiped out 23 years of reserves and assured that even if we had continued to sell earthquake insurance in the years ahead and paid no claims, it would take more than an additional 60 years to break even.

Perhaps the most remarkable aspect of the Northridge quake was that the event even occurred. There were no known faults in the area where the quake occurred. Farmers, and other insurers in the area had no reason to believe that the risks in this area were particularly severe. Moreover, as bad as the Northridge quake was in terms of insured losses, we know that a major rupture of the San Andreas fault in the Los Angeles basin would cause losses many magnitudes greater than those experienced in 1994.

Farmers cannot afford a repeat of the Northridge earthquake, which is why we have elected to reduce our exposure to earthquake losses . . . and why we are doing the same thing in hurricane-prone regions. Absent a means to protect against worst-case catastrophic losses, we risk financial losses so great as to threaten our on-going business. We cannot and will not assume such a risk.

Permit me now to describe to you the circumstances in the Texas homeowners insurance market. Most people do not realize that Texas, on average, has the highest homeowners insurance rates in the Nation. The high rates can be attributed to the high frequency of tornadoes and hail which cause havoc every Spring in particular. Just two weeks ago, I inspected the damage from the costliest tornado in U.S. history, which struck downtown Ft. Worth on March 28. We estimate that the total insured loss from this one tornado will be more than $600 million.

However, as bad as tornadoes and hailstorms are in Texas, the truly grave danger is a major hurricane in the Gulf of Mexico. Two years ago, a hurricane with windspeeds in excess of 170 miles per hour—some of the highest winds ever recorded in a hurricane—struck a relatively unpopulated stretch of the state between Corpus Christi and Brownsville. There was very little damage to people or property from Hurricane Bret because there were few homes within 100 miles of where the storm made landfall. In fact, we have a joke in Texas that in Kenedy County, cattle outnumber people 100-to-1.

The situation would have been very different had Hurricane Bret struck Galveston—or even worse—moved up the Houston ship channel. Modelers tell us that it is not outside the realm of possibility that a Class 4 hurricane with windspeeds in excess of 150 miles per hour could strike this area, easily doing damage in excess of $25 or $30 billion.

This would, by far, be the most expensive natural disaster to strike the United States, ever. It would surely kill many residents, since it is unlikely Houston or Galveston could be properly evacuated in time. A storm that struck Galveston Bay in 1910, for example, killed almost 20,000 people. Today, of course, early warning systems would allow us to better prepare. However, while we can do something about shepherding people to safety, we cannot do the same with property.

Three insurance companies—Farmers, Allstate and State Farm—insure six out of every 10 homes in the state of Texas. Therefore, we are critically aware of the potential problem that could result from a major hurricane that might strike the Texas coast. That is why all three companies have tried to limit their exposure in coastal areas.

The problem is that while Farmers, Allstate and State Farm have tried to limit their exposure to a worst-case hurricane, so too have other insurance companies in the state of Texas. The net result is that there are not enough insurance companies willing to insure all the homes which are exposed along the Texas Coast.

In order to accommodate the tremendous need for insurance coverage in these areas, the Texas Insurance Department has authorized the creation of the Texas Windstorm Underwriting Association, an organization I chair. It is the job of the Windstorm Association to provide wind (hurricane) and hail coverage to homeowners who cannot otherwise obtain insurance coverage in the private market.

Over the last decade, the Texas Windstorm Association has grown enormously. According to its most recent statistics, the Association's property exposure exceeds $12 billion dollars, against a cash reserve of only $239 million. You do not need to be a mathematician to conclude that $239 million pales in comparison to $12 billion. I should also emphasize that the $12 billion refers only to the Windstorm Association's exposure. Individual insurance companies shoulder even greater exposures.

It is a *certainty* that in the aftermath of a major hurricane, the Texas insurance market will be on its knees. There is no question but that the Windstorm Association will be forced to impose assessments on every property insurance company doing business in the state in order to pay claims. Moreover, there is a very real possibility that many domestic insurers in the State, as a result of their own underwriting, as well as their exposure to the state guarantee fund and the windstorm association, could become insolvent. This could have the perverse effect of causing still more insurers to fail, resulting in even further hardship.

Let me provide an illustration of the problem faced by homeowners insurance companies such as Farmers.

There are many different kinds of insurance available including life insurance, health insurance, auto insurance, et cetera. Each of those products must deal with everyday events (such as auto accidents) where there are large numbers of occurrences over a period of time. This makes their costs, and the predictions of their costs, manageable and generally foreseeable. Insurers are therefore able to charge a rate that accurately reflects risk.

This degree of certainty does not apply to the homeowners insurance market. Our actuaries must deal with the possibility of enormous losses at any point in the future, regardless of anything we do. For example, Memphis is just as likely to slide into the river tomorrow as it is 500 years from now. As more and more people move to coastal and earthquake zones, exposures to home insurers grow exponentially.

And as there are more exposures to be covered at greater cost, the ability for us to predict the actual risk posed in those areas becomes more and more difficult. Natural disasters, unlike everyday the occurrences in auto and life insurance, are unusual events. We must deal with unknown earthquake faults and unknown hurricane landfalls.

While we are glad that to this point there have been few of these events, we must find a way to better plan for them. A single 45-second occurrence in homeowners insurance in the billions of dollars, as opposed to a single 45-second occurrence in auto insurance, which is in the thousands of dollars. So statistically speaking it is virtually impossible to have faith that the premium you are charging reflects the risk. Remember as well that we have less control over our rates, and you can see the difficult situation in which we are placed.

So what do we do currently to guard ourselves and our policyholders against this risk? We purchase a product known as reinsurance, sold by the good companies of Mr. Nutter's fine organization.

Reinsurance serves a vital role in the nation's insurance system. For a price, we are able to cede portions of our risk to the reinsurer. Reinsurance, as it is more of a financial tool than "insurance" in the traditional sense, must see a return that is comparable to the cost of capital in other parts of the financial markets. In other words, they can price their products to more accurately reflect the risk.

Additionally, note that primary insurers such as Farmers are mostly rate regulated, as opposed to reinsurers, whose products are generally not rate regulated. As a result, their unregulated rates must be built in to our rates that are paid by homeowners in towns like Baytown, Texas.

As a result we are forced to find a product which will allow us to cede the greatest amount of our risk load for the cheapest possible price. It is a difficult balancing act to keep on one hand enough reserves to pay day-to-day claims and handle administrative costs, while on the other hand pay out enough in reinsurance premiums to cover an ever-expanding risk load.

Reinsurers are not willing to put money at risk that they could otherwise invest in other financial products. So in many cases, they are charging us 6, 8, or 10 times the actuarial risk of what we are ceding.

For example, Farmers is one of the major participants in the California Earthquake Authority, an entity created in the aftermath of the Northridge Earthquake to provide earthquake coverage to California residents. The CEA is the largest purchaser of private reinsurance in the world. In fact, the CEA's coverage is five times larger than any other reinsurance contract sold worldwide. Despite this impressive designation, the CEA can only afford to purchase $2.4 billion in private reinsurance protection. Considering the potential losses in California are in the $80 billion and above range, this price is not reflective of what is needed.

What does that mean? That means that we are unable to cede enough of our risk, which means we have to slow down new policy writings or raise prices. That has a tremendous impact on homeowners in risk-prone areas and on the admirable insurance agents in this country who are trying to make a living selling insurance products.

Why S. 1361 is Solution

The goal we all share is to protect the current availability and affordability of homeowners insurance as well as protect the homeowners insurance market's solvency going forward.

S. 1361 addresses both goals. By providing affordable reinsurance to insurance companies and state, those insurers will be able to lighten their risk load. The result of this will be and expansion in the insurance offerings made by those companies, and will allow greater competition in those markets where there is currently very little or none. S. 1361 will punch a hole in the dam that currently holds back availability and competition in high-risk areas in the country.

S. 1361 addresses the important national implication of insurer solvency by allowing these insurers to purchase high-level protection against the worst case scenarios.

It is important to reiterate that these companies will be paying a premium for these reinsurance coverages, and that premium will be set at a regional auction. The government will not be giving away reinsurance.

A storm of the magnitude we are addressing here could indeed wipe out the surpluses of major insurance carriers in the United States. Then the problem is more than a local one in Texas. Then we have a national insurance crisis.

By passing S. 1361 in the Senate and H.R. 21 in the House, the Congress can signal that it recognizes this serious problem at a time when few people are concerned about it. No one likes to think about a catastrophe unless of course one occurs.

The fact of the matter is that the "big one" is potentially bigger than any of us today can realize. Congress must ask itself whether it is worth putting the national insurance markets at risk, not to mention the tax dollars of hardworking Americans via an emergency appropriation. The option is to pass S. 1361 and provide protection to the nation's homeowners and allow the private marketplace to absorb more of what would otherwise have to fall under an emergency appropriation.

Thank you very much.

REINSURANCE ASSOCIATION OF AMERICA,
Washington, DC, April 21, 2000.

Senator STEVENS,
Washington, DC.

Dear Senator Stevens:

I am writing to supplement the record for the April 13, 2000 hearing on S. 1361 "The Natural Disaster Protection and Insurance Act of 1999" as it relates to statements made regarding the GAO's February 8, 2000 study on "Insurers Ability to Pay Catastrophe Claims."

Numerous witnesses quoted a finding by the GAO that "a catastrophe loss *greater* than a 1-in-100 year loss or a closely spaced series of small could temporarily deplete insurer resources."

GAO states that the results of our analysis suggests that insurers likely could pay most or all claims from a single 1-in-100 year event loss that strikes a single state, without even including reinsurance. GAO estimates that the primary industry could pay the following l-in-l00 year event expected losses in the respective state, without including reinsurance.

State	1-in-100 year expected loss
Florida	$42.8 Billion
California	$20.3 Billion
Texas	$11.6 Billion
New York	$9.8 Billion
Louisiana	$6.8 Billion
Massachusetts	$4.8 Billion
North Carolina	$3.4 Billion
South Carolina	$3.0 Billion
New Jersey	$2.8 Billion
Mississippi	$2.6 Billion

It is important to note that the GAO report did not include the use of reinsurance by insurance companies. GAO specifically points out that the report contains substantial limitations, one of which is the absence of reinsurance from its analysis. GAO states "that it could not estimate the degree to which reinsurance companies would cover the losses that the insurance companies would incur in a 1-in-100 year loss. All recoveries would increase insurers' capacity to pay claims." Thus, GAO's statement that a catastrophe loss *greater* than a 1-in-100 year loss or a closely spaced series of small could temporarily deplete insurer resources does not include reinsurance. Reinsurance would add approximately $20 billion of additional capacity beyond that provided by the primary marketplace and the reinsurance industry usually pays 25–35% of the catastrophe losses.

As you are aware, reinsurance is a major risk management tool used by insurance companies to: (1) limit liability on specific risks; (2) to stabilize loss experience; (3) to protect against catastrophes; and (4) to increase capacity. Through the careful use of reinsurance, the disruptive effects that catastrophes have on an insurer's loss experience can be reduced dramatically. The RAA believes the absence of reinsurance from the GAO's analysis is significant and warrants your attention.

Thank you again for the opportunity to testify at the April 13 hearing. The RAA looks forward to working with you and your staff on this most important issue.

Sincerely,

FRANKLIN W. NUTTER,
President.

PREPARED STATEMENT OF THE NATIONAL ASSOCIATION OF REALTORS®

Thank you for the opportunity to submit this statement for the record which presents the views of the National Association of Realtors® (NAR) on S. 1361, the Natural Disaster Protection and Insurance Act. NAR appreciates the effort of Senator Stevens in building bi-partisan support on this very important issue.

The deterioration in the availability and affordability of homeowners' insurance in disaster-prone areas is an issue of very real concern to NAR. Our members specialize primarily in the business of assisting sellers and buyers in residential sales transactions. It is this business focus that motivates NAR's interest in the resolution of this problem.

We cannot emphasize enough that the ultimate victim of the homeowners' insurance crisis is the consumer who is frustrated in his or her attempt to realize the American Dream of homeownership. When a young family is precluded from owning a home because homeowners' insurance is too difficult to obtain or too costly to afford, we all suffer the consequences.

Last year, NAR testified before the House Banking Committee on the difficulties faced by current and prospective homeowners. One year later, the situation has unfortunately not improved. In a number of states throughout the country, consumers are burdened by rate increases as well as by reductions in coverage such as higher deductibles.

Several states provide state insurance pools through which homeowners can obtain coverage. Although such coverage may be expensive and limited, it is often the only alternative.

The inability to obtain affordable homeowners' insurance is a serious threat to the residential real estate market. Not only does it imperil the market for single family detached homes, but the condominium, co-op and rental markets are affected as well. New home purchases, resale transactions and housing affordability are negatively impacted in the following ways:

- **Homeowners insurance is a necessary component in securing a mortgage and buying or selling a home.** If a potential homebuyer is ultimately unable to obtain the required insurance, because the insurance is either unavailable or unaffordable, the sale will not be completed. As a result, creditworthy potential homebuyers are priced out of the market. In a recent NAR survey, respondents reported that an estimated 2,450 transactions fell through because of difficulties in obtaining disaster insurance. Seventy-five percent of respondents cited unaffordability as the reason.
- **Homeowners' insurance is tied directly to the cost of owning a home.** If a homeowner is unable to maintain insurance required by a mortgage lender, the mortgage is in default. If disaster insurance coverage is optional, potential buyers may choose not to purchase a home simply because the insurance they consider essential is too expensive. Others may choose to go unprotected.
- **Insurance costs impact rent levels.** Insurance costs incurred by landlords are ultimately passed on to tenants. Consequently, increased insurance costs result in higher rents.

NAR supports S. 1361 for the following reasons:

- **It protects against mega-catastrophes.** State programs that have been created to address the problem are well-intentioned first steps, and homeowners' insurance is currently available in these states. However, neither state disaster programs nor the private insurance industry have the capacity to cover the risk presented by mega-catastrophes far more damaging than Hurricane Andrew or the Northridge earthquake. The creation of a federal disaster reinsurance program today will help to prevent future interruptions in the availability of homeowners' insurance.

- **It promotes fiscal responsibility.** By establishing a program which promotes insurance coverage for those at risk of property losses from a natural disaster, S. 1361 will minimize future unforeseen disaster assistance expenditures. It is far more responsible for the federal government to act before disasters occur rather than afterward.

A strong housing market is a linchpin of a healthy economy, generating jobs, wages, tax revenues and a demand for goods and services. In order to maintain a strong economic climate, we must safeguard the vitality of residential real estate.

But more importantly, we must safeguard the cornerstone of the American Dream. NAR supports a federal response to the disaster insurance crisis which helps to make the dream of homeownership a reality for more and more Americans. We urge the Committee to take action this year on this very important issue.

PREPARED STATEMENT OF LOUIS H. NEVINS, PRESIDENT, WESTERN LEAGUE OF SAVINGS INSTITUTIONS

The Western League of Savings Institutions, which represents the thrift industry of California, would like to submit this statement in strong support of S. 1361, "The Natural Disaster Protection and Insurance Act of 1999," into the hearing record of the Committee's proceedings on April 13, 2000. Our members hold and service hundreds of millions of dollars in residential mortgage loans covering both single- and multi-family dwellings on the west coast. We underwrite and assume credit risk on the mortgages we hold (and in many cases on mortgages we make and sell). This is our business. But we are exposed to major disaster losses for which we and our mortgagor customers are largely uninsured. Potentially, the losses form a devastating earthquake could be well in excess of our capital. This is the reason we are such avid supporters of S. 1361 and its House counterpart, H.R. 21.

We are particularly appreciative for the leadership which Senator Ted Stevens continues to provide on this legislation. The Administration, too, has played a very constructive and positive role. The House Banking Committee has given this issue careful scrutiny over the past two years and approved its version of the bill in 1998 and again in 1999, both times with substantial bipartisan majorities. A great deal of progress has been made, narrowing differences and accommodating legitimate concerns. There is now optimism that the House will soon act to approve H.R. 21, and, like the Administration, we sincerely hope this legislation can be enacted this year. Earthquakes and hurricanes are not political events and the development of a national policy should not be politicized.

Critics of natural disaster legislation contend that we should not be adding still another federal program to the statute books—that the private sector, possibly with new tax incentives, or the securities market can handle the problem. But the private sector cannot, and does not, provide unlimited protection against the kind of calamity that Californians dread and those exposed to hurricanes on the east coast fear most. There is more capacity, more reserves, today than the industry has had in the past. But it is the big event, the one that causes tens of billions of dollars in damages, for which we are unprepared.

When terrible things happen, our government always responds with disaster aid. Our citizens are generous. But those who live in areas which are susceptible to disasters of epic proportions should be encouraged to make their own financial preparations. The problem right now is that adequate protection is not available—at virtually any price. Our national policy ought to encourage mitigation and it ought to encourage citizens living in risk prone areas to become less reliant on the generosity of their fellow citizens and more dependent on themselves. This is exactly what S. 1361 does. Ultimately, we would hope that disaster insurance can be made available to a wide variety of property owners. For the moment, we understand the priority is on residential housing, but it should be underscored that multifamily coverage is as much in need as single-family coverage and there should be no distinctions.

In California today, less than one person in five, eligible to purchase earthquake insurance, carries it because deductibles are so high and the cost is so great. In many cases, the deductibles, which are as high as the first 15% of loss, exceed total initial equity in a home. According to the California Earthquake Authority (CEA), only about 1.3 million of a total of 7.9 million properties are insured. In short, most Californians today are completely uninsured against earthquake risk. The reason that the cost of primary insurance is so high may be attributed to the high cost of reinsurance. The CEA is the largest purchaser of reinsurance in the world and it is a fact that over two thirds of premiums that are collected from the Californians who do carry earthquake coverage go to purchasing reinsurance. Some 83% of our citizens have apparently concluded that what is available in the way of insurance coverage is simply not worth the cost.

We need to do better, and we cannot envision a solution if the federal government is not the ultimate reinsurer. Tax-free accumulation of reserves would be of some assistance but, tax incentives generally are inefficient. We believe that a risk acceptance mechanism is the preferable approach.

We are not experts on the exact level at which the federal government should be involved. The Committee has already heard testimony on this subject. Whether the bar should be set at a 100-year event or a 250-year event is not our area of expertise. And given the amount of competition our industry is exposed to from government programs, we are very sensitive to arguments in the insurance industry that they do not want to be crowded out by the government itself. S. 1361 is neither a bailout to the insurance industry nor a replacement for it. Natural disasters, particularly massive earthquakes and hurricane devastation can cause total destruction of huge areas. There is no way that the insurance industry today can price this risk at levels where adequate coverage can be made available at affordable rates. Given the level at which the bar is likely to be set, we may not even make significant strides in affordability, but at least coverage will become more available.

For the financial services sector, the risk of loss from natural disasters probably exceeds the potential of loss from economic calamities. Financial institutions cannot prudently require homeowners to carry natural disaster insurance. But homeowners insurance is virtually mandatory throughout the industry. The fact is that despite the requirement that borrowers carry homeowners insurance, our industry could more prudently insure itself against fire and theft than it can for natural disasters. The potential for natural disaster loss is concentrated in our most populated areas—eastern and western seaboard cities. Our hope is that Congress will enact a natural disaster policy, one that is anchored by federal reinsurance of catastrophic losses before the next event occurs—and it will—we just do not know when or where.

In conclusion, we support S. 1361 because:

- The bill reflects public policy that is rooted in the principle that those who live in high risk areas should be encouraged, and some day even required to, provide their own protection;
- Only the federal government can provide the solution that is needed;
- It makes more disaster insurance available. There is a relationship between the level of Federal involvement and affordability, but the priority should be on availability, at least for the time being; and
- Mitigation is a part of the program.

We urge the Commerce Committee to move this legislation this year.

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