Testimony of
The National Association of Insurance Commissioners

Before the
House Committee on Financial Services

Regarding:
H.R. 3355 – The Homeowners' Defense Act of 2007

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On Behalf of the National Association of Insurance Commissioners

Chair Waters and Kanjorski, Ranking Members Biggert and Pryce, and Members of the Subcommittees on Housing and Community Opportunity and Capital Markets, Insurance, and Government Sponsored Enterprises, thank you for the opportunity to testify on H.R. 3355, the Homeowners' Defense Act of 2007. My name is J. P. Schmidt. I am the Insurance Commissioner for the state of Hawaii and I am here today on behalf of the National Association of Insurance Commissioners.

Last month, in the span of just 24 hours, my state was hit with a magnitude 5.4 earthquake while we watched Hurricane Flossie, a category four hurricane, head straight for the Isles. At the same time, an earthquake in Peru generated a tsunami warning, a lava flow from Kilauea Volcano began winding its way toward old Hilo Town, and we were midway through a week long brush fire burning thousands of acres on the Waianae Coast. Fortunately, the recent earthquake and the weakening hurricane were relatively modest in terms of insured losses, the tsunami didn't develop, and the fire was kept from buildings and residences, but it is safe to say that Hawaii knows something about living with and managing the threat of natural disasters. We're still keeping an eye on the lava flow.

Natural disasters take a heavy economic and emotional toll on Americans across the country each year. The economic impact of natural disasters does not recognize state boundaries and may affect several states or even the economy of the nation as a whole. States in harm's way continue to consider and implement solutions to managing the varying threats they face, and several proposals have been introduced in Congress in recent years to address the issue. Representatives Klein and Mahoney have put forward a bill that appears to build on those efforts, so we commend them for their leadership in addressing the issue, and for recognizing the important role states play in managing the threat of natural disasters.

Background

The availability of insurance is impacted by the perceived risk and historical experience of a particular region. Simply put, insurers have an expectation based on risk modeling, application of actuarial judgment and evaluation of past loss experience regarding the type, scope, and likelihood of experiencing insured losses based on the risks they will face in a given area. Insurers use this information to price their products. When there is an event that falls outside of the expected spectrum of historical risks in terms of severity and likelihood (such as Hurricane Katrina) or frequency (such as the four consecutive hurricanes that pummeled Florida in 2004), insurers recalculate their expectations and typically respond by: 1) making insurance products less available, 2) introducing coverage limitations, and/or 3) raising prices. For example, following the devastation of Hurricane Andrew in 1992, the availability of insurance in Florida became a serious concern as insurers began to question their exposure in a market with volatility they did not and could not fully anticipate. In essence, they could not control their exposure to risk and responded by limiting availability. The same dynamic exists today, but the reductions in availability have spilled over into states that have not recently suffered a significant loss.

The current system of insurance is very good at handling the "normal" disasters ranging from car accidents, storms, and even some hurricanes, where the frequency of events has resulted in collection, compilation and analysis of data that allows for more accurate predictions of future losses, and the severity is such that the private market can cover the risk. However, there is the potential for natural disasters at such a scale that the private market cannot or will not be able to reasonably insure them, or insure them at a price that homeowners are willing to pay without opting out of the coverage. Through their own actions of withdrawing or reducing coverage in markets susceptible to such threats, insurers would seem to agree. In catastrophe prone areas around the country, there is a widening gap between what insurers feel they can reasonably charge to cover certain risks and what homeowners can reasonably afford to pay. This gap leads to a problem of underinsured or uninsured property and demands that local, state, and federal governments consider ways to bridge that gap. The fundamental question then becomes what is the appropriate role of government in managing and insuring for large natural disasters?

State Initiatives

States have employed a number of initiatives to aid in the response to natural catastrophes and to manage the availability and affordability of insurance prior to an event. In those situations when private insurance markets refuse to provide coverage for a particular risk in a particular area, the states have filled the gap through a variety of tools. One tool some coastal states have used is a residual market mechanism, or "wind pool." The wind pools are state-run "insurers-of-last-resort" that provide wind coverage for customers the private market will not insure. If not for these wind pools, the financial and social impact of the 2004 and 2005 storm season would have been far worse. Wind pools typically run as non-profit entities and most set their rates above the private market so as to not compete with private insurers. Following Hurricanes Katrina and Rita, these pools grew dramatically as private insurers withdrew from the coastal market. As with private insurers, wind pools typically purchase reinsurance and have found similar problems with rising reinsurance costs as more and more policyholders at the highest level of risk are entering the wind pool programs.

Some states have residual market mechanisms know as FAIR, or "Fair Access to Insurance Requirements" Plans. Most FAIR plans were created in the 1960s when insurers struggled to manage the threat of rioting and civil unrest and allowed states to obtain federal reinsurance money if they established property insurance pools of last resort to make homeowner and business policies available to those insurers considered living in "high risk" areas. These residual market mechanisms now operate in 30 jurisdictions (including the District of Columbia and Puerto Rico) as insurers of last resort providing property insurance to those persons that the insurance industry decides not to cover.

Another tool used by states like Florida and California to fill insurance availability gaps is a state catastrophe fund. Florida's fund is a reinsurance mechanism that backs up private insurers, while the California Earthquake Authority functions as a direct writer of earthquake insurance. The Florida Hurricane Catastrophe Fund provides billions of dollars of reinsurance capacity for insurers at a lower cost than what is available in the private market (due to its tax-exempt status, low administrative costs, and lack of a profit or risk-load) in an attempt to mitigate some of the catastrophic exposure insurers face in that state.

In the early 1990s when insurance providers dropped wind coverage from their homeowner's policies, Hawaii responded by creating the Hawaii Hurricane Relief Fund (HHRF) to provide standard windstorm coverage for hurricane force winds. Payments beyond the reserve amount were assessed on existing casualty policies on all property and casualty premiums. This approach fixed the risk of participating insurers by the aggregate capital limits of the plan.

The NAIC has tracked and monitored State initiatives in response to catastrophic events and has conducted extensive research and analysis on how to manage and insure for losses stemming from large natural disasters.

<u>NAIC Guiding Principles and H.R. 3355</u>

In 1999, the NAIC adopted eighteen "Guiding Principles" to consider when evaluating federal catastrophe insurance legislative proposals. It is with these principles in mind that the NAIC looked at H.R. 3355, the Homeowners' Defense Act.

1. Legislation should recognize the important role played by the states in insurance regulation with respect to such areas as licensing insurers, solvency surveillance, approving rates and forms, licensing agents, assisting consumers during the claim settlement process and performing market conduct examinations.

   The Homeowners' Defense Act does not unnecessarily impede any of these state regulatory functions.

2. There should be a reasonable coordination and structuring of state and federal regulatory responsibilities with respect to a federal disaster insurance program that achieves the objectives of the program without unnecessarily compromising or preempting state regulatory authority and consumer protection. Necessary preemption of or limits on state regulatory authority should be compensated by requisite federal oversight. There also should be an appropriate balance of different private and public interests in the governance of and regulatory oversight over the program.

   The Homeowners' Defense Act provides for reasonable coordination and allows the Secretary of the Treasury to promulgate regulations needed to work with states.

3. Legislation should recognize that many catastrophe exposures subject insurers to potential adverse selection as persons with less catastrophe risk are less likely to voluntarily purchase coverage, while those persons with greater risk are more likely to purchase coverage. If legislation were to create a government primary program, the program should encourage the inclusion of both low-risk and high-risk insureds to promote greater risk spreading in a way that does not subject individual risk-bearing entities to adverse selection.

   The Homeowners' Defense Act generally does not address adverse selection. It provides a mechanism for all risk transfers assumed by qualified state reinsurance programs.

4. Legislation should promote or encourage that coverage is available to any property that meets reasonable standards of insurability.

   The Homeowners' Defense Act does not address this issue directly. It encourages the availability of coverage without addressing standards of insurability. It is possible that the Secretary of the Treasury would include appropriate land use and mitigation standards in regulations that it might publish.

5. Legislation should supplement but not replace other private and public insurance mechanisms where those mechanisms can provide coverage more efficiently.

   The Homeowners' Defense Act meets with this principle as it does not attempt to replace other mechanisms that are willing and able to offer coverage. It simply makes coverage available in areas where the private market has shown little interest in providing coverage.

6. Rates for the catastrophe peril should be actuarially sound and should consider all reasonable factors that can be feasibly measured and supported by theoretical and empirical analysis.

   The Homeowners' Defense Act does not address primary prices or attempt to regulate them in any way. It provides a federal backstop and a mechanism for cataloging risk and enabling more efficient risk transfers.

7. State residual market mechanisms and other pooling mechanisms for property insurance should be allowed to participate in the entity established by legislation to provide catastrophe insurance, in such a way as to not create incentives for business to be placed in the residual market.

   The Homeowners' Defense Act meets this principle. It encourages the participation of state residual market and catastrophe funds in the consortium and makes liquidity and catastrophic loans available to them.

8. If a program includes provision of primary property insurance for catastrophe perils, voluntary market insurers should exclude coverage for the catastrophe perils from standard property policies and provide all catastrophe coverage through the program mechanism.

   The Homeowners' Defense Act does not provide primary insurance.

9. Legislation should encourage individuals to participate in the program or run the risk of losing access to federal disaster insurance.

   The Homeowners' Defense Act is silent on access to federal disaster assistance.

10. If legislation designates certain states as "disaster prone" and makes provisions for those states, it should also address what happens if a disaster strikes in states not specified as "disaster prone."

    The Homeowners' Defense Act clearly defines what types of programs are eligible to participate.

11. For disasters that are seasonal in nature, any legislation creating primary coverage should encourage policyholders to maintain coverage throughout the year to stabilize premium flows and avoid adverse selection in terms of consumer decisions with respect to starting and ending coverage.

    The Homeowners' Defense Act does not address this issue as it does not provide primary coverage.

12. Jurisdiction over claim settlement practices should remain with the states.

    The Homeowners' Defense Act allows states to retain jurisdiction over claim settlement practices.

13. Tax law changes should be encouraged to avoid penalties on and encourage the accumulation of reserves for catastrophe losses.

    The Homeowners' Defense Act does not address tax-deferred catastrophe reserves for insurers.

14. Legislation should encourage loss reduction and hazard mitigation efforts.

    The Homeowners' Defense Act mentions in its statement of purposes that encouraging mitigation and prevention for catastrophes is one of the purposes of the Act. Details of how that is to occur are left to the Secretary of the Treasury through rulemaking authority.

15. Legislation should encourage the strengthening and enforcement of building codes to reduce loss.

    The Homeowners' Defense Act mentions mitigation, however, it does not discuss building codes specifically.

16. Legislation should not burden states with additional responsibilities without funding the mandated activities.

    The Homeowners' Defense Act does not burden the states with additional responsibilities. It establishes a state-federal partnership through the consortium.

17. There should be coverage protection within reasonable limits for personal property policyholders in the event of the insolvency of the program or its participants.

    The main purpose of the Homeowners' Defense Act is to enable efficient risk transfers and to make liquidity and catastrophic loans available to qualified programs when catastrophic events occur. This is intended to make sure that the state programs do not fail.

18. Federal legislation should encourage the geographic spreading of risk.

The Homeowners' Defense Act enables the more efficient geographic spreading of risk through the consortium. One of its main purposes is to make it easier to mix and match risk so that the market can assume risk that is diversified by both geography and by peril. This reduces the risk load portion of the cost of the risk transfer and the volatility of the resulting capital markets products.

The NAIC is encouraged that the Homeowners' Defense Act meets many NAIC guiding principles. The legislation clearly recognizes the states' important role in insurance regulation and encourages states, but does not mandate them, to participate in the consortium and liquidity loan programs and creates a state-federal partnership approach to attracting private capital to the insurance market to enhance availability. The success and efficacy of the legislation depends to a degree on how it is implemented, the perceived value for various states, and the interest in the private insurance and securities markets in participating. These considerations are difficult to predict, but we look forward to working with Congress to arrive at a viable solution to the natural catastrophe threat.

<u>Title I: National Catastrophe Risk Consortium</u>

Title I of the bill leverages state residual markets and state catastrophe funds by allowing participants to transfer catastrophe risk via the non-profit "Risk Consortium" to the private markets. The NAIC sees this as a possible mechanism to help lower potential losses to state catastrophe funds by extending them to the capital markets which have far greater capacity. The capital and surplus of the residential and commercial property insurance market is approaching $500 billion, while the global securities market is over

$50 trillion. The financial impact of a $50 billion storm would be a relatively small event if absorbed in the securities marketplace. This risk-transfer mechanism for states would create another avenue to cede risk, similar to the role of the reinsurance marketplace. A beneficial aspect of the consortium is the process of cataloging the various risks of its participants. If done in a transparent environment, providing access to such comprehensive data may provide greater knowledge and confidence for the investment community. This would seem to benefit sale of securities by both the consortium and insurers offering products tied to risk in participating states. With greater information about risk characteristics becoming available in a transparent environment, market participants would have greater confidence in projected outcomes and be in a better position to efficiently price the risk transfer.

While securitization is an important tool to spread risk, it is not a panacea. We see it as a potential vehicle that could augment but not replace the traditional reinsurance market. A key unknown that will determine the impact of this type of approach is the appetite of the investment community. The current catastrophe securitization market is relatively modest, but growing, so it is unclear what the appetite for this new state consortium product will be until we know the scope of the underlying risk and the details of the end product.

Title II: National Homeowners' Insurance Stabilization Program

Title II of the bill offers liquidity loans and catastrophe loans to state or regional reinsurance programs to help spread the timing risk associated with large natural disasters. States without qualified reinsurance plans are also eligible for catastrophe loans. This additional access to capital that finances higher level catastrophic events could help reduce price volatility in the market that is reflected in homeowner premiums. It could also cause less of a drain on state and local resources leading to quicker rebuilding after a catastrophic event.

Currently, 32 states could participate in the loan program through a state fund or residual market mechanism. These include states with Fair Access to Insurance Plans (FAIR), Beach and Windstorm Plans, state-run insurance companies and state-sponsored catastrophe funds or pools. Two states, Florida and Louisiana, have state-run insurance companies, - the Florida Citizens Property Insurance Company and the Louisiana Citizens Property Insurance Company – and two, Florida and California, have state-sponsored catastrophe funds – the Florida Hurricane Catastrophe Fund and the California Earthquake Authority.

The impact of a liquidity loan could benefit an area best if it supports all market participants in that area. For example, the Florida Cat Fund makes available reinsurance to all willing participants, and therefore its benefits can be realized by all consumers. For that reason, a reinsurance-type facility would be a better structure for managing liquidity loans than a residual market wind pool. A wind pool is a direct writer of insurance and does not have the ability to provide a backstop to insurers in a region. For all consumers to benefit, states would either need to create a separate reinsurance entity, or restructure the residual market entity to take on this additional role. State reinsurance funds could be structured to allow a robust private insurance and reinsurance mechanism up to some level where losses become catastrophic and rare. Having a state entity provide coverage beyond that point would give insurers some parameters of potential exposure in which to operate. This certainty would be reflected in the pricing of their products. Backing those state entities with a federal guaranty would, in turn, give those state entities the ability to spread their absorbed risk over time. Such an approach leaves the private market as the first line of defense for the vast majority of insured events but recognizes that state and federal government involvement becomes necessary for truly catastrophic events.

The insurance and reinsurance markets have a significant amount of capacity, and access to that capacity for events that are small yet frequent is generally affordable. But for those that live in areas where events can be infrequent yet catastrophic, access to insurance capacity is either unavailable or unaffordable. This is the dilemma that regulators and legislators must face together. We commend Representatives Klein and Mahoney for their approach to tackling this challenging dynamic, and we commend the Subcommittees for today's hearing on this important issue. Thank you for the opportunity to offer my perspective, and I would be happy to answer any questions you might have.