Testimony of
Kevin M. McCarty
Florida Insurance Commissioner

Before the
Subcommittee on Oversight and Investigations
Of the
House Committee on Financial Services

Regarding:
The Homeowners' Insurance Crisis and its Impact on Communities, Homeowners and the Economy

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Chairman Watt, Ranking Member Miller and Members of the House Financial Services Subcommittee on Oversight and Investigations: Thank you for the opportunity to testify here today about the homeowners' insurance crisis, and its impact on communities, homeowners, and the economy.

To provide comprehensive comments on these topics, I will also delve into the related issues of the cost of natural disasters, the impact on local and regional communities, and mechanisms the private sector, state and federal governments have undertaken to address this problem. I applaud you for your leadership on this critical issue of national importance.

My name is Kevin McCarty, and I am the Insurance Commissioner for the State of Florida. I also serve as Chairman of the National Association of Insurance Commissioners (NAIC) Property and Casualty Insurance Committee as well as Chairman of the Committee's Catastrophe Insurance Working Group.

My testimony will focus on four main issues:

- The problems of availability and affordability of insurance, especially in coastal areas.
- The current state of the property insurance market.
- Initiatives taken by the State of Florida to respond to this crisis; and
- The need for a comprehensive national catastrophe plan.

The Availability and Affordability of Insurance

In 1992, Hurricane Andrew reached landfall in south Florida. The impact was devastating to the lives and property of people in that area. The magnitude of that event surprised the insurance industry, and it tested the creativity and responsiveness of government officials. It was the first time that I remember a "next day flyover" by statewide elected officials. Most of Florida's domestic insurers failed in the aftermath of that event, and several regional insurers, some of relatively large size, also failed. The failures were a direct result of the decisions by those companies to retain catastrophic risk, not realizing the danger of "the risk of ruin." The industry and insurance regulators learned from the experience. Since that time, insurance companies have paid more attention to disaster preparedness, and have purchased more catastrophe reinsurance to spread the risk.

This event also motivated Florida to establish a better "safety net." When some national insurers left the Florida market following Hurricane Andrew, insurance became scarce and less affordable for the average Floridian. The state of Florida established the Florida Hurricane Catastrophe Fund (FHCF or the "Cat Fund"). It also created the predecessor organization to today's Citizens Property Insurance Corporation (Citizens). These entities provided state-sponsored insurance for those Floridians who could not find coverage in the private market, and state-sponsored catastrophe reinsurance for insurers that provided homeowners insurance coverage in the Florida market.

In 2004, Florida had four significant hurricanes. We started the season with Tropical Storm Bonnie, followed by Hurricanes Charley, Frances, Ivan and Jeanne. In 2005, we had Hurricanes Dennis, Rita, Katrina, and Wilma. These hurricanes destroyed many homes and damaged many more all across Florida. This damage shattered myths that had been accepted since 1992 -- only Dade, Broward and Palm Beach counties were vulnerable to substantial hurricane damage.

Hurricane Wilma in 2005 swept through from West to East, reaching full strength through the middle of the state, crossing the landward side of Broward County before exiting off the coast and leaving residents trapped in condominium buildings with

significant damage and no electricity for weeks. Although Florida had the most efficient disaster relief program for hurricanes of any state, we still had people stranded, unprepared for some of these disasters. Of course, the federal government quickly assisted with disaster relief.

Those storms also left incontrovertible evidence that building materials and techniques are critical in determining how well homes can withstand hurricane events. We saw many photographs of neighborhoods where one home was destroyed by storm damage, while a newer, stronger-built home next to it survived unscathed.

I supported H.R. 3355, The Homeowners Defense Act passed by this committee in November 2007. The creation of a loan program that encourages state and regional planning, mitigation of homes, responsible enforcement of building codes, and financial preparation for catastrophic events is critically needed. Without it, the federal government and the affected states are forced into a reactive mode when a natural disaster strikes. We are forced to provide assistance without the luxury of time to plan and establish methods for an equitable distribution of assistance.

Florida has taken important planning steps by establishing financing mechanisms such as the Florida Hurricane Catastrophe Fund and Citizens to finance our risk. These entities pool risk, and use bond financing to pay claims. These claims will thus be repaid over a period of years to smooth the costs of financing Florida's risk.

There is a limit to what a single state can do. Florida wants a vibrant private insurance market, but private insurers are insisting a guarantee of a healthy profit-margin to stay in this market. In recent Florida State Senate hearings, companies admitted they had attempted to load profits of more than 25% into their recent rate filings. They also have used "near-term" computer models to project hurricane losses that are not as predictive as long-term models, even according to the scientists that developed them. In some cases, the use of these near-term models dramatically increased the perceived need for premium. Unfortunately for Floridians, an increase in premium attributed to this additional risk is expected to be passed to policyholders.

While I have focused on the needs of Florida, and our experiences in handling hurricane risk, we must also view this problem in a broader context. We must understand how other states handle other types of natural disasters in addition to storm damage. The ability of regional economies to withstand and recover from a natural disaster depends critically on the availability and affordability of insurance, especially property insurance. Areas with significant exposure to catastrophic perils, such as Florida's coastal areas, typically experience greater fluctuations in the price and availability of insurance. This is especially true when the risk is subjected to the economies of the private marketplace.

Publicly subsidized programs like the National Flood Insurance Program (NFIP) or optional earthquake coverage remove much of the volatility from the pricing of insurance products. However, the lack of market dynamics can also create other problems including service problems, and a failure to ensure that products are accurately priced over the long-term.

In many ways, hurricane risk differs from these other risks. There are many areas of the country not at risk for hurricanes (making it different from National Flood Insurance sold in all 50 states). It also differs in that it is required coverage for mortgages in Florida (making it different from optional earthquake coverage in California and other earthquake prone areas). Although there are residual homeowners' markets that handle this risk in Florida, North Carolina, South Carolina, Louisiana and Massachusetts for example, hurricane risk is primarily insured by the private market.

Like any business, insurance companies must earn a fair rate of return on their investment. Unlike other businesses, insurance companies must also protect against a perceived "risk of ruin," that is, the risk that an event or series of events could bankrupt the insurance company. Apart from the profit and contingency factors, the insurance company's challenge is to appropriately price the underlying risk, in this instance, hurricane risk.

To accurately price insurance products for hurricane risk, insurance companies must accurately predict potential storm damage. Predicting storm damage has two main components: 1.) Predicting the frequency and severity of storms; and 2.) Estimating

damage to homes, given specific characteristics of the type of home, and severity of the storm. Predicting both of these elements has created a problem for insurance companies and regulators in recent years.

While historical data is certainly a guide, recent events have drawn into question the relevance of this data. During the 2004-2005 hurricane seasons, eight named storms reached landfall in Florida; a scenario not anticipated by the hurricane models, which have focused on the frequency of mega storms like Hurricane Andrew in 1992. There is also a general consensus among the scientific community that we have entered a period of more active hurricane seasons.

Predicting storm damage to buildings is also challenging. Recent demographic shifts have increased migration to warm-weather states like Florida, and increased building on the catastrophe prone coastline. Now nearly one-half of the United States' population lives near a coastline. All of these elements combine to create uncertainty, which directly impacts the availability and cost of homeowners' insurance.

The basis of the insurance industry is to eliminate uncertainly, and base their products on predicted losses and premiums for the long-term. When an event occurs that defies expectations, whether it is for severity (Hurricane Katrina) or frequency (such as the eight named storms that reached landfall in Florida within a two-year timeframe), insurers must rethink their business models including their interest in catastrophe exposure.

Consequently, several major insurance groups decided to limit their catastrophe exposure. I personally have spoken to representatives of the global reinsurance markets in the Caribbean and in Europe to encourage more investment in the Gulf Region. Given the current situation, there is little interest in expanding investment to insure against large scale natural disasters like hurricanes at any price.

This creates a critical problem for states like Florida. Homeowners must have insurance to obtain a mortgage. If the private insurers will not insure homeowners, the state must

intervene to provide this insurance or its economy will grind to a halt. States, like Florida, have created residual market entities to fill this gap.

Reinsurance Markets

While major national insurers continue to cite the anticipation of future losses as a primary reason for lessening their exposure in Florida and the Gulf States, another reason is the rising cost of reinsurance. Reinsurance is literally, insurance for insurance companies. Similar to other segments of the financial marketplace, diversification is the key to stabilizing (and predicting) losses. Large carriers like Nationwide, AllState, and State Farm accomplish this by writing multiple lines of insurance in several different states.

However, even large insurers purchase reinsurance to diversify their risk and protect against truly catastrophic events. This also allows primary insurers to write more business, and write this business at a more inexpensive rate. Unlike the primary markets, reinsurance is an unregulated market with no price controls other than what the market will bear. The largest reinsurers are located in Europe and the Caribbean. The current state of the reinsurance market dictated that costs for homeowners' insurance in Florida, and other catastrophe prone areas would rise dramatically following the 2004-2005 hurricane cycle.

Not only have reinsurers dramatically increased what they charge insurance companies, reinsurers have restricted the conditions of their reinsurance treaties *(or contracts)* forcing insurance companies to retain more of the risk. Compounding this problem were actions taken by United States' rating agencies *(notably A.M. Best)* that required insurers to have higher capital retention to maintain favorable bond ratings. All of these developments caused capital to "dry up" in 2006 and 2007, translating to higher prices and less availability of insurance for the average American.

A report by Guy Carpenter and Company, a company the studies the reinsurance marketplace, indicated that in 2006 reinsurance rates across the United States rose 76 percent on average, while insurers and reinsurers were covering less and less of the risk. These increases were even more stark in coastal regions which sometimes experienced a

doubling or tripling of the reinsurance rates. For some areas in Florida, insurance companies could not obtain reinsurance at any price. As you may suspect, an increase in reinsurance costs are passed directly to policyholders.

There have been some positive developments. During 2007, reinsurance rates began to stabilize, and preliminary reports in 2008 have indicated that reinsurance rates could decrease by 10-15%. While this is an improvement, it does not return the marketplace to rates during the pre-2004 to 2005 storm cycle.

Current State of the Property Insurance Market

Despite record catastrophe losses in 2004 and 2005, nationwide the property and casualty insurance market for individuals and businesses is healthy and competitive. In fact, the industry has achieved record profits.

While the industry itself is performing well, there are some coastal regions of the country where the insurance market is in crisis. This is due to a combination of a reluctance of insurers to insure property in these areas, combined with the high prices of reinsurance for properties in these areas. Therefore, in characterizing the health of insurance markets for the coastal states we must make another important distinction between "coastal states" and coastal regions within those states.

Most coastal states have a relatively healthy property and casualty market for the vast majority of the state. In Alabama, only two of the 67 counties are having insurance issues, and even within those counties, the problems are largely limited to property within a few miles of the coast. In Mississippi, six of its 82 counties are experiencing problems. Louisiana, which felt the brunt of hurricane Katrina, only has experienced problems in its 24 coastal parishes while its remaining 38 parishes have a competitive market.

Elsewhere, the impact has been dramatic. In North Carolina, the state's residual market "Beach Plan" has seen its policy count rise by over 32% between 2005 and 2007. The plan also has increased its exposure by over 55%, to $64 billion as of September, 2007. In South Carolina, the state's residual market "Beach Plan" has experienced a policy increase of over 38% from 2006 to 2007 while simultaneously increasing its exposure

41% to $16 billion. According to its officials, the Texas Windstorm Association's exposure to hurricane loss was expected to be almost $65 billion by the end of 2007.

Interestingly, insuring against hurricane risk is not confined to the Gulf Coast region. In Massachusetts, the state's FAIR Plan writes one-third of the policies on the Cape, the area most exposed to hurricanes. Some insurers have even recognized a potential problem in New York, even though this state along with Massachusetts has not had a substantial tropical storm in decades.

It does appear that Florida has had the most significant problems in handling hurricane risk in recent years. In Florida, the states' residual market, Citizens Property Insurance Corporation, experienced an increase of nearly 500,000 policies from 2005 to 2006 becoming the largest insurer in the state.

For all states affected by the rising costs associated with storm damage risk, it is difficult to estimate the total economic impact. An increase in insurance premiums affects household budgets. I have even heard from citizens who have had to choose between paying for health care, prescriptions, or property insurance. While these costs are real, it is impossible to calculate the number of home purchases that did not occur due to a lack of affordable insurance, or the number of businesses that rethought their expansion or relocation plans due to the cost or lack of availability of insurance.

Florida has certainly experienced a dramatic downturn in its real estate market, and real estate property values. Florida is also one of the leading states in the nation in the number of property foreclosures. We have experienced a slackening of retail sales, and some areas are actually experiencing migration away from our state. Admittedly, it is difficult to disentangle the direct impact of property insurance rates with other factors affecting our economy like interest rates, and problems in the subprime mortgage industry. However, it is safe to conclude that the property insurance crisis in Florida has had a substantially negative impact on our economy.

Commercial Marketplace

While the media, and even policymakers have focused primarily on the homeowners' market and the average Floridian, problems in our insurance markets have also affected commercial businesses and public entities. During 2006, Florida experienced a serious shortage in commercial property insurance. A substantial part of this market is served by insurers, known as surplus lines companies, whose insurance contracts and rate structures are not subject to review or approval by the Florida Office of Insurance Regulation. Yet even in this market which did not have any rate regulation, we experienced a surge of policy non-renewals. It was not uncommon to hear from a business that had their insurance policy cancelled mid-term. As a result, I had no choice but to activate a residual market mechanism to offer relief to this segment of the marketplace.

Initiatives Undertaken by the State of Florida

Prior to the 2007 Florida Legislative reforms, Floridians were experiencing substantial increases in insurance costs, less availability, while more and more citizens were being forced to find coverage in Florida's residual market, the Citizens Property Insurance Corporation. During the 2006 election cycle, Floridians demanded rate relief prompting the new governor and legislature to meet in special session in January 2007 to address the insurance crisis.

The Florida Legislature passed comprehensive legislation that had several facets:

1.) It expanded the Florida Hurricane Catastrophe Fund (the Cat Fund) to give the industry up to $12 billion in more inexpensive reinsurance;
2.) It changed the Citizens Insurance Corporation rates to be more affordable; and
3.) It provided Floridians incentives to strengthen their homes, thus minimizing future storm damage.

The insurance industry stated the primary culprit for the rise in insurance premiums was the rise in reinsurance costs. At the request of the insurance industry, the legislature expanded coverage offered by the Florida Hurricane Catastrophe fund (the Cat fund); the Cat Fund offered retention to private insurers below the normal industry retention, and expanded the upper level of reinsurance up to $12 billion above the Cat Fund's normal

upper limit. Insurers responded, and purchased virtually all of the new upper level of "reinsurance" from the Cat Fund.

While the Cat Fund now accepts more premiums from the insurance industry, in the event the Cat Fund's reserves are not sufficient, it will be paid by assessments on most property insurance lines written in the state. Put another way, the risk was removed from the insurers' portfolio and is now being supported by the people of Florida. The trade-off for assuming this risk was that the cost savings was to be passed through to the policyholders. We are currently in the middle of verifying that process.

The Florida Legislature also addressed the issue of premiums for policyholders in Florida's residual market, the Citizens Property Insurance Corporation. The Florida Legislature changed the methodology used by Citizens' Corporation from being above the market-based rate, to rates that were actuarially based. The practical effect was to lower premiums for people with these types of policies. Contrary to the initial concerns, from the end of 2006 to the end of 2007, Citizen's policy count grew by less than one half of one percent.

The Florida Legislature also passed initiatives to strengthen Florida's building codes, and encourage Floridians to employ mitigation measures to lessen the damage caused by storm events. More recently, the Florida Building Commission has adopted a "code plus" standard allowing buildings within 2,500 feet of the coast to withstand a one in five hundred year storm making it the most stringent building code in the country.

A National Catastrophe Plan

Insuring national catastrophes may be beyond the resources of any state. The United States is one of the only industrialized nations in the world without a comprehensive national catastrophe plan. While Hurricane Andrew and Hurricane Katrina caused tremendous catastrophic loss, these pale in comparison to potential national disasters. A repeat of the 1906 San Francisco Earthquake could cause $400 billion in damage; the 1938 New York hurricane could cause $300 billion in damage; Even last week featured tornados that ripped through four Southern states causing loss of life and millions of dollars in damage.

While natural disasters clearly affect our national economy, there is a stark difference in how risk events are covered through the private sector, and/or state and federal programs. Wind events, including tornados and hurricanes, are considered a basic covered peril in the vast majority of homeowner's insurance policies in the United States. Flood, on the other hand, is written only rarely by the private insurance industry for residential property; since 1968 the National Flood Insurance Program (NFIP) has been the public solution to managing this risk.

Seismic events, particularly earthquakes, are not considered a standard covered peril, and aside from the California Earthquake Authority (CEA), there is no public mechanism to underwrite this risk; therefore, coverage is optional, where available, in the private insurance market. It also is worth noting that that when coverage is offered (via the CEA) it is somewhat limited (the standard policy carries a 15 percent deductible and offers $5,000 for contents coverage and $1,500 for additional living expenses due to loss of use).

Substantial differences in how catastrophic events are covered, and the fact that many of these are "optional" coverage, create economic problems. If the next natural catastrophe is a significant flood event, the ability of the affected areas to recover is dependent on the number of policyholders with flood insurance. Data from 2004 and 2005 suggest that many property owners were uninsured; either they were outside the mandatory flood plains or they were in the mandated flood zones but were uninsured anyway. A recent study by the Rand Corporation shows that only five percent of homeowners outside flood zones purchase flood insurance, while only 75 percent within flood zones purchase flood insurance.

Interestingly, the National Flood Insurance Program has not historically benefited Florida relative to other states. Florida participates heavily in the National Flood Insurance program (NFIP). From 1978 to 2005 Florida paid 33% of the total premium collected by the NFIP, but only received 12% of all claims payments paid by the NFIP. The reason is

that most Floridians' major water damage risk is from wind driven rain not covered by the NFIP.

If the next natural catastrophe is an earthquake, the ability of the affected regional economy to recover will depend on the degree of disaster relief that comes from the federal government. The reason is quite simple: the majority of residential property in earthquake prone areas is not insured for this risk. In California, for example, it is estimated that only 12 percent of residents have any kind of earthquake coverage.

Both within the U.S. and across other developed economies, a variety of programs have been created to manage the economic consequences of catastrophic events. These programs differ in their structure based on underlying premises regarding the nature of the risk. As such, the resulting roles of the private insurance market and government entities vary considerably across programs. The Government Accountability Office (GAO) report, "U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risks," GAO-05-199 published in February 2005, provides a thorough description of these various approaches.

As you can see, our current system lacks a comprehensive approach to managing the devastating effects of catastrophic natural disasters. Our current policy relies heavily on the Federal government. The federal government has allocated $110 billion, over and above insured loss payments, to facilitate recovery and rebuilding following Hurricane Katrina. As generous and compassionate as the American people are, this current system leaves much to be desired. Although our current reliance on federal payments for large-scale disaster spreads the cost of these events across a broad pool – the American taxpaying public – it is ineffective and inefficient.

The solution is not a large federal insurance program, but the United States does need to think more proactively and strategically about natural disasters. As I stated previously, I supported H.R. 3355, "The Homeowners Defense Act," passed by this committee in

November, 2007. The voluntary nature of the programs offered in the bill eliminates the concern that a federal backstop will be subsidized by all other taxpayers.

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