Testimony of
The National Association of Insurance Commissioners

Before the
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Is the Housing Market Prepared for a Natural Disaster?

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Kevin M. McCarty
Florida Insurance Commissioner
Chairman of the NAIC Catastrophe Insurance Working Group
Chairman of the NAIC Property & Casualty Insurance Committee

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Florida Insurance Commissioner
On Behalf of the National Association of Insurance Commissioners

Mr. Chairman and esteemed members of the Subcommittee on Housing and Community Opportunity, I thank you for the opportunity to testify on the question before you today.

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

The NAIC, through these groups, has been involved in research and analysis of the effect of natural disasters on our society for a number of years, and is currently heavily engaged in developing a comprehensive national plan for managing the economy wide risk of catastrophic natural disasters. In addition, the NAIC has adopted resolutions, both in December of 2005 and most recently in June of 2006, supporting a national disaster plan and calling for a Federal Commission to further study the issues and any alternative solutions.

The Committee has phrased today's question succinctly, the problem is an economic problem, not simply an insurance problem. I have spent much of my professional career working on issues resulting from the economic effects of natural disasters, both before they occur as well as after they occur. As a result of these experiences, I firmly believe that insurance is a critical, but not complete, answer to our nation's resilience in the face of catastrophic natural disasters. Insurance claim payments are the economic catalyst that restarts an affected region in the aftermath of a natural catastrophe. But, as experience repeatedly shows, pre-event disaster planning, effective mitigation and rational building codes are crucial parts of the solution.

My testimony today focuses on the role of insurance within the context of the question: "Is America's Housing Market Prepared for the Next Natural Catastrophe?" If I were to try and offer a simple answer to this terribly important question, I am afraid that answer would have to be "maybe, up to a point."

Is America's Housing Market Prepared for the Next Natural Catastrophe?

Today, the ability of housing markets, as well as local and regional economies, to withstand and recover from the next natural catastrophe depends critically on what type of peril creates the disaster, where the disaster occurs, and the severity of the disaster event. The different types of natural disasters are managed very differently. This, in turn, can lead to highly different outcomes.

Wind events, including tornados and hurricanes, are considered a basic covered peril in the vast majority of homeowner's insurance policies. Flood, on the other hand, is only rarely written by the private insurance industry for residential property; since 1968 the National Flood Insurance Program (NFIP) has been the public solution to managing this risk. Finally seismic events, especially earthquakes, are not considered a standard covered peril, and aside from the California Earthquake Authority, there is no public mechanism to underwrite the risk, so coverage is restricted to being an optional coverage, where available, in the private insurance market.

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

I know that there is pending legislation, both in this body and in the Senate, to improve and modernize the NFIP. I encourage you in your efforts, especially to create current risk assessment maps and tools, and to bring rationality into the pricing of flood insurance. An under-priced policy that does not accurately reflect the risk of the event only makes the economic problems associated with flood worse.

If the next natural catastrophe is an earthquake, the ability of the affected housing markets regional economies to endure and recover is going to be dependent on the degree of disaster relief coming from the federal government. The reason is really quite simple; the majority of residential property in earthquake prone areas is not insured for this very real risk.

In California, for example, it is estimated that the take-up rate for optional earthquake insurance is about 14%. The same take-up rate is frequently suggested to be true in the earthquake prone areas in the Midwest's New Madrid area, and along the eastern seaboard's seismically active areas.

The economic results of a major earthquake could be disastrous. Consider a widely referenced recent study by Risk Management Solutions, a catastrophe modeling firm, which estimated the losses associated with a repeat of the 1906 San Francisco earthquake. While much has been made of the reported estimate of $50 to $80 billion in insured losses, the much more disturbing number is an estimate of total property damage of around $260 billion. How will the majority of the damage be rebuilt without insurance? Without houses for people to live in and business for people to work in, how will the economy recover?

At the same time, in a recent article in *Nature*, Yuri Fialko, of the Scripps Institution of Oceanography at La Jolla, California, analyzes movements along the southern end of the San Andreas Fault, which has been dormant for 250 years. The recent analysis suggests the Fault could be ready to end its dormant cycle with a seismic movement in excess of that experienced during the 1906 San Francisco earthquake or the 1994 Northridge earthquake.

Given these scenarios, one might expect the market for earthquake insurance to be growing. Instead we have seen the opposite. After Northridge 35% of residential property owners had coverage, and now it is 15%. Yet, across the country, insurance companies are making the decision to either substantially reduce, or in some cases eliminate, their earthquake coverage offerings.

If the next natural catastrophe is another hurricane, or series of hurricanes, the impact is likely to be quite different than in either of the two scenarios I have described. The ultimate impact is going to depend on the ferocity of the storm and the level of preparation that has occurred in the affected areas.

For “moderate” storms, the wind damage will be covered by standard homeowner’s policies, so insurance claim payments will find their way quickly to the affected areas so long as the insurance companies have the financial wherewithal to pay the claims. But make no mistake; there is a finite limit to those financial resources. Whether it is in the Gulf of Mexico, along the Carolinas, or in the Northeast, a mega storm, or series of storms, could render parts of the private insurance market insolvent. Being cognizant of this reality, it is not too surprising to see the reports of insurance companies restricting or eliminating their underwriting activities in these areas.

Especially for hurricanes, the private insurance market relies heavily on reinsurance (insurance for insurance companies). Catastrophic reinsurance is obtained in a highly competitive global marketplace. While it is true that the supply of capital in the reinsurance market moving into 2006 has increased, it is also true that the demand has increased even more; the result being a constriction in the market that is expected to continue for some time.

More specifically, following the 2004-2005 hurricane seasons, we have witnessed a significant constriction of global reinsurance funds available to the US markets and primary insurers. Reports of rate increases over 300% or more are not uncommon; so are reports of significant restrictions in the amount available to any one company as well as reports of the inability of some insurers to obtain reinsurance coverage at any price.

A survey conducted by the Reinsurance Association of America and the Association of Bermuda Insurers and Reinsurers were recently provided to the NAIC Catastrophe Working Group and reinforces this point with an estimate of global reinsurance capital capacity for natural disasters at around $55 billion. This amount of global capacity is leaving a shortage for the risks, primarily hurricane, that are currently being written by the private industry in the U.S. It would be woefully inadequate if the take-up rate for seismic events were increased to prudent levels.

What Can Be Done?

I do not think we can truly prepare the housing market for a mega-catastrophe without a comprehensive national strategy. As I said earlier, insurance is critical, and I believe the offer of catastrophic coverage at actuarially fair prices needs to be greatly expanded.

However, insurance is only one of the critical components needed to truly provide a level of economic security in the face of catastrophic natural disasters for all Americans.

Currently, the United States is one of the only industrialized nations in the world not to have a comprehensive catastrophe plan. Part of the reason is historical. In 1945 Congress wisely passed the McCarran-Ferguson Act that delegated most insurance regulation to the states, as insurance issues were deemed to be more effectively regulated at the state level. This act has been the bedrock upon which the United States has built a robust and profitable insurance industry. However, that does not mean the federal government is not involved in disaster prevention and recovery. In the last two years alone, the federal government issued 115 major disaster declarations in more than 30 states. In the aftermath of Hurricane Katrina, the federal government authorized over $100 billion in monies to be used by HUD and FEMA to help catastrophe victims.

It is like the old television commercial featuring the auto mechanic – "You can pay me now, or you can pay me later." Whether it be the tax treatment of insurance company reserves as in HR 2668, the encouragement of mitigation efforts, or a federal financial backstop like those presented in HR 4366 and HR 846, it will be more cost effective in the long-run if the federal government works with the States in a comprehensive catastrophe planning and preparation system, as opposed to the current "system" of paying for the consequences a mega-catastrophe after-the-fact.

Based on my experience as Florida's Insurance Commissioner, I will now outline some things that the federal government can do to become involved in helping the housing market survive another catastrophic event.

Step 1: Improve Disaster Preparedness and Disaster Response

Disaster planning and disaster response are the very first steps to saving lives and protecting communities. The sad evidence from Hurricane Katrina bears solemn testament to this fact. The recently released study of community disaster preparedness by the Department of Homeland Security suggests there is still much to be done around the country. The report states the "current catastrophic planning is unsystematic and not linked within a national planning system." It states that "this is incompatible with 21st century homeland security challenges..." It goes on to suggest, "the need for a fundamental modernization of our Nation's planning processes." The NAIC has endorsed disaster planning as a top priority and maintains disaster preparedness manual for use by all states.

Step 2: Build Better Homes

Catastrophic events like tsunamis hitting the west coast, volcanic eruptions in the Pacific Northwest, a hurricane through downtown Manhattan, and earthquakes along the San Andreas and New Madrid faults have all occurred in our nation's past. It is inevitable that destruction from these perils will occur sometime in our future. We cannot possibly stop natural disasters, but there are measures we can take to mitigate damage. The first component of any comprehensive national strategy must be mitigation.

By mitigation, I mean preemptive measures taken to reduce or eliminate risk to property from hazards and their effects. In practical terms, this involves strengthening building codes for new structures by making them more resistant to hazards such as wind, flood, and earthquakes. It also means stricter state and local guidelines to limit construction in highly hazardous areas. As well, it means a substantial effort to retrofit existing structures in hazardous areas.

After an event, an economic recovery depends on the ability of people to return to livable houses, get their children back in safe schools, and go back to work for their families. Mitigation has proved cost effective in numerous studies and there is growing evidence that safe building is becoming important to the consumer. In Tulsa, houses with "safe rooms" are significantly more marketable and desirable than houses without safe rooms. An article in the New York Times on June 22 highlighted the growing interest and demand for "hurricane proof" homes in Texas, Florida and Mississippi.

Step 3: Mitigate by Improving Infrastructure

Although it may be outside the purview of this committee, another element of improving the homeowners market is to improve our nation's infrastructure. This includes dikes, levees, tunnels, bridges, solid waste facilities, transportation facilities, and roads. Let us recall during the Hurricane Katrina tragedy in New Orleans, many of the structures withstood the initial damage of the storm, only to be destroyed due to the failed levee system. The American Society of Civil Engineers' March 2005 Report Card showed deteriorating conditions in 13 of the 15 infrastructure areas surveyed. Insurers are becoming reluctant to insure structures in areas with outdated or outmoded infrastructure risks. A commitment to improving our infrastructure, especially as it relates to structures that place homes in greater risk during a catastrophic event, will help prevent or mitigate damages to homes.

Step 4: Expand the Capacity of the Insurance Marketplace

The current system of insurance is very good at handling the "normal" disasters ranging from car accidents, to storms, and even to the occasional large hurricane. Catastrophic natural disasters, especially the prospect of mega-catastrophes (i.e. the "big one" hitting California, a category 3 or 4 hurricane hitting New York, the New Madrid Fault leveling the Midwest), create risks that could simply destroy an insurance company or potentially the entire industry. This risk of ruin will likely keep the private sector from offering sufficient capacity for entirely rational reasons. No potential rate of return is going to be worth the risk of losing the entire company.

In order to expand the capacity base, both the quantity available and the terms at which coverage is offered, several things can be done. The first would be maximizing the private sector capacity by imitating the other major industrialized nations and allowing for tax deferred reserves against potential catastrophic losses. While various plans have been introduced over the last several years, no action has been taken. An analysis by my office suggests that had this been done when first introduced, there would be somewhere between $20 and $30 billion (depending on assumptions) in reserves available to pay for catastrophic insured losses.

More recently, HR 4836 was introduced that would allow property owners to create tax advantaged catastrophic savings accounts for either paying their deductibles in the event of a natural catastrophe or for making effective mitigation investments to their property. This is an interesting concept that could also serve to expand capacity.

Lastly, the idea of a federally sponsored reinsurance backstop for large scale natural catastrophes is an idea I encourage you to develop further. If based on actuarial principles, and with the right incentives in place, such a program could encourage better building, better disaster planning and response, and provide the capital support necessary to ensure the stable operation of the insurance market, which in turn provides stability to the housing market. And it can be done without creating another heavily subsidized program.

The Florida Experience

Before the federal reinsurance backstop, I would also encourage you to consider the development of state or regional catastrophe funds. As I close my testimony, I would like to share with you the recent catastrophe experience in Florida as evidence of how important all of these ideas can be. As you know, Florida has been hit by 8 major hurricanes in a 15 month period, creating over $35 billion in insured losses. As a matter of fact, seven of the ten most expensive, in insured losses, natural disasters in U.S. history have occurred in the last 2 years and have touched Florida, either in part or exclusively. Yet, by any measure of economic performance you prefer to examine, you cannot find any lingering impact. A large part of the reason for this is that we have developed and implemented a rigorous building code, we have one of the most comprehensive disaster response and preparation programs in the nation, and we have developed public and private partnerships to enhance the insurance marketplace.

Florida, like many states, is growing rapidly. Projections from the Florida Demographic Estimating Conference show an estimated growth of five (5) million people in Florida from 2005 to 2020. These five million people will require estimated 900,000 homeowner's insurance policies. In order to maintain this growth rate, the Insurance Information Institute estimates a minimum of $7 billion must be added to Florida's insurance market, or roughly $500 million in new capital every year. Without a dramatic overhaul in how we insure against catastrophic damage, the future of the homeowners insurance marketplace in Florida and other states in the Gulf Region is grim. We cannot simply hope to maintain the *status quo*. We must decrease the risk, stabilize the business environment, and infuse more capital into the marketplace.

Fortunately, the Florida Legislature made several proactive changes to our insurance laws that have stabilized the marketplace:

- In 1995, the creation of the Florida Hurricane Catastrophe Fund (CAT Fund), which has been the lynchpin of Florida's property insurance market. Florida's policyholders have ultimately benefited through reduced insurance premiums – The CAT Fund premium for reinsurance purposes is generally three to four times less expensive than the private reinsurance market due to its tax-exempt status, low administrative costs, and has no profit or risk-load. In addition, the CAT fund has fostered a true private-public partnership, wherein private insurers are strong proponents and when faced with buying coverage at different layers, more than 85% are buying at the highest level of CAT fund coverage (the 90% layer).

- In 2002, the creation of Citizens Property Insurance Corporation – Following Hurricane Andrew in 1992, the State of Florida endured several insurer insolvencies and a virtual collapse of the private insurance market in some segments of the homeowners market in Florida. The Florida Legislature created two quasi-governmental agencies, which eventually merged into Citizens Corporation Insurance Company --- the state insurer of last resort for Floridians. Although we struggle with growth in Citizens, the fact remains that our citizens have been able to obtain insurance for their properties following two remarkable hurricane seasons that have caused a number of insurers to, at least temporarily, reduce their Florida exposure.

More recent legislative bills and packages have also been aimed at enhancing and stabilizing the marketplace:

- Funding the Deficit of the Citizens Corporation – the State Insurer of Last Resort.
- Restricting the risk portfolio for Citizens Corporation.
- Augmenting the reserves of the Florida Hurricane Catastrophe Fund.
- Incentivizing Insurer Capital Build-Up by creating a program to issue surplus notes to authorized residential insurers.
- Authorizing the Florida Comprehensive Hurricane Damage Mitigation Program which authorizes free home inspections, and matching grants (of up to $5,000 per policyholder) to encourage policyholders to retrofit older homes to make them more resistant to wind damage; and

- Overhauling the insurance rating guidelines to allow more flexibility for the industry in determining rates.

In addition, our executive branches of government need to play an integral role in improving the marketplace. Florida became the first state in the nation to take a proactive role in promoting the state, its jobs, climate and opportunities to national and international insurance companies. During 2005, the Florida Office of Insurance Regulation created a new unit, called “Business Development and Market Research”. The new unit is responsible for the expansion and retention of companies in the Florida marketplace and serves as the information clearinghouse for the collection and dissemination of public insurance data. The Business Development Section is responsible for promoting the benefits of expanding or moving lines of business to Florida and facilitating the process for established and new insurance companies. Their primary role is to identify solvent companies, communicate the positive aspects of the Florida marketplace, and encourage companies to apply for a Certificate of Authority or license.

We hope that all of these changes will achieve a reduction of risk, larger catastrophe reserves, and the infusion of new investment capital. At the same time we realize that a mega-catastrophe in any state, absent a federal backstop, devastate our economy and its citizens, and severely cripple the U.S. property insurance industry. The $100 billion event is coming sooner rather than later. The economic result or impact will depend largely on what we do now.

Thank you for your time today. Ladies and Gentlemen of this Committee, I commend you for your vision in holding this hearing. The economic security of our country is dependent to a large extent on the result of your deliberations.