REINSURANCE
ASSOCIATION
OF AMERICA

STATEMENT

TESTIMONY

OF

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IS AMERICA'S HOUSING MARKET PREPARED FOR THE NEXT NATURAL CATASTROPHE

BEFORE

THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

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Chairman Ney, Ranking Member Waters and Members of the Subcommittee on Housing and Community Opportunity:

My name is Dennis Burke and I am Vice President of the Reinsurance Association of America (RAA). It is an honor to appear before you on behalf of the RAA. The RAA is a national trade association representing property and casualty organizations that specialize in reinsurance. The RAA membership is diverse, including large and small, broker and direct, U.S. companies and U.S. subsidiaries of foreign companies. Together, RAA members write nearly 2/3 of the gross reinsurance coverage provided by U.S. property and casualty reinsurers and affiliates.

Reinsurance is commonly referred to as the insurance of insurance companies. Reinsurance plays a critical role in maintaining the financial health of the primary insurance marketplace and ensuring the availability of property and casualty insurance for U.S. consumers and businesses. Reinsurance is used for several reasons. One of the most common purposes is for a primary insurance company to transfer the risk of losses from catastrophic events such as hurricanes, earthquakes, and in the case of September 11, 2001, acts of terrorism. To that end, reinsurers have assisted in the recovery after virtually every major U.S. catastrophe over the past century. For natural disasters typically one-third of the insured losses are passed on to reinsurers and in the events of September 11, two-thirds of the losses were absorbed by the reinsurance industry.

As the Committee has called this hearing to address the question of "Is America's Housing Market Prepared for the Next Natural Catastrophe?" I am here to share with you the reinsurance perspective on this most important question. The Committee has also expressed an interest in receiving the RAA's comments on H.R. 4366, legislation that will create a federal reinsurance program for natural disasters. To address both of these issues my testimony will focus on: 1) the 2006 reinsurance marketplace; 2) the RAA's general position on state and federal catastrophe funds; and 3) RAA's specific concerns with H.R. 4366.

The Property and Casualty Reinsurance Marketplace Today

An important component of ensuring the availability of homeowners' insurance is the reinsurance market and its capacity, the amount of reinsurance it is able to provide to primary companies with reinsurance protection. The U.S. attracts reinsurance capacity from all over the world and global reinsurers view U.S. catastrophe risk an essential component of their diverse assumed risk portfolios. The important role reinsurance plays in our nation's economy was demonstrated during the 2004 and 2005 hurricane seasons. As you are aware, in 2004 there were four major hurricanes that hit Florida resulting in $30 billion of damage. The global reinsurance industry paid approximately one-third of those losses, enabling insurance companies who purchased reinsurance to honor their obligations to their homeowner policyholders. Despite this huge financial hit to reinsurers, there were no reinsurer insolvencies and the reinsurance market was able to meet the primary insurance community demand for the 2005 hurricane season.

The hurricane season of 2005 turned out to be a year of unprecedented losses in terms of frequency and severity. The insurance/reinsurance industry weathered the single largest loss in the industry's history (Katrina). Insured Katrina losses were an estimated $45 billion, even greater than the projected $35 billion in 9/11 losses. The 27 named hurricanes and tropical storms in 2005 set a new record, an aggregate total of $80 billion in insured losses. The Big Three: Katrina, Rita and Wilma produced losses estimated to be as high as $60 billion. The reinsurance industry once again played a critical role, providing stability to the insurance market, by paying approximately one-half of all of these losses. Even with these unprecedented losses there were no resulting reinsurer insolvencies.

It has been said that the 2005 hurricane season was an "earnings event" for insurers, rather than a "capital event." The effect of the hurricane losses on the primary industry was mitigated by two major factors: the global reinsurance market paid for 50% of these losses; and the insurance industry was experiencing an excellent year financially. Even after the storms, the primary industry profit was $45 billion for 2005. Thus the effect of these two factors is that the storms impacted earnings but did not reduce industry surplus.

Despite the resilience of the reinsurance industry to respond to these record breaking financial losses, a few primary insurance companies in the industry are suggesting the 2005 hurricane season has demonstrated the need for a federal reinsurance program for natural disasters. The RAA does not believe market conditions warrant the creation of a federal program.

First, remember the primary insurance industry made a profit in 2005.

Second, let us look at the capital markets, response in late 2005 and 2006. As they did in 1993 after Hurricane Andrew and 2001 after the terrorism losses of 9/11, the capital markets promptly provided new reinsurance capital and capacity in response to the 2005 hurricanes. Since late fall 2005, approximately $21 billion in new capital has been raised. Of that capital, $7.5 billion was invested in new start up reinsurance companies; the remainder replenished the capital positions of existing reinsurers. In addition to that new capacity, an additional $3 billion was invested in special purpose vehicles, whose investors, such as hedge funds, collaborate to provide extra underwriting capacity to existing reinsurers for property and catastrophe retrocessions and other short tail lines of business. Thus $24 billion in new capital has been raised in the reinsurance industry since Hurricane Katrina on August 29, 2005. An additional $4 to $6 billion (estimated) was invested in new and existing catastrophe bonds.

So what does that mean for actual reinsurance capacity to provide natural disaster protection for primary insurance companies for 2006? Despite the unprecedented losses in 2004 and 2005, private market reinsurance capacity increased in 2006. The private reinsurance market is financially strong and diverse. Reinsurance capacity continues to be adequate in most markets.

However, in 2006 demand increased in some peak zones at a greater rate than the supply increase due to: rating agencies requiring more capital; reinsurance modelers increasing loss predictions; and insurance company managements' desire to purchase more protection. Rating agencies determined that companies with catastrophe exposures needed additional capital to support their ratings. Insurance catastrophe modelers revised their models due to new data and a belief that we are entering into an era of increased hurricane frequency and severity. Insurance company managements also have reacted due to a changed perception of risk. Such managers have seen the impact of increased hurricane frequency and severity on their losses and want to purchase more reinsurance protection. At the same time as demand is increasing, reinsurers are reevaluating (known as re-underwriting in the industry) the losses that their ceding insurers could suffer. The confluence of these events has resulted in reinsurance prices increasing.

The RAA believes this imbalance will be temporary, however. As the events after Hurricane Andrew suggest, typical insurance and reinsurance cycles involve temporary spikes in pricing, followed by new market participants, leading to increased competition and price moderation. Ultimately, free markets will create a more diversified insurance and reinsurance market that will spread risk widely, increasing capacity and price competition.

RAA's Position on State and Federal Catastrophe Funds

At the core of H.R. 4366 is the creation of state and federal catastrophe funds to provide reinsurance. In H.R. 4366, the U.S. Treasury would sell reinsurance to state catastrophe funds. The state catastrophe funds would then sell reinsurance to insurance companies. The stated intent is that this would result in insurance companies providing more homeowners with insurance in high-risk areas. The RAA believes that there are many flaws with state catastrophe funds. There is no evidence that they result in the availability of more homeowners' insurance. The creation of both a state and federal reinsurance fund would displace the private reinsurance market. Since H.R. 4366 aims to create more state catastrophe funds we wanted to focus the Committee's attention on many of the flaws associated with state catastrophe funds.

The RAA believes that natural disaster risks are insurable in the free market and that state catastrophe funds significantly displace the private market. State catastrophe funds are not a long-term solution. The catastrophe fund concept is one that relies on public subsidies or cross-subsidies from other insurance lines to pay for natural disaster risk, rather than relying on current affected property policyholders paying those costs.

Only Florida has a catastrophe reinsurance fund that meets the standard of the bill, and the Florida Hurricane Catastrophe Fund does not rely solely on its premiums to pay its hurricane losses. The Florida Catastrophe Fund is also broke and in debt. The model of the Florida Catastrophe Fund is one that offers insurers inexpensive reinsurance premiums up front, because it is back loaded - on the backs of the taxpayers, as the current situation demonstrates. When a hurricane occurs which requires the Florida

Catastrophe Fund to pay losses in excess of its cash balance, the Catastrophe Fund issues bonds. The bond debt is not paid by the insurance companies who received the cheap reinsurance. Instead, it is paid by assessing/taxing (the terms are interchangeable) Florida policyholders of other lines of insurance, such as automobile insurance and commercial insurance. So, the effect is that insurers have offloaded a substantial part of their property risk to a government catastrophe fund, and that government is then forced to tax its citizens to make up for the revenue shortfall caused by the low catastrophe fund reinsurance premiums. Real world experience tells us that when government markets like the Florida Catastrophe Fund under-price the market, business will flow to them. That is what happens over time with a government catastrophe fund - it will continue to displace the private reinsurance market and taxpayers will continue to make up the difference.

State catastrophe funds also violate one of the fundamental tenets of insurance-spreading the risk. Private reinsurance spreads the risk globally and the cost of the reinsurance is paid up front. Of the losses caused by Hurricanes Katrina, Rita and Wilma, reinsurers paid approximately 60%, with global reinsurers paying over three-quarters of that amount. A state catastrophe fund concentrates risk in one jurisdiction and shifts the financial risk of catastrophe losses from the private sector insurers to insurance buyers and taxpayers.

It is important that Congress recognize that state funds like the Florida Hurricane Catastrophe Fund are a “pay me later” approach- there is no free lunch- someone will pay for the losses. Private reinsurance is a “pay me now” approach with insurance companies paying reinsurance companies an appropriate risk premium up front. The “pay me later” approach of state catastrophe funds costs homeowners, not insurers, since policyholders are obligated to pay any shortfalls in the state catastrophe fund claims paying ability.

State catastrophe funds also create unfair cross subsidies. First, coastal and earthquake prone properties are subsidized by property policyholders that cannot afford or choose not to live in such hazard zones. In addition to property policyholder subsidies, the catastrophe funds rely on cross-subsidies to pay for hurricane risk rather than relying on current affected property policyholders paying those costs. For instance in Florida, Floridians with cars, small businesses, school districts, day care centers, renters, professionals, and business owners – anyone with a property and casualty insurance policy (other than medical malpractice and workers' compensation) - will pay off the billions of dollars in bonds authorized for the Florida Hurricane Catastrophe Fund shortfalls. These policyholders, even those far from the coast, will pay annual assessments needed to pay off the hurricane bonds that will benefit the coastal property owners.

These are just some of our observations regarding state catastrophe funds. We urge Members of the Committee to take a serious look at the inherent problems with state catastrophe funds and whether they would actually create an improved homeowners' insurance market. We strongly suggest that such funds do not.

<u>RAA's Concerns with H.R. 4366</u>

Over the last 15 years, the RAA has worked with Members of Congress and their staffs on many different legislative proposals to create federal reinsurance programs. We believe that natural catastrophe risk is insurable in a free market. We do not believe the creation of a federal reinsurance program solves the homeowners' insurance availability problem. It ignores the many constraints that are occurring now in the private market. We believe public policymakers should make it their top priority to remove regulatory constraints from the private insurance market's ability to willingly insure risk. By removing regulatory constraints policymakers will maximize private sector risk bearing. These regulatory constraints include: price controls, coverage mandates, and involuntary residual market facilities and associated assessments. If policymakers follow competitive, free market principles, a federal natural disaster reinsurance fund is unnecessary.

The RAA offers the following concerns with H.R. 4366:

1. The trigger levels for the federal reinsurance program are too low and will interfere with the private marketplace. The legislation provides for the sale of federal reinsurance to a state reinsurance fund at a level as low as $25 billion, a relatively low attachment point. These are levels of losses where the private reinsurance marketplace is currently providing capacity. If such a program had been in place last year with such low trigger levels, rather than the private insurance and reinsurance markets paying for the insured losses associated with Katrina, Rita and Wilma, the federal government through its reinsurance fund would have paid for these losses. In past Congresses proposed trigger levels for federal involvement have been set at a 1 in 250 year event.
2. There is no assurance that a federal reinsurance program will result in more availability of homeowners' insurance. Unlike the Terrorism Risk Insurance Act where the quid pro quo for the federal reinsurance is that insurers must offer terrorism insurance on the same terms and conditions as they offer other lines, there is no requirement that insurers who benefit from the federal reinsurance offer more homeowners' insurance. The intent of the legislation is significantly undermined without such a requirement.

3. The federal reinsurance will be under priced because the legislation does not include language that requires the federal government to add a risk load reflecting the true cost of capital when pricing the reinsurance. In the private reinsurance market a catastrophic risk load is required on all pricing, thus there is no way the private reinsurance market can compete with the federal government. This puts taxpayers at a significant risk and further displaces the private reinsurance market.
4. H.R. 4366 strips many of the private sector protections contained in previous bills. In past Congresses, Members of Congress were very concerned that the federal program would compete with the private sector. Thus, various amendments were included that prevented the federal government from competing with the private market. For example, previous bills provided for a "private sector right to compete." This provision provided the private sector an opportunity to step in the shoes of the federal government and sell the reinsurance. The absence of these protections only exacerbates the problems with H.R. 4366.
5. Many supporters of H.R. 4366 suggest that the federal program is necessary because reinsurance prices are too high. The RAA believes that a free market should be allowed to work and that it is totally inappropriate to create a federal program simply because of the concepts of supply and demand playing out in the free market. As we learned following Hurricane Andrew in 1992, markets need time to adjust but they are resilient and the supply/demand equation will come back into balance.
6. A federal fund that sells reinsurance to state catastrophe funds concentrates all of the risk associated with natural disasters in the government. A private market diversifies this risk, spreading it globally. A classic example of the importance of

a diversified insurance/reinsurance market occurred in 2005. In 2005, of the total reported losses, U.S. insurers paid (all approximate) 41%. The other payers and their percentage of losses paid were: U.S. reinsurers 11%, Bermuda reinsurers 24%, European reinsurers 13%, Lloyds 9%, and all others 1%. If H.R. 4366 were to become law, most of this risk would no longer be spread across the global insurance/reinsurance market; instead it would be concentrated in the State and Federal governments.

Conclusion

The reinsurance industry has responded to every major catastrophe that has hit the United States over the past decade and century. Reinsurers have served a vital purpose in providing insurers with the necessary capacity to ensure that homeowners are able to obtain insurance. A federal reinsurance program created to enhance state reinsurance programs would displace the vibrant private reinsurance market to the detriment and cost of the U.S. taxpayers. The RAA believes that natural disaster is an insurable risk in the private sector if the free market is allowed to work. A free market will give insurers the tools they need to better provide homeowners' insurance at an appropriate risk-based cost.