TESTIMONY OF ERNST CSISZAR
ON BEHALF OF
THE PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA
BEFORE THE
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY
CONCERNING
"IS AMERICA'S HOUSING MARKET PREPARED FOR THE NEXT NATURAL CATASTROPHE"

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My name is Ernie Csiszar and I am President and CEO of the Property Casualty Insurers Association of America (PCI). PCI is a trade association representing over 1,000 property/casualty insurers that write 40 percent of the homeowners insurance sold in the United States. Thank you for the opportunity to appear before you today and to present information regarding natural catastrophes, the impact of these disasters on homeowners insurance and housing markets, and what can be done to address future major natural disasters.

Introduction

The Committee has requested comments on a number of important questions, including the role PCI and its members play in supporting housing markets in the United States; whether there's enough insurance capacity to cover homeowners in the event of a major natural disaster; if the private market has been tested sufficiently to give lawmakers an adequate indication that the market is prepared; what lawmakers can do to ensure that the private market is ready to handle a major disaster; models that have worked well for states or foreign governments that should be considered; whether we anticipate that either rising insurance rates or a lack of availability will adversely impact the housing market; whether natural catastrophes in one area of our nation affect the rates of homeowners in other areas; the long-term budgetary implications of disaster recovery expenses incurred by the federal government; steps that need to be taken to expand private-sector capacity for insuring disaster losses; and the impact of decisions by individual insurers to reduce or eliminate coastal exposures on consumers' ability to purchase adequate protection and on insurance markets in general?

PCI believes that developing effective public policy solutions regarding natural catastrophes is one of the most significant issues facing the nation and the insurance industry today. Experts agree that America faces the prospect of more frequent and severe natural disasters in the coming decade. Moreover, significant development, population growth, and rapidly rising real estate prices in areas prone to natural disasters exacerbate the potential for larger human and economic losses, requiring stronger loss prevention and mitigation and greater financial resources for recovery.

Comments on the Catastrophe Problem

PCI members play a pivotal role in supporting housing markets by providing the products and services needed to protect homeowners, lenders, businesses, and communities against exposure to natural catastrophes. Without a healthy private homeowners insurance market, it is impossible to imagine the robust housing market America enjoys today.

Over the past two years, homeowners insurance markets have been tested as never before. Catastrophe losses in 2005 totaled some $57 billion, nearly doubling the previous record losses in 2001. Hurricane Katrina itself caused $40 billion, in insured losses, surpassing the $32 billion from 9/11.

The vast majority of claims from last year's storms have been paid and there is no doubt that the market has the financial capacity to meet its obligations. But the question of whether last year's claims will be paid in full (they will) is not the most important issue in our view. The better question is whether the market has, or is building, the capacity to pay exposures the nation will face in the future.

Given the very serious catastrophe losses we've seen over the past several years and the significance of this issue for our membership, our organization has devoted considerable time and effort to study the problems associated with natural disasters. Over the past nine months, we have had a special task force of our Board of Governors considering the catastrophe problem and have developed a policy framework to guide our thinking.

We can't answer definitively the specific question of whether there is enough capacity to address a "major natural disaster". There are too many possible events that can happen – indeed, that have happened in our history. We can tell you that experts believe that there are catastrophe exposures facing us that may be beyond the capacity of the capital currently available.

There are several fundamental issues that have to be addressed:

> 1. First, America clearly faces the prospect of increased frequency and severity of major hurricanes and the continuing threat of other major natural catastrophes including earthquakes, floods, tsunamis, and volcanic eruptions. Hurricane forecasters have predicted another very busy storm season this year and catastrophe modelers are telling insurers they are in a prolonged period of increased severe storm activity. Seven of the ten most costly natural disasters in U.S. history have occurred since 2004. We can't afford to ignore this reality.
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> 2. Second, America is experiencing significant development, population growth, and rapidly rising real estate prices in areas that are highly prone to natural disasters. Even if storms were no more frequent or severe in the past, this pattern would mean that future storms would be more damaging and more costly to insure. As a result, the nation faces growing exposure to significant catastrophe losses and increasing costs of recovery.

3. A growing number of Americans have a significant and increasing portion of their net worth exposed to catastrophic loss. The impact of future major natural catastrophes on the economy will be larger and will likely lead to significant public policy debates over how best to address this risk.

4. As insurers, we would like to rely on private markets alone to solve this problem with prices set according to the risks assumed. We think that such a system would go a long way toward establishing the incentives needed. At the same time, we have to recognize that our segment of the industry does not operate in an unregulated market. Our members work in a world where prices and coverages are highly regulated and generally are not allowed to respond freely to changing risks or conditions. This is the opposite of the structure in which world catastrophe reinsurance markets operate. Our members have faced restraints on their ability to pass along the real cost of the reinsurance they use, which ignores the economic reality imposed on them by the reinsurance market. In other cases, catastrophe reinsurance has simply been unavailable for the risks our members face.

In addition, since Hurricane Katrina we have seen politically-motivated litigation by a state attorney general seeking to require coverage where none exists. This is an assault on the sanctity of contract, a principle so fundamental that it is enshrined in our Constitution. These restrictions and legal challenges impair the ability of markets to respond, prevent markets from providing accurate risk signals, and discourage new capital from entering these markets.

5. With respect to prevention and mitigation of losses, states frequently have outdated and inconsistent requirements for building codes, code enforcement, and other prevention/mitigation tools in areas dangerously exposed to disasters. These weaknesses imperil lives, property, and policyholder resources.

In summary, while insurance capacity to cover catastrophe exposures is growing and the market has generally done well in protecting against these losses, we believe there are exposures that may, in the right circumstances, overwhelm the existing system. I am not here to tell you that we face a crisis in homeowners markets today. But I do want you to know that we face, and should prepare for, catastrophe losses far larger than before for which a range of policy solutions should be considered.

Policy Options to Consider

I would suggest four major areas for consideration.

Reduce Exposure to Catastrophe Losses

First, we need to do more to control and reduce catastrophe exposure. I would suggest the following:

- State and local governments should urgently and immediately review their building codes in catastrophe-prone areas. Wherever needed, they should upgrade their codes. Stronger building codes protect lives and significantly reduce property damage and repair costs. In a highly competitive insurance market, those savings will be passed directly back to consumers. Some have argued that it costs too much to rebuild to meet modern building code standards. Louisiana State University's Hurricane Center has estimated that the marginal cost of building a structure to meet the wind-borne debris requirements in the International Residential Code is between 1.5 and 4.5 percent of additional cost. On a single-family home with a $100,000 mortgage, that works out to about $27 extra dollars per month. We think such investments are vital.

- A second idea is the establishment by the federal government of incentives for greater investment in loss prevention and mitigation. Let me offer several ideas: (1) the insurance industry's Building Code Coalition has recommended that enhanced disaster mitigation grants under the Stafford Act be provided for states that adopt stronger state-wide building codes; (2) Rep. Tom Feeney (R-FL) has proposed legislation (H.R. 4836) to create a special catastrophe savings account for purposes of allowing homeowners to build up, tax-free, funds for payment of qualified catastrophe expenses. We have not yet studied Rep. Feeney's proposal in detail and have not established a position on the bill, but we need this type of creative thinking; (3) the federal government could consider whether to grant special tax credits for qualifying expenditures by homeowners to retrofit their homes to better protect against disasters. An investment in this protection now could save many dollars later in disaster assistance and other government programs.

- We believe state and local governments must take seriously the need to restrict development in catastrophe-prone areas. Professor Roger Pielke, Jr. of the University of Colorado at Boulder is on point when he says, "More storms like Katrina are inevitable. And the effects of future Katrinas and Ritas will be determined… by the decisions we make now about where and how to build and rebuild in vulnerable locations."[1] This is not only an issue for single family homes. Ongoing condominium and commercial development on our nation's barrier islands or the wetland marsh areas threaten the same risks.

- We believe greater steps can be taken for preparedness. As a first step, PCI has recently completed development of a new PCI Regulators' Kit-Recommendations for Disaster Preparation and Response. We will begin sharing this kit in coming weeks with insurance regulators in the most catastrophe-prone states. This kit contains model regulations covering five critical areas, including: establishing an Insurance Emergency Operations Center; disaster claim reporting requirements; cancellation and non-renewal of insurance under disaster

[1] "Managing the Next Disaster," Roger A. Pielke and Daniel Sarewitz, The Los Angeles Times, September 23, 2005.

conditions; suspension of premium payments under disaster conditions; and mediation of disputed claims. These regulations are modeled on those developed in Louisiana last year and, if adopted, could improve the necessary coordination and communication after a catastrophe.

Fix the Flood Program

Second, we believe Congress should complete its efforts to reform the National Flood Insurance Program (NFIP). The NFIP is a necessary policy response to an uninsurable peril and must be continued. However, the program needs numerous reforms, the majority of which are contained in the reform bills pending in both the House and the Senate. As currently structured, the NFIP does little to discourage development in high risk areas, does not provide the level of protection needed by consumers and has not achieved the breadth of participation needed. PCI encourages your swift consideration and passage of the pending NFIP reform legislation.

Expand Private Sector Capacity

Third, as several of your questions anticipate, a key part of the solution to natural catastrophe exposure is to expand private sector capacity to handle the risk. As I noted earlier, we strongly support this direction and any efforts to tie prices more closely to the underlying risks insured. But homeowners insurance markets are heavily regulated in all aspects of their operations. We face significant regulatory constraints, particularly in rating, but also in other areas, that inhibit effective market responses and discourage capital from entering these markets. There are several things lawmakers can do to address this problem:

- First, policymakers should give insurance markets greater freedom to respond to the exposures we face. In free markets, prices and terms of coverage tell consumers the true cost of insuring against catastrophes and the most efficient means of funding exposures. Regulators often fear that giving up regulatory control will make the problem worse and invite consumer backlash. Based on my experience as the insurance commissioner for South Carolina, where I helped slash regulation in the market for car insurance, I can tell you the results were just the opposite. Free markets encourage new capital to enter where insurance protection is needed and develop more capacity, not less. PCI will support state legislative initiatives intended to remove regulatory barriers to free markets for catastrophe insurance and will oppose enactment of new barriers. We will be working with our partners in the states to develop specific proposals that can be enacted in key state legislatures next year. At the federal level, we would encourage you also to consider measures you can take to encourage greater market freedom, such as enactment of the SMART Act.

- We will also continue to point out, wherever we can, the extremely damaging effects on free markets and capital allocation of politically-motivated litigation, such as that initiated after Hurricane Katrina by Mississippi's attorney general.

This type of litigation does great harm to the principle of sanctity of contract and can only discourage new sources of capital from entering the state.

We would also encourage your review of two additional possible market responses:

- First we are continuing to examine the potential benefits of establishing voluntary, tax-deferred catastrophe reserves. Legislation previously introduced by Rep. Mark Foley (HR 2668) would create the opportunity for this tool to be used and it deserves your consideration.

- Second, we will be examining specific steps that might be taken to remove regulatory, legal, accounting, or tax barriers to further growth in the catastrophe bond market. This market provides another outlet for catastrophe risk financing and introduces new sources of capital and competition. While we don't believe the cat bond market will ever displace traditional reinsurance, market participants tell us that bringing more of these deals "onshore" in the U.S. and reducing a variety of regulatory barriers would permit the market to grow.

State and Federal Government Involvement

Finally, you've asked about regulatory models that might be examined. I'd like to offer several comments:

- First, based on our review, we believe the growth in natural catastrophe exposures is of sufficient magnitude in some states that they may require consideration of state natural catastrophe funding facilities. Recent events show that the industry will respond to severe catastrophe events, but private markets may not always have the capacity to fund increasingly more frequent exposure to "mega catastrophes" or to a series of very large events in a single season. For "mega catastrophes," we are concerned that private markets may not always have all the tools needed. In these cases, we will look at specific conditions in each state to determine whether a catastrophe fund might be helpful.

  When we consider a cat fund for a state, we'll be looking particularly to see: (1) whether private markets have freedom to respond to market conditions; (2) whether care has been taken to prevent a catastrophe fund from damaging private markets or preventing new capital from entering the market; and (3) that their funding doesn't rely on cross-subsidies across lines of business. By their nature, cross-subsidies damage the ability of markets to provide strong price signals and incentives for behavior. Having said that, we believe there may be cases and states where a catastrophe fund can be part of a well-rounded solution and must be considered. We believe they can be structured to avoid crowding out private market capacity while still offering benefits to consumers in some cases.

- Second, we would also suggest that there may be some mega-catastrophe exposures that are beyond the capability of the private market and even of an individual state catastrophe fund to address. In these instances, it may be necessary for the federal government to offer liquidity protection to state catastrophe funds at a very high level, consistent with the maintenance of stable markets and avoidance of widespread insurer insolvency. Federal involvement may be essential if the nation suffers repeated mega-events within a short time period. Lest anyone think such a scenario is far-fetched, I would remind you of how close Hurricane Rita came to hitting Houston last year, only a few short weeks after Katrina devastated New Orleans and the Mississippi coast. It is not inconceivable that several of our major cities could be struck by Category 4 or 5 storms within a single season, or that a major earthquake could strike in the same year.

There are many ideas for how a federal role could be structured, but we would suggest that one idea worth considering is whether a federal catastrophe financing facility could offer credit financing to state catastrophe funds, intended to provide access to liquidity to meet immediate claim requirements in the event of a mega-catastrophe or a series of very large events. A key advantage of this approach (but not the only advantage) would be to offer the benefits of better timing risk management, while limiting the offer to state catastrophe funds and thus helping to minimize any potential disruption in private markets.

We are very mindful of the need to be extremely careful in structuring any federal role and of the overriding need to attract new private capital to the market. Accordingly, we also believe that any federal financing role must also include measures intended to promote freedom for markets to respond to these exposures, including meaningful limitations on the ability of participating states to control or suppress rates or to maintain other unnecessary restrictions on markets. The point of tying standards for market freedoms to the creation of a federal financing facility is to provide incentives for the states themselves to do everything they can to attract private capital before asking for federal assistance. In addition, we believe any federal credit should be specified in advance, as private sector lines of credit are, in order to prevent political pressure from influencing what should be a market-based credit agreement. We would have the same concern about the need for a federal program to avoid cross-subsidies and other negative design elements as we have for state programs.

My main point, however, is to tell you that we think there may be a role, properly structured, for the federal government to play in assisting the financing of mega-catastrophe risk and we believe it should be given further review by Congress. We do not agree with those who would uniformly reject any such role out of hand.

Conclusion

Again, let me thank you on behalf of PCI and our members for the opportunity to appear before you today, respond to your questions, and provide you with our input on possible solutions to the catastrophe problem. We believe this is one of the most serious public policy issues facing our nation and is deserving of your time and thoughtful attention. I look forward to working with you in the future on this very important issue.