UNITED STATES HOUSE OF REPRESENTATIVES
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"IS AMERICA'S HOUSING MARKET PREPARED FOR THE NEXT NATURAL CATASTROPHE?"

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Good afternoon. My name is Marc Racicot. I am president of the American Insurance Association (AIA). AIA represents major property and casualty insurers doing business across the country and around the world.

I appreciate the opportunity to testify this afternoon on a matter of utmost importance to AIA and the nation as a whole: insuring natural catastrophe risk. I commend the Committee for your leadership in examining proactive approaches to the management of this risk.

Hurricane Katrina and the other devastating 2004/2005 storms focused renewed attention on the role of the private sector insurance industry in managing natural catastrophe risk. Fortunately, despite last year's record-breaking losses – and predictions of higher-than-average hurricane activity levels for the foreseeable future – the insurance industry is well positioned financially to manage this risk. However, to do so effectively, insurers must have the tools to measure and reduce catastrophe risk, and the insurance regulatory system must allow rates to reflect the real costs of coastal exposure.

Recent Experience

The 2005 hurricane season was, by far, the worst year on record. Records were set for the number of named storms (28), the number of hurricanes (15), and the number of hurricanes reaching category 5 status (4). The season also was remarkable for its early beginning and late end.

Beyond these statistics, the hurricanes of 2005 underscored the human toll of catastrophes. Ten months after Hurricane Katrina, thousands of former Gulf Coast residents remain homeless. The City of New Orleans has yet to rebuild its infrastructure or housing stock, recover its economic base, or reclaim its unique spirit. Some experts believe it will take years, if not decades, for the recovery process to be complete.

For insurers, 2005 was the most costly year on record, with insured losses from Hurricane Katrina estimated to reach $40 billion, and total catastrophe losses for the year totaling more than $70 billion, taking into account property insurance losses as well as automobile, marine, energy, commercial liability, workers' compensation and other insurance losses. Insurers adjusted more than three million hurricane claims, 1.6 million claims from Hurricane Katrina alone.

Insurers are fully committed to working with local, state, and federal policymakers to “bring back the Gulf.” We recognize that the insurance mechanism plays a vital role in preparing for, and responding to, future natural catastrophes. At the same time, we believe that long-term solutions must look beyond insurance. As a nation, we must make sure we are prepared for, and can respond quickly to, the spectrum of losses that may flow from a major catastrophe. We welcome the opportunity to be fully integrated into the planning process, in terms of logistics, communications, and coordination with relevant government agencies and private groups.

The Homeowners’ Insurance Protection Act

AIA has closely analyzed the Brown-Waite Shaw Homeowners’ Insurance Protection Act. The legislation would create a federal reinsurance mechanism to encourage states to establish catastrophe funds (Cat Funds) for homeowners insurance. The bill also prohibits price gouging for products following a natural disaster, establishes the National Commission on Catastrophe Preparation and Protection, and directs the Government Accountability Office (GAO) to study availability of flood insurance coverage.

The legislation’s Cat Fund provisions are based on the premise that large-scale natural catastrophes are uninsurable by the private sector, and that the government should step in to provide capacity. AIA respectfully disagrees with this premise. Despite last year’s record-breaking losses, private sector capacity for dealing with natural disasters has grown – with approximately $28 billion in new capital entering this market since Hurricane Katrina struck – and is adequate to spread and manage this risk. Even the leading insurance industry proponents of Cat Funds have secured significant amounts of private reinsurance coverage. As Warren Buffett recently told investors at the Berkshire Hathaway annual meeting, "We're willing to lose many billions of dollars in a catastrophe if we think we've been paid adequately for it." Moreover, it is important to recognize that new government programs are no panacea for natural catastrophe risk, and that such programs can encourage and lead to inefficient allocation of capital, unfair subsidization, and increased (and unwise) building in catastrophe-prone regions.

Although we do not support the creation/expansion of federal or state natural disaster Cat Funds, we do support other provisions in the Brown-Waite Shaw bill. After disasters, the prices of virtually all building and construction supplies increase, often exponentially. This greatly – and unfortunately – increases both insured and uninsured costs for policyholders.

Similarly, fraud can flourish. For example, people claiming to be contractors or roofers demand substantial “down payments” from homeowners to do repairs and then disappear. Insurance claim fraud also proliferates after a disaster. The last thing policyholders in the affected areas need is to bear extra costs of artificial pricing and fraud by contractors and other opportunistic individuals/businesses.

We also support the establishment of a national commission and believe that such a Commission provides an opportunity to look beyond insurance to such critical issues as public education and mitigation.

In addition, we support reforms to the National Flood Insurance Program (NFIP) to make sure that the NFIP provides an effective safety net, while encouraging homeowners and businesses to engage in prudent risk management behavior.

Needed Reforms

Although the property insurance market currently is under stress in several Atlantic and Gulf Coast states, the solution rests in improving, not displacing, private sector ability to serve homeowners and businesses in the path of potential storms. The challenge is to identify and advance positive system changes that will allow markets to manage natural catastrophe risk without establishment of new government programs or a bail-out from taxpayers living in less-risky areas. Beyond their benefits to the insurance system, many of these reforms will help prepare individuals and communities for future catastrophes, educate them about the benefits of risk management, and, most importantly, reduce the personal and economic toll of hurricanes and other natural catastrophes.

AIA’s reform agenda includes both federal and state initiatives that could provide short- and long-term benefits. All should be put in place as quickly as possible. The agenda we have developed consists of four major components:

- *protective measures* to keep people out of harm’s way and strengthen their ability to withstand future hurricanes;
- *regulatory and legal reforms* to improve the stability of insurers’ operating environment;
- *tax incentives* to encourage residents to take more responsibility for hurricane preparation and response; and,
- *National Flood Insurance Program (NFIP) reforms* to assure that NFIP continues to play a vital role in protecting the region from the generally uninsurable risk of flood.

Although some of these reforms relate specifically to hurricanes, many of the tools described here can be modified to address earthquake risk and other natural perils.

I. *Protective Measures*

Natural catastrophe losses can be reduced through mitigation, including effective building codes, policies that encourage retrofitting of existing buildings, and sensible land use planning. From a community perspective, mitigation can make the difference between a community recovering relatively quickly from disaster – with citizens returning to homes and jobs – and a community remaining devastated and economically stagnant for many months or longer. From an insurance perspective, mitigation helps preserve market capacity, reduce solvency risk, and enhance insurer ability to cover more risks (assuming a flexible regulatory environment and stable legal environment).

- **Strong building codes help reduce deaths, injuries, and property damage from natural catastrophes and more routine property losses.** Building codes set minimum safety standards for design, construction, and maintenance of residential and commercial buildings. They are based on established scientific and engineering principles that have been thoroughly tested to ensure safe, predictable building performance in wide-ranging situations. Recent benefit/cost studies indicate that each dollar spent to comply with stronger minimum code provisions for natural hazard vulnerability reduction results in long-term savings of $3 to $16. Strong statewide building codes, with no opt-out features, are needed in every state, particularly those with significant catastrophe risk. Statewide building codes also must stay current and consistent with the latest mitigation technologies.

- **Enforcement of, and compliance with, building codes is critical.** Enforcement of building codes is as important as their enactment. Independent studies following Hurricane Andrew revealed that lax code enforcement contributed to total damage. Clearly, training for many new inspectors, as well as contractors, will be needed during the post-hurricane building booms and to implement/enforce new codes.

- **Land use planning can help make communities more disaster resistant.** Hurricane and other catastrophe risk should be factored into land use planning decisions in order to protect lives and property. Research shows that effective land use planning also helps reduce insured hurricane losses. States should enact laws to require local governments to prepare comprehensive plans, specifically taking natural disasters into account in local planning and zoning decisions. Even in jurisdictions without such mandates, the state could offer guidance to local governments on land use planning, even as a voluntary guideline.

- **Disaster awareness and preparedness can mitigate the negative personal and financial impact of a catastrophe.** Natural disasters present a real threat to all individuals and businesses. Having a disaster preparedness plan in place before a disaster strikes can reduce losses, as well as potentially save lives. It can also make the difference between a business continuing its operations after a disaster and closing down temporarily or permanently, and whether residents return to their communities or move to another location.

II. *Regulatory Modernization*

Central to insurers' ability to manage hurricane risk is their ability to predict risk and charge appropriate premiums for bearing such risk. Unfortunately, the political climate in many states includes arbitrary rate suppression, expensive and unpredictable regulatory mandates, and other regulatory and legal burdens. These must be addressed in order to create a more stable business environment for insurers making a capital commitment to the region.

- **Risk-based pricing is critical to *any* viable insurance system.** Property insurance rates must be based on insurer evaluation of underlying catastrophe risk in hurricane-prone areas. Risk-based pricing, utilizing the best possible scientific information, is essential to insurers' ability to provide protection against hurricanes. Equally important, appropriate pricing encourages loss prevention, thus reducing the individual and societal costs of disasters.

  Given the opportunities for politically influenced government rate suppression, all states should repeal requirements for rate approval by state insurance regulators. If a free market system cannot be achieved in the short-term, interim incremental measures are essential. One way this might be achieved is by shifting the burden of proof, so that the insurance department must prove that a filed rate is excessive; another is by allowing insurers to raise or lower rates by a specified percentage (within a "flex band") without regulatory approval.

- **Computer-based disaster models help insurers measure catastrophe risk and reduce likelihood of insurer insolvency.** Since Hurricane Andrew in 1992, the insurance industry has significantly improved its ability to monitor natural catastrophe accumulations through computer-based models that measure risk on a probabilistic basis using sophisticated simulation techniques. The models are not perfect; Hurricane Katrina prompted some improvements, which recently were announced by the major modeling firms. Just as insurers use models to manage catastrophe risk, states should accept their use in the ratemaking process, and protect the confidentiality of proprietary models. However, some states remain opposed to models, particularly if they indicate that higher rates are needed for actuarial soundness. Ignoring scientific models is another form of artificial rate suppression that increases subsidization, reduces incentives for mitigation, and ultimately undermines the role of the private sector in managing catastrophe risk.

- **Higher deductibles can make insurance more affordable; tax incentives can help policyholders pre-fund their deductible obligations.** Higher deductibles reduce the cost of insurance, conserve insurance capacity, and help focus post-event attention on homeowners who have had a major loss. They also encourage residents to take personal responsibility to mitigate loss (prior to and following a storm) and reduce cross-subsidization by shifting a portion of the risk back to policyholders likely to incur the loss.

- **Broad-ranging and shifting post-event regulatory mandates increase insurer uncertainty and divert attention needed to respond to claims.** Insurers must have some certainty that, if a major hurricane strikes, they will not be hit with shifting, wide-ranging regulatory mandates of questionable legality. Following Hurricane Katrina, for example, insurers were confronted with literally hundreds of legislative and regulatory mandates that impacted premium collection, underwriting, claims handling, and claims data reporting; most of these mandates varied from state to state. Recent legislation in Florida recognized the harm these mandates have on the insurance environment. As a result, Florida law now obligates regulators to adopt (through administrative rulemaking) standardized requirements *before* the event that may be applied to insurers *after* a catastrophe. Other states should do the same.

- **States also should facilitate post-event claims adjustment.** While every major hurricane is somewhat unique, a common theme is the need for insurance adjusters to get in quickly and settle claims expeditiously. Yet, there are usually many obstacles in place, such as licensing and establishment of procedures to facilitate payments. In addition to removing specific obstacles, there should be improved integration of insurers into the planning of post-event responses, in terms of logistics, communications, and coordination with relevant federal and state agencies.

III. *Legal Reform*

- **The legal system must preserve the sanctity of contracts.** Insurers must have confidence that the insurance policies they write will be upheld following a major catastrophe. Pending "wind versus water" litigation brought by the Mississippi attorney general and private plaintiffs epitomizes the problem that insurers face in an uncertain legal environment, particularly where cases are tried by "hometown" juries. Insurers should not be made to pay claims for losses that are beyond the scope of an individual's policy, and for which the policyholder did not pay premiums. If trial lawyers or others are successful in retroactively re-writing insurance contracts, the predictability upon which a healthy insurance system is based is undermined.

- **Statutes of limitations should not be extended.** Post-hurricane extension of the statute of limitations on hurricane claims raises fundamental fairness and due process concerns. Moreover, it becomes harder to settle claims equitably as the parties become farther removed from the event which caused the loss. All insurance policies provide ample time for the filing of hurricane damage claims.

Extending the statute of limitations is another attack on the sanctity of contract, in this case, by state legislatures.

IV. *Tax Incentives*

Although such a change may not precipitate substantial capacity in the short term, amending U.S. tax laws to permit insurers to establish tax-deferred catastrophe reserves, if designed properly, would have a positive impact on present and future recovery efforts. There are also other ways that federal and state tax policy can enhance affordability and encourage the use of protective measures. These include:

- federal legislation to establish tax-exempt Catastrophe Savings Accounts (CSAs) for individuals (similar to health savings accounts) as introduced by Rep. Tom Feeney (R-FL);
- federal or state income tax credits (similar to tax credits formerly provided to encourage energy efficiency) to encourage homeowners and business owners to invest in protective measures that go beyond building code requirements; and,
- state sales tax holidays for hurricane mitigation and preparedness purchases, or exempt certain items from state sales tax.

V. *National Flood Insurance Program (NFIP) Reforms*

The NFIP plays a critical role in hurricane preparedness and response. However, the program as currently structured does not cover enough people or provide the level of protection needed by many policyholders. The NFIP must be reformed so that it provides an effective safety net, while encouraging homeowners and businesses to take personal responsibility. Among needed NFIP reforms are:

- introduction of risk-based premiums;
- expanded program mandates to cover more homeowners in more locations;
- increases in maximum coverage limits and deductibles; and,
- policy terms that are more consistent with private insurance. Insurers have developed a comprehensive list of reforms.
- Additionally, NFIP must complete its map modernization initiative as soon as possible.

Comparisons to Terrorism Risk

The tools that I have outlined would improve the ability of private insurers to manage natural catastrophe risk, while at the same time making individuals and communities more disaster resistant and resilient. In doing so, they should obviate the need for new federal or state governmental insurance or reinsurance mechanisms for natural catastrophe risk.

However, these tools are insufficient for managing the complex, man-made risk of catastrophic terrorism. While both natural catastrophes and terrorism are capable of causing extreme loss, they are fundamentally different from an insurability perspective. For terrorism, private sector reinsurance or other risk-sharing capital remains woefully inadequate and shows no signs of robust growth in the near future. This is a strong indicator that the capital markets have reached the same conclusions about the private insurability of terrorism risk. Moreover, there is no reliable method for determining the likelihood of a terrorist attack (event frequency) within the United States, a critical component in determining the insurability of a risk. This is complicated by the fact that terrorism is a deliberate act committed by individuals bent on doing the worst possible harm. Additionally, the interdependence of terrorism risk also limits the potential effectiveness of mitigation. Finally, for national security reasons, vital information necessary to assess the terrorism threat is strictly classified and unavailable to insurers as they attempt to manage this risk.

Because of these factors, a federal reinsurance backstop for terrorism risk must remain in place after the December 2007 expiration of the Terrorism Risk Insurance Act Extension Act, and we appreciate the opportunity to work with this committee to develop long-term solutions to the ongoing problem of managing the nation's economic exposure to terrorism risk.

Conclusion

Thank you very much for giving me the opportunity to appear before you today. On behalf of AIA and our members, I look forward to working with you to address the challenges facing the insurance industry, and our nation as a whole, in preparing for, and responding to, natural catastrophes.