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NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Good afternoon Chairman Ney, Ranking Member Waters, and members of the Committee. My name is Tim Russell, and I am pleased to testify today on behalf of the National Association of Mutual Insurance Companies regarding the disaster preparedness of the U.S. housing market. Founded in 1895, NAMIC is the nation's largest property and casualty insurance association ,underwriting more than 40 percent ($178 billion) of the property/casualty insurance premium written in the United States.

I am the President of Baldwin Mutual Insurance Company, a single-state writer in Alabama that writes more than 35,000 policies, totaling more then $14 million dollars in premium across the state. I am a former Chairman of NAMIC and a current member of the Association's Task Force on Natural Disasters. I also serve as the Mayor of Foley, Alabama, a coastal city in southern Alabama with roughly 13,000 residents. Foley was directly affected by Hurricane Ivan in 2004 and by Hurricane Katrina in 2005. In my dual roles as President of Baldwin Mutual and Mayor of Foley, I have a unique perspective on the devastation caused by natural disasters, and the challenges that face insurers and government policymakers in preparing for and managing large-scale natural disasters.

As this Committee is aware, 2005 was one of the worst years for natural disasters in American history. According to the latest estimates from the Insurance Information Institute, Hurricane Katrina alone caused more then $40 billion in insured losses, including $1.8 billion in Alabama. In addition, Hurricanes Wilma and Rita caused roughly $10 billion and $5 billion in insured losses, respectively. In all, the storms of 2005 produced more then 4 million claims, and over $60 billion in insured losses. For residents in my community, the effects of the 2005 storms were especially severe because we were still recovering from Hurricane Ivan, which is still the worst natural disaster in Alabama history.

I wish I could sit here before this Committee and say that the worst is behind us. However, according to hurricane forecasters, the increases we have seen in hurricane frequency and severity are expected to continue for at least another decade. Forecasters predict that during the 2006 hurricane season, there will be 17 tropical storms and nine hurricanes, five of which will be major events. Earlier this month, the catastrophe modeling firm AIR Worldwide estimated that a level five hurricane hitting Miami, Florida, would cause over $130 billion in insured losses. According to AIR, there is a 20 percent chance that a $100 billion event will occur within the next 10 years.

NAMIC is pleased that the members of this Committee are making a serious effort to understand the nature of catastrophic risk, and the role that insurance can and should play to better prepare for and manage future large-scale natural disasters. To assist in this effort, NAMIC convened a special task force in December 2005 to identify and analyze the critical issues that we believe policymakers should consider as they move forward. Today I'd like to share with the Committee several observations and recommendations that emerged from our deliberations.

General Observations

First, with the exception of flood insurance generally and earthquake insurance in high-risk seismic zones, we believe that the private insurance market is well equipped to provide coverage for most types of natural disasters under most circumstances. That said, we also recognize that a *true* mega-catastrophe comparable to the 1906 San Francisco earthquake, or a high-category hurricane striking heavily populated areas such as Miami, Houston, or New York City, could potentially exceed private market capacity. It may be appropriate for policymakers to study whether government programs should be created to respond to such mega-events in those states or regions that are particularly vulnerable. Such programs, should they prove necessary, must be carefully designed so as not to distort private insurance markets.

Second, we believe that a flexible regulatory environment, in which insurers are free to price coverage based on risk, will create incentives for property owners in high-risk areas to invest in loss mitigation measures. Lawmakers and/or regulators sometimes impose rating and underwriting restrictions on property insurers that allow high-risk property owners to pay artificially low premiums, forcing low-risk property owners to subsidize the insurance costs of high-risk buyers by paying inflated premiums. In our view, using the insurance pricing mechanism to create hidden cross-subsidies among risk classes is deceptive and unfair.

Moreover, government-imposed rate suppression can have the effect of distorting public perceptions of risk. The result is often unnecessary costs for the federal and state governments when they provide disaster aid to repair properties that should not have been built in the first place. Risk-based insurance pricing, on the other hand, sends accurate signals to consumers about the relative level of risk associated with particular regions and types of structures.

Third, policymakers must recognize that disaster under-preparedness is not simply an insurance availability and affordability problem. Human psychology strongly influences the decisions people make with respect to disaster risk management and insurance. There is ample evidence that property owners as well as government officials tend to underestimate catastrophe risk and fail to prepare adequately for natural disasters. Studies also suggest that many consumers view insurance as a financial investment rather than as a protective measure, so that those who purchase insurance and do not collect on their policies over a period of time feel that their premiums have been wasted, leading them to discontinue coverage.

Fourth, we are disturbed by the fact that in discussions of insurance price regulation, the term "actuarially sound" is often used loosely and without definition. For example, the term is sometimes used to refer to prices that solely reflect the expected value of future loss costs. It is important to understand that a definition of "actuarially sound" based solely on the value of expected losses is inapplicable to catastrophe exposed coverages. That is because "actuarially sound" pricing for catastrophe exposed coverages must also include compensation for the unusually large "call on capital" that is required to pay catastrophic losses. The call on capital that results from the large-scale losses typically associated with extreme events may well be several times greater than the total annual "expected loss" of the coverage. In other words, the term "actuarially sound" should be understood to include not just the insurer's expected loss costs and expenses based on yearly averages. It should also include an adequate "risk load" that takes into account the call on capital.

Finally, lawmakers, judges and the general public must recognize the cyclical nature of property insurer profits, how profits relate to surplus, and the role of surplus in ensuring that insurers are able to meet their contractual obligations to policyholders. Using return on equity as the universal benchmark for measuring company profitability, economists have found that property/casualty insurance is less profitable than most other industries. Regulatory decisions and judicial rulings that require insurers to pay disaster-related claims irrespective of the terms of the insurance contract could cause availability problems at best and widespread failures in the market at worst.

These observations aside, we believe there are several measures that Congress should consider immediately to address certain problems associated with natural disaster risk management and insurance.

Policy Proposals that Deserve Immediate Consideration

First, NAMIC supports federal legislation that would create financial incentives to encourage states to adopt and enforce strong, statewide building codes. Strong building codes as well as responsible land-use planning have been shown to greatly reduce the level of property damage and human suffering caused by natural disasters. With respect to existing properties, we support government initiatives to create mitigation grant programs to enable homeowners in high-risk areas to invest in risk mitigation measures.

Second, we support the concept of amending the federal tax code to allow insurers to set aside a portion of premium income in tax-exempt policyholder disaster protection funds. We also support the concept of allowing homeowners to create tax-free catastrophic savings accounts similar to health savings accounts which could be used to pay hurricane deductibles and costs associated with retrofitting properties.

Third, we recognize that a market-based insurance pricing system in which premiums reflect the actual cost of insuring against catastrophic risk could result in significant premium increases for some property owners in high-risk regions. Policymakers should therefore consider creating programs to provide direct government assistance, funded from general revenue, to low-income and other groups according to criteria established by the unit of government providing assistance. However, in designing such programs, care must be taken to avoid reducing incentives to mitigate risk.

Fourth, we believe that the National Flood Insurance Program should be maintained, but that it must undergo significant reforms. First and foremost, NFIP premiums must be actuarially sound for all covered structures. The current method for setting premiums, which is based on average annual losses, has been called “unsustainable” by the Congressional Budget Office. This approach has prevented the NFIP from accumulating the surplus necessary to pay claims during periods when loss costs are above average.

Finally, the borrowing authority of the NFIP should be increased so that program administrators will not be required to seek special appropriations from Congress each time a natural disaster involving major flooding occurs. The flood maps used by the NFIP must be updated and improved. Stiffer penalties should be imposed on financial institutions that either fail to require flood insurance coverage for mortgages on properties in flood-prone areas, or allow the policies to lapse. Greater effort should be made to ensure that more people are aware of the program and the benefits of having flood insurance coverage to protect their properties.

In conclusion, the years ahead will present serious challenges to property owners, insurers, mortgage lenders, realtors, and home builders that live and do business in catastrophe-prone areas. NAMIC believes the most effective mechanism for addressing these challenges is a private insurance market characterized by open competition and pricing freedom. Congress can play a constructive role by reforming the National Flood Insurance Program, offering tax incentives for companies to reserve funds for future disasters, and providing incentives for states to enact and enforce effective statewide building codes.

Thank you again for the opportunity to testify on this issue of vital importance to NAMIC member companies and the U.S economy. NAMIC stands ready to lend its assistance to ensure that the nation’s homeowners are prepared for the next major catastrophe.