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October 14, 2008

The Honorable Kevin McCarty  
Chairman, NAIC Catastrophe Insurance Working Group  
Florida Office of Insurance Information  
200 East Gaines Street, Room 101A  
Tallahassee, Florida 32399-0301

Re:    **Natural Catastrophe Risk: Creating a Comprehensive National Plan**  
**Written Comments on NAIC Draft #13 (September 3, 2008 Draft)**

Dear Commissioner McCarty:

We previously provided you with written comments to the initial drafts of the NAIC proposal titled “*Natural Catastrophe Risk: Creating a Comprehensive National Plan*” (hereinafter the “*Comprehensive National Plan*”). Those comment letters, dated January 9, 2006 and April 4, 2006, attached hereto and marked as Exhibits 1 & 2, respectively, are incorporated by reference as is fully rewritten herein.

While there have been a number of changes to the *Comprehensive National Plan* since it was first exposed for comment in late 2005, our objections to the thirteenth draft of the plan remain basically the same as we expressed them more than two years ago, as outlined in our previous comment letters referenced above.

In addition, we would suggest that the current version of the *Comprehensive National Plan* suffers from structural and organizational infirmities which make it difficult and challenging to comment upon. The document is full of relevant background information and thought provoking comment and opinion, as one would expect in a white paper. But intermingled among the various paragraphs of the white paper-like text are several public policy proposals, many of them controversial in nature, which the NAIC will be asked to adopt and advocate.

We would therefore suggest that the entire document be restructured with an eye toward transparency, inclusiveness of competing views (from both regulators and interested parties), and alternative proposals. We also believe that the document needs to be organized in a more structured manner to ensure that regulators at every level of the NAIC hierarchy know and understand what is contained in the *Comprehensive National Plan* before they pass judgment on it. To that end, we would suggest a restructuring of the *Comprehensive National Plan* along these lines:

1. Executive summary of the plan (including a skeletal outline of the plan)
2. Procedural history of the plan’s review and consideration
3. Relevant factual & background information
4. Detailed explanation of the plan
5. Views of regulators supporting the plan
6. Views of regulators opposing the plan
7. Supporting and opposing views of interested parties
8. Alternative proposals by regulators and interested parties

The Honorable Kevin McCarty  
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We recognize that our comments on the structure of the current document may not be welcomed by the members of the Catastrophe Insurance Working Group. However, given the seriousness of the subject at hand and the relatively recent injection of new and alternative proposals for dealing with the insurance and financial consequences of natural catastrophes, both by regulators and the regulated, we believe an effort to make the document more detailed, inclusive, and representative of competing views would be time well spent.

Thank you for the opportunity to provide input on these important issues. Please feel free to contact me if you have any questions.

Sincerely,

A handwritten signature in black ink, appearing to read "SAG", with a long horizontal flourish extending to the right.

Scott A. Gilliam

SAG/gsa

cc: Eric Nordman, NAIC Staff, [enordman@naic.org](mailto:enordman@naic.org)  
Mary Miller, Ohio Department of Insurance, [mary.miller@ins.state.oh.us](mailto:mary.miller@ins.state.oh.us)

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January 9, 2006

Via E-Mail

**EXHIBIT #1**

The Honorable Kevin McCarty  
Commissioner of Insurance  
State of Florida  
Chair, NAIC Catastrophe Issues Working Group  
Larson Building, Room 101A  
200 East Gaines Street  
Tallahassee, Florida 32399-0301  
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Re: *Natural Catastrophe Risk: Creating a Comprehensive National Plan  
Written Comments on NAIC Draft Paper*

Dear Commissioner McCarty:

The Cincinnati Insurance Companies<sup>1</sup> appreciate the invitation to submit written comments to NAIC Draft Paper titled “*Natural Catastrophe Risk: Creating a Comprehensive National Plan*,” and to provide general comments on the appropriate roles of government and the private market sector under a national approach to catastrophe funding. The comments provided below are substantially similar to testimony I delivered in person during the public hearing held on this matter at the NAIC Winter National Meeting in Chicago on December 3, 2005.

First, our initial observations on the draft plan.

**All-perils policy.** This is a non-starter for us. Flood has been determined to be an uninsurable risk for the private sector and the simple stroke of pen will not change that. We are also concerned that the description of the all-perils policy in the draft document appears to incorporate the reasonable expectations doctrine and obliterates the milieu of coverage limitations and exclusions which are common in standard homeowners insurance policies, mold being one example. We believe our concerns have been partially addressed with the clarification that the all-perils policy would be limited to “all natural catastrophe perils.” Nevertheless, we still have concerns that the adoption of such a policy would cause rates to skyrocket and possibly lead to abandonment of the homeowners insurance market by many insurers.

**Mandatory state catastrophe funds.** This is another non-starter for us. Every state should not be required to create a catastrophe fund. One size does not fit all. The decision as to whether a cat fund is needed or warranted in any state needs to be based on local conditions. We also take issue with level of losses that would be covered by the proposed state cat funds: 1 in 50 year events. Losses at that level are well within private market capacity.

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<sup>1</sup> The Cincinnati Insurance Companies market property and casualty insurance and life insurance in 31 states through 1,000 local independent agencies. The parent company, Cincinnati Financial, is the 19th largest publicly traded property and casualty insurer based on 2004 revenues of \$3.6 billion and assets of over \$16 billion.

**Federal reinsurance for state cat funds.** We have been skeptical of previous calls for federal involvement in catastrophe reinsurance. There have been numerous bills introduced in Congress since the 1990's, all of which would have offered coverage at levels well within private market capacity and would have put the government in competition with the private sector. We have similar concerns with what has been proposed in the National Cat Plan primarily because of the low trigger: coverage for events exceeding the level of losses from a 1 in 50 year event. Such losses are still well within private market capacity. Pricing of federal reinsurance contracts would also be problematic at best. Pricing would be subject to political pressures and could result in rates far below what the private sector would charge. While there may be an appropriate role for federal reinsurance, we cannot support the concept as presently envisioned under the draft plan.

**Tax-deferred catastrophe reserves.** We have supported tax-deferred catastrophe reserves since the concept was first introduced at the NAIC and continue to support the concept. Tax deferred cat reserves would empower and encourage more insurers to serve markets in disaster-prone areas and encourage the insurers now serving those markets to remain. Policyholders will benefit from the resulting increase in competition in a number of ways, including the likely introduction of better insurance products and policy features. After a catastrophe, the reserves would have a stabilizing effect on markets in the area impacted by a catastrophic event and decrease the likelihood of market interruptions. Because tax deferred cat reserves would better prepare insurers for a major catastrophe, they will be less likely to cancel coverage after such an event. This should result in greater stability of consumers' property insurance and fewer insurer insolvencies after a major disaster. We applaud you for including tax-deferred catastrophe reserves in your draft plan.

### **General Comments**

Having been active in this debate for over 10 years, we want to leave you with some general comments on the appropriate roles of government and the private market sector under a national approach to catastrophe funding. As the NAIC prepares to consider these issues in 2006 and industry opposition to federal reinsurance for natural catastrophes continues to grow, it is incumbent that several basic principles and concerns be kept at the forefront of the debate.

**1. Maximize private insurance markets.** With very few exceptions, natural catastrophe remains an insurable risk, which private insurers can manage with the appropriate tools including a private reinsurance market. From 1995 to 2004, insurers managed to pay \$124 billion in U.S. catastrophe losses (in 2004 dollars). In 2005, the industry will pay close to \$60 billion in U.S. catastrophe losses. Any federal catastrophe reinsurance program must be designed to prevent competition with the private sector and must not provide coverage for events well within private market capacity. The private sector's role should be maximized and such financing mechanisms fully exhausted before any government capacity is provided.

**2. Let the private markets work: flexible pricing and underwriting.** Under the concept of risk-based rating, insurance companies rate risks at their proper levels based on the degree of risk. Those choosing to live in high risk areas pay rates which match their higher risk of a catastrophe loss. Those living in lower risk areas pay rates which match their lower risk of suffering a catastrophe loss. The ability of an insurer to shed excess catastrophe exposure goes hand-in-hand with risk-based rates: private insurance markets only work when insurers are permitted to exercise underwriting flexibility to avoid risk concentration. When insurers are allowed to engage in flexible pricing and underwriting, availability is enhanced. Unfortunately, many states suppress risk-based rates and prevent insurers from shedding excess exposure in catastrophe-prone areas because of political pressures, making insurers more reluctant to market insurance in these areas. Federal policy on natural catastrophe insurance should encourage private market flexibility in the pricing and underwriting of catastrophe insurance.

**3. Focus on solvency-threatening events.** The NAIC should focus its efforts on mega-catastrophes: those events which threaten the solvency and claims-paying ability of the insurance industry. As demonstrated by the 2004 and 2005 hurricane seasons, the industry can readily handle a series of events with insured damages as high as \$60 billion. Some reinsurance experts believe the industry can handle a single insured event approaching \$100 billion in claims. Previous proposals would have permitted federal reinsurance payouts for events with as little as \$2 billion in damages. Some in the industry advocate a trigger as low as \$20 billion. At such a low levels, the federal government would become a risk bearing entity for exposures that are adequately and appropriately served by the private sector. The NAIC should oppose any legislation that would trigger federal reinsurance for events within the industry's capacity.

**4. Federal policy should not favor one segment of the insurance industry over another.** Most insurers act responsibly, avoid large concentrations of risk, and purchase adequate reinsurance or otherwise develop adequate resources to absorb large catastrophe losses. Unfortunately, some insurers follow business strategies which produce high concentrations of risk and overexposure in catastrophe-prone areas. Federal policy should not favor these irresponsible insurers with a taxpayer-funded bailout at the expense of responsible insurers who spread their catastrophe risk. Competition in the insurance marketplace should be based on market forces, not on government policies that favor poor risk management.

**5. Avoid ambiguous coverage triggers.** The "trigger" for any federal reinsurance program must be clear and unambiguous. Previous proposals for federal reinsurance have used return times (the amount of damages likely from an event expected to occur once over a specified period of years, e.g., 1/100 year event) to specify the level of losses at which federal reinsurance becomes available to pay claims. Using return times to trigger coverage is disingenuous and subject to manipulation. Ask five catastrophe modelers to estimate the amount of damages likely to be caused by an event with a specific return time and you will get five different answers. The NAIC should oppose any legislation that does not include specific "hard damage" trigger levels for federal reinsurance.

**6. Market-based pricing for federal reinsurance contracts.** To avoid anti-competitive impact, it is imperative that the prices established for reinsurance under any federal reinsurance program be insulated from political pressures and be commensurate with rates that would be charged by the private sector for similar coverage. The pricing approach for federal reinsurance contracts under H.R. 4507 is encouraging in this regard: "[an] amount that is one percent greater than the lowest amount for which a private insurer with an equivalent risk portfolio can obtain equivalent coverage in the private reinsurance market."

**7. Discourage state catastrophe insurance funds.** State catastrophe funds were created for the ostensible purpose of ensuring the availability of residential insurance coverage for persons in areas at high risk for natural disasters. Quite often the availability problem sought to be addressed by state catastrophe funds is a problem that was created by the states themselves by not allowing insurers to charge risk-based rates in catastrophe-prone areas (insurers are reluctant to market insurance when they cannot charge rates which reflect the level of risk being assumed). Federal reinsurance for state catastrophe insurance programs should not be made available in states which do not allow insurers charge risk-based rates in catastrophe-prone areas (the approach taken H.R. 4507).

**8. Allow insurers to accumulate tax-deferred catastrophe reserves.** Instead of creating government insurance programs, the Congress should look at ways to empower the private markets to handle natural catastrophes without government involvement. One way would be to allow insurers to accumulate tax-deferred catastrophe reserves to pay for future mega-catastrophes. The current U.S. tax/accounting system only allows insurers to look backwards – insurers can set aside consumer premiums in reserves to pay for past disasters but not for future, predicted events. As a result, consumers' insurance payments are taxed up front as profits, discouraging insurers from providing insurance in high-risk areas and reducing capacity to deal with catastrophes. Congress should correct this flaw, as many other industrialized nations have, and allow insurers to set aside part of the premiums they receive for catastrophe insurance in special

tax-deferred catastrophe reserves under strict regulation and oversight. This would empower and encourage insurers to serve markets in disaster-prone areas, to remain in those markets after a catastrophe, and result in fewer insurer insolvencies after a major catastrophe.

**9. Encourage catastrophe mitigation and effective land use planning.** Any federal policy on natural catastrophe insurance should promote effective catastrophe mitigation, including the development and enforcement of strong building codes and sensible land use planning that does not encourage inappropriate coastal development.

**10. Natural catastrophe insurance for low income consumers.** The private marketplace should not be called upon to provide catastrophe insurance to low income insurance consumers at less than market rates. The inability of some Americans to afford catastrophe insurance is a societal issue that is best left to government to resolve.

**Conclusion**

Thank you for the opportunity to provide input on these important issues. Please feel free to contact me if you have any questions.

Sincerely,



Scott A. Gilliam

SAG/gsa

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April 4, 2006

Via E-Mail

**EXHIBIT #2**

The Honorable Kevin McCarty  
Commissioner of Insurance, State of Florida  
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[McCartyK@dfs.state.fl.us](mailto:McCartyK@dfs.state.fl.us)

Re: *Natural Catastrophe Risk: Creating a Comprehensive National Plan*  
*(Revised) Additional Written Comments on NAIC Draft #3 (February 20, 2006 Draft)*

Dear Commissioner McCarty:

We provided you with our initial thoughts on the NAIC proposal titled "*Natural Catastrophe Risk: Creating a Comprehensive National Plan*," in a January 9, 2006 comment letter, which is incorporated by reference. Since the NAIC proposal has been revised twice since our initial comment letter we are taking this opportunity to provide you with our comments on the latest draft, dated February 20, 2006, which we will refer to as "Draft #3."

We recognize and appreciate the fact that Draft #3 attempts to address some of the concerns expressed by members of the Working Group and interested parties in their review of the first two drafts. However, further clarifications are necessary and problems remain.

*Specific Concerns*

**All-perils policy.** We reiterate our objections to the all-perils policy as set forth in our January 9 comment letter and offer the following additional comments. Although Draft #3 provides that "traditional property exclusions" would be permitted in the all-perils policy, the list of exclusions in the draft is very short compared to what is included in a standard ISO policy. Why aren't all of the standard ISO provisions being considered? Draft #3 also adds specifics regarding deductibles for cat and non-cat losses and suggests that insurers could offer "mitigation pricing" to reduce deductibles or co-pays. Have these deductibles been vetted? Would mitigation pricing be mandatory? These are just a few of the new issues raised by Draft #3 which demand reasoned and deliberate consideration by the NAIC. The current "rush to adoption" will not allow interested persons and regulators the time they need to consider the ramifications of these changes and offer appropriate input.

**Level of losses for state catastrophe funds.** Draft #3 removes the controversial language which provided that state cat funds would be responsible for handling events "up to the costs expected for a combined 1 in 50 year event" (events at these levels are well within private sector capacity). However, this is simply a cosmetic change; the substance remains unchanged. Consider the fact that the revised Plan still provides that federal reinsurance for state cat funds will be provided for events "from" the 1 in 50 year level, which implies that the state cat funds will handle losses "up to" the 1 in 50 year level. Also, the diagram in Draft #3 still suggests that state cat funds will be responsible for handling events "up to" the 1 in 50 year level.

**States without reinsurance needs collecting federal reinsurance premiums.** Draft #3 provides that states which do not opt to create a single state catastrophe fund or participate in a regional catastrophe fund must develop a mechanism to collect federal reinsurance premiums in their states. Draft #3 also provides that the working group will need to consider how the federal funds are accessed in states that opt out of participating in a state or regional fund. This raises a host of questions since the sole purpose of the federal reinsurance contemplated in the NAIC proposal is to insure state cat funds. If a state rejects the state cat fund option and therefore has no need for federal reinsurance, what does the state purchase with the premiums it collects? Do these states simply become the collectors of a national tax to bailout overexposed insurers? Will the federal government simply pass out money to the states without cat funds to pay cat losses suffered by insurers who have overexposed themselves in cat-prone areas? If a state without a cat fund purchases federal reinsurance, what does the federal reinsurance cover if the state does not have a cat fund? The current "rush to adoption" will not allow interested persons and regulators the time they need to get answers to these and other questions and offer appropriate input.

**Nuclear option (Price-Anderson Act).** A drafting note in Draft #3 suggests that the Working Group consider a model similar to the federal program for nuclear accidents (Price-Anderson Act). It is unclear from the revised Plan how an arrangement similar to the nuclear power plant pooling arrangement would work. The current "rush to adoption" will not allow interested persons and regulators the time they need to consider the ramifications of this idea and offer appropriate input.

**Mitigation provisions.** While all agree that mitigation is a critical to reducing cat losses, the revised Plan identifies several approaches to mitigation which demand further study before they are adopted, including (a) low interest loans for mitigation, (b) premium credits for mitigation efforts, and (c) federal tax credits for mitigation efforts. Whether these programs would be voluntary or mandatory must also be considered. The lengthy discussion of how Japan has approached earthquake mitigation through building codes and premium pricing/discounts is interesting but also raises many questions as to whether such a program is feasible in the U.S. The current "rush to adoption" will not allow interested persons and regulators the time they need to consider the ramifications of these provisions and offer appropriate input.

**Cost of mitigation.** Within the state cat fund provisions of the revised Plan, Draft #3 provides that states must "finance a level of mitigation education and implementation programs that best meet the needs of its citizens," which must include: effective building codes; land use plans; anti-claim fraud programs; and effective mitigation plans. These are all good ideas but who pays for these mitigation programs? Will premiums be taxed to pay for these programs? Why are these requirements included under the state cat fund portion of the NAIC Plan? The current "rush to adoption" will not allow interested persons and regulators the time they need to get answers to these and other questions and offer appropriate input.

### **Additional Comments**

In addition to the foregoing specific concerns, we continue to have a number of general concerns with the NAIC plan, which we offer below.

***1. We disagree with the basic premise that all natural disasters are uninsurable. With the exception of flood, which is insured under the National Flood Insurance Program, other natural disasters are insurable in the private sector.*** Natural disaster risks are insurable risks in the private sector if the free market is allowed to work. If insurance companies are unburdened by regulatory constraints and allowed to participate competitively in the free market (maximize private sector capital), and if loss reduction measures are effectively used, then natural disaster risks are generally insurable and should not be a threat to the solvency of insurance companies.

***2. Modernizing ratemaking should be one of the first responses to solving the current problems and should be an integral part of any plan sponsored by the NAIC.*** There is no recommendation within the NAIC Plan to modernize ratemaking regulations so that the free market is the prime factor in determining

the flow of private capital into the property insurance market. Modernizing ratemaking is a tool uniquely within the control and authority of each member of the NAIC and should be utilized as one way to increase the flow of private capital into the market. States that have taken the initiative and adopted rate modernization over the past few years have found that it promotes competition among insurance companies provides increased capacity to consumers and results in lower rates.

**3. *State and regional catastrophe funds (cat funds) are not a long-term solution.*** The cat 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. Public subsidies and cross-subsidies in the property insurance market lead to inappropriate economic and political decisions by homeowners and government officials. These subsidies and cross-subsidies distort the economic considerations regarding the true cost of property insurance and the location of homes in high-risk areas such as on the coast.

For example, when an event occurs which exceeds its cash balance, the Florida Hurricane Cat Fund raises the money to pay claims by issuing bonds, which are retired through assessments on policyholders of all lines of property and casualty (except workers' compensation and medical malpractice). That means that business owners, non-profit organizations, hospitals, churches, schools, local and state governments, motor vehicle owners, professionals, and others throughout the state will be subsidizing homeowners for the cost of their insurance. Not only is there the cross-subsidy across insurance lines, but there is also a subsidy from the inland residents who subsidize coastal residents who are statistically more likely to suffer natural disaster losses. Citizens with little or no natural disaster risk will subsidize those with a higher risk. Those subsidies will continue each year for the length of time the bonds are outstanding; up to thirty years in the case of the State of Florida.

**4. *A state cat fund also violates one of the fundamental tenets of insurance - spreading the risk.*** The method of funding catastrophe exposure through state cat funds necessarily means that the revenue to pay the claims comes out of the pockets of that state's citizens. A preferred approach is to spread the risk through private insurance and reinsurance. With a state catastrophe fund, the state will essentially have a ring around it. The entire burden of paying for the natural disaster with state catastrophe funds will fall on that state alone. By way of contrast, private reinsurance spreads the risk globally and the cost of that reinsurance is paid up front.

**5. *The establishment of state and regional catastrophe funds is a radical government action and is something that should only be used as a last resort.*** Florida's unique risk profile explains why that state has resorted to this mechanism. However, the Florida experiment is not yet completed. Florida had the good fortune to have a dozen years after Hurricane Andrew in which to accumulate cash reserves to use during the hurricanes of 2004 and 2005. That cash is now essentially exhausted. The next major hurricane event will likely require bonding, with all of the political and economic ramifications associated with the assessment subsidies. If other states or regions create a new cat fund, they cannot count on having a dozen years to accumulate cash that would obviate the need for bonding. That is a gamble that many states and regions may prefer not to take.

**6. *Federal reinsurance should only be made available for events that result in losses that are greater than the private resources that are available. Government's role should be limited to addressing insurer insolvency in the event of a mega catastrophe, thus fostering private sector coverage and preserving the claims paying ability of insurers.*** The best public policy arguments to support a federal natural disaster reinsurance program are those that argue that federal assistance is needed for loss events that threaten the solvency of the insurance industry. The federal government is naturally reluctant to create programs that can be perceived as a "bailout" for insurers as reflected in the recent two-year extension of TRIA. The federal government is naturally also reluctant to create programs that "crowd out" or compete with the private sector.

**7. Consideration should be given to a percentage of surplus trigger for any federal reinsurance program.** In the past, the Reinsurance Association of America has suggested a 15 percent or 20 percent of surplus loss trigger for any federal catastrophic natural disaster program. Surplus is not allocable by line of business, but a percentage of surplus loss measure is relevant to the determination of whether a loss is solvency threatening and thus relevant to the attachment of any federal natural disaster reinsurance or risk financing.

According to the Insurance Information Institute, the property and casualty industry ended 2004 with \$394 billion in surplus and with \$413 billion in earned premium. Using 2004 as the base year, a 15 percent of surplus loss trigger on an aggregate basis would yield a \$59 billion attachment point; at 20 percent of surplus the attachment point would be \$79 billion. These losses are within the projected total industry loss for the 2005 storm season. In fact, reinsurance broker Guy Carpenter's report on the January 1, 2006, reinsurance renewals indicates that on an industry-wide basis the catastrophes of 2005 constitute an earnings event, not a capital event. In other words, for the industry as a whole, the hurricane losses negatively impacted earnings for 2005, not surplus. The 2005 season indicates that a private market for natural disaster catastrophe cover is available to assist individual primary insurers in managing their share of this industry trigger, at least up to this 20 percent of surplus level. On a going forward basis the determination of the trigger for any national cat fund has to be set at a rate high enough to truly provide capacity only when the private industry cannot respond.

**8. The role for state governments is to strengthen building code and land use statutes, and to amend state regulation laws to ensure that individual insurers can charge rates commensurate with the risk insured.** Although the private sector, utilizing free market principles to compete and price the product, can best insure natural disasters, there is an important role for government. The public sector should adopt and enforce strong building codes, encourage property owners to mitigate their potential losses, and utilize creative land planning techniques.

**9. Government officials should create a regulatory environment that fosters competition, including allowing insurers to base pricing upon the underlying risk which is insured.** Government officials should adopt policies that encourage the entry of private capital, thus increasing insurance capacity.

**10. Natural disasters are insurable if the free market is allowed to work.** Paying for natural disaster insured losses through means other than the private sector, such as by state or regional cat funds, ultimately requires public subsidies or cross-subsidies. Government officials should concentrate their efforts on creating incentives for private capital to flow into the property insurance market, establish strong building codes, utilize creative land planning techniques, and create a regulatory environment that fosters competition and bases pricing on the underlying risk which is insured.

### Conclusion

Thank you for the opportunity to provide input on these important issues. Please feel free to contact me if you have any questions.

Sincerely,

Scott A. Gilliam

SAG/gsa

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