Comments on the white paper, *Natural Catastrophe Risk: Creating a Comprehensive National Plan* from Alan Wickman (NE)
Oct. 14, 2008

I don't see Nebraska supporting adoption of the proposed national catastrophe plan, and I don't expect that various minor amendments will make a difference. We might be able to support a document with a minority opinion (or opinions).

The document had started as an NAIC proposal for insurers, states and the federal government to better address natural disasters. The "Air Force One" plan was widely disparaged, where the federal government just throws money at uninsured losses after natural disasters. There seemed to be near-unanimity that we need to come up with something better. I submit that we really haven't come up with much at all, at least in terms of addressing disasters including substantial damage from floods or earthquakes, where the private market has little appetite for risk and property owners rarely purchase coverage. Rather, all we have now is something that is pointed towards hurricane-related market problems and little else. While we agree with the document's recognition of the need for federal reinsurance above a certain unspecified point, we nevertheless feel that the document calls for unnecessary bureaucracy at the state level. We see no need for a plan to require states or groups of states to have catastrophe funds, and believe that they should be largely unnecessary.

NEED FOR NATIONAL HIGH-LEVEL REINSURANCE,
NOT ON A STATE-BY-STATE BASIS

Nebraska is like most states, in that we don't have market problems caused by the industry's hesitancy to overexpose themselves to a mega-catastrophe. Almost every insurer here—as for most states—could write considerably more coverage here if the market opportunity presented itself.

For the most part, hurricanes are the major cause of loss that must be recognized first when we speak of a natural disaster that can cause many billions of dollars of privately insured losses. Thus, while the health of the insurance industry is a concern for all states, and hurricane-related capacity problems can effect a large enough number of states that a federal response is likely to be appropriate, we don't feel that such a program should involve a material federal subsidy in the form of reinsurance by the federal government for less than expected losses plus expenses (and maybe even some expected profit). Why should Nebraska pay for losses in the coastal states? In this regard, I see my views as fairly "middle of the road," in that we also don't want the federal government supplanting the private insurance industry by providing coverage for storm-generated losses at a level that the private insurance industry would be able to efficiently handle absent a government reinsurance program.

The reference to "efficiency" in the last sentence is something that I want to flesh out a little bit. The proposed draft doesn't identify thresholds, and we aren't going to do so, either, but I sense that the insurance industry (to the extent that they would agree with federal reinsurance at all) would want this threshold to be in excess of some very large number, like a $75 or $100 billion storm. While the insurance industry may be able to handle a single storm of this magnitude with a high percentage of its members remaining solvent, it would nevertheless cause serious market problems. Money doesn't flow back into the industry quite that quickly or smoothly. On the flip side, it certainly appears that the insurance industry can handle a $10 or $15 billion dollar insured loss and be financially (if not logistically) ready to handle another loss of this magnitude the following week. One would not expect availability to be materially affected, nor should cost-of-capital concerns cause a spike in pricing.

The development of the "best" threshold(s) should be a carefully thought out, multi-dimensional process, but we suggest that the document should view this entirely on a national basis, without regard to which states are hit, and it should allow abundant capacity to be present to serve coastal markets without the need to charge a profit loading that is substantially more risk-loaded than expected profit margins in other non-hurricane states. Coming from a state without a nickel of hurricane exposure, we want the policyholders in coastal states to pay for every bit of their expected losses, and we don't want the profit loading for insurance in these states to be any less than in others, but we can agree that it also seems unfair for coastal policyholders to pay a materially higher profit loading on account of their catastrophe exposure.

In short, a federal reinsurance facility is necessary. It shouldn't require state catastrophe funds of any sort, and it should be completely independent of how a state regulates its insurance rates. The plan should price its reinsurance based on its professional evaluation of expected losses on an insurer-by-insurer basis, and insurers will have the ability (but not the mandate) to purchase high excess levels of reinsurance from the facility at rates that the private market will probably not care to match. Of course, this is why the facility must be carefully restricted to only write reinsurance that should be expected to apply in relatively uncommon events. Practically speaking, the threshold levels are likely to be subject to political pressure, but we should favor a law that doesn't allow the thresholds to go too high or too low based on politics.

If a coastal state has a rating law that relies largely upon competition and without substantial approval standards, then the rates in the state will be determined by that segment of the industry that wants to write there. As the federal reinsurance facility would assure more-than-adequate capacity, it wouldn't be necessary that all licensed insurers are eager. In the other extreme, if a state regulates rates tightly and a large percentage of its policyholders end up in a market of last resort, then that market will be able to purchase federal reinsurance as well, but the price will be a function of the federal reinsurer's professional evaluation of its exposure, which may not be in agreement with the state's more optimistic evaluations. They can fight it out.

ALL-PERIL COVERAGE

With regard to the original motivation of the document—which was to address disasters with substantial uninsured losses—we observe that we have largely abandoned that fight in view of industry resistance and perhaps the motivation to get something (i.e., some federal reinsurance for hurricanes) out of the paper. That disappoints us and we disagree with backing off on this idea, even though we acknowledge that it will be very difficult politically to work through everything that will need to be worked through.

As we've discussed at length, the way to address this is with mandatory coverage for earthquake and flood as well as hurricanes and other traditional perils. While we recognize the challenges involved here, an "optional purchase" plan simply not going to accomplish the objection of substantially reducing uninsured losses arising out of natural disasters. Flood coverage is available optionally for most people, and yet only a small percentage of policyholders get it. In California, the earthquake peril is widely recognized as a serious matter, and yet less than 15% of policyholders opt to buy it. It simply won't make a difference.

Homeowners coverage with mandatory flood and earthquake coverage included isn't going to be an easy thing to come by, which means that we'll need to roll up our sleeves and figure out how to make it happen. The underlying premise of mandatory coverage would be something like that of mandatory automobile liability insurance. That is, unless you can demonstrate financial responsibility in some other fashion, the cost of the harm that you may cause is part of the cost of driving a car. With the homeowner, we're saying that we (society as the "we") just can't afford to have you gamble that you will lose everything you have because you get hit by a flood or an earthquake. "We" can't afford it because we know that there will be cries for handouts, and we know that "we" will respond.

The details of an almost mandatory plan are too much to begin to cover in a letter of a few pages, but such a program could have a substantial deductible for any or all perils where the policyholder can demonstrate the ability to withstand the loss. Right now, deductibles of $1,000 and less are very common, yet it seems like I have something break or go wrong every couple of years that costs me more than that. Or look at your recent retirement plan losses. The direction that I'd see things going is that deductibles can and probably will become larger to offset the additional coverages that would be provided. What sense does it make to insure my house with a $250 deductible against fire, while having no insurance whatsoever for flood? One tool to make things work here could be a provision for low-interest federal loans to cover losses not otherwise covered on account of a large deductible.

Again, stressing that there isn't enough room here to go into all the details, I certainly don't contemplate that insurers will be forced to retain flood and earthquake exposures, as these are perils that the industry has either avoided (flood) or has avoided or perhaps overpriced (earthquake). Rather, I presume that that these exposures will be eligible for reinsurance with the federal facility up to 100%, if that is what the insurer wishes. In this regard, I feel there to be need for a much closer look at the expected losses for flood and earthquake in low-hazard areas, because I certainly don't want to see some kind of a reinsurance "minimum premium" of $200 or $300 applied to a policyholder on the top of a hill in South Dakota.

Many details of these ideas have already been discussed. To the extent that they have not, we would be glad to expound if there is a legitimate chance that the paper may consider a minority opinion. In this regard, we'd be glad to work with any other state(s) with similar views.

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