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

Re: NAIC Proposed Natural Catastrophe Risk: Creating a Comprehensive National Plan

Dear Commissioner McCarty:

On behalf of the members of the Reinsurance Association of America (RAA), we appreciate the opportunity to offer comments on the NAIC Catastrophe Insurance Working Group's proposed "Natural Catastrophe Risk: Creating a Comprehensive National Plan" (the Plan), dated September 3, 2008, which was discussed at the NAIC Catastrophe Insurance Working Group on Tuesday, September 23, 2008.

The RAA is a national trade association representing property and casualty organizations that specialize in reinsurance. The RAA membership is diverse, including large and small broker and direct U. S. companies and subsidiaries of foreign companies.

The RAA opposes adoption of the Plan as drafted for the following reasons:

1. The premise of the Plan is that natural disasters are uninsurable. Natural disasters are insurable and best left to the private sector.
2. The private market works and has weathered increasingly large and unprecedented disasters with minimal disruption and therefore government insurance risk sharing is unnecessary.
3. Government insurance risk sharing will expose the taxpayers to additional financial exposure at a time when consumers and the nation can least afford the risk.

Instead, the RAA encourages the NAIC to prepare a balanced white paper that examines the pros and cons of displacing a functioning private insurance and reinsurance industry with the probability of post event, deficit-based state and federal government financing. Such a white paper would also address the public policy concerns of environmental, taxpayer, business and non-profit organizations.

Preparation of a balanced white paper seems particularly prudent given the current public concern about taxpayer liability for the government rescue and funding of the nation's financial

services industry. It would also be instructive for the paper to include some “real world” examples, such as a review of Florida’s catastrophe fund versus the actions taken by states like South Carolina, Louisiana and Mississippi to foster consumer mitigation, insurer participation and risk spreading from their residual markets.

In the following comments, we outline the current Plan’s provisions and our concerns while pledging to continue to work with the NAIC toward the publication of a comprehensive white paper on natural catastrophes.

Plan Summary

The Plan contemplates three layers of risk bearing:

1. The first layer of coverage is provided by the private market and envisions the development of state mitigation programs, tax deferred reserves and “enhancement” of the insurance contract. The major proposed change to the insurance contract would be the mandated offer of an “all perils” policy, including flood, although the risk of flood would remain with the National Insurance Flood Program (NFIP). The offer of the “all perils” policy could be declined by the consumer, unless the consumer’s property is financed with a federally guaranteed mortgage and is located in areas of moderate to high risk of catastrophic events. In those cases, inclusion of the “all perils” language in the insurance contract would be mandatory.
2. The second layer provides for risk bearing by the state. Each state would be required to decide whether its exposures to natural catastrophes warrant either the creation of a state catastrophe fund, participation in a regional catastrophe fund or participation in a single or multi-state mechanism to collect funds from a national catastrophe backstop mechanism. Under the Plan, states would be required, by agreement or mandate, to finance mitigation education and implement programs that best meet the needs of its citizens. Currently, only Florida has a state catastrophe reinsurance fund in which the state retains the risk. While California has the California Earthquake Authority (CEA), the CEA aggregates insurance risk and cedes the vast majority of it to private reinsurance companies and other capital market entities.
3. The third layer contemplates the federal government creating a reinsurance mechanism which would provide guaranteed lending or reinsurance to the state or regional funds. States without a fund would not be eligible for the program unless the state elected to participate in a manner established by the federal government. The proposal does not indicate what “in a manner established by the federal government” means in this context. Also, any state receiving federal funds would be required to adopt adequate disaster response and management mechanisms, enforce reasonable building codes, land use, and mitigation efforts to minimize the amount of insured loss. No details are provided on how the loans would be repaid to the federal government. Only Florida presently has a catastrophe fund which would be eligible for the federal reinsurance since the State of Florida retains the risk within the catastrophe fund.

The RAA Response:

As stated earlier, the RAA strongly disagrees with the Plan as outlined and opposes it for the following reasons:

1. Natural catastrophe risk is insurable and best left to the private marketplace.
 - Insurers and reinsurers price risk expertly. Irresponsible behavior, such as building in a high risk, catastrophe prone area, is discouraged when risk based pricing is employed. Economic incentives (usually unintended) to build in harms way are eliminated when risk based pricing is employed. Any other pricing mechanism will increase exposure to loss through additional development in catastrophe prone areas and a reduction in incentives for consumers to strengthen their homes. Risk based pricing sends economic signals to consumers about the cost of living in a catastrophe prone region. Interfering with those economic signals is likely to result in unintended consequences that exacerbate many of the problems that the NAIC is attempting to solve. In addition, inadequate, subsidized premiums in coastal areas add distress to the risk sharing community and may spur the growth of residual markets and amplify associated problems for states, municipalities and consumers.
 - While the Plan suggests loss levels of up to \$400 billion, we suspect that such losses include all economic losses, not insured losses. The best educated estimates of probable maximum insured losses to the private market, which is driven by consumer demand, is in the low \$100 billions, an amount well within the ability of the private market. Because unused catastrophe capacity (capital) is economically inefficient and lowers an insurer's returns on capital/equity, it is in the best interest of the public and the insurance industry to employ as much of the insurance industry's catastrophe capacity capital as possible - to match or slightly exceed market demand. Because the current market demand for catastrophe reinsurance is far below the several hundreds of billions suggested in the Plan, there is no incentive for private capital and catastrophe capacity to enter the market as it will not be utilized. However if the demand increases, history has shown that the private market will respond with increased capital and capacity to meet any increases in demand. Although it is true that supply has sometimes lagged behind demand, historically, any imbalance is usually resolved within 12-18 months as new capital enters the market. After the new capital is employed, capacity historically exceeds consumer demand, leading to increased competition and lower prices. In the two years after Hurricane Katrina 95% of insurance earnings were retained in policyholder surplus which increased the capacity of the industry to underwrite catastrophe risks at lower consumer costs.

2. The private market works and has weathered well the unprecedented catastrophes of the last several years.
 - Of the top 10 most costly world insurance losses from 1970-2005, three are 2005 natural catastrophes (Hurricanes Katrina, Rita and Wilma) that occurred in the U.S. Despite record insured catastrophe losses that year of \$72.7 billion (Hurricane Katrina alone cost insurers \$40.6 billion), the insurance industry was profitable, largely due to diversification and the principle of risk spreading. Although the combined ratio for homeowners insurance averaged 111.8 from 1990 to 2006 (meaning insurers paid out [in claims and expense] an average of \$1.12 for every dollar taken for premiums), homeowners insurers averaged a rate of return of 3.3 percent through 2006.
 - Although reinsurers have paid 61 percent of all the 2005 losses from Hurricanes Katrina, Rita and Wilma, the capital markets greatly enhanced reinsurance catastrophe capacity following these catastrophes. Since late fall 2005, an additional \$43 billion of new capital entered the reinsurance business to support and underwrite U.S. natural catastrophe risk, including \$12-\$15 billion in new securities for catastrophe risk issued by the capital markets.
 - Reinsurers, utilizing their global resources, play an essential role in the U.S. economy and help protect America by spreading the risk and impact of natural disasters among different market segments. For the unparalleled 2005 hurricane losses, U.S. insurers retained 38.9% of the loss, Bermuda reinsurers 24%, US reinsurers 11.5%, European reinsurers 12.6%, Lloyds 12.3% and all others .7%.
3. The program as outlined in the Plan will expose the government and the taxpayers to additional financial exposure.
 - Concentrating risk in a state or region is contrary to the fundamentals and economics of insurance and the principal tenet of spreading risk. A series of individual state funds will be more costly to insurers who in turn will pass these costs on to consumers. While this proposition can be tested using catastrophe models, the realities of insurers' reinsurance purchases demonstrates the point. If segregating state specific risks from the global risk pool was more cost effective, then every insurer would have an economic incentive to design their reinsurance purchases akin to the structure in the proposed Plan. Insurers have not adopted this structure precisely because it is not cost effective.
 - In addition to being more costly generally, concentrating risk raises concerns about an individual state being able to independently fund and assess their losses and exposure. (See the discussion of the Florida Hurricane Catastrophe Fund below.) As the apparent purpose of establishing any such fund is to reduce insurance costs, politics will cause the increase in cost caused by risk concentration to be ignored. Premium charges will become inadequate and those at risk will not bear the costs associated with their risk. Irresponsible and risky behavior will go unchecked and the exposure to loss will spiral

upwards further exaggerating the problems identified by the NAIC including cost, loss potential, availability, and the level of subsidies between those not at risk (typically middle/lower incomes) and those at high risk (coastal typically higher income).

- The experience of the National Flood Insurance Program (NFIP) is instructive in this context. The program was designed to become self sustaining, without the need for government subsidies. Instead, the NFIP became mired in politics. For example, flood maps were not updated, many properties at risk were subsidized, and increased development occurred in flood prone regions. As a result, the NFIP deficit grew to an estimated \$18 billion, not including claims from Hurricane Ike. Legislation was introduced in 2008 to forgive this deficit. Due to the short extension of the NFIP program, it is likely that NFIP deficit forgiveness will be a Congressional issue in early 2009.
- Florida is only the state catastrophe fund writing reinsurance. In effect, it makes consumers the reinsurers for insurers. The state fund offers insurers inexpensive reinsurance premiums up front, enabling insurers to off load substantial risk onto consumers. When a hurricane occurs that depletes the fund's cash reserves (as in 2004 and 2005), the fund issues bonds. The insurance companies who bought the state's cheap reinsurance do not pay the bond debt. The debt is paid by taxing Florida policyholders of other lines of insurance, such as automobile insurance and commercial insurance; including municipalities; non-profits such as United Way, AARP, and the Red Cross; school districts; and small businesses via assessments.
- This year the Florida fund has an estimated \$3.6 billion in cash, so it would need to bond about \$25 billion in order to meet its \$28.6 billion in claims paying obligations to insurance companies. With the current credit crisis, virtually no one – including state officials – believes that the fund can bond that amount. In fact, earlier this summer the state of Florida took the unprecedented step of paying Berkshire Hathaway Insurance Group \$224 million dollars for Berkshire's promise to buy \$4 billion of bonds at 6.5% interest (tax exempt) if necessary later this hurricane season.
- During the 2008 Florida legislature, state Chief Financial Officer Alex Sink asked lawmakers to reduce the size of the Florida catastrophe fund and return some risk to the private market. Sink's office calculated that even if the level of bonding needed could be sold by the state, it could end up causing tax assessments on every home, auto and business insurance policy for a "total of \$1.8 billion each year for 30 years" with a Category Three hurricane. (*Miami Herald*, Feb. 18, 2008)
- As previously mentioned, state catastrophe funds concentrate risk instead of spreading risk, which is a fundamental principle of insurance. The Florida Hurricane Catastrophe Fund has \$1.8 trillion of insured values (Florida now retains nearly two-thirds of the reinsured property catastrophe risk within its borders). Instead of spreading that risk globally, the Florida fund concentrates that risk within the state and shifts the catastrophe

costs from the private insurers to insurance-buying consumers including those not covered by the fund itself.

- Government funds, like the Florida Hurricane Catastrophe Fund, do not reduce the vulnerability of people to natural catastrophes and are not a proactive, disaster planning approach. These funds are a political response to an economic issue. The fund does not reflect risk and, further, creates incentives for additional development in high-risk areas further exacerbating the state's problem.
- Experience with Florida's state catastrophe funds shows it's susceptible to the political suppression of rates. The Florida Hurricane Catastrophe Fund had losses of \$3.7 billion in 2004 and \$3.1 billion in 2005 forcing the issuance of bonds which are currently being paid for via assessments on Florida's insurance consumers.

In September, *BusinessWeek* stated "Florida's concentration of risk in the hands of taxpayers is an example of the potential risks of having states supplement private-sector insurance." (*BusinessWeek*, Sept. 11, 2008). The *Wall Street Journal* has called Florida's government insurance program "Florida's Folly," and "the path to fiscal ruin," stating, "This exercise in Cuban economics is already gutting Florida's once competitive insurance market. Private insurers know the law will artificially depress rates, forcing some to operate at a loss. Many have responded by cancelling policies . . ." (*Wall Street Journal*, April 20, 2007). *USA Today* has editorialized that "It is horrendous public policy." (*USA Today*, November 12, 2007).

- A major question regarding the Plan is the willingness (or opposition) of US taxpayers to support such a proposal. The current economic crisis is a good indicator of the public reaction that can be expected if there is a major event under the Plan, and there are many similarities between the economic crisis and the likely unintended consequences from the Plan. In the credit crisis, Americans learned about the danger of providing mortgages at below cost and with understated risks. The same holds true for insurance products. When the less likely but not expected event happens, under capitalized state funds and insurers who are unable to collect appropriate premiums will fail, leaving the rest of us to reluctantly pick up the pieces.

At that time the federal program will be asked to bail out a state that by its own design did not charge adequate premiums to pay for future losses. As they have with Wall Street banks and financiers, taxpayers will contend that it is wrong to ask them to pay for the excesses and risky behavior of those who could afford to live in higher risk coastal areas.

Summary

The RAA opposes adoption of the NAIC's "Proposed Natural Catastrophe Risk: Creating a Comprehensive National Plan" and hopes to work with the Working Group to publish a white paper that reflects the diversity of opinions on the appropriate role of government in the

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insurance market and presents a thorough review of the different approaches taken to date in various states.

Thank you for the opportunity to comment on this proposal. We look forward to a continued dialogue to develop practical solutions that create a strong insurance market to the benefit of consumers.

Sincerely,



Dennis C. Burke
Vice President, State Relations

Attachment: HeraldTribune.com October 5, 2008 article