Catastrophe Insurance (C) Working Group

March 29, 2015
Phoenix, AZ
Consider Adoption of Nov. 17 Minutes
Catastrophe Insurance (C) Working Group
Washington, District of Columbia
November 17, 2014

The Catastrophe Insurance (C) Working Group of the Property and Casualty Insurance (C) Committee met in Washington, DC, Nov. 17, 2014. The following Working Group members participated: Kevin M. McCarty, Chair represented by David Altmaier, (FL); Charles Angell (AL); Giovanni Muzzarelli (CA); George Bradner and Susan Gozzo Andrews (CT); Martha Im (HI); Martin Hazen (KS); Warren Byrd and Richard Piazza (LA); Kevin Beagan (MA); Sandra Castagna (MD); Angela Nelson (MO); David Browning (MS); Kristine Maurer (NJ); Cuc Nguyen and Brian Gabbert (OK); Paula Pallozzi (RI); Kendall Buchanan (SC); Michael Humphreys (TN); and Rebecca Nichols (VA).

1. **Adopted its Aug. 17 Minutes**

   Mr. Byrd made a motion, seconded by Mr. Hazen, to adopt the Working Group’s Aug. 17 minutes (see NAIC Proceedings – Summer 2014, Attachment Five, Property and Casualty Insurance (C) Committee Aug. 18, 2014, minutes). The motion passed.

2. **Discussed Forming a Subgroup to address the Working Group’s Charges Regarding Consumer Education**

   Mr. Altmaier said that near the end of 2012, a public hearing was held regarding catastrophe insurance. He said a summary of that hearing can be found in the meeting handout. Mr. Altmaier said the Working Group has been charged with reviewing the findings of the public hearing and considering developing best practices to reduce post-disaster recovery obstacles for insurance consumers. He suggested that the Working Group form a subgroup to review the results of the public hearing and to make recommendations regarding best practices. Mr. Altmaier said since there were no objections to forming this subgroup, he would ask for a motion to form a subgroup, which will be chaired by Ms. Nelson, to review the findings of the public hearing and make recommendations to the Working Group regarding best practices. Ms. Pallozzi made the motion, seconded by Ms. Nguyen. The motion carried. The members of the Working Group that volunteered to serve on the subgroup are: Mr. Angell; Mr. Bradner; Mr. Hazen; Mr. Byrd; and Ms. Pallozzi. Mr. Altmaier asked interested parties to monitor the subgroup to provide their input. The subgroup will be named at a later date.

3. **Heard a Presentation Regarding Catastrophe Bonds**

   Steve Cheneko, John Lebans and Rajiv Thomas (Nationwide Insurance) made a presentation regarding the implications of the life insurer treatment of catastrophe bonds and the implications this treatment could have on the P/C industry.

   Mr. Lebans said Nationwide said the topic of catastrophe bonds and how they are pursued, or not pursued, on a life insurance company’s balance sheets is an important topic and an opportunity for the industry to capitalize on some potential diversification benefits that exist between the P/C and the life insurance sides of business. He said that on the P/C side of business, one of the largest risks is catastrophe risk. Mr. Lebans said life insurers, on the other hand, have a great deal of credit risk. He said currently life insurers do not participate to a great degree in the catastrophe bond market. Mr. Leban said the underlying risk between catastrophe risk and credit risk are generally uncorrelated. He said one would think catastrophe bonds would be an attractive investment option for a life insurer.

   Mr. Leban said Nationwide believed a substantial reason as to why life insurers do not participate in the catastrophe bond market is due to the capital treatment a life insurer receives if they did purchase a catastrophe bond. He said if a life insurer purchases a catastrophe bond today, the catastrophe bond is treated like any other corporate credit. Mr. Leban said Nationwide believes a more appropriate treatment would be to reflect the fact that the underlying risk is different. He said the underlying risk is triggered by catastrophe risk, which by definition is not related to macroeconomic risk. Mr. Leban said that Nationwide thinks that the current risk charge does not properly reflect this, which causes life insurers not to invest heavily in this space.
Mr. Leban said they believe that if life insurers did invest in this space, there would be several benefits. He said first of all, P/C insurers would see a larger investment base in the catastrophe bond space, which would provide more capacity and ultimately a lower cost of capital. Mr. Leban said the benefit to the life insurers would be that they would be getting a similar return in terms of asset return on an uncorrelated asset base. He said their risk-adjusted return is improved. Mr. Leban said regulators would benefit by bringing greater diversification into the system. He said ultimately, the benefit is seen by the consumer, as the consumer would benefit from the fact that the P/C capital costs would decline if there were a larger base of catastrophe risk transfer available. Mr. Leban said that life insurance customers would also benefit because life insurance companies would have higher risk adjusted returns than they would have otherwise. He said this is the basic premise of the white paper written by Nationwide that is included in the materials.

Mr. Leban used the example of a company called Cat Re, which illustrates a special purpose vehicle set up by an insurance company. He said its sole purpose is to provide reinsurance protection to the insurance company. Mr. Leban said the way that the special purpose vehicle gets its capital is by issuing bonds to the capital markets. He said the bonds are issued, and the funds are held in a reinsurance trust invested in highly. Mr. Leban said risk-linked securities issued by insurance companies are designed to protect an insurance company from large losses incurred in the event of a major catastrophe. He said its sole purpose is to provide reinsurance protection to the insurance company. Mr. Leban said the way that a reinsurer gets its capital is by issuing bonds to the capital markets. He said the bonds are issued, and the funds are held in a reinsurance trust invested in highly liquid cash-like investments, so there is little to no credit risk.

Mr. Leban said the insurer pays premium to the special purpose vehicle for an agreement that if a certain catastrophe event occurs, the proceeds that are in the trust will go to the insurance company. He said the premiums that are paid in flow to the investors along with the interest payment on the funds. Mr. Leban said in this transaction, there is little credit risk. He said the only credit risk is whether the insurance company makes its premium payments to the reinsurance special purpose vehicle. Mr. Leban said the underlying risk is simply catastrophe risk.

Mr. Cheneko said catastrophe bonds are largely uncorrelated with broader macroeconomic risks and macroeconomic credit risks. He said this was seen during the financial crisis in 2008, when catastrophe bonds had positive total returns and most other investments did not. Mr. Cheneko said certainly bonds with similar ratings to catastrophe bonds did not have positive returns during that period. He said when you think about the traditional sources of credit risk—cession, the overall economy, companies being over-leveraged, companies being mismanaged and obsolescence in company business models—none of these things are applicable to catastrophe risk.

Mr. Cheneko said with the way catastrophe bonds are currently structured, where the principal is generally protected through a trust in high-quality assets such as money market assets or U.S. Treasury assets, then again only the premium from the ceding insurance company, which accounts for most of the interest payment on the catastrophe bonds, is what is at risk and typical bonds are not at risk. He said they have data that shows there is a low correlation between catastrophe bonds and equities and other types of corporate bonds.

Mr. Cheneko said a down economy is not going to cause a natural catastrophe. He said natural disasters can have economic impacts, but those impacts would tend to be limited in geographical scope, and many other types of credit risk in a corporate bond exposure are not geographically sensitive to any one specific area.

Mr. Cheneko said life insurers are not significant investors today. He said 81% of catastrophe bonds are owned by investors. He said through their conversations with life insurance companies, they think this is because of the capital charge for these bonds, which is high relative to the risk. He said catastrophe bonds receive the same treatment today as similarly rated investment grade bonds or unrated bonds for those catastrophe bonds that are unrated. Mr. Cheneko said in neither of these cases is the correlation benefit that we have been discussing been picked up. He said if the catastrophe bonds are unrated, they are categorized as NAIC 6, and the bonds are marked to market under statutory accounting, driving capital volatility. Mr. Cheneko said they believe that there would be a widespread benefit in the overall industry if catastrophe bonds were treated properly, and life insurers found it more advantageous to invest in these bonds. He said it would increase the market for P/C companies where they could see an insurance risk too, which would make that more efficient and reduce the cost of ceding that risk. Mr. Cheneko said for life companies, it would provide strength through diversifying their investment portfolios, which are heavily concentrated in traditional credit risk today, leading to the strength to build P/C and life companies and eventually passing those benefits to the consumer in terms of lower cost.
Mr. Thomas said that the treatment of the risk-based capital (RBC) is the same for a corporate bond as it is for a catastrophe bond. He said there is no differentiation in the current dollar treatment of a catastrophe bond, particularly if the catastrophe bond is assessed a capital charge that is close to the C-1 or the asset risk component. Mr. Thomas said, for example, if a life insurance company bought $500 million of a BB-rated catastrophe bond, it would result in a capital charge of about 3.4%, or a $17 million capital charge, that would be added to the C1 or asset risk component. He said the RBC calculation results in an increase of $16.9 million. Mr. Thomas said this demonstrates that the current capital treatment does not provide any differences in terms of the fact that a catastrophe bond is really more of an insurance risk, as well as the fact that it provides some diversification benefit as opposed to a corporate bond.

Mr. Thomas said an example of an alternate RBC treatment would modify the capital treatment in the RBC calculation. He said the alternate method attempts to recognize the insurance features of a catastrophe bond, as well as the diversification benefit to life insurance companies. He said that in this example, the capital charge is placed under C2, the insurance risk component, as it recognizes that the underlying contract behind a catastrophe bond is an insurance contract because its valuation is primarily determined by weather events. This is unlike a typical corporate bond, which is affected by financial credit risk and market risk. He said this alternative treatment would result in the overall capital charge reducing from $16.9 million to $2.4 million for a $500 million bond.

Mr. Leban said to recap, the basic premise of insurance is risk diversification. He said they think there is a largely untapped potential for risk diversification between catastrophe risk and credit risk. Mr. Leban said they think it is untapped today because of the capital treatment that catastrophe bonds receive on life insurance balance sheets. He said they gave an illustration of one alternative and while it is not bullet-proof by any stretch, they do believe in the underlying premise that the current treatment is not appropriate given the diversification. Mr. Leban said they believe they could find a more appropriate treatment to attract life insurance companies to this space. He said the benefits go across the whole continuum of constituents in the insurance chain. Mr. Leban said casualty/C insurers benefit, life insurers’ benefit, ultimately the consumers of both of those products benefit, and the regulators will benefit from the solvency perspective by having more diverse portfolios.

Mr. Altmaier asked Mr. Leban if he had had any conversations with or given any presentations to either the Financial Condition (E) Committee, the Capital Adequacy (E) Task Force or the Life Risk Based Capital (E) Working Group. Mr. Leban said the Catastrophe Insurance (C) Working Group was the first place this presentation had been given. He said the concept in the white paper that was handed out that was endorsed by the North American Chief Risk Officers Council. Mr. Altmaier suggested that the technical expertise to consider a proposal like this would exist in the groups he mentioned. He said this was of interest to this Working Group because it would have an effect on the P/C catastrophe marketplace, but he said he thinks that if this is a project that Nationwide would like to see implemented, they should meet with the Financial Condition (E) Committee working groups.

Mr. Muzzarelli said he had a question on the asset and liability matching part of this proposal. He said these catastrophe bonds are rated BB for a reason as there is an expected loss with a certain return period, and he would imagine that this correlates to some equivalent credit event with typical corporate bonds. Mr. Muzzarelli asked if Nationwide had some thoughts regarding that impact and whether there really is going to be no change on the asset liability matching part of a life insurer’s portfolio. Mr. Leban said when they talked to some people at life insurance companies, he thought they saw this as an overall way to reduce the credit risk in their portfolios, so they are really more focused on more traditional interest rate asset liability interest matching. He said in terms of the timing, these bonds in the past have tended to be a little shorter than life insurance companies typically buy, but it depends on the portfolio and the product. From a credit perspective, he thinks they see this not just diversifies but reduces the overall credit risk.

Mr. Altmaier said Mr. Leban indicated that right now about 1% of the catastrophe bond market may be attributable to the life insurance marketplace. He asked Mr. Leban if he had an appreciation of how much that might increase if changes of this nature were implemented. Mr. Leban said he did not know that they were able to quantify that, but they do think that even a modest improvement from the life insurance industry could have a big impact on the catastrophe bond market. He said the size of life insurance portfolios relative to the size of the catastrophe bond market is large, so even if that was increased by just a few percent of the industry, it could still have a sizable impact.
Mr. Altmaier said there are different kinds of loss triggers on particular catastrophe bonds that can basically be lumped into two buckets—indemnity-based loss triggers and index-based loss triggers—and he was unsure if life insurers in particular had an appetite for one of those types of loss triggers versus the other or if they were agnostic to the trigger. Mr. Leban said his guess is that they would be agnostic. He said the underlying trigger in both cases, whether it is indemnity-based—it is actually triggered by the actual losses in the insurance company’s portfolio relative to an index, which means it is triggered based on the accumulation of industry losses—the underlying event is still a large natural catastrophe. Mr. Leban said again there is no correlation with the larger macroeconomic issue, so he cannot speak for those companies, but he believes they would be agnostic.

4. Received an update from the Post-Catastrophe Regulatory Guidance (C) Subgroup

Ms. Pallozzi said the Subgroup met via conference call Oct. 3 to discuss its charges and how the Subgroup would proceed.

Ms. Pallozzi said the Subgroup’s discussion began with the work that was done by the Northeast Zone, as it had collected best practices prior to Superstorm Sandy. She said the Subgroup is creating a survey based on the survey that went out the Northeast Zone states to collect best practices from all states. Ms. Pallozzi said the Subgroup was charged with developing best practices to inform industry what the departments of insurance expect in the event of a catastrophe prior to a catastrophic event. She said she was working with NAIC staff to assemble the survey, and the survey will go out to the states within the next few weeks.

Ms. Pallozzi mentioned that the Catastrophe Response (C) Working Group would be meeting Nov. 18. She said there is some confusion regarding the difference between that Working Group and the Post-Catastrophe Regulatory Guidance (C) Subgroup. She said the role of the Subgroup is to discuss the best practices for state departments of insurance to use when issuing directives to industry, as well as let industry know what a state department of insurance (DOI) expects of industry. Ms. Pallozzi said the Catastrophe Response (C) Working Group is looking at the resources needed by the state departments of insurance following a catastrophe. She said an example of these needs would be help manning phone lines, possibly by NAIC staff and neighboring states, for a DOI so that the departments’ personnel are able to get out into the field.

The Working Group will receive an update from Anthony Cotto (NAIC) regarding the National Flood Insurance Program (NFIP) and catastrophe-related legislation at a later date, as he was unable to attend the meeting.

Having no further business, the Catastrophe Insurance (C) Working Group adjourned.
Receive an Oral Report Regarding the Activities of the Post-Catastrophe Regulatory Guidance (C) Subgroup and Consider Adoption of its Feb. 17 Minutes
The Post-Catastrophe Regulatory Guidance (C) Subgroup of the Catastrophe Insurance (C) Working Group of the Property and Casualty Insurance (C) Committee met via conference call Feb. 17, 2015. The following Working Group members participated: Paula M. Pallozzi, Chair (RI); Charles Angell (AL); George Bradner (CT); Sandra Starnes (FL); Colin Hayashida (HI); Richard Piazza (LA); Joy Hatchette (MD); Joan Dutil (MO); Carl Sornson (NJ); Brian Gabbert and Cuc Nguyen (OK); and Brian Hoffmeister and Michael Humphreys (TN). Also participating were: David Browning (MS) and Evelyn Padilla (NM).

1. Discussed the Catastrophe Survey

Ms. Pallozzi reviewed the Subgroup’s charges regarding the need to provide added certainty for insurers and regulators in the advance of a major disaster. She said the intent of the survey is to collect information that will allow the Subgroup to compose a best practices document to address these concerns. Ms. Pallozzi said the survey would also provide information to the Catastrophe Response (C) Working Group with the information needed to update the NAIC State Disaster Response Plan, as well as the Consumer Outreach and Assistance Post-Disaster (C) Subgroup so that multiple surveys would not be sent to the states.

Ms. Pallozzi said the survey consists of the following sections: hurricane deductibles; wind/hail deductibles; earthquakes; tornados; mitigation; state insurance departments’ catastrophe processes; residual market mechanisms; catastrophe underwriting information; and general information.

Mr. Sornson suggested that the survey be more specific regarding whether the questions were regarding commercial lines or personal lines of insurance. Ms. Pallozzi and NAIC staff will review the survey and add information in the header to convey that the survey pertains to both commercial lines and personal lines of insurance.

Ms. Pallozzi said California was unable to be on the conference call and sent the following comments, “California would prefer not to include all questions about the state’s underwriting guidelines and rating plans with respect to underwriting against or charging for prior claims or inquiries or catastrophe claims. Our statutes in this regard are rather broad and their application frequently depends on the details of the underwriting or rating plan. It would be difficult to answer yes or no to many of the related questions. However, we understand the Subgroup may want to retain these questions if the members believe it would be to their benefit to know the statutes that are available in other states to address these circumstances.”

Ms. Pallozzi said the purpose of the survey is to gather current statutes, and the Subgroup may want to consider adding something to the questions that asked for comments from the state if the answer to a question is not strictly “yes” or “no.” She asked if regulators were able to edit their responses once they have submitted the form. Sara Robben (NAIC) said once the form was submitted, any changes or updates would need to be submitted to her to make the change. Ms. Pallozzi said this would need to be added to the submission message so regulators would know where to send changes if necessary.

Mr. Bradner asked whom the survey would be sent to. Ms. Robben said the survey would go to the catastrophe contacts in each state; however, the states that did not have contact information were sent an email to determine the appropriate contact.

Mr. Angell said it would be beneficial to see how other states answered the survey and asked how the results of the survey would be distributed to the Subgroup. Ms. Hatchette suggested looking at the results distributed for the Auto Insurance (C/D) Study Group as a template as a summary guideline. The Subgroup agreed it wants to be able to separate results by states.

Ms. Pallozzi will work with NAIC staff to change the survey based upon the comments received. She said the survey would be distributed with a request to complete within two weeks, with a final deadline of three weeks. She hopes to have initial survey results before the Spring National meeting to present to the Catastrophe Insurance (C) Working Group.

Having no further business, the Post-Catastrophe Regulatory Guidance (C) Subgroup adjourned.
Receive an Oral Report Regarding the Activities of the Consumer Outreach and Assistance Post-Disaster (C) Subgroup and Consider Adoption of its March 16 Minutes
Receive Update Regarding National Flood Insurance Program (NFIP) and Catastrophe Legislation
Hear Presentation Regarding the RiskInsight U.S. Storm Surge Model
Hear Update Regarding Federal Emergency Management Agency (FEMA) and Superstorm Sandy Lawsuits
Any Other Matters Brought Before the Working Group