Testimony of
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Subcommittee on Oversight and Investigations
Of the
House Committee on Financial Services

Regarding:
"The Homeowner's Insurance Crisis: Solutions for Homeowners, Communities, and Taxpayers"

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Chairman Moore, Ranking Member Biggert and members of the Subcommittee on Oversight and Investigations, on behalf of Florida Insurance Commissioner Kevin McCarty, I thank you for the opportunity to testify here today regarding the homeowner's insurance crisis resulting from catastrophic natural disasters and I applaud you for your leadership on this critical issue.

My name is Raymond Spudeck, and I am the Chief Economist for the Florida Office of Insurance Regulation. In addition to my ongoing work with the Florida homeowner's insurance market, I have also been deeply involved in the national debate with the Property & Casualty Insurance Committee of the National Association of Insurance Commissioners (the "NAIC") as well the Committee's Catastrophe Insurance Working Group.

Our Current System for Catastrophic Natural Disaster Insurance

In your invitation to provide testimony, you asked a number of penetrating questions that are central to the ongoing debate regarding the correct system for insuring against catastrophic losses resulting from natural disasters. As the debate continues and as your questions suggest, the one central fact is that the insurance contract is the engine that provides for economic recovery for individuals, communities and regions following a large scale natural disaster. Individuals cannot return home unless their damaged properties are repaired. Moreover individuals may not be able or willing to return to their homes unless their places of employment are returned to operating condition, and schools and social infrastructure repaired. Insurance payments for legitimate insured losses make all of this happen. We have examples from over the last five years, in

Florida, and elsewhere along the coastline of the United States, of where this system works, and sadly, where it does not.

It is also important to recognize that the framework that provides the necessary insurance is an important part of the recovery process. As we meet today, the ability of housing markets and local and regional economies to withstand and recover from natural catastrophes depends critically on what type of peril creates the disaster, where the disaster occurs, and the severity of the disaster event. The different types of catastrophic natural disasters are managed very differently within our current insurance framework. This, in turn, can lead to highly different outcomes.

Wind events, including tornados and hurricanes, are considered a basic covered peril in the vast majority of homeowner's insurance policies. Flood, on the other hand, is only rarely written by the private insurance industry for residential property; since 1968 the National Flood Insurance Program (NFIP) has been the public solution to managing this risk. Finally seismic events, especially earthquakes, are not considered a standard covered peril, and aside from the California Earthquake Authority, there is no public mechanism to underwrite the risk, so coverage is restricted to being an optional coverage, where available, in the private insurance market.

If the natural catastrophe is a significant hurricane, in most cases claims will be paid in a timely fashion. There are sometimes delays in being able to physically get to a property to assess the damage and adjust the claim. There are also sometimes disputes regarding the source of the damage, wind versus water. Following the disaster, as claims are paid, if the hurricane generates sufficiently large losses, it may well be the case that some insurers find themselves in financial distress and possibly unable to continue to underwrite insurance.

As well, following a major hurricane, individual property owners may witness the all too common phenomenon of finding insurance difficult, sometimes impossible, to find, as well as likely seeing budget-busting rate increases. Frequently, following a significant hurricane, there is increasing pressure on residual markets to provide the mandated insurance. This has been especially true since 2004 as many of the “major” national property insurance companies have made the decision to curtail their exposure to natural catastrophe risk. According to the Insurance Information Institute, nationally the amount of residential property exposed to catastrophic risk insured in residual markets has grown from $113 billion in 2000 to $670 billion in 2007.

Experience from the Florida Market

The property insurance market in Florida had, for all intents and purposes, reached equilibrium by 2004 from the shocks created following Hurricane Andrew in 1992. The four land falling hurricanes in 2004 followed by the subsequent four hurricanes in 2005 served not only to disrupt this equilibrium but to put significant stresses on the market that are still in evidence today. Private insurance companies rely heavily on reinsurance acquired in the global marketplace. By 2006, this reinsurance was in many cases either unavailable or only available at rates that were economically unfeasible. Direct writers who could still acquire reinsurance were seeing rate increases in high double digits, sometimes even triple digits. Others who could not find insurance in the private market were forced into Citizens Property Insurance Corporation, our residual market mechanism, which at one point had over 1.2 million policyholders, a number that has since abated as we develop a domestic market.

As this passed through to homeowner’s policies and commercial property policies, the result was devastating to the Florida economy. Real estate transactions were being delayed, forestalled or cancelled. Business expansion and development plans were either scaled back or cancelled. Individuals, facing in some cases a doubling of their insurance cost, if they were able to find coverage, were forced into making tough economic choices, including at the extreme whether to buy homeowner’s insurance, food or prescription medicines. This squeeze in disposable income was felt throughout the Florida economy, and this ripple effect continues today along with the other economic issues facing our citizens.

With the current financial turmoil, our Florida Hurricane Catastrophe Fund entered into 2009 unsure that it would be able to obtain financing in the municipal bond market if needed, despite its Aa rating. That situation has only recently eased somewhat

If the natural catastrophe is a significant flood event, the ability of the affected areas to recover is going to depend critically on the degree to which affected properties were insured with the NFIP. Unfortunately, recent evidence from 2004 and 2005 suggests that far too many properties damaged by flood were uninsured; either they were outside of the mandatory flood plains as dictated by antiquated maps, or they were in the mandated flood zones, but were uninsured anyway. A recent study by the Rand Corporation provides evidence that suggests that the rate of take-up (that is how often the coverage is purchased) outside of the mandated zones is around 5%, and the take-up rate in mandated zones is only about 75%. Following the event, taxpayers are likely to face a bill to subsidize the NFIP losses. Florida knows this all too well. According to the GAO, over the last thirty years Floridians have paid in almost ten billion dollars more in premium than they have received in benefit; an amount of subsidy that is a magnitude large than the next largest subsidizing state, California.

If the natural catastrophe is an earthquake, the ability of the affected regional economy to recover is going to largely depend on the degree of disaster relief coming from the federal government and the American taxpayers. The reason is really quite simple; the majority of residential property in earthquake prone areas is not insured for this very real risk. In California, for example, it is estimated that the take-up rate for optional earthquake insurance has fallen to about 12% or less. The same take-up rate is frequently suggested to be true in the earthquake prone areas in the Midwest’s New Madrid area, and along the eastern seaboard’s seismically active areas.

As you can see, what is lacking in our current system is a comprehensive approach to managing the devastating effects of catastrophic natural disasters. Our current policy relies heavily on the American taxpayer through the Federal government for most types of natural disasters. As generous and compassionate as the American people are, the current system leaves much to be desired. While it is true that our current reliance on federal payments for large-scale disaster does spread the cost of these events across a broad pool, the American taxpaying public, it does so rather ineffectively. At the other extreme, our current system of insuring large scale disasters in the case of hurricanes can and frequently does create unwanted and unneeded volatility in the marketplace, which adversely affects property owners.

Perhaps more problematic is that precious little of this money is being invested in programs or projects to prevent this sort of scenario from repeating. Our current system is largely based on an after the fact reaction. I would argue that a more proactive system that prepares the public and mitigates the potential for catastrophic damage following such an event is more practical, and in the long run less expensive to both affected individuals and the public at large.

Moreover, while the recent focus has been on coastal insurance issues, the broad problem is also one that is national, not regional, in scope. Also in the documents attached to my testimony, you will find maps of the catastrophic exposure to natural disaster facing each state. As these maps show, very few Americans are not moderately or severely exposed to the effects of a natural disaster.

Other Approaches to Managing Disaster Risk and Insurance

What then could be done to create a comprehensive plan? Both within the US and across other developed economies a variety of programs have been created to manage the economic consequences of catastrophic events. These programs differ in their structure based on underlying premises regarding the nature of the risk. As such, the resulting roles of the private insurance market and government entities vary considerably across programs. The Government Accountability Office report “U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risks,” GAO-05-199 published in February 2005, provides a thorough description of these various approaches.

Public policy frequently enters the debate as to whether or not a natural catastrophe is an insurable risk. Here in the US, it was decided in 1968 that flood was not an insurable risk with the creation of the National Flood Insurance Program. Interestingly, other countries consider flood an insurable risk.

Using the same premise, both France and Spain have created risk pools for mandated natural catastrophe coverage that result in the state assuming the risk on an unlimited basis.

On the other hand, many natural catastrophes are considered insurable as a matter of public policy, and government is used sparingly to facilitate the private sector mechanism. Perhaps the most common tool provided under this premise is the insurer’s ability to set aside reserves to pay for catastrophic losses on a tax-deferred basis. While differences do exist in how these reserves are structured and monitored, they are common throughout the world. As a measure of their perceived importance, a recent International Accounting Standard ruling (accounting guidance followed by most of the rest of the world except the US at this point) would have done away with this reserving mechanism. Virtually all European nations, along with a number of other jurisdictions, chose not to adopt this new rule.

The US does not allow for the creation of tax-deferred reserves by insurers, although a number of variants of a tax-deferred reserve have been developed and proposed since Hurricane Andrew in 1992.

A second tool found in many nations is a risk pool funded by private insurers but managed by the government. In Switzerland, for example, coverage for all natural catastrophes, except earthquake, is mandated in property insurance policies. Private insurers as well as state-owned canon specific insurers, pool these risks together and an average actuarial rate is determined and charged by all insurers.

Federal Support of Disasters and Disaster Insurance

As we observed from Hurricane Katrina, the Indian Ocean tsunami, and the 2005 earthquake in Pakistan, federal governments globally will always become involved if there is a national catastrophe that affects its citizens. One important policy question is whether this support is provided before or after an extreme event. It is like the old television commercial featuring the auto mechanic telling the camera “You can pay me now, or you can pay me later.” It is almost always more inexpensive to finance disaster recovery before a catastrophe occurs, rather than after-the-fact. This is precisely the purpose of insurance --- to pay prior to the accident, to provide an economic cushion to survive the adverse event.

Although I believe this Subcommittee should carefully consider the cost/benefit of all options for federal involvement, it is important to stress the solution to handling natural catastrophes, and ensuring a stable insurance market, does not necessarily begin or end with a massive federal program. In its Constitutional powers of taxation and interstate commerce, Congress’ powers directly and indirectly affect state insurance markets. The loan conditions put on federal mortgages, the tax treatment of insurance company’s reserves, economic incentives for individuals to retrofit their homes, improved building codes, and even upgrading our nation’s infrastructure are all areas Congress can address to positively impact the insurance marketplace. In the following section, I will attempt to summarize a few of the key ideas that I believe would be worthy of consideration.

Improve Disaster Preparedness and Disaster Response

Disaster planning and disaster response are the very first steps to saving lives and protecting communities. The sad evidence from Hurricane Katrina bears solemn testament to this fact. The recently released study of community disaster preparedness by the Department of Homeland Security suggests there is still much to be done around the country. The report states the "current catastrophic planning is unsystematic and not linked within a national planning system." It states that, "this is incompatible with 21st century homeland security challenges..." It goes on to suggest, "the need for a fundamental modernization of our Nation's planning processes." Not only is this a key priority for us in Florida, insurance regulators around the country agree. To that end, the NAIC has endorsed disaster planning as a top priority and maintains disaster preparedness manual for use by all states.

Build Better Homes

We cannot stop natural disasters, but there are measures we can take to mitigate damage. The first component of any comprehensive national strategy must be mitigation. By mitigation I mean preemptive measures taken to reduce or eliminate risk to property from hazards and their effects. In practical terms, this involves toughening building codes for new structures by making them more resistant to hazards such as wind, flood, and earthquakes. It also means stricter state and local guidelines to limit construction in highly hazardous areas.

The insurance mechanism can reinforce this mitigation through its pricing. The insurance industry, or whoever provides the insurance, can and should incentivize property owners to take the personal responsibility to protect themselves from catastrophic loss through mitigation by providing meaningful premium discounts for mitigation investment. We have implemented such measures in Florida

The federal government can positively impact these decisions by predicating federal loan decisions through the Federal Home Association (FHA) and Rural Development Home Program to only allow the purchase of homes that meet the most stringent building code standards. If a home does not meet these standards, a procedure for requiring the retrofitting of the home must be enforced.

Mitigation techniques work, are cost effective, and we have seen their successful utilization. In Florida, the Florida Department of Financial Services provided $2.3 million to develop four model “hurricane houses” with advanced building techniques to withstand 140mph winds. In 2004, the eye of Hurricane Frances, a category 2 hurricane, passed over one of these houses located in Ft. Pierce. The house survived with no appreciable damage. In Tulsa, the development of education and marketing to extol the value of “saferooms” has met with tremendous success, significantly increasing the demand for this tornado mitigation safety device.

Although strengthening building codes for new structures will improve the housing stock on a going-forward basis, this will have a minor impact on the entire book of business for property insurers in the short-run. The majority of the housing stock in the US is already built. This is true even in rapidly growing states; the average age of a house in Florida is 24 years. Many of these houses were built prior to any building code standards, much less the most recent, even in areas where building codes are in place.

In 2006,, the Florida Legislature passed the Florida Comprehensive Hurricane Mitigation Program, which provides for free home inspections, as well as 50% matching grants of up to $5,000 to encourage single-family homes to reduce vulnerability to hurricane damage. The response was overwhelming. The Florida Department of Financial Services received over 65,000 applications for the free home inspections that would alert consumers how to harden their homes. Regrettably the target for the year was to inspect 12,000 homes based on resource constraints, but this illustrates the interest homeowners have in protecting their homes when the proper financial incentives are provided. The current economic environment has curtailed expansion of the program right now, but as the economy recovers I expect the program will return as its importance is recognized by all.

Mitigate by Improving Infrastructure

Another element of improving the homeowners market is to improve our nation's infrastructure. This includes dikes, levees, tunnels, bridges, solid waste facilities, transportation facilities, and roads. Let us recall during the Hurricane Katrina tragedy in New Orleans, many of the structures withstood the initial damage of the storm, only to be destroyed due to the failed levee system. The American Society of Civil Engineers' March 2005 Report Card showed deteriorating conditions in 13 of the 15 infrastructure areas surveyed. Insurers are becoming reluctant to insure structures in areas with outdated or outmoded infrastructure risks. A commitment to improving our infrastructure, especially as it relates to structures that place homes in greater risk during a catastrophic event, will help prevent or mitigate damages to homes.

Expand the Capacity of the Insurance Marketplace

The current system of insurance is very good at handling the "normal" disasters ranging from car accidents, to storms, and even to large hurricanes. Catastrophic natural disasters, especially the prospect of mega-catastrophes (i.e. the "big one" hitting California, a category 3 or 4 hurricane hitting New York, major seismic activity along the New Madrid Fault in the Midwest), create risks that could simply destroy an insurance company or potentially the entire industry. This risk of ruin will likely keep the private sector from offering sufficient capacity for entirely rational reasons. No potential rate of return is going to be worth the risk of losing the entire company.

Following major events, disruptions and shocks in availability and pricing also serve to limit the consistent delivery of insurance at rational prices.

I believe there are a number of possibilities that could expand and stabilize the capital flows into the market to ensure sufficient capacity and stabilize pricing. These would include:

Consider Natural Catastrophe Reserves for individuals or, on a tax deferred basis to insurance companies to provide an economic cushion for likely future events. Allowing U.S. companies to join companies in most other industrialized nations, and granting them the ability to set aside tax-deferred reserves specifically for catastrophes, when structured appropriately so as not shelter income, could provide additional capacity for the market. As well, at least some of the "boom or bust" cycle in the property insurance market could be smoothed to everyone's benefit

Consider a Federal Backstop for Catastrophic Risk

For the creation of a federal backstop, a number of innovative ideas have been suggested. It is important to note that these ideas, if deemed appropriate, do not, contrary to some public opinion, necessitate a public subsidy. In fact, actuarial pricing to expected loss seems to be a consistent theme.

One concept is to have the federal government, through the U.S. Treasury Department, implement a reinsurance program offering reinsurance contracts sold at regional auctions. One variation of this proposal would be to allow private insurers to obtain reinsurance contracts.

Other proposals would restrict these reinsurance funds to authorized state catastrophe funds, similar to our Florida Catastrophe Fund, or the California Earthquake Authority.

More recently, there has been discussion of limiting the role of the federal government to providing credit guarantees to state or regional funds which would be repaid over an intermediate term after a qualifying event.

Working with states or regions, there is the possibility of the federal government coordinating products and designs for state or regional groups to obtain financing in the alternative markets, especially through securitizations.

National Catastrophe Reinsurance

Currently, the United States is one of the only industrialized nations in the world not to have a federal comprehensive catastrophe plan. A comprehensive plan should include planning for the disaster, building resistance to the disaster, and economically efficient financing of the disaster. The role of the federal government should be limited to those areas where individuals, private markets or state governments cannot affect a better solution on behalf of the American people. Clearly there are a number of forward thinking ideas that need further consideration, but they should be framed to first answer the question, "Will this make insurance for individuals and businesses more available, and more affordable, with fewer burdens on the American taxpayer than the current system?" We will work with this Subcommittee to find the right answers to that question. The lessons of recent catastrophes may be the only warning we get to start making those decisions, so I thank you for holding this hearing, for inviting me here today, and for your continued interest and leadership on this crucial issue. I'd be happy to answer any questions you have.