REINSURANCE ASSOCIATION OF AMERICA

STATEMENT

TESTIMONY

OF

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REINSURANCE ASSOCIATION OF AMERICA

PERSPECTIVES ON NATURAL DISASTER INSURANCE

BEFORE

THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

March 27, 2007

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Chairman Waters, Ranking Member Biggert and Members of the Subcommittee on Housing and Community Opportunity:

My name is Frank Nutter and I am President of the Reinsurance Association of America (RAA). It is an honor to appear before you on behalf of the RAA. The RAA is a national trade association representing property and casualty organizations that specialize in assuming reinsurance. Together, RAA members write nearly 2/3 of the reinsurance coverage provided by U.S. property and casualty reinsurers and affiliates.

Reinsurance is commonly referred to as the insurance of insurance companies. Reinsurance plays a critical role in maintaining the financial health of the primary insurance marketplace and ensuring the availability of property and casualty insurance for U.S. consumers and businesses. Reinsurance is used for several reasons. One of the most common purposes is for a primary insurance company to transfer the risk of losses from catastrophic events such as hurricanes, earthquakes, and in the case of September 11, 2001, acts of terrorism. To that end, reinsurers have assisted in the recovery after virtually every major U.S. catastrophe over the past century. For natural disasters typically one-third of the insured losses are passed on to reinsurers and in the events of September 11, two-thirds of the losses were absorbed by the reinsurance industry. Fifty percent of 2005 losses associated with hurricanes Katrina, Rita and Wilma ultimately were born by reinsurers.

As the Committee has called this hearing to address the question of "Perspectives of Natural Disaster Insurance," I am here to share with you the reinsurance perspective on this most important matter. My testimony will focus on: 1) status of the 2007

reinsurance marketplace and 2) the RAA's general concerns with the creation of state and federal catastrophe reinsurance funds.

The Property and Casualty Reinsurance Marketplace Today

An important component of ensuring the availability of homeowners' insurance is the reinsurance market and its capacity, that is, the amount of reinsurance it is able to provide to primary companies. Any debate on whether there should be a federal catastrophe fund should include an analysis of the ability of the private reinsurance market to provide catastrophe capacity to insurance companies as well as the capacity of insurers to underwrite and retain this risk.

The U.S. attracts reinsurance capacity from all over the world. Global reinsurers view U.S. catastrophe risk as an essential component of their diverse assumed risk portfolios. The important role reinsurance plays in our nation's economy is best demonstrated by evaluating the 2004 and 2005 hurricane seasons (since 2006 did not result in any significant hurricanes).

As you are aware, in 2004 there were four major hurricanes that hit Florida resulting in $30 billion of damage. The global reinsurance industry paid approximately one-third of those losses, enabling insurance companies who purchased reinsurance to honor their obligations to their homeowner policyholders. Despite this huge financial hit to reinsurers, there were no reinsurer insolvencies and the reinsurance market was able to meet the primary insurance community demand for the 2005 hurricane season.

The hurricane season of 2005 turned out to be a year of unprecedented losses in terms of frequency and severity. The insurance/reinsurance industry weathered the single largest loss in the industry's history (Katrina). Insured Katrina losses alone were an estimated $45 billion, even greater than the projected $35 billion in 9/11 losses. The 27

named hurricanes and tropical storms in 2005 set a new record, an aggregate total of $80 billion in insured losses. The Big Three: Katrina, Rita and Wilma produced losses estimated to be as high as $60 billion. The reinsurance industry once again played a critical role, providing stability to the insurance market, by paying approximately one-half of all of these losses. Even with these unprecedented losses there were no resulting reinsurer insolvencies.

Notwithstanding that 2005 was the worst year on record for insured natural catastrophe losses in the U.S., the insurance industry reported its best ever profitability which can be attributed in large part to the industry's reliance on reinsurance to moderate the losses. In fact, the U.S. insurance industry surplus grew from $356 billion at December 31, 2003 to $439 billion at December 31, 2005. As of December 31, 2006 the industry's claims paying ability and capital base have never been better.

Despite the resilience of the reinsurance industry to respond to these record breaking financial losses, a few primary insurance companies in the industry are suggesting the 2005 hurricane season has demonstrated the need for a federal reinsurance program for natural disasters. The RAA does not believe market conditions warrant the creation of a federal program.

Indeed the capital markets have greatly enhanced reinsurance catastrophe capacity following hurricane Katrina. As they did in 1993 after Hurricane Andrew and in 2002 after the terrorism losses of 9/11, 2001, the capital markets promptly provided new reinsurance capital and capacity in response to the 2005 hurricanes. Since late fall 2005, approximately $32 billion in new capital has been raised and committed to the reinsurance market. Of that capital, $10.4 billion was invested in new start up reinsurance companies; $10.3 billion replenished the capital positions of existing reinsurers; and an additional $5.6 billion was invested in special purpose vehicles, whose

investors collaborate to provide extra underwriting capacity to existing reinsurers for property and catastrophe retrocessions and short tail lines of business. Thus over $26 billion in new capital has been raised in the reinsurance industry since Hurricane Katrina. An additional $5.3 billion was raised in the capital markets in catastrophe bonds for U.S. catastrophe risk.

So what does that mean for actual reinsurance capacity to provide natural disaster protection for primary insurance companies for 2007? Despite the unprecedented losses in 2004 and 2005, private market reinsurance capacity increased in 2006 by approximately 30%. The reports of January 2007 renewals indicate reinsurance capacity for 2007 has grown by 14% even in a moderating price environment. The private reinsurance market is financially strong and diverse. Reinsurance capacity is adequate even for peak catastrophe markets. Thus, RAA does not believe a federal role is appropriate.

Looking back at 2006 and the issues raised by some regarding reinsurance market dynamics, several factors external to the reinsurance market affected the market. Demand increased in some peak zones at a greater rate than the supply increased due to: rating agencies (such as AM Best and Standard & Poors) requiring more capital of insurers and reinsurers to support catastrophe risk; reinsurance modelers increasing loss predictions; and insurance company managements' desire to purchase more protection. Rating agencies determined that companies with catastrophe exposures needed additional capital or needed to buy more reinsurance to support their ratings. Insurance catastrophe modelers revised their models due to new data following 2005 and a belief that the country is entering into an era of increased hurricane frequency and severity. Insurance company managements also have reacted to a changed perception of risk. Such managers have seen the impact of increased hurricane frequency and severity on their losses and

want to purchase more reinsurance protection. At the same time as demand was increasing, reinsurers were re-evaluating the losses that their ceding insurers could suffer. The confluence of these events resulted in reinsurance prices increasing in some peak catastrophe zones dramatically.

In classic supply/demand economics, this period of re-evaluation and re-underwriting by reinsurers and the addition of new capital sources appears to have moderated the market. In 2006 testimony before this Subcommittee, the RAA stated that it believed the imbalance between demand and supply of reinsurance was temporary. As the events after Hurricane Andrew suggest, typical insurance and reinsurance cycles involve temporary spikes in pricing, followed by new market participants, leading to increased competition and price moderation. Ultimately, free markets will create a more diversified insurance and reinsurance market that will spread risk widely, increasing capacity and price competition.

The process we predicted would occur appears to be well underway. Capacity is adequate and reinsurance rates for January 1, 2007 renewals are below the market highs at July 1, 2006 according to reinsurance brokers.

> "**Reinsurance capacity at the end of 2006 was more than adequate, even for most peak exposures** … Strong earnings were driven by low catastrophe losses. Normal dividend payments were maintained, and capital was boosted during the year. **New entrants were eager to join.**"
> *Benfield, "Global Reinsurance Market Review Pick 'n' Mix," January 2007*

> **"[R]ates** at January 1, 2007 renewals for US property catastrophe **were below** the levels of July 1, 2006 renewals. Given that nearly all other lines are experiencing rate decreases or renewing at expiry, **we can now conclude that the U.S. reinsurance market overall has entered the soft phase of the cycle**. If history is a guide, **we can expect soft market conditions to persist for many years**. This will be the 'normal' state of the market."
> *Guy Carpenter, "U.S. Reinsurance Renewals at January 1, 2007 Smooth Sailing Ahead?"*

RAA's Position on State and Federal Catastrophe Funds

Some have called for the creation of a federal catastrophe reinsurance fund. At the core of these proposals is the creation of federal catastrophe funds to provide reinsurance to state catastrophe funds. The state catastrophe funds would then sell reinsurance to insurance companies. The stated intent is that this would result in insurance companies providing more homeowners with insurance in high-risk areas.

The RAA believes that there are many flaws with state catastrophe funds. There is no evidence that they result in greater availability or affordability of homeowners' insurance. Insurers must still manage their accumulated catastrophe exposure and in some cases, limit writings, cancel existing policies or seek premium increases. It is an essential element of solvency regulation and financial management that insurers (or those required to subsidize them) maintain adequate resources to cover losses. Politically charged rate setting does not affect the underlying risk of loss. Premiums (or in the case of Florida, premiums combined with later assessments on policyholders) must still cover catastrophe losses.

The RAA believes that natural disaster risks are insurable in the private insurance and reinsurance market and that state catastrophe funds significantly displace the private market. State catastrophe funds are not a long-term solution. The catastrophe fund concept as applied in Florida for example is one that relies on public subsidies or cross-subsidies from other insurance lines to pay for natural disaster risk, rather than relying on affected property policyholders paying the costs of their own risk exposure.

Florida's Catastrophe Reinsurance Fund meets the standard of proposed legislation, therefore it seems appropriate to examine its structure and its experience. The Florida Hurricane Catastrophe Fund does not rely on its premiums to pay its

hurricane losses. The model of the Florida Catastrophe Fund is one that offers insurers inexpensive reinsurance premiums up front, because it is back loaded. When a hurricane occurs that requires the Florida Catastrophe Fund to pay losses in excess of its cash balance (as in 2004 and 2005), the Catastrophe Fund issues bonds. The bond debt is not paid by the insurance companies who received the cheap reinsurance. Instead, it is paid by assessing/taxing Florida policyholders of other lines of insurance, such as automobile insurance and commercial insurance such as municipalities, daycare centers, school districts and small businesses. The effect is that insurers have off loaded a substantial part of their property risk to a government catastrophe fund, and that government fund assesses its citizens to make up for the revenue shortfall caused by the low upfront catastrophe fund reinsurance premiums. Policyholders from all lines of insurance, including those at low risk to catastrophes are being required to insure insurance companies. In essence the Florida Catastrophe Fund has disintermediated the reinsurance market and in its place, put the insured public, commercial and residential.

State catastrophe funds also violate one of the fundamental tenets of insurance-spreading the risk among various risk bearers. Government funds concentrate risk. The Florida Hurricane Catastrophe Fund, for example has $1.8 trillion of insured values with $1 billion of cash and $980 million of expected 2007 revenue. Private insurance and reinsurance however spreads the risk globally. Of the losses caused by Hurricanes Katrina, Rita and Wilma, reinsurers paid approximately 50% through markets in London, Bermuda, Europe and the U.S. Through bond indebtedness a state catastrophe fund concentrates risk in one jurisdiction and shifts the financial cost of paying catastrophe losses from the private sector insurers to insurance buyers including those not covered by the fund itself. Effectively low risk policyholders insure high risk policyholders.

State funds like the Florida Hurricane Catastrophe Fund do not reduce the vulnerability of people to natural catastrophes. They are not a proactive, disaster planning approach. Rather, they are a cost shifting mechanism. There is no free lunch-someone will pay for the losses. Private reinsurance is a proactive, "pay for the risk up front" by those insured at risk. The "pay me later" approach of state catastrophe funds costs homeowners and businesses, not insurers, since policyholders are essentially obligated to pay insurers for any shortfalls in the state catastrophe fund claims paying ability. For example the Florida fund is currently assessing policyholders for the 2004-2005 hurricane seasons.

The irony of Florida is that the people who vilified insurers are, together with other policyholders, now their reinsurers. State catastrophe funds also create cross-subsidies. First, coastal properties are subsidized by policyholders that have a lower risk to catastrophes, cannot afford or choose not to live in such hazard zones. In addition to property policyholder subsidies, the catastrophe funds rely on cross-subsidies to pay for hurricane risk rather than relying on current affected property policyholders paying those costs. For instance in Florida, car owners, small businesses, school districts, day care centers, churches, hospitals, renters, professionals, and business owners – anyone with a property and casualty insurance policy (other than medical malpractice and workers' compensation) – is required by law to pay the billions of dollars in bonds authorized for the Florida Hurricane Catastrophe Fund due to its shortfalls. These policyholders, even those far from the coast, will pay annual assessments needed to pay off the hurricane bonds that will benefit the coastal property owners.

The experience with state catastrophe funds is that they are susceptible to suppression of insurance rates for those at risk. The effect of this is to mislead high risk insureds about the financial consequences of living in high risk areas, encourage

continued development in those areas and shift the cost of disaster losses to others who may be less at risk and equally less willing to pay the subsidy.

The current Florida fund is riddled with debt and is likely to become worse. What incentives do states have to be fiscally responsible if a Federal fund were to provide financial backing? We urge Members of the Committee to take a serious look at the inherent problems with state catastrophe funds and whether they would actually create an improved homeowners' insurance market. We strongly suggest that such funds do not.

RAA's Concerns with Federal Catastrophe Funds

Over the last 15 years, the RAA has worked with Members of Congress and their staffs on many different legislative proposals to create federal reinsurance programs. We believe that natural catastrophe risk is insurable in a free market. We do not believe the creation of a federal reinsurance program solves the homeowners' insurance availability problem. It ignores the many constraints that are now imposed upon the private market. We believe public policymakers should make it their top priority to remove regulatory constraints from the private insurance market's ability to willingly insure risk. By removing regulatory constraints policymakers will maximize private sector risk bearing. These regulatory constraints include: price controls, coverage mandates, and involuntary residual market facilities and associated assessments. If policymakers follow competitive, free market principles, a federal natural disaster reinsurance fund is unnecessary.

The RAA offers the following observations regarding federal catastrophe funds:

1. Often, the proposed trigger levels for the federal reinsurance program are too low and will interfere with the private marketplace. These are levels of losses where

the private reinsurance marketplace is currently providing capacity. If the federal fund had provided reinsurance at low attachment points as some have proposed, rather than the private insurance and reinsurance markets paying for the insured losses associated with Katrina, Rita and Wilma, the federal government through its reinsurance fund would have paid for these insured losses.

2. There is no assurance that a federal reinsurance program will result in more availability of homeowners' insurance. Unlike the Terrorism Risk Insurance Act where the quid pro quo for the federal reinsurance is that insurers must offer terrorism insurance on the same terms and conditions as they offer other lines, there is no requirement that insurers who benefit from the federal reinsurance of state funds offer more homeowners' insurance. The experience of Florida is that cheap reinsurance has not resulted in greater private sector insurance.
3. To be fiscally responsible any federal reinsurance must include a requirement that the federal government and the state fund add a risk load reflecting the true cost of catastrophe exposure when pricing the reinsurance. In the private insurance and reinsurance market a catastrophic risk load is required on all pricing. Without such a requirement the private reinsurance and insurance market would be further disenfranchised from the market it now serves.
4. It has been suggested that a federal program is necessary because reinsurance prices are too high. The RAA believes that a free market should be allowed to work and that it is totally inappropriate to create a federal program simply based on complaints by some insurers over reinsurance prices at a single point in time. The concepts of supply and demand are playing out in the free market. As we learned following Hurricane Andrew in 1992, after 9/11 terrorism losses and now post-hurricane Katrina, reinsurance markets adjust. They are resilient, they attract

capital and capacity after major events and the supply/demand equation will come back into balance.

5. A federal fund that sells reinsurance to state catastrophe funds concentrates all of the risk associated with natural disasters in government. A private market diversifies this risk, spreading it globally. A classic example of the importance of a diversified insurance/reinsurance market occurred in 2005. Of the total reported losses, U.S. insurers paid (all approximate) 41%: U.S. reinsurers paid 11%, Bermuda reinsurers 24%, European reinsurers 13%, Lloyds 9%, and all others 1%. If H.R. 91 were to become law, most of this risk would no longer be spread across the global insurance/reinsurance market; instead it would be concentrated in the State and Federal governments.

Would a Federal reinsurance program replace government disaster assistance? Some have suggested that a Federal program is appropriate because "we all pay for disaster recovery now" implying that Federal taxpayers are on the hook for disaster losses. First it must be understood that, while natural "disasters" may occur in all states, most are modest potential costs compared with a few regions. Because of unusual risk exposures and concentrative of insured values, 97% of all earthquake losses have occurred in California and since 1900, 75% of all hurricane losses have occurred in Florida, Louisiana and Texas. The natural disaster related losses in other states are notably less and paid for by insureds based on their own risk premium. Secondly, an analysis of Federal disaster assistance indicates that it primarily goes to immediate and temporary shelter and food, infrastructure repairs and emergency responses. These losses would not be covered by a proposed Federal reinsurance program and therefore it would be expected that taxpayers would continue to support them. Third, a high percentage of

catastrophe loss occur to commercial businesses, none of which are covered under existing programs or by any proposed Federal program.

The Role of Government

Government does have a critical role related to natural catastrophes. States should impose appropriate hazard mitigation through sound building codes and land use. With respect to insurers, state government should ensure sound financial management of insurers by seeing that premiums are appropriate for the risk and that insurers remain financially vibrant and solvent. At the Federal level government provides appropriate disaster assistance in times of need. It also provides financial support for research and repair of infrastructure damage such as rebuilding of levees, dams, bridges and roads.

Conclusion

The reinsurance industry has responded well to every major catastrophe in the United States over the past decade. Reinsurers have served a vital purpose in providing insurers with the necessary capacity to ensure that homeowners are able to obtain insurance. A federal reinsurance program created to enhance state reinsurance programs would displace the vibrant private reinsurance market to the detriment and cost of the U.S. taxpayers. The RAA believes that natural disaster is an insurable risk in the private sector if the free market is allowed to work. A free market will give insurers the tools they need to better provide homeowners' insurance at an appropriate risk-based cost.