**TESTIMONY OF ANN W. SPRAGENS
ON BEHALF OF
THE PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA
BEFORE THE
SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES**

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My name is Ann W. Spragens and I am Senior Vice President, Secretary and General Counsel for the Property Casualty Insurers Association of America (PCI). PCI is a trade association representing over 1,000 property/casualty insurers that write almost 40 percent of the homeowners insurance sold in the United States. Because of that, PCI has a deep interest in natural disaster issues and the ways in which we can better prepare our industry and our nation to respond to future natural disasters. Thank you for the opportunity to appear before you today and to present our thoughts on these issues.

Introduction

PCI testified before this Subcommittee in June and September of 2006 on natural disaster issues and as we have stated previously, PCI believes that developing effective public policy solutions regarding natural catastrophes is one of the most significant issues facing the nation and the insurance industry today. Climate experts agree that America faces the prospect of more frequent and severe natural disasters in the coming decade. Moreover, significant property development, population growth, and rapidly rising real estate prices in areas prone to natural disasters exacerbate the potential for larger human and economic losses, requiring stronger loss prevention and mitigation and greater financial resources for recovery.

We commend you and your colleagues for your attention to and leadership on this issue and for your continued efforts to find innovative solutions to the problem of catastrophe risk. Just since the 110th Congress has convened, members have introduced several important legislative proposals, including H.R. 91, the Homeowners Insurance Protection Act, introduced by Rep. Brown-Waite; H.R. 164, the Policyholder Disaster Protection Act, introduced by Rep. Jindal; H.R. 330, the Homeowners Insurance Availability Act, introduced by Rep. Brown-Waite; H.R. 537, the Commission on Catastrophic Disaster Risk and Insurance, introduced by Rep. Meek; H.R. 913, the Hurricane and Tornado Mitigation Investment Act, introduced by Rep. Bilirakis; H.R. 920, the Multiple Peril Insurance Act, introduced by Rep. Taylor; as well as several companion and other bills introduced in the Senate. You have also passed last year, H.R. 4973, the Flood Insurance Reform and Modernization Act of 2006 that would reform the National Flood Insurance Program, for which we commend you. While that legislation was not enacted in 2006, we would urge you to pass flood reform legislation in 2007 and pledge to work with you and your colleagues in the Senate in this effort.

Comments on the Catastrophe Problem

PCI members play a pivotal role in protecting American homeowners and supporting our nation's housing markets by providing the products and services needed to protect homeowners, lenders, businesses, and communities against exposure to natural catastrophes. Our members are proud of the work they do in these markets.

In 2004 and 2005, property insurance markets have been tested as never before. Catastrophe losses in 2005 totaled some $61.9 billion, nearly doubling the previous record losses in 2001. Hurricane Katrina itself caused nearly $40 billion in insured losses, surpassing the roughly $32 billion from 9/11. The vast majority of claims from 2005's events have been paid and the insurance market has met its financial obligations. In PCI's view, the most important catastrophe issue facing us today is whether the market has, or is building, the capacity to pay for catastrophes the nation will face in the future.

Given the very serious catastrophe losses we've seen over the past several years and the significance of this issue for our membership, our organization has devoted considerable time and effort to develop sound public policy solutions that we can recommend.

There are several fundamental issues that have to be addressed:

- First, America clearly faces the prospect of increased frequency and severity of major hurricanes and the continuing threat of other major natural catastrophes including earthquakes, floods, tsunamis, and volcanic eruptions. Catastrophe modelers tell us that we are in a prolonged period of increased severe storm activity. Seven of the ten most costly natural disasters in U.S. history have occurred since 2004. We can't afford to ignore this reality.

- Second, America is experiencing significant development, population growth, and rapidly rising real estate prices in areas that are highly prone to natural disasters. AIR Worldwide, one of the leading risk modelers in this country, that there is currently some $7 trillion in property values exposed to catastrophe risk along America's coastlines; some $3 trillion of it is personal property, rather than commercial property. Even if storms were no more frequent or severe than in the past, this fact alone means that future storms will be more damaging and more costly to insure. As a result of migration and property development, the nation faces growing exposure to significant catastrophe losses and increasing costs of recovery.

- A growing number of Americans have a significant portion of their net worth exposed to catastrophic loss. The impact of future major natural catastrophes on the economy will be larger and will likely lead to significant public policy debates over how best to address this risk.

- As insurers, our members would like to rely on a free market environment to solve this problem whenever possible, with prices and products tailored to match the risks freely assumed. We think that such an approach would, over time, establish appropriate economic incentives for those who live and work in catastrophe-prone areas and would attract badly-needed private capital for risk protection. However, we must also recognize that our industry does not operate in an unregulated market. Our members work in a world where prices and coverage terms are highly regulated and generally are not allowed to respond freely and in an immediate fashion to changing risks or conditions. For example, the Florida legislature, in a special session held just to address the affordability of property insurance, passed landmark legislation that rolled back appropriate rate changes for the state's largest insurer, Citizens Property Insurance Corporation, removed its "market of last resort" status, and required insurers to modify their pricing based on reductions in the cost of reinsurance resulting from changes to the Florida Hurricane Catastrophe Fund. According to our analysis, the legislation also lowers current residential property insurance rates by: providing reinsurance that is less expensive than commercial insurance, which includes provisions for risk load and taxes; deferring some of the risk of paying catastrophic losses to future years, and transferring risk currently borne by property owners to insured motorists and businesses. Clearly there is a problem in the availability and affordability of homeowners insurance in this state and we hope to work with Florida legislators to effectuate long-term solutions to this issue.

In sharp contrast to the highly-regulated structure governing direct writers, the world catastrophe reinsurance markets operate under a regulatory structure that allows free competition with respect to price, underwriting and product. The cost of catastrophe reinsurance is an economic reality PCI's members and their customers face, as they decide how much and where they can assume this risk.

We also recognize, as we must, that people do not simply pick up and move from one place to the next, irrespective of their homes, families, and community ties. Any set of realistic policy options must take this into account.

- Finally, with respect to preventing and reducing losses, states frequently have outdated and inconsistent requirements for building codes, code enforcement, and other prevention/mitigation tools in areas dangerously exposed to disasters. These weaknesses imperil lives, property, and policyholder resources.

In summary, we agree with you that this is a major public policy issue that must be addressed; we believe the problems posed by catastrophe risk are growing more severe, not less; and we believe a range of potential solutions must be considered, including market reforms, stronger loss reduction and prevention, and new approaches to financing catastrophe risk. We do not believe there is one "silver bullet" to solve this problem, but rather a full range of changes that will have to be made.

Policy Options to Consider

As we look at the issue, PCI suggests four major areas for consideration.

Reduce Exposure to Catastrophe Losses

First, we need to do more to control and reduce catastrophe exposure. PCI suggests the following:

- State and local governments should urgently and immediately review their building codes in catastrophe-prone areas. Wherever needed, they should upgrade their codes. Stronger building codes protect lives and significantly reduce property damage and repair costs. In a highly competitive insurance market, those savings will be passed directly back to consumers. Some have argued that it costs too much to rebuild to meet modern building code standards. Louisiana State University's Hurricane Center has estimated that the marginal cost of building a structure to meet higher wind-borne debris requirements in the International Residential Code is between 1.5 and 4.5 percent of additional cost. On a single-family home with a $100,000 mortgage, that works out to about $27 extra dollars per month. We think such investments are vital.

  PCI supported passage of minimum building code legislation in Louisiana and Mississippi this past year, as well as an unsuccessful effort to extend stronger building codes into the Florida panhandle. However, the Florida legislature realized that this delay in applying its strong statewide building code in the panhandle was inappropriate and, in the special session legislation mentioned above, eliminated this exception. Yet we still hear that there are those in Florida that still would oppose or delay implementation of this provision. PCI also applauds NCOIL in taking a leadership position in adopting a statewide building code model. As we look forward, we believe more work is needed to prepare an inventory of where our states' building codes are most in need of strengthening so that we can better target our efforts to strengthen the codes. And, finally, as much as we supported and are proud of our work to enact stronger codes in Louisiana and Mississippi, we know that much work needs to be done to implement and enforce these new standards, including making sure there is enough funding for the training of building inspectors.

- A second idea is the establishment by the federal government of incentives for greater investment in loss reduction and prevention. We suggest consideration of several ideas. First, the insurance industry's Building Code Coalition has recommended that enhanced disaster mitigation grants under the Stafford Act be provided for states that adopt stronger statewide building codes. This would address the funding issue mentioned above and PCI strongly endorses this approach and urge Congress to enact legislation for this purpose. Second, Rep. Feeney introduced legislation (H.R. 4836) in 2006 to create a special catastrophe savings account for purposes of allowing homeowners to build up, tax-free, funds for payment of qualified catastrophe expenses. Third, Rep. Bilirakis has introduced H.R. 913 this year, the Hurricane and Tornado Mitigation Investment Act that grant special tax credits for qualifying expenditures by homeowners to retrofit their homes to better protect against disasters, introduced by Rep. Bilirakis. Roughly one dollar spent to better protect a property results in four dollars saved following an event. Clearly, one of the major limitations of any new building code enactment is the fact that it typically can't address improvements needed in the existing housing stock. This approach gives homeowners themselves additional incentives to make these improvements. This would save many dollars later in disaster assistance and other government programs.

- We believe state and local governments must take seriously the need to restrict development in catastrophe-prone areas. Max Mayfield, who recently left his position as director of the National Hurricane Center stated in a *Los Angeles Times*, January 3, 2007 article that he is more convinced than ever that U.S. residents of the Southeast are risking unprecedented tragedy by continuing to build vulnerable homes in the tropical storm zone and failing to plan escape routes. Professor Roger Pielke, Jr. of the University of Colorado at Boulder is on point when he says, "More storms like Katrina are inevitable. And the effects of future Katrinas and Ritas will be determined… by the decisions we make now about where and how to build and rebuild in vulnerable locations."[1] This is not only an issue for single family homes. Ongoing commercial development on our nation's barrier islands or in the wetland marsh areas also significantly increases these risks.

- We believe greater steps can be taken for preparedness. As a first step, PCI has completed and distributed to forty eight state insurance departments a PCI Regulators' Kit, containing recommendations for disaster preparation and response. This kit contains model regulations covering five critical areas, including: establishing an Insurance Emergency Operations Center; disaster claim reporting requirements; cancellation and non-renewal of insurance under disaster conditions; suspension of premium payments under disaster conditions; and mediation of disputed claims. When adopted, these regulations could improve the necessary coordination and communication after a catastrophe and help those whose lives and property are at stake.

Fix the Flood Program

Second, we believe Congress should complete its efforts to reform the National Flood Insurance Program (NFIP). PCI strongly endorsed your reform efforts last year and we continue to do so. The NFIP is a necessary policy response to an uninsurable peril and must be continued. However, the program needs numerous reforms, the majority of which are contained in the Flood Insurance Reform Act of 2007 introduced yesterday. As currently structured, the NFIP does little to discourage development in high risk areas, does not provide the level of protection needed by consumers and has not achieved the breadth of participation needed. We support efforts to pass a flood insurance reform bill this year and are willing to work with you to obtain passage of this important legislation.

[1] "Managing the Next Disaster," Roger A. Pielke and Daniel Sarewitz, The Los Angeles Times, September 23, 2005.

Expand Private Sector Capacity

Third, a key part of the long-term solution to natural catastrophe exposure is to expand private sector capacity to handle the risk. PCI strongly supports efforts to make markets more responsive to the risks we face. Prices and terms of coverage that are openly and freely established in competitive markets can create essential incentives for property owners and attract new capital to these markets. As you know, homeowners insurance markets are heavily regulated in virtually all aspects of their operations. We face significant regulatory constraints, particularly in rating, but also in other areas, that inhibit effective market responses and discourage capital from entering these markets. There are several things we think policymakers at several levels of government can do to address this problem:

- First, state legislators should give insurance markets greater freedom to respond to the exposures we face. In free markets, prices and terms of coverage tell consumers the true cost of insuring against catastrophes and are an efficient means of funding exposures. Regulators often fear that giving up regulatory control will make the problem worse and invite consumer backlash. However, based on the experience we've seen in states that have taken this approach, including South Carolina and New Jersey most recently, we believe the results would be just the opposite. Free markets encourage new capital to enter where insurance protection is needed and develop more capacity, not less. PCI will support state legislative initiatives intended to remove regulatory barriers to free markets for catastrophe insurance and will oppose enactment of new barriers.

We also encourage your review of two additional proposals:

- First we are very interested in, and in fact endorse, establishing voluntary, tax-deferred insurance company catastrophe reserves such as H.R. 164 introduced by Rep. Jindal. While there are provisions in this bill PCI believes should be modified, we urge your review and debate of this bill as well.

- Second, we will be examining specific steps that might be taken to remove regulatory, legal, accounting, or tax barriers to further growth in the catastrophe bond market. This market provides another outlet for catastrophe risk financing and introduces new sources of capital and competition. A report earlier this year from Guy Carpenter described the growing importance of this market for financing catastrophe risk. While we certainly don't see the cat bond market displacing traditional reinsurance, market participants tell us that bringing more of these deals "onshore" in the U.S. and reducing a variety of regulatory barriers would permit the market to grow. In principle, PCI strongly supports steps that will attract more private capital to address catastrophe risk and we are very interested in how this might be done in the catastrophe bond market.

State and Federal Government Involvement

Finally, with regard to state and federal government involvement:

- First, based on our review of this issue, we believe the growth in natural catastrophe exposures is of sufficient magnitude in some states that they may require consideration of state natural catastrophe funding facilities. Recent events show that the industry can respond to very severe catastrophe events, but private markets may not always have the capacity to fund increasingly more frequent exposure to “mega catastrophes” or to a series of very large events in a single season. Given this, our approach will be to look at specific conditions in each state to determine whether a catastrophe fund, or other financing mechanism, might be helpful.

  When we consider whether a state needs a catastrophe fund, we look also to see: (1) whether private markets have freedom to respond to market conditions; (2) whether care has been taken to prevent a catastrophe fund from damaging stable private markets or preventing new capital from entering the market; and (3) that the funding of the state program doesn’t rely on cross-subsidies across lines of business. By their nature, cross-subsidies damage the ability of markets to provide strong price signals and incentives for behavior. Having said that, we believe there may be cases and states where a catastrophe fund can be part of a well-rounded solution and must be considered. PCI believes that the Florida Hurricane Catastrophe Fund, including its recent capacity expansion through the recently enacted special session legislation provides the basis for ongoing improvement to that program.

- Second, we would also suggest that there may be some mega-catastrophe exposures that are beyond the capacity of the private market and even of an individual state catastrophe fund to address. In these instances, it may be necessary for the federal government to offer liquidity protection to state catastrophe funds at a very high level, consistent with the maintenance of stable markets and avoidance of widespread insurer insolvencies. Federal involvement may also be essential if the nation suffers repeated mega-events within a short time period. Lest anyone thinks that scenario is impossible, we would remind you of how close Hurricane Rita came to hitting Houston last year, only a few weeks after Katrina devastated New Orleans and the Mississippi coast. It is not inconceivable that several of our major cities could be struck by Category 4 or 5 storms within a single season, or that a major earthquake could strike in the same year as a significant hurricane.

  There are many ideas for how a federal role could be structured, but we would recommend, as we have suggested before, serious consideration of establishing a federal catastrophe financing facility. Such a facility would optimally offer credit financing only to state catastrophe funds, intended to provide access to liquidity to meet immediate claim requirements in the event of a mega-catastrophe or a series of very large events. One key advantage of this approach would be to offer important financing benefits while limiting the offer to state catastrophe funds and thus helping to minimize any potential disruption in private markets.

We are very mindful of the need to be extremely careful in structuring any federal role and of the overriding need to attract new private capital to the market. Accordingly, we also believe that any federal financing role should include measures intended to promote freedom for markets to respond to these exposures, including support for greater rating freedom, support for actuarial soundness or private market rates, freedom for product innovations, use of sound underwriting tools, and lower market barriers. The point of connecting standards for market freedoms to the creation of a federal financing facility is to provide incentives for the states themselves to do everything they can to attract private capital before asking for federal assistance. In addition, we believe that any federal credit should be specified in advance, as private sector lines of credit are, in order to prevent political pressure from influencing what should be a market-based credit agreement. We have the same concern about the need for a federal program to avoid cross-subsidies and other negative design elements as we have for state programs.

However, PCI thinks there may be a role, properly structured, for the federal government to play in assisting the financing of mega-catastrophe risk and we believe it should be given serious consideration by Congress now - before the next crisis.

Conclusion

Again, let me thank you on behalf of PCI and its members for the opportunity to appear before you today, respond to your questions, and provide you with our input on possible solutions to the catastrophe problem. Let me thank you also for the work you are already doing to identify and explore constructive policy solutions. PCI believes this is one of the most serious public policy issues facing our nation and is deserving of your time and continued thoughtful attention. PCI and its members look forward to working with you in the future on this very important issue.