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ON BEHALF OF
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"AN EXAMINATION OF THE AVAILABILITY AND AFFORDABILITY OF PROPERTY AND CASUALTY INSURANCE IN THE GULF COAST AND OTHER COASTAL REGIONS"

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Good morning Chairman Dodd, Ranking Member Shelby, and Members of the Committee. My name is Charles Chamness, and I am the president and CEO of the National Association of Mutual Insurance Companies (NAMIC). Founded in 1895, NAMIC is a property and casualty insurance association, whose 1400 members underwrite more than 40 percent ($178 billion) of the property/casualty insurance premium written in the United States. I am grateful for the opportunity to testify this morning on a subject that poses an enormous challenge to the insurance industry and our nation as a whole.

It is widely acknowledged that property insurance has become more expensive and somewhat less available in the Gulf and Atlantic coastal regions of the U.S. While government and the private sector can and should work together to address problems of insurance availability and affordability in these areas, we should not delude ourselves into thinking that economic principles affecting the complex relationship between supply, demand, and price can be erased by government regulation and programs.

Understanding the Nature of the Problem

Any serious discussion of the issue at hand should begin by acknowledging three simple facts:

1. The exposure of densely concentrated, high-value property to elevated levels of catastrophe risk in certain geographic regions means that property insurance in these regions will be relatively expensive compared to regions that lack these attributes.

2. As population growth and commercial development in catastrophe-prone regions increases, the number of people and businesses faced with relatively high insurance costs will naturally increase as well.

3. The Gulf and Atlantic coastal regions of the U.S. have experienced increased population growth and commercial development at a time when the frequency and severity of catastrophic storms in these regions is increasing.

Simply put, the availability and affordability of property insurance in coastal regions is mainly a function of risk. But other variables, including actions taken by government, can also affect the supply and cost of insurance. The availability and affordability of coastal property insurance are particularly influenced by the following factors.

Frequency and Severity of Major Coastal Storms

Higher property insurance prices in coastal areas have come in the wake of the three 2005 Gulf Coast hurricanes that killed more than 1,400 people and cost more than $180 billion in insured losses and federal disaster relief. But the trend was not caused by those hurricanes per se. Rather, insurance prices have increased because of what the 2005 hurricane season portends for the future.

Whether because of global warming or cyclical climate change, a consensus has emerged among hurricane experts that the frequency and severity of major storms will increase during the next several years. During the 2007 hurricane season, which begins 50 days from today, hurricane experts anticipate 17 tropical storms, nine of which will become hurricanes and four or five of which will be classified as Category 3 or above. According to Joe Bastardi, Chief Forecaster at the AccuWeather.com Hurricane Center, ”The Gulf and Florida face a renewed threat, and we will see more powerful storms across the board.” Mr. Bastardi, who correctly predicted last year’s anomalous dearth of hurricane activity, believes that the northern Atlantic Coast is “in a pattern similar to that of the late 1930s, when the Northeast was hit by two major storms.”

Coastal Development and Population Growth

Greater frequency and severity of coastal storms would matter less if the affected areas were sparsely populated and contained few valuable assets. But in fact the areas most at risk of increased storm activity contain a disproportionate share of the nation’s population, as well as its most valuable real estate. What is more, the movement of people and wealth from interior regions with relatively little catastrophe risk to coastal regions with the highest levels of catastrophe risk is increasing even as the likelihood of severe coastal hurricane activity increases. According to the U.S. Census Bureau, Florida will experience significant population growth every year between now and 2030, by which time the state will have added more than 11 million new residents. That is equivalent to the entire current population of Ohio moving to Florida over the next 23 years. In 2015—just eight years from now—Florida will surpass New York as the nation’s third most populous state.

Regulation

Many states in catastrophe-prone coastal regions impose rating and underwriting restrictions on property insurers that act as price ceilings on coverage. Government rate suppression, which allows high-risk property owners to pay artificially low premiums, is the preferred solution of many regulators and state legislators to the property insurance "affordability problem" in catastrophe-prone areas. But rate suppression masks the real problem—the growing concentration of people and wealth in high-risk regions—by forcing insurance buyers in low-risk regions to pay inflated prices in order to subsidize the insurance costs of those in high-risk regions.

Insurance rate suppression also removes a powerful disincentive to further population growth and economic development in these areas. That may seem like a good thing to government and private businesses that thrive on growth and development. But unfortunately, government rate suppression distorts the public's perception of risk, thus encouraging the very phenomenon that created to the problem in the first place. Federal and state governments must then end up bearing the cost of the economically irrational decisions that result from rate suppression by paying for disaster aid to repair properties that should never have been built in the first place. Risk-based insurance pricing alleviates this problem by sending accurate signals to consumers about the relative level of risk associated with particular regions and types of structures.

Rate suppression and underwriting restrictions are also largely responsible for insurance availability problems in coastal areas. Like any other business enterprise, insurers must charge a price that covers the cost of the good or service they provide and allows them to make a profit. Historically, profit margins in the highly competitive property/casualty insurance industry have been quite modest compared to other business sectors. But if government rate regulation prevents insurers from covering their claim costs, replenishing surplus reserves to pay future claims,and making a profit, they may have no choice but to exit the market. The surest way to increase the supply of insurance in catastrophe-prone coastal regions is to remove government restrictions on pricing and underwriting.

Human Psychology

Numerous studies have shown that property owners and government officials tend to underestimate catastrophe risk and fail to prepare adequately for natural disasters. Other studies point to public misconceptions about the nature and purpose of insurance; for example, many consumers view insurance as a financial investment rather than as a protective measure, so those who purchase insurance and do not collect on their policies over a period of time feel that their premiums have been wasted, and often discontinue coverage.

Litigation and the Viability of Insurance Contracts

For more than 30 years, the standard American homeowners insurance policy has contained a provision that excludes coverage for damage caused by flooding. Throughout this period, flood coverage has been provided almost exclusively by the federal government through the National Flood Insurance Program (NFIP).

Nevertheless, after every major disaster involving extensive flooding, attorneys take aim at the flood exclusion in homeowners policies, looking for ways to overcome decades of legal precedent behind that part of the insurance contract. Sometimes they succeed, causing insurance companies to re-examine their policies and make adjustments so that the policy language is as clear and unambiguous as possible in stating that damage due to flood is not covered. They then file those policy contract forms with state insurance regulators and negotiate the terms until they can obtain official approval and issue them to policyholders.

Such was the case in Mississippi, Louisiana, and the other states hit by the 2005 hurricanes. And when it developed that many homeowners whose properties were damaged or destroyed by hurricane-related coastal flooding had not purchased federal flood insurance (or had not purchased enough to cover their losses), class action attorneys, joined in this instance by the Mississippi Attorney General, descended on the courts, trying to persuade judges to abrogate the flood exclusion and force insurers to retroactively provide coverage for which they collected no premium.

The sanctity of contracts is a cornerstone of the free enterprise system. With respect to insurance contracts, this often means deferring to the state insurance regulator that approved the contract language as part of the rigorous “form filing” process that insurers must follow. Insurers who relied in good faith on the decision of a state insurance department that their policy language was clear and unambiguous must not be ordered by a judge to pay claims because, in the court’s view, the insurance department erred in approving the contract language.

The unfortunate lesson that insurers may already have learned from the Katrina-related lawsuits still working their way through the court system is that “juridical risk”—the risk that courts will fail to uphold insurance contracts—is a risk factor that must be taken into account in setting property insurance premiums no less than the risk of loss due to fire, theft, or wind. And just as an inhospitable regulatory climate can cause an insurer to exit a market, a legal system that fails to honor the sanctity of contracts may produce the same result.

Recent Government Action Affecting Natural Disaster Insurance

I would like to comment on a few of the disaster insurance-related proposals that have emerged thus far from the 110th Congress, as well as the legislation recently enacted in the state of Florida. With respect to the topic of today’s hearing, no state figures more prominently than Florida. In crafting solutions to coastal insurance availability and affordability issues, it is especially important for Members of Congress to carefully examine the Florida model of disaster insurance reform.

Florida

During a special seven-day legislative session in January, Florida lawmakers removed restrictions on the ability of the Citizens Property Insurance Corporation—originally conceived as the state-run property “insurer of last resort”—to compete with private insurers, while canceling rate increases that had previously been approved to reduce the disparity between the level of risk assumed by Citizens and the relatively low premiums it charges. Citizens was also encouraged to explore writing additional lines of insurance.

Lawmakers also doubled the risk-bearing capacity of the Florida Hurricane Catastrophe Fund from $16 billion to $32 billion, thus ensuring that the state's disaster reinsurance mechanism will become the predominant reinsurer for public and private insurers doing business in Florida. At the same time, property insurers were ordered to roll back their rates to reflect savings they would realize by having the ability to purchase cheaper reinsurance from the state catastrophe fund. Although there is currently only $1 billion in the fund, it now has a legislative mandate to assume a level of catastrophe risk exposure more than 30 times that amount. Thus, if even one major storm hits the state this year, all Florida insurance consumers—not just property insurance policyholders—will face huge assessments and significant tax increases. Indeed, according to a recent report by the Associated Industries of Florida, total assessment costs to finance the deficits that will inevitably result from this legislation could range from $1,700 per household following a moderate hurricane to as much as $14,000 per household following a major hurricane.

Current Federal Proposals

A highly critical editorial in the *Washington Post* noted that in their misguided attempt to artificially reduce the cost of property insurance, Florida lawmakers "not only are gambling with the state's fiscal future but are also giving people an incentive to keep putting themselves in harm's way." That observation speaks directly to the Senate, which is considering **S. 928, The Homeowners Protection Act of 2007,** a bill that would create a federal reinsurance mechanism to encourage states to establish catastrophe funds for homeowners insurance.

NAMIC readily acknowledges that a genuine mega-catastrophe comparable to the 1906 San Francisco earthquake, or a high-category hurricane striking heavily populated areas such as Miami, Houston, or New York City, could potentially exceed private market capacity. To prepare for a disaster of this magnitude, it is appropriate for policymakers to consider whether government programs should be created to supplement the supply of private sector capacity. At the same time, we believe the Florida example should serve to caution lawmakers against creating a national catastrophe reinsurance program that unintentionally creates incentives for Americans to migrate from regions with relatively little exposure to disaster-related risk to coastal regions with the most frequent and severe hurricanes. The federal government should not reward states that enact politically expedient disaster insurance "reforms" by promising to transfer the cost of such measures to federal taxpayers.

We have similar concerns about HR 920**, The Multi Peril Insurance Act of 2007**, which would add wind hazard to the coverage available to purchasers of flood insurance through the troubled National Flood Insurance Program. Through its chronic failure to charge risk-based premiums for flood insurance, the NFIP has operated for decades in a manner that is both fiscally unsound and environmentally irresponsible. The proposed legislation would make wind coverage contingent on responsible land use planning and zoning by state and local governments, which NAMIC strongly supports. But it is questionable whether the standards developed by the Federal Emergency Management Agency (FEMA) will be sufficiently stringent, whether enforcement will be sufficiently vigorous, and whether the premiums charged for wind coverage will be sufficient to pass the test of true actuarial soundness. A National Flood Insurance Program that was expanded to include wind coverage would need to build up a very large loss reserve very quickly to avoid the under-reserving problem that has plagued the NFIP. Otherwise, the plan would amount to little more than a massive risk transfer from private insurers to federal taxpayers.

NAMIC believes that one of the best proposals to emerge from Congress this year is **S. 930, The Hurricane and Tornado Mitigation Investment Act of 2007**. Instead of interfering with the pricing mechanism or creating taxpayer-subsidized government substitutes for private insurance and reinsurance, this bill would lower costs by creating tax incentives to encourage property owners to mitigate wind-related risk by investing in such measures as more durable roofs, reinforced connections between roofs and supporting walls, protections against wind-borne debris, and enhanced protection of exterior doors and garages. Investing in these proven risk mitigation measures will allow property owners to cut their insurance costs by opting for higher deductibles.

At the other end of the spectrum is **S. 618, The Insurance Industry Competition Act of 2007**, which would almost certainly increase the cost and decrease the availability of coastal property insurance. By repealing the limited insurance exemption from federal antitrust laws created by the McCarran-Ferguson Act of 1945, S. 618 would prevent insurers from sharing historical loss data and utilizing catastrophe models to predict future loss costs. Small insurers whose own book of business is not large enough to allow for independent loss projections depend upon their ability to access this critical industry-wide information. Without it, they would be driven from the marketplace. Their demise would decrease the supply and raise the cost of property insurance, particularly in catastrophe-prone regions.

Taking the Affordability Problem Seriously: A Different Approach

In February, the Wharton Risk Center at the University of Pennsylvania issued a report that identified the “two key principles” that should guide insurers and policymakers as they grapple with natural disaster insurance availability and affordability issues. NAMIC believes that these principles provide Congress with a solid foundation from which to develop innovative solutions and avoid costly mistakes. As stated in the report, the two principles are:

- *Risk-based Premiums*: Insurance premiums should be based on risk to provide signals to individuals as to the hazards they face and to encourage them to engage in cost-effective mitigation measures to reduce their vulnerability to catastrophes.

- *Dealing with Equity and Affordability Issues*: Any special treatment given to lower income residents in hazard-prone areas who cannot afford the cost of living in those locations should come from general public funding and not through insurance premium subsidies.

The Wharton catastrophe risk management experts understand, as does NAMIC, that a market-based insurance pricing system in which premiums reflect the actual cost of insuring against catastrophic risk could result in significant premium increases for some property owners in high-risk regions. We agree with their recommendation that in lieu of cross-subsidization through rate suppression and taxpayer-funded government insurance schemes, policymakers should consider creating programs to provide direct government assistance, funded from general revenue, to particular consumers based on criteria established through a transparent decision-making process.

This should not be all that difficult. The federal government has a long history of designing and administering programs that provide grants and other forms of direct financial assistance to individuals on a means-tested basis for the purchase of essential goods such as food and shelter. For example, government responds to the inability of some individuals to afford basic food staples, not by capping the price of groceries or creating government-run food stores, but by providing food stamps to low-income individuals that can be used to purchase food items from private vendors.

There is no reason why Congress could not provide a similar form of aid to selected property owners for the purchase of insurance. Such an approach would have many advantages over the current system of generalized rate suppression and cross-subsidization, not the least of which is that the assistance could be targeted to particular individuals based on financial need. Moreover, its availability could be limited to those currently residing in disaster-prone areas, and would thus avoid creating incentives for people not currently living in those areas to move into harm's way.

NAMIC's Reform Agenda

In testimony before the House Financial Services Committee last September, I laid out an agenda for improving the ability of insurers, property owners, and government to manage and finance future natural disasters. I am happy to report that several coastal states are considering or have recently enacted legislation consistent with that agenda. I believe that some of these measures could be emulated or reinforced by federal legislation. Here are some examples:

- NAMIC supports federal legislation that would create financial incentives to encourage states to adopt and enforce strong, statewide building codes. In the aftermath of Hurricane Katrina, Louisiana lawmakers enacted a statewide building code. Mississippi lawmakers followed suit in 2006 with a building code covering its six most southerly counties. In both instances, implementation of the codes was delayed, due in part to a lack of funding. Thanks to the persistence of Governors Barbour in Mississippi and Blanco in Louisiana, both states eventually obtained federal funding to help counties hire and train building inspectors. Strong building codes as well as responsible land-use planning have been shown to greatly reduce the level of property damage and human suffering caused by natural disasters.

- With respect to existing properties, we support government initiatives to create mitigation grant programs to enable homeowners in high-risk areas to invest in risk mitigation measures. Florida created the first such program in 2006; lawmakers there are now considering a proposal (H.B. 7057) to expand the "My Safe Florida Home Program," under which it would inspect 400,000 residential properties and provide 35,000 grants before June 30, 2009. Mississippi has enacted a similar program (H.B. 753), but is still trying to develop a funding mechanism. Recently-introduced legislation in South Carolina would partially fund that state's new mitigation grant program with premium taxes from its wind pool and by reducing the commissions that agents receive for placing business with the pool.

- We support the concept of amending the federal tax code to allow insurers to set aside a portion of premium income in tax-exempt policyholder disaster protection funds. South Carolina's governor, Mark Sanford, recently proposed a similar amendment to his state's tax code. We also support the concept of allowing homeowners to create tax-free catastrophic savings accounts similar to health savings accounts which could be used to pay hurricane deductibles and costs associated with retrofitting properties. This idea has been incorporated into the South Carolina legislation as well.

- The National Flood Insurance Program should be subject to substantial reform. The current method for setting premiums, which is based on average annual losses, has been called "unsustainable" by the Congressional Budget Office. This approach has prevented the NFIP from accumulating the surplus necessary to pay claims during periods when loss costs are above average. We also support stiffer penalties to be imposed on financial institutions that either fail to require flood insurance coverage for mortgages on properties in flood-prone areas, or allow the policies to lapse. Greater effort should be made to ensure that more people are aware of the program and the benefits of having flood insurance coverage to protect their properties. Some of these reforms are included in **H.R. 1682, The Flood Insurance Reform and Modernization Act of 2007**. NAMIC supports this legislation and hopes that a companion bill will soon be introduced in the Senate.

In conclusion, NAMIC realizes that property owners, insurers, mortgage lenders, realtors, and home builders that live and do business in coastal areas will face serious challenges in the years ahead. We believe that the most effective mechanism for addressing these challenges is a private insurance market whose defining characteristics are open competition and pricing freedom. Congress can play a constructive role by reforming the National Flood Insurance Program, offering tax incentives for companies to reserve funds for future disasters, creating incentives for states to enact and enforce effective statewide building codes, and providing targeted grants that would enable low-income property owners to pay risk-based property insurance premiums.