Consumer Federation of America
1620 I Street, N.W., Suite 200 * Washington, DC 20006

June 24, 2013

Catastrophes and Insurance
Room 1319 MT
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

RE: Study on Natural Catastrophes and Insurance

Director McRaith:

Consumer Federation of America appreciates the opportunity to present our views on the current state of the insurance market for natural catastrophe coverage in response to your April 24, 2013 Federal Register Notice, "Study and Report to Congress on Natural Catastrophe Insurance."

There has never been a serious attempt to reform the current hodge-podge of insurance/mitigation that serves as our national Catastrophe System. We have federal flood insurance; state earthquake insurance in California and a weak private market[1] elsewhere, semi-private wind insurance and weak mitigation of all such catastrophic risks. As a result, insurance covers less than half of catastrophic losses in the United States, with taxpayers through state and federal entities picking up the tab for a lot of the damage (even for homes that are built where they never should have been). The Federal Insurance Office (FIO) has the opportunity today to start a process that would lead to a national review of the current mess and recent events during and after storms offer some ideas for moving toward a more rational system.

Please do not hesitate to contact me at loonlakeme@aol.com or (703) 528-0062 or Tom Feltner, director of financial services at tfeltner@consumerfed.org or (202) 368-0310 to discuss these findings and recommendations further.

Sincerely,

J. Robert Hunter

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Director of Insurance

[1] The earthquake insurance market was only $2 billion of premium in 2011 according to "Best's Aggregates and Averages," 2012 Edition.

Consumer Federation of America

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STUDY ON NATURAL CATASTROPHES AND INSURANCE

By J. Robert Hunter, FCAS. MAAA, Director of Insurance[1]

There has never been a serious attempt to reform the current hodge-podge of insurance/mitigation that serves as our national Catastrophe System. We have federal flood insurance; state earthquake insurance in California and a weak private market[3] elsewhere, semi-private wind insurance and weak mitigation of all such catastrophic risks. As a result, insurance covers less than half of catastrophic losses in the United States, with taxpayers through state and federal entities picking up the tab for a lot of the damage (even for homes that are built where they never should have been). The Federal Insurance Office (FIO) has the opportunity today to start a process that would lead to a national review of the current mess. Recent events during and after storms offer some ideas for moving toward a more rational system.

FIO should Develop a National Long-Term Solution to the Massive Underinsurance of Natural Catastrophes and to Rationalize our Topsy-Turvy National Catastrophe Insurance System:

Behavioral economics offers some insight on why people fail to purchase catastrophe insurance: a general underestimation of risk and over-hyped expectations regarding federal bailouts in case of an event (e.g., many expect grants rather than loans). These behavioral trends suggest that the catastrophe perils should be part of every basic homeowners policy. There are a number of other insurance issues about which consumers have limited knowledge or understanding that we discuss in more detail below but, as with the presence or absence of flood peril, anti concurrent causation, mold coverage, additional building costs, replacement cost out of pocket and other problems with the homeowners policy provide graphic evidence of the failure of the current insurance market model of consumer "choice" paired with "disclosures." The results of Katrina and Sandy – evidence of under-insurance, irrational insurance choices and surprise and misunderstanding of coverage purchased -- indicates that a new model of insurance markets is needed with regulators becoming far more pro-active in enforcing statutory requirements that policies not be misleading, confusing or deceptive.

The absence of all-risk insurance from the basic homeowners policy leads to massive inefficiencies in addition to massive under insurance. The inefficiencies arise from the second set of administrative costs associated with a flood or earthquake (and sometimes wind or wildfire) insurance policy that would not exist if these coverages were part of the basic homeowner policy and from the additional claim settlement costs associated with determining which policy (if any)

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[1] Mr. Hunter's email address is loonlakeme@aol.com. He served as Federal Insurance Administrator under President's Ford and Carter (where he ran the National Flood Insurance Program and other programs) and also served as Texas Insurance Commissioner. He is an actuary, a Fellow in the Casualty Actuarial Society and a Member of the American Academy of Actuaries.

[3] The earthquake insurance market was only $2 billion of premium in 2011 according to "Best's Aggregates and Averages," 2012 Edition.

covers the damage. (As an example, GAO[4] estimates that the WYO companies take one-third to two-thirds of the premiums the NFIP collects just for overhead costs – and that excludes the federal direct costs). And debates about whether damage arose from flood or wind and other such potential claims issues would be solved.

The absence of these coverages from the basic homeowners policy is inherently misleading and deceptive to consumers. It is unreasonable to expect a consumer to parse through which types of damage are or are not covered by a policy -- wind damage, water damage following wind damage, water damage caused by wind, storm surge, flooding, earthquake, ordinance coverage and so on.

FIO should recommend that catastrophe insurance be included as part of the basic homeowners policy to create a policy with coverage that consumers expect, to provide coverage for earthquake, flood and water losses in the most efficient manner possible and to eliminate unreasonable claim settlement problems.

In addition to providing a product that meets the basic financial and economic security needs of consumers, broadening the risk pool for catastrophe peril, eliminating inefficiencies in the provision of catastrophe insurance and transforming an inherently deceptive product (homeowners) into a fair and reasonable product, requiring catastrophe coverage as part of the homeowners policy will spur insurers to become more proactive on loss mitigation and loss prevention, which is the only long-term strategy for addressing growing natural catastrophe risk.

The transition to an "all-risks" homeowners policy should take place over two to five years and include the creation of a public option insurer with the ability to compete with the private market throughout the state if private insurers fail to offer the all risks policy in all parts of the state.

The basic insurance model -- a risk pool diversifying and spreading the risk of many consumers -- must give way to insurance as both risk transfer and a mechanism to finance and implement loss mitigation and loss prevention. Part of this is accurate pricing of the insurance -- this is essential to give consumers and businesses the appropriate price signals to make informed and rational decisions about their investments in property and structures. But the most important part of this is engaging insurers and the public sector to partner with policyholders to finance the essential investments in loss mitigation -- be that CAT-resistant-structures or other loss prevention measures.

PRINCIPLES FOR PROTECTING CONSUMERS AND TAXPAYERS UNDER A FEDERAL CATASTROPHE INSURANCE PROGRAM

The Consumer Federation of America (CFA) has previously opposed proposals to provide federal reinsurance with taxpayer funds for natural catastrophes. This is because these plans have either directly subsidized insurance companies or have provided below-cost insurance to high-risk areas, which would likely spur an increase in unwise construction. Congress should not expand the federal role in providing catastrophe insurance assistance until the federal government fixes the significant flaws in programs that already exist.

[4] 'FEMA's Management and Oversight of Payments for Insurance Company Services Should be Improved," GAO, Report 07-1078, September 2007.

a) **The National Flood Insurance Program (NFIP) must be repaired and functioning smoothly before proposals to expand federal back up to cover other disasters can be taken seriously**. Mitigation is clearly not working under the NFIP. Too many new structures in high-risk areas are being built. Significant insurance subsidies are available to these structures because of problems like antiquated maps indicating much lower flood risk than is currently likely. Insurance rates are based on these erroneous maps, creating a subsidy for new construction and misleading homeowners and business owners into thinking their property is safe. The penetration of flood insurance in at-risk areas under the NFIP is also very low. Too many Americans who live in flood plains are not insured for the flood risk. Moreover, the NFIP allows insurers to charge too much for servicing insurance policies without assuming any financial risk. Some insurers even get windfall payments for commissions when no agent is involved. Hurricane Katrina resulted in windfall profits for servicing insurers because fees for servicing claims are too high for large events.

b) **The "temporary" Terrorism Risk Insurance Act (TRIA) gives large subsidies to the insurance companies.** There is strong evidence that the private market could easily handle much more terrorism risk. Taxpayers have subsidized the extremely profitable insurance industry through the program by about $7 billion to date. The program also subsidizes corporate insurance buyers, creating a significant disincentive to the mitigation of terrorism risk.

c) **The Federal Crop Insurance Program has been plagued by the payment of fraudulent claims, with little federal response.** CFA is very concerned about any federal catastrophe insurance proposal that would duplicate the kinds of serious problems that exist in these programs. In order to be fair to consumers and taxpayers, any proposal that is offered must conform to the following principles:

Loss of life and property must be clearly and demonstrably reduced.

- Mitigation measures must strictly prohibit construction in extreme risk zones and control construction in all other risk zones.
- Actuarial rates should be charged for each property (with particular emphasis on new construction).
- GAO should monitor compliance on an ongoing basis.
- The federal government should invest in loss prevention instead of spending money after a catastrophic event occurs. It should provide grants and loans to state and local governments to carry out mandatory loss prevention activities and should provide loans to consumers and businesses for loss prevention investments and retrofits.

All at-risk properties in the nation should be insured for all risks.

- Insurance must be required on all properties to achieve maximum spread of risk and to ensure that uninsured properties do not exist after a catastrophic event.
- Insurance companies writing property coverage in the nation must be required to take all homeowners and small business property risks that meet national mitigation standards for disaster risk.
- All risk coverage on new construction should be initially provided for five years on a policy purchased by the builder and sold along with the structure as a strong economic incentive for the builder to choose sites and construct buildings with the catastrophe risk clearly in mind.
- Reasonable deductibles and limits should be standardized under policy terms set nationally. Persons seeking lower premiums through higher deductibles and other changes to the base

policy should be able to do so by signing an agreement that no disaster assistance will be sought for losses in amounts below the higher coverage levels.

Rates should be actuarially sound. There should be no subsidies or cross subsidies.

- Rates on insurance for new construction must be fully actuarial so that new construction that is higher risk will pay its own way and unwise construction will be deterred.

- Rates on insurance for existing construction must be fully actuarial and disclosed at the time of sale so that people buying unsafe structures have fair warning.
- Rates should be adjusted over a reasonable period of time to repay any monies contributed by local, state or federal taxpayers after a catastrophic event.

The role of private sector insurers should be maximized.

- Insurers must make insurance available and be responsible for losses up to a specified insurer deductible. Insurers should be instructed to set up pooling arrangements where they can reinsure business at the insurers' option by sending the loss portion of the premium to the pool. The pool should be monitored to verify that state approved actuarial rates were properly applied to the property.
- The initial insurer deductible for the first year of this program should be $100 billion, indexed to inflation in home prices nationwide on a year-to-year basis. To ensure that all regions of the country will have reinsurance protection and that small insurers benefit from the program, it should require the establishment of a national pool to reinsure all homes and small business properties in the nation over retentions of 15 percent of premiums in the impacted line by insurer group. Each insurer would be required to forward the appropriate part of the premium to cover the claims sent to the pool. These premiums would be earmarked for disaster payments only and held as reserves for such an event. These reserves would not be subject to federal income taxes.

Government at all levels should carefully regulate the program.

- Local governments have the key role of enforcing land-use requirements.
- State governments should regulate both policy forms and prices. This will assure consumers that models and other methods used to rate the business are fair and do not result in excessive charges. It will also assure taxpayers that there are no subsidies in the rates. Regulation should follow the detailed methods in use in California under Proposition 103 regulations. State regulation should be monitored by the GAO to assure that it is competently and efficiently performing this important oversight role.
- The federal government should determine the best, most efficient mitigation standards. Local governments should enact and enforce these strict mitigation standards, subject to state audit of compliance and GAO review of the effectiveness of the implementation of these mitigation standards in high-risk areas.

Federal, state and local governments should assume financial risk.

- To become eligible for the federal backup, local governments should agree to pay 5 percent of costs over the insurer deductible on damage to new construction, as an incentive to encourage rigorous enforcement of land use standards. Bonds could be used for this purpose.

- State governments should contribute a 10 percent layer over insurer and local deductibles. Bonds could also be used for this purpose.
- The federal government should back up the system over the insurer, local and state layers.
- This plan must be designed so that long-term costs to local, state and federal taxpayers will be equal to or less than zero. This means that, as stated above, rates should be actuarially sound to insure that the program is profitable to taxpayers in the long run, or at the very least, does not cost the taxpayers anything.
- No disaster relief should be given to those homes or businesses that should have been insured for coverage but were not, or were inadequately insured. Disaster relief should no longer cover deductibles of insurance policies.

All stakeholders must give up something to make this type of plan work.

- Insurers give up the right to choose to underwrite if mitigation standards are met (i.e., to make sure that insured homes meet construction and loss prevention standards). They must be subject to high quality regulation of price, product, underwriting and claims service.
- Property owners in high-risk areas give up the right to unfettered use of their land unless strong mitigation standards are met.
- Developers give up the right to loosely regulated construction. They must be required to build wisely in risk zones and to arrange for the initial insurance coverage for the first five years.
- Consumers give up their right to take a chance on being uninsured for low frequency/high severity events. Consumers must pay actuarial prices for the coverage, prices that can be very high.
- Government must take on mapping of risk and monitoring to assure compliance with mitigation and actuarial soundness standards. Government must have the ability to obtain funds for the catastrophic back up of the private insurance market.

A fair process and affordable insurance must be ensured.

- One way to ensure that lobbying by private interests does not result in taxpayers shouldering an unjustifiably large portion of the risk in such a program would be to set up a Congressional commission modeled after the base closure commission, which would present Congress with a plan that it could either vote for or against, but not amend.
- Requiring insurers to offer actuarially sound rates will make it difficult for some low and moderate-income households to afford catastrophe insurance. It will likely be necessary to establish a transitional program to help these consumers afford insurance payments.

A Short-term Need: Removing the Claims/Coverage Gaps leading to consumer troubles after the storm

FIO should work with Congress and the State Insurance Commissioners to amend the current homeowners insurance policy and how the consumer gets information about the policy to help consumers to understand the policy and be involved in deciding coverage levels. To do this, it is helpful to look at claims/coverage issues in recent catastrophic events to determine what problems consumers face in the insurance market and what might be done to ensure that consumers have better access to homeowners insurance that meet their needs during catastrophic events. CFA has identified several issues that are important[5]:

[5] California earthquake insurance policies face serious problems that are not covered in the comments on this section. Similar changes should be made to help consumers in earthquake prone areas.

1) **Consumers do not have sufficient catastrophe insurance in force**. This was obvious even in Katrina, which hit an area of the country where NFIP's market penetration was relatively high, about 50 percent. In the Sandy impacted area, at least 70 percent of Sandy-flood-damaged homes did not have flood insurance.

2) **The conditions under which catastrophe deductibles apply are unclear and result in consumer confusion.** Consumers do not understand when and if a separate catastrophe deductible kicks in and how it applies since the consumers had no say in the selection of these deductibles. It is also unclear to consumers whether it is the insurance company or a state regulatory agency that makes the determination that a severe event triggers these deductibles. It is unclear whether, for example, hurricane deductibles apply to claims in an entire state if a storm is classified as a hurricane in one part of a state but not in another part of a state. It is unclear if the wind speed deductible is applied based on wind speed in the specific town or county or whether a trigger applies the deductible statewide.

3) **Consumers are extremely unaware of the anti-concurrent-causation (ACC) clause in their policies.** This little known provision, which states that, if a structure is damaged at about the same time by two risks, one of which is covered (like fire or wind) and the other not (like earthquake or flood), then either no coverage or limited coverage will be provided for the "covered" part of the claim. People do not believe that their own insurance company would design a trap door in the back of their policy through which the coverage they purchased can fall. This is a very new problem, emerging in the aftermath of Hurricane Katrina in 2005. The dense legalese in anti-concurrent causation exclusions confounded esteemed Federal and State judges after Katrina. They defeat consumers' reasonable expectations of coverage and should be banned.

4) **Consumers are often unaware that a cap on replacement costs may result in significant out-of-pocket costs.** Many consumers are not aware that caps on replacement costs are part of their homeowners insurance policy. Almost none are aware of the risk they take if a catastrophic event occurs. After a severe weather event, the price of materials and labor to repair homes often increase considerably, a phenomenon known as "demand surge." The replacement cap limits coverage to the amount stated in the policy as the replacement cost. Some insurers offer additional coverage of approximately 20 percent. Previously insurance policies guaranteed that repairs would be made even if the claims estimate were lower than the actual cost to made necessary repairs. However, replacement caps became common practice in policies written after Hurricane Andrew. If rebuilding prices surge, as is typical after a large event with many damaged homes, homeowners face significant out-of-pocket expenses. For example, if a family buys replacement coverage with a $500 deductible on $200,000 home and files a normal total loss fire claim, they will received a claims check for $199,500. If the damage to their home is the result of a hurricane, and building material scarcity results in a 50 percent price increase in building costs, that family would now need $300,000 to restore their home. If the insurer imposes the replacement cost limit, and they receive a claims check for $199,500, they will be far short of what they would need to be made whole. To rub salt in the wound, if they lived on the beach and the hurricane deductible of 5 percent of value is applied (in this case $10,000) they would only receive a claims check for only $190,000.

5) **Consumers are unaware that their policy probably does not cover the cost of mold removal.** Mold, which frequently follows water damage, is now excluded from most homeowners insurance policies. These exclusions were introduced in the last 10 years. In addition to adding mold exclusions, insurers have been consistently adding language that limits water damage from various sources, (such as sewer backup, off premises pipe damage, and damage resulting therefrom).

6) **Consumers are unaware that many policies do not cover additional costs if construction ordinances or building codes require certain upgrades.** For instance, if a structure is 50 percent damaged, flood insurance rules require elevation of the first floor of the whole home to the 100-year flood elevation, often a very expensive additional cost to rebuild a home. This is a relatively new problem since it was once part of homeowners insurance coverage. This exclusion was added to home insurance policies after Hurricane Andrew in 1992.

Possible Short-Term Solutions

1) **FIO should advise Congress of the need to work with the States to Rewrite the Homeowners Insurance Policy to make it Fairer to Consumers When Future Catastrophes Hit**

Until a long-term plan is implemented, steps must be taken to make catastrophe insurance more transparent and easy to navigate for consumers. Here are some suggestions for FIO to make to Congress and the States to consider to address the claims/coverage issues identified above:

Flood and earthquake insurance should be offered in high-risk areas through private insurers[6]. Using flood insurance as an example, there are reasonably priced, private-sector service providers who can make the flood insurance rate map determination of risk that could be used to trigger the offer of flood insurance when a homeowners insurance policy is sold (they do it today for banks). If a home is in a high-risk flood area, the insurer should be required to offer flood insurance when selling any homeowners insurance policy. If a homeowner wants the flood coverage and the insurance company is an NFIP Write Your Own (WYO) insurer, the company can simply add flood insurance to the homeowner's insurance policy. If the insurer is not a WYO insurer, the home insurance carrier for the consumer can secure the flood policy from the NFIP direct servicing contractor and added to the policy package.

The States should require that a consumer choose the separate catastrophe deductibles. The States should disapprove the current, confusing catastrophe deductibles and only allow deductibles selected by the policyholder to be used in the state. To attach the catastrophe deductible, the insurer would be required to give, when the policy is sold, the policyholder an option to select the catastrophe deductible from a table of different prices for different catastrophe deductibles. The table should include a no separate deductible option. This consumer selection would be made at the time a policy is offered and the consumer would therefore know exactly what to expect if an event occurs.

The States should disapprove all anti-concurrent-causation clauses. The ACC clause was intended to limit or even remove the insurer's liability when a covered risk damages a structure at about the same time as an excluded risk, regardless of the order of such events. After Hurricane Katrina, courts were asked to determine whether the insurance companies'

[6] This proposal is an interim proposal to be in place until the long-term reform we proposed above.

language supersedes the common law doctrine of proximate cause. While many of the courts ruled that insurance companies could, in fact, use ACC clauses to avoid the common law rule of proximate cause, others found the clause too ambiguous and, ruled against the insurance companies. This draconian clause, hidden in the fine print of the homeowners insurance policy, acts like a trap door that snaps open to the surprise of consumers, as the coverage consumers thought that they had disappears. The ACC clause should be prohibited from use for homeowners insurance policies throughout the country.

Caps on replacement cost (RC): CFA proposes that the States require insurers to offer different RC caps at the time of sale with the price impact of each option being disclosed clearly to the consumer. Secondly, in a demand surge situation, insurers should be the risk-takers, not the policyholders. The States should regulate claims practices to remove demand surge price changes from any calculation of the RC cap in a claim in a disaster situation. Recognizing that current policies are overly restrictive with regard to replacement cost coverage, Maryland recently amended its laws[7] to give disaster victims at least 24 months to collect full replacement cost.

Mold exclusion: CFA believes that the States should require that mold coverage be a yes/no choice at the time of the policy sale with the cost implications fully disclosed to consumers.

Law and Ordinance Coverage: CFA proposes that the States require, at time of sale, a yes/no decision on such coverage be offered to the consumer, along with the premium implications disclosed clearly.

2) Catastrophe Claim Reforms

Claims transparency: Consumers should be entitled to a complete copy of all documents in their claim file. Consumers should be informed they have a right to hire their own public adjuster but that they should be warned to check references, license status and experience before doing so. In cases of a declared natural disaster, appraisals should be optional, not mandatory. Information on when to consider the need to hire an attorney should also be included. Some of this material could be included in the homeowners insurance Bill of Rights proposed below. The California Insurance Code at sections 2071, and 2051.5 provide a reference point for suitable language.

Claims adjuster licensing and accountability: states should license claims adjusters and establish minimum standards for training and competency among adjusters. There is a wide range of skill/training and competencies among insurance adjusters. In some cases, financial incentives for independent adjusters cause them to skimp on the quality of loss assessments and move on to the next assessment in order to maximize income. These incentives result in some adjusters underestimating repair estimates and also causes delays.

The contracts that the large independents like Crawford & Co., General Adjustment Bureau and others have in place with the major property/casualty Insurers are enormous. These independents are provided with the claims handling guidelines of the Insurers they have contracted with and are expected (contractually) to adhere to those guidelines. There may also be financial incentives or disincentives written in the contracts between the Independent firm and the insurer. The Insurer will also conduct a percentage of re-inspections, some on-

[7] 2010 Maryland Insurance Code, § 19-213 < http://law.justia.com/codes/maryland/2010/insurance/title-19/subtitle-2/19-213/>.

site and some paper reviews to determine if the independent is adhering to the Insurers' claim handling guidelines and contractual obligations. Regulators should examine these contracts including the SOW (statement of work), which is the section of the contract that outlines the specific expectations, incentives and penalties to determine if policyholders are at risk of being shortchanged.

3) **Require a Consumer Bill of Rights Accompany Every Homeowners Insurance Policy Sold and Every Claim File Opened in each State:** The States should establish an insurance policyholder's bill of rights using the bill of rights adopted in Texas as a model (http://www.tdi.texas.gov/rules/bor-home-english.html). This bill of rights should be provided to policyholders at the time of sale of a policy as well as when a claim file is opened. The Bill of Rights should contain information on how to fairly settle claims in a disaster situation. The Consumer Federation of America's step-by-step instructions for policyholders on filing claims related to Superstorm Sandy might served as a potential model (http://www.consumerfed.org/news/607).

4) **The States should regulate vendors whose products impact the catastrophe claims and pricing decisions of insurers:** The Insurance Departments should be empowered to regulate, vendors whose computerized products have serious impacts on claims settlement offers and on hurricane and other storm prices charged by insurers in the state. Products such as "Xactimate" impact the valuations of homes for claims payout purposes. Products like CAT models impact the price of insurance for New York homeowners. Yet these models and computerized 'black boxes' are not regulated by the DFS. Providers of such products should be regulated as advisory organizations in the same way that other entities, like the Insurance Services Office, are regulated.

FIO Should Propose that Congress Work with Coastal States to help them join together to better manage the hurricane risk

In the wake of the 2004/2005 hurricanes, Florida's legislature enacted numerous changes that significantly reduced costs to Florida citizens when they purchase insurance against catastrophic loss. Florida saw that the reinsurers were charging many times what their own actuaries said was the proper rate for hurricane risk. The State of Florida took on a layer of risk at the real actuarial rate and required the insurers to use that layer and price the savings into homeowners' insurance rates. Raymond James has estimated savings to the policyholders from this step at over $20.6 billion[8]. The premiums Florida charged, the actuarial premium, has resulted in nearly $9 billion in the Florida State Treasury to cover future claims. The total maximum payout for the largest possible storm is about $17 billion, which means the total benefits of the program of more than $29 billion, far exceed even a worst-case claim. Recently, A. M. Best revised its treatment of Florida's Hurricane Catastrophe Fund to allow full (100%) credit for the reinsurance Florida provides to the primary insurers, another sign of the success of this program.[9] The State of Florida also allowed the Citizen's Insurance Company to compete with the private market when the private market's rates became excessive. The effects of this competition have resulted in further significant savings for Florida homeowners. Yet, while Florida was successfully managing the insurer turmoil after the storms to the benefit of its citizens, the insurers intimidated other states into not moving in that direction and those states ended up giving the insurers and

[8] With Florida enjoying an actual return on investment of 678%. From "Building Blocks of a Successful Property Insurance Market in States Prone to Catastrophic Risk," before the Alabama Affordable Homeowners Insurance Commission, November 21, 2011, by John Forney, Managing Director, Raymond James.
[9] "A. M. Best Updates Assessment of Insurer's Potential Exposure to the Florida Hurricane Catastrophe Fund," Best's News Service, May 31, 2013.

reinsurers whatever they demanded in the way of excessive prices. Only Florida's size allowed them to fully protect its consumers. Smaller states like Alabama and Mississippi were unable to do so.

Likewise, when northeast governors banded together to prohibit insurers from applying a percentage hurricane deductible, the industry, while upset, applied the standard dollar deductible, a big benefit for the homeowners whose property was damaged by Sandy. Being big helps state governments better protect consumers as insurer threats of possible pull out of a large state are not credible.

It would be helpful for the coastal states to band together to regulate insurance and develop coastal mitigation/land use measures in the nation's high-risk coastal areas. CFA believes that the hurricane-prone states from Maine to Texas should form an interstate compact or find another mechanism to work jointly to mitigate the costs associated with insuring hurricane risk in a way that protects their citizens exposed to hurricane risk. Together, the states could develop regulatory computer models to determine fair prices and keep rates at actuarially sound and below excessive levels. Together, states could jointly regulate insurance policy language issues like deductibles, claims practices, anti-concurrent-causation clauses and other recommendations discussed previously to protect homeowners and policyholders from abuse. Together, the states could effectively oppose abusive requests from insurers and reinsurers that often intimidate smaller states like Alabama and Mississippi into compliance.

An equally important reason for a coastal states joining together is that a coastal coalition would be in a much more powerful position to work with the federal government to move toward a more logical private/state/federal partnership on natural disasters. At that point, ideas like a true national all-risk homeowners' insurance policy could be meaningfully discussed. The coastal states could construct a stand-by coastal reinsurance program at actuarial rates that could kick in if private reinsurers unfairly raised prices to multiples of the fair rate as they did in Florida after the 2004 storms. The federal government might consider providing ultra-high limit reinsurance to the states but only during the early years (to cover the timing risk of the introduction of such a program in case of an early hurricane that exceeds the pools capacity).

Adoption of a rationalized all-risk homeowners' insurance policy to provide coverage against all forms of risk, including flood and earthquake risk is what the nation needs. Here is an example of how such a plan might be organized:

1) **Consumers would bear the first layer of cost of losses, including catastrophic losses**, through reasonable deductibles and clear exclusions but would not face significant out-of-pocket costs due to a surge in building costs or denials of claims due to anti-concurrent-causation clauses or other such surprise provisions that devastate the unsuspecting policyholder.

2) **The private direct insurance market would bear the responsibility of paying for claims above the policyholder retention** up to the total of all damage.

3) **Private reinsurers (and CAT bond providers, etc.) would participate in funding these damage claims in accordance with an organized system of reinsurance** that included government participation only in the case of extreme events (with a drop down capacity at the state level if private reinsurers price inappropriately). During the early years, to cover the timing risk at introduction, the federal government would reinsure above that level, with state governments responsible for a percentage of the reinsurance cost the federal government paid

out[10]. Ultimately the states would reimburse the federal layer completely through collections from state actuarially sound reinsurance plans.

4) **Homeowners insurance premiums would be distributed to the private and public risk bearers in accordance with their actuarial risk.**

5) **All parties would share in loss mitigation activity,** with the federal government continuing to analyzes and produce risk maps and facilitate the development of serious building and land use codes. The federal government would also monitor code enforcement. In communities with weaker enforcement, a surcharge on the rates would be imposed.

6) **Consideration should be given to requiring a multi-year (e.g., 10 year) policy be purchased by each developer and sold with the home.** In order to internalize the cost of unwise building and incentivize builders to build safely, insurance could be sold with new homes and paid for as part of the mortgage.

Response to Questions in the FR Notice

CFA's responses to the questions contained in the FR Notice of April 24, 2013 are contained in the above material, including the three papers we submitted. One question, 6b, "The potential privatization of flood insurance in the United States," is discussed in this section.

CFA supported passage of the Biggert Waters Flood Insurance Reform Act of 2012 because it made significant steps toward making the NFIP actuarially sound. CFA has often been asked how a consumer group favored bringing the NFIP into actuarial soundness, which will raise rates for some consumers. CFA strongly believes that the program should set fair, actuarially sound rates that accurately reflect the potential loss risk in part because the worst thing government can do is run an "insurance" program that is not true insurance, but an unwise and untargeted subsidy program that misleads consumers into putting their homes, businesses and lives at risk in areas that are dangerously flood-prone and that often unfairly subsidizes affluent individuals and contractors who do this building.

Homeowners who buy new homes in areas that they think are safe from floods are harmed when old maps underestimate risk or when hidden subsidies are granted. Some are misled into believing their homes are safe from floods when they build or buy new homes built to the old map's 100-year flood estimates that are, in fact, far below the real 100-year elevation. These people and their families are at risk of being killed or injured if a storm hits, or of having their homes or treasured possessions destroyed. Paying a little more and being truly aware of the risk is a blessing, not a curse, for consumers. Not buying a high-risk home is a reasonable choice for a consumer as well but that choice cannot be made properly if the prices do not reflect the true risk.

Other homeowners will look at these inaccurate flood maps and think, "I don't need insurance, I am way outside the risk area." But they are really well inside the area of high risk when the maps are old and development, erosion, climate change and other impacts have caused the 100-year flood to rise significantly, as those living on the Gulf found out the hard way during Hurricane

[10] It could work like the Riot Reinsurance Program the Federal Insurance administration ran in the 1970s, under which each state was to reimburse the Department of Housing and Urban Development for certain reinsured losses in a given contract year up to five percent of the aggregate property insurance premiums earned in a state when other stand-by resources were exhausted.

Katrina. CFA"s study of Hancock County Mississippi flood maps after Hurricane Katrina hit found that the average map (of 76 in the county) was 20 years old and 10 feet too low in measuring the 100-year flood elevation.[11] Many home and business owners were misled into building unwisely, or not buying needed insurance, in the county where Hurricane Katrina hit, exposing the deeply flawed program's weaknesses in a most tragic way.

The current patchwork of general subsidies that drain the program of resources should be phased out as the new Act makes an attempt to do. Targeted subsidies should be used to help low- and moderate-income people in flood-prone areas who cannot afford flood insurance, particularly in the transition for full actuarial pricing. It is improper for the government to require the purchase of insurance, as the NFIP does, and not help those who cannot afford it. It is also improper to give broad, hidden subsidies to consumers and call it "insurance." Targeted subsidies for those who are most in need would cost far less than the current mix of general subsidies, some of which appear not to have been authorized by Congress.

Without all aspects of the Biggert-Waters Act being Implemented, the Entire Program is in Serious Trouble

The NFIP was intended to end unwise construction in high-risk flood plains throughout the country, while providing affordable coverage for people who really needed it. In return for taxpayer funding for the development of flood risk maps and the provision of subsidized insurance for older buildings, new construction was to be done wisely, and full "actuarial" rates were to be paid for flood coverage. Over time, the subsidies would be phased out and the program would reach complete actuarial soundness.

The NFIP was brilliantly designed, but it has failed to live up to its promise. Politics and inept administration encourage and even subsidize unwise construction. Millions of consumers have been misled into thinking their homes or businesses were not in harm's way, because FEMA has completely mismanaged the process of updating flood insurance maps.

Biggert-Waters moved strongly to fix several aspects of the Program in many regards. While still not making primary residences fully actuarial, the Act does move strongly to make properties such as second homes, businesses, repetitively-flooded homes, new policies and other properties fully priced after a few year transition period.

The key provision that makes this happen is Section 1308(h) of the National Flood Insurance Act of 1968 (42 USC 4015(h)). It reads:

> **(h) Premium adjustment to reflect current risk of flood**
>
> Notwithstanding subsection (f), upon the effective date of any revised or updated flood insurance rate map under this chapter, the Flood Disaster Protection Act of 1973, or the Biggert-Waters Flood Insurance Reform Act of 2012, any property located in an area that is participating in the national flood insurance program shall have the risk premium rate charged for flood insurance on such property adjusted to accurately reflect the

[11] "An Examination of the National Flood Insurance Program," testimony of J. Robert Hunter, Director of Insurance, CFA before the Committee on Banking, Housing and Urban Affairs of the U. S. Senate, October 2, 2007.
http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/Hunter%27s_Senate_Testimony_Flood_I nsurance_10-2-07.pdf

> current risk of flood to such property, subject to any other provision of this chapter. Any increase in the risk premium rate charged for flood insurance on any property that is covered by a flood insurance policy on the effective date of such an update that is a result of such updating shall be phased in over a 5-year period, at the rate of 20 percent for each year following such effective date. In the case of any area that was not previously designated as an area having special flood hazards and that, pursuant to any issuance, revision, updating, or other change in a flood insurance map, becomes designated as such an area, the chargeable risk premium rate for flood insurance under this chapter that is purchased on or after July 6, 2012, with respect to any property that is located within such area shall be phased in over a 5-year period, at the rate of 20 percent for each year following the effective date of such issuance, revision, updating, or change.

This vital provision, with its five year transition program is the crux of the reform needed to protect consumers from being misled into buying homes in high risk flood zones or underestimating their risk if they already live in such a zone. Finally, the NFIP would be moving toward actuarial soundness, we thought.

The Cassidy Amendment

However, on June 5, 2013, the U.S. House of Representatives passed the Department of Homeland Security Appropriations Act of 2014. Congressman Cassidy proposed an amendment (H.Amdt. 121) which overwhelmingly passed the House by a vote of 281 to 146. The purpose of the amendment was this: "to prohibit the use of funds to implement, carry out, administer, or enforce section 1308(h) of the National Flood Insurance Act of 1968 (42 U.S.C. 4015(h))." In other words, the amendment's intent was to gut the reforms required to make the NFIP a real insurance program and not a sham "insurance" program that encourages unwise construction. This despite the fact that the NFIP suffers extreme problems that full implementation of the Act would fix, problems such as:

A) The NFIP is bankrupt, requiring billions of dollars in taxpayer support.[12] Such a deficit would be acceptable for a short time if the program was doing what Congress originally intended, ending unwise construction in the nation's flood plains and requiring inhabitants of flood plains to bear their own risk through actuarially sound insurance premiums. However, the NFIP is doing the opposite of what Congress originally intended.

B) B. This taxpayer subsidy is not just due to catastrophe losses, but is routine. FEMA Administrator Craig Fugate testified before Congress in June 2011 that it is collecting $3 billion a year in premiums, but said that this amount would be $4.5 billion if coverage rates were actuarially sound. This represents an astonishing 50 percent shortfall in the amount collected.[13] From the beginning of the program until late 2009, the Congressional Budget Office (CBO) determined that the average annual taxpayer subsidy has been $1.3 billion for the known/intended portion of the subsidy involving structures that existed before flood maps were developed. What is more shocking is that the NFIP"s actuarially rated coverage,

[12] The current deficit is estimated at $30 billion.

[13] Testimony of William Craig Fugate, FEMA Administrator, before the Committee on Banking, Housing and Urban Affairs of the U.S. Senate, Hearing on Reauthorization of the National Flood Insurance Program, June 9, 2011.
http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=a2c7e4b9-5b4d-4635- befe-8ce662da1774&Witness_ID=bdf843f6-112e-4009-80bb-2cc0f50d92c8

which is supposedly self-supporting, has been priced 5 percent too low if paid catastrophic claims are not considered and an astonishing 100 percent too low if they are included.[14] Moreover, the GAO reported in 2011 that the number of policies receiving subsidized rates has steadily increased recently and will likely continue to grow if the Biggert-Waters Act changes to the program are not implemented.[15]

C) NFIP subsidies are hidden. FEMA administratively "grandfathers" rates from old maps when new maps are developed, which means that there is a hidden subsidy for structures covered by the NFIP from the old map. (FEMA allows new rates if the price drops but freezes the rate if the risk increases, as is usually the case.) This subsidy, which is not stipulated in law, means that the number of structures receiving subsidies will grow continuously. Absent a huge infusion of funds from Congress, the NFIP has no chance of paying back the borrowed funds or of building adequate reserves for future catastrophic flooding. Another hidden subsidy stems from old maps, which almost always show flood elevations that are too low because construction raises elevations over time.

D) Before Biggert-Waters, GAO found that the NFIP is a "high-risk" program for the American people. GAO placed the program on the high-risk list in 2006 "because of the potential for the program to incur billions of dollars in losses and because the program faces a number of financial and management problems."[16] The GAO findings included: the NFIP could not generate enough revenue to repay the billions it had borrowed from taxpayers; the program would not be able to cover catastrophic claims that it paid in the future; oversight of the WYO program was weak, with potential for overpayment and inefficiency; FEMA does not study the program's expenses to see if WYO insurers are overpaid; the NFIP is actuarially unsound; maps are out of date; FEMA does not understand the long-term impact of planned and ongoing development on projected damage estimates; NFIP debt is likely to grow; and, FEMA has not implemented its own financial control plan.[17] The Cassidy Amendment continues and exacerbates the fiscal mess.

E) Until the Biggert Waters Act was passed, Congress had been unwilling to stop the trend toward making NFIP more of a giveaway program to some consumers and businesses than an insurance program with sound risk management. If the Cassidy Amendment passes, Overall, any possibility of lifting the program toward actuarial soundness will be dashed, and with it the hope for a self-sustaining NFIP anytime in the near future.[18]

I. The Future of the NFIP – Need for FIO Analysis

If the Cassidy Amendment passes, we again see the hopelessness of a government "insurance" program to achieve real insurance status, a goal absolutely essential to protect homeowners and taxpayers.

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[14] Ibid.

[15] GAO, "FEMA: Action Needed to Improve Administration of the National Flood Insurance Program" GAO-11- 297, June 9, 2011, p. 52. http://www.gao.gov/products/GAO-11-297

[16] See GAO"s listing of the NFIP problems at:
http:www.gao.gov/highrisk/risks/insurance/national_flood_insurance.php

[17] Ibid

[18] NFIP is an insurance program and is not designed to be a charity program. The current subsidies are disbursed indiscriminately, with no test of the ability of the subsidy recipient to pay the real cost of risk of the structure he or she owns.

FIO should undertake two studies to prepare for the future of the NFIP:

1) How to either get the private sector into the flood insurance program with enough clout to keep prices real (but with enough government involvement to keep prices from becoming excessive), and

2) If that fails, and particularly if the Biggert-Waters Act is gutted by the Cassidy Amendment, how to responsibly end the NFIP over a long transition period. We cannot continue a program that encourages unsafe building in the flood plains by charging inadequate prices for flood insurance.

The only counter-weight to the one-way pressure from local, state and federal politicians, developers and land owners to soften the program's impact on communities, developers and consumers at taxpayer expense would be to encourage private insurers to get more involved in at least some of the risk-taking aspects of the program. If the private sector has some significant "skin in the game," then there would be pressure brought to bear by insurers to make sure maps are accurate and enforced, updated actuarial rates were used and that everyone was doing all things necessary to make the program effective and to protect the taxpayer (and the insurer's) bottom line. Insurers would resist pressure from politicians and developers to lower rates below cost. Politicians would resist pressure from insurers to have rates that were excessive. These checks and balances would help keep flood insurance prices reasonable but adequate.

However, many private insurers will not jump at the opportunity to underwrite more flood risk. Many are in the midst of significantly cutting back on the coverage they offer on the coasts because of wind risk. As private sector participation in the risk-taking aspect of NFIP is questionable, it is necessary to study the possibility of protecting taxpayers by ending the insurance component of the program in a responsible way that protects vulnerable consumers.

The point of the FIO studies CFA proposes would be to evaluate potential outcomes if (a) the private sector took part of the risk or, absent that, (b) the program is ended in a responsible fashion with a transition plan that allows all affected parties to prepare for the consequences of such an event. The transition plan will be complex and must be done with great concern for the current inhabitants of floodplains, particularly NFIP policyholders. CFA recommends that FIO evaluate the following specific topics when making recommendations about how to end the NFIP:

1) Ending only the insurance part of the program. (As stated below, accurate and up-to-date FIRM information on risk is vital if any private sector insurance underwriting is to become viable.) Ultimately, after a long transition where the federal government participates in risk taking either directly or through reinsurance, a private market could develop if there is accurate and current risk information, a continued purchase requirement on federally-backed mortgages and safe construction in the flood plains.

2) Providing a long transition period to allow all parties time to adjust to the lack of a federal insurance program. Thirty years, for example, would provide time for the government to gradually phase out its subsidies, for insurers to determine how to underwrite flood risk and for consumers to find alternatives to the NFIP.

3) Phasing out the provision of insurance over this period. A likely first step in the phase-out process would be for the federal government to stop writing new business. Even

this measure would have to be done in a way that allowed safely constructed new homes to receive mortgages through the provision of clear, accurate information on flood risk to lenders.

4) Protecting low- and moderate-income (LMI) homeowners and renters. Congress could likely end the NFIP over a five or ten-year period if not for the need to protect LMI consumers from rate shock. The study should consider providing an ongoing subsidy to LMI homeowners during the transition and even after some degree of private insurance enters the market.

5) Requirements that should be placed on communities in flood plains and on FEMA regarding flood maps. Keeping the mapping and community participation requirements in current law would provide private insurers with sufficient information to begin to take risk. This knowledge base is vital to encouraging a private response. Insurers will need information to help them write coverage for structures at actuarial rates and to have an ability to determine which communities are requiring safe building in flood plains to help them focus their insurance capacity. When HUD did its 1966 Feasibility Study into why flood insurance was not privately available at the time, it found that the factors were:

   a) Lack of any way to accurately determine pricing (i.e., no mapping of the flood risk); Consumers knew more about the risk of flood than the insurers, which meant that there would be adverse selection by people against any price insurers set.

   b) If prices were raised, only people at higher and higher risk would buy the insurance; No one was controlling new construction, so changes up or down stream could make prices for insurance too low; Lenders did not require flood insurance.

   c) Unlike 1966, we now have the ability to solve many of these old insurance concerns. Maps, if they are kept up-to-date, can calculate rates that are actuarially sound for every structure. Adverse selection is minimized since lenders in the high-risk flood plains now require all building owners to get flood insurance. Flood plain management is in place as a condition of flood insurance availability in a community.

6. Encouraging private insurers to take some, and ultimately all, of the existing flood risk. This could be done either on a property-by-property basis or with some overall sharing of risk. The sharing might start with the government taking 95 percent of the risk and setting actuarial rates that would have to be paid. Insurers would initially assume 5 percent of the risk and set rates for those structures they would underwrite. FEMA could advertise which insurers were selling flood insurance in its "Flood Smart" ad program. Over time, the government's percentage of the risk would decline. In order to incentivize insurers to participate, the government could develop a stop-loss reinsurance program, which caps the private insurer annual exposure to loss.

7. Mandating the purchase of flood coverage. If flood insurance is unavailable, there should obviously be no requirement to purchase it. On the other hand, if the private market does develop, a purchase requirement should be maintained to allow insurers to effectively spread their risk. This would further increase their ability to soundly underwrite flood coverage. Whether and how to mandate purchase during the transition is a key question the study must consider.

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THE INSURANCE INDUSTRY'S INCREDIBLE DISAPPEARING WEATHER CATASTROPHE RISK:

HOW INSURERS HAVE SHIFTED RISK AND COSTS ASSOCIATED WITH WEATHER CATASTROPHES TO CONSUMERS AND TAXPAYERS

J. Robert Hunter, Director of Insurance
Consumer Federation of America

February 16, 2012

Insured losses from catastrophes around the globe totaled an estimated $108 billion in 2011, the second highest year in history. More than $30 billion of those losses occurred in the United States, likely the fifth or sixth most expensive year on record. Since 2004, storms like Katrina, Rita, Wilma and Ike, combined with other events have resulted in nearly $200 billion in catastrophe claims paid to millions of home, business and vehicle owners.

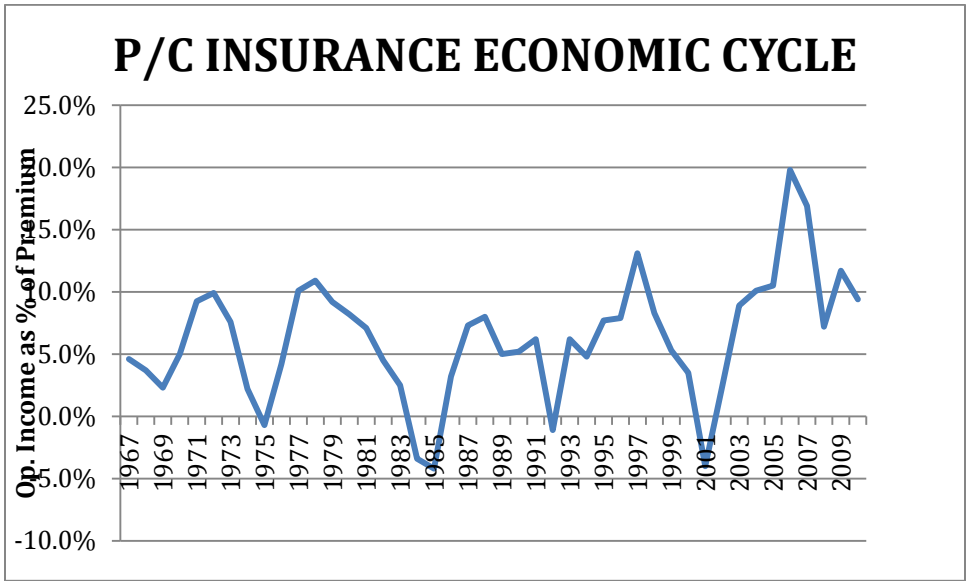
Robert Hartwig, President of the Insurance Information Institute[1]

The question of how insurers deal with weather catastrophes, especially in years in which multiple events occur, has serious policy implications for Americans. In short, how can insurers handle all this risk, and is it legitimate to shift these costs to consumers and taxpayers?

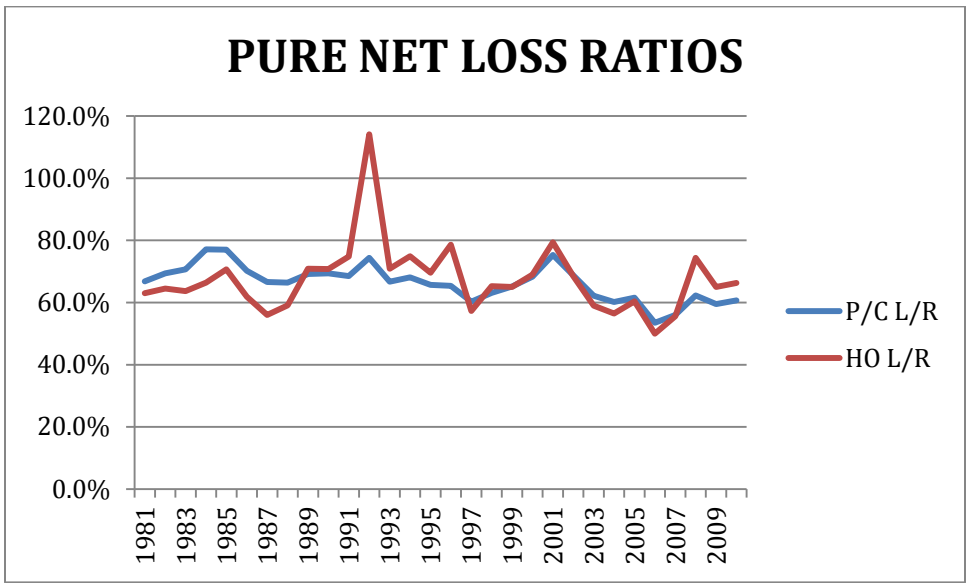
While insurance executives frequently remind the public and regulators of the frequency and severity of catastrophic events, industry data demonstrates that insurers have significantly and methodically decreased their financial responsibility for these events in recent years and shifted much of this risk to consumers and taxpayers. Some of the savings they have achieved is the result of the use of reinsurance and wise risk diversification strategies. However, most these savings have been achieved by hollowing out the coverage in homeowners insurance policies and raising rates. Insurers have also exposed taxpayers to more disaster assistance payouts and shifted high risk homes to state pools. This study investigates and analyzes the significant weather catastrophe risk-shift that has occurred in the last twenty years and offers recommendations to stop insurers from continuing to illegitimately shift costs and risks to taxpayers and consumers.

CATASTROPHES: ONCE A SERIOUS PROBLEM FOR INSURERS

The fact is that catastrophic weather events were once a serious problem for insurers. Consider the following charts:[2]



[1] "III Response to Americans for Insurance Reform Report," December 15, 2011.
[2] The data underlying these charts can be viewed at Addendum A.



"P/C L/R" is total property/casualty insurance losses divided by premium, called the "loss ratio." "HO L/R" is the loss ratio for the homeowners' insurance line of insurance.

The first chart illustrates the insurance industry economic cycle, showing operating income as a percentage of premium for the entire property-casualty insurance business over the last thirty years. There is a strong cyclical pattern to the industry's results. Periodically, insurers' profits decline to the break-even point. This is followed by what is known as a "hard market," in which coverage is hard to get and prices rise sharply. For example, a hard market began in 1975. Profits rose quickly thereafter and then, slowly, declined during the soft market until 1985, when another hard market started as profits dropped to zero and even a bit below that. A soft market began in 1987 and stayed in place until profits bottomed out again in 2001. The market is still soft as 2012 begins, but declining profits indicate that a hard market might be on the way. In fact, insurers are hoping for a hard market soon.[3]

One noteworthy aspect to the first chart is the sharp drop in overall property-casualty profits in 1992. What caused that one-year deviation from the normal cycle? The answer is that Hurricane Andrew adversely affected the insurance industry. Overall property-casualty profits fell that year by seven points as a direct result of Andrew. This is exactly what one would expect when a huge catastrophe occurs, because this is why Americans buy insurance, to cushion such occasional blows.

The impact of Hurricane Andrew can also be clearly seen in the second chart. Net loss ratios of the property-casualty industry increased by about seven points because homeowner's insurance profits were reduced by a whopping 40 points by Andrew.

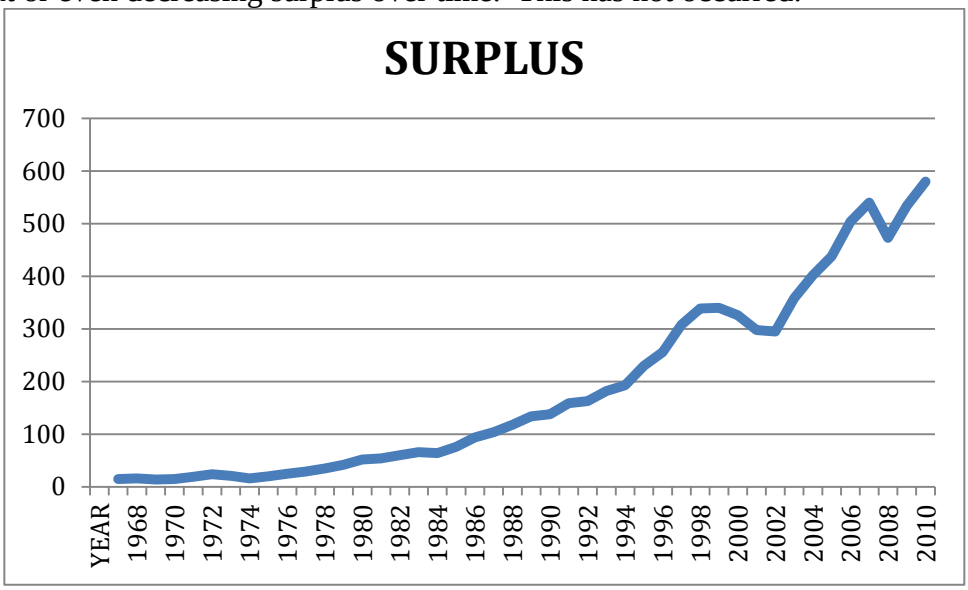
These charts demonstrate that at one time -- when hurricane Andrew hit in 1992 -- insurers bore much of the financial risk of hurricanes. This trend clearly changed in the last decade, in which seven of the most destructive ten disasters in American history occurred, according to the Insurance Information Institute.[4]. The huge hurricane damages of 2004 (four

[3] "Repeat Offenders: How the Insurance Industry Manufactures Crises and Harms America," Americans for Insurance Reform, December 2011.

[4] See http://www.iii.org/facts_statistics/catastrophes-us.html.

Florida hurricanes) and 2005 (Katrina and other hurricanes) had almost no impact on the overall property-casualty loss ratio or even the homeowners insurance loss ratio, as shown by the above chart.

One factor that illustrates the trend of large events having minimal impact on insurers is the increasing surplus that property casualty insurers have accumulated in recent years. One would expect that, in years when large hurricane events occurred, insurers losses would increase, leveling out or even decreasing surplus over time. This has not occurred.



INSURERS HAVE NOW "MASTERED" CATASTROPHIC EVENTS

When four hurricanes hit Florida in 2004 and Hurricane Katrina pummeled the Gulf Coast in 2005, there was no noticeable impact on the overall profits or loss-ratios of property-casualty insurers in either year. An examination of just the loss ratios for homeowners' insurance in those two years shows an impact from the storms that is not noticeable. According to the Insurance Information Institute,[5] Hurricane Andrew resulted in overall losses of $28 million, of which $17 million (64 percent) were paid out in insured losses. Hurricane Katrina resulted in overall losses of $125 million, of which insurers paid out $62 million (just under 50 percent). Had the payout ratio for Katrina been the same as for Andrew, insurers would have paid out $80 billion, or $18 billion more than they did. The bottom line in these comparisons is that, if insurers had not reduced policyholder coverage and increased rates after Hurricane Andrew, they would have paid out almost 30 percent more to them

How is it possible that the property-casualty industry's surplus would sharply increase as the number and severity of catastrophic weather events also increases? The primary reason is that the insurers have "mastered" hurricanes by shifting the lion's share of the risk and costs to consumers and taxpayers. In other words, property-casualty insurers have paradoxically emerged as masters of risk avoidance, rather than continuing their historic role of risk taking.

[5] See http://www.iii.org/facts_statistics/catastrophes-global.html.

HOW INSURERS REDUCED THEIR HURRICANE LOSSES AND SHIFTED RISK TO CONSUMERS AND TAXPAYERS

First, insurers have made intelligent use of reinsurance, securitization and other risk spreading techniques.[6] Some insurers now spread risk by issuing securities that couple the threat of a catastrophic event with the purchase of construction stocks that would likely increase in value if a catastrophic event occurs and the demand for construction increases. The use of this kind of creative approach to diversify risk is wise.

Second, after Hurricane Andrew, insurers changed ratemaking techniques by using computer models to project either 1,000 or 10,000 years of weather experience. While this caused huge price increases to consumers at the time, consumer leaders supported this change because insurers appeared to be genuinely surprised by the level of damage caused by Hurricane Andrew and promised that the models would bring long-term stability to prices. The model contained projections of periods of intense activity and very large hurricanes, as well as periods of little or no activity, and based rates on these estimates.

However, Risk Management Solutions (RMS) and the other risk modeling companies have recently stopped using this scientific method to project storms over a 1,000 or 10,000-year period and are now using one to five-year projections. This has caused at least a 40 percent jump in loss projections in Florida and the Gulf Coast and a 25 percent jump in the Northeast. This move reneges on promises of pricing stability made by insurers in the mid-1990s and has led to rates that are excessive. Insurance rates on the coasts have soared for property risks, homes and businesses in the last few years.

Third, insurers have sharply hollowed out the catastrophe coverage offered to consumers in recent years by placing a number of new requirements on policyholders and limits on coverage in policies:

- Deductibles of 2 to 5 percent have been imposed with little fanfare or notice. This reduction in coverage was accompanied in many cases by large rate increases.

- Caps on replacement costs and other limits on needed coverage. State Farm, for instance, caps payments for increased rebuilding costs at 20 percent. Other insurers allow no increased payments at all. A consumer who buys a $100,000 policy would receive only $100,000 to rebuild from some insurers, and $120,000 from State Farm, even if the cost of repairs skyrockets after a storm due to increased demand for materials and labor. Costs can also increase when homeowners are required to make special repairs to comply with building codes that were enacted after a home was first constructed. For example, many municipalities require such code upgrades to comply with the National Flood Insurance Program if a home is more than 50 percent damaged by a flood.

[6] This report is focused on the primary insurance market, not the reinsurance market. The worldwide reinsurance market has had rather stable catastrophe prices since 2002, with "rates on line" – defined by the reinsurer Guy Carpenter as "Premium divided by indemnity (claims paid). A British term for the rate which, when multiplied by the indemnity, would produce the premium." in a tight range since 2002. The highest rate on line observed in the data was in 1993 as Andrew severely impacted pricing. Today prices are stable because the catastrophe reinsurance sector "was overcapitalized by more than US $20 billion, or 12 percent at the beginning of 2010." This led to share buy-backs by many reinsurers. (Material in this footnote based on "World Catastrophe Reinsurance Market," Guy Carpenter, September 2010.)

Reimbursement for costs incurred to comply with building codes is now excluded from many homeowners' insurance policies. Coverage for mold mitigation is also now excluded from most policies. Given the surge in demand for home building and repair that occurs in the wake of a hurricane, and corresponding increases in prices, and new coverage exclusions, these changes significantly shift risk and costs to consumers.

- "Anti-concurrent-causation" clauses. This is the most draconian reduction in coverage that insurers have attempted to impose in recent years. It removes all coverage for wind damage if another, non-covered event (usually a flood) also occurs, regardless of the timing of the events. Under this anti-consumer measure, if a hurricane of 125-miles-per-hour rips a house apart but hours later a storm surge floods the property, the consumer would receive no reimbursement for wind losses incurred.

Given the cutbacks in coverage that have occurred in coastal areas, there is a serious question as to whether this diminished coverage is worth the higher rates that many consumers must pay. However, most consumers have no option but to purchase such coverage as it is required by lenders or the law or both. Demand for insurance is relatively inelastic.

Insurers have claimed that they are facing higher risks because of a sharp increase in the number of people and amount of construction in areas of the country vulnerable to earthquake and hurricane disasters. This claim was investigated in 2006 by the Los Angeles Times investigative reporter Peter Gosselin, who wrote that:

> …Key statistics don't support the argument….Census figures…show that the population of coastal and earthquake counties grew at an annual average rate of 1.56 percent between 1980 and last year. But they show that the U.S population grew at a reasonably close pace of 1.24 percent.

Gosselin interviewed Judith T. Kildow, director of the government-funded National Ocean Economics Program at California State University at Monterey, who said, "You simply cannot make the case from the numbers that America's coastal counties have grown at a disproportionately faster rate than the country as a whole over the last 25 years."[7]

Fourth, insurers have also shifted risk, sometimes onto taxpayers. Taxpayers are exposed by the high deductibles, anti-concurrent causation and other limits on coverage as disaster relief will fill in what insurers used to cover.

Taxpayers might also be called upon to subsidize state-run insurers-of-last resort, which were sharply populated by insurers non-renewing tens of thousands of homeowner and business properties. Allstate, the leading exemplar after Hurricane Andrew, emerged once again as the company that was most aggressive in refusing to renew homeowner's policies in the wake of Hurricane Katrina. After Hurricane Andrew, Allstate threatened to non-renew 300,000 South Floridians, leading the state of Florida to place a moratorium on such precipitous actions. After Hurricane Katrina, Allstate non-renewed thousands of homeowners, even many on Long Island, New York and Cape Cod, Massachusetts. Allstate has also announced that it will no longer offer new homeowner's policies in many states, from Connecticut to Delaware, and has refused to

[7] "The New Deal – Insurers Learn to Pinpoint Risks – and Avoid Them," Peter Gosselin, Los Angeles Times, November 28, 2006.

write new business in large portions of other states, such as Maryland and Virginia. Other insurers have also cut back coverage on the nation's coasts (See Addendum B, for more information).

Insurers have become quite adept at convincing government to use tax dollars to help them avoid risk. Consider the federal Terrorism Risk Insurance Act (TRIA), the California Earthquake Authority, Citizen's Insurance in Florida, and wind "pools" in a number of other states. The state pools have become the largest writers of insurance in some states[8]. Such an arrangement allows insurers to "cherry-pick" these states, keeping the safest risks for themselves and shifting the highest risks onto the taxpayers of the state, thereby socializing high-risk, potentially unprofitable policies and privatizing the low-risk, profitable business. This adverse result for policyholders and taxpayers is hardly surprising. It is akin to "solving" the health insurance crisis by requiring states to cover sick or terminally ill patients, while the private sector writes coverage for young and healthy consumers. Allstate has also led efforts at the federal level that failed to create a taxpayer-backed program modeled on TRIA to reinsure the private market against the perils of wind and other weather damage.

INSURERS COULD EASILY HANDLE CATASTROPHE RISK THEY ARE AVOIDING BECAUSE THEY ARE SIGNIFICANTLY OVERCAPITALIZED

In determining whether the property-casualty insurance industry is adequately capitalized, one must first examine the losses incurred for major catastrophe or terrorism events. According to the Insurance Information Institute, the top ten insured loss disasters for property were:

EVENT[9]	PRE-TAX 2010 DOLLAR LOSS	POST TAX 2010 DOLLAR LOSS
1. Hurricane Katrina, August 2005	$45.5 billion	$29.6
2. World Trade Center, Pentagon terrorist attacks, September 2001	22.9	14.9
3. Hurricane Andrew, August 1992	22.4	14.6
4. Northridge, California earthquake, January 1994	17.3	11.2
5. Hurricane Ike, September 2008	12.7	8.3
6. Hurricane Wilma, October 2005	11.4	7.4
7. Hurricane Charley, August 2004	8.5	5.5
8. Hurricane Ivan, September 2004	8.1	5.3
9. Hurricane Hugo, September 1989	6.7	4.4
10. Hurricane Rita, September 2005	6.2	4.0

Source: Insurance Services Office (ISO); Insurance Information Institute (See http://www.iii.org/facts_statistics/catastrophes-us.html). (Ranked on constant dollar cost to insurers)

[8] According to PIPSO – The Property Insurance Plans Service Office, the Florida FAIR Plan had 1.5 million policies, of which over 285,000 were high-risk coastal properties on May 2011. The Texas wind pool had 247,972 residential and 17,998 commercial policies in 2010. In 2010, Alabama's pool had 18,800 policies (mere than double the 7,800 of 2007z), Mississippi's Beach/Windstorm Plan had 46,546 policies and Georgia had 26,340 policies in its Pool.

[9] The catastrophes were ranked by III based on size of loss in 2005 dollars, which we do not display here. What is displayed is the actual dollars in the year of the event. We calculate the post-tax figure by deducting the corporate tax rate of 35 percent.

Considering that property-casualty insurers now have surplus in excess of $580 billion,[10] catastrophes of this size are very easy to manage.

Terrorism risk is an interesting case study. While insurers are rightly concerned about a huge event, such as a nuclear, chemical or biological attack, the actual terrorism events that have occurred so far have been easily managed by private industry. There were hundreds of terrorism events in America in the 20 years leading up to the September 11th attacks. In spite of this fact, insurers did not even bother to charge a separate price for terrorism coverage in their rating structures. September 11th changed this practice, but even that attack was a "small" insured event compared to the industry's mammoth capital and surplus, which has grown significantly since 2001. Yet, insurers convinced the federal government to provide free reinsurance that CFA estimates has represented about a ten billion taxpayer subsidy to date.

Historically, the prime test for the solidity of the property-casualty insurance industry has been the ratio of net premiums written (NPW) to surplus, discussed above. Regulators became concerned about the financial soundness of an insurer if its ratio exceeded 3 to 1. The so-called "Kenney Rule," named after financial writer Roger Kenney, held that a safe insurer should not exceed about a 2 to 1 ratio. This guideline was introduced in the 1960s and served as the standard that insurers and regulators followed for many decades. More recently, analysts have recommended lowering the acceptable ratio to about 1.5 to 1, in recognition of some more extreme risks that insurers now face, such as catastrophic hurricanes and terrorist attacks. Net premium written to surplus ratios for almost thirty years are as follows:

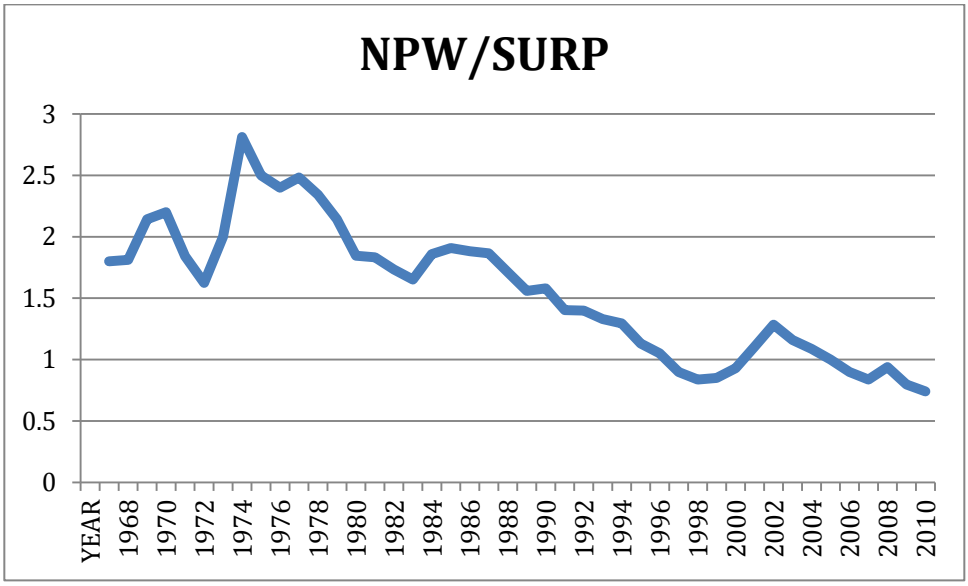
YEAR	NPW/SURP
1967	1.80
1968	1.81
1969	2.14
1970	2.20
1971	1.84
1972	1.63
1973	2.00
1974	2.81
1975	2.50
1976	2.40
1977	2.48
1978	2.34
1979	2.14
1980	1.85
1981	1.83
1982	1.73
1983	1.65
1984	1.86
1985	1.91
1986	1.88
1987	1.87
1988	1.71

[10] As of December 31, 2010, Bests Aggregates and Averages, 2011 Edition, page 366.

1989	1.56
1990	1.58
1991	1.40
1992	1.40
1993	1.33
1994	1.30
1995	1.13
1996	1.05
1997	0.90
1998	0.84
1999	0.85
2000	0.93
2001	1.10
2002	1.28
2003	1.16
2004	1.09
2005	1.00
2006	0.90
2007	0.84
2008	0.94
2009	0.80
2010	0.74

Source: Best's Aggregates and Averages, 1988-2011

Property-casualty insurers have not exceeded the recommended 1.5 to 1 ratio of NPW to surplus in almost twenty-five years. The sharp downward trend in this key leverage ratio is very clear, demonstrating that the industry is now significantly overcapitalized. Here is a graphic display of these data:



Consider this startling fact: Even if all of the top ten catastrophic events, including the September 11, 2001 attack, the Northridge Earthquake, and the top eight hurricanes, had

occurred in the last year and had been paid for last week (a total of $162 billion in 2010 dollars after tax[11]), the property-casualty industry surplus would still be at $418 billion and the leverage ratio would still be at an ultra safe ratio 1.0.[12]

WHO PAYS WHEN INSURERS DO NOT?

Consumers

Data indicates that Hurricane Katrina cost $125.0 billion, of which $62.2 billion (just under 50 percent) was paid by insurance. Hurricane Andrew cost $26.5 billion, of which $17.0 billion (64 percent) was paid by insurance.[13]

To show the difference in coverage now that the policies have been hollowed out, consider a hypothetical $100,000 home that incurred different levels of wind damage under the Hurricane Andrew compared to Hurricane Katrina. Assume the home had a $500 deductible under Andrew and a 5 percent deductible under Katrina.

	Benefit after Deductible		Katrina as a % of Andrew
Damage	Andrew	Katrina	
$10,000	$ 9,500	$ 5,000	53.6%
(Consumer pays $500 in Andrew; $5,000 in Katrina)			
$50,000	$49,500	$45,000	90.9%
(Consumer pays $500 in Andrew; $5,000 in Katrina)			

Assume further that additional work must be done when it is reconstructed to bring it up to code. If, for instance, the home required $1,000 of electrical work, the policyholder would be paid an additional $1,000 for Hurricane Andrew in both circumstances. However, under Katrina, there would the policyholder would receive no additional payment under the policy for mandated code work.

	Benefit after Deductible		Katrina as a % of Andrew
Damage	Andrew	Katrina	
$10,000	$ 9,500 + $1,000	$ 5,000	47.6%
(Consumer pays $500 in Andrew; $6,000 in Katrina)			
$50,000	$49,500 + $1,000	$45,000	89.1%
(Consumer pays $500 in Andrew; $6,000 in Katrina)			

If the home was in a flood plain and not elevated, damages that totaled 50 percent of the home's value would trigger a "non-conforming use" under the National Flood Insurance

[11] From Insurance Information Institute at http://www.iii.org/facts_statistics/catastrophes-us.html.

[12] $430 million in premium divided by ($580 million in surplus less $162 million in assumed after-tax loss) Data on Net Premiums Written and Surplus for all insurers is from A. M. Best Aggregates and Averages, 2011 Edition, Page 369.

[13] See http://www.iii.org/facts_statistics/hurricanes.html.

Program and the home would have to be upgraded to withstand a "100-year" flood. If such an improvement costs $10,000, the damage situation with $50,000 in losses would be:

Damage	Benefit after Deductible Andrew	Katrina	Katrina as a % of Andrew
$10,000 (Consumer pays $500 in Andrew; $6,000 in Katrina))	$ 9,500 + $1,000 + $10,000	$ 5,000	24.4%
$50,000 (Consumer pays $500 in Andrew; $16,000 in Katrina)	$49,500 + $1,000 + $10,000	$45,000	74.4%

It could get even worse if the home is destroyed and a demand surge of 50 percent raised the rebuilding cost for the $100,000 home to $150,000. If there was any additional flood damage to the home, even minor damage, (such as $5,000) the insurer might invoke the anti-concurrent causation clause of the policy and pay nothing. If the damage is caused only by wind, but the severe damage in the area causes rebuilding costs to rise by 50 percent, the benefit situation would be:

ANDREW: $150,000[14] less $5,000 for flood damage plus $10,000 flood elevation less $500 deductible = $154,500. Consumer pays $5,500.

KATRINA: Insurance pays nothing. Consumer pays $160,000.

It is very clear that much of the cost that used to be paid by private insurers has been shifted to consumers, ranging from a small amount to 100 percent of what used to be paid. Much of this will be shifted again, to taxpayers, in the form of increased disaster relief payouts as discussed now.

Taxpayers

Taxpayers are also bearing more risk. The National Flood Insurance Program is almost $20 billion in debt because the program is poorly administered by the Federal Emergency Management Agency (FEMA) and is poorly designed. FEMA has allowed flood risk maps to become antiquated, which has resulted in inadequate premiums that encourage unwise construction. The "Write Your Own" program which requires taxpayers to shoulder all financial risk, but allows insurers to service the NFIP, has also allowed insurers to collect excessive fees. The program will surely go deeper in debt in coming years due to these among other hidden subsidies, such as "grandfathering" in low, inadequate rates when new maps are issued. Congress should require the private sector to take a small, but growing, percentage of the risk over time. This will reduce taxpayer exposure in two ways: (1) The private sector will pay for flood losses incurred on their own accounts and (2) once the private sector has financial responsibility for some flood losses, it will police against hidden subsidies, such as FEMA's unauthorized (by Congress) grandfathering of low rates on supposedly actuarially-rated homes when a new map raises flood elevations.

[14] Some companies, such as State Farm, would pay an additional 20% or $30,000 more in this example.

The subsidy to taxpayers under TRIA has amounted to roughly $10 billion. Although there is no need for the federal government to back terrorism risk (except for exotic risks like nuclear and biological attacks), insurers are enjoying what amounts to free reinsurance, making TRIA another example of a wasteful corporate subsidy.

When private insurance payouts decline during catastrophic weather events, it stands to reason that government disaster relief costs will increase. Hurricane Andrew generated public disaster relief payments of $7 billion in 2009 dollars, whereas Hurricane Katrina generated $51 billion.[15] Insurance payments were twice as high for Katrina as for Andrew but disaster relief payments were over seven times higher. In 2008, with Hurricanes Gustav and Ike, among others, federal disaster relief was $13 billion (2009 dollars). When storms like these eclipse Andrew in the amount of government disaster relief that is paid out, it is hard not to conclude that a major cause of this increased taxpayer burden is the reduction in risk carried by insurers. The total cost of disaster relief from 1990 to 1999 was $40 billion; from 2000 to 2010 it was more than double, at $94 billion (all in 2009 dollars).

Because private insurers have fled America's coasts, many homes are insured through state pools. In Florida, Florida Citizens' Property Insurance Corporation (CPIC), the state pool, covers 1.5 million homes. If a storm or series of storms depletes Citizens' rather healthy reserves, assessments may be placed on other property-casualty companies in the state to address the shortfall. The state has the authority, since assessments are limited, to finance loss payments via tax-exempt bonds. State taxpayers could be at some risk if Citizens' or the CAT Fund (also backed by the state) ever ran out of money, even though this possibility has become less likely as the state has built up reserves. In California, earthquake risk is mostly written through the California Earthquake Authority, an entity similar to Florida Citizens, where state taxpayers may be exposed in extreme events.

RECOMMENDATIONS

There are many conclusions to be drawn from the reduced losses that insurers have experienced in recent years. The prime conclusion is that the insurance industry has moved from its historic role as a calculated risk-taker to one of a risk-avoider, exposing consumers and taxpayers to much higher costs. Not only have insurers insulated themselves from their historic share of hurricane risk, they have made no serious effort to write flood risk and terrorism risk, which are entirely backed by federal taxpayers.

Although insurers have become adept at shifting the cost of catastrophe losses to others, they still use catastrophic weather events to advocate for measures that would shift risk even more, such as higher rates, or putting more policyholders in pools or created taxpayer-supported entities. Thus, many consumers exposed to catastrophe weather risk are also vulnerable to insurer attempts to unjustifiably increase rates or hollow out coverage.

Recommendations for the States

CFA recommends that the states carefully examine national data on limited catastrophe losses and excessive surplus before approving any insurer requested rate increases. State

[15] Database maintained by Congressional Research Service based upon US Budget documents and appropriation statutes, Table 1 of "Disaster Relief Funding and Emergency Supplemental Appropriations, CRS, May 24, 2010.

insurance commissioners should be on guard against unwarranted attempts by insurers to use catastrophe losses as part of their rationale for jacking up rates.

We recommend that states carefully review the reasons why insurers are dumping risks into state pools and to take action to stop insurers from unjustifiably refusing to cover qualified homeowners. It is unnecessary for any more dumping to occur since insurers have now twice purged their portfolios of risk, once after Hurricane Andrew and again after Hurricane Katrina. States should also look at the high prices being charged to homeowners in their states in light of the fact that, in the aftermath of Andrew, insurers made major adjustments to pricing, dumped risk, reduced coverages and significantly reduced their hurricane risk exposure. Repeating these adjustments in the wake of 2004/5 storms was really more about gouging than correction. Rates requested by insurers in non-competitive markets after hurricanes can easily be excessive, violating sound actuarial principles. The coastal states must revisit hurricane pricing in recognition of the fact that the industry has mastered hurricanes on a national basis as evidenced by the almost negligible impact of Hurricane Katrina on their national results, a vast change compared to results during Hurricane Andrew, a smaller event. States should ban the use of non-scientific pricing models, such as short-term catastrophe models.

States should ban use of anti-concurrent causation clauses and any other attempt by insurers to build a "trap-door" hidden in the policy, through which coverage can unexpectedly fall when policyholders most need help.

States should not allow hurricane deductibles to apply unless a storm is classified as a hurricane throughout its journey through the state, from entry to exit. It is impossible to tell where a hurricane exactly becomes a tropical storm within a state so this ambiguity must be decided to the benefit of the consumers who have bought the coverage, not insurers who are compensated for being risk-takers.

States should adopt the California approach to consumer participation in regulatory proceedings, where consumers can receive reimbursement from the filing insurer to hire experts (like actuaries, lawyers and economists) if they make a "substantial contribution" to a case. They receive no compensation if they do not make a substantial contribution, so consumer groups in California study filings prior to risking an intervention very carefully. Costs paid by the insurers for such intervention would be allowed to be included as part of the rate filing.

States should make sure that they have all the data they need to monitor the home insurance market, including data by census track on who is writing and where, non-renewal patterns, etc. This will allow regulators to make informed decisions about whether markets in their states are truly competitive.

Coastal states should join together to form an interstate compact to deal with common issues stemming from their shared hurricane risk. A pool of states with common policies could allow states to spread risk and lower costs by developing common pools and provide consumers and insurers with consistent requirements. A common approach would also better position states – especially small ones – to resist coercive efforts by insurers to weaken regulatory protections for consumers. For example, after the hurricanes of 2004/5, several smaller states (AL, MS and LA) were pressured by insurers with threats of withdrawal to take actions that would harm consumers in those states.

One action a consortium of coastal states could take is to create a regulatory model for calculating hurricane risk to test the reliability of insurer-proposed catastrophe premiums in rates.

Using the model, states could create a stand-by reinsurance mechanism that would sell reinsurance to insurers at 50 percent more than actuarial rates developed by the model, which would keep premiums in check during the non-competitive phase of the insurer cycle or after hurricane events when reinsurers often gouge. When private reinsurance is reasonably priced at or near the actuarial level, the state back-up would not kick in. Florida successfully did sell reinsurance to the industry after the 2004/5 storms and now has, through premium accumulation and bonding, no real risk for its reinsurance. At the same time, policyholders saved about 15 percent of premiums because Florida requires insurers to use their reinsurance (or at least adopt the cost of that state reinsurance or less in home insurance ratemaking). This system temporarily replaced private reinsurance in Florida, which was priced at four to five times the actuarial rate in the non-competitive reinsurance market after 2004 and 2005 storms.

States should also develop model language that would be required in every minimum insurance policy sold in the region. Among other things, this language should remove the anti-concurrent causation clauses from use and clarify exceptions and exclusions in coverage. Coverage above the minimum would be allowed to be sold to consumers with pricing for such enhancements made clear to the policyholder.

Recommendations for the Federal Government

The fact that insurers do not take financial risk for either flood or terrorism insurance is a huge policy error. With the NFIP, it tempts unscrupulous insurers to illegitimately shift wind risk to the flood program. With both programs, taxpayers are required to pick up huge risks that private insurers are more than capable of identifying and backing. Taxpayers deserve to have at least some of this risk removed from them, particularly at this time of economic stress, and a search for ways to cut federal spending. We recommend that Congress limit the exposure of taxpayers to terrorism risk to only extreme events such as nuclear, chemical or biological events exceeding a 100 billion threshold. TRIA should be amended to only cover losses caused by nuclear, biological or chemical attacks that exceed $100 billion.

We recommend that the National Flood Insurance Program bills currently under consideration be amended to require a study on how to involve the private sector in sharing the risk from the first dollar of loss, perhaps starting with a low, but increasing, percentage of the risk for insurers wishing to participate in the NFIP as "Write Your Own" companies.[16] FEMA should also lower the excessive WYO servicing fees that create a windfall for the WYO companies at taxpayer expense. Recommendations for private reinsurers to cover losses only above the federal insurance coverage that is offered should be rejected, as they will only add the cost of reinsurers' overhead and profit to the program over time. It does not make sense to have the relatively tiny reinsurance industry backing up the federal government, at the same time as insurers are pushing for a federal backstop for their wind exposure. Logically, a smaller entity should not be backing up a bigger one, which argues for a private NFIP role at the low end of flood loss spectrum, not at the high end. If the program were privately reinsured, it would most

[16] See June 23, 2011 Testimony given by Travis Plunkett to the US Senate Banking Committee on the "Authorization of the National Flood Insurance Program" for detailed comments on CFA's recommendations.

likely add the unnecessary cost of the overhead and profit the reinsurers receive to the cost of the program, requiring more taxpayer expenditures over time. Further, if significant events occur, reinsurers are likely to either retrench or severely raise prices, just when reinsurance is most needed, as they do with wind coverage.

Data on home insurance in a format similar to what is required of banks under the Home Mortgage Disclosure Act (HMDA) should be collected by the Federal Insurance Office (FIO) and made available to the states and to the public. This would allow detailed analysis of why certain markets are stressed, which insurers are doing their best to serve markets in stressed areas and which are causing problems. This would enable policyholders to craft solutions based on solid statistical evidence. It would also allow analysis of markets to see if low- and moderate-income areas are being properly served.

We recommend that the federal government assist the states in forming an interstate compact to regulate hurricane insurance by authorizing such a combined effort and by taking action to assist the states in several ways, including:

- Offering the expertise of the federal government (entities like FEMA, NOAA, etc.) to the group of coastal states. These experts could help develop the regulatory hurricane model for states to use in regulating insurance and in developing stand-by reinsurance pricing.

- Offering bridge loans at low-interest when stand-by reinsurance is used, if such use suffers losses due to timing risk (such as a large storm in the early years of the development of reserves.) These loans would be required to be fully repaid over reasonable time periods.

ADDENDUM A

DATA UNDERLYING THE CHARTS FOUND IN THE BODY OF THIS REPORT

COLUMN 1 YEAR	COLUMN 2 Total P/C Op Inc/Prem	COL 3 YEAR	COLUMN 4 P/C L/R	COL 5 HO L/R	
1967	4.6%				
1968	3.7%				
1969	2.3%				
1970	5.0%				
1971	9.3%				
1972	9.9%				
1973	7.6%				
1974	2.2%				
1975	-0.7%				
1976	4.2%				
1977	10.1%				
1978	10.9%				
1979	9.2%				
1980	8.2%				
1981	7.1%	1981	66.8%	63.0%	
1982	4.5%	1982	69.4%	64.5%	
1983	2.5%	1983	70.7%	63.7%	
1984	-3.4%	1984	77.1%	66.4%	
1985	-4.2%	1985	77.0%	70.7%	
1986	3.2%	1986	70.2%	61.9%	
1987	7.3%	1987	66.6%	56.0%	
1988	8.0%	1988	66.4%	59.1%	
1989	5.0%	1989	69.2%	70.9%	
1990	5.2%	1990	69.4%	70.8%	
1991	6.2%	1991	68.5%	74.8%	
1992	-1.1%	1992	74.4%	114.1%	HURRICANE ANDREW
1993	6.2%	1993	66.7%	70.9%	
1994	4.8%	1994	68.1%	74.9%	
1995	7.7%	1995	65.7%	69.6%	
1996	7.9%	1996	65.4%	78.6%	
1997	13.1%	1997	60.3%	57.3%	
1998	8.3%	1998	63.1%	65.3%	
1999	5.3%	1999	65.2%	65.0%	
2000	3.5%	2000	68.3%	69.0%	
2001	-4.0%	2001	75.3%	79.4%	
2002	2.4%	2002	68.8%	68.5%	
2003	8.9%	2003	62.2%	59.0%	
2004	10.1%	2004	60.2%	56.5%	4 FLORIDA HURRICANES
2005	10.5%	2005	61.6%	60.4%	HURRICANE KATRINA
2006	19.8%	2006	53.5%	50.0%	
2007	16.9%	2007	56.0%	55.6%	
2008	7.2%	2008	62.3%	74.4%	

2009	11.7%	2009	59.5%	65.0%
2010	9.4%	2010	60.7%	66.3%

Source: All data from Best's Aggregates and Averages, various years.

Columns 1 and 2 were used to create the chart showing the Property-casualty Insurance Industry's Economic Cycle over more than four decades.
Columns 3, 4 and 5 were used to create the chart showing the loss ratios for both the overall Property-casualty Insurance Industry and for homeowners insurance over a thirty-year period.

Addendum B: Reprinted from The Los Angeles Times, November 28, 2006

Insurance company cutbacks have left more than 1 million coastal residents scrambling to land new insurers or learning to live with weakened policies. As insurers retreat, states and homeowners are left to bear the biggest risks.

Massachusetts

During the last two years, six insurers have stopped selling or renewing policies along the coast, especially on Cape Cod, leaving 45,000 homeowners to look for coverage elsewhere. Most have turned to the state-created insurer of last resort. The Massachusetts FAIR Plan, now the state's largest homeowners insurer, recently received permission to raise rates 12.4 percent.

Connecticut

Atty. Gen. Richard Blumenthal has subpoenaed nine insurance companies to explain why they are requiring thousands of policyholders whose houses are near any water —coast, river or lake —to install storm shutters within 45 days or have their coverage cut or canceled.

New York

Allstate has refused to renew 30,000 policies in New York City and Long Island, and suggested it may make further cuts. Other insurers, including Nationwide and MetLife, have raised to as much as 5 percent of a home's value the amount policyholders must pay before insurance kicks in, or say they will write no new policies in coastal areas.

South Carolina

Agents say most insurers have stopped selling hurricane coverage along the coast. Those that still do have raised their rates by as much as 100 percent. The state-created fallback insurer is expected to more than double its business from 21,000 policies last year to more than 50,000.

Florida

Allstate has offloaded 120,000 homeowners to a start-up insurer and has said it will drop more as policies come up for renewal. State-created Citizens Property, now the state's largest homeowners insurer with 1.2 million policies, was forced to use tax dollars and issue bonds to plug a $1.6- billion financial hole due to hurricane claims. The second-largest, Poe Financial Group, went bankrupt this summer, leaving 300,000 to find coverage elsewhere. The state also has separate funds to sell insurers below-market reinsurance and cover businesses. Controversy over insurance was a major issue in this fall's election campaign, causing fissures in the dominant GOP.

Louisiana

The state's largest residential insurer, State Farm, will no longer offer wind and hail coverage as part of homeowners policies in southern Louisiana. In areas where it still covers these dangers, it

will require homeowners to pay up to 5 percent of losses themselves before insurance kicks in. In a move state regulators call illegal and are fighting, Allstate is seeking to transfer wind and hail coverage for 30,000 of its existing customers to the state created Citizens Insurance.

Texas

Allstate and five smaller insurers have canceled hurricane coverage for about 100,000 homeowners and have said they will write no new policies in coastal areas. Texas' largest insurer, State Farm, is seeking to raise its rates by more than 50 percent along the coast and 20 percent statewide.

California

The state has bucked the trend toward higher homeowners insurance rates with three major insurers, State Farm, Hartford and USAA, seeking rate reductions of 11 percent to 22 percent. Regulators have begun to question whether insurers are making excessive profits after finding that major companies spent only 41 cents of every premium dollar paying claims and related expenses. Alone among major firms, Allstate is seeking a 12.2 percent rate hike.

Washington

Allstate has dropped earthquake coverage for about 40,000 customers and will have its agents offer the quake insurance of another company when selling homeowners policies in the state. Nationally, the company has canceled quake coverage for more than 400,000.

Sources: Risk Management Solutions (map); interviews with state insurance regulators

Consumer Federation of America

AMERICA'S DISASTROUS DISASTER "SYSTEM"

BY
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JANUARY 1998

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AMERICA'S DISASTROUS DISASTER "SYSTEM"

Introduction

America has allowed its system for preparing and responding to natural disasters to grow in a haphazard way that inconsistently deals with natural disasters and which inadequately acts to save lives and property damage from natural hazards.

Consider the following inconsistent approaches to the three major hazards in America:

HAZARD	MITIGATION REQUIREMENTS	INSURANCE FROM:
FLOOD	Federal	Federal Government
WIND	State or local	Private (in Homeowners) or through State mandated Wind Pools or Joint Underwriting Associations
EARTHQUAKE	State or local	Private (separate policy) or through State Facility (California Earthquake Authority)

The lack of a planned, thoughtful approach to these problems puts our nation at risk -- leaving us vulnerable to sharply changing conditions, leaving taxpayers at great exposure, and resulting in unnecessary loss of life and property.

This paper takes an in-depth look at these three major hazards, the exposure society faces from them, how society covers the cost of these risks, current problems in covering the risks and why the current system needs to be changed. It also suggests how to move America toward a system that ends taxpayer subsidy of anticipated levels of damage, move the cost of high disaster risk to those who choose to live in high risk areas and minimize death and damage from unwise construction.

Societal Exposure

There has been tremendous growth in the costs of natural disasters in America as the chart below demonstrates. Since 1953, disasters over $100 million were declared from the Presidents's Disaster Relief Fund 18 times, of which 8 were in the 1990s. Of the $9.5 billion spent in disaster relief in these major events, $5.8 billion was spent in the 90s. For the total payouts for all size disasters, from 1980-1984, Federal Emergency Management Agency (FEMA) spent $2.6 billion; from 1985-1989 the cost

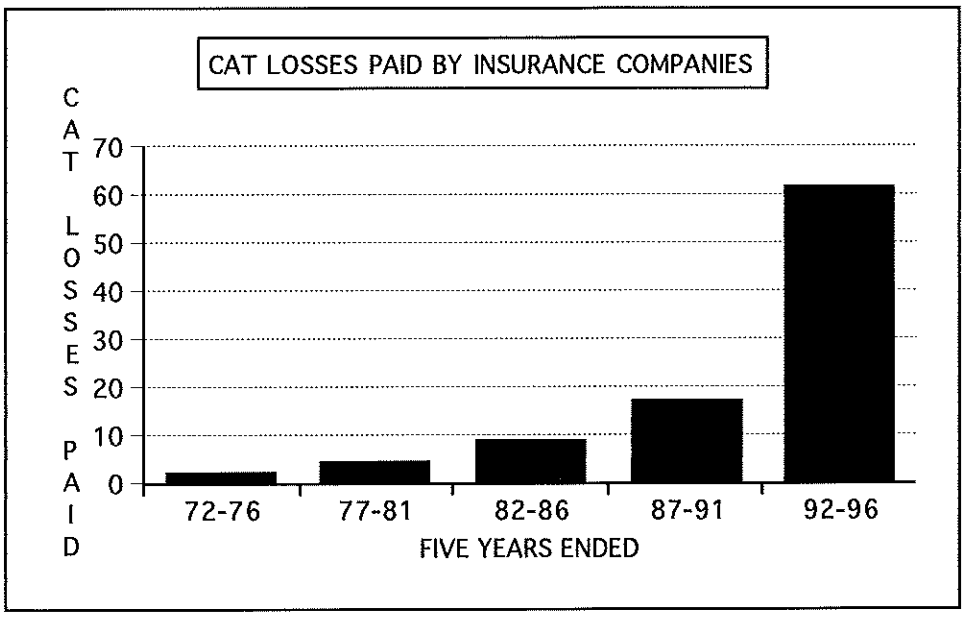
was $4.6 billion; from 1990 to 1994 the cost was $15.5 billion and for 1995-6, the cost was $8.4 billion (which translates into a greater than $20 billion clip on a five year basis).

The government costs would have been much greater, of course, had there not been significant payments made by private insurance companies for disaster losses.

During recent years, the insurance company catastrophe payments have also risen, viz:

FIVE YEARS ENDED:	CATASTROPHE LOSSES PAID BY INSURANCE COMPANIES[1]
1971	$ 1.3 billion
1976	2.1
1981	4.7
1986	9.0
1991	17.5
1996	61.4

Viewed graphically, one sees a remarkable growth in catastrophe payouts:



Of the top ten most costly insured losses of all time, only Hurricane Hugo (1989) was not a 1990s event.[2]

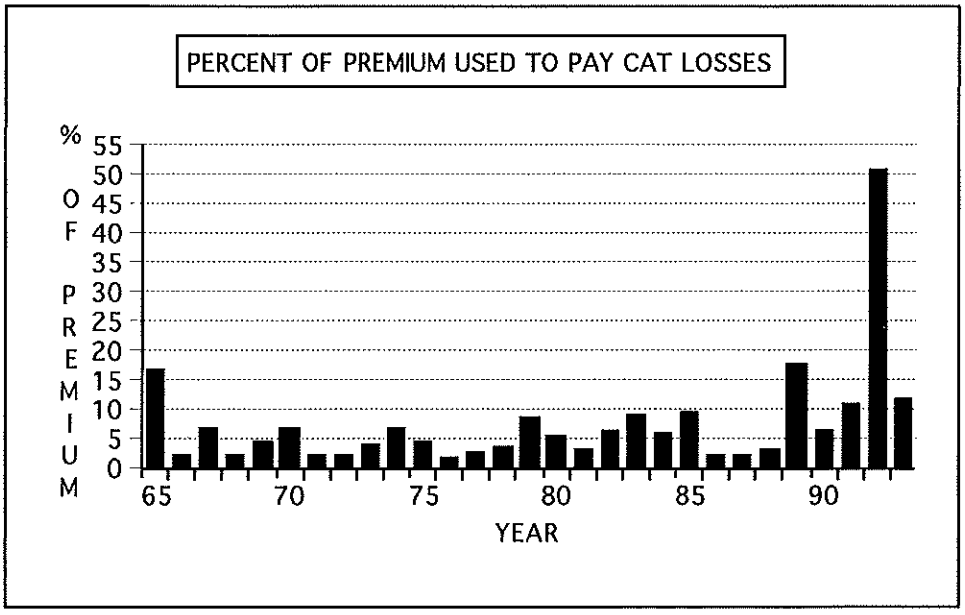
[1] See Exhibit 1, attached, for detail.

[2] Source: Insurance Information Institute, Insurance Issues Update, May, 1997.

A recent federal report found that the anticipated level of damage from hurricanes currently is $5 billion a year.[3]

Who Pays?

The question of who pays for natural disasters is an interesting one. For those who are insured, actuarial principles would require that risks pay their own way with actuarially sound prices. Over time, the percentage of premium used to pay for catastrophes varies, viz[4]:



1992 saw fully half of affected premiums[5] used to cover catastrophes. In a typical year, under 10% of premiums are so used. But the result is highly variable, causing great risk to be felt by primary insurance companies. This implies a great need to lay off, or "reinsure" a significant part of the risk.[6]

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[3] National Oceanic and Atmospheric Administration, November, 1997.

[4] Source: Table 2.4 of "federal Disaster Assistance," Bipartisan Task Force on Funding Disaster Relief, U.S. Senate, March 15, 1995.

[5] The premiums used in the calculation are fire, allied lines, homeowners' multi peril, farmowners' multi peril, and commercial multi peril. If all property/casualty premiums are used, the ratios are much lower. For instance, in 1992, the percentage of total P/C premiums related to catastrophe payouts for claims is 10.1% rather than 51.0% related to the selected lines of insurance used for this chart. It is important to note that, in 1992, when catastrophes hit the insurance industry with this 10.1% impact on the bottom line, the industry still enjoyed a growth in surplus. This powerful performance related to investment returns and to the federal tax help the industry got at the end of the year (a form of federal subsidy not included in the disaster relief payments cited earlier in this report.

[6] Reinsurance is a sort of lay off bookie arrangement where the primary insurance company insures itself with a secondary market insurance company. This second insurance company insures the insurance the first insurance company wrote. Insuring insurance is caller "reinsurance."

\1992 was the year of Hurricane Andrew, of course. Andrew was unique, a $15.5 billion event for the insurers. Hurricane Hugo (1989) was the previous record payout, at $4.2 billion.

Payment for disasters depends upon whether they are fundamentally insured or not. Insured events will, over time be borne by those who are at risk. As Exhibit 2 shows, insurance catastrophe loadings -- the amount in rates for catastrophe costs -- vary by state. The five highest paying states are Hawaii (8.56% of premiums), Florida (7.73%), South Carolina (5.22%), Kansas (4.51%) and Oklahoma (4.16%).[7]

Of course, in the short run, insurance involves a sort of "cross subsidy", from those who do not suffer the loss to those that do. In the long run, given the nature of the competitive market in insurance, prices will reflect risk. Insurance subsidies may exist, but they are minimized by state regulatory practices which only allow small impact, if any, of disasters from other states. However, within a state, cross subsidies may exist (such as between the coast of Florida and those living in the north-center of the state; between those with little exposure to risk of earthquake in California and those with the largest risk[8]).

The insurance industry has complained about regulation suppressing disaster insurance rates, but that is not a significant factor. Since insurance companies can reject risks through underwriting, the regulator has little opportunity to hold rates too low. Indeed, the problem of rates being too low prior to Hurricane Andrew in Florida can be shown to be caused by industry desire for market share, not suppression by the regulators.

But disaster relief payments involve cross subsidy from those not exposed to those who are exposed with no or inadequate private or public insurance. There is no risk testing in the collection of federal taxes. Therefore there is no surcharge on taxes for living in a high risk area.

Exhibit 3 shows the Federal Emergency Management Agency (FEMA)/SBA disaster relief payments made by state from 1988 to 1996. California received $13.1 billion in assistance, 46% of the national total. Florida, albeit Hurricane Andrew is in this time frame, received $2.5 billion, 9% of the national total over the period. A major reason is that Hurricanes are covered in the Homeowners and other fire-related insurance policies, but earthquake is not.

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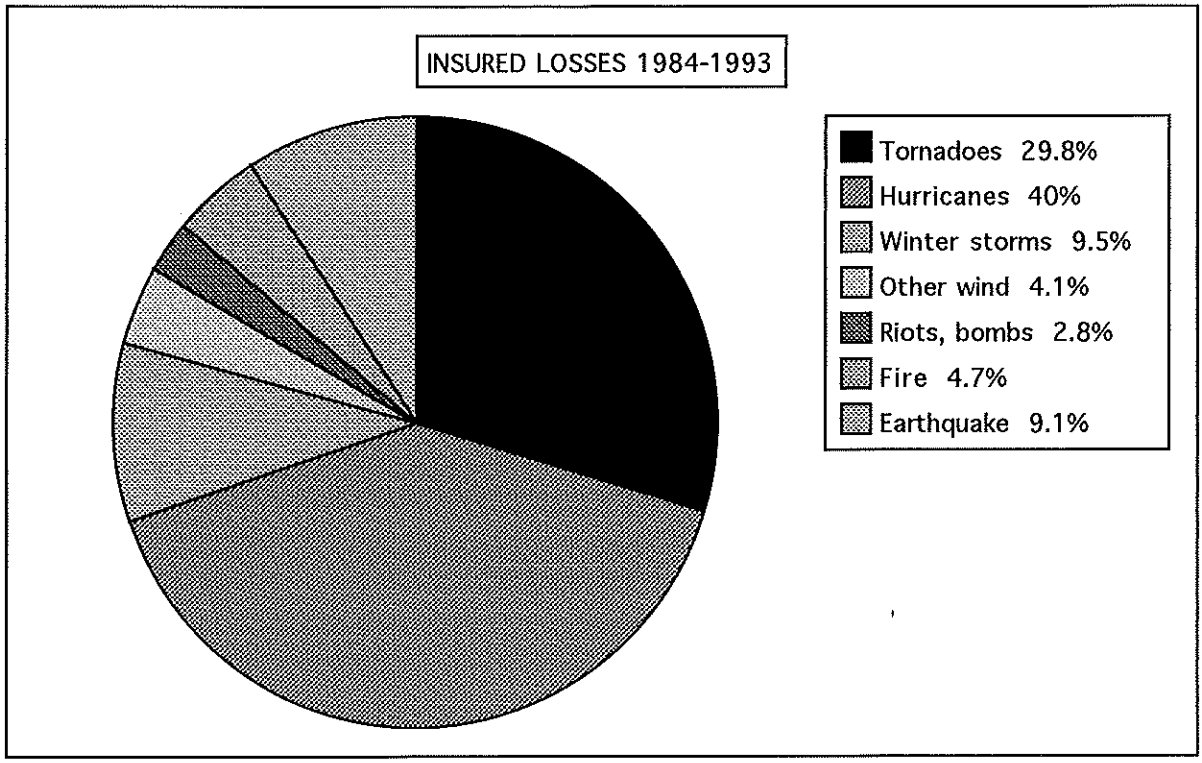
[7] The National Association of Insurance Commissioners approach is based on historical experience for all perils except flood (including hail, tornado, hurricane and earthquake). Other approaches involving modeling, such as the rate loads for catastrophe adopted by the Insurance Services Organization might also be used for this sort of analysis.

[8] Indeed, the California Earthquake Authority explicitly filed for such a cross subsidy in its first rate request. This dangerous precedent could lead to unwise construction since the subsidy applies not only to existing construction, but to new construction as well.

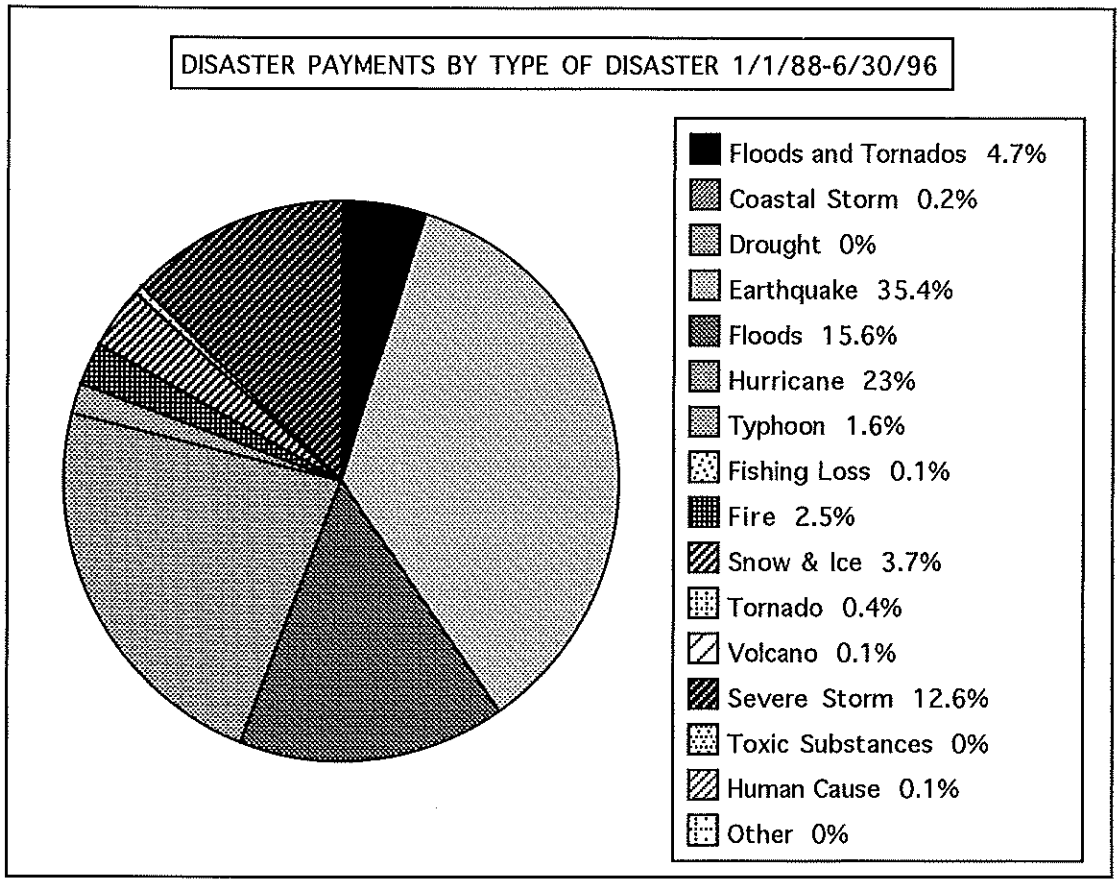
Consider the breakout of payments for insurance vs. disaster relief:

INSURANCE:



It should be noted that this excludes the National Flood Insurance Program loss payments.

DISASTER RELIEF:



Looking at the major payout comparisons:

Type of Disaster	Relief payouts	Private Insurance payouts
Earthquake	35.4%	9.1%
Floods	15.6	0
Hurricanes	23.0	40.0
Severe Storms	12.6	4.1
Tornadoes	5.1	29.8
Ice/Snow	3.7	9.5
Other Disasters	4.6	7.5
Total	100.0%	100.0%

Insurance takes care of smaller wind events such as tornadoes almost completely. Insurance covers a significant portion of the larger wind events, too. Federal Flood Insurance has been rightly criticized for failing to make necessary market penetration to reduce tax support, albeit, between 1977 and 1993, it paid out $6.8 billion requiring only a $3.0 billion governmental outlay.[9]

State cross subsidies in disaster relief are apparent (See Exhibit 4). For example, California received over $13 billion of relief for disasters in the 1988-1996 period, which, related to the tax base was about 2.4 cents back per dollar of tax paid. New Mexico, DC, Colorado, Utah and Wyoming got back under $10 Million in the period, representing under 0.1 cents per dollar of tax paid. Exhibit 4A shows an estimate of the subsidy by state in dollars per household per year. Receiving the largest subsidies are ND ($104), CA ($100), HA ($74), and SD ($52), . Paying most are CT ($63), NJ ($52), DC ($50), MD ($44), NH ($44) NV ($44), MI ($42), NY ($39), MA ($38) and WY ($38). Note that, because they pay there own way through insurance, Florida had a relatively low $22 per household subsidy, even with Hurricane Andrew's impact.

Indeed, one state, California, has received 46% of the disaster dollars spent by the government in recent years, over five times the dollars flowing into the second highest collecting state, South Carolina at 9%.

Very interestingly, as Exhibit 5 shows, farmers and farm corporations fare well under disaster relief. 58% of disaster relief dollars in the total disaster picture for 77-93 were paid out by the US Department of Agriculture or by FmHa, compared to 24% for small businesses and about 12% for families.[10]

The federal government does run two disaster-type insurance programs, the National Flood Insurance Program (NFIP) and the Federal Crop Insurance Program.[11] While still a money loser, the NFIP is predicated on a plan to reduce taxpayer subsidy as new construction must meet federal building codes in high flood hazard areas of maps produced by the government.

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[9] The National Flood Insurance Program (NFIP) is a federal program run by the Federal Insurance Administration (FIA), housed in the Federal Emergency Management Agency, which sells flood insurance in participating communities. In order to participate, communities must enact land use and control measures for those parts of the community found to have high flooding risk according to FIA maps. New structures, built after the map is published in the community, must pay full, unsubsidized, actuarial rates. Market penetration problems have been exacerbated by the public perception that "it can't happen to me" and the expectation of federal bailouts "if it does happen to me." Another problem has been the lack of a requirement for banks to maintain insurance coverage after the initial year of coverage.

[10] Research of farm disaster relief payout detail by state was beyond the scope of this report but is research which should be undertaken.

[11] The results of the programs are as follows (1977 to 1993 cumulative data, 000 deleted):

	FLOOD PROGRAM	CROP PROGRAM
PREMIUMS	$ 8,426	$ 7,324
LOSSES	6,835	13,451
EXPENSES	4,533	3,862
GOVT OUTLAY	2,992	9.989

Coverage Historically

Insurance coverage for Earthquake and Wind has normally been made available privately (flood insurance was never widely available through private sector). In the era leading up to the recent spate of large disasters, there was a rush to write all risks, including catastrophic risk. Aggressive competition was the order of the day, even in high risk hurricane and earthquake zones.[12]

When California first required review of fault exposure in the late 1970s-early 1980s, the reaction of the insurance companies was a panic -- they had unknowingly written freely along faults (interestingly, while they had undeserved such areas as South Central Los Angeles[13]). In Florida, following Hurricane Andrew, companies started to retrench. Allstate even threatened to terminate 300,000 policies until the state stopped that with a moratorium on terminations. A state task force found that, in the period leading up to Andrew, Allstate and State Farm had wildly competed themselves into a market characterized by the task force as an oligopy. In great measure, the insurers brought trouble onto themselves by careless writing, not paying enough attention to proper spread of catastrophic risk.

Similar findings of insurance industry self-inflicted problems in the catastrophic insurance market were reported by Conning & Company. Conning determined that not only aggressive writing, but expansion of coverage under the Homeowners' Policy led to the high costs. The biggest change, Conning found, was the expanded use of replacement cost policies for homes and contents. Further, Conning found that the cost of insuring homes fell by 40% per $100,000 of coverage between 1984 and 1995.[14]

How The System Has Worked Quantitatively

Insurance has paid more of the cost of disasters than the federal government disaster programs have. In the decade 1986 to 1995, disaster payouts have been about $66 billion, whereas private insurance payouts have been $72 billion. Out of pocket costs[15] have not been estimated, but are large and getting larger as both the insurance industry and the government try to tighten up their belts as respects disaster exposures. For example, in California, earthquake policies are now written by the California Earthquake Authority which, like other insurers writing earthquake insurance, uses a "mini-policy" with sharp coverage restrictions. The most noteworthy

[12] The homeowner's insurance market was very "soft" (that is, characterized by low price and easy availability of insurance) for many years leading up to 1992. Hurricane Andrew turned the market "hard" (that is high in price and difficult to obtain coverage, particularly near coasts and earthquake faults).

[13] See studies of California Department of Insurance following Los Angeles Riots, 1992.

[14] Conning & Co., November, 1996.

[15] Out of pocket costs are due to lack of insurance, inability to buy insurance, large deductibles, coverage restrictions imposed in so-called "mini-policies" and other coverage restrictions.

restriction is the deductible of 15%. Estimates there are that consumers (and/or taxpayers) will pay about 63% of earthquake claims under the new California Earthquake Authority limited policies.[16]

In recent years the consumer has had difficulty in seeking coverage in high risk areas for private coverage (Federal Flood Insurance is always readily available). Following the large recent disasters, insurance companies have moved in the direction of significantly higher prices and much narrower coverage for catastrophes. Insurers have cut their exposure using some of the following strategies:

- limits on coverage, such as increasing deductibles and the advent of intra-policy coverage controls, such as the "mini-policy" used to write earthquake coverage in California
- rate hikes, based on new models (often without disclosing the model or the assumptions used in the model) rather than using the historic methods of relying on state long-term data[17]
- changed underwriting (eg Allstate pullout in Florida; coastal pullouts; other adjustments; quotas by region for some carriers)
- creation of plans to get insurance companies off the hook for risk (Florida JUA, California Earthquake Authority)
- role of reinsurance in market stability over recent years -- first a significant tightening of the reinsurance market, now an easing, even recent rate reductions
- creation of new ways to spread risk (USAA and other insurers looking to the securities market to spread the catastrophe costs)

It appears evident that the insurance market overreacted in the wake of Hurricane Andrew. But it has been righting itself. Reinsurance was the most exposed area of the insurance market. It retrenched very severely following Andrew. But it has come back with a vengeance. The Bermuda reinsurance market raised $4.5 billion in capacity in 1994 alone. Prices for catastrophe reinsurance began to fall in early 1995 and that trend continues to this day. Securitization of insurance risk began in 1995 when Nationwide Mutual Insurance Group secured $400 million in backup from Morgan Stanley and other investors. "Act of God" bonds, hedges and derivative approaches to the problem were created in 1995. In 1996 and 1997, this trend continued with several major insurers, including USAA, obtaining new mechanisms to spread the risk

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[16] Testimony of J. Robert Hunter in the Matter of the Rate Filing of the California Earthquake Authority, April 14, 1997. CEA has not called for upgraded building codes nor offered meaningful incentives for private mitigation efforts.

[17] CFA believes that use of models is a step forward, scientifically. However, the assumptions involved must be made public for all to see and debate, to assure that the models do not hide improper techniques to determine prices. Instances of different modelers producing widely different results is troubling. Altered assumptions should be made public for consumers to have confidence in actuarial pricing so that cross subsidies can be minimized.

or spread the cost of unusually high catastrophes.[18]

Critique of Existing "System"

Simply put, there is no "system" in place to systematically deal with disasters in the United States of America. But there should be. The nation rocks along from disaster to disaster, with the President or Vice-President dutifully flying over each major disaster with the governor and mayor and the Federal Emergency Management Agency (FEMA) Director, bringing with them checks to hand out.

This is not a "system". This is a tragedy. You would think that once, as he flies over yet another tragedy, the President (not just Clinton, but all the Presidents, Democrat or Republican, who have been in that helicopter over and over again for decades) would say, "Wait a minute. What are we doing? How can we help the current victims, yes, but move the nation toward a rational plan to lower damage and loss of life and ultimately get the taxpayer off the hook for all these costs?"

The current "system" is a prescription for Disaster, not a prescription to avoid a disaster. Only in the National Flood Insurance Program is there required safe building standards in place. There are no national wind or earthquake standards.

Nor are there national enforcement tests of any standards that are in place. Studies after Hurricane Andrew indicated that, had the standards in place in Florida been enforced, damage would have been reduced by 40%.

California's new earthquake facility, the California Earthquake Authority, not only has adopted no building standards, it has no research underway to even test existing codes or enforcement of such codes. Worse, the rating plan has cross subsidies built into it, even for new construction, an invitation to builders to build in higher risk areas.

There have been some self-serving attempts to broaden the national perspective on disaster. In the 1980s, the insurance industry created an entity, the Earthquake Project, to try to obtain access to the treasury in the event large earthquakes happened. That project was expanded, and the name changed to the Natural Disaster Coalition, following Hurricane Andrew in 1992. But it remained committed less to a real solution than to a guarantee to bail out private insurance interests if a large event occurred. Wisely, Congress never acted on the bills put forth by either the Earthquake Project or its successor organization.

[18] See, e.g., "Private Sector Responses to U.S. Natural Disaster Threats," Reinsurance Association of America, April 15, 1997 for a through look at innovative ways capital is being made available to back up catastrophic risk privately. The USAA deal was the purchase of $400 million of reinsurance from a special purpose reinsurer (SPR), backed by catastrophe bonds. The SPR acts as a transformer, the real risk is borne by the bonds. USAA will be reimbursed for a loss of between $1 and $1.5 billion from a single Class 3, 4 or 5 hurricane in the 21 covered Atlantic and Gulf Coast States, with USAA taking 20% of the layer.

The problem faced by the nation is obvious. We need an integrated plan to, over several decades, assure that the taxpayers interests are protected and that damage and loss of life are reduced to a minimum.

This requires careful analysis to determine a comprehensive plan to (1) mitigate damage through enforced, national minimum standard building controls, (2) determine how to maximize private responses (be it traditional insurance or innovative ways to securitize risk) to natural disaster claims, (3) eventually eliminate taxpayer liability for natural disaster and (4) assure generally available, affordable insurance protection to all, including mechanisms to include the low income persons in high risk areas.

Solutions with no study not appropriate

Congress wisely has resisted solutions with no analysis undergirding the proposals. It would be worse than inappropriate for Congress to enact a plan that backed up private insurance with no analysis of how to mitigate risk, no time-line for the removal of taxpayer support, no enforcement guarantees as to building codes and no guarantee that safely built structures would be able to be protected from natural disasters through insurance or other affordable approaches.

Approaching a Solution

The only way to approach a solution is by careful study. The nation needs the answers to such questions as:

* Do we really need to do this for windstorm? After all, the private sector has handled wind for all time, including Hurricane Andrew, without a federal program and the catastrophe reinsurance market is robust today. Careful study in Florida showed that the availability problem in that state has a lot to do with the fact that the homeowners insurance market is over concentrated in two insurers, Florida study shows that in a relatively brief time, that state can garner the resources to handle its own problem. What states really need federal back-up in the long run? The Florida study makes it clear that the State would have fared much better if codes were enforced. Does this means that nationally enforced building codes should be adopted or are there other enforcement tools -- perhaps private approaches -- that can assure safe building occurs?

* What are the long term ramifications of the proposal? Where is the cost/benefit analysis? How does the mitigation component really work over time? When can the taxpayer really expect to get off of the hook in this program? Do we need temporary direct or cross subsidies? Who pays the subsidy? Who receives the subsidy? How can insurance be structured to encourage mitigation efforts by policyholders through price discounts, lower deductibles, etc.? Can a plan be devised which would combine a loan for the

cost of the mitigation with an insurance price discount so that the homeowner who chooses to mitigate would actually see a lower net monthly payment for the loan/premium combination?

* Does Michigan subsidize California more or less than Michigan does today under the current disaster relief approach? Who gets subsidy and how much? Who pays subsidy and how much? Will the people who chose to inhabit high risk zones ever fully pay their own way?

* As to mitigation, what is the state of the art standards that will be required? Who enforces it? Who gets it by the builders, with their focused economic interest and powerful lobby at the local and state level? Is just one standard required or should it vary by place? Should there be federal minima that must be met for a state or locality to qualify for the insurance or reinsurance? To what extent should mitigation be required vs. encouraged by financial incentives? Does the answer to this depend on whether we are considering mitigation on a new or an existing structure?

* Should there be one plan for all catastrophic hazards or is the issue different coverage by coverage? How should the National Flood Insurance Program be integrated into the overall plan? What are the lessons from the NFIP that should be instructive in developing the overall plan? Was the NFIP good legislation? How has it worked to get mitigation in place? Have lives and property been saved?

* What alternatives to traditional insurance can be developed to spread the risk beyond insurance to the far greater securities markets?[19]

* What happens to those who must buy the insurance under the purchase requirements of the bill but can't afford the price? Is this the right way to force spread of risk? Should there be some transition plan similar to the existing structure subsidies used when the National Flood Insurance program was enacted? Study of the rather tiny benefits being offered under California's so-called "Mini-policy" for earthquake and the likely adverse ramifications on the public and the taxpayer of sharp coverage limitations should be part of the analysis.

[19] Research indicates that a large natural disaster might use up one-third of the insurance industry's surplus, but the same loss would only represent about 1% of the security value traded on U.S. stock markets. Indeed, the addition of securities covering natural disasters to investor's portfolios would reduce the risk of a securities portfolio, given the counter-cyclical nature of natural catastrophes (i.e. not moving with giant market movements -- known as a zero beta). See Can Insurers Pay for the "Big One"? Measuring the Capacity of an Insurance Market to Respond to Catastrophic Losses, J. David Cummins and Neil A Doherty, The Wharton School, December, 1997.

Before the flood insurance program was enacted, Congress did the right thing. It undertook a feasibility study under the leadership of the National Academy of Sciences that carefully answered the questions that attended to the flood risk. This sort of impartial study is needed to determine of what sort of federal back-up, if any, is needed for this country's insurance industry for natural disaster, what appropriate mitigation measures should be employed, what other quid-pro-quos should be exacted to protect taxpayers and answers to many other fundamental questions.

The Wharton School has begun such an effort. This study could answer many of these and other important questions.

There is also hope for movement toward informed future action in these recent developments:

- The Federal Emergence Management Agency has prepared a National Mitigation Strategy. It is a beginning, but requires promotion and endorsement so it is not too little and too late.

- The American Red Cross has incorporated natural disaster loss mitigation as a core program.

- Most property insurers are supporting the Institute for Business and Home Safety (IBHS) which focuses on the mission of natural disaster loss mitigation. It is surprising that about one-third of insurers, including some big names, have not become involved.

- Public Private Partnership 2000 (PPP2000) initiated by IBHS and 19 federal agencies (coordinated by the Subcommittee on Natural Disaster Loss Reduction) consists of 14 educational forums intended to develop the framework for formation of public and private partnerships to mitigate the effects of natural disasters. Bringing together all of the stake holders for joint thought and development of ideas is a very positive step.

Political Dilemma -- Solutions Possible

Naturally, the ultimate solution will require political compromise. It is no surprise that support for an earthquake-only solution gained support only from California's congressional delegation. When the Earthquake Project metamorphosed into the Natural Disaster Coalition after Hurricanes Andrew and Iniki in 1992, it is no wonder that the support came from California, Florida and Hawaii's Congressional delegations.

It is also no surprise that the states likely to pay more into the plan rather than take out of it resisted the plan so that it failed.

Careful study is the only way to bridge this political impasse. If we can find the right balance of mitigation, response, insurance, risk securitization and enforcement, we can devise a plan to pay for current natural disasters and plan for future ones in a way that demonstrates to the taxpayer in states such as Colorado, Michigan, Utah and Wyoming (those currently footing the cost of disaster relief) that they will be freed from today's cycle of higher and higher tax support of unwise construction in high risk areas of the country. We can devise a plan to assure that reasonably priced insurance can be available to all, including the poor. We can devise a plan that eliminates taxpayer subsidy and insurance cross subsidy so that those choosing to live in high risk areas will pay their own way. We can maximize mitigation efforts through a proper combination of building codes and financial incentives. We can make sure that the protection for natural disasters is covered privately by insurance and newer, financial market based mechanisms.

We can have a thoughtful, integrated system to deal with natural disasters in America. It is time to develop it.

Peer Review

The author wishes to thank those who reviewed this paper, which includes Howard Kunreuther and Charles Nyce of the Wharton School at the University of Pennsylvania, Robert Klein of Georgia State University, Mary Griffin of Consumers Union, Herman Brandau of State Farm Insurance Company, Deborah Ballen of the American Insurance Association, Paula Hayes of CNA Insurance Companies, Eldon Ziegler of Nationwide Insurance Company and Stephen Brobeck of Consumer Federation of America. These reviewers gave the author significant and helpful advice. To the extent that there are errors in this paper, however, they are the authors.

The Author

J. Robert Hunter is Director of Insurance for Consumer Federation of America (CFA). He formerly served as Insurance Commissioner for the State of Texas, Federal Insurance Administrator (during which time he ran the National Flood Insurance Program), President of the National Insurance Consumer Organization and as an actuary in several private sector insurance company jobs. Hunter also served as an advisor to the Florida Academic Task Force which studied the insurance market problems and opportunities in the aftermath of Hurricane Andrew. He also was a consultant to the State of California in the review of the California Earthquake Authority proposed prices, policies and procedures.

CFA is a federation of some 250 pro-consumer groups with a combined membership of over 50 million Americans.

EXHIBIT 1

DISASTER PAYOUTS BY INSURANCE COMPANIES IN THE U.S.A.

YEAR	CAT LOSSES[1]	YEAR	CAT LOSSES
1965	$ 694 Million	1981	714 Million
1966	111	1982	1,529
1967	327	1983	2,255
1968	135	1984	1,548
1969	256	1985	2,816
1970	450	1986	872
1971	174	1987	905
1972	215	1988	1,409
1973	376	1989	7,642
1974	696	1990	2,825
1975	514	1991	4,723
1976	271	1992	22,970
1977	423	1993	5,705
1978	646	1994	17,010
1979	1,703	1995	8,310
1980	1,177	1996	7,375

[1] Source: Property Claims Services Division of American Insurance Services Group, Inc. Actual payouts. These payouts include commercial insurance as well as insurance on homes.

INS. CAT LOADS BY STATE

Exhibit 2

STATE	PREMIUM FACTORS (%)	STATE	PREMIUM FACTORS (%)
Hawaii	8.56	Virginia	0.95
Florida	7.73	Tennessee	0.93
South Car.	5.22	Minnesota	0.89
Kansas	4.51	Pennsylvania	0.84
Oklahoma	4.16	Oregon	0.76
California	3.49	Ohio	0.76
Texas	3.22	New York	0.76
Colorado	3.17	Maryland	0.7
Louisiana	3.07	Washington	0.62
Mississippi	2.94	New Jersey	0.62
Alabama	2.78	Maine	0.62
Nebraska	2.47	Vermont	0.61
Rhode Is.	2.32	Wisconsin	0.58
Arkansas	2.29	Alaska	0.55
North Car.	1.85	New Hampshire	0.43
Wyoming	1.75	Arizona	0.39
Delaware	1.75	Utah	0.35
Iowa	1.65	Michigan	0.29
Missouri	1.61	Idaho	0.21
South Dakota	1.45	Dist. of Col.	0.2
Georgia	1.42		
Kentucky	1.41		
Connecticut	1.31		
North Dakota	1.28		
West Virginia	1.27		
New Mexico	1.24		
Indiana	1.24		
Nevada	1.23		
Massachusetts	1.11		
Illinois	1.09		
Montana	0.97		

Source: New York Insurance Department Catastrophe Premium Reserve Factors, 5/14/97 (used unadjusted factor as proxy for cat costs)

FEMA/SBA
TOTALS
DISASTER
RELIEF
1988-96

EXHIBIT 3

$ MILLIONS	STATE
13061.7	California
2491.5	Florida
859.2	Illinois
736.8	Texas
706.9	Georgia
618.7	South Carolina
602.5	Missouri
590	Louisiana
511.1	North Carolina
471.8	New York
467.9	Iowa
444.2	Washington
425.8	Pennsylvania
410.5	Hawaii
304	Minnesota
293.1	Alabama
231.1	North Dakota
204.8	Oregon
195.9	Massachusetts
186.3	Kentucky
172.7	Nebraska
164.6	Ohio
163.3	South Dakota
160	New Jersey
154.4	Mississippi
153.5	Kansas
137.6	Arizona
136.9	Virginia
134	Wisconsin
133	West Virginia
130.1	Tennessee
129.6	Alaska
128.4	Indiana
103.2	Oklahoma
86.8	Arkansas
55.2	Maryland
54.2	Connecticut
53.3	Idaho
52.6	Maine
35.8	Michigan
30.9	Nevada
21.3	Vermont
20.5	Rhode Island
17.2	Delaware
14.9	New Hampshire
14.5	Montana
8.5	New Mexico
8.2	Dist. of Col.
4.8	Colorado
2.6	Utah
0.4	Wyoming
28289.9	Countrywide

EXHIBIT 4

DISASTER RELIEF PAYMENTS AS A PERCENTAGE OF FEDERAL TAXES PAID -- 1/1/88 TO 6/30/96

STATE	DISASTER PAY AS A % OF TAX	STATE	DISASTER PAY AS A % OF TAX
North Dakota	2.9	Oklahoma	0.3
California	2.4	Maine	0.3
Hawaii	2.0	Arkansas	0.3
South Dakota	1.8	Arizona	0.3
South Carolina	1.5	Wisconsin	0.2
Louisiana	1.2	Tennessee	0.2
Iowa	1.2	Pennsylvania	0.2
Florida	1.1	Montana	0.2
Alaska	1.0	Massachusetts	0.2
Nebraska	0.8	Virginia	0.1
Missouri	0.8	Rhode Island	0.1
West Virginia	0.7	Ohio	0.1
Georgia	0.7	New York	0.1
Mississippi	0.6	New Jersey	0.1
Alabama	0.6	New Hampshire	0.1
Washington	0.5	Nevada	0.1
Oregon	0.5	Maryland	0.1
North Carolina	0.5	Indiana	0.1
Minnesota	0.4	Dist. of Col.	0.1
Kentucky	0.4	Delaware	0.1
Kansas	0.4	Connecticut	0.1
Illinois	0.4	Wyoming	0.0
Idaho	0.4	Utah	0.0
Vermont	0.3	New Mexico	0.0
Texas	0.3	Michigan	0.0
		Colorado	0.0
		Countrywide	0.7

Note: Taxes for 1/1/95 to 6/30/96 estimated to be at 1994 levels.

EXHIBIT 4A

ESTIMATED PER HOUSEHOLD[1] CROSS SUBSIDY BETWEEN STATES FOR DISASTER RELIEF 1/1/88 TO 6/30/96

STATE	SUBSIDY PER HOUSEHOLD
12 STATES RECEIVE:	
North Dakota	$104.32
California	99.56
Hawaii	74.38
South Dakota	52.00
South Carolina	31.73
Iowa	25.69
Alaska	24.95
Florida	21.62
Louisiana	20.19
Missouri	4.57
Nebraska	3.31
West Virginia	0.10
OTHER STATES PAY:	
Georgia	-0.09
Mississippi	-2.36
Alabama	-5.75
North Carolina	-8.07
Kentucky	-11.83
Oregon	-12.22
Idaho	-13.11
Arkansas	-13.86
Washington	-15.36
Kansas	-15.40
Maine	-16.75
Oklahoma	-17.39
Minnesota	-17.73
Vermont	-20.60
Montana	-21.76
Arizona	-21.81
Illinois	-22.74
Texas	-23.41
New Mexico	-25.92
Tennessee	-27.40
Pennsylvania	-27.42
Wisconsin	-28.91
Indiana	-30.32
Utah	-30.48
Rhode Island	-31.22
Ohio	-32.62
Colorado	-34.66
Virginia	-35.57
Delaware	-36.06
Wyoming	-37.88
Massachusetts	-38.11
New York	-39.20
Michigan	-41.60
Nevada	-43.41
New Hampshire	-43.65
Maryland	-43.99
Dist. of Col.	-49.73
New Jersey	-51.71
Connecticut	-62.61
Countrywide	$ 0.00

[1] Households estimated by dividing population of state by 2.7 persons per household

	A	B	C	D	E	F
1	FEDERAL DISASTER RECOVERY OBLIGATIONS					EXHIBIT 5
2	1977-1993 IN 1993 DOLLARS, ANNUALIZED					
3						
4	Agency	Activity		$ (millions)	% OF TOTAL	
5						
6	FEMA	UNEMPLOYMENT BENEFITS		32.1	0.6	
7		TEMPORARY HOUSING		86.9	1.7	
8		PUB. ASSISTANCE GRANTS		389.7	7.6	
9		IND AND FAMILY GRANTS		101.1	2.0	
10		COMMUNITY DISASTER LOANS		1.2	0.0	
11	CORP OF ENG	FLOOD CONTROL REPAIR		13.7	0.3	
12	DOT (FHWA)	EMERG RELIEF FOR HIGHWAYS		239.7	4.7	
13	COAST GUARD	EMERG RELIEF		2.2	0.0	
14	USDA (ASCS)	EMERG CONSERVATION		20.8	0.4	
15		DISASTER ASSIST PAYMENTS		943.2	18.4	
16	(FmHa)	EMERG DISASTER LOANS		2029.2	39.7	
17	TVA	RECOVERY ACTIVITIES		0.3	0.0	
18	COMM. (EDA)	DISASTER RECOVERY GRANTS		17.8	0.3	
19	NOAA	VARIOUS		0.1	0.0	
20	EDUCATION	IMPACT AID		23.8	0.5	
21	SBA	DISASTER LOANS		1224.2	23.9	
22						
23	TOTAL RECOVERY OBLIGATIONS			5117	100.0	
24						
25	PREPAREDNESS OBLIGATIONS			131.2	1.9	
26	MITIGATION OBLIGATIONS			1592.8	22.6	
27	RESPONSE OBLIGATIONS			198.8	2.8	
28	RECOVERY OBLIGATIONS			5117	72.7	
29						
30	TOTAL OBLIGATIONS			7039.6	100.0	