REINSURANCE
ASSOCIATION
OF AMERICA

STATEMENT

TESTIMONY

OF

FRANKLIN W. NUTTER
REINSURANCE ASSOCIATION
OF
AMERICA

THE HOMEOWNERS DEFENSE ACT
H.R. 3355

BEFORE

THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY AND THE SUBCOMMITTEE ON CAPITAL MARKETS

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Chairmen Waters and Kanjorski, Ranking Members Biggert and Pryce, and Members of the Subcommittees:

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

Reinsurance is commonly referred to as the insurance of insurance companies. Reinsurance plays a critical role in maintaining the financial health of the primary marketplace, and ensuring the availability of property and casualty insurance for U.S. consumers and business. Reinsurers have assisted in the recovery after virtually every major U.S. catastrophe over the past century. For natural disasters, typically one-third of the insured losses were absorbed by the reinsurance industry. Fifty percent of the 2005 losses associated with Hurricanes Katrina, Rita and Wilma ultimately were born by the private reinsurance market.

The RAA appreciates the opportunity to testify on H.R. 3355, The Homeowners Defense Act of 2007. Clearly any natural disaster financing solution is an issue of utmost importance to the RAA. While the RAA does not support this legislation, and has significant concerns that provisions of this legislation would unnecessarily crowd out the private reinsurance market, we do agree with some of the principles in the legislation, and pledge to work with the Committee to improve it as it moves through the legislative process.

The natural catastrophe events of 2004-2005, related developments in insurance and reinsurance markets, and state legislative activity in 2007, have focused interested communities, public and private, on the appropriate relationship of government and the private sector. In this regard, I commend Representatives Mahoney and Klein for their leadership in exploring solutions that seek to maximize the resources of both in addressing coastal insurance matters. It is in the interest of private sector insurers and government officials to explore solutions to the concerns of coastal residents about the cost of their insurance and to non-coastal residents who, as is the case in Florida, are asked to help finance shortfalls in state insurance programs and, in the case of taxpayers, are asked to fund government disaster recovery and repair whether or not they live in disaster-prone areas.

Both the federal government and the private insurance sector have committed extraordinary resources in disaster recovery efforts. Indeed a partnership exists between the federal disaster recovery efforts and the insurance industry's contractual and financial stake in the recovery of its insureds from natural disasters. Published reports reviewing the 2005 hurricane season show that the federal government committed nearly $30 billion to the Department of Defense for immediate disaster recovery, nearly $20 billion to the National Flood Insurance Program for its insured's claims, $18 billion to infrastructure repair, $17 billion to Block Grants for community initiatives, $13 billion to temporary housing and $6 billion for loans. The insurance and the global reinsurance industry contributed nearly $70 billion in rebuilding and recovery for homes and commercial buildings of its policyholders. The roles are fully complementary: the federal government focused on its traditional role in disaster response, assistance, public infrastructure and the NFIP; the insurance industry provided recovery financing for the homes and businesses of its insureds.

It is important for the Committee to understand that, notwithstanding the extraordinary losses from natural catastrophes in 2004 and 2005, the private insurance and reinsurance sector proved exceptionally resilient. The record losses for insurers reduced insurer earnings in 2004 and 2005, but U.S. property and casualty insurers increased capital from $359 billion at year-end 2003 (prior to the hurricane seasons) to $437 billion at year-end 2005 and $500 billion at year-end 2006. Despite record losses after Hurricane Katrina, an additional $41 billion of new capital entered the (re)insurance business to support and underwrite U.S. natural catastrophe risk, including $12 to 15 billion of new securities for catastrophe risk issued by the capital markets. The capital markets and the insurance and reinsurance industry have shown their ability to meet natural catastrophe risk transfer needs of insurers and consumers when market dynamics are allowed to work.

We are pleased that the principle of utilizing the private reinsurance and capital markets underlies HR 3355 as introduced by Representatives Klein and Mahoney. Spreading the risk of natural catastrophes to the private sector, rather than state insurance programs, is the best long-term solution to addressing catastrophe exposure and cost issues. Most states, in fact, embrace this same goal of de-populating state wind programs and residual market mechanisms. In fact, the growth in residual markets in states generally reflects a market that is not functioning properly to spread risk or which does not reflect a premium based on risk exposure. Many states have taken action to address market issues based on increasing private market participation. South Carolina introduced policyholder or catastrophe savings accounts to assist consumers and address cost issues; Louisiana and

South Carolina addressed rating and regulatory matters by encouraging greater competition among insurers rather than rate controls that discourage private market competition; Louisiana has committed financial incentives for insurers to underwrite or take policies from the residual market and write-in coastal areas. Several states have also improved building codes and their enforcement as part of the long-term solution to catastrophe risk.

The alternative to competitive private markets are state insurance and reinsurance programs, such as in Florida, that encourage state entities to replace or compete with the private sector by underpricing catastrophe risk. These programs serve to concentrate catastrophe risk in a state rather than spread it to the global reinsurance and capital markets. This turns sound risk management on its head. If government reinsurance programs do not collect premiums based on the catastrophe risk of the insurers that transfer risk to it, those programs will be financed with public debt rather than on the books of the private sector. State programs that do not collect adequate, risk-based premiums up front, such as in the case of the Florida Hurricane Catastrophe Fund, cannot afford to lay off the risk to the capital or global reinsurance markets. They must rely on the issuance of bonds and have the taxpayers and other insurance consumers to pay off the debt and subsidize catastrophe exposed insurers.

A major concern the RAA has with HR 3355 is that it appears to provide incentives for the creation of more such state catastrophe reinsurance programs. We understand the legislation reflects the concern that state programs may have liquidity issues by providing that the federal government be a lender of last resort to ensure that state programs meet their cash needs. This is not an issue for most states with catastrophe exposure. They have chosen not to create a Florida-style reinsurance program. Their residual markets or wind pools, and in its case, the California Earthquake Authority, rely on private reinsurance and capital markets for risk transfer and on assessments on insurers as a means to access cash in the event the program does not have sufficient liquidity.

Reinsurance markets embrace and, in fact regularly reflect, the principle contained in Title I of HR 3355: insured catastrophic risk can and should be transferred to the private market rather than concentrated in a state sponsored program. We do not understand why a federally-chartered corporation or consortium is necessary to achieve this spread of risk when this is already done in the private market. While this is difficult if not impossible to achieve with under-funded or under-capitalized state programs (only Florida arguably has a fund that would qualify under the proposed legislation), reinsurance brokers and intermediaries to the capital markets regularly perform the functions described for the proposed federally-chartered consortium. In fact, Florida's own financial intermediary did approach the State Board of Administration with a risk transfer proposal for the Florida Hurricane Catastrophe Fund to transfer Fund exposure to the private sector. Florida rejected the offer based on its' proposed cost relative to what the state fund collected from ceding insurers. It is unclear why a federal corporation or consortium is needed to replace these private market intermediaries. On numerous occasions, states, in particular Florida, have explored the consortium's stated goal of risk transfer of catastrophe exposure among the states. Although there appears to be no legal impediment for them to do so, to date states have chosen not to join together to pursue this. Rather, reinsurers and capital markets now serve to assimilate risk among various risk bearers, public and private, as an efficient way to achieve a spread of risk and competitive market pricing. To achieve this, financial intermediaries and brokers now serve the valid functions the consortium is designed to have.

The consortium's underlying finances and value to consumers should be further analyzed. The authors of the bill are to be commended for the principle that the federal government will have no liability under the program. Yet, it is difficult to understand how a federally-chartered corporation or consortium that does not bear risk on its own account can issue securities (government securities?) and not expose the federal government to liability. Another critical question that should be asked is what are the expected savings to consumers? The consortium notwithstanding, it should be expected that the capital and reinsurance markets will require a risk based rate for assuming a state program's, or a consortium of state program's, catastrophe risk. The savings, if any, from a federally-chartered enterprise, which serves as a “conduit,” would not seem to have much savings to pass along. If, instead, the goal of the consortium is to encourage uniformity for laying off risk into the capital markets, the Committee should hear from the Chicago Mercantile Exchange or the New York Mercantile Exchange, both of which have introduced trading in catastrophe contracts within the past year. Uniformity of contracts for trading is a stated goal for each exchange platform.

The RAA has significant concerns with Title II of this legislation. We believe Title II will encourage the creation of state catastrophe reinsurance funds and unnecessarily crowd out the private reinsurance market. The principle stated in Title II of HR 3355 that reflects concerns over the liquidity of state reinsurance programs is valid, but currently of limited application. The Florida Hurricane Catastrophe Fund, the only fund that arguably qualifies under the program, is heavily exposed to debt financing. The Florida Fund is expected to have $2.4 billion of cash at year-end and an additional $55 billion in debt financing capacity, if needed, to pay claims. This assumes, of course, that the capital markets will assume the debt when authorized and issued. No other state has a reinsurance fund. Hawaii enacted one after Hurricane Iniki in 1994, but closed it two years later as private market conditions rebounded. California does not have a reinsurance fund nor liquidity issues, but has a consumer earthquake program that aggregates the earthquake risk and, through private sector financial intermediaries, places much of it in the reinsurance market or into capital market products. Other state catastrophe programs, wind pools or residual markets which provide consumer coverage, not reinsurance, are financed by charging premiums to cover their risk, laying off risk into the reinsurance markets and, if necessary, assessments on insurers.

The liquidity provisions of the bill will likely incent states to create reinsurance programs, like Florida's, based on under-funded debt. With the carrot of low interest loans from the federal government, states will create reinsurance programs which to date they have chosen not to do. The risk of loss will no longer be spread through the private reinsurance market, but instead, will be concentrated within that particular state and its insurance consumers. States should encourage risk bearers, public and private, to base their financing on risk-based rates and, as appropriate, laying off risk to the capital markets and reinsurance. Unfortunately, the likely effect of the liquidity provisions of Title II is to transfer risk from consumers who live in catastrophe prone areas to federal taxpayers, most of whom have little, if any, catastrophe exposure that they do not now fully fund through their own insurance premiums. If the goal of the liquidity portion of the bill is to address "timing risk" (the risk that the loss event will occur before sufficient funds are collected), existing consumer-based wind pools and residual markets, like private insurers, address this now through the transfer of risk to reinsurers and capital markets— a goal of the legislation, but potentially undermined by low-cost federal loans.

Our belief is that the federal loans will reduce the need for private reinsurance and that this is not sound public policy. Appropriately, HR 3355 does contain language that its goal is not to make loans unless state programs cannot access capital at a lower cost. If the Committee wishes to ensure that the private reinsurance sector and captive markets is maximized before any federal debt is issued, this provision should be further clarified to ensure that the liquidity provisions do not compete with the private sector, but serve as a last resort when reinsurers and capital markets are unwilling or unable to assume a state program's own debt or catastrophe exposure on competitive market terms.

The RAA cannot support this legislation as introduced because of the emphasis on encouraging the creation of state catastrophe reinsurance funds. If the Committee chooses to further consider HR 3355, we recommend changes to the bill that will facilitate its stated goal of improving private market access. A few of these suggested amendments are described below.

We support the provisions of the bill giving the Secretary of Treasury significant authority over state programs that might use the consortium or the liquidity provisions. However, the criteria for state programs need to be enhanced. A federal role to protect the federal exposure will be essential. To achieve the bill's goal of promoting private reinsurance and capital markets, the Secretary should have authority to see that risk-based rates and competitive market conditions exist in participating states. As reflected in part in the bill, this should include provisions that the Treasury be authorized to address underlying policy coverage and see that competitive rating systems, rather than price controls, should be in place in those same states. States should not be permitted to cross subsidize coverage among lines of insurance not covered by the state program or by consumers who do not benefit from the state program.

Of utmost importance is that these loans should only trigger for a major catastrophic event. The size of such events varies dramatically from state to state. The triggers for the loans in H.R 3355 are set at 150% of homeowners' premiums. This is very small event in most states and would result in borrowing for many events that historically have been easily absorbed by the private market without any disruption in capacity or pricing. In fact, many hail storms and tornados would fall in this category. To address this, the loans should trigger on the greater of (1) a dollar amount of insured homeowners catastrophe losses that exceeds expected annual losses, (2) a minimum event size (a 1 in 100 to 1 in 250 year event is standard practice for insurers and rating organizations) or (3) the capacity of the state fund, whichever is greater. The Treasury Secretary should have authority to analyze the capacity of private marketplace and raise these trigger levels if they infringe on the private market. We support inclusion in the findings and purposes of this legislation, language that states the legislation must not interfere with the private marketplace. We also support language that ensures private market participants and interested parties have the opportunity to submit relevant information to the Treasury Secretary in setting the trigger levels of these loans.

We are also very concerned that the interest rate on the loan will be so low that states will game the system by creating reinsurance funds and spreading the risk of loss by securing low interest loans, rather than purchasing reinsurance. The Committee must consider the interest rate of this loan and ensure that it is not so low that it provides a disincentive for the state to purchase competitive market reinsurance or catastrophe securities. All liquidity loans should have the full faith and credit of the state that sponsors the state program, not just non-qualifying state programs that apply for loans.

We recommend that the legislation include a private market “right to participate” procedure. In sum, an administrative procedure could be set up under Title II that provides the private sector, including private insurers, reinsurers, capital markets and or a consortia of such entities, an opportunity to provide pre-event borrowing or risk financing needs of the state catastrophe funds and the residual markets. The pre-event loans would only be provided if the state program demonstrated that they were unable to secure private capital.

We also ask the Committee to examine where the consumer savings, if any, are to be applied. The legislation provides no guarantee that the state catastrophe funds will pass along the savings of the low-interest loans and that homeowners and consumers who are demanding more affordable insurance will benefit.

The RAA looks forward to working with the Committee to improve this legislation and we very much appreciate the opportunity to testify today on this most important issue.