TESTIMONY OF CHARLES CHAMNESS
ON BEHALF OF
THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES
BEFORE THE
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTITIES
CONCERNING
"STABILIZING INSURANCE MARKETS FOR COASTAL CONSUMERS

SEPTEMBER 13, 2006

Good morning Baker, Ranking Member Kanjorski, and members of the Committee. My name is Charles Chamness, and I am the president and CEO of the National Association of Mutual Insurance Companies (NAMIC). Founded in 1895, NAMIC is the nation's largest property and casualty insurance association, underwriting more than 40 percent ($178 billion) of the property/casualty insurance premium written in the United States.

Let me first start off by saying that NAMIC is pleased that you Mr. Chairman and the members of this Committee are making a serious effort to understand the nature of catastrophic risk, and the role that insurance industry and the federal government can and should play to better prepare for and manage future large-scale natural disasters.

With respect to the subject of this hearing—which is encapsulated in its title, "Stabilizing Insurance Markets for Coastal Consumers"—I have good news and bad news. The good news is that despite the enormous challenges property insurers have faced in the wake of last year's hurricanes, I can report that almost all claims have been paid, take-up rates for the flood insurance program have increased significantly, people in the affected regions are rebuilding at record rates, and a recent study found that nearly 90% of those who filed claims in Mississippi and Louisiana are satisfied with their insurance company. The bad news is that most forecasters predict that the 2005 storms cycle will be the norm for the next several years. The future stability of these markets will be threatened by the increase in storms, state suppression of rates, and litigation that seeks to rewrite regulator-approved insurance contracts that have been in force for decades.

First, let me elaborate on the good news. As this Committee is aware, 2005 was one of the worst years for natural disasters in American history. According to the latest estimates from the Insurance Information Institute, Hurricane Katrina alone caused approximately $40.6 billion in insured losses arising from 1.7 million claims. Yet one year later, roughly 95 percent of homeowners claims and 99 percent of auto insurance claims have been settled. As a result, while residential building permits declined by four percent nationwide, the two states hit hardest by Katrina—Louisiana and Mississippi—saw building permits increase by four percent and 32 percent, respectively. That is very good news, indeed. Even more encouraging is that despite the magnitude of insurers' losses in 2005, their prudent risk management strategies have enabled them to stand ready to respond to future catastrophes.

That is all the more remarkable when one considers that according to hurricane forecasters, the increases we have seen in hurricane frequency and severity are expected to continue for at least another decade. Forecasters have predicted that during the 2006 hurricane season, there will be 13 tropical storms and 5 hurricanes, 2 of which will be major events. Earlier this year, the catastrophe modeling firm AIR Worldwide estimated that a level five hurricane hitting Miami, Florida, would cause over $130 billion in insured losses. According to AIR, there is a 20 percent chance that a $100 billion event will occur within the next 10 years.

Yet despite these dire forecasts, NAMIC believes that the private insurance market is well equipped to provide coverage for most types of natural disasters under most circumstances. That said, we also recognize that a *true* mega-catastrophe comparable to the 1906 San Francisco earthquake, or a high-category hurricane striking heavily populated areas such as Miami, Houston, or New York City, could potentially exceed private market capacity. Therefore, it is appropriate for policymakers and others to study whether government programs should be created to help assist policy holders and insurance companies to prevent, and prepare to such mega-events in those states or regions that are particularly vulnerable. Such programs, should they prove necessary, must be carefully designed so as not to distort private insurance markets.

That is a very important caveat, because the temptation will be to create government-subsidized insurance and reinsurance entities whose ostensible purpose will be to "stabilize" insurance markets by increasing the "affordability" and "availability" of insurance in catastrophe-prone areas.

While NAMIC does support several federal proposals that would help stabilize the market, we must also be careful not to create government programs that subsidize property owners in high risk areas. In fact, the general public is critical of government policies and programs designed to subsidize property owners in high-risk areas, although the public's objection is rooted more in notions of fairness than economic rationality. An August 2006 opinion survey by the Insurance Research Council found that 68 of those surveyed disagreed with the notion that taxpayers should subsidize insurance costs for people who want to build in coastal areas vulnerable to hurricanes. Sixty-one percent believe policyholder subsidies for wind damage to homes in coastal areas are "somewhat unfair" or "very unfair."

With that cautionary note about the use of government interventions to stabilize insurance markets out of the way, I'll offer a few observations:

First, it is an unfortunate but undeniable fact that state lawmakers and/or regulators sometimes impose rating and underwriting restrictions on property insurers that allow high-risk property owners to pay artificially low premiums, forcing low-risk property owners to subsidize the insurance costs of high-risk buyers by paying inflated premiums.

In my view, using the insurance pricing mechanism to create hidden cross-subsidies among risk classes is deceptive and unfair. NAMIC believes that a flexible regulatory environment, in which insurers are free to price coverage based on risk, will create incentives for property owners in high-risk areas to invest in loss mitigation measures.

Second, as I suggested above, government-imposed rate suppression can have the effect of distorting public perceptions of risk. Federal and state governments must bear the cost of the economically irrational decisions that result by paying for disaster aid to repair properties that should not have been built in the first place. Risk-based insurance pricing alleviates this problem by sending accurate signals to consumers about the relative level of risk associated with particular regions and types of structures.

Third, managing catastrophe risk in coastal areas is not simply an insurance availability and affordability problem. Numerous studies suggest that property owners as well as government officials tend to underestimate catastrophe risk and fail to prepare adequately for natural disasters. Other studies point to public misconceptions about the nature and purpose of insurance; for example, many consumers view insurance as a financial investment rather than as a protective measure, so that those who purchase insurance and do not collect on their policies over a period of time feel that their premiums have been wasted, leading them to discontinue coverage.

Fourth, the use of the term "actuarially sound" in discussions of insurance price regulation often lacks precision and can therefore be misleading. There is a tendency to use the term to refer to prices that reflect only the expected value of future loss costs. It is important to understand that "actuarially sound" pricing for catastrophe-exposed coverages must also include compensation for the unusually large "call on capital" that is required to pay catastrophic losses. The call on capital that results from the large-scale losses typically associated with extreme events may well be several times greater than the total annual "expected loss" of the coverage. In other words, the term "actuarially sound" should be understood to include an adequate "risk load" that takes into account the call on capital, rather than just the insurer's expected loss costs and expenses based on yearly averages.

Fifth, it is important for lawmakers, judges and the general public to understand the cyclical nature of property insurer profits, how profits relate to surplus, and the role of surplus in ensuring that insurers are able to meet their contractual obligations to policyholders. Economists who use return on equity as the universal benchmark for measuring company profitability have found that property/casualty insurance is less profitable than most other industries.

Finally, the nation's courts must preserve the sanctity of contracts. With respect to insurance contracts, this often means deferring to the authority of the state insurance regulator that approved the contract language as part of the rigorous "form filing" process that insurers must follow in all 50 states. Insurers who relied in good faith on the decision of a state insurance department that their policy language was clear and unambiguous must not ordered by a judge to pay claims for which the insurer collected no premiums simply because, in the court's view, the insurance department erred in approving the contract language. If trial lawyers or others succeed in retroactively rewriting insurance contracts because of the supposed "ambiguity" in contract language that was approved by insurance regulators, they will have introduced a degree of legal capriciousness that will undermine the predictability upon which a healthy insurance system is based.

These observations aside, we believe there are several measures that Congress should consider immediately to address certain problems associated with natural disaster risk management and insurance.

Policy Proposals that Deserve Immediate Consideration

First, NAMIC supports federal legislation that would create financial incentives to encourage states to adopt and enforce strong, statewide building codes. Strong building codes as well as responsible land-use planning have been shown to greatly reduce the level of property damage and human suffering caused by natural disasters. With respect to existing properties, we support government initiatives to create mitigation grant programs to enable homeowners in high-risk areas to invest in risk mitigation measures.

Second, we support the concept of amending the federal tax code to allow insurers to set aside a portion of premium income in tax-exempt policyholder disaster protection funds. We also support the concept of allowing homeowners to create tax-free catastrophic savings accounts similar to health savings accounts which could be used to pay hurricane deductibles and costs associated with retrofitting properties.

Third, we recognize that a market-based insurance pricing system in which premiums reflect the actual cost of insuring against catastrophic risk could result in significant premium increases for some property owners in high-risk regions. Policymakers may therefore consider creating programs to provide direct government assistance, funded from general revenue, to low-income and other groups according to criteria established by the unit of government providing assistance. However, in designing such programs, care must be taken to avoid reducing incentives to mitigate risk.

Fourth, we believe that the National Flood Insurance Program should be subject to substantial reform. This is an area in which NAMIC strongly praises the work that this committee has accomplished. We believe that HR 4973 goes along way in addressing some of the shortcomings that currently exist within the NFIP. Specifically we strongly support moving all second homes to actuarial rates, and stronger enforcement measures in the bill. NFIP premiums must be actuarially sound for all covered structures. The current method for setting premiums, which is based on average annual losses, has been called "unsustainable" by the Congressional Budget Office. This approach has prevented the NFIP from accumulating the surplus necessary to pay claims during periods when loss costs are above average. We also support stiffer penalties to be imposed on financial institutions that either fail to require flood insurance coverage for mortgages on properties in flood-prone areas, or allow the policies to lapse. Greater effort should be made to ensure that more people are aware of the program and the benefits of having flood insurance coverage to protect their properties.

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

Thank you for giving me the opportunity to testify on this issue of vital importance to NAMIC member companies and the U.S economy. I look forward to working with you to help consumers in coastal areas meet the challenges involved in effectively managing the risk of natural catastrophes.