REINSURANCE ASSOCIATION OF AMERICA

STATEMENT

TESTIMONY

OF

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PRESIDENT
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LEGISLATIVE PROPOSALS TO REFORM THE NATIONAL FLOOD INSURANCE PROGRAM

UNITED STATES
HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON
INSURANCE, HOUSING AND COMMUNITY OPPORTUNITY

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My name is Frank Nutter and I am President of the Reinsurance Association of America (RAA). The RAA is a national trade association representing reinsurance companies doing business in the United States. RAA membership is diverse, including reinsurance underwriters and intermediaries licensed in the U.S. and those that conduct business on a cross border basis. I am pleased to appear before you today to provide the reinsurance industry's perspective on reforms to the National Flood Insurance Program.

Reinsurance is critical to insurers and state-based property insurance programs to manage the cost of natural catastrophe risk. It is a risk management tool for insurance companies to improve their capacity and financial performance, enhance financial security, and reduce financial volatility. Reinsurance is the most efficient capital management tool available to insurers.

Reinsurers have helped the U.S. recover from every major catastrophe over the past century. By way of example, 60% of the losses related to the events of September 11, 2001 were absorbed by the global reinsurance industry, and in 2005 61% of Hurricanes Katrina, Rita and Wilma losses were ultimately borne by reinsurers. In 2008, approximately one-third of insured losses from Hurricane Ike and Gustav were reinsured.

The National Flood Insurance Program (NFIP) was established on the fundamentally sound principles of encouraging hazard mitigation and promoting the use of insurance to reduce post-event disaster assistance. However, the NFIP, as it has evolved and been modified by legislative action, compromises, rather than embraces sound public policy, insurance principles and practices. Actions (in whole or in part) to introduce private sector risk assessment into the NFIP, therein retaining the proper role for government in land use planning and hazard mitigation, could address those issues and re-establish the flood risk management program as a successful public-private partnership.

In 1973 George Bernstein, the first Federal Insurance and NFIP Administrator, cautioned prophetically: "It is the combination of land use controls and full actuarial rates for new construction that makes the National Flood Insurance Program an insurance program rather than a reckless and unjustifiable giveaway program that could impose an enormous burden on the vast majority of the Nation's taxpayers without giving them anything in return."

As it currently operates, the NFIP is not an insurance program. But it should be and can be. The fuller application of risk-based rates and an appropriate risk-bearing role for the private reinsurance sector would transform the program. By doing so, the NFIP could also achieve the goal of protecting taxpayers and the Treasury, thereby returning the Program to its original goal of being fiscally sound.

It is a commonly held belief the NFIP is fundamentally bankrupt and a private sector risk bearing role is unachievable. Given the nearly $18 billion dollar debt to Treasury, the Program is demonstrably a millstone on the Federal budget and US taxpayers. The assumption about a private sector risk-bearing role, however, deserves to be considered.

Protecting Taxpayers with Risk-Based Rates

Rates in the NFIP that have been subsidized without regard to the present character or ownership of the property should be risk-based. Subsidized rates were introduced early in the Program as an inducement for communities to enter the Program. It was a successful strategy. Nearly 22,000 communities now participate. However, it was the intent of the original legislation that subsidized rates and the properties to which they apply were to be gradually eliminated. In the last twenty years, however, the number of subsidized properties has actually risen by 1.2 million. Additionally, the Program was designed to address primary residences, yet second homes, investment and vacation properties continue to receive the benefit of subsidized rates.

The Program's subsidies have also facilitated the development of environmentally sensitive coastal areas, including those at high risk to flood losses. The Government Accountability Office (GAO) reports that repetitive loss properties account for 1% of policies and 25-30% of losses. The Congressional Budget Office (CBO) reports the number of repetitive loss properties has increased by 50% in the last decade.

The Congress must also recognize that statutory caps on rates may be popular with its beneficiaries, but the caps distort risk assessment by builders, local officials, property buyers and NFIP policyholders. They increase the cross subsidy from low or no risk persons and taxpayers to those living in high risk flood areas. The classic "robbing Peter to pay Paul" analogy applies.

According to the GAO, subsidized-rated properties generate 70% of the Program's claims. The NFIP and the Congress should address these fundamental flaws in the Program and remove inequitable and unjustifiable rate subsidies. Proposals to provide needs-based subsidies independent of NFIP rates are worthy of support.

The NFIP Should Plan for Extreme Events

From 1978 to 2004, the NFIP had a net loss of just $2 billion. CBO reports that if the "early" years, when rates were lower and community participation was not as significant as now, were not included, the Program would have had a profit of $600 million. As a result of losses in 2005 – the year the Program had to borrow $20 billion from Treasury – debt service of 30% of premiums collected is built into the NFIP's finances. With the addition of a contingency plan for extreme event years and without this financing load, the Program can be fiscally sound.

FEMA represents that 75% of its policies are "actuarially" sound. Sound insurance pricing would reject this representation because the NFIP does not incorporate a catastrophe factor for infrequent, yet severe, loss years. The Program unfortunately takes into account only 1% of the losses from the 2005 program year (Hurricanes Katrina, Wilma and Rita) and relies on the "average annual loss" model for its pricing. This ignores the fact that extreme event catastrophes must be financed. FEMA's average annual loss (FEMA presumes $1.3 billion) pales in comparison to actual insured and reinsured loss costs in recent natural catastrophes. This average annual loss pricing model is ill-suited for natural catastrophe risk—whether it be in the private or public sector.

Because of the pricing model, the NFIP has neither adequately planned, nor priced for, extreme event(s) years. As a result, the GAO recently concluded the Program does not have a viable funding model to repay the existing debt to Treasury. No private sector solution is available for this existing debt. However, as the GAO points out, the Program should operate like an insurance entity. If it did, it could reduce or eliminate taxpayer exposure to future debt by laying off risk to the private sector through reinsurance and catastrophe bonds. As the GAO admonished,

> "Private insurers typically retain only part of the risk that they accept from policyholders, ceding a portion of the risk to reinsurers (insurance for insurers). This mechanism is particularly important in the case of insurance for catastrophic events, because the availability of reinsurance allows an insurer to limit the possibility that it will experience losses beyond its ability to pay. NFIP's lack of reinsurance, combined with the lack of structure to build a capital surplus, transfers much of the financial risk of flooding to Treasury and ultimately the taxpayer."

The Private Sector Role in the Program

In recent years, the private insurance sector has worked in partnership with FEMA through the *Write Your Own* program (WYO). This role for insurers has provided the NFIP with a valuable marketing arm and administrative capability that minimizes the need for a Federal bureaucracy to issue policies and adjust claims.

A private insurance market for flood risk has not developed. Insurers are concerned about state rate regulatory manipulation and suppression and adverse selection of risk. Historic rate subsidies by the NFIP make a traditional private market flood insurance product for homeowners non-competitive. Without a viable private insurance market, the NFIP cannot be terminated or put into run-off in the short term.

Yet, there have been positive developments in recent years: (1) recognizing there are significant concerns about map integrity, the NFIP has established a map program for all communities participating in the NFIP; (2) catastrophe modeling firms, as well as some reinsurance brokers and underwriters, now provide flood models for underwriting purposes in the US and in other countries; (3) there has been growth in private sector flood mapping entities; (4) twenty-two universities now have flood research programs; and (5) satellite imaging has improved risk assessment.

We believe a private reinsurance risk bearing role for the NFIP can be established, with the following conditions: (1) preserve the WYO program; (2) retain the current Federal risk bearing role; (3) introduce the risk analysis and risk spreading role of the private reinsurance and capital markets; (4) utilize the existing statutory framework; and (5) consult with knowledgeable public and private interests about long-term approaches to the development of a greater private sector flood insurance market.

The Role of Reinsurance: Two Complementary Options

We believe the NFIP can address its volatility and extreme event exposure and reduce the dependence of the Program on taxpayers and Federal debt through risk transfer to reinsurance and private market capital providers. The NFIP could also seek the placement of catastrophe bonds to augment reinsurance. Both financial sectors have significant capacity and believe flood risk can be reinsured or transferred into capital markets. Utilizing private reinsurance or catastrophe bond risk transfer mechanisms also introduces a private sector rating verification model into the NFIP – thus providing an incentive and guidepost for risk-based rates.

Transactional Reinsurance: As with most state property insurance plans, and nearly all private insurers, the NFIP could address its volatility and extreme event problem through the purchase of reinsurance from private market capital providers. Additionally, where appropriate, NFIP could seek the placement of catastrophe bonds to supplement reinsurance capacity. Both markets have significant capacity and an appetite to take flood risk. These sectors believe flood risk can be reinsured or transferred into capital markets if properly structured. As with other governmental insurance entities and private sector insurers, the NFIP would work with modelers, underwriters and/or brokers to provide the market with an evaluation of its risk portfolio, determine what types of risk (by geography, insured exposure, or category of risk) are amenable to risk transfer and then seek coverage in the private sector. This would allow these entities to evaluate the NFIP data and introduce their own risk assessment into the process. Like any catastrophe reinsurance and "cat" bond program, it would transfer catastrophe risk from taxpayers and the Treasury to the capital markets. Should the NFIP find the bids unattractive on a price or coverage basis, it would not go forward with the placement. The NFIP would, therefore, be in the same place as it is now: dependent on public debt. If the placement were successful, the private sector would provide financial relief to taxpayers. No study is necessary to evaluate this approach as the market and NFIP officials can pursue it at this time with the full opportunity to evaluate coverage proposals without prior commitment.

Reinsurance Pool: Section 4011 of the NFIP legislation adopted in 1968 provides for the Director of FEMA (at the time HUD) to "encourage and arrange for appropriate financial participation and risk sharing … by insurance companies and other insurers." Section 4051 provides that the Director is authorized "to assist insurers to form, associate or join in a pool" on a voluntary basis "for the purpose of assuming on such terms… as may be agreed upon, such financial responsibility as will enable such insurers, with the Federal financial assistance" to assume a reasonable proportion of responsibility for the adjustment and payment of claims for losses under the flood insurance program." Such a pool of insurers did in fact operate as the National Flood Insurers Association from 1968 to 1978, as the administrative arm of the Program and with a risk bearing role through a formula negotiated with the government. Section 4052 authorizes the Director to enter into agreements with the pool to address risk capital, participation in premiums and losses realized, and operating costs. Section 4055 authorizes the Director to enter into a reinsurance relationship with the pool to address losses in excess of those assumed by the pool.

The provisions of the statute authorizing the pool, created in conjunction with the adoption of the Act, have long been dormant. Yet they remain a viable mechanism for the creation of another pool. This time it would be to reinsure the NFIP — capitalized by those insurers that voluntarily wish to provide capacity. By doing so, these insurers would have access to the NFIP's flood insurance coverage and underwriting data. The Director and those participating insurers would enter into negotiations over the risk sharing formula and could individually subscribe capacity on an annual basis. As with the traditional reinsurance proposal noted above, FEMA would work with modelers, underwriters, and brokers to assess its risk portfolio. Such collaboration would determine what types of risk are appropriate, what method of reinsurance the pool would offer to the NFIP, as well as what type of reinsurance, if any, FEMA would provide to the pool. As with the prior suggestion of laying-off risk through traditional catastrophe reinsurance placement, this proposal does not change the WYO program. FEMA remains the insurer of flood risk at the consumer level, transfers flood risk from taxpayers to the private sector and allows those insurers that wish to participate in the risk to do so through a standing facility.

These two approaches, a traditional property catastrophe program and the re-authorization of a standing reinsurance facility or pool, are both complementary and yet not exclusive to each other. The existing statutory authority may well be sufficient to move forward without delay, on either or both.

The RAA looks forward to working with members of this Committee, the Congress, FEMA and officials from the NFIP to explore and pursue private sector reinsurance and capital market options.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: FRANKLIN W. NUTTER	**2. Organization or organizations you are representing:** REINSURANCE ASSOCIATION OF AMERICA
3. Business Address and telephone number: [redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? ☐ Yes ☒ No	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?** ☐ Yes ☒ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: FW Nutter	

Please attach a copy of this form to your written testimony.