TESTIMONY OF GREGORY W. HEIDRICH
ON BEHALF OF
THE PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES FINANCIAL SERVICES COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

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My name is Gregory W. Heidrich and I am Senior Vice President – Policy Development and Research for the Property Casualty Insurers Association of America (PCI). PCI is a trade association representing over 1,000 property/casualty insurers that write almost 40 percent of the homeowners insurance sold in the United States. Because of that, we have a deep interest in how these markets work and the ways in which we can better prepare our industry and our nation to respond to future natural catastrophes. Thank you for the opportunity to appear before you today and to present our thoughts on these issues.

Introduction

As we testified in June before the Subcommittee on Housing and Community Opportunity, PCI believes that developing effective public policy solutions regarding natural catastrophes is one of the most significant issues facing the nation and the insurance industry today. Climate experts agree that America faces the prospect of more frequent and severe natural disasters in the coming decade. Moreover, significant development, population growth, and rapidly rising real estate prices in areas prone to natural disasters exacerbate the potential for larger human and economic losses, requiring stronger loss prevention and mitigation and greater financial resources for recovery.

We commend you and your colleagues for your attention to and leadership on this issue and for your efforts to find innovative solutions to the problem of catastrophe risk. Over the past year, members of Congress have introduced several important legislative proposals, including H.R. 4366, the Homeowners Insurance Protection Act, introduced by Rep. Brown-Waite; H.R. 2668, the Policyholder Disaster Protection Act of 2005, introduced by Rep. Foley; H.R. 4836, the Catastrophe Savings Accounts Act of 2006, introduced by Rep. Feeney, and H.R. 5891, the Catastrophic Disaster Risk and Insurance Commission Act, introduced by Rep. Wasserman-Schultz. You have also been vigorous in pursuing important reform of the National Flood Insurance Program, for which we commend you. We urge final passage of flood reform legislation and pledge to work with you and your colleagues in the Senate in this effort.

Comments on the Catastrophe Problem

PCI members play a pivotal role in protecting American homeowners and supporting our nation's housing markets by providing the products and services needed to protect homeowners, lenders, businesses, and communities against exposure to natural catastrophes. Our members are proud of the work they do in these markets.

Over the past two years, property insurance markets have been tested as never before. Catastrophe losses in 2005 totaled some $57 billion, nearly doubling the previous record losses in 2001. Hurricane Katrina itself caused some $40 billion in insured losses, surpassing the roughly $32 billion from 9/11. The vast majority of claims from last year's storms have been paid and the market has the financial capacity to meet its obligations. In our view, the most important catastrophe issue facing us today is whether the market has, or is building, the capacity to pay for catastrophes the nation will face in the future.

Given the very serious catastrophe losses we've seen over the past several years and the significance of this issue for our membership, our organization has devoted considerable time and effort to develop sound public policy solutions that we can recommend.

There are several fundamental issues that have to be addressed:

- First, America clearly faces the prospect of increased frequency and severity of major hurricanes and the continuing threat of other major natural catastrophes including earthquakes, floods, tsunamis, and volcanic eruptions. Catastrophe modelers tell us that we are in a prolonged period of increased severe storm activity. Seven of the ten most costly natural disasters in U.S. history have occurred since 2004. We can't afford to ignore this reality.

- Second, America is experiencing significant development, population growth, and rapidly rising real estate prices in areas that are highly prone to natural disasters. AIR Worldwide, one of the leading risk modelers for our industry estimates that there is currently some $7 trillion in property values exposed to catastrophe risk along America's coastlines; some $3 trillion of it is personal property, rather than commercial property. Even if storms were no more frequent or severe than in the past, this fact would mean that future storms will be more damaging and more costly to insure. As a result, the nation faces growing exposure to significant catastrophe losses and increasing costs of recovery.

- A growing number of Americans have a significant portion of their net worth exposed to catastrophic loss. The impact of future major natural catastrophes on the economy will be larger and will likely lead to significant public policy debates over how best to address this risk.

- As insurers, we would like to rely on private markets alone to solve this problem, with prices and products tailored to match the risks freely assumed. We think that such an approach would, over time, establish appropriate economic incentives for those who live and work in catastrophe-prone areas and would attract badly-needed private capital for risk protection. However, we must also recognize that our industry does not operate in an unregulated market. Our members work in a world where prices and coverage terms are highly regulated and generally are not allowed to respond freely and in an immediate fashion to changing risks or conditions. This is the opposite of the structure in which world catastrophe reinsurance markets operate. Indeed, a report just released by the international reinsurance brokerage firm, Guy Carpenter, notes that U.S. catastrophe reinsurance rates have increased on average 76 percent in 2006 over 2005, compared to an average increase of 32 percent worldwide over the same period. The cost of catastrophe reinsurance is an economic reality our members face, as they decide how much and where they can assume this risk. We also recognize, as we must, that people do not simply pick up and move from one place to the next, irrespective of their homes, families, and community ties. Any set of realistic policy options must take this into account.

- Finally, with respect to prevention and mitigation of losses, states frequently have outdated and inconsistent requirements for building codes, code enforcement, and other prevention/mitigation tools in areas dangerously exposed to disasters. These weaknesses imperil lives, property, and policyholder resources.

In summary, we agree with you that this is a major public policy issue that must be addressed; we believe the problems posed by catastrophe risk are growing more severe, not less; and we believe a range of potential solutions must be considered, including market reforms, stronger loss prevention and mitigation, and new approaches to financing catastrophe risk. At the end of the day, we believe there will not be one “silver bullet” solving this problem, but rather a full range of policies that will have to be used.

Policy Options to Consider

As we look at the issue, PCI suggests four major areas for consideration.

Reduce Exposure to Catastrophe Losses

First, we need to do more to control and reduce catastrophe exposure. PCI suggests the following:

- State and local governments should urgently and immediately review their building codes in catastrophe-prone areas. Wherever needed, they should upgrade their codes. Stronger building codes protect lives and significantly reduce property damage and repair costs. In a highly competitive insurance market, those savings will be passed directly back to consumers. Some have argued that it costs too much to rebuild to meet modern building code standards. Louisiana State University’s Hurricane Center has estimated that the marginal cost of building a structure to meet higher wind-borne debris requirements in the International Residential Code is between 1.5 and 4.5 percent of additional cost. On a single-family home with a $100,000 mortgage, that works out to about $27 extra dollars per month. We think such investments are vital. PCI supported passage of minimum building code legislation in Louisiana and Mississippi this past year, as well as an unsuccessful effort to extend stronger building codes into the Florida panhandle. As we look forward, we believe more work is needed to prepare an inventory of where our states’ building codes are most in need of strengthening so that we can better target our efforts to strengthen the codes. And, finally, as much as we supported and are proud of our work to enact stronger codes in Louisiana and Mississippi, we know that much work needs to be done to implement and enforce these new standards.

- A second idea is the establishment by the federal government of incentives for greater investment in loss prevention and mitigation. We suggest consideration of several ideas. First, the insurance industry's Building Code Coalition has recommended that enhanced disaster mitigation grants under the Stafford Act be provided for states that adopt stronger state-wide building codes. We strongly endorse this approach and urge Congress to enact legislation for this purpose. Second, Rep. Feeney has proposed legislation (H.R. 4836) to create a special catastrophe savings account for purposes of allowing homeowners to build up, tax-free, funds for payment of qualified catastrophe expenses. While we have not established a position on this bill, we are encouraged to see this type of creative thinking underway. Third, Congress could consider whether to grant special tax credits for qualifying expenditures by homeowners to retrofit their homes to better protect against disasters (as is being done in Florida now). Clearly, one of the major limitations of any new building code enactment is the fact that it typically can't address improvements needed in the existing housing stock. One approach to solving this problem is to give homeowners themselves additional incentives to make these improvements. An investment such as this could save many dollars later in disaster assistance and other government programs.

- We believe state and local governments must take seriously the need to restrict development in catastrophe-prone areas. Professor Roger Pielke, Jr. of the University of Colorado at Boulder is on point when he says, "More storms like Katrina are inevitable. And the effects of future Katrinas and Ritas will be determined… by the decisions we make now about where and how to build and rebuild in vulnerable locations."[1] This is not only an issue for single family homes. Ongoing commercial development on our nation's barrier islands or in the wetland marsh areas also significantly increase these risks.

- We believe greater steps can be taken for preparedness. As a first step, PCI has recently completed and distributed to more than twenty state insurance departments a new PCI Regulators' Kit, containing recommendations for disaster preparation and response. This kit contains model regulations covering five critical areas, including: establishing an Insurance Emergency Operations Center; disaster claim reporting requirements; cancellation and non-renewal of insurance under disaster conditions; suspension of premium payments under disaster conditions; and mediation of disputed claims. If adopted, these regulations could improve the necessary coordination and communication after a catastrophe and help those whose lives and property are at stake.

[1] "Managing the Next Disaster," Roger A. Pielke and Daniel Sarewitz, The Los Angeles Times, September 23, 2005.

Fix the Flood Program

Second, we believe Congress should complete its efforts to reform the National Flood Insurance Program (NFIP). When we testified in June, we strongly endorsed your reform efforts and we continue to do so. The NFIP is a necessary policy response to an uninsurable peril and must be continued. However, the program needs numerous reforms, the majority of which are contained in the reform bills today. As currently structured, the NFIP does little to discourage development in high risk areas, does not provide the level of protection needed by consumers and has not achieved the breadth of participation needed. PCI has been encouraged by the passage of H.R. 4973. Although we do not support all of the amendments made at the last minute, we believe that the Senate should act and pass its pending NFIP legislation, so a conference can begin and common sense reforms can be enacted.

Expand Private Sector Capacity

Third, a key part of the long-term solution to natural catastrophe exposure is to expand private sector capacity to handle the risk. PCI strongly supports efforts to make markets more responsive to the risks we face. Prices and terms of coverage that are openly and freely established in competitive markets will create essential incentives for property owners and attract new capital to these markets. As you know, homeowners insurance markets are heavily regulated in virtually all aspects of their operations. We face significant regulatory constraints, particularly in rating, but also in other areas, that inhibit effective market responses and discourage capital from entering these markets. There are several things we think policymakers at several levels of government can do to address this problem:

- First, state legislators should give insurance markets greater freedom to respond to the exposures we face. In free markets, prices and terms of coverage tell consumers the true cost of insuring against catastrophes and the most efficient means of funding exposures. Regulators often fear that giving up regulatory control will make the problem worse and invite consumer backlash. However, based on the experience we've seen in states that have taken this approach, including South Carolina and New Jersey most recently, we believe the results would be just the opposite. Free markets encourage new capital to enter where insurance protection is needed and develop more capacity, not less. PCI will support state legislative initiatives intended to remove regulatory barriers to free markets for catastrophe insurance and will oppose enactment of new barriers. We will be working with our partners in the states to develop specific proposals that can be enacted in key state legislatures beginning in next year's legislative sessions.

We also encourage your review of two additional proposals:

- First we are very interested in, and are examining the potential benefits of, establishing voluntary, tax-deferred catastrophe reserves. We are looking particularly at the legislation introduced by Rep. Foley (H.R. 2668). We find his bill to be an intriguing concept and are working with our members to prepare specific comments on his approach. We urge your review of this bill as well.

- Second, we will be examining specific steps that might be taken to remove regulatory, legal, accounting, or tax barriers to further growth in the catastrophe bond market. This market provides another outlet for catastrophe risk financing and introduces new sources of capital and competition. A report earlier this year from Guy Carpenter described the growing importance of this market for financing catastrophe risk. While we certainly don't see the cat bond market displacing traditional reinsurance, market participants tell us that bringing more of these deals "onshore" in the U.S. and reducing a variety of regulatory barriers would permit the market to grow. In principle, PCI strongly supports steps that will attract more private capital to address catastrophe risk and we are very interested in how this might be done in the catastrophe bond market.

State and Federal Government Involvement

Finally, with regard to government involvement:

- First, based on our review of this issue, we believe the growth in natural catastrophe exposures is of sufficient magnitude in some states that they may require consideration of state natural catastrophe funding facilities. Recent events show that the industry can respond to very severe catastrophe events, but private markets may not always have the capacity to fund increasingly more frequent exposure to "mega catastrophes" or to a series of very large events in a single season. Given this, our approach will be to look at specific conditions in each state to determine whether a catastrophe fund, or other financing mechanism, might be helpful.

  When we consider whether a state needs a catastrophe fund, we look also to see: (1) whether private markets have freedom to respond to market conditions; (2) whether care has been taken to prevent a catastrophe fund from damaging private markets or preventing new capital from entering the market; and (3) that their funding doesn't rely on cross-subsidies across lines of business. By their nature, cross-subsidies damage the ability of markets to provide strong price signals and incentives for behavior. Having said that, we believe there may be cases and states where a catastrophe fund can be part of a well-rounded solution and must be considered. We believe they can be structured to avoid crowding out private market capacity while still offering benefits to consumers in some cases.

- Second, we would also suggest that there may be some mega-catastrophe exposures that are beyond the capacity of the private market and even of an individual state catastrophe fund to address. In these instances, it may be necessary for the federal government to offer liquidity protection to state catastrophe funds at a very high level, consistent with the maintenance of stable markets and avoidance of widespread insurer insolvencies. Federal involvement may also be essential if the nation suffers repeated mega-events within a short time period. Lest anyone thinks that scenario is impossible, we would remind you of how close Hurricane Rita came to hitting Houston last year, only a few weeks after Katrina devastated New Orleans and the Mississippi coast. It is not inconceivable that several of our major cities could be struck by Category 4 or 5 storms within a single season, or that a major earthquake could strike in the same year as a significant hurricane.

There are many ideas for how a federal role could be structured, but we would suggest that one idea worth considering is whether a federal catastrophe financing facility could offer credit financing to state catastrophe funds, intended to provide access to liquidity to meet immediate claim requirements in the event of a mega-catastrophe or a series of very large events. One key advantage of this approach would be to offer important financing benefits while limiting the offer to state catastrophe funds and thus helping to minimize any potential disruption in private markets.

We are very mindful of the need to be extremely careful in structuring any federal role and of the overriding need to attract new private capital to the market. Accordingly, we also believe that any federal financing role should include measures intended to promote freedom for markets to respond to these exposures, including support for greater rating freedom, support for actuarial soundness or private market rates, freedom for product innovations, use of sound underwriting tools, and lower market barriers. The point of connecting standards for market freedoms to the creation of a federal financing facility is to provide incentives for the states themselves to do everything they can to attract private capital before asking for federal assistance. In addition, we believe any federal credit should be specified in advance, as private sector lines of credit are, in order to prevent political pressure from influencing what should be a market-based credit agreement. We would have the same concern about the need for a federal program to avoid cross-subsidies and other negative design elements as we have for state programs.

However, PCI thinks there may be a role, properly structured, for the federal government to play in assisting the financing of mega-catastrophe risk and we believe it should be given further review by Congress.

Conclusion

Again, let me thank you on behalf of PCI and our members for the opportunity to appear before you today, respond to your questions, and provide you with our input on possible solutions to the catastrophe problem. Let me thank you also for the work you are already doing to identify and explore constructive policy solutions. We believe this is one of the most serious public policy issues facing our nation and is deserving of your time and continued thoughtful attention. PCI and its members look forward to working with you in the future on this very important issue.