Consumer Federation of America

Testimony of

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Consumer Federation of America

Before

The U.S. House of Representatives
Committee on Financial Services
Subcommittee on Housing and Community Opportunity

Is America's Housing Market Prepared for the Next Natural Catastrophe?

June 28, 2006

Good morning Chairman Ney, Ranking Member Waters and members of the Subcommittee. My name is Travis Plunkett and I am Legislative Director for the Consumer Federation of America. CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy and education. I appreciate the opportunity to provide CFA's comments on the impact of natural disasters on the ability of homeowners to purchase insurance. This issue has been one of special concern to CFA and our Director of Insurance, Bob Hunter, for over a decade. Bob, as you may know, is a former Federal Insurance Administrator under Presidents Ford and Carter who helped launch the National Flood Insurance Program.[1]

Introduction

In order to understand why many homeowners in coastal areas are now experiencing sharp insurance rate hikes, cutbacks in coverage and non-renewals, it is important to examine developments in the insurance industry since the devastating losses caused by Hurricane Andrew in Southern Florida in 1992. Hurricane Andrew was a shot across the bow of the insurance industry. Insurers had not properly prepared for a storm of this magnitude. In the wake of the storm, insurers made massive changes in how they did business:

- They adopted new ratemaking techniques, based on scientific models that forecasted wind damage many years into the future, rather than using a simple history of hurricanes for the last few decades.

- They "purified" their portfolios of business along the nation's coasts by non-renewing hundreds of thousands of people and balancing their risk near the coasts.

- They sharply increased out-of-pocket costs for consumers by introducing much higher percentage deductibles, caps on replacement cost payouts and other coverage cuts.

- They introduced state-only insurance company "running mates" to lower the possible impact on national corporate capital.

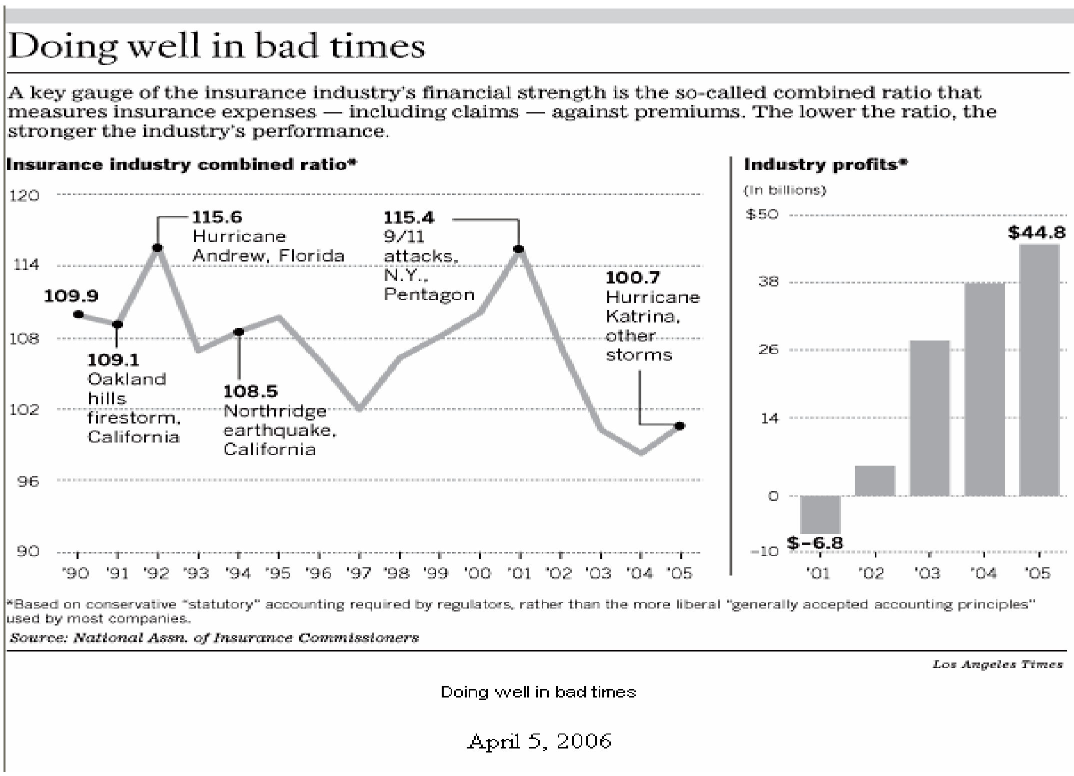
Although this upheaval hurt consumers with higher prices and less coverage, consumer groups supported most of these changes because we saw that insurers had not properly prepared for large hurricane risk in heavily developed areas. It is very important to note that consumers were also promised that the changes of the mid 1990s would bring stability into the coastal insurance markets, a promise that the insurers have now broken.

In the wake of the hurricane activity of the last two years, property-casualty insurers are once again causing major market upheaval that is harming consumers. This time the upheaval is precipitous and unnecessary. It demonstrates either gross insurer mismanagement since Hurricane Andrew or duplicity and opportunistic price gouging today.

[1] Bob Hunter is also a former Texas State Insurance Commissioner, a Fellow of the Casualty Actuarial Society and a member of the American Academy of Actuaries.

Where Have All the Risk Takers Gone?

In 2004, four major hurricanes hit Florida, but the property-casualty insurance industry enjoyed record profits of $38 billion. In 2005, Hurricane Katrina resulted in the highest hurricane losses ever, but the insurance industry also had another record year of profits, which reached $45 billion.[2] Here is a chart from the *Los Angeles Times* article on this subject:



The property-casualty industry is overcapitalized because of all of the retained earnings it is piling up. At year-end 2005, the industry had $427 billion in capital, up from $297 billion in 2001. The net premium written to surplus ratio as of 2005 was one to one, which means that for every dollar of premium that was sold, the industry had a dollar of surplus. Historically, this is an extremely safe leverage ratio. As a result, with the exception of property insurance on the nation's coasts, insurance prices are falling and coverage is easily available.[3]

Data on existing industry profits and surplus is extremely relevant to any discussion about whether the industry can handle catastrophe losses in the future. This data shows that

[2] Gosselin, Peter, "Insurers Saw Record Gains in Year of Catastrophic Losses," *Los Angeles Times*, April 5, 2006.

[3] Council of Insurance Agents and Brokers, news release, "Commercial PC Rates Hold Flat or Drop Slightly for First Quarter 2006 Renewals, Council Survey Shows," April 19, 2006. According to the Council, commercial property-casualty rates held steady or fell slightly during the first quarter of 2006, with renewal premiums for half of all account sizes remaining stable or dropping between 1 and 10 percent in the first three months of the year.

because of the market developments since Hurricane Andrew that have reduced the industry's exposure to risk, the industry has not only survived the two worst hurricane years on record, but has done so with record profits. Secondly, surplus and windfall profits can be allocated for unexpected losses in the future.

Some might argue that insurers are risk takers. That may be true for the reinsurance industry, but it is certainly not true for the primary market. The primary market has succeeded in eliminating much risk. This is not an opinion, but a simple fact.

If one purchases a property-casualty insurance company's stock, with few exceptions, one has bought into a business that is lower in risk than the market in general, hurricanes notwithstanding. This is shown in any Value Line publication, which tests the riskiness of a stock. One key measure is the stock's Beta, which is the sensitivity of a stock's returns to the returns on some market index, such as the Standard & Poor's 500. A Beta between 0 and 1, such as utility stocks, is a low-volatility investment. A Beta equal to 1 matches the index. A Beta greater than 1 is anything more volatile than the index, such as a "small cap" fund.

Another measure of a shareholder's risk is the Financial Safety Index, with 1 being the safest investment and 5 being least safe. A third measure of risk is the Stock Price Stability reported in five percentile intervals with 5 marking the least stability and 100 marking the highest.

Consider these numbers from the Value Line of March 24, 2006 for Allstate, which has taken a leading role in claiming that catastrophe insurance is too risky for the private market alone to bear:

Beta = 0.90 Financial Safety = 2 Stock Price Stability = 90

The top 12 insurers in Value Line post these average results:

Beta = 0.95 Financial Safety = 2.2 Stock Price Stability = 84

By all three measures, property-casualty insurance is a below-average risk business: safer than buying an S&P 500 index fund. Another measure of insulation from risk is the record industry profits for 2004 and 2005 that have already been mentioned.

How did insurers do it? Some of the answers are clear:

First, insurers made intelligent use of reinsurance, securitization and other risk spreading techniques. That is the good news.

Second, after Hurricane Andrew insurers modernized ratemaking by using computer models. This development was a mixed blessing for consumers. While this caused huge price increases for consumers, CFA and other consumer leaders supported the change because we saw insurers as genuinely shocked by the scope of losses caused by Hurricane Andrew. Insurers promised that the model, by projecting either 1,000 or 10,000 years of experience, would bring stability to prices. The model contained projections of huge hurricanes (and earthquakes) as well as periods of intense activity and periods of little or no activity.

In the last few months, however, CFA has been shocked to learn that Risk Management Solutions (RMS) and other modelers are moving from a 10,000-year projection to a five-year projection, which will cause a 40 percent increase in loss projections in Florida and the Gulf Coast and a 25 percent jump in the Northeast. It is truly outrageous that insurers would renege on the promises made in the mid 1990s. CFA has called on regulators in coastal states to reject these rate hikes.

It is clear that insurance companies sought this move to higher rates. RMS's press release of March 23, 2006 states:

> 'Coming off back-to-back, extraordinarily active hurricane seasons, the market is looking for leadership. At RMS, we are taking a clear, unambiguous position that our clients should manage their risks in a manner consistent with elevated levels of hurricane activity and severity,' stated Hemant Shah, president and CEO of RMS. 'We live in a dynamic world, and there is now a critical mass of data and science that point to this being the prudent course of action.'

The "market" (the insurers) sought leadership (higher rates), so RMS was in a competitive bind. If it did not raise rates, the market would likely go to modelers who did. So RMS acted and other modelers are following suit.[4] It is simply unethical that scientists at these modeling firms, under pressure from insurers, appear to have completely changed their minds *at the same time* after over a decade of using models they assured the public were scientifically sound.

In a third major development, insurers have not only passed along gigantic price increases to homeowners in coastal areas, but they have also sharply gutted coverage. Hurricane deductibles of two to five percent were introduced. Caps on home replacement costs were also added. State Farm has a 20 percent cap. Other insurers refuse to pay for any increased replacement costs at all, even though demand for home rebuilding usually surges in the wake of a hurricane, driving replacement costs up sharply. Insurers also excluded coverage for laws and ordinances, so that if a home has to be elevated to meet flood insurance standards or rewired to meet local building codes, insurers no longer have to pay.

Finally, insurers have simply dumped a great deal of risk, non-renewing tens of thousands of homeowner and business properties. Allstate, the leading culprit after Hurricane Andrew, is emerging as the heavy once more in the wake of Katrina. After Andrew, Allstate threatened to non-renew 300,000 South Floridians, provoking a state moratorium on such action. Today, Allstate is non-renewing even in Long Island.

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[4] According to the *National Underwriter's* Online Service on March 23, 2006, "Two other modeling vendors—Boston-based AIR Worldwide and Oakland, Calif.-based Eqecat—are also in the process of reworking their hurricane models."

These actions present a serious credibility problem for insurers. They told us, and we believed, that Hurricane Andrew was their "wake up" call, with the size and intensity surprising them and causing them to make these massive adjustments in price, coverage and portfolio of risk. What is their excuse now for engaging in another round of massive and precipitous actions?

Insurers surely knew that forecasters had predicted for decades that an increased period of hurricane activity and intensity would occur from the 1990s to about 2010. They also surely knew a storm of Hurricane Katrina's size, location and intensity was possible. The *New Orleans Times-Picayune* predicted exactly the sort of damage that occurred in a series of articles four years ago.[5]

Take Allstate's pullout from part of New York. It is very hard to look at this move as a legitimate step today when no pullout occurred after Hurricane Andrew. Why isn't the probability of a dangerous storm hitting Long Island already accounted for in the modeling – and rate structure – that were instituted after Hurricane Andrew? This type of precipitous action raises the question of whether Allstate is using the threat of hurricane damage as an excuse to drop customers they have had but do not want to retain for other reasons, such as clients in highly congested areas with poorer credit scores. Whether it was mismanagement that started a decade ago or the clever use of an opportunity today, consumers are being unjustifiably harmed. Insurance is supposed to bring stability, not turmoil, into peoples' lives.

Should Congress Expand Federal Backup to Wind Coverage While the Flood Insurance Program is Near Collapse?

Calling for greater federal involvement in catastrophe insurance is remarkable, given the significant problems that the National Flood Insurance Program (NFIP) is currently experiencing. The NFIP was brilliantly conceived. Taxpayers would subsidize existing construction but new construction would not be allowed to occur in the highest-risk areas, such as high velocity "V" zones. In lower risk areas that would still experience serious wind damage and flooding, all new construction would have to be elevated according to local building codes.

However, poor management by the Federal Emergency Management Agency and lax enforcement of building requirements by local governments has made the program insolvent. Flood maps that FEMA was originally supposed to update every three years are antiquated. Some are over 20 years old. As a result, flood levels that were predicted before Hurricane Katrina were more than ten feet too low in areas like Hancock County, Mississippi. Moreover, the areas of predicted high-risk were much too small. Many who appeared to be "outside" the flood plain were actually in it and should have been required to buy flood insurance coverage. Since rates and mitigation requirements are based on these maps, taxpayers are subsidizing unwise construction as a result.

[5] McQuaid, John; Schleifstein, Mark, "Washing Away," *New Orleans Times Picayune.* June 23-27, 2002.

Problems with the National Flood Insurance Program are so dire that in testimony before the Senate Banking Committee,[6] CFA raised the frightening possibility that it might have to be ended. If the program encourages unwise construction in flood plains, it is a danger to the nation rather than a blessing. If the program lures people into flood plains, if it subsidizes construction in unsafe places, if it can't stop communities that defy the program's mitigation requirements, if it falsely assures people that they are in a low-risk area that does not need flood insurance, then either it must be reformed to keep the promises of safer construction made to the taxpayers when the program was begun or it must be abolished.

The idea of Congress expanding taxpayer involvement in catastrophe insurance by creating a taxpayer-backed disaster insurance pool is almost laughable given the federal failure in handling flood insurance. Congress should stick to trying to repair this program and to proving to taxpayers it can actually end subsidies of unwise construction. It should bring the program into fiscal soundness before thinking about expansion into the wind insurance field. CFA opposes any expansion of federal authority regarding catastrophe insurance until the NFIP is fixed.

If Insurers Want Out of the Risk-Taking Business, Are They Really Necessary?

The unmistakable long term trend is that insurers are increasingly avoiding risk and shifting it to consumers and taxpayers. Higher rates, declining coverage and periodic non-renewals on a large scale have gotten to the point where the states and Congress must ask the question: "Do we really need private insurers writing any of this business?" Perhaps insurers should get out of the high-risk business but under terms and conditions that benefit the consumers and taxpayers.

For example, CFA has proposed a Florida fund for all wind insurance coverage in the state. Because of the ability of the state to build reserves tax-free, to avoid purchasing reinsurance and to set up a non-profit insurer, this approach could increase reserves by at least $3 billion a year if rates stayed the same. The program could be launched through the competitive bidding of contracts with private insurers. The risk of large losses during the transition to a self-funded state plan would be borne by insurers who, after all, aggressively wrote high-risk business and have created the current situation. Assessing all property-casualty insurers for all lines of insurance in Florida, if such a step is necessary, would build up adequate reserves and protect against this "timing risk." If wind coverage by itself is too narrow a base upon which to make such a program work, the state should consider expanding it to cover all lines of homeowners and possibly even the highly profitable auto insurance line. Perhaps an interstate compact could help states along the Gulf Coast to launch this kind of program.

Private insurers would be able to sharply lower their prices as wind coverage was removed from all contracts. Insurers would no longer have excuses for high rates and limited

[6] Hunter, Robert J., testimony before the Senate Committee on Banking Housing and Urban Affairs, "Oversight of the National Flood Insurance Program," October 18, 2005 (available at http://www.consumerfed.org/pdfs/Flood_Insurance_Senate_oversight_testimony_101805.pdf).

coverage. Regulators would no longer have to regulate policies for which they are given inadequate information, in "black box" filings. The market would likely be stabilized and would stay stable: as stable as the property-casualty stock risk has been.

Support for a Federal Role in Catastrophe Insurance is Very Limited

It is important to note that Congress is phasing out the federal role in the Terrorism Risk Insurance Act, the program that some have pointed to as a model for a federal catastrophe insurance program. Last year, Congress increased the amount of money that insurers would have to pay in the event of future terrorist attacks, eliminated some lines of coverage, reduced potential federal expenditures and rejected proposals to expand the scope of the program. The program is scheduled to completely terminate at the end of 2007 and is likely to do so.

Support for a federal catastrophe program is also limited within the insurance industry. Only a few companies have supported such a program. The American Insurance Association, the Reinsurance Association of America and Lloyd's America oppose such a plan. For instance, Ms. Wendy Baker, President of Lloyd's America has said, "We don't need taxpayer natural catastrophe funds…Lloyd's is in very good shape going into this hurricane season. And capital markets are showing a robust confidence in us and the wider industry, with billions of dollars coming into the business."

Simply put, there is no need for the federal government to get into another program covering insurance risk. However, if such a role is contemplated, at the very least a number of important conditions should be met first. As we have already mentioned, the National Flood Insurance Program should be put in order first. Measures must also be taken to ensure that loss of property is clearly and demonstrably reduced. All at-risk properties should be insured for all risks covered by the program and rates should be actuarially sound, with no cross subsidies. The role of the private sector must be maximized and closely regulated. Insurers must not be allowed to adversely select against the program by selecting the lowest risks and leaving the highest risks to taxpayers. Government at the local and state level should also assume financial risk, as a way to provide financial assistance to federal taxpayers and as an incentive for these governments to ensure that home builders and developers abide by building restrictions. Finally, federal financial involvement should be clearly defined and strictly limited. (Please see the attached, "Principles for Protecting Consumers and Taxpayers under a Federal Catastrophe Insurance Program.")

Answers to Questions in the Hearing Notice

1. **What role does your organization play, if any, in supporting or enhancing the housing market in the United States**? Through our educational and advocacy efforts, CFA has worked vigorously over the last decade to help Americans of modest means buy and keep their homes. CFA has been a strong advocate of state and federal reforms to eliminate reckless and abusive lending practices, including predatory

mortgage lending, to help Americans protect their income and assets. CFA has also launched a major, national social marketing campaign called *America Saves*, which has helped over fifty thousand low and moderate income Americans build wealth. One of the major goals of *America Saves* is to increase home ownership.[7]

2. **Is there enough insurance capacity to cover the nation's homeowners in the event of a major natural disaster? Has the national market been tested sufficiently to give lawmakers an adequate indication that the market is prepared?** Only a few insurance companies are seeking federal catastrophe backup, an indication that many insurers in the business of underwriting major risks think adequate capacity exists. As stated above, the American Insurance Association, Lloyds of America, the Reinsurance Association of America and other major players in the property-casualty market oppose a federal role and say that they can handle the risk. Additionally, despite record hurricane losses in the last two years, property-casualty insurers have posted record profits and have increased their surplus, pushing their capitalization to the highest levels in history. Reinsures are gaining capital as well. The use of securitization of risk, such as through "CAT Bonds," is gaining momentum. The *National Underwriter* recently reported that industry experts are saying that, "Catastrophe bonds and other risk securities are seeing steady growth and appear to have a bright future …. despite opinions to the contrary that the vehicles were fated to obscurity just a few short years ago."[8] A federal catastrophe reinsurance program would likely stymie these positive private sector developments.

3. **Is there anything lawmakers can do to ensure that the private market is ready to handle a major disaster? Are there any models that either states or foreign governments have established that lawmakers should consider?** The proper federal role would be limited to facilitate the tax-free buildup of reserves in pools and ensure the proper use of these funds for catastrophic claims. The federal government could also consider encouraging the development of regional pools (coastal state pools) by explicitly authorizing interstate compacts for such a purpose.

4. **Do you anticipate that either rising homeowner insurance rates or a lack of insurance availability will adversely affect the U.S. housing market?** Homeowners are definitely at risk if the states continue to allow insurers carte blanche in unjustifiably raising rates and refusing to renew policies. Maintaining the record homeownership gains of the past decade depends upon whether recent circumstances that have favored this growth can continue. Already there are indications that home affordability is eroding and the gap between median home prices and household incomes is widening. This is particularly true for the hottest real estate markets. Responding to these pressures, borrowers are further stretching their household budgets and taking on riskier mortgage products, such as interest-only loans. These products feature rapidly escalating mortgage payments. The sustainability of these loans is often dependent upon continuing house price appreciation. Sharp increases in property and casualty insurance premiums only add to the financial pressures many of

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[7] For more information, see http://www.americasaves.org/strategies/homeownership/default.asp.

[8] Ruquet, Mark E., "Future Brightening for CAT Bonds," *National Underwriter* Online Service, June 22, 2006.

these homeowners are facing and could even contribute to the current rise in mortgage defaults and foreclosures.[9]

Some "adverse impact" might be a good thing if the result is a decrease in dangerous building practices along the coast. However, it is clear that reasonably priced homes can be built safely.[10] Further, insurance rates along the coast may have been artificially increased by the unjustifiable modeling changes implemented by RMS others that are mentioned above. Politicized rate-making, caused by pressure from the insurance industry, is inappropriate and totally in violation of promises made when these models were introduced.

5. **How do natural catastrophes in one area of our nation affect the rates of homeowners in other areas, if at all?** Hurricanes should not impact rates around the nation. Actuarial methods are prospective, not retrospective and a few hurricanes should not significantly impact long-term projections. States should be checking to assure that prices are prospective and based upon the risk in their own state. The one exception to this rule is the reinsurance industry, which is not regulated. They may price beyond state boarders. If an insurer gets a higher reinsurance bill, it may have to raise its price somewhat to cover that cost. However, most states make prices on a direct (before reinsurance) basis. In these states, the cost of reinsurance is not passed through and there will be no impact. Indeed, prices for property insurance away from the coasts are falling today.[11]

6. **What do you see as the long-term budgetary implications of disaster recovery expenses incurred by the federal government?** The NFIP was supposed to reduce the long-term budget impact on taxpayers by requiring safe building and, ultimately, by ending subsidies through the charging of full actuarial rates for flood insurance. As stated above, the program has failed miserably in this effort and, indeed, clearly has encouraged unwise construction in the nation's floodplains. The budget impact of NFIP has been extremely negative, as recent bills authorizing over $20 billion in taxpayer payouts for flood claims demonstrate. To add other natural disasters to the taxpayer burden is not justified given this negative track record. CFA urges Congress to fix the NFIP before even thinking about an expanded federal role in insurance. If catastrophe pooling is put in place without meaningful mitigation measures that are vigorously enforced at the local level, it will fail.

7. **What steps, if any, should be taken to expand private-sector capacity for insuring disaster losses?** The insurance industry is currently taking steps to increase capacity. States with catastrophe insurance problems are also taking steps to set up or improve state programs. The federal government need do nothing more that it does today. Indeed, federal intervention could upset the positive developments that will help

[9] Simon, Ruth, "Late Payments on Mortgages Rise: Studies Find Higher Loan Delinquencies Stemming from 2005" Lending Boom, *Wall Street Journal*, May 18, 2006.
[10] Treaster, Joseph B., "Let a Hurricane Huff and Puff," *New York Times*, June 22, 2006.
[11] Treaster, Joseph B., "Home Insurers Embrace the Heartland," *New York Times*, May 20, 2006.

increase catastrophe coverage in the future, such as the growth in the reinsurance market and the expansion of CAT Bonds.

8. **Major primary insurers operating in coastal high-hazard Gulf and Atlantic Coast areas have decided that they cannot adequately spread their catastrophe risks. Consequently, many primary insurers have stopped writing new policies in hurricane-exposed states or have shut down operations altogether for fear of over-exposure, financial impairment, or even insolvency. What impact do you see this having on the ability of consumers to secure adequate homeowners insurance? What impact will this have on the insurance market in general?** If insurers have stated that they cannot spread this risk, they are grossly exaggerating. As stated above in great detail, the financial fundamentals of the insurance market are extremely strong: in some cases, the strongest in history. The market has the capital to cover catastrophic weather losses without federal back-up. Problems are concentrated in a few states. There are solutions even for Florida, the epicenter of the problem, through innovative approaches such as those outlined earlier in this testimony. There are also new ways to spread the hurricane loss privately, such as through the growing CAT Bond market.

Conclusion

This testimony documents the many reasons why no federal role is necessary in the catastrophe insurance industry, especially given the problems with the National Flood Insurance Program. Indeed, a federal intervention now will likely undo positive private sector developments. Such a backstop should only be established if the NFIP is fixed, if local mitigation on building standards is in place and working and if the program that is developed conforms to all of the attached principles.

Thank you for the opportunity to testify.

Consumer Federation of America

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 that already exist.

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.

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.

- 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.

<u>All at-risk properties in the nation should be insured for all risks.</u>

- 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.

- 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.

<u>Rates should be actuarially sound. There should be no subsidies or cross subsidies.</u>

- 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.

<u>The role of private sector insurers should be maximized.</u>

- 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.

- 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.

<u>A fair process and affordable insurance must be ensured.</u>

- 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.

- 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.