Testimony of
The National Association of Insurance Commissioners

Before the
Subcommittee on Housing and Community Opportunity

Regarding:
All-perils Insurance Coverage

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Chairwoman Waters, Ranking Member Biggert and Members of the House Financial Services Subcommittee on Housing and Community Opportunity: Thank you for the opportunity to testify here today on behalf of the National Association of Insurance Commissioners (NAIC) regarding all-perils insurance coverage. I applaud you for your leadership on this critical issue of national importance.

My name is Sandy Praeger, and I am the Insurance Commissioner for the State of Kansas. I also serve as the president-elect of the National Association of Insurance Commissioners. As a resident and public official of a state that has just now suffered massive flooding and millions of dollars of insured (and uninsured) losses, I commend you for focusing attention on improving insurance coverage.

Although the recent storms and flooding in Kansas pale in comparison to the devastation wrought by hurricane Katrina, there are some alarming parallels as insurance claims are settled. Private insurers have moved in quickly to pay out millions in wind claims, but there are some flooded communities where only a handful of residents had flood insurance, leading to significant uninsured losses. With regard to flood insurance, our state, like so many others, has a massive problem of underinsured and uninsured. The current system of coverage is not good enough. Congressman Taylor has first hand experience with that, and we commend him for raising the issue of how comprehensive coverage is delivered to consumers.

<u>Discrepancy between economic losses and insured losses</u>

There is a growing discrepancy between total economic losses following a catastrophic event, and total insured losses. This discrepancy is exacerbated by a lack of all-perils coverage. For example, insurers paid out a record amount for hurricane Katrina of roughly $40 billion. And yet, the federal government authorized well over $100 billion in additional aid, and roughly $20 billion in additional funding for the flood program. Private insurance covered only one third of the total economic response, with taxpayers covering the remaining seventy percent. When Hurricane Andrew hit, those percentages were effectively reversed, with the majority of losses covered by insurance. Taxpayers across the country are paying an increasing share for the natural catastrophes that hit this country. It's important that as we discuss changes to insurance coverage, that we find ways to encourage consumer participation. Affordability and availability are clearly one component of that, but consumer education is needed, and consumers must be discouraged from going without coverage and relying on government relief.

The ability of housing markets and local and regional economies to withstand and recover from the next natural catastrophe currently depends critically on what type of peril creates the disaster, where the disaster occurs, and the severity of the disaster event. The varying types of catastrophic natural disasters are managed very differently within our current insurance framework. This, in turn, can lead to highly different outcomes. Wind events, including tornados and hurricanes, are considered a basic covered peril in the vast majority of homeowner's insurance policies. Flood, on the other hand, is written only rarely by the private insurance industry for residential property; since 1968 the National Flood Insurance Program (NFIP) has been the public solution to managing this risk. Finally, seismic events, particularly earthquakes, are not considered a standard covered peril, and aside from the California Earthquake Authority (CEA), there is no public mechanism to underwrite the risk; therefore, coverage is restricted to being an optional coverage, where available, in the private insurance market. It also is worth noting that the coverage provided by the CEA is somewhat limited (the standard policy carries a 15 percent deductible and offers $5,000 for contents coverage and $1,500 for additional living expenses due to loss of use).

If the next natural catastrophe is a significant flood event, the ability of the affected areas to recover is going to depend critically on the degree to which affected properties were insured with the NFIP. Unfortunately, recent evidence from 2004 and 2005 suggests that far too many properties damaged by flood were uninsured; either they were outside of the mandatory flood plains as dictated by antiquated maps, or they were in the mandated flood zones but were uninsured anyway. Unfortunately, some short-sighted communities in flood plains have even opted out of participation in the flood program to save residents money by not having to buy the coverage, expanding the problem of uninsured properties where coverage is most needed. A recent study by the Rand Corporation provides evidence that suggests that the rate of take-up (that is how often the coverage is purchased) outside of the mandated zones is around 5 percent, and the take-up rate in mandated zones is only about 75 percent. Lenders may require the purchase of flood insurance at the outset, but there is no mechanism to ensure that coverage is maintained.

If the next natural catastrophe is an earthquake, the ability of the affected regional economy to recover will depend on the degree of disaster relief that comes from the federal government. The reason is really quite simple: the majority of residential property in earthquake prone areas is not insured for this very real risk. In California, for example, it is estimated that the take-up rate for optional earthquake insurance has fallen to about 12 percent or less. The same take-up rate is frequently suggested to be true in the earthquake prone areas in the Midwest's New Madrid area and along the eastern seaboard's seismically active areas.

As you can see, our current system lacks a comprehensive approach to managing the devastating effects of catastrophic natural disasters. Our current policy is inefficient and discourages personal responsibility and risk avoidance by relying too heavily on the Federal government. Providing consumers with all-perils coverage would unify these disparate approaches under one policy, shifting the burden off the consumer. Structuring such coverage with federal involvement could help pre-fund the government's involvement when a large disaster occurs, and capitalize on the government's ability to spread the risk over time. Moving towards this approach will raise issues of affordability. Regardless of the role of federal government in addressing that challenge, state catastrophe funds and residual market or pooling mechanisms should be encouraged to participate in any federal action so that comprehensive coverage is affordable for those who want it.

Consumers Expect All-Perils Coverage

There are many lessons to be learned from hurricane Katrina, but perhaps the greatest insurance lesson we can take from that tragic event is that many consumers are confused about what their property insurance policy covers, and what it does not. The NAIC recently conducted a survey of homeowners and found some alarming information about how they perceive their homeowners insurance coverage. Despite extensive media coverage of hurricane Katrina victims whose claims were denied because they lacked flood insurance, 33 percent of U.S. heads of household still incorrectly believe flood damages would be covered by a standard homeowners or property and liability policy. 35 percent of homeowners believe that damage caused by earthquakes is covered, and 68 percent believe that vehicles damaged on their property (potentially from a storm) are covered by the homeowners policy. The results of the survey are alarming and revealing. Clearly consumers have an expectation of broader coverage than their policies currently allow. The rationale is simple to appreciate: They are paying a premium and want their property to be covered. They don't care what the cause of loss is or what the mechanics of covering that loss is. They simply want to be made whole and begin rebuilding their lives as quickly as possible. The offer of a single policy for a single risk-based premium, where the only natural catastrophe-related exclusions are dictated by the consumer, is in the best interest of consumers, maximizes personal responsibility, and eliminates confusion over what is and is not covered. Disclosing the coverage in a check list, similar to one the NAIC has worked on, would also help the consumer not only obtain the coverage, but better understand what he or she is paying for. Delivering such a policy is going to take a collaborative effort on the part of the insurance industry, state officials, and Congress.

A Broad Approach Is Needed

Congressman Taylor's approach is to allow the national flood insurance program to take on the additional peril of wind. This approach has its advantages and deserves consideration, but we must be careful that in focusing on the challenges illustrated by the last natural disaster that we don't ignore the next natural catastrophe. A debate in Congress on this broad national issue should be structured to develop a national solution. Addressing the private market role and the federal role separately may create an inefficient system with gaps or redundancies, much like we have now. As Congress moves forward on flood reform it should do so in the context of broader natural catastrophe proposals so that solutions to these interlaced problems are not crafted in isolation. Congressman Taylor's effort is an important first step, but a debate over wind or water could just as easily be a debate over earthquake and fire when the next disaster strikes. While we applaud Congressman Taylor for his leadership on the issue, we think there are alternatives that can move toward the common goal of providing comprehensive coverage without expanding the federal government's role in pricing and providing direct insurance. The NAIC continues to work on ways to manage natural catastrophes, and as we consider the role of the federal government, we think it should be structured to meet a few key principles:

- A national program should promote personal responsibility and preparedness among policyholders;
- A national program should support reasonable building codes, development plans, and other common sense mitigation tools;
- A national program should maximize the benefits and strength of the private markets, and;
- A national plan should enable the government and decision makers with quantifiable risk management.

Developing a broad approach that recognizes the roles of the private market, the states, and the federal government, will result in a comprehensive solution that benefits all consumers.

<u>The Two Problems: Quality of Coverage and Cost of Coverage</u>

Hurricane Katrina revealed two main problems with catastrophic insurance as it is offered today:

Gaps in Coverage: Coverage is provided by multiple programs (private homeowners, state-run wind pools, federal flood, state-run earthquake, etc) that still manage to leave gaps in coverage for some consumers. Separate programs have provided fertile ground for abuses by bad actors, and ultimately result in costly litigation over the proximate cause of loss, as illustrated by the wind vs. water debate following Katrina. A lack of comprehensive insurance coverage leaves consumers underinsured or uninsured, creating a massive economic obligation for taxpayers when a natural disaster strikes and the federal government steps in. Consumers should have access to all-perils insurance coverage if they're willing to pay for it. The NAIC has worked on a checklist to include in a standard policy that spells out clearly what is and is not covered, and should be combined with an offer of all-perils coverage to give consumers more clarity. Only after the quality of coverage is improved can we accurately debate the second issue: the challenges of availability and affordability. Addressing availability and affordability without first improving the product is not a viable solution.

Availability and Affordability of Coverage: Providing seamless, comprehensive coverage puts the right product in the hands of consumers, but it does not solve the problem of affordability and availability that typically follows large natural disasters. Some might argue that providing all-perils comprehensive coverage even worsens the affordability problem, because taking personal responsibility to be fully insured is more expensive than being underinsured. While true, enabling this dynamic is clearly not good public policy. And for those that have managed to already piece together comprehensive coverage, one could argue that if homeowner's insurance pricing is risk-based, and flood insurance pricing is reformed and made risk-based, then providing that coverage in one policy instead of two or three should have little or no impact on the overall cost and may even result in efficiencies to lower the cost. The problem of affordability and availability derives from insurers' exposure to catastrophic risk. As Congress considers flood reform and all-perils insurance, it should do so in parallel with ways to address affordability and availability.

The burden of developing, implementing, and managing the mechanics of insurance coverage should not be placed on consumers through a system of segregated policies that leave gaps in coverage and provides fertile ground for abuses. That burden should rest with insurers, regulators, and legislators. Seamless all-perils insurance must be an option for those that want it. Reaching this objective requires a fundamental restructuring of the flood program, and therefore, federal action. The following are examples of concepts that can be considered, any of which could be combined with other steps like tax-deferred reserving, mitigation incentives, better building codes, and other efforts to minimize losses and increase capacity:

<u>NFIP as Insurer of Wind and Flood (Congressman Taylor Approach)</u>
Congressman Taylor's bill would enable NFIP to offer wind coverage at actuarial rates. Critics of this approach have questioned whether a government program with ingrained subsidies will ever be able to charge a risk-based rate. If it does not, the private market effectively would be displaced because the coverage does not include profit load or other expenses associated with a private product. With the addition of an extra peril,

particularly one associated with even greater losses than flooding, rates that are not actuarially-sound create an even greater obligation for taxpayers.

This approach would resolve the wind vs. water issue for those that buy the multi-peril coverage, but it does require those policyholders to buy additional homeowners coverage for fire, theft, and liability. Additionally, homeowners may also need to buy excess wind coverage above the limits of the NFIP product. The purchase of multiple policies still leaves problems with consistency of coverage where the line of dispute has been moved, not eliminated. It is not uncommon for flooding to cause widespread fires due to electrical shorts or broken gas lines. One could foresee arguments about whether the fire occurred before or after the house collapsed from the wind or was flooded by storm surge. By focusing on just wind and water, this approach may not fully address all the perils associated with a hurricane and clearly does not address those from other types of natural disasters.

This approach also does not eliminate the possibility for bad actors to shift their obligations from one policy to another. For example, if the NFIP-backed multi-peril coverage is provided on a “write-your-own” basis and adjusted by those companies who are also providing excess wind coverage, bad actors may be inclined to artificially suppress the loss amount so that coverage resides entirely under NFIP and does not puncture the ceiling where their obligations would kick in.

Again, Congressman Taylor is right to address the quality of insurance coverage and eliminate the conflict of interest that allows bad actors to shift obligations from one policy to another, but we think there are other alternatives to realize that goal and not merely move the line of contention, but eliminate it. Any fundamental change to insurance coverage is difficult to encapsulate in a few paragraphs, so the following alternatives are snapshots that would need to be discussed and further explored to ensure appropriate structure and safeguards, but they are meant to stimulate the discussion:

<u>NFIP as a Reinsurer</u>

One possible alternative is to convert the flood program to a reinsurer. Private insurers would write policies directly for both wind and flood, with the flood policy backed up on a first dollar basis by the flood program as a reinsurance mechanism. The wind vs. water distinction would still exist, but any debate would exist between the insurers and the federal government, not consumers who may be in no position after a loss, economically or emotionally, to debate the technicalities of various insurance products. Consumers would have a seamless product and would be compensated for a loss with one check for the full amount of loss. As the policy is provided to consumers, it would indicate the wind and water amounts, and the water amount would be remitted to the flood program. When a loss occurs, the insurer pays the claim and is reimbursed by the flood program. For smaller events, insurers should be able to manage the payment and seek reimbursement. For larger events, the flood program may need to set up a mechanism to start the flow of money to insurers so that they have the cash on hand to settle a large number of claims quickly. This approach provides a comprehensive product to consumers but preserves the federal government's capacity to spread the timing risk. As structured, this approach would be consistent with Congressman Taylor's approach of addressing wind and water, but it does not address other perils, such as earthquake risk.

A recent article in the Chartered Property Casualty Underwriters (CPCU) Society eJournal addressed the need for such an approach:

> *Finally, serious study should be given to incorporating flood coverage into the homeowners policy, based on actuarially adequate rates, reflecting the location of the property and probability of loss. Homeowners flood coverage must continue to be reinsured through the federal government; therefore, the NFIP would essentially be rolled into the homeowners program with the homeowners policy including the coverage presently provided under the flood policy. Clear guidelines would be required in order to differentiate between the wind and flood damages with federal reinsurance recovery for the flood losses. Including flood coverage in the homeowners policy will dramatically improve the spread of risk for the flood peril, provide comprehensive coverage for hurricane events, and reduce the probability of expensive litigation.*[1]

[1] "Troubled Waters in Mississippi: The Homeowners Market and the Attorney General Lawsuit," Thomas Marshall CPCU, CLC, CIC and Faith Neale Ph.D., November 2006, *CPCU Society eJournal*, http://www.cpcusociety.org/file_depot/0-10000000/010000/3267/conman/CPCUeJournalNov06article.pdf

Private Market All-Perils with Federal Backup

The flood program could be eliminated, along with any conflicts of interest between private companies and the federal government. Insurers could be required to offer all-perils coverage, with any catastrophe exclusions dictated solely by the consumer. In exchange for this system, and as a way to manage affordability, the federal government could provide a backstop or credit line over a certain magnitude event (for example, $75 billion) to cap catastrophic exposure, similar to what TRIA has done for commercial terrorism coverage. The point at which the government involvement activates for any particular company would have to be structured to allow for companies of different sizes to participate. States that have established catastrophe funds, wind pools, or other mechanisms to address availability and affordability could serve as an intermediate layer, backing up companies directly and supported by a federal commitment over a certain size event. This would allow different states to recognize that a "catastrophe" in a smaller state may not reach that threshold in a larger state, and preserve the role of states in helping their citizens manage catastrophic risk.

This leaves the private market and the states as the first and second line of defense for the vast majority of events but uses the power of the federal government to spread the timing risk for mega catastrophes. The approach recognizes that federal government involvement is inevitable when dealing with an event of a certain magnitude, but gives the insurance industry and the states the peace of mind to factor in that involvement to where they offer coverage and at what price. This approach provides comprehensive coverage, eliminating the wind vs. water problem and costly litigation, and should smooth the spike of availability and affordability following a natural disaster.

One challenge with this approach is that if the coverage is merely offered and homeowners can opt out of certain coverages, they may be inclined to make their decision based solely on price rather than on personal financial responsibility. However, this would at least engage the homeowner and require him to actively make a decision and recognize what is and is not covered. The addition of a checklist to the policy would also make it clear to the consumer what he or she has opted for. Alternatively, consideration could be given to making all-perils coverage mandatory under this approach, so that personal responsibility is guaranteed, adverse selection is avoided, and the potential burden for taxpayers is further reduced in the event of a catastrophe.

Private Market All-Perils with Federal Securitization

Another option to consider is a private market all-perils policy supplemented by the purchase of federally-backed catastrophe funds in an open financial market. This would involve a new type of investment where government-backed catastrophe bonds would be provided to the industry with certifiable catastrophe triggers. The idea is that a basket of time-limited bonds (the bonds expire after a set period of time; 6-month, 1-year, 2-year, etc.) that could be sold to the insurance industry based on the amount of risk the government wishes to take on. For example, the federal government wished to create a basket of cat bonds to cover losses up to $250 billion for aggregated certifiable catastrophe losses in 2008. It could make available a series of denominated bonds ($10 million bonds, $1 billion bonds, etc.) to the insurance industry, for example, $0.05 for every $1.00 of coverage. A trading market would be established where insurers, if they determine they want to obtain additional coverage throughout the year, could purchase additional bonds at a market-clearing price from other insurers holding them. The government could monitor the market and add additional bonds to the market if the market price become significantly high, signaling a need for additional coverage capacity. The market could be designed to provide bonds to either primary insurers or reinsurers. Such a program, for the federal government, would potentially provide the government with a source of revenue and preplanning of potential federal expenditures on catastrophes in exchange for stability in the insurance market.

Regardless of the approach, we think any discussion of reforming the flood program should be in the broader context of natural catastrophes. This is not a problem that can be compartmentalized and broken into pieces to be modified separately. A holistic approach is needed so there are no gaps, redundancies, or wasted steps in delivering a better insurance product to consumers. The threat of natural disasters on a massive scale exists in virtually all states. Inland flooding and earthquakes are capable of widespread devastation that can span multiple states, and wild fires and winter storms can cripple states with no coastline to speak of. The problems and solutions we discuss today are in the context of the coast because of the last catastrophe, but they are every bit as relevant for the next catastrophe, regardless of what it is or where it occurs.

A Commission Can Focus The Debate

Congressman Taylor has shed light on the gaps in insurance coverage as it's offered today. We commend him for that and hope that our alternatives will be met with an open mind and recognized as an effort to move toward a common goal. Providing all perils insurance will require a collaborative effort. There are challenges of affordability that while often ignored in an economist's theoretical view of free markets, are serious considerations for public policymakers. Given the variety and complexity of concepts under consideration, the NAIC continues to strongly endorse the concept of a National Commission on Catastrophe Preparation to weigh all the options. Clearly, there are a number of forward thinking ideas that require further consideration, but they should be framed to answer the question, "Will this make insurance for individuals and businesses more available and affordable?" State insurance commissioners look forward to working with this subcommittee to find the right answers to this question.

Thank you for holding this hearing, for inviting the NAIC here today to participate, and for your continued interest and leadership on this crucial issue.