Natural Catastrophe Risk: Creating a Comprehensive National Plan

This paper contains various perspectives on preparing the United States of America and the various states for natural catastrophes. The various perspectives are presented to demonstrate the diversity of views on this important topic.

6/15/2009

Despite relatively quiet storm seasons in 2006 and 2007, thes

H.R. 3355, the Homeowners Defense Act of 2007, is notable because it passed the US House of Representatives on November 8, 2007. This marks the first significant insurance legislation for natural catastrophes since the Legislature founded the National Flood Insurance Program in 1968. The following summary of the bill was prepared by the Congressional Research Service:

> **Homeowners' Defense Act of 2007 - Declares that the purpose of this Act is to provide federal support for state-sponsored insurance programs to: (1) help homeowners prepare for and recover from damages caused by natural catastrophes; and (2) promote the use of private market capital as a means to insure against such catastrophes.**
>
> **Title I: National Catastrophe Risk Consortium**

Title III: Reinsurance Coverage for Qualified Reinsurance Programs - (Sec. 301) Authorizes the Secretary to make contracts for reinsurance coverage under this title available for purchase only by qualified reinsurance programs.

(Sec. 302) Declares that contracts for reinsurance coverage made available under this title: (1) shall not displace or compete with the private insurance or reinsurance markets or the capital market; (2) shall minimize the administrative costs of the federal government; and (3) shall provide coverage based solely on insured losses covered by the qualified reinsurance program purchasing the contract.

(Sec. 303) Specifies terms and conditions of qualified reinsurance programs, including: (1) a minimum attachment point; and (2) 90% coverage of insured losses in excess of retained losses.

(Sec. 304) Sets the maximum aggregate potential federal liability for payment of claims under all reinsurance contracts sold in any single year at $200 billion, or such lesser amount as the Secretary determines based on review of the reinsurance market.

Limits the authority of the Secretary to enter into reinsurance contracts for any fiscal year to the extent or in such amounts as are or have been provided in appropriation Acts for that fiscal year.

(Sec. 305) Establishes in the Treasury the Federal Natural Catastrophe Reinsurance Fund, to be credited with amounts received annually from the sale of reinsurance contracts, appropriations, and any amounts earned on investments.

Authorizes the Secretary to invest in U.S. bonds any amounts in the Fund in excess of current needs.

Title IV: General Provisions - (Sec. 401) Prescribes criteria for a qualified reinsurance program under this Act.

Directs the Secretary to establish procedures for state and regional reinsurance programs and certain state residual insurance market entities to apply for certification (and recertification) as qualified reinsurance programs.

Requires each qualified reinsurance program (except any existing state residual insurance market entity, or state-sponsored provider of natural catastrophe insurance, deemed to be a qualified reinsurance program during an initial five-year transition period) to: (1) maintain risk-based capital in accordance with requirements established by the Secretary, in consultation with the National Association of Insurance Commissioners (NAIC) and consistent with the NAIC Risk-Based Capital Model Act; and (2) take into consideration asset risk, credit risk, underwriting risk, and other relevant risks.

Directs the Secretary to recognize and give credit for the ability of any qualified reinsurance program to access capital through the liquidity loan program (established under title II of this Act) to the extent that such program is deficient in complying with any aspect of risk-based capital requirements.

Requires the Secretary to increase the credit recognized and given for a qualified reinsurance program by an amount equal to the losses paid by the program as a result of a catastrophe.

(Sec. 402) Directs the Secretary to study, on an expedited basis, the need for and impact of expanding the programs established by this Act to apply to insured losses of qualified reinsurance programs for losses arising from all commercial insurance policies covering properties composed predominantly of residential rental units (commercial residential lines of insurance).

Requires the Secretary, to the extent a need to expand is determined, and that such expansion will be effective in increasing insurance capacity for the commercial residential insurance market, to: (1) apply the provisions of this Act, as appropriate, to any such insured losses of a qualified reinsurance program; and (2) provide restrictions, limitations, or conditions with respect to the programs under this Act that the Secretary deems appropriate, based on the study.

After a review by the Catastrophe Insurance Working Group, followed by a review and approval vote of the Property and Casualty (C) committee, the NAIC endorsed the bill as being consistent with the guiding principles established by the NAIC in 1999 (see Appendix III).

Alternative Solutions to Managing Catastrophic Risks outside the US

The US and other nations with developed economies have enacted a variety of programs to manage the economic consequences of catastrophic events. The programs differ in their structure based on underlying premises of the nature of the risk. Consequently the roles of the private insurance market and government entities vary considerably across programs. The GAO report “U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risks,” GAO-05-199 published in February 2005, provides a thorough description of these various approaches.

There is considerable public policy debate as to whether a specific type of natural catastrophe is an insurable risk. In 1968, the US Congress decided that flood was not an insurable risk, which resulted in the creation of the National Flood Insurance Program. Interestingly, other countries *do* consider flood an insurable risk. Indeed, both France and Spain have created risk pools that feature a state assumption of risk on an unlimited basis for specific natural catastrophes.

The draft document has been revised numerous times to reflect consensus. On some issues, regulators could not achieve a consensus.

The current plan is based on several guiding principles:

- A national program should promote personal responsibility among policyholders;
- A national program should support reasonable building codes, land use development plans, and other mitigation tools;
- A national program should maximize the risk-bearing capacity of the private markets, and;
- A national plan should provide quantifiable risk management by the federal government.

The current plan envisions two layers of risk-bearing capacity before federal government resources are utilized. The Federal government, represented in the third layer, would become financially involved if the catastrophic losses exceed the capacity of the first two layers.

The First Layer: Shaping the Risk, Enhancing Capacity, and the Insurance Contract

Developing a Comprehensive Mitigation Program

Mitigation can produce profound benefits by reducing insured losses from a catastrophic event. Consumers should be educated about how specific mitigation efforts can increase property values and give consumers greater security in knowing their property is better protected to withstand the forces of nature. State and local governments, along with the insurance, construction, real estate and mortgage industries can be utilized to educate both current homeowners and prospective homebuyers.

Mitigation policies should provide property owners with meaningful mechanisms for effective mitigation measures. These mechanisms could include such things as low interest loans, grants and premium credits to upgrade existing properties, strengthen and enforce building codes for new properties, and to improve land use regulations in the development and redevelopment of communities located within hazard-prone areas. Policyholders should be further encouraged to invest in effective mitigation through a modification of the US Tax Code to allow federal income tax credits for investments that better protect property from natural disaster losses.

At the core of the proposed plan is the need for a comprehensive program to establish and implement effective mitigation and land use plans among the states. Clearly, this is not a “one-size fits all” endeavor; different natural catastrophes require different mitigation considerations. Therefore, the implementation of these standards is best reserved for state governments; mitigating for hurricanes in Florida requires a different set of techniques than mitigating for flood along the Mississippi or Platte Rivers. Other unique examples include insuring against tornadoes in Oklahoma, or earthquakes in Missouri.

The NFIP has determined that repetitive flood claims represent an inordinately high percentage of their overall claims. The recent Florida hurricanes provided stark evidence that homes built or retrofitted to modern building codes withstand catastrophic events, while those built to lesser codes are more likely to structurally fail. Most recently, some media reports have suggested that 40 – 75% of the wind damage from hurricane Katrina could have been avoided if homes had been built to modern building codes.

Despite outreach by the Institute for Business and Home Safety (IBHS, www.DisasterSafety.org) and the Federal Alliance for Safe Homes (FLASH, www.Flash.org), one of the primary challenges facing a long-term solution is to incorporate this information into the economic decision-making processes. A competitive market requires an informed consumer and

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even more ambitious initiative that involves rating structures for earthquake resistance (see Appendix IV for an overview of the program).

More recently, Florida introduced a home grading and mitigation program for residential properties, the My Safe Florida Home program. At a CIWG meeting, representatives of the program presented an overview of the program to the working group. CIWG members agreed about the importance of a comprehensive mitigation program.

Creating Meaningful, Forward Looking Reserves

To further expand the capital base available for underwriting property risk, insurance companies should be allowed to set aside, on an objective formulaic basis, some portion of the premiums paid by the policyholders into a reserve for future catastrophic events. This ability will require a modification of the US Tax Code to allow insurers to establish these pre-event reserves on a tax-deferred basis.

Through the CIWG chaired by Florida, the NAIC developed a model plan in 2000. This plan is still pending, as it will take political initiative by the US Congress to amend the Internal Revenue Service Code. Before becoming governor of his state, Rep. Jindal (LA) offered a reserving plan bill during the 110^{th} Congress. This bill, H.R.164, offers amendments to the Tax Code that would allow insurers to voluntarily create pre-event reserves on a tax-deferred basis subject to a cap.

While the mechanics of the bill are different than the NAIC proposal, they share many of the same features. Reserves are calculated using a specific formula based on the amount of business an insurer writes in the lines of insurance potentially affected by a catastrophic event. This formula minimizes the opportunity for insurance companies to inflate reserves to defer federal taxes. When the cap is reached additional reserve contributions are fully taxed. Similarly, if an insurer leaves the business, the accumulated reserves are also fully taxed as income. Additionally, both Jindal’s bill and the NAIC model plan have a 20-year phase-in period to accumulate maximum reserves. Use of the reserves is limited to events officially declared a disaster.

The NAIC proposal is state specific with regard to the reserve calculation, while the Jindal bill is based on an aggregate line of business calculation. The NAIC proposal has an aggregate industry dollar cap; H.R. 164 does not. Among the CIWG members and most industry interested parties, there was general but not unanimous agreement and support for the need to establish these types of reserves.

Enhancing the Insurance Contract

Policyholders are not generally sophisticated consumers of insurance products. However, policyholders do have an

As a compromise, the working group agreed that to meet the expectations of consumers, the policyholder should be given a mandatory offer of an all-perils policy. If the consumer does not feel the need to insure against a specific risk at the price being offered by the insurer, the consumer can then decide which coverage(s) they wish to purchase and which they do not wish to purchase. Exclusions and coverage limitations should be disclosed to the consumer and explained to the consumer prior to the purchase of the policy. Subtleties of whether flooding was caused by wind-driven water, storm surge or rain-induced flooding should be eliminated to alleviate any coverage confusion. Policyholders should also be required to acknowledge the impact of changes to coverage on the policies they purchase. At some point in the future, consideration may be given to changing the mandatory offer feature to a mandatory coverage of these perils.

However, the working group did feel that for those properties financed with a federally guaranteed mortgage (whether the guarantee is explicit or implicit), natural disaster coverage should be mandatory for those properties located in areas of moderate to high risk of catastrophic events. This may be expressed by the prevalence of the risk for a specific type of peril. For example, it could be mandatory for a 1 in 250 year flood event or earthquake event, or a 1 in 100 year catastrophic hurricane. Individuals with federally guaranteed mortgages are already receiving a sizeable subsidy from the US government, Regardless of whether a state determines there is a need for a fund, states should be required, by agreement or mandate, to finance mitigation education and implement programs that best meet the needs of its citizens. Under this scenario, all states would be required to:

- Use accepted engineering and science to establish effective building codes that properly reflect their catastrophic exposures.

Connecticut Perspective

Connecticut Perspective

Connecticut is a small and densely populated state, but repres a knowledgeable producer would indicate that most policies exclude risks caused by floods and earthquakes, to name only the best known exclusions. Connecticut endorses language offered by South Carolina and Mississippi that more care should be taken by companies and agents to explain policy coverage completely to individuals whose risks are within catastrophe prone areas, and that policies should have easily recognized simple language showing policy coverage.

Louisiana Perspective

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Louisiana Perspective

Consistent with its guiding principles and three layer approach to risk-bearing capacity, *Natural Catastrophe Risk: Creating a Comprehensive National Plan* should include more detailed discussion of and proposals for (1) relieving the tax burden on reserves for catastrophes, (2) requiring state-sponsored entities to charge actuarially sound premiums to receive federal financial support; and (3) enabling private insurers to require flood insurance as a prerequisite to issuance of wind and hail insurance coverage. The guiding principles, unlike the well-developed discussion on layers of risk-bearing, require more explanation of why they are principles and how they guide the discussion.

Guiding Principles: The guiding principles are more effectively and efficiently stated as follows: (1) personal responsibility; (2) reasonable mitigation; (3) maximal private risk-bearing capacity; and (4) quantifiable federal risk management.

was litigation concerning the extent of coverage available to policyholders who did not have flood insurance. When a home is damaged or destroyed by multiple causes, it can be difficult to determine the extent of damage attributable to each risk. Insurers have an incentive to push the claim to other coverage or to a gap in coverage. Policyholders seek recovery from any available policies.

Federal law should require FEMA to provide timely cancellation notice to property and casualty inspTT2 016 Tc.0031 Twm 016 Tc.003(y

South Carolina/Mississippi Perspective

EDITOR'S NOTE: Director Scott Richardson (SC) and Commissioner Mike Chaney (MS) have provided the following edits to the paper as their suggested change. The underlined text is new and the overstrike text they recommend be deleted.

Introduction
Natural disasters take a heavy financial and emotional toll on Americans every year. Over fifty percent of the population in the United States lives within fifty miles of a coastline.

Following Hurricane Katrina, the Government Accountability Office (GAO) issued a report that concluded the United States is not well prepared to handle extreme natural disasters such as flooding, high category hurricanes, tornados and earthquakes; this includes the initial emergency response as well as the financial aftermath. Americans need to be better prepared for natural disasters both logistically and financially; insurance has an important role to play in this equation. NAIC favors an emphasis on "personal responsibility" and "private market" solutions over government solutions. NAIC does endorse a federal backstop for extreme catastrophic events.

The National Association of Insurance Commissioners (NAIC) has actively examined approaches to insuring against natural disasters for the last four decades. In fact, Volume 1 of the 1973 NAIC Proceedings cites a report from the Availability of Essential Insurance (D2) Subcommittee that recommends a five-step program to address this problem. Interestingly, step five is, "The Federal Government, in cooperation with the insurance industry and the NAIC, study and develop a mechanism that would provide additional capacity for catastrophe insurance and would allow for the accumulation of funds from which catastrophe losses could be paid without having those funds depleted by Federal income tax in loss-free years."

The Property and Casualty (C) Committee has developed a possible model system for implementing this concept of tax deferred catastrophe reserves, and has advocated legislative changes to the Federal Tax Law since 2000. More recently, the (C) Committee re-constituted the Catastrophe Reserve Subgroup to revisit the model system and to recommend possible changes. The NAIC feels it is imperative and prudent that Congress amend the Internal Revenue Code to encourage more billion. Two other hurricanes in 2005—Wilma and Rita—caused $7.64 billion and nearly $5 billion in damage respectively. It is not simply the frequency of large storms that created financial problems for the U.S. insurance industry --- all seven of these storms are now included in the list of top ten costliest storms in United States history.

With a few exceptions, all of the insured losses related to wind-damage have been handled by the insurance and reinsurance industries. This speaks well to the ability of the private market to handle most catastrophe events. However, proponents for government involvement point to the fact that some of the uninsured losses associated with these events have been paid by the states and the federal government using taxpayer funds. Despite relatively quiet storm seasons in 2006 and 2007, significant catastrophe losses appeared again in 2008. The potential consequences of extreme catastrophic events have public policymakers concerned about the industry's ability to continue to: (a) handle these catastrophic losses; and (b) have the capacity to handle an additional future natural disaster in the short term.

The Potential for a Mega-Disaster

While Hurricane Katrina was devastating, catastrophe modelers have identified a number of possible natural disasters that would dwarf the damages caused by this event. These are not fantastic scenarios, but instead, have already occurred in our nation's history – just not at current exposures, and structure values. The 1906 San Francisco earthquake would create damage of $400 billion with over $200 billion in uninsured property losses if it had occurred today; a repeat of the 1900 Galveston hurricane would cause $36 billion in possible damages; a repeat of the 1938 Category 3 hurricane that reached landfall in the Northeast would cause damage exceeding $300 billion; a repeat of the series of earthquakes that struck the New Madrid Fault in 1811 and 1812 would cause potential economic damage of up to $275 billion with insured losses reaching $100 billion. All of these scenarios have occurred in the past, and could potentially occur again in the future. The current structure to handle catastrophe losses may be overwhelmed by an event of this magnitude. . It is interesting to note that "catastrophe models" often have different projections for the same event, which emphasizes the need to allow insurers to use all of the scientifically valid tools at their disposal to evaluate the potential for risk. At the same time, to fulfill their obligation to ensure that insurer rates are neither inadequate nor excessive, regulators need to understand if catastrophe models are scientifically valid.

The Insurance Industry and Regulators Must Take Additional Measures

Many residential properties are overly exposed to natural disasters thus increasing the risk of damage. Whether it is through regional planning, mitigations measures, or more substantive building codes, cost-effective steps must be taken to reduce exposure to catastrophic losses. Insurers should provide incentives for consumers by providing risk appropriate credits for homes built to comply with effective building codes or for existing homes that are retrofitted to have a greater capacity to withstand damage.

Policymakers should also review how insurance benefits are delivered to the public. Despite the realities of wind pools, beach plans and the National Flood Insurance Program, there are some who believe that requiring a person to buy multiple insurance contracts to cover their homes and belongings clearly is not efficient, does not meet consumer needs, and often creates confusion during the claims settlement process. While Hurricane Katrina resulted in numerous disputes over whether a loss was caused by wind or water, most hurricanes do not result in this conundrum. When it does occur, however, determining whether a loss is due to wind or water is not just problematic, it is time-consuming and stressful to the public—especially if one peril is covered, and the other (often flood) is not. There have been several solutions examined on this issue, Several bills have already been introduced in the 111th Congress that would address catastrophe losses. Those bills are listed in Appendix I.

Alternative Solutions to Managing Catastrophic Risks outside the US

The US and other nations with developed economies have enacted a variety of programs to manage the economic consequences of catastrophic events. The programs differ in their structure based on underlying premises of the nature of the risk. Consequently the roles of the private insurance market and government entities vary considerably across programs. The GAO report "U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risks," GAO-05-199 published in February 2005, provides a thorough description of these various approaches.

There is considerable public policy debate as to whether a specific type of natural catastrophe is an insurable risk. In 1968, The current paper is based on several guiding principles:

- A national program should promote a solution through the maximum participation of the private markets.
- A national program should promote personal responsibility among policyholders.
- A national program should support reasonable building codes, land use development plans, and other mitigation tools.
- A national program should maximize the risk-bearing capacity of the private markets.
- A national program should provide quantifiable risk management by the federal government.
- A national program should provide a backstop similar to the terrorism program to manage risk that cannot be absorbed by the private market.

The current plan envisions risk bearing by private market insurance participants supplemented by optional state facilities before federal government resources are utilized. The Federal government would become financially involved through a backstop program if the catastrophic losses exceed the private market and state capacity.

Developing a Comprehensive Mitigation Program

Mitigation can produce profound benefits by reducing insured losses from a catastrophic event. Consumers should be educated about how specific mitigation efforts can increase property values and give consumers greater security in knowing their property is better protected to withstand the forces of nature. State and local governments, along with the insurance, construction, real estate and mortgage industries can be utilized to educate both current homeowners and prospective homebuyers.

Mitigation policies should provide property owners with meaningful mechanisms for effective mitigation measures. These mechanisms could include such things as low interest loans, grants and premium credits to upgrade existing properties, strengthen and enforce building codes for new properties, and to improve land use regulations in the development and redevelopment of communities located within hazard-prone areas. Policyholders should be further encouraged to invest in effective mitigation through a modification of the US Internal Revenue Code to allow federal income tax credits for investments that better protect property from natural disaster losses.

At the core of the proposed plan is the need for a comprehensive program to establish and implement effective mitigation and land use plans among the states. Clearly, this is not a “one-size fits all” endeavor; different natural catastrophes require different mitigation considerations. Therefore, the implementation of these standards is best reserved for state governments; mitigating for hurricanes in Florida requires a different set of techniques than mitigating for flood along the Mississippi or Platte Rivers. Other unique examples include insuring against tornadoes in Oklahoma, or earthquakes in Missouri.

The NFIP has determined that repetitive flood claims represent an inordinately high percentage of their overall claims. The NAIC believes that paying multiple claims on uninsured risks within Federal Flood Zones should not be allowed. This practice provides incentives for bad behavior and substantially weakens the ability of the program to pay losses to those who properly participate by paying premiums. The recent Florida and Texas hurricanes provided stark evidence that homes built or retrofitted to modern building codes withstand catastrophic events, while those built to lesser codes are more likely to structurally fail. Most recently, some media reports have suggested that 40 – 75% of the wind damage from hurricane Katrina could have been avoided if homes had been built to modern building codes.

Despite outreach by the Institute for Business and Home Safety (IBHS, www.DisasterSafety.org) and the Federal Alliance for Safe Homes (FLASH, www.Flash.org), one of the primary challenges facing a long-term solution is to incorporate this information into the economic decision-making processes. A competitive market requires an informed consumer and consumers need to be made aware of the options available to them when building or buying a home.

even more ambitious initiative that involves rating structures for earthquake resistance (see Appendix IV for an overview of the program).

More recently, Florida introduced a home grading and mitigation program for residential properties, the My Safe Florida Home program. At a CIWG meeting, representatives of the program presented an overview of the program to the working group. CIWG members agreed about the importance of a comprehensive mitigation program.

Creating Meaningful, Forward Looking Reserves

To further expand the capital base available for underwriting property risk, insurance companies should be allowed to set including flood in the basic policy would create additional risks for the insurance company as the insurance companies would be required to pay the initial flood claims, and wait for reimbursement from the NFIP.

As a compromise, the working group agreed that to meet the expectations of consumers, the policyholder should be given a mandatory offer of an all-perils policy. If the consumer does not feel the need to insure against a specific risk at the price being offered by the insurer, the consumer can then decide which coverage(s) they wish to purchase and which they do not wish to purchase. Exclusions and coverage limitations should be disclosed and explained to the consumer prior to the purchase of the policy. Subtleties of whether flooding was caused by wind-driven water, storm surge or rain-induced flooding should be eliminated to alleviate any coverage confusion. Policyholders should also be required to acknowledge the impact of changes to coverage on the policies they purchase. At some point in the future, consideration may be given to changing the mandatory offer feature to a mandatory coverage of these perils.

However, the working group did feel that for those properties financed with a federally guaranteed mortgage (whether the

H.R. 3355, as summarized earlier, contemplates such a voluntary state participation structure

Mandatory Requirements of States

Regardless of whether a state determines there is a need for a fund, states should be required, by agreement or mandate, to disaster coverage. If disaster insurance is modified based on the recommendations in the report, and the private market continues to write disaster risk, the "true" answer may be in the middle: some level of public involvement is needed.

To fully address these important issues, a national debate needs to occur that involves all stakeholders, preferably through a congressionally appointed Natural Catastrophe Commission. The NAIC has adopted a resolution supporting the creation of such a Commission. Congress should establish this Federal Commission immediately, with an initial charge to complete an inventory of the disaster prone insurance markets in this country, and to establish the degree of required public support. In its analysis, the Commission's focus should be to determinelimited levels of public support, and the appropriate form of that support.

The current debate focuses on the establishment of a "public trigger" or attachment points, and to make this point just short of private insurer insolvency. Given the dynamics of the market and the possible economic devastation combined with the imprecise calculation of this exact point, some argue that it would be more prudent to find a level of public support that supports the stability the market after an event.

If the Commission finds there is a need for a public/private partnership to insure against extreme catastrophic natural disasters, the Commission may wish to consider a layered approach similar to the NAIC's plan. Under such a plan, the private markets would have the first layer of responsibility, while the state or regional mechanisms would represent the second layer. This layer would in turn be backed by federal support at a level established by the findings of the Federal Commission. Both the state and federal government involvement should be structured to complement, not replace or displace private markets.

An approach that utilizes a federal reinsurance, liquidity or loan guarantee program has been advocated by some as an economical solution. These advocates propose that a federal facility be created to provide guarantee lending or reinsurance to the state or regional funds. States would be eligible for the program only if they could show their rates were actuarially sound and their fund or program could withstand a 1/150 event for wind or 1/200 earthquake. Any loans should be based on a maximum payback period of 10 years in order to insure reasonably certain repayment by the state, and provide the state the reasonable ability to participate in future loans due to multiple events. .

In return for the financing support, states would be obligated to adopt adequate disaster response and management mechanisms and enforce reasonable building code, land use, and mitigation efforts to minimize the amount of insured loss. To participate, state facilities would be required to pay risk based premiums and the pricing mechanism must be used to encourage active development and enforcement of these standards. Any losses beyond the federal reinsurance layer would, like now, remain uninsured, with the private insurer, state facility or be financed from the general Treasury and future taxing authority of the United States government.

Such a federal program is controversial within the private industry and between regulators. No consensus on the need for or appropriateness of a federal reinsurance facility has been reached. Also, there is a concern that a greater federal role in catastrophe financing could lead to greater federal involvement in the regulation of insurance.

However, if a federal program is developed, it should require actuarially sound premiums, including a risk load in addition to funding for the average annual expected loss and related expenses, for the underlying insurance coverage and for coverage provided by any state or regional insurance or reinsurance facility. Such a risk load is needed to adequately reflect the full cost of the risk being underwritten.

Any national program should also abide by this paper's guiding principles:

- A national program should promote a solution through the maximum participation of the private markets.
- A national program should promote personal responsibility among policyholders.
- A national program should support reasonable building codes, land use development plans, and other mitigation tools.
- A national program should maximize the risk-bearing capacity of the private markets, and
- A national program should provide quantifiable risk management by the federal government.

Other Considerations

The NAIC should continue to address perceived roadblocks within the U.S. Internal Revenue Code and within SEC

Appendix I –Guiding Principles

Guiding Principles for Consideration of Federal Catastrophe Insurance.
Adopted by
Catastrophe Insurance Working Group
of the Property and Casualty Insurance (C) Committee
May 21, 1999

1. Legislation should recognize the important role played by the states in insurance regulation with respect to such areas as licensing insurers, solvency surveillance, approving rates and forms, licensing agents, assisting consumers during the claim settlement process and performing market conduct examinations.

2. There should be a reasonable coordination and structuring of state and federal regulatory responsibilities with respect to a federal disaster insurance program that achieves the objectives of the program without unnecessarily compromising or preempting state regulatory authority and consumer protection. Necessary preemption of or limits on state

15. Legislation should encourage the strengthening and enforcement of building codes to reduce loss.

16. Legislation should not burden states with additional responsibilities without funding the mandated activities.

17. There should be coverage protection within reasonable limits for personal property policyholders in the event of the insolvency of the program or its participants.

18. Federal legislation should encourage the geographic spreading of risk.

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Appendix II – Catastrophe Legislation in the 111th Congress

111th Congress

Senate Bills related to Catastrophes and Insurance

- S. 505, The Homeowners Defense Act of 2009 would create a National Risk Consortium for the purpose of gathering data on catastrophic risk obligations held by state funds and facilitate the issuance of securities or other financial instruments related to funding of state catastrophe risks, and coordinating private reinsurance contracts between private parties and qualified state funds. It would also establish the National Homeowners' Insurance Stabilization Program to provide liquidity and catastrophic loans for qualified state and regional reinsurance programs.

  This bill is similar to H. 3355, The Homeowners Defense Act of 2007, which the NAIC endorsed as being consistent with the guiding principles established by the NAIC in 1999 (see Appendix II). The NAIC letter to Representative

Appendix III – NAIC Letter to Rep. Klein

November 6, 2007

The Honorable Ron Klein
313 Cannon House Building
Washington, DC 20515
The Honorable Timothy Mahoney
1541 Longworth House Building
Washington, DC 20515

RE: H.R. 3355, the Homeowner's Defense Act

Dear Congressmen Klein and Mahoney:

A more ambitious example of this kind of outreach can be found in Japan with respect to the earthquake exposure of

Appendix V – Florida Homeowners Policy Checklist

Checklist of Coverage

Policy Type: ___________________

	Loss Assessment			
	Collapse			
	Glass or Safety Glazing Material	V	k	a

	Loss Assessment			

Insurer May Insert Any Other Liability Coverage Below	
(Items below marked Y (Yes) indicate coverage IS included, those marked N (No) indicate coverage is NOT included)	Limit of Insurance

Appendix VI – Various Other Catastrophe Funding Proposals

Protecting America (Protecting America.org; "Allstate Proposal")

Advocates a public-private partnership. States would create privately funded catastrophe reinsurance funds (currently only in place in Florida) intended to provide reinsurance at lower rates than available in the private reinsurance market. The funds would be financed through mandatory premiums paid by insurers in the state in an amount that reflects the catastrophe risk of the policies that they write in each state.

A portion of investment funds earned by the cat funds (a minimum of $10 million up to a maximum of 35 percent) would be used for mitigation, prevention, preparation and first responder programs in each state.

A federal natural catastrophe reinsurance fund would be create

2. Transparency in calculation of premium.

Insurance companies would individually and competitively set risk-based and actuarially sound rates using approved standards and certified windstorm risk models. The proposed Federal commission would certify models after reviewing and validating underlying model assumptions such as frequency, vulnerability and mitigation factors to ensure that rates are set in a transparent manner. In addition, the Plan calls for a rating calculation mechanism to generate prospective premium credits for customers if models and actual experience become misaligned over time to eliminate the possibility that insurers "win" and customers "lose."

3. Cost-based federal reinsurance mechanism with savings passed on to consumers.

To improve affordability and availability of insurance, a federal reinsurance mechanism would be created to provide coverage to insurers. Coverage could vary by zone to match the regional risk profile. Insurers would be charged actuarially-based rates. The plan does not propose an event trigger, but provides that the federal board would adjust reinsurance levels based on storm activity or market need. Public press materials indicate that such coverage would apply for events several times larger than hurricane Katrina

4. Mitigation against losses.

The Plan states that mitigation must be a centerpiece of any effective catastrophe insurance proposal, and there should be federal guidelines for strong building codes, incentives for state and local adoption and enforcement of those codes, enhanced construction technology, and land use planning requirements. In addition, the Plan endorses meaningful premium credits for mitigation and consideration of state and local property tax incentives for retrofitting houses.

<u>Coastal Catastrophe Partnership (Hartford)</u>

This plan is outlined as six core principles, calling for: disaster preparedness, land use planning and enforcement of building codes; rate regulation to allow risk-based rating; requiring state residual market plans to require risk based rating and adequate capitalization; a federal reinsurance backstop; reaffirmation of state-regulated policy language; and permitted state financial assistance for working families and retirees.

The plan calls for participation by coastal residents, insurers, state government and federal government – the 4 participants in the "Partnership."

Components of the plan are:

- States and local governments focus on building codes and land-use policies.
- Homeowners should be encouraged to accept a greater share in losses through higher deductibles and mitigation.
- Tax advantaged accounts should be permitted for homeowners to pre-fund losses; tax deductions or incentives should be permitted to offset mitigation costs.
-

insurers could retain losses up to, for example, a 1-50 year event. A federal backstop could start, for example, at a 1-100 year event

- State Cat Funds could be established to reinsure events between 1-50 to 1-100 years. Costs would be financed

- The second deductible would be paid by the state and would be fixed at a certain dollar amount (approximately $100 million or Utah); and
- The third deductible would be paid by the federal government and would be set at four times the state deductible.

The Plan anticipates a risk mitigation policy that may include a review of building codes, and/or a statewide survey of all building risks to establish a database upon which local building code administrators could rely for the purpose of managing and mitigating risk.

A national premium tax proposal to fund federal inv3(a)/4s.xement