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The Hon. Michael T. McRaith
Director, Federal Insurance Office
Attention: Study on Natural Catastrophes and Insurance
Room 1319 MT
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220.

Docket number: 2013-09670

June 21, 2013

Director McRaith,

The R Street Institute welcomes the opportunity to comment on the Federal Insurance Office's study of natural catastrophes and insurance. R Street is a non-partisan, non-profit public policy research institution dedicated to free markets; limited, effective government; and responsible environmental stewardship.

Operating from offices in Washington, D.C.; Columbus, Ohio; Austin, Texas; and Tallahassee, Fla., R Street aims to advance free market policies in a pragmatic, common sense fashion. R Street's founding staff members previously worked for the Heartland Institute's Center on Finance, Insurance and Real Estate and, under the R Street banner, continue research and outreach in a wide variety of insurance-related public policy issues.

R Street is particularly interested in the intersection of public policy and catastrophe insurance issues. We believe federal and state policies that suppress or subsidize the cost of property insurance coverage in catastrophe-prone regions have distorted markets, subsidized environmental destruction and encouraged people to build and live in harm's way. We would encourage the FIO advocate for shrinking large state residual market entities like Florida's Citizens Property Insurance Corp., which could destabilize local insurance markets, as well as shifting more risk currently borne by federal entities such as the National Flood Insurance Program and Federal Crop Insurance Corp. to the private sector.

Our responses to specific FIO queries follow:

1. **The current condition of, as well as the outlook for, the availability and affordability of insurance for natural catastrophe perils in all regions of the United States, including whether a consensus definition of a "natural catastrophe" should be established and, if so, the terms of that definition;**

Private sector property insurance to protect against most major perils – including windstorm, wildfire, earthquake and hail – has remained broadly available, despite steadily increasing (and in some cases, record) catastrophe losses. The past two years have seen U.S. insurers, first, hit by the second-worst year for natural catastrophe losses in history in 2011, and then followed by Superstorm Sandy in 2012, which is itself the second-largest natural catastrophe on record in the United States. The property/casualty sector, which held up well through the financial crisis, nonetheless has continued to see growing net income that reached $20.1 billion in 2011 and $36.3 billion in 2012.

There also is a definition of "catastrophe" that has consensus agreement within the insurance industry. As defined by the Insurance Services Office, a catastrophe is an event that affects a broad range of policyholders and produces more than $25 million in insured losses. This definition serves useful purposes in financial reporting and in some reinsurance contracts. It is less apparent the purpose it would serve in public policy.

Rather than invent from whole cloth a new federal definition of "catastrophe," we would recommend FIO lend its expertise to finding a more transparent and coherent definition of a related term, which is "disaster." Federal disaster declarations made under the Robert T. Stafford Disaster Relief and Emergency Assistance Act have grown steadily year-by-year and decade-by-decade. In the 1960s, there were an average of 18 major disasters declared each year. By the 2000s, that number had increased to an average of 56. In 2011, a new high of 99 major disasters were declared. Given the strong intersection of the insurance sector with disaster response, it would be useful for Treasury's FIO to provide input to FEMA and other agencies on how disasters ought to be defined.

2. The current ability of States, communities, and individuals to mitigate their natural catastrophe risks, including the affordability and feasibility of such mitigation activities;

Our contention is that risk-based rates are the best form of mitigation. Unfortunately, most states impose price controls that prevent insurers from establishing rating and underwriting standards without regulatory approval. The legal grounds on which such regulations rely is the limited exemption from federal antitrust authority granted to the business of insurance under the McCarran-Ferguson Act. At the time McCarran-Ferguson passed, virtually all insurance rates and forms were established collectively by industry-owned rating bureaus. States were granted jurisdiction over rates and forms submitted by these bureaus to stave off anticompetitive collusion and to ensure that rates were neither excessive nor insufficient.

Seventy years later, the rating bureaus do not play the same role in the market they once did. Most are no longer owned by the industry, and many large insurers now establish rates using proprietary formulas. State rate controls persist and in many states – particularly those most prone to major catastrophes like windstorms and earthquakes – these controls serve to stifle competition and suppress rates, particularly politically unpopular rate increases. If insurers were permitted to craft rates that reflect their assessment of risk, development patterns in high-risk areas would be altered drastically. Moreover, the cost of risk would be priced into the built environment, in some cases reducing property values and, hence, the total value that would need to be insured.

R Street supports targeted mitigation efforts, particularly those that are demonstrated to reduce federal spending. The Congressional Budget Office found in a 2007 study that investment by one notable federal mitigation program reduced the 50-year cost of disaster spending by between $500 million and $1 billion. We also believe the formularies of federal programs like the Stafford Act should be reformed to provide a sliding scale of aid to which states might become eligible, with more funds available to states that adopt comprehensive mitigation programs and less aid to those that do not.

a. **The current and potential future effects of land use policies and building codes on the costs of natural catastrophes in the United States;**

Because subsidies to development and regulatory controls on insurance rates distort risk-based land use planning, we would highlight the value of approaches such as that taken by the 30-year-old Coastal Barrier Resources Act. The legislation barred a broad range of federal programs from operating within a network of undeveloped wetlands and barrier islands along the Gulf and Atlantic coasts. The law was reauthorized in 1990 and expanded to include undeveloped coastal barriers along the Florida Keys, Great Lakes, Puerto Rico and the U.S. Virgin Islands.

Under the CBRA, federal expenditures for activities such as beach nourishment, infrastructure construction and the National Flood Insurance Program are barred within the Coastal Barrier Resources System. Recently, the State of Florida adopted legislation modeled on the CBRA that bars the state-run Citizens Property Insurance Corp. from offering subsidized property insurance to new construction in areas seaward of the Coastal Construction Control Line, a line of jurisdiction defining the landward limit of the state Department of Environmental Protection's authority to regulate coastal construction.
We believe similar restrictions have great promise in a variety of contexts relevant to natural catastrophes. For instance, a similar system could proscribe development in areas prone to wildfire, a growing problem in the Western United States. Similarly, CBRA-style restrictions should be applied to any funds distributed by the RESTORE Act, or risk massive new subsidies to development in the already fragile Gulf Coast ecosystem.

b. **The percentage of residential properties that are insured for earthquake or flood damage in high-risk geographic areas of the United States, and the reasons why many such properties lack insurance coverage;**

While insurance for earthquakes is generally available in most areas of the United States vulnerable to seismic tremors, take-up rates are typically low. In California, where coverage is generally provided by the state-created California Earthquake Authority, less than 12 percent of homeowners have insurance that will respond to earthquakes. This is despite predictions from the U.S. Geological Survey predicts that, over the next 30 years, there is a 99.7 percent chance that a magnitude 6.7 earthquake (equal in strength to the 1994 Northridge quake) will strike and a 46 percent chance that a magnitude 7.5 earthquake (45 times stronger than M6.7) will strike.

The low take-up rates of earthquake insurance are, in part, reflective of rules established for residential mortgages assumed by the Federal National Mortgage Association (better known as "Fannie Mae") and the Federal Home Loan Mortgage Corp. (better known as "Freddie Mac"). The two government-sponsored enterprises together own or guarantee more than half of all outstanding mortgages in the country. As of year-end 2012, Fannie Mae's total book of business was $3.2 trillion, while Freddie Mac's was $1.8 trillion.

Under the rules for qualified mortgages promulgated by the FHFA and its predecessor agency, OFHEO, mortgages purchased or guaranteed by the GSEs must have and maintain property insurance coverage for most standard perils, including fire and windstorm and, where the property is included in a 100-year floodplain, coverage from the National Flood Insurance Program. However, despite the enormous destructive power of seismic events, there is no requirement that the properties carry insurance for earthquake risks.

This is a significant oversight. Based on U.S. Census estimates for 2012, there are at least 66 million Americans who live in metropolitan statistical areas identified by U.S. Geological Survey as facing elevated earthquake risk. This includes not only those cities that have seen significant earthquake events in the recent past, like Los Angeles and San Francisco, but also places as disparate as St. Louis, Seattle, Las Vegas, Honolulu, Memphis, Salt Lake City, and Charleston, S.C. Indeed, because many of these cities haven't seen significant earthquake damage in recent times, local building codes are less likely to require the kinds of seismic retrofitting that serves to mitigate earthquake risk in California.

For the GSEs, the result is that, in the event of a major earthquake, there would be no insurance to recover on most of the properties that serve as security for the mortgages held by Fannie and Freddie. The USGS estimates a 7.8 southern California quake on the San Andreas Fault could produce $200 billion in damage, and much of that would be uninsured.

4. The current financial condition of State residual markets and catastrophe funds in high-risk regions, including the likelihood of insolvency following a natural catastrophe, the concentration of risks within such funds, the reliance on post-event assessments and State funding, and the adequacy of rates;

We at R Street long have been concerned about the risks posed by the creation and growth of certain state-run residual markets and reinsurance mechanisms. These entities have their origins in state rate controls, which leave insurers in some markets unable to charge market-clearing prices and consumers in those markets unable to find coverage.

Most of these residual market mechanisms--35 states maintain a total of 37 of them—have little or no significance. However, some have grown large enough that that they may even be considered a source of systemic risk. The largest state-controlled entities, such as Florida Citizens, compete directly with private insurers. In fact, Citizens ranks as the largest homeowners' insurer in that state. Other entities -- like Louisiana Citizens Property Insurance Corp., the Texas Windstorm Insurance Association, and the CEA – are likewise significant competitors and in some cases are the only entities willing to write coverage in some regions or for some specific perils.

The typical post-catastrophe funding mechanisms of large U.S. residual market entities must raise concerns about interconnectedness. Rather than setting aside actuarially appropriate reserves to prepare for the risks they take on, entities like Florida Citizens rely on post-event borrowing as a source of liquidity following a major event. The loans taken out by these entities are then to be serviced over time using funds raised by assessments on private market insurers, which are then typically passed on to consumers.

However, in a market like Florida, where several entities – Citizens, the Cat Fund, and the Florida Insurance Guaranty Association, which is charged with resolving private insurers that become insolvent – all rely on post-event assessments to make up for funding shortfalls, private carriers may respond to such assessments by exiting the market. This leaves a smaller assessable base of private insurers to bear the burden of the shortfalls, and the potential for cascading insolvencies that ripple out through the market exists.

6b. The potential privatization of flood insurance in the United States;

Floods are a privately insured risk in many developed Western markets, and even in some emerging markets. Severe floods in Central Europe in May and June of 2013 are projected to result in some 2-3 billion euros in private flood insurance claims. Where such risks are privately insured, a network of modeling and support services – such as satellite-based flood footprint tracking – has built up to assist insurers in better parsing and responding to flood risks.

The experience of the NFIP is markedly different. After 45 years, the program is $25 billion in debt and remains nearly the only available source for first-dollar flood insurance coverage for residential structures. We believe a transition to fully private coverage is feasible, but it will be difficult.

While private flood insurance premiums would certainly be more expensive than those charged by the NFIP, as currently constituted, the NFIP represents a regressive subsidy to wealthier taxpayers from poorer ones. Research by the Institute for Policy Integrity shows that the NFIP's benefits currently flow overwhelmingly to the rich, with the wealthiest counties filing 3.5 times more claims and receiving $1 billion more in NFIP payments between 1998 and 2008 than the poorest counties.

In other to move forward in the direction of privatization, it is essential that reforms spelled out in the Biggert-Waters Act of 2012 are implemented. Under the law, subsidized premium rates would be phased out for all severe repetitive loss properties, second homes and vacation homes, commercial properties, and any property that has suffered damage exceeding 50 percent of its fair market value or that has undergone improvements of more than 30 percent of its fair market value. The law also phases in NFIP premiums for properties newly included in Special Flood Hazard Areas due to rate map revisions. If private insurers are ever to be drawn to write flood insurance, rates charged by the NFIP must at least be sufficient to meet actuarial requirements.

The law also projects to raise nearly $800 million over the next decade through the assessment of additional charges that are to be used to capitalize a reserve fund. While private insurers' rates are designed to build a capital surplus, with the risks of catastrophic losses typically ceded risks to reinsurers, NFIP historically has operated strictly on a cash-flow basis, borrowing money to cover expenses in years of extreme loss.

Finally, and most importantly, the law grants FEMA statutory authority to explore the use of private reinsurance and alternative risk transfer mechanisms such as catastrophe bonds to limit its exposure to catastrophic flood events. The development of an active reinsurance market for U.S. flood risks is absolutely the most crucial step, if privatization is ever to become a reality, and we would urge FIO to advocate that FEMA move forward with such plans as soon as feasible.

Respectfully submitted,

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