

State-Backed Insurance Schemes

The Role of Insurers

**Insurance Institute of London
London Institute Centenary Lecture
London, UK**



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Presentation Outline

- **Historical Role of the State in (Re) Insurance Markets**
- **The Case of Terrorism**
- **The Case of Natural Disaster Risk**
- **Public Policy Remedies: Recent Trends & Developments in the United States**
- **The Case of ‘*Florida Re*’**
- **Could ‘*United States Re*’ be Far Behind?**
- **Outlook for State-Backed Insurance Schemes**
- **Summary**
- **Q&A**

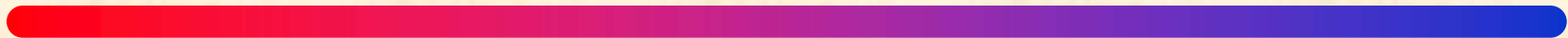


Historical Role of the State in Insurance Markets

- 1. Solvency**
- 2. Rate and Form Regulation**
- 3. Consumer Protection**
- 4. (Re) Insurer of Last (or Only) Resort**
- 5. *(Re) Insurer of First Resort***

SOLVENCY REGULATION

*Government Wants to Insure
CATs, but How Well Do They
Regulate that Risk Now?*

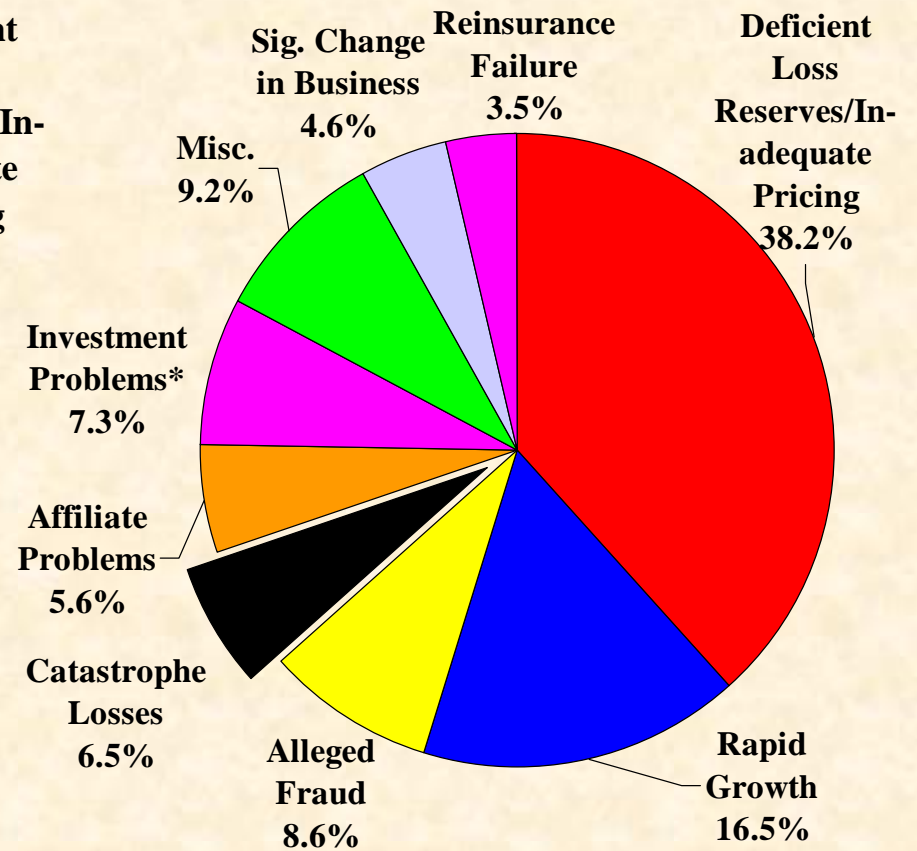
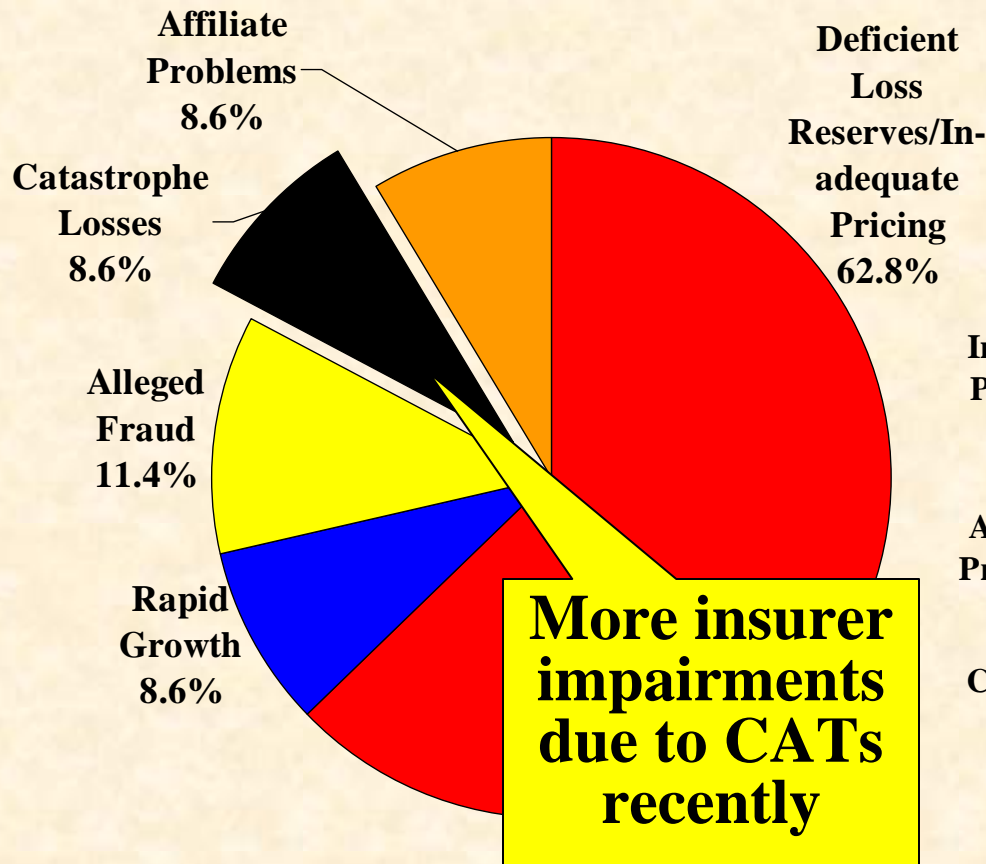




Reasons for US P/C Insurer Impairments, 1969-2005

2003-2005

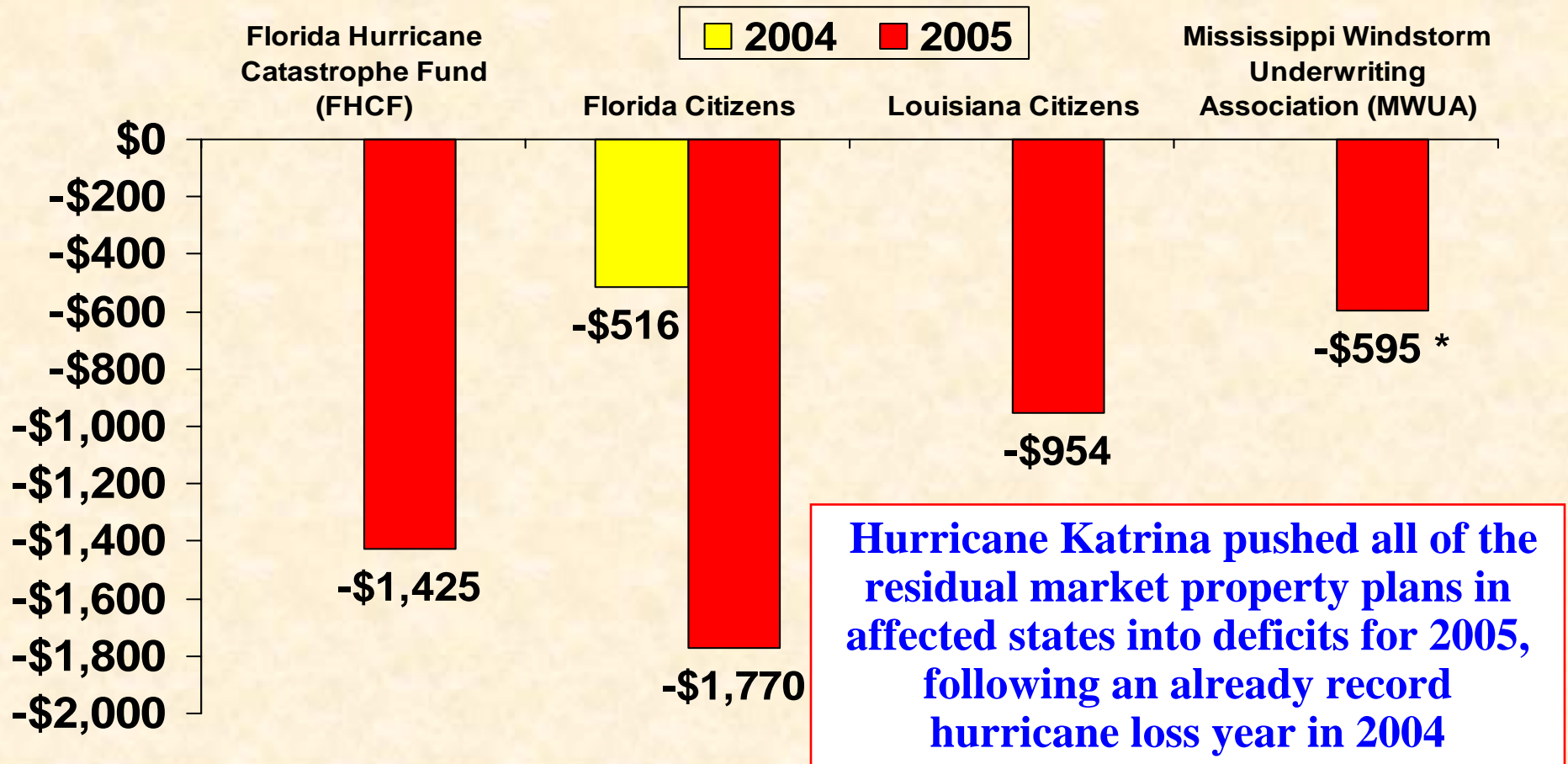
1969-2005



*Includes overstatement of assets.



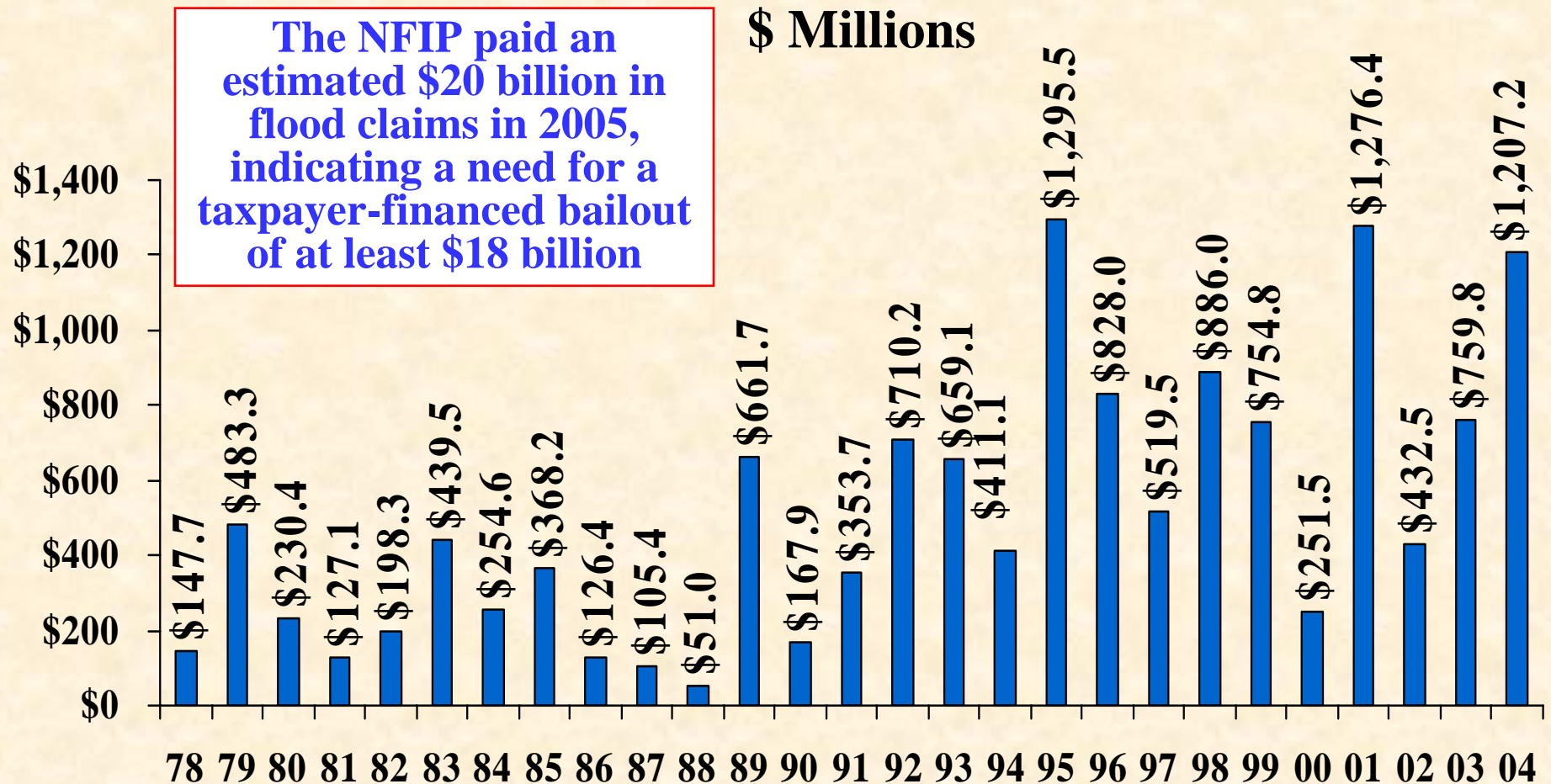
Major Residual Market Plan Estimated Deficits 2004/2005 (Millions of Dollars)



* MWUA est. deficit for 2005 comprises \$545m in assessments plus \$50m in Federal Aid.
Source: Insurance Information Institute



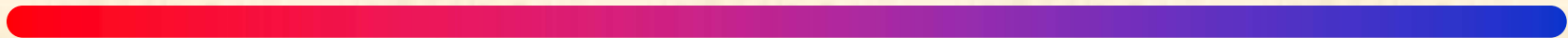
NFIP: Loss Dollars Paid by Calendar Year 1978-2004



Source: FEMA, National Flood Insurance Program (NFIP)

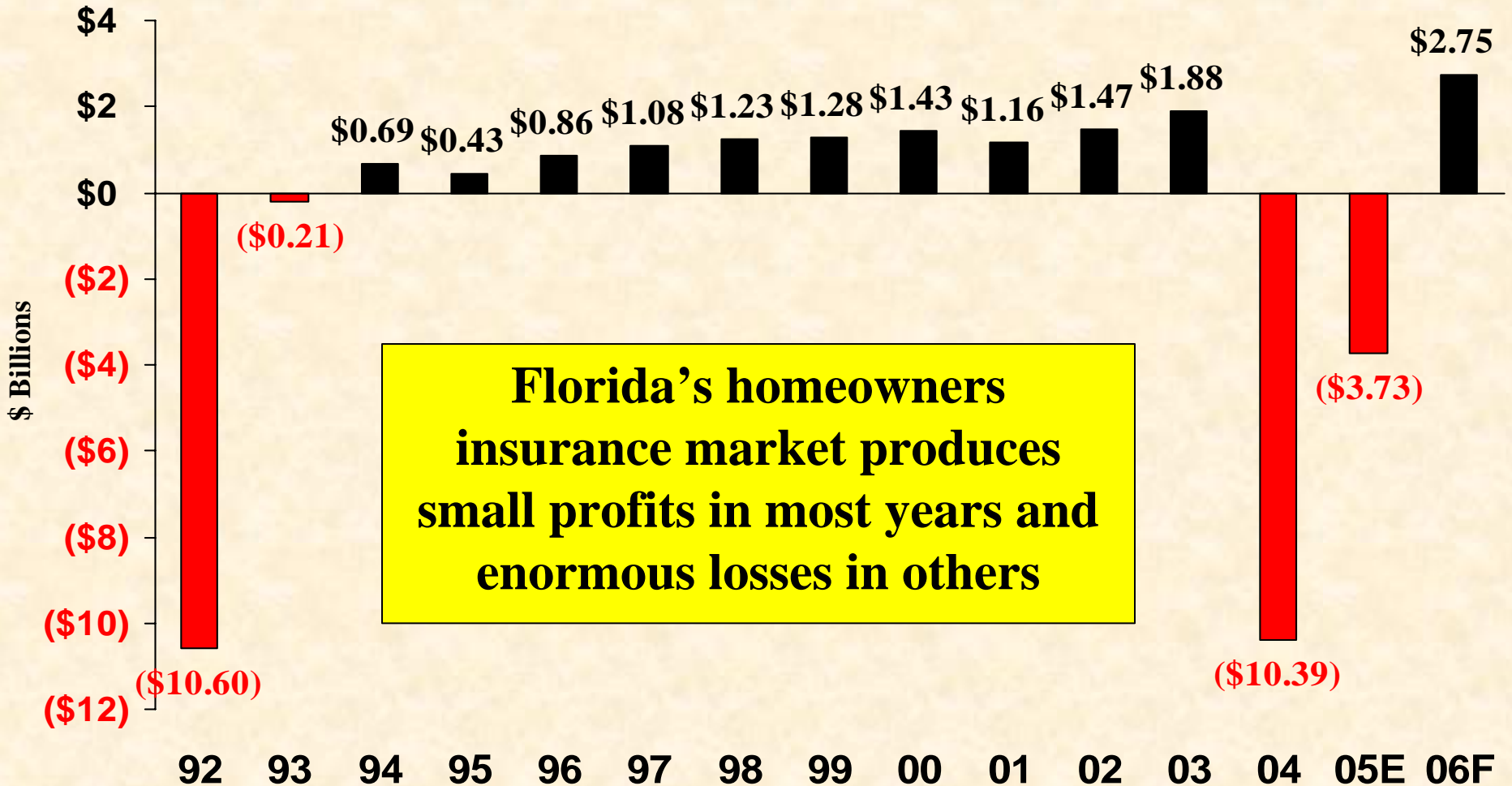
RATE REGULATION

*Government Wants to Insure
CATs, but Do They Know What
to Charge?*





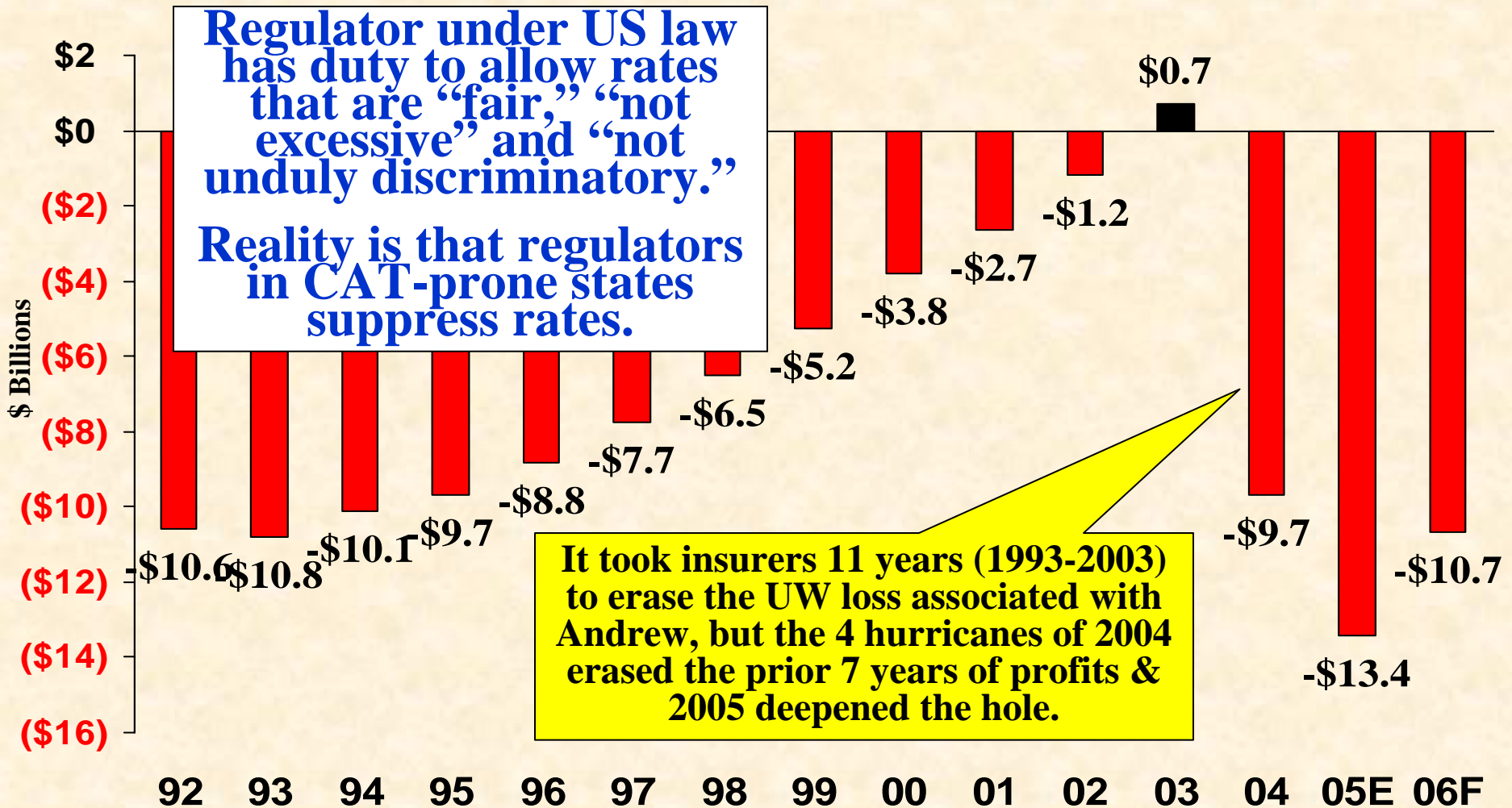
Underwriting Gain (Loss) in Florida Homeowners Insurance, 1992-2006E*



*2005 estimate by Insurance Information Institute based on historical loss and expense data for FL adjusted for estimated 2005 residential windstorm losses of \$7.35B. 2006 estimate from Ins. Info. Inst.



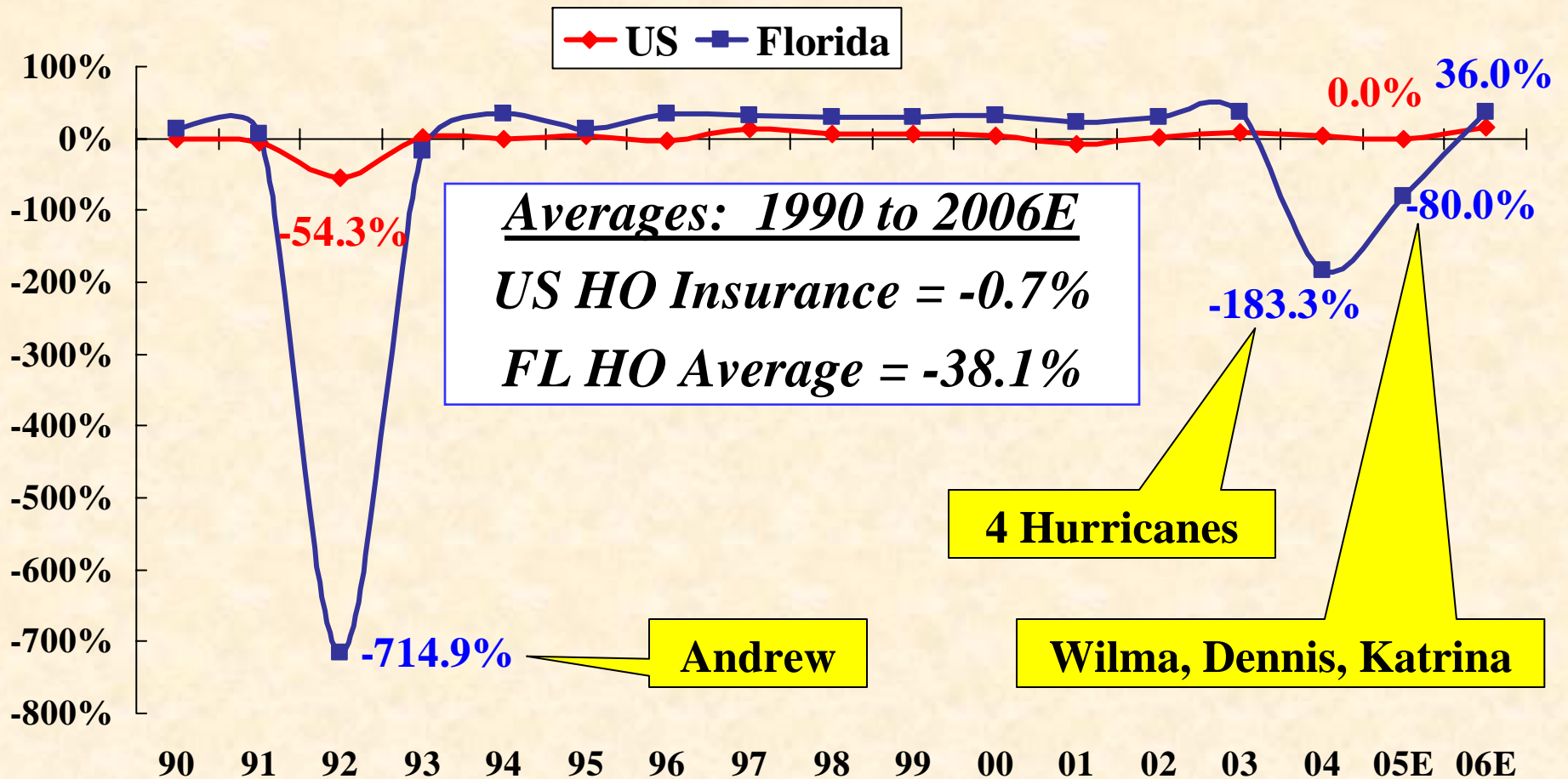
Cumulative Underwriting Gain (Loss) in Florida Homeowners Insurance, 1992-2006E*



*2005 estimate by Insurance Information Institute based on historical loss and expense data for FL adjusted for estimated 2005 residential windstorm losses of \$7.35B. 2006 estimate from Ins. Info. Inst.



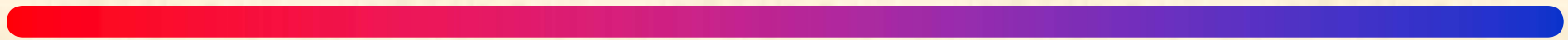
Rates of Return on Net Worth for Homeowners Ins: US vs. Florida



Source: NAIC; 2005/6 US and FL estimates from the Insurance Information Institute.

RATIONALE FOR GREATER GOVERNMENT INVOLVEMENT

*Insurability, Magnitude of Loss,
Price, Availability*





Commonly Cited Rationale for Greater State Role in Insurance

1. Insurability

- Questions of insurability of some risks

2. Magnitude of Loss (Severity)

- Losses so large only the state can manage?

3. Price

- Concerns over price charged by private (re)insurers

4. Availability

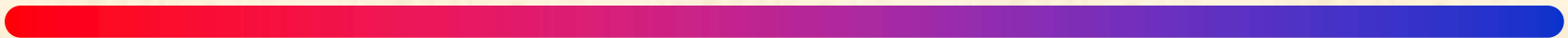
- Concerns over availability at “affordable” prices (or any price at all)

5. Government Participation via Aid

- State already provides economic relief

Terrorism

*The Classic Example for a State
Role in (Re) Insurance Markets*





Cost of Largest Terrorist Attacks (Millions of 2006 Dollars)



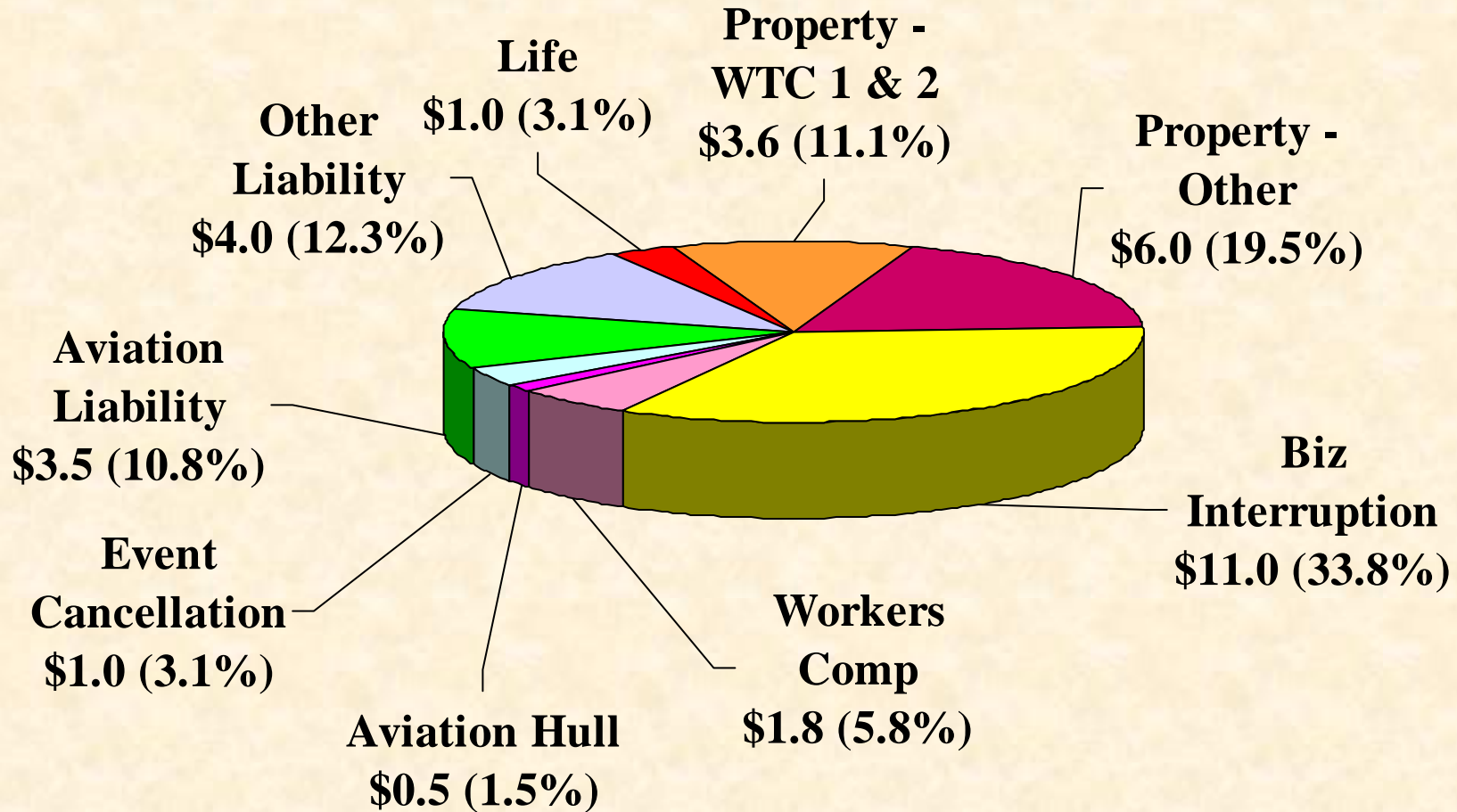
Source: Insurance Information Institute research, GAO.

*Clean-Up Expenses: \$130M Brentwood Postal; \$80M Trenton Postal; \$27 Hart Senate Office Bldg.



Sept. 11 Industry Loss Estimates

(\$ Billions)



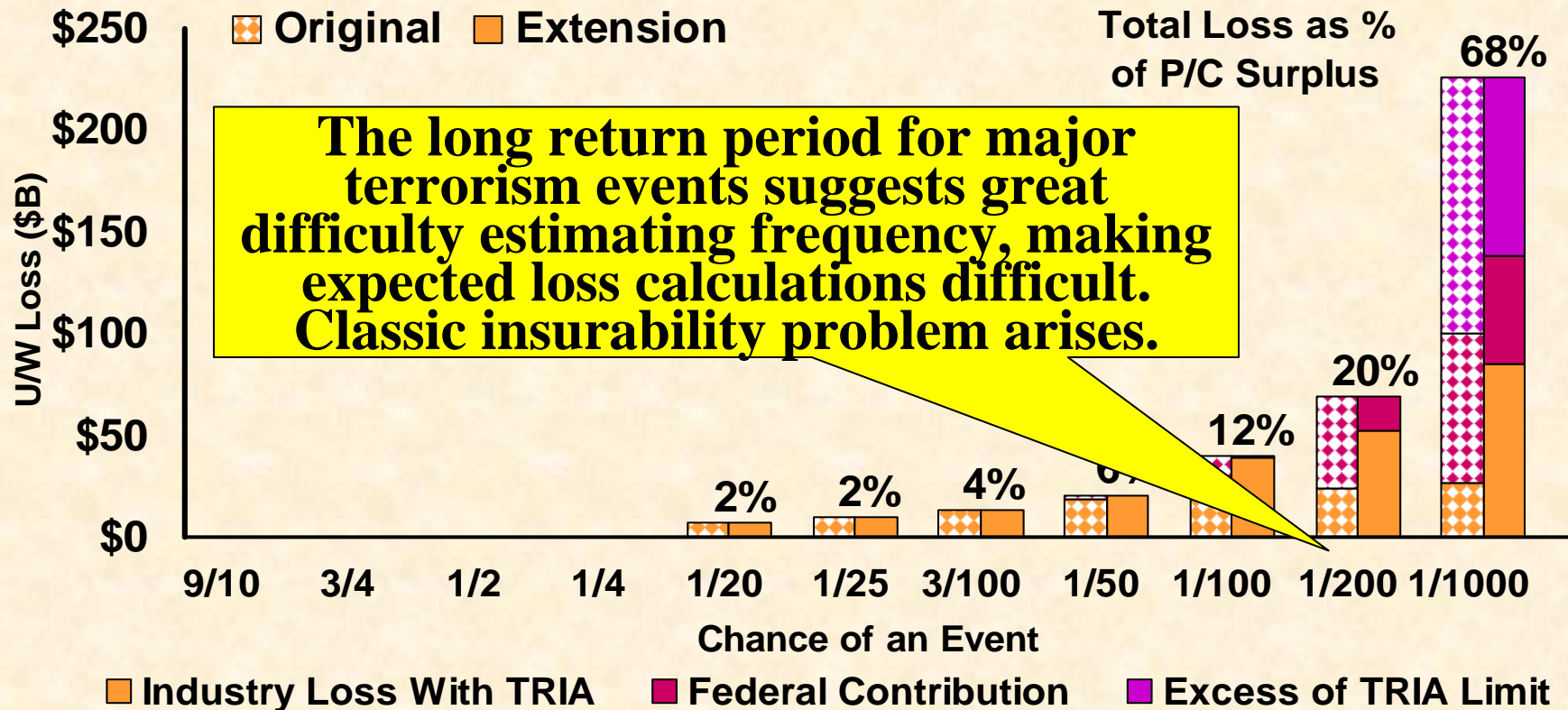
Insured Losses Estimate: \$32.5B

Source: Insurance Information Institute



TRIA's Extension Modified Industry Retention Limits, but Remains Vital

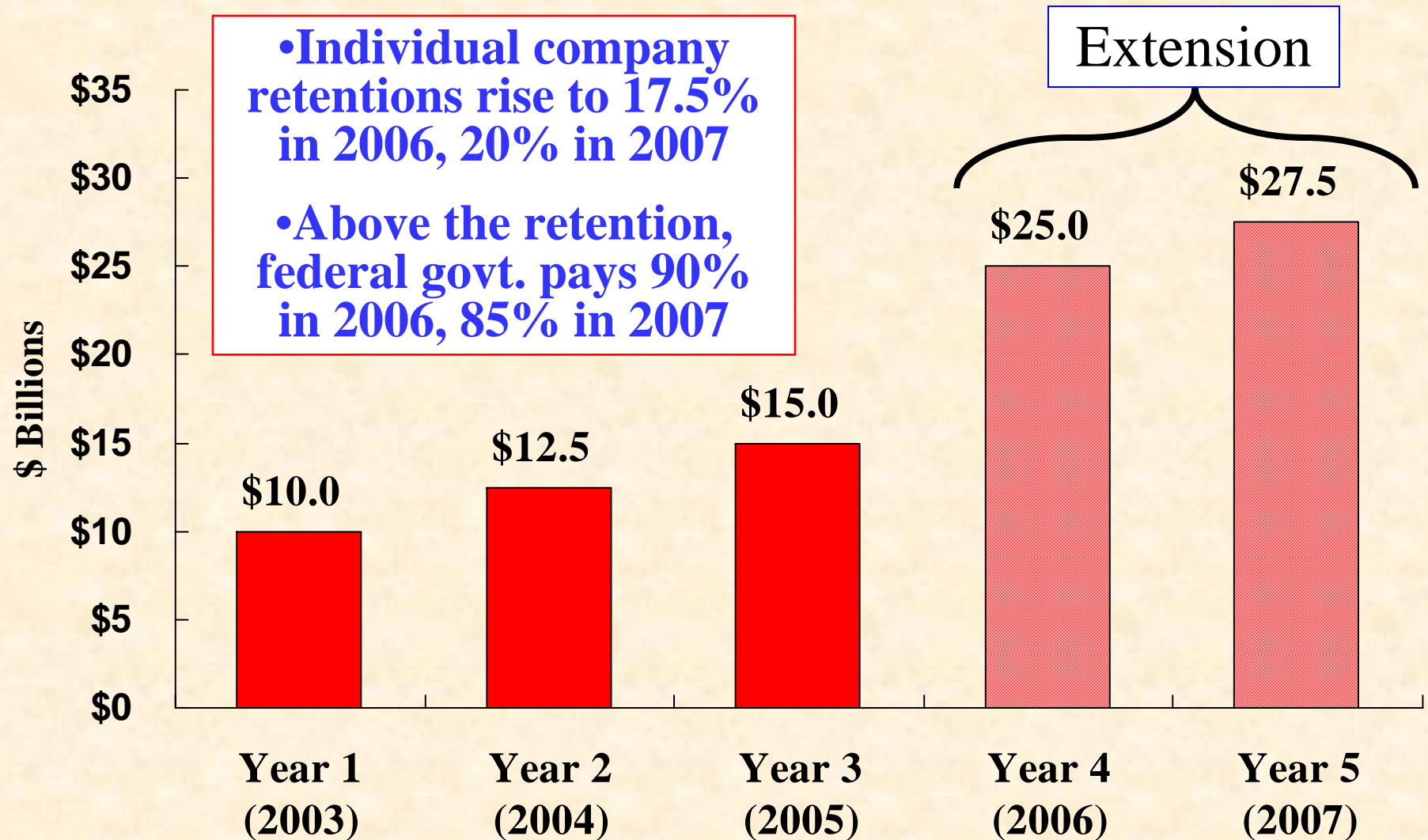
Allocation of P/C Underwriting Loss—Original vs. Extension





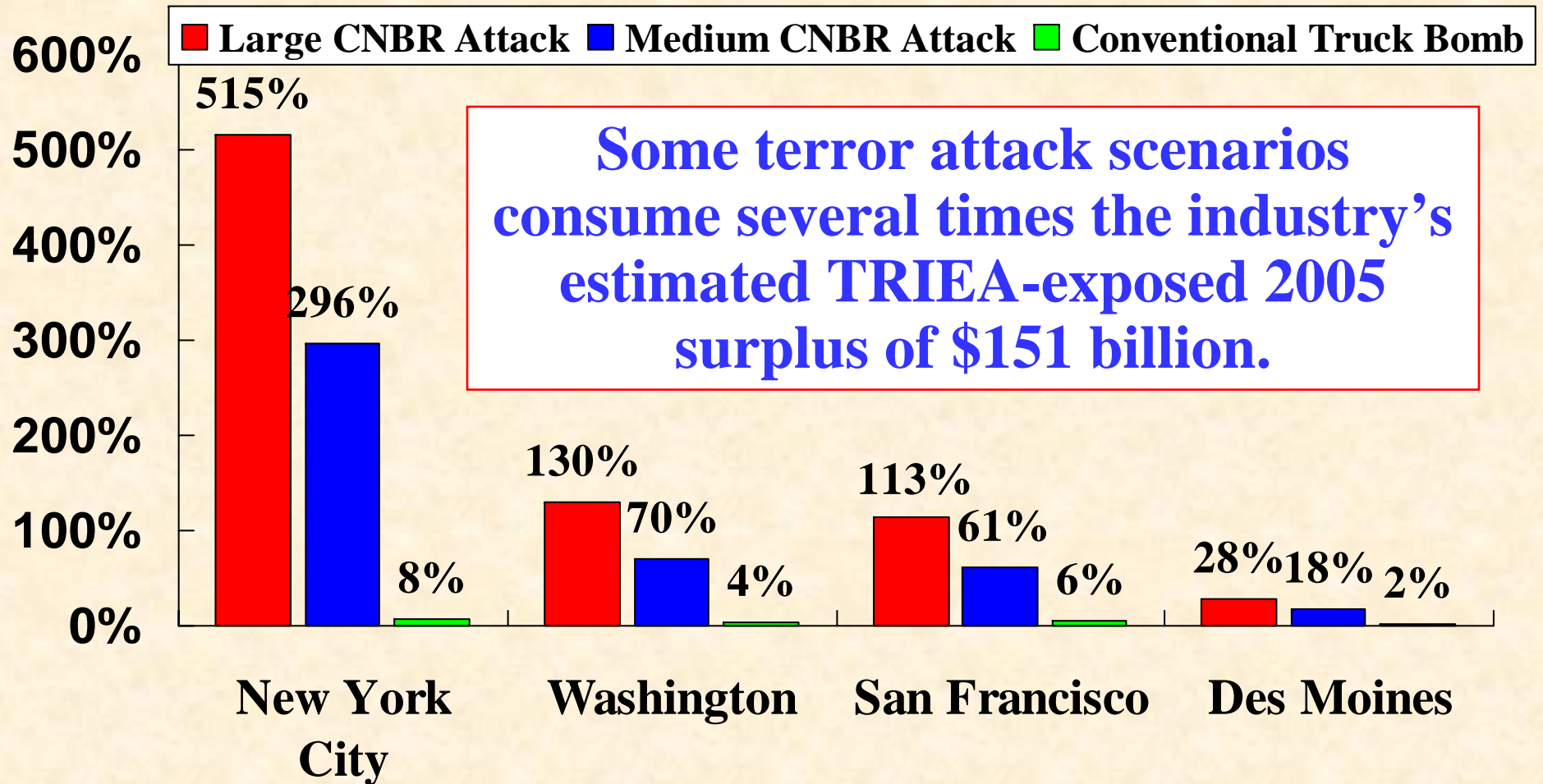
Insurance Industry Retention

Under TRIA (\$ Billions)





*Insured Terrorism Loss as a % of TRIEA-Exposure Industry Surplus**



*Insurance Information Institute preliminary estimate of 2006 TRIEA-exposed surplus of \$151 billion.

Source: Insurance Information Institute preliminary estimate of TRIEA exposed p/c insurance industry surplus and calculations using American Academy of Actuaries modeled scenarios, Response to President's Working Group, Appendix II, April 26, 2006.

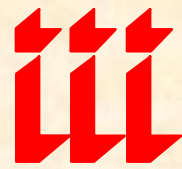


Insured Loss Estimates:

Large CNBR Terrorist Attack (\$ Bill)

Type of Coverage	New York	Washington	San Francisco	Des Moines
Group Life	\$82.0	\$22.5	\$21.5	\$3.4
General Liability	14.4	2.9	3.2	0.4
Workers Comp	483.7	126.7	87.5	31.4
Residential Prop.	38.7	12.7	22.6	2.6
Commercial Prop.	158.3	31.5	35.5	4.1
Auto	1.0	0.6	0.8	0.4
TOTAL	\$778.1	\$196.8	\$171.2	\$42.3

Source: American Academy of Actuaries, Response to President's Working Group, Appendix II, April 26, 2006.



Insured Loss Estimates:

Medium CNBR Terrorist Attack (\$ Bill)

Type of Coverage	New York	Washington	San Francisco	Des Moines
Group Life	\$37.7	\$22.5	\$21.5	\$3.4
General Liability	7.3	2.9	3.2	0.4
Workers Comp	313.2	126.7	87.5	31.4
Residential Prop.	10.3	12.7	22.6	2.6
Commercial Prop.	77.8	31.5	35.5	4.1
Auto	0.2	0.6	0.8	0.4
TOTAL	\$446.5	\$106.2	\$92.2	\$27.3

Source: American Academy of Actuaries, Response to President's Working Group, Appendix II, April 26, 2006.



Insured Loss Estimates: Truck Bomb Terrorist Attack (\$ Bill)

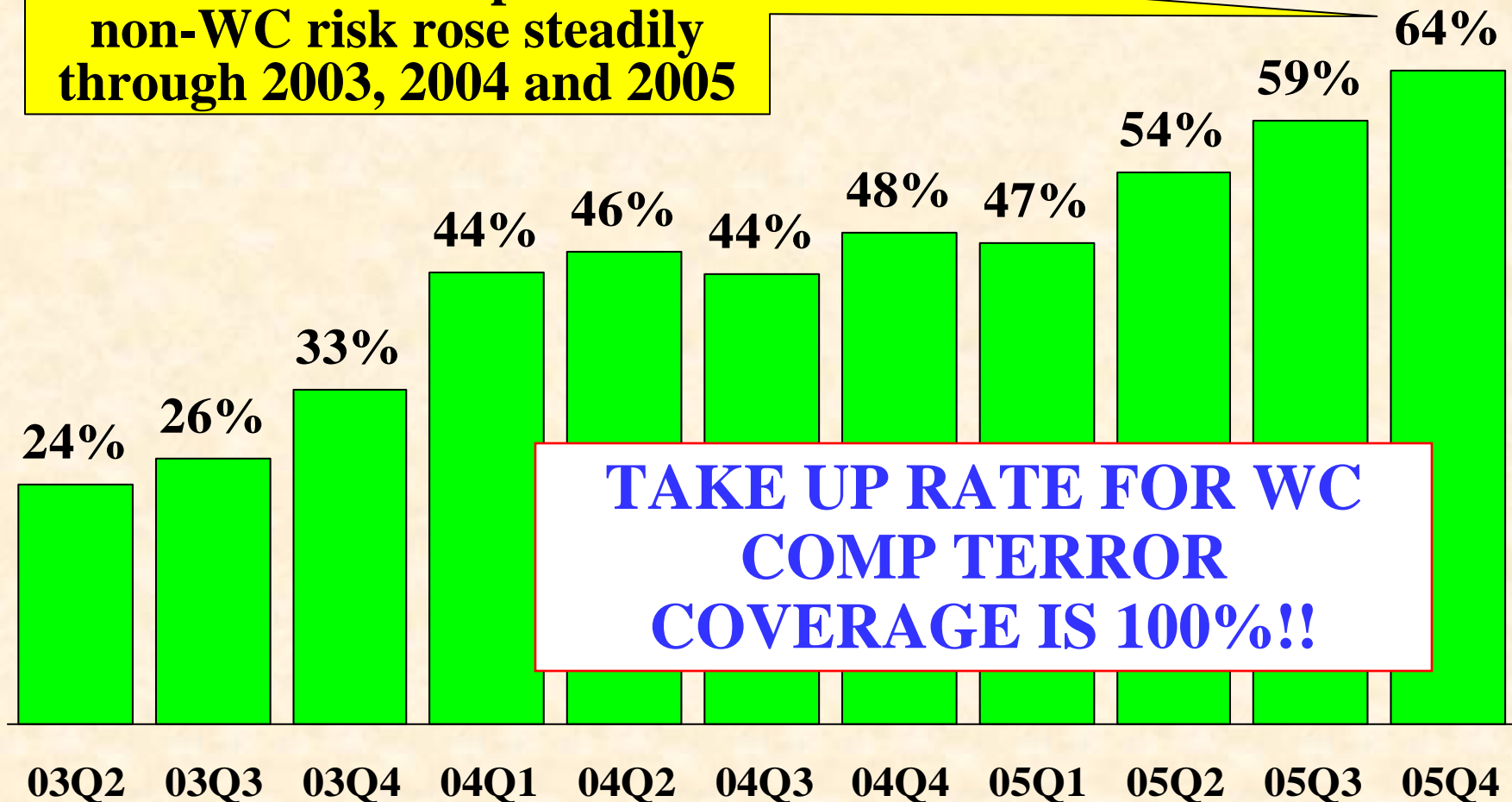
Type of Coverage	New York	Washington	San Francisco	Des Moines
Group Life	\$0.3	\$0.2	\$0.3	\$0.1
General Liability	1.2	0.4	0.7	0.2
Workers Comp	3.5	2.8	3.9	1.5
Residential Prop.	0.0	0.0	0.0	0.0
Commercial Prop.	6.8	2.1	3.9	1.2
Auto	0.0	0.0	0.0	0.0
TOTAL	\$11.8	\$5.5	\$8.8	\$3.0

Source: American Academy of Actuaries, Response to President's Working Group, Appendix II, April 26, 2006.



Terrorism Coverage Take-Up Rate Continues to Rise

Terrorism take-up rate for non-WC risk rose steadily through 2003, 2004 and 2005





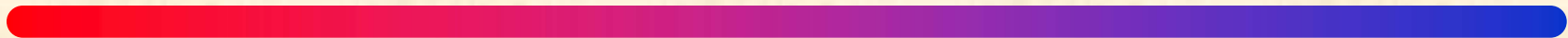
Outlook for Terrorism

Risk Insurance

- **Democratic Control in Congress Implies Less Resistance to Government Involvement in Insurance Markets**
- **Many key Democrats are from terrorism exposed states: NY, MA, CA**
- **Senate Banking Cmte. chaired by Christopher Dodd (D-CT); House Financial Services Cmte. by Barney Frank (D-MA)**
- **Hearings Held Feb. 28 (DC) and March 5 (NYC) Indicating Little Opposition**
- **Possible Bill Could Emerge by Late April**
- **May Propose Long-Term Solution: 10-20 yrs.**

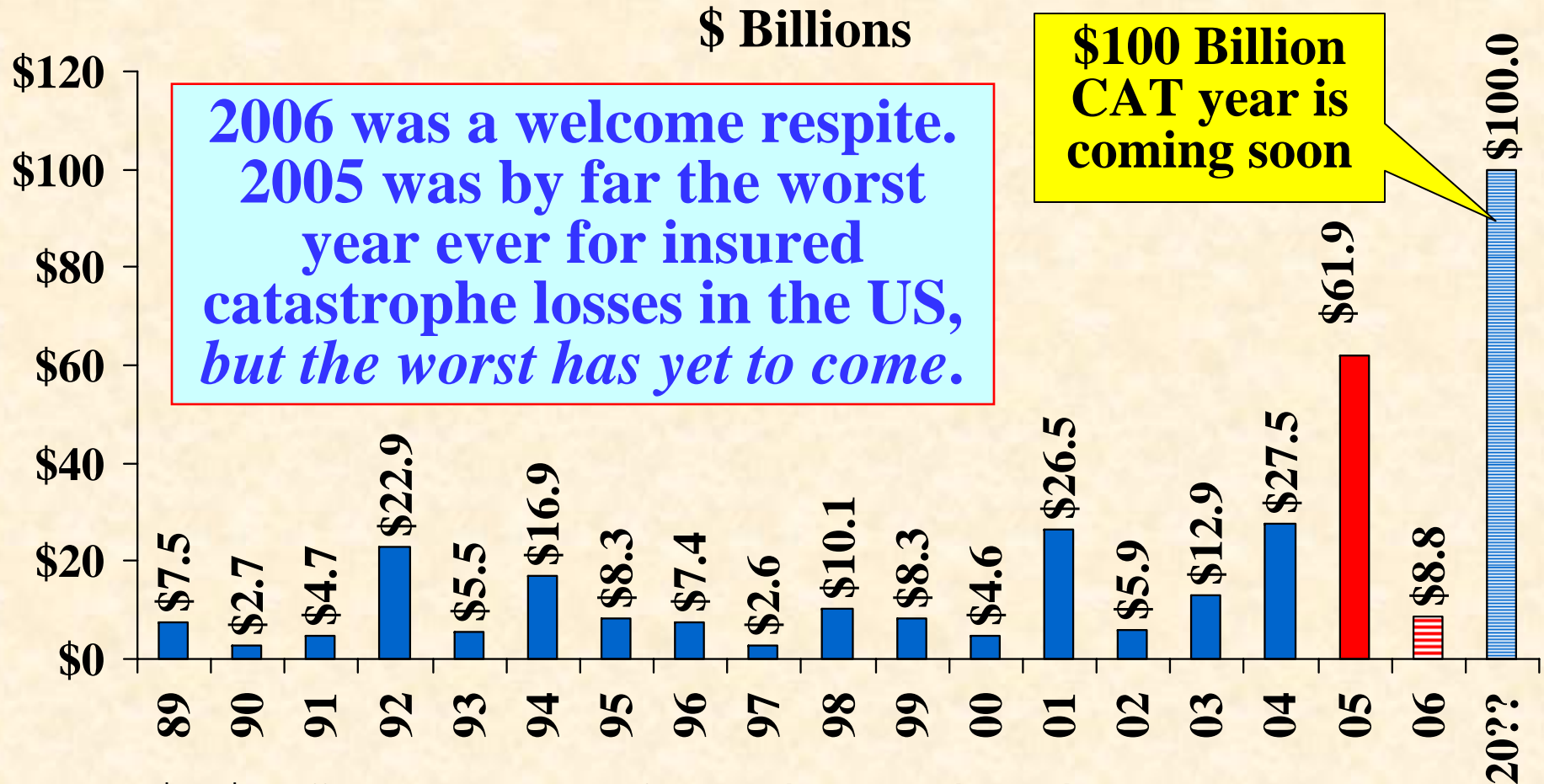
Natural Catastrophes

*View by Some that Government
Must Play a Larger Role*





U.S. Insured Catastrophe Losses*



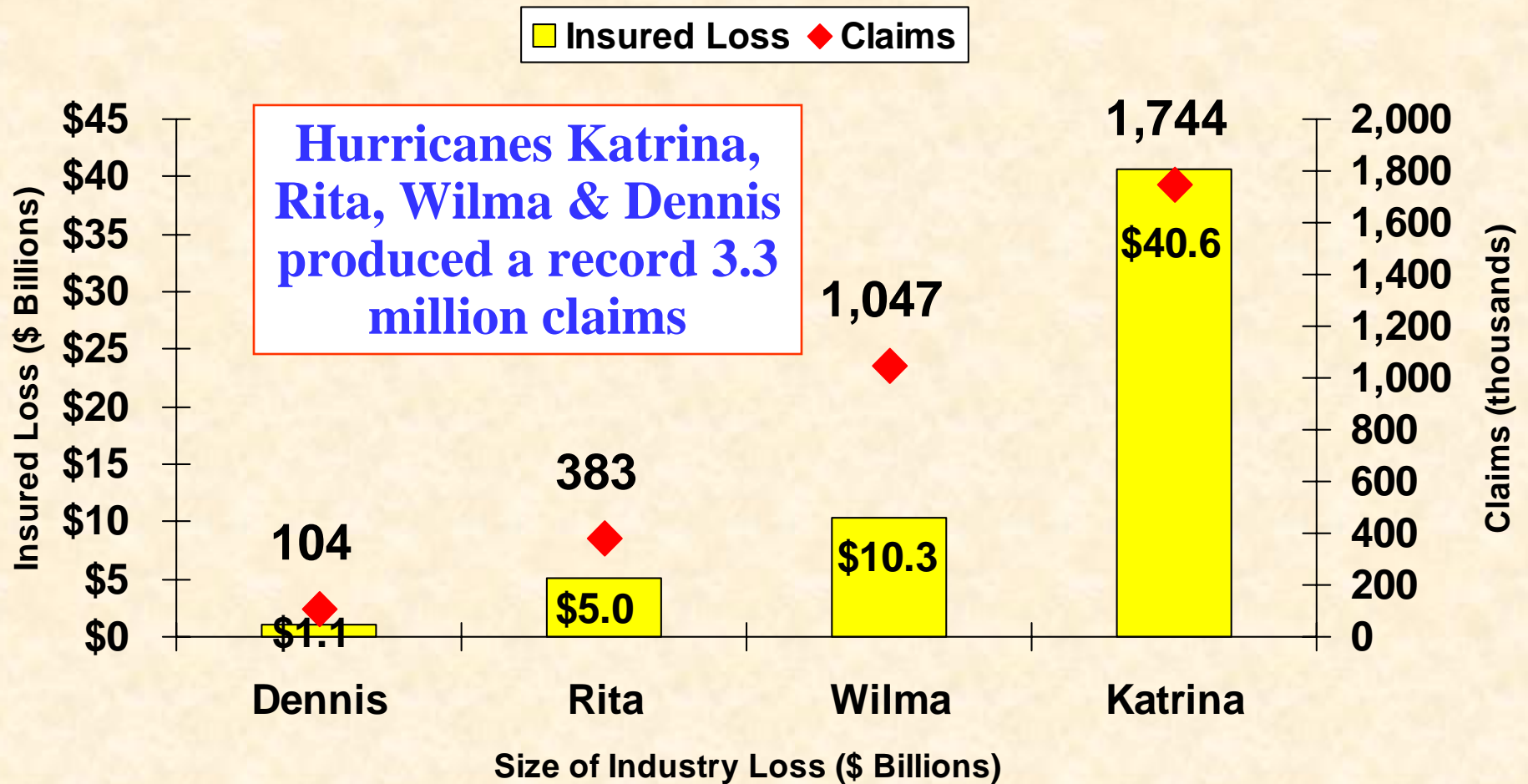
*Excludes \$4B-\$6b offshore energy losses from Hurricanes Katrina & Rita.

Note: 2001 figure includes \$20.3B for 9/11 losses reported through 12/31/01. Includes only business and personal property claims, business interruption and auto claims. Non-prop/BI losses = \$12.2B.

Source: Property Claims Service/ISO; Insurance Information Institute



Insured Loss & Claim Count for Major Storms of 2005*

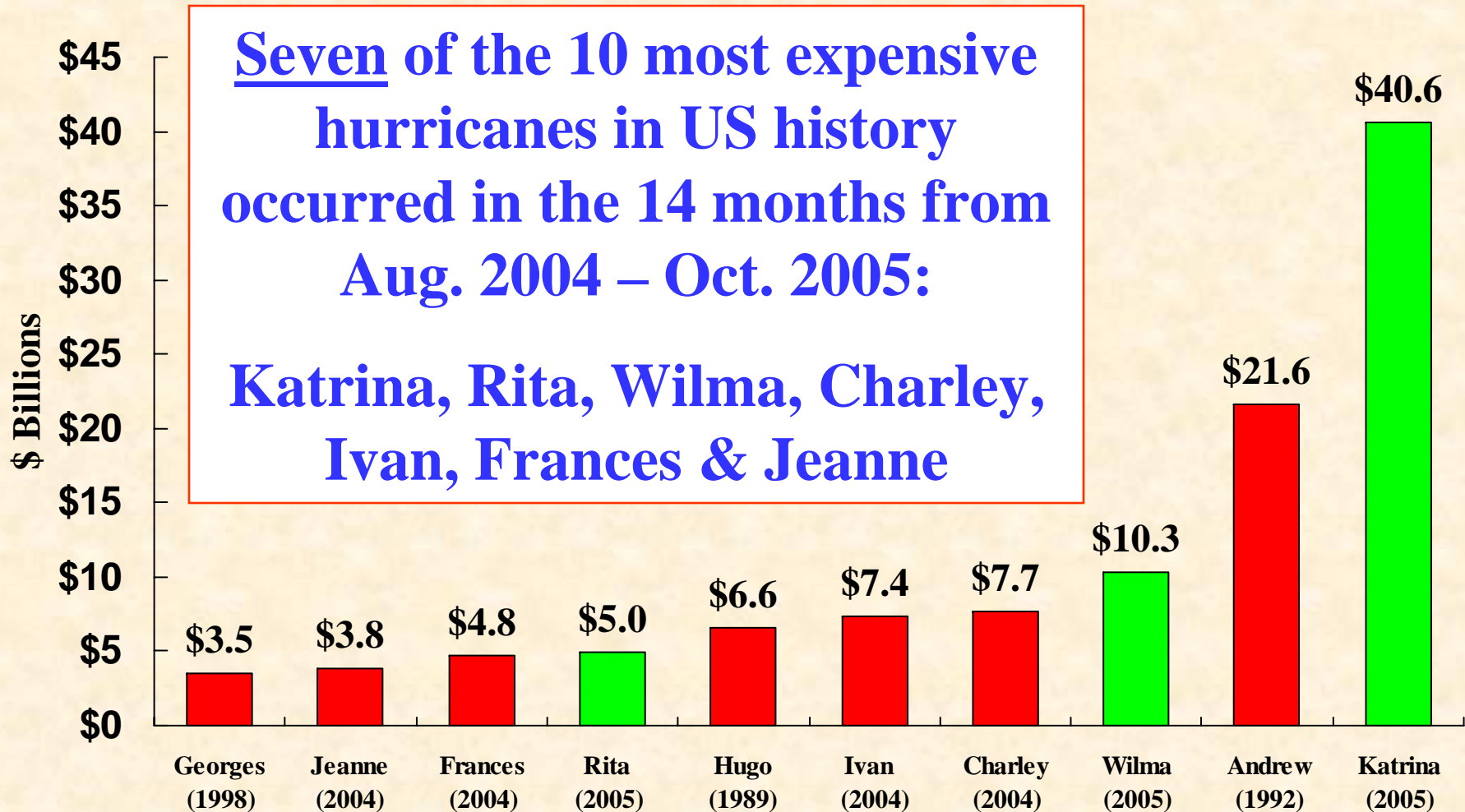


*Property and business interruption losses only. Excludes offshore energy & marine losses.

Source: ISO/PCS as of June 8, 2006; Insurance Information Institute.



Top 10 Most Costly Hurricanes in US History, (Insured Losses, \$2005)

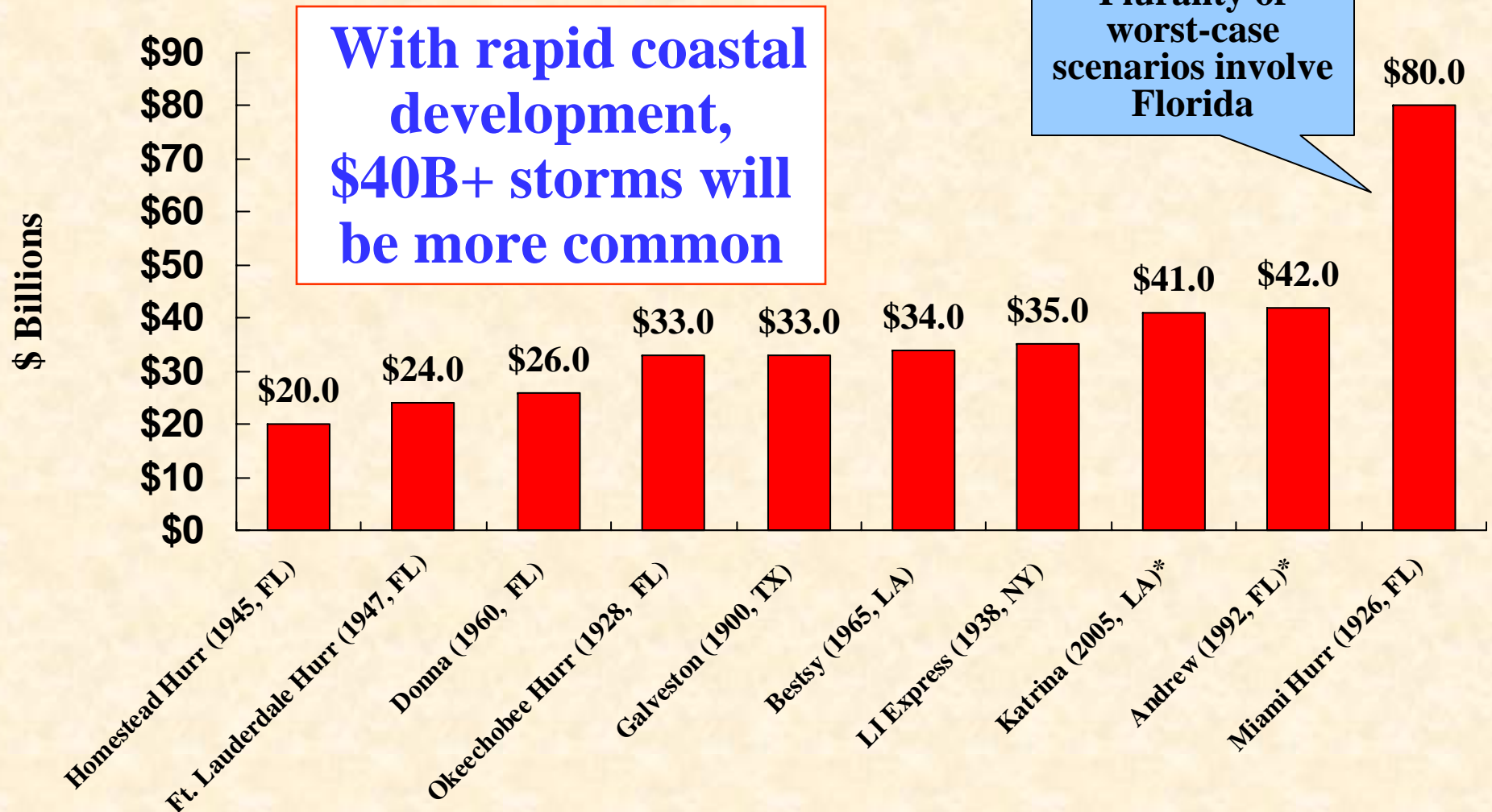


Sources: ISO/PCS; Insurance Information Institute.



Insured Losses from Top 10 Hurricanes Adjusted to 2005 Exposure Levels

(Billions of 2005 Dollars)



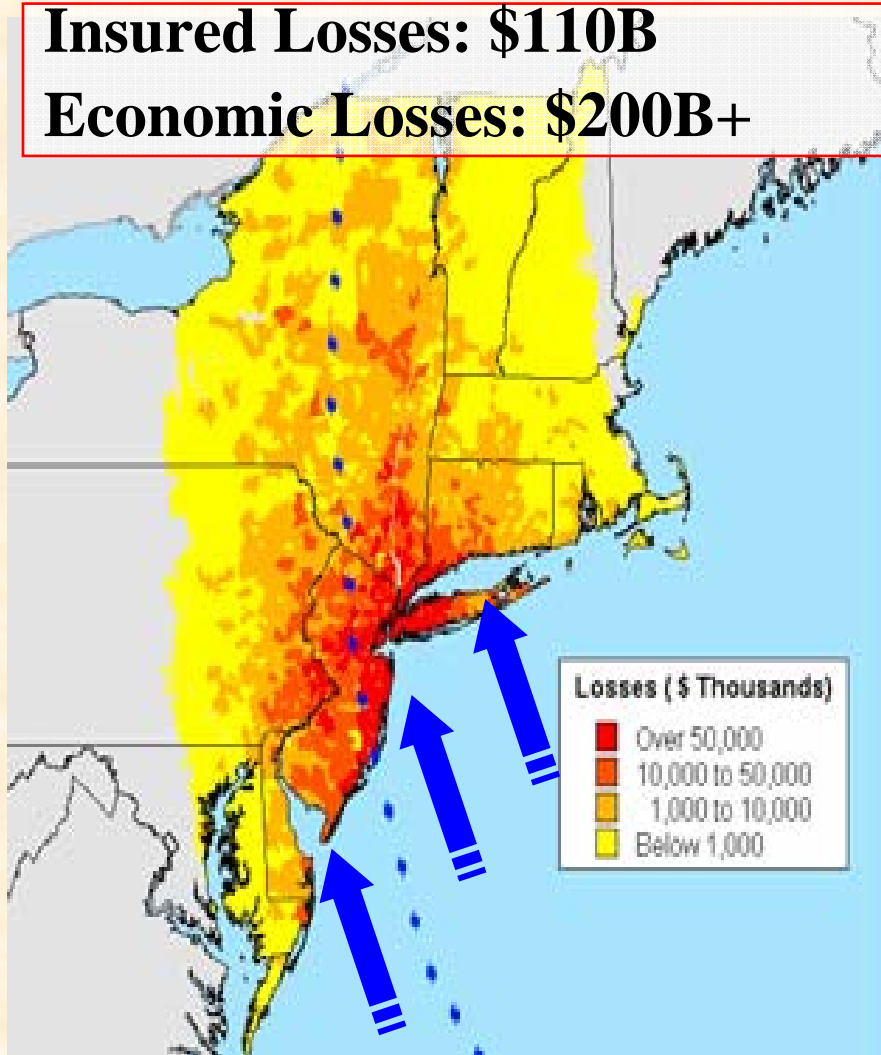
With rapid coastal development, \$40B+ storms will be more common

Plurality of worst-case scenarios involve Florida

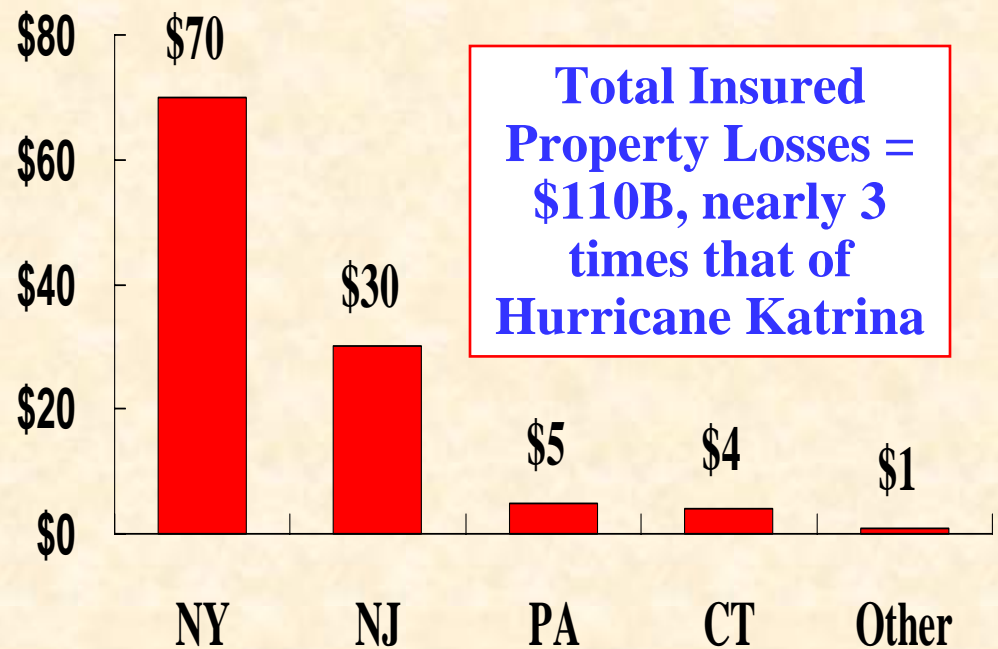


Nightmare Scenario: Insured Property Losses for NJ/NY CAT 3/4 Storm

Insured Losses: \$110B
Economic Losses: \$200B+

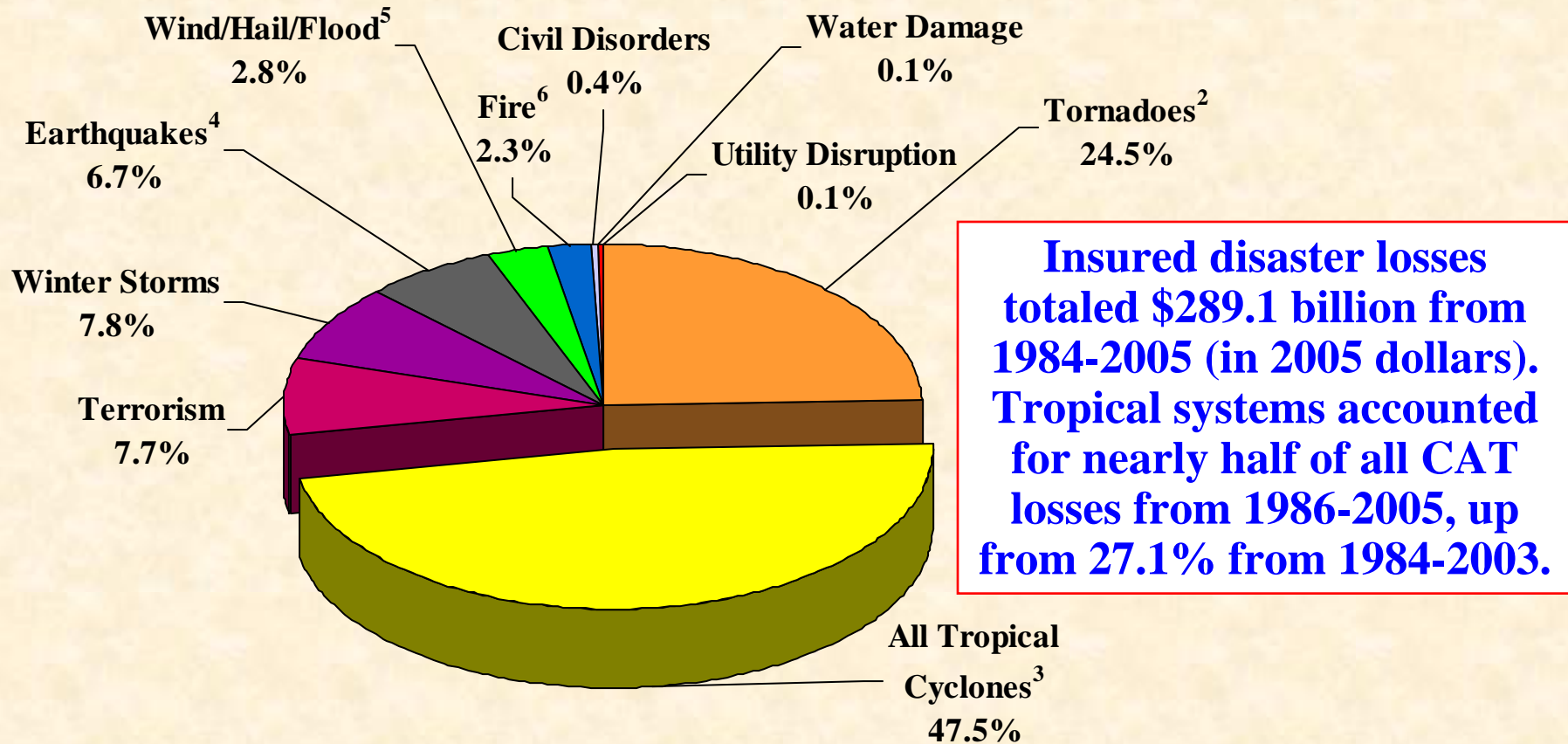


Distribution of Insured Property Losses, by State, (\$ Billions)





Inflation-Adjusted U.S. Insured Catastrophe Losses By Cause of Loss, 1986-2005¹

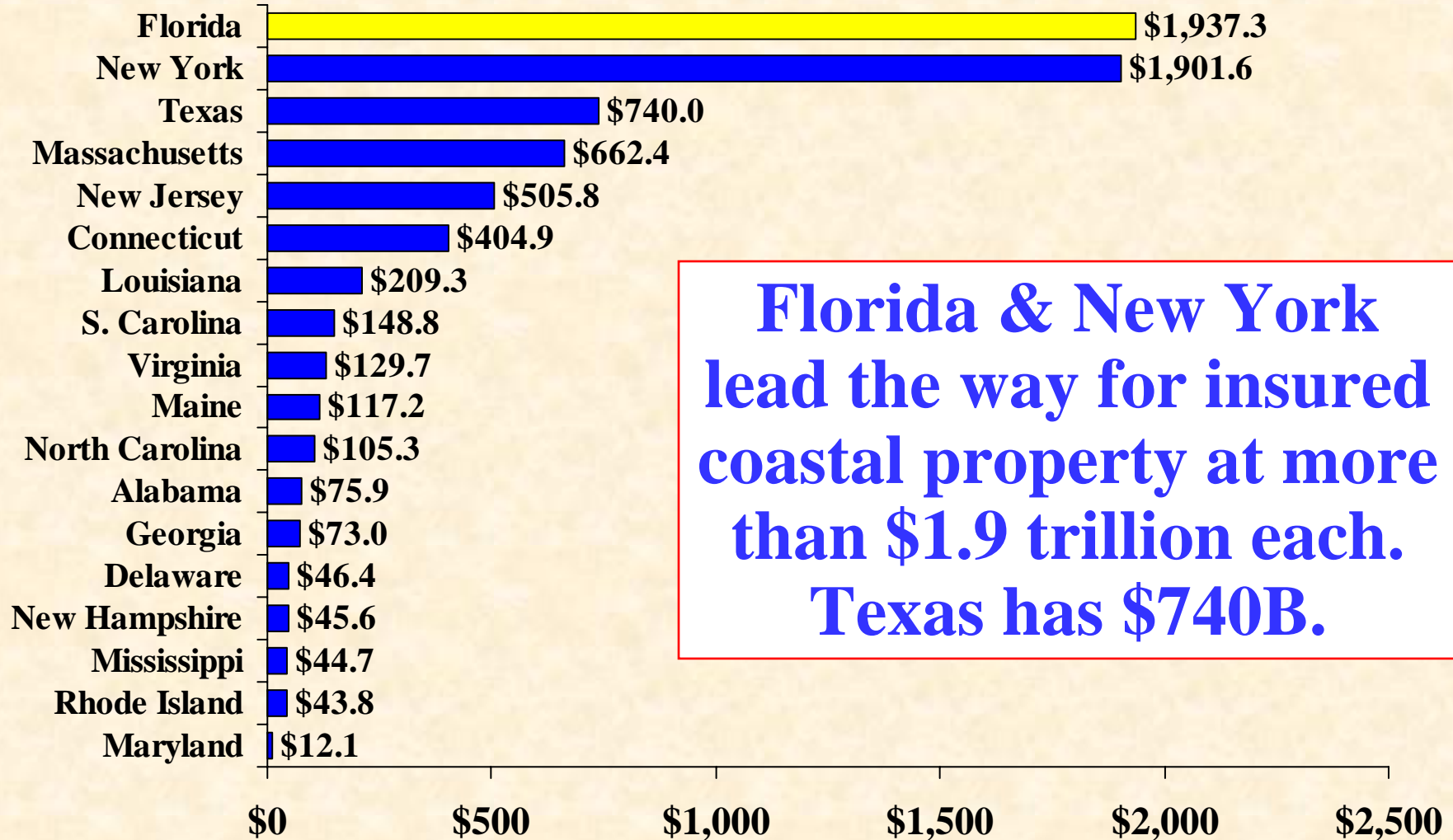


¹ Catastrophes are all events causing direct insured losses to property of \$25 million or more in 2005 dollars. Catastrophe threshold changed from \$5 million to \$25 million beginning in 1997. Adjusted for inflation by the III.

² Excludes snow. ³ Includes hurricanes and tropical storms. ⁴ Includes other geologic events such as volcanic eruptions and other earth movement. ⁵ Does not include flood damage covered by the federally administered National Flood Insurance Program. ⁶ Includes wildland fires.



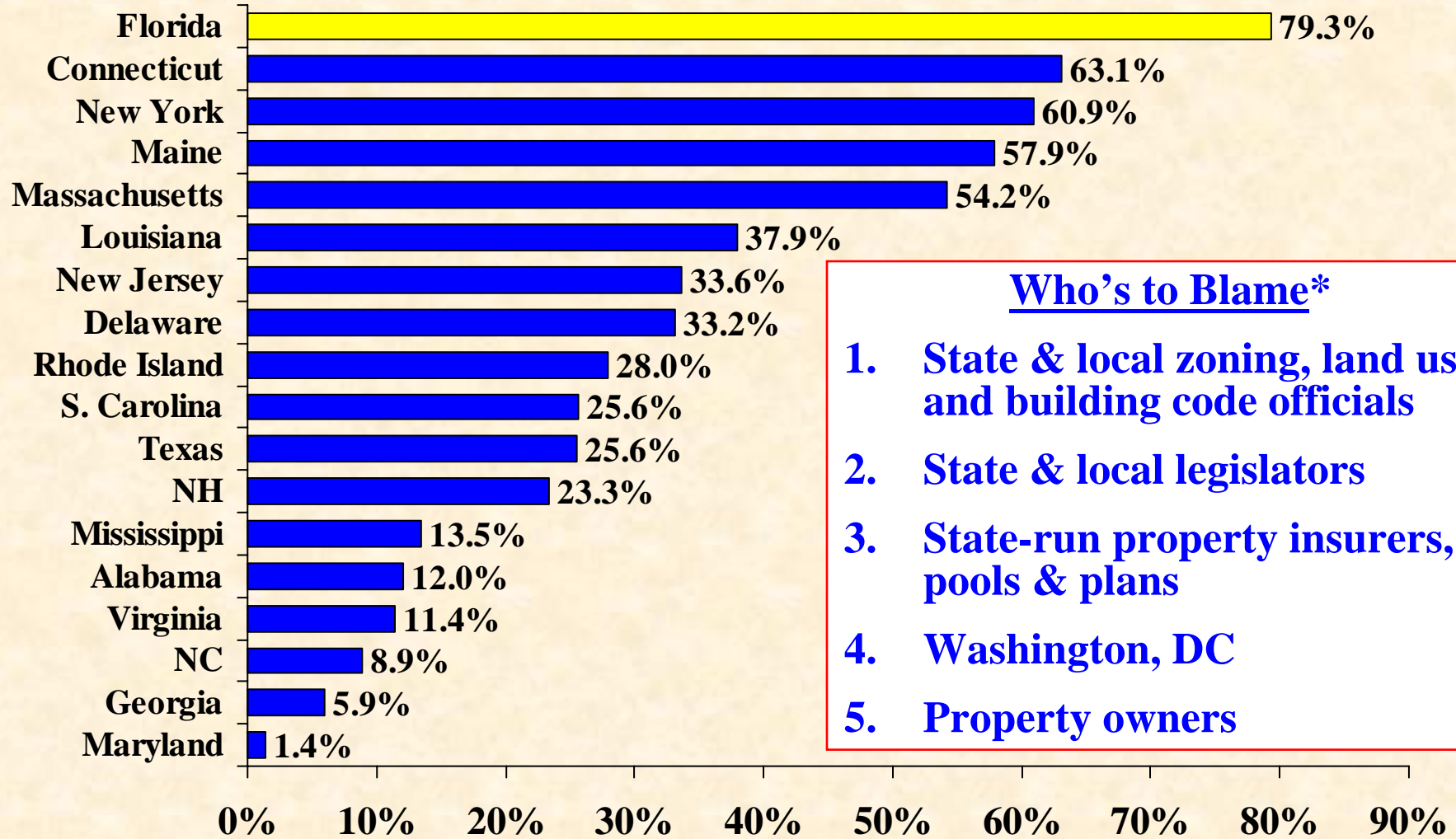
Total Value of Insured Coastal Exposure (2004, \$ Billions)



Source: AIR Worldwide



Insured Coastal Exposure as a % of Statewide Insured Exposure (2004, \$ Billions)



Who's to Blame*

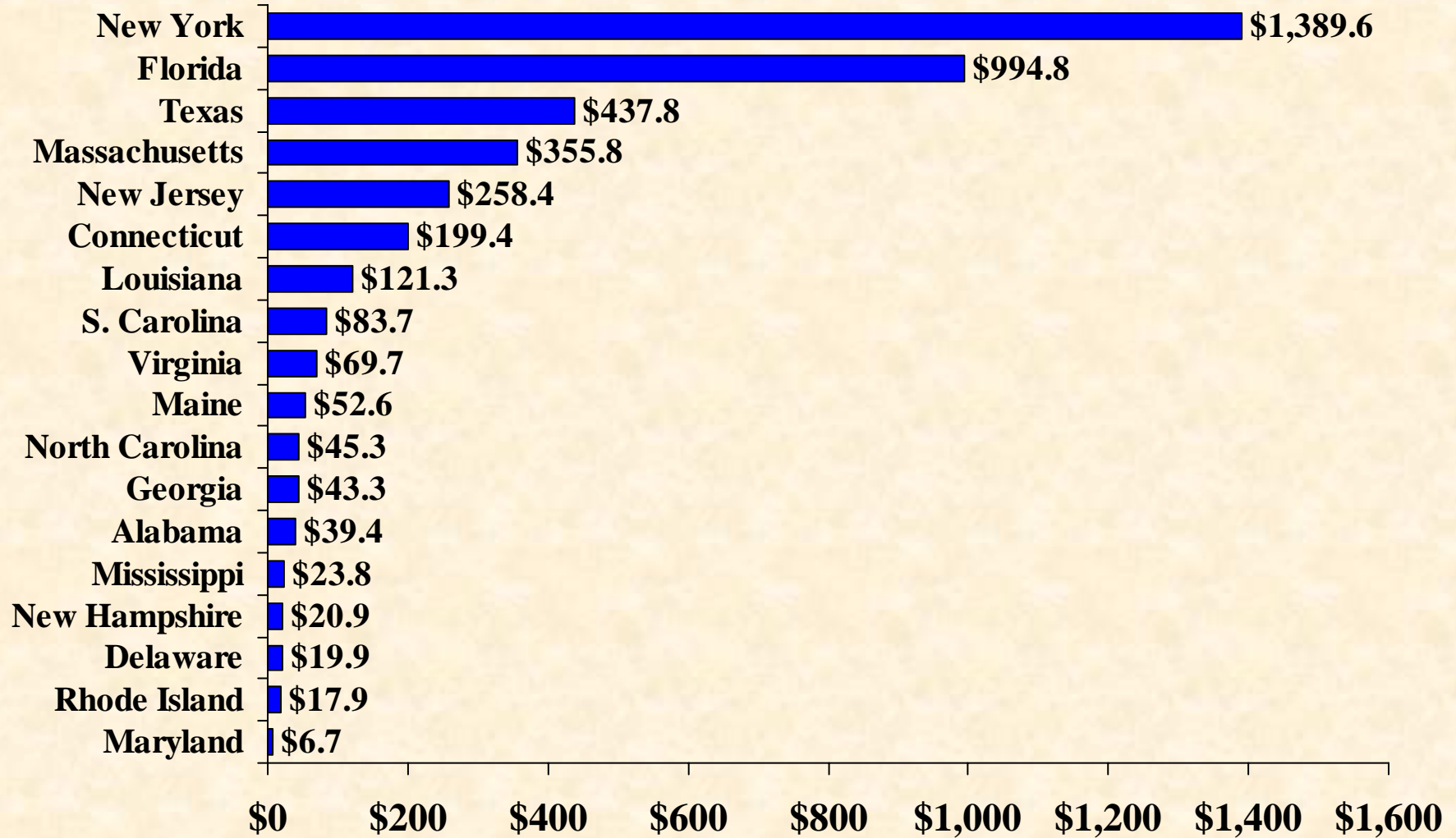
1. State & local zoning, land use and building code officials
2. State & local legislators
3. State-run property insurers, pools & plans
4. Washington, DC
5. Property owners

*Ill list

Source: AIR Worldwide



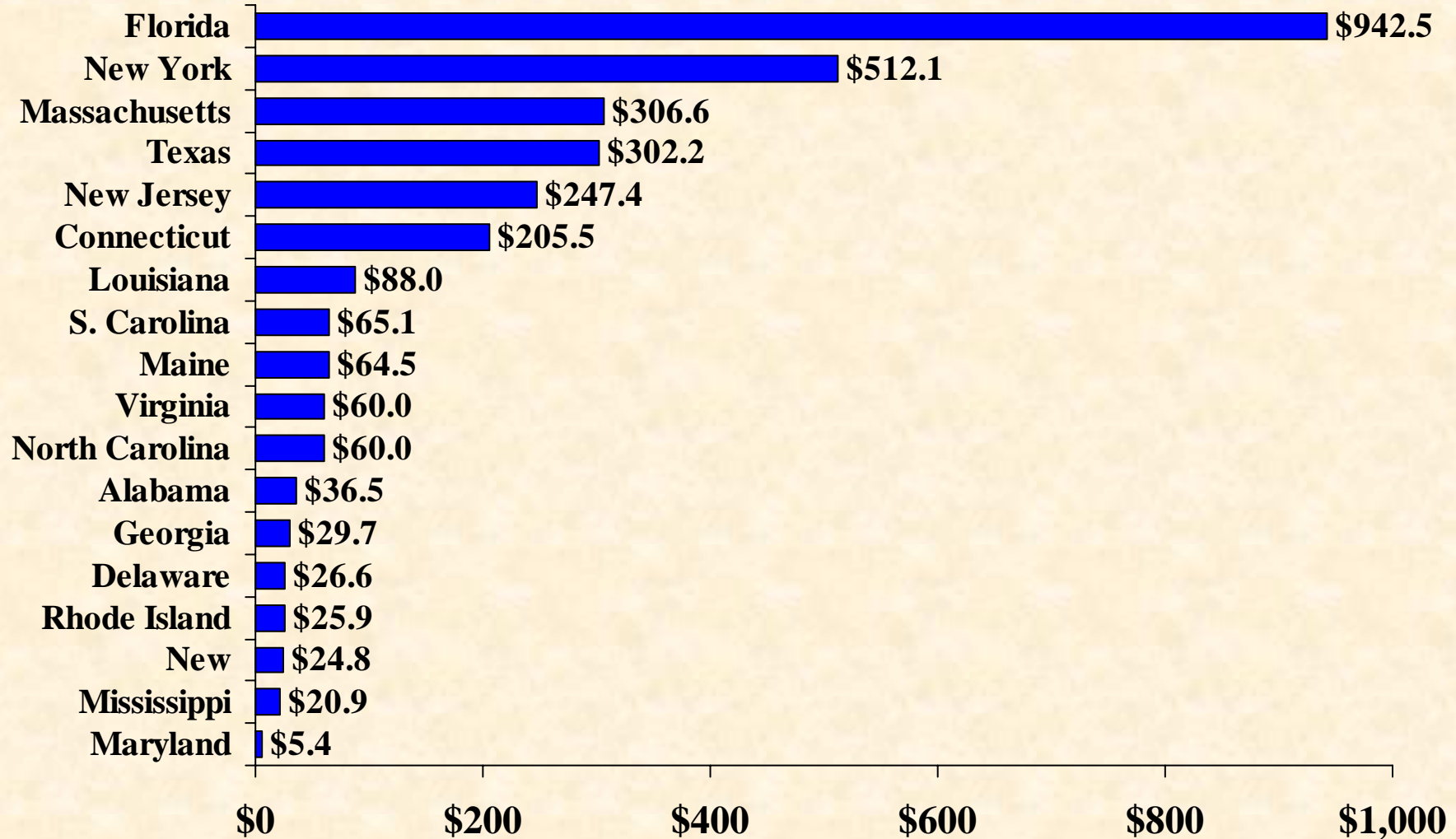
Value of Insured Commercial Coastal Exposure (2004, \$ Billions)



Source: AIR



Value of Insured Residential Coastal Exposure (2004, \$ Billions)

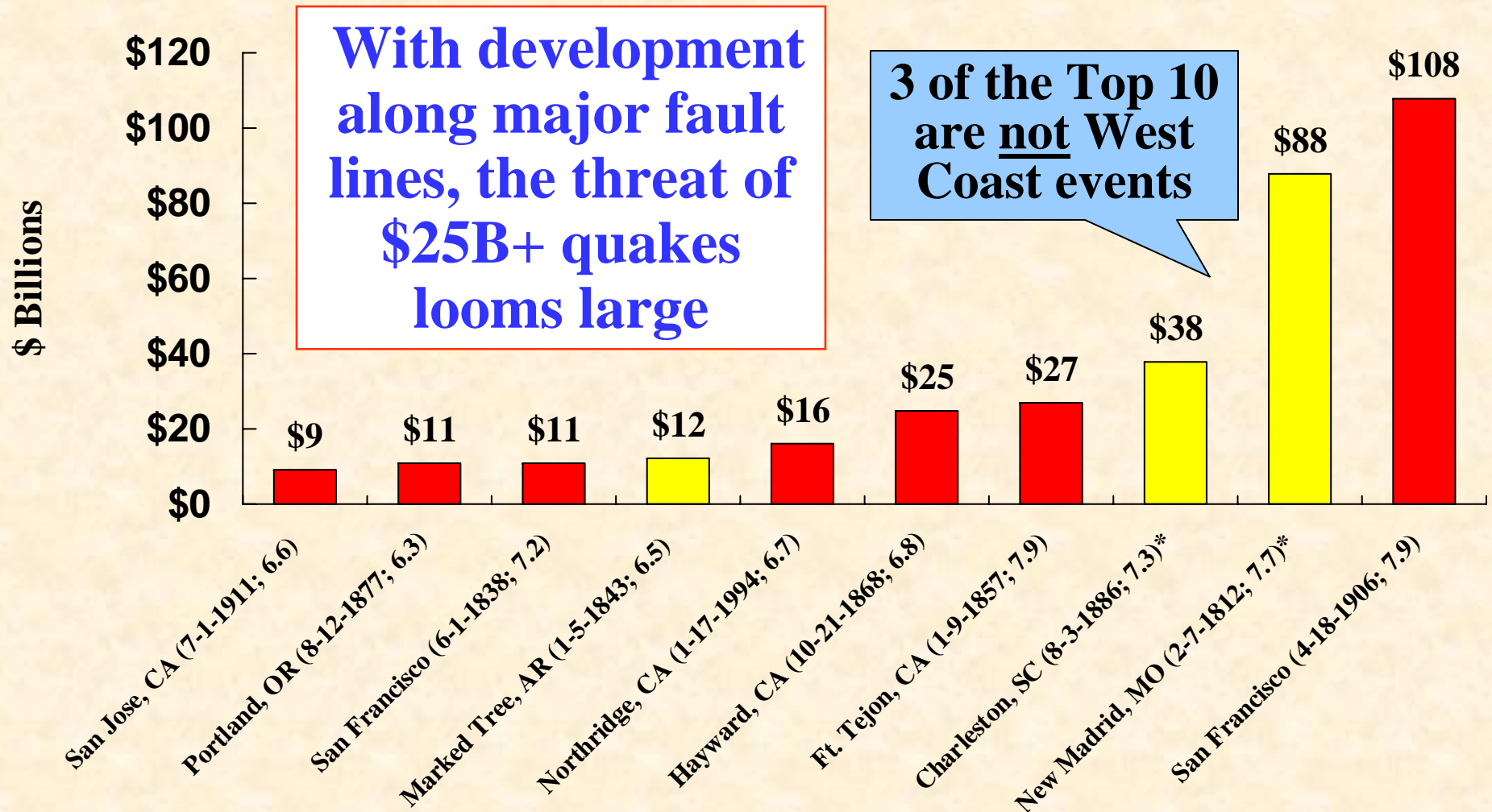


Source: AIR



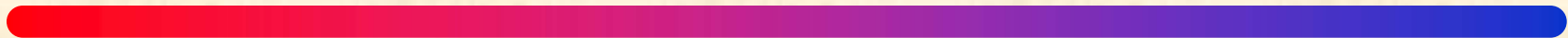
Insured Losses from Top 10 Earthquakes Adjusted to 2005 Exposure Levels

(Billions of 2005 Dollars)



ARE COASTAL DEVELOPMENT PATTERNS RATIONAL?

*The Answer May
Surprise You*





Excessive Catastrophe Exposure: Outcome of Economically & Politically Rational Decision Process?

- **Property Owners**

- Make economically rational decision to live in disaster-prone areas
- Low cost of living, low real estate prices & rapid appreciation, low/no income tax, low property tax, rapid job growth
- Government-run insurers (e.g., CPIC, NFIP) provide implicit subsidies by selling insurance at below-market prices with few underwriting restrictions
- Government aid, tax deductions, litigation recovery for uninsured losses
- No fear of death and injury

- **Local Zoning/Permitting Authorities**

- Allowing development is economically & politically rational & fiscally sound
- Residential construction creates jobs, attracts wealth, increases tax receipts, stimulates commercial construction & permanent jobs, develops infrastructure
- Increases local representation in state legislature & political influence
- Property and infrastructure damage costs shifted to others (state and federal taxpayers, policyholders in unaffected areas)

- **Developers**

- Coastal development is a high-margin business
- Financial interest reduced to zero after sale

Source: Insurance Information Institute.



Excessive Catastrophe Exposure: Outcome of Economically & Politically Rational Decision Process?

- **State Legislators**

- Loathe to pass laws negatively impacting development in home districts
- Local development benefits local economy and enhances political influence
- Rapid development lessens need for higher income and property taxes
- Can redistribute CAT losses to unaffected policyholders and taxpayers
- Can suppress insurance prices via state insurance regulator, suppress pricing and weaken underwriting standards in state-run insurer & redistribute losses

- **Congressional Delegation**

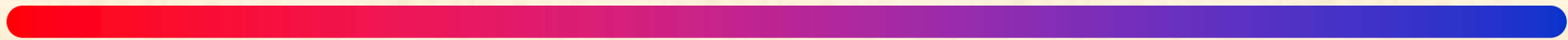
- Home state development increases influence in Washington
 - Political representation, share of federal expenditures
- Loathe to pass laws harming development in home state/district
- Tax law promotes homeownership and actually produces supplemental benefits for property owners in disaster-prone areas
- Large amounts of unbudgeted disaster aid easily authorized
- Tax burden largely borne by those outside CAT zone & those with no representation (children & unborn)

- **President**

- Presidential disaster declarations and associated aid are increasing
- Political benefits to making declarations and distributing large amounts of aid
- Direct impact on favorability ratings & election outcomes
- Losses can be distributed to other areas and the unrepresented

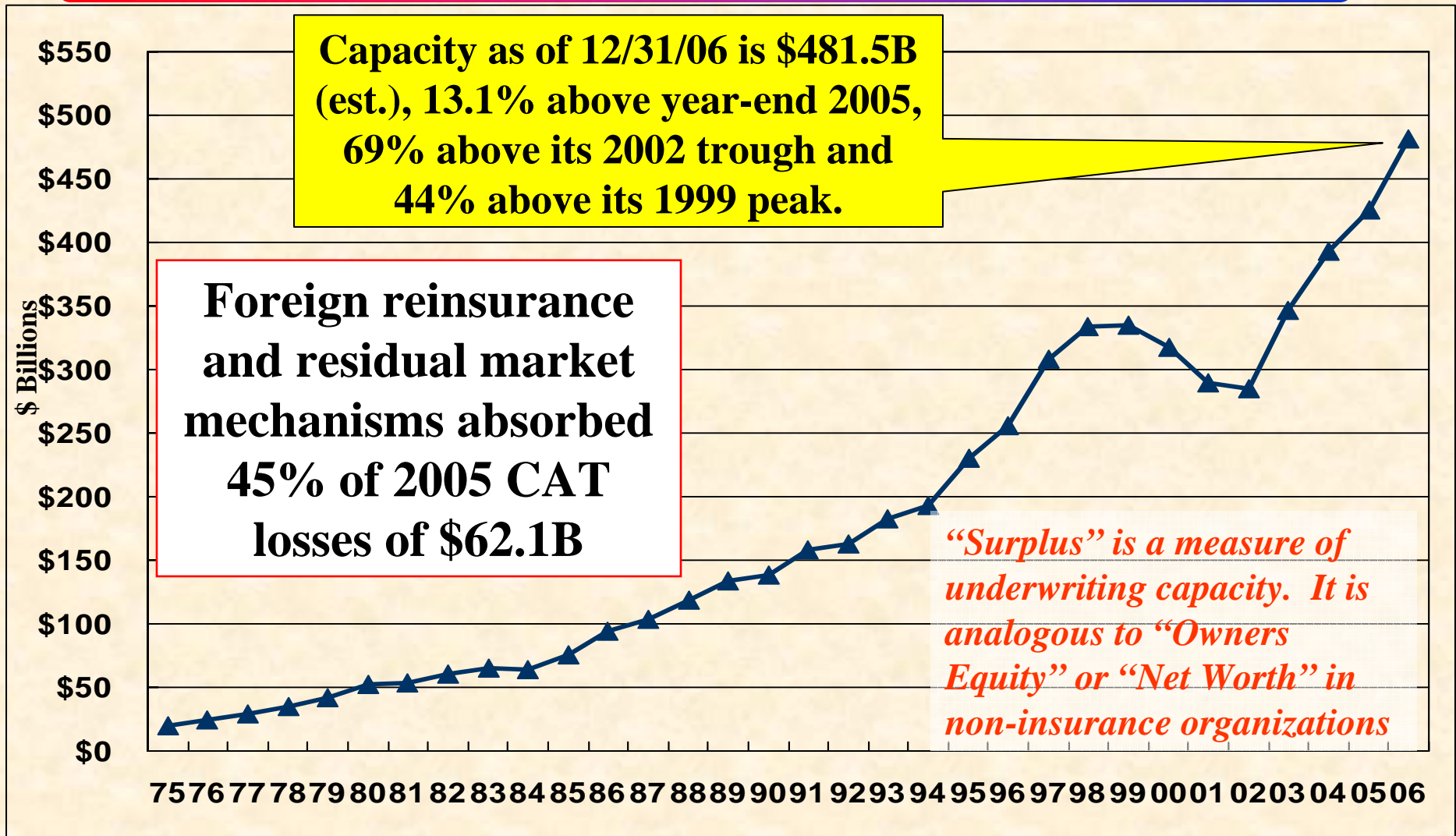
UNDERWRITING CAPACITY

*Are the Industry's Claims
Paying Resources are
Adequate?*





U.S. Policyholder Surplus: 1975-2006E* (\$ Billions)



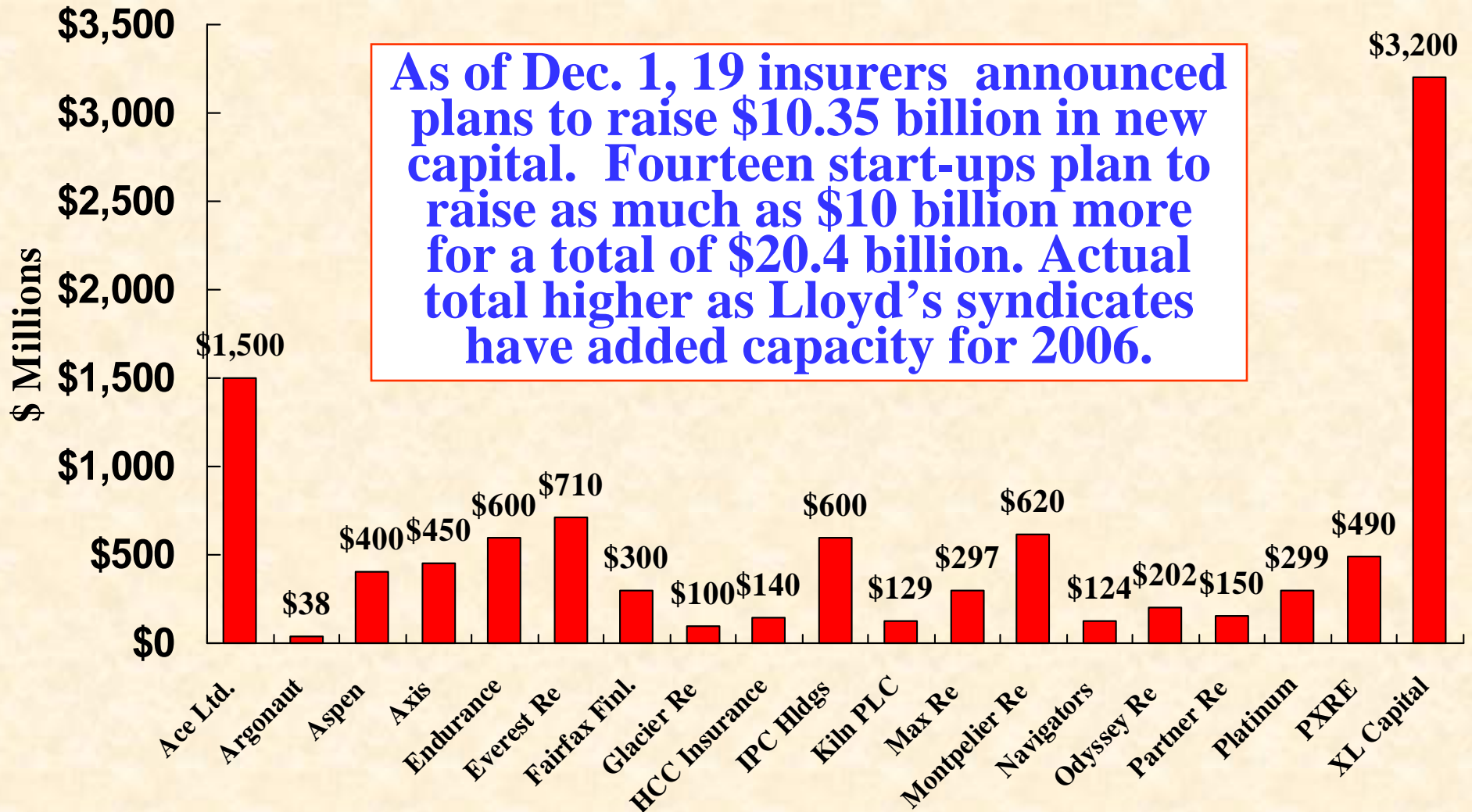
Source: A.M. Best, ISO, Insurance Information Institute

*Ill estimate for 2006.



Announced Insurer Capital Raising*

(\$ Millions, as of December 1, 2005)



*Existing (re) insurers. Announced amounts may differ from sums actually raised.

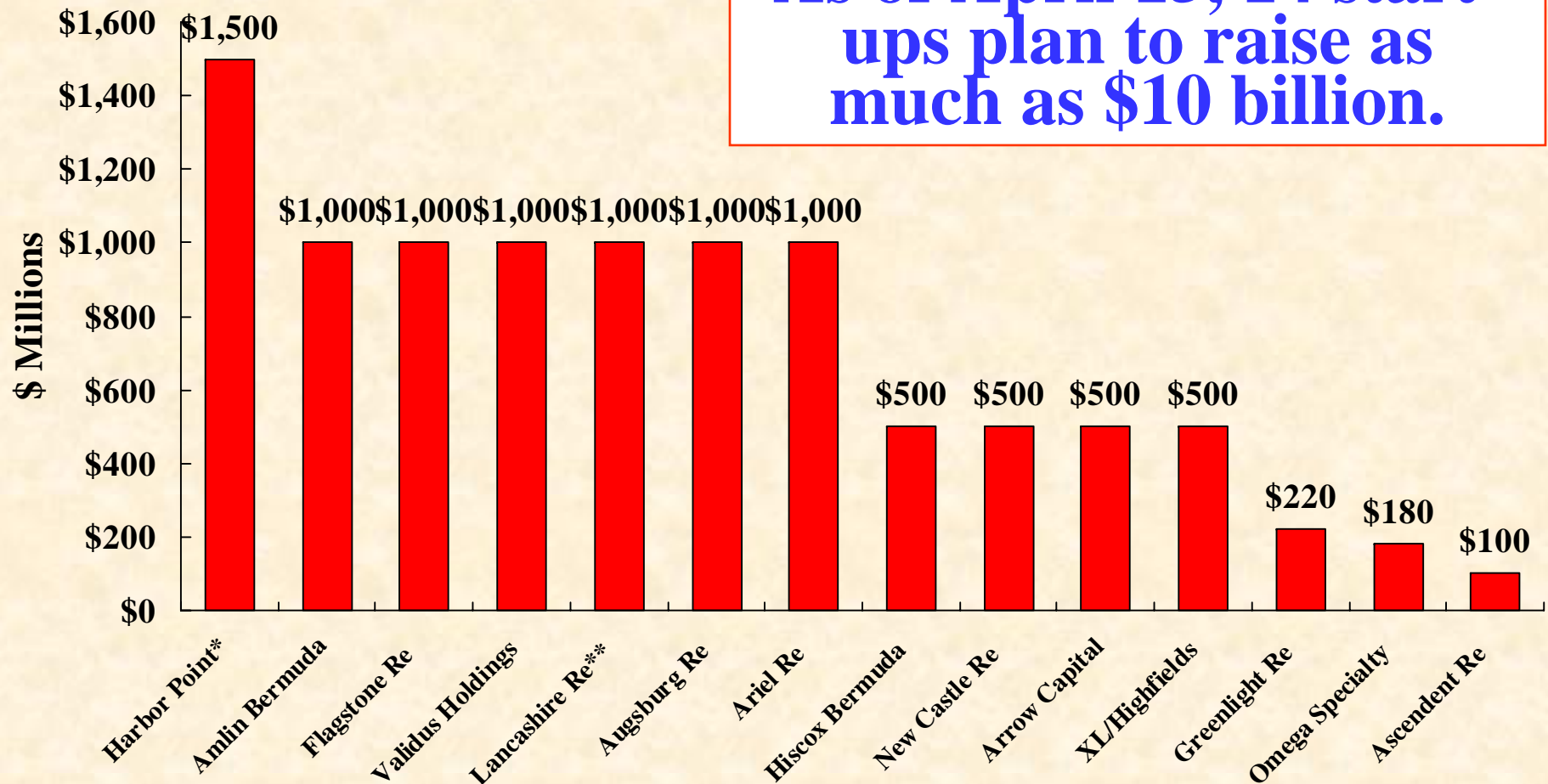
Sources: Morgan Stanley, Lehman Brothers, Company Reports; Insurance Information Institute.



Announced Capital Raising by Insurance Start-Ups

(\$ Millions, as of April 15, 2006)

As of April 15, 14 start-ups plan to raise as much as \$10 billion.



*Chubb, Trident are funding Harbor Point. Announced amounts may differ from sums actually raised. **Stated amount is \$750 million to \$1 billion. ***XL Capital/Hedge Fund venture. Arrow Capital formed by Goldman Sachs.
Sources: Investment Bank Reports; Insurance Information Institute.



Capital Raising by Class Within 15 Months of KRW

\$ Billions

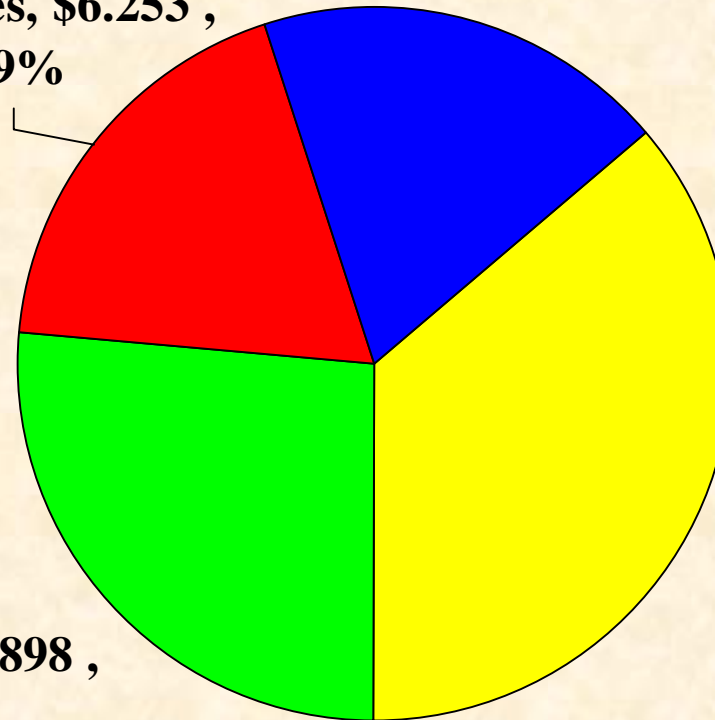
Sidecars, \$6.359 ,
19%

Insurance Linked
Securities, \$6.253 ,
19%

Existing Cos.,
\$12.145 , 36%

New Cos., \$8.898 ,
26%

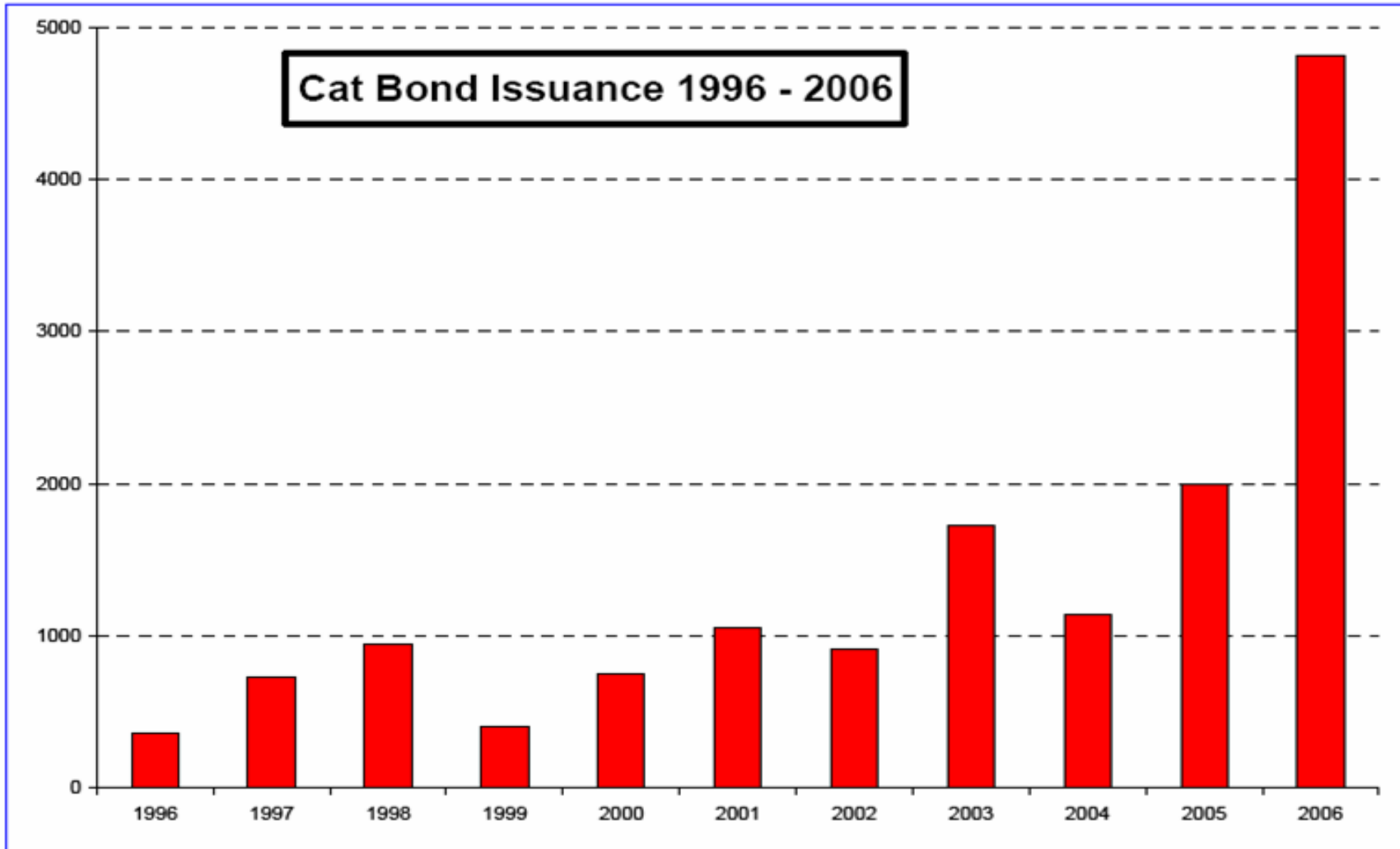
**Insurers &
Reinsurers raised
\$33.7 billion in the
wake of Katrina,
Rita, Wilma**





Capital Market Participation

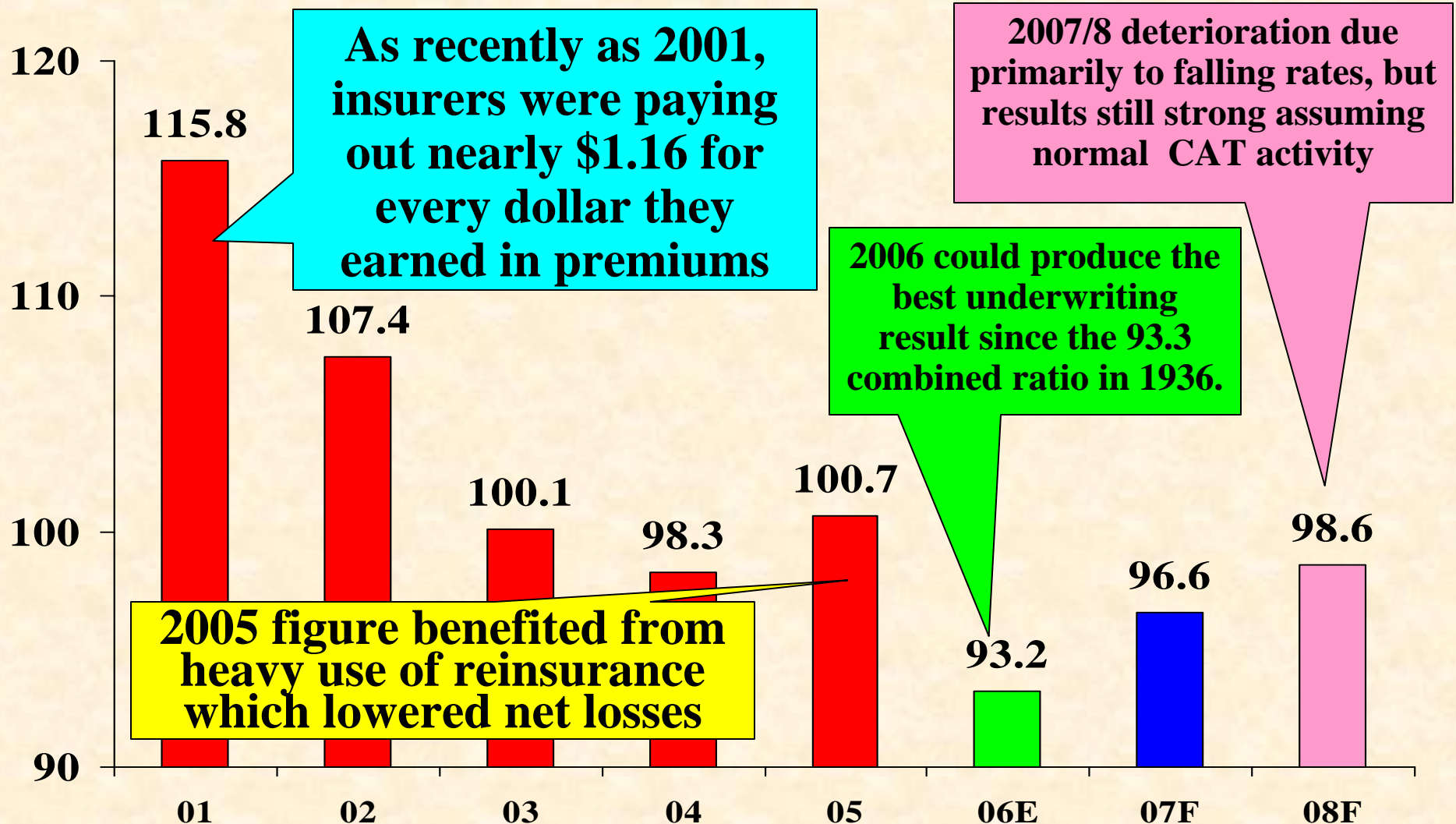
Post-KRW Reaches Record Highs



Source: Lane Financial *Trade Notes*, January 31, 2007.



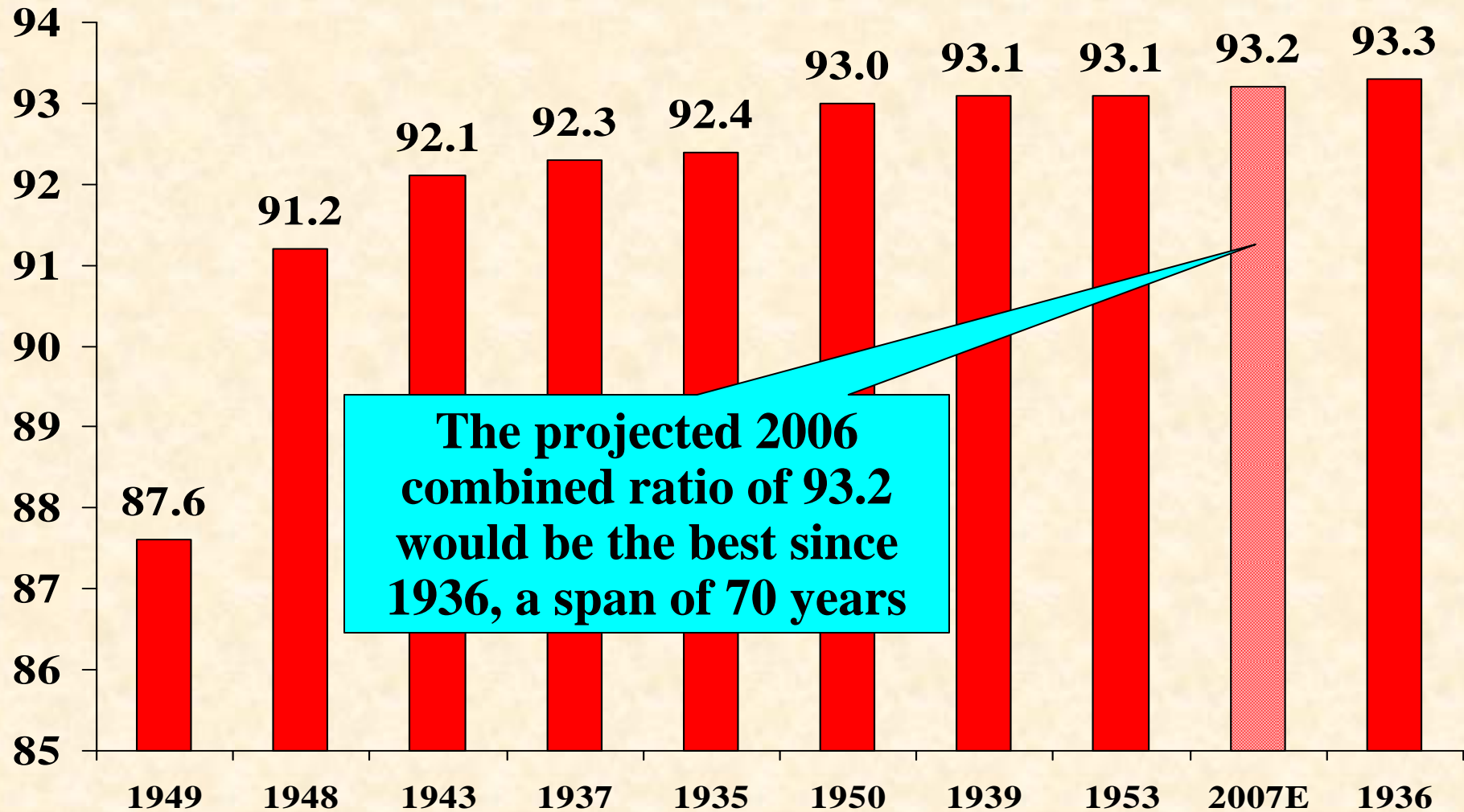
P/C Industry Combined Ratio



Sources: A.M. Best; ISO, III. *Estimates/forecasts based on III's 2007 Early Bird survey.



Ten Lowest P/C Insurance Combined Ratios Since 1920

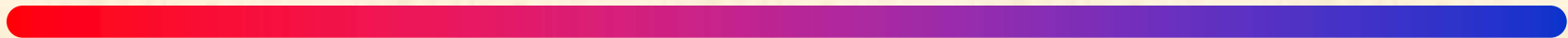


Sources: A.M. Best; Insurance Information Institute.

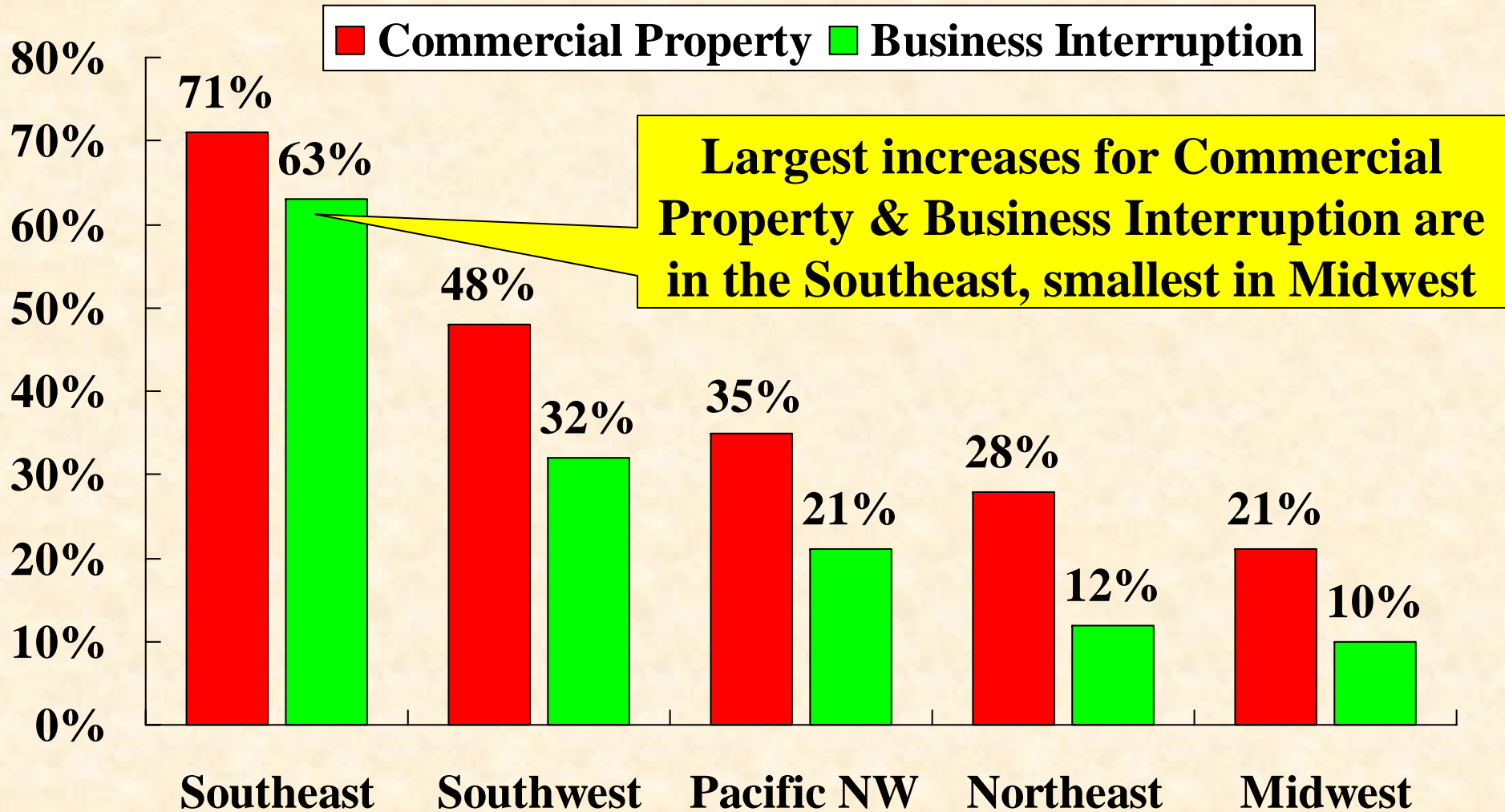
*III Groundhog Survey forecast, Feb. 2007.

PRICING

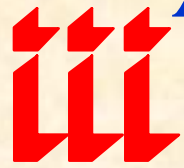
*Are Low and Stable
Prices Valid Arguments
for an Expanded Role of
the State?*



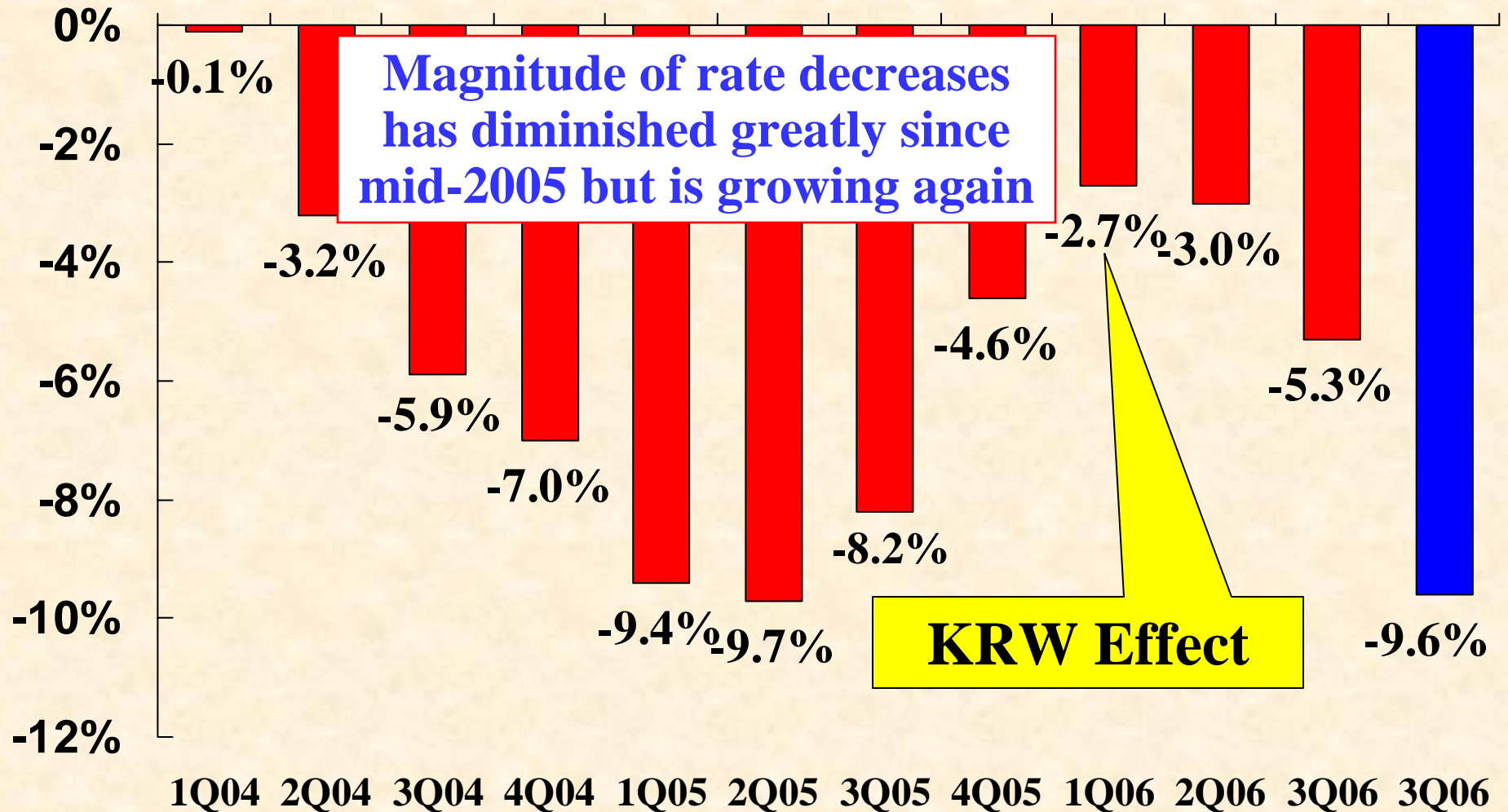
Percent of Commercial Accounts Renewing with/Positive Rate Changes, 2nd Qtr. 2006



Source: Council of Insurance Agents and Brokers



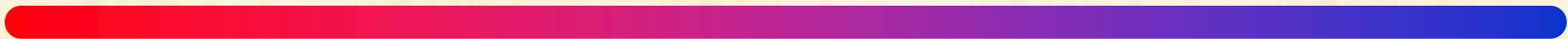
Average Commercial Rate Change, All Lines, (1Q:2004 – 4Q:2006)



Source: Council of Insurance Agents & Brokers; Insurance Information Institute

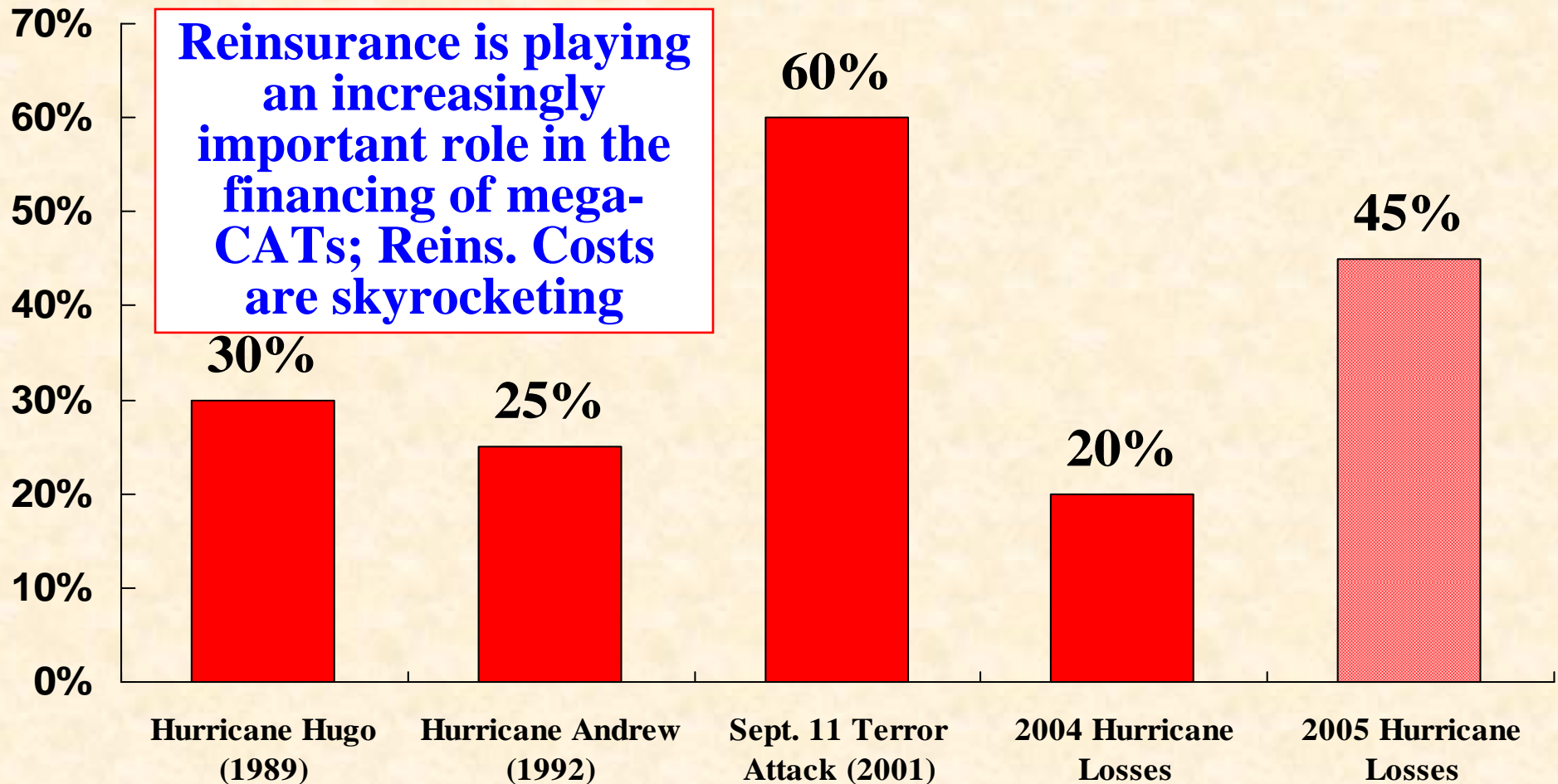
REINSURANCE MARKETS

*View Among Some that
Reinsurance Markets
“Failed” Post-Katrina*





Share of Losses Paid by Reinsurers, by Disaster*

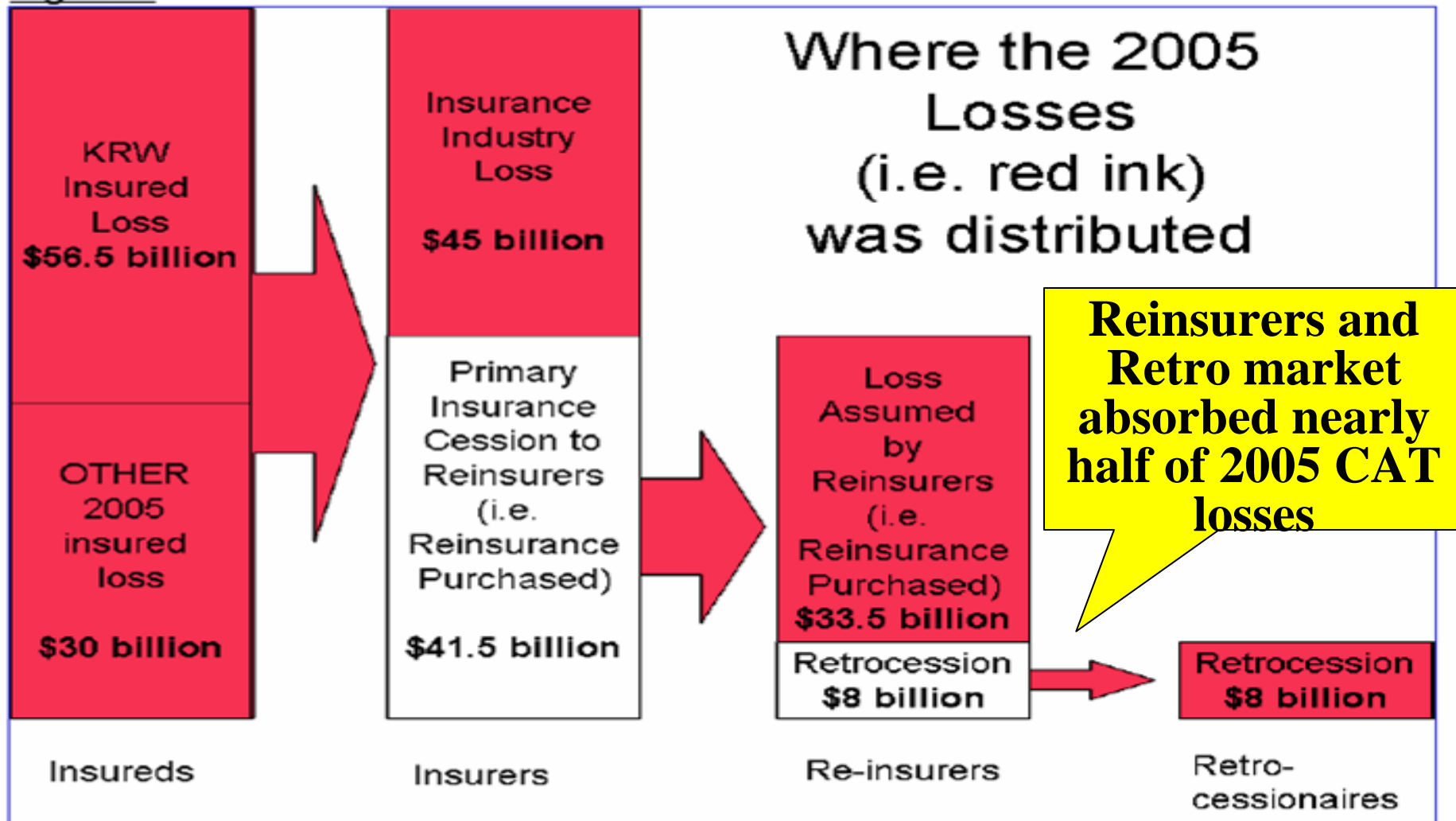


*Excludes losses paid by the Florida Hurricane Catastrophe Fund, a FL-only windstorm reinsurer, which was established in 1994 *after* Hurricane Andrew. FHCF payments to insurers are estimated at \$3.85 billion for 2004 and \$4.5 billion for 2005.

Sources: Wharton Risk Center, Disaster Insurance Project; Insurance Information Institute.

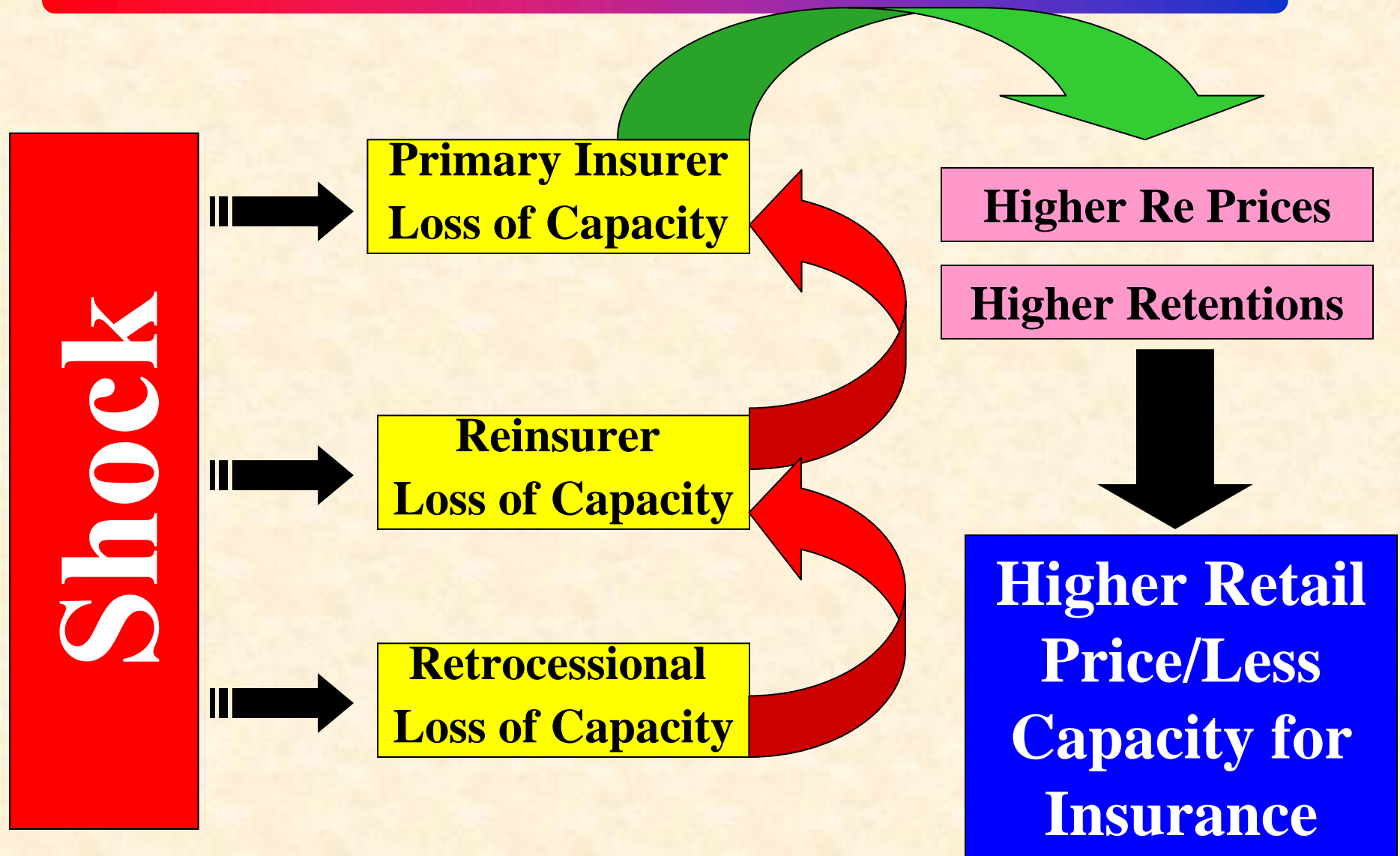


Loss Distribution of 2005 CAT Losses

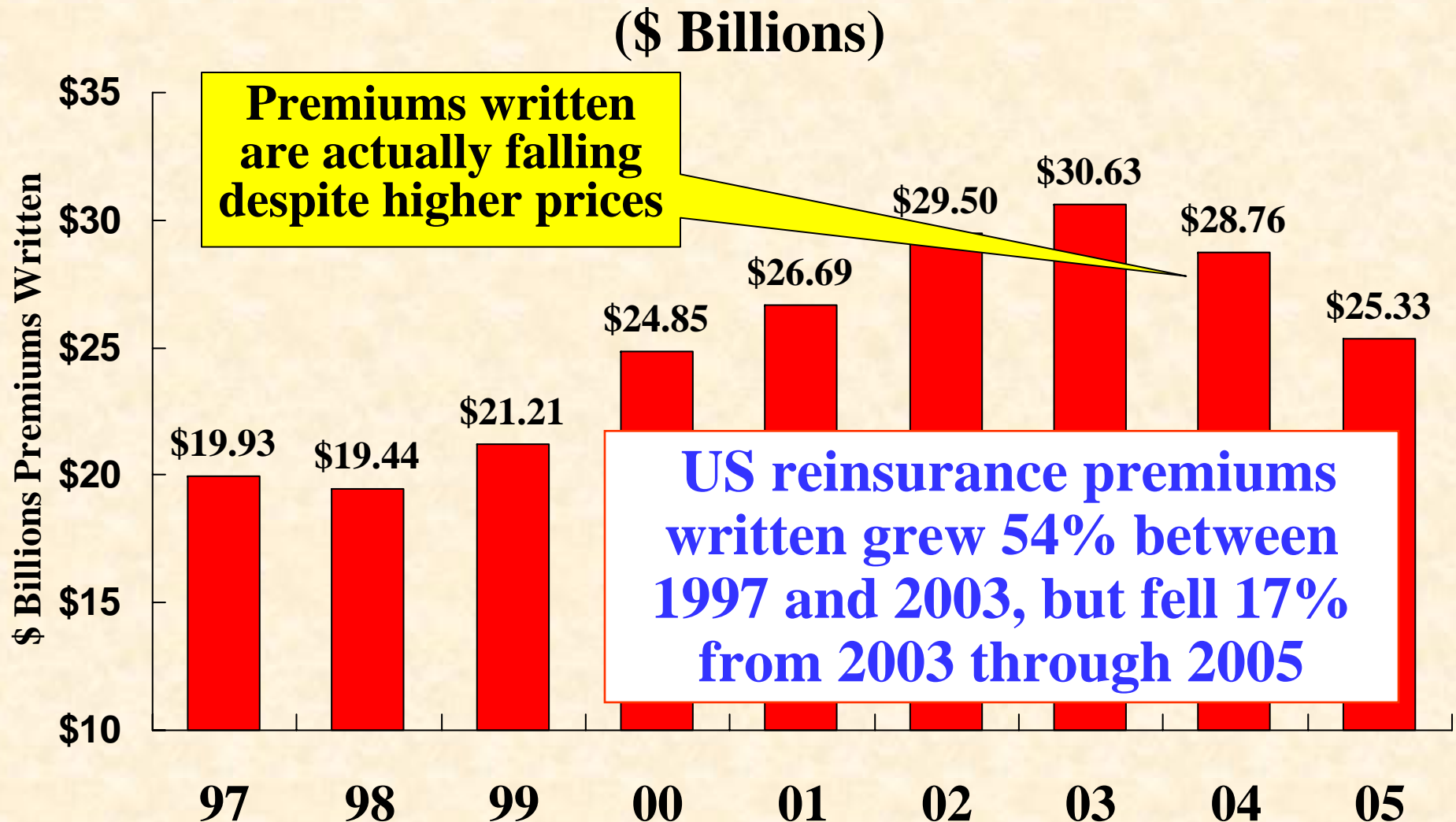




Transmission of Shock Through Insurance/Reinsurance Markets



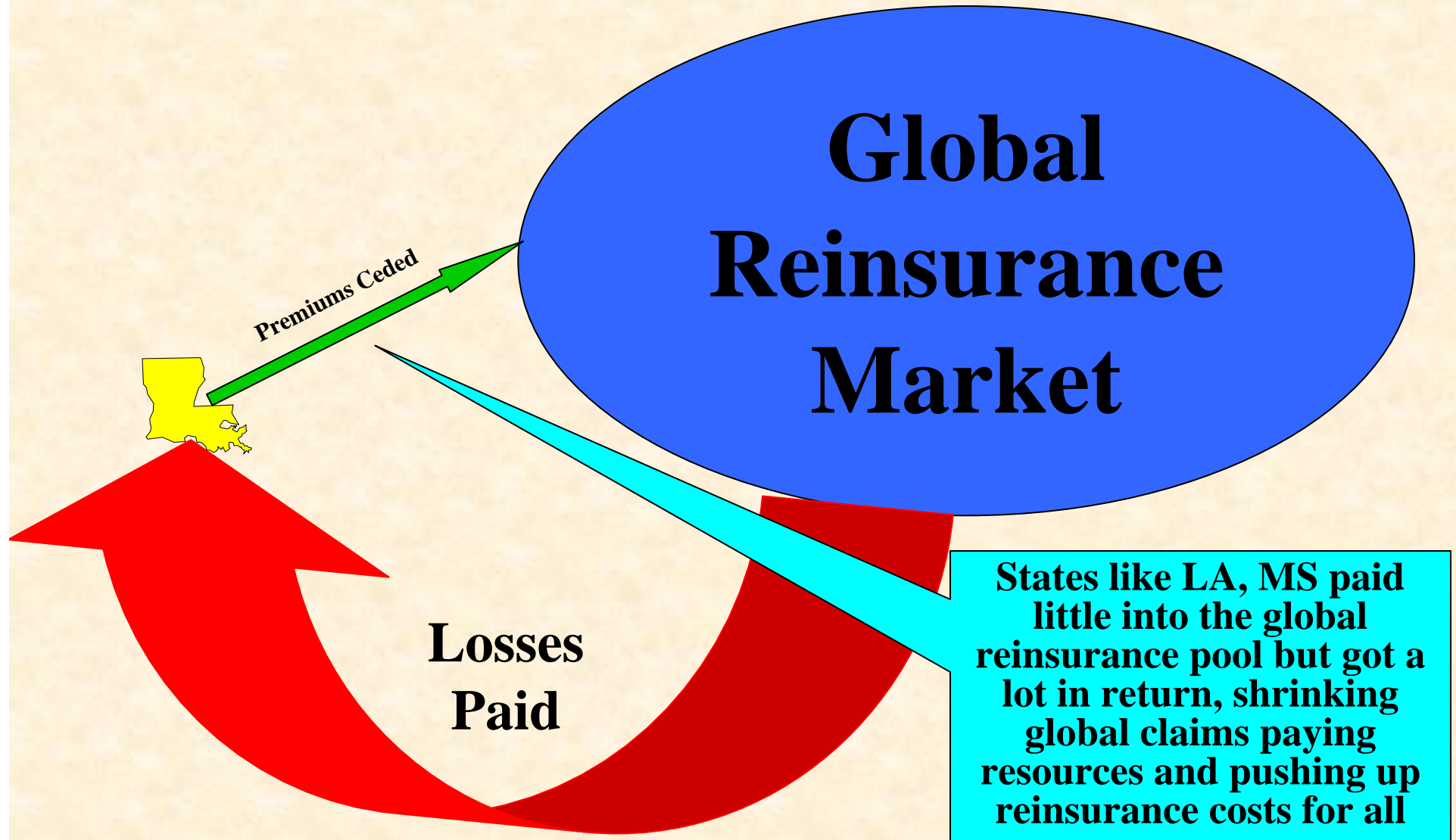
Reinsurers Net Written Premiums, US Business, 1997 - 2005



Source: Reinsurance Association of America; Insurance Information Institute *Fact Book 2007*, p. 38.



Reinsurance Markets are Globally Linked



**Global
Reinsurance
Market**

Premiums Ceded

Losses
Paid

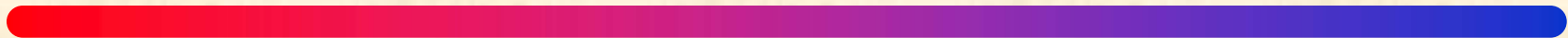
States like LA, MS paid little into the global reinsurance pool but got a lot in return, shrinking global claims paying resources and pushing up reinsurance costs for all



Debate Over Reinsurance Market Performance & Government

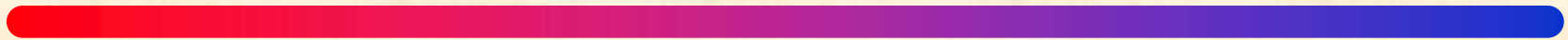
- Reinsurance markets typically suffer large shocks, followed by a period of higher prices and transient capacity constraints
- A new equilibrium between Supply and Demand is typically found within 18 months, commensurate with changes in the risk landscape. This is Economics 101 and is a textbook illustration of how capitalism works.
- A competing hypothesis suggests that reinsurance markets “fail” because they do not provide a stable price or quantity of protection as is required in an economy with *continuously exposed fixed assets, especially one that is growth oriented*
- **Public Policy Solution:** Acting on this hypothesis generally results in displacement of private (re)insurance capital by government intermediaries
- **Open Question:** Are policyholders and the economy better served through free markets, government or some hybrid?

*What Role Should the
Federal Government
Play in Insuring
Against Natural
Disaster Risks?*



PUBLIC POLICY REMEDIES

Helpful or Harmful?



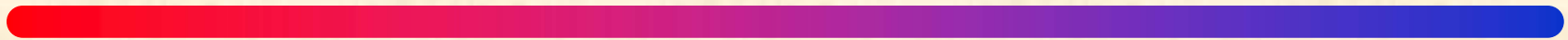


Public Policy: The Role of the State

- **Government Disaster Aid**
- **State-Run Residual Markets (Markets of Last Resort)**
- **Federal Natural Catastrophe Plan**
- **Socialization of the (Re) Insurance Markets**

GOVERNMENT AID

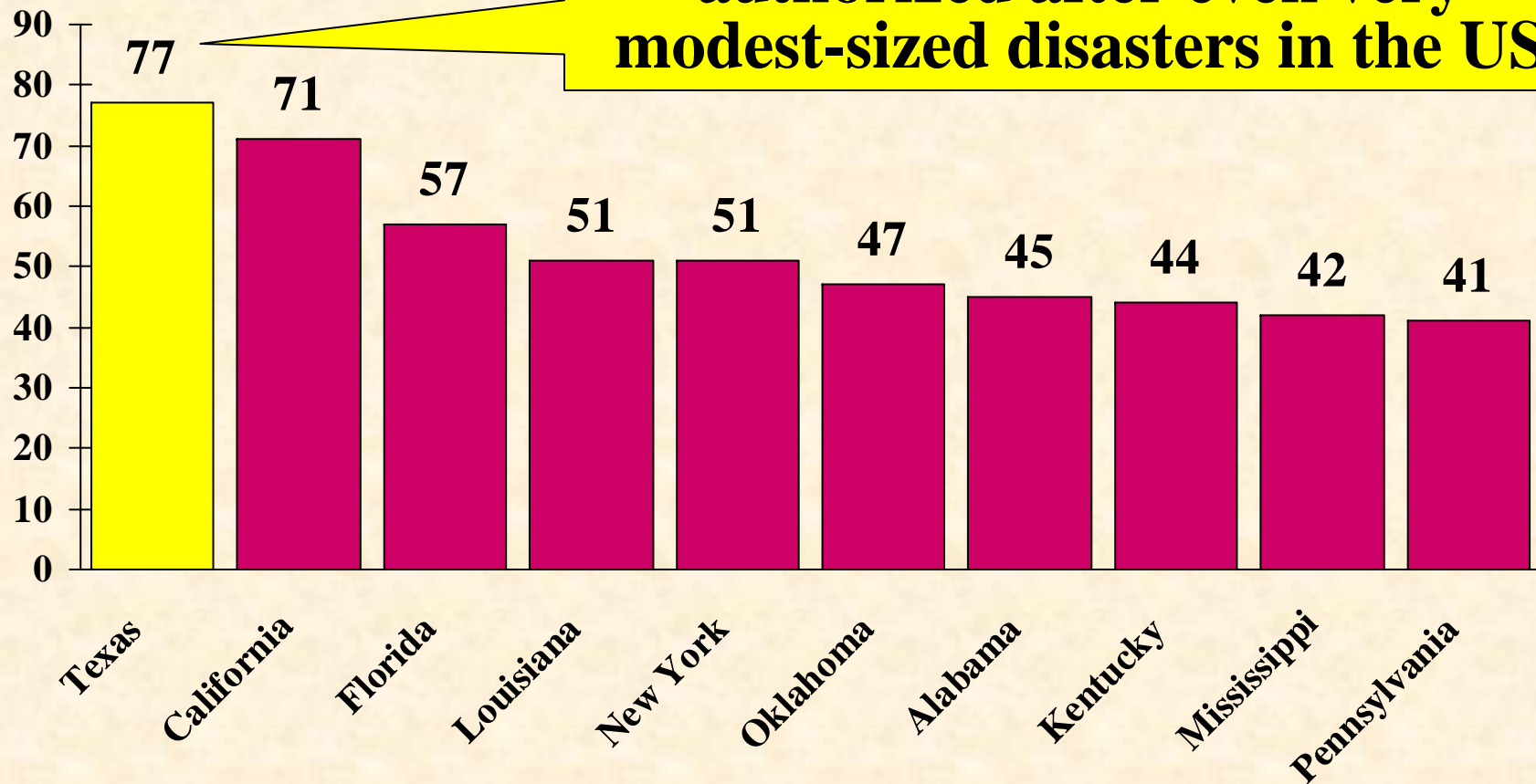
*Helpful but Inefficient &
Not a Solution*





Top 10 Major Disaster Declaration Totals By State: 1953- 2006*

Total Number

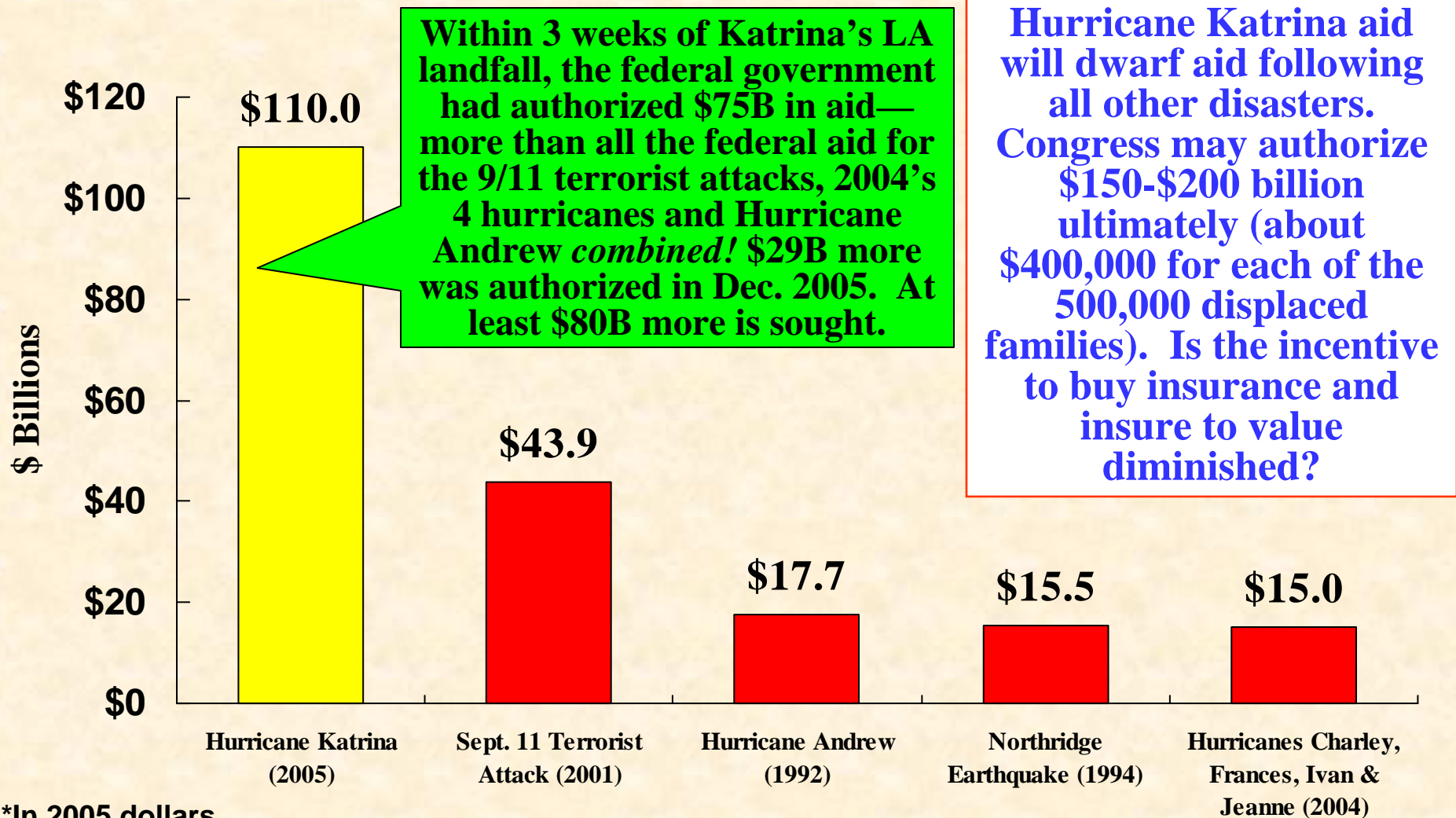


*Through July 12, 2006.

Source: Federal Emergency Management Agency (FEMA)



Government Aid After Major Disasters (Billions)*

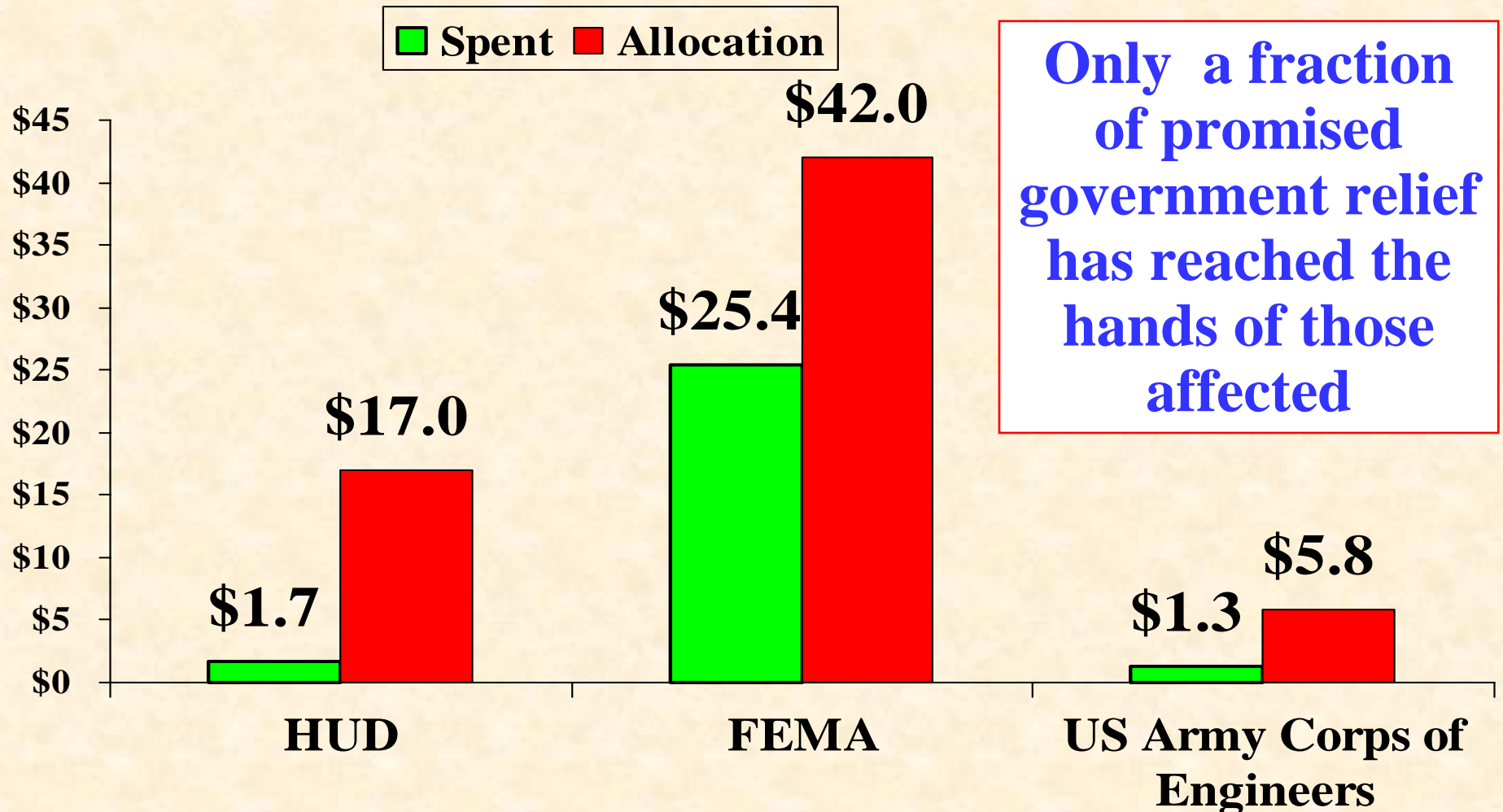


*In 2005 dollars.

Source: United States Senate Budget Committee, Insurance Information Institute as of 12/31/05.



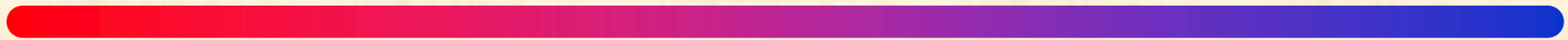
Spending on Hurricane Katrina Reconstruction (Through Dec. 2006)



Source: *Wall Street Journal*, January 27, 2007, p. A1.

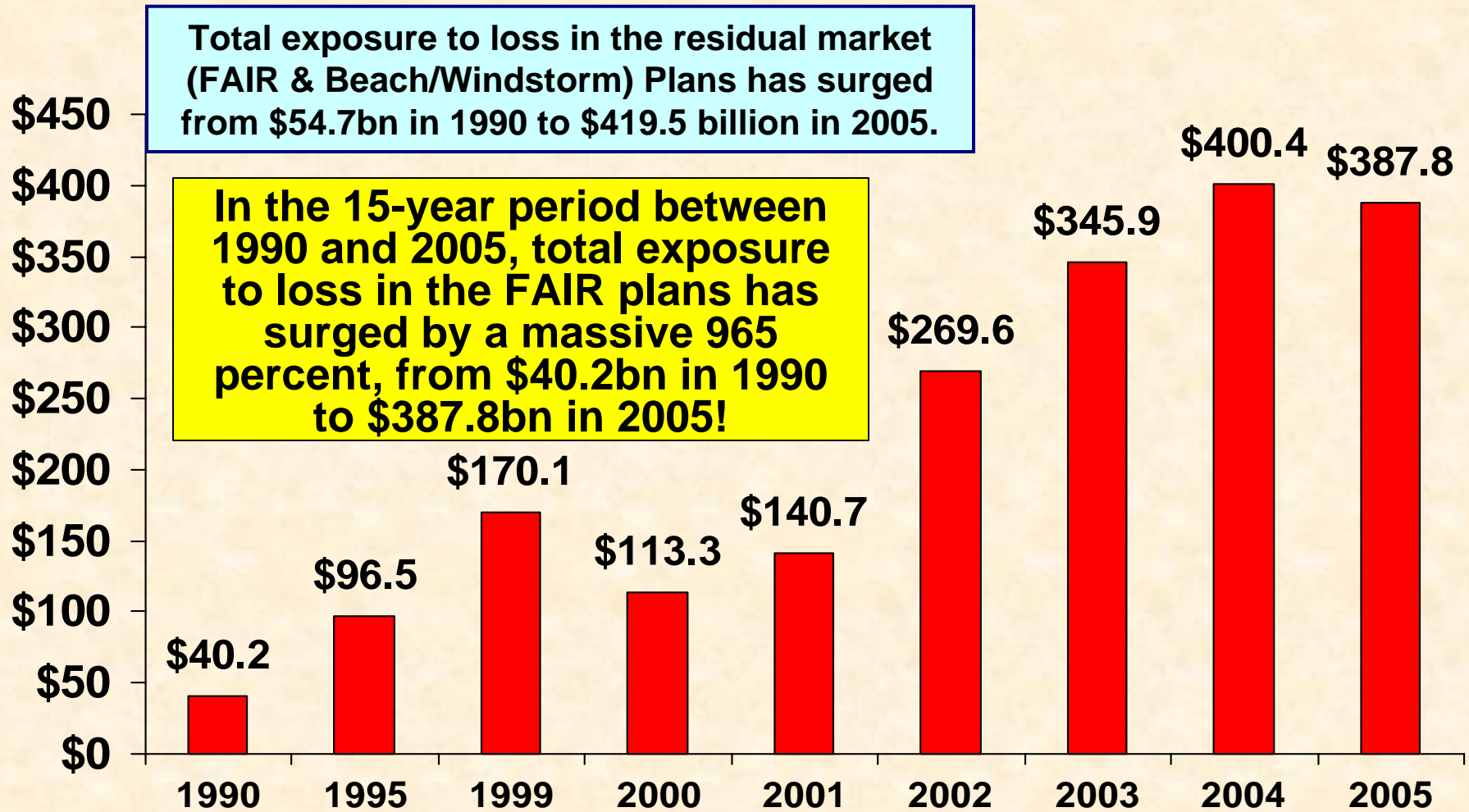
STATE RESIDUAL MARKETS

How Big is Too Big?





US FAIR Plans Exposure to Loss* (Billions of Dollars)



Source: PIPSO; Insurance Information Institute

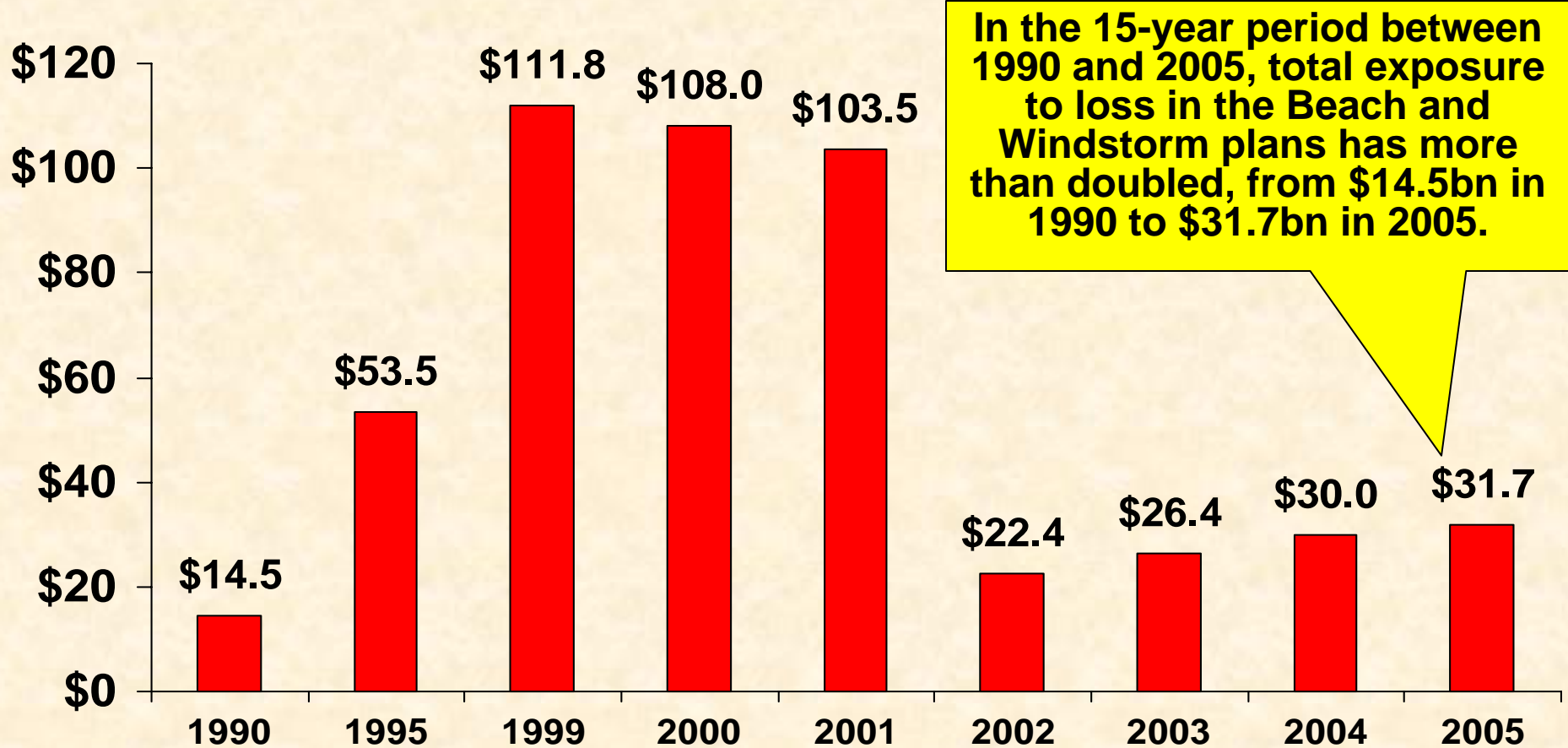
*Hurricane exposed states only.



US Beach and Windstorm Plans

Exposure to Loss (Bill. of Dollars)

In 2002 Florida combined its Windstorm and Joint Underwriting Association to create Florida Citizens, so Florida data shifted to the FAIR plans from this date.

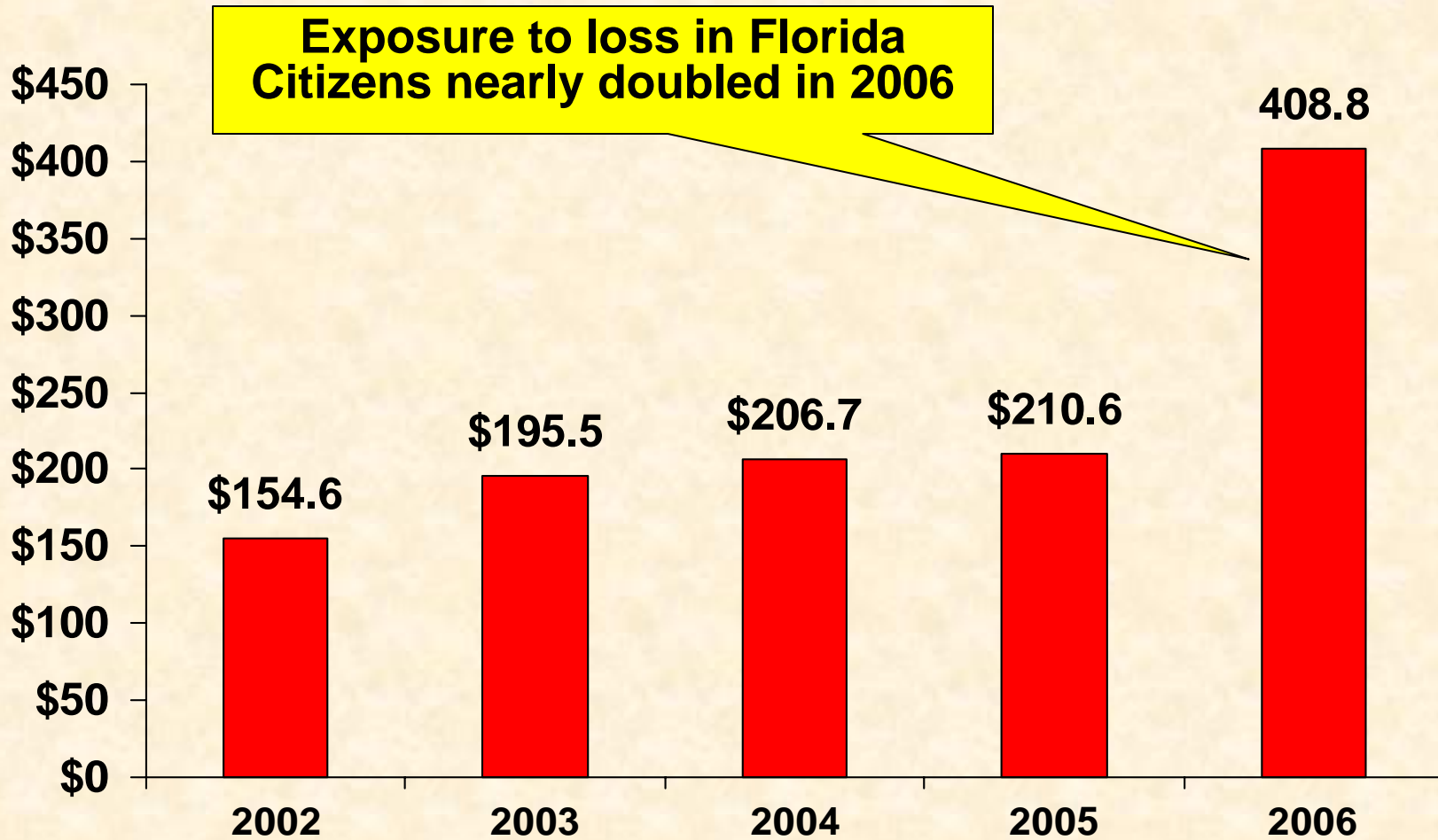


Source: PIPSO; Insurance Information Institute.

*Hurricane exposed states only.



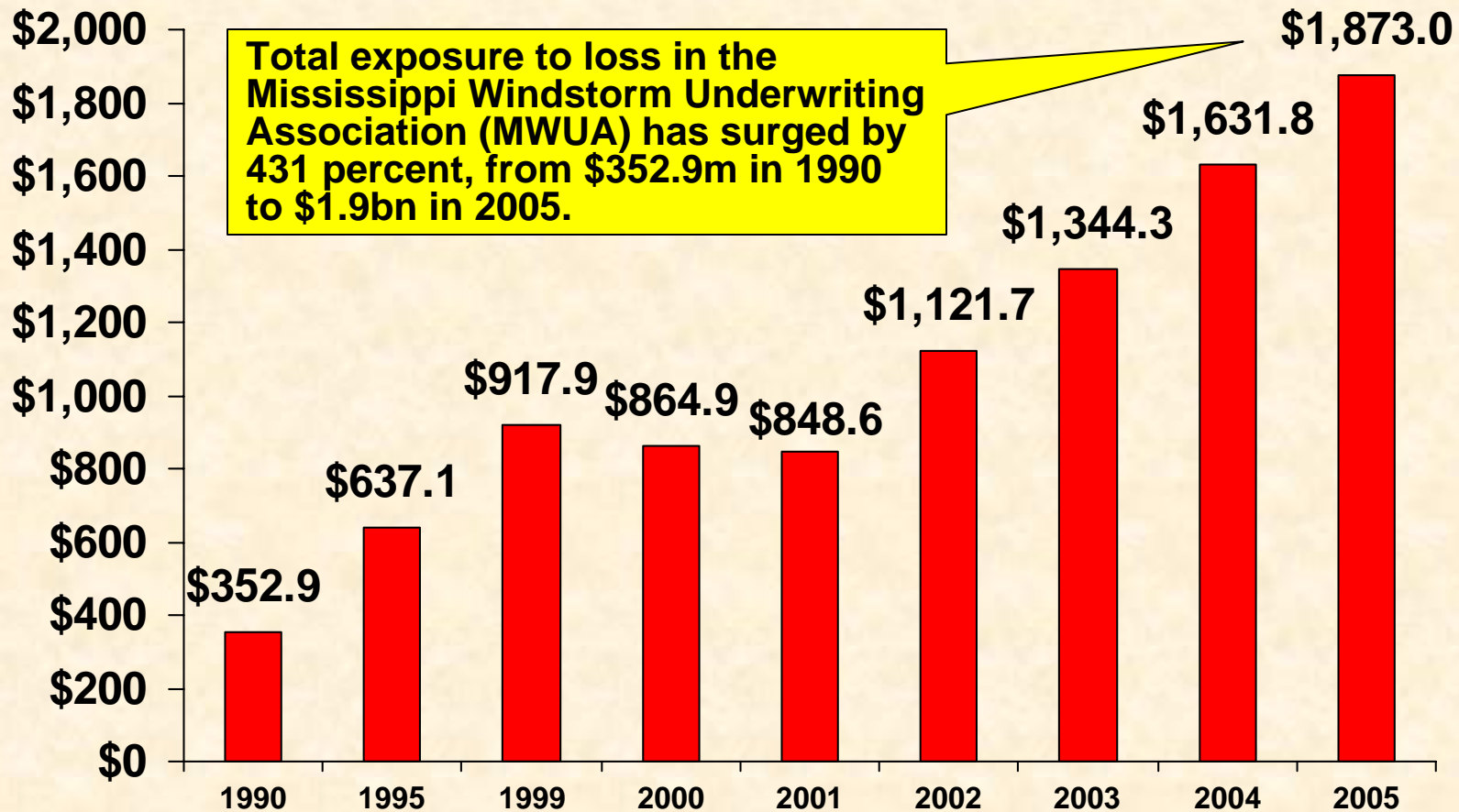
Florida Citizens Exposure to Loss (Billions of Dollars)



Source: PIPSO; Insurance Information Institute



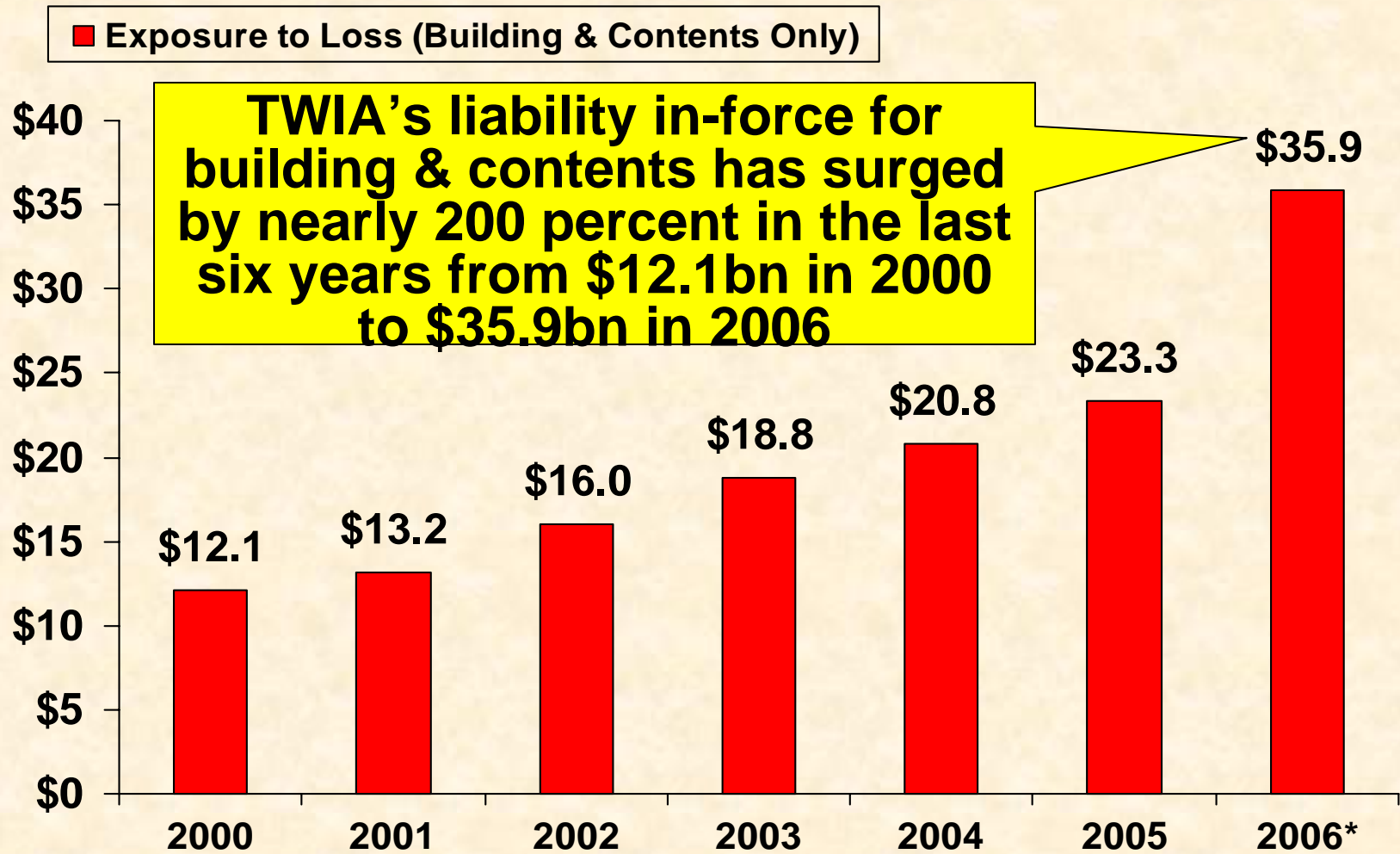
MS Windstorm Plan: Exposure to Loss (Millions of Dollars)



Source: PIPSO; Insurance Information Institute



Texas: TWIA Growth In Exposure to Loss (Building & Contents Only, \$ Bill)



Source: TWIA (as of 11/30/06); Insurance Information Institute

Overview of Plans for a National Catastrophe Insurance Plan





NAIC's Comprehensive National Catastrophe Plan

- **Proposes Layered Approach to Risk**
- **Layer 1: Maximize resources of private insurance & reinsurance industry**
 - Includes “All Perils” Residential Policy
 - Encourage Mitigation
 - Create Meaningful, Forward-Looking Reserves
- **Layer 2: Establishes system of state catastrophe funds (like FHCF)**
- **Layer 3: Federal Catastrophe Reinsurance Mechanism**

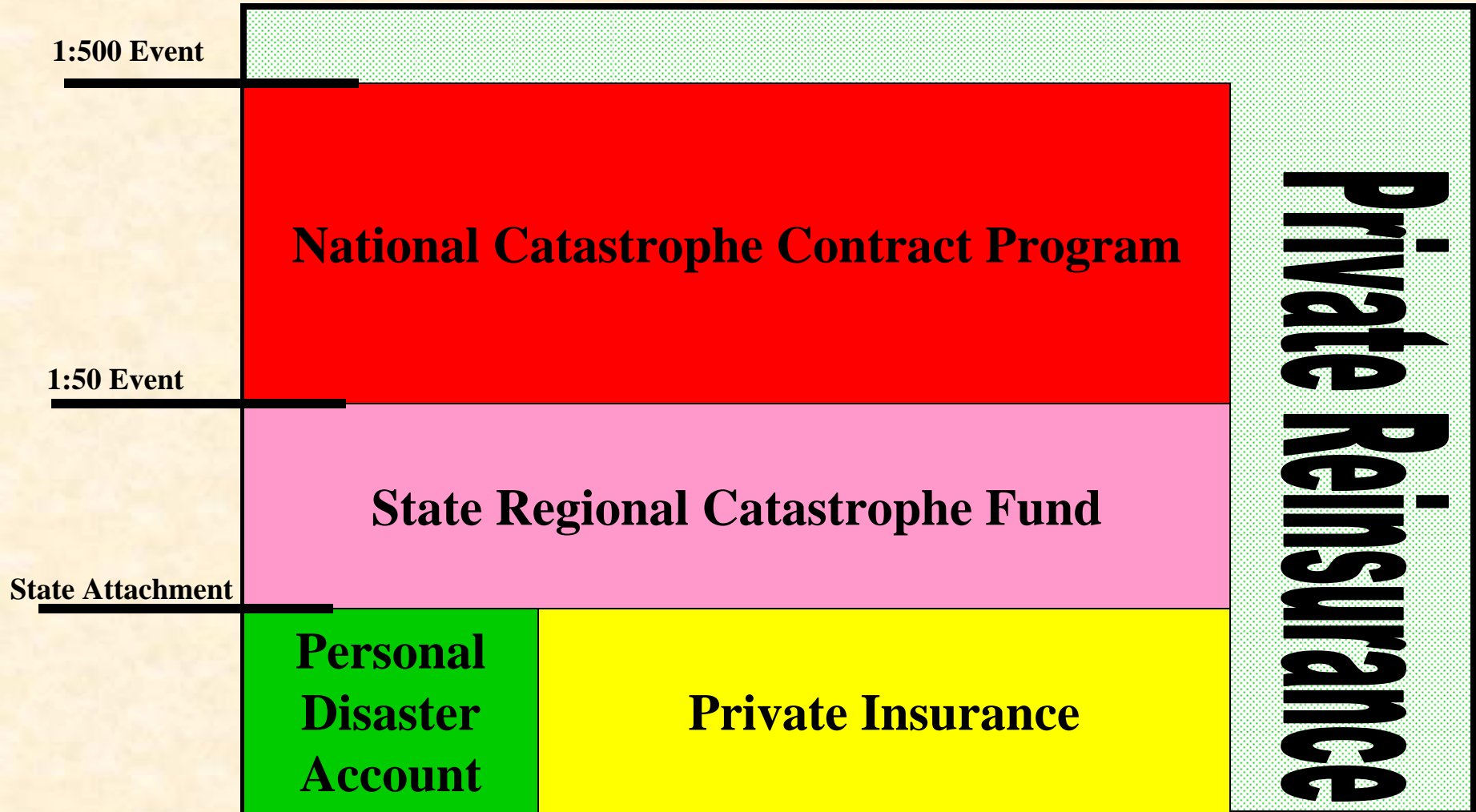


Guiding Principles of NAIC's National Catastrophe Plan

- **National program should promote personal responsibility among policyholders**
- **National program should support reasonable building codes, development plans & mitigation tools**
- **National program should maximize risk-bearing capacity of private markets, and**
- **National plan should provide quantifiable risk management to the federal government**



Comprehensive National Catastrophe Plan Schematic



Source: NAIC, *Natural Catastrophe Risk: Creating a Comprehensive National Plan*, Dec. 1, 2005; Insurance Information. Inst.



A VULNERABLE AMERICA

HURRICANES EARTHQUAKES

WHAT ARE YOU AT RISK FOR?

OUR MISSION IS TO RAISE AWARENESS, EDUCATE THE PUBLIC AND POLICYMAKERS, AND OFFER SOLUTIONS THAT WILL BETTER PREPARE AND PROTECT AMERICA FROM MAJOR CATASTROPHE IN A SENSIBLE, COST-EFFECTIVE FASHION.

REPLAY

SEARCH

- HELP PROTECT AMERICA**
- UNDERSTAND YOUR RISKS
 - STRENGTHEN 1ST RESPONDERS
 - BUILD SMARTER & STRONGER
 - ADVOCATE CATASTROPHE FUNDS

PREPARE YOURSELF:

HOW YOU CAN BETTER PREPARE
tips for average americans

- RECENT NEWS:**
- Teaching Earthquake Science Made Easy: USGS Partnership Puts Curriculum into the Classroom
2.1.06
 - Faculty Senate hears report on emergency-preparedness plan
2.1.06
 - It's Earthquake Preparedness Week In Kentucky
2.1.06

AMERICA NEEDS YOUR VOICE!

Our current system leaves too many people unprotected and unable to rebuild their lives following a catastrophe. We need to prepare for future catastrophes and protect ourselves.

CONTACT YOUR ELECTED OFFICIALS > **JOIN OUR CAUSE >**

STATS & FIGURES:

Repeat of the 1886 Charleston, South Carolina, earthquake today would cause



A VULNERABLE NEW YORK

HURRICANES

WHAT ARE YOU AT RISK FOR?

OUR MISSION IS TO RAISE AWARENESS, EDUCATE THE PUBLIC AND POLICYMAKERS, AND OFFER SOLUTIONS THAT WILL BETTER PREPARE AND PROTECT NEW YORK FROM MAJOR CATASTROPHE IN A SENSIBLE, COST-EFFECTIVE FASHION.

REPLAY

NEW YORK NEEDS YOUR VOICE!

Our current system leaves too many people unprotected and unable to rebuild their lives following a catastrophe. We need to prepare for future catastrophes and protect ourselves.

[CONTACT YOUR ELECTED OFFICIALS >](#) [JOIN OUR CAUSE >](#)

STATS & FIGURES:

In 1938, the Long Island Express missed Manhattan by only 55 miles, a close call in

- HELP PROTECT NEW YORK**
 - NEW YORK AT RISK >
 - COMMON SENSE SOLUTIONS >
 - LEGISLATION >
 - TAKE ACTION >

PREPARE YOURSELF:

HOW YOU CAN BETTER PREPARE
tips for average americans >

- RECENT NEWS:**
- LI Unprepared for Disaster, Terrorism
1.30.06
 - ProtectingNewYork.org Applauds N.Y. Congress Members Israel and McCarthy For Their Leadership to Better Prepare New York and America for Catastrophe
1.20.06
 - Information about the "Long Island Express"
8.26.05



Legislation: Comprehensive National Catastrophe Plan

- **H.R. 846: Homeowners Insurance Availability Act of 2005**
 - Introduced by Representative Ginny Brown-Waite (R-FL)
 - Requires Treasury to implement a reinsurance program offering contracts sold at regional auctions
- **H.R. 4366: Homeowners Insurance Protection Act of 2005**
 - Also worked on by Rep. Brown-Waite
 - Establishes national commission on catastrophe preparation and protection
 - Authorizes sale of federally-backed reinsurance contracts to state catastrophe funds
- **H.R. 2668: Policyholder Disaster Protection Act of 2005**
 - Backed by Rep. Mark Foley (R-FL)
 - Amends IRS code to permit insurers to establish tax-deductible reserve funds for catastrophic events
 - 20-year phase-in for maximum reserve
 - Use limited to declared disasters

Source: NAIC, Insurance Information Institute



Layer 1: *The Insurance Contract,* *Enhancing Capacity & Shaping the Risk*

- **All Perils Policy**
 - No exclusion except acts of war
 - Contains standard deductibles of \$500 - \$1000 *but requires* separate CAT deductible of 2% – 10% of insured value; Consumer could buy down the deductible to non-CAT fixed dollar amount
- **Encouraging Mitigation**
 - Policy will provide meaningful discounts for effective mitigation measures
- **Creating Meaningful, Forward-Looking Reserves**
 - Change tax law to allow insurers to set aside a share of premiums paid by policyholders as a reserve for future events
 - Amount set aside would be actuarially based
 - Phased-in to maximum reserve over 20 years
 - Use limited to declared disasters



Layer 2: State Level Public/Private Partnership (State CAT Fund)

- **Requirement to Create Fund**
 - **To participate in national fund, states must establish state CAT fund or participate in regional CAT fund**
 - **Funds responsible for managing capacity of their funds up to costs expected for combined 1-in-50 year CAT loss level**
- **Operation of State/Regional CAT Funds**
 - **Operating structures left to states' discretion, including**
 - **Financing mechanism (e.g., debt, pool etc.)**
 - **Trigger point for qualifying loss (if any)**
 - **Amount of retention between private insurers & state fund**
 - **Participation by surplus lines & residual markets**
 - **Requirement that rates are actuarially sound**
 - **Requirement that fund will finance a level of mitigation education and implementation**



Layer 2: State Level Public/Private Partnership (State CAT Fund) [Cont'd]

- **Building Codes**
 - Participating states expected to establish effective (enforced) building codes that properly reflect their CAT exposures as well as the latest in accepted science and engineering
 - States also required to develop high land use plans where appropriate
- **Anti-Fraud Measures**
 - State funds and DOIs maintain rigorous anti-fraud programs to ensure losses paid actually due to insured CAT loss
- **Mitigation**
 - DOIs required to establish & implement effective mitigation plans
 - Review of mitigation plans will be considered as part of an NAIC certification process

Layer 3:



The Role of a National Mechanism

- **The National Catastrophe Plan Mechanism**
 - **Federal legislation is needed to create a National Catastrophe Insurance Commission (NCIC)**
 - **NCIC purpose is to serve as conduit between state funds and US Treasury for purpose of providing reinsurance to state funds for insured losses resulting from catastrophic events beyond the state-mandated 1-in-50 year exposure**
 - **States & NCIC will enter into National Catastrophe Financing Contracts**
 - **Reinsurance will attach at 1-in-50 year level and provide protection through the 1-in-500 year level event**

Layer 3: [Cont'd]

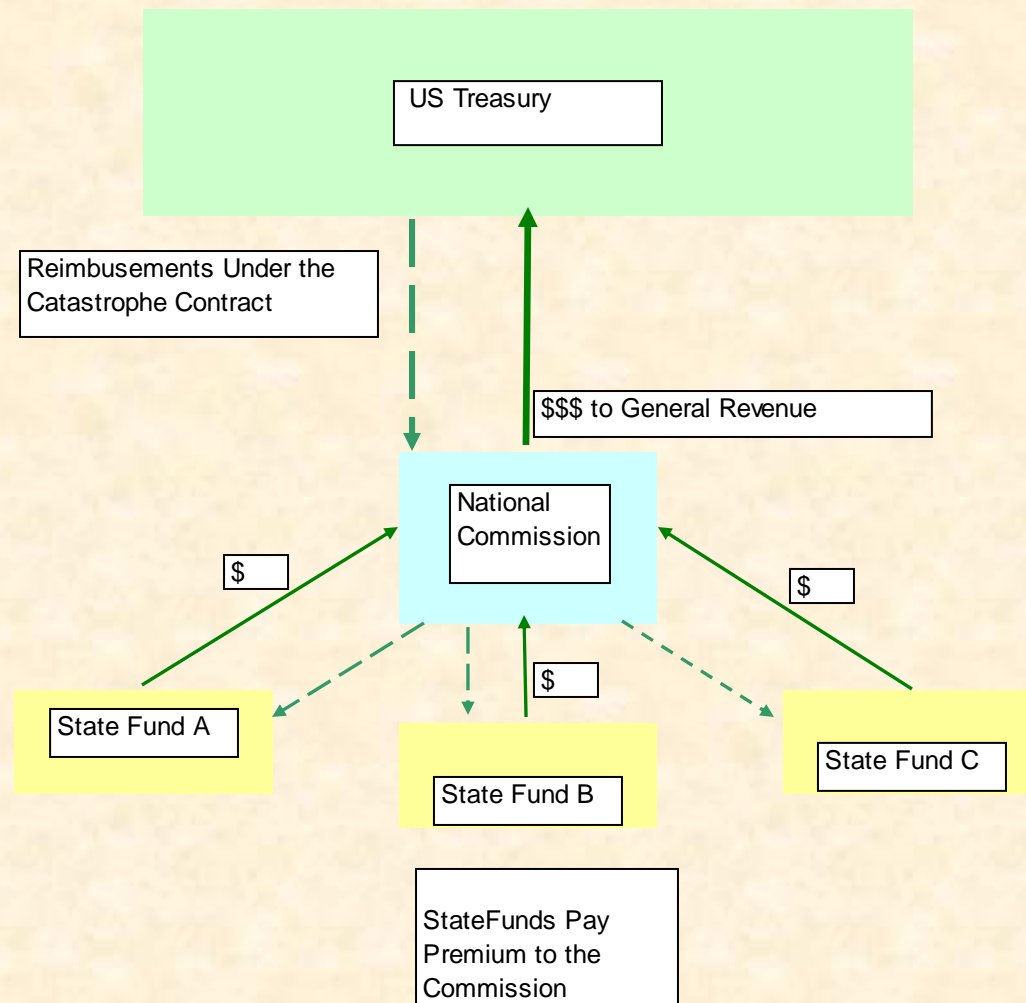


The Role of a National Mechanism

- **The National Catastrophe Insurance Commission Structure & Duties**
 - **NCIC would annually establish actuarially sound rates, with no profit factor, for each state's aggregate catastrophic exposure**
 - **State fund responsible for collecting premium and remitting to NCIC.**
 - **NCIC remits premiums to US Treasury general revenues**
 - **No separate fund is created, nor are any funds accumulated**
 - **In the event of a loss, US Treasury provides funds pursuant to catastrophe financing contract**
 - **NCIC will consist of 11 members serving 6-year terms**
 - **1 member from each of 4 NAIC zones, 1 US Treasury rep., remainder are to be experts in actuarial science, engineering, meteorological/seismic science, consumer affairs & p/c insurance**
 - **Members are selected by the President & confirmed by the Senate with chair appointed by the President**



Interaction of State Funds, National Commission & US Treasury





Pros/Cons of Federal CAT (Re) Insurance Facility

- **Rationale *FOR* Federal Involvement**
 - Insurance was not meant to handle mega-catastrophes
 - Such risks are fundamentally uninsurable
 - Federal government already heavily involved in insuring against weather-related mega-catastrophes (e.g., flood, crop)
 - Insurers are not allowed to charge risk appropriate rates (including rising reinsurance costs)
 - Price/availability of private reinsurance is volatile
- **Rationale *AGAINST* Federal Involvement**
 - Crowds-out pvt. insurance/reinsurance markets; stifles innovation
 - Relationship between price and risk assumed is diminished since fed insurance programs are seldom actuarially sound
 - Increases federal involvement and regulatory authority in p/c insurance (*not a negative for some market participants*)
 - Cost to US Treasury (esp. taxpayers in less disaster prone states)
 - Diminishes incentives for mitigation, tougher building codes and wiser land use policies if Fed rate are politically influenced



Proponents/Opponents of National Catastrophe Plan

- **Proponents of a National Catastrophe Plan**
 - Some major personal lines insurers: Allstate, State Farm
 - Insurance regulators from some CAT-prone states: FL, CA, NY as well as NY (but not TX)
 - Some elected officials in state legislatures & Congress, esp. from disaster-prone states like FL
 - Coalition building on-going (ProtectingAmerica.org)
- **Opponents of a National Catastrophe Plan**
 - Reinsurers, American Insurance Association, numerous large insurers both domestic and foreign
 - Many smaller insurers concerned about federal intrusion into the p/c regulatory arena
 - Many insurers operating outside areas prone to major CAT risk
 - Some regulators in states not prone to major catastrophic risk
 - Likely opposition among legislators and policymakers in Washington opposed to deeper involvement of government in p/c insurance sector

Regional Natural Disaster Pool(s)

• KEY ELEMENTS

- Share of property premiums in certain states (homeowners, commercial property) premiums collected would be ceded to pool and used to finance mega-catastrophes in participating states
- Funds would earn investment income tax-free to speed accumulation
- Federal government would provide a backstop to the pool as:
 - Reinsurance purchased by pool from the government
 - Line of credit offset by assessing authority

• KEY CHALLENGES

- Is participation by insureds mandatory or optional?
- If optional, significant adverse selection problem
- Determination of “actuarially sound” rates
- Maintaining role for private reinsurance
- Keeping rates free of political influence and manipulation
- Formula for assessing shortfalls in pool (including taxpayer share)
- Attracting support of states not prone to mega-catastrophes
- Anneasing deficit hawks, advocates of small government



Federal Reinsurance Program

- **KEY ELEMENTS**

- Insurers purchase CAT reinsurance from federal government

- **KEY CHALLENGES**

- Determination of “actuarially sound” rates
- Maintaining significant role for private reinsurers
- Maintaining significant role for ART and risk securitization
- Keeping rates free of political influence and manipulation
- Appeasing advocates of small government
- Keeping natural disaster risk programs separate and distinct from terrorism risk

Tax-Preferred Treatment of Pre-Event Catastrophe Reserving

- **KEY ELEMENTS**

- Insurers would be allowed to deduct from their taxable income amounts set aside in reserve for natural disaster risks *in advance of the occurrence of the actual event*
- Presently, US tax law does not allow for such treatment
 - Most other countries already permit pre-event reserving

- **KEY CHALLENGES**

- Determination of appropriate reserve levels
- Overcoming criticism of impact on US Treasury receipts
 - Note that impact on Treasury is limited to time value of tax receipts

FLORIDA SPECIAL SESSION LEGISLATIVE CHANGES

iii Insurer, Policyholder &
State Impacts



Summary: Florida Legislature Special Session (January 2007)

1. Exponential Expansion of the Role of the State in Insuring Homes & In Reinsurance Markets

- **Doubles exposure of Florida Hurricane Catastrophe Fund to \$32 billion from \$16 billion (FHCF only has \$1B cash), greatly displacing private reinsurers**
- **Allows Florida Citizens to compete with private insurers by lowering rates and lowering eligibility standards**
- **Allows Florida Citizens to displace private insurers by expanding into non-wind coastal business**
- **Disbands disciplined, small and adequately priced Commercial JUA and transfers business to poorly run, underpriced, Citizens Commercial Account**



Summary: Florida Legislature Special Session (January 2007)

2. Dramatically Increases Exposure of Florida Policyholders to Post-Catastrophe Taxes

- **Expands the Citizens assessment base more than 4 fold**
- **Increases maximum annual assessment facing Florida policyholders from \$9.2 billion to \$25 billion**
- **Increases maximum general liability and commercial auto assessment exposure from 14% to 74% (*These are 2 types of insurance that having nothing to do with hurricane risk*)**
- **Accelerates growth of Citizens, already the largest home insurers in the state and which doubled in size in 2006, by lowering rates and making access easier**



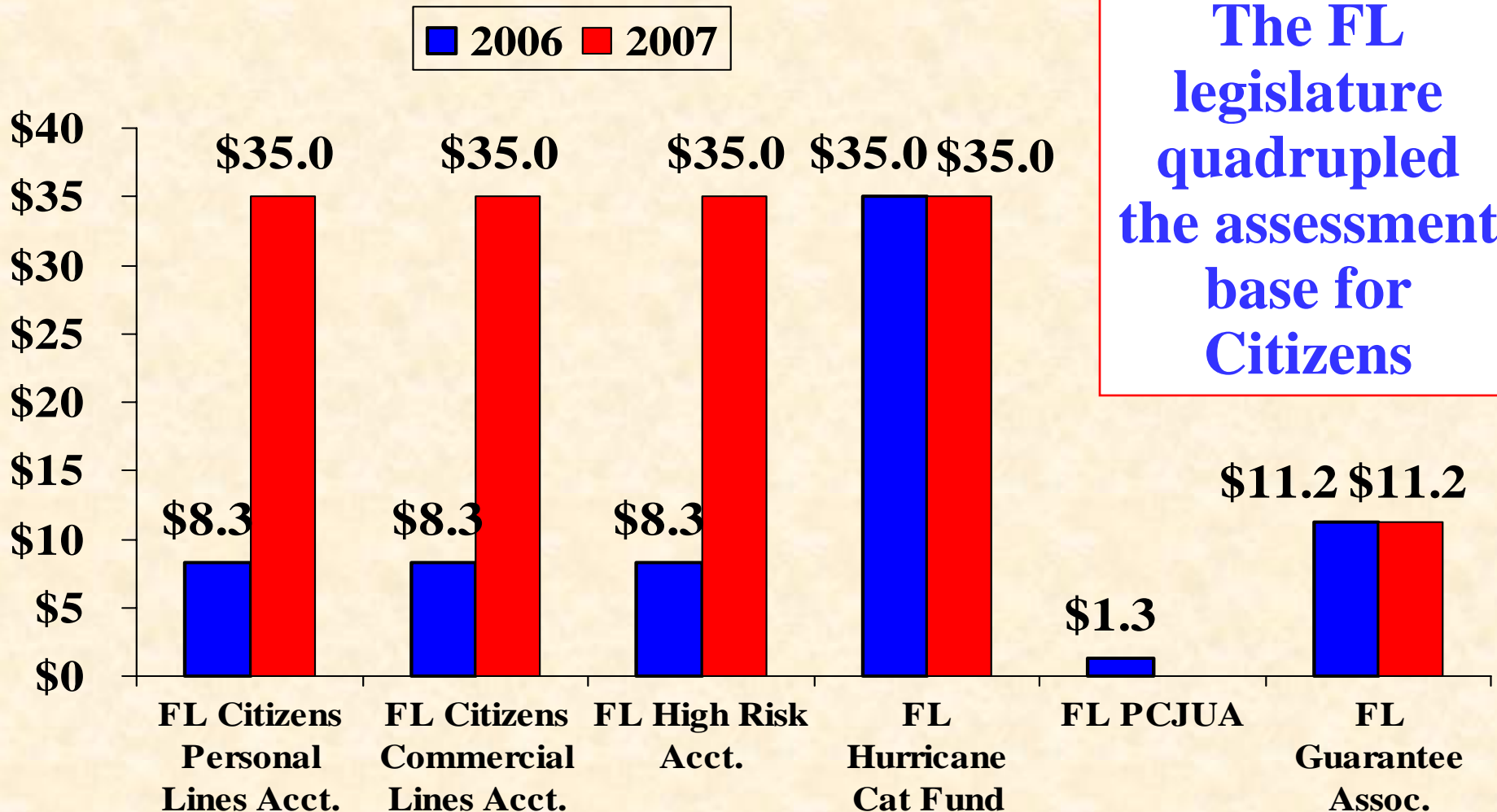
Summary: Florida Legislature Special Session (January 2007)

- 3. Disincentives for Insurers to Offer Policies in Florida**
 - Introduces “excess profits law” (a virtual oxymoron in FL)
 - Requires Executive Officer review on routine rate filings
 - Threatens perjury charges and administrative penalties
 - Increases cost of processing and maintaining policies
 - Requires “premium discounts” even if not actuarially justified

- 4. Threatens State of Florida’s Credit Rating**
 - Major event could result in simultaneous issuance of \$40+ billion in debt from Cat Fund, Citizens and Guarantee Fund
 - Governor’s promise to cut property taxes could compound state’s fiscal problems after an event



Florida Hurricane Assessment Base, 2006 vs. 2007* (\$ Bill)

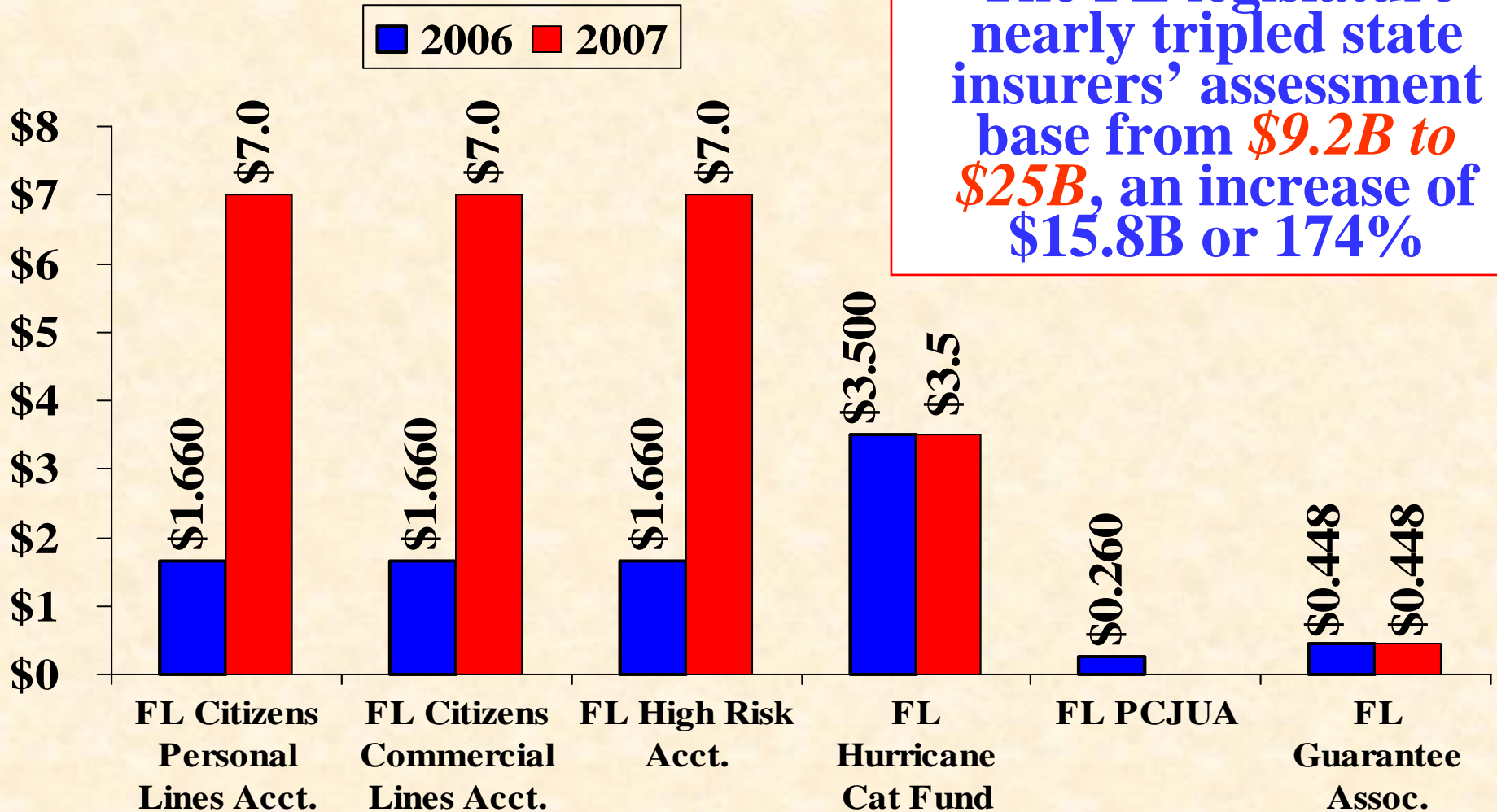


The FL legislature quadrupled the assessment base for Citizens

Sources: Zurich Insurance Technical Center; Ins. Info. Inst. *Per special legislative session, Jan. 2007.



Florida Hurricane Max. Policyholder Annual Burden, 2006 vs. 2007* (\$ Bill)



The FL legislature nearly tripled state insurers' assessment base from **\$9.2B** to **\$25B**, an increase of **\$15.8B** or **174%**

Sources: Zurich Insurance Technical Center; Ins. Info. Inst. *Per special legislative session, Jan. 2007.

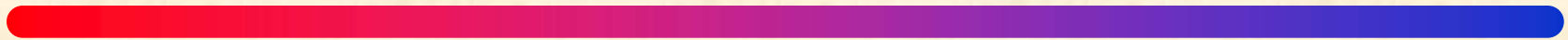
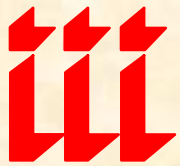


Why There is Concern Over the Florida Legislature's & Governor's Changes

- **Risk is Now Almost Entirely Borne Within State**
- **Virtually Nothing Done to Reduce Actual Vulnerability**
- **Creates Likelihood of Very Large Future Assessments**
- **Potentially Crushing Debt Load**
- **State May be Forced to Raise/Levy Taxes to Avoid Credit Downgrades**
- **Many Policyholder Will See Minimal Price Drop**
 - **“Savings” came from canceling recent/planned rate hikes**
- **Residents in Lower-Risk Areas, Drivers, Business Liability Policyholders Will Come to Resent Subsidies to Coastal Dwellers**
- **Governor's Emergency Order for Rate Freezes & Rollbacks Viewed as Unfair & Capricious**

WHAT REALLY HAPPENED?

“Florida Re”



What Really Happened in Florida?

- **Problems *Began* in 1992 with Hurricane Andrew**
 - Continuous escalation in home and commercial property insurance prices; \$21.6B insured losses (\$2005); 700K+ claims
- **Issue *Ignited* in 2004: Charlie, Frances, Ivan & Jeanne**
 - \$23B in insured catastrophe losses; 2.3 million claims
 - Large rate increases requested; Wind deductibles triggered
 - 100,000+ homeowners non-renewals issued
 - Channeling of policies into expensive market of last resort
- **Issue *Exploded* in 2005: Dennis, Katrina, Wilma**
 - \$12B in insured losses; 1.2 million claims
 - More large rate requests
 - 125,000+ non-renewals
 - Several insurers announce moratoria on new policies
 - Sharply higher commercial property prices
 - Failure of Poe Financial Group



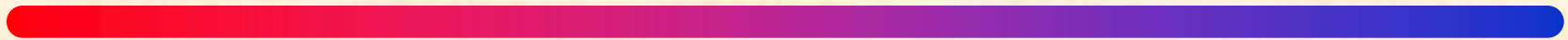
What Really Happened in Florida?

(Cont'd)

- **Florida Elections of 2006: Populist Issues Dominant**
 - #1 Campaign Issue: Lowering insurance costs
 - Populist tide was unstoppable
 - Promises made by *all* political candidates, new governor on down
 - Republicans completely abandoned free market principles
- **Insurers Offered No Cohesive Plan of Their Own**
 - Reflects disunity about how to approach natural cat exposure in the US; Some support state's expansion, others do not
 - Industry misjudged populist groundswell
 - Opportunist politicians filled the void
- **“Record” Profits of 2006 Spawned Resentment & Made Insurers Easy Political/Media Targets**
- **Calm Storm Season of 2006 Allowed Politicians and Media to Assert that Insurers Were “Gouging” Public**
- **Inability/No Willingness of Public to Understand Potential Post-CAT Assessments; Debt Load Impacts**

FUTURE CASE STUDY?

“United States Re”???



Could the Florida Model be Adopted in Other State or Federal Level?

- **(Re) Insurers Fear Export of Florida Model**
 - Louisiana is a concern
- **Several States Considering State/Regional CAT Funds**
 - Louisiana, South Carolina, Massachusetts & others
 - Would be a major negative for private reinsurers
- **Federal Level**
 - Several bills introduced to facilitate Natl. CAT Plan concept
 - Would be a negative development for private reinsurers
- **New Federal Bill: Multiple Peril Insurance Act of 2007**
 - HR 920: Would further expand federal role by requiring government to provide flood and wind coverage
 - Theoretically coverage offered on “actuarial basis” but given history of National Flood Insurance Program is unlikely

CONCLUSIONS

*Are State-Backed
Insurance Schemes the
Wave of the Future?*





Conclusions: Role of the State in Insurance Markets

- **Government's Role as *Provider* of Re/Insurance Grows**
 - Federal and State Level
 - Democratic Congress less opposed to state involvement
- **Significant Displacement of Private Insurance Markets**
 - Reinsurer displacement supported by some insurers
 - As much as 15-20% percent of US property-cat reinsurance market displaced by FL; If other states follow, up to 30-35%
- **Government Programs Tend to Become Entrenched**
 - Displacement could become permanent
 - Political determination of rates could cause further displace of private capacity in the future
- **Opportunity: State's May Look to Offload Risk to Avoid Fiscal Crisis and Debt Downgrades**
 - States will quietly look for ways to offload risk
 - Private reinsurance, ILS offer solutions



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