

“Natural Disasters and the Role of the Federal Government”

**A Speech by Kevin McCarty
Florida Insurance Commissioner**

**To the National Association of Realtors
September 18, 2006**

I would like to thank Cynthia Shelton (*moderator*) for that introduction, and thank the National Association of Realtors for inviting me to speak with you today. It is a very special honor to be invited to the Federal Natural Disaster Policy Symposium, as the National Association of Realtors has shared our vision for the development of a National Catastrophe Plan, and understands the complex relationship between natural catastrophes, the homeowners’ insurance markets, and our national economy.

If I can leave you with one message today it is this: Natural Catastrophes are a national problem that requires a national solution.

In August of 2005, two years of intense storm activity culminated with one of our worst nightmare scenarios when Hurricane Katrina reached landfall near New Orleans. More than the estimated cost of \$36 billion in damage to five Gulf coast states, it was the human suffering that crystallized several axioms about this “insurance problem”:

- **State resources are not sufficient to handle a mega-catastrophe**
- **We must engage in catastrophe planning before a disaster; and**
- **We are confronting an economic problem, not an insurance problem.**

Hurricane Katrina was not the only storm to hit the Gulf-Coast region during the 2004-2005 hurricane seasons. In fact, seven other hurricanes reached landfall in the Gulf coast causing a total of \$70 billion in insured damage. For those living in high-risk areas, the real tragedy occurred in the aftermath of the storms as policyholders experienced displacement, shortages in building supplies, shortages in homebuilding labor, rising insurance premiums, mortgage defaults, and the unavailability of private insurance. During recent trips across the state of Florida, I still saw “blue tarps” covering homes that have not been fully repaired.

When a catastrophe hits, it affects far more than insurance companies, and the victims of these events. It places stress on the homebuilders market, the banking market, land development markets, real estate values, community tax-bases, unemployment rates, and ultimately affects the economic security of all Americans – even those not in the devastated areas.

The Role of the Federal Government

The 79th Congress displayed incredible foresight in passing the McCarron-Ferguson Act in 1945 which delegated regulation of the insurance industry to the states. Not only did it lessen the burden on the Federal government, it

allowed the expansion of state regulation to tailor laws to specific market conditions based on demographic and geographic differences. Yet the Federal government still becomes involved when problems in the insurance industry threaten the economic security of the United States. The National Flood Insurance Program, National Crop Insurance, and most recently, legislation creating a Federal backstop for catastrophic losses suffered from a terrorist attack are all examples of the Federal government becoming involved in insurance issues. We must add natural catastrophes to this list.

Although we have monitored these recent events with great compassion, my greatest concern does not pertain to natural catastrophes. My greatest concern is the potential for far greater mega-catastrophes; either repeats of those that have occurred in our nation's past, or others that will inevitably occur in the future. A repeat of the 1906 San Francisco earthquake would cause an estimated \$400 billion in damage in today's dollars; a repeat of the 1938 hurricane that hit New York and the Mid-Atlantic region would cause \$300 billion in damage; and a repeat of the 1811-1812 New Madrid Fault Line earthquakes in Arkansas, Illinois, Kentucky, Missouri, and Tennessee would cause \$275 billion in damage. As you can see, none of these scenarios include my home state of Florida.

In the instance of Katrina, the Federal government eventually appropriated \$120 billion to help rebuild the storm-ravaged region and the lives affected by that event. However, it is like the old television commercial featuring the auto mechanic – “You can pay me now, or you can pay me later.” It is always easier to engage in pre-event financing, than in post-event financing. Pre-event financing is the driving force behind the concerted push for a National Catastrophe Plan.

To Find a Solution, We Must First Define the Problem

Whether it is legislators, businessmen, or average Americans, we constantly hear about an “insurance problem.” But what exactly is this problem, and what can the public and private sectors do to address it?

The problems in the insurance market can be summarized by three broad categories:

- ◆ **Capacity**
- ◆ **Availability; and**
- ◆ **Cost**

The First Problem: Capacity of the Private Insurance Market. By capacity, I mean the ability of insurance companies to write insurance business. As a result of the recent hurricane damage companies are enforcing stricter underwriting standards to limit their exposure in certain high risk areas, or limiting types of properties they select to insure.

In addition, private insurers are feeling market pressures from global reinsurance markets. I have personally met with representatives of the global reinsurance markets in the Caribbean and in Europe to encourage increased investment in Florida, and the Gulf Region. Frankly, it is a difficult sell. Given the current situation, there is little interest in an expanding investment to insure against mega-catastrophes, like hurricanes.

The Second Problem: Availability of Insurance. From a consumer perspective, there are fewer policies “available” for purchase. This creates a considerable problem in a growing economy, and a growing homebuilders market, which requires a constant infusion of new capital to compensate for the new homeowners needing insurance to satisfy their mortgage requirements. If people cannot find insurance, they cannot buy homes, or afford to live in their current residences.

The Final Problem is Cost to the Insureds. It seems that policyholders complain the most about cost ---the one issue that I as Insurance Commissioner have the least regulatory authority to address. Cost is determined by risk, and the competitive marketplace. Yet as regulators we must pay attention to cost. If insurance policies become too unaffordable, this will restrict people’s alternatives to purchase homes, or live in certain regions of the country.

All three of these problems are interrelated.

A Federal/State Partnership is Needed to Ameliorate Problems in the Insurance Marketplace

When some people suggest federal involvement in the insurance marketplace, it raises the specter of a government take-over, and a ballooning federal bureaucracy to directly intervene in insurance issues all over the country. This need not be the case. I have recently testified twice to Congress regarding the role the Federal government can play in facilitating solutions to problems in the insurance marketplace. There are a

multitude of ideas and proposals ranging from private initiatives, to private-public joint ventures, to direct Federal involvement. In reality, a combination of these approaches will probably yield the most success.

Step 1: Improving Infrastructure

One element of improving the homeowners' insurance risk is to improve our nation's infrastructure. This includes upgrading the structural integrity of our dikes, levees, tunnels, bridges, solid waste facilities, transportation facilities, and roads. Let us recall during the Hurricane Katrina tragedy in New Orleans, many of the structures withstood the initial damage of the storm, only to be destroyed due to the failed levee system. The American Society of Civil Engineers' March 2005 Report Card showed deteriorating conditions in 13 of the 15 infrastructure areas surveyed. Insurers are becoming reluctant to insure structures in areas with outdated or outmoded infrastructure risks. A commitment to improving our infrastructure, especially as it relates to structures that place homes in greater risk during a catastrophic event, will help prevent or mitigate damages to homes.

Step 2: Building Better Homes

The first component of any comprehensive national strategy must be mitigation. In practical terms, this involves toughening building codes for new structures by making them more resistant to hazards such as wind, flood, and earthquakes. It also means stricter state and local guidelines to limit construction in highly hazardous areas.

Enhanced building techniques include reinforcing roof-to-wall connections, reinforcing roof systems, use of superior roof material attachment methods,

placement of secondary water barriers on roof decking, and protection of all openings (windows, doors, garage doors and gable vents) by either installing shutter systems or using wind and impact-resistant window and/or door systems.

The Federal government can positively impact these decisions by predicating Federal loan decisions through the Federal Home Association (FHA) and Rural Development Home Program to only allow the purchase of homes that meet the most stringent building code standards. If a home does not meet these standards, a procedure for requiring the retrofitting of the home must be enforced.

Step 3: Augmenting State Based Plans

Several states have augmented their private insurer capacity by creating their own quasi-governmental agencies or trust funds to supplement capacity and become the “insurers of last resort.” Following Hurricane Andrew in 1992, the State of Florida endured 12 insurer insolvencies and a virtual collapse of the private insurance homeowner’s market. In response to this crisis, the Florida Legislature created two quasi-governmental agencies, which eventually merged into Citizens Corporation Insurance Company --- the state insurer of last resort for Floridians. In addition, the Legislature created the Florida Hurricane Catastrophe Fund. In September of this year, the State of Florida even created a Florida Property and Casualty Joint Underwriting Association (PCJUA) to assist small businesses unable to access insurance coverage in the private market.

These types of “solutions” have placed a tremendous strain on our state’s resources. As private insurers limit their exposure, the Citizens Corporation

has experienced an explosion of growth. Currently Citizens has 1.2 million policies and insures over \$250 billion in structure exposure. It is the largest insurer in the state of Florida surpassing State Farm in July 2006. In 2005, Citizens Corporation ran a deficit of \$1.7 billion which had to be financed through premium surcharges, and a cash infusion from the Legislature.

Step 4: Creating Catastrophe Reserves

The concept of catastrophe reserves is a diverse one, and involves many different concepts. Virtually all of the proposals in this category would require an overhaul of the IRS tax code. One concept is to develop a catastrophe reserve for individuals through Hurricane or Catastrophe Savings Accounts (HSAs). Modeled after the success of the Medical Savings Accounts (MSAs), or Roth IRAs, this financial instrument would allow individuals to set aside money on a yearly basis that would accumulate tax free, and could only be withdrawn for specific purposes such as paying their hurricane deductible, or to take mitigation measures to lessen catastrophe damage. Although originally envisioned for the hurricane risk, it is sensible this concept could be expanded to include all catastrophe risk.

Another concept is to amend the IRS tax code to provide incentives for individual insurance companies to set aside reserves for their policyholders for catastrophic losses on a tax-deferred basis. Current tax laws discourage property & casualty insurers from accumulating assets to pay for future catastrophe losses. Payments for catastrophe losses are made from unrestricted policyholder surplus after losses are incurred. Current tax law and accompanying accounting standards require insurers to limit the

recording of loss reserves which have already occurred and require the recognition of catastrophe premiums in prior periods.

Yet another concept would be to have the Federal government, through the U.S. Treasury Department, implement a reinsurance program offering reinsurance contracts sold at regional auctions. These reinsurance funds would be restricted to authorized state catastrophe funds, similar to our Florida Catastrophe Fund, or the California Earthquake Authority.

Step 5: Development of a National Catastrophe Plan

Currently, the United States is one of the only industrialized nations in the world not to have a Federal comprehensive catastrophe plan. I strongly endorse the concept of a National Commission on Catastrophe Preparation, as well as a national layer of reinsurance which could be purchased by eligible state programs like we have in Florida.

A multi-layered approach, with the Federal government's commitment to reinsure state entities against a mega-catastrophe as its capstone, will not only proactively help in any catastrophe recovery effort, but provide stability in the housing insurance market by allowing states to diversify their risk. If we can accomplish this goal it will likely lure additional private capital to the insurance market. More capital means more competition, lower premiums for insurers, and ensures availability of property insurance.

A keystone of the "American Dream" has been homeownership. In practical terms, this dream cannot be achieved without homeowners insurance --- required by every lending institution that underwrites home mortgages. The amount of private capital invested in the Florida insurance market by private

insurers and reinsurers has been stagnant in recent years, and is fundamentally inconsistent with the needs of a growing state and a growing economy. Other states are also experiencing problems obtaining insurance capital, not just those in the Gulf region.

Fortunately, the 2006 hurricane season has been a calm one. As we pass the five year anniversary of 9/11 we can also be grateful there have no terrorist attacks on U.S. soil in five years. We have not recently experienced catastrophic earthquakes, tsunamis or other natural disasters, but we must not become complacent. It is a certainty the United States will experience another mega catastrophe --- it is just a matter of time. If anything can be learned from the tragedy in New Orleans, it should be this: mega-catastrophes are a national problem that requires a national solution. We must find a solution before it occurs.