NAMIC STATEMENT OF PRINCIPLES ON NATURAL DISASTERS

August 2009

Introduction

The havoc wreaked by the 2005 Gulf Coat hurricanes raised important questions about how Americans should prepare for and respond to natural disasters in the future. The likelihood of more frequent and severe natural disasters, as well as the continuing concentration of the country's population in areas vulnerable to natural disasters, pose significant challenges for government policymakers, insurers, realtors, home builders, mortgage lenders and property owners.

The National Association of Mutual Insurance Companies (NAMIC) formed a Task Force on Natural Disasters in December 2005 to deepen our understanding of these challenges, and to search for and promote viable solutions. The Task Force, which consists of representatives from 20 of NAMIC's member companies, held regular meetings in the first half of 2006 during which members were briefed by researchers, analysts, and practitioners from a variety of disciplines who were selected for their expertise in particular areas of disaster risk management and insurance. The Task Force also studied and discussed a sizable body of literature on natural disaster issues.

In June 2006, the Task Force formulated four general principles that served to guide NAMIC members and staff as the natural disaster debate evolved. In March 2008, the NAMIC Board of Directors asked the Task Force to review the principles and make any necessary revisions in light of developments that had occurred since the principles were initially adopted. Issues of particular interest included several new legislative proposals at both the state and federal levels, as well as the potential impact of climate change on natural catastrophes.

The Task Force reconvened and held regular meetings during the second quarter of 2008 and 2009. These meetings included presentations from experts and staff who briefed the members on current natural disaster legislative initiatives and the state of the reinsurance market

The Task Force ultimately concluded that it was not necessary to substantially revise or modify the four general principles that were originally adopted in June 2006. However, the Task Force added new language to the discussion of the principles' underlying rationale.

The general principles are:

1. Market freedom and competitive risk-based pricing will lead to innovation in developing solutions to problems relating to disaster insurance and mitigation.

2. Competitive risk-based pricing and risk-based underwriting are essential to developing and maintaining a viable disaster insurance market.

3. Mitigation and consumer education must be indispensable elements of any disaster risk management and insurance initiatives.

4. The National Flood Insurance Program should be maintained, but must be reformed.

The following is an elaboration on the rationale behind each of the four principles.

1. Market freedom and competitive risk-based pricing will lead to innovation in developing solutions to problems relating to disaster insurance and mitigation.

a) Insurance markets function most efficiently in the absence of government rate suppression and underwriting restrictions. A flexible regulatory environment in which insurers are free to price coverage based on risk will create incentives for property owners in high-risk areas to invest in loss mitigation measures. Likewise, risk-based pricing will create incentives for individuals, home builders and mortgage lenders to engage in risk avoidance strategies (such as refraining from purchasing or building homes in high-risk areas).

b) Risk-based pricing will foster greater competition among insurers and increase the availability of property insurance in disaster-prone areas. Developing sufficient capacity to insure against losses caused by low probability/high consequence events is dependent on the ability of insurers and reinsurers to generate and hold capital. With an adequate rate of return, capital will flow into insurance markets.

c) The private insurance market is best equipped to provide coverage for most types of natural disasters under most circumstances. Exceptions include flood insurance generally, and earthquake insurance in high-risk seismic zones. NAMIC recognizes that both recent and anticipated increases in the number and severity of natural disasters over the next decade has caused some observers to question whether primary insurers, reinsurers and the capital market will continue to have the ability to finance a “mega-catastrophe,” or a series of high-consequence events occurring within a relatively short time frame.

d) To date, the private marketplace has had the capacity to handle natural disasters. However, in jurisdictions with a restrictive regulatory environment, a significant increase in major storm frequency or the occurrence of a mega-catastrophe (e.g., an earthquake comparable to the 1906 San Francisco event, or a high-category hurricane striking heavily

populated areas such as Miami, Houston, or New York City) could test or exceed private market capacity in high-risk regions. Such a mega-event could result in the inability of many insurers to meet their claim obligations and still offer protection on a going-forward basis. This is particularly true where insurers have established single-state companies as a way to manage their exposure. Therefore, consideration of state or federal programs designed to respond to these mega-events may be appropriate.

e) Disaster under-preparedness is not simply an insurance availability and affordability problem. Policymakers must recognize that human psychology strongly influences the decisions people make with respect to disaster risk management and insurance. Attention must be paid to the reasons why property owners as well as government officials tend to underestimate catastrophe risk and fail to prepare adequately for natural disasters. It is also important to acknowledge the tendency among many consumers to view insurance as a financial investment rather than as a protective measure. Studies indicate that this tendency leads people to discontinue coverage after a period during which they suffer no losses and file no claims, on the grounds that continuing to pay premiums "isn't worth it."

f) NAMIC supports the concept of amending the federal tax code to allow insurers to set aside a portion of premium income in tax-exempt policyholder disaster protection funds. NAMIC also supports the concept of allowing homeowners to create tax-free catastrophic savings accounts similar to health savings accounts which could be used to pay hurricane deductibles and costs associated with retrofitting properties.

2. Competitive risk-based pricing and risk-based underwriting are essential to developing and maintaining a viable disaster insurance market.

a) Open and competitive property markets are ultimately in the best interest of consumers. Lawmakers and/or regulators sometimes impose rating and underwriting restrictions on property insurers that allow high-risk property owners to pay artificially low premiums, forcing lower-risk property owners to subsidize the insurance costs of high-risk buyers by paying inflated premiums. NAMIC believes that using the insurance pricing mechanism to create hidden cross-subsidies among risk classes is not good public policy.

b) A market-based insurance pricing system in which premiums reflect the actual cost of insuring against catastrophic risk could result in significant premium increases for some property owners in high-risk regions. Policymakers may consider creating programs to provide direct government assistance, funded from general fund revenue, to low-income

and other groups according to criteria established by the unit of government providing assistance. In designing such programs, care should be taken not to reduce risk mitigation incentives.

c) In discussions of insurance price regulation, the term "actuarially sound" is often used without definition. This term must be carefully defined, as there is no common definition shared by all participants. For example, "actuarially sound" pricing for catastrophe exposed coverages must also include compensation for the unusually large call on capital that is required to pay catastrophic losses. The call on capital that results from the highly correlated large-scale losses typically associated with extreme events may well be several times greater than the total annual "expected loss" of the coverage. In other words, the term "actuarially sound" should be understood to include not just the insurer's expected loss costs and expenses based on yearly averages. It should also include an adequate "risk load" that takes into account the call on capital.

d) Lawmakers, judges and the general public must recognize the cyclical nature of property insurer profits, how profits relate to surplus, and the role of surplus in ensuring that insurers are able to meet their contractual obligations to policyholders. Using return on equity as the universal benchmark for measuring company profitability, economists have found the return on equity of insurance companies to be lower than that of most other industries. Regulatory decisions and judicial rulings that require insurers to pay disaster-related claims irrespective of the terms of the insurance contract could cause availability problems at best and widespread failures in the market at worst.

3. Mitigation and consumer education must be indispensable elements of any disaster risk management and insurance initiatives.

a) Effective mitigation efforts including the development of strong building codes as well as responsible land-use planning have been shown to greatly reduce the level of property damage and human suffering caused by natural disasters.

b) Government policymakers, insurers, builders, realtors, mortgage lenders and other stakeholders have a shared responsibility to help Americans who live in harm's way understand the nature of catastrophic risk and the threat it poses to their property and personal safety. Government-imposed rate suppression and reliance by private insurers on actuarially unsound government reinsurance programs can have the effect of distorting public perceptions of risk. Risk-based insurance pricing, on the other hand, sends accurate signals to consumers about the relative level of risk associated with particular regions and types of structures.

c) Government officials and private insurers should work to educate consumers about measures they can take to mitigate their exposure to natural disaster risk, and to help consumers understand the importance of maintaining appropriate levels of coverage.

d) NAMIC supports the concept of federal legislation that would create financial incentives to encourage states to adopt and enforce strong, statewide building codes. Such incentives should include funding to allow local governmental units to establish building inspection departments or to enhance existing enforcement mechanisms.

e) With respect to existing properties, NAMIC supports government initiatives to create mitigation grant programs to enable homeowners in high-risk areas to invest in risk mitigation measures.

f) While acknowledging the growing interest among policymakers and insurers in the possible relationship between climate change and natural disasters, NAMIC notes that current climate science is uncertain as to the probable effects of climate change on future catastrophic events. Therefore, legislative and regulatory initiatives that are based on speculative assumptions about the impact of climate change should be avoided.

4. The National Flood Insurance Program should be maintained, but must be reformed.

a) The National Flood Insurance Program (NFIP) has provided flood insurance coverage to homeowners across the country since 1968. While Hurricane Katrina revealed shortcomings in the program, NAMIC believes the NFIP should continue to operate, but it must adopt significant reforms.

b) NFIP premiums must be actuarially sound for all covered structures. The current method for setting premiums, which is based on average annual losses, has been called “unsustainable” by the Congressional Budget Office. This approach has prevented the NFIP from accumulating the surplus necessary to pay claims during periods when loss costs are above average.

c) The borrowing authority of the NFIP must be increased so that program administrators will not be required to seek special appropriations from Congress each time a natural disaster involving major flooding occurs.

d) Additional federal funds should be allocated to the national flood hazard mapping program. Updating and improving flood maps should be a priority within NFIP also in those communities that will benefit most from updated flood maps.

e) The NFIP needs additional resources and a renewed mandate to improve and expand its public education programs to ensure that more people are made aware of the program and the benefits of having flood insurance coverage to protect their properties.

f) The NFIP must remain exclusively a flood insurance program; its scope should not be expanded to include other hazards for which coverage is available in the private insurance market.

g) NAMIC urges policymakers and other interested parties to work together to develop additional improvements to the National Flood Insurance Program.