COMPETITIVE ENTERPRISE INSTITUTE

Dear Chairman McCarty and Members of the Property and Casualty Insurance (C) Committee:

I write to you on the behalf of the Competitive Enterprise Institute, a Washington, D.C.-based think tank devoted to classical liberal economic policies. We advocate these policies because we believe in freedom for both individuals and business enterprises. We want a market where consumers can purchase the insurance products they want and where companies can sell these products. To that end, we oppose all price controls and insurance-company subsidies. Our permanent interest is simple: we believe in the Free Market.

We agree with much of NAIC's recent plan "Natural Catastrophe Risk: Creating a Comprehensive National Plan."[1] We heartily endorse the calls for retrofitting of homes, more flexible policy terms, and a concerted response from federal policy makers. We also agree with the implication that the current problem requires a national-level response and the calls for a National Catastrophe Commission.

We do, however, have concerns about the Committee's call for "public/private partnerships" for backstops and its call for the establishment of a "National Catastrophe Insurance Mechanism." On these issues, we wish to make four related points:

- The C Committee should strongly discourage the creation of state catastrophe funds rather than suggesting principles to make them work better.
- The Committee should not endorse H.R. 3355 (as it implicitly does) or any level of public involvement with the financing of reinsurance. Such efforts will not work.
- The Committee should focus on efforts that would encourage greater capital investments in insurance and reinsurance.
- Risk-Based insurance rates, coupled with mitigation programs, will do the most to make America safer.

Discussion of these points follows:

The C Committee should strongly discourage the creation of state catastrophe funds rather than suggesting principles to make them work better.

State level catastrophe funds, which the plan before the Committee refers to under its discussion of Layer 2, clash with fundamental principles of good insurance risk management. Insurance works best when authorities manage risks across broad pools of non-correlated risks. State level catastrophe funds and wind pools attempt to reduce costs by managing risks across narrow pools of heavily correlated risks. In all cases, the actuarially adequate rates necessary to sustain such pools will be *higher* than the rates that would exist in a private, voluntary market.

[1] National Association of Insurance Commissioners. "National Catastrophe Risk: Creating a Comprehensive National Plan," September 3, 2008.

Rather than proposing principles for running catastrophe funds, the committee should discourage their creation in the first place. They simply do not work. States where the "private market does not have the capability to provide" affordable insurance are invariably responsible for the messes they have created through systems of price controls.[2]

Thus, any system that encourages states to set up catastrophe funds—even implicitly—deserves condemnation. Right now, a full-scale catastrophe fund exists only in Florida (although Hawaii and California have mechanisms that might be considered Cat Funds.) Guidelines for Cat Fund creation, therefore, do not make sense. Rather than adopting guidelines for the prudent administration of catastrophe funds, the C Committee should consider issuing a statement discouraging their creation.

The C Committee Should Not Endorse H.R. 3355 (as it implicitly does under layer 3) or any level of public involvement with the financing of reinsurance. Such efforts will not work.

The Homeowners Defense Act of 2007 (which "layer 3" endorses by implication) is misguided in just about every way. The proposed consortium cannot work, the idea of liquidity loans to state cat funds will only displace private investment, and post-event backstopping will only benefit one state. Moreover, the entire system will cost more than anticipated and, ultimately, will require a federal bailout.

The "voluntary" nature of the system envisioned under H.R. 3355's consortium of "layer 3" seems destined to failure. The States most likely to join are those with the worst insurance environments and the least stable markets. The demands placed on private insurers in consortium participating states will only exacerbate the negative environment pushing all but a few private insurers to flee those states, decreased availability of private insurance and increasing the state's reliance on federal assistance.

For similar reasons of adverse selection bias, proposed liquidity loans to state wind pools are also a bad idea. A soundly run wind pool can always access private capital and, indeed, even the unstable Florida Hurricane Catastrophe Fund recently managed to convinced Berkshire-Hathaway to provide what is essentially a $4 billion retrocession facility. The federal government does not need to involve itself in such lending.

Finally, direct post-event Cat Fund backstops make no sense at all. Only one state—Florida—currently has a Cat Fund that would qualify. We think the NAIC should encourage Florida to come up with a plan for transferring this liability to the private market rather than attempting to transfer it to the nation's taxpayers.

In any case, the entire plan lacks a workable funding mechanism. Although HR 3355 contains some apparently reassuring language requiring the Secretary of the Treasury to accept nothing less than full repayment and simultaneously forbidding the use of federal funds for repayment, we don't believe it can work.[3] A corporation headed by the Treasury Secretary and made up largely of government officials will have an implicit guarantee the same way Fannie Mae and Freddie Mac did and still do. (In fact, because it won't have private stockholders, the guarantee will be even more explicit.) The structure of the proposal makes it clear that the federal government will bail out the Consortium and Florida. If it saves money on receives lower interest rates it will only be because of this promise of a bailout.

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[2] Quotation from NAIC, 8.
[3] H.R. 3355 Sec. 108.

We also are extremely skeptical of the bill's claim that it will be require only a few million dollars--$20 million the first year--for administration because it will charge actuarially adequate rates.[4] The National Flood Insurance Program was supposed to operate on an actuarial basis. Instead, it currently owes over $17 billion to the United States Treasury.[5] We don't know what the cost of the Consortium will be but we expect it will be at least as twice large as the $32 billion in potential liability that the Florida Hurricane Catastrophe Fund imposes on its state. In fact, no major government run insurance program in charges truly adequate rates. A major study conducted by a former Clinton administration official has, in fact, concluded that taxpayers in at least 20 states would face burdens over $1 billion as a result of these programs.[6]

In short, the structure proposed in H.R. 3355—or any other national reinsurance mechanism—simply cannot work on an actuarial basis because government is *not* the best manager of risk.

The Committee Should Focus on Efforts that Would Encourage Greater Capital Investments in Insurance and Reinsurance.

Rather than proposing the creation of "level three" (discussed above) the C Committee should encourage greater investment in insurance and reinsurance markets. We heartily endorse the paragraph ideas expressed under "additional consideration." In particular, we agree with the passage that says:

> The NAIC should continue to address perceived roadblocks within the U.S. Tax Code and within SEC regulations that are impediments to the private market's ability to fully utilize financial market structures to transfer catastrophic insurance risk from the insurance industry to other willing and informed investors.[7]

In fact, we believe that this course of action—rather than the creation of a national backstop—will do the most to encourage a stronger, wealthier, more resilient insurance market. This is the root solution to the nation's insurance woes and NAIC should focus its attention there.

Risk-Based Insurance Rates, Coupled with Mitigation Programs Will Do the Most to Make America Safer

We are deeply disturbed that the report, as currently written, does not once mention the concept of risk-based rates. Basing rates on risk alone—something many state regulators seem reluctant to do—appears the one sure way to make insurance available to all Americans who desire it.

We believe that the committee should encourage NAIC members to transition their insurance regulatory systems to those that allow insurers and consumers to make robust use of all relevant risk factors. With risk taken into account, market forces alone will strongly encourage the levels of mitigation necessary order to make insurance affordable for everyone. In particular, we believe that the committee

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[4] H.R. 3355 Sec. 108.
[5] Office of Management and Budget. "Focus Areas: National Flood Insurance Program," http://www.whitehouse.gov/omb/expectmore/issue_summary/issueDetailedPlan_28.pdf
[6] Robert J. Shapiro and Aparna Mathur. "The Economic Effects of Proposals for Federal Natural Catastrophe Reinsurance and New Loan Programs: Who Pays and Who Benefits?" Sonecon, August, 2008.
[7] NAIC, 10.

should call for the dismantling of all prior approval regulatory systems and price controls that currently exist.

Although we strongly encourage the committee to endorse a system that bases rates entirely on risk, we also acknowledge that the transition to such a system will take time and could cause significantly dislocations if undertaken too hastily. Therefore, we encourage the committee to continue its advocacy for strong state and national level efforts to encourage programs that assist with mitigation, relocation and other efforts to reduce the harm from catastrophic events.

Concluding Thoughts

The proposed plan contains a number of well-thought out points that we agree with. We feel, however, that the overall tone of the report betrays a strong distrust in market forces. Our message is simple: the free market will work if the government will let it.

Respectfully Submitted,

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