TESTIMONY OF

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BEFORE THE

SENATE COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION

ON

THE NATURAL DISASTER PROTECTION AND INSURANCE ACT OF 1999

(S. 1361)

APRIL 13, 2000

Introduction

Chairman McCain, Senator Hollings, Senator Stevens, members of the Committee, my name is Scott Gilliam. I am Director of Government Relations for The Cincinnati Insurance Companies, headquartered in Fairfield, Ohio, just north of Cincinnati.

Our group of companies market property and casualty insurance in 30 states through an elite corps of fewer than 1,000 local independent insurance agencies. That group of companies has nearly one million policies in force insuring businesses and families. Our parent company, Cincinnati Financial, is among the top 20 publicly traded property and casualty insurers based on 1999 consolidated revenues of $2.1 billion.

I am honored to be with you today to present The Cincinnati Insurance Companies' perspective on S. 1361. We commend Chairman McCain and Senator Hollings for holding this hearing and Senator Stevens for his leadership over the last several years in raising awareness of the issues associated with natural catastrophe exposure and insurance.

The frequency and severity of natural disasters have created serious issues that the insurance industry and government need to address. In recent years there have been a number of attempts at the federal level to deal with the problems associated with insurance protection for losses arising from hurricanes, earthquakes and other natural disasters.

The catastrophe exposure we face from our own book of business has prompted us to engage in this important debate. For example, our hurricane exposure in Florida and Alabama alone is nearly $1.8 billion, representing over 10,000 homes. In the New Madrid earthquake region in the Midwest, our total insured values are $89.5 billion, based on the amount of earthquake coverage currently in force for homes and businesses. These are significant exposures for The Cincinnati Insurance Companies when considered in relation to the current level of assets for our property/casualty group ($5.9 billion).

We have been further motivated by several basic concerns which have presented themselves over the years as various legislative proposals, the most recent being S. 1361, have been presented to deal with the problems associated with insurance protection for losses arising from hurricanes, earthquakes and other natural disasters. These include:

- the need to preserve state regulation of insurance (McCarran-Ferguson Act);
- finding a solution that will enhance private markets and not compete against them;
- the need to oppose legislation that is detrimental to any segment of our industry or would unfairly favor one insurer over another.

<u>The S. 1361 Proposal</u>

Let me know turn to the legislation at hand, S. 1361, which would create a new federal agency, the "Natural Disaster Insurance Corporation" (NDIC), through which federal reinsurance contracts would be offered for purchase by state insurance programs and for auction to state insurance programs and private insurers to cover residential losses in the event of a natural disaster. The federal reinsurance contracts would provide natural disaster peril coverage on an excess-of-loss basis with a trigger as low as $2 billion. Pricing of the contracts would be established by the NDIC, in consultation with a new federal commission, the "Independent Natural Disaster Board of Actuaries." The NDIC would be authorized to make unlimited annual payments under the contracts and to engage in borrowing through the Secretary of the Treasury as necessary to pay claims and expenses under the contracts.

We do not disagree that there may be a need for high-level federal involvement in excess of private market capacity to ensure that Americans are provided with appropriate insurance protection for losses arising from hurricanes, earthquakes and other natural disasters. However, we believe that the following principles must be embodied in any legislation which endeavors to provide a federal safety net for catastrophe insurance:

1. The risk of natural catastrophes is best insured in a diversified marketplace which avoids concentration of risk in too few insurers or state programs.

2. The private sector's role, including insurance, reinsurance and capital markets, should be maximized and such financing mechanisms fully exhausted before any government capacity is provided, state or federal.

3. Government's role should be to address insurer solvency in the event of a mega-catastrophe and should not come at the expense of taxpayers.

4. Any federal proposal should include personal and commercial lines of insurance since both forms of coverage are affected by catastrophic events.

Unfortunately, S. 1361, in its current form, falls short in a number of these areas.

<u>Low Trigger And New Unfunded Federal Liability</u>

Our primary concern with S. 1361 is its trigger for payment of losses, a trigger which is far below existing industry capacity. As currently drafted, the trigger for payment of losses is as low as $2 billion, despite the fact that the industry paid insured losses of $15.5 billion from Hurricane Andrew in 1992 and $12.5 from the Northridge Earthquake in 1994. Why should the government step in at such low levels at a time when the industry continues to gain financial strength? Since 1992, the industry's policyholder surplus has increased from $162 billion to over $333 billion today. Fact of the matter is, the industry has handled all catastrophes to date regardless of their size and has handled them totally within the private sector.

Simply put, with a private market which is twice as prepared today to cover the back-to-back natural disasters it handled on its own in the early 1990s at a cost of $28 billion, the federal government should not be stepping in to pay for events with damages as low as $2 billion. This is reinforced by the sentiments of Treasury Secretary Larry Summers, who told a New York forum for property-casualty insurers in January, 1999 that a federal reinsurance program like that proposed under S. 1361 should be limited to those "risks that private markets currently have difficulty handling."

Equally distressing is the fact that S. 1361 will expose taxpayers to new unfunded federal liability. In its February 9, 2000 "Cost Estimate" for H.R. 21, the House counterpart to S. 1361, the Congressional Budget Office concluded "it is unlikely that the federal government would be able to establish prices for disaster reinsurance that would fully cover the potential future costs of these financial obligations," as a result of which "federal payments for disaster insurance claims would exceed the premiums collected" under H.R. 21. This situation will be even worse under S. 1361, since the Senate bill gives the program's governing body, the Natural Disaster Insurance Corporation, unlimited authority to borrow federal funds to pay claims if the premiums collected are insufficient to pay claims. This has the potential of creating a crisis similar to what we saw in the savings and loan industry not too many years ago.

Similar concerns were voiced by Secretary Summers in his remarks to the same property-casualty forum mentioned above, Mr. Summers telling the group that a federal reinsurance program like that proposed under S. 1361 "should impose no net cost on the taxpayer" since "the federal government cannot be the bill-payer of last resort" for such insurance. However, that is exactly what will happen if

S. 1361 is enacted in its current form.

Government Competition With The Private Market

We are also very concerned that S. 1361 will supplant the private market and stifle private sector development of new and innovative approaches to the problem of protecting Americans against catastrophic risk. Despite what others may have said today, reinsurance is available and affordable through the private sector for those who properly manage their risk. As 1999 data from the Reinsurance Association of America reflects, there is approximately $20 billion of catastrophe reinsurance capacity available per region, per event in the U.S., and prices for catastrophe reinsurance have declined for five years in row.

The federal reinsurance program proposed under S. 1361 overlooks these important facts and invites the federal government to compete with and displace private markets for reinsurance. S. 1361 is a classic "government-knows-best" approach to public policy issues. By offering subsidized federal reinsurance to state insurance programs, S. 1361 displaces the private insurers and reinsurers already assuming risks in those markets. The likely result is markets that are dictated by government officials with no room for private sector ingenuity.

As the private reinsurance market continues to improve, we are also witnessing the introduction of innovative capital market approaches which are expanding the industry's risk-bearing capabilities for catastrophe exposures. An evolving form of securitizing risk through capital market instruments is providing significant new capacity to the insurance industry. In 1998, there were eighteen such transactions totaling $2.5 billion and similar approaches for securitizing catastrophe risk are in various stages of development. It is these types of approaches to catastrophic risk protection which Treasury Secretary Summers views as the most promising. As Secretary Summers told the property-casualty forum in New York:

> "Ultimately, we believe that the most efficient means for underwriting these risks may involve the capital market as an important complement to the traditional reinsurance industry."

Unfortunately, S. 1361 may stifle further development of such innovative free market approaches to catastrophe securitization since it encourages the shifting of catastrophe risk out of the private sector and displaces private market capacity in favor of federal capacity. The bill's stifling effect on private market development and innovation is exacerbated by the fact that S. 1361 does not contain a sunset provision, unlike its House counterpart, S. 1361, which provides for a sunset of the federal reinsurance program after 10 years.

Proliferation Of State Insurance Programs And Anti-Competitive Effects

S. 1361 will also encourage the development and proliferation of underfunded and overexposed state insurance programs by making low-cost federal reinsurance available to these programs at very low trigger levels. Providing subsidized federal reinsurance to state programs will supplant private risk capacity and foster the existence of these pools of last resort which are often underfunded and overexposed (they contain each state's most undesirable risks and suppress risk-based rates for insurance). If the federal government steps in and offers to indemnify state programs at the low levels contemplated in S. 1361, there is little incentive for insurance commissioners and state legislators to consider common sense alternatives to underfunded and overexposed state insurance programs, e.g., market driven solutions premised upon two of the most essential principles of insurance: spreading of risk and risk-based pricing.

Another concern is the anti-competitive effect S. 1361 may have on existing markets. Most insurers act responsibly, avoid large concentrations of risk, and purchase adequate reinsurance or otherwise develop adequate resources to absorb shock losses. Under S. 1361, these responsible insurers would have to compete against irresponsible carriers who have over concentrated their risk in catastrophe-prone areas and put themselves in a position of having to rely upon state insurance programs or other government mechanisms to absorb shock losses. As one major insurer admitted in a notice to its Florida policyholders after Hurricane Andrew:

> "In the past, despite well-intentioned efforts to determine what our policyholders should pay for insurance, we greatly underestimated the costs of covering hurricane damages. Over the years, our policy of providing insurance to everyone who qualified meant we sold our product at too low a cost to too many people. We know now that it is not good business for anyone to insure every third or fourth home in an area where natural disasters strike."

With the low-level federal backstop afforded to state insurance programs under S. 1361, such overexposed carriers will likely continue to rely on state programs to absorb shock losses and ignore the peril of risk concentration. Clearly, this gives those companies an immediate and unfair market advantage and rewards irresponsible behavior. Moreover, S. 1361 would give these carriers further incentive to write insurance in even higher concentrations in high risk areas, further exposing the federal treasury.

Commercial Risks

S. 1361 does not provide coverage for commercial losses despite the fact that both personal and commercial lines of insurance coverage are affected by catastrophic events. For example, our company's commercial hurricane exposures in Florida and Alabama are nearly as large as our personal lines exposure (personal lines exposure: $1.7 billion; commercial lines exposure: $1.5 billion). There is simply no logical reason why commercial risks should be excluded from S. 1361.

State Regulation

S. 1361 will further endanger state regulation of the business of insurance. Since 1945, the insurance industry in the United States has been regulated by the States under authority of the McCarran-

Ferguson Act. State regulation of insurance has and continues to work well. S. 1361 would strike at the heart of McCarran-Ferguson and open the door for the federal government to enter into the business of insurance regulation.

If S. 1361 becomes law, it would not be long before the federal government took an active role in the insurance industry. As soon as significant federal dollars are spent to bail out the over-exposed insurers who seek S. 1361 as a solution to their balance sheet problems, an argument would be made for more federal control over these insurers, and ultimately over all insurers. The bill's provision for the creation of two new federal bureaucracies: the "Natural Disaster Insurance Corporation" and the "Independent Natural Disaster Board of Actuaries," would provide further impetus for full scale federal intrusion into regulation of the business of insurance.

McCarran-Ferguson has worked well and we need to do all we can to preserve it. The passage of S. 1361 would imperil McCarran-Ferguson.

Determining An Appropriate Trigger Level – Two Approaches For Consideration

While we have a number of concerns with S. 1361 as presently drafted, we see little chance for the bill to gain industry-wide support unless the unreasonably low triggers are addressed. The current triggers fall far below the actual claims paid by industry for our Nation's largest insured losses: Hurricane Andrew at $15.5 billion and the Northridge Earthquake at $12.5 billion. The $2 billion trigger significantly underestimates private insurance capacity and would likely lead to a major dislocation of private market capacity in favor of federal capacity.

We do not disagree that there may be a need for high-level federal involvement in excess of private market capacity to ensure that Americans are provided with appropriate insurance protection for losses arising from hurricanes, earthquakes and other natural disasters. The pivotal question remains: what is an appropriate trigger level for federal involvement?

The underlying goal of S. 1361 is sound—that is, to create a federal reinsurance mechanism to buttress the solvency of the insurance industry in the rare event of a mega-catastrophe that exceeds current or projected claims-paying ability. With this goal in mind it should not be difficult to determine an appropriate trigger for federal involvement.

As a starting point for determining an appropriate trigger level, we believe it makes sense to look at the magnitude of past catastrophe losses handled by the insurance industry. As already mentioned, the industry handled back-to-back catastrophe losses of $15.5 billion (Hurricane Andrew) and $12.5 billion (Northridge Earthquake) in the early 1990s. With the industry's current policyholder surplus at an all-time high of $330 billion plus, which is more than twice what is was at the time the industry paid combined losses of $28 billion for Andrew and Northridge, we believe the industry is more than equipped to handle a $35 billion catastrophe without federal involvement.

For those who view the selection of a static trigger as problematic, another approach which has been given consideration is a percentage trigger based on industry surplus or individual insurer surplus. For example, under Senator Stevens' bill in the 104th Congress, S. 1043, payments under the federal reinsurance program were triggered when insured losses exceeded 15 percent of industry surplus ($49 billion in today's dollars) or 20 percent of an individual insurer's surplus. By using surplus rather than a static number, the trigger adjusts based on the financial experience of the industry. This method of calculation and the accompanying dynamic trigger level would take into account private insurance capacity and would avoid a major dislocation of private market capacity in favor of government intrusion into the marketplace.

We offer these comments as a starting point for determining an appropriate trigger level under S. 1361.

S. 1914 – The Private Sector Alternative to S. 1361

As a property and casualty insurer, we are concerned that some high-level catastrophes may be beyond the financial ability of our industry. However, there is a viable alternative to the perils of S. 1361. Under S. 1914, the "Policyholder Disaster Protection Act of 1999," property-casualty insurers would be permitted to set aside catastrophe reserves on a tax-deferred basis to better prepare for mega catastrophes, a bill introduced in the Senate last November by Senators Connie Mack and Kay Bailey Hutchison.

The intent of the S. 1914 is to motivate insurers, through the correction of a flaw in federal tax law, to establish reserves for future catastrophes on a voluntary basis and to hold the funds backing those reserves in a segregated account until they are released to pay for catastrophic losses. But the current U.S. tax/accounting system is flawed in that it only allows insurers to look backwards – insurers can set aside consumer premiums in reserves to pay for past disasters but not for future, predicted events. As a result, consumers' insurance payments are taxed up front as profits, discouraging insurers from providing insurance in high-risk areas and reducing capacity to deal with catastrophes.

The United States is one of the few countries in the industrialized world which does not allow insurers to prepare for future disasters by setting up pre-event catastrophe reserves. S. 1914 corrects this flaw by allowing and encouraging insurers to set aside part of the premiums they receive in special tax-deferred catastrophe reserves under strict regulation and oversight and dedicate them solely to pay for future major disasters. This will empower and encourage more insurers to serve markets in disaster-prone areas and encourage the insurers now serving those markets to remain. Policyholders will benefit from the resulting increase in competition in a number of ways, including the likely introduction of better insurance products and policy features and more competitive pricing.

S. 1914 will also reduce the possibility that a significant portion of the private insurance system would fail in the wake of a major natural disaster and that governmental entities would be required to step in to provide relief at taxpayer expense.

We strongly support S. 1914, as do the National Association of Professional Insurance Agents (PIA) and the Council of Insurance Agents and Brokers (CIAB), and believe it is a viable alternative to the federal reinsurance program proposed under S. 1361.

Conclusion

Regardless of which legislative proposal is ultimately adopted to deal with the problems associated with insurance protection for losses arising from hurricanes, earthquakes and other natural disasters, it is incumbent that we keep these basic principles and concerns at the forefront of the debate:

- The risk of natural catastrophes is best insured in a diversified marketplace which avoids concentration of risk in too few insurers or state programs.

- The private sector's role, including insurance, reinsurance and capital markets, should be maximized and such financing mechanisms fully exhausted before any government capacity is provided, state or federal.

- Government's role should be to address insurer solvency in the event of a mega-catastrophe and should not come at the expense of taxpayers.

- Any federal proposal should include personal and commercial lines of insurance since both forms of coverage are affected by catastrophic events.

- The need to preserve state regulation of insurance (McCarran-Ferguson Act).

We do not disagree that there may be a need for high-level federal involvement in excess of private market capacity to ensure that Americans are provided with appropriate insurance protection for losses arising from hurricanes, earthquakes and other natural disasters. But if this Committee and this Congress is serious about passing legislation to protect policyholders against the perils of natural catastrophes, the legislation ultimately adopted must not encourage government subsidization of catastrophe risk or supplant the private market for insurance and reinsurance.

Unfortunately, S. 1361, as presently drafted, does not satisfy these minimum criteria.

Thank you for your consideration of this important issue. I would be happy to answer any questions.