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June 24, 2013

Michael T. McRaith
Director, Federal Insurance Office
Attention: Study on Natural Disasters and Insurance
Room 1319 MT
U.S. Department of Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

RE: Comments for the Study for Natural Disasters and Insurance

Dear Mr. McRaith:

On behalf of 1 million members of the National Association of REALTORS®, I am pleased to submit comments to the Department of Treasury's Federal Insurance Office for a report to Congress on the current state of the market for natural catastrophe insurance in the United States. This report is required under Section 247 of the Biggert-Waters Flood Insurance Reform Act of 2012.

The National Association of REALTORS® (NAR) represents over 1 million members who are involved in all aspects of the real estate industry, including commercial, residential, land and property management. A key component to a vibrant and sustainable real estate market is affordable and available property insurance. NAR urges the Federal Insurance Office to develop a report that accurately assesses the current market for this insurance product and ensures that such a market remain healthy so that the real estate recovery may continue unimpeded.

The Federal Insurance Office's Notice in the Federal Register requests commenters respond to several questions related to the market for natural catastrophic perils. Detailed below are NAR's responses to the areas of inquiry that most directly impact real estate professionals and real estate markets.

In summary, the private insurance market has failed to ensure access to affordable property insurance for hurricanes, earthquakes and other major catastrophes, including floods. As a result, federal disaster relief – all at taxpayer expense – has become the default method for financing community and home rebuilding after the fact, when the cost has become many times what it would have otherwise been, had the country adopted a more forward looking national policy.

From 1989-2010 alone, Congress appropriated $250 billion.[1] NAR urges an expanded federal role to correct the inefficiencies of this insurance market and reduce the burden not only on taxpayers, but also homeowners who want to buy insurance and protect themselves -- rather than relying on the federal

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[1] Congressional Research Service, "Disaster Relief Funding and Emergency Supplemental Appropriations," April 12, 2011.

government after it's too late. NAR rejects the notion that the private market could fill the void left by the National Flood Insurance Program (NFIP) as the evidence shows below, and strongly opposes any effort to privatize the program. On the contrary, the federal government should consider expanding the NFIP to include wind or additional coverage or provide for an additional federal reinsurance program that would reduce the cost of property insurance and save taxpayers money.[2]

General observations on natural catastrophe insurance

If the natural disasters of recent years are any indication of what America will face in the future, it is time to recognize that our country may have entered a new era of weather-related catastrophes. Because of increased population and more exposed assets in hazard-prone areas, the country should expect more devastating and costly natural disasters in the coming years. Scientists believe changes in climate patterns could exacerbate this trend, bringing sea level rise, increased flooding from more intense hurricanes and coastal erosion.

According the National Oceanic and Atmospheric Administration (NOAA) the number and cost of the most damaging extreme weather events have grown over the past three decades. In the 1980s there was an average of fewer than two events per year that each caused $1 billion in damages, compared to an average of 9.5 such events per year in this decade. And the average annual total damage cost from these severe events soared from $20 billion per year in the 1980s to $85 billion in the 2010s.

Currently, there are multiple ways in which the costs of natural catastrophes are borne by society, and these differ depending upon the type of event. The primary focus of any policy or program in this area should be to maximize the purchase of insurance. This is because: (1) insurance purchased in the private marketplace provides better protection than after-the-fact disaster relief given by the government; and (2) the broader the insurance coverage, the less disaster relief will be necessary. With insurance, the costs of the risk are borne by those exposed to the risk through the purchase of premiums. In contrast, taxpayers who may or may not bear risk pay the costs of disaster relief.

However, despite society's reliance on private market insurance, some risks are so large and/or uncertain that government must play a role in supporting and facilitating insurance markets.

The current condition and future outlook for natural catastrophe insurance in the United States

Natural disasters not only devastate communities and individuals but also are costly to insurers, state governments, and the federal government. As hurricanes such as Katrina and Sandy, wildfires in the West, floods in the Midwest and Southeast and earthquakes in California have demonstrated time and time again, the costs associated with a large natural disaster can be enormous. For example - aside from the human toll - Hurricanes Katrina, Rita, and Wilma in 2005 caused insured losses of an estimated $56.5 billion and total economic losses, including both insured and uninsured losses, of more than $100 billion. The federal government alone appropriated more than $88 billion for disaster relief and recovery following the 2005 hurricanes.

Future disasters could be even more expensive. Experts estimate that a large hurricane in southeast Florida could cause insured losses of more than $130 billion and a total economic loss of more than $260 billion. Similarly, if San Francisco's 1906 earthquake were to be repeated today, it is estimated that it would cause insured losses of more than $70 billion and a total economic loss of more than $280 billion. A major earthquake in Los Angeles could lead to estimated insured losses of more than $140 billion and a total economic loss of more than $500 billion.

A repeat of the 1938 hurricane known as the "Long Island Express" could cause $100 billion in damages if it struck today and much more if it directly hit Manhattan. The 1906 San Francisco earthquake could cause economic damages of $400 billion or more today.

The private market does not have unlimited capacity, and major hurricane and earthquake events still have the capacity to lead to a market collapse. The exposure to major hurricanes alone (not counting earthquake or other

[2] See: http://www.protectingamerica.org/pdf/2013/Milliman-PAO-Report-6-5-13-FINAL.pdf

perils) is significant, with insured properties valued at about $15 trillion in hurricane-prone areas on the Atlantic coast and along the Gulf of Mexico, with New York, Florida and Texas the states with the greatest exposure

Most residential property in the U.S. is insured under homeowners' policies, which in 2011 accounted for $72 billion of direct written premiums countrywide. Generally, the homeowner insurance market is characterized substantial competition, with more than 400 insurance groups providing coverage in the private sector. At the same time, the market tends to be dominated by a number of large personal lines insurers, with the top 5 carriers accounting for around 50% of total homeowner premiums nationwide, and the top 10 around 65%. The market described above is the market for primary homeowner insurance – the insurance that is sold directly to the policyholder.

However, the primary market could not function adequately without the participation of other entities that share in the risk attributable to property insurance exposure. These other entities are principally reinsurers, who provide insurance coverage to insurance companies, and thereby share in the risks undertaken by the carrier initially writing the exposure. A smoothly functioning reinsurance mechanism is critical for the survival of primary property insurance markets in the U.S., particularly in those states where the exposure to natural catastrophes is significant.

The main reason reinsurance is critical is that in the case of catastrophe exposure, the fundamental statistical principle underlying the insurance mechanism – the principle of "pooling" – fails to operate normally or efficiently for relatively low frequency but very high severity events. As a consequence, the losses borne by the insurer are highly variable and potentially extremely large relative to annual premiums. Reinsurance is required to reduce the potential for these extremely large individual events to threaten the solvency of the primary insurer.

Large losses associated with natural catastrophes are some of the biggest exposures that property and casualty insurers face. To remain financially solvent, these companies must estimate and prepare for the potential impact of such events. Because of the increased risk of natural catastrophes and the challenges of predicting losses from them, insurance companies have been limiting both renewals of existing contracts and the writing of new contracts in catastrophe-prone regions of the United States, such as coastal areas (from Massachusetts to Texas), earthquake zones in California, the Mississippi River area of the central United States along the New Madrid earthquake fault, as well as areas in the west at risk for wildfires.

This behavior by insurance companies in high-risk markets has produced a fundamental shift in the property insurance markets, in the form of a dramatic increase in the use of programs created to assure insurance availability in the absence of private insurer participation in the market.

These programs, which are known as residual or involuntary markets, have grown far beyond their original objective; while they were intended to be markets of last resort, in some jurisdictions they have become the markets of first choice.

In recent years, residual market mechanisms have grown extremely rapidly, to the point where in some states they account for a substantial portion of insurance on catastrophe exposed properties. Examples of residual market plans include the Florida Citizens Property Insurance Corporation and the Texas Windstorm Insurance Association, both of which have grown significantly over the past decade.

For the following reasons, NAR believes that the current status and future prognosis for the availability and affordability of insurance for catastrophic perils is problematic at best. These disasters place enormous stress on insurance markets and governments, carry huge costs, and have raised concerns about who ultimately bears the costs and receives the benefits of government disaster insurance programs.

Natural disasters in 2012 in the U.S. cost insurance companies about $58 billion, making it the second most expensive year ever, bested only by 2005 when hurricanes Katrina and Rita smashed into the Gulf Coast. Insurance companies, in an effort to reduce risk in their portfolio, remain solvent and produce shareholder profit, will continue their current risk management practices, including increasing premiums, increasing deductibles, pulling out of risky or non-profitable markets and limiting their risk in certain regional markets. These practices will further

destabilize insurance and real estate markets, thereby making this kind of insurance product less available and more expensive.

The importance of mitigation activities to reduce risk

Risk mitigation – taking steps and action to reduce risk before a natural catastrophe occurs – is the most cost-effective way for government entities and individuals to become and remain resilient in the face of natural disasters. A well-known rule of thumb is that every dollar spent on risk mitigation saves four dollars in disaster assistance.

However, there are several obstacles to effective pre-disaster mitigation: (1) mitigation is expensive to do effectively and a homeowner may not have access to sufficient amounts of capital to do the mitigation required to place their home out of harm's way; (2) perception of risk may vary from owner to owner and some may underestimate the risk and not prepare appropriately; and (3) a lack of urgency makes it difficult to convince someone to, as an example in the case of flooding disasters, elevate their home when it is has never been flooded, even when information is provided that flood risk exists or has even increased over time.

For these reasons, it is difficult for states, communities and individuals to find the resources to develop and implement comprehensive mitigation programs. Consequently, there is a bias towards reserving funds for post-disaster responses and recovery activities because of the urgency and importance of these kinds programs to function effectively after a disaster has occurred.

Mitigation activities can be accomplished in three ways: (1) a market-based approach, such as charging actuarially-based premiums, so that the premium reflects the risk and the insured has an accurate economic incentive to reduce that risk; (2) government mandates, such as building codes for new construction or zoning that prohibits construction in the flood way; or (3) government incentives, such as subsidies, which provide property owners with the ability to avoid economic disaster as a result of a natural disaster.

NAR would also emphasize that mitigation activities are not "one-size-fits-all"; different natural catastrophes require different mitigation considerations. That is why implementation of this basic building block should be left to states and localities to best determine the most effective mitigation approaches for their specific set of risks and considerations. A different set of tools and techniques are required for mitigating hurricanes in Florida, flooding in Nebraska, wild fires in Colorado and earthquakes in California.

NAR believes that a market-based approach, one that provides consumers with accurate information and pricing signals to allow them to allocate their own resources most effectively, is the preferred way to help individuals and communities conduct mitigation activities to make their communities more resilient and disaster resistant. The insurance industry can enhance that approach by providing a robust set of incentives and discounts for property owners to reduce their premiums by doing mitigation on their property. This kind of pricing signal would result in properties becoming more disaster resistant, make insurance companies more profitable, and reduce post-disaster recovery costs to communities, property owners and tax payers.

However, insurance pricing alone will not be sufficient to generate adequate mitigation, and therefore government mandates or incentives may be necessary to supplement or complement the current system of mitigation. Incentives by governmental entities could include tax credits to property owners for voluntarily making their property safer and more disaster resistant, or low interest loans, grants and premium credits to upgrade existing properties. Government mandates could include improved building codes for new construction and thoughtful land use planning and zoning regulations to direct and encourage growth out of harm's way.

However, if these kinds of programs and incentives are implemented, governments must proceed cautiously to protect property rights and to ensure that well-functioning markets are not impaired or skewed in favor of one set of property owners over another. Especially in the areas of planning and zoning, these kinds of mandates have the potential to do enormous harm to the rights of property owners. Governments must ensure that public participation is maximized during the decision-making process and that the process is transparent and accountable to the general public. Decision-makers must also fully explore the full costs of these mandates; for example,

building codes for new construction might make the property more disaster resistant but may also make the property too expensive for many potential buyers to purchase.

Current approaches to insuring natural catastrophes

Over the years, there have been many approaches to address the issue of affordable and available disaster insurance. The following is not an exhaustive list but merely a sampling of a few of the ideas to demonstrate the wide variety that have emerged:

- Federal Government Backstop – The federal government would become more involved in insurance markets either by guaranteeing insurance after a disaster has surpassed a monetary trigger, providing reinsurance to state insurance programs or guaranteeing debt issued by state reinsurance programs.

- Regional/State Cat Funds/Programs – Would allow states and/or regions to pool and spread their risk.

- Tax-deferred reserves for insurance companies – Would allow insurance companies to collect additional premiums to be held in a fund to be used to pay claims for future catastrophic events.

- Mitigation tax credits – Would provide property owners with tax benefits if they made disaster resistant property improvements.

- Allow the National Flood Insurance Program to include multi-peril coverage. The program has been ensured access to affordable flood insurance for many years, and could do the same and more if wind or other risks were added to the program.

This discussion has been going in Washington, DC and parts of the country for many years, and NAR welcomes any and all ideas to the debate and encourages any approach that will raise the visibility of this critical issue.

Can flood insurance be privatized?

The National Flood Insurance Program (NFIP) was created in the 1968 after Hurricane Betsy because there was no private market alternative for flood insurance. Historically, most communities were built along rivers and coastlines. Because property owners were unable to purchase flood insurance on the private market and pre-pay for future flood damage, communities were forced to look to the federal government for rebuilding assistance. Given the level of devastation and homelessness among impacted families and communities, Congress had little-to-no choice but to respond with yet another disaster relief package of subsidized loans, grants and public assistance – all at taxpayer expense.

In the aftermath of Hurricane Betsy, the federal government could no longer ignore the rising cost to taxpayers of such a backward-looking public policy approach to floods. The result was establishment of a HUD Commission, authorized by Congress and convened by President Johnson, which in 1966 recommended creation of a federal flood insurance program as an alternative to the government rebuilding aid. According to the Commission, every insured property would mean one fewer one would be rebuilt with taxpayer dollars.

A private market for flood insurance may not be able to guarantee either the availability or affordability of flood insurance in flood-prone areas. If the NFIP did not exist, the only way to rebuild after a flood would be for Congress to respond as it did prior to 1968, i.e. to approve taxpayer-funded disaster relief.

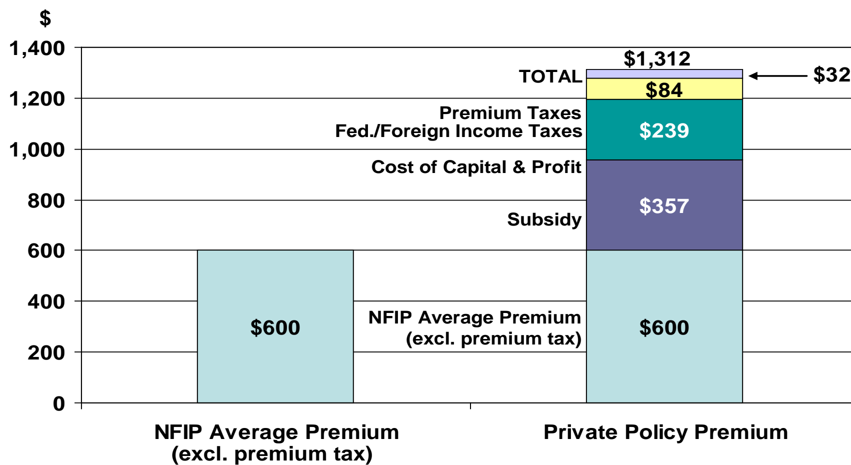
However, the NFIP was created in the first place because the private market failed. As a result, federal intervention was, and continues to be, justified today.

The conditions for market failure are created because of poor information and adverse selection. Flood risk is inherently unpredictable and so property owners understandably under- or over-estimate their risk according to a subjective set of probabilities. The most likely owners to opt for flood insurance are the ones who most recently experienced flooding. Knowing this, private insurers would naturally have to be highly selective of whom and

which areas to insure. They would also have to set insurance rates at a level that accurately reflects the risk of living in a floodplain, which is skewed toward the higher risk properties. That rate may be so high that even those demanding insurance can no longer afford it, prompting them to opt-out and the rates to be increased further to reflect the remaining risk. This in turn would cause another round of opts-out and rate increases, and so on.

The existence of this market failure is supported by the market research of RAND and the General Accountability Office (GAO).[3] These studies demonstrate limited-to-no private market potential, as there are no governmental or other barriers preventing private insurers from entering the flood insurance market today. The GAO found that there were just four large companies willing to write what private flood insurance is offered in the United States. However, these four companies are willing to write only for owners with "high net worth" and high-value property (at least $1 million). RAND's analysis reinforced the GAO's findings and estimated that there were fewer than 200,000 private policies in a market where NFIP currently writes 5.6 million. RAND also surveyed the current rates for these private policies and found that the rates ranged from 1.3 to 3.4 times that of "full risk" NFIP premiums depending on flood zone.

Because the private market would bear the full risk if the NFIP was ended, primary insurers would have to cede some of that risk to secondary markets and purchase reinsurance. They would also have to account for additional costs – costs a federal program do not incur, including taxes, cost of capital (i.e., the rate of return to attract investors), and profits paid to shareholders. Building on RAND's private flood insurance rate survey, the Property Casualty Insurance Association of America (PCI) has calculated how much the average NFIP premium would have to rise in order to cover these additional expenses. According to PCI, the cost of capital and profit would add $115 to $713 dollars to the average premium, depending on flood zone. Additional taxes would add from $40 to $250. Not included in the NFIP rate is the amount of the underwriting expense allowance which NFIP currently passes through to claims adjusters. That amount would also have to be included and is estimated to range from $15 to $95. In total, the average premium would more than double to $1,300 from $600 according to PCI's estimates based on conservative assumptions.



The private market cannot guarantee property owners' access to affordable flood insurance. Even if private insurers were able to obtain state-by-state approval to charge rates sufficient in the insurer's judgment to manage the additional expense and risk, few property owners (except the wealthiest) could afford flood insurance at more than double the current average rate. Already fewer than 50% of those in the 100-year floodplain purchase flood insurance at the NFIP rate. The percentage is much lower for those for which NFIP is voluntary. This helps explains why many primary insurers (which would stand to profit most from privatizing NFIP) have taken a public

[3] 2 RAND Corporation, —The Lender Placed Flood Insurance Market for Residential Properties, 2007. 3 The GAO, —Information on Proposed Changes to the National Flood Insurance Program, Letter to Rep. Barney Frank, Report GAO-09-420R, February 27, 2009.

stand in **opposition** to privatization (e.g., see NAMIC's letter to FEMA dated December 29, 2010). The profit potential is simply not there.

At the same time, the federal government would still have to assist in flooded community rebuilding efforts. Imagine if Congress had not responded to TV images of New Orleans families living in makeshift tents or in the Superdome after Hurricane Katrina. The amount of federal assistance would not decline; the only difference would be in the form of assistance the government provides. Rather than authorizing a federal program to collect premiums from property owners to cover their claims in a typical year, Congress would likely have to increase the amount of taxpayer-subsidized SBA loans, grants and public assistance to these communities. By increasing the number of self-insured properties, the NFIP reduces the number that would have to be rebuilt at taxpayer expense. In fact, the NFIP reduces taxpayer burden by providing an alternative to expensive post-disaster relief and financial assistance.

Conclusion

The current state of the market for natural catastrophe insurance is unsettled. Disparities within the country related to the affordability and availability of insurance are stark. Insurance companies are stressed by the realities of a global, competitive marketplace. Weather and climate trends point to increased extreme weather events. More people are moving to high-risk areas, exposing trillions of dollars of property to these events. Superstorm Sandy highlighted the fragility of our current system, while also providing some lessons and principles from which to learn.

Some of these, which NAR supports as well, include:

- Acknowledging the importance of personal responsibility of those living in high-risk areas to undertake mitigation measures, including the purchase of adequate insurance;
- ensuring that transparent and comprehensive insurance coverage is available and affordable, with premiums being reflective of the risk involved;
- Providing property owners adequate incentives to undertake mitigation measures;
- Recognizing the importance of building codes and smart land use decisions while also emphasizing that proper enforcement of both is best left in the hands of state and local governments, and also vigorously protecting property rights; and
- Recognizes the role of States as the appropriate regulators of property insurance markets while identifying the proper role of federal government intervention in cases of mega-catastrophes.

Absent these conditions, NAR does not believe the private market is capable of functioning in large catastrophes. NAR would encourage the Federal Insurance Office, in its report to Congress, to embrace an approach that preserves and enhances free-market competition, while allowing for aggressive government intervention that helps to eliminate systemic market inefficiencies, urge all market participants to aggressively pursue all forms of mitigation activities in whatever way they can be accomplished, and provides property owners with transparency and information to enable them to make good decisions on how best to allocate their own scarce economic resources. NAR believes this approach will best protect the consumer, the property owner and society as a whole from devastating natural disasters.

Sincerely,

Gary Thomas
2013 President, National
Association of REALTORS®