Statement of

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on the

Natural Disaster Protection and Insurance Act of 1999

before the

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On behalf of the 300,000-member National Taxpayers Union, thank you for the opportunity to present our views on the Natural Disaster Protection and Insurance Act of 1999.

We have appreciated the opportunity to work with Senator Ted Stevens, his staff, and Committee staff in the past in an attempt to develop a consensus among a number of associations in this important area of public policy.

While we hope that consensus can be reached, we must strongly state our opposition to S. 1361 because it would greatly and unnecessarily increase the potential liabilities of the government, displace well-functioning private insurance markets, and stifle innovations that are greatly increasing insurance capacity.

The legislation proposes to establish a federally-chartered private corporation that would have enormous access to federal loans. The corporation, consisting of member insurance companies and called the Natural Disaster Insurance Corporation (NDIC), would sell derivative contracts that resemble reinsurance directly to eligible state programs or through an auction to private and state insurers and reinsurers.

The NDIC would create many disincentives for the insurance industry to properly assume risks in a disciplined fashion at the right price. It would do little or nothing to encourage insurance companies to manage their disaster insurance risks well and it would likely reward companies that have been the least disciplined and the least professional in their accumulation of risks.

Given its virtually unlimited access to federal borrowing, the structure and management of the proposed NDIC is unacceptable and extremely risky. S. 1361 would require the Treasury Department to guarantee payments on the multi-billion dollars-worth of contracts that could be sold by this corporation.

The issue of an appropriate federal role in this area, if any, is highly complex and controversial. In our view, the Committee should legislate on this issue as carefully as it would if it were to create a new system of deposit insurance. There are very significant taxpayer, financial, public safety, consumer, insurance, and environmental risks involved, and all viewpoints should be heard. There are still a number of provisions in the legislation that are either unclear or pose a substantial risk of massive taxpayer losses.

<u>S. 1361 Would Create Enormous And Unlimited Unfunded Liabilities</u>

There can be no doubt that this legislation could prove to be enormously expensive. Section 7 would create a new Section 310 in the Earthquake Hazards Reduction Act of 1977 explicitly authorizing massive federal borrowing when it states:

> To the extent that the accumulated assets of the trust accounts described in subsection (a) or funds raised by issuing obligations in the private market pursuant to section 301(e)(3)(C), are insufficient to pay claims and expenses resulting from the primary insurance coverages or the reinsurance coverage, the Secretary of the Treasury shall provide direct loans from the Private Loss Account described in section 402 in sufficient amounts to cover that shortfall in accordance with this subsection.

The bill contains no effective limit on the total potential liability. There is no limitation on the number or the dollar amount of all the contracts that may be sold by the NDIC.

S. 1361 provides that if "claims under existing contracts for reinsurance coverage exceed the applicable maximum amount, each claimant shall receive a prorated portion of the amount available for payment of claims." Yet does anyone seriously believe that after a catastrophe Congress and the President would allow the federally-backed Natural Disaster Insurance Corporation to ration payments on claims and refuse to pass legislation making full payment on the contracts?

The Congressional Budget Office agrees that such a program is likely to lead to losses. In its analysis of H.R. 21 (in many ways similar to S. 1361), CBO said "because the frequency and severity of future catastrophic events are exceedingly difficult to estimate, 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."

NDIC Has Overwhelming Incentives To Not Set Actuarially-Sound Rates

S. 1361 requires that the NDIC board shall develop a plan of operation, including the "guidelines, criteria, definitions, clarifications, and procedures necessary for the reinsurance coverage." The plan of operations and rates to be charged would be subject to review by an allegedly independent "Natural Disaster Insurance Board of Actuaries."

Despite the bill's language to the contrary, the rates will not be fiscally sound for several reasons. The NDIC corporate members are specifically excluded from any liability for the NDIC's debts; the board and actuaries will be subject to strong political pressures to minimize rates; and, the NDIC rates would not accurately reflect reasonable risk capital charges.

NDIC Members Are Not Liable For Its Debts, But Taxpayers Are

Like the other versions of this legislation, this bill would have the practical effect of subsidizing insurance companies while putting taxpayers at substantial risk. Section 301 explicitly says that its insurance company members "shall not be liable, or in any way responsible, for the obligations of the Corporation" created by the bill.

As noted earlier Section 310 makes it clear who is on the hook for perhaps tens or even hundreds billions of dollars: the American taxpayer, who is left without redress to those who took on the risk in the first place. This is moral hazard at its worst.

Since the NDIC is intended to be a nonprofit corporation that only writes disaster insurance policies, this leaves less of a cushion for financially sound rates. Profit-making concerns, which now provide such insurance, can absorb reductions in their profits or capital because their rates reflect the actuarial risk to their capital. Most of these companies also have diversified risks since they insure many events other than natural disasters. Profit-making companies have much more incentive to develop advanced forecasting tools for proper rate-setting and analysis of risks.

NDIC Board Likely To Become A Revolving Door, With Little Accountability

The rates would largely be set by the NDIC board, which would be composed almost entirely of insurance industry representatives. Of the 15-member board of directors, there would be nine insurance directors, and up to two insurance agents or brokers who can be elected to the board. Additionally, the other directors who might be elected will likely have close relationships with the insurance industry.

Such a board would probably develop into a revolving door for property and casualty insurance interests to move in and out of the NDIC board, making decisions with respect to the disaster insurance market. There is a time lag between establishment of a policy and the moment when the NDIC reports the losses from that policy. That time lag would permit such revolving door directors to be out of the NDIC when fiscal losses occur, allowing them to escape accountability.

Furthermore, the NDIC board would face many political incentives to avoid charging the proper rates. The property and casualty insurance industry greatly fears federal regulation, and if actuarial soundness requires higher rates in politically sensitive areas, it is entirely possible, and indeed likely, that the board will avoid imposing such rates. Of course the failure to set proper rates will not be felt until perhaps many years after those directors are no longer on the NDIC board.

A Shocking Conflict Of Interest

Even more surprisingly, the NDIC would essentially sell insurance to state governments. Yet these very same state governments regulate the insurance industry today. How can we expect the NDIC to negotiate a fair rate for reinsurance under such a clear conflict of interest?

Board Of Actuaries Would Not Be Independent

Proponents will claim that the "independent" board of actuaries must approve the NDIC's plan of operation and insurance rates. But this board would be a lap dog, not a watchdog.

First, the legislation gives the actuaries only 90 days to review the plan of operation or rates. This is a ridiculously short period of time. If it is not disapproved within 90 days, the plan "shall be deemed to have been approved and shall become final." Likewise if the board fails to disapprove within 90 days, the rate " methodologies shall be deemed to have been approved."

Second, the actuaries themselves are likely to be subject to political control in several different ways. Most of the actuaries must rely on selling their services to current property and casualty insurance companies in the United States. Remember that the NDIC board of directors will represent some of the largest property and casualty insurers in the country. If an actuary tried to veto rates being proposed by the NDIC board, he might find it difficult to either find employment or to sell his services to NDIC member insurance corporations.

Third, the terms of office make it easy for a President to appoint actuaries who will represent his wishes. The actuaries “shall serve staggered terms for a maximum of 6 years as determined by the Secretary at the time of appointment.” This wording is unclear, and may mean that the Treasury Secretary could appoint a member for a three-year term or a six-year term. In any event, the Secretary could clearly appoint a majority of the board within a President’s term, which is hardly enough to protect independence. The President may feel intense political pressure to hold down rates in politically-important states such as California and Florida.

Fourth, it appears that the commission members can be removed at the will of the

Treasury Secretary or President, which would greatly reduce the already low chance of objective findings.

Fifth, given that the pressures on the actuaries may well be intense, it is especially unfortunate that the board would apparently make its decisions by a simple majority vote. A unanimous vote would better ensure a more rigorous review.

Sixth, the bill makes it very difficult for the actuaries to disapprove proposed rates. Here is the absurd standard: The board "may disapprove the prices or methodologies . . . only if [it] presents compelling and substantial actuarial evidence on the record that the prices or methodologies are materially inconsistent with actuarial soundness." If anyone should have the burden of proving compelling and substantial actuarial evidence, it should be the NDIC board.

Seventh, if new developments occur, the actuaries have no power to reopen and reject the current rates. Once the 90-day review period has been closed, that appears to be it. Certainly, the actuaries should have the power to reopen the rates or methodologies at any time and to declare them actuarially unsound. Yet the bill appears to prohibit such action by the actuaries.

Reinsurance Contracts

One portion of the proposal authorizes the NDIC to auction excess-of-loss-style reinsurance contracts. While such contracts can be designed and auctioned in a budget-neutral fashion, the legislation to authorize such contracts would likely lead to taxpayer losses, competition with the private sector, and distortions in the reinsurance markets.

In a paper by Christopher M. Lewis -- who is credited with developing the concept of these contracts -- entitled "The Role of Government Contracts in Discretionary Reinsurance Markets for Natural Disasters," he explains how to design a fiscally sound program for federal excess-of-loss reinsurance. He writes that "Only federal reinsurance proposals that provide coverage based on industry losses, offer capacity at levels above what is being provided in the private market, are capped and fully-funded, and are market neutral, are worthy of consideration."

Unfortunately, the bill as currently drafted does not meet these key tests. As already noted, the bill does not cap the amounts.

Following are some of the other flaws we have been able to identify at this time:

Crowding out the Private Sector. We fully agree with the comments made by many others that the triggers for payments on the contracts are much too low. The contracts could be structured to pay claims once losses exceed as little as $2 billion.

Last year the Reinsurance Association of America (RAA), citing highly credible industry reports, indicates that there is "approximately $20 billion of catastrophe reinsurance capacity available per region, per event."

That is *just* for reinsurance. As noted by RAA, "the primary insurers have paid two-thirds to three-quarters of catastrophic claims, passing the remainder through to reinsurers."

According to industry estimates, the overall industry surplus now exceeds $330 billion. If just 20% of that surplus were available to pay for a catastrophe, that alone would equal $66 billion.

There is even more capital available in the private sector. Thanks to recent financial innovations, increasing efforts have been made to securitize the financial risks of catastrophes. While still relatively small, the size of this market has dramatically grown in recent years. According to RAA, this securitization has "grown from one transaction in 1994 totaling $85 million to eighteen transactions in 1998 totaling approximately $2.5 billion." My understanding is that the total of all such transactions completed to date now exceeds $5 billion.

To stay out of the way of the private market, we believe any federal contracts should attach at points no less than $60 billion, and more likely $100 billion, under current conditions and should be increased based on the capacity of the sector.

Low attachment points for the contracts threaten to crowd out existing private sector mechanisms and completely kill off financial innovations that have the potential to further expand capacity from private sector sources.

Unless legislation is very carefully designed, it would seriously damage the private reinsurance markets and prevent financial innovators from entering this important sector.

Current laws and regulations already pose high risks for the private markets and S. 1361 would exacerbate the current situation.

Under current tax laws, state insurance pools have an enormous tax advantage over similar private sector funds in that all income to such pools is tax exempt (as are all earnings from capital in those pools.) This advantage alone has exerted substantial pressure for creation of state insurance pools. If low cost federally-backed reinsurance is made available, state pools will undoubtedly become more common, and those states with pools may well expand coverage limits.

The end result will be a greater reliance on politically-run insurance programs and less opportunity for private insurers.

Risk Loads. The legislation would set a price for state reinsurance contracts at the estimated annual losses, plus a risk load equal to those losses. A similar amount would be the basis of the minimum price for auctioned contracts.

While such pricing sounds sufficient, one has to remember who would be responsible for estimating the likely losses -- a politically influenced NDIC that has no responsibility to bear any financial risk from a too-low estimate. Equally important is the fact that such estimates are highly uncertain to say the least. After all, who really knows the chances of an earthquake striking in California or Missouri next year, or a strong hurricane passing directly over a major metropolitan area on the coast?

The risk load is meant in part to compensate for, as CBO notes, "the likelihood that available historical data do not fully capture current catastrophe risks."

The reality is that the price for sale of such contracts may well be less than the actual cost of the contracts, and is certain to be less than the price that would be offered by true private sector firms. CBO notes that "risk loads observed in private transactions for disaster reinsurance against infrequent events, similar to those that would be covered under H.R. 21, are typically four to six times but sometimes exceed 10 times actuarially expected losses."

Cost of Capital. There is no provision requiring consideration of the cost-of-capital, except for some vague and unenforceable language requiring "fair compensation for the risks" being undertaken by the federal government. The NDIC should not compete with private reinsurers by charging less for the federal capital it has at risk. If it charges less, it will either drive out truly private firms or prevent them from entering the market.

A Limited Supply of Contracts Is Essential. The Lewis paper notes that the program should be "designed to enable the private sector to 'crowd out' the federal government . . .. Once the market for these contracts is established, private companies can offer similar contracts in competition with the federal government." This is an essential component of this concept, but the draft legislation would make it virtually impossible for the private sector to accomplish the feat.

In fact the legislation has no effective limitation on the supply of contracts, which would undercut the whole concept of an "auction."

If the supply of contracts is not limited, the bids will be too low and a private sector market would not emerge at higher levels of capacity, defeating one of the key points of such a proposal.

We strongly believe it would be a mistake for legislation to be completely silent on the auction process. While discretion is needed, guidance is essential.

One cannot have a true auction with real bidding if the market is oversupplied. A rule must be devised that would be easily enforceable on the NDIC and would protect against political manipulation of the auctions.

Taxpayer Standing. The bill appears to contain some provisions to protect the private sector and taxpayers. The reality is that these provisions are weak and unenforceable. Any such legislation creating enormous federal guarantees should allow taxpayers to have standing to sue to enforce any restrictions in the law protecting the private sector from NDIC competition or taxpayers from losses. There also may be enormous political pressure exerted in order to force the conclusion that a certain trigger has been reached, and that payouts should be made on the contracts. We believe in the principle of trust, but verify. Taxpayers should be given the standing in court to enforce the contracts if necessary in order to help ensure that they are honestly followed.

Protection for the Private Sector. The tendency for government is to expand and crowd out the private sector. Since one goal of the excess-of-loss contracts is to expand the capacity of the private market, any such legislation should give the private sector a right to expand (and demand that the NDIC shrink) its sale of such contracts. For example, if a qualified reinsurer is willing and able to sell a contract, then we see no reason for the NDIC to sell a similar contract at a lower or even equal price.

<u>Political Risks of Reinsurance Contracts</u>

The comments expressed above outline our technical concerns with the bill's description of the contracts as defined by the "Administration Policy Paper on Natural Disaster Insurance and Related Issues" and the Lewis paper. A discussion of these contracts would be incomplete without a review of the inherent political risks.

These political risks take two forms. First, and most important, are the political risks to prudent management of these contracts by the Congress, the President, and the Treasury Department and how payments are made. Second, and of legitimate concern to Members of Congress, is the public perception of the wisdom of offering these contracts should a disaster hit.

Management Risks. The legislative description of the contracts leaves much discretion to an industry run federally-created corporation with virtually unlimited federal borrowing authority.

While flexibility can be useful in designing a contract that would be accepted by the market, it can also be abused by a future Treasury Secretary who might be intent on granting back-door subsidies to the insurance market in a misguided attempt to increase capacity.

A future Treasury Secretary might act politically to keep the reserve price down by putting pressure on the NDIC and the Board of Actuaries to lower their estimations of the costs of various risks.

There may also be a great deal of pressure brought on the NDIC and Secretary to over-supply the market as early and for as long as possible. Please remember that the reserve price on auctioned contracts is at best an educated guess. We need a healthy, functioning auction market to incorporate more educated guesses -- the guesses of those who wish to buy the contracts. If the auction market is flooded, that information will not be collected, nor will it be reflected in the bid prices for the contracts.

After a major disaster, there may be great pressure on the NDIC to err on the side of making payments under the contracts. After all, those who hold the contracts can be expected to bring intense political pressure for billions of dollars in payments. Holders of the contracts might hire public relations and lobbying firms to state that payments on homeowners' claims could be made more quickly or completely if the NDIC were to make quick payments on the contracts.

Clearly those who hold the contracts will have a court-enforceable right to force the NDIC to make the payments. But what would happen if the NDIC were to interpret the contracts and make payments that might not be clearly authorized? By contrast there is no legal recourse for taxpayers who will pay the bills -- only a political recourse, which would likely come long after the improper payments were made.

Public Perception of Risk. There is also political risk to Members of Congress from public perceptions of these contracts before or after a disaster. Consider the public's reaction if it appeared that these contracts were sold at too low a price or without a prudent auction process that would under supply the market, thereby ensuring healthy receipts to the NDIC. After a disaster that would result in taxpayer losses, the public reaction might be intense because there could be a perception of a huge subsidy to the insurance business, which both sold and became the owners of many, if not almost all, of the auctioned contracts. It is very important to get the technical details correct in order to minimize these political risks.

<u>Other Substantial Political Risks For Members Of Congress</u>

Members of Congress who vote for this should know that these contracts are actually a derivative instrument, not reinsurance. In fact, under current state regulatory rules, these contracts would not be treated as reinsurance – they would be treated as investments because the losses that trigger the payment of the contracts are not the direct losses of the insurer. This means that an insurer may or may not have incurred losses in proportion to the regional losses that cause contracts to be paid. There is nothing theoretically wrong with a properly-priced derivative. Yet the public perception of derivatives is that they are inherently risky and were responsible for the massive losses in California's Orange County.

Even if the reserve price for the contracts is actuarially correct, which we doubt would happen, the federal government can still lose a lot of money very soon after passage of legislation. We could be unlucky. The first set of contracts could be sold in a year when a major disaster would cause the trigger to be reached and billions of dollars in payments to be made when receipts are merely in the millions. Such an event could immediately damage the fiscal reputation of the program.

After a disaster, new information might become available that would show the reserve price was based on incorrect information. This is to be expected. With each subsequent disaster, new information is learned and incorporated into pricing decisions by the market. That's not to say that people won't try to use hindsight to criticize the NDIC's actions, especially if it appears that political pressure was successfully brought to bear on the NDIC and the Treasury Department to set a low reserve price.

<u>Fix Laws And Regulations First</u>

Before undertaking a risky and perhaps incredibly expensive experiment in selling federal reinsurance, Congress should first examine and reform laws and regulations that have the effect of making catastrophe insurance less available and more expensive.

During our work over the last five years studying proposed legislation and public policy regarding natural disasters, we have found that a number of federal and state laws and regulations greatly hamper the ability of the private sector to provide insurance for catastrophes.

Perhaps the most important impediment to affordable catastrophe insurance is the federal tax law, which contains a huge implicit penalty on homeowners who attempt to purchase such insurance. These same laws also prevent insurance companies to deduct an amount equal to the risk of catastrophic natural disasters; amounts that we consider legitimate business expenses. Here is why.

When a taxpayer buys a homeowner's policy in a catastrophe-prone area, a large part of the premium represents the annual amount that needs to be saved over many years to cover the likely loss from a major catastrophe. Unlike normal fire or theft losses, which occur smoothly year to year and thus are deductible from income, losses from catastrophes are huge. An insurance company might go for many years or even decades before paying claims on a catastrophe.

A prudent tax law would recognize that premiums that represent the best estimate of the risk from catastrophe losses should be deductible as a cost of doing business. That is not the case. Under our current tax system, virtually all premium income that represents the risk of loss flows into taxable income. Effectively our tax laws have created a sales tax on risk premiums for catastrophe losses! This misguided tax exacerbates the problems of availability and affordability of homeowner's insurance in catastrophe-prone areas.

Of course, when the catastrophe comes, these claim payments can be deducted against an insurance company's income that year. Yet that does little good if the insurance company goes insolvent. For companies that remain solvent, loss carry-backs and carry-forwards are limited and the losses might never be fully recognized by the Tax Code. When it comes to catastrophes, we have created a tax policy that is not much different from the trick coin-toss choice: "heads we win, tails you lose."

We believe a consensus is emerging around legislation to fix this problem in the tax laws and urge Senators who are interested in this issue to support S. 1914, sponsored by Senator Connie Mack.

Conclusion

S. 1361 is both politically and economically risky and should be subjected to more extensive examination and comment before being enacted into law. We strongly urge the Committee to remember that even the best-intentioned programs can have budget-busting consequences. While legislation may be needed to reduce the impact of natural disasters, Congress must move carefully in this highly complex area to ensure that it does not create a fiscal disaster or unwisely interfere with private markets. We would be pleased to work with you in order to protect against taxpayer losses and improve federal disaster policies.