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NATURAL DISASTER INSURANCE

Federal Government's Interests Insufficiently Protected Given Its Potential Financial Exposure

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to provide our comments on H.R. 1856, which would establish a federally-sponsored enterprise to provide natural disaster insurance and reinsurance. The bill would also require the Federal Emergency Management Agency (FEMA) to establish and administer natural disaster hazard mitigation programs. In testimony before the Senate Committee on Commerce, Science, and Transportation last year, we expressed several concerns regarding the ability of the primary insurance and reinsurance programs proposed in a Senate bill—S. 1350, the Natural Disaster Protection Act, to fairly and efficiently spread insurance risks among policyholders, insurance companies, and the government.[1] On the basis of this past work, we would like to offer our observations on the legislation under consideration.

The objectives of H.R. 1856 are to reduce the loss of life and property, as well as the economic consequences of future natural disasters, including reliance on government disaster assistance. To achieve these objectives, the bill proposes multihazard mitigation programs to encourage states, communities, and property owners to reduce potential damage from natural disasters by building structures better able to withstand such disasters. The bill also proposes to establish a federally-chartered corporation to provide (1) primary insurance to protect residential property owners against financial loss resulting from damage due to earthquakes, volcanos, tsunamis,[2] and hurricanes; and (2) reinsurance to protect insurers from large residential and commercial losses arising from such catastrophes.[3]

In 1980, we reported that insurance, when coupled with hazard mitigation measures, can be a better means of fairly and efficiently providing federal disaster assistance than other forms of federal disaster assistance, such as loans and grants.[4] H.R. 1856 attempts to combine insurance, reinsurance, and hazard mitigation into a unified program. Such an effort raises two important questions. First, would the insurance mechanisms in this bill fairly and efficiently spread insured disaster risks among insureds,

[1]Federal Disaster Insurance: Goals Are Good, But Insurance Programs Would Expose Federal Government to Large Potential Losses (GAO/T-GGD-94-153, May 26, 1994).

[2]As defined in the bill, a tsunami is an ocean wave generated by underwater disturbances in the earth's crust.

[3]Reinsurance is insurance for insurance companies that allows them to spread their risks and protect themselves from catastrophic losses.

[4]Federal Disaster Assistance: What Should The Policy Be? (GAO/PAD-80-39, June 16, 1980).

insurance companies, and the federal government?[5] Second, would the bill adequately provide for hazard mitigation and include sufficient incentives for states and communities to adopt and enforce appropriate mitigation standards? As you requested, our statement addresses the first of these questions. However, both are important and, in its deliberations on this bill, we hope that Congress will carefully consider each.

In evaluating the implications of H.R. 1856, we compared how the insurance mechanisms in this bill differ from those proposed last year in S. 1350. We drew on last year's interviews with staff of FEMA and the Congressional Budget Office. We also reviewed our past work relating to insurance regulation and federal flood and crop insurance programs to compare past findings with provisions in the bill. We also reviewed our previous work on the government's exposure to financial risks arising from its connection with government-created private entities, primarily government-sponsored enterprises.

Background

While the insurance industry has so far absorbed losses from recent natural disasters without large-scale failures, there has been concern expressed in the industry about its ability to handle future losses from potentially larger catastrophes. The federal government also has absorbed substantial losses from past disasters and, if current trends continue, could pay out even larger amounts in the future. As a result, the federal government clearly has an interest in reducing both the total amount at risk from a disaster as well as the federal share of losses. Hazard mitigation efforts, such as enforcement of stricter building codes, can reduce the losses from a natural disaster. In addition, amounts paid by private insurers and reinsurers reduce, in the case of those who are insured, the amount of disaster assistance required from the federal government. For the insured, insurance becomes, in effect, a mechanism for prepaying a portion of disaster losses.

Last year, S. 1350 proposed an approach for increasing the availability of disaster insurance, encouraging adoption of hazard mitigation practices, and possibly reducing the economic consequences of future natural disasters, including reliance on government disaster assistance. S. 1350 would have set up three interrelated programs—a multihazard disaster mitigation program, a primary insurance program for earthquakes and volcanic eruptions, and a reinsurance program to limit insurers' losses

[5]Some damages resulting from natural disasters are unlikely to be covered by insurance. These include damage to roads, schools, and other public buildings, most of which will remain the responsibility of local, state, and federal governments even if this bill were to pass.

when major disasters occurred. The mitigation program was to be funded through a surcharge on premiums collected from homeowners and insurance companies. This program was to provide states and communities with resources for disaster mitigation in exchange for their adopting and enforcing better building codes and emergency plans.

S. 1350 would have required FEMA to provide primary insurance to be sold through participating private insurance companies. FEMA would also have been required to offer catastrophe reinsurance to insurers participating in the federal primary insurance program, private reinsurers selling reinsurance to participating insurers, and certain state insurance programs. The reinsurance program was to be funded by premiums paid by insurance companies. Under the reinsurance program, the government would have been liable for most of the industry's losses once the losses exceeded a specified share of the industry's capital and surplus.

The Primary Insurance Program

Under H.R. 1856, the Natural Disaster Insurance Corporation (NDIC) would be established to provide primary insurance covering homeowners against damages resulting from earthquakes, volcanic eruptions, tsunamis caused by undersea earthquakes and volcanic eruptions, and hurricanes. The insurance would not be available from the NDIC for commercial properties. The NDIC would provide the coverage, on its own behalf, as a supplemental insurance contract to the standard homeowners' policies of those private insurers that elect to act as service providers for the NDIC.

Our Concerns About the Primary Insurance Program in S. 1350

Our two greatest concerns about the primary insurance program proposed in S. 1350 were (1) whether affordable, actuarially sound premiums could be set, and (2) the lack of a mechanism in the bill for attaining a level of participation broad enough to effectively spread risks and significantly reduce the cost of multihazard coverage. Setting actuarially sound rates would be difficult, in part, because of data and technological limits in predicting earthquake and volcano risks. Moreover, premium rates that accurately reflect a homeowner's exposure to catastrophic loss may be unaffordable for many people. The objectives of actuarial soundness and affordability may, in fact, conflict. If, for example, premium rates were set too low in order to encourage wide participation, the program's solvency and ability to pay claims could be endangered. On the other hand, some homeowners in catastrophe-prone areas who are currently uninsured or underinsured may not be able to afford to purchase adequate private insurance unless rates are low.

Furthermore, without broad participation, the primary insurance program proposed in S. 1350 would not have effectively spread risk and improved the affordability of coverage. S. 1350 required participating insurers to provide disaster coverage, but it did not require that homeowners in disaster-prone areas purchase the insurance. In contrast, the current federal flood insurance program has a mandatory purchase requirement for homeowners in flood-prone areas,[6] and it uses premium subsidies to encourage participation by people living in high-risk areas who otherwise could not afford to pay risk-based premiums. However, according to Flood Insurance Administration officials, even with the subsidies, only about 20 percent of those living in special flood hazard areas nationwide had flood insurance. Given this background, we questioned whether participation goals needed in S. 1350 could be reached.

We also had concerns about some of the incentives created by S. 1350 for private insurers. Under the bill, an insurer selling federal policies would have borne no risk of loss for coverage provided under the primary insurance program and could have recouped all its administrative and loss adjustment expenses from the primary insurance fund. As a result, participating insurers would have had little incentive to underwrite conservatively, minimize administrative expenses, or prudently adjust claims to protect the government from excessive losses. Finally, S. 1350 would have permitted insurers to select the lowest risks for themselves, leaving the federal government with most of the loss exposure but only part of the premiums collected.

H.R. 1856 Contains Some Improvements to the Primary Program, but Concerns Remain

Under H.R. 1856 as proposed, setting actuarially sound rates would remain a problem, in large part because of data and technological limitations. We believe this bill's purchase mandates, however, may better encourage homeowners to buy disaster insurance, possibly allowing for lower rates due to wider spreading of risks. The bill also provides an incentive for private insurers selling the NDIC's policies to underwrite conservatively and prudently adjust claims. However, insurers would still be able to select lower risk policies for themselves (known as "cherry-picking"), thereby increasing the loss exposure for the NDIC and potentially for the federal government.

[6] See appendix 1 of Federal Disaster Insurance: Goals Are Good, But Insurance Programs Would Expose The Federal Government to Large Potential Losses (GAO/T-GGD-94-153, May 26, 1994) for a description of which homeowners are required to purchase flood insurance

Purchase Requirements May Not Lead to Widespread Participation

Improving the affordability of disaster insurance can only occur if risks are shared among a large number of policyholders. To increase participation, H.R. 1856 would require homeowners in disaster-prone states who have a federally-related mortgage loan to purchase either the primary insurance coverage provided by the NDIC or insurance from a private insurer that has at least the equivalent terms, conditions, and rates for the seismic perils. For the hurricane peril, private insurance coverage must have at least the equivalent terms and conditions (but not rates) as the NDIC's coverage.

This mandatory purchase requirement could help in getting more homeowners to purchase insurance against natural disasters. However, the requirement may still not lead to widespread participation by homeowners because of (1) the significant number of homeowners who do not have a federally-related mortgage and (2) the difficulty in enforcing a mandatory purchase requirement. According to FEMA, in 1994 about 60 percent of all homeowners in disaster-prone states either had no mortgage loan or had a nonfederally-related mortgage loan and thus would not have been subject to the purchase mandate. In addition, the experience of the National Flood Insurance Program, which has a similar insurance purchase requirement, shows that because of inadequate enforcement, the mandate has not been as effective as intended. H.R. 1856 does not contain an effective mechanism for enforcing the purchase requirement. Without such an enforcement mechanism, the mandate's potential success would be severely limited.

Another deterrent to widespread participation in insurance programs has been the expected availability of post-event federal disaster relief. As long as people expect relief, they are reluctant to pay for insurance coverage. H.R. 1856 would address this problem by requiring, as a condition for receiving any federal disaster financial assistance, that homeowners in natural disaster-prone states have their property insured at coverage levels at least equal to the NDIC's coverages and have any insurance required under the National Flood Insurance Program. H.R. 1856 would further require that, to qualify for federal disaster assistance, these insurance coverages must be in effect at the time of the disaster.

However, the bill would exempt many residential property owners from this requirement. Any household with annual income of $60,000 or less would not be required to have insurance to qualify for disaster assistance.[7] Although the bill does not specify that commercial disaster insurance

[7]According to the 1990 Census, median household income in the United States for 1989 was $30,056.

would be available through the NDIC, business property owners would also have to be insured against disaster losses to be eligible for any federal disaster assistance in the future.

The success of any mandate requiring homeowners in disaster-prone states to purchase insurance as a condition for receiving federal disaster relief will depend on whether the government enforces this requirement. Furthermore, payment of federal disaster relief to uninsured homeowners would encourage homeowners not to comply with the requirement.

Quota-Share Arrangement Provides Insurers Incentive to Underwrite Conservatively and Adjust Claims Prudently

A fair and actuarially sound risk-based premium paid by a homeowner should reflect several risk factors in addition to location, including the age, type, and value of the particular structure; its architectural style; and existing mitigation features. For an insurance company doing business for its own account, it is critical that the premium charged matches the homeowner's risk. This is called underwriting, and a failure to underwrite carefully can expose an insurer to losses greater than it has been paid to accept. In H.R. 1856, the NDIC is the insurer and thus bears most of the financial risk, but the individual insurance companies do the underwriting and sell the policies. The bill attempts to create a financial incentive for private insurers selling the NDIC's policies to carefully match premium charges to the underlying risks.

Under the bill, private insurers acting as service providers must agree to a quota-share arrangement; that is, they must accept responsibility for paying at least a set percentage share of any losses covered by the NDIC. Insurers would be required to hold, and pay the losses on, at least 10 percent of each seismic policy (earthquake, tsunami, and volcanic) and at least 50 percent of each hurricane policy that they sell. The insurers would, however, have the option to accept a higher share of the coverages and retain a correspondingly higher share of the premium income.

Under the disaster insurance program proposed in under S. 1350, insurers could have underwritten and adjusted claims without concern for the potential costs involved because they would have borne no risk of loss for their actions. Requiring insurers to bear some of the risk of loss for coverage should provide them an incentive to act prudently in underwriting and settling claims for the NDIC. This incentive may be weakened, however, because H.R. 1856 permits insurers to reinsure their quota-share amounts with the NDIC, which could also increase the NDIC's exposure to natural disaster losses.

Insurers Would Be Able to Select the Lower Risks for Themselves

Under H.R. 1856, service providers must offer the seismic coverage to all of their policyholders in seismic-prone states and may elect to offer the hurricane coverage provided they also offer it to all their policyholders in hurricane-prone states. We are concerned that insurers may select the lower risks for themselves (cherry-pick) and pass the higher risks to the NDIC. To the extent that risks are not equal throughout the rating territories the NDIC is to establish, an insurer could subclassify risks within those territories to a more detailed level. Such a subclassification would enable an insurer to identify which homeowners paying the same price for insurance would be at lower risk of damage from a natural disaster. Insurers would then be able to accept higher than minimum quota-share amounts (and retain a correspondingly higher share of the premium) for those properties with lower risk exposure and the minimum quota-share amount for the higher risks.

For the hurricane coverage, insurers could also cherry-pick in a second way. Although participating insurers must offer the NDIC's hurricane coverage to all their policyholders in hurricane-prone states, they would not be precluded from (1) at the same time, also offering their own coverages (at rates lower than the NDIC's) to low-risk policyholders, and (2) offering only the NDIC's coverage to high-risk policyholders.

Such opportunities for cherry-picking could expose the NDIC to adverse selection. That is, the NDIC would only receive part of the premiums (from high-risk homeowners) but would be responsible for most of the losses. This could significantly affect the NDIC's ability to pay all its claims, thus increasing the government's potential exposure to losses.

Policyholders Would Have No Protection If the Ndic Became Insolvent

After a catastrophe occurred, insured policyholders would be paid by service providers who would then be reimbursed by the NDIC within 90 days of the date when the claims were paid. However, before any policyholders were paid, the NDIC would have to certify to the service providers that sufficient amounts were available to reimburse them. Private insurers acting as service providers would not pay homeowner claims, except their share under the quota-share arrangement, if the NDIC determined it could not reimburse them for settling outstanding policyholder claims. Homeowners who had purchased federally required insurance would, in this case, be left without payment for most of their losses.

The Reinsurance Program

Under H.R. 1856, the NDIC would provide reinsurance to any private insurer, reinsurer, or state insurance pool that meets its eligibility requirements. Each eligible entity would pay a premium based on several factors, including its financial standing and exposure to losses resulting from hurricanes, earthquakes, volcanoes, and tsunamis. The reinsurance would be payable when covered losses exceeded trigger levels specified in the bill. In addition, the reinsurance coverage would apply to losses for residential insurance coverages and to those commercial insurance coverages the NDIC determined to have a significant potential for disaster losses.

Little Change to Reinsurance Program Proposed in H.R. 1856

The reinsurance coverage in H.R. 1856 in most respects is the same as that proposed in S. 1350, and we had major concerns about the design and structure of the reinsurance program proposed last year under that bill. Under the program, the federal government could have been required to take on unlimited liability for disaster losses because S. 1350 required the federal reinsurance program to take all comers without any ability to screen risks. H.R. 1856, on the other hand, would require that companies meet minimum criteria and financial viability standards to be specified by the NDIC. However, despite such technical improvements, the reinsurance program under H.R. 1856 raises concerns about the federal government's potential exposure to disaster losses.

Payment Triggers Raise Concerns About Federal Exposure to Losses While Protecting the Insurance Industry and Individual Firms

Our greatest concern with the proposed reinsurance program is that the basis for triggering reinsurance payments to private insurers and reinsurers would expose the NDIC, and ultimately the federal government, to significant losses while limiting the exposure of the insurance industry and individual insurers. As in S. 1350,[8] the payment triggers in H.R. 1856 would be based on the amount of surplus held by the industry and individual companies. This basis for determining the NDIC's share of disaster losses raises several concerns.

The bill appears to suggest that the insurance industry would pay losses equal to 15 percent of industry consolidated surplus before the NDIC would begin to pay reinsurance. In fact, the actual losses paid by insurers

[8]Under S. 1350, federal reinsurance would have been payable when losses from disasters exceeded (1) an industry-wide trigger of 15 percent of the industry's consolidated surplus during any 12-month period, or (2) a company trigger of 20 percent of an individual insurer's surplus. Under the industry-wide trigger, the federal government's losses would have been limited only by the size of the disaster losses; under the company trigger, the government's losses would have been capped at 200 percent of the insurer's capital and surplus.

under the industry-wide trigger could be considerably less than the nominal trigger amount. The industry would pay the full 15 percent only in the unlikely event that every insurer in the industry sold in the disaster area and had losses that at least equalled 15 percent of its surplus. The actual amount paid by insurers would depend on the type and severity of a disaster, where it occurred, and how many insurers were operating in the affected area. In our previous simulations of large disaster losses, we found that similar trigger provisions under S. 1350 could have capped the actual losses paid by insurers well below 15 percent of industry-wide surplus, leaving a correspondingly greater liability for the reinsurance program.[9]

Moreover, the reinsurance program also would be liable for substantial payments to individual insurers in the event of natural disasters that did not affect the insurance industry as a whole. The bill's company trigger means, in effect, that the reinsurance program would be protecting the solvency of individual insurers from most of the consequences of large natural disasters even when the solvency of the industry was not threatened.

Definition of Qualifying Losses Raises Several Concerns

We remain concerned, as we were last year, about which losses qualify for reimbursement. Similar to S. 1350, H.R. 1856 defines as qualifying losses assessments by state insurance pools[10] and guaranty funds[11] for insurer failures resulting from natural disasters. Determining whether the failure of an insurer and any resulting fund assessments should be attributed primarily to a natural disaster or some altogether unrelated cause would be difficult. For example, a Florida Insurance Department official told us that, although losses from Hurricane Andrew pushed some companies over the edge, many of the insurers placed into liquidation after the hurricane were already on the brink of insolvency for a variety of other reasons. Also, most states permit insurers to recover their guaranty fund assessments at a later time, either through a rate increase or an offset on premium taxes.

[9]See pp. 15-20 of GAO/T-GGD-94-153 for a fuller discussion of this point and an illustration of how losses would be shared by insurers and the reinsurance program for various amounts of hurricane damage.

[10]H.R. 1856 defines a state insurance pool as any state-authorized joint underwriting or joint reinsurance association, risk pool, residual market mechanism, or other state-sanctioned entity providing natural disaster insurance.

[11]Guaranty funds provide a mechanism in each state for policyholders to be protected when their insurer fails. Surviving insurers pay assessments into the fund to cover policyholder claims after a failure.

Finally, the bill would allow insurers to obtain reimbursement for some unspecified portion of uncollectible private reinsurance. We believe this provision would diminish the incentives for insurers to diligently assess the quality and collectibility of their private reinsurance arrangements or to actively pursue delinquent reinsurers through legal means. Essentially, it would insulate insurers from the effects of bad business decisions.

The Natural Disaster Insurance Corporation

The most significant change that H.R. 1856 proposes is the creation of the NDIC to provide disaster insurance to homeowners and to sell reinsurance to the private insurance industry. These coverages reportedly are either unavailable or very expensive in some private insurance markets. In proposing to establish the NDIC, the bill is attempting to offset this perceived market failure.

The NDIC would be a privately-owned, federally-chartered entity. Other privately-owned entities have been chartered by the federal government to achieve the public policy objective of ensuring that adequate private funding was available to meet some publicly desirable need. The NDIC would share a number of similarities with these other government-sponsored enterprises (GSEs). It too would be established by the federal government to fulfill a public policy objective: to gather sufficient premium income to provide insurance protection against disasters and to reduce the government's expenditures for future disaster relief. In addition, the NDIC would be able to issue debt in private markets at a cost that, because of its links to the government, would likely be below private market rates. Moreover, the NDIC would have authority to borrow from the U.S. Treasury.

However, the NDIC would differ substantially from most other GSEs in that its operations and governance would be exempt from government oversight and regulation. The NDIC would be functionally an insurance company. With the backing of the federal government, it could become a sizable insurance company. Yet the NDIC would have no solvency or net worth requirements. Moreover, its policyholders would have few of the protections provided by the state insurance regulatory system that oversees other insurance companies around the nation. Finally, the bill provides no federal control or oversight of NDIC policies and actions that would ultimately determine its solvency and its ability to pay legitimate claims without loans or other assistance from the federal government. In the following remarks, we address three specific aspects of the proposed

NDIC: its ownership and control, its borrowing authority, and its lack of regulatory oversight.

The Ndic Would Be Wholly Owned and Controlled by Private Insurers

The NDIC would be wholly owned by its members—the private insurers acting as its service providers and the insurers buying reinsurance. H.R. 1856 would require the member insurers to own shares of the NDIC, but would not require them to invest permanent capital in the NDIC. Instead, the member insurers would provide start-up loans that would be repaid by the NDIC, with interest, within 36 months.

Of the 15 directors on the NDIC's board, 9 directors would represent the private insurers, and the remaining 6 directors would be nominated by the insurance directors and elected by the member insurers. The six noninsurance directors would be drawn from five special interest groups: (1) insurance agents or brokers, (2) state insurance regulators, (3) risk assessment experts, (4) insurance consumers, and (5) representatives of the banking and real estate industries. However, no one on the Board would be charged with ensuring that the NDIC fulfilled its public policy purposes. Unlike the NDIC, most GSE boards of directors have some members appointed by the president of the United States to represent the interests of the federal government and the taxpayers.

H.R. 1856 would give the NDIC's directors total authority to develop a plan of operation establishing the necessary framework for selling both primary insurance and reinsurance, including the terms and conditions of coverage (to include deductibles and coverage limits), the rates (prices), and the mechanisms for paying claims. The directors also would exercise total control over decisions about how to invest the potentially billions of dollars held by the NDIC that are not immediately needed for paying claims and expenses. Finally, while H.R. 1856 states that the NDIC's purpose would be "to provide primary insurance coverages and reinsurance coverage for [natural disasters]," nothing in the Bill would specifically preclude the directors from deciding to engage in additional activities, insurance-related or otherwise. In contrast, GSE charters generally restrict such enterprises to activities reflecting their public policy purposes.

The Ndic Could Borrow Private and Treasury Funds Without Treasury Approval

H.R. 1856 would authorize the NDIC to issue debt securities in the private market and to borrow from the United States Treasury. These special features would allow the NDIC to have access to lower cost financing and more ready liquidity than are typically available to a private firm.

We are concerned that giving the NDIC authority to borrow private and federal funds might expose taxpayers to large costs without adequate government scrutiny. Because of its financial backing from the federal government, the NDIC would likely be able to issue private debt at or below private market rates, even with little or no capital. Creditors would likely be willing to lend to the NDIC because they would expect that, in most cases, the government, not they, would suffer any losses. This is a common perception about the debt obligations of GSEs. Despite strong statutory language that the "full faith and credit" of the federal government does not stand behind a GSE's debt securities, the perception remains that such federal backing exists. The resulting weak investor discipline may allow a GSE to continue borrowing in the private market even if it is performing poorly. In part for this reason, most GSEs must receive Treasury approval to issue debt securities. The NDIC, however, would have no similar requirement.

In the event that the NDIC had insufficient resources to pay disaster claims and expenses, the Treasury would be required to lend funds to cover the shortfall. H.R. 1856 appears to set a firm limit on the NDIC's federal borrowing: the total amount of Treasury loans outstanding is not to exceed the NDIC's capacity to repay the loans within 20 years.[12] However, the NDIC's capacity to repay would depend on a host of uncertainties, including assumptions about the expected number and magnitude of future disasters and premium income.

The bill is silent about how to measure the NDIC'S capacity to repay or whether the Treasury would have access to the NDIC'S financial records. As a result, the bill does not clearly indicate the actual credit line available to the NDIC from the Treasury and, consequently, the potential taxpayer exposure. Based on the language in the bill, it is not clear whether the NDIC would have the authority to decide for itself both the amount of funds it requires from the Treasury and its own capacity to repay. In contrast, other GSEs generally have finite lines of credit, and the Secretary of the Treasury has discretion to deny federal borrowing.

[12]The bill also specifies that (1) the terms and conditions of Treasury loans to the NDIC would be set so that there would be a zero subsidy cost to the federal government and (2) all loans would be subject to such extent and in such amounts as are provided in appropriations acts.

The Ndic Would Be Subject to No Regulatory Oversight

H.R. 1856 does not provide for regulatory oversight of the risk-taking or the financial condition of the NDIC. The function of the NDIC would be to accept risk, both through decisions about the prices it charges for disaster coverage and the underwriting standards it sets to limit its exposure to uninsurable losses. The NDIC's choices about how to invest the trust account funds also could pose a risk of loss. State insurance regulation serves as a protection for policyholders of other insurance companies by monitoring insurers' financial solvency and ability to pay claims. However, H.R. 1856 would largely remove the NDIC's operations from state insurance regulatory oversight.[13]

The insolvency of the NDIC would expose not only the policyholders to losses, but also the federal government as well. The bill, however, proposes no mechanism for the federal government to protect the interests of either taxpayers or policyholders. No routine federal oversight would exist, nor would any federal entity other than Congress have the authority to set standards for, or monitor the performance of, the NDIC.

In place of regulatory oversight, the bill would establish an independent board of five actuaries to be appointed by the Secretary of the Treasury. The sole responsibility of the Board would be to approve or disapprove the NDIC's plan of operation and its rates for both primary insurance and reinsurance. The actuarial board's ability to disapprove the NDIC's plan of operation would be limited. Disapproval would be authorized only if the plan as a whole were materially inconsistent with provisions of the bill. (Yet the bill defers to the NDIC to establish and implement the plan of operation.) Likewise, the actuarial board could disapprove the NDIC's rates only if "compelling and substantial actuarial evidence is presented on the record that the rates or methodologies are materially inconsistent" with actuarial soundness.

While the actuarial board would be similarly responsible for reviewing any changes the NDIC proposed to its plans and rates, it would have no authority to monitor the NDIC's operations to ensure compliance with the approved plan. We believe that an actuarial review is clearly desirable for an insurance undertaking as complex as that proposed for the NDIC. However, given the narrow role of the actuarial board under H.R.1856, its limited ability to disapprove the NDIC's plans and rates, and the lack of ongoing monitoring and enforcement authority, we do not believe the

[13]The NDIC's board of directors would include state regulators but those persons would have a fiduciary duty to the NDIC and would not provide regulatory oversight.

actuarial board could possibly substitute for regulatory oversight of the NDIC's solvency and its risk-taking activities.

In summary, under the current environment, either a mega-catastrophe or a series of closely timed disasters could greatly strain or even overwhelm the capacity of the insurance industry and, at the same time, result in large federal payments for disaster relief. The federal government clearly has an interest in reducing both the total amount at risk from a disaster as well as the federal share of losses. A well-designed mitigation program along with an insurance program that provides incentives for mitigation could help to minimize the total amount at risk.

The goals of improving hazard mitigation and reducing government financial exposure to natural disasters are laudable. Compared with S. 1350, this bill contains changes that, we believe, move in the right direction. However, there are issues warranting congressional consideration relating to aspects of both the primary insurance and reinsurance programs proposed in H.R. 1856 and, most particularly, to the NDIC that would be established to carry out those programs.

For primary insurance, the major issues relate to the challenges of establishing actuarially sound, affordable rates and of achieving widespread participation. The purchase mandates in H.R. 1856 are likely to improve participation. However, many homeowners would be exempt from the mandates, and, in any case, the bill provides for limited enforcement.

Moreover, H.R. 1856 would exempt insurers who own the NDIC from any liability for its primary insurance obligations. If the NDIC, even with its federal borrowing authority, were unable to pay claims, the NDIC's share of homeowners' disaster claims would go unpaid. To protect policyholders, the federal government might feel the need to meet the NDIC's obligations in the event of its insolvency. In effect, the bill could shift the financial exposure resulting from natural disasters either to homeowners or to the federal government, with no assurance that insurance companies would also make a substantial contribution in paying those losses.

Issues relating to the reinsurance program raise questions about the federal government's exposure to losses. The major issue is that the reinsurance payment triggers appear to shift costs for natural disasters away from the insurance industry, toward the NDIC, and ultimately to the U.S. Treasury.

However, in our view, the most significant issue is that, under H.R. 1856, the Natural Disaster Insurance Corporation would be an unregulated, privately-owned entity that could expose the federal government and taxpayers to significant losses. The NDIC would resemble other GSEs in its public policy purposes and its powers. Yet, the NDIC would not be subject to oversight of its risk-taking or solvency. We believe that the NDIC's public policy purpose of protecting homeowners and private insurers from the financial devastation arising from natural disasters, the sheer size of its catastrophic obligations, and the probability that the federal government would bear losses in the event of the NDIC's failure, make it appropriate to make sure that the federal government's and the taxpayers' interests are protected when considering the merits of H.R. 1856.

Mr. Chairman, that concludes our prepared statement. We would be pleased to answer any questions you or the other Members might have.

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