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Hearing on “An Examination of the Availability and Affordability of Property and Casualty
Insurance in the Gulf Coast and Other Coastal Regions”

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Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today. Your committee is tackling an important and difficult set of issues in this hearing. I believe we share similar goals, but we must be mindful of unintended consequences that may arise from some government actions.

Insurance plays a vital role in America’s economy by helping households and businesses manage risks. Individuals purchase insurance so they can sleep well at night; they gain comfort from the knowledge that they and their families are protected from some of the adverse effects of future events beyond their control. Businesses purchase insurance for much the same reason. It allows them to reduce the uncertainty associated with future costs and revenues, which enables them to plan for the future more effectively. Today, one can purchase insurance protection against a myriad of economic hazards, from poor health to motor vehicle accidents to legal liability to lightning strikes. Insuring economic losses arising from large-scale catastrophes pose special challenges for the insurance industry and for federal and state governments.

The Administration opposes legislation to create a new federal program to backstop catastrophe insurance. There are a variety of forms that the backstop could take. The federal government could directly subsidize the purchase of insurance in the private market, it could

provide primary insurance directly to homeowners and others, or it could enter the reinsurance business allowing private companies to sell their insurance policies to the government at subsidized rates. We believe that none of these approaches would be helpful nor are they warranted. They would create primarily three kinds of unintended consequences and problems for the economy. First, government insurance would displace insurance provided by the private market. For the most part that market is healthy, and were it not for other forms of interference, the market could operate effectively to insure risks faced by homeowners and businesses. Second, a federal program would undermine economic incentives to mitigate risks because the program would likely distort rates from their actuarial values. Individuals would be encouraged to take on risks that are inappropriate, specifically putting themselves in harm's way because they do not bear the full expected costs of damages incurred. Third, a federal backstop would mean that all taxpayers nationwide would subsidize insurance rates for the benefit of a relatively small group of people in high-risk areas. The general taxpayer would pay for actions over which they have no control. Those who can avoid the risk would be passing the cost on to others, creating a system of distortion and inequity.

For the most part, the national insurance industry is healthy today. Despite the record \$57 billion estimated insured losses incurred as a result of the 2005 hurricane season, industry-wide capital available to cover future losses actually increased during 2005. As a result of lessons learned in 2004 and 2005, insurers have increased their estimates of probable losses from future hurricanes. They have upwardly adjusted the actuarial weights necessary to cover future losses and enhance solvency – which in turn implies higher rates. Although it is true that Florida, North Carolina and parts of Mississippi, Louisiana and Alabama are experiencing

difficulties with insurance availability, much of this can be traced to certain state regulatory actions.

First, some states have used state regulation to suppress prices, which has the effect of making insurance unavailable where it may be most needed. The role of state regulation should be to protect consumers from fraud and inadequate risk management by insurance companies, but states sometimes use their regulatory power to control prices. This discourages insurance companies from voluntarily providing insurance in those high-risk areas where unregulated rates would naturally be highest. For example, a new Florida law includes a number of provisions that are likely to deter private sector insurers from operating in the state. The law suspends “rate-flex” rules that had previously allowed residential property insurers to increase or decrease rates (within a band) without prior approval by regulators. Insurers must now file a request for review with regulators 90 days in advance of increasing rates, and new rate reviews have been temporarily suspended – effectively freezing insurance rates. Insurers need to charge rates that are high enough to allow them to cover expected losses and purchase reinsurance or maintain surplus to cover catastrophic losses. When premiums are not permitted to rise in tandem with loss forecasts, insurers have a very strong incentive to limit their catastrophe risk exposures by withdrawing from high-risk markets and product lines; to do otherwise would jeopardize their financial soundness.

Some states are already beginning to recognize that their well-intentioned attempts to keep insurance prices low have had the unintended consequence of making insurance less available. In Louisiana an advisory committee is considering proposals that would disband the state’s insurance rating commission and allow insurers to set hurricane deductibles on the basis of risk rather than requiring one deductible for all policy holders state-wide. The Governor of

South Carolina has called for market-based solutions to insuring coastal homes against storm damages by imposing the costs of those damages directly on those who build in risky areas.

Second, through regulation some states have created state-sponsored insurance programs, which can further drive out private market participants. For example, in Florida, the state-sponsored Citizens Property Insurance Corporation (Citizens) sells property insurance to cover wind storm losses, and the Hurricane Catastrophe Fund provides reinsurance to cover private insurers at below-market rates. Citizens was designed to be the insurer of last resort, but is now the largest insurer in the state. Florida's insurance law passed earlier this year makes it easier for Citizens to compete with private insurers by charging competitive rates and by offering a broader array of coverage. The law also expands reinsurance coverage available through the Florida Hurricane Catastrophe Fund. Florida's Office of Insurance Regulation reports that neither program has sufficient funds to cover losses from a severe hurricane, so the next major storm could result in significant taxes or assessments on policyholders in order to cover any shortfalls by Citizens and the Hurricane Catastrophe Fund. A private insurance market that was allowed to appropriately price risk would build up the financial resources necessary to remain solvent even when faced with very large claims. Reinsurance, which is a common feature of the industry, helps diversify risk among a very large number of investors. Unfortunately, the Florida Hurricane Catastrophe Fund displaces private reinsurance that would have spread the cost of covering future storm losses to investors worldwide with a state program under which costs will ultimately be borne by Florida residents and businesses.

A national catastrophic risk insurance plan would likely distort rates and undermine economic incentives to mitigate risk. The experience of the National Flood Insurance Program and the steps needed to reform it illustrate some of the challenges that would likely arise in a

broader federal natural catastrophe insurance program. The National Flood Insurance Program plays an important role in helping homeowners insure against flood losses, but it needs to be further reformed and should not now be expanded. Currently the program is required to provide insurance to some older properties at rates that are not sufficient to cover expected claims. In many cases the program cannot deny coverage to high-risk properties, so it continues to provide insurance for properties that have been damaged numerous times by floods. An October 2005 study by the U.S. Government Accountability Office found that while repetitive loss property claims were only 1 percent of all properties insured, they account for 25 to 30 percent of program losses from the National Flood Insurance Program. By making insurance available at below-market rates for some structures, the Flood Program allows homes and commercial properties to be located in areas that are extremely risky. Were the owners required to pay market rates for insurance, they would be less likely to be in those areas and more likely to build on safer ground. Reforms passed in 2004 authorized a pilot program to remove some of the worst repetitive loss properties from the Flood Program rolls, and the President's FY2008 budget calls for doubling the funding of this program. Furthermore, the Administration has proposed several principles for improving the National Flood Insurance Program, including making premiums more flexible and actuarially sound. We look forward to working with the Committee on developing these principles. However, the challenges of this program show it does not serve as a good model for a broader Federal catastrophe insurance program.

National catastrophe risk insurance would displace private insurance and undermine the economic incentives to mitigate risk. It would force all taxpayers nationwide to subsidize insurance rates for the benefit of a relatively small group of people in high-risk areas. This would be both costly and unfair to taxpayers. Indeed my personal experience is a case in point.

I own a home in the San Francisco Bay area, which is known for its beauty and lovely climate but which is also famous for its earthquake potential. My house is located a very short distance from the San Andreas Fault which runs along the coastline of California. It would certainly be possible for the federal government to subsidize my earthquake insurance and to pass the burden on to the general U.S. population. Passing the burden to taxpayers in Indiana and New Jersey is inappropriate both because I have the ability to avoid locating in an earthquake prone area, and because those who live in other states do not reap the benefits of the location and climate that I have chosen.

Returning again to the example of the National Flood Insurance Program, the financial consequences of passing claims on to the general federal taxpayer is no minor issue. The National Flood Insurance Program has borrowed \$16 billion from the Treasury cover 2005 losses. The cost will in large part be borne by taxpayers nationwide, many of whom are not exposed to flood risks and do not receive coverage under the program.

The insurance industry is healthy and the private sector is well equipped to provide insurance for hurricanes and other natural catastrophes, but state regulators and the federal government must allow the private market to function. Therefore, the Administration believes that a federal program to provide catastrophe risk insurance at the federal level, although well intentioned, would have significant adverse consequences to the economy, and would be unfair.

I welcome your questions.