Testimony of Treasury Assistant Secretary for Economic Policy Phillip Swagel Before the House Committee on Financial Services Subcommittees on Capital Markets, Insurance, and Government Sponsored Enterprises; and Housing and Community Opportunity

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Washington, DC -- Good afternoon Chairman Kanjorski, Chairwoman Waters, Ranking Member Pryce, Ranking Member Biggert, and Members of the Subcommittees. The effects of Hurricanes Katrina, Rita, and Wilma are reminders of the destructive forces of nature. Insurance coverage against natural catastrophes cannot undo the toll of these events, but insurance can provide families and businesses with the ability to recover from their financial losses. Government actions that interfere with well-functioning private insurance markets can have unintended consequences that make it more difficult and costly for families and businesses to obtain coverage. Such actions can further detract from the long-term financial soundness of our government.

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The Administration seeks to ensure that there is a stable and well-developed private market for natural hazard insurance and reinsurance. The Administration strongly opposes H.R. 3355 because its provisions are at odds with this goal.

The Private Insurance Market Provides Coverage for Natural Hazards

Private insurance markets for natural hazard insurance are active and effective. The experiences with catastrophes in 2004 and 2005 led insurers to increase their estimates of probable losses from future hurricanes. As a result, insurers obtained state regulatory approval and increased their premiums to cover future losses and enhance solvency. Certain coastal areas have experienced increases in rates. This can be difficult for homeowners, but this is fundamentally a reflection of the cost of risk, not a defect of the market. While certain coastal areas have seen reduced availability of private insurance as well, these shortages generally can be traced to state regulatory actions.

H.R. 3355: The Homeowners' Defense Act of 2007

H.R. 3355, the Homeowners' Defense Act of 2007, is intended to provide support and assistance to state-sponsored insurance and reinsurance programs. State-sponsored programs generally can be divided into two categories: (1) programs such as assigned risk pools or residual market facilities that provide coverage directly to homeowners who cannot obtain private coverage, and (2) state-run reinsurance programs that provide coverage for private insurers and state-run residual funds. Florida, for example, has both types of programs: the state-sponsored Citizens Property Insurance Corporation sells wind-loss property insurance and homeowners' insurance to homeowners, and the Hurricane Catastrophe Fund, backed by the state's ability to cover future losses through taxation, provides reinsurance to private insurers at below-market rates. Florida is currently the only state with a reinsurance program.

H.R. 3355 provides two distinct mechanisms to help state-sponsored programs. The first is the creation of a federally chartered organization, the National Catastrophe Risk Consortium. The bill empowers the Consortium to issue risk-linked securities in the capital markets and enter into reinsurance contracts. The Consortium would facilitate the transfer of catastrophe risks insured by state-sponsored programs to private reinsurance markets and capital markets. The second proposed mechanism is the establishment of the National Homeowners' Insurance Stabilization Program at the Treasury Department. Through the Stabilization Program, the Treasury Department would provide medium- and long-term loans to state insurance programs at below-market rates.

The Consortium and the Stabilization Program Provide Subsidies

The functions of the Consortium could be accomplished without new legislation. State-sponsored programs are free to pool risks today and they have access to competitive, world-wide reinsurance and capital markets designed to pool risks globally. This can be done today with traditional reinsurance arrangements or through natural catastrophe bonds.

I understand that in designing the Consortium, the intent of the bill's sponsors may not have been to create a new subsidy; nevertheless, as written, the Consortium would provide one. The Consortium's federal charter would benefit state-sponsored programs in that the reinsurance contracts and financial instruments entered into or facilitated by the Consortium would be seen as carrying an implicit federal government guarantee. This implicit guarantee would distort prices for these instruments and result in subsidized coverage for the participating states. This would impose a hidden cost to all taxpayers.

The Stabilization Program would provide subsidies in a more straightforward manner. The Stabilization Program's title requires Treasury to extend 5- to 10-year "liquidity loans" and longer-term, post-disaster "catastrophe loans" at below-market rates to state-sponsored programs.

The ability to borrow at below-market rates would lower the cost of running a state-sponsored program and reduce the need for states to purchase private reinsurance and charge adequate rates in order to maintain capital reserves. This would lead the state-sponsored programs to further subsidize rates.

Subsidizing Insurance Would Displace Private Markets, Promote Riskier Behavior, Be Costly, and Be Unfair to Taxpayers

The subsidies provided by the Consortium and the Stabilization Program would encourage the creation of new state-sponsored programs and the expansion of existing state-sponsored programs to offer subsidized insurance and reinsurance. These subsidies would result in the displacement of private coverage, lead to costly inefficiencies, and retard innovation in the private sector. Lower insurance premiums would reduce economic incentives to mitigate risks and encourage individuals to take on inappropriate risks. This would also make taxpayers nationwide subsidize insurance rates in high-risk areas.

Rather than relying on the federal government, state programs should purchase private market reinsurance to cover their capital needs. Purchasing reinsurance from private markets would allow the states to take full advantage of the world-wide diversification of private markets and send the appropriate economic signals to mitigate risk and to discourage individuals from taking on inappropriate risk.

State-sponsored programs that lower insurance prices below the actuarially fair value encourage people to locate in high-risk areas. The experience of the National Flood Insurance Program (NFIP) illustrates this concern. The NFIP provides insurance to some older properties at below-market rates, including some properties that have been damaged numerous times by floods. This encourages families to continue to live in vulnerable areas without sufficient mitigation. Subsidies for natural catastrophe insurance will encourage over-development in hurricane- and earthquake-prone areas, putting more people in harm's way.

The bill could result in large liabilities for the federal government, which might be expected to step in to support the operations of the contracts entered into or facilitated by the Consortium. In addition, there is a risk that the Stabilization Program would not receive full repayment of the loans with interest. The Stabilization Program reduces incentives for state reinsurance programs to be sufficiently capitalized--state programs will hold less capital because they have the federal line of credit. The burden of repaying those federal loans will fall on the state's citizens. This tax burden may lead the state to seek deferrals or reductions in its federal loans. With federal financing, it is more than likely that there will be significant pressures to forgive outstanding debt in the case of a huge catastrophe. The NFIP again illustrates this likelihood. In these cases, taxpayers nationwide would subsidize insurance rates in high-risk areas, which would be both costly and unfair.

Conclusion

Allowing private insurance and capital markets to fulfill their roles is the best way to maintain the economic sustainability of communities at greatest risk of natural catastrophes. Federal government interference in a functioning natural hazard insurance market would crowd out an active and effective private market, increase the incentive for people to locate in high-risk areas, result in potentially large federal liabilities, and be unfair to taxpayers. For these reasons, the Administration opposes H.R. 3355.