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House Committee on Financial Services
Subcommittee on Housing and Community Opportunity and Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
hearing on
"Approaches to Mitigating and Managing Natural Catastrophe Risk: H.R. 2555, The Homeowners' Defense Act"

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Good afternoon, Chairman Kanjorski, Chairwoman Waters, Ranking Members Garrett and Capito, members of the subcommittees. I am Steve Ellis, Vice President of Taxpayers for Common Sense, a national non-partisan budget watchdog. Thank you for inviting me here today to testify on H.R. 2555, The Homeowners' Defense Act.

Taxpayers for Common Sense believes H.R. 2555 is fundamentally flawed and strongly opposes the legislation. The euphemistically named Homeowners' Defense Act would actually end up putting taxpayers at risk and subsidizing people to live in harm's way. Taxpayers across the country would be forced to pay for a narrow bailout that primarily helps the well off. It doesn't make sense.

But don't just take our word for it. TCS works with SmarterSafer.org. These allied groups oppose H.R. 2555 and run the gamut from American Rivers to Americans for Prosperity. From the National Association of Professional Insurance Agents to the National Wildlife Federation. From PLAN!T NOW to the National Fire Protection Association.[1] The depth and breadth of the coalition of consumer, taxpayer, environmental and insurance industry groups underscores the broad-based concerns with H.R. 2555.

[1] Full list is available at www.smartersafer.org

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The major elements of H.R. 2555 would establish a national catastrophe risk consortium for states to pool risk, create a new federal reinsurance program for state catastrophe funds, and make federal taxpayers guarantee potentially billions of dollars of debts incurred by state catastrophe insurance programs. I would like to take a few minutes to put the legislation in context and describe our concerns with the various elements of H.R. 2555. In addition, I would like to outline a better, more fiscally sound path forward.

The Primrose Path

Much of the argument for the programs under H.R. 2555 relies on a "pay me now or pay me later." Essentially, by providing reinsurance and debt guarantees, taxpayers will avoid fiscally messy and expensive bailouts of state programs in the aftermath of large disasters. Unfortunately, we have heard that seductive siren song before. And we know how it ends: instead of reducing the cost to taxpayers, we will have in fact forced the federal government to shoulder more of the burden and alleviate the financial incentives to properly manage risk.

You don't have to look any further than the National Flood Insurance Program to see how this song plays out. Part of the justification for the establishment of NFIP in 1968 was that the program's premium payments would reduce ad hoc post-disaster recovery costs. Claims were also made about the lack of availability of flood insurance, similar to the argument for federal reinsurance today.[2]

The sad reality is that the availability of cheap federal flood insurance over the last several decades made it financially attractive to develop in high risk areas. Along with other factors, NFIP helped fuel the coastal development boom that increased the program's risk exposure and losses. Though intended to provide only limited, short term subsidies and encourage responsible construction, the program actually served to increase subsidies. Before 1986, the program received nearly $2 billion in direct appropriations, and borrowed from (and repaid) the treasury in the 1990s.[3] But that was nothing compared to the present day. The huge storm year of 2005 (Hurricanes Katrina, Rita, and Wilma in particular) forced NFIP to borrow heavily from the Treasury. Now a program that takes in roughly $2 billion in premiums annually is $20 billion in debt to the U.S. taxpayer. It is extremely likely that most, if not all, of this debt will be forgiven.

The ability to borrow from the Treasury is an enormous subsidy that enabled NFIP to charge rates that, despite assertions to the contrary, were not actuarially sound and certainly didn't include catastrophic risk.

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[2] Pidot, Justin R. "Coastal Disaster Insurance in the Era of Global Warming: The Case for Relying on the Private Market. P18.

[3] National Wildlife Federation. "Higher Ground." July 1998. P 16-17.

We walked down the primrose path decades ago, and now we are stuck with the National Flood Insurance Program.

But today, staring into a budgetary abyss with predicted average deficits of $1 trillion a year over the next ten years,[4] we cannot afford to make that costly mistake again.

The three major components of H.R. 2555 are all directed at accomplishing the same thing: Shifting the cost and risk from bad decisions by a few to the rest of country. And in so doing, they would enable continued subsidized insurance rates which promotes unwise development and increased risk.

Taxpayers as a Backstop

A key part of H.R. 2555 is the federal reinsurance program for "eligible" state programs. Currently, only Florida and California have programs that would meet the criteria specified in the legislation.[5]

Curiously, the legislation stipulates that the program "shall not displace or compete with the private insurance or reinsurance markets or the capital market."[6] But that seems to be the whole point. Reinsurance is available in private markets, as illustrated by annual renewal prices declining this year, with record share repurchase by the private sector.[7] However it is not offered at the price the states want to pay. This leads me into the next odd assertion in the legislation: that the program should charge actuarially sound rates.[8] First, if this limited program's rates were truly actuarially sound, they would exceed the private market's rates because the program would be forced to sell reinsurance to a very narrow pool of high risk states, whereas the private market could distribute the risk worldwide. But, remember, the federal flood insurance rates were supposed to be actuarial as well.

The legislation stipulates that the maximum amount of contracts written under the federal reinsurance program would be capped at $200 billion per year.[9] But contracts written under the plan would kick in at a shockingly low level. It describes the attachment point as the loss level that would result from an event that has a .5 percent chance of occurring in any given year

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[4] Congressional Budget Office. "Preliminary Analysis of the President's Budget Request for FY2011." March 5, 2010. Available at http://www.cbo.gov/ftpdocs/112xx/doc11231/frontmatter.shtml.

[5] With slight modifications to their existing wind program Texas could also qualify.

[6] Section 302 (1)

[7] Guy Carpenter and Co. "Rates Retreat as Capital Rebounds: Global Reinsurance Renewals at January 1, 2010" January 3, 2010. http://www.gccapitalideas.com/2010/01/03/rates-retreat-as-capital-rebounds-global-reinsurance-renewals-at-january-1-2010/

[8] Section 303 (g)

[9] Section 304

(a 200-year event).[10] But that total would be aggregate for the year, so several small events would eventually trigger payments under this reinsurance.

Bailing Out Bad Decisions

Another section of H.R. 2555 creates a debt guarantee program for eligible state programs. Again, this appears to target California and Florida. These programs would put taxpayers on the hook to back state programs that insure earthquake losses at $5 billion (California) or other perils at $20 billion (Florida). In fact, the $20 billion figure fits fairly closely with the gap between the total liabilities faced by the Florida Hurricane Catastrophe Fund, the state reinsurance program, and the fund's available hard assets.[11]

TCS has long been skeptical of federal guarantee programs. They are almost always presented as having little or no cost proposals to federal taxpayers. But time and time again, from energy loan guarantees in the 1980s[12] to the Title XI shipbuilding program,[13] Uncle Sam has been left holding the bag. In these cases, it has been private companies that failed to repay loans. But it is easy to see that if the federal government picks up the tab for enormous state losses – particularly those of politically powerful states such as Florida and California – that much of that amount could be forgiven over the specified 30-year repayment period.[14]

In addition, the provision of this guarantee is a subsidy in and of itself. Explicitly promising the full faith and credit of the federal government behind the states' debts would enable them to borrow far more than they would otherwise, particularly in Florida, which doesn't have a income tax.

Fannie and Freddie Redux

H.R. 2555 envisions the creation of a National Catastrophe Risk Consortium. This consortium, at least initially, would be chaired by the Secretary of the Treasury, and the members would include the Secretary of Homeland Security, Secretary of Commerce and an appointee from

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[10] Section 303 (a)

[11] The actuarial firm AON Benfield reported that the total potential liabilities for FHCF were $28 billion in 2009, which should be roughly $26 billion in 2010. Available at http://fhcf.paragon.aonbenfield.com/pdf/09ratereportaddendum.pdf. Separately the FHCF audited statement includes $1.7 billion cash and $5 billion in pre-event bonds (although some have not been sold). Available at http://www.sbafla.com/fhcf/LinkClick.aspx?fileticket=U7k4ZIFZocM%3d&tabid=319&mid=1006. The difference of these two numbers is roughly $20 billion.

[12] Rudolph, Barbara. "Shattered Hopes for Synfuels." *Time Magazine*. April 18, 2005. Available at http://www.time.com/time/magazine/article/0,9171,1050485-1,00.html

[13] Government Accountability Office. Maritime Administration: Weaknesses Identified in Management of the Title XI Loan Guarantee Programhttp://www.gao.gov/products/GAO-03-728T

[14] Shapiro, Robert J. and Mathur, Aparna. "The Economic Effects of Proposals for Federal Natural Catastrophe Reinsurance and New Loan Programs: Who Pays and Who Benefits?" August 2008.

each State participating.[15] Although the legislation stipulates that the Consortium "is not a department, agency, or instrumentality of the United States Government,"[16] it is pretty clear that with high profile board membership and a federal charter, it will be viewed as such.[17] And as such, the provisions to have the Consortium "issue securities and other financial instruments linked to the catastrophic risks insured or reinsured through members of the Consortium in the capital markets" or "coordinate reinsurance contracts between participating, qualified reinsurance funds and private parties" will be viewed as activities with the backing of the federal government.[18]

You don't have to look any further than Fannie Mae and Freddie Mac to see how such arrangements were viewed by the public and markets. These government-sponsored entities were explicitly described as not being backed by the federal government. But everyone perceived them to be, and considering the federal takeovers, the public, not government protestations to the contrary, were right.

A Better Way Forward

The findings section in H.R. 2555 notes that natural disasters are going to continue to damage and destroy homes and that the U.S. needs to be better prepared for and better protected from catastrophes.[19] We agree.

We have long supported efforts to mitigate or eliminate (through buyout) the impacts associated with natural disasters. Several steps should be taken immediately. The Federal Emergency Management Agency's pre-disaster mitigation program has become littered with earmarks in recent years. This program is supposed to be about making communities more disaster-resistant and is too important to be treated like a parochial piggy bank. Separately, under the American Recovery and Reinvestment Act – the stimulus – nearly $5 billion has been given to the states for weatherization, but according to the Department of Energy Inspector General, an "alarming" amount of this funding has not been spent.[20] Congress could enable

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[15] Section 105. The Cabinet Secretaries could be represented by designees and the DHS and Commerce Secretaries are only members when there are less than two States participating in the Consortium.
[16] Section 101 (b).
[17] 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. September 6, 2010. Available at http://financialservices.house.gov/hearing110/swagel.pdf
[18] Section 103 (2) and (3).
[19] Section 2(a)(3) and (5)
[20] U.S. Department of Energy Inspector General. Progress in Implementing the Department of Energy's Weatherization Assistance Program Under the American Recovery and Reinvestment Act. http://www.ig.energy.gov/documents/OAS-RA-10-04.pdf

some of these funds to be redirected to catastrophe mitigation efforts. Other available stimulus funds could help jumpstart this area.

In Title IV, H.R. 2555 authorizes $75 million over five years for mitigation measures. But that seems to be more of an afterthought than a real goal of the legislation. There are other several pieces of legislation that would provide for a more robust investment in mitigation without all the other baggage included in H.R. 2555.

Finally, Florida needs to only look slightly north to South Carolina and Virginia for examples of good policy. Simply put, South Carolina's programs have let risk, not politics, determine rates in coastal areas, and the state has used its own resources to encourage residents to mitigate their homes vulnerability to hurricanes. As a result, more insurance carriers are entering the state. And in Virginia, the FAIR plan (Fair Access to Insurance Requirements) provides true "last resort" coverage for those who can't get coverage elsewhere. In addition, the state has private reinsurance to cover claims.

The major provisions in H.R. 2555 would actually serve as impediment to a better way forward. These provisions would enable Florida, or other states, to continue to subsidize high risk development and remove market incentives to mitigate future storm damages or move out of harm's way.

Conclusion

Higher insurance premiums are never popular, and politicians are in the business of being popular. This is a key reason why government-run insurance programs are fraught with fiscal peril. Witness the federal flood insurance program. Or look at Florida. Program changes in 2007 shifted the state-run Citizens Property and Casualty Insurance Company from insurer of last resort to the largest insurer in the state by a wide margin.[21]

Taxpayers for Common Sense's mission is "making government work." Sometimes the best way for government to work is to not make matters worse. H.R. 2555 would pile subsidy on top of subsidy to preserve an insurance house of cards in Florida. The federal flood insurance program has already demonstrated where this will lead. In these difficult budgetary times, we cannot afford to bailout one state for politically expedient decisions of the past.

[21] http://www.floir.com/pdf/NumberPIF3Q2009.pdf