MARYLAND INSURANCE COMMISSIONER QUASI-LEGISLATIVE HEARING ON THE AVAILABILITY AND AFFORDABILITY OF PERSONAL AND COMMERCIAL PROPERTY AND CASUALTY INSURANCE IN COASTAL AREAS OF MARYLAND

COMMENTS OF ALLSTATE INSURANCE COMPANY

DECEMBER 16, 2011

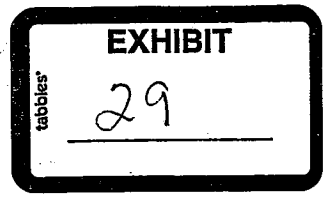
Allstate applauds the Commissioner for conducting a hearing on issues of availability and affordability of homeowners insurance in Maryland. We think it is important for legislators and regulators to fully evaluate the risks to the current system and explore options for improving the affordability and availability of homeowners insurance. A vibrant homeowners insurance market is essential to protect people from life's risks and to help individuals and communities rebuild when disaster strikes.

The first three questions raised in the hearing agenda seek information on the activities of market participants, and we think it is appropriate for that information to be gathered on an industry-wide basis. Therefore, we are focusing our comments on Questions 4-6 which examine the broader policy issues and potential solutions.

Question 4. What impact, if any, do coastal markets have on the availability and affordability of insurance in non-coastal areas?

Currently, we do not see signs in Maryland that issues along the coast have had a discernible impact on the availability or affordability of property insurance in non-coastal areas. Generally, issues of availability and affordability along the coast spill over to non-coastal areas when: (1) insurers must address catastrophe exposure issues subject to a state law, or regulatory mandate, that requires exposure reductions to be taken on a statewide basis; (2) insurers are encouraged by regulators to shift a portion of a proposed rate increase to non-coastal areas to minimize the impact of rate increases on the coast; or (3) a major catastrophic event leads to a spike in reinsurance costs or a contraction in reinsurance supply, or both. We currently do not see any of these conditions in Maryland.

We cannot, however, ignore the increased exposure to catastrophe loss that has developed on the Atlantic coast. In response, Allstate has taken steps in Maryland to manage our exposure to catastrophe risk and to maintain our ability to protect our policyholders from a position of financial strength. We examined all of our coastal risk from Texas to Maine and determined that we needed to take significant actions, tailored to each state's respective risk. In each state, we took the action or combination of actions designed to achieve our exposure reduction with the least amount of policyholder and market disruption. In Maryland, these actions included a



decision to stop writing new property insurance business along the Atlantic Ocean and portions of the Chesapeake Bay. In addition to limiting new business in the most exposed areas of the state, Allstate has also purchased reinsurance and implemented underwriting restrictions and Tropical Cyclone Deductibles. We were able to avoid policy nonrenewals along the coast by reducing our risk exposure primarily through the moratorium and by applying Tropical Cyclone Deductibles.

Allstate took these actions due to changing demographics and well-founded scientific predictions. The explosive population growth near the Atlantic coast is undeniable. The National Oceanic and Atmospheric Administration (NOAA) has reported that 53% of the nation's population lives in coastal counties. The insured value of homes in those coastal counties has been skyrocketing. The continued growth in coastal population and insured value would not be such a concern if the Atlantic Ocean was not in the early stages of a 40 year cycle of warmer ocean temperature that results in increased hurricane frequency and severity. There is broad consensus among meteorologists and other scientists that it is not a question of if, but when, more severe hurricanes will strike the Atlantic coast. Only three months ago, we all breathed a sigh of relief when Hurricane Irene fortuitously weakened and turned out to sea without causing the devastation that so many coastal residents feared. Had Hurricane Irene proceeded along its original course, or diverted up the Chesapeake Bay, the focus of this hearing would be decidedly different. We remain concerned about the possible adverse impact that hurricane like Irene could have on the reinsurance market and, consequently, the Maryland private insurance market.

While we see no current impact on non-coastal areas, we believe that it is likely that future major natural catastrophes will disrupt the availability and affordability of insurance in both coastal and non-coastal areas. A major storm in Texas or Florida, or an earthquake in California can have a significant impact on the cost and availability of reinsurance everywhere, including Maryland. If a major event depletes the capital of primary insurers and reinsurers, prices for insurance and reinsurance would rise significantly as insurers and reinsurers are forced to replenish capital. If a major hurricane strikes Maryland, the impact on the availability and affordability of insurance in both coastal and non-coastal areas would be much more direct. As we will discuss in greater detail below, we support efforts to better prepare individual states and the nation as a whole for natural catastrophes so that this future risk is minimized.

Questions 5 and 6. What has been the effectiveness, cost, long term viability of alternative mechanisms implemented or being considered in other states or Congress; initiatives adopted in other states.

Existing Alternative Mechanisms. A variety of mechanisms have been used to address limited availability or limited affordability of insurance in states with natural catastrophe exposures. Many states have residual markets to address areas where private insurers no longer write. Over the past 20 years, the total exposure to loss in state residual markets (these include FAIR, Beach and Windstorm plans) grew from $54.7 billion in 1990 to $757.9 billion in 2010 as states deal with growing availability and affordability issues. The two most prominent are Florida Citizens Property Insurance Corporation and the California Earthquake Authority. Other states with residual markets providing coverage to specifically address natural catastrophe risk include: Texas, Louisiana, Mississippi, Alabama, South Carolina, North Carolina and Connecticut. These

plans currently play an important role in serving as insurers of last resort, but they will continue to come under financial strain with the growth of coastal population and insured property values.

While residual property insurance markets may increase the availability of coverage beyond that which is already available in the voluntary market, a properly functioning residual market must charge actuarially justified rates. Rate adequacy has been a challenge in many states because of the countervailing public and/or political demand for affordable coverage. Suppressed residual market rates lead to deficits that must be passed on to private insurers and their policyholders through an assessment process. If unchecked, rate suppression can transform a market of last resort into a growing market competitor. For residual markets to maintain their appropriate role, proper pricing is a prerequisite. Unfortunately, many residual markets run by state governments are placed in the untenable position of dealing with the political challenges created by their role as a direct writer of insurance. State governments are much better suited to facilitating the creation of a backstop to the private market, and consumers are better served when private insurers are encouraged to offer coverage in areas with catastrophe risk. Legislation creating state catastrophe funds with a national backstop would therefore significantly reduce the subsidies currently associated with residual markets.

The Florida Experience. As part of an effort to support the private market, Florida has created the Florida Hurricane Catastrophe Fund (FHCF), which provides private insurers with reliable, cost-effective reinsurance coverage, and enables them to write more coverage than they otherwise would. Much criticism has been aimed at the catastrophe reinsurance fund concept by reinsurers and others in the insurance industry that wrongly lay the multifaceted problems plaguing the Florida property insurance market at the feet of the FHCF. Before describing how a catastrophe reinsurance fund would function in Maryland, however, it is important to correct certain misunderstandings about the FHCF.

The FHCF was created after Hurricane Andrew in 1993 following the collapse of the private reinsurance market. Since its creation, the Fund has worked exactly as it was intended. It has provided reinsurance to private insurers at lower cost, stabilizing the reinsurance market for Florida risks, and paying nearly $10 billion in hurricane claims. While homeowners insurance costs have not declined in Florida since the Fund was established, the reduced cost of reinsurance available through the Fund has enabled private insurers to charge less for homeowners coverage than they would without the Fund's availability. Consumers save billions every year in premiums and, without the FHCF, homeowners insurance would be less available and less affordable in Florida.

Understandably, policymakers have been concerned about the worst-case scenario presented by the FHCF. However, that system was tested during the 2004-05 hurricane season, and the availability of lower cost reinsurance and the additional reinsurance capacity to pay claims prevented numerous insolvencies following the eight hurricanes that struck Florida in 2004 and 2005. Policyholders have been assessed to help pay claims, but Florida policyholders are still paying less than they would have paid because of the reduced reinsurance costs experienced by private insurers. While critics of the FHCF like to focus on the potential exposure associated with a worst-case scenario, they conveniently ignore the collapse of the insurance market in Florida that would accompany such as worst-case scenario if the FHCF did not exist.

Fortunately, Maryland is not presented with the same challenges as Florida. The natural catastrophe exposure in Maryland that would be addressed by a catastrophe fund is less than 1/50th the exposure in Florida. Therefore, while Maryland citizens are vulnerable to market disruptions from natural catastrophes striking Maryland or elsewhere, a Maryland fund would not face the same exposure and timing issues that states with much larger exposures must navigate.

Why the Status Quo is Unacceptable. Major natural disaster scenarios vividly show that the current system for addressing natural catastrophe risk is not viable over the long-term. At the federal level, the current system relies on ad hoc federal government intervention with taxpayer bailouts to help communities rebuild and make up for insurance shortfalls. In the case of Hurricane Katrina, the GAO estimated that the federal government expended $25 billion due to underinsurance. It is questionable whether the federal government will be able to help communities rebuild after major catastrophes. The current budget battles demonstrate that the status quo is likely not sustainable and requires a thorough examination of how to best prepare society to deal with catastrophe risk. From the perspective of the State of Maryland, it is important to examine how the natural catastrophe response system may evolve in the coming years and to make sure Maryland citizens remain protected.

In December 2010, the National Commission on Fiscal Responsibility and Reform documented how important it is to our nation's short and long-term fiscal health to move to a system that budgets and builds resources for natural disaster recovery. While the Commission plan calls for the federal government to set aside funds in advance for disaster relief and to establish strict parameters for use of these funds, it is also important to supplement these funds by building reserves with private insurance premiums to support disaster recovery.

To address future natural catastrophes, we need a system of catastrophe preparedness and relief that is financially sound and that is organized to efficiently utilize the resources of private and public entities, including the federal government. Currently, a significant gap exists between the ability of the private insurance and reinsurance sectors to deal with the financial consequences of major natural catastrophes and the protection that is required. State residual markets have helped to limit that gap in some areas, but they too are not fully equipped to deal effectively with the financial losses that can result from a major natural catastrophe. In many states, the private market remains contracted in highly-exposed areas, and many states are growing more reliant on state government programs to provide coverage in these areas. The private reinsurance market has limited capacity and does not provide any guarantees about future capacity or availability except that significant price increases always follow major events that stress the system. The federal government already effectively acts as the insurer of last resort against major catastrophes, but its current structure is both disorganized and inefficient.

Catastrophe Reinsurance Funds. A better way to encourage homeowners insurers to serve a broader market is one that preserves the role of the voluntary market as the primary insurer of coastal business in a way that increases claim paying capacity for major catastrophes without requiring non-coastal policyholders to subsidize those who live close to the water. Specifically, Allstate advocates a catastrophe reinsurance fund similar to the model adopted by the National

Conference of Insurance Legislators. This approach has been opposed by insurers who fear government intrusion into their business and by reinsurers who suggest that such a fund is unnecessary because reinsurance capacity is adequate. Both argue that there is no coastal availability problem that adequate pricing cannot solve. We disagree. Undeniable changing demographics and scientific predictions of more frequent and more severe hurricanes in the Atlantic have created a situation where the demand for available and affordable insurance will collide with unstable and volatile price conditions.

Allstate believes that a Maryland catastrophe reinsurance fund will help more Maryland homeowners afford adequate insurance protection, without bailouts and subsidies, while providing additional funding from investment income to support important public safety objectives. The MIA has heard broad-based support at this hearing for tougher building codes, financial support for first responders, sales tax holidays and other tax incentives for loss mitigation efforts, as well as vouchers to help the poor pay for their insurance coverage. No one, however, has suggested the means to pay for these important public initiatives. Given the broad support and anticipated need for government funding, an additional source of funding would be welcome, and probably essential. A properly structured reinsurance fund can be leveraged to help pay for these initiatives while supporting the affordability of insurance.

Reinsurance companies sell reinsurance to insurance companies, providing a mechanism for insurers to spread risk to the broader market. However, the reinsurance market has shown extreme price volatility over the past 20 years. Increased hurricane activity in the Atlantic has led to increased demand, limited supply, and skyrocketing reinsurance prices. Reinsurers are quick to emphasize a modest decline in reinsurance rates in recent years, but they carefully avoid discussing the fact that reinsurance rates remain significantly higher than their pre-Katrina levels, and show no signs of ever retreating. In the wake of catastrophic events this year, the reinsurance market in the United States has again tightened, demonstrating the vulnerability of the market to events around the globe. Allstate is very concerned about the potential adverse impact on 2012 reinsurance prices and availability in light of the hurricanes, earthquakes and tsunamis experienced worldwide during 2011. Predictions made at this hearing of increased capacity and a “softer” market are no consolation.

It is important to recognize the nature of the reinsurance market because reinsurance costs are passed on to individual homeowners insurance policyholders in the form of higher premiums. It is also important because the cost of reinsurance may affect the willingness or ability of a homeowners insurer to assume more risk, thus potentially affecting the availability and affordability of insurance. A certain and stable homeowners insurance market is necessary to help prepare and protect the citizens of Maryland from catastrophe. The volatility of the reinsurance market threatens the predictability and stability that the homeowners insurance market needs to continue providing capacity in states like Maryland, where the growth of population and insured values along the coast is expected to continue its sharp increase.

How Would The Fund Operate? The key elements of a state catastrophe reinsurance fund include:

- All private homeowners insurers licensed in the state would be required to participate in the fund by purchasing at least some of their reinsurance needs from the fund each year.
- Reinsurance coverage would be available for losses above a specified layer of retained loss, calculated to pay out only for the biggest of storms.
- The fund would be self-supporting except for $10 million in start-up costs from the State of Maryland. This state-funded component is essential to obtaining tax-exempt status for the fund.
- Reinsurance premiums paid by insurers are projected to be 60-70% lower than private market reinsurance premiums under current conditions due to the fund's lower operating costs and the lack of a need to provide a market based return. The savings would be passed on to consumers, making homeowners coverage more affordable and available.
- Reinsurance premiums paid by private insurers would be calculated on an actuarially sound basis to ensure that rates reflect the risk that consumers face and to avoid subsidization of consumers in high-risk areas by consumers in lower risk areas.
- The Maryland State Treasurer would administer the fund and protect the fund from being raided for other purposes.
- The fund would be operated on a tax-exempt, not-for-profit basis. This would allow the fund to charge lower rates than private reinsurers. The savings would be passed on to consumers, making homeowners coverage more affordable and available.
- Private insurance companies would be required to meet all their obligations before utilizing the fund to pay claims. This guarantees that the fund covers only losses from mega-catastrophes that cause damage of such magnitude that private insurers are at a significant risk of financial collapse.
- **If you don't use it, you DON'T lose it.** A catastrophe reinsurance fund is notably distinguishable from private reinsurance because, at the end of a year when Maryland is spared from catastrophes, the private industry premiums and interest earnings would stay in the Maryland fund and continue to grow to protect Maryland consumers and taxpayers from future catastrophic events. In stark contrast, private industry premiums paid to private reinsurers are a "use it or lose it" proposition: no storms means no reinsurance recovery, and the premiums paid to reinsurers become huge profits reaped in large part by foreign investors.
- The fund would be required to allocate anywhere between 10% and 35% of investment income to loss mitigation programs, funding for first responders, and to help develop and enforce sensible building codes and land use policies.

Timing Risk: Maryland is not Florida. Reinsurers will often raise the concern that an extremely large event during the early years of a state catastrophe fund could deplete the fund's capital and potentially cause it to rely on short-term borrowing or assessments to make up for the shortfall. Ignored in such an objection is the fact that the types of catastrophes outlined in such a scenario would severely disrupt the reinsurance and private homeowners insurance in the absence of a catastrophe fund. Furthermore, as noted above, the natural catastrophe risk in Maryland that a state fund would address is less than $1/50^{th}$ the risk present in Florida. Therefore, the timing risk is easily manageable in Maryland. Thus, while Maryland residents remain vulnerable to shocks to the insurance market from within and outside of Maryland, policymakers in Maryland have much more flexibility to effectively address the possibility of an

extremely large event occurring during the early years of the fund, and addressing that issue upfront is much easier than reacting after the fact to a breakdown in the market from an extremely large event.

To further address this timing risk, we also support the creation of a federal catastrophe fund which would serve as a backstop to state and regional funds. Under legislation which has previously been introduced in the U.S. House of Representatives with broad bi-partisan support, state catastrophe funds would be able to buy reinsurance from a national fund that would address the largest events. If the State of Maryland does not wish to enact a state fund until there is assurance that the federal fund exists as a backstop, the General Assembly could pass enabling legislation that would make operation of the state catastrophe fund contingent on the national fund being created. This is the option recently taken by Louisiana, leaving that state well-positioned to participate in the federal fund upon its creation.

Enabling Legislation Positions Maryland to Participate in Future Federal Initiatives. Allstate supports the creation of a public-private partnership to better support private markets in protecting against financial losses from major catastrophic events. We are a member of ProtectingAmerica.org, a national coalition of more than 350 organizations representing emergency management officials, first responders, disaster relief agencies, non-profits, businesses and insurers. The coalition supports a comprehensive system to strengthen America's financial infrastructure by taking steps that include support for state and federal catastrophe reinsurance funds, and by promoting initiatives to encourage preparation, mitigation and recovery from inevitable major catastrophes such as earthquakes, hurricanes and wide-spread wildfires.

We believe that a system which more efficiently utilizes the resources of the private and public sectors could reduce the chance that enormous financial losses generated by a natural catastrophe will cripple the insurance industry and compromise the affordability and availability of coverage for homeowners. As the recent Japan tsunami demonstrates, a well-designed system can be critically important to protecting the economy from a financial shock that could occur after a catastrophe. Such a system could also be leveraged to promote better loss mitigation, significantly reducing the exposure we currently face.

We project that a system that uses state catastrophe funds supported by a federal backstop would bring stability to the homeowners insurance market. If a national backstop were created, then states like Maryland could decide whether to participate by creating its own catastrophe fund and then purchasing coverage from the federal fund**.** The volatility of the reinsurance market threatens the predictability and stability that the homeowners insurance market needs to continue providing capacity in states like Maryland, where the growth of population and insured values along the coast is expected to continue its sharp increase.

In sum, growing natural catastrophe risk continues to place greater strains on the private insurance market and the ability of communities to recover from natural disasters. The time to address this growing challenge is now. A large hurricane like Irene will inevitably make a direct strike on Maryland, and the citizens of Maryland will only be fully protected if action is taken to prepare for such an event.