TESTIMONY OF THE

AMERICAN INSURANCE ASSOCIATION

HEARING BEFORE THE MARYLAND INSURANCE COMMISSIONER

ON

THE AVAILABILITY AND AFFORDABILITY OF PERSONAL AND COMMERCIAL PROPERTY AND CASUALTY INSURANCE IN COASTAL AREAS OF MARYLAND

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MARYLAND INSURANCE ADMINISTRATION
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EXHIBIT

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Commissioner Goldsmith, good morning. My name is James Whittle, and I am Assistant General Counsel & Chief Claims Counsel to the American Insurance Association (AIA). Thank you for this opportunity to discuss our views today on a matter of utmost importance to AIA, our members, Maryland and the nation as a whole—insuring the risks associated with coastal exposure.

AIA is a national trade association of more than 300 property and casualty insurers. AIA members have a strong and abiding commitment to Maryland. Indeed several of our members were founded here. Moreover, many AIA members do business in Maryland, writing personal and commercial property and casualty insurance for the residents and business of the state.

AIA commends you for convening this hearing. The recent hurricane season has focused renewed attention on natural catastrophe and coastal risk. AIA has a wealth of experience in the public policy of coastal exposures and we are glad to share our views with you today. In these comments AIA will examine the continuing vitality of the Maryland property insurance market, positive reforms that can be enacted here and, finally, alternative risk mechanisms which are neither warranted nor prudent given the strong state of the Maryland marketplace. AIA stands ready to work with you and other stakeholders to ensure that insurance coverage is available for Maryland's residents and businesses.

The Maryland Property Insurance Market Remains Healthy

In 1992 Hurricane Andrew demonstrated that massive, recent building in coastal areas had vastly expanded coastal exposures. That expansion of coastal exposure was, of course, reaffirmed by the dramatic storms of 2004 and 2005. The Florida Four—Charley, Frances, Ivan & Jeanne—resulted in more than $29 billion in insured losses in 2004. Hurricane Katrina resulted in 1.7 million claims and $45 billion dollars in insured losses in 2005. Katrina was so big in fact, that people also forget that Hurricanes Wilma and Rita contributed more than another $16 billion dollars in insured losses that year.

Maryland is, of course, no stranger to coastal perils like hurricanes and Nor'easters. Hurricane Isabel in 2003 and Hurricane Irene this year are recent reminders that Maryland's more than 3000 miles of coastline[1] are exposed to potential catastrophic losses. Isabel caused $1.7 Billion in insured losses in all states,[2] whereas current estimates of Irene's impact are $4.3Billion in insured losses from the Carolinas to Maine.

Under such circumstances there is little wonder that Maryland's coastal residents and business might be concerned about their own situation. Further, any announcement or even perception that

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[1]According to the National Oceanic and Atmospheric Administration , Maryland has 3,190 miles of coast. http://coastalmanagement.noaa.gov/mystate/md.html

[2] http://www.iii.org/articles/maryland-hurricane-insurance-fact-file.html

insurers might scale back new writings, are issuing nonrenewal notices, or changes in deductibles can understandably raise concerns for policyholders and public officials in light of recent events.

Notwithstanding these concerns, there are good things to report about the state of the Maryland market. Indications are that property insurance remains readily available, and the property insurance market is competitive throughout the state including coastal areas.

• *MJIA Remains an Insurer of Last Resort*

One way to gauge the availability of homeowners' insurance in the private or voluntary marketplace is to examine the experience of Maryland's property residual market, the Maryland Joint Insurance Association (MJIA). Sudden or dramatic growth in the residual market is indicative of problems in the voluntary market. Fortunately, we have not seen this in Maryland. In fact, we have seen the opposite—the MJIA remains quite small and has actually been decreasing in size.

This chart shows MJIA policies in force and exposures in Sept. 2010 versus Sept. 2011.

Maryland Coastal Areas	Inforce 2011	Inforce 2010	Inforce Variance	Exposure 9/30/11	Exposure 9/30/11	Exposure Variance
Anne Arundel	91	82	9	26,888,700	25,029,200	1,859,500
Baltimore	209	225	-16	59,514,200	62,108,700	-2,594,500
Baltimore City	1331	1700	-369	167,492,300	206,424,300	-38,932,000
Calvert	8	12	-4	1,685,300	2,346,300	-661,000
Caroline	43	50	-7	8,802,200	9,420,900	-618,700
Cecil	16	22	-6	3,962,700	5,161,200	-1,198,500
Charles	30	36	-6	7,750,400	8,792,900	-1,042,500
Dorchester	50	64	-14	7,803,900	10,038,200	-2,234,300
Harford	35	36	-1	11,343,900	10,781,200	562,700
Kent	18	22	-4	2,849,900	3,156,400	-306,500
Prince Georges	171	185	-14	58,866,200	57,899,900	966,300
Queen Anne's	9	8	1	1,737,200	1,649,200	88,000
Saint Mary's	31	34	-3	6,202,950	6,823,150	-620,200
Somerset	31	35	-4	4,794,800	4,510,300	284,500
Talbot	35	38	-3	5,983,500	6,250,300	-266,800
Wicomico	66	67	-1	13,843,400	11,344,700	2,498,700
Worchester	38	39	-1	6,651,700	6,687,500	-35,800
Totals	**2212**	**2655**	**(443)**	**396,173,250**	**438,424,350**	**-42,251,100**

As you can see, there has been a sizeable decline in MJIA policies in force in coastal counties and Baltimore City from 2655 on September 30, 2010 to 2212 on September 30, 2011.[3] Moreover, with the exception of slight upticks in Anne Arundel and Queen Anne's totaling 10 policies, there has been an 84 policy decline in the rest of the coastal counties representing a total decline of 7.75% (7.7486) in coastal counties just the last year. In Baltimore City the declines in one year are even more dramatic, in September 2010 there were 1700 MJIA policies in force, in September 2011 there are 1,331. That represents a 369 policy reduction in the property insurance residual market in the city or a more 21% (21.705) decline there in the last year alone. Together the counties and Baltimore City represent only 2212 MJIA policies in force today compared to 2655 last year or a 16.68% (16.6854) decline.[4]

These numbers suggest that there is a healthy homeowners insurance market in coastal Maryland. According to U.S. Census Bureau data estimates there were 1,606,243 households in the coastal areas of Maryland in 2009. MJIA policies currently in-force (2212) represent only .1377% of all those households. In other words, MJIA coastal exposures are exceptionally small and actually declining, whereas the private market continues to meet the needs of all but a few coastal policyholders. The market is functioning well—private insurers write all but a handful of policies and the MJIA is functioning precisely as was intended—as a safety valve for a very relatively small number of insureds who are unable to obtain policies in the voluntary market.

When compared to Florida, the absence of a coastal problem in Maryland is profound. As of December 6, 2011 Florida Citizens Property Insurance Corporation, the state owned property residual market, had 1,482,707 policies inforce with a total exposure of over $515 billion dollars in insured valued. Moreover, Florida Citizens' policy in force count grew 42 percent in the 21 months ending Sept. 30th 2011. Indeed, since January 1st policies grew from just under 1.3 million to 1,482,707, or over 14% in less than a year. In fact, Florida Citizens is now the largest homeowner insurer in the state with 16% of the market and a larger still share of the coastal market in Florida. Florida Citizens has more than $515 Billion in total exposure whereas the total exposure for MJIA (both coastal and non-coastal) is a little over $456 Million. Thus, Maryland's residual market exposure is an astounding one thousandths that of Florida.

• ***Competition is Active among Insurers Here***

The homeowners' market here remains very competitive, which is another sign of a healthy market. In a market like Maryland's, where scores of insurers are competing for business, one insurer's

[3] Given that many parts of these counties and the City are miles in land it is fair to say that the true coastal exposures within the MJIA are probably even smaller.

[4] Total MJIA policies in force were 2443 at the end of September and down from 2905 a year before.

decision to cut back on its writings has less effect on the overall market. This is true even in coastal areas, where there still is not a serious threat of market disruption.

Statewide marketplace statistics for 2008 through 2010 show companies gaining, as well as losing, various percentages of market share over this period.[5] In fact, the largest homeowners' insurer in Maryland—State Farm—gained nearly .75% of the market in that period. While the market share of second, third and fourth largest writers became smaller by a total of 2.38%,[6] the fifth, sixth and seventh writers picked up market share at a greater pace—2.60%.[7] At the same time the market share in the top ten writers was reduced by .5% showing less concentration and greater competition.[8] This is a perfect example of the homeowners' insurance market working exactly as it should when given the opportunity.

• *Affordability and the Effects of Competition, Regulation and Cost Increases*

There are, of course, also concerns being expressed about the affordability of coastal homeowners' insurance. In light of antitrust laws, insurers are legitimately reticent about discussing insurance pricing. Nonetheless, there are a few important observations that we can share to add perspective on the affordability issue.

First, of course, Maryland has a lot of insurers competing for business and a small residual market. That competition will foster the most competitive prices if permitted to do so. That will help maintain affordability.

Second, regulatory risk can discourage capital formation. It is axiomatic that companies strive to provide favorable returns on stakeholder investments; it encourages capital formation. Failing to provide reasonable returns may likely mean less investment in an insurer. Consequently, businesses identify, and capital flows to favorable business environments. Like any factor influencing the business environment, the regulatory environment in a state can encourage and discourage capital formation and thus impact capital formation with a state. Predictable regulatory environments encourage capital formation; unpredictable or onerous regulatory environments discourage it.

Third, meteorologists and other experts agree that we are in a period of greater hurricane activity and that that could last for several more years. Event frequency does, of course, relate to risk and greater hurricane frequency does represent greater risk of property loss.

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[5] The latest AM Best annual data covers up to 2010.

[6] Allstate went from 16.52 to 14.84; Travelers went from 13.32 to 12.69; and Nationwide went from11.22 to 10.15. This totaled a 2.38% reduction in market share over two years

[7] Erie went from 7.62 to 7.99; USAA went from 5.72 to 6.94; and Liberty Mutual went from 5.15 to 6.16. This represented a 2.60% increase in market share over two years.

[8] The top ten homeowner insurers had 86.05% of the market in 2008 and only 85.56% of the market at the end of 2010.

Fourth, there continues to be an escalation of property repair and replacement costs. As product or service costs form an integral part of insurer expenditures, they ultimately find their way into premiums.

As the foregoing illustrates, there are inherent reasons why costs may increase. It is critical to encourage capital and market formation or expansion; otherwise a state may exacerbate the problems of availability and affordability. In this regard, South Carolina's reforms are one example of the things Maryland should consider.

Some Proposals Would Be Challenging

Several items were identified for consideration in the notice for this hearing. They include: (a) percent deductibles; (b) the impact coastal exposures may have on non-coastal areas of the state; (c) alternative market mechanisms; (d) windpools; (e) residual market mechanism, and (f) so-called catastrophe funds. We address them in turn and recommend that the MIA not adopt any limitations on the market place or alternative mechanisms.

- ***A Catastrophe Fund Is Unnecessary***

Over the course of the last several years there has been much discussion of "catastrophe funds" as a means to finance coastal insurance exposures. With the purpose of reducing costs to consumers, the homeowners insurers in Florida are forced to purchase reinsurance from a state pool. Florida is the only state in the United States that has an active state-run reinsurance facility for catastrophes—specifically, for hurricanes—which is similar in structure to the legislative proposals that have been introduced unsuccessfully elsewhere and federally.

The Florida Hurricane Catastrophe Fund was created after Hurricane Andrew, when private reinsurance essentially dried up. Legislators and regulators were faced with imminent collapse of the market in Florida, and so the Florida legislature created the "Cat Fund" to enable primary insurers to purchase reinsurance from the state, and consequently, to continue writing property insurance there. Fortunately, there is no similar reinsurance crisis facing Maryland homeowners' insurers.

A case has not been made, either in Maryland or on the federal level, for a state run reinsurance facility to manage natural catastrophe risk. Despite the record-breaking losses in the 2005 hurricane season, the private insurance industry remains in a position to manage this risk without new state or federal cat funds. To continue to do so, insurers need to better manage catastrophe exposures, and to be allowed to use tools to accurately underwrite and price risk. Insurers also need a regulatory environment that fosters competition among insurance companies.

Maryland is also very different from Florida in a number of other important respects. As already examined Maryland's coastal exposure is far less than Florida's (one thousandth the residual market exposures of Florida), and hurricanes make landfall in Maryland far less frequently than they do in Florida. This is not to say that Marylanders who live in coastal areas are not susceptible to hurricanes – in fact, scientific experts predict that it is only a matter of time before a hurricane does hit Maryland directly. Despite this, the current homeowners' insurance environment here certainly does not necessitate the creation of a cat fund and there has been no disruption in reinsurance for Maryland.

Additionally, there are other trade-offs that will directly affect policyholders should a cat fund be created. Many insurers already purchase national reinsurance treaties that provide adequate protection for their natural catastrophe exposures on a country-wide basis. If these insurers are required to purchase potentially duplicative reinsurance coverage in Maryland, or to purchase reinsurance at levels they do not purchase today, from a state-run facility, costs could actually increase, and these costs will have to be passed along to insurance consumers to avoid rate inadequacy.

Rather than having policyholders with the greatest risk pay a commensurate premium, the cat fund concept relies on substantial cross-subsidization to pay for catastrophe risk. Policyholders statewide – including those that have little or no exposure to catastrophe risk – would be included in the cat fund's assessment base to pay its obligations. AIA does not believe it is proper, as a matter of public policy, to require policyholders in areas of Maryland that are less exposed to a catastrophic loss and policyholders of policies other than homeowners' policies to essentially subsidize insurance costs for those who live in more catastrophe-prone areas. Rather, allowing insurers to charge an actuarially sound price that reflects the homeowner's risk of loss, instead of an artificially suppressed rate, is likely to stimulate a more robust property insurance marketplace.

The creation of a catastrophe fund in Maryland is not warranted. The creation of such a fund would cause Marylanders living in non-coastal areas of the state to subsidize those homeowners who choose to live in the areas more at risk from hurricanes. A cat fund would also have the potential of raising premiums for non-homeowners' insurance policies across Maryland as cat funds rely upon post event funding across policy lines. In addition, Florida has a substantial larger population with a substantially greater insurance market to underwrite the cross subsidizations there.

- ***Percent Deductibles Are Needed As Part of Insurer Underwriting Tools***

Since Hurricane Irene there has been a lot of discuss about percentage based hurricane or windstorm deductibles. Unfortunately, it appears that many consumers do not realize that the premiums they pay include percent deductibles related to hurricane or wind storm losses. In this way it is somewhat akin to flood coverage which, notwithstanding all manner of notice, policyholders routinely do not understand must be purchased separately.

Hurricane and windstorm deductibles are an important means for insurers to manage their coastal exposures. As insurers look at a state, knowing that they have the means to manage their total or probable maximum loss gives them confidence as a participant in that market. Moreover, percent deductibles encourage policyholders to mitigate potential losses.

AIA opposes limitations on windstorm and hurricane deductibles. If a company needs or believes it needs to use a percent deductible to manage its coastal exposure, it should be allowed to do so. If a policyholder does not want a policy with a windstorm deductible, there may be other alternatives in the marketplace to choose from. A homeowner typically has the choice of many different policies with all different types of deductibles. Not allowing a carrier to use a deductible it feels is necessary and appropriate to control its coastal exposure could lead to less capacity in the coastal homeowners insurance market, as well as fewer choices for consumers. Simply put, discouraging capital is not the way to expand the private insurance market place. The Florida experience is illustrative of this problem and needs to be avoided.

As amply examined above, Maryland's coastal homeowners insurance marketplace is healthy with coverage readily available. Hindering carriers from managing their coastal exposures as they feel necessary and appropriate may only have negative implications for capacity in the marketplace. Limiting the availability of hurricane and windstorm deductibles could also transfer risks inland as insurers, restricted in managing their probable maximum loss exposures in one part of a state, may necessarily look elsewhere to manage their potential exposure.

- ***Decisions in Coastal Markets Can Impact Non-Coastal Markets in Maryland***

As we already examined above catastrophe funds, with their post-event assessments, will likely impact non-coastal risks and many lines of insurance as they do in Florida. Similarly, restrictions on percent deductibles for coastal exposures, such as hurricanes and windstorms, can result in transfers of risk inland as insurers will necessarily look to establish and maintain reasonable probable maximum loss exposures. Thus, limitations in one part of a state can impact other parts of a state and this has been seen time and again in Florida for example.

- ***Additional Alternative Market Mechanisms Are Not Necessary***

The notice asked for comments on a variety of alternative market mechanisms including windpools, residual market mechanisms and catastrophe funds. We have already addressed why a catastrophe fund is neither necessary nor appropriate for Maryland. Maryland does, of course, have an existing residual market mechanism, a FAIR plan, and the MJIA functions well. Given its small size and yet availability for policyholder in coastal areas having problems acquiring property insurance, we believe the MJIA is sufficient for Maryland's current needs and that a separate "wind pool," such as the Texas Windstorm Insurance Association, is not necessary. Texas' property insurance market is again qualitatively and quantitatively different from Maryland. Texas has substantial greater coastal exposure and hurricane activity. Maryland is well served by its existing FAIR plan.

Positive Steps Maryland Can Take To Improve Its Coastal Market

As already examined, Maryland's property insurance market is not currently under stress. To maintain a healthy property insurance market in the state, the private sector's ability to serve homeowners and businesses in the path of potential storms must be improved, not displaced. There are a number of changes Maryland could adopt that aid coastal availability and affordability.

• *AIA's Reform Agenda*

In the aftermath of Hurricane Katrina, AIA began the process of identifying ways to improve the insurance industry's ability to serve homeowners and businesses in the path of potential storms, in particular, positive system changes that will allow markets to manage natural catastrophe risk without establishing new government programs, or a bail-out from taxpayers living in less-risky areas. Beyond their benefits to the insurance system, many of these reforms will help prepare individuals and communities for future catastrophes, educate them about the benefits of risk management and, most importantly, reduce the personal and economic toll of hurricanes and other natural catastrophes.

AIA's reform agenda includes both state and federal initiatives that could provide short-term and long-term benefits. The agenda we have developed consists of four major components:

- *protective measures* to keep people out of harm's way and strengthen their ability to withstand future hurricanes;
- *regulatory and legal reforms* to improve the stability of insurers' operating environment;
- *tax incentives* to encourage residents to prepare and respond to hurricane and coastal storm threats; and,
- *National Flood Insurance Program (NFIP) reforms* to assure that NFIP continues to play a vital role in protecting the region from the generally uninsurable risk of flood.

AIA reform agenda is attached to this testimony.

• *Continuing & Encouraging Mitigation Efforts*

Maryland should be commended for its continuing efforts to strengthen the state's building code. It appears that most local jurisdictios have now adopted the International Code Council's 2009

International Residential Code (IRC) and International Building Code (IBC) and this was the right thing to do. Unfortunately, there have been recent legislative efforts in other jurisdictions to weaken adopted codes. We believe this would be a move in the wrong direction and urge the Maryland Insurance Administration to be on guard for such efforts. Reducing wind-resistant building standards can only worsen, not improve, catastrophe experience and efforts to weaken building along the coast should be rejected. Finally, with each passing storm season more is learned and Maryland and its communities should continue to keep up to date with the latest IRC and IBC. This is the single most reliable means to reduce losses of life and property in a catastrophic storm.

Although I have stated that Florida's market and environment are much different than Maryland's, Florida is the "poster child" for the adoption and enforcement of enhanced building codes, and these efforts have more than proven their worth. The evidence was crystal clear in the aftermath of the four hurricanes in 2004. Hurricane Charley—a very intense, Category 4 storm—provided a true test of the newest IRC building codes. One only had to compare homes in the same vicinity built to pre-building code standards and those constructed after the Florida Building Code went into effect. There outcome was dramatic as properly and inspected newer structures fared much better than structures built under the older codes. In fact, a study conducted by Applied Insurance Research-Worldwide (AIR) after Hurricane Andrew found that insured losses would have been reduced by approximately 40% following a storm similar to Hurricane Andrew if all structures were constructed in accordance with the current Florida Building Code. This difference in total probable losses would also be due to a lower impact on personal property losses—furniture, clothing, photo albums, and so forth—as well as structural losses. So, the dreadful, emotional impact of not being able to "replace memories" is itself lessened through smaller losses of personal possessions. Thus, we encourage Maryland to continue the work of improving, updating and implementing building codes.

Beyond keeping the Maryland building code and its provisions for high wind up to date, it is important to remember that building codes only impact new construction, reconstruction, or substantial remodeling. A high percentage of the housing stock has been built under older codes predating the ICC codes that had minimal requirements for wind protection. As coastal areas are already substantially built with millions of housing units, the Department and insurers need to bear in mind that Maryland Insurance Code Section 19-210 already provides incentives to encourage remodeling and retrofitting with an eye toward hurricane mitigation.

• ***South Carolina's Reforms***

South Carolina's 2007 coastal reforms are instructional on ways government can increase capacity and encourage mitigation. The goal of South Carolina's coastal insurance relief plan was to encourage, rather than discourage, insurers to write policies along the coast. The proposal included a number of tax incentives, such as deductions for: (1) catastrophe savings accounts established by homeowners who choose to carry large deductibles or create accounts to "self insure;" (2) disaster mitigation measures; and (3) lower-income property owners who pay more than five percent of their incomes towards insurance premiums. In addition, the legislation incents private enterprise by authorizing tax credits for insurance companies who write full coverage for property owners along the coast.

Allowing insurers the greatest flexibility possible in underwriting and rating could also increase capacity. For example, the now-common use by insurers of percentage windstorm deductibles has allowed carriers to reduce premiums, and better manage their risk, which in turn has created additional capacity to write more business. Any attempt to restrict carriers in how they use their windstorm deductibles could have the unintended effect of *decreasing* capacity in the marketplace and should therefore be discouraged.

To encourage increased capacity, prices for insurance in catastrophe-prone regions must reflect the true costs of the risk. Risk-based pricing helps to provide insurers with confidence and predictability to encourage more competition and investment of capital, resulting in more coverage and more choices for consumers.

Conclusion

The property insurance market in coastal Maryland is largely healthy. If policymakers allow markets to adjust, there is nothing about recent underwriting decisions by a few insurers that should have any long term affects on the marketplace. Homeowners' insurance has been, and should continue to be available to coastal homeowners. Any governmental efforts to address availability and affordability in the homeowners' insurance market should focus on fostering greater competition, attracting new capital to the market, and creating a regulatory environment that allows insurers to manage their catastrophic exposures. The American Insurance Association stands ready to work with all stakeholders to develop private market solutions to ensure continued growth of capacity in the downstate homeowners' insurance market.

Thank you. I am happy to respond to any questions you might have.