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United States House of Representatives
Committee on Financial Services
Washington, D.C. 20515

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Memorandum

To: Members, Subcommittee on Housing and Community Opportunity & Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

From: Committee Staff

Subject: Legislative Hearing on "H.R. 3355: The Homeowners' Defense Act of 2007"

The Subcommittees on Housing and Community Opportunity & Capital Markets, Insurance, and Government Sponsored Enterprises will hold a legislative hearing entitled "H.R. 3355: The Homeowners' Defense Act of 2007" Thursday, September 6, 2007, at 2 p.m. in room 2128 Rayburn House Office Building.

The hearing will consist of two panels of witnesses. The first panel will include government representatives. The second panel will include a broad array of senior experts from several key sectors affected by the Homeowner's Defense Act, including real estate professionals, insurers, reinsurers, insurance brokers, and participants in the catastrophe bond market. Witnesses will appear by invitation only, and a witness list will circulate by separate cover.

Issue Background

The increasing costs of natural catastrophes have significantly stressed insurance markets. Participants in the insurance marketplace have the most experience with and are best prepared to deal with high-frequency, low-severity events. In contrast, catastrophic events, and particularly mega-catastrophes such as Katrina, with insured losses in excess of $50 billion, violate, to some degree, nearly all of the standard conditions for insurability. These low-frequency, high-severity events violate standard loss models by affecting many insured exposures at one time.

Insurance markets tend to respond adversely to mega-catastrophes. They respond to large events, particularly those that cause them to reevaluate their estimates of the probability and severity of loss, by restricting the supply of insurance and raising the price of the limited coverage that is made available. This occurred, for example, following Hurricane Andrew in 1992 and the Northridge earthquake in 1994.

The recent spate of natural disasters has caused insurance companies to reexamine their business models for insuring natural disasters. This process has resulted in insurers and reinsurers pulling out of or reducing their portfolios in certain areas of the country. This resulting insurance capacity loss has caused homeowners insurance rates to spike from 100 percent to over 600 percent in certain higher-risk areas. According to reporting by Aon, active wind insurance and earthquake insurance capacity have declined by 60.5 percent and 21.6 percent respectively.

This hearing represents the first time that the Subcommittees have convened to jointly consider this legislation or to consider legislation of this type. However, the concept that motivates this legislation has been around for sometime. On March 27th of this year, the Subcommittee on Housing and Community Opportunity held a hearing entitled "Perspectives on Natural Disaster Insurance," at which Congressmen Klein and Mahoney testified. Also, during the last Congress, Congresswoman Brown-Waite introduced H.R. 4366, the "Homeowners Insurance Protection Act of 2005" that addressed similar issues as H.R. 3355.

<u>Hearing Focus</u>

This hearing will focus on H.R. 3355, The Homeowners' Defense Act of 2007. Congressman Ron Klein introduced this bill on Friday, August 3rd for himself and Congressman Mahoney.

The purpose of this bill is to provide Federal encouragement for States to develop State-sponsored reinsurance programs designed to enhance the efficiency by which catastrophic risks are transferred into the capital markets. In so doing, the provisions of this Bill are designed to help homeowners prepare for and recover from the damages caused by natural catastrophes. Furthermore, this bill is intended to encourage mitigation and prevention for such catastrophes and to encourage participating State-sponsored reinsurance programs to maintain reasonable, market-based underwriting practices. Lastly, the efficiencies envisioned in this bill are intended to help expedite the payment of claims and better assist in the financial recovery from such catastrophes. While the forthcoming Section-by-Section provides greater details about this legislation, a discussion of several of its key provisions follows.

<u>Title I- The National Catastrophe Risk Consortium</u>

Title I establishes the National Catastrophe Risk Consortium, an organization that states can, but need not, join for the purposes of transferring catastrophe risk. Risk transfer would be achieved through the issuance of risk-linked securities or through reinsurance contracts. The consortium is designed to function as a conduit, so that at no time would risk transfer either to or from the Federal Government.

The Consortium would be governed by a board comprised of federal and state representatives with all members having a single vote. The Consortium will be jointly funded by the federal government and participating states. All states are eligible to join. A minimal federal appropriation will be matched by state obligations prorated according to each state's participation in the consortium. The Consortium will employ a limited, mainly administrative staff. Much of the Consortium's needs for risk modeling, financial consulting, and relations with the capital markets would be arranged for on a contract basis rather than provided by permanent staff.

The Consortium offers states and private market participants a unique opportunity to benefit from a combining of catastrophic risk diversified by type of peril and geographic region. The Consortium staff would work in coordination with participating states to catalogue inventories of catastrophic risk. Catastrophe bond underwriters and other market participants would be able to access this database to structure bonds or reinsurance contracts and treaties. The Consortium would serve as a conduit issuer of catastrophe bonds on behalf of the participating states, but not actually take possession of any bond proceeds, coupon payments or underlying risk.

Through the aggregation and maintenance of market statistics, the Consortium would develop industry standards for the catastrophe bond and risk transference markets. Such standards include, but are not limited to, the terms of bond offerings, the nature of triggers used and the definitions of risks.

Title II- National Homeowners Insurance Stabilization Program

This title creates a National Homeowners Insurance Stabilization Program within the Department of Treasury designed to ensure a stable private insurance market by extending low interest federal loans to State-sponsored insurance programs in states that have been impacted by severe natural disasters. Specifically, the program would make two types of loans available: liquidity loans and catastrophic loans.

Liquidity loans would be extended to state or regional reinsurance programs that have a capital liquidity shortage. The amount of the loan cannot exceed the ceiling coverage level for the reinsurance program. The liquidity loan would have an interest rate set at 3 percentage points higher than marketable obligations of the Treasury having the same term to maturity and maturity of between 5 and 10 years.

Catastrophic loans would be extended to a qualified reinsurance program if it has sustained losses above the ceiling coverage level. The catastrophic loan will have an annual interest rate 0.20 percentage points higher than marketable obligations of the Treasury and have a term to maturity no less than 10 years.

For the first 5 years of the program, states that do not have a qualified reinsurance plan, would be eligible to participate in the Title II program through their residual insurance market entities (e.g., state FAIR Plans and windstorm plans).

Title III- General Provisions

This title defines, for the purposes of this bill, a "qualified reinsurance program" as a state authorized entity that provides reinsurance or retrocessional coverage to underlying primary insurers or reinsurers for losses arising from all personal real property and homeowner's lines of insurance.

If you have any questions about this hearing or H.R. 3355, please contact Kathleen Mellody at extension 6-3383, Tom Glassic at extension 6-3907, or Nat Thomas at extension 6-5593.