Competitive Enterprise Institute
1899 L Street, NW • 12th Floor • Washington, DC 20036
202.331.1010 • www.cei.org
*Advancing Liberty – From the Economy to Ecology*

**December 2, 2008** **No. 146**

# Compounding Catastrophe

## Why Federal Involvement in State Catastrophe Insurance Is a Bad Idea

By Arin Greenwood[*]

Recent events, from the subprime mortgage crisis to the credit crunch, have made clear that not all home ownership is good home ownership. Despite this, some members of Congress continue to propose legislation to promote the bad kind of home ownership, this time by bolstering disastrous catastrophe insurance and reinsurance plans.

There are several problems with these proposals. First, they would encourage poor construction on overbuilt, fragile coasts. Second, they would promote Florida's unsustainable and dangerously underfunded, underpriced state catastrophe fund. Finally, they would shift the burden of paying for property damage in catastrophe-prone areas to taxpayers around the country, away from the property owners themselves.

The most recent proposed legislation of this kind, the Homeowners' Defense Act of 2007 (H.R. 3355), is representative of the problems posed by legislation of this kind. It is unlikely to pass this Congress, but its problem features may reappear in other legislative proposals. The Act was introduced by Rep. Ron Klein (D-Fla.) as a response to the devastation caused by a series of hurricanes in 2005. That year, Hurricane Katrina, caused an estimated $80 billion in insured losses,[1] while other storms caused over $200 billion in total economic losses and over $50 billion in insured losses to homeowners.

**The Homeowners' Defense Act.** Coastal states have borne the brunt of hurricane losses, which are increasing as the population continues to increase rapidly along the coasts, particularly along Florida's east coast and up through the Gulf Coast.[2] Property insurance premiums in coastal areas have concomitantly gotten progressively higher. In response, a more than 20 coastal states have created "insurers of last resort"—state-

---

[*] *Arin Greenwood is a lawyer and writer living in Washington, D.C. She is a graduate of Columbia Law School. Her articles have appeared in* Slate, Washington City Paper, American Bar Association Journal, *and many other publications.*

created and -backed insurers and reinsurers that sell below-rate property insurance for property that is otherwise prohibitively expensive to insure. Seeking to keep insurance premiums for such high-risk properties at affordable levels, these insurers take on ruinous amounts of liability.

Florida has the most egregiously ruinous insurer of last resort—it is liable for $441.9 billion on 1,216,960 policies it carries. Florida has also taken the next step of reinsuring this enormous liability to the tune of $36 billion.[3] Florida has no realistic way to pay. Thus, if a disaster were to hit, the losses it would cause could bankrupt the state.

The Homeowners' Defense Act and other similar legislation would make these problems worse. The Act purports to address a number problems affecting states' catastrophe reinsurers. Specifically, it seeks to: 1) regularize and regulate state catastrophic reinsurance schemes; 2) lower property insurance premiums for homeowners in catastrophe-prone areas; 3) create a non-profit consortium to work with state reinsurance schemes helping them organize, share information, and perform their duties, without incurring any liability; and 4) reduce non-catastrophe prone states' burden of paying for catastrophic losses in catastrophe-prone states.

In fact, this legislation would increase hurricane losses, while failing to protect taxpayers in non-catastrophe prone states from paying for those losses. State catastrophic reinsurance schemes need reform, and soon, but this is not the reform they need.

**Why It Will Not Work.** There are five main problems with this proposal.

***1. It establishes an unnecessary government agency.*** The National Catastrophe Risk Consortium is a nonprofit entity established by the Act whose purpose is to perform a number of functions relating to state disaster insurance and reinsurance schemes, particularly gathering and disseminating information about state schemes both to the states themselves and to private parties who may invest in state schemes.[4] This Consortium is unlikely to coordinate information about state disaster insurance and reinsurance schemes any better than the states themselves or private parties.

***2. It is unclear whether the Consortium or the federal government could be liable for any defaults or other problems arising out of the activities of the Consortium or of its members.***[5] For example, consider U.S. government agency securities. These are securities issued by federal agencies that are not backed by the government's full faith and credit.[6] Investors buy these securities because they believe that the government would not allow the securities to go into default—a belief that is widely promoted in the investment community, especially in the wake of the recent bailouts of U.S. financial institutions.[7]

***3. It purports to reduce federal spending, but in fact mandates***[8] ***the federal government to grant nearly unlimited liquidity and catastrophe loans to state reinsurance programs that cannot make their repayment obligations and cannot secure loans on the private market at a reasonable rate.***[9] These loans are required to be repaid, but the only

consequence of their not being repaid is for the Secretary of the Treasury to file a report to Congress explaining why the loans were not repaid.[10] The loan obligations under this Act may be tremendous. For example, what would happen if Florida were to ask the federal government for a loan to pay for its catastrophe fund? As noted, Florida has catastrophe reinsurance obligations of around $36 billion, an amount it currently cannot pay. This means that the federal government could be on the hook for $36 billion in mandatory loans to Florida alone. An August 2008 report issued by Sonecon, a consultancy, estimates that Washington could be liable for losses of $140 billion to $161 billion in 2009, $197 billion to $230 billion in 2013, and $278 billion to $332 billion in 2017.[11]
.

***4. It would create a Federal Disaster Reinsurance Fund that would compound the problems already affecting state reinsurance programs.*** The Act would authorize the Treasury Secretary to sell up to $200-billion's worth of reinsurance policies to states that are unable to secure private funding. Thus, the federal government would pick up the liability for Florida's plan—which has premiums that are unsustainably low, cannot possibly fulfill its reinsurance obligations, and is therefore most desperately in need of reform. Premiums would remain artificially low and taxpayers would be on the hook for billions of dollars. Moreover, it is bad risk management policy for government to get into the catastrophe reinsurance business. Private catastrophe reinsurers manage their risks by insuring different kinds of catastrophes in different parts of the world—for example, blizzards in Japan and hurricanes in Florida—since those are unlikely to occur all at once.[12] A federal reinsurance fund, by contrast, would insure against very few kinds of catastrophes in a geographically homogenous area—primarily the Atlantic coast—where all reinsured catastrophes are likely to occur at the same time. In other words, while the federal government undercuts private insurers by providing below-market catastrophe reinsurance, and while bolstering state reinsurance schemes which are in serious need of reform, it also takes on enormous liability for itself, and ultimately for taxpayers.

***5. It would create incentives for people to build poorly constructed homes in fragile environments.*** Keeping property insurance premiums at artificially low levels lessens incentives for people to build away from coastal areas, or to build stronger houses in those areas. Those who choose to live in catastrophe-prone areas should bear the cost of that choice, while those unwilling to bear that cost should move to safer areas. Just as it was a mistake for the federal government to encourage Americans to buy too-large homes for too much money, it is a mistake for it to encourage Americans to build too-flimsy houses in too-fragile, catastrophe-prone areas. A February 2008 study by Roger Pielke, Jr., of the University of Colorado and colleagues estimates potential yearly hurricane damage at $10 billion—and growing. The study's authors caution that reducing this potential damage requires for people to move away from coastal areas, as well as mitigation actions such a building stronger, more durable houses and preserving wetlands, which help buffer the coast against storms.[13] The Homeowners' Defense Act has no provisions to encourage either mitigation or the construction of stronger houses.

**Conclusion.** Hurricanes are predictable. They are going to happen, and they are going to happen in coastal states like Florida. Poorly constructed houses will fall down, creating devastating social, economic, humanitarian, and environmental losses. Given that, making taxpayers in Maine subsidize people in Florida living on the coasts is sheer folly—and that is precisely what legislation like the Homeowners' Defense Act would do. For the federal government, a wiser approach would be to create incentives for people to build better, in less fragile, less catastrophe-prone areas of the country.

## Notes

[1] "Hurricane Gustav losses could reach $10 billion," Environmental Finance, http://www.environmental-finance.com/onlinews/0904hur.html.
[2] Roger A. Pielke Jr.,et al, "Normalized Hurricane Damage in the United States: 1900-2005," *Natural Hazards Review*, February 2008, http://sciencepolicy.colorado.edu/admin/publication_files/resource-2476-2008.02.pdf.
[3] Figures provided by Florida reinsurers to Eli Lehrer of the Competitive Enterprise Institute.
[4] For example, the Consortium keeps a compendium of information about state disaster insurance and reinsurance risks and obligations for the use of states and private parties, to, "on a conduit basis…[i]ssue securities and other financial instruments linked to the catastrophe risks insured or reinsured through members of the Consortium in the capital markets," coordinate reinsurance contracts between states and private parties, and "perform any other functions, other than assuming risk or incurring debt, that are deemed necessary to aid in the transfer of catastrophe risk from participating States to private parties." Sec. 101 (1)-(7).
[5] The Consortium is "not a department, agency, or instrumentality of the United States Government" under the Act. Rather, it is a nonprofit government corporation like the 40-odd government corporations which have been established in various forms for more than 200 years, but in greater numbers in the past two decades. The legal status—and liabilities—of these government corporations is not clear, and it is similarly unclear whether the Consortium would be allowed the release from liability provided for in the Act. *See, e.g.,* Froomkin, "Reinventing the Government Corporation," 1995 U. Ill. L. Rev. 543.
[6] United States Department of the Treasury, Report on Finances and Operations of Government Securities Brokers and Dealers, www.treasurydirect.gov/forms/gsrg405sched1.pdf.
[7] See, for example, BONDTRAC Professional's information page on U.S. Government Agency Securities, http://www.bondtrac.com/professional/information/education/GovAgency.xml,
[8] Section 202(c).
[9] Section 202(e)
[10] Section 203, Section 204(c).
[11] Robert J. Shapiro and Aparna Mathur, "The Economic Effects of Proposals for Federal Natural Catastrophe Reinsurance and New Loan Programs: Who Pays and Who Benefits?" Sonecon report, August 2008, http://www.sonecon.com/docs/studies/Report_on_the_Effects_of_Proposed_Hurricane_Legislation-Shapiro-Mathur-August_2008.pdf.
[12] *See, e.g.,* Mojdeh Keykhah, "Global Hazards and Catastrophic Risk: Assessments, Practitioners, and Decision Making in Reinsurance," Belfer Center for Science and International Affairs Discussion Paper 2000-22, Environment and Natural Resources Program, Kennedy School of Government, Harvard University, 2000, http://environment.harvard.edu/gea.
[13] Pielke.