Statement of the Shadow Financial Regulatory Committee

On

Proposed Federal Catastrophe Reinsurance

December 13, 1999

Increases in the frequency and severity of losses from earthquakes, hurricanes, and other natural catastrophes in recent years have produced substantial debate concerning the scope of private sector catastrophe insurance/reinsurance and the possible need for government intervention to expand the supply of coverage. Three states (California, Florida, and Hawaii) have adopted programs for providing catastrophe insurance or reinsurance. In November 1999, the House Committee on Banking and Financial Services approved H.R. 21, The Homeowners’ Insurance Availability Act of 1999. This bill would establish a federal reinsurance program for the risk of loss from natural disasters, thus expanding the role of the federal government in property insurance well beyond the existing flood and crop insurance programs.

H.R. 21 would authorize the Secretary of Treasury to sell reinsurance contracts for catastrophe losses to residential property. The bill would permit direct sales of federal reinsurance to state catastrophe programs at a price determined by the Treasury based on consultation with a special commission on catastrophe risk and loss costs. The bill also would authorize auctions of regional contracts to state programs and private insurers/reinsurers, with minimum prices established by the Secretary in consultation with the commission. The contracts would pay up to 50 percent of eligible losses above the largest of (1) $2 billion, (2) the estimated magnitude of loss from a one in 100 year event, and (3) in the case of state programs, the program’s available resources to pay claims. The Secretary would have the authority to establish higher triggers. The aggregate amount of coverage sold is to be limited so that it is “unlikely” to produce annual costs above $25 billion. The amount of coverage for a particular state or region would be limited to the difference between the estimated cost of one in 500 and one in 100 year
would allow substantial discretion to establish low prices in response to inevitable political pressure for subsidies to high risk regions. Based on experience of other federal insurance programs, significant program expansion would be likely, including an extension of federal influence to private sector pricing and underwriting of primary catastrophe coverage. The bill could also encourage the creation of government insurance mechanisms with subsidized rates in additional states, further crowding out private coverage and distorting incentives for loss control.

Before beginning down the slippery slope of another large federal insurance program, the Committee believes that several crucial questions must be answered. First, what is the extent of any problem in the availability and affordability of catastrophe insurance? Second, what are the underlying causes of any problems, including the roles of disaster assistance, federal taxation, and state restrictions on private sector underwriting and pricing of coverage? Third, is it likely that existing federal insurance programs for crop and flood losses have reduced costs to taxpayers and improved incentives for loss control? Fourth, and more broadly, will ex ante government insurance against catastrophe losses, with its tendency toward subsidies and program expansion, likely be efficient compared to relying primarily on narrower, ex post assistance in the form of disaster relief? Fifth, are possible alternative responses that would strengthen private sector capacity, such as changing tax law to establish catastrophe reserves (as is proposed in another House bill) and permitting favorable tax treatment of onshore catastrophe bond mechanisms, more attractive than a new government insurance program?