

CRS Report for Congress

Hurricanes and Disaster Risk Financing Through Insurance: Challenges and Policy Options

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Summary

The U.S. Atlantic and Gulf of Mexico coastal states, Hawaii, Puerto Rico, and the U.S. Virgin Islands are exposed to relatively high levels of risk from hurricanes and tropical storms. To address the financial and economic effects of such risks, residents and business owners have relied on private insurance, state-sponsored insurance pools, and/or federal emergency disaster assistance to manage their natural hazard risk.

The 2005 hurricane season was devastating to residents and businesses in the coastal high-hazard areas of the Gulf Coast and New Orleans. Although insured catastrophe losses in 2005 totaled \$61.2 billion, the industry had the financial resources to pay all insured claims without threatening its solvency and claims-paying ability. Hurricane Katrina losses were \$41.1 billion.

Insurance industry participants, legislators, and policymakers learned a great deal from both Hurricane Andrew in 1992 and the four major hurricanes during the 2004 season, and they took specific actions that had the effect of minimizing the impact of the 2005 hurricane season. Nevertheless, most disaster experts and policymakers did not anticipate nor were they prepared for the magnitude of flood damage and the subsequent number of flood claims filed in the wake of Hurricane Katrina. As a result, the U.S. Congress was called upon to consider major revisions to the National Flood Insurance Program (NFIP). On September 27, 2007, the full House approved H.R. 3121, the Flood Insurance Reform and Modernization Act of 2007, to restore the financial solvency of the program. On November 1, 2007, Senator Christopher Dodd introduced S. 2284 to reform the flood insurance program while forgiving the estimated \$17.5 billion in debt owed to the U.S. Treasury, as of December 31, 2007.

With respect to the broader issues of managing and financing catastrophe risk, members of the 110th Congress might also focus attention on the long-term budgetary implications of disaster recovery expenses incurred by the federal government, and finding ways to expand private-sector capacity for insuring disaster losses. Previous Congresses responded to insurers' concerns by considering legislation to create a federal catastrophe reinsurance program for residential property.

This report examines the role of insurance in financing disaster risk and the changes implemented by insurers and legislators that helped to minimize market disruptions following the 2005 and 2004 hurricane seasons. After reviewing the congressional interest in financing catastrophe risk and summarizing the results of the last two hurricane seasons, the report describes lessons learned, the insurance market's response to hurricanes, and existing mechanisms for insuring hurricane losses. The concluding two sections analyze issue and policy options as well as future challenges that policymakers in the 110th Congress face.

This report will be updated as events warrant.

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Hurricanes and Disaster Risk Financing Through Insurance: Challenges and Policy Options

Introduction

The eighteen states along the U.S. Gulf and Atlantic coast,¹ extending from Texas to Maine, along with Hawaii, Puerto Rico and the U.S. Virgin Islands, are at relatively high risk from hurricanes and tropical storms.² Hurricanes and tropical storms typically produce violent winds, heavy rains, and storm surges that result in flooding, coastal erosion, and ecological damage. When they strike in populated, commercial, or industrial areas, hurricanes and tropical storms can cause dozens of deaths and billions of dollars in both direct costs (e.g., loss of capital stock and investments) and indirect costs (e.g., disruption of economic activity, including loss of income, employment and services).³

Hurricanes are normally described as being in one of five categories, depending on their wind velocity. Category one hurricanes have winds of 74 to 95 miles per hour, category two hurricanes have winds of 96 to 110 miles per hour, category three hurricanes have winds of 111 to 130 miles per hour, category four hurricanes have winds of 131 to 155 miles per hour, and category five hurricanes have winds greater than 155 miles per hour.

Lessons learned from the 2005 and 2004 hurricane seasons have led the 110th Congress to focus attention on the mounting cost of federal outlays for disaster assistance involving hurricanes, and deciding whether and how the federal government could improve the nation's ability to finance the losses created by these events. Insurers, legislators and policymakers learned a great deal from the devastation caused by Hurricane Andrew in 1992, especially in the areas of pre-disaster mitigation and the financing of catastrophic risk, and actions they took served to minimize market disruption following both the devastating 2005 and 2004

¹ These 18 states are: Alabama, Connecticut, Delaware, Florida, Georgia, Louisiana, Maryland, Massachusetts, Mississippi, Maine, New Hampshire, New Jersey, New York, North Carolina, South Carolina, Texas, Vermont, Virginia.

² Hurricanes are formed in the North Atlantic, Caribbean Ocean, Gulf of Mexico, and the Pacific Coast of Mexico. The greatest likelihood of a hurricane striking land areas is along the Gulf Coast and the Southeastern Seaboard, as well as Hawaii. Some hurricanes have struck central Pennsylvania and the coast of New Jersey, New York, Maryland, and New England.

³ Rachel A. Davidson, and Kelly B. Lambert, "Comparing the Hurricane Disaster Risk of U.S. Coastal Counties," *Natural Hazards Review*, August 2001, p. 132.

hurricane seasons. However, the short-term insurance solutions designed to finance loss caused by a small (category one) or moderate hurricane (category two, three or four) will not work for a catastrophic hurricane (category five) because state pools lack the financial capacity for financing events of such magnitude.

Prior to the beginning of the 110th Congress, some Members of Congress had begun to rethink federal disaster policy, particularly with respect to the financing of catastrophic risk and the unwillingness or inability of insurers to provide property insurance coverage to the extent sought and needed. An important issue these Members grappled with was deciding how to reconcile the possible roles for the public and private sectors in disaster risk financing and risk reduction. Several questions arose: What has been the experience of using financial tools, such as insurance and other financial services, to reduce disaster risk? What challenges and opportunities exist for disaster risk transfer and risk reduction schemes? And lastly, what concrete steps must be taken, and by whom, to form partnerships between the public and private sectors to use insurance and other financial services for disaster risk reduction?

In preparation for continued debate on financing disaster risks in the 110th Congress, this report examines the role of insurance in financing disaster risk and the changes implemented by insurers and state legislators that helped to minimize market disruptions following the 2005 and 2004 hurricane seasons. After reviewing the congressional interest in financing catastrophe risk and summarizing the results of the last two hurricane seasons, the next three sections describe lessons learned, insurance market's response to hurricanes, and existing mechanisms for insuring hurricane losses. The concluding sections analyze issues and policy options as well as future challenges that policymakers in the 110th Congress face.

Financing Catastrophic Risk With Insurance

Individuals and policymakers have two options to reduce losses from disasters: pre-disaster mitigation that reduces physical /environmental vulnerabilities and risk financing designed to reduce financial vulnerabilities. The first step in the disaster management framework is to mitigate damages from disasters. The residual economic risk can then be managed with risk financing strategies. Financing is thus an integral part of managing disaster risk; it would not be feasible to quickly reconstruct the damaged property and infrastructure, and also to restore the livelihood of the affected persons without adequate financial arrangements.

Insurance is the primary method of financing natural disaster losses in the U.S. Risk financing with insurance avoids the time lag that is associated with post-disaster assistance or financing. Insurers are able to assess damages and reimburse disaster victims for financial losses. In providing insurance coverage, an insurer will agree to assume a portion of the policyholder's disaster risk exposure in exchange for a premium. From this premium payment, the insurer sets aside loss reserves to pay expected claims and build up capital reserves to "buffer" against the risk of insurer insolvency from low-probability, high-cost events. Insurance companies supplement

this arrangement by purchasing reinsurance from a reinsurance company so that losses from a catastrophic event are spread worldwide.⁴

Most insurance experts agree that although primary insurers and traditional reinsurers could absorb the loss shock from a moderate (category two, three, or four) hurricane (e.g., less than \$50 billion in insured losses), their financial capacity may not be adequate to cope with a catastrophic (category five) hurricane. Estimates of the probable maximum losses (PMLs) from a catastrophic hurricane striking the U.S. range up to \$100 billion, and this figure could be even higher depending on the location, time and intensity of the event. The PML loss from a Category 5 hurricane directly hitting a densely populated area along the Gulf and Atlantic Coast (e.g., the Miami-Ft. Lauderdale area) could exceed the total capacity (policyholder surplus) of the U.S. insurance industry.⁵ The policyholders surplus of the entire property and casualty insurance industry stood at approximately \$521.6 billion at the end of 2007.⁶ Only a fraction of this industry-wide total surplus amount would be available to compensate victims of a hurricane. Insurers must rely on this same limited pool of capital to pay for other potentially catastrophic and unpredictable risks, such as terrorism, mold, and medical malpractice and asbestos liability claims. Insurers may have to liquidate bonds and other financial assets in order to pay claims, triggering an adverse impact on U.S. financial markets.⁷

Congressional Interest In Financing Catastrophic Risk

The property and casualty insurance industry will be able to pay all claims from the devastating 2005 hurricane season without jeopardizing the solvency and claims-paying ability of the industry as a whole. In the absence of an efficient and effective catastrophe insurance market — one that provides property insurance at reasonable rates to residents and business owners and spreads catastrophe risk globally — the government often becomes the *de facto* financier of disaster recovery efforts through

⁴ Reinsurance provides considerable protection to the primary insurer by: (1) limiting that insurer's loss exposure to levels commensurate with their net assets; (2) reducing the wide swings in profit and loss margins inherent to the insurance business; (3) protecting against catastrophic loss; and (4) increasing capacity or the dollar amount of risk an insurer can prudently assume, based on its surplus and the nature of the business written.

⁵ David J. Cummins, Neil A. Doherty and Anita Lo, "Can Insurers Pay for the 'Big One'? Measuring the Capacity of an Insurance Market to Respond to Catastrophic Losses," *Journal of Banking and Finance*, vol. 26, no. 2, p. 557.

⁶ Policyholders surplus refers to "net worth" or "owners' equity" in other industries. It is a measure of the capacity of insurers to underwrite policies, and it must increase to meet the demands of a growing U.S. economy and claims resulting from hurricanes and other natural hazards.

⁷ Ross J. Davidson Jr., "Working Toward a Comprehensive National Strategy for Funding Catastrophe Exposures," *Journal of Insurance Regulation*, vol. 7, no. 2, Winter 1998, p. 134.

existing government disaster response and recovery programs and the “traditional” appropriation process.

As the frequency and severity of natural disasters increase, state governments have used their taxing and bonding capacities to establish public/private insurance pools to engage in catastrophe risk management and financing. Recent catastrophes, however, have strained these pools and most insurance market analysts would agree the private sector insurance industry has enormous capacity to provide catastrophe risk insurance, but that coverage is limited. As demonstrated by the 2004 and 2005 hurricane seasons, the industry can readily handle a series of events with insured damages above \$60 billion. Some reinsurers experts and insurance analysts insist the insurance industry can handle a single insured event approaching \$100 billion in claims.

Hurricane Katrina has focused public debate on whether to implement a comprehensive (ex-ante or post-disaster financing) solution to the problems presented by natural catastrophe exposure. In an environment of budgetary deficits and spending constraints, policymakers are seeking to find ways to confront the excessive and inequitable reliance upon federal disaster relief. The 110th Congress might be asked to consider proposals which would permit federal reinsurance payouts for events over the level of exposure that the private sector can adequately and appropriately insure.

Table 1, which shows the value of insured coastal properties in the 18 states along the U.S. Gulf and Atlantic coasts, indicates that \$6.8 trillion out of \$19 trillion in insured property is vulnerable to hurricanes. The nation realizes this risk when hurricanes strike and individuals, businesses, and communities suffer, while American taxpayers, through the federal government, bear the costs associated with indemnifying uninsured victims of natural disasters and rebuilding critical infrastructure.

Table 1. Value of Insured Coastal Properties Vulnerable to Hurricanes By State, 2004

(\$ Billion)

State	Coastal	Total Exposure ^a	Coastal as a Percent of Total
Florida	\$1,937.4	\$2,443.5	79%
New York	1,901.6	3,123.6	61
Texas	740.0	2,895.3	26
Massachusetts	662.4	1,223.0	54
New Jersey	505.8	1,504.8	34
Connecticut	404.9	641.3	63
Louisiana	209.3	551.7	38
South Carolina	148.8	581.2	26
Virginia	129.7	1,140.2	11
Maine	117.2	202.4	58
North Carolina	105.3	1,189.3	9
Alabama	75.9	631.3	12
Georgia	73.0	1,235.7	6
Delaware	46.4	140.1	33
New Hampshire	45.6	196.0	23
Mississippi	44.7	331.4	13
Rhode Island	43.8	156.6	28
Maryland	12.1	853.6	1
Coastal States	\$6,863.0	\$19,041.1	36

Source: AIR Worldwide Corporation.

a. Exposure is the total amount of insured property in the state.

Table 2 shows that while the frequency of catastrophic events in the last few years is less compared with earlier years, insured losses have increased significantly. The increasing magnitude of both insured and uninsured losses from natural disasters represent an ongoing challenge for governments and the private sector. Catastrophes result in large government outlays for disaster assistance and they place a financial strain on private disaster insurance/reinsurance markets. The federal government alone, facing fiscal constraints to cover the losses to the private sector, will find it challenging to meet long-term disaster-related spending. Further, insurers have been and will continue to be reluctant to cover properties in high-risk areas because of high long-run costs (which translates into high prices for disaster insurance) and low demand for disaster insurance.⁸ To make insurance available and affordable, state governments have created public/private partnerships (state-sponsored catastrophe funds) to provide catastrophe insurance or reinsurance coverage at subsidized rates.

⁸ The high long-run costs and low demand for disaster insurance results from insurers having to hold huge amounts of capital to pay claims resulting from rare but potentially large catastrophe losses, and the limited willingness of many consumers to pay risk-based premiums for disaster insurance, respectively.

Table 2. Total U.S. Insured Losses and Federal Outlays for Uninsured Losses from Major Disasters: 1995-2005^a

(\$ millions)

Year	Insured Losses				Uninsured Losses	
	Number of Events	Number of Claims (Millions)	Dollars When Occurred	Insured Losses in 2004 Dollars	Total ^b Appropriations (available funds)	Federal Outlays ^c
1995	34	2.7	\$8,310	\$10,033	\$4,235	\$2,492
1996	41	3.9	7,375	8,649	4,042	2,581
1997	25	1.6	2,600	2,981	5,248	2,898
1998	37	3.5	10,070	11,367	2,155	2,242
1999	27	3.3	8,321	9,190	2,597	4,149
2000	24	1.4	4,600	4,915	3,019	2,853
2001	20	1.6	26,548	27,582	6,249	3,413
2002	25	1.8	5,850	5,932	12,677	4,114
2003	21	2.6	12,885	12,885	2,255	8,761
2004	22	3.4	27,490	27,490	2,068	3,082
2005	24	4.3	56,779	56,779	70,542	N/A

Source: Insurance Services Office, Inc., Jersey City, New Jersey

Note: NA = not applicable.

- The definition of a catastrophe changed in 1996. Beginning in 1997 the catastrophe definition was raised from \$5 million to \$25 million in insured damage. This change might explain why the number of recorded catastrophes and the aggregate losses attributed to catastrophes on average is lower than in earlier years. The figures for appropriations and outlays in the last two columns are different because Congress appropriates funds to make it available, but the actual amounts spent could be different.
- Total appropriations into the Disaster Relief Fund. Figures are in 2002 constant dollars. The data in this column comes from: CRS Report RL32242, *Emergency Management Funding for the Department of Homeland Security: Information and Issues for FY 2005*, by Keith Bea.
- These figures, which are in 2002 constant dollars, come from: CRS Report RL33053, *Federal Stafford Act Disaster Assistance: Presidential Declaration, Eligible Activity Funding*, by Keith Bea.

The last two columns in **Table 2** show total appropriations into and outlays from the Disaster Relief Fund (DRF) for federal disaster assistance to help individuals, families, state and local governments, and certain nonprofit organizations affected by severe disasters. Average annual federal outlays exceeded \$3.6 billion since 1995 because of significant hurricanes (Andrew and Iniki FY1992), earthquakes (Northridge in FY1994), floods (Midwest floods of 1993, Red River Floods of 1995) the terrorists attacks of September 11, 2001, and the sequence of four major hurricanes in 2004.⁹ For purposes of illustration, prior to FY1989, outlays from the DRF averaged \$568 million, and on only two occasions exceeded \$1 billion.¹⁰

⁹ CRS Report RL33053, *Federal Stafford Act Disaster Assistance: Presidential Declaration, Eligible Activity Funding*, by Keith Bea.

¹⁰ *Ibid*, p. 7.

Most disaster experts and policymakers did not anticipate and therefore were unprepared for the magnitude of flood damage, and the subsequent number of flood claims filed, in the wake of Hurricane Katrina. Given the magnitude of Katrina-related damages and their impact on the NFIP, the 110th Congress might be called upon to consider ways to overhaul the program.

With respect to the broader issue of managing and financing catastrophe risk, the 110th Congress might choose to focus attention on the long-term budgetary implications of disaster recovery expenses incurred by the federal government and finding ways to expand private-sector capacity for insuring disaster losses. The last time Congress took a critical examination of the federal disaster policy was in 1998.¹¹ This is likely to occur in 2008 at the same time that the property insurance industry seeks some type of federal assistance in reducing their catastrophe exposure. Ironically, the insurance industry has historically opposed federal intervention in the insurance marketplace. But, faced with new terrorism risk following the September 11, 2001, terrorists attacks, and the recognition of a possible mega-catastrophic hurricane far more devastating than Hurricanes Katrina, Rita, and Wilma, some insurers and their trade associations have begun to rethink their support for federal involvement in disaster insurance markets.

Previous Congresses responded to insurers' concerns about a mega-catastrophe that threatens the solvency and claim-paying ability of the insurance industry by considering legislation to create a federal catastrophe reinsurance program for residential property.¹² Despite broad bipartisan support for addressing America's exposure to natural disasters, the full Congress did not approve the creation of a federal reinsurance program until the enactment of the Terrorism Risk Insurance Act (TRIA) of 2002.¹³ TRIA provides a temporary federal reinsurance backstop for future terrorist acts once a high insurance-industry loss is sustained. The law, which was scheduled to expire on December 31, 2007, was extended through the end of 2014.¹⁴

All federal disaster insurance bills have one thing in common: they seek to improve the nation's ability to finance catastrophe risk through insurance as opposed to increased direct spending for federal disaster assistance. Their justification is based on the argument that such initiatives will: (1) enhance the current catastrophe funding system; (2) make property insurance more available and affordable in high-risk areas; (3) promote the funding of research studies (i.e., earthquake science, actuarial science, economics, and finance) on disaster insurance issues; and (4) expand our knowledge and understanding of the scientific and financial aspects of

¹¹ See U.S. Congress, House Committee on the Budget, Task Force on Budget Process, *Budgetary Treatment of Emergencies*, hearing, 105th Cong., 2nd sess., June 23, 1998 Washington: GPO,

¹² Elliott Mitter, "Alternative National Earthquake Insurance Programs," *Earthquake Spectrum*, August 1991, vol. 7, no. 3, p. 757.

¹³ P.L. 107-297; 116 Stat 2322.

¹⁴ CRS Report RL34219, *Terrorism Risk Insurance Legislation in 2007: Issue Summary and Side-by-Side*, by Baird Webel.

natural hazards. Professor Howard Kunreuther at the University of Pennsylvania has suggested that improvements in the scientific and financial areas are thought to be important because of the urgency in finding ways to predict the probability and magnitude of future natural hazards, plan for the necessary funding for disaster recovery, and devise the optimum allocation of resources after the event in order to promote speedy economic recovery of the affected region and the rebuilding of the damaged residential, commercial, and public structures.¹⁵

Opponents of federal disaster insurance, however, say such measures conflict with long-established sociological, economic, and actuarial principles that focus on the “true” cost of government programs (the opportunity cost of the funds), the foregone benefits of a competitive insurance marketplace (e.g., cost efficiency and rate competition), and the absence of consumer choice (the ability to decide whether to purchase coverage).¹⁶ Citing the development of innovative financial instruments for natural disaster risk management and expanded reinsurance capacity, critics of public insurance systems say there is no need for a federal insurance program at this time. They insist that such programs shield the private sector from loss while creating sizable taxpayer-financed subsidies that undermine private-sector incentives for efficient risk management. Further, it has been argued that these programs encourage population growth and development in high-risk, hurricane-prone areas that should not be developed, and would allow insurers to “cherry pick” the best risks and send the federal government the poor risks. Rather than providing insurance protection for natural hazard losses, critics argue, the federal government should take actions to expand private-sector capacity for insuring disaster losses.

Proponents of federal disaster insurance argued that such a scheme would reduce dependence on “free” disaster assistance and support efficient risk management by households and businesses.

The 2005 Hurricane Season

The 2005 hurricane season was the most destructive in recent U.S. history. There were 27 named storms of which 14 were hurricanes. The 27 named storms more than doubled the national average over the past five decades. According to researchers at Tillinghast-Towers Perrin, a global actuarial, management, and financial services consulting firm, over the past 50 years, there have been, on average, 9.8 named storms, 5.8 hurricanes, and 2.3 intense hurricanes. Not all of these storms made landfall. Some catastrophe risk modeling firms contend that while the 2005 hurricane season was above normal, it was not so unusual. According to their hurricane models, insurers should expect to see four hurricanes making landfall in the United States approximately once every 12 years and this is within the range to which most insurers manage their catastrophe risk.

¹⁵ Howard Kunreuther and Richard J. Roth, Sr., *Paying the Price: The Status and Role of Insurance Against Natural Disasters in the United States* (Washington: Joseph Henry Press, 1998), p. 92

¹⁶ Kunreuther, p. 93.

Tables 3 shows that the three major hurricanes in 2005 (Katrina, Rita, and Wilma) and three of four of the major hurricanes in 2004 (Charley, Ivan, and Frances) accounted for six of the top 10 most costly catastrophes in U.S. history. Before the 2005 hurricane season, Hurricane Andrew ranked as the single most costly U.S. natural disaster at \$22.9 billion in 2007 dollars. Insured losses from Hurricane Katrina alone are estimated to be \$43.6 billion. The three most destructive hurricanes in 2005 together account for \$60.5 billion. Total economic losses from Katrina will likely exceed \$200 billion. Despite the magnitude of the insured property losses suffered in 2005, the insurance industry has the financial strength to pay the claims from Hurricane Katrina.

Table 3. Ten Most Costly Catastrophes in the United States
(\$ billions)

Rank	Date	Disaster	Dollar Losses When Occurred	In 2007 Dollars
1	Aug. 2005	Hurricane Katrina	\$41,100	\$43,625
2	Aug. 1992	Hurricane Andrew	15,500	22,902
3	Sept. 2001	WTC Terrorist Attacks	18,800	22,006
4	Jan. 1994	Northridge, CA Earthquake	12,500	17,485
5	Oct. 2005	Hurricane Wilma	10,300	10,933
6	Aug. 2004	Hurricane Charley	7,475	8,203
7	Sept. 2004	Hurricane Ivan	7,110	7,803
8	Sep. 1989	Hurricane Hugo	4,195	7,013
9	Sep. 2005	Hurricane Rita	5,627	5,973
10	Sept. 2004	Hurricane Frances	4,595	5,043

Source: Insurance Services Office's Property Claims Service; Insurance Information Institute.

Hurricane Katrina caused widespread damage to homes and businesses in six states — Louisiana, Mississippi, Alabama, Florida, Tennessee, and Georgia. Much of the damage from the storm was the result of flooding, rather than wind. In response to the devastation from the 2005 hurricane season, rating agencies are changing their methods of assessing the adequacy of an insurer's capital.¹⁷ In the past, rating agencies examined an insurer's exposure to loss relative to a "100-year" catastrophe event. That is, they looked at a disaster that occurred once every 100 years. The new capital adequacy threshold is 250-year events, because the 100-year events are forecast to increase in frequency. Rating agencies are also considering the potential losses from catastrophes in the aggregate and requiring an insurer's estimate of its probable maximum loss to include the increase in the cost of labor and materials as the reconstruction cost rises.

Several insurance coverage issues have arisen in the wake of Hurricane Katrina. For example, losses from floods are not covered under homeowners insurance policies, and homeowners have filed lawsuits against insurers seeking to void the

¹⁷ Susanne Sclafana, "Big Cats Force Change in Disaster Models," *National Underwriter Property and Casualty Edition*, December 5, 2005, p. 20.

flood exclusion in homeowners policies. In other lawsuits, plaintiffs claim that flooding was caused by negligence in the construction and maintenance of the levees which broke and inundated the city rather than an “Act of God.” With respect to business and commercial property losses, plaintiff lawyers representing homeowners have pursued oil and chemical businesses, seeking compensation for damages. Many of these businesses, which face longer and costly business interruption losses and untold amounts of extra expenses incurred in an attempt to restore business operations, are suing their insurers. Insurers are still assessing individual losses and analyzing various scenarios that will affect ultimate claim payments.

The 2004 Hurricane Season

According to the National Oceanic and Atmospheric Administration (NOAA), there were 12 named storms during the 2004 hurricane season, of which nine affected the United States: three as tropical storms (Bonnie, Hermine and Matthew) and six as hurricanes (Alex, Charley, Frances, Gaston, Ivan and Jeanne). Four of the hurricanes (Charley, Ivan, Frances and Jeanne) made landfall as “major” or Category 3 or higher events on the Saffir-Simpson Hurricane Scale. Three other hurricanes (Danielle, Karl, and Lisa) did not make landfall.¹⁸ The nine named storms that affected the United States resulted in 21 Presidential declarations of major disaster covering 12 states, Puerto Rico and the U.S. Virgin Islands.¹⁹ Florida was affected the most by the four hurricanes followed by Alabama, Georgia, Pennsylvania, and North Carolina.²⁰

Table 3 shows that three of the four 2004 major hurricanes — Charley, Ivan, and Frances — rank among the top ten for both the costliest U.S. hurricanes and insured loss events in U.S. history. For the first time since 1886, three hurricanes — Charley, Frances, and Jeanne — made landfall in the same state — Florida; Ivan made landfall in Alabama, but continued its path across Florida.²¹ Meteorological forecasters had correctly predicted above-normal activity during the 2004 hurricane season,²² based on a trend of above-average activity during seven of the last nine seasons. Insurers therefore had knowledge of and presumably were prepared for

¹⁸ The National Oceanic and Atmospheric Administration (NOAA) also reported that there was subtropical storm Nicole and ten tropical depressions.

¹⁹ These 12 states are: Alabama, Delaware, Florida, Georgia, Louisiana, Mississippi, New Jersey, New York, North Carolina, Pennsylvania, South Carolina, and Virginia.

²⁰ For more information on the impact of the four hurricanes on Florida see Insurance Services Office, Inc., Press Release, “AIR Analysis Concludes 2004 Hurricane Season Is Not As Unusual,” available at [http://www.iso.com/press_releases/2004/11_03_04.html], visited on January 31, 2008.

²¹ Matt Brady, “Insurers Post Record First-Half Profits,” *National Underwriter: Property and Casualty*, October 25, 2004, p. 32.

²² Forecasters attribute the recent rise in Atlantic basin hurricane activity on long-term climate patterns, including continuation of warmer-than-normal ocean temperatures across the tropical Atlantic. The warmer waters are associated with circulation patterns that form an above-average hurricane season.

these events. According to climatologists, the level of activities for 2004 was similar to that of 2003, but consumers and insurers were spared huge losses in 2003 because very few of the tropical storms and hurricanes made landfall in the United States.²³ Thus, insurers faced limited losses from the 2003 hurricane season in terms of damages relative to their activity, but that was not the case in 2004 when four major hurricanes made landfall in August and September.

The Insurance Information Institute in New York indicated that the four major hurricanes that struck Florida and other Gulf and Atlantic Coast states in 2004 caused \$21.0 billion in wind-related insured losses, and total claims filed of 2.2 million.²⁴ Total economic losses were about \$56 billion.²⁵ The four major hurricanes, as a whole, exceeded the property damages from the 9/11 terrorist attacks (\$22.0 billion) and Hurricane Andrew (\$22.9 billion). In addition to insurance pay-outs, Congress passed two emergency supplemental appropriations statutes that provided a total of \$17.535 billion to hurricane victims.²⁶

Property and casualty insurance typically incur an underwriting loss on their business and make up these losses on the investment of premiums and loss reserves. Despite record catastrophe losses, the year 2004 was the first time the industry managed an underwriting profit in 26 years. Policyholders surplus, a measure of claims-paying capacity, increased to a record \$521.8 billion in 2007 (3rd Quarter), compared to \$427.1 billion at year end 2006.

Unlike Hurricane Andrew that led to 11 insurer insolvencies and 63 insurers announcing plans to withdraw from the Florida market or significantly curtailing of new business, only one small insurer — American Superior Insurance Company — became insolvent as a direct result of last year's hurricanes. The 11 insolvencies were the largest number of hurricane-related insolvencies in U.S. history.²⁷ Several insurers did have their financial strength rating downgraded by various rating agencies, and at least four insurers have started canceling insurance policies in

²³ "Dangerous Planet: Living on Borrowed Time," *Reaction*, July 2004, p. 18.

²⁴ Robert P. Hartwig, *Catastrophes: Insurance Issues* (Insurance Information Institute: February 2005), available at [<http://www.iii.org/media/hottopics/insurance/xxx>], visited on January 31, 2008.

²⁵ Swiss Re, *Natural Catastrophes and Man-Made Disasters in 2006: Low Insured Losses*, [http://swissre.com/resources/ce8f6a80455c6b9f8b2bbb80a45d76a0-sigma2_2007_e.pdf], visited on January 31, 2008.

²⁶ See CRS Report RL32581, *Supplemental Appropriations for the 2004 Hurricanes and Other Disasters*, by Keith Bea and Ralph M. Chite.

²⁷ The number of property/casualty insolvencies in any given year differ based on an organization's specific criteria for including a company in the insolvency count. The National Association of Insurance Commissioners, for example, list an insurer as insolvent when a company triggers some formal regulatory action in the calendar year because of significant financial impairment. Other organizations like A.M. Best list an insurer as insolvent when they meet the same criteria, but they count each company in a group.

Florida.²⁸ In addition, several insurers have announced that they will no longer seek new business in the state.

American Superior Insurance Company wrote homeowners insurance coverage for nearly 60,000 Floridians and had a premium volume of \$34 million, representing less than 1 percent of total homeowners insurance premiums collected in Florida.²⁹ The company voluntarily consented to be placed into rehabilitation by the Florida Department of Financial Services, Division of Rehabilitation and Liquidation. Under a plan of receivership, a state-appointed official takes over the company's operations and, in the event the insurer cannot be rehabilitated, could liquidate its assets to pay policyholder's claims. If the liquidated assets cannot pay all claims the Florida Property and Casualty Insurance Guaranty Fund will pay the shortfall in claims up to \$300,000, and impose an assessment on all property insurers operating in Florida to pay claims on behalf of the insolvent insurer. Insurers, in turn, can write off the guaranty fund assessments against their state income taxes, thereby shifting some of the cost of the insolvency to all taxpayers in the state.

Insurance Lessons Learned from Hurricane Andrew (1992)

There is little doubt that property insured losses from the 2005 and 2004 hurricane seasons would have been even higher were it not for actions taken by insurers, regulators, and state legislators to both protect the industry's balance sheets and stabilize the property insurance markets in the aftermath of Hurricane Andrew in 1992.³⁰ After Andrew, Florida faced a "capacity gap" — the difference between the amount of capital (insurance) available and the demand for coverage — and a sudden shortage of reinsurance for hurricanes. This situation meant major primary insurers operating in coastal high-hazard Gulf and Atlantic Coast areas could not adequately spread their catastrophe risks, which, in turn, forced many of them to stop writing new policies in hurricane-exposed states or to shut down operations altogether for fear of over-exposure, financial impairment, or even insolvency.

Insurers were caught off-guard by the \$15.5 billion (1992 dollars) in insured losses associated with Hurricane Andrew because of significant errors in actuarial estimates of potential hurricane-related losses. Prior to Hurricane Hugo in 1989, the insurance industry never suffered any loss over \$1 billion from a single hurricane. Further, most insurance industry experts estimated the probable maximum loss (PML) for a single hurricane in the United States at between \$8 and \$10 billion, and that such an event would occur only once in a century. Hurricane Andrew took insurers and forecasters by total surprise. In hindsight, because of the lull in

²⁸ Paige St. John, "Florida Insurers Start Pulling Out of State," *The Ft. Myers News-Press*, January 7, 2005, p. A1.

²⁹ Theo Francis, "Hurricanes Claim Their First Victim in Insurance Field," *Wall Street Journal*, September 30, 2004, p. B2.

³⁰ Theo Francis, "This Year's Storms Fail to Blow Down Insurers," *The Wall Street Journal*, September 28, 2004, p. C3.

hurricane activity during the 1970s and 1980s, insurance policies were underpriced and insurers accepted far more hurricane exposure than could be supported by their capital resources (including reinsurance). Also, there were deficiencies in the storm-resistant capabilities of homes in Florida as well as poor enforcement of building codes in the region.

In response to post-Andrew insurance market disruption, state insurance regulators undertook several steps to restrict insurers' products, pricing, underwriting decision and claims settlement practices for disaster coverage.³¹ In addition, the South Florida Building Codes were extended statewide and the state legislature established the Florida Commission on Hurricane Loss Projection Methodology to review hurricane catastrophe models used for rate filings. These two major changes were instrumental in defining how insurers process and analyze hurricane risk.

Insurers prospectively evaluated their catastrophe exposures in coastal areas for the first time and discovered that the magnitude of risk was both unexpectedly high and unacceptable, given the risk tolerances of management and the expected long-term return on the business written in hurricane-prone areas in coastal states.³² The concern was that insurers with excessive catastrophe exposures would have difficulty achieving or maintaining profitability and balance-sheet strength, and this could lead to rating downgrades, insurer insolvencies, and insurance availability problems.³³

One major outcome of insurers' assessment of catastrophe risk exposure was that large national property insurers began forming single-state affiliate insurers to protect the capital of the holding company. Also, with the approval of state regulators, insurers began shifting the risk of windstorm losses away from overexposed insurers to all property owners and other consumers (through assessments from state-sponsored pools). This decision allowed consumers and insurers to withstand hurricane-related losses in 2005 and 2004 with limited market disruption in terms of policy cancellations, non-renewals and insurer insolvencies.³⁴

³¹ For example, regulators sought to: (1) issue moratoriums disallowing cancellations and non-renewals of homeowners insurance policies; (2) suppress homeowners insurance rates in response to political pressure, but later approved rate hikes and special hurricane or "wind" deductibles; and (3) open up the market to excess and surplus lines insurers and state-sponsored insurance.

³² Rude Musulin, "Property Insurance Market Crisis," *Presentation before the Institute for International Research*, May 14, 1996, New York, NY.

³³ Jeanne H. Dunleavy, Daniel, L. Ryan, and C. Brett Lawless, "Catastrophes: A Major Paradigm Shift for P/C Insurers," *Best Week Property/Casualty Supplement: A Special Report*, March 25, 1996, p. 1.

³⁴ On August 18, 2004, Florida implemented a moratorium prohibiting insurance companies from non-renewing or cancelling the policies of homeowners hit by this year's hurricanes. Under the moratorium, residential insurers have been kept from dropping any policies, even in cases involving nonpayment of premiums. Florida Treasurer Tom Gallagher announced on November 16, 2004, that he wanted to extend the order beyond the end of November because thousands of homeowners waiting on insurance checks would not be able to complete repairs by that time and therefore not be able to get coverage elsewhere until the

(continued...)

The economic rationale for shifting the risk of windstorm loss to property owners through state-sponsored insurance and reinsurance pools was that these pools have a cost of capital advantage over private insurers. State-sponsored insurance pools can offer coverage at a price below what the risk would normally require a private insurer to charge. The pooling arrangement works because state insurance pools can largely avoid the accounting and tax rules governing the private sector. A state-sponsored insurance facility is able to defer part of the cost of capital to the future by virtue of the government's authority to issue public sector debt to pay losses, and favorable tax treatment. But, as economists and financial analysts note, there are limits to the ability of states to fund/capitalize insurance pools in advance of catastrophe losses. That is, many consumers could face unpaid claims.

Insurance Market Response to Past Hurricanes

Insurers responded to Hurricane Andrew in 1992 by taking action in four areas: hurricane insurance deductibles, a capital market for catastrophe securities, building code regulation and construction standards, and catastrophe modeling and forecasting tools. Collectively, these four marketplace changes allowed private insurers, reinsurers, and state-sponsored insurance pools to withstand significant losses from the 2004 hurricane season and to continue operating in disaster-prone states.

Hurricane Insurance Deductibles

Seventeen states and the District of Columbia now require property owners to pay hurricane or windstorm deductibles from 1% to 15% of the insured value of the property, depending on the type of home (e.g., mobile homes carry a higher percentage deductible) and where the property is located, rather than traditional dollar deductibles used for other types of claims, such as fire damage and theft.³⁵ According to the Insurance Information Institute, the hurricane insurance deductibles have had the beneficial effects of making insurance coverage more available in high-risk areas, and getting customers more motivated to invest in disaster mitigation, such as hurricane shutters, damage resistant windows, and homes fortified to withstand severe storms.³⁶ By imposing a higher deductible for windstorm-related losses, property owners assume a greater share of the risks associated with living in high-risk areas, and, therefore, they presumably take steps to mitigate potential losses.

³⁴ (...continued)
repairs are finished.

³⁵ These 17 states are: Alabama, Connecticut, Florida, Georgia, Hawaii, Louisiana, Maine, Maryland, Massachusetts, Mississippi, New Jersey, New York, North Carolina, Rhode Island, South Carolina, Texas, and Virginia.

³⁶ For more information on windstorm deductibles see New York-based Insurance Information Institute's press release, dated September 20, 2004, "Insurance Deductibles Apply for Each Claim," available at [<http://www.iii.org/media/updates/press.737890/>], visited on March 21, 2005.

The requirement that Florida homeowners pay a per-occurrence versus a seasonal (aggregate) windstorm deductible emerged as an important state legislative issue following the 2004 hurricane season.³⁷ Some 108,000 homeowners were struck by two or more hurricanes, and approximately 36,000 policies had multiple deductibles applied and the cost to policyholders of second and subsequent deductibles may total about \$70 million.³⁸ Residential hurricane deductibles are typically 2% of policy limits and may be as high as 5% of policy limits, or even higher for certain policies.³⁹ For this reason, the multiple deductible can result in significant out-of-pocket expense for many policyholders.

After the 2004 hurricane season, the Florida Legislature passed legislation — Hurricane Deductibles for Residential Insurance Policies (HB 9-A) — that established a program to reimburse policyholders for financial hardships suffered due to multiple hurricane deductibles being applied to their insured losses in 2004. Under HB 9-A, policyholders of residential property insurance policies who paid two deductibles in 2004 were eligible for reimbursement from the Department of Financial Services up to \$10,000 per storm, per policy, per structure, and up to \$20,000 if they paid three or more deductibles.

The Multiple Deductible Reimbursement Program is funded with \$150 million borrowed from the Florida Hurricane Catastrophe Fund (Cat Fund) to reimburse residential property insurance policyholders.⁴⁰ The borrowed funds would be repaid over five years starting in 2006. The Cat Fund estimates that there was a statewide average increase of 0.5% in homeowner rates to cover the payments.⁴¹

While insurers were generally pleased with the new law because they will not have to reopen thousands of already settled claims, they had lobbied to make it easier for insurers to be reimbursed by the Cat Fund. Currently, there is a \$4.5 billion threshold trigger before insurers can be reimbursed for losses under the Cat Fund's reinsurance agreement. Florida's Chief Financial Officer, Tom Gallagher, had recommended a plan to the Legislature's Joint Select Committee on Hurricane Insurance to reduce the Cat Fund retention to \$4 billion for each of the two hurricanes and \$1 billion for the third and subsequent events in a season.⁴²

³⁷ Aaron DeSlatte, "Catastrophe Fund Stirs Debate," *The Florida Today*, December 9, 2004, p. 1.

³⁸ For more information see, Office of the Florida State Senate Secretary, "Summary of Legislation Passed: 2004-A Special Session," available at [<http://www.flsenate.gov>], visited on February 16, 2005.

³⁹ It should be noted that \$500 hurricane deductibles are still prevalent for homes and mobile homes valued under \$100,000.

⁴⁰ For a summary of legislation passed by the Florida Legislature during the 2004-A Special Session, see [<http://flsenate.gov/Publications/2004A/Senate/reports/summaries/pdf/sumsum04A.pdf>], visited on February 17, 2005.

⁴¹ Frank Matso Lysiak, "Bill Frees Catastrophe Fund to Reimburse Florida Deductibles," *Best's Review*, January 2005, vol. 105, p. 10.

⁴² NAMIC Online, "Florida: Senators Hear Testimony on How Hurricane Affected the (continued...)

Capital Market Instruments Linked to Catastrophe Risk

Insurers have traditionally used reinsurance to manage a portion of their catastrophe risk. Insurers, reinsurers, and an increasing number of corporations came to the realization beginning in the late-1980s that the traditional reinsurance mechanisms were limited in their ability to provide coverage for catastrophic risk.⁴³ Recognizing the limits of their ability to finance catastrophe risk, the high cost of reinsurance, and the sheer size of the capital markets, insurers and investment banks became more active in offering capital market instruments linked to catastrophe risk. Investors are attracted to innovative financial instruments for natural disaster risk management for several reasons, including their above-average risk-adjusted rate of return versus the typical fixed income instruments and the fact that the rate of return is not correlated with the returns associated with stock and bond portfolios.

The first risk-linked securities (called “catastrophe bonds”) were introduced in 1994, but it was not until 1997 that they gained some acceptance as catastrophe risk financing alternatives. Total cat-bond issuance in 2005 is estimated at around \$6 billion. Investors in these securities continue to demand a high-risk premium because of their lack of familiarity with catastrophe risk and uncertainty about the likelihood that these instruments will be triggered.⁴⁴ The full acceptance of this new asset class for securitization has been limited by: (1) the tax, cost and regulatory treatment of the financial instruments — the so-called “special purpose reinsurance vehicles” (SPRVs) — underlying the securitization; (2) the lack of standardization in risk measurements; (3) lack of a generally-accepted index on which to base payouts; and (4) high transaction costs relative to traditional reinsurance coverage.

Building Codes and Construction Standards

Disaster risk reduction requires effective enforcement of building codes, land-use planning, environment risk and human vulnerability monitoring and safety standards. In hurricane-prone coastal states like Florida, homeowners insurance rates are now based on new building code standards and the structure’s ability to withstand damage by high winds. In the 1980s, the insurance industry came to the realization that the level of building code enforcement affected the cost of claims. It was not until Hurricane Andrew in 1992, however, that a new organization, the Insurance Institute for Property Loss Reduction (IIPLR), launched a study to develop better wind and seismic building codes so structures could better withstand the force of storms and earthquakes. The work of the IIPLR led to the development by Insurance

⁴² (...continued)

Industry, [<http://www.namic.org/PrintPage.asp?ArticleID=7510>], visited on January 31, 2008.

⁴³ Paul R. Kleindorfer and Howard Kunreuther, “Challenges Facing the Insurance Industry in Managing Catastrophe Risks”, In *The Financing of Catastrophe Risk*, ed., Kenneth A. Front (Chicago, University of Chicago Press, 1999), p. 149.

⁴⁴ Martin Grace, Robert W. Klein, and Richard D. Phillips, “An Economic Appraisal of Securitizing Insurance Risk Via Onshore Special Purpose Vehicles,” *Risk Management and Insurance Review*, 2002, vol 4, p. 33.

Service Office (ISO) of a building code compliance rating system. The ISO Building Code Effectiveness Grading Schedule (BCEGS) assesses the building codes in effect in a particular community and the community enforcement of these codes. The BCEGS takes into account factors such as the size of the community's building code enforcement budget relative to the amount of building activity, the professional qualifications of building inspectors, and past code enforcement levels. By incorporating the BCEGS into the underwriting and pricing process, communities now have the incentive to undertake mitigation activities such as requiring property owners to use certain roofing material, the installation of hurricane shutters, and the identification of appropriate load combinations for buildings.

With the availability of BCEGS, insurers and state insurance regulators combined forces under the auspices of the National Association of Insurance Commissioners (NAIC) to develop and encourage states to adopt model insurance laws, regulations and guidelines that link insurance practices to building codes. The Florida legislature requires insurers to reflect BCEGS in their rates. Insurers now offer discounts on property insurance premiums to property owners and businesses located in communities with enforced, up-to-date building codes that conform to BCEGS standards. Communities with a BCEGS grade of 1 (reflecting exemplary commitment to building-code enforcement), for example, can demonstrate better loss experience, resulting in lower insurance premiums. Insurers may also impose surcharges in communities where enforcement is lax. The BCEGS program was initially implemented in states with high exposure to wind (hurricane) and seismic exposure, but now is available throughout the rest of the country.

Catastrophe Modeling and Insurance Underwriting

Before Hurricane Andrew in 1992, most insurers had not used electronic information processing systems to keep track of their potential hurricane loss exposure and to help them make informed insurance underwriting decisions.⁴⁵ After the Andrew disaster there was a widespread use of catastrophe simulation modeling — a type of modeling that allows insurers and regulators to better predict future windstorm losses on the basis of current demographics and construction techniques, rather than historical loss experience. Actuaries had gained access to sophisticated statistical databases and computer modeling techniques that could integrate long-term weather data, engineering studies of storm loss potential, and population trends.⁴⁶ By combining mathematical representations of the natural occurrence patterns and characteristics of hurricanes, tornadoes, severe winter storms, earthquakes, and other catastrophes, with information on property values, construction types, and occupancy classes, these computer simulation models provide information concerning the potential for large disaster losses before they occur.

⁴⁵ Tom O'Brien, "Catastrophe Modeling for Corporate Risk Managers," *Risk Management Magazine*, May 2004, p. 18.

⁴⁶ Michael Ha, "Catastrophe Modeling, Forecasting Tools More Sophisticated," *National Underwriter: Property & Casualty/Risk & Benefits Management Edition*, September 23, 2004, p. 17.

There are significant limitations to these types of computer modeling techniques. For example, loss models work best when they are used to develop a relative understanding of potential damage rates rather than absolute losses. Despite the comparative wealth of data and knowledge about hurricanes and the sophistication of insured loss models for these events, some experts believe that these models are often wrong by an order of three, even if all the important event characteristics are known. Thus, a model may predict that a given storm will produce \$300 million of insured losses, but the actual insured losses would vary from \$100 million to \$900 million.

Transferring Risk Through Insurance

Most existing structures in hurricane-prone areas are susceptible to hazard risks, such as strong winds, storm surges, heavy rains, and flooding. Insurance as a risk transfer mechanism can play a key role in helping to minimize disaster losses and reduce the financial and economic impacts of disasters. The problem is that multiple-peril insurance policies held by homeowners exclude damages caused by wind and water damage. To fill this gap in coverage, state catastrophe funds, such as the California Earthquake Authority and the Florida Hurricane Catastrophe Fund, provide coverage for windstorm and earthquake hazards. In a similar fashion, flood-related damages associated with hurricanes may be insured through a separate policy offered by the federal National Flood Insurance Program (NFIP).

Hurricane Katrina demonstrated the importance of the NFIP for protecting many families from financial ruin, but participation rates in flood-prone areas are under 30%. Many homeowners appear not to be insured despite a mandatory purchase requirement as a condition of being eligible for a federally insured loan.

Federal Flood Insurance Program

Insurance against flood hazard is generally not available in the private insurance market because flood risk is generally considered uninsurable: only people living in flood zones could be expected to purchase flood insurance (adverse selection), and these people would have frequent claims, thus making the coverage prohibitively expensive.⁴⁷ In addition, insurers generally lack the ability to spread risk sufficiently to safeguard their assets against catastrophic flood losses. Therefore, as part of the National Flood Insurance Act of 1968,⁴⁸ Congress authorized the National Flood Insurance Program (NFIP) to serve as an insurance alternative to disaster relief and to meet the escalating costs of damage to buildings and their contents.

⁴⁷ Some insurers provide coverage under homeowners insurance policies for backup of sewers and drains. Coverage may also be provided for flood damage under the comprehensive section of standard auto insurance policies and some coverage is available under special commercial insurance policies.

⁴⁸ P.L. 90-448; 83 Stat. 476.

Prior to 1968, the federal government responded to flooding on a national scale through the building of flood control structures that restricted the flow of waters (e.g., dams, levees, and dikes) and providing disaster relief to flood victims. After decades of federal expenditures for structural flood works and expanded disaster relief, the focus shifted to flood insurance as a policy tool for reducing loss and for spreading the risk of loss among individuals and businesses. It was expected that homeowners and businesses would pre-fund their own losses by purchasing federal flood insurance. At the same time, the program would encourage preventive and protective measures to reduce future losses. A key mechanism for doing so was the development of flood plain maps and the requirement that local communities restrict development in areas most subject to flooding.

The NFIP provides subsidized, low-cost flood insurance to homeowners and small businesses in flood-prone communities that have agreed to adopt and enforce floodplain management and building code standards. Federal flood insurance is available in each of the 50 States, the Virgin Islands, Puerto Rico, Guam, the District of Columbia, and American Samoa to meet the escalating costs of repairing damage caused by flood to buildings and contents.

The NFIP operates under a statutory mandate that premium charges for Pre-FIRM risks — i.e., structures built before the issuance of a Flood Insurance Rate Map (FIRM) or before 1975, whichever is later — must be reasonable. The subsidy is provided by charging premium rates discounted from full risk rates. In order to make up the premium shortfall from subsidizing premiums, the NFIP establishes a target level of premium income for the program as a whole that accommodates the combined effect of the portion of NFIP business paying less than full risk premiums and the portion of the business paying full risk premiums.

Hurricane Katrina will ultimately cost the NFIP approximately \$21 billion in insured losses. In addition, both FEMA and the NFIP are under attack by property owners and the insurance industry to improve the program to more appropriately protect property values in flood-prone areas. Some members of Congress have called for changes in the NFIP that include:

- expanding the mandatory flood zones from their current 100-year flood zone level to the 500-year level;
- increasing the building and contents limits of flood coverage from \$350,000 for residential and \$ 500,000 for commercial properties;
- adding business interruption insurance coverage.

Faced with the growing costs of federal expenditures on flood-related disaster relief assistance, including insurance claim payments, and the cumulative impact of low-intensity hurricanes on local economies (in terms of property damage and subsequent reconstruction activity) Congress has continuously sought to strengthen

the operational and financial aspects of the NFIP.⁴⁹ On June 30, 2004, President Bush signed legislation to reauthorize the NFIP until September 2008 and to provide states and local communities with an additional \$40 million a year for mitigating (i.e., buyouts, elevation or move the home) severe repetitive loss properties (SRLPs).⁵⁰

On September 27, 2007, the House approved H.R. 3121, the Flood Insurance Reform and Modernization Act of 2007 to reform the program while retaining its original intent to keep rates affordable for people to buy the insurance. H.R. 3121 would also increase the NFIP's Treasury borrowing authority from \$20.775 to \$21.5 billion. On November 1, 2007, Senator Christopher J. Dodd introduced S. 2284 to restore the financial solvency of the program and to forgive the debt.

In the absence of federal government intervention into the disaster insurance market, several states — Florida, California, Hawaii, Louisiana — have had to address the issue of “uninsurable risks,” meaning risk that cannot get coverage from private insurers in the “voluntary market.” States with a high risk of natural disasters have created catastrophe funds or residual markets to deal with the unavailability and unaffordability of property insurance. The residual market initiatives take on various forms, such as: (1) Fair Access to Insurance Requirement (FAIR) Plans that are used to cover “hard to insure” exposures; (2) Beach & Windstorm Plans that operate by spreading the risks among insurers operating in the state; (3) Marketing Assistance Plans (MAP) that address short-term insurance availability and affordability problems in a state; and (4) provision for the operation of surplus lines. Both the property insurance residual markets and catastrophe funds as state-sponsored loss-sharing mechanisms will be discussed in the next section.

State-Sponsored Lost-Sharing Mechanisms

In states where insurers in the private market have reached the limits of their willingness or ability to provide coverage for homes and businesses in high risk areas, the state has created catastrophe funds and property residual insurance markets (i.e., Fair Plan and Beach & Windstorm Plans), marketing assistance plans, and provisions for surplus line operations that serve to stabilize the property insurance market — without the involvement of the federal government. Following is a brief discussion of these state residual insurance markets.

Fair Plans. The District of Columbia and 34 states have Fair Access to Insurance Requirement (FAIR) plans that make property insurance available to applicants on eligible property located in coastal areas who have been unable to secure such insurance in the normal insurance market. FAIR Plans are syndicated associations of property insurers doing business under the auspices of the state insurance regulator. Although the FAIR Plans act as a single insurer, participating companies actually share on a pro rata basis all of the premiums as well as the profits or losses and expenses incurred.

⁴⁹ Robert T. Burris *et al*, “Impact of Low-Intensity Hurricanes on Regional Economic Activity,” *Natural Hazards Review*, August 2002, p. 118.

⁵⁰ P.L. 108-264; 118 Stat. 712.

The concept for FAIR Plans emerged in response to urban riots and civil disorder in the 1960s and the withdrawal of insurers from the property insurance market in communities with a high potential for loss. Congress enacted the Housing and Urban Development Act of 1968⁵¹ which sought to ensure the availability and affordability of fire, crime, and other property insurance in high-risk urban areas by offering federal riot reinsurance to property insurance companies operating in states that voluntarily adopted a FAIR Plan.⁵²

Beach and Windstorm Insurance Plans. In 1969, following Hurricane Camille, the first Coastal or “Beach” Pool was created to address the shortage of windstorm insurance in areas vulnerable to hurricane losses. Today, nine states have formed Beach and Windstorm Plans which provide coverage for the wind peril alone in designated risk-prone coastal areas.⁵³ In some states the FAIR Plan serves as the windstorm plan. Under a state-sponsored windstorm pool, the wind coverage is isolated, and a separate policy is issued for this peril by the private insurer. Windstorm pools typically purchase reinsurance to cover future losses.

Florida’s Citizens Property Insurance Corporation. On July 1, 2002, the Florida Legislature passed a law that created the Citizens Property Insurance Corporation (Citizens) as a market of last resort for residential and commercial residential⁵⁴ coverages in high-risk areas where the property owner is unable to procure insurance in the open, private insurance market.⁵⁵ Citizens was created with the merger of the two existing property residual markets: Florida Residential Property and Casualty Joint Underwriting Association (FRPCJUA) and the Florida Windstorm Underwriting Association (FWUA).

Citizens operates under the authority of a seven-member Board of Governors, approved by the State Treasurer. The State Treasurer also appoints a technical advisory Board of Governors to provide information and advice to the seven-member Board of Governors. All revenues, assets, liabilities, losses, and expenses of Citizens are divided into three separate accounts: (1) a personal lines account for personal residential policies issued by Citizens or the FRPCJUA, and renewed by Citizens, that provides comprehensive, multi-peril coverage on risks which are not located in areas eligible for coverage in the FWUA (and for such policies that do not provide coverage for the peril of wind); (2) a commercial lines account for commercial

⁵¹ P.L. 90-448; 83Stat. 476.

⁵² The Federal Riot Reinsurance Program was terminated on September 30, 1984, due to the small number of insurers buying the reinsurance.

⁵³ These nine states are: Alabama, Georgia, Florida, Hawaii, Louisiana, Mississippi, North Carolina, South Carolina, and Texas.

⁵⁴ Commercial residential simply refers to small business located in areas primarily zoned residential.

⁵⁵ Residential coverage includes both personal lines residential coverage (which consists of the type of coverage provided by homeowner’s, mobile home owner’s, dwelling, tenant’s, condominium unit owner’s, and similar policies) and commercial lines residential coverage (which consists of the type of coverage provided by condominium association, apartment building, and similar policies).

residential policies; and (3) a high-risk account for personal residential policies and commercial residential and commercial non-residential property policies.

Citizens is authorized by statute to issue bonds and impose emergency assessments on all licensed property insurers in the state. For the most part, these assessments are eventually passed onto consumers. In order to maximize the financial resources to pay claims following a catastrophic hurricane, Citizen's income and the interest on the debt obligations issued by the corporation are exempt from federal income taxation.

Although the presence of Citizens in the market has stabilized the availability and pricing of insurance in coastal areas of Florida, legislators and regulators have concerns about the growth in the number of policies issued during the past few years as well as the fact that all insurance customers statewide are responsible for a significant deficit.⁵⁶

On January 22, 2007, the Florida Senate and House passed a final bill which goes to the Governor for signature. The Governor has not indicated whether he will sign the bill. In general, the Florida legislature has (1) expanded Florida Citizens exposure and decreased rates, (2) expanded the Florida Hurricane Catastrophe Fund, (3) expanded the assessment authority of FIGA, and (4) rolled the Commercial Lines JUA into Citizens.

Florida Hurricane Catastrophe Fund. In 1993, the Florida Legislature created the Florida Hurricane Catastrophe Fund — “Cat Fund” — in response to insurers' concerns about actual and threatened catastrophic losses to property in the state from hurricanes, and their unwillingness or inability to provide property insurance coverage to the extent sought and needed. The Cat Fund was therefore established as a tax-exempt source of reimbursement to property insurers for a selected percentage of hurricane losses above the insurer's retention (deductible).

The reinsurance provided by the Cat Fund is designed to stabilize the residential property insurance market in the event of a major hurricane by offering relatively inexpensive reinsurance to property insurers and the state's insurers of last resort — Citizens. The cost of this reinsurance is below what the private reinsurance market charges because the Cat Fund is not only exempt from federal income tax, but also the state's income tax and premium tax. The Cat Fund was the first program in the United States in which a state provided for tax-exempt accumulation of private cash to pay for major disasters. The relatively inexpensive reinsurance sold by the Cat Fund to Citizens (and other residential property insurers) allows them to write more residential property insurance in the state — than otherwise would be the case — and also acts to lower premiums for consumers.

On June 1, 2004, the Florida Legislature expanded the overall claims paying capacity of the Cat Fund from \$11 billion to \$15 billion. The \$15 billion amount is financed primarily through reinsurance premiums paid by primary insurers (based on

⁵⁶ David Sedore, “Citizen may Bill \$60 for Deficit,” *Palm Beach Post*, February 16, 2005, p. C1.

their exposure to hurricane losses) and investment income.⁵⁷ Retained earnings are held in a reserve fund account that accumulates, along with investment earnings, on a tax-free basis. In the event cash reserves are insufficient to pay claims, the Cat Fund could issue state government revenue bonds or other debt instruments to raise billion of dollars for claims payout.

Under the Cat Fund's reinsurance arrangement, private insurers and Citizens are reimbursed for as much as 90 percent of insured hurricane losses in excess of a \$4.5 billion per storm deductible, up to a total of \$15 billion each year. Insurers can choose from three reimbursement coverage options — 45 percent of losses over the retention, 75 percent or 90 percent — depending on their risk tolerance levels and how much they want to pay for reinsurance. The \$4.5 billion is an industry deductible. Each insurer has an individual deductible, which is its proportionate share of the \$4.5 billion industry aggregate. This individual insurer deductible allows smaller insurers that suffer unusually heavy losses to qualify for reimbursement, while the industry overall might not. Insurers also have an individual maximum coverage which is their individual share of the \$15 billion maximum industry aggregate collected by the Cat Fund. Insured losses above \$15 billion would be covered by the insurer's high layer reinsurance and their surplus or reserves.

Louisiana Citizens Property Insurance Corporation. On January 1, 2004, the Louisiana legislature merged the Louisiana Joint Reinsurance Plan (FAIR Plan) and the Louisiana Insurance Underwriting Plan (Beach and Windstorm Plan) to create the Louisiana Citizens Property Insurance Corporation as an insurer of last resort for property owners unable to obtain insurance in the state. Policies in force at the time of the merger were to be handled by their respective plans. New insurance business is being placed with Louisiana's Citizen. This new entity can build up reserve funds on a tax-free basis to pay claims after a natural disaster. In the event the fund falls short, the state can issue revenue bonds to pay claims. Private insurers are responsible for retiring the bonds, but can pass on the costs to policyholders in the form of a surcharge.

Hawaii Hurricane Relief Fund. After Hurricane Iniki struck in 1992, the Hawaii legislature created a Hawaii Hurricane Relief Fund (HHRF) to provide windstorm coverage for residential properties in Hawaii. Under the state-sponsored insurance scheme, insurers are allowed to sell homeowners insurance with a hurricane exclusion. Each participating insurer in the state then acts as a servicing insurer for the HHRF, issuing the insured a separate hurricane policy and collecting a separate premium that is then forwarded to the HHRF.

⁵⁷ This debt may be serviced with future reinsurance premiums collected by the Cat Fund and/or post-hurricane assessments levied on all property and casualty insurers and, hence reflected in future property and casualty insurance premiums. In the event that premiums and proceeds that can be raised through the issuance of tax-exempt revenue bonds are insufficient to address a catastrophic loss, claims submitted by insurers to the Cat Fund are paid on a pro-rata basis. Because the annual post-hurricane assessments are subject to a cap, losses generated by a major catastrophe could be paid over a number of years following the event. The Cat Fund is never obligated to pay more than its assets and borrowing capacity permit. The state is not liable for unpaid claims.

The HHRF receives ongoing revenue from hurricane premiums, and insurance companies post-hurricane assessments on property business and mortgage recording fees. The plan provides coverage for losses up to approximately \$2 billion in residential damages from hurricanes. Homeowners are responsible for the first 10% in losses from a major hurricane. Private insurers participating in the HHRF would be responsible for the next loss layer after the insured's deductible. The Fund uses some of the hurricane premium revenues to buy reinsurance, which covers the third loss layer. The last layer of coverage comes from lines of credit, which are secured by future surcharges on all property and casualty premiums. If losses exceed the total coverage amounts, claims are paid on a pro-rata basis.

Market Assistance Plans (MAP). Four states — Florida, New York, New Jersey, and Texas — have established Marketing Assistance Plans (MAPs) as service organizations designed to assist consumers in obtaining property and casualty insurance coverage from authorized insurers in the private market. These organizations are voluntary mechanisms coordinated by private insurers and agent groups in cooperation with the state insurance regulators to provide insurance when there is a “temporary” market failure. The MAPS collect and maintain information on agents and insurers writing certain coverages.

MAPS are typically administered by insurance agents' associations that will assign insurance applicants who are declined coverage in the voluntary market to participating insurers that agree to accept applicants on a proportional market-share basis. Some states have created “Property Protection Programs” in conjunction with MAPs to provide insurers with financial incentives (e.g., state premium tax credits) to underwrite basic residential insurance coverages which can be tailored to fit the specific needs of residents in a particular community exposed to catastrophe risk.

Surplus Lines Insurance

Any risk for which insurance is not available through a company licensed in the applicant's state (an “admitted” insurer) may be covered by a surplus lines insurer. The business is placed with a “non-admitted” insurer in accordance with surplus or excess lines provision of state insurance laws. Regulators allow catastrophe insurance or “hard-to-place” coverage such as insurance for antique cars to be sold in a less regulated environment on a surplus lines basis because of the unusual nature of the risks, and the need for greater flexibility in policy terms and pricing. Also, coverage may be offered on a surplus lines basis if the voluntary or involuntary markets will not write expensive homes in a high-risk community.

Challenges for the 110th Congress and Beyond

In 2005, despite the ability to better predict and manage individual insurance-company hurricane exposures, the property insurance industry, as a whole, still faces the long-term challenge of maintaining viable insurance markets following a megacatastrophe that could threaten the solvency and claims-paying ability of the insurance industry. Complicating this challenge is the recognition that the country is increasingly exposed to greater hurricane-related losses as a result of three major

ongoing developments: (1) rapid expansion of the population into areas that are susceptible to natural disasters; (2) rising property values in coastal areas; and (3) climatological and environmental changes.

Population Growth and Coastal Development

With a significant percentage of our population now living in hurricane-exposed areas, even larger insured property losses from hurricanes are possible.⁵⁸ The American population is migrating toward the coasts at a rapid rate, placing people and property investments at risk of loss. In the last three decades, the nation's shorelines have come under increasing pressure from population growth and development, and this has profound consequences for the insurance industry (through higher losses) and the federal budget (through emergency supplemental appropriations). As an illustration, according to the 2000 U.S. Census data, 55% of the U.S. population live within 50 miles of a coastline (including Great Lakes shorelines). The National Oceanic and Atmospheric Administration (NOAA) reports that the population density per square mile in hurricane-prone Southeast coastal areas increased 129%, versus 38% in the total U.S., during the 30-year period from 1960 to 1990.⁵⁹ The Insurance Services Office (ISO) found that from 1970 to 1990, the Southeast Atlantic Coast had a nearly 75% increase in population density, far surpassing the countrywide increase of more than 20%.⁶⁰

Given this trend in population growth and coastal development, policymakers have become increasingly aware of the erosion risks facing homeowners and communities due to high intensity storms and coastal flooding.⁶¹ It is not uncommon, for example, for a hurricane or severe coastal storm to cause the coast to erode 100 feet or more in a single day. This situation has led to debate over the economic consequences of erosion and the use of federal programs, such as the National Flood Insurance Program (NFIP), to address the coastal erosion problem. The principal concern is that while the NFIP covers erosion damage that occurs in connection with floods, it does not account for erosion in setting flood insurance rates in coastal areas.

The insurance industry and FEMA have both taken steps to address coastal erosion. Insurers responded to coastal erosion risk by making policyholders vulnerable to windstorms pay more of the cost of living in hurricane prone areas. For example, insurers now impose hurricane deductibles equal to a percentage of the structure's insured value and establish rates for windstorm coverage based on the

⁵⁸ Rude T. Musulin, "Would a Federal Role in Disaster Protection Be a Catastrophe?" *Contingencies*, November 29, 2003, p. 28.

⁵⁹ Conning & Company, *Lighting Candles in the Wind: Industry Response to the Catastrophe Problem*. Hartford, Connecticut. November 1994, p. 27.

⁶⁰ *Ibid.*

⁶¹ The National Flood Insurance Reform Act of 1994 required that FEMA submit a report evaluating the economic impact of erosion on coastal communities and the NFIP. The study, which was written by the Heinz Center, recommended that FEMA develop maps that identify coastal erosion hazard areas and include the cost of expected erosion losses when setting flood insurance rates for coastal areas.

structure's ability to withstand damage from high wind. FEMA has begun to prepare and disseminate maps showing areas subject to erosion, created and imposed a mandatory surcharge for erosion on flood insurance in Coastal High Hazard Zones, and, with the passage of the Flood Insurance Reform Act of 2004, provided relocation assistance and/or buyouts.

The National Coastal Zone Management Program (CZMP) is a federal-state partnership authorized by the Coastal Zone Management Act⁶² to encourage coastal states to develop and implement coastal zone management plans. Some 34 states and territories participate in the CZMP.⁶³ The CZMP is designed to encourage the states to work with the federal government in finding a balance between protecting the coast and preserving the human uses that depend on the environment. The CZMP supports states through financial assistance and technical services and information. In addition, the NFIP is managed in a manner that is consistent with the criteria and standards established for the federally approved state coastal zone management plans.

Rising Property Values in Coastal Areas

Along with rising coastal population growth, there has been a tendency for coastal development to consist of relatively more expensive properties.⁶⁴ **Table 1** shows that \$6.9 trillion of the estimated \$19 trillion of insured coastal properties are vulnerable to hurricane risk. Whether provided by an insurer's surplus, reinsurance agreements, or securitized insurance instruments, capital is needed to underwrite property insurance covering potential losses from weather and climate events. It became obvious after Hurricane Andrew that exposures in disaster-prone areas were far beyond the capital that was available from existing sources before the event.

Insurers have responded to the urgency of strengthening their capital position with reforms of insurance systems. They have also played an active role in encouraging the development of better wind and seismic building codes so future construction could better withstand the force of hurricanes and earthquakes. It takes time, however, to implement and realize the results of construction standards nationwide. Because most of the building in coastal areas were constructed in the 1970 through 1990 period, when these building standards did not apply, most homes remain vulnerable to damages from natural disasters. In addition, insurers have shifted more responsibility for catastrophe damages to the property owners. They have accomplished this by requiring higher deductibles and employing computer-generated rates — rates which are based on a simulation of various scenarios involving a structure's ability to withstand damage by high winds and from water damage.

⁶² P.L. 92-583; 86 Stat. 1280.

⁶³ For more information on Coastal Zone Management, see National Ocean Administration Agency's Office of Ocean and Coastal Resources Management, "Celebrating 30 Years of Coastal Zone Management Act," available at [<http://www.ocrm.nos.noaa.gov/czm>], visited on March 21, 2005.

⁶⁴ Musulin, p. 30.

Climatological and Environmental Changes

There is a growing body of scientific evidence suggesting that the global climate may be changing (i.e., global warming), with more frequent extreme weather events occurring, thereby increasing the incidence and severity of natural disasters such as hurricanes and floods.⁶⁵ According to Dean John Dutton of Pennsylvania State University and the National Oceanic Administration Agency (NOAA), up to \$2.2 trillion of the U.S. economy are believed to be affected annually by weather and climate events. At the core of the global warming debate is the belief that human-derived so-called “greenhouse gases” emissions have risen in recent decades, resulting in a dramatic rise in both the temperature at the earth’s surface and the frequency and severity of hurricanes, windstorms and floods.

The basic assumptions underpinning the pricing of insurance against hurricanes does not take into account changes in the global climate. Moreover, insurers traditionally assume that the average insured losses over a recent historical period accurately reflect future losses over some arbitrary future period. This assumption works well with automobile insurance and other widely distributed, independent risk, but is less appropriate for low-frequency/high consequence events like hurricanes. In other words, the average activity in any arbitrary period of the past is not necessarily a good predictor of future activity. The inability to predict future disasters will impact the capacity for disaster financing as part of a comprehensive disaster management approach.

Issues and Policy Options

The devastation caused by Gulf Coast hurricanes in 2005 has stimulated an important public dialogue about the efficacy of our current system for managing and financing natural catastrophe risk. A central challenge facing members of the 109th Congress is determining what public and private initiatives are needed to mitigate and finance losses stemming from future mega-catastrophes. Is there a need to improve the nation’s ability to finance catastrophe risk and, if so, how? More specifically, Congress might be called upon to determine the appropriate roles and policies of the public and private sectors in addressing disaster risks, how they affect hurricane risk, and how they might be restructured to better achieve social objectives.

Three points of view usually emerge when debating the catastrophe funding problem. One view is that catastrophes (e.g., hurricanes) are “uninsurable” in the private sector and the federal government should directly take over underwriting insurance. This view is not widely supported because the private sector has access to capital market resources that can be used to fund the cost of a catastrophic hurricane.

A second point of view argues that catastrophe risk is fundamentally uninsurable and federal involvement in the catastrophe insurance market is needed before a really

⁶⁵ Kelly Quirke, “Global Warming and Increasing Catastrophe Losses,” *Journal of Insurance Regulation*, Summer 1994, p. 451.

“big” event occurs only at the higher layers of coverage.⁶⁶ A consensus among insurance and public policy experts seems to have emerged that a public-private partnership in financing a mega-catastrophe over the \$60-100 billion threshold might eventually be needed. As demonstrated by the 2005 and 2004 hurricane seasons, insurers and reinsurers are able to handle a series of catastrophes with insured damages as high as \$60 billion. Some insurance market analysts believe the industry can even handle a single insured event approaching \$100 billion in claims.

A public-private catastrophe insurance partnership would leave the private sector responsible for underwriting property insurance, and the federal government responsible for providing capital only where consumers and the private insurance and capital markets are unable to do so. The government could facilitate more effective risk-spreading, which can be achieved by more effective pooling of losses over time and broader pooling of losses among risks. A more effective pooling of losses over time could be achieved by borrowing mechanisms and tax deferral of loss reserves for natural disasters. Broader pooling of losses among risks could be facilitated by requiring property owners to purchase insurance against natural hazards. Economists note, however, that any scheme that imposes a mandatory insurance requirement for all property owners could create economic distortions, such as cross subsidization of risks, where low risk individuals subsidize high risk individuals.

A third point of view presupposes that the financial resources available in the private sector are sufficient to make federal involvement unnecessary at this time.

There have been many proposals considered by Congress during the last three decades to address various types of catastrophic losses.⁶⁷ Members of the 109th Congress could pursue any one or all of the following policy options if it could be shown that potential losses from hurricane-related hazards are beyond the capacity of private markets to diversify such risks:

- establish an emergency reserve fund to provide timely financial assistance in response to domestic disasters and emergencies;
- provide financial backstop or guarantees to innovative financial instruments and activities involving insurance interstate compacts between states set up to address regional exposure to catastrophic losses involving hurricanes in the Gulf and Atlantic coast states, and earthquakes in the Pacific northwest states and other areas exposed to similar hazard risks;
- develop a large regional pool for hurricane insurance with potential benefits of spreading the risks across impacted states. Currently,

⁶⁶ For more information on this argument, see; James E. Rutrough, “Funding Major Disasters with Traditional Insurance,” in *Financial Risk Management for Natural Catastrophes: Proceedings of a Conference Sponsored by Aon Group Australia Limited*, Neil R. Briton and John Oliver, ed., (Brisbane, Australia: Griffith Uni Print, 2002), p. 1

⁶⁷ For more information, see CRS Report RL33086, *Hurricane Katrina: Insurance Losses and National Capacities for Financing Disaster Risk*, by Rawle King.

each state relies on its own financial resources to develop a substantial pool of funds for insurance. Some supporters of this policy option have even suggested pooling risks with the same characteristics as hurricanes, such as earthquakes, volcanos, and tsunamis, into a single national hazard insurance program designed to solve the catastrophe funding problem;

- establish a federal hurricane program to provide reinsurance to state-sponsored insurance programs;
- establish an explicit federal windstorm insurance program, similar to the National Flood Insurance Program;
- focus on tax policy to allow insurers to create tax-deferred reserves to fund future catastrophe losses from natural disasters;
- encourage innovative new financing mechanisms of insurance, reinsurance and capital markets to mitigate and diversify disaster risk; and
- implement a comprehensive national disaster mitigation policy strategy for reducing future losses.

These approaches have been debated in previous Congresses and some have enjoyed bipartisan support; however, no consensus emerged, largely because of concerns that such approaches would (1) encourage home construction in high-risk areas, (2) serve as a tax giveaway to rich insurers, (3) expose the federal treasury to large contingent costs at a time of budgetary deficits, or (4) give a competitive advantage to certain segments of the insurance industry.

Conclusion

During the 2005 hurricane season, Hurricanes Katrina, Rita, and Wilma demonstrated both the destructive nature of natural disasters and the importance and shortcomings of insurance as a major financial source for post-disaster economic recovery. As demonstrated by the 2005 and 2004 hurricane seasons, the industry can readily handle a series of events with insured damages as high as \$60 billion. Insurers are expected to easily cover the \$66.1 billion in insured losses from the 2005 catastrophes, including Hurricane Katrina, without threatening the industry's solvency or claims-paying ability. Many questions, however, have been raised about the industry's continued willingness and ability to sell property insurance coverage in hurricane-prone states. While some insurance market experts believe insurers and reinsurers can even handle a single insured event approaching \$100 billion, this amount of protection might not be enough for the potential mega-catastrophe. For example, catastrophe modeling firms note that a repeat of the 1938 Category 3 hurricane that hit the Northeast could cause over \$300 billion in possible damages. As development increases in coastal areas, a mega-catastrophic hurricane could result in huge government outlays for disaster assistance and present insurers with significant financial hazards, such as the risk of insolvency, a rapid reduction of earnings and statutory surplus, forced asset liquidation to meet cash needs, and ratings downgrade.

To the extent property insurance markets fail to offer adequate levels of coverage after a catastrophic hurricane, and the federal government avoids the disaster insurance market (with the exception of terrorism risk insurance), the states will likely continue to offer various, loss-sharing mechanisms that provide catastrophe insurance or reinsurance coverage at subsidized rates. In a similar manner, the federal government will continue to offer flood insurance under the National Flood Insurance Program (NFIP) to offset repair and rebuilding costs in flood-prone regions.

Members of the 110th Congress will likely be called upon to determine whether there is a need to improve the nation's ability to finance catastrophe risk and, if so, how. Previous Congresses responded to similar concerns by considering legislation to create a federal catastrophe reinsurance program for residential property. But, despite broad support for several bills over the past few Congresses, the full Congress did not authorize a federal reinsurance program until the enactment of the Terrorism Risk Insurance Act of 2002.

Finally, most observers would agree that for the very highest layers of catastrophe risk, the government (and consequently the taxpayer) is now, by default, the insurer of last resort. In the 110th Congress, any one of a number of policy options could be pursued, but passage will likely be based on whether it can be shown that potential losses from hurricane hazards are beyond the capacity of private markets to diversify catastrophe risks. Members will likely be grappling with several

policy questions. For example, will reinsurance and securitization be enough to maintain insurance solvency after a catastrophic hurricane? How can the various funding sources available for catastrophe insurance be expanded and refined to cope with a catastrophic hurricane? And lastly, what role, if any, should the federal government play in catastrophe insurance