February 2005

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Highlights

Highlights of GAO-05-199, a report to the Chairman, Committee on Financial Services, House of Representatives

CATASTROPHE RISK

U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risks

Why GAO Did This Study

Natural catastrophes and terrorist attacks can place enormous financial demands on the insurance industry, result in sharply higher premiums and substantially reduced coverage. As a result, interest has been raised in mechanisms to increase the capacity of the insurance industry to manage these types of events. In this report, GAO (1) provides an overview of the insurance industry's current capacity to cover natural catastrophic risk and discusses the impacts of the 2004 hurricanes; (2) analyzes the potential of catastrophe bonds—a type of security issued by insurers and reinsurers (companies that offer insurance to insurance companies) and sold to institutional investors—and tax-deductible reserves to enhance private-sector capacity; and (3) describes the approaches that six European countries have taken to address natural and terrorist catastrophe risk, including whether these countries permit insurers to use tax-deductible reserves for such events.

We provided a draft of this report to the Department of the Treasury and the National Association of Insurance Commissioners. Treasury provided technical comments that were incorporated as appropriate.

www.gao.gov/cgi-bin/getrpt?GAO-05-199.

To view the full product, including the scope and methodology, click on the link above. For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

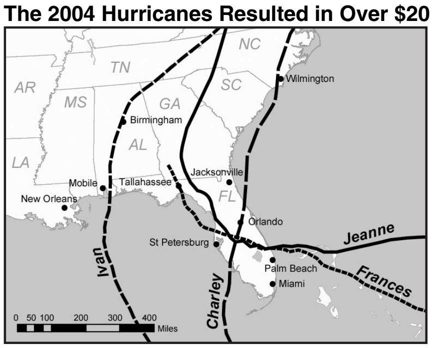
What GAO Found

Despite steps that governments and insurers have taken in recent years to strengthen insurer capacity for catastrophic risk, the industry has not been tested by a major catastrophic event or series of events (at least $50 billion or more in insured losses). While insurers suffered losses of over $20 billion in Florida from the 2004 hurricanes, steps such as implementing stronger building codes and stricter underwriting standards may have limited market disruptions as compared with the aftermath of Hurricane Andrew in 1992. For example, in 2004, only 1 Florida insurance company failed in contrast to the 11 that failed after Hurricane Andrew in 1992. However, a more severe catastrophic event or series of events could severely disrupt insurance markets and impose recovery costs on governments, businesses, and individuals.

Some insurers and reinsurers benefit from catastrophe bonds because the bonds diversify their funding base for catastrophic risk. However, these bonds currently occupy a small niche in the global catastrophe reinsurance market and many insurers view the costs associated with issuing them as significantly exceeding traditional reinsurance. In addition, industry participants do not consider catastrophe bonds for terrorism risk feasible at this time. Authorizing insurers to establish tax-deductible reserves for potential catastrophic events has been advanced as a means to enhance industry capacity, but according to some industry analysts such reserves would lower federal tax receipts and not necessarily bring about a meaningful increase in capacity because insurers may substitute the reserves for other types of capacity.

The six European countries GAO studied use a variety of approaches to address catastrophe risk. Some governments require insurers to provide natural catastrophe insurance and provide financial assistance to insurers in the wake of catastrophic events, while others generally rely on the private market. However, the majority of these governments have established national terrorism insurance programs. Although their approaches vary, insurers in all six countries were allowed to establish tax-deductible reserves for potential catastrophic events as of 2004.

The 2004 Hurricanes Resulted in Over $20 Billion in Losses in Florida



	Estimated insured losses (dollars in billions)	Number of claims reported (in thousands)
Charley	$7.885	449
Frances	4.801	504
Ivan	3.914	197
Jeanne	4.153	393

Sources: Risk Management Solutions (map); Florida Office of Insurance Regulation (data).