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Highlights

Highlights of GAO-08-07, a report to the Ranking Member, Committee on Financial Services, House of Representatives

November 2007

NATURAL DISASTERS

Public Policy Options for Changing the Federal Role in Natural Catastrophe Insurance

Why GAO Did This Study

In recent years, much attention has been focused on the roles that the private sector and federal government play in providing insurance and financial aid before and after catastrophic events. In this context, GAO examined (1) the rationale for and resources of federal and state programs that provide natural catastrophe insurance; (2) the extent to which Americans living in catastrophe-prone areas of the United States are uninsured and underinsured, and the types and amounts of federal payments to such individuals since the 2005 hurricanes; and (3) public policy options for revising the federal role in natural catastrophe insurance markets. To address these questions, GAO analyzed state and federal programs, examined studies of uninsured and underinsured homeowners and federal payments to them, identified and analyzed policy options, and interviewed officials from private and public sectors in both high- and low-risk areas of the United States. GAO also developed a four-goal framework to help analyze the available options.

What GAO Recommends

This report does not contain recommendations. However, GAO evaluates seven public policy options that are discussed in the right-hand column and on the reverse side of this page. In written comments, the National Association of Insurance Commissioners (NAIC) generally agreed with GAO's report findings.

To view the full product, including the scope and methodology, click on GAO-08-07. For more information, contact Orice Williams at (202) 512-8678 or williamso@gao.gov.

What GAO Found

The federal government and some states have developed natural catastrophe insurance programs that supplement or substitute for private natural catastrophe insurance. These programs were created because homeowner coverage for catastrophic events is often not available from private insurers at prices deemed affordable by insurance regulators. Large losses associated with natural catastrophes are some of the biggest exposures that insurers face. Particularly in catastrophe-prone locations, government insurance programs have tended not to charge premiums that reflect the actual risks that homeowners face, resulting in financial deficits. After a resource-depleting disaster, the programs have postfunded themselves through, among other sources, payments from insurance companies and policyholders and appropriations from state and federal taxpayers.

Large numbers of Americans are not insured for natural catastrophes. Homeowners may not purchase natural catastrophe insurance because doing so is voluntary and they may not believe that the risk justifies the expenditure. In addition, some homes may be underinsured—that is, not insured for the full replacement value. GAO estimates that the federal government made about $26 billion available to homeowners who lacked adequate insurance in response to the 2005 Hurricanes Katrina, Rita, and Wilma. Given the unsustainable fiscal path of federal and state governments, they will be challenged to maintain their current fiscal role.

As Congress reevaluates the role of the federal government in insuring for natural catastrophes, Congress is faced with balancing the often-competing goals of ensuring that citizens are protected and limiting taxpayer exposure. This report examines seven public policy options for changing the federal government's role, including establishing an all-perils homeowner insurance policy, providing reinsurance for state catastrophe funds, and creating a mechanism to provide federal loans for state catastrophe funds. Each option has advantages and disadvantages, especially when weighed against competing public policy goals. For example, establishing an all-perils homeowner policy is a private sector approach that could help create broad participation. But low-income residents living in parts of the United States with high catastrophe risk could require subsidies, resulting in costs to the government. Similarly, federal reinsurance for state programs could lead to broader coverage, but could displace private reinsurance. GAO also identified several policy options for tax-based incentives for insurance companies, homeowners, investors, and state governments. But these options, which could help recipients better address catastrophe risk, could also result in ongoing costs to taxpayers. While some options would address the public policy goals of charging risk-based rates, encourage broad participation, or promote greater private sector participation, these policy goals need to be balanced with the desire to make rates affordable.

Selected Advantages and Disadvantages of Options for Changing the Federal Role in Natural Catastrophe Insurance

	Advantages	Disadvantages
Option 1: All-Perils Homeowners Insurance Policy This option would create a homeowner insurance policy that would provide coverage against all types of natural catastrophes.	• A mandatory all-perils policy could eliminate the problems of uninsured property owners and adverse selection. • A mandatory all-perils policy would end homeowners' uncertainty about coverage for some perils.	• The all-perils option could require government subsidies for low-income property owners. • Premiums for an all-perils policy could be more expensive than current homeowner policy premiums, and these premium increases could be seen as unfair.
Option 2: Federal Reinsurance for State Catastrophe Funds This option would create federally backed reinsurance policies for state catastrophe funds. In one version of this option, states would create catastrophe funds that would be reinsured by the federal government. In another version, the Secretary of the Treasury would create an auction process for the sale of reinsurance contracts to private and state insurers and reinsurers.	• The federal reinsurance option could lead to greater participation from private insurers. • This option would not use tax dollars if premiums were risk-based.	• Federal reinsurance could compete with the private reinsurance sector. • Federal reinsurance could create inequities among states because of geographical differences in natural catastrophe risk.
Option 3: Federal Lending to State Catastrophe Funds This option would create a federal lending facility to provide temporary loans at market prices to state catastrophe funds.	• This option could help state catastrophe insurance funds with financing needs after a disaster. • The federal lending option would require states to demonstrate that they were doing all they could to attract private capital.	• The federal lending option imposes credit risk on taxpayer– the risk that the loans would not be repaid. • Political pressure could be exerted to keep the terms and conditions of federal loans more favorable than those in the private market.
Option 4: Insurance Company Catastrophe Reserving This option would permit private insurance companies to establish tax-deferred reserves for future natural catastrophes.	• With reserves, insurance companies could be more willing to underwrite policies. • Insurance regulators could be more willing to approve risk-based rates for consumers, because premium income could be set aside in a reserve fund.	• Allowing insurance companies to build reserves could involve tax benefits that favored one type of activity over another and could hamper economic efficiency. • Reserves could be costly for the federal government, because they would reduce federal tax revenue.
Option 5: Homeowner Catastrophe Savings Accounts This option would permit individuals to establish tax-deferred reserves to pay expenses related to disasters.	• Allowing homeowners to use tax-deferred dollars to pay for catastrophe insurance could induce more people to buy it. • This option might encourage more homeowner mitigation activities.	• Such accounts may not be enough to induce people to buy costly catastrophe insurance and, thus, may not broaden citizen participation in natrual catastrophe insurance programs. • These accounts would reduce federal tax revenues but must be weighed against any reduction in postdisaster spending by the federal government.
Option 6: Favorable Tax Treatment for Catastrophe Bonds This option would facilitate the onshore creation of catastrophe bonds through tax exemptions for income from the underlying assets.	• Favorable tax treatment of catastrophe bonds would increase the ability of insurance markets to access capital markets. • Insurance companies could be more willing to underwrite catastrophe risk because the risk could be passed on to investors	• This option creates a new class of reinsurer that would operate under regulatory and tax advantages not afforded U.S. reinsurance companies. • It is not clear how this option would encourage risk-based premiums or lead to more citizen participation in catastrophe insurance programs.
Option 7: Property Tax Assessment for Private Insurance with Federal Deductible Payment This option has property tax assessments paying a premium for an all-perils catastrophe insurance policy that would be provided by private insurance companies, with the federal government responsible for the deductible.	• This option would protect the tax base of a state's economy. • The property tax assessment option would increase homeowner participation in catastrophe insurance programs.	• The property tax assessment option would reduce federal tax revenue. • This option could be expensive for taxpayers because the federal government would pay some portion of the homeowner deductible.

Source: GAO.