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A Disaster in the Making

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Late last year, two recently elected southern Republican governors, Louisiana's Bobby Jindal and Florida's Charlie Crist, vowed to work together for a "national catastrophe fund" to reduce the soaring insurance premiums for owners of homes in disaster-prone areas. With the endorsement of the governors of all 16 southern states plus Puerto Rico and a bill that has passed in the House of Representatives, the idea has a decent chance of becoming law. It could, though, end up causing significant fiscal and monetary problems for the nation as a whole.

A national catastrophe fund, also known as "federally backed reinsurance" or "backstopping," would essentially transform the U.S. Treasury into the ultimate insurer of last resort for nearly every disaster-prone private home in the country. When damages exceeded a certain level as a result of natural disaster or terrorist attack, a newly created reinsurer--under a proposal currently in Congress, a "private" company with a board made up of high government officials--would step in and pay off the insurers. Another similar proposal focuses on selling such "reinsurance" to states. Under any such proposal, the insurers, in turn, would pay out claims to consumers.

Dozens of private companies already sell reinsurance that functions this way, but--by virtue of tax-free status, creditworthiness, economies of scale, and the implicit promise of a government bailout--the new quasi-governmental insurer could presumably do it for less money. The theory is that this would cut costs for insurers and protect their profits, and they in turn would pass the savings on to consumers. Taxpayers, the theory goes on, would have little to lose because the new reinsurer could, at minimum, break even.

To see why this is unlikely to work, one needs only to look at two existing programs: Governor Crist's own Florida Hurricane Catastrophe Fund and the National Flood Insurance Program (NFIP). Florida's catastrophe fund, founded in 1993 in the wake of Hurricane Andrew, has done almost nothing to reduce rates for consumers in the private market and imposed a potentially bankrupting $30 billion liability on the state. Like the legislation before Congress, the Florida plan is a reinsurance mechanism that sells nothing directly to consumers. Unlike the legislation before Congress, however, it lacks the private façade and operates under guidelines that leave insurance companies with significant exposure. Because of this, it has less flexibility and next to no support from the insurance industry.

The NFIP works even less well. Although Congress intended the program to support itself, it regularly borrows money from the U.S. Treasury (it currently owes almost $18 billion that many in Congress want to forgive), has fallen years behind on a project to modernize the maps it uses for setting rates, and, as a result, doesn't achieve its main objective of discouraging building in flood prone areas.

A bill has already passed the House of Representatives that would let the program issue "multi-peril" insurance to cover hurricanes, tropical storms, and perhaps other events. This proposed expansion of the NFIP would still leave the government as a primary insurer (as it is today for floods) rather than being a reinsurer. This might be better than "backstopping" since the government would probably only write policies in the highest risk places and thus would take a smaller market share.

It could, however, make things worse in the long run because a federal wind program would likely lose lots of money each time a serious hurricane hit the United States. It would also encourage the withdrawal of private companies from the wind insurance market by undercutting their rates. As the legislative language would stop the proposed wind program from writing new policies if it ever goes into debt, consumers would likely end up without government or private wind coverage.

This would create some unenviable choices for Congress and the program's overseers at the Department of Homeland Security. Because of the flexibility of the flood program's chief authorizing legislation--its structure is largely a product of regulations rather than laws--however, it appears likely that DHS could morph it into a somewhat more stable general-purpose catastrophe fund generous enough to nudge at least some private companies into the market. Even if DHS could not do this on its own, however, Congress would likely turn around and replace the wind and flood program with a general purpose catastrophe fund. Indeed, it would have little choice but to do so.

Considering the $30 billion price tag for Florida's own fund, a national program's liability--however structured--could easily top $100 billion. And it seems unlikely to help consumers. Even if a federal fund actually did cut private insurance premiums where Florida's hasn't, its total liabilities following a major catastrophe would likely be high enough to raise both interest and inflation rates nationally. And it would promote development in lots of disaster-prone places.

Ultimately, people living far from coasts and earthquake-prone areas would end up paying for those who do through either taxes or higher insurance premiums. Since existing private reinsurers can spread their risks internationally and already avoid most taxes, government-backed reinsurance might not cost less either unless Congress imposed prices so low that a government reinsurer would need a bailout.

Insurers don't all like the idea either even though it might improve their bottom lines. While the country's two largest writers of homeowners' insurers--State Farm and Allstate--support catastrophe funds (as does one of the two property and casualty insurance trade associations), others haven't followed. Marc Racicot, the head of the American Insurance Association--makes the predominate industry position clear: "We do not want Congress going down the road of incenting the creation of additional mechanisms that would interfere with the private market's ability to protect homeowners and businesses." Consumer groups have generally concurred.

While Crist, Jindal, and their counterparts are making an effort to confront a real problem, several other ideas deserve a try before the nation takes the enormous risk of setting up a national catastrophe fund. First, reducing regulation on insurance companies marketing securities to back insurance policies--an idea even the left-wing Consumer Federation of America supports--could provide many of the benefits of a government program without the need for intervention.

Second, broader markets for insurance--through proposals to let insurance companies organize themselves under federal rather than state laws, sell insurance across state lines, and operate under interstate agreements--could manage risk on a broader scale and reduce costs.

Third, better tax treatment of reinsurance and money that insurers set aside for catastrophes would probably help cut rates. Finally, a proposal from the Travelers Companies to create a special zone for private wind insurance has significant promise for helping hurricane-prone areas.

Although none of these ideas provides the tempting quick fix of a new federal reinsurance capacity, they also don't expose taxpayers to massive new liabilities.