

When the Government is Your Reinsurer

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Larry P. Schiffer¹
LeBoeuf, Lamb, Greene & MacRae LLP

Insurers and reinsurers are part of the fabric of a vibrant free economy based upon private enterprise. The reinsurance market ebbs and flows as supply and demand fluctuates between the needs of insurers to spread their risk and protect their surplus, and the available capital capacity of the reinsurers. This dynamic, however, has been affected by the insinuation of governmental reinsurance programs into the insurance and reinsurance market. Whether that is good or bad depends on your point of view.

Background to Governmental Intervention

Government insurance and reinsurance programs are nothing new. Various government programs exist to cover risks where there is no available private insurance market. These include various assigned risk pools for automobile liability, mandatory pools for medical malpractice coverage, property insurance programs in low-income neighborhoods, and the National Flood Insurance Program. Most government insurance programs exist to fill a gap in the voluntary marketplace.

Since the third quarter of 2005, when a second straight year of record hurricane losses buffeted property/casualty underwriters, an availability/affordability of property insurance crisis developed throughout the Gulf Coast and other costal communities. To help ease affordability and availability problems for coastal home and business owners, various legislative proposals for insurance reform have been implemented and suggested. Among them are proposals that have the government directly subsidizing of the purchase of insurance from the private market, providing primary insurance to policyholders; or reinsuring private insurers that sell their insurance policies at subsidized rates. In early 2007, the Florida legislature expanded the role of the Florida Hurricane Catastrophe Fund to provide significantly more reinsurance to insurers writing property business in Florida and substantially lower rates than the market. Rather than

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purchasing all their reinsurance in the private marketplace, Florida property insurers can purchase low-cost reinsurance at layers previously covered by private reinsurance.

The increasing costs associated with the heightened frequency and severity of natural and man-made catastrophes have significantly impacted the insurance industry. Of the eleven most costly catastrophes in United States history, seven, occurring in the last three years, were hurricanes. Catastrophic disaster losses throughout the Gulf Coast and southeastern seaboard are likely to escalate in the foreseeable future as the density and cost of residential and commercial development in these coastal areas increase and as more and more forecasters and modelers predict stronger and more frequent storms.

The private reinsurance industry, however, has responded to these storms in various ways. Large catastrophic property losses, while draining the surplus of many existing property reinsurers, often spawn the creation of new property reinsurers whose capitalization is funded by those who wish to ride the crest of increased rates following a period of significant losses. The creation of the many Bermuda reinsurers over the past two decades has been a direct result of the industry's response to hurricanes and other major catastrophic losses.

What is perhaps different about the government programs already implemented or being discussed to address catastrophic property losses for the Gulf Coast region is that while the private reinsurance market has the capacity and willingness to provide reinsurance, the cost of that reinsurance and its effect on policyholder premiums is not something the government wishes to impose upon its constituents.

How Government Reinsurance Affects the Market

Insuring against catastrophic economic loss in highly developed coastal areas poses significant challenges to the insurance and reinsurance industry as well as to the federal and state governments. Private market reinsurers can spread a localized risk throughout the global financial markets through reinsurance. In contrast, government insurance/reinsurance programs assume local or regional concentrations of risk without spreading the risk of loss throughout the market.

A primary cause for concern with public-sector involvement in the insurance industry offering below market rates on insurance and reinsurance is that the government will supplant private insurance/reinsurance and deter private insurers from charging a rate high enough to cover expected losses, purchase reinsurance, or maintain a surplus adequate to cover catastrophic

losses. Public-sector participation in the catastrophe insurance/reinsurance industry may effectively flood the market with excess capacity. The concern is that this excess capacity will be offered at below market rates, which artificially suppresses rates from rising in tandem with loss forecasts. This certainly has happened to some extent in Florida, where the expansion of the Florida Hurricane Catastrophe Fund has essentially displaced substantial capital from the private reinsurance market. This could create a strong incentive for insurers to limit their catastrophe risk exposure by withdrawing from high-risk markets and product lines. The unintended effect of a governmental insurance/reinsurance program, designed with the well-intentioned goal of keeping insurance prices low, may be to lower the availability of insurance. Additionally, insurers and reinsurers with excess capacity may move to write property business in other regions or even write other lines of business, which could soften rates elsewhere.

Yet, by displacing reinsurance capacity, the Florida program has opened up opportunities for property insurers to purchase catastrophe reinsurance for the one in one hundred year storm from those reinsurers cut out of the lower layers of the Florida catastrophe market. This allows insurers will significant accumulation of risk in Florida to use their savings on the low cost reinsurance provided by the Florida Hurricane Catastrophe Fund to purchase protection from a mega-storm.

Who Will Pay When Disaster Strikes?

Another major area of concern with governmental insurance and reinsurance programs in the catastrophic risk arena is who will pay when the disaster strikes? It may be the taxpayers who will wind up subsidizing insurance rates for the benefit of a relatively small group of people in states or regions categorized as high-risk areas. A government fund that concentrates risk within a particular state or region would hit property owners with assessments on their insurance bills to replenish the revenue shortfall caused by low, upfront, below-market premiums if a series of catastrophes depletes the fund. For example, the Florida Hurricane Catastrophe Fund was depleted in 2004 after Florida was battered by four consecutive hurricanes and was forced to tap Florida property owners to replenish the fund. Similarly, the National Flood Insurance Program borrowed \$16 billion from the Treasury to cover 2005 losses. This cost will in large part be borne by taxpayers nationwide, many of whom are not exposed to flood risks and do not receive coverage under the program. Florida's expanded Catastrophe Fund, if wiped out again by a series of storms, will require the Florida taxpayer to make up any shortfall.

The financial consequences of obligating taxpayers to keep governmental insurers solvent pose significant concerns. Taxpayer replenishment of depleted government insurance funds essentially results in the purchase of double coverage — taxpayers are effectively buying coverage twice. Insurance companies pay a reduced reinsurance premium because they are not paying for the full loss while taxpayers ultimately wind up paying for losses that they thought they had paid for through insurance premiums. This cost burden-shifting back to the taxpayer is further exacerbated among policyholders from all lines of insurance, including those in low-risk areas, who would also be required to make up these deficits. Allowing insurers to purchase reinsurance from a state or federal catastrophe fund produces savings by increasing the amount of risk that the state or federal government is assuming, ultimately placing a greater burden on the taxpayers in the event that a major catastrophic natural disaster depletes the fund.

Should Government Support Development in High-Risk Areas?

Governmental insurance programs may be aimed at alleviating the property insurance availability and affordability crisis in certain regions, but by providing lower cost insurance and reinsurance it encourages development in high-risk areas. In Florida, for example, where 80 percent of property lies in coastal areas and the insurance crisis is seen as a threat to the state's economy, the state expects to gain more than 1,000 new residents a day and new condominiums and high-rise luxury developments right on the water are being built unabated. Yet government insurance and reinsurance programs provide no disincentive for homeowners in high-risk areas to mitigate their risk exposure or take full economic responsibility for their choice to live in a high-risk area. Instead, property owners in high-risk areas are beginning to expect a government bail-out should disaster strike. A government reinsurance program that undermines economic incentives to mitigate risks would likely distort premium rates from their actuarial values. Individuals would be encouraged to assume inappropriate risk levels because they themselves would not bear the full expected costs of damages incurred.

Conclusion

The debate over the expansion of the Florida Hurricane Catastrophe Fund and over other regional and national catastrophe initiatives will continue for some time. From the reinsurance perspective, displacing capacity from one of the largest catastrophe risk markets in the world has its economic ups and downs depending on your perspective.