



Consumer Federation of America

PRINCIPLES FOR PROTECTING CONSUMERS AND TAXPAYERS UNDER A FEDERAL CATASTROPHE INSURANCE PROGRAM

The Consumer Federation of America (CFA) has previously opposed proposals to provide federal reinsurance with taxpayer funds for natural catastrophes. This is because these plans have either directly subsidized insurance companies or have provided below-cost insurance to high-risk areas, which would likely spur an increase in unwise construction. Congress should not expand the federal role in providing catastrophe insurance assistance until the federal government fixes the significant flaws in programs that already exist.

- a) **The National Flood Insurance Program (NFIP) must be repaired and functioning smoothly before proposals to expand federal back up to cover other disasters can be taken seriously.** Mitigation is clearly not working under the NFIP. Too many new structures in high-risk areas are being built. Significant insurance subsidies are available to these structures because of problems like antiquated maps indicating much lower flood risk than is currently likely. Insurance rates are based on these erroneous maps, creating a subsidy for new construction and misleading homeowners and business owners into thinking their property is safe. The penetration of flood insurance in at-risk areas under the NFIP is also very low. Too many Americans who live in flood plains are not insured for the flood risk. Moreover, the NFIP allows insurers to charge too much for servicing insurance policies without assuming any financial risk. Some insurers even get windfall payments for commissions when no agent is involved. Hurricane Katrina resulted in windfall profits for servicing insurers because fees for servicing claims are too high for large events.
- b) **The “temporary” Terrorism Risk Insurance Act (TRIA) gives large subsidies to the insurance companies.** There is strong evidence that the private market could easily handle much more terrorism risk. Taxpayers have subsidized the extremely profitable insurance industry through the program by about \$7 billion to date. The program also subsidizes corporate insurance buyers, creating a significant disincentive to the mitigation of terrorism risk.
- c) **The Federal Crop Insurance Program has been plagued by the payment of fraudulent claims, with little federal response.**

CFA is very concerned about any federal catastrophe insurance proposal that would duplicate the kinds of serious problems that exist in these programs. In order to be fair to consumers and taxpayers, any proposal that is offered must conform to the following principles:

Loss of life and property must be clearly and demonstrably reduced.

- Mitigation measures must strictly prohibit construction in extreme risk zones and control construction in all other risk zones.
- Actuarial rates should be charged for each property (with particular emphasis on new construction).
- GAO should monitor compliance on an ongoing basis.
- The federal government should invest in loss prevention instead of spending money after a catastrophic event occurs. It should provide grants and loans to state and local governments to carry out mandatory loss prevention activities and should provide loans to consumers and businesses for loss prevention investments and retrofits.

All at-risk properties in the nation should be insured for all risks.

- Insurance must be required on all properties to achieve maximum spread of risk and to ensure that uninsured properties do not exist after a catastrophic event.
- Insurance companies writing property coverage in the nation must be required to take all homeowners and small business property risks that meet national mitigation standards for disaster risk.
- All risk coverage on new construction should be initially provided for five years on a policy purchased by the builder and sold along with the structure as a strong economic incentive for the builder to choose sites and construct buildings with the catastrophe risk clearly in mind.
- Reasonable deductibles and limits should be standardized under policy terms set nationally. Persons seeking lower premiums through higher deductibles and other changes to the base policy should be able to do so by signing an agreement that no disaster assistance will be sought for losses in amounts below the higher coverage levels.

Rates should be actuarially sound. There should be no subsidies or cross subsidies.

- Rates on insurance for new construction must be fully actuarial so that new construction that is higher risk will pay its own way and unwise construction will be deterred.
- Rates on insurance for existing construction must be fully actuarial and disclosed at the time of sale so that people buying unsafe structures have fair warning.
- Rates should be adjusted over a reasonable period of time to repay any monies contributed by local, state or federal taxpayers after a catastrophic event.

The role of private sector insurers should be maximized.

- Insurers must make insurance available and be responsible for losses up to a specified insurer deductible. Insurers should be instructed to set up pooling arrangements where they can reinsure business at the insurers' option by sending the loss portion of the premium to the pool. The pool should be monitored to verify that state approved actuarial rates were properly applied to the property.
- The initial insurer deductible for the first year of this program should be \$100 billion, indexed to inflation in home prices nationwide on a year-to-year basis. To ensure that all regions of the country will have reinsurance protection and that small insurers benefit from the program, it should require the establishment of a national pool to reinsure all homes and small business properties in the nation over retentions of 15 percent of premiums in the impacted line by insurer group. Each insurer would be required to forward the appropriate part of the premium to cover the claims sent to the pool. These premiums would be earmarked for disaster payments only and held as reserves for such an event. These reserves would not be subject to federal income taxes.

Government at all levels should carefully regulate the program.

- Local governments have the key role of enforcing land-use requirements.
- State governments should regulate both policy forms and prices. This will assure consumers that models and other methods used to rate the business are fair and do not result in excessive charges. It will also assure taxpayers that there are no subsidies in the rates. Regulation should follow the detailed methods in use in California under Proposition 103 regulations. State regulation should be monitored by the GAO to assure that it is competently and efficiently performing this important oversight role.
- The federal government should determine the best, most efficient mitigation standards. Local governments should enact and enforce these strict mitigation standards, subject to state audit of compliance and GAO review of the effectiveness of the implementation of these mitigation standards in high-risk areas.

Federal, state and local governments should assume financial risk.

- To become eligible for the federal backup, local governments should agree to pay 5 percent of costs over the insurer deductible on damage to new construction, as an incentive to encourage rigorous enforcement of land use standards. Bonds could be used for this purpose.
- State governments should contribute a 10 percent layer over insurer and local deductibles. Bonds could also be used for this purpose.
- The federal government should back up the system over the insurer, local and state layers.

- This plan must be designed so that long-term costs to local, state and federal taxpayers will be equal to or less than zero. This means that, as stated above, rates should be actuarially sound to insure that the program is profitable to taxpayers in the long run, or at the very least, does not cost the taxpayers anything.
- No disaster relief should be given to those homes or businesses that should have been insured for coverage but were not, or were inadequately insured. Disaster relief should no longer cover deductibles of insurance policies.

All stakeholders must give up something to make this type of plan work.

- Insurers give up the right to choose to underwrite if mitigation standards are met (i.e., to make sure that insured homes meet construction and loss prevention standards). They must be subject to high quality regulation of price, product, underwriting and claims service.
- Property owners in high-risk areas give up the right to unfettered use of their land unless strong mitigation standards are met.
- Developers give up the right to loosely regulated construction. They must be required to build wisely in risk zones and to arrange for the initial insurance coverage for the first five years.
- Consumers give up their right to take a chance on being uninsured for low frequency/high severity events. Consumers must pay actuarial prices for the coverage, prices that can be very high.
- Government must take on mapping of risk and monitoring to assure compliance with mitigation and actuarial soundness standards. Government must have the ability to obtain funds for the catastrophic back up of the private insurance market.

A fair process and affordable insurance must be ensured.

- One way to ensure that lobbying by private interests does not result in taxpayers shouldering an unjustifiably large portion of the risk in such a program would be to set up a Congressional commission modeled after the base closure commission, which would present Congress with a plan that it could either vote for or against, but not amend.
- Requiring insurers to offer actuarially sound rates will make it difficult for some low and moderate-income households to afford catastrophe insurance. It will likely be necessary to establish a transitional program to help these consumers afford insurance payments.