

COME HELL AND HIGH WATER: CAN THE TAX CODE SOLVE THE
POST-KATRINA INSURANCE CRISIS?

by
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As Americans struggle to appreciate the full extent of the damage and destruction caused by Hurricane Katrina, a terrifying question resonates with a shell-shocked nation: what is the next major disaster? Forecasters have been quick to respond with a laundry list of the most unimaginable disasters with price tags ranging from \$50–\$400 billion dollars apiece. Imagine what would happen if these catastrophes occurred back-to-back like they did during the 2004 and 2005 Atlantic hurricane seasons.

Prior to Katrina, the thought of a disaster causing a twelve-digit loss was unfathomable. Today, catastrophe modelers consider such a loss inevitable and the only question that remains is who will bear it. Congress is particularly concerned since the private insurance industry began bailing out of markets with a history of, or potential for, natural disasters. If these markets are uninsured and disaster strikes, the majority of this enormous loss could fall to the insurer of last resort—Uncle Sam. In an attempt to deal with the insurance crisis, Congress proposed a four-part National Catastrophe Plan that, inter alia, involves amending the Tax Code to allow insurers and homeowners to deduct amounts set aside to pay for losses arising from a natural disaster. The purpose of the proposed legislation is to increase the availability and affordability of private insurance in peak risk areas and to reduce the risk of insurer insolvencies following disasters.

This Article provides an extensive legal and economic analysis of the post-Katrina insurance crisis and considers what impact (if any) the Tax Code can have on the crisis. This Article describes recently proposed tax legislation that attempts to solve the crisis by amending the Tax Code and explains why this proposed legislation would provide insurers with a windfall. Most importantly, this Article uses the proposed tax legislation as a poignant example of why subsidizing insurance costs through the Tax Code threatens to destabilize an otherwise stable insurance industry.

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I. INTRODUCTION

On August 23, 2005, a tropical depression formed in the southeastern Bahamas.¹ Within a few days, it had morphed into “one of the strongest storms to impact the coast of the United States during the last 100 years.”² At its peak, the storm—now better known as Hurricane Katrina—reached Category 5 intensity on the Saffir-Simpson scale, with maximum sustained wind speeds of over 170 miles per hour.³

Although the wind caused substantial damage, it did not compare to the horrific storm surges that accompanied the wind. Louisiana experienced storm surges ranging from ten to nineteen feet. Those surges caused the level of Lake Pontchartrain to rise, straining the levee system protecting New Orleans beyond the point of failure.⁴ The deluge that followed inundated more than eighty percent of New Orleans under water at depths of up to twenty feet.⁵

What followed was unimaginable. For more than a week, human and animal remains lay in the streets of New Orleans. “Hundreds of other bodies were . . . tucked into attics, buried under debris, [and] floating in the bruise-colored waters rubbing against rooftops” for even longer.⁶ Most of those who were “lucky” enough to survive the storm desperately awaited rescuers for

¹ AXEL GRAUMANN ET AL., TECHNICAL REPORT 2005-01: HURRICANE KATRINA, A CLIMATOLOGICAL PERSPECTIVE 1 (National Oceanic and Atmospheric Administration 2005) (Updated 2006), available at <http://www.ncdc.noaa.gov/oa/reports/tech-report-200501z.pdf>.

² *Id.*

³ *Id.* at 2.

⁴ *Id.* at 4.

⁵ *Id.*

⁶ Dan Barry, *A City’s Future, and a Dead Man’s Lost Past*, NY TIMES, Aug. 27, 2006, at 1.

days, baking atop sun-soaked bridges and rooftops that were surrounded by the same water that, in only a few hours, had whisked away what had taken a lifetime to build.

Once the waters began to recede, one set of images depicting the convergence of hell and high water was replaced with another. The storm had destroyed or rendered uninhabitable more than 300,000 homes, surpassing Hurricane Andrew's record by more than 375%.⁷ Much of the Gulf Coast's infrastructure, including transportation, communications, power, and water systems, were compromised or completely destroyed.⁸ The long-term environmental damage and health hazards from standing water, sewage, chemicals, and the more than 7.4 million gallons of oil that poured into the Gulf Coast region's waterways will not be known for years.⁹

As Americans struggle to appreciate the full extent of the damage and destruction caused by Hurricane Katrina, a terrifying question resonates with a shell-shocked nation: what is the next major disaster? Forecasters have been quick to respond with a laundry list of the most unimaginable disasters, with price tags ranging from \$50–\$400 billion dollars apiece.¹⁰ Imagine what would happen if these catastrophes occurred back-to-back like they did during the 2004 and 2005 Atlantic hurricane seasons.

Prior to Katrina, the thought of a disaster causing a twelve-digit loss was unfathomable. Today, catastrophe modelers consider such a loss inevitable and the only question that remains is who will bear it. Congress is particularly concerned since the private insurance industry¹¹ began bailing out of markets with a history of, or potential for,¹² natural disasters ("At-Risk Markets").¹³ The concern is justified.

⁷ THE FEDERAL RESPONSE TO HURRICANE KATRINA—LESSONS LEARNED 7 (Frances Townsend ed., 2006), available at <http://www.whitehouse.gov/reports/katrina-lessons-learned.pdf> [hereinafter FEDERAL RESPONSE]. Prior to Hurricane Katrina, Hurricane Andrew (1992) was the most costly hurricane in U.S. history. Estimated insured losses (adjusted to 2006 dollars) were \$22 billion. Insurance Information Institute, Catastrophes, <http://www.iii.org/media/facts/statsbyissue/catastrophes/>.

⁸ *Id.* at 8.

⁹ *Id.*

¹⁰ Forecasters predict that an earthquake in San Francisco could cause more than \$400 billion in damage and destruction. If a hurricane hit Manhattan or Miami, forecasters estimate losses in excess of \$150 billion and \$50 billion, respectively. See, e.g., Homeowners Insurance Protection Act of 2005, H.R. 4366, 109th Congress (2005) (introduced in the House of Representatives on Nov. 17, 2005 by Ms. Ginny Brown-Waite of Florida, for herself and Mr. Shaw) (referred to the Committee on Financial Services).

¹¹ The private insurance industry comprises two segments: property/casualty (which includes auto, home, and business insurance) and life/health. All subsequent references to insurance, insurer or any derivative thereof includes the property/casualty segment of the insurance industry and excludes the life/health segment.

¹² For example, the second largest property insurer in the United States (Allstate) announced that it will not write any new homeowners policies in New York City, Long Island, or Westchester County. "Although Long Island hasn't been struck by a major hurricane since 1938," the company is reducing exposure because the probability exists. Marilyn Adams, *Strapped Insurers Flee Coastal Areas*, USA TODAY, Apr. 25, 2006,

The exodus of U.S. property and casualty insurers (“P&C Insurers”) and global re-insurers (together with P&C Insurers, the “PCI Industry”) shifts the risk of loss from the PCI Industry to property owners, state insurance pools, and the federal government.¹⁴ The potential exposure is staggering. Demographic trends and increased standards of living have resulted in an increase in the number and value of exposed property in coastal communities.¹⁵ “Overall, 38% of the total exposure in Gulf and East Coast states is located in coastal counties, which accounts for 16% of the total value of properties in the U.S.”¹⁶ Although the exposure along the Gulf and East Coasts is staggering, it is dwarfed by exposure on the West Coast¹⁷ and by the possibility of multiple catastrophic events occurring within a relatively short period of time.¹⁸

The PCI Industry’s withdrawal from the private market has spawned a debate over what role, if any, the federal government should play in (1) securing catastrophe insurance for the insured, underinsured, and uninsured, (2) protecting the insured from insurer insolvencies, and (3) protecting those who want to self-insure.¹⁹ In 2006 and 2007, members of the U.S. House of Representatives and U.S. Senate took steps toward answering these questions by introducing four bills (the “National Catastrophe Plan”) that are intended to

available at http://www.usatoday.com/money/industries/insurance/2006-04-25-hurricane-usat_x.htm.

¹³ U.S. Personal Lines Midyear 2006 Outlook: Low Volatility Means Few Ratings Changes In 2006, (Jun. 5, 2006). While some insurance companies are exiting at-risk markets, new companies are entering the market. The problem is that the exodus of companies is outpacing the entry of new companies. *See, e.g.*, FLA. DEP’T OF FIN. SERVS., TASK FORCE ON LONG-TERM SOLUTIONS FOR FLORIDA’S HURRICANE INSURANCE 3 (2006), available at <http://www.fldfs.com/hurricaneinsurancetaskforce/TaskforceRS2/draftlts6.pdf> [hereinafter TASK FORCE ON LONG-TERM SOLUTIONS]. The Task Force on Long-Term Solutions for Florida’s Hurricane Market was formed by the state’s legislature and charged “with gathering information and making recommendations for ways to ensure that hurricane insurance is available for Floridians.” *Id.*

¹⁴ STANDARD & POOR’S, INDUSTRY OUTLOOK: U.S. COMMERCIAL LINES MIDYEAR 2006 OUTLOOK: SECTOR ENJOYING EXCEPTIONAL EARNINGS (June 9, 2006) (on file with author).

¹⁵ AIR Worldwide Corporation, *The Coastline at Risk: Estimated Insured Value of Coastal Properties*, Sept. 21, 2005, available at http://www.air-worldwide.com/_public/NewsData/000797/The_Coastline_at_Risk-AIR_Worldwide.pdf. [hereinafter AIR Coastline Study]. DENNIS MILETI, DISASTERS BY DESIGN: A REASSESSMENT OF NATURAL HAZARDS IN THE UNITED STATES (1999) (discussing how changes in behavior have contributed to the growing disaster losses, and why understanding this behavior would assist in better managing disaster risks).

¹⁶ AIR Coastline Study, *supra* note 15, at 1.

¹⁷ *See, e.g.*, note 10, *supra*.

¹⁸ Consider the following: In the course of a three-month period, the U.S. experiences three major hurricanes on the Eastern Seaboard. Two weeks later, a major U.S. city experiences a terrorist attack destroying several large buildings. By itself, each event would be manageable, but together, the damage could dwarf the losses sustained in the 2004 and 2005 hurricane seasons.

¹⁹ The terms “catastrophe,” “disaster,” and “natural disaster” are used interchangeably. Each term includes natural disasters such as hurricanes and earthquakes. The terms do not include man-made disasters, such as terrorist attacks. Insuring the risks of man-made disasters have different implications and are beyond the scope of this Article.

increase the availability and affordability of private insurance in peak risk areas and to reduce the risk of insurer insolvencies following disasters.²⁰

Two components of the National Catastrophe Plan involve amending the Internal Revenue Code (the “Code” or “Tax Code”)²¹ to provide tax benefits to insurance companies and homeowners who are exposed to natural catastrophe risks. In broad strokes, the Policyholder Disaster Protection Act of 2007 (“Proposed Catastrophe Reserve Legislation”) would permit insurance companies to deduct amounts set aside in reserves to fund future catastrophe claims;²² the Catastrophe Savings Accounts Act of 2006 (“Proposed CSA Legislation”) would allow homeowners to put money aside—on a tax-free basis—to cover uninsured losses, deductible expenses, and building upgrades to mitigate damage that could be caused in future disasters.²³

The debate is not new and neither is the proposed legislation.²⁴ In 1999, the 106th Congress proposed amending the Code to allow tax-deductible reserves for catastrophes.²⁵ Similar legislation followed in the 107th, 108th, 109th, and now the 110th Congress.²⁶ Prior attempts to pass the legislation have failed.²⁷ Currently, the Proposed Catastrophe Reserve Legislation and the

²⁰ Commission on Catastrophic Disaster Risk and Insurance Act of 2007, H.R. 537, 110th Cong. (2007); S. 292, 110th Cong. (2007) (creating a commission to recommend to Congress the best approach to addressing catastrophic risk insurance); Catastrophe Savings Accounts Act of 2006, H.R. 4836, 109th Cong. (2006), S. 3115 109th Cong. (2006); Homeowners Insurance Protection Act of 2007, H.R. 91, 110th Cong. § 2 (2007); Homeowners Insurance Protection Act of 2006, S. 3117, 109th Cong. (2006) (establishing a fund to sell Federal catastrophe insurance to State catastrophe funds, a measure that is akin to retrocession); and Policyholder Disaster Protection Act of 2007, H.R. 164, 110th Cong. (2007), Policyholder Disaster Protection Act of 2006, S. 3116, 109th Cong. (2006).

²¹ All references to the “Code” or “Tax Code” are to the Internal Revenue Code of 1986, as amended.

²² Policyholder Disaster Protection Act of 2007, H.R. 164, 110th Cong. (2007); Policyholder Disaster Protection Act of 2006, S. 3116, 109th Cong. (2006).

²³ Catastrophe Savings Accounts Act of 2006, H.R. 4836, 109th Cong. (2006), S. 3115, 109th Cong. (2006).

²⁴ The debate, as well as the proposed tax legislation, was heavily influenced by the efforts of the National Association of Insurance Commissioners. For a more detailed discussion, see Nat’l Ass’n of Ins. Comm’rs, *Natural Catastrophe Risk: Creating a Comprehensive National Plan*, (Draft, Oct. 5, 2006), available at http://www.naic.org/documents/committees_papers_natural_catastrophe.doc.

²⁵ Policyholder Disaster Protection Act of 1999, H.R. 2749, 106th Cong. (1999), S. 1914, 106th Cong. (1999).

²⁶ Policyholder Disaster Protection Act of 2001, H.R. 785, 107th Cong. (2001); Policyholder Disaster Protection Act of 2004, H.R. 4186, 108th Cong. (2004); Policyholder Disaster Protection Act of 2005, H.R. 2668, 109th Cong. (2005); Policyholder Disaster Protection Act of 2006, S. 3116, 109th Cong. (2006); Catastrophe Savings Accounts Act of 2006, H.R. 4836, 109th Cong. (2006); S. 3115, 109th Cong. (2006).

²⁷ The proposed tax legislation gathered tremendous momentum on the heels of a record breaking hurricane season, but the urgency that fueled the momentum tempered after an inactive 2006 hurricane season in which P&C Insurers posted record profits. Unfortunately, the absence of a mega-catastrophe and record insurance profits may project a false sense of security.

Proposed CSA Legislation (collectively, the “Proposed Tax Legislation”) have been referred to the appropriate committees.

Although substantively similar, the Proposed Tax Legislation is distinct from earlier bills. Significantly, the legislation is introduced at a time when Congress has been forced to recognize that this is neither a one-state crisis nor a private industry crisis. Quasi-governmental insurers are in crisis. Losses from the 2004 and 2005 Atlantic hurricane season have bankrupted the National Flood Insurance Program and state residual insurance providers on the East and Gulf Coasts. Future disasters could bankrupt property owners in At-Risk Markets who are unable to buy affordable insurance and their financial institutions whose debts are secured by uninsured property. This dynamic has given the Proposed Tax Legislation new momentum.

This Article provides an extensive legal and economic analysis of the post-Katrina insurance crisis and considers what impact (if any) the Tax Code can have on the crisis. The Article describes the Proposed Tax Legislation that attempts to solve the crisis by amending the Tax Code and explains why this proposed legislation would provide insurers with a windfall. Most importantly, the Article uses the Proposed Tax Legislation as a poignant example of why subsidizing insurance costs through the Tax Code threatens to destabilize an otherwise stable insurance industry.

The balance of this Article is divided into four parts. As background, the first two parts explain the peculiar economics that form the foundation for insuring natural disasters; Part II focuses on the supply-side of insurance and Part III addresses the demand-side. Part IV scrutinizes the Proposed Tax Legislation and Part V summarizes the issues and concludes that the Proposed Tax Legislation cannot solve the post-Katrina insurance crisis. Worse, it threatens to turn the insurance crisis into an insurance disaster.

II. THE SUPPLY OF CATASTROPHE INSURANCE POST-KATRINA

A. *P&C Insurers Post Record Profits and Record Losses*

Worldwide, mega-catastrophes claimed more than 97,000 lives in 2005.²⁸ Economic losses directly attributable to those catastrophes are expected to exceed \$230 billion dollars.²⁹ Although \$230 billion is a staggering number, it is slight compared to the many losses that can never be quantified. Property insurers will absorb approximately \$83 billion of the quantifiable losses.³⁰ The \$147 billion dollar shortfall will be covered, if at all, by governments, charities, survivors, friends, families, and kind strangers.

It is unsurprising that the United States accounted for the majority of these losses. In only three months, Hurricanes Katrina, Rita, and Wilma caused over

²⁸ SWISS RE, NATURAL CATASTROPHES AND MAN-MADE DISASTERS 2005, at 7 (2006) [hereinafter SWISS RE REPORT].

²⁹ *Id.* at 5. Unless otherwise indicated, all references to “dollars” shall mean United States dollars, adjusted to the dollar’s value in 2005.

³⁰ *Id.* at 7.

\$200 billion in total economic losses.³¹ At \$135 billion and counting, Hurricane Katrina accounted for the largest of these economic losses.³² Property insurers will cover a record-high \$61.2 billion in catastrophe-related losses, with five hurricanes in 2005 accounting for ninety-four percent of the total 2005 insured losses.³³ Many feared that the 2006 hurricane season would set new records, but seasonal activity was lower than expected.³⁴

It is not unusual for the United States to outpace the rest of the world in terms of record catastrophe losses. From 1970–2005, the top eight most costly world insurance losses occurred in the United States.³⁵ Six of the eight occurred in 2004 or 2005.³⁶ What is unique is that unlike catastrophe losses in prior years, the 2004 and 2005 hurricane seasons unveiled a different kind of peril; one that forecasters failed to predict. Rather than a single mega-catastrophe, the

³¹ Commission on Catastrophic Disaster Risk and Insurance Act of 2006, H.R. 5587, 109th Cong. § 2 (2006).

³² See SWISS RE REPORT, *supra* note 28, at 5. Hurricane Wilma ranked second, with destruction estimated at \$20 billion dollars. Hurricane Rita ranked third at \$15 billion and Hurricane Dennis, fourth, at \$4 billion. *Id.*

³³ The losses arise from 24 events, including the following five hurricanes: Katrina, Wilma, Rita, Ophelia, and Dennis. Insurance Information Institute, Catastrophes, <http://iii.org/media/facts/statsbyissue/catastrophes/>.

³⁴ In May of 2006, the National Oceanic and Atmospheric Administration was predicting that the hurricane season would produce “13 to 16 named storms, with eight to 10 becoming hurricanes, of which four to six could become ‘major’ hurricanes of Category 3 strength or higher.” Press Release, Nat’l Oceanic and Atmospheric Admin., NOAA Predicts Very Active 2006 North Atlantic Hurricane Season: Residents in Hurricane Prone Areas Urged to Make Preparations (May 22, 2006), *available at* <http://www.publicaffairs.noaa.gov/releases2006/may06/noaa06-056.html> (quoting retired Navy Vice Adm. Conrad C. Lautenbacher, Ph.D., Undersecretary of Commerce for Oceans and Atmosphere and NOAA Administrator). Fortunately, seasonal activity was lower than expected “due to the rapid development of El Niño—a periodic warming of the ocean waters in the central and eastern equatorial Pacific which influences pressure and wind patterns across the tropical Atlantic.” Press Release, Nat’l Oceanic and Atmospheric Admin., Return of El Niño Yields Near Normal 2006 Atlantic Hurricane Season, *available at* <http://www.noaa.gov/stories2006/s2748.htm>. That’s not to say that 2006 was free of natural catastrophes. However, “direct insured losses from catastrophes dropped to \$7.6 billion in nine-months 2006 from \$51.1 billion in nine-months 2005.” Press Release, Ins. Serv. Office, Absence of Hurricane Losses Drove Improvement in Property/Casualty Insurers’ Results Through Nine Months (Dec. 27, 2006), *available at* http://iso.com/press_releases/2006/12_27_06.html.

³⁵ Insurance Information Institute, Catastrophes, *supra* note 33. In descending order, the top ten most costly world insurance losses are Hurricane Katrina (2005, \$66.3 billion), Hurricane Andrew (1992, \$22.3 billion), Terrorist attacks on 9-11 (2001, \$19 billion), Northridge Earthquake (1994, \$18.5 billion), Hurricane Ivan (2004, \$13.6 billion), Hurricane Wilma (2005, \$13 billion), Hurricane Rita (2005, \$10.4 billion), Hurricane Charley (2004, \$8.6 billion), Typhoon Mireille/No. 19 (1991, \$8.4 billion), and Hurricane Hugo (1989, \$7.4 billion). With the exception of Typhoon Mireille (which occurred in Japan), the foregoing events took place (in whole or in part) in the United States.

³⁶ Insurance Information Institute, Catastrophes, *supra* note 33. The 2005 hurricane season also broke several meteorological records: 27 named storms (previous record year: 1933 with 21), of which 15 reached hurricane windspeeds (previous record year: 1969 with 12). For the first time ever, three hurricanes attained category 5, the highest on the Saffir-Simpson scale. SWISS RE REPORT, *supra* note 28, at 11.

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United States experienced eight mega-hurricanes within a span of seventeen months, including the most costly natural disaster of all time—Hurricane Katrina. Many of these hurricanes affected the same areas, which produced an even more devastating economic impact on those insuring (or reinsuring) these particular markets.

With few significant exceptions, the PCI Industry weathered record catastrophe losses remarkably well.³⁷ However, the frequency and severity of these losses, together with the threat of future disasters, triggered a shift in the industry's cycle to "hard market" conditions.³⁸ Following the end of the 2005 hurricane season, for example, many P&C Insurers and global re-insurers stopped writing new policies and declined to renew certain expiring policies in At-Risk Markets. Some offloaded their policies in At-Risk Markets to smaller, unrated insurers.³⁹ Many increased premiums, tightened policy limits, and raised deductibles.⁴⁰

Historically, hard market cycles following mega-disasters are temporary. In the short-term, it is likely that P&C Insurers' capacity to provide coverage will shrink further and prices will continue to increase.⁴¹ The extent of price

³⁷ Only a few primary insurers failed as a result of recent catastrophe losses. The most significant failure was the 2006 liquidation of Poe Financial Group's three insurance subsidiaries—Southern Family Insurance Company, Atlantic Preferred Insurance Company, and Florida Preferred Property Insurance Company. Prior to the liquidation, Poe Financial Group was Florida's third largest home insurer. Tom Zucco, *Insurer Poe Files for Bankruptcy*, ST. PETERSBURG TIMES, August 19, 2006, http://www.sptimes.com/2006/08/19/Business/Insurer_Poe_files_for.shtml. Vesta Fire Insurance Company, the sixth largest homeowners insurance company in the state of Texas, also failed. *Vesta Fire and Subsidiaries Headed for Liquidation in Texas*, INSURANCE JOURNAL, July 19, 2006, <http://www.insurancejournal.com/news/southcentral/2006/07/19/70583.htm>.

³⁸ Like most industries, the PCI Industry is cyclical. The PCI Industry's cycle is characterized by periods of "soft market" and "hard market" conditions. In a soft market, premium rates are stable or falling and insurance is readily available. In a hard market, premium rates rise and coverage may be more difficult to find and insurers' profits increase.

³⁹ In early 2006, Allstate, the number two insurer in the State of Texas, dropped windstorm coverage from renewals on 65,000 home policies along the Texas coast. In September 2006, it announced that it does not plan to renew policies on approximately 16,000 non-brick homes in Texas and will discontinue mobile home coverage in certain Texas counties effective December 3, 2006. Purva Patel, *Insurer to End Some Policies on Coast*, HOUSTON CHRON., Sept. 15, 2006, available at <http://www.chron.com/dispatch/story.mpl/hurricane/4188716.html>.

⁴⁰ See e.g., STANDARD & POOR'S INDUSTRY OUTLOOK, *supra* note 14.

⁴¹ *Id.*

increases depends on reinsurance costs,⁴² loss expectations,⁴³ and increased capital requirements for certain rated insurance (and reinsurance) companies.⁴⁴

Although the PCI Industry's response to the record breaking hurricane seasons is typical, its recovery from back-to-back mega-catastrophe losses is remarkable.⁴⁵ In 2005, P&C Insurers had more than \$850 billion in resources—\$426 billion from premiums and \$427 billion in surplus.⁴⁶ The PCI Industry posted an after-tax profit in the same year it sustained record losses, and it recorded record profits the following year.

Some observers wonder why insurers are abandoning markets and curtailing coverage at a time when they are posting record profits. Equally questionable is Congressional support for tax legislation that would increase insurer profitability at the expense of an ever-increasing federal deficit. Before addressing these questions, it is necessary to understand the peculiar economics of catastrophe insurance and how different economic models affect the supply of affordable insurance, particularly after a major disaster. The next four parts describe the three-tiered system for delivering catastrophe insurance and how each fared when tested by the 2004 and 2005 Atlantic hurricane seasons.

B. The Three-Tiered System for Insuring Disaster Losses

Broadly, "Insurance is a method of managing risk by distributing it among large numbers of individuals."⁴⁷ Risk refers to the possibility that a loss will occur.⁴⁸

⁴² Premium increases for catastrophe reinsurance policies renewing on January 1, 2006 reached as high as 40% for insurers with significant storm claims. Rates for other insurers rose 10%–15%. Analysts predict further increases for insurers renewing and acquiring new policies after January 1, 2006. *Id.*

⁴³ Revised models for how companies assess catastrophe losses are expected to raise loss expectations and those losses are expected to be passed on to consumers in At-Risk Markets. *See infra* Part II.C.1.c.

⁴⁴ Ratings agencies such as Standard and Poor's, Moody's, and Fitch, are imposing new, higher capital requirements on rated insurers and re-insurers who want to maintain their rating. This additional capital requirement is expected to adversely affect the affordability and availability of insurance and reinsurance. *See* Task Force on Long-Term Solutions, *supra* note 13, at 13. Each of these variables, along with an explanation of how insurance companies make money, is discussed *infra* Part II.C.

⁴⁵ Insurance Services Office, Insurer Financial Results: 2005, *available at* http://www.iso.com/studies_analyses/docs/study024.html [hereinafter PCI Industry 2005 Financials]. A.M. Best reported that after-tax income was as high as \$48.4 billion. *U.S. P/C Industry Reports Operating Profit in 2005 Despite Record-High Catastrophe Losses*, BEST'S REVIEW, July 1, 2006. Not everyone fared so well. For example, Hurricanes Katrina, Rita and Wilma wiped out more than a year's worth of earnings for one S&P-rated insurer. Most other S&P-rated insurers lost less than three-fourths of their earnings and did not take a material hit on their balance sheets. STANDARD & POOR'S INDUSTRY OUTLOOK, *supra* note 14. *See also* discussion *supra* note 37 (regarding the liquidation of Poe Financial Group's subsidiaries).

⁴⁶ *See* PCI Industry 2005 Financials, *supra* note 45.

⁴⁷ KENNETH S. ABRAHAM, *DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY* 1 (1986).

⁴⁸ *Id.* at 1–2.

Most property owners manage the risk of loss from a natural disaster by purchasing a policy from a private insurer. For example, a typical homeowner insurance policy will cover losses from natural disasters such as fires and windstorms.⁴⁹ If the property owner is unable to procure insurance from a private insurer, he or she may be able to purchase it from a residual market insurer. A residual market insurer generally is a state-sponsored insurance company that sells insurance to those who cannot obtain it in the voluntary market.⁵⁰

In addition to (or in lieu of) purchasing an insurance policy from a private or state-sponsored insurance company, a property owner may reduce the risk of loss from a natural disaster ex post with de facto insurance. Federal, state and local governments often provide direct and indirect reimbursements for property that has been damaged or destroyed in a natural disaster. Charitable organizations also provide similar assistance.⁵¹

What follows is a discussion of the two main vehicles for delivering traditional disaster insurance ex ante—private insurers and residual market insurers. After that, the Article explores the types of disaster losses that may be covered by so-called de facto insurance; that is, disaster insurance provided ex post by the insurers of last resort: federal, state, and local governments.

C. *The Private Insurance Market for Catastrophe Losses*

1. *The Economics of Private Insurance: Managing Risks*

Risk management begins when a policyholder enters into a contract whereby the policyholder pays a premium over a specified period of time with the understanding that if damage occurs from a covered loss, the P&C Insurer will pay to repair or replace the insured property, less any deductible.⁵² The policyholder manages “the risk of suffering a large loss by substituting the certainty of a smaller one.”⁵³

The economics of managing risk from the insurer’s perspective are unique. A P&C Insurer agrees to assume the policyholder’s risk of loss without

⁴⁹ Insurance against flood and earthquake damage generally is furnished under a separate policy. Insurance Information Institute, What Type of Disasters are Covered?, <http://www.iii.org/individuals/home/hbasics/whattype/>.

⁵⁰ The private market generally will not insure risks that are considered “high risk.” For example, many homes in South Florida are considered high risk due to the area’s active hurricane seasons. Insurance Information Institute, Residual Markets, August 2007, <http://www.iii.org/media/hottopics/insurance/residual/>.

⁵¹ For example, the Oprah Angel Network Katrina registry raised more than \$11 million to build homes for Hurricane Katrina evacuees. Oprah.com, O Philanthropy: Building Oprah Katrina Homes, http://www.oprah.com/uyl/katrina/uyl_katrina_main.jhtml.

⁵² Southwestern Insurance Information Service, Frequently Asked Questions, <http://www.siiinfo.org/data/cfaqs.htm>. The deductible is the portion of the loss that the parties agree will be paid by the policyholder. Deductibles can be a specified dollar amount or a percentage of the insured value of the property. The latter has become standard for catastrophe losses. Insurers prefer the higher deductible because it provides them with an additional layer of cushion before a policyholder can claim a loss. Policyholders may prefer the higher deductible because it reduces their premiums.

⁵³ See ABRAHAM, *supra* note 47, at 2.

knowing what the actual cost of doing so will be. Generally, an insurer manages a policyholder's risk by pooling it with the risks of other policyholders in its risk portfolio, anticipating that only a small percentage of those who buy policies will actually experience covered losses in any given year.⁵⁴ Depending on the type of risks involved, an insurer may have to employ techniques other than pooling. The types of risks that P&C Insurers cover fall into two categories: high frequency, low severity loss events; and low frequency, high severity loss events.

The classic example of a high frequency, low severity risk event is an automobile collision. Using the "law of large numbers," an insurer typically pools contracts that are not perfectly correlated so that the risk of loss becomes more predictable and the aggregate premiums charged for the risk pool reflect the appropriate risk and profit loads.⁵⁵ The law of large numbers is an efficient loss-predictor with respect to "high-frequency, low-severity, relatively stationary, relatively independent events with good data and moderate loss volatilities."⁵⁶ In other words, "the chances become small that the actual observed losses will deviate from expected losses by an amount which is large relative to the overall expected value of loss."⁵⁷

The classic example of a low frequency, high severity risk is a natural catastrophe, such as a hurricane. The law of large numbers is not particularly efficient for these types of risks because these events are too infrequent.⁵⁸ "For this type of loss, the insurer is essentially in the same position as the policyholder in the usual insurance transaction, i.e., the insurer faces a loss that amounts to a high proportion of its resources and that is highly uncertain or unpredictable."⁵⁹

A P&C Insurer's capacity to manage both types of risks begins with the "dismal science" of economics; resources are scarce. The allocation of those scarce resources in a market economy is propelled by supply and demand. On the demand side, there are many theories on what factors affect a consumer's decision to procure catastrophe insurance and these factors are explored in Part III, *infra*. On the supply side, the maximum amount of risks that each individual P&C Insurer can assume is limited by its financial capacity to satisfy claims in the event a covered loss is sustained.

⁵⁴ See Southwestern Insurance Information Service, *supra* note 52.

⁵⁵ J. David Cummins & Neil A. Doherty, *Can Insurers Pay for the 'Big One'? Measuring the Capacity of an Insurance Market to Respond to Catastrophic Losses*, 26 J. BANKING & FIN. 557, 558 (2002), available at <http://knowledge.wharton.upenn.edu/papers/38.pdf>. The statistical foundation of insurance is referred to as the "law of large numbers."

⁵⁶ J. David Cummins, *Should the Government Provide Insurance for Catastrophes?*, 88 FED. RES. BANK OF ST. LOUIS REV. 337, 345 (2006).

⁵⁷ See Cummins & Doherty, *supra* note 55, at 558.

⁵⁸ *Id.*

⁵⁹ *Id.*

a. How Do P&C Insurers Fund Anticipated Claims?

A P&C Insurer funds *anticipated* future claims with premiums collected from assuming policyholders' risks, and with investment income generated by investing a portion of the insurer's unearned premiums and capital in financial markets.⁶⁰ The amount that insurers can charge for insurance is a function of market forces and state law regulation; the market sets the price, subject to a state cap or ceiling. By law, insurance rates for each insurance policy in each state must reflect the risk of loss for that particular line of business in that state, and that state only.⁶¹ In other words, each line of business in each state must be self-sufficient. Profits from GEICO's auto insurance business cannot be used to subsidize losses in its homeowners' insurance business. Likewise, hurricane-related losses to homes in a state like Florida cannot be subsidized by profits generated by homeowners' insurers in Minnesota.

b. How Do P&C Insurers Fund Unanticipated Future Claims?

The most obvious source for funding unanticipated claims is the insurer's "policyholder surplus," or capital—essentially its assets over liabilities, or net worth. As discussed below, this source works well for fluctuations in losses from high frequency, low severity events. However, it cannot serve as the sole source of funds for low frequency, high severity events. P&C Insurers learned that lesson the hard way after their failure to diversify risk portfolios led to an industry-wide meltdown following Hurricane Andrew and the Northridge Earthquake. That crisis provided the industry with the momentum it needed to find an alternative model for financing catastrophe risks, a model that would be tested by the 2004 and 2005 Atlantic hurricane seasons.⁶² What evolved is a multi-pronged approach to ensuring that the risks assumed through insurance are aligned with the insurer's capital base.

⁶⁰ In essence, the financial markets "bridge the gap between today's premiums and tomorrow's claims." SWISS RE, THE ECONOMICS OF INSURANCE: HOW INSURERS CREATE VALUE FOR SHAREHOLDERS 7, *available at* <http://www.swissre.com/internet/pwswpspr.nsf/fmBookMarkFrameSet?ReadForm&BM=../vwAllbyIDKeyLu/bber-55davj?OpenDocument> [hereinafter SWISS RE ON ECONOMICS OF INSURANCE]. Some insurance companies, like Berkshire Hathaway, are able to rely solely on "float" as a source of insurance funds. Most of Berkshire's float arises because (1) premiums are paid in advance of the services rendered (insurance protection), and (2) the loss that occurs today may not be paid immediately (i.e., asbestos claims). They are able to invest the unearned premiums and unpaid claims at little or no cost, depending on the profitability of the underwriting business. For a brief description on Berkshire Hathaway's use of float to cover insured losses, see Letter from Warren J. Buffett, Berkshire Hathaway, Inc., to Shareholders (2005), *available at* <http://www.berkshirehathawrvieway.com/letters/2005ltr.pdf>.

⁶¹ For an overview of how states regulate insurance rates, see Insurance Information Institute, Rates and Regulation, <http://www.iii.org/media/hottopics/insurance/ratereg/>. For a thoughtful critique of state insurance regulation (including rate regulation) and options for federal intervention, see SCOTT E. HARRINGTON, NETWORKS FIN. INST., FEDERAL CHARTERING OF INSURANCE COMPANIES: OPTIONS AND ALTERNATIVES FOR TRANSFORMING INSURANCE REGULATION (2006).

⁶² U.S. GOV'T ACCOUNTABILITY OFFICE, CATASTROPHE RISK: U.S. AND EUROPEAN APPROACHES TO INSURE CATASTROPHE AND TERRORISM RISKS 9 (2005), *available at* <http://www.gao.gov/new.items/d05199.pdf> [hereinafter GAO, CATASTROPHE RISK].

As discussed in more detail below, if claims from a covered disaster exceed the insurer's premiums and investment income, there are three lines of defense to backstop the loss. The first line of defense generally will be policyholder surplus, or capital. In certain instances, an insurer may transfer peak risks to re-insurers or the capital market. In this case, the insurer's exposure for a disaster loss is capped at a specified level and a third party bears exposure for losses above that level. This is the insurer's second line of defense. If an insurer cannot satisfy claims after exhausting both lines, policyholders will look to guaranty funds—the third line of defense.

i. Capital Base—The First Line of Defense

"One critical component in the supply of insurance is the amount of capital that insurers hold as a buffer if claim costs turn out to be higher than expected."⁶³ Once that capital is exhausted, the insurer defaults and has no further obligation with respect to unpaid claims.⁶⁴ Accordingly, the adequacy of an insurer's capital relative to its exposure to loss is an important measure of solvency. That is why most states and rating agencies require P&C Insurers to maintain a certain level of policyholder surplus or capital to underwrite risks.⁶⁵ Because holding back enormous amounts to cover unanticipated losses can be costly, P&C Insurers generally retain the minimum amount required and distribute the excess to investors.

The minimums are sufficient to absorb adverse fluctuations in losses from high frequency, low severity events like car accidents. These losses are small relative to the insurer's total assets.

It would appear that an industry with a capital cushion in excess of \$400 billion also would be in a position to satisfy low frequency, high severity events like hurricanes. However, only a fraction of the industry's \$440 billion in surplus is available to pay claims from any given disaster. Most of the capital will belong to companies who do not write policies in the affected area. For example, surplus from GEICO's California auto insurance line of business cannot be used to pay hurricane losses owed by Allstate's homeowner line of business. Even if insurers were permitted to tap the entire industry's capital pool, it could devastate the entire insurance industry across business and state

⁶³ Scott Harrington & Greg Niehaus, *Government Insurance, Tax Policy, and the Affordability and Availability of Catastrophe Insurance*, J. INS. REG. 591, 593 (2001).

⁶⁴ If policyholders are unable to collect from an insolvent insurer, they can file a claim with insurance guaranty funds. Guaranty funds are discussed *infra* Part II.C.1.b.iii.

⁶⁵ The amount of the holdback can differ dramatically, depending on where the insurer is underwriting risks. In 2006, for example, a P&C Insurer in Florida was required to hold back \$5 million or ten percent of total liabilities, whichever is greater. FLA. STAT. ANN. § 624.407 (West 2004). In Montana, the holdback amount was only \$500,000. MONT. CODE ANN. § 33-2-109 (West 2006). For a summary identifying the statutory minimum capital and surplus requirement for each state, see Nat'l Ass'n of Ins. Comm'rs, *Statutory Minimum Capital and Surplus Requirements*, http://www.naic.org/documents/industry_ucaa_chart_min_capital_surplus.pdf.

lines. A single mega-catastrophe, such as a hurricane in Manhattan, has the potential to wipe out nearly forty percent of the industry's capital.⁶⁶

Increasing capital above the statutory minimums is the most obvious technique to ensure that a P&C Insurer has sufficient capital to cover claims following a mega-catastrophe. There are two problems with retaining large amounts of capital. First, insurers would be required to retain more policyholder surplus and to reduce the amounts they would ordinarily distribute to investors. Investors' return on equity would be reinvested (rather than being distributed). In effect, investors would be placing more capital at risk and would expect to be compensated for increased risks and lost opportunity costs associated with the reserve.⁶⁷ Second, there is a substantial tax cost to retaining capital and that cost increases as the reserve increases. These two problems make enormous reserves cost-prohibitive.⁶⁸

Because the loss potential is so high relative to an insurer's assets, insurers look to only a portion of their policyholder surplus as the first line of defense against disaster losses. Disaster losses that exceed this cushion are shifted to third parties using the techniques described below.

ii. Reinsurance, Retrocession, and Securitizations—The Second Line of Defense

There are some losses, such as mega-catastrophes like Hurricane Katrina, whose costs are so large and unpredictable that it would be prohibitively costly and inefficient for the insurer to cover with its own capital because it would severely restrict the insurer's capacity to insure other potential losses. Thus far, the industry has embraced two techniques to diversify particularly volatile risks by shifting them to others in the PCI Industry (through reinsurance and retrocession) and to others in the capital markets (through securitizations).

Insurers, particularly those whose portfolios are heavily exposed to natural catastrophes, often acquire "reinsurance" to protect their capital base against

⁶⁶ An insurer typically needs to recapitalize in the aftermath of a disaster. The cost of raising new capital can be significant, particularly if the insurer has historically failed to maximize shareholder value. Capital is also diminished when dissatisfied investors withdraw their capital.

⁶⁷ At its core, the PCI Industry is like every other for-profit service industry: each market participant's end goal is to achieve a specified rate of return on investors' equity. Return on equity generally is defined as net income divided by total equity, and it gauges profitability by showing how efficiently invested-capital is being used. Generally, an investor will expect a return equal to the base cost of capital (i.e., the return that the investor would earn if he had invested the funds directly in financial markets rather than through an insurance company) plus frictional capital costs. Frictional capital costs are the costs of (1) double taxation on the insurer's investment returns (discussed *infra* Part II.C.1.c.iii.(a)), (2) regulatory capital requirements, and (3) a risk premium (investors will want to be compensated for putting their capital at risk). For a discussion on how insurance companies create value for their owners, see SWISS RE ON ECONOMICS OF INSURANCE, *supra* note 60, at 7.

⁶⁸ Likewise, it would be prohibitively expensive for insurance companies to attempt to raise new capital to satisfy a capital shortfall in the aftermath of a mega-catastrophe.

large deviations from expected losses.⁶⁹ Reinsurance is basically insurance for insurance companies.⁷⁰ The insurer transfers the risk of suffering a large loss by substituting it with the certainty of a smaller one.

Reinsurance begins with an agreement between an insurer (referred to in industry parlance as the “cedent”) and a re-insurer whereby the re-insurer agrees to indemnify the cedent against claims that the cedent may incur under its insurance policies. In exchange, the cedent pays the agreed premium.

Consider the following example:

Reinsurance Example

Acme insures homeowner multiple peril risks with a \$6 million exposure. Acme only wants to retain \$1 million of risk so it acquires reinsurance of \$5 million for losses in excess of \$1 million, determined on a per event basis.

If there is a covered loss of \$4 million, Acme satisfies the policyholders’ claims and collects \$3 million from the re-insurer.

Re-insurers may also insure against assumed risks by ceding all or any part of their indemnification obligations to another re-insurer through a process known as retrocession. This is like insurance for re-insurers. Retrocession is considered one of the riskiest businesses in the insurance industry; it also offers the largest potential for returns.⁷¹ “Generally speaking, retrocessional covers attach at industry loss triggers of \$5 billion, \$10 billion or \$15 billion Katrina will trigger at least two of these breakpoints, possibly the \$15 billion trigger too.”⁷²

Although insurers (and re-insurers, through retrocession) reduce their risks by ceding losses to re-insurers (or retrocessionaires), they assume counter-party risk—the risk that the counterparty (i.e., the re-insurer) will be unable to satisfy its obligations under the reinsurance contract. If, in the example above, the re-insurer defaults, Acme remains responsible for \$4 million in covered losses.

Securitization is another technique used by insurance and reinsurance companies to spread risk broadly. Securitization involves transferring peak risks to the capital markets in the form of securities whose interest rates are

⁶⁹ SWISS RE, UNDERSTANDING REINSURANCE: HOW REINSURERS CREATE VALUE AND MANAGE RISK (2004), available at http://www.swissre.com/resources/ac856600455c3bb7a887ba80a45d76a0-Understanding_reinsurance_p.pdf [hereinafter SWISS RE ON REINSURANCE].

⁷⁰ *Id.* at 4.

⁷¹ Alistair Barr, *Katrina Hits ‘Reinsurance for Reinsurers’: Hedge Funds in So-called Retrocessional Market to be Tested*, MARKETWATCH, Sept. 1, 2005, available at <http://www.marketwatch.com/News/Story/Story.aspx?guid=%7B2DD7509B-8AFA-4653-917C-3E9E6704FF1C%7D&siteid=mktw&dist>.

⁷² *Id.* (quoting Fox-Pitt, Kelton analysts).

based on the likelihood of a catastrophe's occurrence.⁷³ These have been used to shift the risks of natural catastrophes in the capital markets. Securitizations do not have the same counter-party risks inherent in reinsurance.

The ability to spread risks to others (by reinsurance or otherwise), allows insurers to assume more risk at the same level of capital. This means that insurers can spread their overheads over a broader base of business and benefit from economies of scale.⁷⁴

iii. Guaranty Funds—The Third Line of Defense

If an insurer is insolvent and unable to pay claims, policyholders may file their unpaid claims with the applicable guaranty fund. Guaranty funds are state mandated, but are funded and operated by the insurance industry.⁷⁵ Following an insurer's insolvency, the guaranty fund will cover claims by assessing other insurers doing business in the state.⁷⁶ However, there are limits on the amount of assessments, and there is no government backstop if the claims exceed the assessment.⁷⁷

c. Funding Mechanisms Are Failing in At-Risk Markets

The main reason P&C Insurers are exiting At-Risk Markets is that the usual mechanisms used to fund disaster losses are failing. The failures are caused by many factors, including the following four, each of which is discussed in further detail below:

- Breakdown of catastrophe risk-assessment technology,
- Increased cost and limited availability of risk-shifting techniques,
- Increased tax costs for catastrophe insurers, particularly when the insurer must rely on policyholder surplus or capital as a cushion for mega-catastrophes; and
- Inability to charge risk-based premiums in At-Risk Markets.

i. Unreliable Technology

To ensure that its capital base and risks assumed are aligned, insurance companies historically relied on cutting-edge technology and sophisticated risk control tools to quantify the probability that an insured event will occur and to estimate its severity.⁷⁸ Catastrophe models—the main tool used by the PCI

⁷³ SWISS RE ON REINSURANCE, *supra* note 69, at 13.

⁷⁴ As Mike Barth explains:

Economies of scale are present when operating expenses do not rise as fast as revenues, so that the larger a company grows, the more cheaply it can operate, which in turn allows it to grow even faster because its marginal costs are lower than other companies in the market. When economies of scale are present, there is a natural tendency for growth in the largest companies because they can operate with lower expense margins.

Mike Barth, *Economies of Scale in Property-Casualty Insurance*, NAIC RES. Q., Apr. 1995, at 57.

⁷⁵ Insurance Information Institute, Insolvencies/Guaranty Funds, <http://www.iii.org/media/hottopics/insurance/insolvencies/>.

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ Other methods include diversifying the lines of business (i.e., life versus non-life insurance) and geographical areas.

Industry to assess catastrophe exposure—are undergoing significant revisions necessitated by their failure to accurately assess the costs of catastrophes.⁷⁹

Until these revisions are complete, the PCI Industry lacks a clear picture of its exposure.⁸⁰ Without a clear picture of the risks involved, P&C Insurers and re-insurers are reluctant to offer coverage in At-Risk Markets. Florida's insurance commissioner recently testified that

[I]nsurance costs are not going up directly to recoup the losses of 2004 and 2005. They are going up because the losses of 2004 and 2005 have demonstrated a level of risk potential for the future that has insurers rethinking what their prospective losses will be going forward. When an insurer suffers a 1-in-500 year event in consecutive years, it rightly begins to question the validity of its models and risk management assumptions, and adjusts its future expected losses accordingly. At the same time, reinsurers are drawing those same conclusions, which adds to the overall price increase.⁸¹

ii. Reinsurance, Retrocession, and Securitization—Limited Availability and Expensive

Primary insurers have been unable to expand capacity by shifting risks to re-insurers following the 2005 hurricane season. Although 2004 had its share of major catastrophes,

[T]he nature of incurred losses in 2004 differed from 2005 in that the smaller size of each of the four major hurricanes hitting the U.S. coast in 2004 (Charley, Frances, Ivan, and Jeanne) caused the bulk of the losses from these events to be contained within primary companies' retention layers. In 2005, however, the severe nature of the three hurricanes hitting the U.S. seaboard (particularly Katrina) led to the bulk of the losses hitting reinsurance and retrocessional layers.⁸²

⁷⁹ Catastrophe models predicted that losses from Hurricane Katrina would not exceed \$10 billion. Charles E. Boyle, *A Seriously Shaken Reinsurance Industry Rebuilds*, INS. J., Jan. 23, 2006, available at <http://www.insurancejournal.com/magazines/west/2006/01/23/features/65748.htm>.

⁸⁰ Many catastrophe modelers used a 100-year historical record of storms to project the likelihood that a storm will affect a covered market and what the scope of the damage may be. "While the event set is historically accurate, it does not account for cyclical variations—such as the presence of an El Niño or La Niña or long-term temperature fluctuations, whether natural or manmade—that could affect the severity of a hurricane season. Consequently, model results have been accurate over the long term, but less so in any given three- to five- year period." NAPCO LLC, *THE IMPACT OF CHANGES TO THE RMS U.S. HURRICANE CATASTROPHE MODEL 4* (2007), <http://www.napcollc.com/articles/JuneReviewRMSHurricane.pdf>. See also STANDARD & POOR'S, *supra* note 14.

⁸¹ Stabilizing Insurance Markets for Coastal Consumers: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services 6 (2006) (statement of Kevin McCarty, Florida Insurance Comm'r on Behalf of The National Association of Insurance Commissioners), available at http://naic.org/documents/govt_rel_issues_catastrophe_testimony_0609_mccarty.pdf.

⁸² Standard & Poor's, *Outlook on Global Reinsurance Sector Remains Stable*, (Sept. 8, 2006), available at <http://www2.standardandpoors.com/portal/site/sp/en/eu/page.article/2,1,1,0,1145835332667.html?vregion=eu&vlang=en>.

Although there were no reinsurance failures as a result of the 2005 catastrophe losses, “global reinsurers posted a consolidated pretax operating loss (including non-life and life results) of \$240 million in 2005 compared with pretax operating gains of \$15 billion in 2004.”⁸³ Those re-insurers who specialize in catastrophes lost 40%–100% of their capital base; the equivalent of many years of earnings.⁸⁴

It is unsurprising that re-insurers and retrocessionaires are limiting (or eliminating) their coverage in At-Risk Markets. Those who are writing policies are charging extraordinary premiums for less coverage, as is typical in the aftermath of such events.⁸⁵ “Insurers operating in the hurricane belt face reinsurance costs that are up 100 percent or more in 2006.”⁸⁶ As discussed below, P&C Insurers are unable to pass the expense along to insureds. In the near term, the use of reinsurance and retrocession to increase capacity is likely limited. Undoubtedly, this industry will rebound once catastrophe modeling improves and those who were hit the hardest have had a chance to recapitalize.

Securitizations also have limited availability and are expensive, albeit for different reasons. Despite the fact that these techniques have yet to receive industry-wide acceptance, they have seen tremendous growth in the last few years and they provide insurers with a mechanism for diversifying the funding base.⁸⁷

iii. Maintaining a Larger Capital Cushion is Costly: Increased Tax Costs of Insuring Catastrophes

Recall that an insurer’s two lines of defense to satisfy catastrophe claims are policyholder surplus and reinsurance. When access to reinsurance is limited, as is the case in the post-Katrina era, an insurer must increase its capital cushion (i.e., policyholder surplus) or assume less risk in At-Risk Markets. P&C Insurers have chosen the latter approach, in part, because accumulating large amounts of capital, rather than distributing it to investors, is very expensive. Investors are placing more capital at risk and they will expect the insurer to compensate them for the increased risks and lost opportunity costs associated with the reserve. In addition, there are two major aspects of

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ Standard & Poor’s, North American Reinsurance Midyear 2006 Outlook: U.S. and Bermuda Re-insurers Face Quite Different Prospects 3, *available at* <http://www2.standardandpoors.com/spf/pdf/events/North%20American%20Reinsurance%20Midyear%202006%20Outlook%20US%20And%20Ber.pdf>.

⁸⁶ Insurance Information Institute, 2006—First Quarter Results, <http://www.iii.org/media/industry/financials/2006firstquarter/>.

⁸⁷ From year-end 2002 through year-end 2004, catastrophe bonds experienced fifty percent growth. GAO, CATASTROPHE RISK, *supra* note 62, at 6. Reportedly, the relative high cost of issuing securities in the capital markets compared to the cost of traditional reinsurance is the chief reason that insurers (and re-insurers) have been reluctant to access the capital markets. These securities will likely gain widespread acceptance as they become more commonplace, rates for traditional reinsurance rise, and insurers feel the need to off-load risks to the capital markets (which don’t suffer from the counter-party risks inherent in reinsurance).

federal tax law that make increasing capital an unattractive substitute for reinsurance. These tax costs are explained below and are also taken up in Part IV because they are the costs that the Proposed Tax Legislation attempts to reduce in order to make catastrophe insurance more affordable.

(a) The Tax Costs of Corporate Capital

One of the well known disadvantages of operating any business through a corporation⁸⁸ is that returns on “equity” generally are subject to at least two levels of federal income tax.⁸⁹ Equity, also referred to in insurance industry parlance as capital or policyholder surplus, is basically the corporation’s assets minus its liabilities. Insurers, like any other business, invest a portion of their equity and will earn a return on that investment. This return generally is taxed at the corporate level and the after-tax investment returns generally are taxed again (as a dividend or capital gains) when distributed to shareholders.

Although double taxation on investment income earned on corporate equity is not a cost that is exclusive to the insurance industry, it does have a particularly detrimental impact on P&C Insurers with risk portfolios that are heavily exposed to natural disasters. As previously discussed, these insurers must retain enormous amounts of capital to cover the risks of large, but relatively infrequent, catastrophic events. The corporate returns from investing this capital are also larger, which increase the amount of investment income subject to double taxation. As a result, P&C Insurers have higher frictional costs (because of double taxation) relative to other businesses (including other insurers) that are not required to retain large amounts of equity as a cushion for catastrophe claims.

Consider the following example:

⁸⁸ For purposes of this discussion, the term “corporation” refers to any business entity that is treated as a corporation subject to tax under Subchapter C of the Code. See I.R.C. §§ 301–318 (2000).

⁸⁹ Returns on equity may be taxed once if, for example, the investment return being distributed was tax-exempt interest. In that situation, the return would only be taxed at the shareholder level. Similarly, investment returns may be subject to multiple levels of tax if the return is distributed through multiple unrelated entities.

Example 1: Double tax on investment income

Assume Acme has a tax rate of 35% and receives \$100,000 of interest income for the year. Acme distributes its after-tax investment income to its shareholders, all of whom would be taxed on the distribution at a 15% rate. The corporation pays \$35,000 of tax and has \$65,000 to distribute to its shareholders. The shareholders pay approximately \$10,000 of tax on the distribution, and have an after-tax return of \$55,000. The tax rate on interest income earned indirectly is 45%.

Assume that the shareholders are subject to a 30% tax rate on ordinary income items. If the shareholders invested directly in the interest-bearing obligation instead of through Acme, they would have had an after-tax return of \$70,000. The tax rate on interest income earned directly is 30%.

To ensure that the shareholders receive a commensurate after-tax return, Acme must increase the amount of its premiums by at least \$28,000. The double tax cost of corporate equity will increase as retained earnings and investment returns thereon increase.

The increased tax cost of retaining large amounts of capital could be ameliorated by passing the costs on to policyholders.⁹⁰ They are, after all, the beneficiaries of the minimum surplus requirements. The problem is that state regulators are purportedly suppressing insurance rates and insurers are unable to pass the tax costs along.

The Proposed Catastrophe Reserve Legislation, discussed *infra* Part IV.A.1, could exacerbate the double tax on investment income because it requires insurers to increase their reserves, which will increase the amount of investment income subject to double taxation.

(b) The Tax Costs of Untimely Catastrophes

Under the Code, a P&C Insurer computes its taxable income on the basis of a tax year. In arriving at taxable income, it generally (1) includes in gross income all income items earned during the tax year and (2) deducts allowable expenses and losses incurred during that same period.⁹¹ In computing deductible losses, insurers may deduct the discounted value of estimated losses that they will be required to pay in the future under insurance policies currently

⁹⁰ For a discussion on who bears the incidence of the corporate tax, see MARIAN KRZYZANIAK & RICHARD M. MUSGRAVE, *THE SHIFTING OF THE CORPORATE INCOME TAX* 65-66 (1963). For a discussion on integrating the corporate and individual income tax, see U.S. DEP'T OF THE TREASURY, *INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS* (1992); ALVIN C. WARREN, JR., *AMERICAN LAW INSTITUTE, INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES: REPORTER'S STUDY OF CORPORATE TAX INTEGRATION* (1993); Fred W. Peel, *A Proposal For Eliminating Double Taxation of Corporate Dividends*, 39 *TAX LAWYER* 1 (1985).

⁹¹ I.R.C. § 11 (2000); *see also* I.R.C. § 831 (2000).

in force, including claims in dispute.⁹² In effect, this provision allows the insurer to deduct future expenses against current income and defer tax until a later year.

If otherwise deductible expenses exceed income, the excess generally constitutes a net operating loss ("NOL") that may reduce the amount of taxes a taxpayer owed in a prior tax year or will owe in a future tax year.⁹³ "Generally, a corporation must carry an NOL back 2 years prior to the year the NOL is generated, if the NOL is not used in the prior 2 years the remaining NOL can be carried forward for up to 20 years after the tax year in which the NOL was generated."⁹⁴

A P&C Insurer who covers catastrophe losses must include large profits from its insurance business as well as investment returns earned on corporate capital. The insurer may not currently deduct amounts retained to pay future claims because that deduction is only available with respect to claims under *current* policies.⁹⁵

When catastrophe losses occur, the insurer may not have sufficient income to fully use the deduction. Any unused losses can be carried back to reduce or eliminate taxable income in the two tax years preceding the tax year in which the NOL is generated. If the insurer paid taxes in either of these two tax years, the carryback may generate a refund. Given the insurer's need for increased cash flow in the wake of a catastrophe, the refund would be helpful.

Any NOLs that were not absorbed by the prior two tax years may be carried forward to reduce or eliminate the insurer's taxable income over the next twenty years.⁹⁶ Whether and when the insurer obtains the benefit of the carryforward depends on a multitude of factors, the most important of which is that the insurer must have income before it can utilize an NOL carryforward. By the time that the insurer has income, assuming it remains solvent and manages to become profitable at some point, any cash flow crunch from the catastrophic event will be over. If the insurer liquidates before using the NOL, it paid more taxes than it should have.

To illustrate, consider the following example:

⁹² I.R.C. § 832(b)(5) (2000); *see also* I.R.C. § 846 (2000).

⁹³ I.R.C. § 172 (2000).

⁹⁴ I.R.S., PUBLICATION 542: CORPORATIONS 15 (Revised Feb. 2006). *See also* I.R.C. § 172 (2000); *but see*, I.R.C. § 831(b)(3) (2000) (limiting carry back of NOL). A corporation can make an election to waive the two-year carry back period and use only the twenty-year carry forward.

⁹⁵ *Cf.* I.R.C. § 832(b)(5) (2000).

⁹⁶ I.R.C. § 172(b)(1)(A) (2000). From a liquidity and time value of money perspective, insurers generally prefer to carry back the NOL because a refund could increase much-needed cash flow in the aftermath of a mega-catastrophe.

Example 2: Tax cost of untimely disasters

In each of the ten years preceding Hurricane Katrina, Acme generated \$5 million of taxable income from underwriting homeowners multiple peril risks in Louisiana. Acme is in the 35% tax bracket and has paid federal income tax of approximately \$17.5 million.

In 2005, Acme paid \$450 million in Katrina claims. To keep it simple, assume that Acme's taxable income and deductible expenses offset each other. Acme is insolvent and is forced to liquidate in 2006.

Acme may carry back \$10 million of losses to its last two tax years and will receive a refund of \$3.5 million for taxes it paid in those two years. The remaining \$440 million in losses cannot be used in the future.

Acme paid net taxes of \$14 million on profits that it ultimately lost from its operations in Louisiana.

As discussed, catastrophe insurers generally pay higher taxes in years without catastrophes and may not have sufficient income to fully deduct catastrophe losses when incurred. Increased tax costs (including increased tax costs from investment returns, discussed above) are typically passed along to policyholders by increasing premiums, which further increases the tax on P&C. Insurers in years without substantial catastrophe losses. Increased tax costs also impair the insurer's ability to grow capital through retained earnings—growth that reduces the cost of catastrophe insurance either because it increases investor returns (which makes investment in catastrophe insurers more attractive) or increases capacity.

The Proposed Catastrophe Reserve Legislation, discussed *infra* Part IV.A.1, would reduce the tax cost of untimely disasters by allowing the insurer to take a current deduction for amounts set aside in reserves for future catastrophes.

(c) Regulatory Restrictions and Residual Insurance Markets

By way of background, insurance rates generally are either fixed by state regulators or subject to their approval.⁹⁷

⁹⁷ A detailed discussion of state regulation of insurance rates is beyond the scope of this Article. States may regulate or require approval of rates and charges for insurance companies doing business within its borders. LEE R. RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE § 2:31 (3d ed. 2005). In some states, the insurance regulator determines the insurance rates. In others, the insurance company submits a schedule to the regulator setting the rate, subject to approval. Rate approvals in these states generally come in two varieties—open competition and prior approval. In prior approval states, the insurer must file proposed rate changes with the state regulator before putting them into effect. In open competition states, the insurer may put new rates into effect without prior approval, but the insurance regulator may disapprove the rate request.

While the regulatory processes in each state vary, three principles guide every state's rate regulation system: that rates must be adequate (to maintain insurance company solvency), but not excessive (not so high as to lead to exorbitant profits), nor unfairly discriminatory (price differences must reflect expected claim and expense differences). Recently, in auto and home insurance, the twin issues of availability and affordability, which are not explicitly included in the guiding principles, have been assuming greater importance in regulatory decisions.⁹⁸

There is considerable debate over whether state regulators have used these twin issues to suppress insurance rates in At-Risk Markets. Although a working group within the National Association of Insurance Commissioners dismisses as mere "rhetoric"⁹⁹ the notion that regulators are engaging in price controls, there are many who think otherwise.¹⁰⁰

Even if states are not suppressing insurance rates *de jure*, there is ample empirical and anecdotal evidence to support the fact that *de facto* price controls exist. For example, a 2005 report prepared by the Florida Office of Insurance Regulation suggests that Citizens Property Insurance Corporation ("Citizens"), a state-sponsored insurer, is competing with private insurers for market share.¹⁰¹ Citizens is suppressing insurance rates by offering broader coverage at cheaper prices than its counterparts in the private market. If P&C Insurers are unable to charge risk-based premiums, then the use of premiums as a funding mechanism fails.

2. *Private Market's Economics and Post-Katrina Results Summarized*

By law, private insurers must ensure that their capital base is aligned with the risks assumed. By necessity, they also must pay an appropriate profit to their investors. Private insurers ensure that their capital bases are aligned with risks assumed by shifting peak risks to third parties *ex ante* and maintaining state-mandated reserves for a portion of the retained risks. These techniques are expensive and the added costs of assuming a particular type of peril in an At-Risk Market should be reflected in the cost of insurance in that particular market. However, some states have precluded private insurers from charging

⁹⁸ Insurance Information Institute, *supra* note 61.

⁹⁹ Nat'l Assoc. of Ins. Comm'rs, *Personal Lines Regulatory Framework* (Draft, 2006), available at http://www.naic.org/documents/committees_models_framework.doc.

¹⁰⁰ According to the Insurance Information Institute, "Regulators have . . . [created a] system of artificial price controls on homeowners insurance policies in Florida and other states [which] is largely responsible for the current availability problems and recent rapid growth in markets of last resort." Insurance Information Institute, *supra* note 86.

¹⁰¹ FLA. OFFICE OF INS. REGULATIONS, *THE PROPERTY INSURANCE MARKET IN FLORIDA 2004: THE DIFFERENCE A DECADE MAKES* 34 (2005). The report also suggests that "it is the nature of the risk, not the regulatory process that drives the property market in Florida." *Id.* Anecdotaly, Edward Liddy, CEO of AllState, said "[i]f you talk to someone from Florida, they say, 'Boy, in the last five years, my home has gone up 80% in value,' . . . But if you ask them, 'Well, are you paying 80% more for your insurance?' they would say, 'Oh, no! I only want to pay 8% more.' There's a disconnect." John Simons, *Risky Business*, FORTUNE, Nov. 2, 2006, available at http://money.cnn.com/magazines/fortune/fortune_archive/2006/09/04/8384736/index.htm.

actuarially sound rates de jure (by regulating insurance rates) and de facto (residual insurers competing with below-market rates).

Having learned their lesson after Hurricane Andrew, most private insurers chose to retreat rather than compete with residual market insurers in peak risk markets. This strategy paid off: most P&C Insurers rebounded quickly from the 2004–2005 Atlantic hurricane seasons.

Despite record catastrophe claims in 2005, private insurers posted an overall after-tax profit of approximately \$43 billion.¹⁰² Ten months after Hurricane Katrina devastated the Gulf Coast, market analysts forecasted a “stable” outlook for the industry and the relative financial strength of the vast majority of P&C Insurers was considered strong.¹⁰³ Three months later, insurers were reportedly expecting record high profits in 2006.¹⁰⁴

The discussion now turns to the residual insurance market, with an emphasis on understanding how the regulatory and economic environment of supplying government-sponsored insurance is markedly different from private insurance. The discussion also explains how this approach to delivering insurance fared after being tested by the 2004–2005 Atlantic hurricane season.

D. *The Residual Insurance Market for Catastrophe Losses*

1. *Overview*

The first place a property owner or a primary insurer would seek insurance (or reinsurance) is through the private market. As the last section demonstrates, access to insurance and reinsurance may be limited or nonexistent in At-Risk Markets. In this case, the residual market may provide a viable alternative to the private market. Thirty-two states and the District of Columbia have created state-sponsored residual insurance markets that make insurance, and in some cases reinsurance, available.¹⁰⁵ Generally, coverage is available to those living in peak risk areas.

¹⁰² FLA. OFFICE OF INS. REGULATIONS, *supra* note 101, at 36. Joseph B. Treaster, *Earnings for Insurers Are Soaring*, N.Y. TIMES, Oct. 14, 2006, at C1, *available at* <http://www.nytimes.com/2006/10/14/business/14insure.html?ex=1318478400&en=23e68b2119666a09&ei=5088&partner=rssnyt&emc=rss>.

¹⁰³ *See, e.g.*, STANDARD & POOR’S, *supra* note 14. In fact, one analyst, Standard and Poor’s (S&P), concluded that ninety percent of the S&P-rated groups or companies that are predominately in the business of providing personal lines insurance had a financial strength rating of “A” or higher and only ten percent rated “BBB” or lower. Of the S&P-rated groups or companies in the commercial lines insurance business, the median financial strength was A-rated. *Id.* S&P’s financial strength ratings refer to its “current opinion of the financial security characteristics of an insurance organization with respect to its ability to pay under its insurance policies and contracts in accordance with their terms.” Standard & Poor’s, *Insurer Financial Strength Rating Definitions*, <http://www2.standardandpoors.com/spf/pdf/fixedincome/IFSDDefinitions.pdf>. The highest rating is “AAA.” “An insurer rated ‘A’ has STRONG financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.” *Id.* “An insurer rated ‘BBB’ or higher is regarded as having financial security characteristics that outweigh any vulnerabilities, and is highly likely to have the ability to meet financial commitments.” *Id.*

¹⁰⁴ Treaster, *supra* note 102.

¹⁰⁵ Note:

Despite being tax-exempt and having no profit load, residual market insurers are rarely self-sufficient. If the rates charged to policyholders are insufficient to cover claims, private insurers doing business in the state generally are assessed the shortfall and they pass the assessment on to their policyholders throughout the state.

The discussion below highlights some of the challenges facing one state—the state of Florida—as it attempts to supply affordable property insurance and reinsurance in an At-Risk Market. Examining Florida’s residual insurance mechanisms is useful on many levels; particularly because Florida has had more than ten years to ruminate on the 1992 failure of the private insurance industry and how its response to that failure—no matter how well-intended, now threatens the viability of the entire state. The discussion then turns to the federal government’s entry into the residual insurance market through the National Flood Insurance Program.

2. *Florida’s Residual Insurance Market Mechanisms*

Hurricane Andrew struck Florida in 1992. It remains the largest, most expensive natural disaster the state of Florida has ever experienced. Andrew’s wrath ravaged more than the property and the lives that it touched. Its wake left Florida’s residential property insurers and re-insurers with “cold feet and empty pockets.”¹⁰⁶

Andrew left twelve insurance companies insolvent.¹⁰⁷ Those that survived began planning the fastest route out of Florida’s catastrophe insurance business. Florida found itself in an insurance crisis and the State legislature stepped in to fill the gaps left by the private market. What evolved is a comprehensive two-tiered state-sponsored insurance and reinsurance system designed to provide primary insurance to those who are unable to secure it privately and to provide a form of reinsurance to private insurers.

a. *Citizens*

Citizens appears to function much like a private insurer. It insures a certain pool of policyholders against the risk of future perils in exchange for a premium paid today. Once past that veneer, Citizens is nothing like a private insurer.

Residual market mechanisms include assigned risk plans, pursuant to which insurers are assigned the underwriting risk for a proportionate share of applicants unable to obtain coverage in the voluntary market, reinsurance facilities, whereby losses [sic] incurred by insurers assuming substandard risks are pooled with other insurers, joint underwriting associations, which issue policies through servicing carriers that service policies and adjust claims for a fee, however, losses are born by the association which in turn makes assessments on all insurers that are required to participate, or “competitive funds,” which directly provide insurance for those excluded from the voluntary market.

RUSS & SEGALLA, *supra* note 97, at § 2:35 (internal citations omitted).

¹⁰⁶ Lynn Waddell, *Rising Insurance Rates Push Florida Homeowners to Brink*, N.Y. TIMES, June 29, 2006, available at <http://www.nytimes.com/2006/06/29/us/29florida.html?ex=1309233600&en=c24bc7f781bfada6&ei=5088&partner=rssnyt&emc=rss>.

¹⁰⁷ FLA. OFFICE OF INS. REGULATIONS, *supra* note 101, at 22.

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For one thing, Citizens is a non-profit corporation that was formed by the Florida Legislature.¹⁰⁸ Because it is a non-profit, it does not have to generate a profit to return to investors for use of capital, a substantial cost savings, as compared to a private insurer. It is also tax-exempt, which means that it generally does not pay federal taxes—a reported savings of over a \$100 million.¹⁰⁹ Citizens may issue tax-exempt bonds to cover catastrophe losses. This feature allows it to finance mega-catastrophe losses at a very low interest rate, reducing financing costs by hundreds of millions of dollars.¹¹⁰ All totaled, the tax and capital cost savings (along with investment returns on investing those savings) are substantial and can be used as a cushion to offset future claims.

For another thing, Citizens is not free to choose whom it insures. Citizens' purpose is to operate insurance plans that function exclusively as residual market mechanisms to generally provide property insurance coverage to Floridians who are unable to find coverage in the private market.¹¹¹ In other words, Citizens is required by law to assume risks that private insurers regard as uninsurable.¹¹²

Although Citizens generally funds claims like any other private insurer (net premium and investment income), it is not required to maintain a minimum amount of capital or policyholder surplus, as is the case for private insurers. Essentially, it is a pay-as-you-go system, funding losses with current premiums. If there is a deficit in any given year, Citizens may offset the deficit by assessing insurers authorized to write one or more subject lines of business in the state, levying a surcharge on policyholders, or issuing tax-exempt bonds.¹¹³ If an insurer is assessed, it is typically passed along to policyholders throughout the State of Florida.

¹⁰⁸ Note:

The Florida Residential Property Casualty Joint Underwriting Authority (FRPCJUA) was created to provide a public/private response to the deterioration of insurance availability in the private market following Hurricane Andrew. As well, the Florida Windstorm Underwriting Association (Windpool), established in 1972, offered wind-only coverage in limited coastal areas to those who could not acquire it in the private market. By year-end 1995, the FRPCJUA had about 850,000 policies in force. By year-end 1999, the Windpool had roughly 500,000 policies in force with a combined exposure of almost \$86.5 billion. In 2002, these two entities were merged to create Citizens.

TASK FORCE ON LONG-TERM SOLUTIONS, *supra* note 13, at 14.

¹⁰⁹ Insurance Information Institute, Residual Markets, August 2007, <http://iii.org/media/hottopics/insurance/residual/>.

¹¹⁰ *Id.*

¹¹¹ Citizens requires applicants and agents to sign an affidavit on the application that they do not have a voluntary insurer that will insure them. FAQs About Eligibility for Coverage with Citizens 1, available at <http://www.floir.com/pdf/FAQsUF.pdf>.

¹¹² See S.B. 1980, 2006 Leg., Reg. Sess. (Fla. 2006). For an analysis of some provisions, see DAVID B. REDDICK, NAT'L ASS'N OF MUTUAL INS. COS., THE 2006 FLORIDA LEGISLATIVE SESSION: WINNERS AND LOSERS IN THE PROPERTY INSURANCE DEBATE (2006), available at <http://www.namic.org/insbriefs/060515Florida.pdf>.

¹¹³ FLA. STAT. § 627.351(6)(b)(1) (2006).

Until 2007, Citizens was not permitted to compete with its for-profit counterparts in the insurance business. In fact, Citizens was mandated to be the provider of last resort, to charge noncompetitive rates, and to pay a bonus to private insurers who take its customers (so-called “depopulation efforts”).¹¹⁴ That did not happen.

The Task Force on Long-Term Solutions for Florida’s Hurricane Insurance Market (“Task Force”) released a report on March 6, 2006, in which it found, *inter alia*, that Citizens has not always operated as an insurer of last resort.¹¹⁵ In fact, it may be the only insurer for Floridians in certain markets.¹¹⁶

Despite depopulation efforts, Citizens became the single largest property insurer in the State of Florida in 2006, with approximately 1.2 million policyholders and an exposure to loss in the hundreds of billions of dollars.¹¹⁷ The Task Force warned the Florida Legislature that the “growth trends of Citizens could jeopardize the economic viability of the state of Florida and impact all Floridians with respect to the affordability and availability of insurance.”¹¹⁸

Although Citizens’ rates were required to be noncompetitive, many considered its rates too low. In response, the Florida Legislature required Citizens to raise its rates in 2006 to ensure that its rates were actuarially sound and exceeded the top twenty insurers in the market.¹¹⁹

In January 2007, the Florida legislature convened a special session to address the current insurance crisis. The legislature passed a bill that, among other things, deletes the requirement that Citizens not compete with the private market, allows Citizens to charge rates that are lower than the top twenty private insurers in the market and freezes Citizens’ insurance rates at their 2006 levels.¹²⁰ Florida Representative Don Brown, chairman of the Florida insurance committee, described the measure as “the most irresponsible measure that I

¹¹⁴ When Citizens was formed, the Florida Legislature made it clear that it intended “that the rates for coverage provided by [Citizens] be actuarially sound and not competitive with approved rates charged in the admitted voluntary market such that [Citizens] functions as a residual market mechanism to provide insurance only when the insurance cannot be procured in the voluntary market.” FLA. STAT. § 627.351(2)(b)(5)(b) (2006).

¹¹⁵ TASK FORCE ON LONG-TERM SOLUTIONS, *supra* note 13, at 42.

¹¹⁶ According to the Insurance Information Institute, as of August 2006, “Citizens is the only insurer currently writing coverage for mobile homes. There are about 800,000 mobile homes in Florida, according to the latest data from the U.S. Census.” Insurance Information Institute, Residual Markets, December 2006, http://www.ct.gov/cid/lib/cid/app12_itt2006.pdf.

¹¹⁷ Citizens was the second largest insurer, but earned the top position following the transfer of approximately 330,000 policies from the liquidation of Florida’s third-largest insurance group. *Id.*

¹¹⁸ TASK FORCE ON LONG-TERM SOLUTIONS, *supra* note 13, at 41.

¹¹⁹ Linda Kleindienst & Kathy Bushouse, *Florida Legislature Passes Bill to Lower Insurance Rates*, THE SUN SENTINEL, January 23, 2007, <http://www.ccfj.net/insbillpassed>. In 2007, the Florida legislature repealed the 2006 rate increase.

¹²⁰ FLA. SENATE COMM. ON BANKING AND INS., 2007—A SPECIAL SESSION: SUMMARY OF LEGISLATION PASSED (2007), available at <http://www.flsenate.gov/Publications/2007A/Senate/reports/summaries/pdf/sessum07A.pdf>.

ever was asked to vote on.”¹²¹ Representative Brown was responsible for one of only two votes in the Florida House against the measure.

b. Florida Hurricane Catastrophe Fund

The Florida Hurricane Catastrophe Fund (“FHCF”) is a tax-exempt entity created by the Florida Legislature to provide a form of protection similar to reinsurance for catastrophic hurricane events.¹²² The FHCF is mandatory for residential property insurers writing covered policies in the state of Florida. The costs are substantially lower than what an insurer would pay if it procured reinsurance in the private market.

Until 2007, FHCF provided coverage of up to \$15 billion in losses above an industry retention level of \$4.5 billion in losses, generally determined on a per event basis.¹²³ In effect, the industry was responsible for the first \$4.5 billion in losses, some portion of the next \$15 billion in losses (depending on the insurers collective level of participation), and any losses in excess of the \$15 billion. Insurers used some of the techniques described above (private reinsurance, securitizations, etc.) to reduce exposure for the retention amounts.

In January of 2007, the Florida Legislature increased FHCF’s funding limits from \$16 billion to \$28 billion.¹²⁴ FHCF has approximately \$1 billion in reserves and has assumed catastrophe risk exposure of more than thirty times that amount. As described below, FHCF has no real means to increase its reserves.¹²⁵

FHCF is financed by three sources: premiums charged to participating insurers, investment earnings, and emergency assessments on Florida property and casualty insurers. In 2006, the Florida legislature passed a measure that required FHCF to raise its premiums and recapitalize its reserves.¹²⁶ The 2007 legislation repealed that requirement in an effort to allow insurers to reduce policyholders’ insurance costs by approximately three percent.¹²⁷

3. The National Flood Insurance Program

Private and residual market insurers typically do not provide flood insurance. Instead, property owners rely on the National Flood Insurance Program (“NFIP”), which makes federally backed flood insurance available to

¹²¹ Peter Whoriskey, *Florida’s Big Hurricane Gamble; To Cut Insurance Rates, State Pledges Billions for Future Claims*, WASH. POST, Feb. 20, 2007, at A2.

¹²² FLA. STAT. § 215.555(1)(e) (2006) (FHCF’s purpose is “to provide a stable and ongoing source of reimbursement to insurers for a portion of their catastrophic hurricane losses [in order to provide] additional insurance capacity [for the] state.”).

¹²³ Industry retention levels vary depending on the year the losses are incurred and the number of hurricanes giving rise to the loss. STATE BD. OF ADMIN. OF FLA., FLORIDA HURRICANE CATASTROPHE FUND: FISCAL YEAR 2004-2005 ANNUAL REPORT 11, available at <http://www.sbafla.com/fhcf/pdf/reports/2004-05%20Final.pdf>.

¹²⁴ See FLA. SENATE COMM. ON BANKING AND INS., *supra* note 120 at 3.

¹²⁵ National Association of Mutual Insurance Companies, *Private Market is Best Mechanism to Address Coastal Insurance Issues*, NAMIC CEO Tells Congress, NAMIC Online, April 11, 2007, available at <http://www.namic.org/newsreleases07/070411nr1.asp>.

¹²⁶ FLA. SENATE COMM. ON BANKING AND INS., *supra* note 120, at 2.

¹²⁷ *Id.*

homeowners, renters, and business owners in communities that participate in the NFIP.¹²⁸ The NFIP is managed by the Mitigation Division of the Federal Emergency Management Agency (“FEMA”), an agency within the Department of Homeland Security.

The NFIP functions much like a private insurer. It insures a certain pool of policyholders against the risk of a specific peril (flood) in exchange for a premium paid today. Flood insurance premiums vary depending on the risk and the level of coverage desired. The premiums can be very inexpensive—as low as \$112 per annum in 2006. Nevertheless, a February 2006 study conducted by the Rand Corporation and the NFIP revealed that flood insurance is underutilized.¹²⁹ Approximately half of all single family homes (“SFHs”) in special flood hazard areas (“SFHAs”) have flood insurance and only one percent of SFHs outside of SFHAs have flood insurance.¹³⁰

The NFIP has been self-sufficient for *average* loss years. In other words, it pays claims and expenses with premium income.¹³¹ If there is a deficit, the NFIP has authority to borrow funds, up to a statutory cap, from the U.S. Treasury. Amounts borrowed must be repaid with interest.

NFIP claims arising from Hurricanes Katrina and Rita are estimated at \$23–\$25 billion.¹³² Congress increased the NFIP’s borrowing authority three times in six months,¹³³ but it still does not have sufficient funds to pay all outstanding claims without another increase.¹³⁴ “In the absence of additional borrowing authority, FEMA would eventually advise those insurance companies participating in the NFIP ‘Write-Your-Own’ program (companies that sell flood policies on FEMA’s behalf) that due to the absence of borrowing authority, the companies should stop processing claims.”¹³⁵ Homeowners who are not paid could initiate legal action against the U.S. Government.

¹²⁸ Homeowners who have a federally backed mortgage secured by a home located in a high-risk area are required by federal law to purchase flood insurance. In addition, property owners who have received a federal grant for previous flood losses must have a flood policy to qualify for future aid. FloodSmart.gov, What is Flood Insurance?, <http://www.floodsmart.gov/floodsmart/pages/whatfloodins.jsp>.

¹²⁹ LLOYD DIXON ET AL., THE NATIONAL FLOOD INSURANCE PROGRAM’S MARKET PENETRATION RATE: ESTIMATES AND POLICY IMPLICATIONS (2006), *available at* http://www.fema.gov/pdf/nfip/market_pen.pdf.

¹³⁰ *Id.* at xiii.

¹³¹ FLOOD INSURANCE REFORM AND MODERNIZATION ACT OF 2006 REPORT 2 (2006) [hereinafter FLOOD INSURANCE LEGISLATIVE REPORT].

¹³² *Id.*

¹³³ Note:

On September 20, 2005, the President signed into law the National Flood Insurance Enhanced Borrowing Authority Act of 2005 (P.L. 109-65), which authorized the NFIP temporarily to borrow up to \$3.5 billion from the U.S. Treasury to pay claims. H.R. 4133, signed into law by the President on November 21, 2005, as P.L. 109-106, further increased FEMA’s borrowing authority to \$18.5 billion. A third borrowing authority increase (S. 2275) was signed into law on March 23, 2006 (P.L. 109-208) and increased FEMA’s borrowing authority to \$20.775 billion.

Id.

¹³⁴ *Id.*

¹³⁵ *Id.* at 2–3.

4. *Residual Market's Economics and Post-Katrina Results Summarized*

Unlike private insurers, residual market insurers need not ensure that their capital base is aligned with the risks assumed. They operate like a pay-as-you-go system with no state-mandated reserves. If there is a shortfall, the state residual market insurers shift assumed risks to private insurers at little or no cost, generally by way of insurance assessments. NFIP covers its shortfalls with taxpayer-financed debt. In addition, residual market insurers are able to keep the price of insurance low because they do not have profit loads and are tax-exempt. These significant cost-savings could be passed along to reduce the cost of insurance.

Having established that it could deliver catastrophe insurance cheaply, residual market insurers operating in states tested by the 2004–2005 Atlantic hurricane season proved something else. Their below-market pricing strategy was irresponsible. As of the time of this writing, the National Flood Insurance Program remains insolvent.

Citizens and FHCF were able to pay claims only after receiving massive capital infusions from the State of Florida.¹³⁶ Similarly, the Texas Windstorm Insurance Association¹³⁷ and Louisiana Citizens Property Insurance Corp.¹³⁸ could not satisfy claims out of current premiums and had to cover enormous deficits by, inter alia, assessing the private insurance industry.

E. *Uncle Sam and his State and Local Counterparts: The Insurers of Last Resort*

This section explains the notion of ex post disaster insurance—recovering property losses from the insurers of last resort—and considers the efficiency of managing risks through this mechanism.

To provide context, assume that a property owner decides, for whatever reason, not to purchase insurance for his home through the private or residual markets. Alternatively, assume that he has private insurance, but that he has agreed to carve out coverage for windstorm damage to make premiums more affordable. An uninsured or underinsured property owner may be able to recover property losses from the insurers of last resort: federal, state and local governments.

¹³⁶ Citizens faced an estimated \$1.7 billion dollar deficit. To ameliorate the deficit, the Florida legislature appropriated \$715 million to Citizens from its general revenue funds. The balance will be covered, in part, by assessing in-state, private insurers, who, in turn, will pass along the assessment to policyholders in the form of a one-time surcharge applied to annual premiums. This creates a cross-subsidy from low- to high-risk policyholders within the state and distorts the true cost of insurance, which distorts incentives for loss control and loss mitigation. INSURANCE INFORMATION INSTITUTE, *RESIDUAL MARKET PROPERTY PLANS: FROM MARKETS OF LAST RESORT TO MARKETS OF FIRST CHOICE* 22 (2007), available at http://server.iii.org/yy_obj_data/binary/774480_1_0/ResidualMarketWhitePaper.pdf.

¹³⁷ *Texas Windstorm Insurance Association: Challenges and Solutions*, INS. J. (May 8, 2006), available at <http://www.insurancejournal.com/magazines/southcentral/2006/05/08/currents/>.

¹³⁸ STEVE J. THERIOT, LOUISIANA CITIZENS PROPERTY INSURANCE CORP.—ASSESSMENT 1 (2006), available at [http://app1.la.state.la.us/PublicReports.nsf/E1C69E22CD5D9C548625723C0079288C/\\$FILE/0000083E.pdf](http://app1.la.state.la.us/PublicReports.nsf/E1C69E22CD5D9C548625723C0079288C/$FILE/0000083E.pdf).

The government has been in the insurance business for nearly 250 years. Through a labyrinth of disaster assistance programs and tax breaks (collectively, "Disaster Relief"),¹³⁹ federal, state, and local governments play the role of insurer of last resort to the insured, underinsured, and uninsured.

In many respects, Disaster Relief is a lot like traditional forms of insurance: a person who sustains a covered loss is partially compensated for that loss. If there are gaps in coverage left by exclusions, deductibles or caps, Disaster Relief can serve as a form of co-insurance. For those without insurance, or those with policies that carve out a particular peril, Disaster Relief is akin to primary insurance.

Disaster Relief and traditional insurance vehicles are not without their differences. For example, Disaster Relief comes in many forms, including government grants, below market loans, deep discounts on property sales and tax breaks. In addition, most forms of Disaster Relief only cover losses caused by a major disaster, whereas relief under an insurance policy is available once a covered loss exceeds the policyholder's deductible, regardless of the size of the event involved.

What follows is a comparison between the types of disaster losses covered under a typical homeowner multiple peril policy and those covered by Disaster Relief available at the federal level.¹⁴⁰

1. *Typical Homeowners Policy*

In the event of an insured disaster, a standard homeowners multiple peril policy will pay to repair or replace a home and personal property damaged or destroyed in a covered disaster. The policy also covers any additional living expenses incurred if the policyholder is temporarily unable to live in his or her home because of the insured disaster. Such expenses include meals and hotel bills. All amounts paid are subject to any agreed deductibles and caps.

A covered disaster generally includes events such as fire, lightning, windstorm, and hail. Damage caused by floods and earthquakes are generally covered under a separate policy.

2. *Disaster Relief for Insured, Underinsured and Uninsured*

The President's declaration of a major disaster sets in motion most long-term federal programs delivering federal Disaster Relief.¹⁴¹ FEMA leads the federal response and recovery efforts following a national disaster, but federal Disaster Relief may be available from other federal departments and agencies,

¹³⁹ The term "Disaster Relief" generally refers to direct and indirect governmental subsidies. It does not include the NFIP (discussed *supra* Part II.D.3) or any amounts paid under a policy issued by the NFIP.

¹⁴⁰ A detailed survey of all Disaster Relief is beyond the scope of this Article. For a more detailed discussion, see Francine Lipman, *Anatomy of a Disaster Under the Internal Revenue Code*, 6 FLA. TAX REV. 953 (2005).

¹⁴¹ In contrast, a Presidential Emergency Declaration is of limited scope and does not trigger the same long-term federal recovery programs as a Major Disaster Declaration. Robert T. Stafford Disaster Relief and Emergency Assistance (Stafford) Act, Pub. L. No. 93-288 §§ 501-502, 88 Stat. 143 (1974) (codified as amended at 42 U.S.C. §§ 5191-5192 (2006)).

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including the U.S. Department of Housing and Urban Development,¹⁴² the U.S. Small Business Administration,¹⁴³ and the U.S. Department of Agriculture's Rural Development.¹⁴⁴

The most significant federal Disaster Relief is provided by FEMA and the Internal Revenue Service and is described below.

a. Department of Homeland Security, FEMA

FEMA provides disaster grants to help meet serious disaster-related needs and necessary expenses not covered by insurance and other aid programs. Covered expenses include grants to repair or replace a home and personal property damaged or destroyed in a covered disaster.¹⁴⁵ Homeowners may also secure grants to cover the cost of temporary housing, moving, and storage expenses.¹⁴⁶

b. Tax Breaks

The Code contains a number of tax expenditures that, inter alia, compensate for catastrophe losses. Tax expenditures are government incentives and subsidies made through the Code to accomplish a specific economic or social policy.¹⁴⁷

¹⁴² In addition to providing emergency assistance (including temporary housing), HUD may provide assistance to catastrophe survivors by facilitating a foreclosure moratorium on FHA-insured loans in Presidentially-declared disaster areas, advancing mortgage payments for up to 12 months for eligible borrowers, and selling homes at a discount to disaster victims. See, e.g., Press Release, U.S. Dep't of Housing and Urban Development, HUD Announces 120-Day Extension of Foreclosure Moratorium to Assist Hurricane Victims in the Gulf Coast Area (Feb. 27, 2006), available at <http://www.hud.gov/news/release.cfm?content=pr06-022.cfm>; Press Release, U.S. Dep't of Housing and Urban Development, HUD to Sell Homes at a Discount to Disaster Victims (Apr. 6, 2006), available at <http://www.hud.gov/news/release.cfm?content=pr06-046.cfm>.

¹⁴³ The SBA provides low interest loans to renters and homeowners who have suffered property damage in a declared disaster area. Homeowners may borrow up to \$240,000 (\$200,000 for primary residence and \$40,000 for personal property) and renters may borrow up to \$40,000 (for personal property) to replace or repair property to its pre-disaster condition. The amount of loan that an individual is eligible to receive generally is limited to the cost to repair and replace property to pre-disaster condition and is reduced by (1) reimbursements from property and casualty insurance and (2) any grants or other subsidies that the applicant received with respect to the property. U.S. Small Business Admin., Disaster Assistance: Home and Personal Property Loans, <http://www.sba.gov/services/disasterassistance/homeownersrenters/homeandpersonal/index.html>.

¹⁴⁴ There are many additional programs not described in the text that are designed to assist catastrophe victims with matters unrelated to uninsured property losses. These programs include food, crisis counseling, disaster-related unemployment assistance, and legal aid.

¹⁴⁵ FEMA, Disaster Assistance Available from FEMA, <http://www.fema.gov/assistance/process/assistance.shtm>.

¹⁴⁶ If temporary housing is unavailable, FEMA will provide a housing unit. *Id.*

¹⁴⁷ Tax expenditures are defined as federal "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 3(3), 88 Stat. 297.

Rather than providing a cash or in-kind benefit like the ones discussed above, tax expenditures generally reduce the amount of tax that a taxpayer would otherwise have to pay under normal tax rules. Tax expenditures come in different forms, including deductions, credits, exclusions, exemptions, deferrals, and preferential tax rates.

Originally enacted in 1867, the deduction for personal casualty losses is one of the oldest tax subsidies for individuals who sustain certain uninsured property losses.¹⁴⁸ An exception to the general rule that personal losses are nondeductible,¹⁴⁹ the deduction applies to personal-use property losses arising from “fire, storm . . . or other casualty.”¹⁵⁰ The legislative history is silent as to the policy justification for its enactment, but there is a strong inference that the provision was enacted because taxpayers suffering casualty losses have a reduced ability to pay an income tax.¹⁵¹ Regardless of the rationale, the provision makes the government the primary insurer or coinsurer of uninsured losses to non-income producing property held for personal use in certain instances.¹⁵²

The starting point for determining the deduction is to calculate the amount of the loss, which is the difference between the value of the property damaged or destroyed immediately before and immediately after the casualty,¹⁵³ but no more than the adjusted basis of the property.¹⁵⁴ The loss is reduced by a \$100 deductible (“\$100 Floor”)¹⁵⁵ and reimbursements from insurance and other sources.¹⁵⁶ Net personal casualty losses for the taxable year (personal casualty

¹⁴⁸ H.R. 1161, 39th Cong., 2d Sess. § 13, 14 Stat. 471, 477 (1867).

¹⁴⁹ “Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal . . . expenses.” I.R.C. § 262(a) (2000).

¹⁵⁰ I.R.C. § 165(c)(3) (2000).

¹⁵¹ COMPTROLLER GEN. OF THE U.S., THE PERSONAL CASUALTY AND THEFT LOSS DEDUCTION: ANALYSIS AND PROPOSALS FOR CHANGE (1979), *available at* <http://archive.gao.gov/d46t13/111188.pdf>. The legislative history of subsequent amendments to the casualty loss deduction supports the inference. *See, e.g.*, S. Rep. No. 88-830, at 57 (1964), *reprinted in* 1964-1 C.B. 505 (deduction applies to those casualty and theft losses that have a “significant effect upon an individual’s ability to pay Federal income taxes.”), S. Rep. No. 97-494, at 115 (1982) (referring to a taxpayer’s “ability to pay” five times).

¹⁵² COMPTROLLER GEN. OF THE U.S., *supra* note 151.

¹⁵³ Treas. Reg. § 1.165-7(b)(1)(i) (as amended in 1977).

¹⁵⁴ Treas. Reg. § 1.165-7(b)(1)(ii) (as amended in 1977). Adjusted basis generally is the cost of personal-use property, if acquired by purchase. I.R.C. § 1012 (2006); *but see* I.R.C. § 1016 (2006). If the property was acquired in another way (i.e., by gift, inheritance, or other non-recognition event), adjusted basis is computed differently. *See, e.g.*, I.R.C. §§ 1014-1016 (2006).

¹⁵⁵ The \$100 Floor is applied on a per casualty event basis, not with respect to each piece of personal-use property damaged or destroyed in the casualty. I.R.C. § 165(h)(1) (2000).

¹⁵⁶ I.R.C. § 165(a) (2000). If the taxpayer has insurance, the taxpayer must file a timely claim to take the deduction. I.R.C. § 165(h)(4)(E) (2000). Gifts, donations, and disaster relief payments may constitute reimbursements which reduce the amount of the casualty loss if they are specifically designated for the purpose of restoring and rehabilitating property loss or damage in the disaster. *See* I.R.S., PUBLICATION 547: CASUALTIES, DISASTERS AND THEFTS 5 (2005). *See also* JOHN C. MCCOY, TAX MANAGEMENT: PORTFOLIOS – LOSS DEDUCTIONS, at A-84.

losses over casualty gains) are reduced by another deductible equal to 10% of adjusted gross income (“10% Floor,” and together with the \$100 Floor, “Casualty Loss Floors”).¹⁵⁷ The Casualty Loss Floors do not apply to personal casualty losses arising in a Hurricane Katrina disaster area, Hurricane Rita disaster area, or a Hurricane Wilma disaster area if such losses are attributable to Hurricanes Katrina, Rita or Wilma, as the case may be.¹⁵⁸

The loss must be deducted, if at all, in the year sustained.¹⁵⁹ However, losses attributable to certain disasters may be deducted in the tax year preceding the disaster if the taxpayer so elects.¹⁶⁰ If the allowable casualty loss exceeds the taxpayer’s income, the taxpayer would derive limited or no benefit from the personal casualty loss deduction.

3. *Uncle Sam’s Economics and Post-Katrina Results Summarized*

It would appear that federal, state, and local governments would be in the best position to manage the risk of a mega-disaster. After all, the federal government “can shift risk, spread risk or reduce risk directly.”¹⁶¹

Although the government may be in the best position to manage risks, it does not mean that it does so efficiently. Disaster Relief is delivered through different levels of government and, within each level of government, through different agencies. The system is complex, disorganized, discriminatory, and inefficient, primarily because it lacks transparency.¹⁶² Defrauding the

¹⁵⁷ I.R.C. § 165(h)(2) (2000).

¹⁵⁸ Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, 199 Stat. 2577, 2605 (2005).

¹⁵⁹ Treas. Reg. § 1.165-1(d)(1) (as amended in 1977).

¹⁶⁰ A taxpayer may make this election with respect to losses arising from a disaster that warrants assistance under the Robert T. Stafford Disaster Relief and Emergency Act. I.R.C. § 165(i) (2000). The benefit is that the taxpayer may have more taxable income in the prior year to absorb the loss and trigger a refund.

¹⁶¹ Diane Francis, *Let’s Praise the Insurer of Last Resort: Governments Cover Risk that the Private Sector Can’t—or Won’t*, FIN. POST, Jan. 3, 2006 (quoting Professor David Moss), available at <http://www.canada.com/nationalpost/columnists/story.html?id=c6a41b6c-bbcc-4e12-9fd9-8dae2f1acbdc>.

¹⁶² To illustrate, the following compares the disparate treatment accorded to the various forms of direct and indirect Disaster Relief. Assume that two taxpayers (Cathy and Polly) each suffered \$50,000 in uninsured property damage to their respective homes.

Scenario 1: FEMA Grants

Assume FEMA provides each taxpayer with a \$10,000 grant. The grants are not taxed. Both suffered like economic losses and both receive the same treatment.

Scenario 2: Casualty Loss Deduction and Different Tax Rates

Assume that Cathy’s and Polly’s loss is attributable to Hurricane Rita and that their highest marginal tax rate is 30% and 10%, respectively. Assume further that each properly claims a \$50,000 personal casualty loss deduction.

The value of a tax deduction generally is the amount of the deduction multiplied by the taxpayer’s highest marginal tax rate. Although each has suffered like economic losses, Cathy receives a government benefit worth \$15,000, while Polly’s benefit is worth only \$5,000. If the 10% Floor applied, the tax subsidy’s disparity would be reduced, but not eliminated.

Scenario 3: Casualty Loss Deduction and Different Catastrophes

government to obtain Disaster Relief has become an easy sport.¹⁶³ And those who truly need Disaster Relief may never receive it—either because funds are unavailable or because they are unable to navigate the morass.

III. THE DEMAND FOR CATASTROPHE INSURANCE POST-KATRINA

The economics of insurance are, in some respects, peculiar and in other respects, quite conventional. Fundamentally, it is simply a matter of supply and demand. The last section explained the peculiar economics that form the foundation for supplying natural disaster insurance and the three different vehicles through which such insurance is delivered—private insurance, public-private insurance (residual market insurers), and de facto insurance (governments, as the insurers of last resort). This section discusses the impact that federal Disaster Relief and post-Katrina insurance litigation may have on the demand for catastrophe insurance.

In theory, “[a] rational, risk-neutral consumer would purchase [insurance] coverage at an actuarially fair price that is equivalent to the expected loss.”¹⁶⁴

Assume that Cathy and Polly are in the same tax bracket, but Cathy’s loss is attributable to a tornado in Kansas and Polly’s loss is attributable to Hurricane Rita. Here both taxpayers suffered identical economic losses and have identical tax profiles, yet Cathy’s casualty loss deduction is limited by the Casualty Loss Floors whereas Polly’s is not.

Scenario 4: Casualty Loss Deduction and Different Tax Bases.

Assume that Cathy has a \$300,000 cost basis in her house and Polly has a \$30,000 cost basis. Assume further that both properties were worth \$300,000 prior to the disaster and \$250,000 after. Despite identical economic losses, Polly’s starting point for the personal casualty deduction is \$30,000 and Cathy’s is \$50,000.

If Congress converted the personal casualty loss deduction into a direct subsidy, such as government grants, the amount of the subsidy would be a sliding scale. Despite suffering the same economic loss, some would receive larger grants simply because they earned more income (Scenario 2), suffered the loss in a high profile catastrophe (Scenario 3) or only suffered a partial loss on appreciated property (Scenario 4).

¹⁶³ Following Hurricane Katrina, the Government Accountability Office (GAO) conducted an audit of FEMA’s Individuals and Household Program. A 2006 report detailing the audit’s findings exposed substantial flaws in the system which led to significant fraud and abuse. For example, when GAO auditors visited “over 200 of the case study damaged properties in Texas and Louisiana” they discovered “that at least 80 of these properties were bogus—including vacant lots and nonexistent apartments.” It found that FEMA also made duplicate emergency assistance payments “to about 5,000 of the nearly 11,000 debit card recipients—once through the distribution of debit cards and again by check or electronic funds transfer,” and that some debit cards “were used for adult entertainment, bail bond services and weapons purchase, which do not appear to be items or services that are essential to satisfy disaster related essential needs.” U.S. GOV’T ACCOUNTABILITY OFFICE, EXPEDITED ASSISTANCE FOR VICTIMS OF HURRICANES KATRINA AND RITA: FEMA’S CONTROL WEAKNESSES EXPOSED THE GOVERNMENT TO SIGNIFICANT FRAUD AND ABUSE (2006), available at <http://www.gao.gov/new.items/d06403t.pdf>. See also U.S. GOV’T ACCOUNTABILITY OFFICE, HURRICANES KATRINA AND RITA DISASTER RELIEF: IMPROPER AND POTENTIALLY FRAUDULENT INDIVIDUAL ASSISTANCE PAYMENTS ESTIMATED TO BE BETWEEN \$600 MILLION AND \$1.4 BILLION (2006), available at <http://www.gao.gov/new.items/d06844t.pdf>.

¹⁶⁴ Eric J. Johnson et al., *Framing, Probability Distortions, and Insurance Decisions, in CHOICES, VALUES, AND FRAMES* 225 (Daniel Kahneman & Amos Tversky eds., 2000).

Such a consumer would weigh a multitude of factors in reaching this rational decision, including the maximum loss exposure, the probability that a loss will occur, the cost of premiums, the availability of government subsidies, and the discount rate. Additional factors that will influence the consumer's decision include the extent to which the consumer is required to insure property¹⁶⁵ and the consumer's cognitive ability to appreciate the nature of the covered risks.

There is considerable evidence to suggest that consumers do not make insurance decisions rationally.¹⁶⁶ This evidence suggests that consumers tend to underestimate the chances that a catastrophe will occur and to overestimate the costs of protection (like insurance or building upgrades) relative to the expected benefits.¹⁶⁷ Even if the consumer appreciates the cost-benefit analysis, other factors may distort the decision-making process.

For those with limited resources, catastrophe insurance may be considered a discretionary expense that should only be incurred after paying for life's other necessities.¹⁶⁸ For those with means, insurance may be regarded as an investment. If the individual does not collect on a policy after a certain period of time, the policy may be cancelled or the coverage may be limited.

Earlier studies suggest that the expectation of Disaster Relief does not factor heavily in the insurance decision-making process.¹⁶⁹ However, there is evidence (albeit anecdotal) to the contrary. A Government Accountability Report described a high-income taxpayer "who stated that he had opted not to insure . . . because he had determined that the cost of insurance premiums, less reimbursement, exceeded the tax saving value of a loss deduction, given his estimate of the probability of loss"¹⁷⁰ The taxpayer was referring to the personal casualty loss deduction, discussed *supra*, Part II.E.2.b. as a substitute for regular insurance.

Whether the earlier studies or the anecdotal evidence represents today's insurance consumer remains to be seen. Some commentators have questioned whether the media coverage of the Disaster Relief promised to Hurricane Katrina victims will influence the public's perception about whether insurance is a necessity or whether the government will come to their rescue if they are

¹⁶⁵ For example, a mortgage company may require a consumer to insure all or a portion of the value of the property securing the mortgage in case of certain perils. There is a continuum of insurance products that range from minimal to comprehensive. For a summary of varying coverage available under homeowners policies, see Insurance Information Institute, Homeowners Insurance Information: Are there different types of policies?, <http://www.iii.org/individuals/homei/hbasics/arethere/>.

¹⁶⁶ See e.g., Richard Watt et al., *An Experiment on Rational Insurance Decisions*, 51 THEORY AND DECISION 247 (2001).

¹⁶⁷ Howard Kunreuther, *Has the Time Come for Comprehensive Natural Disaster Insurance?*, in ON RISK AND DISASTER: LESSONS FROM HURRICANE KATRINA 175, 178 (Ronald J. Daniels, Donald F. Kettl, and Howard Kunreuther eds., 2006) [hereinafter Kunreuther on NDI].

¹⁶⁸ *Id.* at 8.

¹⁶⁹ *Id.*

¹⁷⁰ COMPTROLLER GEN. OF THE U.S., *supra* note 151, at 40.

unprotected.¹⁷¹ FEMA apparently recognizes this risk. In promoting flood insurance, it warns prospective insurers that

Federal disaster assistance is usually a loan that must be paid back with interest. For a \$50,000 loan at 4% interest, your monthly payment would be around \$240 **a month** (\$2,880 a year) for 30 years. Compare that to a \$100,000 flood insurance premium, which is about \$500 **a year** (\$33 a month).¹⁷²

Post-Katrina insurance litigation may also contribute to the public perception that Disaster Relief is a more attractive alternative to private insurance. In these cases, the insurers typically argue that the property damage was caused by flooding (generally not covered by homeowners insurance) rather than wind (generally covered).¹⁷³ If consumers believe that insurers will try to skirt their claims by arguing that property damage was caused by flooding rather than wind, then the payment of premiums may seem like an unnecessary expense.

IV. THE TAX COMPONENTS OF THE NATIONAL CATASTROPHE PLAN

The National Catastrophe Plan is proposed legislation that is intended to increase the availability and affordability of private insurance in peak risk areas and to reduce the risk of insurer insolvencies following disasters. This Part describes the two components of the National Catastrophe Plan that involve amending the Code, and explains why each falls short of accomplishing its objectives and could end up costing taxpayers more in the long run.

A. Increasing Capacity and Bolstering Liquidity with Tax-Deductible Catastrophe Reserves

1. Overview of Proposed Catastrophe Reserve Legislation

The Proposed Catastrophe Reserve Legislation would allow insurers (but not re-insurers) to make tax-deductible contributions to a special reserve for catastrophe-related lines. All contributions would be held in a "Policyholder Disaster Protection Fund" ("Fund"), which is a segregated account that generally would be used to satisfy catastrophe losses in certain situations.¹⁷⁴ Contributions to the Fund would be voluntary, but irrevocable once made except for a few carefully tailored distributions such as distributions for catastrophe losses.

To qualify for the deduction, the Fund must satisfy a few simple requirements. The Fund must be a custodial account, trust, or other

¹⁷¹ Kunreuther on NDI, *supra* note 167, at 178.

¹⁷² FEMA, FloodSmart.gov, Fast Facts, <http://www.floodsmart.gov/floodsmart/pages/fastfacts.jsp> (emphasis in original).

¹⁷³ See *Leonard v. Nationwide Mut. Ins. Co.*, 438 F. Supp. 2d. 684, 688–89 (S.D. Miss. 2006).

¹⁷⁴ Distributions could also be made in situations where the department of insurance for the jurisdiction in which the insurer is domiciled requires a distribution from the Fund. Policyholder Disaster Protection Act of 2006, S. 3116, 109th Cong. (2006).

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arrangement established to hold assets to be used “solely for the payment of qualified losses.”¹⁷⁵ Contributions to the Fund would be tax deductible to the extent they do not exceed the difference between the “fund cap” for the tax year in which the contributions are made, and the “fund balance” as of the close of the preceding tax year.¹⁷⁶ The fund balance generally would be cumulative contributions less investment losses and distributions.¹⁷⁷

The fund cap is the sum of the business caps for each qualified line of business multiplied by the applicable phase-in percentage.¹⁷⁸ Business caps are calculated by multiplying the net written premiums (“NWP”), as reported on the insurer’s annual statement for the prior year, for each qualified line of business by the multiplier applicable to such business.¹⁷⁹ Qualified lines of business and their respective multipliers include: earthquake (13.0), fire (0.25), homeowners multiple peril (0.75), and allied (1.25).¹⁸⁰ The Fund builds up gradually by multiplying the fund cap for the applicable year by the phase-in percentage for the applicable year. The phase-in percentage is five percent in 2008 and increases by five percent each year over a twenty-year period.¹⁸¹

Consider the following example:

¹⁷⁵ *Id.* at § 3(h).

¹⁷⁶ *Id.* at § 3(h)(3).

¹⁷⁷ H.R. 164 § 3(h)(7) (2007); S. 3116 § 3(h)(7) (2006).

¹⁷⁸ H.R. 164 § 3(h)(9)(A) (2007); S. 3116 § 3(h)(9)(A) (2006).

¹⁷⁹ H.R. 164 § 3(h)(9)(E) (2007); S. 3116 § 3(h)(9)(E) (2006).

¹⁸⁰ H.R. 164 § 3(h)(9)(C) (2007); S. 3116 § 3(h)(9)(C) (2006).

¹⁸¹ H.R. 164 § 3(h)(9)(B) (2007); S. 3116 § 3(h)(9)(B) (2006).

Example 3: Annual Contribution Calculation (\$000 omitted)

Acme underwrites homeowners multiple peril (“HMP”) and allied risks in Maryland. Its highest marginal tax rate for tax years 2008, 2009 and 2010 is 30%. At year-end 2009, the Fund’s balance is \$2,200 and it reported NWPs of \$22,000. One half of the NWPs is attributable to the HMP line and the other half to the allied line.

The Fund Cap for 2010 would be the sum of the business caps for each qualified line of business multiplied by the phase-in percentage (15% for 2010). The business caps for each qualified line of business equals the specified multiple of NWPs reported in 2009 for such line of business.

BusinessNWPMultipleBus. Cap

HMP\$11,000 x 0.75= \$ 8,250

Allied\$11,000 x 1.25= \$13,750

Tentative Fund Cap \$22,000

Fund Cap = \$22,000 x 15% = \$3,300

The maximum contribution in 2010 is the excess of the fund cap (\$3,300) over the fund balance for the preceding taxable year (\$2,200), or \$1,100.

Assuming a 30% marginal tax rate, Acme defers \$330 in current taxes (\$1,100 x 30%) by contributing \$1,100 in net premiums to the fund and previously deferred \$660 in taxes (\$2,200 x 30%) from earlier contributions totaling \$2,200.

A Fund’s assets may be distributed in the following four circumstances:

Distributions of Investment Income. The Fund is required to invest its assets in a manner that is consistent with state insurance laws. Net income derived from these investments must be distributed annually.¹⁸²

Catastrophe Loss Distributions. If “qualified losses” exceed a threshold, the insurer may withdraw some or all of the Fund’s assets.¹⁸³ Qualified losses are catastrophic events—such as windstorms, earthquakes, floods—that the President of the United States, the Property Claim Service, or the chief executive official of a state has declared a catastrophe.¹⁸⁴ The insurer may withdraw Fund assets to the extent that qualifying losses for the current year exceed the lesser of 1) the insurer’s prior year fund cap or (2) thirty percent of

¹⁸² H.R. 164 § 3(c) (2007); S 3116 § 3(c) (2006) (amending § 3(h)(1)(B)(ii)).

¹⁸³ H.R. 164 § 3(c); S 3116 § 3(c) (amending § 3(h)(1)(B)(iv)).

¹⁸⁴ H.R. 164 § 3(c); S 3116 § 3(c) (amending § 3(h)(8)(B)).

the insurer's prior year surplus.¹⁸⁵ This threshold may be reduced if the insurer experiences major catastrophe losses in prior years.¹⁸⁶

State-Mandated Distributions. The insurer may withdraw Fund assets to the extent required by the department of insurance in the state where the insurer is domiciled.¹⁸⁷

Excess Fund Balance Distributions. The insurer must make distributions in an amount equal to the excess of the fund balance for the preceding year over the fund cap for the following year.¹⁸⁸ The fund balance for the preceding year could exceed the fund cap if, for example, the Fund's NWP in specified lines decreases.

The insurer generally will be required to include the distribution in income.¹⁸⁹ Whether it will owe any tax depends on the insurer's tax position at that time. For example, if the distribution is made on account of "qualified losses," the insurer may not owe any taxes because the income inclusion will be offset by deductions for catastrophe losses.¹⁹⁰ Similarly, the income inclusion from an excess fund distribution could be offset by deductible losses unrelated to natural catastrophes, such as net losses from its auto insurance line of business.

The benefits of the Proposed Catastrophe Reserve Legislation are twofold. First, the deduction ameliorates the tax costs of untimely disasters by permitting the insurer a deferral on premium income until it is used to pay deductible disaster losses. In effect, it matches the premium income with a deductible expense and avoids distortions created by the limited two-year NOL carryback rule. Recall that in Example 2 on page 723, Acme sustained a net loss on its insurance business, but was unable to recover \$14 million in prior taxes paid due to the two-year NOL carryback limitation. If Acme had been permitted a deduction for setting aside some or all of its premium income, the \$14 million in overpaid taxes would have been reduced or eliminated.

The second benefit also relates to the deferral of tax on the portion of premium income contributed to the Fund.¹⁹¹ To illustrate, recall that, in Example 3, Acme's total contributions to the Fund by year-end 2010 add up to \$3.3 million, \$990,000 of which is attributable to taxes that Acme would have been required to pay if the Proposed Catastrophe Reserve Legislation was not

¹⁸⁵ H.R. 164 § 3(c); S 3116 § 3(c) (amending § 3(h)(5)(B-C)).

¹⁸⁶ H.R. 164 § 3(c); S 3116 § 3(c) (amending § 3(h)(5)(D)).

¹⁸⁷ H.R. 164 § 3(c); S 3116 § 3(c) (amending § 3(h)(1)(B)(v)).

¹⁸⁸ H.R. 164 § 3(c); S 3116 § 3(c) (amending § 3(h)(1)(b)(iii), 3(h)(4)).

¹⁸⁹ There are two limited exceptions to the general rule that all Fund distributions are taxable. First, the insurer is required to take into account income derived from the assets held in the Fund, as well as losses from the sale or other disposition of such assets without regard to the distribution. Distributions of net income will not be taxed again when distributed. *Id.* (amending section 3(h)(10)). Second, distributions made to return certain contributions are not taxable.

¹⁹⁰ See Example 3—Annual Contribution Calculation, *supra* at page 740.

¹⁹¹ As discussed in Part II.C.1.c.3.(a), P&C Insurers typically pay high taxes on premium income in years with few catastrophe claims, while deductions for claims may not be taken until later tax years and may be subject to limitations.

enacted.¹⁹² Acme will later include the \$3.3 million in income (subject to offset by Acme's tax attributes, such as losses) when it is distributed from the Fund, as described above. In the meantime, Acme must invest the tax savings of \$990,000 (along with the Fund's other assets totaling \$2.31 million) and will receive investment returns. The benefit is the sum of all net investment returns (after expenses, including corporate and shareholder-level taxes on the investment income) that are attributable to the tax savings.

Although there is a tax benefit, there may be added tax costs to creating and maintaining a Fund. Assume that an insurer would have distributed to investors the amount set aside in the Fund (after reduction for corporate-level taxes) but for the deduction for catastrophe reserves. In such case, investors would have invested the distributions directly and avoided a corporate-level tax on investment returns.¹⁹³ By creating the Fund, the insurer is creating an additional layer of tax on the portion of the Fund that is not attributable to the tax deferral. In the example above, Acme would be subjecting the annual net investment returns on \$2.31 million to a corporate-level tax.¹⁹⁴

There are non-tax costs as well. To begin with, the amount of investment returns that the Fund earns may differ from those that the shareholders could earn if they had invested the \$2.31 million of retained earnings directly. The Fund may only invest in certain classes of assets that will have lower volatility and will yield smaller returns. If amounts were distributed to the shareholders for direct investment, the shareholders may choose investments that yield higher returns. In addition, the shareholders are placing more capital at risk and will expect a higher rate of return. The added tax and non-tax costs should be taken into account in determining the true savings realized in connection with creating and maintaining a Fund.

Notwithstanding the foregoing, recall that insurers already set aside amounts in reserve to satisfy minimum capital and policyholder surplus requirements set by state regulators and rating agencies.¹⁹⁵ That requirement typically is determined in relation to the total risk assumed by the insurer, without regard to whether sufficient policyholder surplus is earmarked for one type of risk or another. Accordingly, an insurer could simply shift policyholder surplus from a nondeductible account to the Fund. If the amounts set aside

¹⁹² A back-of-the-envelope calculation of the tax savings is the product of the deduction (\$1,100,000) and the taxpayer's highest marginal tax rate (30%). Based on the fact pattern, Acme, Inc. made deductible contributions to the tune of \$2,200,000 in prior tax years and was subject to the same tax rate.

¹⁹³ See *supra* Part II.C.1.c.iii.(a), (discussing the tax costs of corporate capital).

¹⁹⁴ One of the reasons insurers do not retain large amounts of capital is double taxation on investment returns. See *supra* Part II.C.1.c.iii.(a). In the Acme example, the Fund earns investment income on the Fund's assets, including the portion that does not represent tax savings (i.e., \$2,310,000). All of the investment income will be subject to double taxation—once at the corporate level and again at the shareholder level when the after-tax investment income is distributed. If Acme had paid the current tax and distributed \$2,310,000 to its shareholders (rather than making a tax-deductible contribution to the Fund), the shareholders could invest the distribution (net of taxes) directly and avoided the corporate-level tax on the investment income.

¹⁹⁵ See *supra* note 65 and accompanying text.

would not have been returned to investors in any event, then a corporate-level tax on investment returns and the non-tax costs described above would not be an added cost of creating or maintaining a Fund. Rather, it would be a cost that the insurer would have borne in any event. More importantly, this illustrates one instance where an insurer can manipulate the Proposed Tax Legislation to produce a tax advantage without yielding any of the legislation's intended benefits. Shifting surplus from one account to another will not increase capacity or bolster an insurer's solvency. This is tantamount to a tax windfall.¹⁹⁶

a. The End Game: Reduced Federal Disaster Relief by Increasing Access to Safe, Affordable Private Insurance in At-Risk Markets

Advocates for tax-deferred catastrophe reserves argue that it will increase access to affordable catastrophe insurance and reduce the risk of insurer insolvencies.¹⁹⁷ This, in turn, would reduce the need for costly and inefficient Disaster Relief. The theory is that the deduction provides an economic incentive to insurers to increase their capital and to expand their capacity, which would increase the supply of insurance and could drive prices down.¹⁹⁸ The solvency of insurers is bolstered because there is a dedicated reserve to ensure that future claims can be satisfied.¹⁹⁹

The proponents' analysis assumes that the double tax costs, along with the costs of avoiding the double tax of covering natural catastrophe losses, are what make catastrophe insurance so expensive.²⁰⁰ Their rationale is twofold. First, catastrophe insurers must retain larger amounts of capital, and investment returns thereon are taxed twice. Second, because retaining large amounts of capital is so expensive, insurers often turn to reinsurance as a substitute for retaining large amounts of capital. However, that does not work well when reinsurance prices rise as they have post-Katrina. Although not a perfect solution, the Proposed Catastrophe Reserve Legislation ameliorates the tax costs of holding back large amounts of capital and reduces the need for expensive reinsurance.

b. The Proposed Catastrophe Reserve Legislation Will Not Increase Access to Safe, Affordable Private Insurance in At-Risk Markets

Whether the proposed legislation can increase the availability of affordable private insurance in At-Risk Markets or bolster the solvency of insurers operating in such markets is subject to considerable debate. For the reasons set

¹⁹⁶ "Tax benefits obtained by persons who would have performed the desired activity without the tax incentive are '*tax windfalls*,' which are programmatically inefficient because they are costs that 'caused' no benefit." JOSEPH DODGE ET AL., *FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY* 132 (3d ed. 2004) (emphasis in original).

¹⁹⁷ S. 3116 § 2 (setting forth a number of findings regarding catastrophe insurance); see also, GAO, *CATASTROPHE RISK*, *supra* note 62.

¹⁹⁸ GAO, *CATASTROPHE RISK*, *supra* note 62, at 29.

¹⁹⁹ *Id.*

²⁰⁰ See Scott E. Harrington & Greg Niehaus, *Capital, Corporate Income Taxes, and Catastrophe Insurance*, 12 J. FIN. INTERMEDIATION 365 (2003) (providing an economic analysis of the tax costs incurred in connection with supplying catastrophe insurance).

forth below, this Article concludes that the Proposed Catastrophe Reserve Legislation, as presently drafted, will not achieve its objectives.

To begin with, the regime is elective. An insurer can choose to participate or not. For example, "Financially weaker insurers may not be in a position to build a segregated surplus account, but could still remain active in the insurance market writing business that would be prone to loss in the event of a natural disaster."²⁰¹ In addition, P&C Insurers would not elect the regime and increase capacity in At-Risk Markets if these markets represent uninsurable risks,²⁰² or if insurers are unable to rely on current technology to assess their exposure.²⁰³ In these cases, the value of any tax deduction is dwarfed by the potential exposure.

Those who elect the regime may manipulate the proposed legislation to gain a tax advantage. As described above, an insurer may use the Fund to hold amounts it already sets aside to satisfy state and ratings agencies. This would neither increase insurance in At-Risk Markets nor bolster insurer solvency: it maintains the status quo.

Similarly, it is possible that the Fund could be used to shield unrelated activities of P&C Insurers from tax.²⁰⁴ For example, an insurer could increase amounts contributed to the Fund when income is high across business lines and trigger distributions from the Fund when it has excess deductions or other tax attributes. To do so, the insurer would increase or decrease net written premiums in certain business lines at the appropriate times. Increases and off-setting decreases to the Fund may not improve capacity over the long-haul. Worse, shifting capacity between different business lines could destabilize the entire insurance industry.

These shell games are not limited to P&C Insurers in At-Risk Markets because the proposed legislation is over-inclusive. Among other things, it provides a tax windfall for P&C Insurers underwriting risks outside of At-Risk Markets. Recall that the maximum amount that an insurer may contribute to the Fund is based on a multiple of the net written premiums attributable to a specified line of business.²⁰⁵ Net written premiums include premiums collected in business lines outside of At-Risk Markets. For example, a dollar of premium collected with respect to a homeowners multiple peril insurance policy written in Boise would count the same as a dollar of premium collected on the same

²⁰¹ Letter from Wayne Fisher, Chairperson, Catastrophe Insurance Work Group, on behalf of the American Academy of Actuaries, to the Honorable Bill Archer (Sept. 20, 2000), available at http://beta.actuary.org/pdf/casualty/ltr_catastr_092000.pdf.

²⁰² There are many who believe that At-Risk Markets (or certain risks in At-Risk Markets) are uninsurable through the private market. For example, the Florida Insurance Task Force repeatedly states, "Determining whether or not hurricanes and sinkholes represent risks insurable in the private market is a critical determination that needs to be made." TASK FORCE ON LONG-TERM SOLUTIONS, *supra* note 13, at 36.

²⁰³ See *supra* notes 79–81 and accompanying text (discussing the breakdown of catastrophe models).

²⁰⁴ DAVID L. BRUMBAUGH & RAWLE O. KING, CONG. RES. SERV., TAX DEDUCTIONS FOR CATASTROPHIC RISK INSURANCE RESERVES: EXPLANATION AND ECONOMIC ANALYSIS 6 (2005), available at <http://www.fas.org/sfp/crs/misc/RL33060.pdf>.

²⁰⁵ See *supra* notes 178–79 and accompanying text.

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type of policy written in New Orleans. The proposed legislation is not intended to increase underwriting efforts in one of the safest cities in America.

Similarly, the definition of business lines is over-inclusive because it does not take into account inflated deductibles or, more importantly, exclusions. Assume Acme and InsureCo write homeowners multiple peril insurance in South Florida, but Acme excludes hurricane and windstorm perils from its policies. Under the proposed legislation, each would include premiums collected on their respective policies for purposes of determining the maximum business cap. Although the proposed legislation may increase the supply of insurance in an At-Risk Market, it may not cover (or may offer reduced coverage of) catastrophe risks.

Tax windfalls are not the only flaws in the proposed legislation. The Proposed Catastrophe Reserve Legislation applies static multipliers to determine the fund cap for each business line.²⁰⁶ This may not be an appropriate way to gauge the cushion needed to cover catastrophic exposure over a twenty-year period because there are a number of unknown variables (such as weather and subsequent appreciation/depreciation in property values) that affect this determination. The proposed legislation does not include a mechanism to evaluate the effectiveness of the multipliers or to modify the multipliers if, for example, there is a need in any given year to bolster underwriting in homeowners multiple peril instead of earthquake.

If an insurer decides to use the Fund as a substitute for reinsurance, then the insurer's capacity to underwrite catastrophe risks remains unchanged.²⁰⁷ In addition, increased reliance on reserves and decreased use of reinsurance could raise additional liquidity concerns. Although the insurer saves the expense of transferring the risk to the re-insurer, it would be responsible for 100% of the covered loss in the event of a catastrophe. One of the key benefits to reinsurance that cannot be duplicated through reserves is the ability to spread peak risks globally.²⁰⁸

The proposed tax legislation will not address the fact that private insurers cannot compete with residual market insurers in At-Risk Markets and remain afloat. Tax breaks may allow insurers to lower premiums, but residual market insurers can still price their policies lower because they have less frictional costs. Private insurers still pay taxes on net premium income that is not contributed to the Fund, they have a profit load, and the cost of recapitalizing post-disaster is substantial. Residual market insurers generally pay no taxes, have no profit load, and can recapitalize cheaply with tax-exempt bonds.²⁰⁹

More importantly, it would be imprudent to encourage private insurers to follow the Residual Market's lead and charge non-risk-based premiums. Despite having no profit load and no tax costs, residual market insurers are insolvent.²¹⁰ The only reason why many remain in business is because they can

²⁰⁶ *Id.*

²⁰⁷ GAO, CATASTROPHE RISK, *supra* note 62, at 53.

²⁰⁸ See Part II.C.1.b.ii, *supra*.

²⁰⁹ As discussed above, Citizens is a tax-exempt corporation. See *supra* Part II.D.2.a.

²¹⁰ See Part II.D.4.

reach into someone else's deep pockets to fund shortfalls.²¹¹ A private insurer does not have access to the same deep pockets, unless it is being liquidated and its unpaid claims are being satisfied by a guaranty fund.²¹²

Speaking of deep pockets, query whether the Fund will become a source of funds for assessments made by state residual market insurers. Recall that the Fund's assets may be distributed to satisfy state-mandated distributions.²¹³ This could occur, for example, if Citizens has another shortfall and assesses the insurers domiciled in Florida. In this case, federal taxpayers would be partially subsidizing Citizens' below-market rates because the assessment would come from the tax-deferred reserve.

c. The Proposed Catastrophe Reserve Legislation Will Not Reduce Disaster Relief

Whether higher market penetration rates are associated with lower amounts of Disaster Relief is an empirical question. Intuitively, one would think that they would be associated. However, there are at least three critical issues to consider:

- Whether insurers will penetrate the same markets that are receiving Disaster Relief, and if so,
- Whether private insurance will leave any gaps in coverage that Disaster Relief will likely fill, and if so,
- Whether those who would otherwise receive Disaster Relief will purchase private insurance instead, assuming it is available.

Even if the Proposed Catastrophe Reserve Legislation increases capacity, there is no guarantee that it will increase capacity in areas where federal Disaster Relief is utilized most, namely At-Risk Markets. Although the proposed legislation provides incentives to increase underwriting of catastrophe losses in catastrophe-related lines of business (e.g. earthquake), there is no inducement for writing these types of policies in At-Risk Markets. If capacity does not increase in At-Risk Markets, like Florida, then it is unlikely that the deduction will have a material impact on the provision of Disaster Relief.

If there are gaps in catastrophe coverage, then increased market penetration will not likely diminish the provision of Disaster Relief. A study by the Rand Corporation found, at least with respect to flood insurance, that the impact of market penetration on the amount of Disaster Relief

is not large and is statistically significant only for that relatively small part of overall disaster assistance that most overlaps with the insurance coverage available from the NFIP. This makes it unlikely that increasing flood insurance market penetration would cause substantial reductions in

²¹¹ Insurers doing business in the State of Florida may be called upon to satisfy Citizens' and FHCF's policyholder claims in the event of a shortfall. In addition, the NFIP relies on the U.S. Treasury to cover shortfalls.

²¹² In the event of bankruptcy, policyholders may look to guaranty funds to satisfy claims that the bankruptcy estate is unable to pay. The guaranty fund is funded by insurance companies so in a sense an insurer can reach into another insurer's pocket to satisfy claims. Guaranty Funds are described *supra* Part II.C.1.b.3.

²¹³ See *supra* note 187 and accompanying text.

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[Disaster Relief], unless flood insurance policies were broadened to cover other types of losses, particularly temporary housing assistance.²¹⁴

Before federal Disaster Relief will be reduced, private insurance coverage would need to be broad-based in terms of the amount and types of losses that are covered. There is nothing in the Proposed Catastrophe Reserve Legislation that would provide incentives for closing the gaps in private insurance coverage that disaster assistance fills. For example, the tax benefit is based on net written premiums without regard to whether the insured has a high deductible or reduced the amount or extent of coverage.²¹⁵

Consumers may choose no or low insurance coverage despite increased supply of insurance. The reasons for this are discussed *supra* Part III and include the consumer's subjective perspectives on whether purchasing insurance is worthwhile, particularly in light of recent events.

Finally, consumers may not have any meaningful insurance options. Increasing supply does not guarantee that catastrophe insurance will be affordable; particularly to those who avail themselves of Disaster Relief.²¹⁶ The Proposed Catastrophe Reserve Legislation does not require the tax savings be passed along to consumers. As previously discussed, the tax savings could be used to shelter income from other lines of business, or it could be passed along to the shareholders.

B. Increasing Insurer (Including Self-Insurer) Capacity with Catastrophe Savings Accounts

1. Overview of Proposed CSA Legislation

The Proposed CSA Legislation would allow homeowners to contribute money to a "Catastrophe Savings Account" (CSA).²¹⁷ The homeowner would not be entitled to a deduction for the contribution, but all future investment returns on the CSA would be exempt from tax if certain conditions are satisfied.²¹⁸ Distributions from the CSA are tax-free if they are (a) used to cover certain qualified catastrophe expenses, or (b) considered a retirement distribution (i.e., a distribution made on or after the date that the taxpayer

²¹⁴ DIXON, ET AL., *supra* note 129, at xvi.

²¹⁵ See *supra* note 179 and accompanying text.

²¹⁶ The Rand Corporation Study speculated that market penetration may not have a meaningful impact on the supply of disaster aid because:

[those] who receive disaster assistance by and large do not have the means to buy flood insurance. If this were the case, the variation in the percentage of structures with flood insurance (within the ranges observed in this sample) would have little affect on the group of people that receives most disaster assistance and, consequently, on disaster assistance overall.

DIXON, ET AL., *supra* note 129, at 119.

²¹⁷ Catastrophe Savings Accounts Act of 2006, S. 3115, 109th Cong. § 530A(b) (2006), *supra* note 20.

²¹⁸ S. 3115 § 503a(a) (2006). This is similar to the treatment accorded to a Roth IRA. See I.R.C. § 408A (2000).

attains the age of sixty-two).²¹⁹ Otherwise, a portion of the distribution from the CSA would be taxable and subject to a ten percent penalty.²²⁰

The maximum amount of a homeowner's contribution to a CSA depends on the annual deductible for the individual's homeowners insurance.²²¹ If the deductible is \$1,000, the maximum CSA contribution is \$2,000.²²² If the deductible is greater than \$1,000, the maximum CSA contribution is \$15,000, or twice the individual's deductible, whichever is less.²²³

2. *Pros and Cons*

The Proposed CSA Legislation may encourage homeowners to insure their homes because the tax benefit is only available to those with homeowners insurance. In addition, CSAs may reduce premium costs if a homeowner retains more risks under the individual's policy (i.e., the homeowner purchased coverage with higher deductibles, higher limits or more restrictions or exclusions). In such case, the individual could use the CSA as a cushion to cover uninsured catastrophe losses. However, it is equally possible that CSAs will have no impact on a homeowner's insurance decisions.

The proposed legislation has several disadvantages. For one thing, CSAs encourage homeowners to assume more risks because the tax benefits increase (up to the cap) as the deductible increases. Although it *may* reduce the homeowner's premiums, the homeowner could end up worse off if the individual suffers a loss that would have been covered by the foregone coverage.

The purpose of the CSA is to cover "uninsured losses, deductible expenses, and building upgrades to mitigate damage that could be caused in future disasters."²²⁴ It is intended to make insurance in At-Risk Markets more affordable and to shift peak risks from the homeowner to the private insurer. However, there is nothing in the legislation that requires the homeowner to reside in an At-Risk Market in order to be eligible for the deduction. In addition, the deduction applies without regard to whether the policy excludes the peak risks that the government is trying to cover.

The proposed legislation is not touted as another retirement savings vehicle. However, it permits tax-free retirement distributions, even though they have no relationship to disaster losses.

C. *Attempts to Salvage the Proposed Tax Legislation Are Problematic*

As the previous sections illustrated, the Proposed Tax Legislation is replete with loopholes. Many can be fixed by careful drafting. For example, deductions for amounts set aside in the Fund should be available only to insurers providing catastrophe-related coverage in At-Risk Markets. If there are

²¹⁹ S. 3115 § 503a(e)(2), (4) (2006).

²²⁰ S. 3115 § 503a(e)(3) (2006).

²²¹ S. 3115 § 503a(c), (d) (2006).

²²² S. 3115 § 503a(c)(1) (2006).

²²³ S. 3115 § 503a(c)(2) (2006).

²²⁴ 152 CONG. REC. S5333 (daily ed. May 26, 2006) (statement of Sen. Nelson).

increases and decreases in catastrophe- and non-catastrophe-related lines of business that occur in close time proximity, the previously deferred income should be taxed at the rates in effect when earned, or the rate in effect when distributed, whichever is higher, plus interest. To provide an appropriate incentive to insurers, the legislation should permit the Fund's investment returns to be retained in the Fund and grow tax-free until ultimately distributed.

There are aspects of the Proposed Tax Legislation that cannot be fixed with careful drafting. For instance, the Proposed Tax Legislation could decrease federal revenue, cause disruptions throughout the insurance industry, and could fortify current demographic trends. The ramifications of each are explored briefly below.

At a minimum, the Proposed Tax Legislation would reduce federal revenues in an era of enormous budget deficits. Furthermore, the proposed legislation will take time before results, if any, become apparent. Accordingly, the federal government could be increasing its exposure—reduced federal revenues without an offsetting decrease in expenditures for federal Disaster Relief.

More troubling is the possibility that the Proposed Tax Legislation could further impair the economic efficiency of the insurance market. In analyzing the Proposed Catastrophe Reserve Legislation, for example, economists observed that if “insurance markets are operating smoothly, the diversion of resources into catastrophe insurance by means of a tax deduction likely reduces economic efficiency.”²²⁵ If there is a market failure, then a subsidy (by way of a tax deduction or direct expenditure) may be an appropriate mechanism to correct that failure.²²⁶ These economists, however, concluded that “the presence of such failures is not certain.”²²⁷

To illustrate, consider the following examples:

- Acme diverts policyholder surplus intended to cushion losses from one line of business (say, auto insurance) to HMP in order to maximize deductible contributions to the Fund. The capital shift to catastrophe lines weakens Acme's auto insurance business. If Acme is rendered insolvent because its other lines of business are failing, state insurance regulators could look to the Fund's assets to satisfy Acme's debts.
- Acme shifts its underwriting capacity between catastrophe lines and other lines, depending on its tax position from year-to-year. Acme would have an incentive to increase capacity in catastrophe lines to take advantage of the deduction when the company has high net profits and decrease capacity when it experiences net losses.

²²⁵ BRUMBAUGH AND KING, *supra* note 204, at 7.

²²⁶ *Id.*

²²⁷ *Id.* at 10. See also Dwight M. Jaffee, *Commentary*, 88 FED. RES. BANK OF ST. LOUIS REV. 381, 381–85 (2006). Some economists, however, believe that there is a market failure. See, e.g., Robert E. Litan, *What is the Appropriate Role of the Federal Government in Private Markets for Credit and Insurance? What Is the Outlook?*, 88 FED. RES. BANK OF ST. LOUIS REV. 387, 388 (2006).

- Acme overexposes itself in catastrophe lines in an effort to increase the deduction. This could occur, for example, if Acme insures otherwise uninsurable risks or places too much reliance on the Fund and not enough on other risk-spreading techniques.

Additionally, the Proposed Tax Legislation adds another price control implement to the governments' tool box. To illustrate, recall that state governments moderate the pricing of catastrophe insurance *de jure* (by regulation) and *de facto* (through residual insurance markets).²²⁸ These price control implements are used to spread risks among the insured throughout the state, compelling low-risk insureds to subsidize the insurance costs of high-risk insureds. Citizens, for example, is the leading (and, in some cases, the exclusive) P&C Insurer covering Florida's At-Risk Markets. If it experiences a shortfall in capital because its annual claims exceed collected premiums, Citizens generally assesses private insurers to make up the difference. Private insurers pass the assessment to the insured. In effect, those who can procure private insurance in the state subsidize those who cannot.²²⁹

The Proposed Tax Legislation could have a similar effect, but on a broader scale. Instead of shifting a portion of the cost of insurance from high-risk insureds to low-risk insureds, the Proposed Tax Legislation would shift the cost to all federal taxpayers.

Finally, artificially driving the cost of catastrophe insurance down sends the wrong message. Risk-based premiums that reflect the nature of the risks assumed encourage risk avoidance, risk control, and risk mitigation efforts. If the government continues to block the message by subsidizing insurance costs, it is encouraging more people to move into harm's way without providing a commensurate incentive for risk avoidance, risk control, and risk mitigation.²³⁰ That policy would be fiscally and socially irresponsible.

V. BRIEF SUMMARY AND CONCLUSION

Large-scale natural disasters are certain to occur. Mother Nature cannot be controlled, but her legacy can be contained by managing the risk of disaster *ex ante* instead of *ex post*.

Insurance is a key mechanism for managing risks, but it is not without costs. It is supplied by the private insurance market, the residual insurance market, and a host of government agencies who deliver Disaster Relief. In theory, there is a pecking order in the supply chain: the private market should insure most disaster risks, residual markets, and Disaster Relief should operate as fail safes.

²²⁸ Governments ensure that P&C insurance premiums are low, relative to the cost of such insurance, through insurance regulations and assessments on P&C Insurers for residual insurance market shortfalls. *See supra* Part II.D.

²²⁹ *Id.*

²³⁰ For a thoughtful discussion of the ramifications of subsidizing insurance in At-Risk Markets, see generally Scott E. Harrington, *Rethinking Disaster Policy*, 23 REGULATION 40 (2000).

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Over the last decade or so, the supply chain has shifted in At-Risk Markets. Residual market insurers began competing with private insurers. In peak risk markets, the residual market has been able to freeze out the private market by offering broader coverage at cheaper prices. It has been able to do so, at least in part, because the free market economics of private insurance are very different from the economics of quasi-governmental insurance.

By law, private insurers must ensure that their capital base is aligned with the risks assumed. By necessity, they also must pay an appropriate profit to their investors. Private insurers ensure that their capital bases are aligned with risks assumed by shifting peak risks to third parties *ex ante* and maintaining state-mandated reserves for a portion of the retained risks. These techniques are expensive and the added costs of assuming a particular type of peril in an At-Risk Market should be reflected in the cost of insurance in that particular market. However, some states have precluded private insurers from charging actuarially sound rates *de jure* (by regulating insurance rates) and *de facto* (residual insurers competing with below-market rates).

In contrast, residual market insurers need not ensure that their capital bases are aligned with the risks assumed. They operate as a pay-as-you-go system with no state-mandated reserves. If there is a shortfall, they shift assumed risks to private insurers at little or no cost, generally by assessing private insurers doing business in the state. In addition, residual market insurers are able to keep the price of insurance low because they do not have profit loads and are tax-exempt. These significant cost-savings may be passed along to reduce the cost of insurance.

Having learned its lesson after Hurricane Andrew, most private insurers chose to retreat rather than compete with residual market insurers in peak risk markets. This strategy paid off: P&C Insurers rebounded quickly from the 2004–2005 Atlantic hurricane seasons.

Having established that it could deliver catastrophe insurance cheaply, residual market insurers in states tested by the 2004–2005 hurricane season proved something else. Their below-market pricing strategy was irresponsible. As of the time of this writing, the National Flood Insurance Program remains insolvent. Citizens and FHCF were able to pay claims only after receiving massive capital infusions from the State of Florida. Similarly, the Texas Windstorm Insurance Association and Louisiana Citizens Property Insurance Corp. could not satisfy claims out of current premiums and had to cover enormous deficits by, *inter alia*, assessing the private insurance industry.

Although the meltdown of the private insurance industry post-Andrew provided the private market with the momentum it needed to reevaluate how it managed risks, the same cannot be said for the meltdown of the residual insurance market post-Katrina. Rather than charging risk-based premiums or offering meaningful incentives for private insurers to reenter the market, some residual market insurers are seeking deeper penetration into peak risk markets by reducing already below market insurance rates. This is a huge gamble that threatens the economic viability of at least one state. If it loses the gamble, the federal government's capacity as an insurer of last resort will be tested again. It

is tough to find comfort in that safety net, having witnessed the efficiency with which the federal government handled the Katrina crisis.

Recognizing the need to shift risks back to the private sector, members of the House and Senate have proposed a National Catastrophe Plan. The tax components of the plan are two-fold: the Proposed CSA Legislation would allow homeowners to put money aside—on a tax-free basis—to cover uninsured losses, and the Proposed Catastrophe Reserve Legislation would permit insurance companies to deduct amounts set aside in reserves to fund future catastrophe claims.

Although well-intended, the Proposed Tax Legislation simply does not work. As presently drafted, the Proposed Catastrophe Reserve Legislation creates a windfall for P&C Insurers who bear none of the risks inherent in At-Risk Markets. For example, the deduction would be available to P&C Insurers who do not sell insurance in At-Risk Markets. For those who do business in At-Risk Markets, the deduction would be available even if the P&C Insurer excludes peak risks from its insurance policies. The Proposed CSA Legislation is subject to the same criticisms as it is simply a retirement vehicle, available to all taxpayers without regard to whether they live in an At-Risk Market or whether the funds will be used to pay for catastrophe-related losses.

Worse, the Proposed Tax Legislation threatens to destabilize an otherwise stable insurance industry by rewarding irresponsible underwriting practices. It is fiscally irresponsible for P&C Insurers to assume more catastrophe-related risks at below-market pricing through increased reliance on current premiums and reserves. Current premiums and reserves *may* be sufficient to cover one disaster, but consider the impact of back-to-back disasters like (or worse than) the ones witnessed in 2004 and 2005. Once reserves are depleted, it will take insurers years to recapitalize, and the insurers of last resort will have to fill in the gaps while they are doing so. Increased reserves are an excellent mechanism for managing risks, but they are not a substitute for spreading risk globally through reinsurance.

The proposed legislation also is socially irresponsible. It encourages more people to move into harm's way without providing a commensurate incentive for risk avoidance, risk control, and risk mitigation. It bears repeating: insurance is a key mechanism for managing risks, but it is not without costs. The best way to keep the cost of insurance low is to reduce the risk of loss, not to subsidize the loss.

The Tax Code cannot fix the post-Katrina insurance crisis, but it can make it worse. If there are any doubts, think about the images depicting the convergence of hell and high water in this Nation's thirty-fifth largest city. Now imagine what that would have been like if no one had insurance.