

Protecting U.S. Insurance Consumers and Taxpayers From the Financial Effects of Natural Disasters



The Public Policy Case for Policyholder Disaster Protection Reserves

(AAA Hill Staff Briefing)



1994 Northridge Earthquake

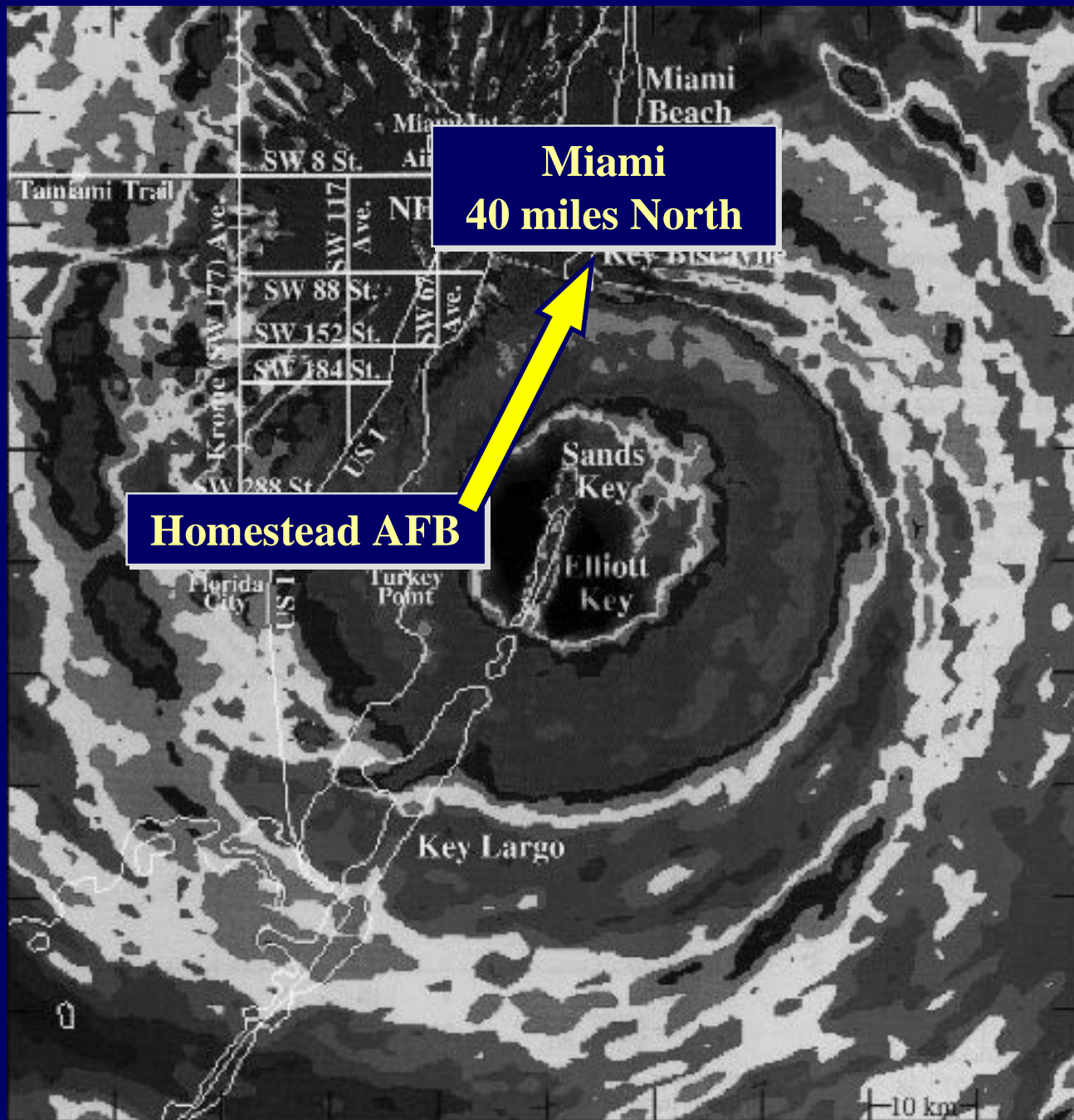


1992 Hurricane Andrew

1993 Midwest Floods



1989 Hurricane Hugo



In 1992, Andrew resulted in \$15.5 B of insured damage.

Ten insurers failed.

Nearly \$500 M in unpaid claims were ultimately paid by other insurance consumers or taxpayers.

But, if Andrew had passed 40 miles North, insured losses would have exceeded \$50 B.

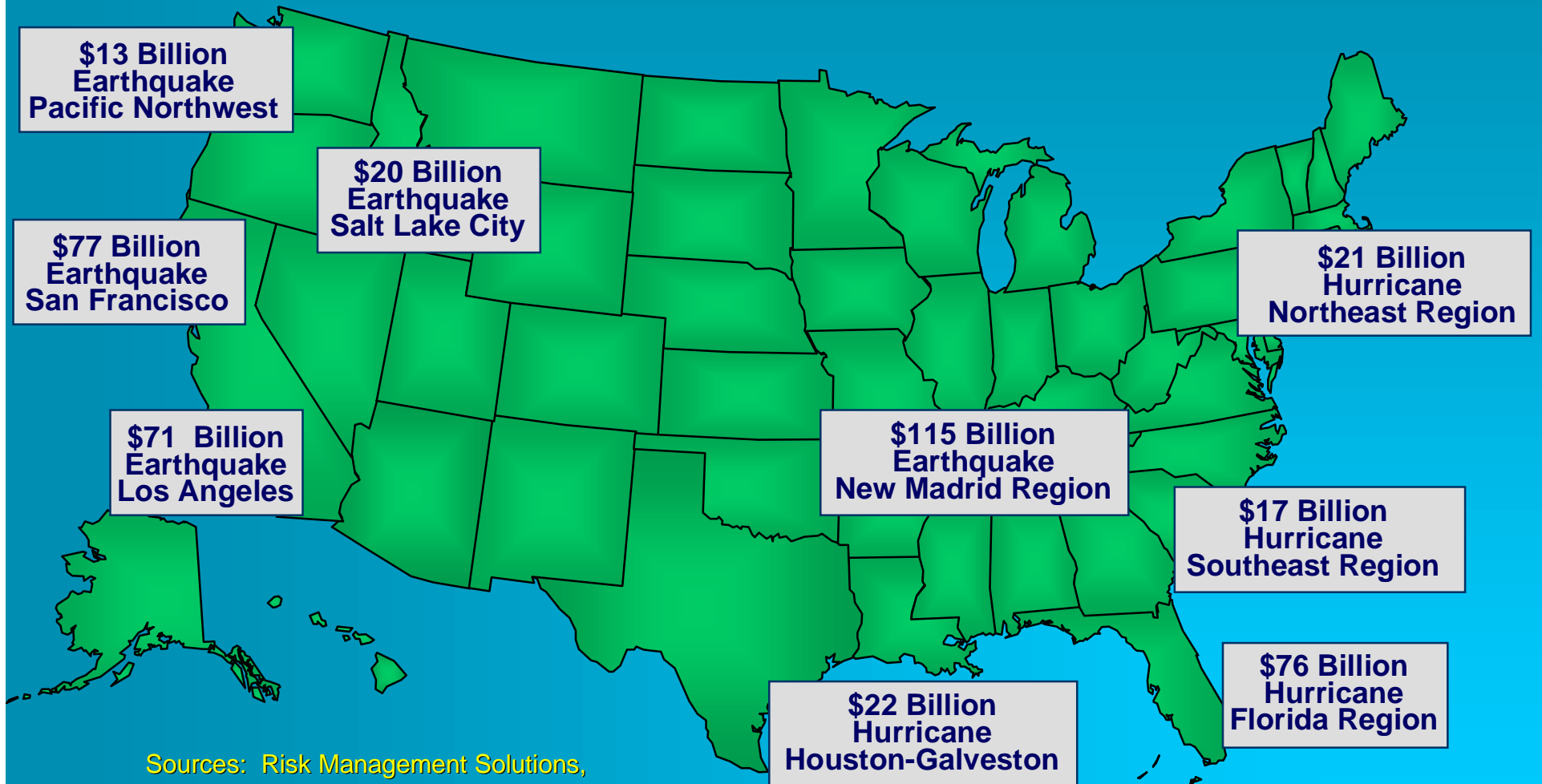
Insurance Services Office Study

❖ Effect of \$50 Billion Industry Catastrophe

- ◆ Up to 36% of Insurers Insolvent
- ◆ Up to \$56 Billion in Unpaid Losses
- ◆ Reinsurance, Guaranty Funds Not Adequate
- ◆ Not Ready for a “Mega-Cat”

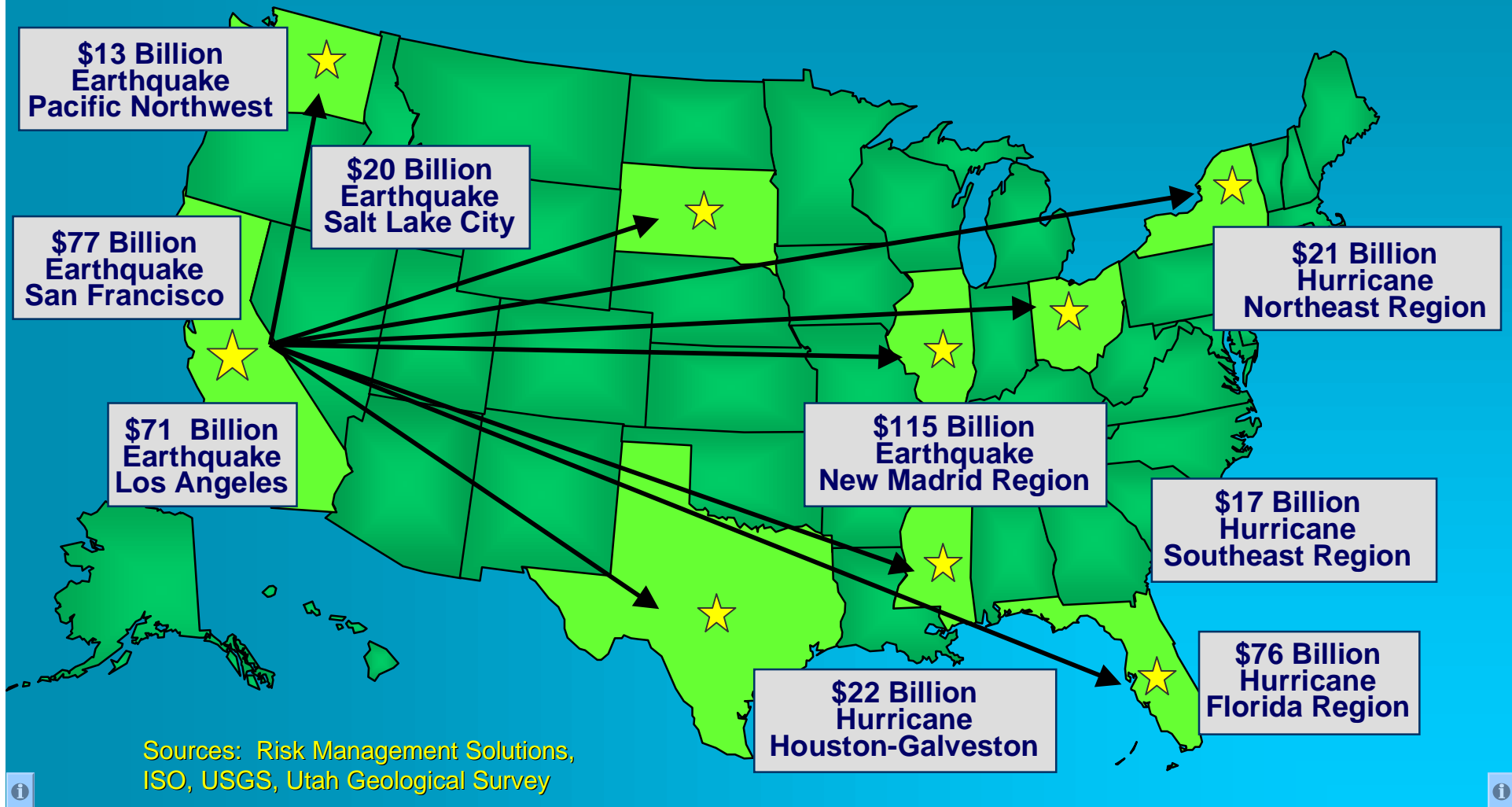


National Mega-Catastrophe Exposures



Sources: Risk Management Solutions, ISO, USGS, Utah Geological Survey

National Mega-Catastrophe Exposures



**Policyholders in Other States Can Be Affected
by a Mega-Catastrophe that Causes Multi-state Insurers to go Insolvent**



Does the Current System Encourage or Allow Insurers to Prepare for Large, Infrequent Disasters?

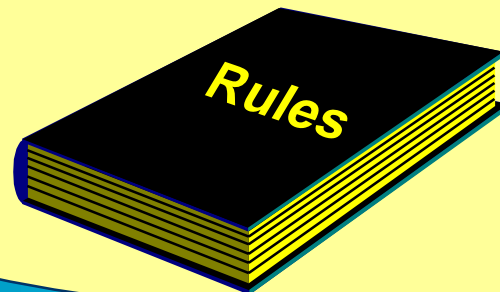
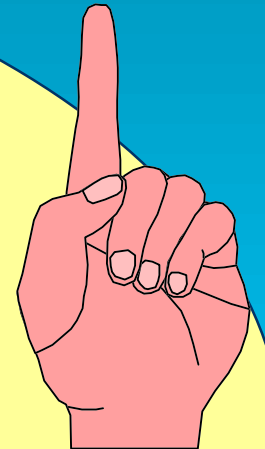
Current Tax, Accounting Rules for Property Casualty Insurance Reserves

❖ Insurance Accounting Rules:

- ◆ Do not allow reserves for future catastrophes

❖ U.S. Tax Code:

- ◆ Only allows deduction for post-event reserves



The Effect of Current Tax, Accounting Prohibition of Pre-event Reserves

- ❖ Insurance premiums include a future disaster charge
- ❖ If no disaster loss, premium goes to income, is taxed
 - ◆ Insurers seek to recover tax by raising rates
 - ◆ Or, if cannot raise rates, will reduce coverage



❖ As a result, disaster insurance is either:

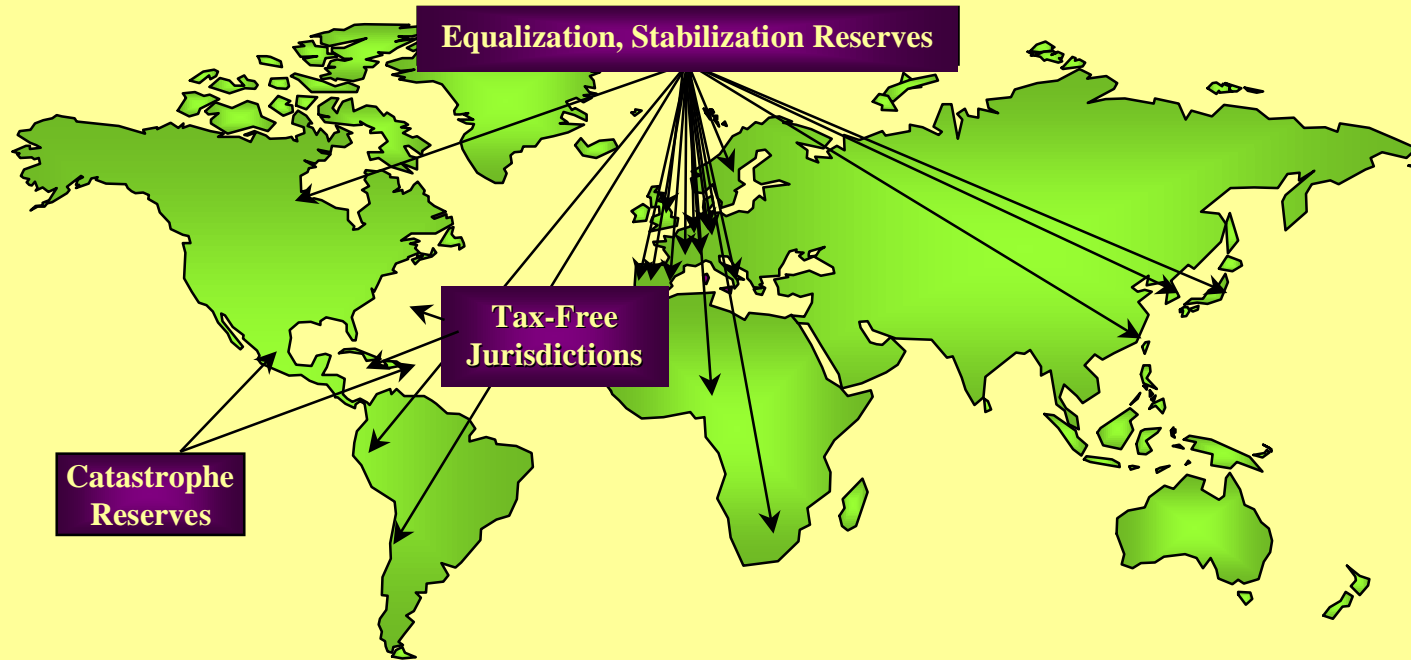


- ◆ less affordable, or
- ◆ less available

than it would be if future reserving were allowed

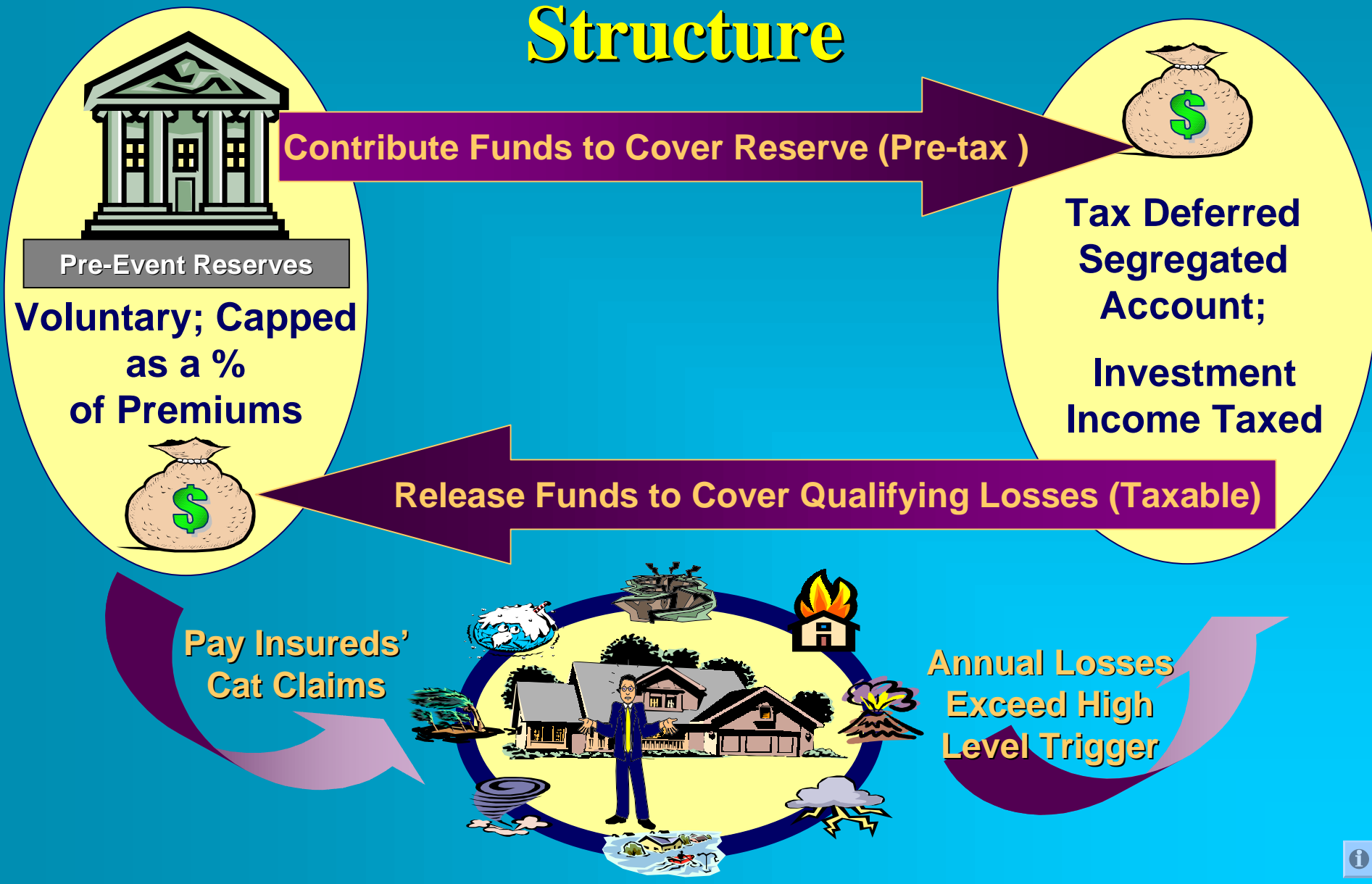
- ❖ The tax disincentive is greatest in high risk areas

What Other Countries Do



- ❖ Most have insurers hold reserves for future cats.
- ❖ Each has its own rules for setting up the reserves.
- ❖ But, in all cases the reserves are tax-deferred.

Policyholder Disaster Protection Reserve Structure



Policyholder Disaster Protection Reserve

Calculation of Reserve Cap

Insurer may establish the reserve up to these maximum levels:

<u>Line of Business</u>	<u>Fund Cap Multiplier of Net Written Premium</u>
❖ Fire	.25
❖ Allied Lines	1.25
❖ Farmowners Multiple Peril	.25
❖ Homeowners Multiple Peril	.75
❖ Commercial Multiple Peril	.50
❖ Earthquake	13.00
❖ Inland Marine	.25
❖ Auto (non-liability)	.01







Designed to yield a maximum \$40 billion industry-wide reserve;
Evaluating inclusion of reinsurance lines of business

Policyholder Disaster Protection Reserve Qualifying Catastrophe

- ❖ A catastrophe that is:
 - ◆ Declared by the President per the Stafford Act,
 - ◆ Declared by a state or territorial governor, or
 - ◆ Reported as a Cat by Property Claim Services
- ❖ And is caused by:
 - ◆ Earthquake
 - ◆ Volcanic Eruption
 - ◆ Tsunami
 - ◆ Snow/Ice/Freezing
 - ◆ Wind
 - ◆ Fire
 - ◆ Flood
 - ◆ Hail



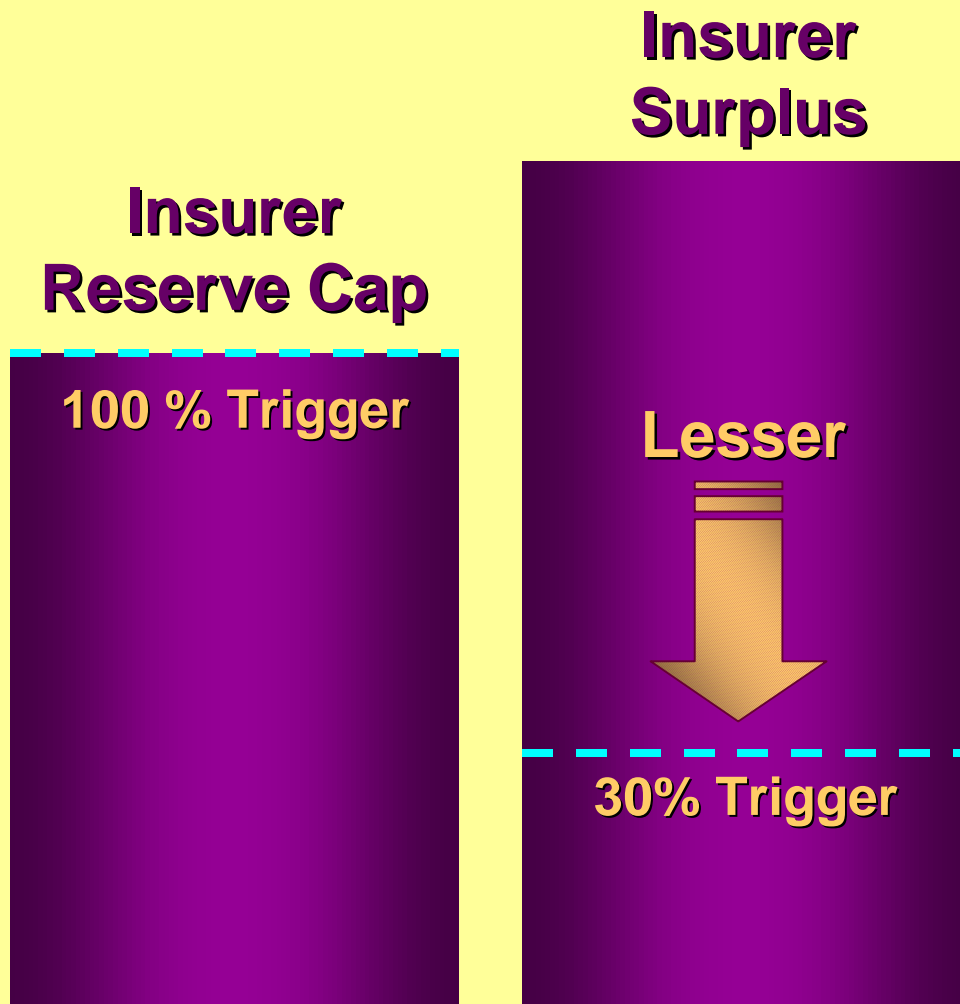
Policyholder Disaster Protection Reserve Proposal

- ❖ **Exposure-Based:** Insurer may set reserve per estimated cat exposure or as state regulator may require
- ❖ **Capped:**  Cannot exceed a max % of premiums. 
Varies by coverage type; 20 year phase-in
- ❖ **Funded:** Funds are set aside, segregated, invested per state insurance investment law
- ❖ **Income Taxed:** Investment income on funds set aside is included in insurer's taxable income
- ❖ **For Mega-Losses:** Funds only available for losses from official cats above high level trigger 
- ❖ **Tax Deferred:** Funds set aside are tax-deductible; funds withdrawn are taxable 

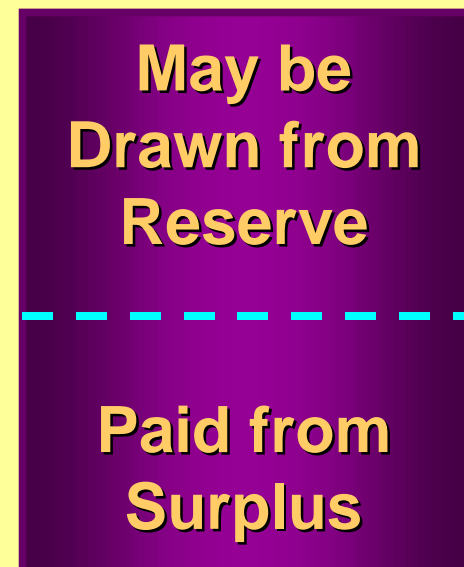


Policyholder Disaster Protection Reserve Drawdown Criteria (“Trigger”)

Trigger for Reserve Drawdown



Qualifying Losses

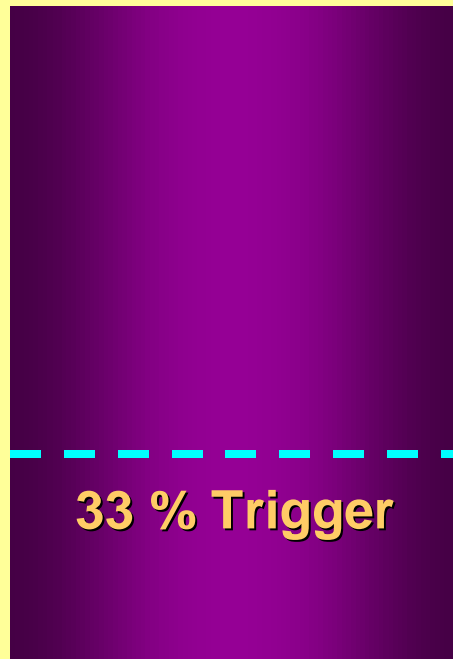


Policyholder Disaster Protection Reserve Second Event Trigger

Second Event Trigger

Insurer
Surplus

Insurer
Reserve Cap

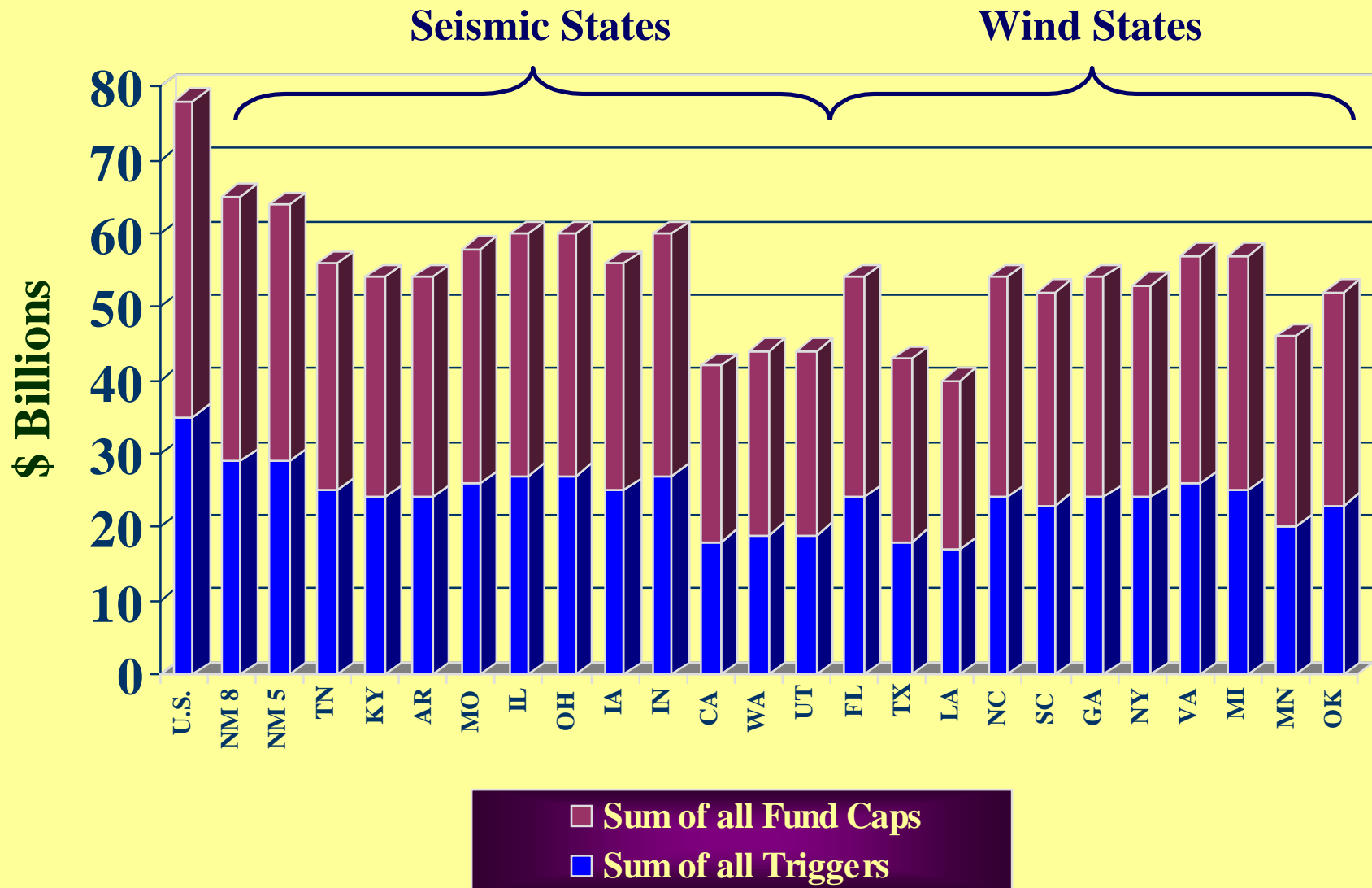


Qualifying
Losses in
any of the
3 Years
After
Reserve
Drawdown

May be
Drawn from
Reserve

Surplus

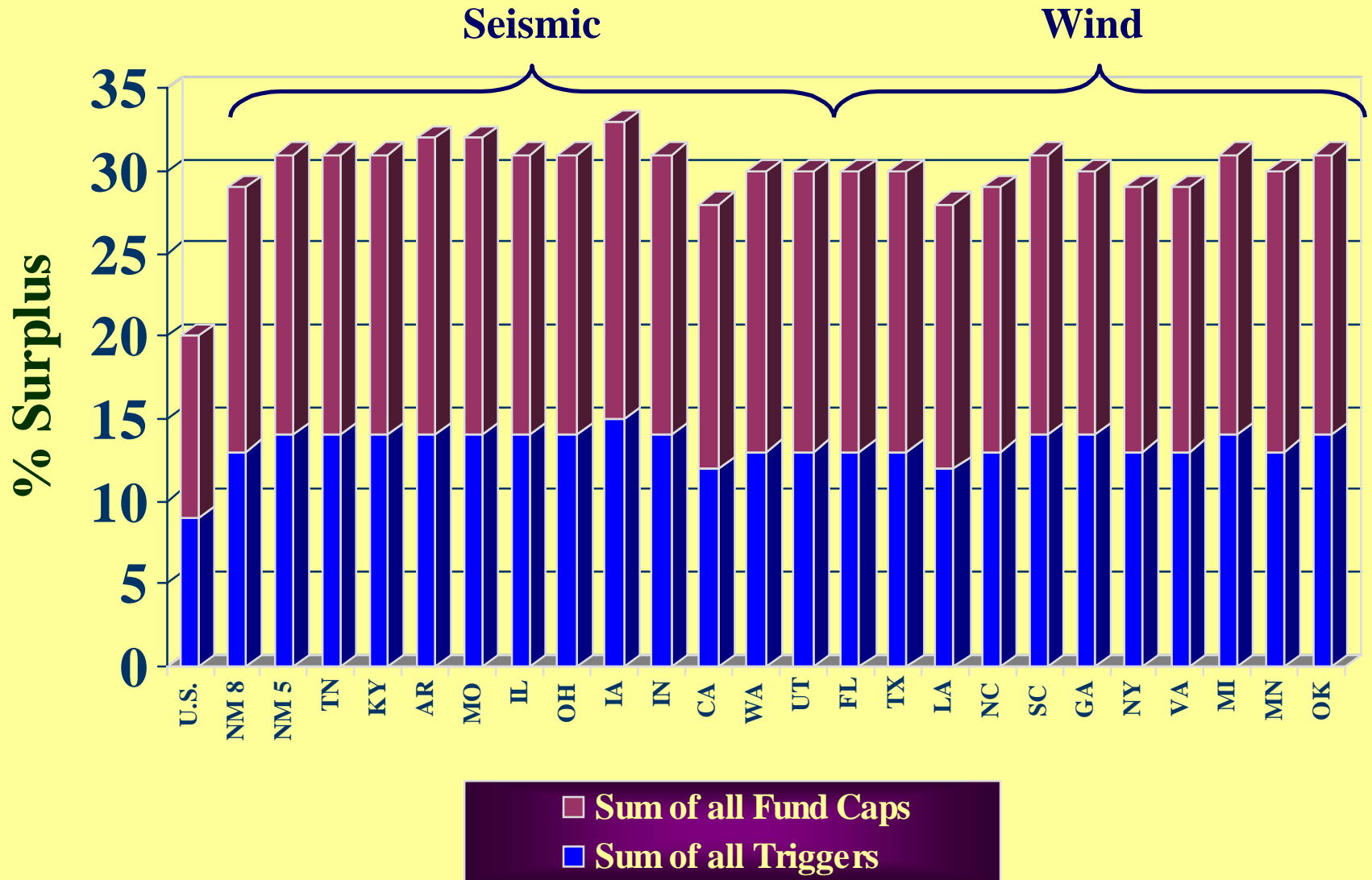
PDPA - Sum of 1999 Triggers and Caps for All Companies in a State/Region - \$ Billions



Based on 1999 Net Written Premiums



PDPA - Sum of 1999 Triggers and Caps for All Companies in a State/Region - % Surplus



Based on 1999 Net Written Premiums



Policyholder Disaster Protection Reserve

Benefits



- ❖ **Reliability:** Fewer insolvencies; More protection of policyholders after a major disaster
- ❖ **Availability:** More readily available cat coverage for homeowners and small businesses
- ❖ **Fairness:** Helps taxpayers, other policyholders to avoid paying for other's cat losses
- ❖ **Efficiency:** Policyholder payments used in an effective manner to keep costs down
- ❖ **Regulated System:** Strong governmental controls, audits to ensure funds are used as intended



Policyholder Disaster Protection Reserve From the Federal Perspective

Lower Risk That the Private Market Will Fail to Protect Insured Public From Losses Due to a Mega-Catastrophe

\$20-30B Long-Term, Pre-Funded Coverage Against Mega-Cats

What the Federal Government Gets (After Ten Years)

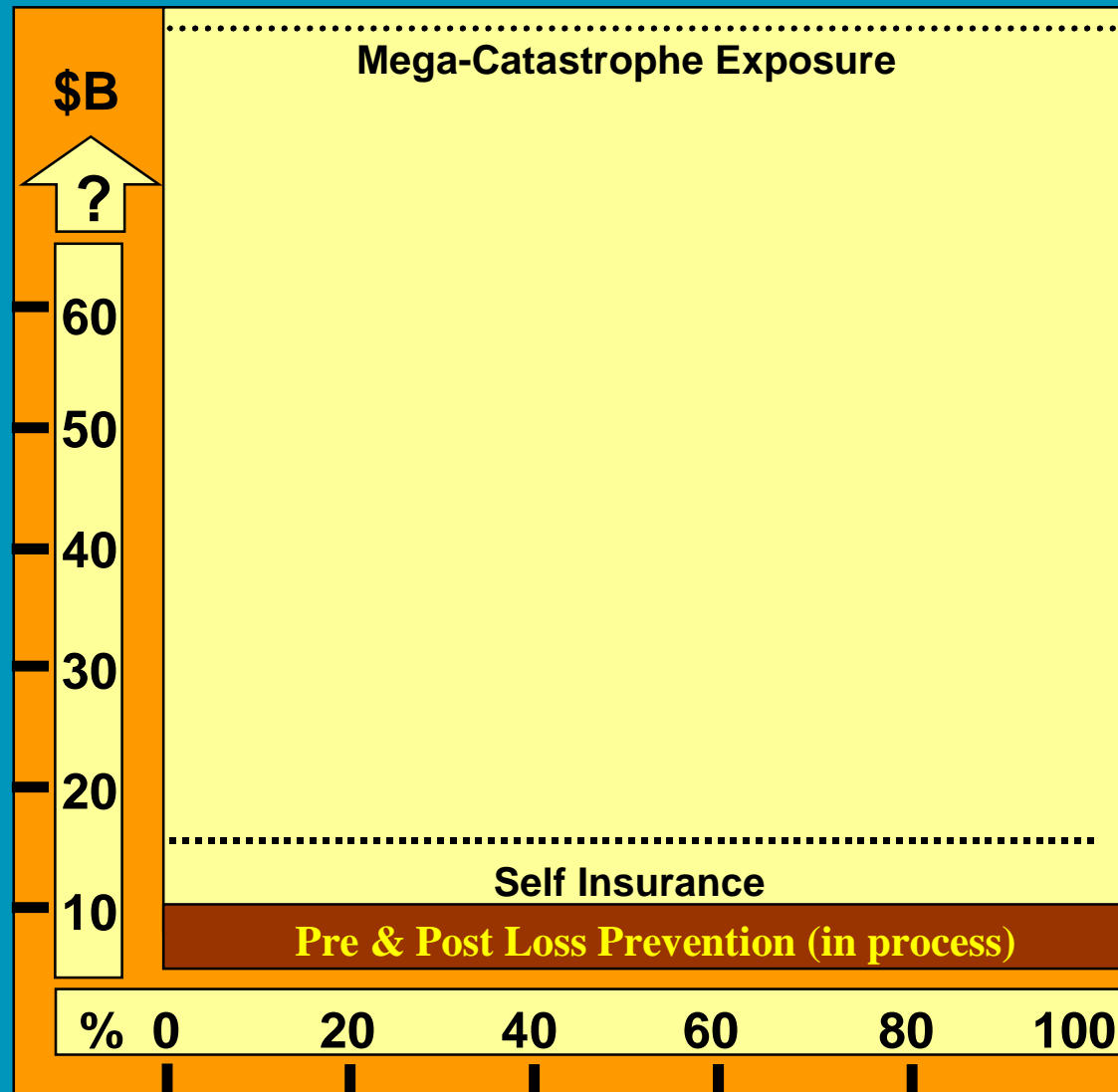
More Available and Reliable Private Disaster Coverage



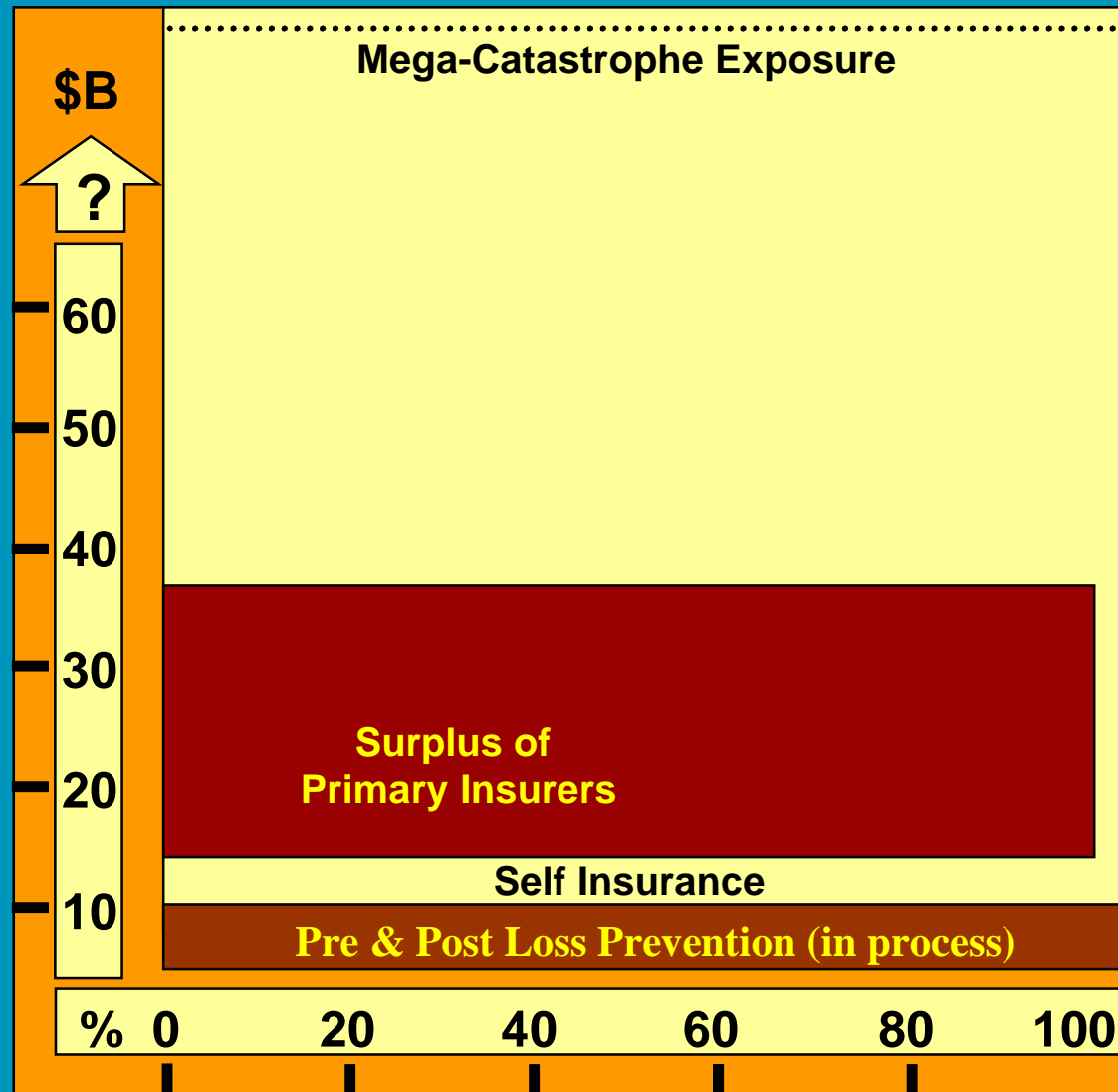
What it Gives Up
Temporary Deferral of Federal Tax Revenue as Reserve Builds Up



National Catastrophe Exposures Today's Methods of Coverage

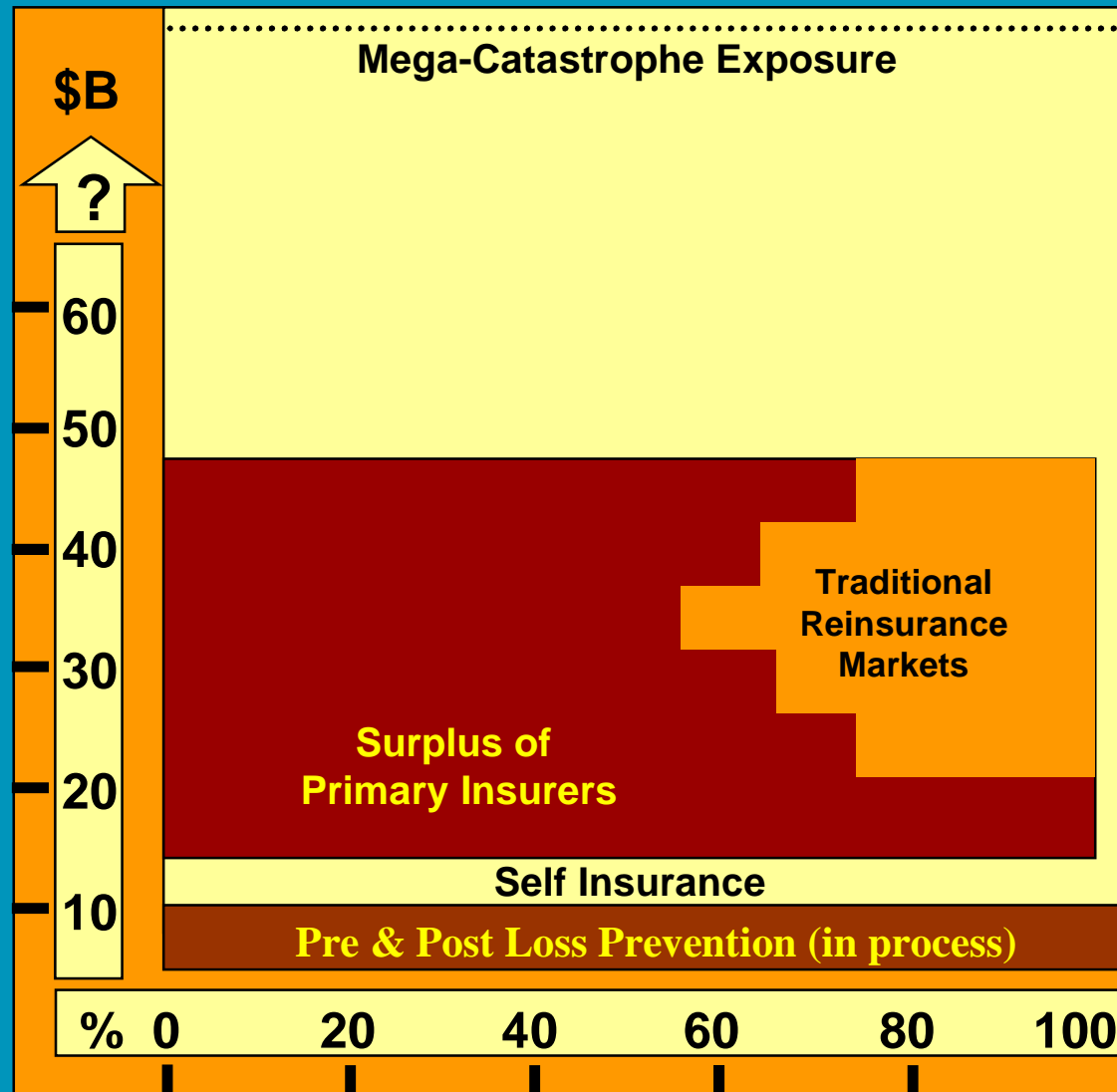


National Catastrophe Exposures Today's Methods of Coverage



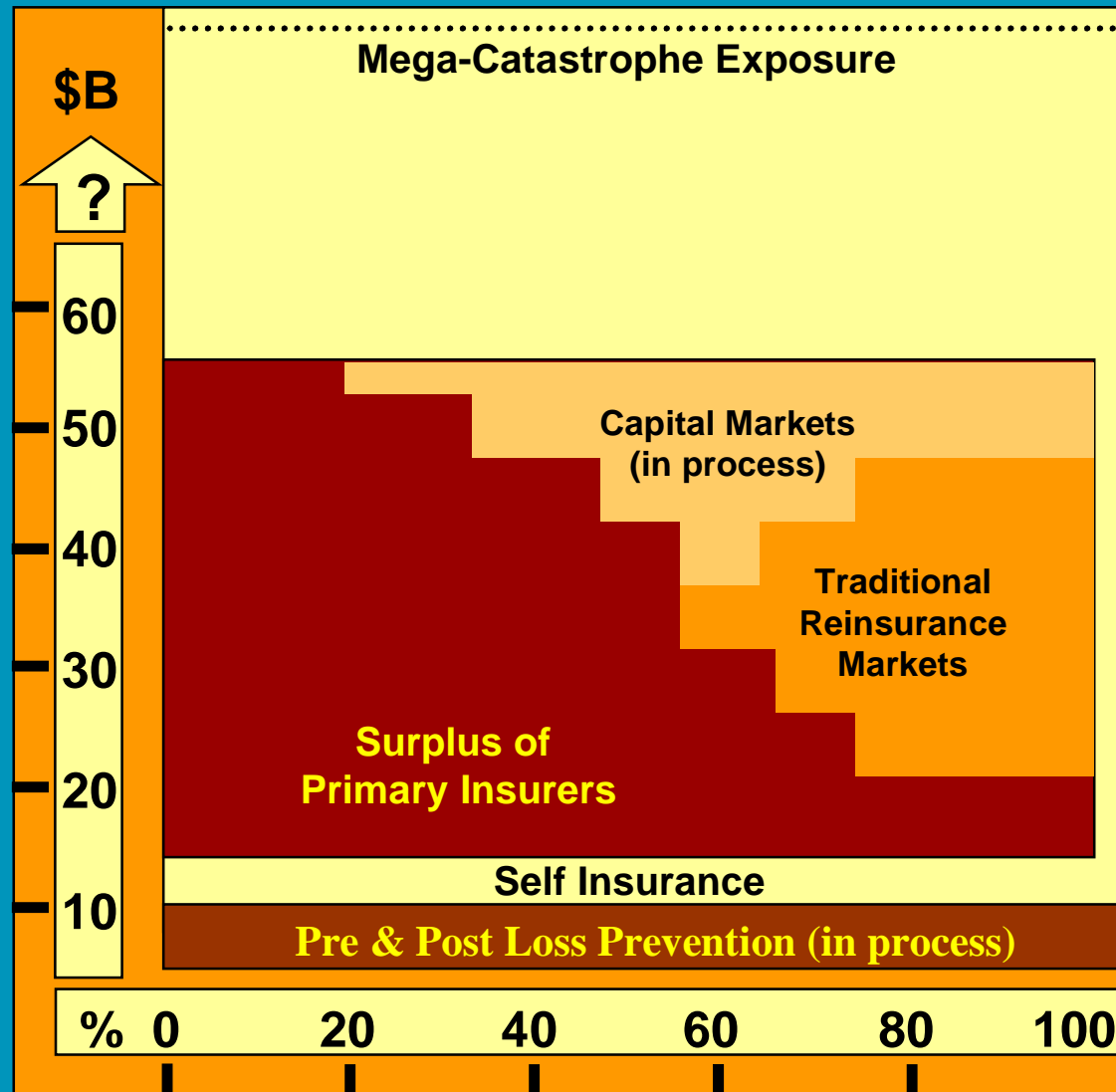
National Catastrophe Exposures

Today's Methods of Coverage



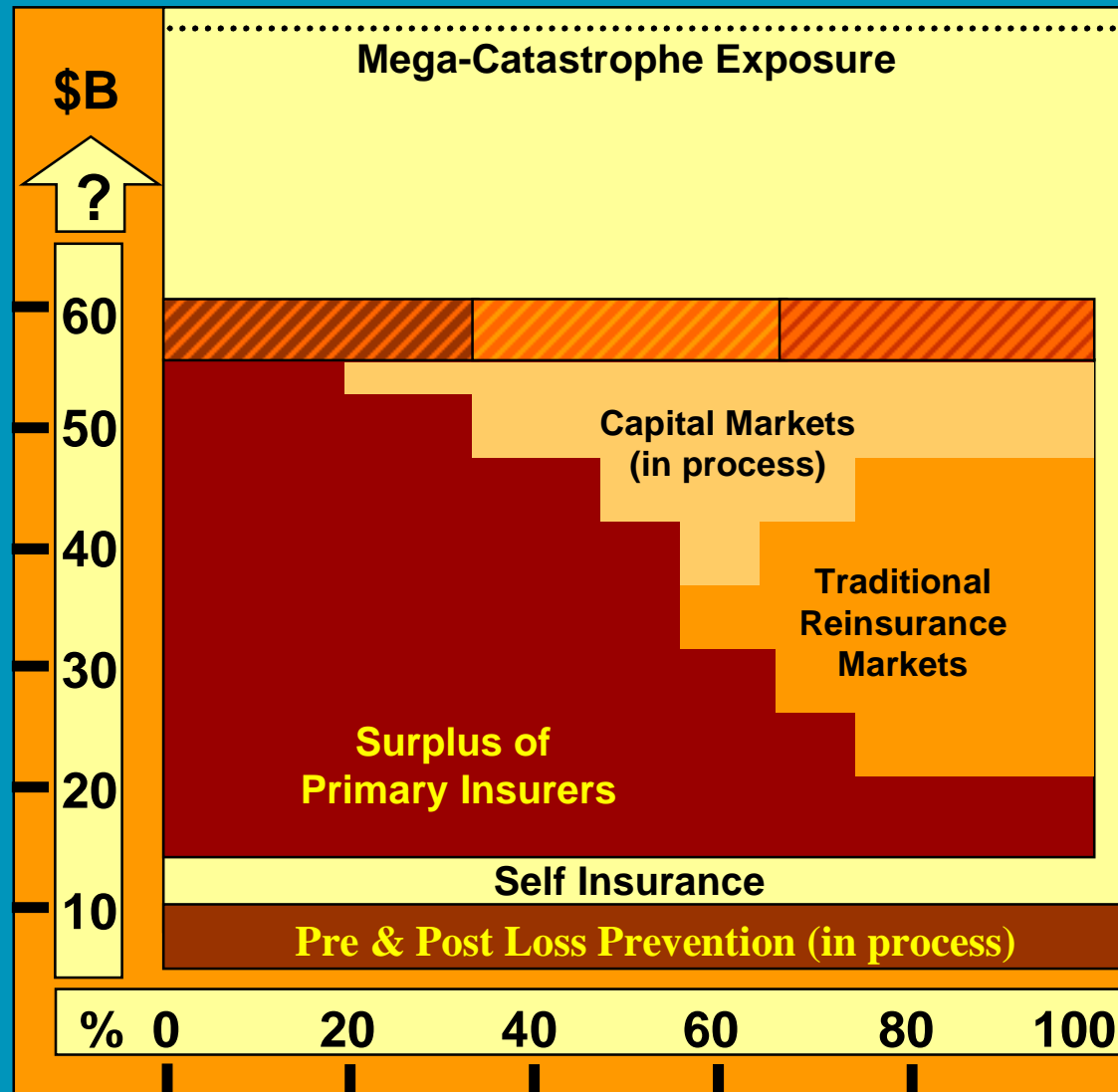
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Today's Methods of Coverage



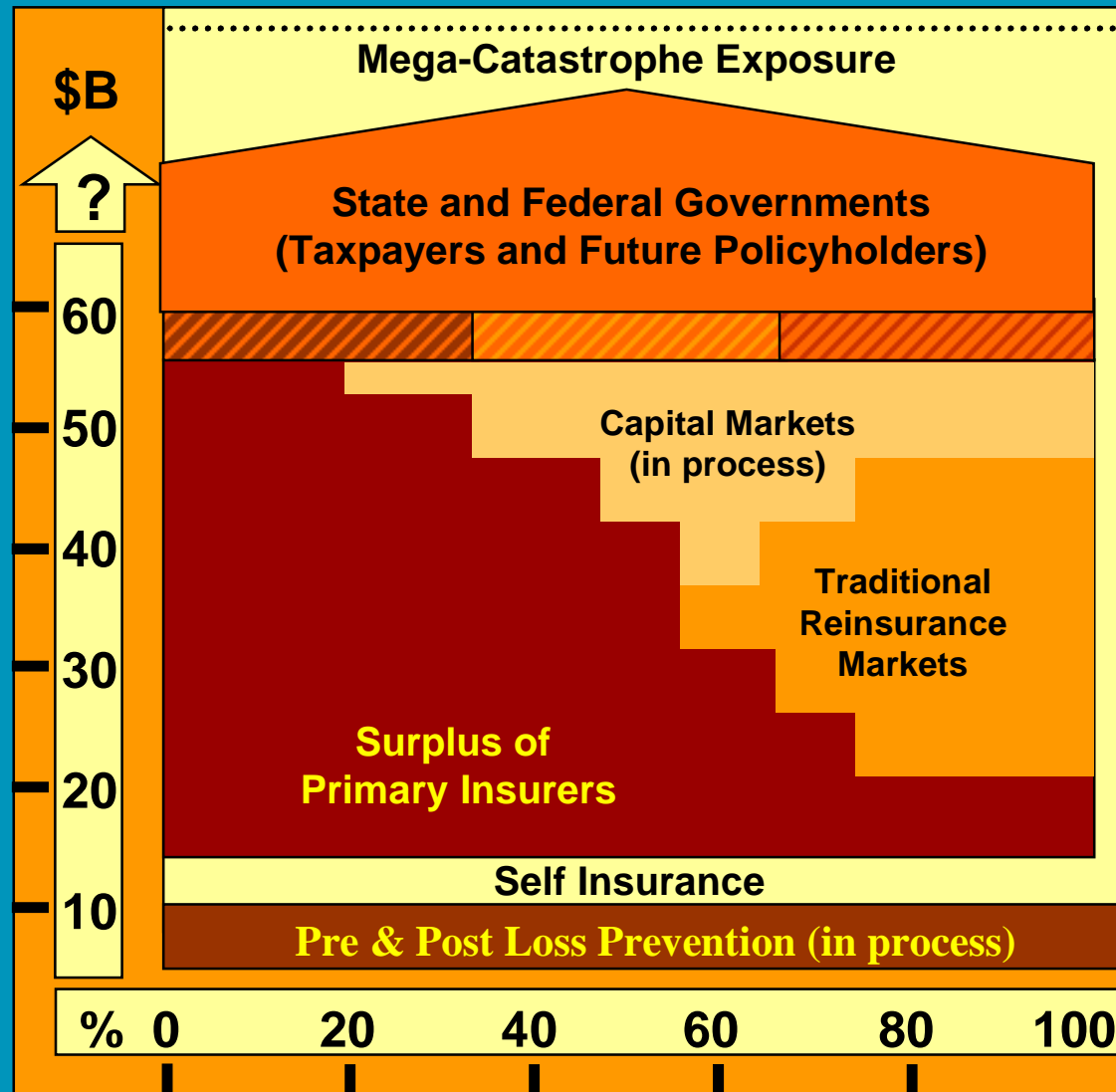
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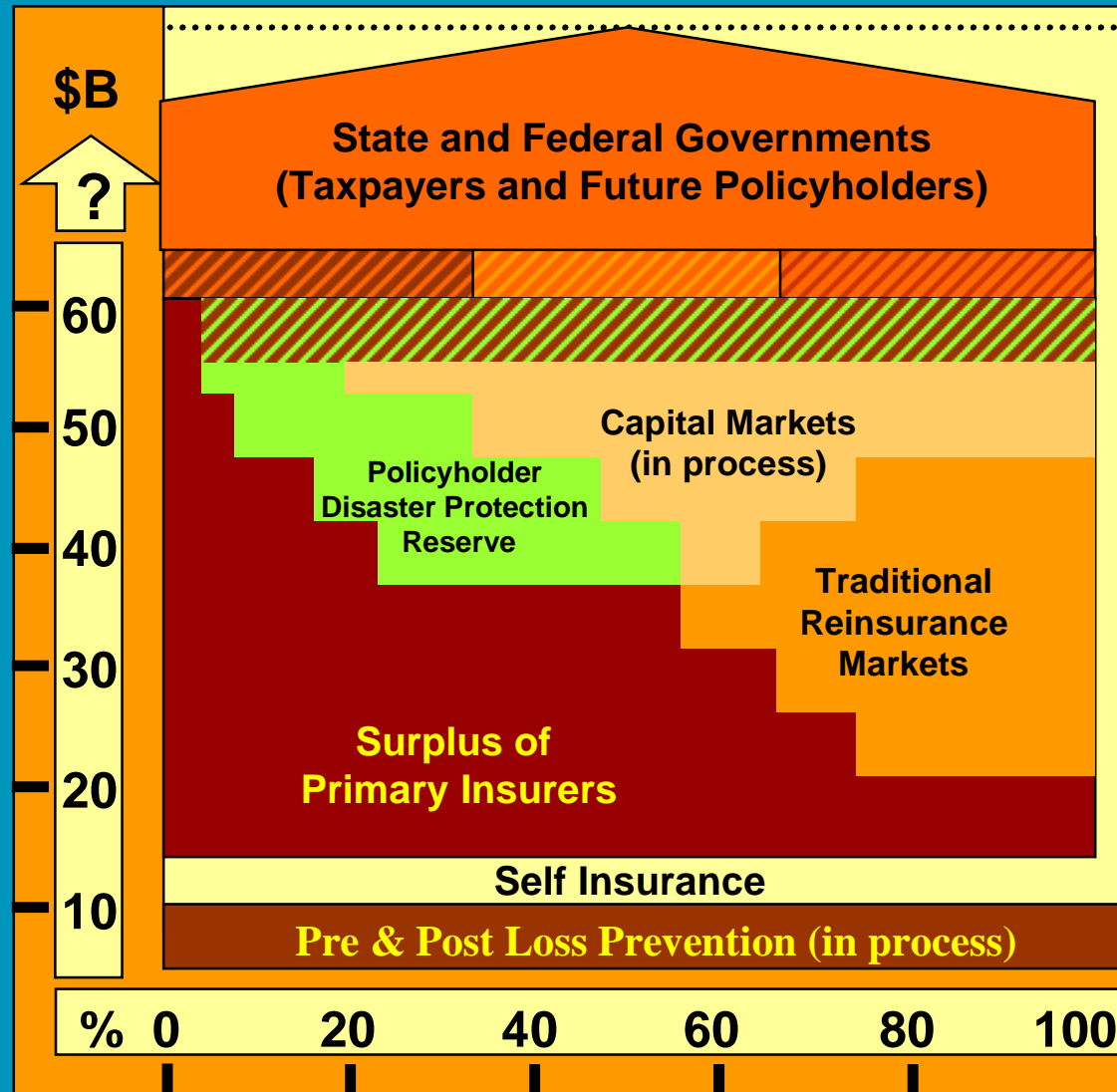


National Catastrophe Exposures

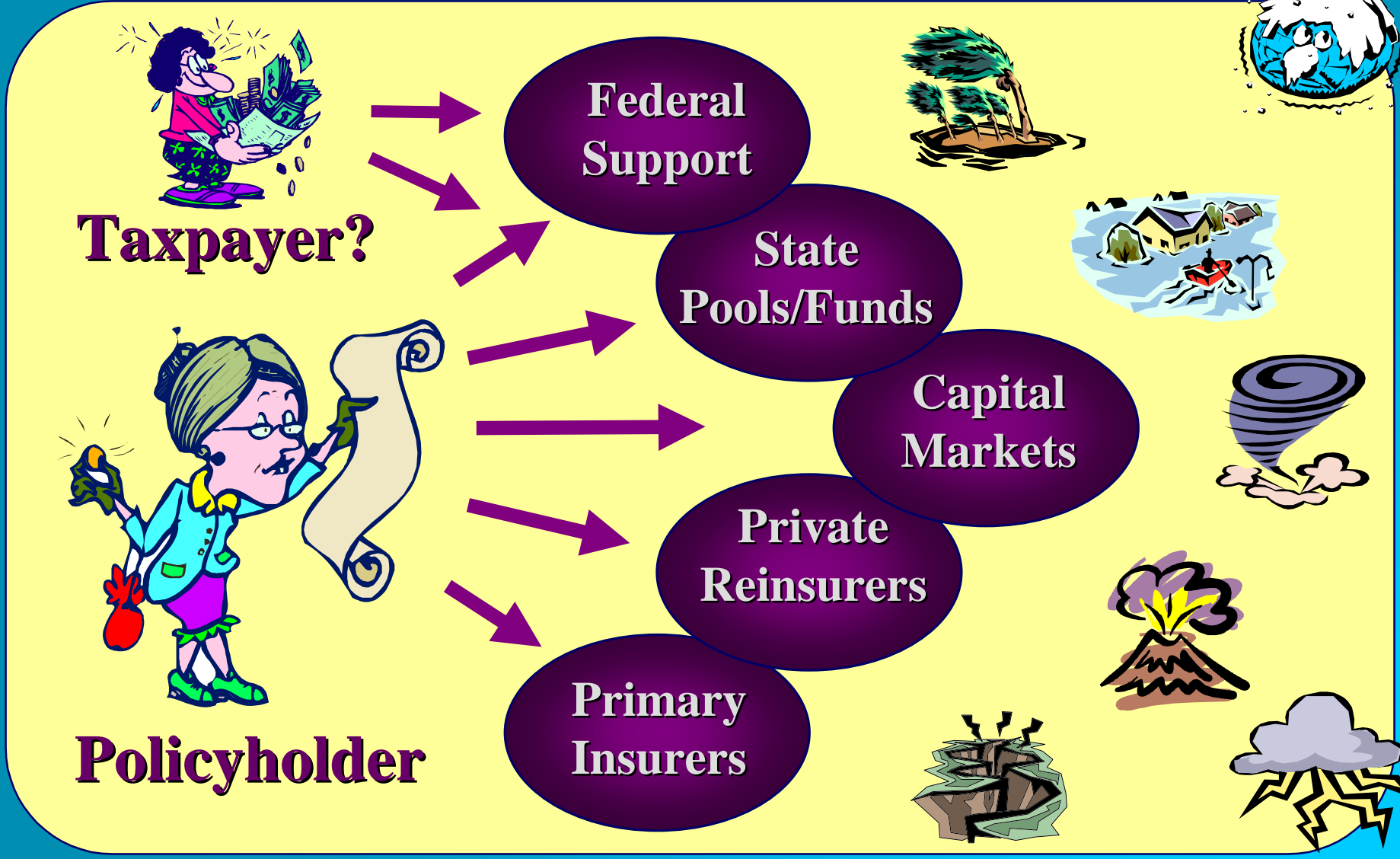
Today's Methods of Coverage



National Catastrophe Exposures Coverage Policyholder Disaster Protection Reserve



Policyholder Premiums Are the Ultimate Source of Funding



Policyholder Disaster Protection Reserves Principal Objective

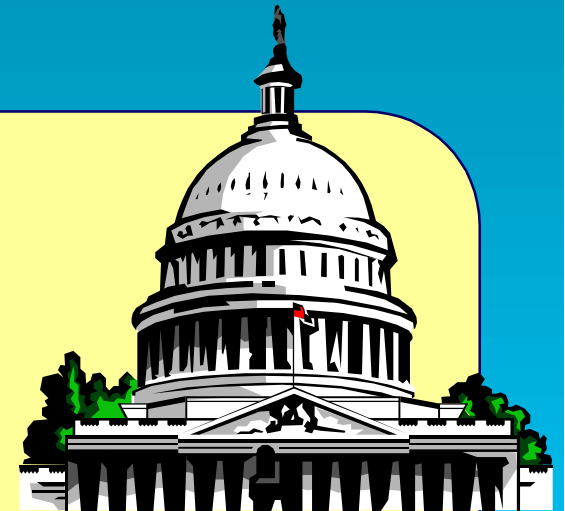


Protect Policyholders and Taxpayers

HR 2749

Bill Status and Strategy

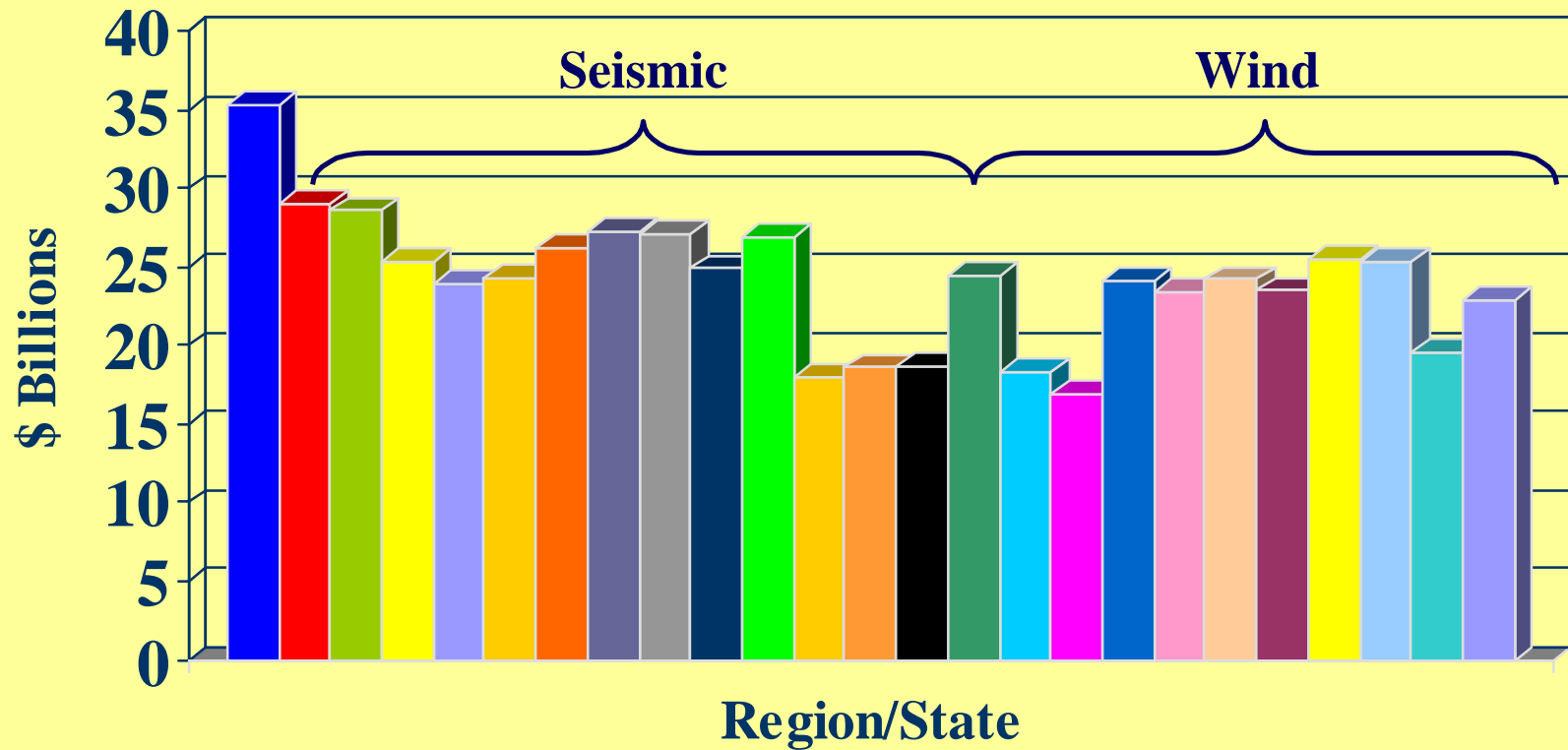
- ❖ **Introduced in House 8/99**
- ❖ **Referred to Ways & Means**
 - ❖ **Rep Mark Foley (R-FL)**
 - ❖ **Rep Robert Matsui (D-CA)**
 - ❖ **74 Co-sponsors; bi-partisan, multi-regional**
 - ❖ **21 Ways & Means Members**
- ❖ **One Element of a Major Tax Bill**



Questions/Discussion

(Backup Slides Follow)

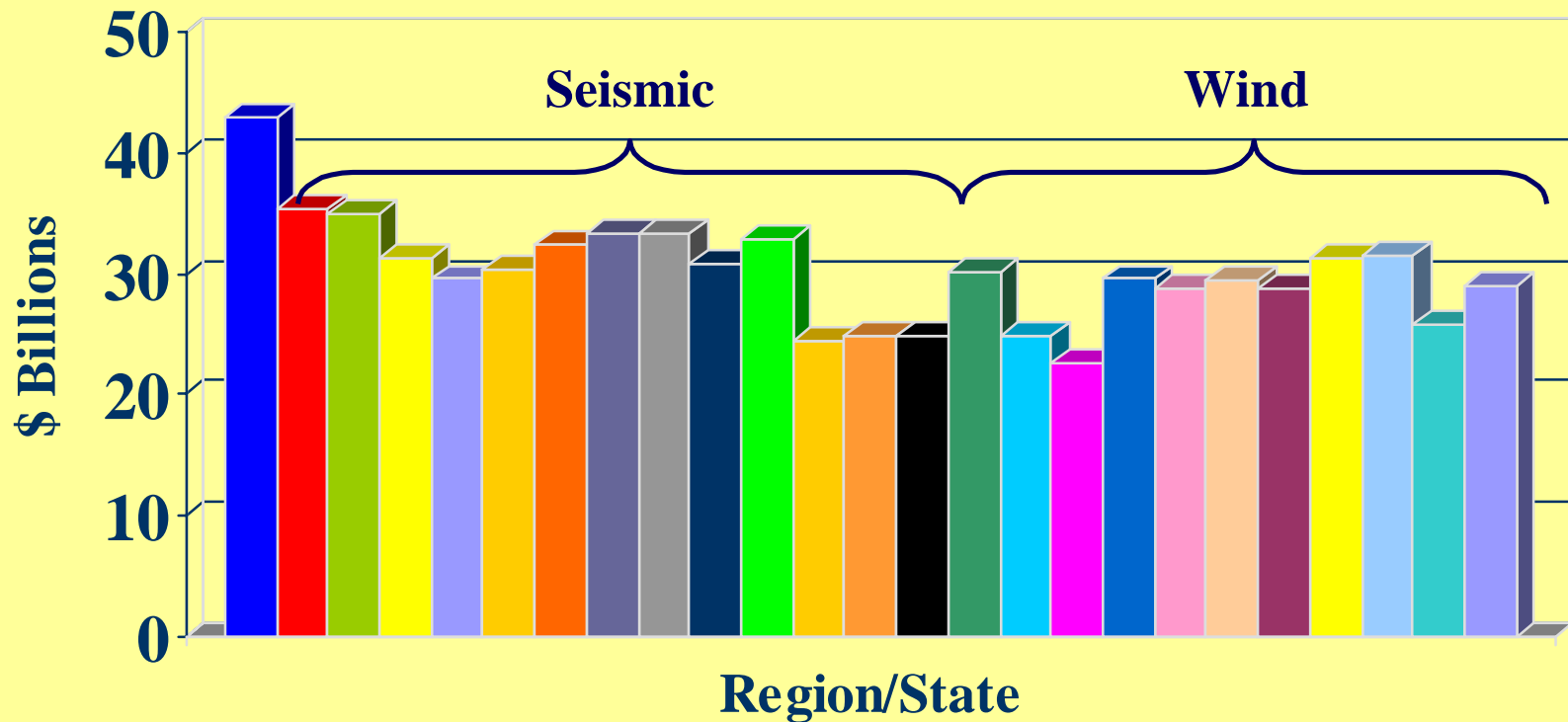
PDPA - Sum of Individual Insurer Triggers for All Companies in a State/Region - 1999



- U.S.
- New Madrid 8
- New Madrid 5
- TN
- KY
- AR
- MO
- IL
- OH
- IA
- IN
- CA
- WA
- UT
- FL
- TX
- LA
- NC
- SC
- GA
- NY
- VA
- MI
- MN
- OK

Based on 1999 Net Written Premiums

PDPA - Sum of Individual Insurer Fund Caps for All Companies in a State/Region - 1999

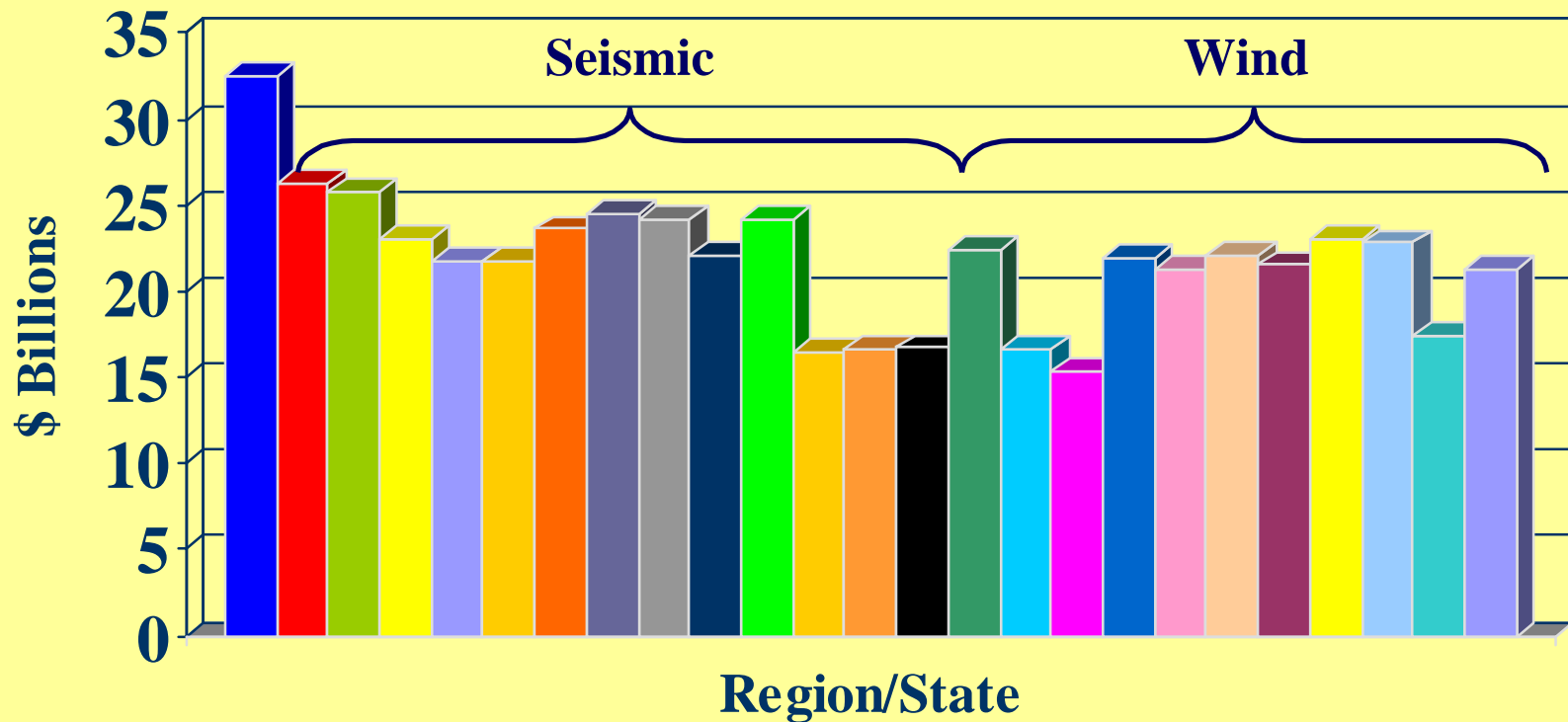


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| ■ AR | ■ MO | ■ IL | ■ OH | ■ IA |
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| ■ NY | ■ VA | ■ MI | ■ MN | ■ OK |

Based on 1999 Net Written Premiums



PDPA - Sum of Individual Insurer Triggers for All Companies in a State/Region - 1997

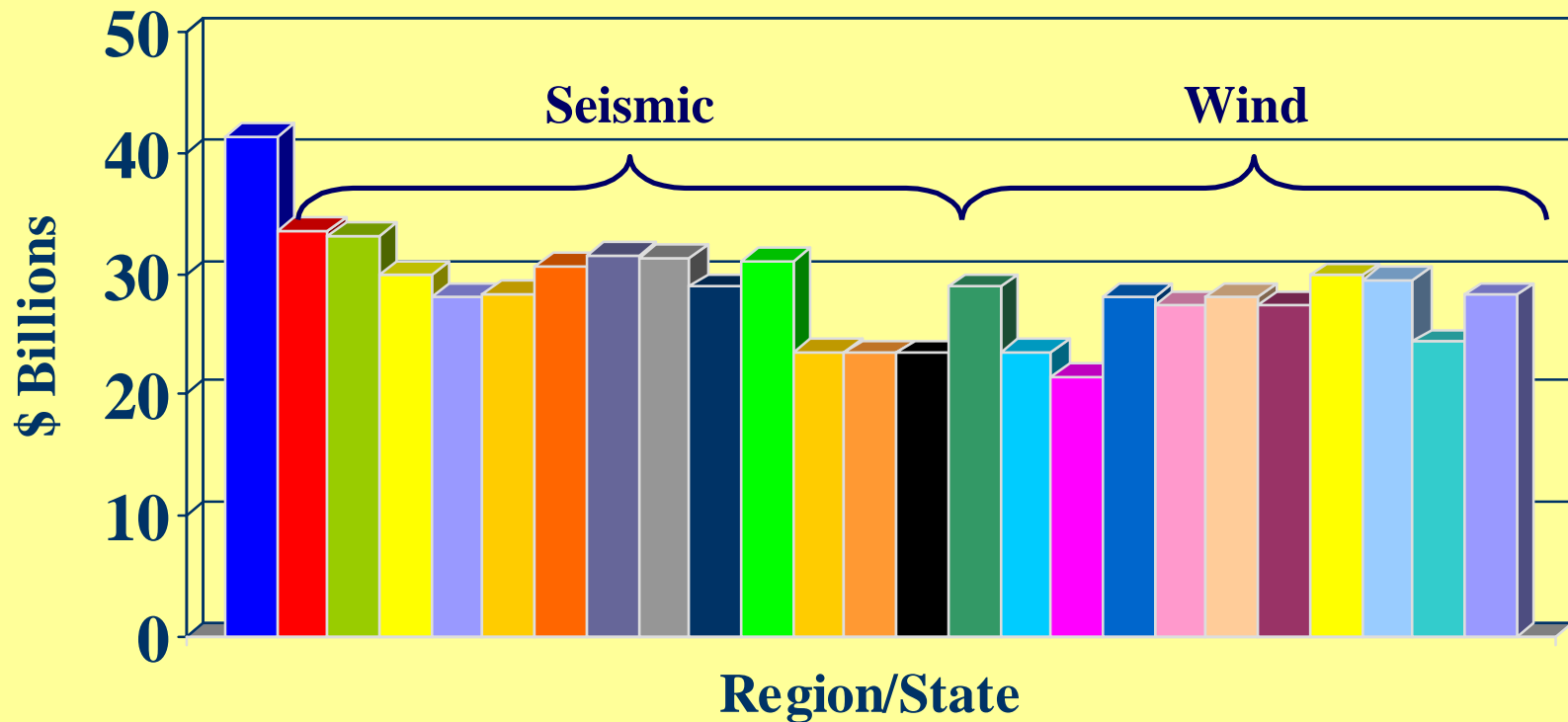


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