Order Code RS22756
November 13, 2007

CRS Report for Congress

The Homeowners' Defense Act: An Overview

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Summary

In the aftermath of Hurricane Katrina in 2005, the demand for homeowners' insurance in East and Gulf Coast states has outpaced supply, leaving policymakers and insurance regulators struggling to find ways to assure the continued availability of affordable property insurance. While a consensus has yet to emerge, many insurance analysts would maintain that probable maximum losses (PML) associated with mega-catastrophes, above a 250-year expected return frequency, are beyond the global insurance and reinsurance industry's capital asset capacity. Insurers and policymakers are now pursuing alternative forms of risk transfer, such as securitization. While the securitized insurance risk market remains modest compared to traditional reinsurance, the number and value of catastrophe bond transactions increased dramatically after the 2005 hurricane season. As one would expect with a relatively new market, insurer and investor preferences as to form and structure of insurance-linked securities (ILS) continue to evolve. Investors tend to want to fully understand the nature of risk they assume while insurers tend to want to transfer at least some risks that are not easily quantified.

Legislation (H.R. 3355/S 2310) has been introduced to establish a not-for-profit corporation, the National Catastrophe Risk Consortium, to facilitate states in creating pools of catastrophe risks that are partially transferred to capital market investors through ILS and financial products that provide insurers with a mechanism to generate sufficient funds if an event occurs. The bill also would extend federal direct loans to qualified state reinsurance programs experiencing capital liquidity shortages and long-term debt needs. The aim of the liquidity loans, which must be repaid, is to ensure that participating programs can access immediate cash to make good on their obligations after a catastrophic event. The objective of the long-term loan program is to ensure that qualifying reinsurance programs can find a buyer of long-term debt to finance large loss events. Both the Consortium and loan programs seek to promote a stable catastrophe insurance market and avoid widespread insurer insolvencies after a natural catastrophe. The Consortium would operate as a congressionally chartered not-for-profit corporation. H.R. 3355 also clarifies that the federal government will bear no liabilities from the actions of the Consortium. This report will be updated as events warrant.

Background

Traditionally, risk transfer from primary insurers has been accomplished through reinsurance agreements with reinsurance companies. Primary insurers typically transfer the risk of loss from a given set of exposures to reinsurers in exchange for a premium. There are two main types of treaty or portfolio reinsurance: pro rata reinsurance, in which premium and loss are shared on a proportional basis; and excess-of-loss reinsurance, for which a premium is paid to cover losses above a pre-determined threshold. The excess-of-loss reinsurance is the predominant form of reinsurance for financing catastrophic property risks.

Immediately after the devastation caused by the 2005 hurricane season, reinsurance rates soared and availability contracted. Insurance companies from Texas to Maine that depended on reinsurance for capacity ceased writing new catastrophe coverage for homeowners. This situation led insurers and policymakers to explore additional ways to transfer the catastrophic risk from primary insurers. Given the reinsurance capacity shortage and significant increases in property insurance prices, industry participants and policymakers are pursuing alternative forms of risk transfer, such as securitization.

Insurance risk securitization has become an active option because of the high cost of catastrophe reinsurance and an emerging belief among many insurance industry analysts that the probable maximum losses (PML) associated with mega-catastrophes exceed the amount of capital the global insurance and reinsurance industry will be able to provide to cover insured loses above a 250-year expected return frequency. Capital markets contain capital several orders of magnitude larger than the reinsurance market and handle daily fluctuations in value greater than the most severe East Coast hurricane or California earthquake.

While the securitized insurance risk market remains relatively small, it has picked up momentum after the 2005 hurricane season. According to Swiss Re, the largest reinsurer in the world, the catastrophe bond market has grown from approximately $7 billion of capacity in 2002 to approximately $32 billion in 2007. This alternative market plays a significant role in making insurance and reinsurance more available and affordable. Questions remain about what form and structure of insurance-linked securities (ILS) and derivatives would ultimately be viewed most favorably by investors and at what point the ILS market reaches "critical mass" sufficient to broaden investor interest. Investors will likely want to understand the nature of risk they assume before seriously considering new investment opportunities in the area of securitized insurance risk.

Summary of H.R. 3355

On August 10, 2007, Representatives Ron Klein and Tim Mahoney introduced the Homeowners' Defense Act of 2007 (H.R. 3355). On November 8, 2007, the legislation was approved by a vote of 258-155 in the House of Representative. Two days before, on November 6, 2007, Senators Hillary Clinton and Bill Nelson introduced identical legislation (S. 2310). Both bills would establish a non-profit corporation, the National Catastrophe Risk Consortium, to facilitate qualified state insurance programs and state residual insurance market entities in voluntarily pooling their catastrophic property insurance risk. That risk could be transferred to the capital markets through the issuance

of insurance-linked securities or through the coordination of reinsurance contracts. Proponents contend that transferring mega-catastrophe risks to the capital markets will allow state-sponsored insurance facilities to expand private sector capacity to handle catastrophe risk (i.e., increase the supply of property insurance coverage) and reduce the insurance availability problems being experienced in disaster-prone states. Critics of the proposal believe that states are already free to pool risks and access the ILS markets and a federal program is not necessary. Some have also expressed concern that the creation of a federal not-for-profit to coordinate ILS transactions may imply a federal guaranty of the performance of the catastrophe bonds, which would result in a federal subsidy for certain state insurance programs and policyholders and potential exposure of taxpayer money.

H.R. 3355/S. 2310 also would provide two types of federal direct loans to qualified state reinsurance programs facing a certain level of insured losses. First, liquidity loans would be available if a program faces a liquidity shortage following a natural disaster and is not able to access short-term capital at a reasonable rate in the private market. Second, long-term catastrophe loans would be available if losses exceed 150% of the aggregate amount of premiums assessed for private property and casualty insurance issued in the state over the previous 12-month period. The bill explicitly states that the Consortium will not be a department, agency, or instrumentality of the U.S. government. H.R. 3355 would also clarify that the federal government would bear no liabilities from the actions of the Consortium.

Title I — National Catastrophe Risk Consortium

The objective of the National Catastrophe Risk Consortium is to help homeowners prepare for and recover from the damages caused by natural hazards, stabilize the market, and avoid widespread insurer insolvencies after a mega-catastrophe by encouraging the creation of state catastrophe funds to complement homeowners insurers' current reliance on private reinsurance. The Consortium would facilitate the transfer of some of the aggregated catastrophe risks assumed by individual state insurance facilities into the capital market or arrange for the risks to be reinsured in the global reinsurance market.

Operationally, the Consortium would be established to carry out six primary objectives: (1) gather and maintain an inventory of catastrophe risk obligations held by state reinsurance funds and state residual insurance market entities; (2) serve as a centralized repository of state risk information that can be assessed by private-market participants interested in underwriting ILS; (3) use a catastrophe risk database to perform research and analysis that encourages standardization of the ILS market; (4) serve as a conduit for the issuance of securities and other financial instruments linked to catastrophe risks; (5) coordinate reinsurance contracts between participating reinsurance funds and private parties; and (6) perform any other factors deemed necessary to aid in the transfer of catastrophe risks from state reinsurance programs to private parties.

Figure 1 provides an illustrative overview of how the National Catastrophic Risk Consortium would operate by transferring catastrophic property risks from state reinsurance and state residual insurance market entities to the capital markets. First, homeowners would purchase coverage from a traditional homeowners' insurer or state residual insurance market entity. Second, the primary insurer or state-sponsored insurance entity would then cede (i.e., reinsure) all or a portion of the catastrophe risks to a qualified

state reinsurance program. Third, the QRP would utilize the Consortium as an intermediary or facilitator to transform the catastrophe risk into marketable insurance-linked securities (ILS) or to coordinate reinsurance contracts. Fourth, investors (e.g., fixed income money managers, hedge funds, banks) in the capital market would purchase the ILS (catastrophe bonds) with the help of investment professionals.

The bills would vest the Consortium with certain legal, regulatory, and contractual powers similar to other corporations. For example, the entity could sue and be sued in any court of competent jurisdiction. It could also enter into contracts and other agreements with any individual or other private or public entity, allow for the authorization of obligations, employ and fix the compensation of employees and officers, lease and own property (real, personal, or mixed), and accept gifts or donations of services.

The Consortium would be governed by a Board of Directors, and chaired by the Secretary of the Treasury, with members to include the Secretary of Homeland Security, Secretary of Commerce, and one representative from each state participating in the Consortium. Consortium personnel would be prohibited from conflicts of interests and personally benefitting from the corporation. The Consortium would also hire professional staff to track state insurance risk obligations, and coordinate the issuance of ILS with private capital market participants. Under the provisions of H.R. 3355/S. 2310, Congress would authorize the Consortium $20 million in operating capital for each of five years, 2008 through 2013.

Title II — National Homeowners' Insurance Stabilization Program

Proponents of H.R. 3355/S. 2310 contend that the legislation is based upon the "actuarial" view that catastrophe risks are insurable in the long run. Thus, the federal government would function as a "lender of last resort" to the insurance industry in exactly the same way the Federal Reserve provides temporary emergency liquidity to the banking industry. A federal liquidity (loan) program would presumably address the pattern of loss over time where insurers have difficulty matching losses each year with premiums received in that year. That is, insurers collect a more or less consistent premium each year for catastrophes but pay out catastrophe losses sporadically. In theory, because the government can take a long run view by borrowing to pay for catastrophes after an event, proponents maintain that the "timing risk" problem becomes manageable through a catastrophe fund program. The idea behind Consortium appears to be to mitigate some of the post-event catastrophe fund assessment burden on taxpayers by transferring some amount of the post-event debt-risk to the pre-event capital markets.

H.R. 3355's loan program would provide two types of loans: liquidity loans and catastrophe loans. The purpose of these loans would be to: (1) ensure the claim-paying ability of qualified reinsurance programs (QRP); (2) improve the availability and affordability of homeowners' insurance, and (3) spread the catastrophic risk over time and across a broader base through post-event borrowing. The Secretary of Treasury would enter into these lending arrangements with qualified reinsurance programs (QRP) upon the request of the QRP after assurances that the QRP cannot access capital in the private lending capital markets.

The Liquidity Loan. Under a H.R. 3355 Liquidity Loan, the Treasury Secretary would be required to find that a QRP has a capital liquidity shortage and is unable to

obtain capital at effective rates of interest lower than those offered in the private market. Liquidity loans would have a duration of 5-10 years and bear an interest rate 3% higher than that of marketable obligations of the Treasury (debt) with a comparable maturity as a loan issued during the most recently completed month. Loan amounts for the reinsurance program cannot exceed the "ceiling coverage level" established by the Treasury Department.

The Catastrophe Loans. These loans are available to QRPs following a catastrophic event that results in insured losses that exceed 150% of the aggregate amount of a participating state's direct written premiums for privately issued property and casualty losses during the calendar year preceding such event. The loan amount cannot exceed the amount by which the insured losses exceed the "ceiling coverage level" of the QRP. Catastrophe loans would be provided for 10 years or more at an annual interest rate 0.2% points higher than marketable obligations of the Treasury having a term to maturity of 10 years. The term to maturity of catastrophe loans could be extended under the same circumstances and conditions as liquidity loans.

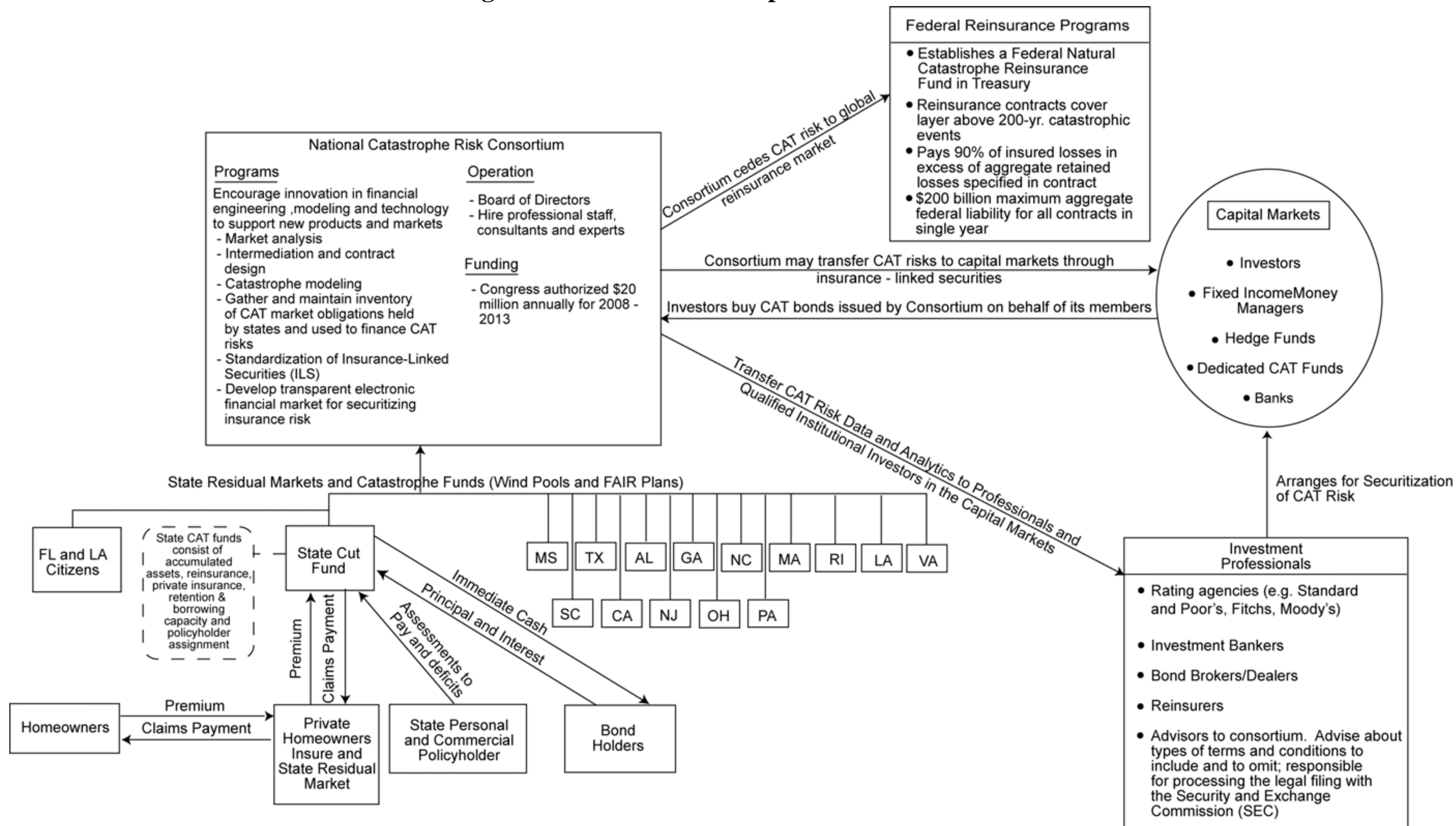
Qualified Reinsurance Programs. To be a qualified state or regional reinsurance program (QRP), the state authorizing the facility must have a "material, financial interest" in the facility. The facility must (1) provide reinsurance coverage to primary insurers for "all personal real property and homeowners lines of insurance"; (2) have a governing body the majority of which are public officials; and, (3) comply with Treasury regulations which may include the regulation of organization, financial requirements, underwriting, and holding company requirements, anti-concurrent clauses, and cost savings for consumers.

States Without Qualified Reinsurance Programs. During the first five years after enactment, states without a QRP would be eligible to participate in the National Homeowners' Insurance Stabilization Program through their residual insurance market entity until they create a qualified reinsurance program, provided the state residual insurance market entity is in place before enactment of the legislation. The Secretary of the Treasury would be authorized to make a catastrophic loan to a Fair Access to Insurance Requirements (FAIR) Plan, or a Beach and Windstorm plan, or to a state or regional reinsurance plan if: (1) the facility cannot borrow at a lower rate in the private market, (2) sustains a loss in excess of 150% of its prior year's homeowner's premium, (3) the state co-signs the loan with the borrowing facility, (4) the rate of the loan exceeds the amount available to qualified reinsurance programs; and (5) the term to maturity of the loan is shorter than the term available to qualified reinsurance programs. In addition, the legislation provides that loans to a non-qualified facility are not permitted to be made after 2112. A catastrophe loan to a state without a QRP shall have a higher rate of interest and shorter term to maturity than a catastrophe loan to a QRP as determined by the Secretary.

Title III — Reinsurance Coverage for Qualified Reinsurance Programs

H.R. 3355, as passed the house, includes a provision that would allow state qualified reinsurance programs (QRP) to purchase one-year reinsurance contracts from the Treasury. The contracts only would pay in a 200-year (0.5% chance of occurring) catastrophic event up to 90% of insured losses in excess of aggregate retained losses that the contract requires. The maximum aggregate federal liability under the reinsurance program is $200 billion in any single year for all contracts for reinsurance coverage.

Figure 1. National Catastrophe Risk Consortium



Source: Congressional Research Service.