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CRS Issue Statement on Disaster Risk Financing

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Insurance plays a key role in the U.S. economy in covering, among other things, the financial losses caused by natural disasters. It also provides incentives for disaster mitigation investments, which helps to reduce the vulnerability of households and businesses to natural hazards.

Reliance on the decades old practice of reallocating resources throughout the economy after a major natural disaster to compensate disaster victims has become problematic, particularly in light of current fiscal deficits and the increasing frequency and severity of natural disasters. Importantly, the magnitude of damages caused by the 2004, 2005, and 2008 hurricane seasons, and predictions of more frequent storm activity in the Atlantic Basin over the next 15 to 20 years, have restricted homeowners' insurance, reduced availability, and raised affordability issues in disaster-prone areas. Insurance market analysts now question whether the economy's market for catastrophe insurance is sufficient to meet the burdens of a future mega-catastrophe.

Some insurance experts reject the notion of a federal role in catastrophe insurance market, arguing there is adequate worldwide reinsurance capacity to protect U.S. primary insurers against catastrophe losses. Others support expanded government intervention, pointing to market failure and the insurance industry's limited claims-paying capacity in the event of a mega-catastrophic event.

Congress may consider a wide range of policy options and strategies for managing the nation's exposure to catastrophic risk, including a federal reinsurance backstop for future natural disasters, authorizing the Treasury Department to make loans available to states affected by natural disasters, and authorizing the Federal Reserve to guarantee the bond obligations of the states' catastrophe funds—a move that would make it easier for states to sell bonds to finance the payments of claims in the event of a mega-catastrophe. The funds obtained through issuing bonds would be repaid by assessments on insurers and policyholders. Finally, Congress is also considering tax policy changes to allow for the deductibility of multi-year catastrophe loss reserves and the creation of a bi-partisan commission to examine catastrophe risks and recommend possible solutions for Americans living in areas that are prone to natural disasters.

Some Policy Questions

- Does the catastrophe insurance market provide a sufficient amount of insurance against a mega-catastrophe? To the extent that catastrophe insurance exists, are the insuring firms sufficiently capitalized so that widespread insolvencies will not occur?
- Should the federal government provide some kind of "backstop" insurance to the private market for large-scale natural disaster losses?
- What alternative catastrophe risk management arrangements or tax policy changes should Congress consider to reduce future disaster losses, accommodate the risk transfer needs of the public and private sectors, and stabilize the extreme fluctuations in the availability, affordability and utilization of natural catastrophe insurance?
- When is it appropriate (or inappropriate) for the federal government to assume a risk, and for those occasions and locations where it is inappropriate, how should that be articulated to those who are at risk without federal back-up?

- What is the appropriate role of the public sector in addressing the financial and economic effects of all-hazard risks, and encouraging insurance and loss mitigation practices in both the public and private sectors?

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