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Homeowners' Defense Act Rewards States for Bad Property Insurance Decisions

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The newly reintroduced Homeowners' Defense Act (HDA) is a dangerous step toward a federal government subsidy of property insurance coverage for natural disasters. The bill would also make it easier for individual states to create unrealistic disaster insurance programs—with underpriced property insurance policies—by creating a federal reinsurance fund to cover losses suffered by those programs. Attempts to place the risk of property losses due to natural disasters on the federal government are exceptionally bad policy and should be avoided.

Passing the Cost to Taxpayers. The Homeowners' Defense Act would establish a consortium of state-sponsored natural disaster insurance funds that would be able to issue bonds to jointly finance these programs. There is nothing inherently wrong with this practice, and states are already empowered to create such consortiums. However, the HDA would especially benefit the several states that have reacted to increasing property insurance rates by setting up state property insurance and reinsurance systems. In many cases, these state systems provide coverage at artificially low rates that are more influenced by short-term political considerations than actuarial estimates of risk.

Additionally, the HDA would make it easier for states with the most unrealistic insurance rates to pool their risks with more responsible states and issue bonds that reflect the overall pool risk level rather than their own high risk level. This would allow these high-risk states to issue bonds at lower interest rates than they would otherwise be able to do. In addition, the HDA would grant this consortium a federal charter, making it appear that the bonds issued by the group have a federal guarantee when in fact no such guarantee would exist. This false federal *imprimatur* could increase pressure for a federal bailout following any disaster.

What is worse, while bonds issued by the consortium would not have a federal guarantee, the legislation would also create both a federal guarantee of bonds issued by state catastrophe insurance programs and a new $200 billion federal reinsurance program for these state programs. Together, these two programs are nothing less than a blatant attempt to have the taxpayers assume much of the risk for property losses caused by hurricanes and similar disasters. In essence, under the HDA taxpayers across the country would be subsidizing the owners of large beach houses.

Those Who Fail to Heed History's Lessons Are Doomed to Repeat Them. The HDA ignores the history of the National Flood Insurance Program (NFIP). Started in 1968, the NFIP aimed to provide flood insurance to people living in known flood plains. From 1968 to 2005, the NFIP paid roughly $15 billion in claims. However, its losses have

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exceeded revenues, and the program has received several federal bailouts, the most recent being in 2005 after the Hurricane Katrina disaster.[1]

Part of the problem was that some policyholders paid premiums covering only 35 percent to 40 percent of the expected costs.[2] NFIP also covered many "repetitive-loss properties," which are legally defined as properties that had claims in excess of $1,000 twice over a 10-year period.[3] In fact, some properties have been flooded and rebuilt a number of times, although reforms passed in the last 10 years have gradually reduced the number of these properties, which represent almost 30 percent of all claims.[4] Furthermore, in many flood plains the vast majority of individuals lack flood insurance.

The HDA would repeat the mistakes of the NFIP by creating another federal program via the National Catastrophic Risk Consortium and Federal National Catastrophe Reinsurance Fund that would guarantee that the American taxpayer will be on the hook when state property insurance and reinsurance programs inevitably go broke or get expanded.

Additionally, the HDA fails to define what "catastrophic" means, thereby raising the possibility that this term could be applied to virtually any disaster.[5] For example, one of the deficiencies of the 1988 Robert T. Stafford Disaster Relief and Emergency Assistance Act is that it did not contain strict enough limits on what can qualify for a federal declaration by ambiguously defining disaster as something "of such severity and magnitude that effective response is beyond the capabilities of the State and the affected local governments and that Federal assistance is necessary."[6] As a result, since 1993, the Federal Emergency Management Agency has routinely ignored the Stafford Act's pliable requirement and treated even comparatively small disasters as requiring a federal response. Although very few disasters that occur in America are truly beyond the capabilities of state and local governments, this reality does not aid those who see natural disasters as "very political events."[7]

If the point of the HDA is to create a "national backstop" to deal with a 1-in-200 year truly catastrophic event, then it strains credibility to define disaster in a way that includes those disasters that are actuarially predicted to occur every year. Such an approach ensures only that taxpayers could be called on to pay for even more of the natural disasters that happen each year.

There Is a Better Way. Earlier this year, The Heritage Foundation developed principles for reform of catastrophic natural disaster insurance.[8] Comparing these principles to the HDA makes it clear that the bill contains serious policy mistakes.

Specifically, policy errors in the HDA include:

- *Catastrophic should mean* nationally *catastrophic.* As noted above, the HDA fails to define "catastrophic" and thus permits an expansionary application of the program that will cover non-nationally catastrophic natural disasters that predictably occur in the United States each year.
- *Those who assume the risk should bear the risk.* Contrary to the claims of HDA supporters, the majority of Americans actually live in areas that have a low risk of nationally catastrophic disasters. Rather than to require those who choose to live in risky areas to bear most of the cost of their

1. Matt A. Mayer, David C. John, and James Jay Carafano, "Principles of Reform of Catastrophic Natural Disaster Insurance," Heritage Foundation *Backgrounder* No. 2256, April 8, 2009, at *http://www.heritage.org/Research/HomelandSecurity/bg2256.cfm*.
2. *Ibid.*
3. *Ibid.*
4. *Ibid.*
5. The 2007 version of the bill included tornadoes, blizzards, and fires among those disasters that would be covered by the bill.
6. 42 U.S. Code § 5191(a).
7. Christopher Cooper and Robert Block, *Disaster: Hurricane Katrina and the Failure of Homeland Security* (New York: Times Books, 2006), p. 64.
8. Mayer, John, and Carafano, "Principles of Reform of Catastrophic Natural Disaster Insurance."

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decision, the bill seeks to spread the risk to those who do not live in such areas.

- ***State eligibility should depend on meeting five requirements:*** (1) no rate caps; (2) sound building codes; (3) no redevelopment of disaster-prone areas; (4) tort reform; and (5) mandated P&C insurance. Although the bill does include some language on actuarially sounds rates and mitigation actions, that language contains little to no enforcement aspects but merely "encourages" such rates.[9] This means the artificially low arbitrary rate caps in place today will persist, thereby preventing private sector insurers from actually charging actuarially sound rates. Similarly, the requirement for building codes standards is met based on the opinion of the secretary of housing and urban development,[10] which means that politics—like with the Stafford Act—will determine outcomes. The bill does not contain any tort reform or mandated property and casualty insurance requirements, thereby leaving states at the mercy of plaintiffs' lawyers and moral hazard.
- ***State participation should be opt-in only.*** The program does allow the states to opt in, yet the taxpayer guarantee ensures that the taxes or premiums paid by the citizens of states that do not opt in will directly or indirectly fund the program.[11] This means that states that do not opt-in receive none of the benefits of the program, but their taxpayers still bear the costs of it.
- ***Tax and accounting policies must permit insurance and reinsurance companies to retain sufficient capital reserves.*** The bill does not address this issue, so private insurance and reinsurance companies will not be able to build up sufficient capital reserves to deal with a catastrophic natural disaster.

State governments are free to develop irresponsible property insurance programs as long as they and their citizens understand that they and only they must bear the consequences. The HDA, however, creates a way for those states to make taxpayers in other states share in the inevitable losses. This bad policy should be avoided.

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9. "The Homeowners' Defense Act of 2009," H.R. 2555, 111th Cong., 1st Sess., Section 501.
10. *Ibid.*
11. *Ibid.*, Section 101(d).