



Suggestions for Enhancing Private Insurer Participation and Competition in Coastal Alabama Property Insurance Markets

Coastal Recovery Commission of Alabama
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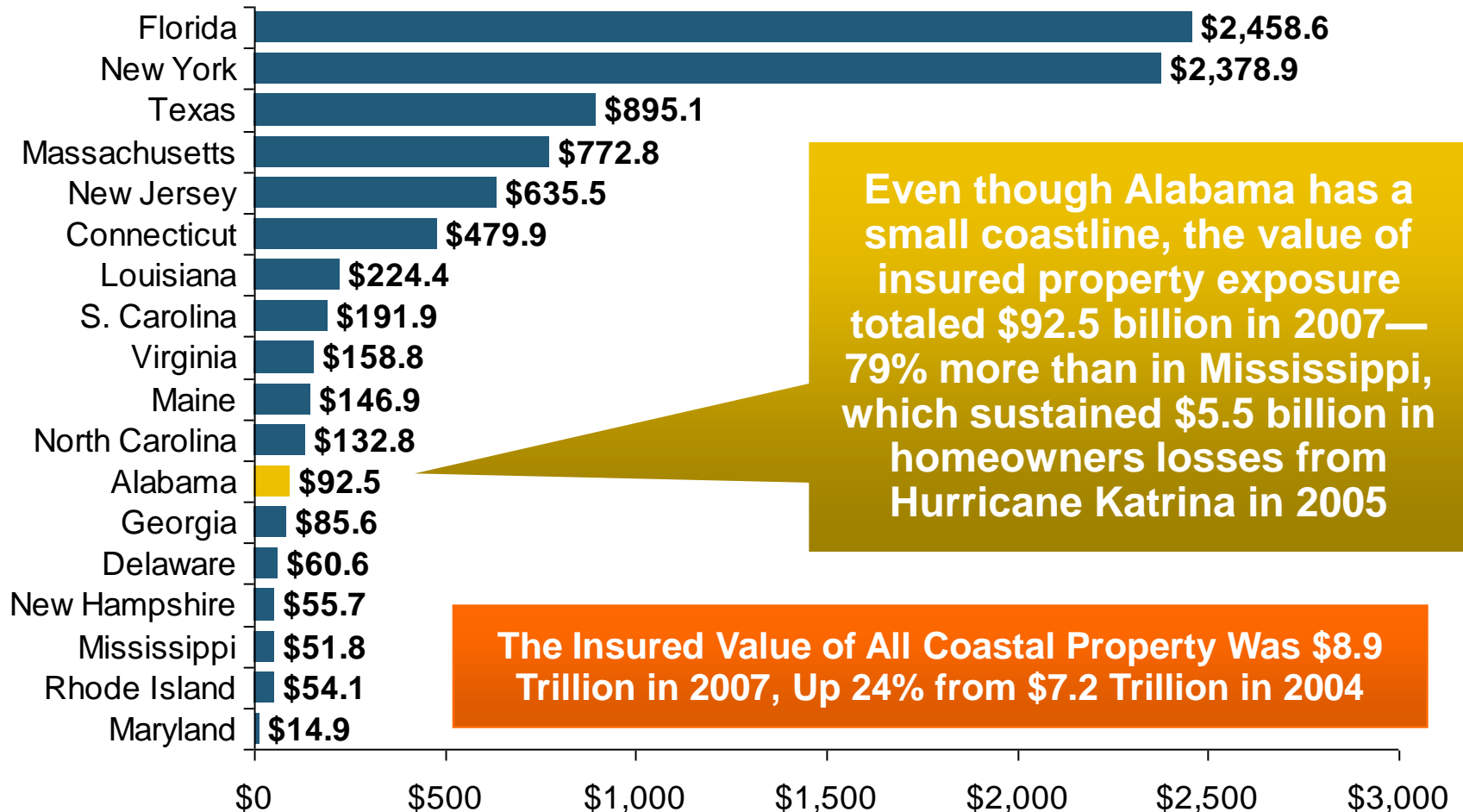


The Dollars and Cents of Alabama's Coastal Exposure

**Exposure is Sizable but Better
Managed than in Most States**

Total Value of Insured Coastal Exposure in 2007*

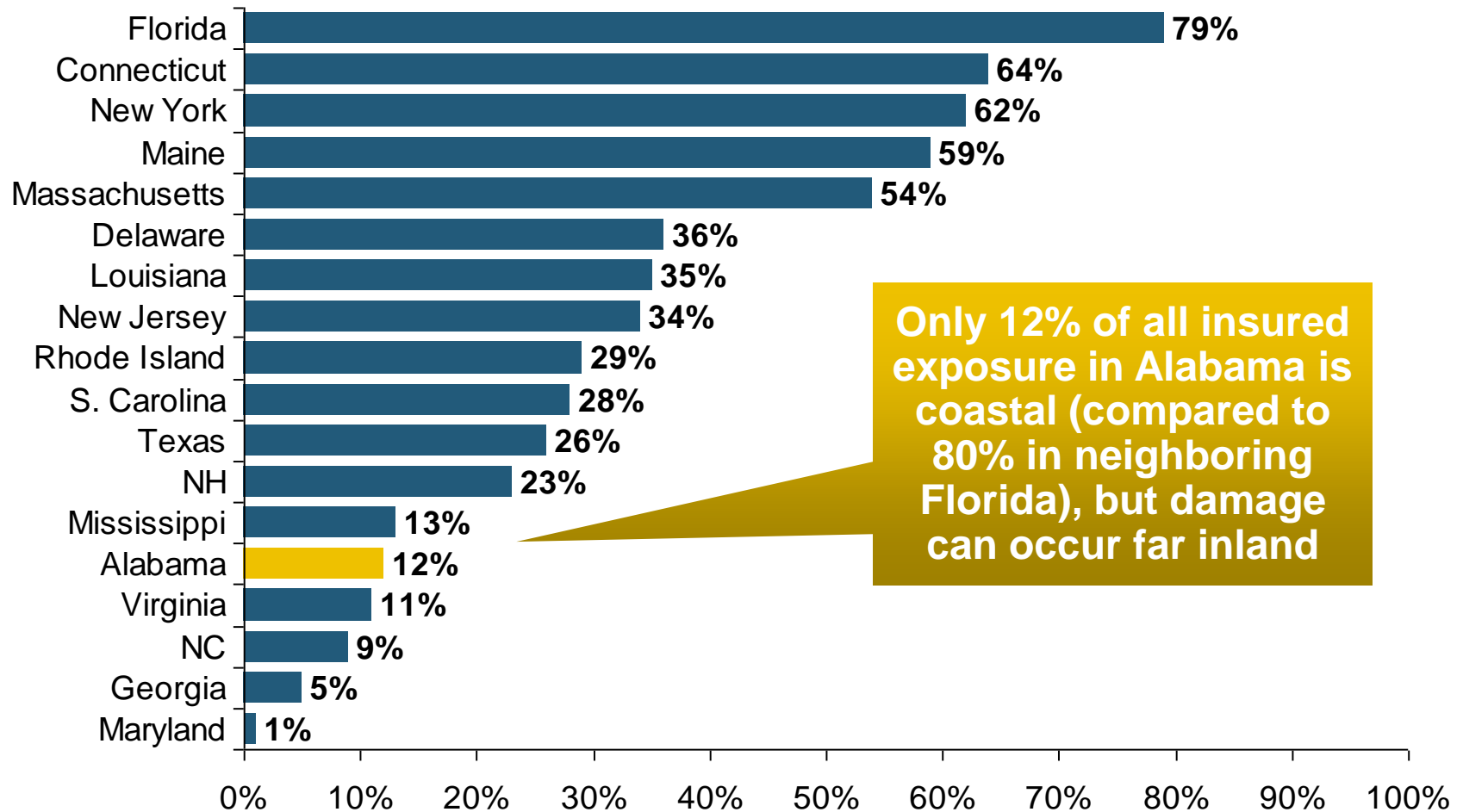
(\$ Billions)



*Latest available.

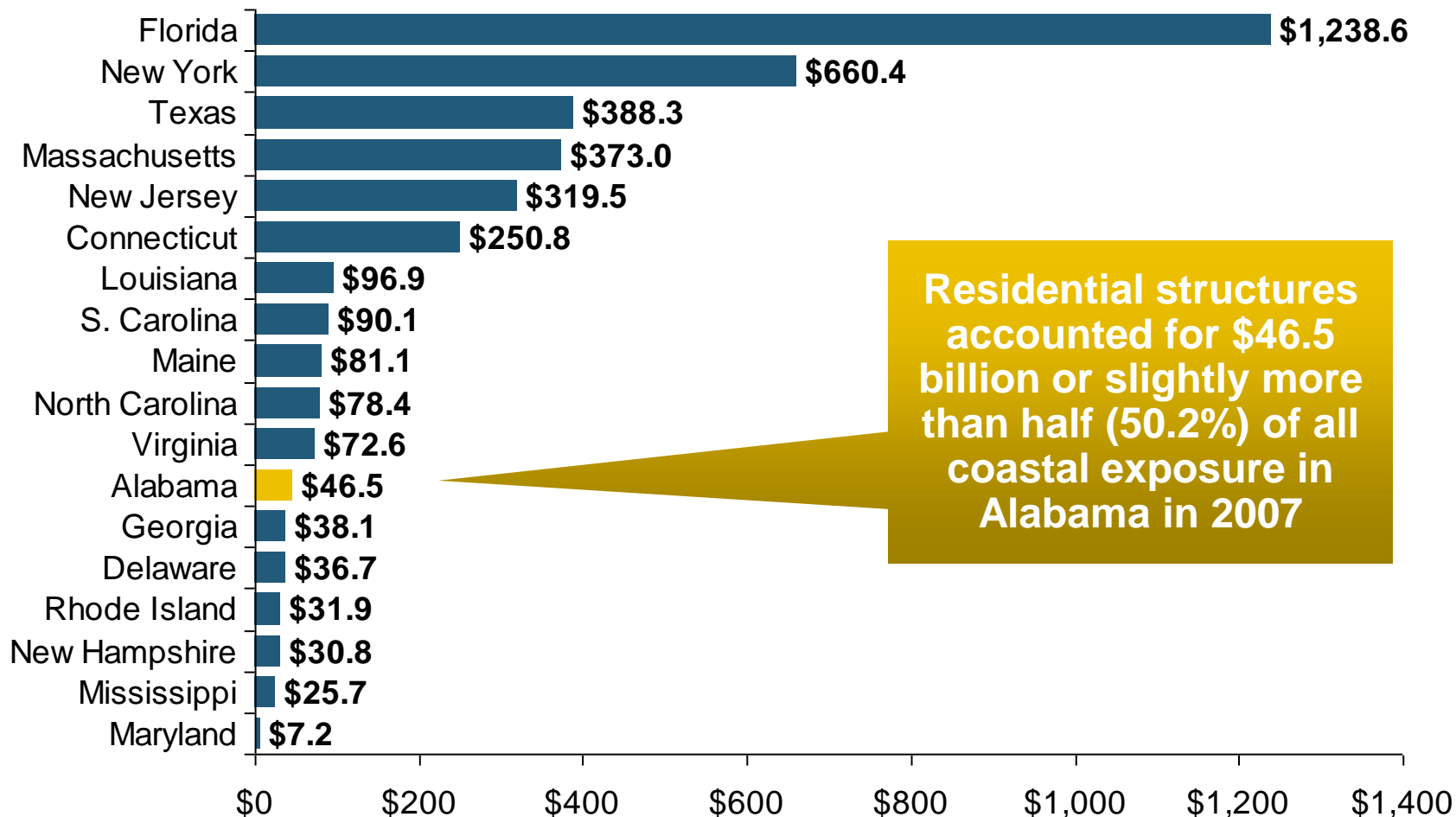
Source: AIR Worldwide

Insured Coastal Exposure as a Percentage of Statewide Insured Exposure, 2007



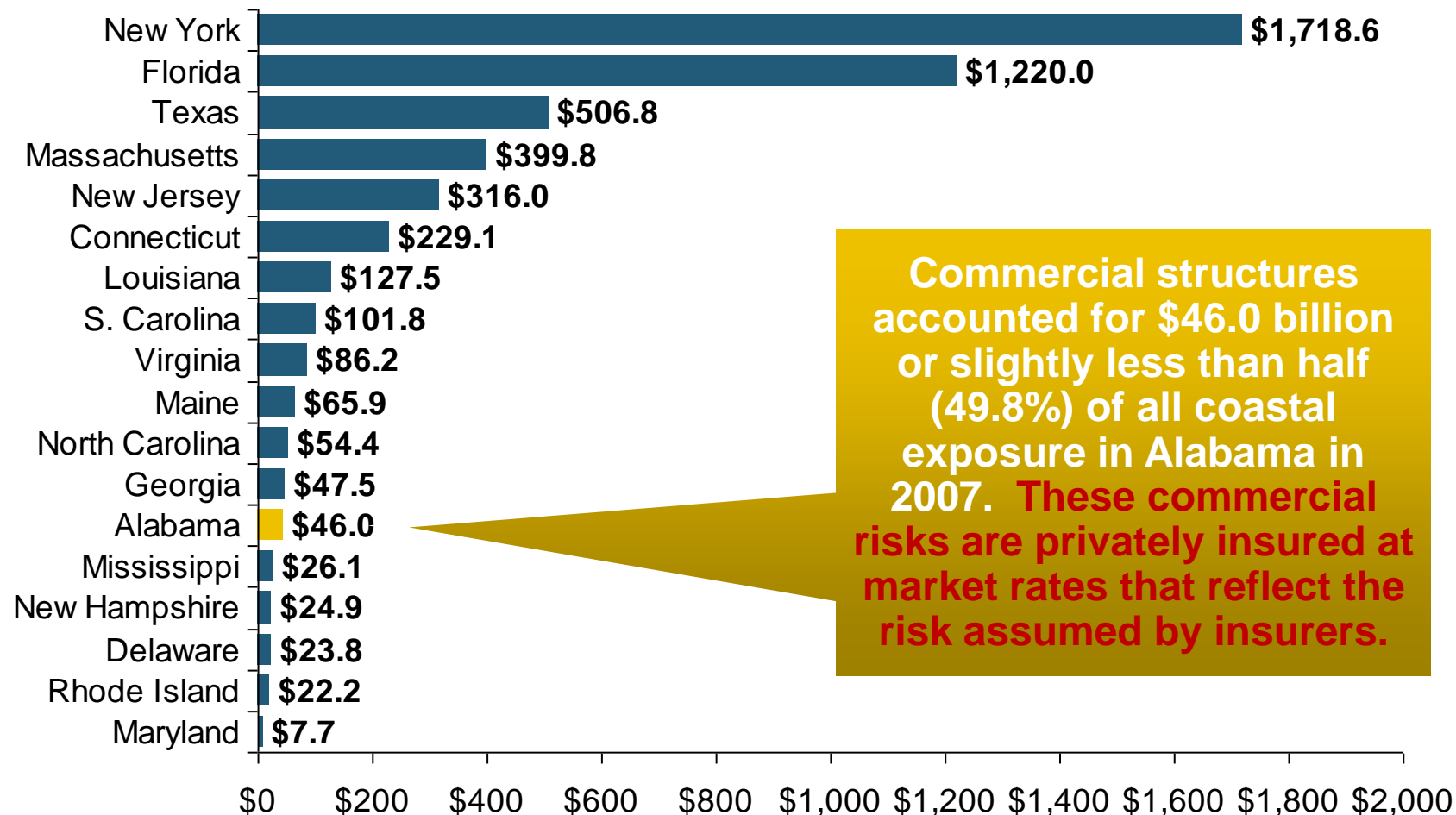
Value of Insured Residential Coastal Exposure in 2007

(\$ Billions)



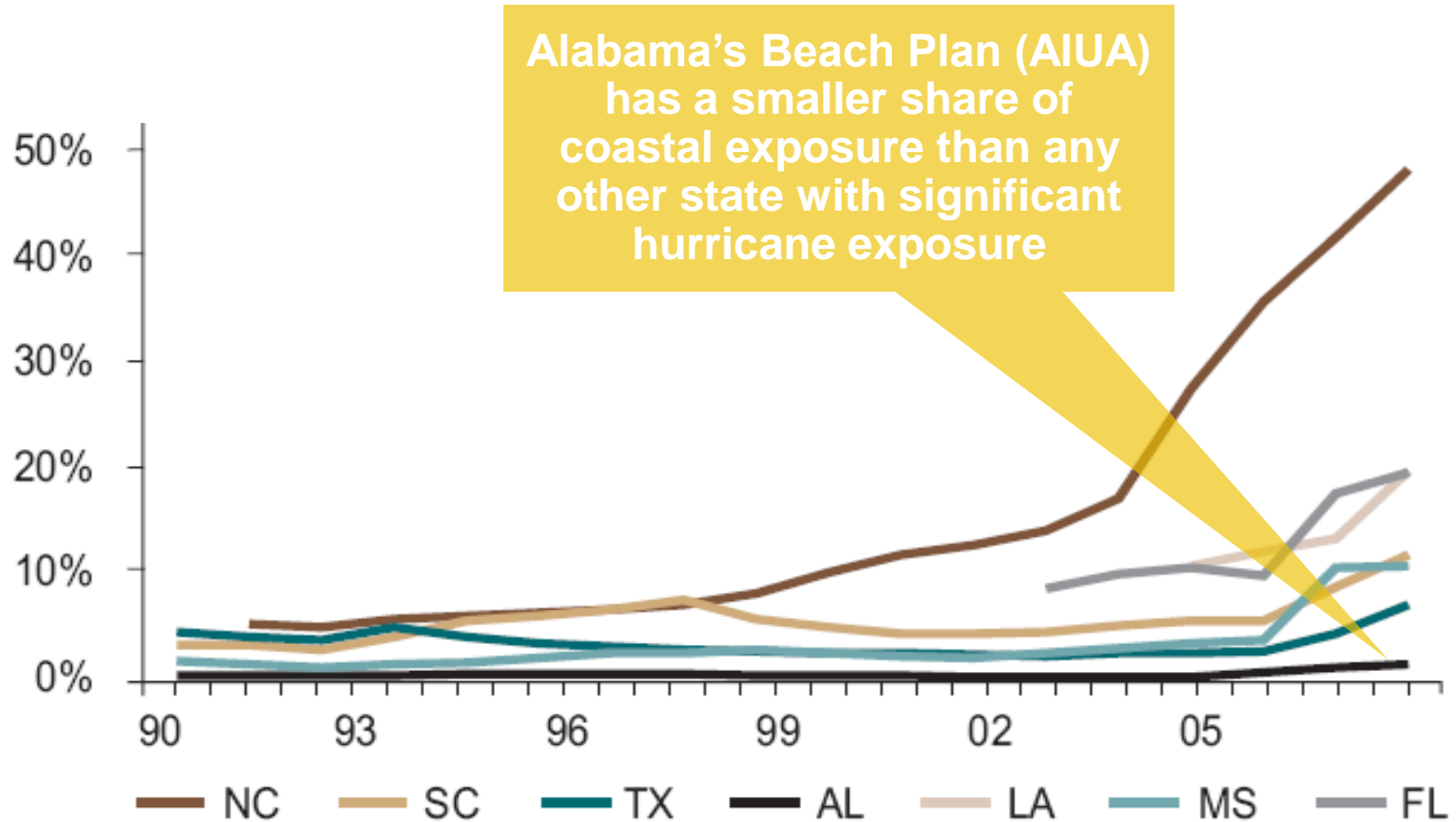
Value of Insured Commercial Coastal Exposure, 2007

(\$ Billions)

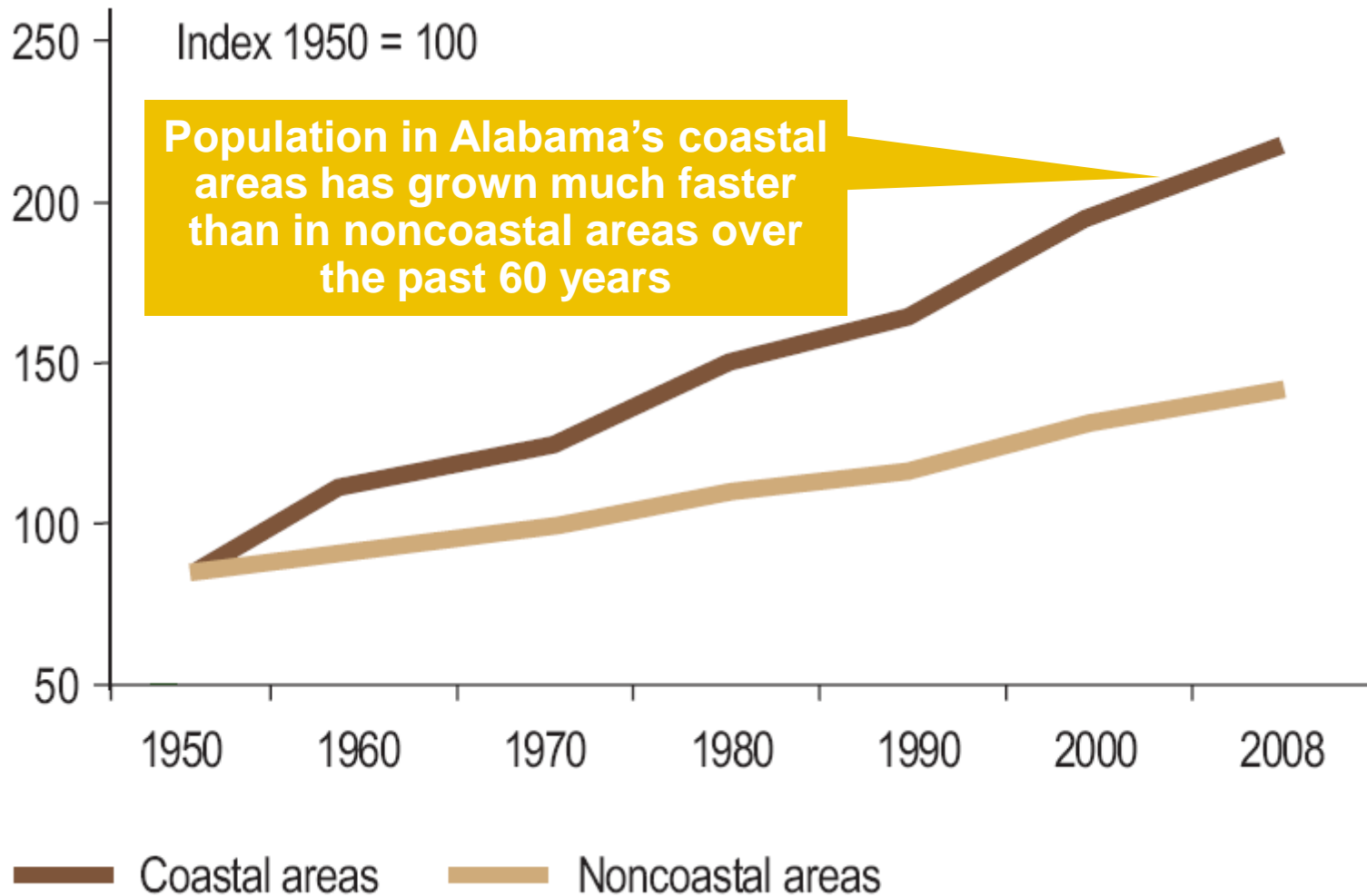


Beach/Hybrid Plan Exposure as a Share of Total Coastal Exposure

(Share of Total Coastal Exposure)

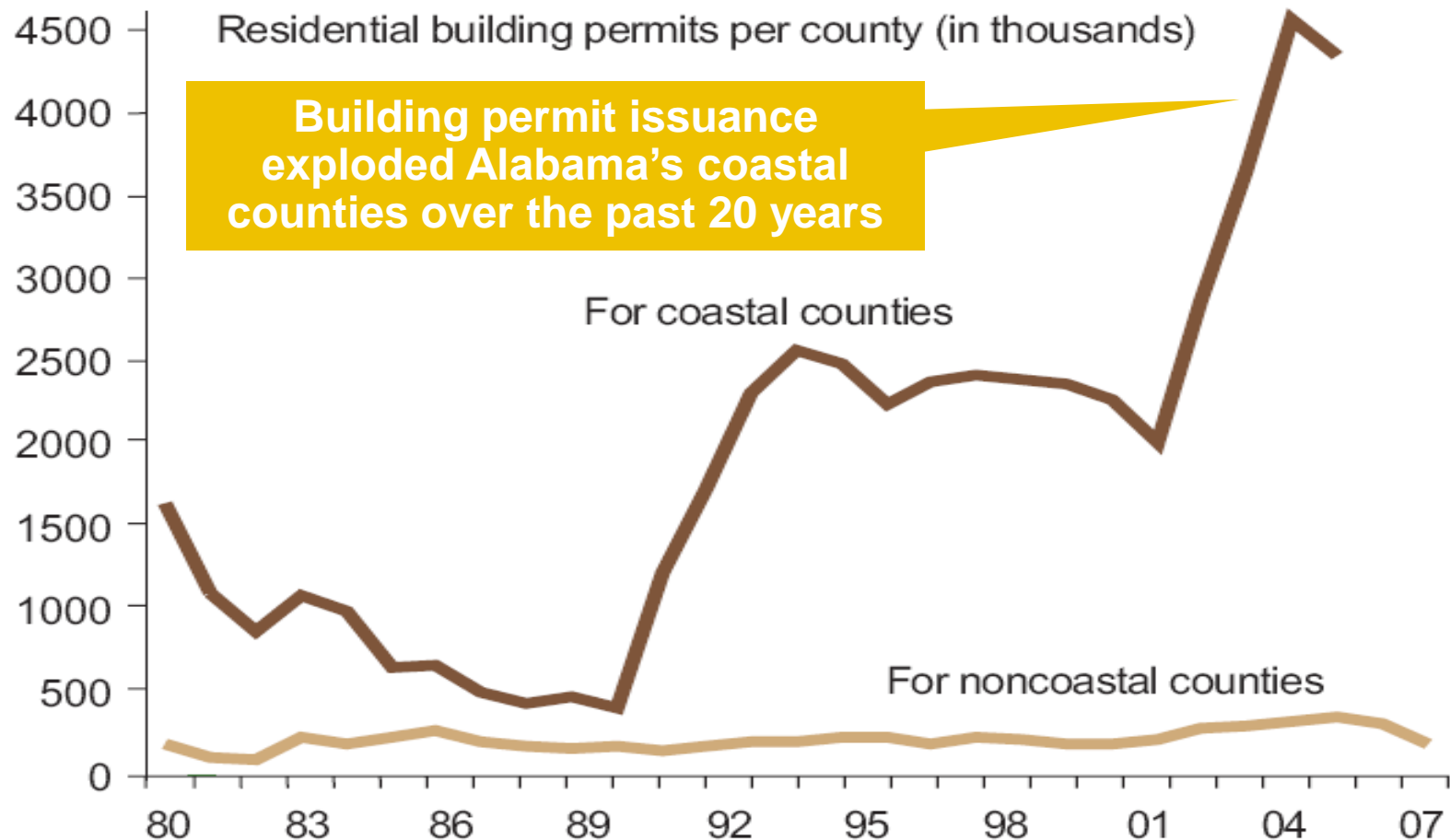


Population Density in Alabama



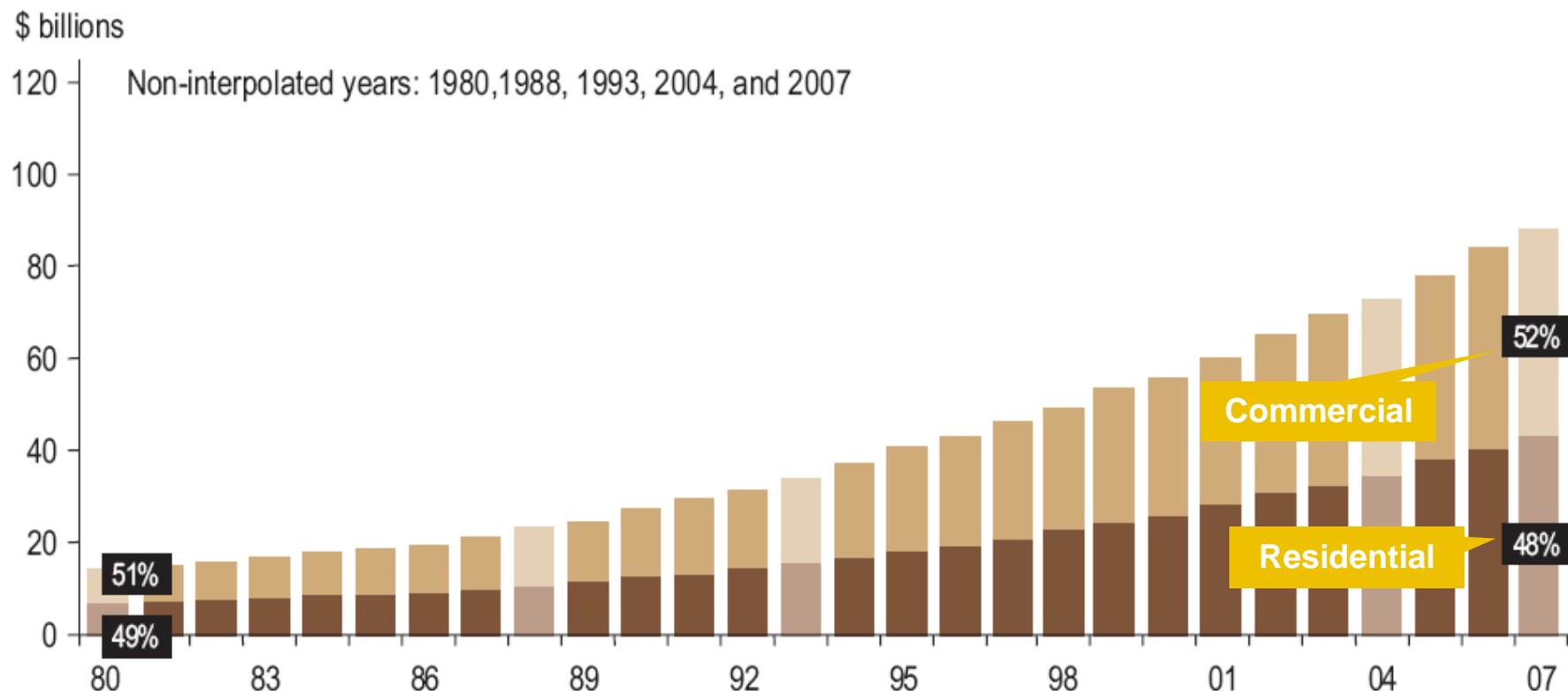
Source: Insurance Research Council, *State Beach and Windstorm Plans: An Overview of Operations and Financial Structures*, Sept. 2010 from U.S. Census Bureau data; Insurance Information Institute.

Alabama Coastal Development vs. Noncoastal Development



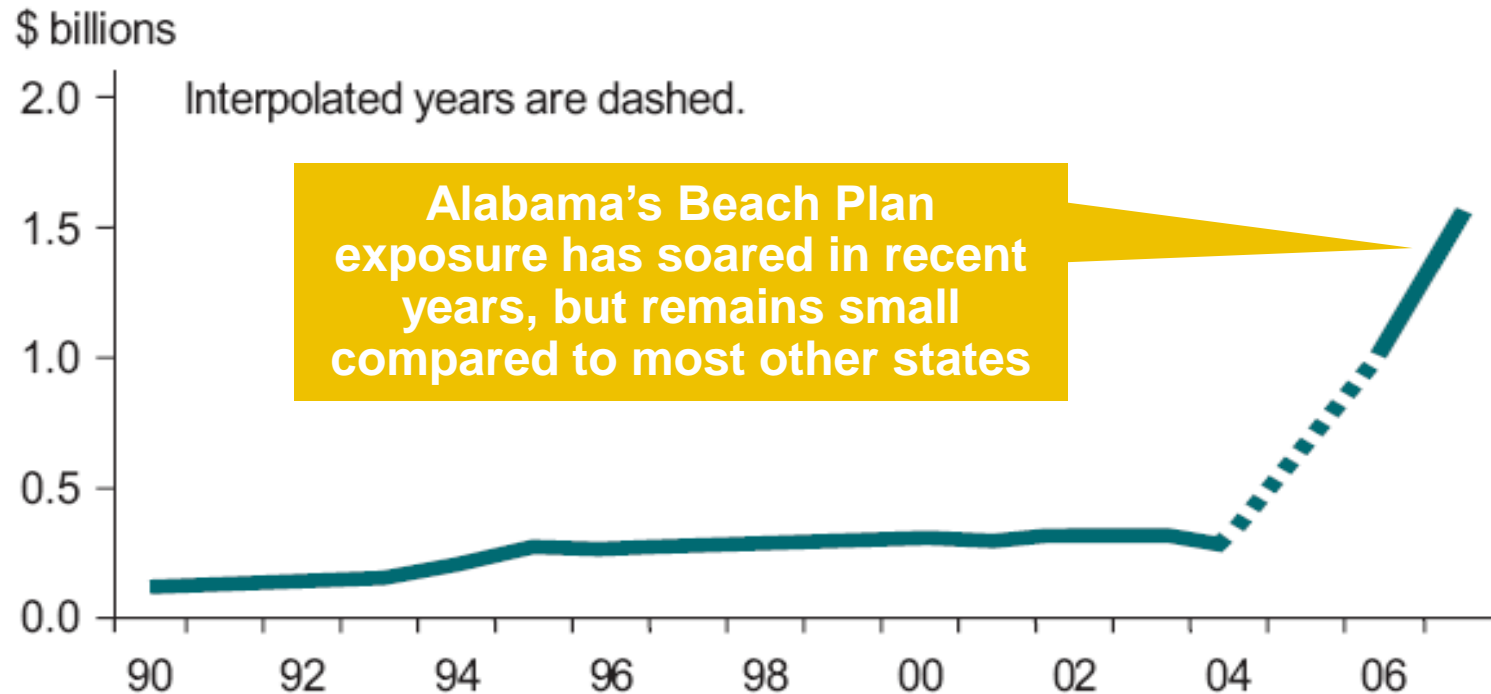
Alabama: Value of Insured Coastal Exposure, 1980 - 2007

508% Growth from 1980 to 2007, Average Annual Growth 6.9%

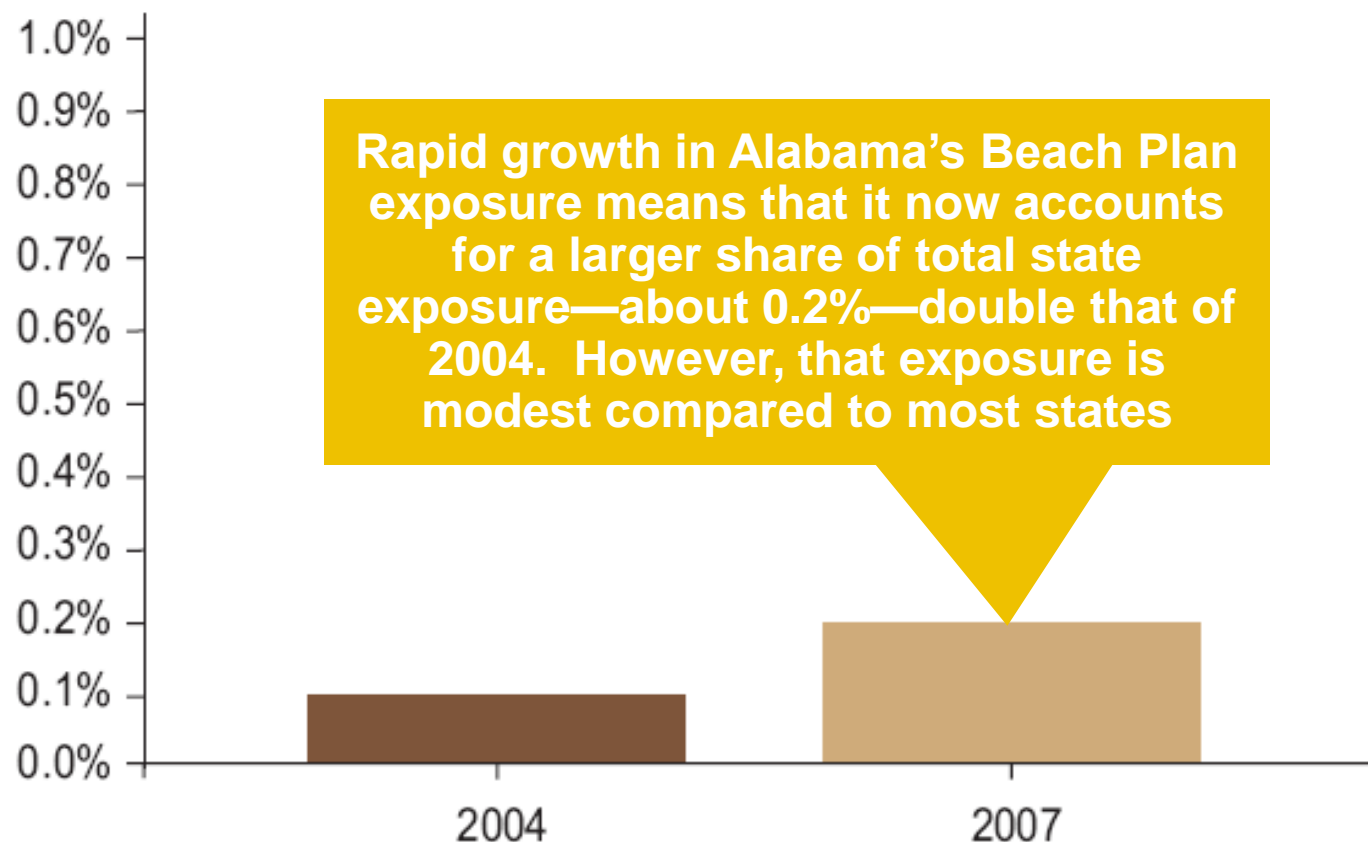


Alabama Beach Plan Exposure to Loss, 1990 - 2007

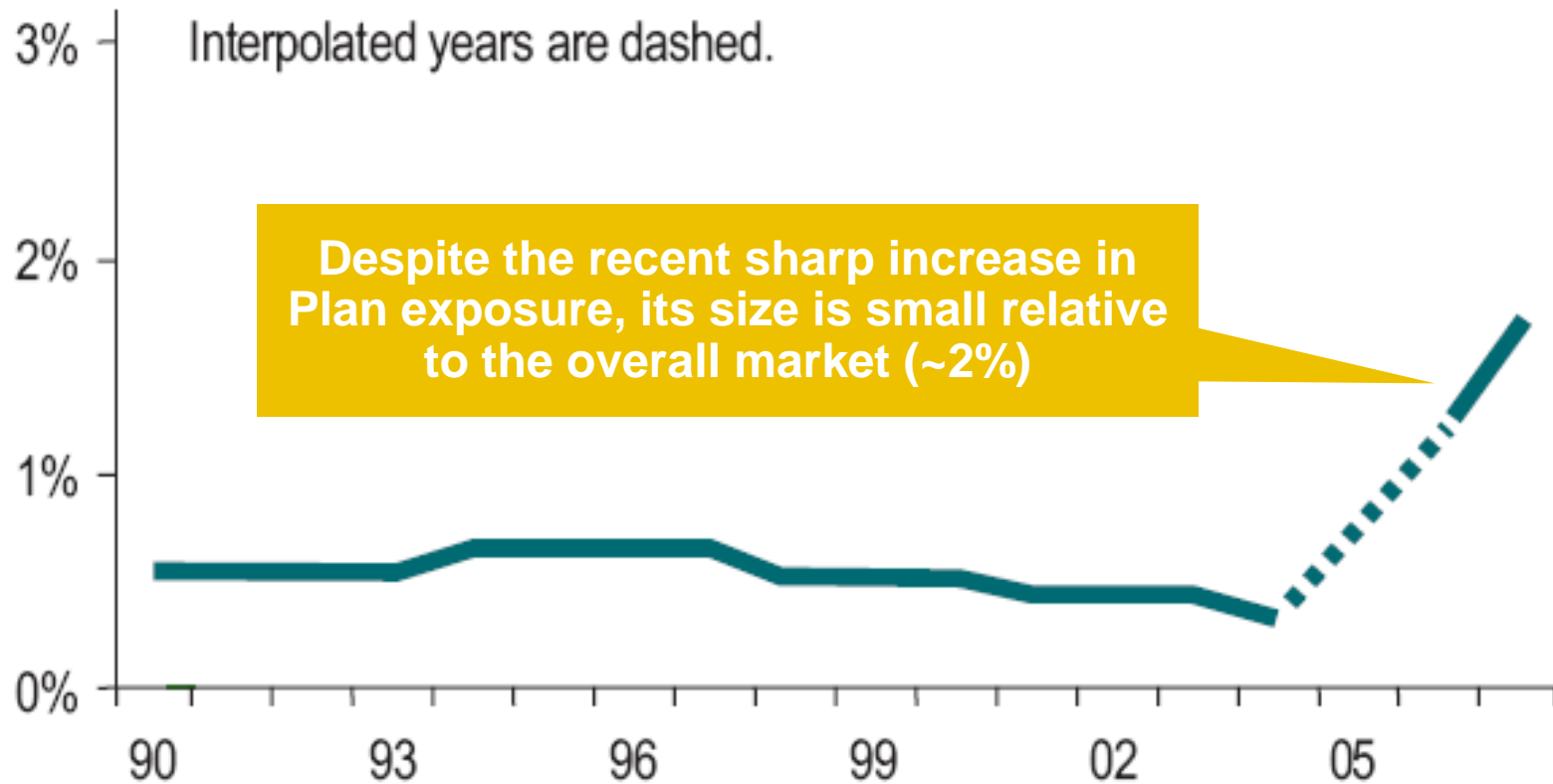
793% Growth From 1990 to 2007, Average Annual Growth 16.85%



Alabama's Plan Exposure as a Share of Total State Exposure, 2004 vs. 2007



Alabama's Plan Exposure as a Share of Total Coastal Exposure, 2004 vs. 2007





So What Can We Say About Alabama's Coastal Exposure Problem?

Summary of Alabama's Coastal Issue

- **Population Growth: Faster in Coastal Counties for Past 60 Years (2x)**
- **Coastal Development: Permitting as Much as 10x Higher**
- **But Situation is Much Better than Most Other States**
 - ◆ Only 2 coastal counties have direct coastal exposure
 - ◆ Plan limits sale of policies to these 2 counties (Baldwin, Mobile)
- **Alabama's Herfindahl-Hirshman Index Value in 2009 = 1348**
 - ◆ Interpretation: State is "moderately concentrated"
 - ◆ It is not much higher than many noncoastal states (TN = 1318, KY = 1298)
- **Factors Helping Alabama**
 - ◆ Plan covers the state's 2 coastal counties only
 - ◆ Risk sharing through the use of deductibles
 - ◆ Incentives to build to stronger standards

Are Coastal Development Plans Rational?

For Individual Decision Makers: *Yes*
For Society as a Whole: *No*

Excessive Catastrophe Exposure: Outcome of Economically & Politically Rational Decision Process?

- **Property Owners**

- ♦ Make economically rational decision to live in disaster-prone areas
- ♦ Low cost of living, low real estate prices & rapid appreciation, low/no income tax, low property tax, rapid job growth
- ♦ Government-run insurers (e.g., CPIC, NFIP) provide implicit subsidies by selling insurance at below-market prices with few underwriting restrictions
- ♦ Government aid, tax deductions, litigation recovery for uninsured losses
- ♦ No fear of death and injury

- **Local Zoning/Permitting Authorities**

- ♦ Allowing development is economically & politically rational & fiscally sound
- ♦ Residential construction creates jobs, attracts wealth, increases tax receipts, stimulates commercial construction & permanent jobs, develops infrastructure
- ♦ Increases local representation in state legislature & political influence
- ♦ Property and infrastructure damage costs shifted to others (state and federal taxpayers, policyholders in unaffected areas)

- **Developers**

- ♦ Coastal development is a high-margin business
- ♦ Financial interest reduced to zero after sale

Excessive Catastrophe Exposure: Outcome of Economically & Politically Rational Decision Process?

- **State Legislators**

- ♦ Loathe to pass laws negatively impacting development in home districts
- ♦ Local development benefits local economy and enhances political influence
- ♦ Rapid development lessens need for higher income and property taxes
- ♦ Can redistribute CAT losses to unaffected policyholders and taxpayers
- ♦ Can suppress insurance prices via state insurance regulator, suppress pricing and weaken underwriting standards in state-run insurer & redistribute losses

- **Congressional Delegation**

- ♦ Home state development increases influence in Washington
 - Political representation, share of federal expenditures
- ♦ Loathe to pass laws harming development in home state/district
- ♦ Tax law promotes homeownership and actually produces supplemental benefits for property owners in disaster-prone areas
- ♦ Large amounts of unbudgeted disaster aid easily authorized
- ♦ Tax burden largely borne by those outside CAT zone & those with no representation (children & unborn)

- **President**

- ♦ Presidential disaster declarations and associated aid are increasing
- ♦ Political benefits to making declarations and distributing large amounts of aid
- ♦ Direct impact on favorability ratings & election outcomes
- ♦ Losses can be distributed to other areas and the unrepresented

How Insurers Signal What Should Be Built and Where

Price as a Messenger of Risk

Government-Run Insurers Lead to Poor Land Use/Design Decisions

- **Government-run insurers (markets of last resort) serve as a vital safety valve after major market disruptions, but also serve as an enabler of unwise development...**
- **Government-run property insurers wash away market-based signals about relative risk**
- **Consequence is runaway development in disaster-prone areas**
- **Government-run insurers:**
 - ♦ Generally fail to charge actuarially sound rates
 - ♦ Have weak underwriting standards
 - ♦ Are thinly capitalized
 - ♦ Can assess losses to policyholders other than their own
 - ♦ Vulnerable to political pressure
- **Inadequate premiums, insufficient capital and weak underwriting mean that most government plans, from Citizens Property Insurance Corporation to the National Flood Insurance Program operate with frequent deficits**

Negative Outcomes from Flaws in Government-Run Insurers

- **True risk associated with building on a particular piece of property is obscured**
- **Subsidies are generated leading to market distortions/inequities:**
 - ♦ Many thousands of homes likely would not have been built (or built differently) if property owner obligated to pay actuarially sound rates
 - ♦ CPIC assessments from Wilma will require grandmothers living in trailer parks on fixed incomes in Gainesville to subsidize million dollar homes in Marco Island via assessment (surcharges).
- **Serial rebuilding in disaster-prone areas is the norm**
- **Property owners come to assume that the government rate is the “fair” rate and object to moves to actuarially sound rates.**
- **Government-run insurer can’t control its own exposure**
 - ♦ Legislature mandates that CPIC offer coverage in most cases if no private insurer will offer coverage due to high risk, near certainty of destruction
 - ♦ No restrictions on value of property, so high-valued properties represent disproportionate share of potential loss
- **Taxpayer Burden: NFIP borrowed \$20B+ in 2005**

What Works, What Doesn't

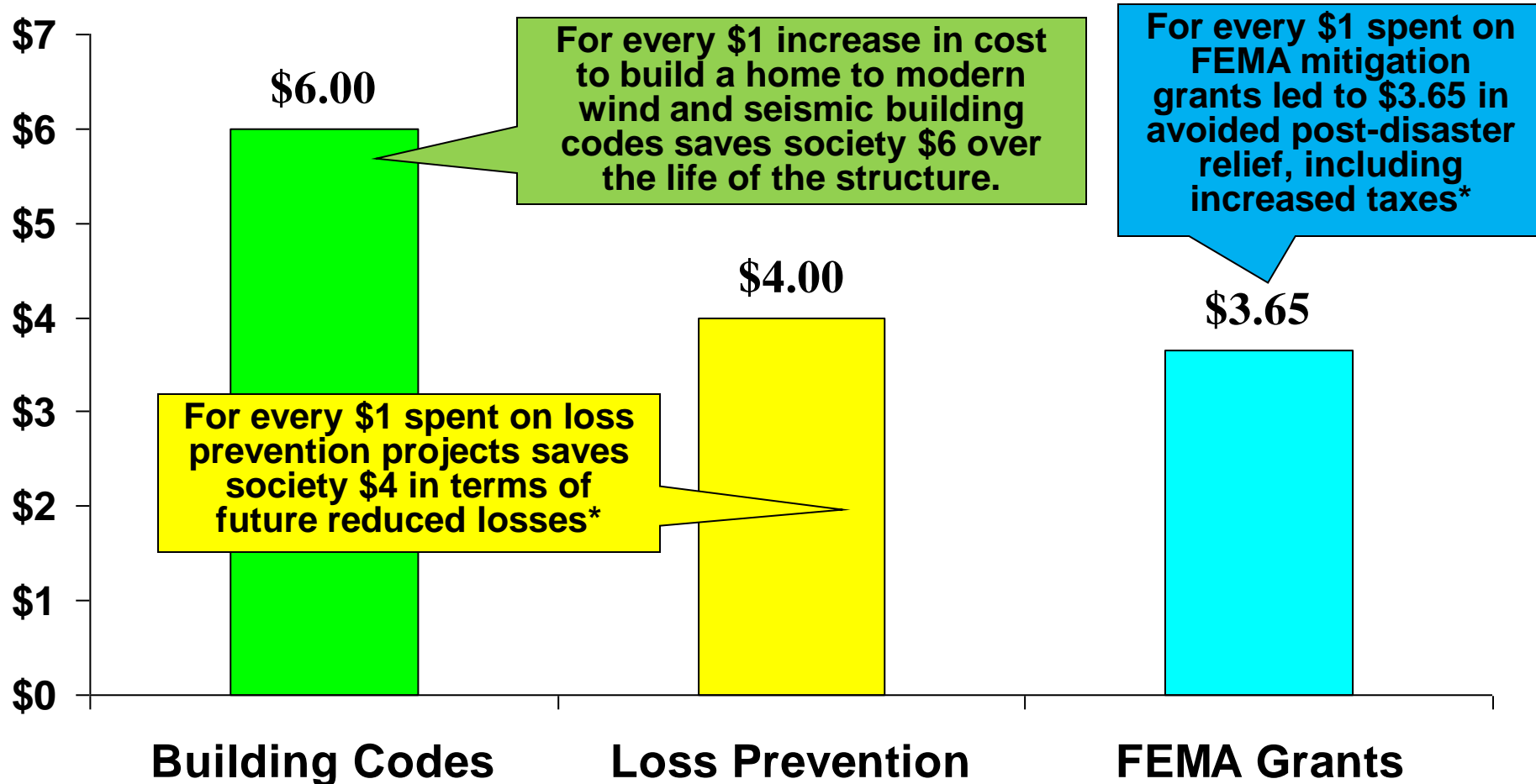
**History, Past Actions
Provide Lessons**

Successful Tools for Controlling Hurricane Exposure

- **Strengthened building codes**
- **Stringent enforcement of building codes**
- **Fortified home programs**
- **Insurance rates based on sound actuarial principles (risk-based rates that are not government controlled); Works for commercial insurers**
- **Disciplined underwriting**
- **Removing impediments to capital flows**
- **Lowering insurers' cost of capital (e.g., pre-tax reserving)**
- **Incentives to adopt mitigation**
- **Forcing communities to consider and take a larger stake in their catastrophe exposure**

Loss Prevention Has a High ROI: Property Owners, Insurers and Contractors All Benefit

Return on Each \$1 Invested in Mitigation



*According to the Multi-Hazard Mitigation Council of the National Institute of Building Science.
Source: Institute for Business and Homes Safety; Insurance Information Institute.

Unsuccessful Tools for Controlling Hurricane Exposure

- Insurance rates that are not actuarially sound (i.e., don't reflect true risk)
- Political interference in rate process
- Inadequate underwriting controls
- Subsidies
 - ♦ Intra-state (policyholders/taxpayers)
 - ♦ US Taxpayer
- Voluntary flood coverage
- Litigation

- **Local control of land use and permitting creates significant incentive problems**
 - ♦ **Benefits accrue locally while many costs can be redistributed to others via taxes, insurance and aid**
- **Prospect of government aid reinforces unsound building and location decisions**
- **States don't want to raise taxes to pay for mitigation/prevention even if state is sole beneficiary**
 - ♦ **E.g., NO levees; Beach replenishment**

Recommendations

Toward a Long-Term Solution

Recommendations for Controlling Hurricane Exposure

- **Raise public awareness of risk**
 - ♦ Mandatory risk disclosure in all residential real estate transactions
 - ♦ Require signed waivers if decline flood coverage that also waive rights to any and all disaster aid, or
 - ♦ Mandate flood coverage
- **Continue to strengthen & enforce of building codes**
- **Allow markets to determine all property insurance rates**
 - ♦ Role of state focused on difficult-to-insure or income issues
- **Increase incentives to mitigate**
- **Require state-run insurer to charge actuarially sound rates and limit high value exposure**
- **Require communities/counties to a financial stake in their catastrophe exposure**
 - ♦ Reimburse disaster aid to state/federal government

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and your attention!*

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