

Issue Brief

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Property/Casualty Insurance: Providing the Foundation of Economic Recovery

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Executive Summary

The destruction caused by Hurricanes Katrina and Rita will necessitate one of the most ambitious reconstruction efforts in U.S. history. The insurance industry will play a key role in the rebuilding efforts by fulfilling its contractual claims obligations to its insureds. Efforts to distort the fundamental principles of risk-sharing on which the property/casualty industry is based could put the recovery in jeopardy and make already bad economic impacts even worse. All Americans could be affected.

Introduction

The scale of the catastrophe along the Gulf Coast regions of Alabama, Florida, Louisiana, Mississippi and Texas has been indelibly impressed onto the national psyche. Katrina's wrath was by far the worst. Half a million people were evacuated from Louisiana and another 120,000 from Mississippi. The Army Corps of Engineers estimates that the storm left more than 150,000 homes uninhabitable. And officials in Biloxi, Mississippi estimate that about 20 percent of the city's structures have been destroyed.

The resulting impacts to our national economy are clear. The most obvious was the initial spike in gasoline prices, followed by lower, but still high prices at the pump. Several offshore petroleum platforms and oil refineries were either damaged or destroyed by the storms, causing a sudden interruption in gas production, which reduced supply, leading to a sudden jump in prices. U.S. dependence on petroleum-based products creates a relatively inelastic demand for gas, so even as prices increase, demand does not automatically fall. Nevertheless, recent price increases will eventually begin to curtail nonessential driving trips and reduce spending that might otherwise occur. The U.S. Department of Commerce reported a 0.5 percent drop in consumer spending through August, but when adjusted to reflect higher energy prices, consumer spending has actually fallen off by a full percentage (1.0 percent) point. This marks the biggest drop in consumer spending since September, 2001.

Oil prices also impact the airline industry, which estimates that every penny increase in the price of gas (and the resulting increase in the cost of jet fuel) translates to \$1 billion in losses to the industry annually. Meanwhile, air travel will likely decline as consumers look to reduce expenses. Higher transportation costs will reverberate throughout the economy, effectively increasing the cost of all goods and services, which will also slow consumer spending, a key driver of the entire economy.

In addition to disruptions in oil and gas production, other important industries (such as gaming, seafood, timber and other sectors of the agricultural industry) critical to the national economy and areas of economic specialization in the affected states have also been severely impacted. While the total extent of all economic damages is still being calculated, current estimates run as high as \$125 billion. Moreover, because the U.S.

contributes roughly 20 percent of the world's GDP, major shocks to domestic patterns of production and consumption will also impact the availability and price of goods and services worldwide.

Will the Economy Bounce Back?

Pre-existing national commitments will make responding to this crisis difficult. Most prominently among these is the federal government's ongoing commitment to the war in Iraq. The non-partisan Congressional Budget Office (CBO) estimates current spending at \$9 billion each month in addition to \$13 billion already spent on the initial deployment of troops. The CBO recently estimated that for the first 11 months of the latest fiscal year, the federal government ran a deficit of \$352 billion.

Total federal spending will increase when the costs of hurricane recovery are factored into the equation. Initial projections suggest federal expenditures on Katrina-related reconstruction could reach \$200 billion. Temporary jumps in crop insurance payouts, National Flood Insurance Protection (NFIP) payouts, assorted individual assistance grants, tax relief and other forms of assistance to those displaced, unemployed, and injured will add even more to the federal deficit.

Despite these pressures, economists still predict that in the long term, the U.S. economy will absorb this latest shock; the CBO has thus far held to its original economic growth forecasts of 3.7 percent for 2005 and 3.4 percent for 2006. The CBO also noted that reverberations from Katrina could slow economic growth for the second half of 2005 by as much as 0.5 percent to 1.0 percent, but economic growth and employment should rebound by the first half of 2006 as the reconstruction effort shifts into high gear.

The Role of Property/Casualty Insurance

Critical to the confident economic projections is the expectation that the property/casualty insurance industry will meet its contractual obligations to its customers. Estimates of payouts to storm victims vary, but a recently revised prediction made by catastrophe modeler Risk Management Solutions, Inc. places total insured losses in the range of \$40-\$60 billion. If these estimates hold true, Katrina will prove to be the costliest U.S. hurricane on record, dwarfing the previous high of \$20 billion in insured losses attributed to Hurricane Andrew. And, while this represents a

disaster of unprecedented scale, industry is able to pay the claims for which policyholders have paid premium. The September 2, 2005 edition of the *Insurance Journal's National News* noted, "The U.S. property and casualty industry maintains policyholders' surplus of roughly \$390 billion and holds assets in excess of \$1.3 trillion. State insurance regulators require insurers to maintain minimum levels of surplus to absorb the volatility inherent in property and liability policy coverages." This infusion of capital that these claims payments represent will be integral to the recovery.

Individuals and businesses purchase property insurance to cover specific risks. Hurricane wind damage is a risk insurers willingly assess, agree to underwrite, receive premium payments to cover and establish reserve funds to meet. Wind (as opposed to flood) damage is in fact a common coverage feature contained in most standard homeowner's policies. Regulations governing the property/casualty industry ensure consumer protection and insurer solvency by establishing appropriate rating guidelines and reserve requirements. As a result, the insurance industry is well positioned to meet its specific obligations to cover wind damages tied to this potentially unprecedented loss event. The industry's ability to assess damage and pay claims in a timely fashion is of pivotal importance and will impact the expediency with which the nation's collective reconstruction efforts unfold.

Because sudden and severe shocks to oil production set off intense, rippling effects that reverberate throughout the economy, the importance of oil is widely understood. Property/casualty insurance is an even greater, economic imperative. Since losses are individual or, as in this case, concentrated regionally, this reality is not as well accepted.

Insurance provides a necessary safety net that enables the free flow of commerce. It represents a contractually specified and validated agreement to transfer risks tied to virtually all personal and business investment decisions. This in turn allows individuals and businesses to confidently manage their risk and make investments, important actions that spur economic growth.

Insurance not only represents the most important safety net in our society; it is the single most important factor in our nation's ability to react to and recover from catastrophic events. The industry's ability to pay claims in a timely fashion initiates the recovery process

for individuals, businesses and communities. Swift assessment and claims payouts are therefore critically important to the ability of affected regions to fully recover from catastrophic devastation and its related economic impacts.

Insurance is critical to reconstruction and economic recovery efforts tied to the aftermath of all catastrophic events. But, insurance plays an even more significant role in the overall health of our national economy. Insurers employ more than 600,000 people nationwide and the premium taxes they pay generate more than \$12 billion in total state government revenue.

Perhaps, more important and less well known is the fact that insurer investments represent a critically important source of funding for public construction on buildings and infrastructure such as hospitals, schools, airports and highway projects.

In essence, the promise that insurance represents is a necessary ingredient in the development of a civilized society by impacting the ability of commerce to develop and flourish within a free market economy.

Dangers of Disrupting the Risk Sharing Model

The enormity of the losses to which families in Alabama, Florida, Louisiana, Mississippi and Texas have been subject are sobering. It is impossible not to feel great pain on their behalf. The temptation is tremendous to initiate actions intended to be helpful but which, when examined closely for their longer-term significance, are counterproductive. As an example, Mississippi Attorney General Jim Hood has brought legal action intended to compel insurers to pay all Katrina-related damage claims without consideration to the actual source of the damages (wind or flood.) This action is ill-advised. If the Attorney General were to prevail, the insurance industry's ability to efficiently assess and pay appropriate claims would be impeded and the recovery delayed.

While such an action might be presented as a well-intended effort to help people who did not purchase flood insurance coverage from the federal government, it is an attempt to rewrite the basic underwriting contract after the loss has occurred. While there are attempts to do this every day by private parties, it is extraordinary for a public official to take this step.

The NFIP was created by Congress in 1968 in recognition of the fact that flood loss is an uninsurable

risk in the private market. To make it affordable to the many property owners who need it, the premiums for individual flood insurance policies are partly backed by the federal government. If a legal action such as the one brought by Attorney General Hood or a similar private legal actions were to succeed, they would pose a huge threat to the solvency of the entire insurance industry by requiring insurers to pay for losses not covered under the policies they wrote and by putting the entire concept of enforceable insurance contracts into question. Insurers not rendered insolvent would almost certainly be forced to withdraw from the market of any state whose government abrogated insurance contracts.

The potential for this scenario is well understood by Mississippi Gov. Haley Barbour, who reacted to Attorney General Hood's lawsuit by observing, "It's crucial that people who enter into contracts keep their contracts. And that's what an insurance policy is – it's a contract." While adding that the state is working hard to find ways to extend financial assistance to help people who did not have flood coverage, the governor emphasized that, "forcing insurance companies to pay for coverage they did not charge a premium for will either bankrupt those companies or drive them out of your market."

A recent editorial from the Biloxi *Sun Herald* echoed Gov. Barbour's concerns, stating, "By filing suit against the state's largest insurance providers, Hood is sending a dangerous signal to the entire private sector. Does he really want people to think that contracts may not be worth the paper they are written on in the Magnolia state?"

Conclusion

Residents of Alabama, Florida, Louisiana, Mississippi and Texas are struggling to recover from what may be the costliest natural catastrophe in U.S. history. The rest of the U.S. joins them in trying to absorb its reverberating economic impacts at a time of extensive federal spending. The insurance industry will do its part by fulfilling its contractual obligations to pay claims to its insureds. In this way, property/casualty insurance plays a key sustaining role for the American economy and provides hope where it is needed. Policymakers should resist the temptation to retroactively change the scope of insurance contracts. Such a result would not only put a tremendous strain on the ability of insurance companies to serve their customers, it would impede all commercial activity by

undermining the long-established system of promise and performance.

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Complaint and Motion for Temporary Restraining Order, in the matter of Jim Hood, AG for the State of Mississippi VS. Mississippi Farm Bureau Insurance, State Farm Fire and Casualty Company, Allstate Property and Casualty Insurance Company, United Services Automobile Association, Nationwide Mutual Insurance Company, et al.