THE STANDARD
NEW ENGLAND'S INSURANCE WEEKLY
Published Since 1865
Boston, Mass.
January 12, 2007
Vol. 260 No. 1

The Coast Is Clearly the Biggest Challenge Facing Northeast P/C Insurers in 2007

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By far, the most challenging public policy issue facing property-casualty insurers in the Northeast in 2007 is the potential response to changes in the coastal property insurance market.

In order to keep a difficult situation from developing into a real crisis, a broad and comprehensive effort is needed to educate not only policymakers but also the public about the developments that have taken place in the property insurance market and what will happen if those developments are met with misguided legislative or regulatory responses. The extent and scope of the issue and the potential for long-lasting damage make it incumbent on all insurance professionals first to understand the issue and second to do what they can to promote greater understanding among the public.

A Confluence of Factors

It is significant to understand that the current situation is the result of several factors rather than a single one. An attempt to attribute significant marketplace developments to a single factor is likely to meet with incredulity, and rightly so. It is only by considering the way several factors operating independently have interacted that the situation can be understood.

Taking the factors in chronological sequence, the first one that has to be recognized is the increase in construction of high-value properties in coastal areas. This is part of a trend that extends back decades, and the recent real estate boom did nothing to slow it.

The next factor is the increased use of more sophisticated catastrophe modeling techniques. The role of modeling is one of the harder aspects of the situation to explain. In doing so, it is important to stress that insurers started to significantly increase their use of sophisticated computer-based models several years ago. The development of modeling is a function of advances in technology and science. In other words, there is simply more known today about the potential effects of storms than there was yesterday. And what has been learned is not encouraging, as it has been found that the potential for destruction was severely underestimated in the past.

A development related to modeling is long-range weather forecasting that suggests that we are just entering an extended period of increased hurricane activity. The idea is that an examination of the frequency of hurricanes that have made landfall in the U.S. over a period of 100 years or more shows there are periods in which there are stretches of years in which they are relatively concentrated, and there is scientific data suggesting that one such concentrated period has begun.

Increased coastal construction together with increased hurricane activity to destroy that construction is obviously a recipe for trouble. And the increased use of models has brought this situation to the attention of not only insurers but also rating agencies, regulators charged with solvency oversight, and reinsurers.

The hurricanes of 2005, completely unprecedented in their degree of devastation, reinforced the idea that the nation's exposure to damage from such

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storms had been underestimated. It is important to understand that while these events have had some effect on the situation that is now affecting coastal states, they are not the sole or even direct cause. The trends that have caused the present situation started well before.

Insurers' Response

As a result of these trends, insurers with substantial amounts of coastal business have come to the realization that their existing books present more exposure than they can prudently maintain, and they have had to respond accordingly. It should be noted that, contrary to some very public accusations, insurers are acting appropriately and responsibly by taking steps to address their exposure. In fact, by seeking to protect their financial viability, insurers are serving the interests of their policyholders and the public.

There are a limited number of responsive steps an insurer can take in order to address excessive exposure to risk. It can control risk through mitigation, avoid the risk by reducing coastal policies, transfer risk through deductibles, or use reinsurance to transfer risk financially.

It would be nice if the factors that made insurers need more reinsurance also caused reinsurance rates to go down, but such is not the case. In fact, the opposite is true. Catastrophe reinsurance rates have risen dramatically at the same time that circumstances have caused insurers to need more reinsurance coverage. Furthermore, the worldwide reinsurance market has only so much appetite for risk in a given region. Therefore, the option of purchasing more reinsurance can achieve only so much.

To address the newly understood reality of their exposure, insurers in coastal markets have been raising rates to cover higher reinsurance costs, requiring insureds to implement mitigation measures, applying higher deductibles, and reducing business through nonrenewals.

Aggrieved Owners

Property owners, of course, do not like to see their premiums rise, they do not like to be told to install mitigation devices, they do not like to see their coverage reduced through a higher deductible, and they do not like being told that their insurance company no longer wants them as a customer. Since they do not understand why these things are happening, they have become frustrated and even angry.

Everyone in the industry must realize the degree to which property owners are aggrieved. They do not understand why they should have to be subject to the changes in the market because they do not understand why they are occurring. Lacking accurate information, they make erroneous assumptions, about the reality of risk and the reasons for insurers' actions.

Feeling as though they have been unjustifiably wronged, frustrated citizens have brought emotionally-charged complaints to their elected officials. Such officials may not have much better understanding of why market developments have occurred, but they do know they are feeling enormous pressured to do something. The problem is, there is no silver bullet or quick and simple solution. Furthermore, the kinds of regulatory and legislative measures that appear to be solutions, things like restrictions on insurers' ability to underwrite or nonrenew business, would actually make matters worse.

To be sure, there are solutions, including increased use of mitigation and the implementation of stronger building codes, but they are neither quick nor satisfying to most. Time itself may be a partial solution as the situation is likely to moderate with time as market participants make adjustments.

Need for Accurate Information

The immediate need is for accurate information. Industry representatives have been engaged in the process of educating lawmakers regarding the reasons for marketplace developments. But since property insurance is an issue that touches virtually every citizen, a broad and comprehensive effort to educate and explain is needed. Insurance professionals should take every opportunity, in business and social interactions of all kinds, to educate and explain.

There are two aspects to the education/explanation effort. One aspect is to explain what has happened to the coastal property insurance market and why. Fortunately, here the industry has a story to tell, and it is a compelling one. It is not a simple story that can be related in a sound-bite or quick retort, but it is possible to explain the reality of the risk and the need for insurers to respond. And though there are many people who would rather complain than understand, there are many others who would be open to accurate information.

The other aspect is to explain what would happen if policymakers respond to these marketplace developments with a misguided approach in which insurers are constrained or restricted or subject to arbitrary mandates such that their ability to underwrite and assess risk is impaired. Attempts to address the situation by imposing restrictions on insurers' ability to underwrite risk can wreak havoc in the marketplace, transforming a situation that is challenging for all participants into a bona fide crisis.

It is important to see, and to convey, that the industry's interests are not in any way in opposition to the interests of consumers. The fact is that everyone — insurers, agents, property owners, realtors, bankers — benefits from a properly functioning, healthy property insurance market. The way to maintain a functional insurance market for all participants is to maintain underwriting freedom.

The public needs to understand that severe hurricanes have struck the Northeast before and they will do so again. When (not if) an event does occur, the property casualty insurance industry will be instrumental in helping the region recover. It is imperative that marketplace developments are not permitted to result in misguided measures that could impair the market or hamper the ability of the industry to fulfill its essential role. ■