STATEMENT OF ROBERT DETLEFSEN
ON BEHALF OF
THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES
BEFORE THE
MARYLAND INSURANCE ADMINISTRATION
ON

THE AVAILABILITY AND AFFORDABILITY OF PERSONAL AND COMMERCIAL PROPERTY AND CASUALTY INSURANCE IN COASTAL AREAS

DECEMBER 13, 2011

BALTIMORE, MARYLAND

Good morning Commissioner Goldsmith. My name is Robert Detlefsen. I am vice president of Public Policy for the National Association of Mutual Insurance Companies (NAMIC). Founded in 1895, NAMIC is a property/casualty insurance association whose 1,400 member companies serve more than 135 million auto, home, and business policyholders, writing in excess of $196 billion in annual premiums that account for 50 percent of the automobile/homeowners market and 31 percent of the business insurance market.

According to the official notice of today's hearing, its purpose is to enable the Maryland Insurance Administration to gather the following information:

1. The current number of admitted carriers, excess and surplus lines carriers, residual market mechanisms, captives and reinsurers offering property/casualty insurance products in coastal areas of the state;

2. The types of products offered in coastal areas of the state by admitted carriers, excess and surplus lines carriers, residual market mechanisms, captives and reinsurers;

3. The rates and deductibles offered per carrier in coastal areas within the state;

4. The impact, in any, of coastal markets on the availability and affordability of personal and commercial property/casualty insurance in non-coastal areas of the state;

5. The effectiveness, cost, and long-term viability of alternative market mechanisms, such as limited coverage products, wind pools, the expansion of residual market mechanisms, and catastrophe funds, that have been implemented or are being considered in other states or by the federal government; and

6. Initiatives adopted in other states to increase availability and affordability of personal and commercial property/casualty insurance in coastal areas.

With respect to items 1 through 4, I will defer to others who have a better sense of local market conditions and trends than I do. My remarks will focus instead on items 5 and 6 in the hope that NAMIC's experience with coastal property insurance issues in other states will help inform the thinking of policymakers in Maryland.

Understanding the Nature of the Problem

Any serious discussion of coastal insurance availability and affordability should begin by acknowledging three simple facts:

1. The exposure of densely concentrated, high-value property to elevated levels of catastrophe risk in certain geographic regions means that property insurance in these regions will be relatively expensive compared to regions that lack these attributes.

2. As population growth and commercial development in catastrophe-prone regions increase, the number of people and businesses faced with relatively high insurance costs will naturally increase as well.

3. The Gulf and Atlantic coastal regions of the U.S. have experienced increased population growth and commercial development at a time when the frequency and severity of catastrophic storms in these regions are increasing.

Simply put, the availability and affordability of property insurance in coastal regions are mainly a function of risk. But other variables, including actions taken by government, can also affect the supply and cost of insurance. The availability and affordability of coastal property insurance are particularly influenced by the following factors.

<u>Frequency and Severity of Major Coastal Storms</u>

Whether because of global warming or cyclical climate change, a consensus has emerged among hurricane experts that the frequency and severity of major storms will increase during the next several years. Last spring, the influential catastrophe modeling firm Risk Management Solutions released RMS 11.0, an updated version of a hurricane catastrophe model widely used by insurers and reinsurers to assess hurricane risk, manage exposure, and price coverage. The revised model predicts increased wind risk for all hurricane-prone states on an industry-wide basis. The largest increases in windstorm-related losses are projected to occur in non-coastal areas, with areas along the coast experiencing somewhat smaller increases in windstorm-related losses.

<u>Coastal Development and Population Growth</u>

Greater frequency and severity of coastal storms would matter less if the affected areas were sparsely populated and contained few valuable assets. But in fact the areas most at risk for increased storm activity contain a disproportionate share of the nation's population, as well as its most valuable real estate. What is more, the movement of people and wealth from interior regions with relatively little catastrophe risk to coastal regions with the highest levels of catastrophe risk is increasing even as the likelihood of severe coastal hurricane activity increases.

Regulation

Many states in catastrophe-prone coastal regions impose rating and underwriting restrictions on property insurers that act as price ceilings on coverage. Government rate suppression, which allows high-risk property owners to pay artificially low premiums, is the preferred solution of many regulators and state legislators to the property insurance "affordability problem" in catastrophe-prone areas. But rate suppression masks the real problem – the growing concentration of people and wealth in high-risk regions – by forcing insurance buyers in low-risk regions to pay inflated prices in order to subsidize the insurance costs of those in high-risk regions.

Insurance rate suppression also removes a powerful disincentive to further population growth and economic development in these areas. That may seem like a good thing to government and private businesses that thrive on growth and development. But unfortunately, government rate suppression distorts the public's perception of risk, thus encouraging the very phenomenon that created the problem in the first place. Federal and state governments must then end up bearing the cost of the economically irrational decisions that result from rate suppression by paying for disaster aid to repair properties that should never have been built in the first place. Risk-based insurance pricing alleviates this problem by sending accurate signals to consumers about the relative level of risk associated with particular regions and types of structures.

Rate suppression and underwriting restrictions are also largely responsible for insurance availability problems in coastal areas. Like any other business enterprise, insurers must charge a price that covers the cost of the good or service they provide and allows them to make a profit. Historically, profit margins in the highly competitive property/casualty insurance industry have been quite modest compared to other business sectors. But if government rate regulation prevents insurers from covering their claim costs, replenishing surplus reserves to pay future claims, and making a profit, they may have no choice but to exit the market. The surest way to increase the supply of insurance in catastrophe-prone coastal regions is to remove government restrictions on pricing and underwriting.

Litigation and the Viability of Insurance Contracts

For more than 30 years, the standard American homeowners insurance policy has contained a provision that excludes coverage for damage caused by flooding. Throughout this period, flood coverage has been provided almost exclusively by the federal government through the National Flood Insurance Program (NFIP).

Nevertheless, after every major disaster involving extensive flooding, attorneys take aim at the flood exclusion in homeowners policies, looking for ways to overcome decades of legal precedent behind that part of the insurance contract. Sometimes they succeed, causing insurance companies to re-examine their policies and make adjustments so that the policy language is as clear and unambiguous as possible in stating that damage due to flood is not covered. They then file those policy contract forms with state insurance regulators and negotiate the terms until they can obtain official approval and issue them to policyholders.

Such was the case in Mississippi, Louisiana, and the other states hit by the 2005 hurricanes. And when it developed that many homeowners whose properties were damaged or destroyed by hurricane-related coastal flooding had not purchased federal flood insurance (or had not purchased enough to cover their losses), class action attorneys, joined in this instance by the Mississippi attorney general, descended on the courts, trying to persuade judges to abrogate the flood exclusion and force insurers to retroactively provide coverage for which they collected no premium.

The sanctity of contracts is a cornerstone of the free enterprise system. With respect to insurance contracts, this often means deferring to the state insurance regulator who approved the contract language as part of the rigorous form filing process that insurers must follow. Insurers who relied in good faith on the decision of a state insurance department that their policy language was clear and unambiguous must not be ordered by a judge to pay claims because, in the court's view, the insurance department erred in approving the contract language.

The unfortunate lesson that insurers learned from the Katrina-related lawsuits is that the possibility that courts will fail to uphold insurance contracts is a significant risk factor that must be taken into account in setting property insurance premiums. And just as an inhospitable regulatory climate can cause an insurer to exit a market, a legal system that fails to honor the sanctity of contracts may produce the same result.

The False Promise of Alternative Market Mechanisms

Historically, most attempts to devise alternative market mechanisms to address problems related to the "availability" and "affordability" of property insurance in hurricane-prone coastal areas have proved problematic at best. One type of residual market mechanism, generally known as a beach plan or windstorm plan, was created specifically to provide property coverage for the peril of windstorm for property owners unable to obtain coverage from private carriers. These plans, available in seven states (Alabama, Florida, Louisiana, Mississippi, North Carolina, South Carolina, and Texas), were originally created to be markets of last resort. As such, they were designed to be actuarially sound – rates were commensurate with risks – in order to preserve their solvency and not interfere with the private insurance market's fundamental supply-demand equilibrium.

Over time, however, policymakers increasingly viewed beach and windstorm plans as tools for promoting economic development in coastal areas through the provision of low-priced insurance. States with strict rate regulation provided an especially fertile terrain for this "mission creep" to occur. As residual markets grew, prices in the private market were suppressed. The result was a widening of the gap between demand and supply as insurers were unwilling to provide coverage at artificially suppressed rates.

In some areas, beach and windstorm plans insured more risks than were insured in the voluntary market, partly as a consequence of their failure to charge rates that reflected the true cost of the risk involved. Moreover, because the prices were so low, development and demand for coverage increased, which further increased the size of residual markets. In an attempt to maintain the

solvency of beach and windstorm plans without resorting to actuarially sound pricing, some state plans imposed assessments on private market insurers operating in lower-risk areas. As a result, private insurance policyholders in the lower-risk non-coastal regions subsidized the cost of insurance for property owners in the higher-risk coastal markets.

Aside from residual market mechanisms designed to provide primary insurance coverage directly to coastal property owners, one state – Florida – has instituted a catastrophe fund whose purpose is to provide inexpensive reinsurance to primary insurers in both the private and residual markets. The theory behind the Florida Catastrophe Fund is that, insofar as the availability and affordability of coastal property insurance is adversely affected by the high cost of reinsurance, a state-run reinsurance fund could provide a less costly alternative to private reinsurance. But because the only way any such fund can do this is by charging rates that do not accurately reflect the risk of loss, the Florida Catastrophe Fund has been chronically underfunded. Most analysts believe the fund will be incapable of meeting its obligations when the state is struck by a major hurricane or series of storms within a single hurricane season.

Taking the Affordability Problem Seriously: A Different Approach

In 2009, MIT Press published an important book, *At War With the Weather: Managing Large-Scale Risks in a New Era of Catastrophes*, which was hailed by Terri Vaughan, CEO of the National Association of Insurance Commissioners, as "essential reading for anyone searching for solutions to the problem of financing large-scale catastrophes." Authored by a team of distinguished insurance scholars from the University of Pennsylvania's Wharton School and Georgia State University, the book identifies "two key principles" that should guide insurers and policymakers as they grapple with natural disaster insurance availability and affordability issues. NAMIC believes that these principles provide policymakers with a solid foundation from which to develop innovative solutions and avoid costly mistakes. As stated in the book, the two principles are:

- *Risk-based Premiums:* Insurance premiums should be based on risk to provide signals to individuals as to the hazards they face and to encourage them to engage in cost-effective mitigation measures to reduce their vulnerability to catastrophes.

- *Dealing with Equity and Affordability Issues:* Any special treatment given to lower-income residents in hazard-prone areas who cannot afford the cost of living in those locations should come from general public funding and not through insurance premium subsidies.

The book's authors recognize, as does NAMIC, that a market-based insurance pricing system in which premiums reflect the actual cost of insuring against catastrophic risk could result in significant premium increases for some property owners in high-risk regions. We agree with the recommendation that in lieu of cross-subsidization through rate suppression and taxpayer-funded government insurance schemes, policymakers should consider creating programs to provide direct government assistance, funded from general revenue, to particular consumers based on criteria established through a transparent decision-making process.

This should not be all that difficult. State governments have a long history of designing and administering programs that provide grants and other forms of financial assistance to individuals on a means-tested basis for the purchase of essential goods such as food and shelter. For example, government responds to the inability of some individuals to afford basic food staples, not by capping the price of groceries or creating government-run food stores, but by providing food stamps to low-income individuals that can be used to purchase food items from private vendors.

There is no reason why governments could not provide a similar form of aid to select property owners for the purchase of insurance. Such an approach would have many advantages over the current system of generalized rate suppression and cross subsidization, not the least of which is that the assistance could be targeted to particular individuals based on financial need. Moreover, its availability could be limited to those currently residing in disaster-prone areas, and would thus avoid creating incentives for people not currently living in those areas to move into harm's way.

In conclusion, NAMIC realizes that the property owners, insurers, mortgage lenders, realtors, and home builders that live and do business in coastal areas will face serious challenges in the years ahead. We believe that the most effective mechanism for addressing these challenges is a private insurance market whose defining characteristics are open competition and pricing freedom.