

Issue Brief

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Compulsory ‘All-Perils’ Coverage Would Worsen Disaster Insurance Problems

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Introduction

The 2005 Gulf Coast hurricanes and their aftermath have stimulated an important national conversation about the efficacy of our current system for managing and financing natural catastrophe risk. The question facing policymakers and leaders in the private sector is: What public and private initiatives are needed to mitigate and to finance risk stemming from large-scale disasters?

In answer to this question, the National Association of Insurance Commissioners (NAIC) has drafted a ten-page white paper that proposes an ambitious “comprehensive national plan” for managing natural catastrophe risk.¹ In addition to asserting that “cost-effective steps should be taken to mitigate potential losses,” the paper declares that “the way insurance benefits are delivered to the public needs to be revisited.” Elaborating on this point, the paper observes:

Clearly, having disputes over whether a loss is attributable to wind or water is not what the public has in mind when they purchase insurance for their homes. The policyholders simply want to buy a policy that provides them with peace of mind and pays for their loss, minus some reasonable deductibles or co-payments, when bad things occur. The insurance industry needs to find a way to meet those expectations. Perhaps the time has come to consider providing an all-perils policy that meets those expectations and avoids all of the pitfalls that have been observed in recent catastrophic events.²

The “insurance industry,” the paper continues, “cannot be expected to provide all of this broad coverage without adequate financial backstops for the most extreme events.” The paper thus sets forth a plan comprising “three layers of risk-bearing capacity.” The first layer is the private insurance market; the second layer is a network of state and regional catastrophe reinsurance funds; and the third layer is a federally-funded catastrophe reinsurance program to be administered by a new federal entity, the “National Catastrophe Insurance Commission.” In essence, the plan is designed so that the first layer of risk-bearing capacity is backstopped by the second layer, which in turn is backstopped by the third layer. As suggested by the passage quoted above, the *sine qua non* of the NAIC plan is a provision that would compel property insurers to offer an “all-perils” homeowner’s policy. While the white paper states that such a policy “should be mandated,” it is not entirely clear whether this means that property owners who wished to purchase a less comprehensive policy would be precluded from doing so. Viewed in context, however, that appears to be the plan’s intent.

According to the white paper, the government backstop mechanisms envisioned by the plan are necessary because of the insurance industry’s inability to provide “this broad coverage” without some form of government assistance. Interestingly, some observers have suggested that state and federal reinsurance backstops are needed even under the current system, which allows insurers to exclude perils such as floods and earthquakes.

Others maintain that there is sufficient private reinsurance capacity available to handle all but the most extraordinary mega-catastrophes, as long as primary insurers limit their exposure, in part by judiciously excluding certain perils from coverage in high-risk areas. The NAIC plan sidesteps this debate by establishing a mandatory all-perils policy as a prerequisite for access to state and federal reinsurance. Hence, our evaluation of the NAIC plan must focus primarily on its call for a mandatory all-perils policy.

Rationale and Feasibility of a Mandatory All-Perils Policy

The paper’s discussion of the all-perils policy begins by announcing:

Consumers have a reasonable expectation that their residential insurance policy will, net of a deductible; [sic] indemnify them in the event of damage to their home, regardless of the cause. To that end, an all-perils policy, containing no exclusions except for acts of war,³ should be mandated.

There is more than a subtle difference between this statement and the notion that “policyholders simply want to buy a policy that provides them with peace of mind and pays for their loss [irrespective of the cause]....” It is one thing to say that consumers “simply want to buy” a comprehensive policy but are, for whatever reason, not able to do so. It is quite another thing to say that buying a policy that specifically excludes certain clearly defined perils nevertheless creates a “reasonable expectation” that the policy will provide comprehensive coverage. The plan seems to take the dubious position that if some consumers expect a level of coverage that does not accord with the terms of their policy agreement, government should step in and require all insurers to provide that level of coverage to all consumers.

Pricing an all-perils policy

The plan gives no indication as to whether the price of a mandatory all-perils policy would be determined by market forces or by government fiat. Instead, the plan provides details concerning the conditions under which various premium *discounts* would be available to policyholders. For example, the plan calls for mandatory discounts for policyholders who adopt “effective mitigation measures,” and mandates additional discounts for policyholders whose property is located in jurisdictions that receive a favorable “Building Code Enforcement Grade.”

The plan’s reticence with respect to the pricing issue leads one to suspect that the price of coverage for high-risk properties would be suppressed through regulation. In that case, coverage for property owners in high risk regions would be subsidized partly by property owners in low-risk regions (who would necessarily be charged inflated premiums to compensate for the artificially low premiums paid by high-risk buyers), and partly by taxpayers through the state and federal reinsurance mechanisms envisioned by the plan. If this is what the plan intends, it is ill-advised for at least three reasons:

1. Unless all homeowners are required to purchase an identical all-perils policy, the plan will lead to adverse selection. An all-perils policy whose price does not reflect the greater risk associated with particular perils in particular regions will attract a disproportionately large number of high-risk buyers and a disproportionately small number of low-risk buyers, thus increasing the likelihood that losses will outstrip private sector capacity and trigger recourse to the taxpayer-funded reinsurance mechanisms envisioned by the plan.
2. If, on the other hand, all homeowners are required to purchase an all-perils policy, the plan will be unfair to policyholders who choose not to live in high-risk areas.
3. The plan would increase the potential loss costs from natural disasters by decreasing incentives for risk mitigation and aggravating moral hazard. For some individuals, the optimal risk mitigation strategy may be to avoid owning property in certain regions altogether.⁴ A plan

that combines mandatory coverage, cross-subsidies through price suppression, and taxpayer-funded government reinsurance will ultimately discourage risk mitigation. Moreover, if premiums in high-risk areas are artificially low to begin with, providing mandatory discounts and tax credits to policyholders who invest in risk mitigation measures could actually make matters worse.

Removing government barriers to effective disaster management

Before using regulation to force insurers to offer comprehensive homeowners coverage, policymakers should consider whether the goal of better catastrophe risk management could be achieved by removing government barriers that prevent insurers from offering comprehensive coverage voluntarily. One such barrier is the federal tax code, which prevents insurers from establishing dedicated catastrophe reserves on a tax-deferred basis. As noted in the NAIC white paper, tax-deferred catastrophe reserves are common throughout the world; to its credit, the plan lays out a workable formula for allowing insurers to create such reserves. What is missing from the plan is any acknowledgement of what is arguably the single greatest impediment to insurers’ ability to offer an all-perils policy: the current system of government price controls that prevents insurers from pricing coverage based on risk.

It is quite possible that in the absence of rate regulation and government-imposed underwriting restrictions, a competitive private insurance market for an all-perils policy would develop, provided that the price property owners are willing to pay for an all-perils policy exceeds the cost to insurers of offering the policy. As with any risk, the insurability of catastrophe-related risk depends on whether insurers have the freedom to assess and classify the risk, and to price coverage accordingly. In an insurance market that featured risk-based pricing, one would expect an all-perils policy to cost considerably more for properties located along the Gulf Coast, for example, than for properties located in parts of the country that are less prone to wind and water damage from hurricanes. Conversely, individuals who own properties in areas where the risk of floods, tornadoes, and hurricanes is very low would pay next to nothing for a policy that covers these hazards.

NAMIC would support changes to tax policy that would increase insurer capacity and create incentives for risk mitigation. We also believe government can play a useful role in mitigating disaster-related risk by enacting and aggressively enforcing strong building codes. Moreover, NAMIC would support a proposal that allowed (but did not require) insurers to offer an all-perils policy in a regulatory environment free of price controls and underwriting restrictions. We recognize that for some consumers whose properties are located in areas that are highly susceptible to certain perils, the price of comprehensive coverage may be prohibitive. In such cases, policymakers could determine which government interventions, if any, are appropriate. The plan proposed by the NAIC represents one possible approach, but others should be considered as well. For example, programs could be created to provide direct financial assistance to individuals whose insurance costs society wishes to subsidize. Such subsidies could be provided on a means-tested basis and would operate much like current government programs that provide food and housing subsidies for low-income individuals.

Conclusion

There are a variety of potential public and private responses to the problem of managing and financing natural disaster risk. NAMIC believes that all are worthy of careful study and deliberation. As a first step, however, we believe that unfettered market forces should be given a chance to work before adopting a plan that would further increase government intervention in ways that could damage private insurance markets and exacerbate the very problems it seeks to correct.

Endnotes

¹National Association of Insurance Commissioners, “Natural Catastrophe Risk: Creating a Comprehensive National Plan,” December 1, 2005.

²*Id.*, pp 2-3.

³Taken literally, this would seem to imply that acts of terrorism are among the hazards to be covered under the proposed mandatory all-perils policy. The idea of including terrorism within the scope of the all-perils

policy was discussed at the National Catastrophe Insurance Summit held in San Francisco last November. By summit’s end, the four insurance commissioners who hosted the event stated that their intention was not to include terrorism among the covered hazards. Moreover, the plan that is the subject of this Issue Brief is described by the NAIC as a *natural* catastrophe risk plan. We will therefore proceed on the assumption that the NAIC does not intend for the all-perils homeowners policy to cover terrorism risk.

⁴In a working paper distributed at last November’s “Natural Catastrophe Insurance Summit,” economist Robert Litan notes approvingly that, “Faced with the actuarially justified annual costs for living or working in exposed areas, some individuals and businesses may choose to locate elsewhere.” See Litan, “Sharing and Reducing the Financial Risks of Future ‘Mega-Catastrophes,’” Brookings Institution, November 11, 2005.