Discussion Note

October 22, 2010 Meeting in Foley, AL

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The chair opened the meeting by stating that the subcommittee was moving toward recommendations. The meeting will have three small presentations, beginning with one about transparency.

A member asked how potential conflicts over ideas would be resolved. The chair said the members who have volunteered to be on the subcommittee are the final redactors. He likened the subcommittee's approach to finding ways to push on a water balloon so that it reaches a certain point -- the point being a decrease in the increase in the insurance rate.

Responding to questions about the procedure going forward and the timeline of the report, the chair said there would be a draft of the insurance section of the report available for comment, and the information and recommendations coming from the subcommittee would need to be sent to the writers of the report during the first week of November. He added that a CRC meeting on October 26 will include a short presentation about some tentative ideas and recommendations.

The presentation about transparency focused on a legislative bill that would require insurance companies to send certain data to the Alabama Department of Insurance, which would make the data available to the public. The data includes aggregate data by zip code; number of policies; the dollar amount and premiums collected; and the dollar amount of claims paid out.

The member presenting the transparency bill noted she supported funding for education and awareness efforts, but that there are problems which need to be addressed now. She said there is something wrong with an insurance system where insurance rates in Baldwin County are 300 to 600 percent higher than the state average, which is slightly more than $900. The injustice is we do not know why. Consumers want answers to why rates are so much higher here than in other parts of the state where tornadoes frequently occur. Consumers only have circumstantial evidence. The data would help to show if these higher rates are deserved. The state of Texas already provides similar data and Alabama should do the same.

The member questioned the validity of the subcommittee's process for selecting members, adding that being serious about public participation would require hours and hours of listening to many people. The chair pointed out that everyone in the room is considered a member and there were no limits on who could be a member and who could participate.

The chair asked whether there was support for recommending the transparency bill and a number of people said yes. When the chair asked if there was anyone who did not support it, a member pointed out that such data could be misinterpreted by individuals who may not understand the long-term nature of how insurance in priced. Another member suggested the decision on whether to recommend the transparency bill or a similar transparency recommendation wait until all the presentations were complete.

Continuing the discussion, another member said hurricanes take place every certain number of years, and one would expect when hurricanes do not come rates would be lower, so people could save a little money between storms. The concern over the data in the transparency bill is if we took a snap shot of any particular year we would see that maybe Mobile and Baldwin counties did not have many claims, but that does not mean the company would have a savings account in holding for when the big one hits. For example, his insurance company paid out about $2 billion dollars for wind damage claims in Mississippi after Katrina, but the company only brings in about $200 million in revenue from the state each year. Another member noted that the point of the transparency bill is not to get into the issue of company profits, but to shed light on why people in coastal Alabama are paying so much for insurance. A point was raised that the Department of Insurance would not be able to gather data from non-admitted carriers; in response, it was noted the data would still be valuable for statistical analysis.

A question was asked about whether there was data for the number of “functionally uninsured”, which are those that have property insurance but not comprehensive coverage, or have comprehensive coverage but do not have the money in the bank to pay the deductible on their policies. In response, it was noted that the Department of Insurance could not determine that number without the data which would be required in the transparency bill.

A comment was made that it is unlikely the data being requested would satisfy consumers. Instead, we would need to make the insurance carriers’ rate filings public information once the filing was approved and, in those filings, the consumer would see what the wind loads and the non-wind loads are by territory. The wind loads are driven by hurricane models and not driven by actual losses -- but unless somebody is looking at what the territorial wind loads are, they are never going to be satisfied or understand what the driving force is behind the premiums being charged. Furthermore, a lot of public education would be needed to accompany the rate filings being made public.

Another member disagreed, commenting the public would be able to grasp the math behind the long-term nature of insurance pricing if the data in the transparency bill were made available. Agreeing, another member added that nobody has any problem with insurance companies making profit, but that many people distrust the models that insurance companies use to price risk.

Addressing models, the chair noted when he served as insurance commissioner; there was a company which came to the DOI to ask for a rate increase. The company told him that the profits the company had made in the region over the last 30 years had been wiped out by Katrina. Regarding what the model may say, the chair noted the current models are based on the actuality of what would happen. The other issue is the models that were being used prior to the storms in 2004 and 2005 had a different frequency and severity to them. Prior to hurricane Fredrick in 1979, there were not a lot of high-priced homes on the Gulf. The increase in the cost of construction in more places during the last 25 or 30 years has been at an unbelievable rate. This increase in the cost of building and in building in more risky places -- all of this information is now factored into models. Then when a Category 4 storm comes, the model is basically what would happen.

A member noted the insurance company that insures her home ranks high on the list of Fortune 500 companies, but she will be getting a 9.9 percent increase on her already inflated premium. Another member noted an instance where an insurance company dropped a homeowner's wind and hail coverage, but they were still being charged $1,000 a year for fire insurance. The lowest premium another homeowner could find was $700. The member reiterated that we need data to analyze.

The chair said the transparency bill will be given consideration along with other recommendations; the subcommittee could offer as many recommendations as is necessary -- the question is how they are prioritized. It was suggested that transparency be part of the education initiative recommended by the committee. Someone else noted the subcommittee is not opposed to a transparency bill -- transparency would help bring more people into the process -- but the question is how we could make the legislation better, by utilizing the expertise of professionals on the subcommittee. A member added the transparency bill would ask for historical data going back 10 years.

The discussion moved to a presentation by the president of the Insurance Information Institute about strategies to encourage more private insurers to enter the market, enhancing competition. Alabama has significant exposure along the coast, about $93 billion in insured coastal exposure. Florida has 2.5 trillion. Alabama has 80 percent more than Mississippi.

Alabama's coastal market is "a relative bastion of calm." The share of the market that is in the state's wind pool is very small compared to other states. Alabama's homeowner's insurers market is in better condition than any other Gulf coast state. Which does not mean it can't improve. He added the price of insurance must reflect the risk that is assumed, and that the idea is to ensure enough availability so the price more accurately reflects the risk assumed. That has been the primary problem in the state of Florida, where he noted years of rate suppression has resulted in probably the most dysfunctional insurance market in the U.S., if not the world.

He reviewed a list of things that the Institute knows will work -- successful tools for controlling hurricane exposure but at the same time stimulating competition among insurers. For an insurer to be in a market, they make a very conscious decision to allocate capital to that particular market. Insurers enter a business venture where they ultimately need to make a profit, in order to justify remaining in the market.

Aside from having actuarially sound rates based on risk-based principles, near the top of the list is strengthening building codes and fortifying homes. The insurance industry opened a $40 million facility in South Carolina that will blow hurricane force winds over structures to help develop construction designs which can better withstand hurricane force winds. Much like a facility in Virginia that crashes Automobiles, the testing and science conducted by this facility will help lower losses for companies and consumers.

The Institute has also advocated putting more information in the hands of consumers. When you buy a new home, you get a lot of info about the home. One thing you will not read is any kind of hurricane rating, based on whether there are roof tie-downs or fasteners to the foundation, for instance. It would make a lot of sense, as we do with automobiles, for people to understand the features on their homes. If the information is disclosed, all else being equal, then a home that is fortified against hurricane loss will sell for more than one that is not. However, this information is not routinely disclosed and there is no mandatory disclosure requirement. When the suggestion for a hurricane rating was made several years ago in another state, the Realtor community there criticized the suggestion. This type of information in the hands of consumers would empower them to make decisions which will drive home-builders to build stronger homes, and give incentives to current homeowners to retrofit their existing homes against the effects of storms.

Building codes, and enforcement of them, is another big issue. Building codes have improved. In the past, building codes in some jurisdictions -- in Mississippi after Katrina and in Florida after Andrew, for instance -- were not worth the paper they were printed on. Enforcement needs to be tight.

Another strategy would be to find ways to lower the cost of capital for insurers -- in that the lower the cost of capital, the greater the ability to allocate capital to markets. This could encourage insurers to commit to a new market, or encourage insurers already with a presence to expand in a market. There are a number of proposals around lowering the cost of capital. One idea would be to allow insurers under the U.S. tax code to set aside reserves for an event before it happens; under current U.S. tax law, an insurer can't establish a recognized reserve for tax purposes until after an event has happened. In Europe, insurers are allowed to do it before an event. A proposal has come before Congress several times, but has yet to gain traction.

It is also important to look at the decision-making process involved in coastal development. If you are flying over many coastal areas, the pattern of building seems to make no sense, given the risk of hurricanes -- until you look at the individual incentives involved in coastal development. In fact, it is logical for individuals to build in these areas, and it is even more logical for individuals who are in charge of zoning to allow the development. It brings in jobs, tax revenue, more population, wealth, and ancillary development, more representation in the state legislature and in Congress. There are a lot of reasons to approve the kind of development which has gotten us into a lot of trouble all across the country. The development has been enabled, in part, by state and federally subsidized insurance programs, including the National Flood Insurance Program (NFIP). The damage from some of the storms over the last decade would not have been as large if there had been market-based incentives to mitigate and avoid risks. There would likely be fewer homes in vulnerable areas.

There are also approaches that do not help foster competition in the insurance market. Political interference in the insurance rate process never works. Subsidies ultimately backfire because someone else winds up paying the tab. Looking at the flood issue, it is reasonable to consider mandatory flood coverage. Even in the coastal counties of the Gulf -- in one coastal county in Mississippi, for instance, barely a third of people had a flood policy when Katrina hit. If everyone had flood policies, there would not have been any litigation, and the communities would have recovered more quickly.

Going back to the issue of local control of land use, we have had local control basically since the beginning of this country and there is nothing wrong with this until you look at the incentives it creates. All the incentives -- jobs and taxes, etc. -- are going to accrue locally. However, when something goes wrong there is a tendency to try to redistribute those losses outside of the community, to taxpayers in other parts of the state or in other states. If local communities were required to assume all or a much larger share of the losses incurred, then they would have less incentive to approve inappropriate development in coastal areas. This prospect of government aide reinforces unsound building and location decisions. If you subsidize something, you get more of it, and that includes subsidizing poor or unwise construction. It is what has happened.

The Institute has also found states are not willing to raise taxes to pay for mitigation or prevention, even if the state is the sole beneficiary. Why would reducing subsidies make a market more attractive to insurers? Insurers cannot compete in a subsidized market. That’s why insurers by and large don’t offer flood coverage in the private market; the NFIP sells insurance well below the actual cost. It is also another reason why private insurers do not participate as much as they might in Florida and Texas coastal residential markets.

Regarding the return-on-investment (ROI) associated with mitigation efforts, it was noted that each dollar invested in more stringent building codes returns an investment of about six dollars; each dollar invested in the prevention of loss (resistant windows and doors, etc) returns four dollars in benefits; and FEMA’s analysis is that for every dollar invested in grants to fortify homes returns $3.65. On the website of the Institute for Business and Home Safety (IBHS), which built the $40 million facility discussed earlier, it states for $3,000 dollars a home can be made to withstand most of the ill effects associated with hurricanes. Costs are very modest, and once done less costly to insure the home. More companies would then be willing to underwrite the property. We have seen this with fortified new homes. Even if no new insurers enter the state, the fortified home will have more options for insurance.

We know that private sector competition will not exist unless there is a way to earn a profit in the long run. In Florida, for instance, the market for commercial property is 100 percent serviced by the private market with no problems. The price is higher because it is commensurate with the risk. But the price of insurance, like the price of anything else, is factored into the cost of doing business there. So the commercial insurance market does work because there are market incentives for insurers to commit capital in that state.

There is a role for the market of last resort -- such as the Alabama Insurance Underwriters Association (AIUA). The AIUA is fulfilling its original role. Its market share is only about 2 percent of the entire exposure along the coast and only about one-fifth of one percent of the value of insured homeowner's exposure in the entire state.

A member asked the presenter to confirm that Alabama's coastal insurance market is better than other coastal states. The response was that indeed it was true. One criteria used in judging whether a homeowner is better off in a particular state is whether there is an option outside of the state-run plan. If you were in Florida, you would almost certainly be in the state-run plan since it would be your only option. It would also be very likely in Mississippi or Louisiana. In Texas, it is also pretty much guaranteed a homeowner would be in the state-run plan. The coverage may not be inexpensive in Alabama, but the condition of the state's homeowner's insurance market is better. The first thing to do is create an environment of availability, and availability and competition occurs when insurers have an incentive to be there. The insurer must be able to charge a rate that reflects the risk.

Another question was asked about the prospects of the proposal mentioned earlier to allow insurance companies to create a tax-deductible insurance reserve in advance of an event. The principal benefit of it would be the realization of the preferential tax benefit, in the form of a deferral or postponement of taxes.

Large corporations have a marginal federal tax rate of 35 percent. If insurers were allowed to reserve funds on a pre-event basis, then their cost of capital would be lowered by about one-third. On the margins, this would create more incentive to operate in coastal markets. The law could be structured to ensure that the money will be set aside for coastal exposure or catastrophe exposure in general. The proposal, primarily supported by Florida lawmakers in Congress, has been included in larger bills. The chair noted Alabama lawmakers have not supported it.

This particular provision has been tied up in much larger bills advocating a federal government reinsurance mechanism. Those bills have attracted much opposition from inland legislators and the reinsurance industry. Even on the single issue of pre-event reserving, there may not be unanimity. If there were a bill structured solely around this tax provision, one might argue it could get more traction. He added that the provision is considered revenue neutral.

Another question was asked about what the state or coastal counties could do in the area of mitigation to attract insurers. The presenter responded that mitigation is basic risk management

-- a win for the consumer, the insurer, and the state. Empowering the buyer gives incentives to everybody down the line to make sure that construction is up to par. So far, consumers have been left out of this. Getting them accustomed to asking about mitigation measures in the home will take a long-term educational effort, much like it took a long time to get people to wear seat belts and consider crash test ratings. He added that the Realtor and home builder communities need to sign on to any mitigation plan.

The discussion turned to an announcement that an insurance company has donated money to Smart Home Alabama, an educational 501(c) (3), to retrofit three homes. Smart Home is hoping the effort will help educate insurance companies, by showing them they can effectively write insurance in coastal counties. The idea is when the state is ready to set up a mitigation program -- whether the program is state run or nonprofit run -- we will be able to say that mitigation measures can be done in a cost effective way.

A member noted the IBHS conducted a test recently -- a video of which is available on their website -- in which two homes were put through hurricane force winds, and how much a difference you could see that $3,000 dollars in fortification measures made in limiting damage.

The discussion turned to a member presentation about market forces in the insurance system, including the issue of wind pool recoupment. The member, who represents a large insurance company, also took time to discuss the insurance industry's perspective.

The thing that makes larger insurance companies, Fortune 500 companies, is the fund that the company tried to keep for catastrophes. Some say the industry holds too much, some say too little. Over the last 20 years, Alabama and Mississippi have taken more out of his company's fund than it has put in.

Post-2005, the industry has been concerned with several things: it is not making money in the state; the exposure was greater than they thought; litigation and investigations were negatively affecting the brand of the companies and requiring resources to handle; and there had been so many claims the company struggled to handle them all.

We have to be careful when we make recommendations. If we start moving too far on the consumer side, or too far on industry side, either way we will start creating other problems. The consumer issues which have come up again and again are: rates increasing; coverage problems and, on top of that, the economy and housing crisis has made it especially difficult on the consumer. The industry is taking the time to understand the consumer side, although it does not mean that the industry is getting it right.

Three of the largest insured losses in the history of the U.S. occurred in 2004 and 2005. Talking about models, the payouts on claims were greater than the models the companies use had anticipated. In those two years, there was $84 billion in losses that occurred in the private market. A comment was made that the Department of Insurance at that time asked why insurance companies' rates needed to increase so quickly. Part of the reason was the private industry was feeling something it had not felt before. If a lot of companies had not raised their rates in 2001 and 2002 during the recession, the losses would have been more. It was added that if Alabama made the wrong choices, it could end up like its neighboring states, with much less private market availability and many more policies in the state-run wind pool.

Things that have been utilized in other states include: mitigation grants and discounts, which has been discussed; tax free catastrophe savings accounts, which has been proposed as legislation in Montgomery; legislation that has attempted to limit rate increases, mandate discounts (which has occurred in Alabama) and require companies write a certain number of policies, which have all met with opposition from the industry and threats they will leave the state; legislation aimed at making the insurance system more transparent, which the industry is not necessarily against, but depending on the details harbor concerns about; legislation establishing a bill of rights for homeowners spelling out what is in a policy and what the consumers rights are.

Residual plans, such as the state-run wind pool, began as voluntary plans that insurers established to insure people who could not get insurance. The insurers were able to share in the profits of those plans. Alabama had the last voluntary plan in the country until legislation was passed two years ago codifying the plan and ensuring that insurers were doing what they intended to do. The sharing of profits was removed, which was not a concern because the number of policies was small. Post Katrina, the number of policies has substantially increased along with the exposure. Insurers are concerned about the growth in wind pools because the companies must cover losses in the wind pool through an assessment that is based on the company's share of the market in the state. It is a problem for small and large companies in the state. As the wind pool increases in size, and the exposure to companies increase along with it, companies may decide to leave the state. Mississippi and some other states have passed legislation that has capped the exposure. If it goes over a certain amount, the state will find another way to pay for it -- by either selling bonds to pay it back over time, or charging consumers across the state a small amount. What Mississippi basically did when it capped the exposure was if a company did not write a certain percentage of its state-wide writings in coastal counties, then the state would take some of the recoupments away. Carriers operating in the north part of the state have incentive to write along the coast to reduce their wind pool assessment.

It was noted that in Mississippi, prior to Katrina, there were six companies that wrote 90 percent of the homeowner's market. The idea behind adopting its recoupment plan was to find a way to incentivize companies. The state thought that it would rather have 50 companies each writing two percent of the market, especially since none of the six said they would come back and write as many policies as they had before. It was also noted that the MS legislature unanimously agreed to the recoupment plan because the entire state was feeling the effect following Katrina, when insurers went insolvent due in part to the assessment load. When the next hurricane hits, now the risk will be spread across the whole state.

It was also noted that the state's formula for assessments is much different than formulas in other states. For instance, every carrier in Mississippi has a piece in the game. Perhaps the subcommittee should consider revamping the assessment formula. Currently, commercial insurance writers in Alabama have a bigger burden than the homeowner writers because there is not enough commercial business on the coast for them. Commercial writers are hit with an unfair burden. Is that good or bad for the overall economics of the state?

Responding to a separate statement, a member explained the relationship between private insurance companies and the state wind pool. There is a misperception that when a policy comes to the state wind pool, that the companies are out of the equation. Actually, the companies are on the hook for every dollar of loss, and the wind pool collects premiums and buys reinsurance to hopefully cover the losses. But in the event that the wind pool does not have enough money to cover those losses, the companies that are licensed in the state pay the freight. Their statewide market share generally determines the amount they should write in Baldwin and Mobile counties. There are factors applied based on the zones where the voluntary policies are written. If a company writes more business in Zone 1, it will get more credit than if it wrote a similar risk in Zone 4. There are a few more than 20 companies who have voluntarily written sufficient business in coastal counties to achieve an exemption from assessments from the wind pool.

A question came up whether companies consider sea level when calculating the risk associated with a property, and the chair indicated they should. It was also brought up about how the price of insurance can be so high even though a property does not seem to be in a high-risk area. In response, a discussion ensued about how reinsurers view anything within 50 miles of the coastline as a Tier 1 coastal exposure. Therefore, when reinsurers price reinsurance charged to the wind pool and to companies, reinsurers look at almost the entire counties of Baldwin and Mobile in the same light. Then companies and the wind pool will look at the counties and break those up into rating zones based on their experience.

A new insurance carrier being brought into the state is using their own mapping system and working closely with their reinsurers. The company is looking at geo-coding (latitude, longitude), elevation, surge potential, etc., and is putting that information into their system. A lot of the information on rates is not necessary in other parts of the country, but it is necessary in Alabama because of the possible impact of surge from Mobile Bay. It was further noted the tools and data being used by this company and other companies will allow a better ability to rate policies. That will bring in more competition. Companies already in the market want more competition in order to have risk in a region spread.

The discussion turned to a presentation by the state fire marshal, who discussed an effort in Alabama to create a building code standard for homes. In Alabama, we can build residential structures without any requirement for architectural or engineered plans. However, last year the state enacted a law that created the Alabama Residential Code and Energy Code Council. The council includes 16 people representing different groups -- architects, engineers, consumers, insurers, home builders, the fire service, and some state lawmakers. The council is tasked with formulating building codes the state will adhere to, and will use the 2006 international code as the model. Subcommittee members were urged to follow the process, get to know the people on the council, and stay up to date with developments.

The 2006 international building code is a code that is formed in total. One part interconnects with other parts. If changes are made to the model code, it could negatively impact other portions of the code. In lightweight construction, for instance, the code allows for I-beams made out of plywood or particle board or two-by material to replace heavy timbers built into homes. We don't think about the fact that it is much cheaper in today's market. It is just as strong until it gets in the wrong type of environment. The code requires that you protect that lightweight construction with a sprinkler system because in a fire environment, the plywood or particle board deteriorates very quickly. Although the example doesn't speak to wind coverage, the same principle applies. If we change a provision in the code because it would be a little bit more cost effective to build a home without the provision, then we are lessening the quality of the code to which we are building.

Another recommendation is to do better at enforcing existing codes. A homebuilder is under time and cost pressures, and shortcuts are taken. In the commercial market, for instance, an architect is required to design commercial buildings larger than 2,500 feet that are not single-family building or farm structure. But the fire marshal has found that although the designs are sound, some things are not built to the design. The problem could be worse in the residential market, where inspections are less frequent. When a storm hits and structures suffer damage, the problem is perpetuated because we rebuild the homes in a short amount of time, with untrained people, no plans, and no code enforcement. One thing which would help is educating home builders. Some will voluntarily comply. The industry can have preferred home builders they do business with. There would be less doubt when insuring the home because of the confidence in the homebuilder.

It was asked whether code enforcement officials are generally salaried employees of municipalities or counties. The fire marshal said most inspectors are located in municipalities. A small number of counties employ some inspectors. Mobile and Baldwin counties are fortunate to have vital enforcement programs, but the vast majority of counties do a very minimal amount of inspection. Asked if cities charge a fee for code inspection, he responded that they do charge a fee for building permits, and an inspection comes with the permit. He added that different entities apply different resources to bear. In one jurisdiction, for instance, a permit will be sold but there is not a lot of inspecting; there might be one person who is a general inspector and does not have a lot of knowledge about various trades. In other jurisdictions, like Mobile and along the coast, there are a host of people working together, each with a different specialty (wiring, HVAC systems, plumbing, etc.). A member noted insurance companies are bringing along their own inspectors when they evaluate a home. There are also private inspectors which can be hired.

At a prior meeting it was discussed that in the 2006 international code is an absolute minimum standard, and there is dispute over whether a home built to that standard could take the wind loads from a hurricane. Jurisdictions in the region need the ability to do code plus standards. It was recommended the subcommittee recommend the state allow local jurisdictions to build to a higher standard than whatever the state code will be. It was explained that jurisdictions who have codes in effect at the time of enactment, and are above the minimum code that will be established, can in fact maintain those codes. But when the jurisdiction changes its code, it must adopt the standards adopted by the state.

Asked whether the state requires a level of training that inspectors must have, the fire marshal said there is no required level. But there is an effort to train local inspectors at the state fire college.

Regarding mitigation, a member asked whether it was possible to know what the average cost per home would be to fortify to the point where the price of insurance could return to the state average for property insurance, about $900. A member responded to take an existing home and get it back down to the state average is probably not possible. But to get the premium for an existing home from about $3000 to about $1500 or $1600 is possible. It has been done in five other states and the return on investment is very good.

The chair asked what would need to be done to a home to qualify for a 15 to 20 percent discount on a policy. The response was it would partly depend on the home's location. The closer it is to the water, the bigger the discount -- because the mitigation measure will have more benefit. If a home is built to full 2006 international standards, the minimum is 20 percent near the coast. If it is built to IBHS Gold or Silver standard, there is a 15 to 20 percent discount depending on the location. The Gold standard is just about impossible to reach for existing homes, but Silver is reachable. We must ensure that when houses are re-roofed, they automatically reach the Bronze standard, which would cost an additional $400 or $500 during a re-roofing. The donation to Smart Home Alabama to retrofit three homes will help illustrate for people what they can do and what it will cost.

Asked whether there were many more fires in Mobile than in Birmingham, the fire marshal said he did not know how many fires there were in Birmingham, but that generally there are more fires in north Alabama than in south Alabama. He added that it has been a bad year in Alabama for fires and deaths related to fires.

Concluding the meeting, the chair said that the subcommittee will identify recommendations at the next meeting. There is no need to prioritize the recommendations yet. The subcommittee will get together again, Friday, October 29th.