# PCI SPECIAL REPORT

# Natural Catastrophes Create a Fragile Homeowners Insurance Market in Alabama

## *Executive Summary*

For decades, the risk of loss from natural catastrophes such as hurricanes and tornadoes was fairly predictable and relatively manageable. Over the last 20 years, stronger and more frequent windstorms have elevated this risk, affecting all coastal regions and other parts of the country. Losses stemming from unprecedented events have become an even greater consideration in the underwriting and pricing of homeowners insurance.

Alabama is no stranger to extreme weather conditions that have contributed to a tripling of homeowners claim costs in the last decade. Although the average price for coverage paid by Alabamians is now in the top third of the nation, the overall premiums intended to pay for insured losses and expenses have not been adequate. Unless something is done to contain the ever-increasing losses from more forceful and destructive catastrophes, this state's tenuous homeowners insurance market will be further stressed.

Increasing losses from hurricanes, tornadoes and other windstorms have forced property insurers in a number of coastal states to re-evaluate their portfolios and business strategies. In order to mitigate their catastrophic loss exposures and ensure they have sufficient funds to pay claims and make customers whole after a disaster, some companies have found it necessary to restrict their coverage and limit their writings; some have even had to withdraw from the market. As a result, homeowners in certain areas, especially along the water, regrettably have fewer choices of insurance products and prices and more costly coverage today.

No doubt, Alabama's homeowners insurance market is in a fragile state now. Care must be taken to avoid placing additional strains on it. It is time for Alabama lawmakers to take positive steps to strengthen the competitive private insurance market so that greater coverage access at more affordable prices is provided to the citizens of this state. To this end, more property insurers must be encouraged to enter the market, hence bringing greater capital investments into the state and offering consumers a wider selection of products and prices. Homeowners must also receive appropriate incentives so they can have greater control of their losses.

A healthy and durable homeowners market can be achieved by adopting effective legislative reforms, such as the recently passed "Strengthen Alabama Homes" bill intended to help policyholders make their residences more loss resistant. This program is expected to reduce property damage and stabilize insurance rates for consumers. Other legislative reforms designed to lower disaster costs, help consumers prepare for catastrophe losses and promote the availability and affordability of homeowners coverage include the following:

- Implement and enforce a uniform statewide building code with wind-design requirements for new construction.
- Establish income tax deductions on "catastrophe savings accounts" for homeowners to set aside policy deductibles.
- Provide state income tax deductions on sales tax spent on materials to retro-fit properties.
- Combat insurance fraud by enacting insurance fraud legislation.
- Permit insurers to recoup assessments paid to the state's Beach Plan.[1]
- Modernize the state's rate regulatory system from prior approval to flex-rating to ensure greater price stability and a stronger competitive market.
- Provide income tax deductions for consumers whose homeowners insurance premiums are greater than 5 percent of their adjusted gross income.

## *More Widespread and Destructive Catastrophes Affect Alabama's Insurers and Consumers*

With a long history of devastating catastrophes, Alabama has had its share of hurricanes, tornadoes, and other severe storms. The April 27, 2011 tornado outbreak that was part of a series of destructive tornadic activity (April 25-28) through the eastern third of the country was unimaginable. Among the various states ravaged, the central and northern Alabama regions were the hardest hit with 235 fatalities.[2] Alabama's outbreak alone – its deadliest since 1932 – is now ranked among the top 10 worst natural disasters in U.S. history, resulting in about 165,000 property claims worth $3.5 to $4.2 billion primarily in the Tuscaloosa, Birmingham and Huntsville metropolitan areas.[3]

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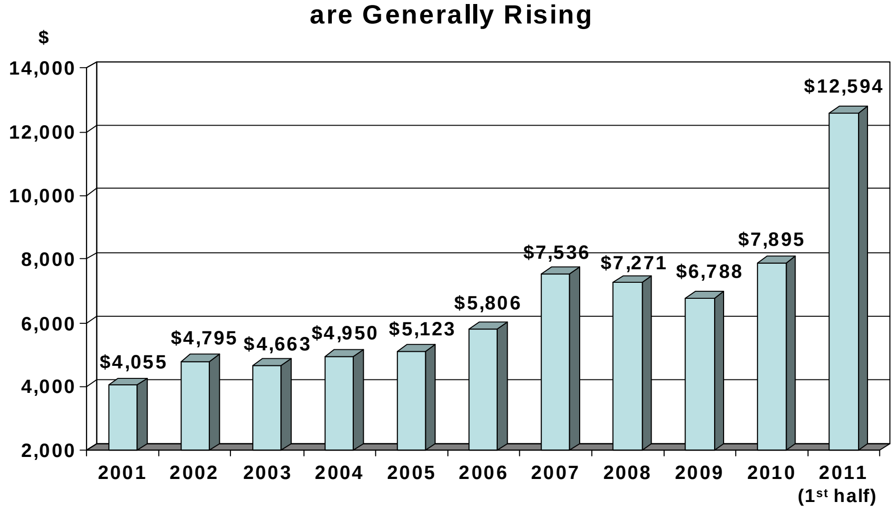
[1] Alabama's Beach Plan (officially known as the Alabama Insurance Underwriting Association) is a state-sponsored program that serves as the market of last resort for coastal residents.

[2] National Oceanic and Atmospheric Administration, "Spring 2011 U.S. Climate Extremes"

[3] Munich Re and Insurance Information Institute, 2011 Half-Year Natural Catastrophe Review; July 12, 2011; and National Underwriter, "RMS: April Tornado Outbreak to Cost Insurers Up to $6 B; Majority of Loss in Alabama," May 17, 2011. Risk Management Solutions states that 70 percent of the total loss from the spring outbreak can be attributable to damages in Alabama.

The average cost of a homeowners insurance claim in Alabama is now at a record-high level. During the first part of the last decade, claim severities (i.e., average claim costs, reflecting catastrophes and non-catastrophes) were in the $4,000-$5,000 range, and increased to $6,000-$8,000 per claim in the latter years. The claim severity for the first half of 2011 shot up to $12,594, more than three times its level in 2001 (Fig. 1). Even before the spring tornado outbreak, Alabama's average homeowners claim cost was more than $9,100 during the first quarter of this year (not shown).[4]

**Figure 1**
**Alabama Homeowners Insurance Claim Costs are Generally Rising**




Source: Fast Track Monitoring System @ 2nd Qtr. 2011; amounts reflect all claims (cats and non-cats)

Alabama's growth in claim severity results from a combination of factors including more powerful weather events, increased construction costs and greater public demand for larger residences with more expensive contents. Since 2005, the cost of residential construction has risen by nearly a third countrywide.[5] In addition, more households are obtaining higher amounts of insurance to reflect the higher values of their properties and personal belongings. In 2003, only 10.7 percent of Alabama's policyholders had homeowners coverage limits of $200,000 or greater. Five years later, this proportion has more than doubled with nearly one-fourth (23.0%) of policyholders now having higher limits.[6] A review of the state's coastal market shows that Beach Plan exposures (i.e., insurance values purchased) have tripled in amount since 2006.[7]

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[4] Fast Track Monitoring System @2nd Qtr. 2011, a publicly available report of loss trends prepared jointly by the Independent Statistical Service, Insurance Services Office, Inc. and National Independent Statistical Service

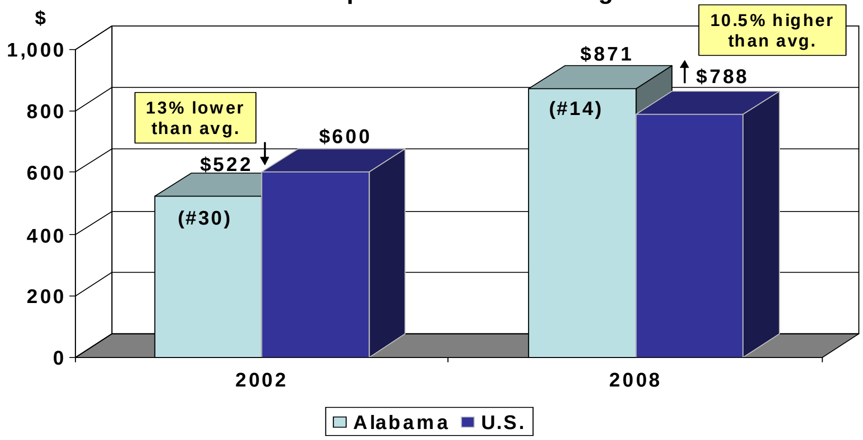
[5] U.S. Bureau of Labor Statistics, Producer Price Index

[6] National Association of Insurance Commissioners (NAIC), *"Dwelling Fire, Homeowners Owner-Occupied, and Homeowners Tenant and Condominium/Cooperative Unit Owner's Insurance,"* 2010 and 2005 Editions; figures do not reflect renters and condo-coop owners

[7] Property Insurance Plans Service Office, *PIPSO Reports*, June 2011

Clearly, the degree to which people are exposed to any type of catastrophe affects their cost of insurance. Alabamians now pay the 14th highest average homeowners premium in the country, 10.5 percent *higher* than the national mean (annual premium of $871 – AL vs. $788 – U.S.). Six years earlier, the state ranked 30th highest with an average annual premium that was 13 percent *below* the norm ($522 – AL vs. $600 – U.S.) (Fig. 2).[8]

**Figure 2**
**Alabama Annual Average HO Premium Has Surpassed U.S. Average**




Source: NAIC Premium reflects all policy forms combined for owner-occupied dwellings and excludes tenants, condo/co-op unit owners; figures in bars represent premium ranks (#1 = highest)

## *Natural Catastrophes Contribute to Growing Homeowners Losses and Expenses that Exceed Premiums*

Damages caused by natural catastrophes have led to increasing homeowners losses and loss adjustment expenses (LAE) in Alabama. Over the years, these two components have grown so much that, when combined with the necessary underwriting expenses to operate the business, the total amount has surpassed the premiums paid by policyholders. In other words, the state's homeowners premiums that are intended to cover losses and expenses have for the most part been insufficient. This is especially apparent during 2005 and 2009; premiums fell slightly short during 2008 and 2010 as well[9] (Fig. 3).

Specifically, the state's total homeowners premiums earned over the period 2005 to 2010 were $6.8 billion. In contrast, insurers have had to pay out more money – almost $7.5 billion – to settle claims and take care of underwriting costs. What has resulted from the premium inadequacy is a total shortfall of nearly $700 million. Even insurers' investment income has not been large enough to help offset total costs.

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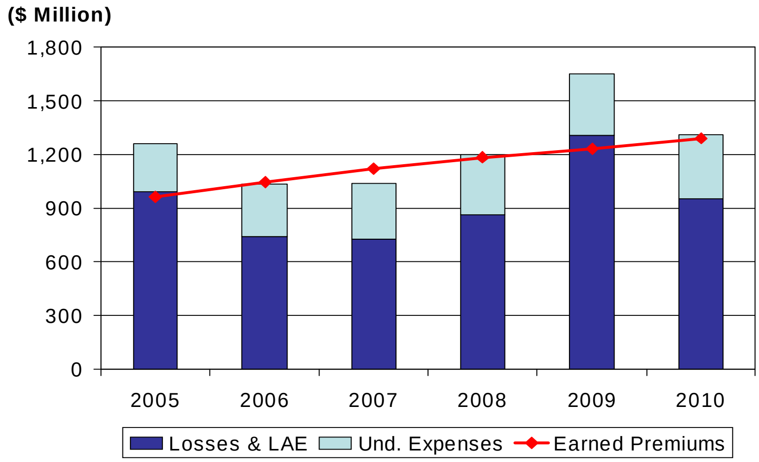
8 Various NAIC Average Homeowners Premium reports; premiums reflect all owner-occupied dwellings, excluding condo and co-op owners and renters.

9 PCI, based on NAIC data; LAE includes defense costs and other costs to settle claims, while underwriting expenses include administrative costs, commissions, taxes, license and fees, dividends, etc.

**Figure 3**
**Alabama Homeowners Insurers Have Not Collected Enough Premiums to Cover Losses and Expenses**




**Source: PCI, based on data compiled by NAIC**

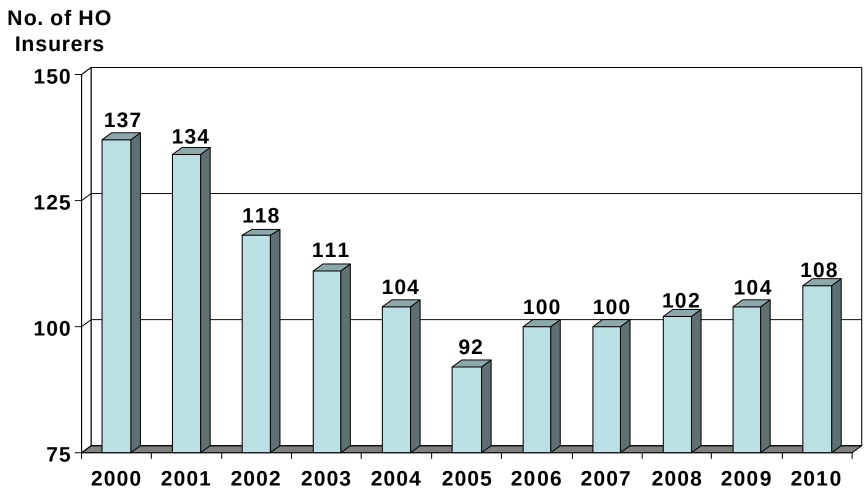
## *The Need to Provide a Competitive and Viable Market for Consumers*

Alabama's April 2011 storms that were part of the largest tornado outbreak in U.S. history are just the latest in a long line of very costly disasters that are prompting insurers to re-evaluate their property business. Not only must insurers have sufficient reserves to ensure payment of claims as promised when the next disaster occurs, but they must continually demonstrate to rating agencies and investors that they are able to withstand extraordinary losses. Like most other businesses, they must show that they are solid and, hence, worthy of shareholders' capital. Without the necessary financial resources, insurers cannot remain viable in hazard-prone locations and provide high-quality and affordable coverage to meet the needs of current and future policyholders.

A review of insurer trends shows that the Alabama homeowners market is not as competitive as it was 10 years earlier; the public is more limited today in its choice of companies and the products and prices offered. There are now 108 carriers offering homeowners insurance in the state – almost 30 fewer than the number a decade ago (Fig. 4). While there has been a slight improvement in numbers since Hurricane Katrina (2005), Alabama's homeowners market is considered to be "moderately concentrated" or only moderately competitive.[10]

[10] The level of market concentration is determined by the Herfindahl-Hirshman Index, a commonly accepted measure used by the U.S. Department of Justice and many economists. Alabama's 2005-2010 index values are in the 1200-1300 range, indicating a "moderately concentrated" homeowners market. Values of 1,000 or lower denote "low concentration," while values greater than 1,800 denote "high concentration;" the closer a market is to being non-competitive, the higher its concentration.

**Figure 4**
**Alabama Consumers are Now More Limited in their Choice of HO Insurers Compared to 10 Years Ago**




Source: NAIC

# *Time to Rebound: Solutions Aimed at Loss Mitigation*

While the frequency and severity of weather events cannot be controlled, something can be done to help control the cost impact on consumers. As was done in other states, it is now Alabama's time to address its vulnerability to catastrophic losses and take positive action towards transforming the private homeowners insurance system into a healthy and competitive market for the residents of this state.

Loss mitigation (i.e., actions to reduce disaster losses) should be at the forefront of any property insurance solution as it promotes public safety, minimizes property damage, and preserves communities hit by natural disasters. According to a study by the University of Pennsylvania's Wharton School of Business,[11] future hurricane losses could be reduced by as much as one-third if appropriate mitigation steps are taken.

Two essential measures to transform Alabama's homeowners market are offering hazard mitigation grants and establishing uniform statewide building codes. By building stronger and incentivizing policyholders to harden their residences, more property carriers will be encouraged to operate in Alabama and invest much needed capital in the state.

### *Hazard Mitigation Grants*

It is important to raise public awareness of catastrophe risks and motivate homeowners to become more proactive in reducing their losses. During the last regular session, a bill was passed that created a "Strengthen Alabama Homes" fund so coastal residents can retrofit

[11] University of Pennsylvania presentation at the1st Intl. Conference on Asian Catastrophe Insurance, Innovation & Management, "Catastrophe Insurance Challenges for the U.S. and Asia," Dec. 2007

their homes for strong windstorms without having to personally pay for improvements.[12] This legislation is expected to result in lower premiums and more resilient houses. It is similar to programs established in South Carolina ("Hurricane Damage Mitigation Program") and Mississippi ("A Safe Place to Go"), both which offer grants to certain homeowners who have taken steps to fortify existing residences.

The issuance of hazard mitigation grants has demonstrated high benefit-to-cost ratios. One study found that, on average, a dollar spent by the U.S. Treasury on Federal Emergency Management Agency mitigation grants provides about $3.65 in savings. This translates into reduced post-disaster relief costs and lower tax revenues from the nation's citizens.[13]

### *Uniform Statewide Building Code with Wind-Design Requirements for New Construction*

Another straightforward legislative solution aimed at loss mitigation is implementing a uniform statewide building code with wind-design requirements for new construction. A building code is the minimum acceptable standard used to regulate the design, construction, and maintenance of buildings for the purpose of protecting the lives and general welfare of consumers from the hazards of unsafe structures and conditions. A uniform statewide code is particularly important as the same standards would apply to virtually every type of structure (residential, commercial, industrial, schools, farm buildings, etc.) in all Alabama jurisdictions.

Consideration should be taken into account to properly determine wind loads on new construction to help improve hurricane resistance. By increasing construction standards to make buildings more resistant to damage, the frequency and severity of property claims will decrease over time and provide a positive stabilizing effect on costs. Lower amounts of property damage speeds up the recovery process, causes less disruption for property owners and puts less pressure on the insurance marketplace. Studies have shown that for each dollar increase in construction costs, there is a long-term savings of $3 to $16.[14]

In order to be effective, enforcement of a uniform statewide building code is critical. Enforcement ensures compliance with the building code and is a key factor in saving lives and minimizing the impact of a natural disaster on overall losses and premiums.

## *Other Effective Homeowners Legislative Reforms*

The following reforms would also contribute to building a business-friendly insurance environment in Alabama and have an overall positive effect on the state's long-term economic growth:

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[12] Fines from the Gulf oil spill and grants are expected to finance the Fund's storm-proofing money initially.

[13] Multihazard Mitigation Council, National Institute of Building Sciences, "Natural Hazard Mitigation Saves: An Independent Study to Assess the Future Savings from Mitigation Activities," 2005

[14] Institute for Business & Home Safety, "Natural Hazard Mitigation Insights," Nov. 2005

1) Establish income tax deductions on “catastrophe savings accounts” for homeowners to set aside policy deductibles.

2) Provide a state income tax deduction on sales tax spent on retro-fit materials.

3) Combat insurance fraud by enacting insurance fraud legislation.

4) Allow insurers to recoup their Beach Plan assessments.

5) Enact a flex-rating system instead of a prior approval system.

6) Provide an income tax deduction if the homeowners premium exceeds 5 percent of the policyholder’s adjusted gross income.

***1) Offer Income Tax Deductions on “Catastrophe Savings Accounts”***

Consumers should also be permitted to establish tax-deductible savings or money market “catastrophe savings accounts (CSAs).” These accounts would pay for insurance deductibles or any uninsured losses from a qualified catastrophic windstorm event, including hurricanes, tornadoes and rising floodwaters.

Consumers can deposit into the CSA a certain sum of money equal to, e.g., at least two times the amount of their policy deductible, or for those who self-insure, a pre-determined maximum not to exceed the value of their residence. If a catastrophe occurs, the amount can be withdrawn from the CSA to pay for the deductible. The amount withdrawn will not be included in the homeowner’s taxable income for that tax year, and any interest earned by the CSA may be exempt from state income tax.

Income tax deductions on CSAs act as an incentive for Alabama homeowners to be prepared financially for the next hurricane or tornado, and they will allow homeowners to increase their deductibles and lower their premium costs.

***2) Provide a State Income Tax Deduction on Sales Tax Spent on Materials to Retro-fit Properties***

Alabama homeowners should be allowed a state income tax deduction up to a certain amount for state sales tax paid on materials used to retrofit their residences against powerful windstorms. Methods of retro-fitting may include ordinary repair, replacement, and upgrades to existing residential property and new construction so long as the repair, replacement, and upgrades are designed to resist loss.

South Carolina has a similar program in place, whereby a taxpayer is allowed an individual income tax credit for state sales or use taxes paid on purchases of tangible personal property that qualify for the residential retrofit credit. The allowable credit is the lower of either 6 percent of the purchase price of tangible personal property qualifying for residential retrofit credit or $1,500.

### 3) *Enact Homeowners Insurance Fraud Legislation*

Homeowners fraud typically takes place when someone knowingly submits an inflated claim on their homeowners or renters policy for more than the actual value of the loss or damage. Examples of this type of crime include staging a phony burglary and falsifying a theft or property damage; overstating the value of stolen items or lying about the extent of damage; intentionally damaging property to make a claim; asking a repairman to increase an estimate or bill; and fabricating repair bills, receipts or other supporting evidence, often in collusion with a crooked contractor, plumber, repairman or insurance adjuster.

According to the Insurance Information Institute, fraudulent property and casualty claims on homeowners insurance policies cost insurers nationwide about $30 billion annually. Fraud hurts everyone since the increased insurance losses are ultimately passed on to policyholders in the form of higher premiums.

Lawmakers can make a positive difference in combating property fraud. Legislation can include defining insurance fraud as a specific crime and creating an insurance fraud unit within the insurance department with the power to investigate and punish perpetrators. Insurers should be required to develop thorough plans for preventing and detecting fraud and have warnings on applications and claim forms that fraud is a serious crime. Insurers should also be allowed a reasonable amount of time to investigate potentially fraudulent claims before making any payments, and be given immunity when they share fraud-related information with other insurers, investigators and law enforcement.

### 4) *Implement Recoupment Provision for Beach Plan Assessments*

The Alabama Beach Plan (also known as the Alabama Insurance Underwriting Association or Wind Pool) is a state-sponsored property insurance program formed to provide wind/hail coverage to the state's residents in hazard-prone coastal areas who are unable to obtain it through the voluntary market. These "markets of last resort" often lack sufficient funding, especially after a large storm; hence, insurers in the private sector are required to support them by means of subsidies and assessments. It is not uncommon for beach plans in the different coastal states to create an undue burden on the private market, and in extreme situations, a state's general revenue fund could also be impacted, hurting all of its citizens.

Alabama is currently 1 of 2 Gulf Coast states (Louisiana is the other) without a mechanism where insurers can recoup Beach Plan assessments which they are forced to make to finance the wind pool. The recoupment provision would permit assessments to be passed on to policyholders once the surplus, reinsurance deductible and reinsurance have been exceeded. Certain safeguards such as a minimum reinsurance amount would be put in place to ensure that recoupment is available only for large events such as a hit from a major hurricane. In this way, consumers – especially those living inland – would be protected from frequent and unnecessary surcharges.

Implementing a recoupment provision would make Alabama less risky for insurers to do business in, thereby increasing competitiveness and stabilizing the private insurance market. Without the ability of insurers to get back their assessments, the entire state's homeowners market is likely to tighten even more after the next large hurricane. That

Alabama insurers cannot recover their losses, especially when it is permitted in most other Gulf Coast states, is a deterrent from writing in the state and must be remedied.

### 5) *Enact a Flex-Rating System*

Alabama currently has a prior approval rating law that requires homeowners rates to be confirmed by the insurance regulator before going into effect. Under this system, political pressures to provide low cost insurance can lead to rate levels that are insufficient to cover losses and expenses (as shown in Fig. 3). Not only is there greater price inequity among policyholders, but added regulatory costs are created and passed on in the form of higher premiums. Insurers can also face additional underwriting risk due to the time lag from the review process; such delays make them hesitant to lower rates out of fear they will not be able to increase them later if needed.

Alabama should join the 39 other states and D.C. that currently have a more competitive-based rating law. One way is to adopt a "flex-rating" system that enables insurers to implement rate changes within a designated percentage band without regulatory approval (changes outside the band must still be approved). This approach relies on competitive forces to ensure that rates are consistent with underlying costs. Flex-rating and other competitive-based rating laws operate to curtail excess profits, improve insurance availability, remove rate regulation from political volatility, and increase regulatory efficiency. Insurers are more willing to accept a broader range of applicants as well in this type of environment.

Benefits resulting from a move to greater rate competition generally include: (i) an increased number of insurers that are more willing to operate under improved conditions; and (ii) the ability for insurers to more accurately price their products, creating cost savings in the form of lower rate increases or even rate decreases. For example, South Carolina converted its homeowners rating law from prior approval to flex-rating in mid-2004. Since 2005, this state has welcomed 27 new or returning insurers, offering greater choices to its pubic along with a 5 percent drop in rates. In contrast, Alabamians' rates have continued to climb; on average, homeowners here are paying 13 percent more for coverage than their South Carolina counterparts.[15]

### 6) *Provide an Income Tax Deduction if Homeowners Premium is Greater than 5 Percent of Adjusted Gross Income*

For some Alabamians, homeowners insurance coverage can be very costly. On average, policyholders in this state spend about 2 percent of their household income for coverage (the average annual premium is $871 compared to $44,476 of the state's median household income[16]). To encourage the purchase of insurance by making it more affordable, tax subsidies may be provided whereby the money spent on homeowners coverage can lower some consumers' income taxes at the end of the tax year.

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[15] Various NAIC databases and Average Homeowners Premium reports

[16] NAIC Average Homeowners Premium report and U.S. Bureau of Commerce; both premium and household income reflect 2008 experience.

Alabama policyholders whose homeowners premiums are greater than 5 percent of their adjusted gross incomes (AGIs) should qualify for an income tax deduction. This approach would incentivize the purchase of insurance, hence reducing the number of uninsured homeowners in the state and helping to stabilize the market.

The concept of a tax incentive for insurance is not unique. South Carolina provides a similar tax credit for homeowners premiums, while most states including Alabama now offer tax deductions on long-term care insurance if the premium exceeds a certain percentage of the adjusted gross income.

## *Transformation Will Benefit Alabamians*

Effective legislative solutions have worked in other states and can work in Alabama, too. By having homeowners become more engaged in loss reduction activities and accountable for their own costs, additional carriers will be persuaded to operate in hazard-prone areas and pay claims when disasters occur to make their customers whole. Not only will their additional financial capacity help fuel the economy, but the state's citizens will also gain from a wider array of choices in homeowners insurance prices and products.

It is important to build on the momentum of the "Strengthen Alabama Homes" program and push for other straightforward measures such as a uniform statewide building code which will bring disaster-related costs under control and help slow the rate of premium growth. Furthermore, establishing "catastrophe savings accounts" and providing certain income tax credits will help claimants be better prepared if they must pay their deductibles and other uninsured losses. Additional solutions to bolster Alabama's homeowners insurance market include the enactment of fraud legislation, a provision allowing the recoupment of insurers' Beach Plan assessments, and instituting a flex-rating law that would help stabilize rates.

In conclusion, it is time for Alabama's fragile homeowners market to turn itself around, create a business-friendly insurance environment and achieve long-term growth and prosperity for the benefit of all. PCI is pleased to work with state lawmakers in enacting sound legislative reforms, raising public awareness of the availability of loss mitigation techniques and encouraging residents to strengthen their homes from future catastrophes.

*The Property Casualty Insurers Association of America (PCI) is a trade association consisting of more than 1,000 insurers of all sizes and types. PCI members represent 38.3 percent of the total general insurance business and 31.6 percent of the total homeowners business in the nation. In Alabama, PCI members represent 32.8 percent of the homeowners market.*