



# **Suggestions for Enhancing Private Insurer Participation and Competition in Coastal Alabama Property Insurance Markets**

**Coastal Recovery Commission of Alabama  
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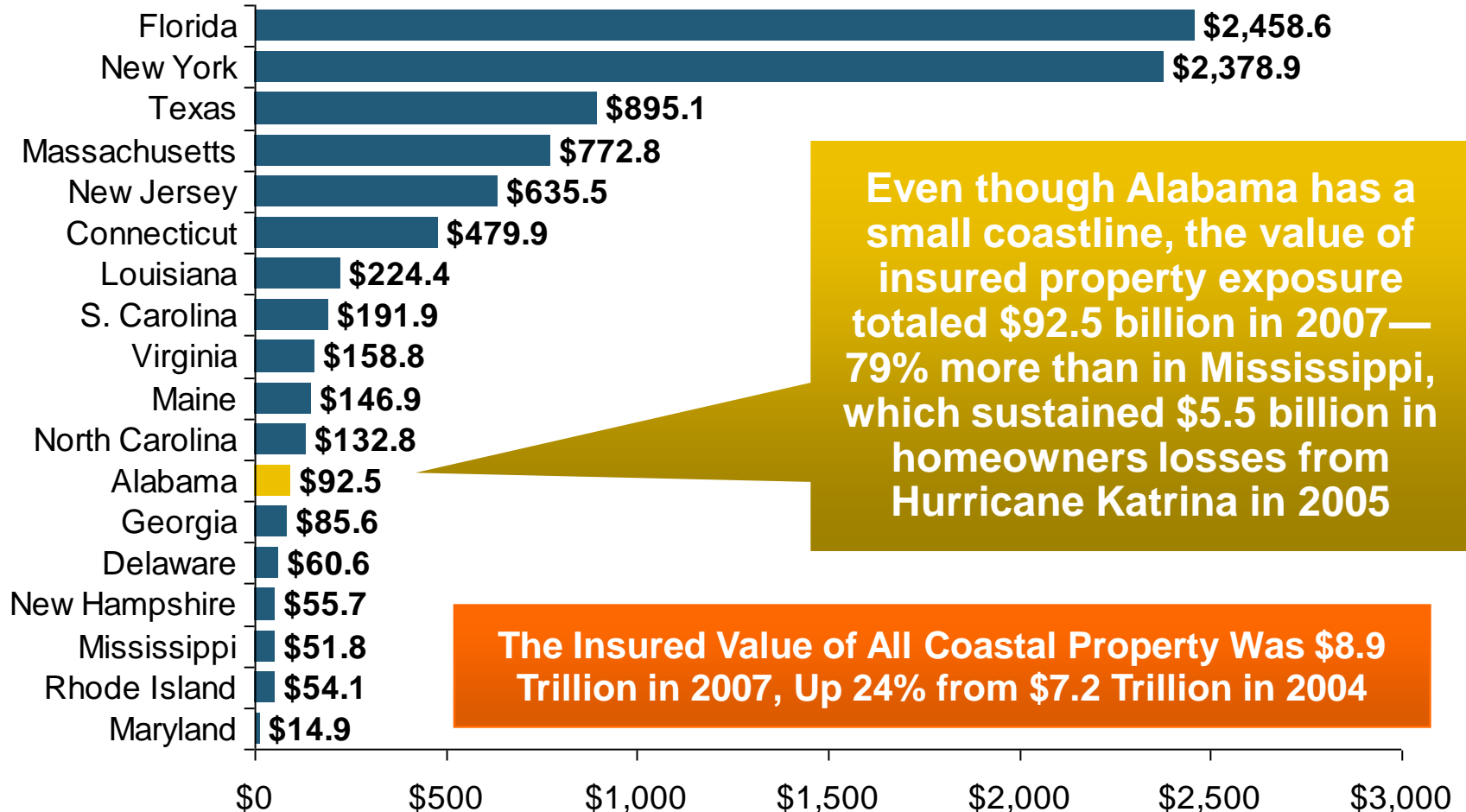


# The Dollars and Cents of Alabama's Coastal Exposure

**Exposure is Sizable but Better  
Managed than in Most States**

# Total Value of Insured Coastal Exposure in 2007\*

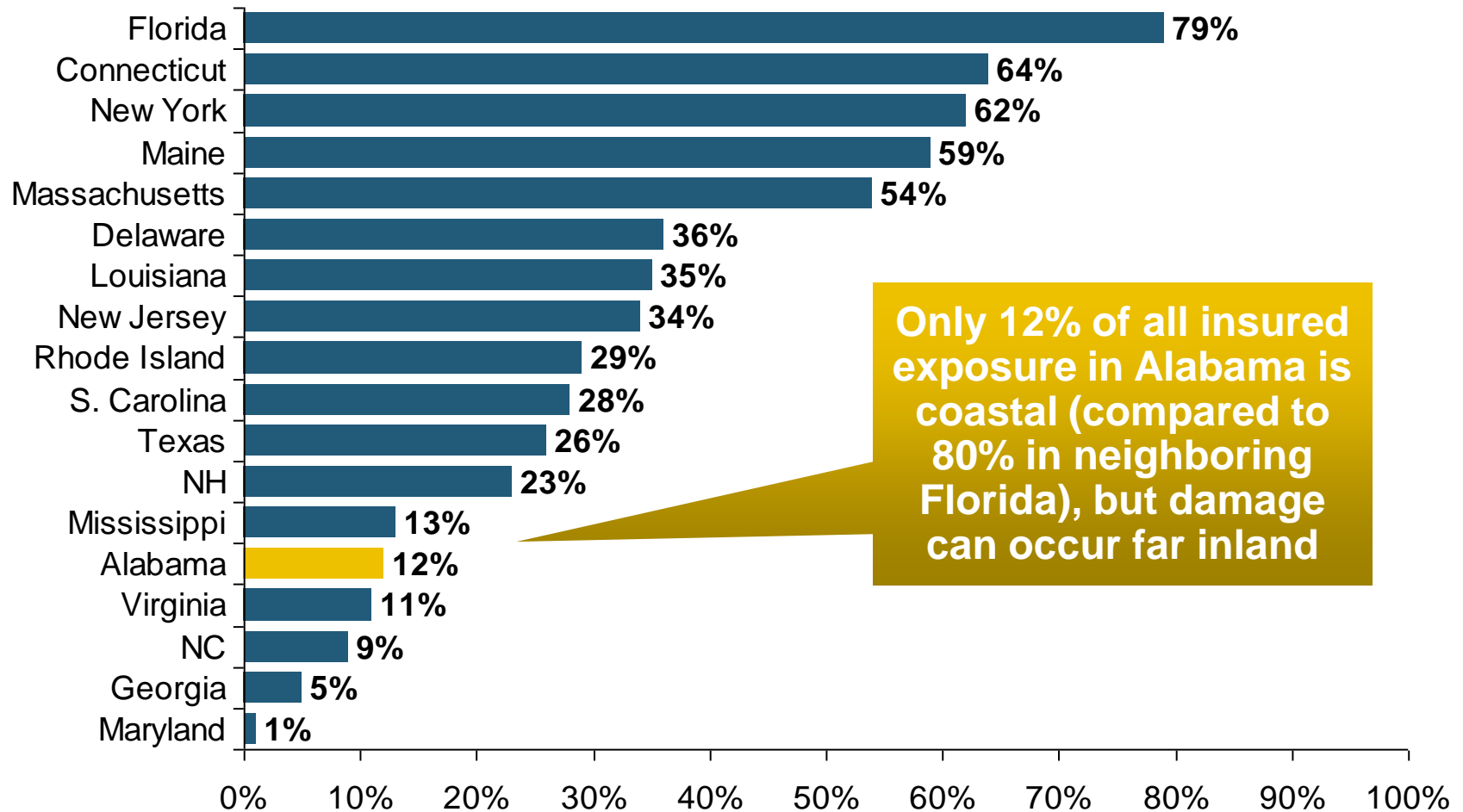
(\$ Billions)



\*Latest available.

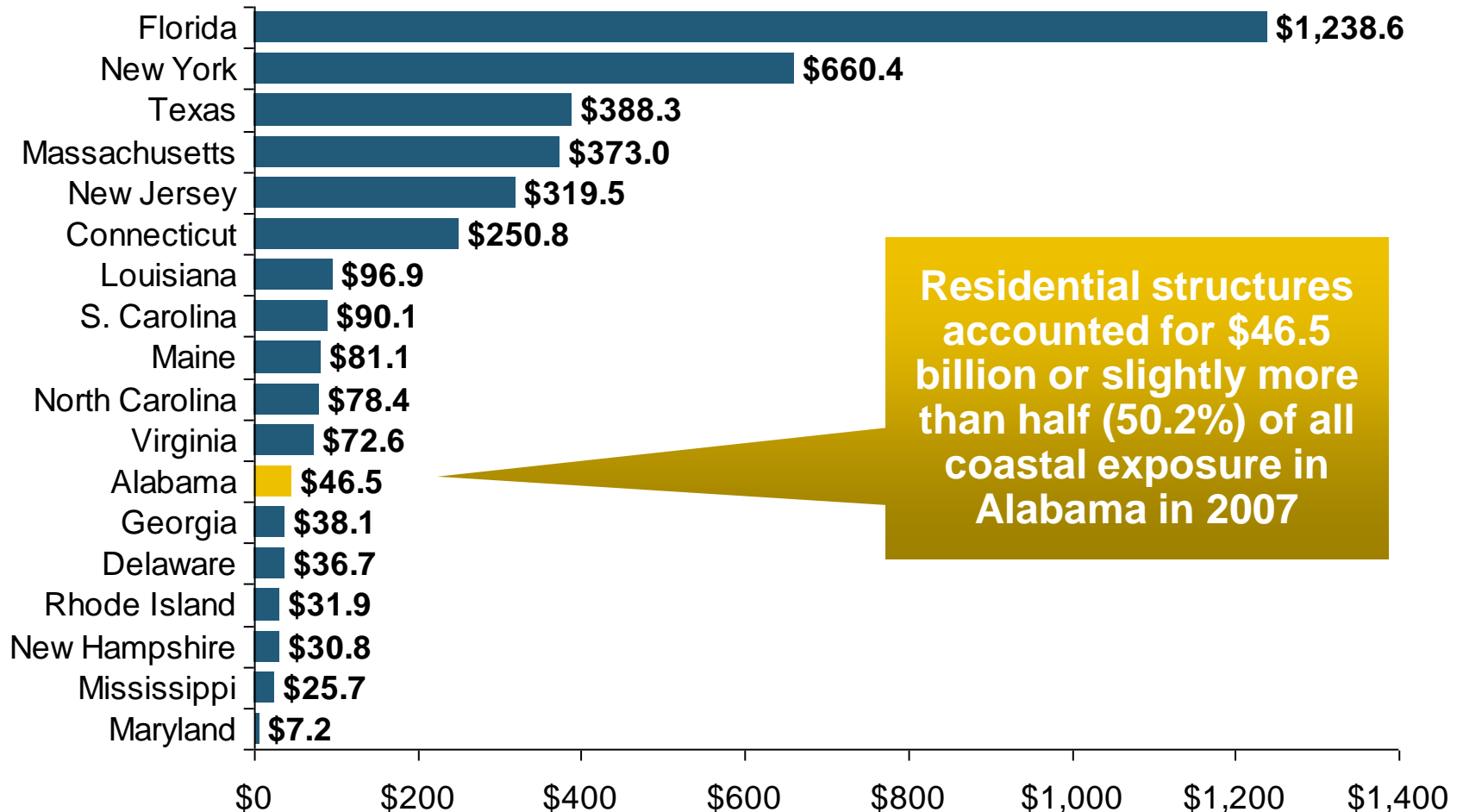
Source: AIR Worldwide

# Insured Coastal Exposure as a Percentage of Statewide Insured Exposure, 2007



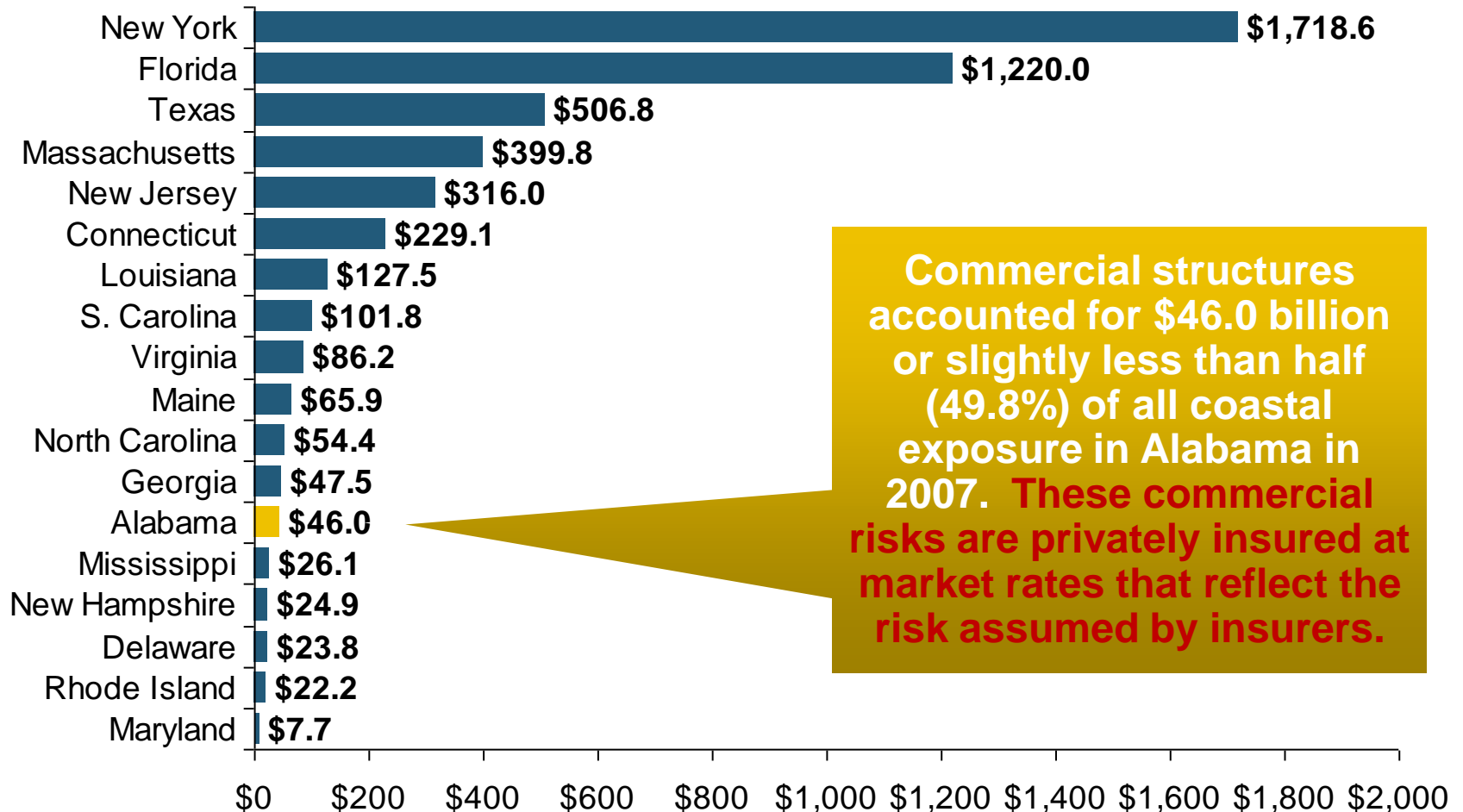
# Value of Insured Residential Coastal Exposure in 2007

(\$ Billions)



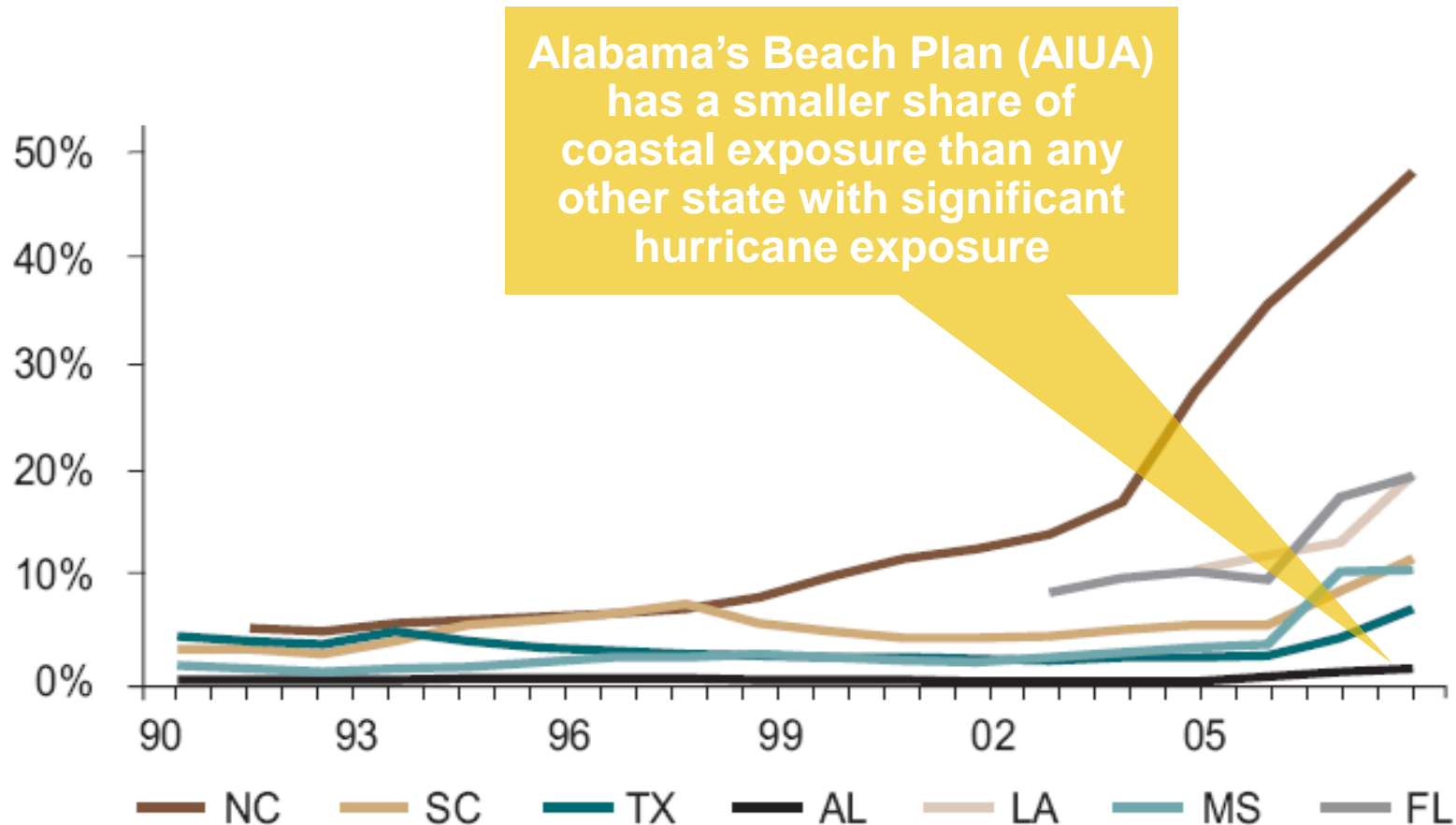
# Value of Insured Commercial Coastal Exposure, 2007

(\$ Billions)

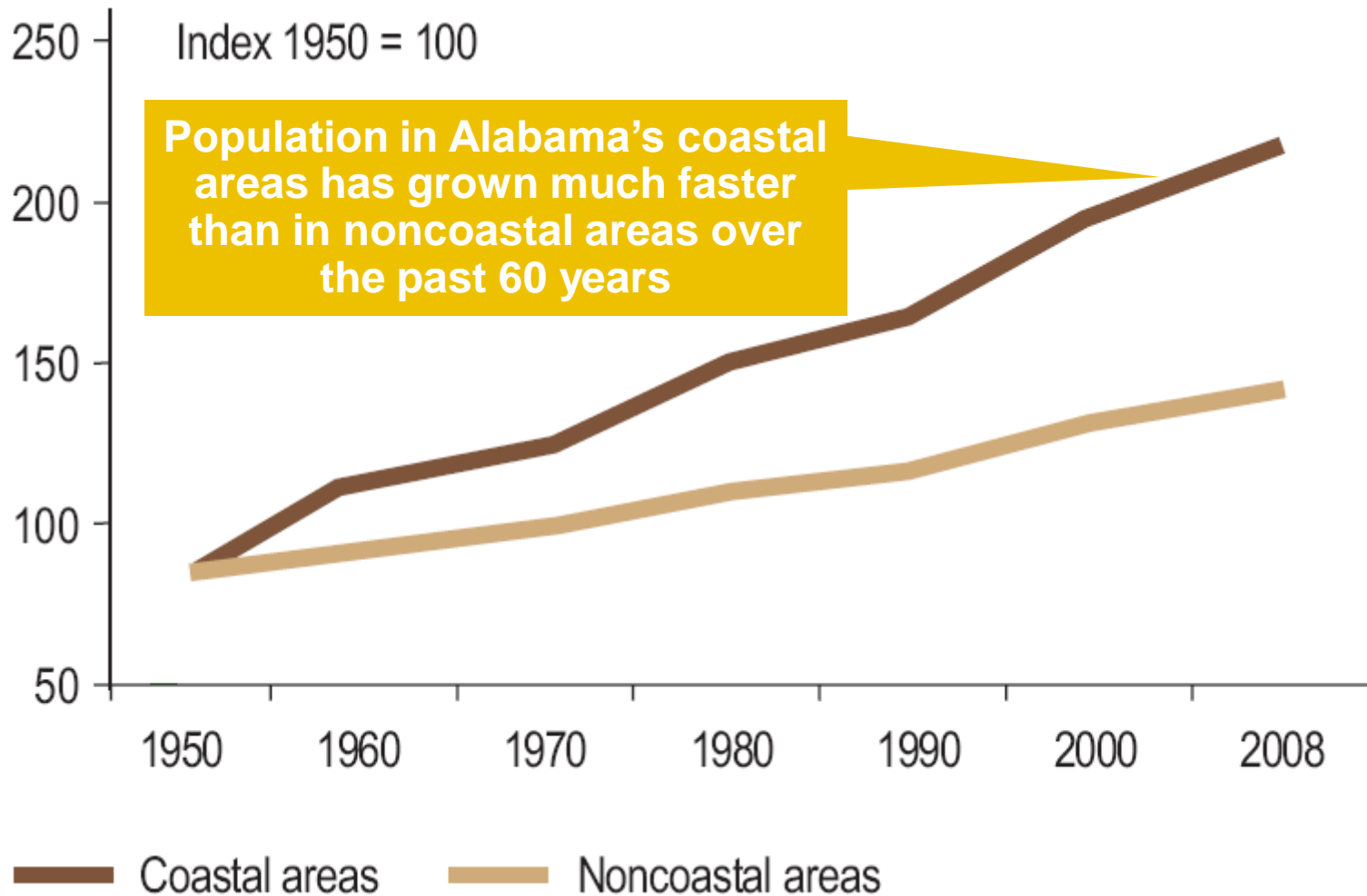


# Beach/Hybrid Plan Exposure as a Share of Total Coastal Exposure

(Share of Total Coastal Exposure)

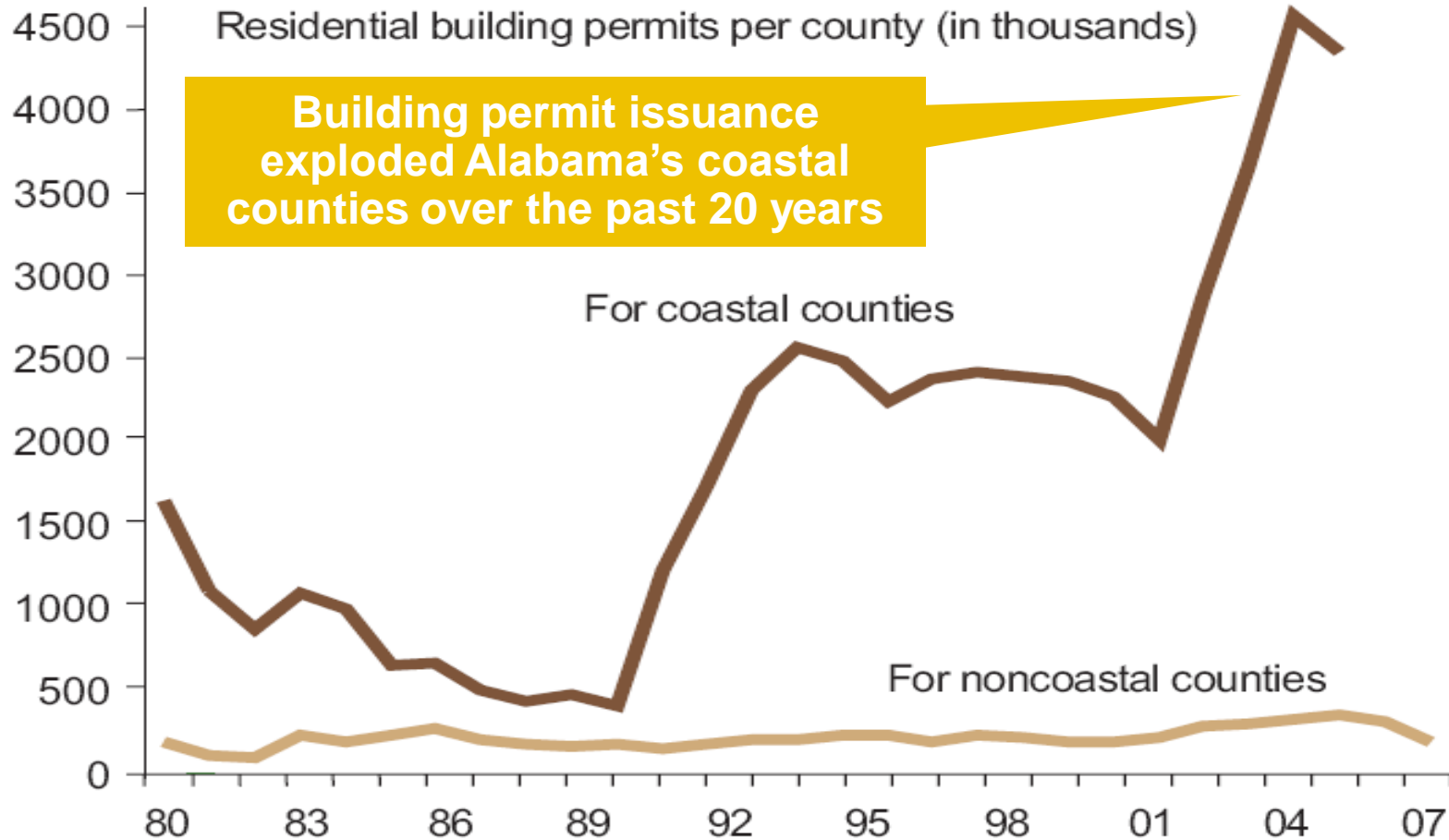


# Population Density in Alabama



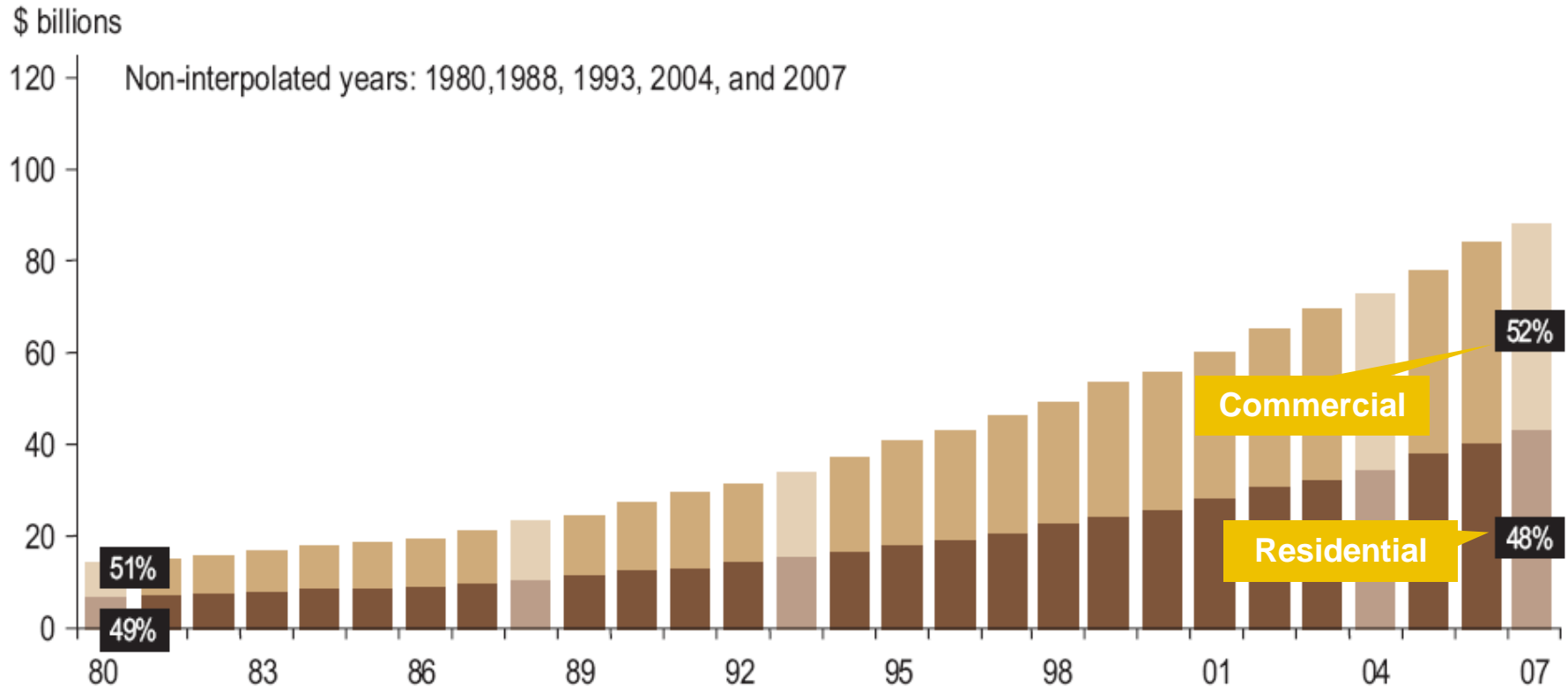


# Alabama Coastal Development vs. Noncoastal Development



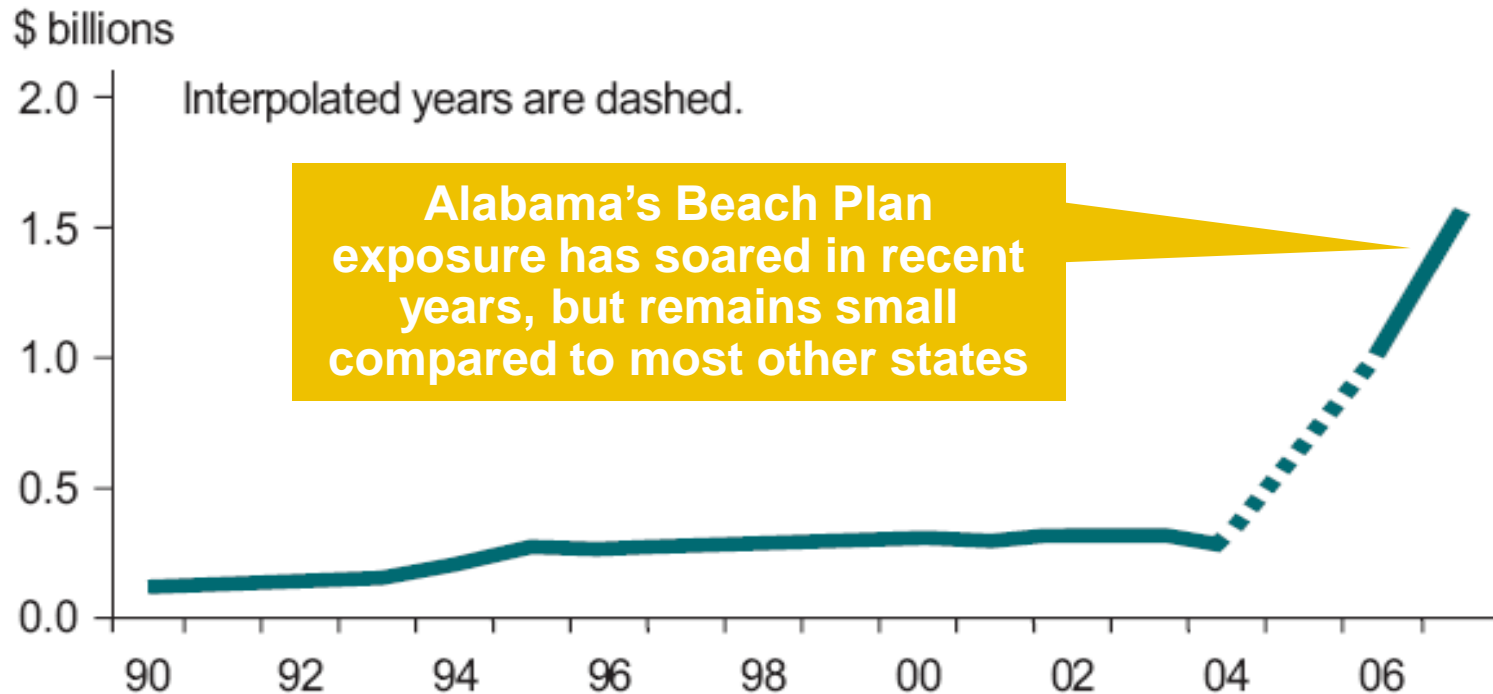
# Alabama: Value of Insured Coastal Exposure, 1980 - 2007

508% Growth from 1980 to 2007, Average Annual Growth 6.9%

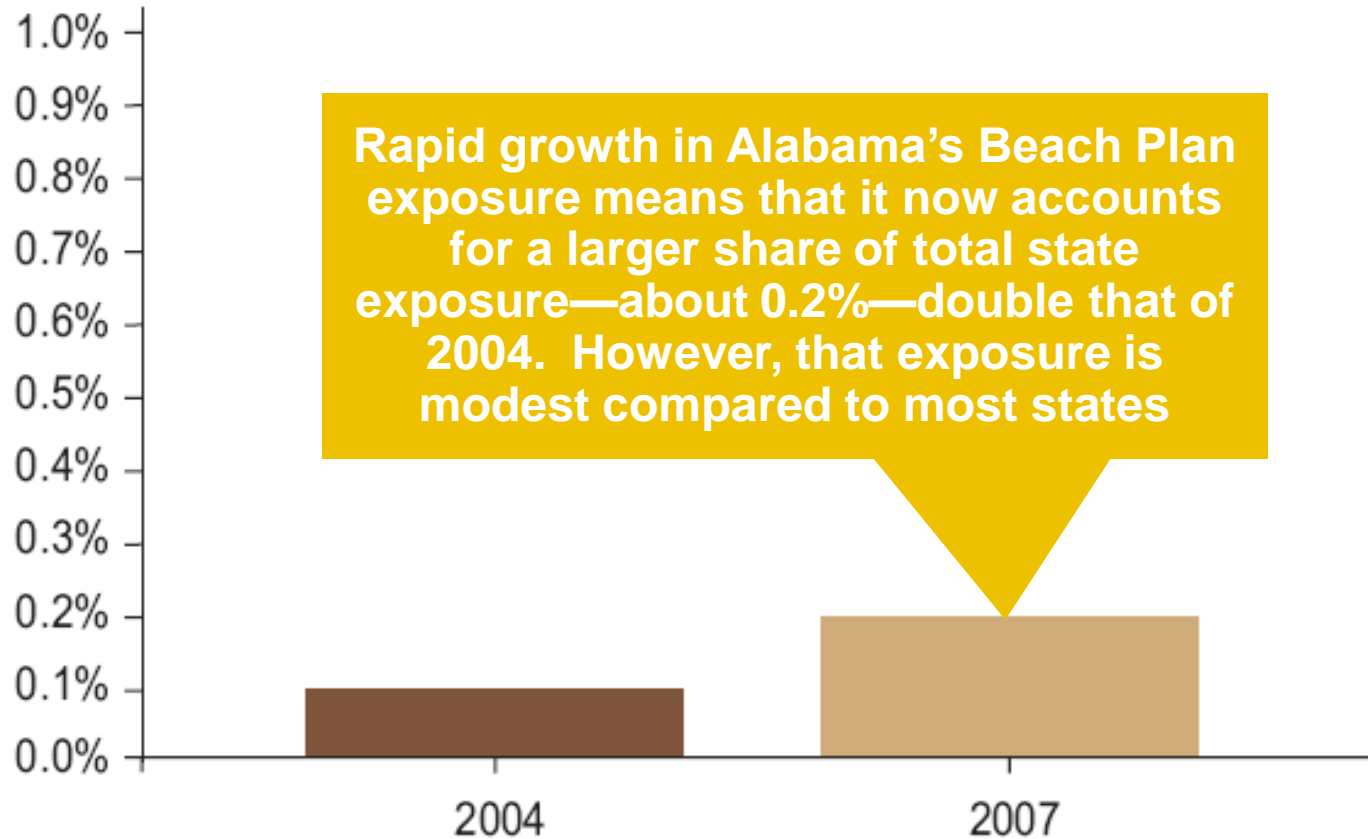


# Alabama Beach Plan Exposure to Loss, 1990 - 2007

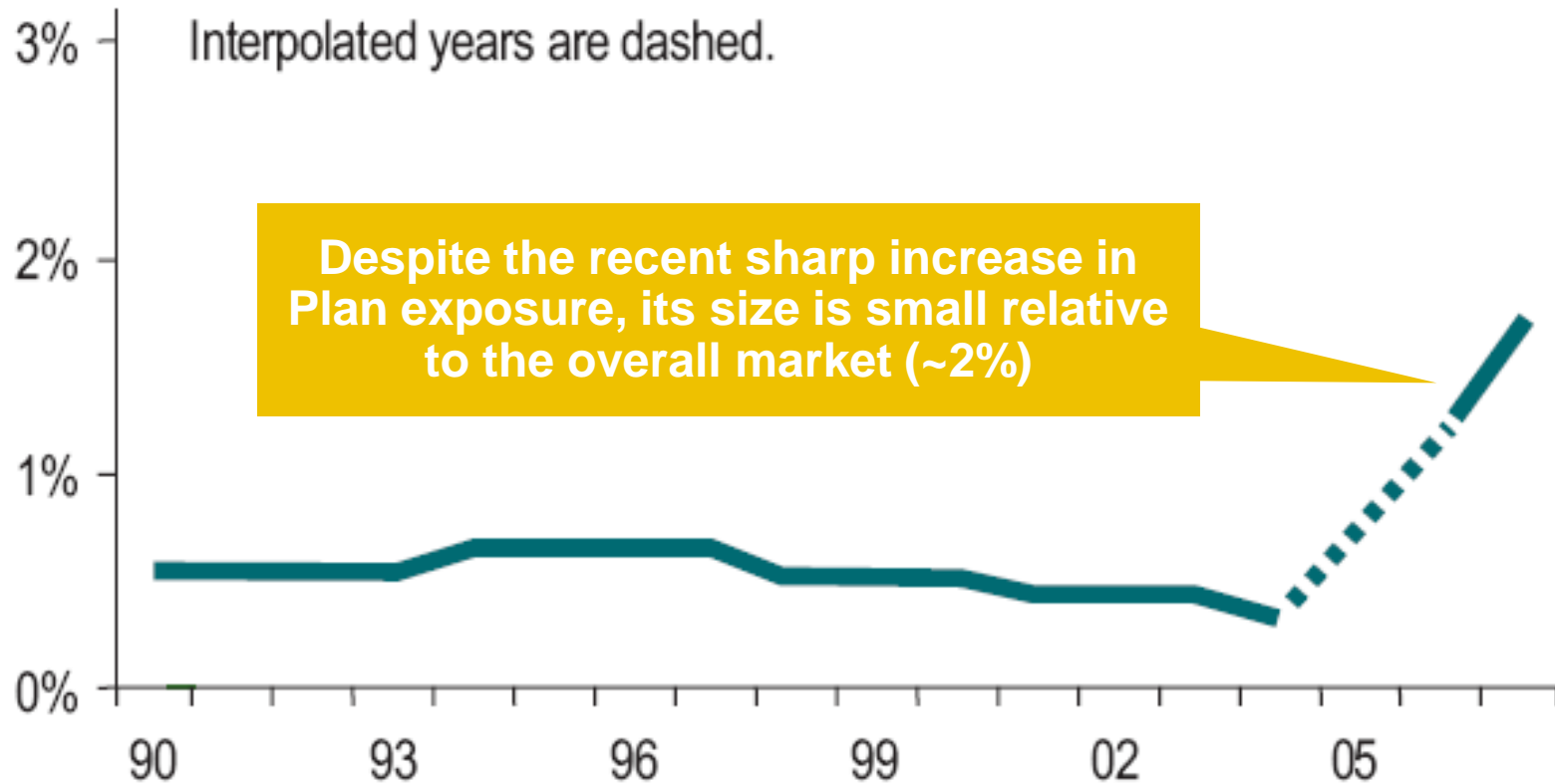
793% Growth From 1990 to 2007, Average Annual Growth 16.85%



# Alabama's Plan Exposure as a Share of Total State Exposure, 2004 vs. 2007



# Alabama's Plan Exposure as a Share of Total Coastal Exposure, 2004 vs. 2007





# So What Can We Say About Alabama's Coastal Exposure Problem?

- **Population Growth: Faster in Coastal Counties for Past 60 Years (2x)**
- **Coastal Development: Permitting as Much as 10x Higher**
- **But Situation is Much Better than Most Other States**
  - ◆ Only 2 coastal counties have direct coastal exposure
  - ◆ Plan limits sale of policies to these 2 counties (Baldwin, Mobile)
- **Alabama's Herfindahl-Hirshman Index Value in 2009 = 1348**
  - ◆ Interpretation: State is "moderately concentrated"
  - ◆ It is not much higher than many noncoastal states (TN = 1318, KY = 1298)
- **Factors Helping Alabama**
  - ◆ Plan covers the state's 2 coastal counties only
  - ◆ Risk sharing through the use of deductibles
  - ◆ Incentives to build to stronger standards



# Are Coastal Development Plans Rational?

**For Individual Decision Makers: *Yes***  
**For Society as a Whole: *No***



# Excessive Catastrophe Exposure: Outcome of Economically & Politically Rational Decision Process?

- **Property Owners**

- ◆ Make economically rational decision to live in disaster-prone areas
- ◆ Low cost of living, low real estate prices & rapid appreciation, low/no income tax, low property tax, rapid job growth
- ◆ Government-run insurers (e.g., CPIC, NFIP) provide implicit subsidies by selling insurance at below-market prices with few underwriting restrictions
- ◆ Government aid, tax deductions, litigation recovery for uninsured losses
- ◆ No fear of death and injury

- **Local Zoning/Permitting Authorities**

- ◆ Allowing development is economically & politically rational & fiscally sound
- ◆ Residential construction creates jobs, attracts wealth, increases tax receipts, stimulates commercial construction & permanent jobs, develops infrastructure
- ◆ Increases local representation in state legislature & political influence
- ◆ Property and infrastructure damage costs shifted to others (state and federal taxpayers, policyholders in unaffected areas)

- **Developers**

- ◆ Coastal development is a high-margin business
- ◆ Financial interest reduced to zero after sale

# Excessive Catastrophe Exposure: Outcome of Economically & Politically Rational Decision Process?

- **State Legislators**

- ◆ Loathe to pass laws negatively impacting development in home districts
- ◆ Local development benefits local economy and enhances political influence
- ◆ Rapid development lessens need for higher income and property taxes
- ◆ Can redistribute CAT losses to unaffected policyholders and taxpayers
- ◆ Can suppress insurance prices via state insurance regulator, suppress pricing and weaken underwriting standards in state-run insurer & redistribute losses

- **Congressional Delegation**

- ◆ Home state development increases influence in Washington
  - Political representation, share of federal expenditures
- ◆ Loathe to pass laws harming development in home state/district
- ◆ Tax law promotes homeownership and actually produces supplemental benefits for property owners in disaster-prone areas
- ◆ Large amounts of unbudgeted disaster aid easily authorized
- ◆ Tax burden largely borne by those outside CAT zone & those with no representation (children & unborn)

- **President**

- ◆ Presidential disaster declarations and associated aid are increasing
- ◆ Political benefits to making declarations and distributing large amounts of aid
- ◆ Direct impact on favorability ratings & election outcomes
- ◆ Losses can be distributed to other areas and the unrepresented

# How Insurers Signal What Should Be Built and Where

## Price as a Messenger of Risk

# Government-Run Insurers Lead to Poor Land Use/Design Decisions

- **Government-run insurers (markets of last resort) serve as a vital safety valve after major market disruptions, but also serve as an enabler of unwise development...**
- **Government-run property insurers wash away market-based signals about relative risk**
- **Consequence is runaway development in disaster-prone areas**
- **Government-run insurers:**
  - ◆ Generally fail to charge actuarially sound rates
  - ◆ Have weak underwriting standards
  - ◆ Are thinly capitalized
  - ◆ Can assess losses to policyholders other than their own
  - ◆ Vulnerable to political pressure
- **Inadequate premiums, insufficient capital and weak underwriting mean that most government plans, from Citizens Property Insurance Corporation to the National Flood Insurance Program operate with frequent deficits**

# Negative Outcomes from Flaws in Government-Run Insurers

- **True risk associated with building on a particular piece of property is obscured**
- **Subsidies are generated leading to market distortions/inequities:**
  - ◆ Many thousands of homes likely would not have been built (or built differently) if property owner obligated to pay actuarially sound rates
  - ◆ CPIC assessments from Wilma will require grandmothers living in trailer parks on fixed incomes in Gainesville to subsidize million dollar homes in Marco Island via assessment (surcharges).
- **Serial rebuilding in disaster-prone areas is the norm**
- **Property owners come to assume that the government rate is the “fair” rate and object to moves to actuarially sound rates.**
- **Government-run insurer can’t control its own exposure**
  - ◆ Legislature mandates that CPIC offer coverage in most cases if no private insurer will offer coverage due to high risk, near certainty of destruction
  - ◆ No restrictions on value of property, so high-valued properties represent disproportionate share of potential loss
- **Taxpayer Burden: NFIP borrowed \$20B+ in 2005**

# What Works, What Doesn't

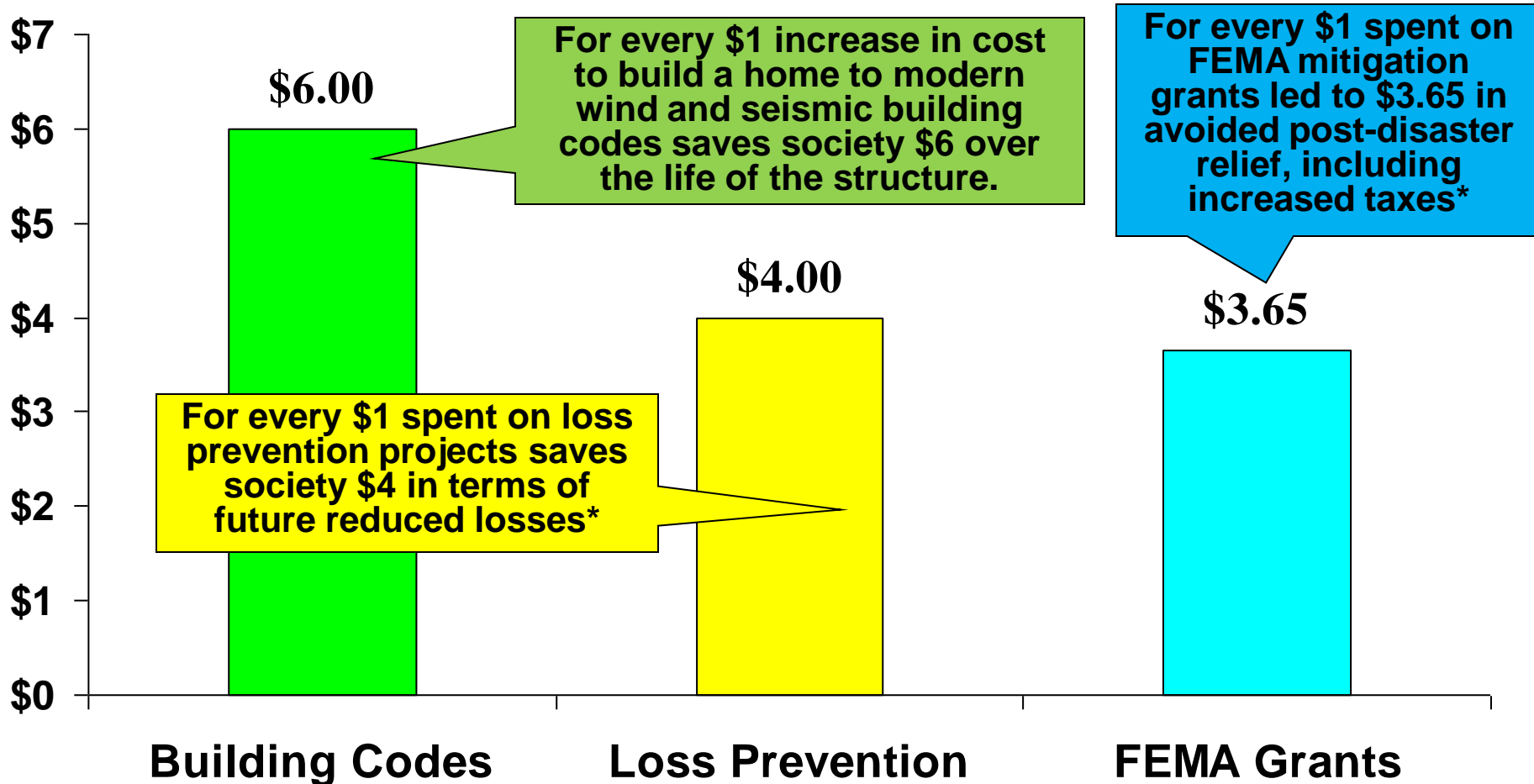
**History, Past Actions  
Provide Lessons**

# Successful Tools for Controlling Hurricane Exposure

- **Strengthened building codes**
- **Stringent enforcement of building codes**
- **Fortified home programs**
- **Insurance rates based on sound actuarial principles (risk-based rates that are not government controlled); Works for commercial insurers**
- **Disciplined underwriting**
- **Removing impediments to capital flows**
- **Lowering insurers' cost of capital (e.g., pre-tax reserving)**
- **Incentives to adopt mitigation**
- **Forcing communities to consider and take a larger stake in their catastrophe exposure**

# Loss Prevention Has a High ROI: Property Owners, Insurers and Contractors All Benefit

## Return on Each \$1 Invested in Mitigation



\*According to the Multi-Hazard Mitigation Council of the National Institute of Building Science.  
Source: Institute for Business and Homes Safety; Insurance Information Institute.



# Unsuccessful Tools for Controlling Hurricane Exposure

- **Insurance rates that are not actuarially sound (i.e., don't reflect true risk)**
- **Political interference in rate process**
- **Inadequate underwriting controls**
- **Subsidies**
  - ◆ **Intra-state (policyholders/taxpayers)**
  - ◆ **US Taxpayer**
- **Voluntary flood coverage**
- **Litigation**

- **Local control of land use and permitting creates significant incentive problems**
  - ◆ **Benefits accrue locally while many costs can be redistributed to others via taxes, insurance and aid**
- **Prospect of government aid reinforces unsound building and location decisions**
- **States don't want to raise taxes to pay for mitigation/prevention even if state is sole beneficiary**
  - ◆ **E.g., NO levees; Beach replenishment**

# Recommendations

## Toward a Long-Term Solution

# Recommendations for Controlling Hurricane Exposure

- **Raise public awareness of risk**
  - ◆ Mandatory risk disclosure in all residential real estate transactions
  - ◆ Require signed waivers if decline flood coverage that also waive rights to any and all disaster aid, or
  - ◆ Mandate flood coverage
- **Continue to strengthen & enforce of building codes**
- **Allow markets to determine all property insurance rates**
  - ◆ Role of state focused on difficult-to-insure or income issues
- **Increase incentives to mitigate**
- **Require state-run insurer to charge actuarially sound rates and limit high value exposure**
- **Require communities/counties to a financial stake in their catastrophe exposure**
  - ◆ Reimburse disaster aid to state/federal government

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and your attention!***

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