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INSURING RESILIENCE: The Potential Impact of an Optional Federal Charter on the Social Resiliency of Hazard-Prone Regions

DAVID C. MARLETT

*Chair, Department of Finance, Banking, and Insurance,
Appalachian State University
Affiliated Senior Scholar, Mercatus Center*

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About David C. Marlett, author

David C. Marlett, PhD, is an affiliated senior scholar with the Gulf Coast Recovery Project of the Mercatus Center at George Mason University. He is the chair of the Department of Finance, Banking, and Insurance at Appalachian State University. He teaches the insurance principles, property/liability, and risk-management courses. Dr. Marlett is the editor for the *CPCU Journal* and he is published over twenty articles in peer-reviewed journals.

Dr. Marlett earned a bachelor of science in risk management and insurance and a PhD from Florida State University.

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THE POTENTIAL IMPACT OF AN OPTIONAL FEDERAL CHARTER ON THE SOCIAL RESILIENCY OF HAZARD-PRONE REGIONS

DAVID C. MARLETT, PHD, CPCU

EXECUTIVE SUMMARY

This paper assesses the potential impact that an optional federal charter (OFC) for property and casualty insurance would have on social resiliency in affected communities in the United States. It discusses the benefits and problems associated with the current state regulatory system and then gives a similar analysis of federal regulation. Specific attention is given to the National Insurance Consumer Protection Act, which is the most recent OFC proposal. The paper concludes with a list of recommendations for policy makers to consider when evaluating the insurance regulatory system with focus on enhancing social resiliency.

THE POTENTIAL IMPACT OF AN OPTIONAL FEDERAL CHARTER ON THE SOCIAL RESILIENCY OF HAZARD-PRONE REGIONS

I Introduction

THE CAPACITY TO withstand disruptions, rebuild, and retain essentially the same identity and culture after a natural or manmade disaster is the root of a community's social resiliency. The ability of a community to recover from disasters depends on a number of institutions, both formal and informal, that have been the subject of much discussion in the social sciences. Critical, however, to the ability of a community to recover from disasters is a well-functioning insurance market.

This issue of the Mercatus Policy Series assesses the potential consequences of federal regulation—as opposed to the current system of state regulation—on property and casualty insurers and their ability to provide coverage in hazard-prone regions. The current insurance market in coastal regions relies heavily on state-created, residual-market insurance programs to provide coverage. These residual markets depend upon subsidies to remain solvent following a disaster. Private insurers, meanwhile, are at times hobbled by excessive regulation, which has a negative impact on social resiliency.

The merits of moving from a state-managed regulatory regime to a federally regulated one have been debated for many years, usually in the name of alleviating some of the problems states face. Legislators have made numerous unsuccessful attempts to reform the regulatory system and move to a federal approach. The most common model in recent years is the optional federal charter (OFC). This approach would provide insurers the option of obtaining either a state or a federal charter to issue insurance policies.

Because social resiliency is closely intertwined with the condition of the insurance markets, it is very important to assess the current insurance regulation system and see what is working, what is not working, and what can be done to fix it. A healthy insurance market is critical to

credit markets that provide funding for individuals and businesses after a disaster. Lenders typically will not provide funds without adequate insurance coverage. Not having access to loans constricts the ability of people to rebuild homes or restart businesses. A community will therefore have a much more difficult time recovering from a disaster without a functioning insurance market.

The first part of this paper provides some background on the insurance industry and the rise of the current system of insurance regulation through the states. Section two assesses the benefits and costs of the current regulation system, the state regulation of insurance. The third section analyzes the benefits and costs of the proposed OFC system. The final section, focusing on recommendations, compares the costs and benefits of each system to ascertain possible paths moving forward.

2 About Insurance

INSURANCE PROVIDES COMPENSATION for losses and allows homeowners and business owners to rebuild. It may also provide funds for personal property, lost income, and additional living expenses so that life can retain some semblance of normalcy. These benefits only exist if insurers are willing to sell the coverage to policy holders and are then financially able to fulfill their contractual obligations following a disaster.

Insurance regulation is based on the existence of market failures. Market failures arise from asymmetric information problems, where one party to a contract has more or better information than the other. This information asymmetry can result in suboptimal consumer decisions, excessive insolvency risk, and abusive market practices.¹ For example, since insurance is a complex product that is not readily understood by many consumers, insurers

1. Martin F. Grace and Robert Klein, "Efficiency Implications of Alternative Regulatory Structures for Insurance" (presentation, American Enterprise Institute Conference on Optional Federal Chartering and Regulation of Insurance, June 10, 1999).

could offer inadequate coverage that would leave the consumer unprotected. Because the financial literacy of much of the public, this argument goes, is not adequate to make informed decisions, policy holders must be protected. Even under the best of circumstances, there will be confusion regarding the policy language and coverage terms.² Furthermore, policy holders are not in strong positions to monitor the actions of the management of the insurance company. Management could engage in inappropriate behavior or take excessive risks without their knowledge.³ This could endanger the solvency of the insurer and increase the likelihood of claims going unpaid.

Proper regulation can reduce market failures and the information problems. Regulators review forms to ensure readability and fairness, evaluate market conduct, and monitor insurer solvency (that is, the ability to pay claims). In recent years, regulators have directed their efforts toward ensuring that the consumer has access to an affordable source of coverage.

Traditionally, it has been the responsibility of the state governments to regulate insurance. The case of *Paul v. Virginia* (75 U.S. 168) first established the authority of states to regulate insurance in 1868. The state's authority was confirmed through numerous court decisions until the *Southeastern Underwriters* (322 U.S. 533) case in 1944. In this case, the Supreme Court ruled that the commerce clause in the U.S. Constitution did apply to insurance and therefore the industry was subject to federal antitrust law. In an attempt to clarify, Congress passed the McCarran-Ferguson Act (15 U.S. Code § 1011, et seq.) in 1945. The McCarran-Ferguson Act states that it is in the public's interest for states to continue as the primary regulator of insurance, except in instances where federal law specifically supersedes state law. It also provides a partial federal antitrust exemption to the insurance industry.⁴ This system has remained in place for decades while the insurance industry has grown and evolved. Many insurers now operate on a national and international level and offer an assortment of complex financial products.

2.1. How Insurance Works

THE PRIMARY ELEMENTS of insurance are the pooling of risk among many different policy holders and the transfer of that risk to another entity (an insurer). Insurance companies do not create the risk; they simply coordinate the sharing of the risk amongst the affected parties. In order for insurers to be able to facilitate this process, certain conditions must exist. Not all risks are insurable. In order for a risk to be insurable, the following conditions generally must be met:

- there must be a large number of similar exposure units;
- any losses must be accidental and definite;
- insurers must be able to calculate estimated losses;
- catastrophic exposure must be manageable; and
- premiums must be affordable.

When these elements do not exist, it is very challenging for insurers to offer coverage responsibly.

Potential losses attributed to perils such as fire and theft are predictable due to reliable historical measures and minimal catastrophic exposure; for example, the number of total house fires across the United States every year has been steadily decreasing and is fairly predictable. There is unlikely to be a massive spike in that number in any given year. However, damages resulting from catastrophic perils such as hurricanes are much more difficult to gauge because they are not as predictable, have an enormous loss potential, and the losses to the exposure units are correlated. In other words, while house fire damage remains roughly constant from year to year, catastrophic perils only happen occasionally. When they do, however, their cost is extremely high. This correlation restricts insurers' abilities to reduce their risks through a geographic spread since a single, catastrophic event will affect many of their policy holders at once.

Because of the inherent nature of these catastrophic perils, private insurers are quite reluctant to risk their capital to insure properties at premium levels deemed by property owners to be "affordable." Insurers (and their

2. The thousands of wind-versus-water claim disputes following Hurricane Katrina are an example.

3. Harold D. Skipper and Robert W. Klein, "Insurance Regulation in the Public Interest: The Path Towards Solvent, Competitive Markets," *Geneva Papers on Risk & Insurance—Issues and Practices* 25, no. 4 (2000): 482–504.

4. Lawrence S. Powell, "The Assault on the McCarran-Ferguson Act and the Politics of Insurance in the Post-Katrina Era," *Journal of Insurance Regulation* 26, no. 3 (Spring 2008): 3–22.

stockholders) require a higher return on their capital to justify the higher risks they face when they insure coastal or other catastrophe-prone property. Given the nature of the hurricane exposure, the unpredictability of hurricanes, and the difficulty in obtaining a return to match the risk, many insurers have chosen to reduce the number of policies they write or withdraw from the market altogether.

2.2. Insurance Rating Principles

ACCORDING TO COMMONLY accepted actuarial principles propagated by the Casualty Actuarial Society, rates should be “reasonable, not excessive, not inadequate, and not unfairly discriminatory.” Furthermore, “a rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer.”⁵ In theory, rates should depend on expected claims costs, insurer administrative costs, and the insurance company’s cost of holding capital sufficient to pay claims. These principles also guide the actions of state regulators when determining whether rates are acceptable. Of course, what is considered adequate, not excessive, and not unfairly discriminatory can vary from person to person and state to state. Ensuring that rates are adequate yet not excessive is a difficult task and requires interaction between insurers and regulators. Given the coastal exposure and the unpredictable nature of hurricanes, both insurers and regulators must contend with considerable uncertainty and political pressures.

2.3. The Role of Guaranty Associations

AS PREVIOUSLY DISCUSSED, prompt insurance claim payments play a key role in helping a community rebuild and maintain social resiliency. Under the current state-based system of insurance regulation, when a licensed insurer experiences financial distress, the state insurance department typically initiates a process to guide the company back to solvency. If the insurer cannot be rehabilitated and is declared insolvent, the insurance commissioner can seek authority to seize its assets and operate the company pending liquidation. In essence,

the state becomes the administrator of the insolvent insurer. After the state conducts an accounting of assets and liabilities, it prepares to distribute any remaining cash among creditors.

When a state guaranty fund takes over a troubled insurer, it can draw from two sources to pay claims. First, any remaining assets from a defunct insurer are put in the estate, and the guaranty fund is a preferred creditor. Second, the guaranty fund can assess insurers (typically 2 percent of the premium on eligible lines of business) and use this capital to pay policy holders who make claims through their state guaranty association. The guaranty association steps into the shoes of a failed insurer and investigates the claims of policy holders. If the claims are valid, the guaranty association will pay at least a portion of them. State guaranty funds have maximum limits on the amounts payable to a single policy holder, typically either \$300,000 or \$500,000.⁶ The role of the guaranty association and the criteria regarding payments from the guaranty fund are currently defined by state law. Although there is no set of minimum standards that apply to all state guaranty funds, the NAIC does provide guidance to facilitate a degree of uniformity.

State guaranty associations have a solid history of operation. A potential area of weakness, though, is whether the guaranty funds could manage an extreme event that results in multiple large insurer failures at same time. The limits on post-loss assessments on remaining insurers could delay recovery and hinder social resiliency.

3

Benefits and Problems with State-Based Insurance Regulation

3.1. Benefits of State Regulation

UNDER THE CURRENT state-based regulatory system, each state has a staff of insurance regulators led by an insurance commissioner (or director). These organizations have experience dealing with the insurance markets and claims histories of the particular state. Proponents of continued state regulation note that the system is working at least as well as the federally regu-

5. Casualty Actuary Society, “Statement of Principles Regarding Property and Casualty Insurance Ratemaking,” *Actuarial Standards of Practice 9*, <http://www.casact.org/standards/princip/spprcrate.pdf>.

6. National Conference of Insurance Guaranty Funds, “Data Sheets,” <http://www.ncigf.org/datasheets/>.

lated financial sectors.⁷ Most Departments of Insurance are staffed by dedicated professionals who focus on market conduct, consumer protection, and insurer solvency.⁸

Perhaps the greatest advantage of state regulation is the connection to the local population and the awareness of regional problems, concerns, and economic conditions.⁹ Proponents of continuing state regulation promote this approach as a benefit to the consumer since it allows flexibility and responsiveness to local needs. However, it also leads to unique rules and regulations throughout the nation that create inefficiencies for national insurers.

The National Association of Insurance Commissioners (NAIC) attempts to coordinate state insurance regulatory activities to promote uniformity; however, there is still a great deal of variation among the states.¹⁰ Some variability can be a good thing because it allows new laws and regulatory models to be tested in a confined system with potential damage limited to one state.

It is not possible to say in general terms if state regulation succeeds or fails. Some states have healthy markets and collaborative relationships between regulators and insurers.¹¹ Other states have markets that are in turmoil and combative regulatory relationships. Overall, despite two decades of unprecedented catastrophes, most state insurance markets have remained functional with relatively few insurer failures. When an insurer has failed, the guaranty funds have raised adequate capital to protect policy holders of the insolvent insurers. However, there is legitimate concern over how the state-based system could handle an extreme event such as a powerful hurricane or earthquake occurring in a major population center.

3.2. Problems with State Regulation

THE LACK OF uniformity among state laws and regulations has been the traditional criticism of the state sys-

tem and a prime motivation for supporters of federal regulation. This lack of uniformity is unavoidable if regulators are to be responsive to local needs. When state legislators and regulators respond to perceived local needs, the resulting patchwork system of rules will inevitably become awkward and costly to national insurers. Navigating the numerous state regulations costs time and delays response to changing market conditions.

The lack of uniformity became more prominent after the implementation of Financial Services Modernization Act of 1999 (commonly called GLB for Gramm-Leach-Bliley). This legislation, among other things, removed legal barriers separating insurance and banking operations and allowed federally regulated banks to begin competing directly with state-regulated life insurers. As insurers began to expand and started offering non-insurance financial services (such as banking, derivative trading, and investment services), their operations began to exceed the experience of regulators who had traditionally focused only on insurance activities. State regulators were not, and still are not, in a position to monitor activities that present a systemic risk to the broader economy. State regulation is also ill-suited to monitor international insurers and reinsurers attempting to do business in the United States.

Rate suppression and the resulting market problems are another prominent criticism of state regulation. Most hurricane-prone states employ a prior-approval rating system for residential property insurance policies. Under this kind of system, insurance companies file rates with the Department of Insurance, and, under certain conditions, must receive the commissioner's approval before their implementation. If rates are not approved, insurers may not charge them. Though insurers are usually allowed to challenge the commissioner's decision in the courts, it is a costly and time-consuming process.

7. The collapse of AIG, the world's largest insurer, has been raised as a failure of state insurance regulation. However, the insurance operations of AIG were in a strong position, and the financial ruin was due to derivative trading in the Financial Products (AIGFP) division. It should be made clear that in addition to unregulated derivative trading in the AIGFP division, the failure of existing federal regulation facilitated the collapse of AIG. More specifically, as a thrift holding company, AIG was subject to umbrella regulation by the Treasury's Office of Thrift Supervision (OTS) to ensure that actions of the holding company or an affiliate do not pose a material risk to the safety, soundness, or stability of the subsidiary thrift.

8. The main source of funding for the departments is a required premium tax (often 2 percent of the premium) paid by insurers operating in the state. The primary purpose of the premium tax is to raise general revenues for the state, not to provide funds for regulation. Many departments are underfunded and receive only a fraction of the premium taxes collected.

9. Joseph F. Zimmerman, "Dual Insurance Regulation: Is It Desirable?" *Journal of Insurance Regulation* 27, no. 1 (Fall 2008): 1–22.

10. The NAIC members meet regularly to draft model laws and offer recommendations to state legislative bodies. The NAIC has no legal authority to force states to adopt the recommendations.

11. For example, the Commonwealth of Virginia has a rating system based on competition, a small residual market with a reliable catastrophe financing plan, and a director who is insulated from political pressures.

Prior-approval regulations are another name for price controls. They allow state regulators to intervene in setting rates. The system relies more on the judgment of regulators in setting rates that are “adequate but not excessive” than on the forces of market competition. Because prior approval interrupts market-based pricing signals, it makes the markets less competitive. As rates are held down for the high-risk policy holders, the low-risk policy holders can end up paying too much for their coverage since insurers are forced to make up lost premiums by not taking indicated premium reductions for lower-risk property owners. (In the language of economics, the lower-risk policy holders are forced to cross-subsidize the higher-risk policy holders.) Furthermore, subsidizing high-risk property owners reduces the incentive to mitigate their exposure. Low premiums may attract consumers in the short run, but the true value of insurance is the payment of a covered claim.¹²

The ability of a society to recover after a disaster is dependent upon a viable insurance market that not only pays claims, but also remains solvent and provides coverage after the event. It is important to not only have a source of affordable insurance coverage before the disaster, but after as well. The state efforts to manage the insurance marketplace through the use of rate controls have reduced incentives for private insurers to participate and provide a source of coverage.

3.3. The Beginning of the Crisis

STARTING WITH HURRICANE Hugo in 1989, a series of catastrophic events dramatically changed the property insurance market. Hurricane Hugo made landfall near Charleston, South Carolina as a category 4 storm, then moved through the Carolinas and struck Charlotte as a category 3 hurricane. Hugo caused \$7 billion in privately insured losses, making it the most costly hurricane recorded to that date.¹³ At the time, it was widely viewed as the worst-case scenario.

Those views quickly changed after Hurricane Andrew struck southern Florida during the summer of 1992. Andrew was a powerful category 4 hurricane that caused \$23 billion in insured damage, the largest insured loss

caused by a natural disaster in history. Seven domestic insurance companies and one foreign company became insolvent directly because of Hurricane Andrew. The Florida Insurance Guaranty Association was forced to issue bonds to provide for the payment of claims from insolvent insurance companies.

Following Andrew, insurers were reeling and scrambling to find a strategy to manage their losses as well as preparing for an uncertain future. Insurers needed to better understand their exposure in order to remain financially solvent and to obtain better estimates of the potential frequency and severity of losses so that they could calculate the appropriate premium levels and manage their exposure. To do this, insurers turned to a relatively new computer-based tool catastrophe modeling (commonly called cat models). Consulting organizations helped to clarify the potential exposure by creating mathematical models to synthesize extreme events on insurers’ portfolios of insured properties and estimate damage based on historical and hypothetical events. The models provided output that quantified the exposure and assigned probabilities to described levels of losses, including a return-period probable maximum loss (PML) event that considered the probability of a certain high value being exceeded in a given period. For example, a 100-year PML estimate has a 1 percent probability of being exceeded in a year. The results from the cat models generally supported the insurers’ concerns that they were overexposed in hazard regions and had underestimated the exposure due to lack of information in their earlier estimates. Insurers and regulators have struggled with the use of cat models since they become more prevalent in the mid-1990s.

3.4. The Reactions of State Legislators and Regulators

THE SEVERITY OF the disasters and potential for future financial losses caught the public, insurance industry, regulators, and state legislators by surprise. As insurers began requesting large rate increases and processing massive cancellations of policies, state legislators began developing legislation to suppress the increases, limit cancellations, and offer alternative sources of insurance

12. For more on this, see Daniel Sutter, *Ensuring Disaster: State Insurance Regulation, Coastal Development, and Hurricanes*, Mercatus Policy Series, Policy Comment 14 (Arlington, VA: Mercatus Center at George Mason University, 2007).

13. Loss estimates provided in this paper are in 2008 dollars. See Insurance Information Institute, “Catastrophes: U.S.,” <http://www.iii.org/media/facts/statsbyissue/catastrophes/>.

coverage to the public. The insurance market problems initially spread from Florida to Hawaii and California, and then to the rest of the coastal states in the Southeast and Mid-Atlantic.

In some states (most notably South Carolina and Virginia), competitive forces have worked, and residual markets are truly used as a last resort. Lawmakers in North Carolina recently enacted a reform package that has improved the property insurance market conditions. Those markets have stabilized and are functioning. In other states (including Florida and Texas), the market is in disarray, and the outlook is somewhat perilous. These states have residual markets with billions of dollars in exposure and vastly inadequate capital to pay the claims from even a single mid-sized storm. They instead rely on post-loss assessments on insurers and policy holders that can further destabilize a fragile market. The reality is that a severe storm season could effectively bankrupt these states, inevitably leading to calls for a federal bailout. In other words, the poorly functioning insurance markets of these states have potential cost ramifications for the entire country.

4

A Federal Insurance Regulator: The Optional Federal Charter

IN FEBRUARY 2009, Federal Reserve Chairman Ben Bernanke stated before the House Financial Services Committee that establishing optional federal charters (OFCs) for insurers is a “useful idea.” In the following month, Treasury Secretary Timothy Geithner testified before the committee and described the need for wide-ranging new authority to oversee insurers that present “systematic” risk. The National Insurance Consumer Protection Act (H.R. 1880), introduced in April 2009, provides a framework for an OFC along with a new regulatory approach for managing systemic risk in the U.S. financial sectors.¹⁴

Given the recent economic crisis, the approval for distribution of Troubled Asset Relief Program funds to several of the nation’s largest insurers, and the prominent troubles of world’s largest insurer, AIG, this issue has received a great deal of recent attention. The implementation of OFC legislation would have a substantial impact on the insurance industry and hence the social resiliency of communities to disasters.

An OFC would allow eligible insurers to issue policies governed either by federal regulation or under the state system. A large insurer that is operating nationally is currently under the authority of 50 state regulators plus those of Washington, DC and territories, each with unique laws and systems. If an insurer obtains a federal charter, it would no longer be subject to licensing, examination, or supervision by state regulators. Insurers would also be free of the state controls on rates and products. When free of excessive regulation, the homeowners insurance market is highly competitive.¹⁵

There have been numerous proposals over the last decade that would offer insurers the option of choosing a federal charter. Interest spiked after the passage of Gramm-Leach-Bliley, which allowed banks and insurers to compete with one another. Large life insurers quickly realized they were at a competitive disadvantage against banks when offering similar products due to the different regulatory system. Banks that chose to be federally chartered were required to obtain regulatory approval on product offerings only at the federal level, while life insurers had to navigate 50 state insurance departments that had different statutes, procedures, and regulatory philosophies. Life insurers began calling for the option to choose a federal charter so that they could compete on a level regulatory playing field with the banks. European insurers also voiced support for a single federal point of entry and claimed the state-based system of regulation presented a trade barrier. Many property and casualty insurers have begun to more aggressively support this in recent years, as they want to be free of the state rate controls and have a desire for uniform regulations.

14. The Obama administration’s much more limited proposal for an Office of National Insurance, which despite provisions for dealing with identification of systemic risk factors, international insurance matters, and information gathering, does not provide for an OFC or federal regulation of domestic insurance matters for some companies and producers. Also, in contrast to the broad preemption of state insurance laws and regulations which is essential for the functioning of an OFC mechanism, the administration’s proposal also strictly limits federal preemption of state insurance matters, an approach consistent with strict limitation of preemption of state laws proposed for banking under the Consumer Financial Protection Agency Act (CFPAA) of 2009.

15. Edward B. Rust, Jr. and Kerry Killinger, *The Financial Services Roundtable Blue Ribbon Commission on Mega-Catastrophes, A Call to Action* (Washington, DC: The Financial Services Roundtable, 2007), <http://www.fsround.org/media/pdfs/FINALmegacat4.pdf>.

Optional federal chartering has not been able to generate the consistent support needed to make progress in Congress. The various sectors and associations within the insurance industry remain divided about the wisdom of this idea, though less so than in the past. Following the September 11, 2001 terrorist attacks and the decision of the federal government to offer federal reinsurance against losses due to terrorism through the Terrorism Risk and Insurance Act (TRIA), it seemed that the next step would be for Congress to expand its regulation of insurance. Senators Johnson (D-SD) and Sununu (R-NH) introduced the National Insurance Act of 2007, and Representatives Bean (D-IL) and Royce (R-CA) introduced H.R. 3200 in the House in July 2007. The bills, like others before them, provided for an optional federal insurance charter similar to the current system that exists in the banking industry. As in the past, these bills failed to generate momentum and stalled. However, the most recent financial crisis has again created a sense of urgency to address the issue.

4.1. The National Insurance Consumer Protection Act

IN MARCH 2009, Representatives Melissa Bean and Ed Royce introduced the National Insurance Consumer Protection Act (NICPA) to the 111th Congress with the stated purpose of “encourag[ing] innovation and competition by national insurers and national insurance agencies” (section 314). As of this writing, there has not yet been a companion bill introduced in the Senate. The NICPA combines the earlier calls for the OFC with the newer systemic risk regulator concept. A key difference between the earlier National Insurance Act and the recently introduced NICPA is that the “optional” portion would be removed for specified insurers. The NICPA would require that insurers designated as “systemically important” to be subject to federal regulation.

The NICPA Act calls for the following:

- The establishment of the Office of National Insurance (ONI) within the Department of the Treasury.¹⁶ The ONI would be funded by the col-

lection of assessments on national insurers at a level determined by the commissioner.

- The presidential appointment (subject to Senate confirmation) of a National Insurance Commissioner to lead head the ONI. The commissioner would oversee the organization, incorporation, operation, regulation, and supervision of the national insurers and insurance agencies, subject to oversight by the Secretary of the Treasury.
- The establishment of a Division of Consumer Affairs within the ONI.
- The designation of a Systemic Risk Regulator for covered institutions.¹⁷ The Systemic Risk Regulator would have the authority to obtain information on the activities of covered institutions and determine if they would have serious adverse effects on economic conditions or financial stability.

4.1.1. State Laws and the Rate Approval Process

UNDER THE NICPA (as introduced), federally chartered insurers would not be subject to licensing, examination, reporting, regulation, or supervision by state regulators.¹⁸ The act would subject national insurers to participation in state residual markets with one very significant exception: insurers would not have to participate if the state law “results in rates in effect for an assigned risk, mandatory joint underwriting association or any other mandatory residual market mechanism that fail to cover the expected value of all future costs associated with insurance policies written by such residual market mechanism.” That is, national insurers would not have to pay into state pools that do not charge actuarially sound rates. Furthermore, national insurers would not be required to participate if the state “[r]equires a national insurer to use any particular rate, rating element, price or form.” These exceptions could allow national insurers to avoid participating in many of the state residual markets. This would be a critically important issue for coastal states with large residual markets that rely on assessments upon insurers for financing catastrophic losses.

16. The Obama administration has recently submitted legislation, the Office of National Insurance Act of 2009, to establish an ONI in the Treasury with powers, among others, to collect and analyze information and handle an array of international insurance matters.

17. The president, after consultation with the chairman of the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, would be responsible for designating the Systemic Risk Regulator.

18. *National Insurance Consumer Protection Act* § 109.

The act states that “Except to the extent expressly provided in this act, national insurers, national insurance agencies, and national insurance producers shall not be subject under State law to any form of licensing, examination, reporting, regulation, or other supervision relating to the sale, solicitation, or negotiation of insurance, to the underwriting of insurance, or to any other insurance operations.”¹⁹ Under this act, national insurers would clearly not be subject to the authority of state legislators and regulators in regard to their operations.

The act would still allow state taxation of national insurers.²⁰ A national insurer would still be subject to the same state and local taxes, assessments, and charges as a state-chartered insurer, except for “special assessments and charges that fund services that the State does not provide with respect to the national insurer.” It is unclear to what extent this exception would reduce the obligations of national insurers to pay state premium taxes.

The NICPA would allow national insurers to develop and use their own policy forms as long as they file them with the commissioner and meet general policy requirements (a so-called “file and use” system). When developing the general policy requirements, the commissioner would be required to take existing NAIC standards, models, and practices into consideration when making decisions.²¹ The act would forbid the commissioner to require a national insurer to use any particular rate, rating element, or price. In effect, national insurers would be allowed to develop their own rates and would be required to file their policy forms before using.

4.1.2. Guaranty Associations

THE NICPA CALLS for the creation of a National Insurance Guaranty Corporation (sections 601–605). The commissioner would have the authority to appoint a receiver to a national insurer who is insolvent, has substantial dissipation of assets, and is unable to meet obligations. If a national insurer is placed in receivership for purposes of liquidation, claims would be paid in a manner consistent with the terms and limits of the Post-Assessment Property and Liability Insurance Guaranty Association Model Act of the NAIC. This model act limits property and casualty claims to \$300,000, as is common in most states.

19. *Ibid.*, § 701.

20. *Ibid.*, § 321.

21. *Ibid.*, § 312.

National insurers would be subject to assessment by the National Insurance Guaranty Corporation, and assessments would only be imposed when funds are actually needed, which follows the model used currently in most states. The amount of the assessment is not yet specified and would be determined by the director of the National Insurance Guaranty Corporation. The act would require national insurers to continue participation in state guaranty funds and subject them to an assessment equal to the rate of state chartered insurers.

It will certainly be unappealing to national insurers if they have to participate in both the federal and state guaranty funds. However, not having to participate in state funds would weaken the funds’ ability to pay claims since the large insurers have the greatest resources. If national insurers are ever allowed to disengage from participating in state guaranty funds, it will need to be a gradual process that allows for reduced annual obligations spread over the course of several years.

4.1.3. Anti-Trust Exemption

THE ACT RETAINS the current antitrust exemption for insurers obtaining federal charters. Section 702 specifies that the Sherman Act, the Clayton Act, the Federal Trade Commission Act, and the Robinson-Patman Act shall apply to national insurers, except as they relate to the development of standard insurance forms or to the activities incidental thereto, where consistency between competing companies is largely seen as beneficial to both insurers and consumers.

4.2. Benefits of Federal Regulation

PASSAGE OF THE National Insurance Consumer Protection Act would create uniform regulations for national insurers and would allow savings from the economies of scale and the reduction in redundant compliance costs. These savings could lower expenses for insurers and could lead to lower insurance premiums so long as national insurers are truly exempt from state regulation and not subject to dual regulation from both state and federal authorities.

A national insurance commissioner would be in a better position than state regulators to monitor systemic risk and focus on national trends rather than state-specific issues. Additionally, a national insurance commissioner would also be in a better position to regulate and monitor international insurers operating in the United States.

The availability of a federal option would enhance the ability of insurers to set the premiums guided by actuarial and scientific principles and allow insurers to compete in the marketplace. Current state rate suppression in hazard-prone regions causes insurers to withdraw from the market and minimize their exposure.²² This reduction in capacity forces property owners into residual markets that are often underfunded. National insurers who are able to use adequate premiums would reenter the market and increase the number of policy holders.

The proposed National Insurance Guaranty Fund would back national insurers who incur financial distress. Although the current state-based system has performed well over the years, there is concern regarding the ability to handle an extreme event (or events) leading to multiple large insurer solvencies. Although it is not a certainty, it is more likely that a national guaranty fund would be backed by the federal government (operating similarly to the Federal Deposit Insurance Corporation) than state guaranty funds, which are not (at least explicitly) federally backed. This could lead to faster claims payment and improved social resiliency. A potential unintended consequence is that agents and brokers representing national insurers who are competing against state-chartered insurers could use this as a competitive advantage when promoting their products.

4.3. Problems with Federal Regulation

THE CONSEQUENCES OF allowing an OFC are unknown. The track record of federal regulation is not particularly strong, and recent events in the financial sector have shown that federal regulators can become too closely aligned with the entities they regulate. One of the greatest potential problems arising out of this approach is that it will create competition between state and federal regu-

lators to attract insurers. Allowing the regulated entity to choose its regulator is dangerous and could lead to a race to the bottom. Alternatively, having an option could pressure state regulators who have behaved poorly or unprofessionally to modify their behavior for fear of being made irrelevant if insurers select the federal option.

The concept of requiring the vaguely termed “systemically important” insurers to obtain a federal charter is perilous. It may be impractical to pick such insurers as establishing fair and objective criteria may prove impossible. Insurers receiving this designation could be viewed as too big to fail and as a result take excessive risk and lose market discipline. (The federally regulated commercial banks are examples of this.) National insurers could have an unfair competitive advantage against state insurers who could be perceived as less reliable.

The NICPA would exempt federally chartered insurers from state rate regulation and calls for a move to an open-competition rating system where pricing is based on the insurers’ assessments of the risk and competitive forces rather than by the state authorities.²³ However, there is a risk that federal regulators would become overly influenced by residents in hazardous regions just as some state regulators have in the current system. Could this approach malfunction in the same way as the problematic states? It would be considerably more difficult for insurers to deal with a federal regulator implementing national changes than it is now when the problems are isolated to a handful of coastal states.

Based on the current form of the NICPA, national insurers would remain subject to state premium taxes to fund state insurance departments and assessments from state guaranty funds. Since national insurers would also be subject to assessment to fund the proposed Office of National Insurance, as well as assessments for the National Insurance Guaranty Fund, they would be subject to duplicative charges. National insurers would likely seek to disengage completely and avoid funding state programs in which they no longer participate and from which they no longer receive benefits. This would put a financial strain on these state programs.

22. Daniel Sutter, “Policy Uncertainty and the Market for Wind Insurance” (working paper, Mercatus Center at George Mason University, 2009), <http://www.mercatus.org/PublicationDetails.aspx?id=27434>.

23. Most hazard-prone states currently require insurers to obtain approval for rate changes prior to implementing them—a process that is influenced by substantial political pressure.

The NICPA would exempt insurers from participating in residual markets if those markets use inadequate rates.²⁴ This would be a critically important issue for coastal states with large residual markets that rely on assessments upon insurers for financing catastrophic losses. The national insurers are the entities with the greatest financial resources and the primary funders of the residual markets. The disengagement of national insurers could create a huge hole in the financing arrangement for some residual markets.

	STATE REGULATION	FEDERAL REGULATION
BENEFITS	<ul style="list-style-type: none"> Experienced Track record is as least as good as federal Responsive to local needs Opportunity for innovation and is a confined system in case it does not work out well 	<ul style="list-style-type: none"> Uniformity and reduction in compliance costs Better position to monitor systemic risk Better position to interact with international insurers Open competition rating National Insurance Guaranty Fund that could bolster financial support following catastrophic events
PROBLEMS	<ul style="list-style-type: none"> Lack of uniformity Not in good position to monitor system risk Not in good position to interact with international insurers Growth of residual markets Financing arrangements of residual markets Ability of guaranty funds to handle extreme events with multiple large insurer failures 	<ul style="list-style-type: none"> Unknown consequences Regulator shopping Create unfair competitive advantage Duplicate programs and funding requirements Impact on state residual markets

5 Recommendations

THE PURPOSE OF this paper is to assess the potential consequences of federal regulation, as opposed to the current system of state regulation, on property and casualty insurers and their abilities to provide coverage in hazard-prone regions. As discussed earlier, the social resiliency of a community is contingent upon reliable sources

of insurance coverage; to the extent that resilient communities are a desirable policy goal, it is important to understand how regulation and markets in insurance contribute to this end.

The current state-based system of insurance regulation has significant benefits as well as significant costs. If implemented, the NICPA would have a substantial impact on the insurance industry and would create new benefits, but it would also impose new costs and would likely create as-of-yet unforeseen problems. This section provides a series of recommendations for policy makers to consider when evaluating the insurance regulatory system with focus on enhancing social resiliency.²⁵

1. Minimize Political Risk

BROADLY, POLITICAL RISK refers to the complications businesses face as a result of political decisions, or any political change, that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives.²⁶ This is a legitimate concern to insurers since they are highly regulated and subject to the whims of state legislative bodies. Insuring against catastrophes is a complicated business and requires long-term planning; this becomes more difficult when the rules change and property owners and developers pressure legislatures and regulators to artificially depress insurance rates. Political risk causes insurers to become reluctant to commit resources and capital. If political risk can be reduced, insurers will be more likely to participate in the hazard-prone markets, which will strengthen social resiliency.

A federal approach should provide consistent direction instead of the current patchwork system of regulations that vary from state to state. The critical question is: would a federal approach offer more stability and be less reactionary than the current system? That is, would Congress and a national insurance commissioner be more insulated and able to take a longer-term view than state insurance commissioners (especially elected commissioners or those appointed by officials with aspirations to higher office)?

The stakeholders in the insurance industry have expressed mixed support for a federal approach, but the one outcome that everyone wants to avoid is regulation

24. National Insurance Consumer Protection Act § 109 and 701.

25. The recommendations are based upon the features of the initial version of the NICPA.

26. Eurasia Group and PricewaterhouseCoopers, *Integrating Political Risk into Enterprise Risk Management*, http://www.pwc.com/en_GX/gx/political-risk-consulting-services/pdf/prermfinal.pdf.

by both state and federal governments. Nearly everyone agrees that greater consistency and uniformity would yield benefits both to insurers and to policy holders, yet adding a federal regulator on top of the existing framework would lead to even more variability and increased political risk.

2. Allow Competitive Rating and Minimize Rate Suppression

THE PRIOR-APPROVAL RATE-APPROVAL process found in some of the hazard-prone states is costly and time consuming. The regulatory timeframe simply does not keep pace with the rapidly changing modern insurance marketplace. The recent increase in the cost of catastrophic reinsurance provides an example of the problem. Reinsurance premiums are based upon competitive forces and can change rapidly. After an active hurricane season, catastrophic reinsurance premiums can increase substantially, but insurers selling coverage in states with prior-approval laws cannot adjust their premiums to reflect their increased costs without first having to go through the approval process, which can take months or even years. As insurers are caught between the increased costs of reinsurance and the downward pressure on rates from regulators, they are unable to profitably provide the coverage, so they withdraw from the market.

If insurers are not allowed to earn premiums commensurate with exposure, they become reluctant to make coverage available to the higher-risk property owners. This lack of available coverage forces applicants into a residual market. This is particularly true of areas with catastrophic exposure such as hurricanes.

The NICPA would allow open competition to guide rating for national insurers, which would create a competitive pricing system that would end rate regulation for federally chartered insurers. National insurers would compete against each other and against state-chartered insurers that would still be subject to state rate regulation. Although there would very likely be struggles for high-risk property owners to begin paying premiums commensurate with their risks, it would lead to a more stable market in the long term and smaller residual markets.

Insurers should continue to be subject to strict regulation on policy forms covering residential property. Keeping policy language consistent allows consumers to shop based on price and reputation for service, finan-

cial strength, and the claims process. Coastal property owners already face a confusing situation in which they typically have to buy a homeowners policy (possibly excluding wind), a flood insurance policy, and then a wind/hail policy from the state residual market. Allowing companies to use unique forms of insurance would require consumer knowledge that exceeds the financial literacy of the vast majority of policy holders.

3. Minimize Immediate Impact on State Residents

IF THE NICPA were enacted in its current form, it would have a substantial impact on policy holders if large insurers opt to sell policies under a federal charter. The federal charter would allow national insurers to opt out of state regulation and possibly the residual markets. The catastrophe loss financing of residual markets is a major weakness in several of the most hazard-prone states. Post-loss assessments on insurers (based loosely upon market share) make up a key part of the financing plans. If the large insurers disengage, they would destabilize the state residual market plans.

Eventually, as national insurers were able to charge increased premiums, they would be willing to offer a source of coverage and the residual markets would shrink, but in the short term it could be chaotic. If a catastrophic event occurs during this time, residual markets will face a monumental challenge to obtain funds to pay claims. This could have a disastrous effect on social resiliency. A temporary federal backstop could stabilize the market in the short term. For example, Representative Ron Klein (D-FL) recently reintroduced the Homeowners Defense Act, which would essentially make the Treasury Department a reinsurer during massive events that have a half of a percent chance of occurring in any given year.²⁷ Representative Gene Taylor (D-MS) has introduced the Multiple Peril Insurance Act, which calls for expanding the National Flood Insurance Program to include wind losses in addition to flood.²⁸ While the costs of these approaches vastly outweigh their benefits, at least policy makers are considering the need to prepare for the aftermath of national insurers exiting residual markets.

The NICPA specifies that national insurers must continue paying state premium taxes. The operating costs of the proposed Office of National Insurance are also to be funded by assessments and fees imposed on national

27. HR 2555, 111th Cong., 1st sess. (2009).

28. HR 1264, 111th Cong., 1st sess. (2009).

insurers by the commissioner. The costs associated with the systemic risk regulator would also be supported by assessments on insurers subject to its overview. National insurers may resist being subject to multiple charges for both state and federal regulation. Since the majority of the state premium taxes go toward state general revenue and not just toward funding state regulators, it is important for policy makers to retain the requirement for national insurers to pay state premium taxes.

As the current proposal requires national insurers to continue to participate in state guaranty funds, these funds would not be adversely affected by insurers changing the source of their charters. However, there is concern that insurers would not want to continue to be subject to assessments for funding state guaranty funds while simultaneously contributing to the National Insurance Guaranty Associations. Without national insurers, the viability of state guaranty funds would be in jeopardy.

A national guaranty fund approach has elements that could help stabilize the insurance marketplace and enhance social resiliency. Perhaps most importantly, a national guaranty fund would be more likely to receive a federal bailout in the event of an extreme event than a state guaranty fund. If so, this would bring additional capacity to the market in the event of a mega-catastrophe that bankrupted a substantial number of insurers. The collective capacity of the state guaranty funds is estimated to be at \$7.4 billion per year,²⁹ and it is conceivable that an extreme event, or multiple events, could overwhelm the current system.

4. Maintain Antitrust Exemption

THE MCCARRAN-FERGUSON ACT not only declares states to be the primary regulators of insurance, it also provides a limited exemption for the “business of insurance” from federal antitrust laws. The proposed NICPA would allow this to apply to federally chartered insurers as well. While both acts allow insurers to share loss data and use standardized forms, the limited antitrust exemption does not extend to “any agreement to boycott, coerce or intimidate, or act of boycott, coercion, or intimidation.”

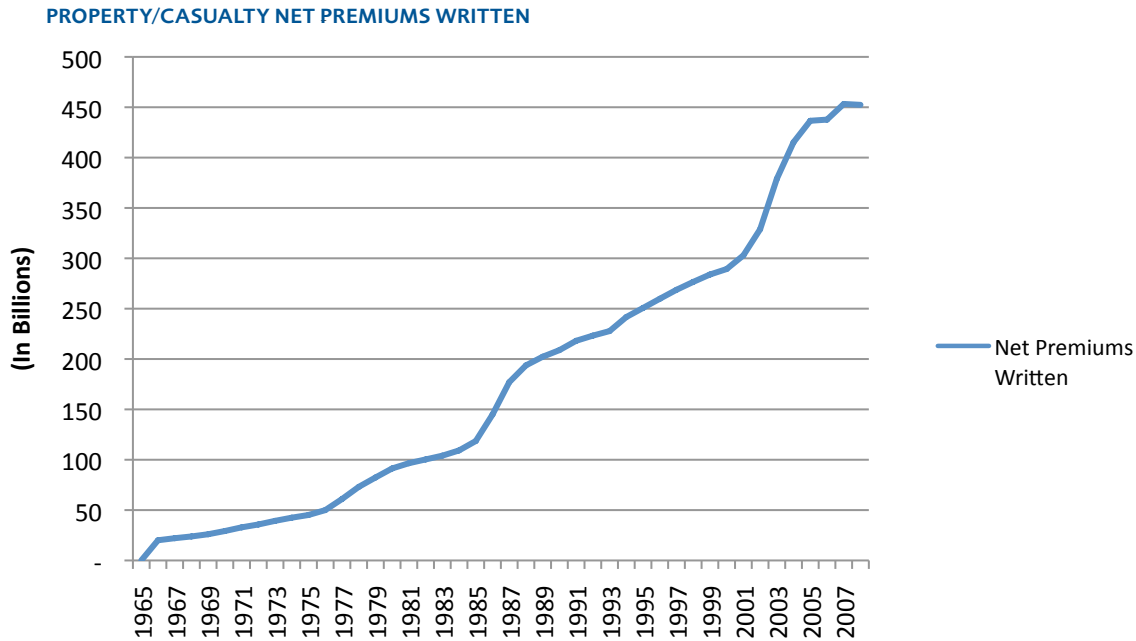
The purpose of the antitrust exemption is to allow many insurers (especially smaller, regional companies) to share actuarial information. Actuaries require large numbers of exposure units and comprehensive historical data to assess the risk properly and make accurate predictions, which are a prerequisite for stable insurance markets, reduced insolvencies, and greater price competition. The antitrust exemption permits the development of standard policy forms that would allow consumers to compare on an “apples to apples” basis. It also would make it easier for independent agents to obtain quotes from multiple insurers and would allow the consumer to choose a plan based on price and service, rather than attempt to decipher each insurer’s policy language.

The removal of the antitrust exemption would likely have a lesser impact on large, nationally chartered insurers than on smaller insurers because larger insurers have access to better proprietary data and consequentially do not rely as heavily on sharing information to make sound actuarial decisions. If the exemption were ever removed, it could put smaller, regional companies at a disadvantage compared to large, national insurers. It also would create a substantial errors and omissions exposure for the independent agents. The net result would be that consumers would face a less competitive market and have difficulty comparing different policies on an “apples to apples” basis.

Although it seems strange at first glance to give federally chartered insurers the antitrust exemption, it actually makes sense given the nature of insurance and would lead to a more competitive market.

29. Roger Schmelzer, President and CEO of the National Conference of Insurance Guarantee Funds, personal correspondence with author.

Appendix A: Growth of Property and Casualty Insurance Industry



Source: Best's Aggregates & Averages Property/Casualty, 2008 ed. Numbers have not been adjusted for inflation.

Appendix B: Top Writers of Homeowners Insurance (2008)

RANK	GROUP	MARKET SHARE (%)
1	State Farm Group	21.7
2	Allstate Insurance Group	10.8
3	Zurich Insurance Group (Farmers Insurance)	7.2
4	Liberty Mutual Insurance Group	5.0
5	Travelers Group	4.5
6	Nationwide Corp. Group	4.4
7	USAA Group	4.1
8	Chubb & Son Group	2.9
9	American Family Insurance Group	2.2
10	Hartford Fire & Casualty Group	1.7

Source: Insurance Information Institute, <http://www.iii.org/media/facts/statsbyissue/homeowners/>.

Appendix C: Insurance in the States

Florida

AFTER HURRICANE ANDREW, the residential property insurance market in Florida went from a highly competitive market to near collapse. In an attempt to provide a degree of stability, state legislators imposed strict regulations on insurers and greatly expanded the public sector's presence as a residential property insurer. To reduce exposure, insurers refused to renew thousands of policies and were very selective in providing new ones, which hampered economic development. They also recognized that they had underestimated the frequency and severity of hurricanes, resulting in under-pricing of insurance coverage. Though insurers requested approval for rate increases, the Florida Department of Insurance would not approve the full amount. The Department of Insurance was caught between the political pressure from consumers wanting lower rates and the economic reality that rate increases were needed. In just a few months, insurers switched from aggressively trying to write new business to taking drastic measures to reduce their market shares. As one would expect, this caused considerable angst among property owners, regulators, and legislators.³⁰

The limitation on rate increases removed the incentive for insurers to enter the market and provide coverage. The approved rate increases led consumers to complain that their residential property insurance was no longer affordable. In an attempt to manage the expanding market crisis, the Florida legislature created two state-sponsored programs in 1993: the Florida Hurricane Catastrophe Fund (Cat Fund) and the Florida Residential Property and Casualty Joint Underwriting Association. In 2002, Florida's governor signed legislation creating Citizens Property Insurance Corporation (Citizens) by merging the Florida Residential Property and Casualty Joint Underwriting Association, which provided homeowners property coverage statewide, and the Florida Windstorm Underwriting Association, which had provided wind-only coverage in designated coastal areas

since 1970. Citizens is a not-for-profit, tax-exempt government corporation whose public purpose is to provide policy holders with affordable property insurance protection.³¹ Following the reforms, Citizens provided wind coverage to those Florida homeowners in designated high-risk areas who were unable to procure policies in the voluntary market and offered multi-peril residential coverage in certain areas throughout the state.

During the 2004 and 2005 hurricane seasons, a total of eight hurricanes made landfall in Florida.³² These storms caused an estimated \$36 billion in losses based on approximately 2.8 million claims.³³ Citizens incurred billions in losses and required bailout funds from the state legislature as well as the authorization of emergency assessments on insurers and policy holders. A family with a residential insurance policy and two automobile policies could potentially incur three policy assessments: one each from Citizens, the Florida Cat Fund, and the Florida Insurance Guaranty Association.³⁴

The political uncertainty and the combative relationship between the governor and the insurance industry have discouraged national insurers and reinsurers from investing more capital into the market. Citizens's problems continue to worsen as it experiences significant growth and increasing exposure. Citizens remains the largest property insurer and is the primary source of coverage in the state because the standard market continues to withdraw. State Farm, the largest private insurer in the state, has announced it will drastically reduce its policy count over the next several years. Citizens's actuaries and executives testified before the 2008 legislature that their rates are substantially below what would be considered adequate. Furthermore, the rates had been frozen through the end of 2009. The capacity of both Citizens and the Cat Fund to pay claims is in question since the majority of its loss financing arrangements relies on a massive state bond issuance. The sheer size of the Cat Fund imperils Florida's fiscal condition. The largest state bond issue *anywhere in the country* to date has been \$11 billion. Florida's \$32 billion proposed issue would nearly

30. David C. Marlett, "The Expansion of the Public Sector's Role in Providing Windstorm Coverage in Florida," *CPCU Journal* 52, no. 2 (Summer 1999): 106–14.

31. Citizens Property Insurance Corporation, "Company Overview," <http://citizensfla.com/about/generalinfo.cfm>.

32. Hurricanes Charley, Frances, Ivan, and Jeanne in 2004; Hurricanes Dennis, Katrina, Rita, and Wilma in 2005. See National Weather Service, "National Hurricane Center Archive of Hurricane Seasons," <http://www.nhc.noaa.gov/pastall.shtml>.

33. Property and Casualty Insurance Reform Committee, *Property and Casualty Insurance Reform Committee Final Report and Recommendations*, November 15, 2006, 1.

34. Richard J. Fidei and Fred E. Karlinsky, "Florida Insurance Dilemma: Efforts to Manage the Unmanageable," *CPCU eJournal*, March 2009.

triple that and could only be paid with assessments on every insurance policy in the state.³⁵ Florida Representative Dennis Ross stated that a catastrophic event could translate into added expense of \$1,600 per year, per family assessed on auto and property insurance policies.³⁶ Even if the state were able to sell the bonds and use future assessments to repay them, it would be soaking up the capacity of funds needed to rebuild schools, hospitals, etc. If Citizens and the Cat Fund are unable to pay claims, it threatens the claims-paying capacity and solvency for the standard market. If insurers are unable to pay, the burden would be shifted to the Florida Insurance Guaranty Association, which would also rely on bond issuance and assessments on policy holders. The Florida insurance market is on the brink of collapse, which would devastate the social resiliency of the coastal communities.

Hawaii

THE MARKET DISRUPTIONS have not been limited to the U.S. mainland. Hurricane Iniki struck the Hawaiian Islands just weeks after Hurricane Andrew in 1992. Iniki was the most powerful storm to strike the Hawaiian Islands on record. After Hurricane Iniki, private insurance companies began to reduce their market shares in Hawaii in an attempt to limit their potential losses from future hurricanes. The 1993 Hawaii State Legislature created the Hawaii Hurricane Relief Fund (HHRF) to manage the shortage of homeowners insurance. The HHRF policy provided coverage only for hurricane damage and was designed to accompany a privately insured residential insurance policy, such as a homeowners policy, which covered non-hurricane wind damage. The state carved out the catastrophic risk and transferred it to the HHRF. As the private insurance market stabilized over the next several years, the need for the HHRF declined and the program was eventually discontinued. This program was successful because it did not compete with the private sector and only acted as a short-term measure to stabilize the market until insurers reassessed their exposure and were able to re-enter and offer coverage.

California

IN THE 1990S, insurance companies in California faced a combative regulatory environment, which, coupled with increasing exposure, led them to undertake efforts to reduce their market shares. This created a decrease in the supply of insurance coverage, a problem that grew dire when the Northridge Earthquake struck California in 1994 and caused \$19 billion in insured damage.³⁷ Given the extensive publicity of the damage, consumers were more aware of their exposure and attempted to obtain earthquake insurance. This led to an increase in the demand for the coverage, but the market was unable to reach an equilibrium that balanced the competing interests of insurance companies, regulators, and the public.

The California legislature established the California Earthquake Authority (CEA) in 1996 as an attempt to provide an affordable source of basic coverage. State lawmakers, the insurance commissioner, representatives of the insurance industry, and consumer groups negotiated the stakeholders' financial obligations. The result was a privately funded, publicly managed earthquake risk pool designed to revitalize the residential property insurance market.³⁸ The goal of the CEA is to stabilize the California residential property insurance market by separating the undesirable earthquake peril from the remaining insurable perils. The legislation requires that the CEA adopt actuarially justified rates, although that term is at times subject to interpretation and manipulation. Residents in higher-risk areas do pay a higher premium than those in more stable areas. If the rates prove to be inadequate, the CEA would use a combination of insurance industry contributions, reinsurance, bonds, and debt to fund any revenue shortfalls.

Seismologists with the United States Geological Survey believe that another earthquake at least as powerful as Northridge will occur within the next two decades.³⁹ Despite the clear risk and a source of coverage, still less than 15 percent of California homeowners purchase earthquake insurance.⁴⁰ The problem begins with the homeowners' view that the CEA coverage is costly

35. Eli Lehrer, *First Steps toward Restoring Florida's Insurance Market*, The James Madison Institute Policy Brief no.3 (Tallahassee, FL: The James Madison Institute, March 2008), <http://www.jamesmadison.org/pdf/materials/625.pdf>.

36. "National Study Focuses on Florida's Insurance Crisis," *Insurance Journal*, Southeast News, February 5, 2008, <http://www.insurancejournal.com/news/southeast/2008/02/05/87013.htm>.

37. Insurance Information Institute, "Earthquakes," <http://www.iii.org/media/facts/statsbyissue/earthquakes/>.

38. According to Richard Weibe, spokesman for California Insurance Commissioner Chuck Quakenbush, "Once the CEA is up and running, there will be a healthy homeowners market again, and that is critically important if our economy is going to continue its recovery." Reuters MSNBC, November 30, 1996.

39. U.S. Geological Survey, "Earthquake Hazards Program," <http://earthquake.usgs.gov/>.

40. Insure.com, "Get the Facts on Earthquake Insurance," <http://articles.moneycentral.msn.com/Insurance/InsureYourHome/GetTheFactsOnEarthquakeInsurance.aspx>.

and inadequate.⁴¹ Not only is there concern that it is too expensive, it has a 10 to 15 percent deductible based on the insured value of their homes. Given that property owners must incur substantial damage before coverage, many prefer to give up their equity (if they have any) in their home and simply default on the mortgage and walk away from the property. This leaves the lenders with a pile of rubble and little hope of financial recovery, effectively transferring much of the earthquake risk to the lenders and holders of collateralized debt. This would threaten the social resiliency of a community since abandoned properties will not be rebuilt in a timely manner.

Beach Plans and Wind Pools

IN ADDITION TO the programs in Florida, six other Atlantic and Gulf states have legislatively mandated programs designed to provide coverage for coastal properties.⁴² Although they go by different titles (such as “beach plans,” “wind pools,” “underwriting associations,” etc.), the basic function is the same. These programs provide a market of last resort to property owners unable to obtain wind and hail coverage from the standard market. Residents and business owners in designated areas are eligible to purchase the coverage, which no rational standard insurer would write in such high-risk areas at a rate acceptable to the public. To remain solvent and financially responsible, an insurer must charge a rate that is adequate to cover their operating expenses, predicted losses, reinsurance costs, and also establish a reserve to pay for the unexpected catastrophic events. So how are these residual markets able to insure something that the private sector views as impossible? The answer is that the residual markets are not constrained by the need to have adequate rates. Evidence that residual markets charge below-market premiums comes from the assessments levied after a major hurricane.⁴³ While insurers must maintain adequate reserves and have their financial condition closely examined by rating agencies and regulators, the residual markets do not. Political pressure and the desire to keep rates affordable heavily influence the rate levels implemented by residual markets, which are able to ignore the economic necessity of rate adequacy faced by insurers.

North Carolina

RESIDENTS OF NORTH Carolina have been spared the catastrophic events that have occurred in many of the other coastal states. Hurricanes Bertha and Fran in 1996 and Floyd in 1999 each caused substantial damage, but not on the scale experienced in Florida, Mississippi, or Texas. Despite the relatively mild loss experience, North Carolina is experiencing a market crisis along the coast and has a woefully underfunded residual market. Much of the problem lies with the unusual regulatory environment and the efforts of state legislators to keep insurance rates artificially low to encourage coastal development.⁴⁴

North Carolina employs a *prior-approval* rating system for residential property insurance. With this kind of system, insurance companies coordinate their efforts through the North Carolina Rate Bureau to file standard rates with the Department of Insurance. State legislators granted the bureau its authority, with the principal function to establish, subject to the approval of the commissioner, standard forms and rates. All of the insurance companies licensed to write residential property coverage in North Carolina must subscribe to and be members of the bureau, and all rate increases are subject to the insurance commissioner’s approval. During the last decade, insurers have not been able to obtain approval for the full amount of the requested rate increases, primarily in the coastal counties. Rate suppression causes insurers to become more selective in who they are willing to insure. Higher-risk property owners are then unable to obtain coverage from the standard market, forcing them to seek coverage from the residual market. As more property owners turn to a residual market, the exposure increases and it becomes more difficult to administer the plan and responsibly prepare for potential catastrophic events. This is exactly what is happening in North Carolina

North Carolina has two residual markets: the North Carolina Joint Underwriting Association (NCJUA) and the North Carolina Insurance Underwriting Association (NCIUA). The NCJUA, often referred to as the FAIR Plan, and the NCIUA, commonly called the Beach Plan, are administered jointly and share the same mission statement.⁴⁵ The overwhelming bulk of the exposure

41. “Insurance Assurance,” *Los Angeles Times*, April 9, 2009, <http://www.latimes.com/news/opinion/la-ed-quake9-2009apr09,0,5129038.story>.
42. The states are Alabama, Louisiana, Mississippi, North Carolina, South Carolina, and Texas. Virginia coastal property owners are insured through a Fair Access to Insurance Requirements (FAIR) plan.
43. Sutter, *Ensuring Disaster*.
44. For an additional analysis of insurance markets in North Carolina, South Carolina, and Virginia, see David C. Marlett, “Insuring Coastal Properties in the Mid-Atlantic Region,” *Journal of Insurance Regulation* 27, no. 3 (Spring 2009).

is in the Beach Plan,⁴⁶ and it has been growing at a rate of \$1 billion per month over the last several years. The Beach Plan offers generous coverage through a homeowners policy and provides a deductible that is lower than what is found in the standard market. The state legislature expanded the eligibility standards and coverage territory in 1999 and also required the Beach Plan to offer a homeowners policy starting in 2003. In March 2009, the Senate introduced a bill to impose a stay on further rate increases and to maintain fixed deductibles instead of matching the percentage deductibles that are offered by the standard insurers.

The rapid development along the coast, coupled with the actions of the state regulators and legislators, have pushed the coastal insurance market in North Carolina to the brink of collapse. The Beach Plan is woefully overexposed and underfunded. The Beach Plan will rely on accumulated surplus, reinsurance, and assessments on insurers to provide funds needed to pay claims following a severe storm. The 100-year PML will require billions in assessments on standard insurers, which could drive some to insolvency. The insurers will pass this cost along to their policy holders in the form of higher rates; hence all property owners in the state will subsidize the reconstruction of the coast. The uncertainty regarding the loss financing, and the likely delays, will hinder the ability of the coastal communities to recover.

South Carolina

THE REGULATORY ENVIRONMENT in South Carolina has at times mirrored that of North Carolina. As in North Carolina, insurers in South Carolina were bound to using bureau rates following the enactment of the McCarran-Ferguson Act in 1945. Proponents supported this approach because individual insurers lacked the ability to develop and implement accurate rates on their own. As insurers became more sophisticated and a more modern market developed, many states allowed insurers to have greater flexibility in their pricing structure and move toward a more open market. South Carolina

(like North Carolina) did not move in this direction. Instead, it retained tight prior-approval requirements and attempted to use legislation to deal with the resulting market dysfunctions.

The *prior-approval* regulations were replaced with a banded *file-and-use* approach under the Property and Casualty Insurance Personal Lines Modernization Act of 2004.⁴⁷ This rating flexibility allows insurers to increase or decrease their rates by up to 7 percent in a 12-month period. If insurers wish to deviate by an amount greater than 7 percent, then the South Carolina Department of Consumer Affairs must review the filing. If needed, an administrative law judge (not the Director of Insurance) acts as a hearing officer in rate-review hearings. The rates are effective within 30 days without prior approval of the Director of Insurance as long as the market is designated “competitive.” The state code of laws describes the elements of a “competitive” market.⁴⁸ If the market is deemed to be non-competitive, then the flex-band file-and-use approach is modified and additional information supporting the requested rate change could be required. Based upon the assessment by the Director of Insurance, the homeowners insurance market in South Carolina is competitive.

The South Carolina legislature created the Wind and Hail Underwriting Association (SCWHUA) in 1971. Commonly referred to as the “Wind Pool,” SCWHUA is the residual property insurance market in South Carolina and provides coverage for the perils of wind and hail in the coastal area of the state as defined by state law. All property and casualty insurance companies conducting business in the state are required to participate in funding the plan and share in any losses or profits.⁴⁹

In 2008, the SCWHUA had \$13.2 billion in total insured value based on 32,036 policies in force. The 100-year PML is approximately \$1 billion. The exposure is growing in part due to the expansion of the eligible territory in May 2007. There was a great deal of political pressure to expand the coverage territory that was originally

45. See NCJUA/NCIUA, “Our Mission,” <http://www.ncjua-nciua.org/>. “North Carolina Joint Underwriting Association (NCJUA) and North Carolina Insurance Underwriting Association (NCIUA) are insurance industry supported organizations committed to providing a basic property insurance market to protect policy holders while offering quality products and services to producers and insured, as well as protecting the assets of our member companies.”

46. The combined insured value of the residual markets is approximately \$73 billion dollars as of March, 2009. The 100-year PML is \$3.8 billion, up from \$1.4 billion in 2004. See NCJUA/NCIUA, “Financials,” <http://www.ncjua-nciua.org/html/fin.htm>

47. *South Carolina Code of Laws* § 38-73-220, “Approval Process for Rate Level Changes.”

48. *South Carolina Code of Laws*, § 38-73-230.

49. South Carolina Wind and Hail Underwriting Association, “About Us,” www.scwind.com/about.html.

established in 1971 since the development of the coastal area expanded. Since insurers can only exclude wind and hail in the SCWHUA territory, coastal residents lobbied for an expansion. It is typically less expensive for a consumer in the coastal region to purchase a homeowners policy (excluding wind) and a wind and hail policy from the SCWHUA than to purchase the entire coverage from a surplus lines company. The Omnibus Coastal Property Insurance Reform Act of 2007 expanded the SCWHUA coverage territory and divided it into two zones. The legislation also allows the creation of catastrophe savings accounts for homeowners. The contributions are tax deductible and the funds build tax free. The accounts can be used to fund higher deductible levels, which lower the exposure to the SCWHUA. There has not been much use of these accounts thus far. The legislation also makes state income-tax credits available to consumers for costs associated with wind mitigation. Effective mitigation efforts can reduce the exposure as well. Lastly, it clearly mandates that SCWHUA rates must not be competitive with the standard market.

As mentioned earlier, the 100-year PML is \$1 billion. Member companies share in the losses and expenses of the SCWHUA and their level of participation is initially based on their market share in the state. This amount is modified through credits earned by voluntarily providing coverage along the coast. The Emergency Special Assessments can be issued if needed and insurers must pay within 15 days of notification. Fortunately for the member companies, the use of assessments is limited due to the prudent purchase of adequate reinsurance. The SCWHUA has purchased \$1.5 billion in reinsurance protection with retention of approximately \$470 million. The rates that are approved by the state are adequate to purchase reinsurance protection well in excess of the 100-year PML and equal to the 150-year PML. The retention would be funded through a combination of cash reserves and assessments. Hence, it is clear that the SCWHUA relies primarily on reinsurance protection and to a lesser degree on assessments and accumulating a reserve fund. Insurers certainly prefer this approach to one that has an over-reliance on assessments.

Virginia

THE REGULATORY ENVIRONMENT in the Commonwealth of Virginia is quite different from that of North Carolina, but somewhat similar to that of South Carolina. In

Virginia, the Bureau of Insurance is subject to the oversight of the State Corporate Commission (SCC). The SCC acts as one of Virginia's primary regulatory agencies, with oversight of varied business and economic interests throughout the commonwealth. The SCC's authority encompasses not only insurance, but also utilities, state-chartered financial institutions, securities, retail franchising, and railroads. Three SCC commissioners (judges who are appointed by the General Assembly) appoint the commissioner of insurance. This is in contrast to states like North Carolina where the insurance commissioner is elected by the public. This is also unlike South Carolina, in which the insurance commissioner is appointed by the governor. Proponents of this approach contend that this insulates the regulator from public pressure and reduces the incentives for political manipulation.

The philosophy regarding rate regulation is also in stark contrast to that of North Carolina. In Virginia, the regulatory focus is on standardizing forms and then allowing competition in the marketplace to establish the appropriate rates.⁵⁰ Virginia adopted a file-and-use rate filing process in the 1970s (before that, a prior-approval approach was used). As long as the market is deemed to be competitive, the Code of Virginia allows competitive rating.⁵¹ In title 38.2, chapter 19, it is quite clear that regulation should focus on fostering a competitive environment and that will in turn produce rates that "protect policy holders and the public against the adverse effects of excessive, inadequate, or unfairly discriminatory rates." The chapter goes on to specify that regulators should "authorize cooperative action among insurers in the rate making process, and regulate such cooperation in order to prevent practices that tend to create monopoly or to lessen or destroy competition; and provide rates that are responsive to competitive market conditions and improve the availability of insurance in this Commonwealth." Allowing the insurers to set rates according to risk characteristics in a competitive market will minimize availability and affordability problems. Even with this approach, there will still be a small percentage of property owners who are uninsurable by the private sector.

Despite the substantial values along the coast, there is no beach plan or wind pool in Virginia. Instead, the residual market in Virginia is organized as a traditional FAIR plan called the Virginia Property Insurance Association (VPIA).⁵² The purpose of the residual market is estab-

50. "Purposes of Chapter," *Virginia Code* § 38.2-1900. B. 1; "Rate standards," *Virginia Code* § 38.2-1904.

51. "Filing and use of rates," *Virginia Code* § 38.2-1906.

lished in the state statutes.⁵³ The VPIA plan has market penetration of less than 1 percent of statewide property coverage. What is remarkable is that there is very little coastal property insured (less than 100 policies). The 100-year PML is only \$34.5 million. Recall that the North Carolina residual market has a 100-year PML of \$3.9 billion. Both states have similar coastal values, and yet markedly different approaches to insuring. Given the relatively minor 100-year PML, arranging loss financing is not a major issue. The VPIA purchases reinsurance coverage to a substantial portion of the PML, but also relies on accumulated reserve funds and the ability to assess. Given the very limited exposure, this does not present a threat to the financial condition of member companies. The VPIA truly functions as a market of last resort. The regulators foster a market based on competition and insurers willing to provide coverage. The state also has a healthy surplus lines market that can provide even better coverage than what is found on the homeowners policy, and certainly better than the dwelling coverage offered by the VPIA.

52. Virginia Property Insurance Association, <http://www.vpia.com/>.

53. See "Establishment of residual market facility," *Virginia Code* § 38.2-2702: "A residual market facility shall be established and maintained by all insurers licensed to write basic property insurance or other insurance containing a basic property insurance component. The plan of operation of the residual market facility shall be subject to approval by the Commission."



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3301 North Fairfax Drive, Suite 450
Arlington, Virginia 22201
Tel: (703) 993-4930
Fax: (703) 993-4935