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Robert Detlefsen is Vice President of Public Policy at the National Association of Mutual Insurance Companies (NAMIC), an Indianapolis-based national trade association that represents more than 1,400 property-casualty insurance companies. In this role, Detlefsen conducts public policy research and analysis, and coordinates the development of NAMIC's issue agenda and advocacy campaigns.

Detlefsen's analyses and commentaries have appeared in scholarly journals, specialized insurance publications, and a variety of newspapers and magazines. He is a coauthor of *The Future of Insurance Regulation* (Brookings Press, 2009) and author of *Civil Rights Under Reagan* (ICS Press, 1991). He has testified on numerous occasions before state legislative committees and regulatory bodies.

Detlefsen holds a Ph.D. in political science from the University of California, Berkeley, and a B.A. in political science from the University of Massachusetts, Amherst. He has served on the faculties of several colleges and universities, teaching courses in American government, constitutional law, and political theory.

NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Statement

of

Robert Detlefsen

Vice President – Public Policy

on behalf of the

The National Association of Mutual Insurance Companies

to the

Oversight and Investigations Subcommittee

of the Committee on House Financial Services

U.S. House of Representatives

"The Homeowners Insurance Crisis:

Solutions for Homeowners, Communities, and Taxpayers"

JULY 2, 2009

Good morning Chairman Moore, Ranking Member Biggert, and Members of the Subcommittee. My name is Robert Detlefsen. I am Vice President of Public Policy for the National Association of Mutual Insurance Companies (NAMIC). Founded in 1895, NAMIC is a property and casualty insurance association, whose 1400 members underwrite more than 40 percent of the property/casualty insurance premium written in the United States. I am grateful for the opportunity to testify this morning on a subject that poses an enormous challenge to the insurance industry and our nation as a whole.

It is widely acknowledged that property insurance has become more expensive and somewhat less available in the coastal regions of the U.S. The private sector and government can and should work together to address problems of insurance availability and affordability in these areas. However, we must be careful that any expansion of the federal government's role does not artificially suppress insurance rates, crowd out the private insurance market, and encourage unwise residential and commercial development in high-risk coastal regions.

The Problem of Coastal Insurance

Three simple facts help define the problem of coastal insurance:

1. The exposure of densely concentrated, high-value properties to elevated levels of catastrophe risk in certain geographic regions. This means that

property insurance in these regions will be relatively expensive compared to others with lower risk.

2. As population growth and commercial development in catastrophe-prone regions increases, the number of people and businesses faced with relatively high insurance costs will naturally increase as well.

3. The Atlantic and Gulf coastal regions of the U. S. have experienced increased population growth and commercial development at a time when the frequency and severity of catastrophic storms in these regions is increasing.

Factors Influencing the Availability and Affordability of Coastal Insurance

Simply put, the availability and affordability of property insurance in coastal regions is mainly a function of risk. But other variables, including actions taken by governments and *post hoc* reinterpretations of insurance contract language by courts, can also affect the supply and cost of insurance. The availability and affordability of coastal property insurance are particularly influenced by the following factors:

Frequency and Severity of Major Coastal Storms

In 2005 three Gulf Coast hurricanes killed more than 1,400 people and caused more than $180 billion in insured losses and federal disaster relief. Since 2005, property insurance prices in coastal areas have increased because of what the 2005 hurricane season portends for the future.

Coastal Development and Population Growth

The fact of the matter is that the areas most at risk of increased storm activity contain a disproportionate share of the nation's population, as well as its most valuable real estate. What is more, the movement of people and wealth from interior regions with relatively little catastrophe risk to coastal regions with the highest levels of catastrophe risk continues to increase even as the likelihood of severe coastal hurricane activity increases. According to the U.S. Census Bureau, Florida will experience significant population growth every year between now and 2030, by which time the state will have added more than 11 million new residents. That is equivalent to the entire current population of Ohio moving to Florida over the next 21 years. In 2015 —just six years from now—Florida will surpass New York as the nation's third most populous state.

Consider just this one dramatic example. The Great Miami Storm of September 18, 1926, a Category 4 hurricane with 145 mile per hour winds, caused $42 billion in economic damages (in today's dollars), according to the web site www.icatdamageestimator.com. Because of the enormous growth in population and wealth of Miami since then, were a similar storm to strike Miami today, the web site estimates that it would cause $180 billion in damages.

State Regulation

Many states in catastrophe-prone coastal regions, including Florida, impose rating and underwriting restrictions on property insurers that act as price ceilings on coverage. Many state officials believe that insurance rate suppression, which allows high-risk property owners to pay artificially low premiums, is the answer to the property insurance “affordability problem” in catastrophe-prone areas.

While rate suppression lowers the “price” of insurance in the short term, it has long term consequences that are far worse for consumers. First, rate suppression lowers prices for people living in high-risk regions at the expense of insurance consumers in low-risk regions, forcing people living in low-risk regions to pay inflated prices in order to subsidize the insurance costs of those in high-risk regions.

Second, rate suppression encourages rapid population growth and economic development by distorting the public’s perception of risk. The growing concentration of people and wealth in high-risk regions will continue to drive up the cost of insuring those regions and further adding to the problem.

Federal and state governments end up bearing the cost by paying for disaster aid to repair properties that might never have been built in the first place. Risk-based insurance pricing alleviates this problem by sending accurate signals to consumers about the relative level of risk associated with particular regions and types of structures.

Rate suppression and underwriting restrictions are also largely responsible for insurance availability problems in coastal areas. Like any other business enterprise, insurers must charge a price that covers the cost of the good or service they provide. But if government rate regulation prevents insurers from covering their claim costs and replenishing surplus reserves to pay future claims, they may have no choice but to exit the market, as we have seen recently in Florida.

Litigation and the Viability of Insurance Contracts

For more than 30 years, the standard American homeowners insurance policy has contained a provision that excludes coverage for damage caused by flooding. Throughout this period, flood coverage has been provided almost exclusively by the federal government through the National Flood Insurance Program (NFIP).

Nevertheless, after every major disaster involving extensive flooding, attorneys take aim at the flood exclusion in homeowners policies, looking for ways to overcome decades of legal precedent. Sometimes they succeed, causing insurance companies to re-examine their policies and make adjustments so that the policy language is as clear and unambiguous as possible in stating that damage due to flood is not covered. They then file those policy contract forms with state insurance regulators and negotiate the terms until they can obtain official approval and issue them to policyholders.

Such was the case in Mississippi, Louisiana, and the other states hit by the 2005 hurricanes. And when it developed that many homeowners whose properties were damaged or destroyed by hurricane-related coastal flooding had not purchased federal flood insurance (or had not purchased enough to cover their losses), class action attorneys, joined in this instance by the Mississippi Attorney General, filed dozens of lawsuits in which they tried to persuade judges to abrogate the flood exclusion and force insurers to retroactively provide coverage for which they collected no premium. This type of litigation is a cost of doing business in certain areas and has an affect on the whether a company decides to serve those areas or not.

The Example of Florida

Florida lawmakers passed, and Gov. Charlie Crist signed into law, HB 1495, allowing Citizens to increase premium rates, by 10 percent, for individual policyholders each year until actuarially sound levels are attained. Additionally, this bill increases rates and lowers coverage amounts over time for the Florida

Hurricane Catastrophe Fund. The changes HB 1495 brings are encouraging. Not only does it put Citizens on a path to appropriately matching rate to risk, it puts the entire state on the path to better financial preparation for future storms.

However, Florida failed to pass HB 1171 which would have allowed Floridians the option to choose between rate-regulated property/casualty insurers and a select group of well-capitalized, mostly nationally recognized carriers exempt from price controls. While this bill should have been applied to all insurers, it was another step to improve the market in Florida.

Although Gov. Crist chose to veto the bill despite consumer support, the swift passage through the state legislature reflects the growing understanding of legislators of the importance in keeping a vibrant marketplace that provides choices for consumers. As reported in the *Tallahassee Democrat*, “New capital and new companies are important, because the state's insurer of last resort, Citizens Property Insurance Corp., is so underfinanced that it couldn't possibly pay off claims in the event of major storm damages.”

The Wall Street Journal, in an editorial published on June 29, 2009, summarized the approach that Governor Crist chose when he vetoed HB 1171:

> Mr. Crist and the media portrayed the reform as a giveaway to the big insurers, and the Governor claims people can't afford "large and unpredictable" increases in premiums. The truth is large increases are

> precisely what is sometimes needed to cover the risk of living on coastal property. Mr. Crist's program makes the long-term losses much more severe because cut-rate insurance has encouraged overbuilding in coastal areas that are historically in the path of hurricanes. "We are one major hurricane away from an economic disaster in this state," says House bill sponsor William Proctor.

The state's opinion leaders agreed as well and in an editorial published on June 25, the *Tallahassee Democrat* urged the Florida Legislature to take the unusual step of coming back into session for the express purpose of overriding the governor's veto of HB 1171.

The Affordability Problem: What We Can Do

Last month, MIT Press published an important new book, *At War With the Weather: Managing Large-Scale Risks in a New Era of Catastrophes*, which has been hailed by Terri Vaughan, CEO of the National Association of Insurance Commissioners, as "essential reading for anyone searching for solutions to the problem of financing large-scale catastrophes." Authored by a team of distinguished insurance scholars from the Wharton School and Georgia State University, the book identifies "two key principles" that should guide insurers and policymakers as they grapple with natural disaster insurance availability and affordability issues. NAMIC believes that these principles provide Congress with a solid foundation from which to develop innovative solutions and avoid costly mistakes. The two principles are:

- *Risk-based Premiums:* Insurance premiums should be based on risk to provide signals to individuals as to the hazards they face and to encourage them to engage in cost-effective mitigation measures to reduce their vulnerability to catastrophes.

- *Dealing with Equity and Affordability Issues:* Any special treatment given to lower income residents in hazard-prone areas who cannot afford the cost of living in those locations should come from general public funding and not through insurance premium subsidies.

The book's authors recognize, as does NAMIC, that a market-based insurance pricing system in which premiums reflect the actual cost of insuring against catastrophic risk could result in significant premium increases for some property owners in high-risk regions. In lieu of cross-subsidization through rate suppression and taxpayer-funded government insurance schemes, policymakers should consider creating programs to provide direct government assistance, funded from general revenue, to particular consumers based on criteria established through a transparent decision-making process.

The federal government has a long history of designing and administering programs that provide grants and other forms of direct financial assistance to individuals on a means-tested basis for the purchase of essential goods such as food and shelter. For example, the government responds to the inability of some individuals to afford basic food staples, not by capping the price of groceries or creating government-run food stores, but by providing food stamps to low-income individuals that can be used to purchase food items from private vendors.

Congress could provide a similar form of aid to selected property owners for the purchase of insurance. Such an approach would have many advantages over the current system of generalized rate suppression and cross subsidization, not the least of which is that the assistance could be targeted to particular individuals based on financial need. Moreover, its availability could be limited to those currently residing in disaster-prone areas, and would thus avoid creating incentives for people not currently living in those areas to move into harm's way.

NAMIC's Reform Agenda and Federal Legislation

In 2006, a NAMIC Task Force issued a "Statement of Principles on Natural Disasters" (a copy of which is attached) that laid out an agenda for improving the ability of insurers, property owners, and government to manage and finance future natural disasters.

NAMIC readily acknowledges that a genuine mega-catastrophe comparable to the 1926 Miami hurricane striking heavily populated areas could potentially exceed private market capacity. To prepare for a disaster of this magnitude, it is appropriate for policymakers to consider whether government programs should be created to supplement the supply of private sector capacity. At the same time, we believe the Florida example should serve to caution lawmakers against creating a national catastrophe reinsurance program that unintentionally creates incentives for Americans to migrate from regions with relatively little exposure to catastrophe risk to coastal regions with the most frequent and severe hurricanes. The federal government should be careful not to subsidize states that enact disaster insurance "reforms" by transferring the cost of such measures to federal taxpayers.

The NAMIC Statement of Principles seeks to establish a proper balance between the roles of the private insurance sector and governments in order to send the proper signals to discourage development and/or mitigate its effects in dangerous areas while addressing affordability issues for low-income people already living in areas prone to natural catastrophes. The principles are as follows:

1. Market freedom and competitive pricing will lead to innovation in developing solutions to problems relating to disaster insurance and mitigation.
2. Competitive pricing and risk-based underwriting are essential to developing and maintaining a viable disaster insurance market.
3. Mitigation must be an indispensable aspect of any disaster risk management and insurance initiative.
4. The National Floor Insurance Program should be maintained, but must be reformed.

With the Congress absorbed with health care reform, energy, and financial regulatory reform legislation, there has been little time for consideration of natural catastrophe issues. As you know, it now appears as if the House and Senate will just extend, rather than reform, the NFIP this year.

Recently, Rep. Klein, D-D-Fl., introduced H.R. 2555, the Homeowners Defense Act of 2009. NAMIC commends Rep. Klein and the bill's cosponsors for keeping the Congress' attention focused on this important issue.

The bill would provide for mitigation grants to prevent and mitigate losses from natural catastrophes, which NAMIC believes is a key for property owners to reduce their exposure to catastrophe risk and a good way to reduce their insurance premiums. The larger the grant program, the more effective it will be.

NAMIC opposes the portions of the bill that seek to build on state catastrophe funds. As with Florida's programs, we believe such mechanisms invariably result in cross-subsidies by those not in risk-prone areas to those in risk-prone areas, under price the cost of insurance, and discourage private sector participation. To establish a federal debt guarantee program of obligations issued by state catastrophe funds on top of such a faulty floor would only aggravate the underlying problems.

NAMIC is also concerned that the federal natural catastrophe fund that the bill would create would crowd out the private reinsurance market; whether a 1 in 200 year event attachment point is high enough to warrant a federal reinsurance backstop; and whether a federal reinsurance program should be premised on flawed state reinsurance funds.

As for other legislative proposals, NAMIC strongly supports H.R. 2246, the Community Building Code Administration Grant Act, introduced by Congressman Dennis Moore, D-Kan and included as part of the climate change legislation passed by the House of Representatives on June 26, 2009. By providing $100 million a year for five years in federal grants to building departments, it will help local governments hire, train and equip code officials, including building and fire inspectors. More effective enforcement of building codes will improve safety for those residing in disaster-prone areas.

NAMIC also supports H.R. 2592, the Safe Building Code Incentive Act, introduced by Congressmen Mario Diaz-Balart, R-Fl, and Michael Arcuri, D-NY. The bill would amend the Robert T. Stafford Disaster Relief and Emergency Assistance Act to authorize the President to increase the maximum total contribution for a major disaster by 4 percent of the relief grant, if the affected state has in effect and is actively enforcing a nationally recognized statewide building code. As with H.R. 2246, this legislation would improve building safety for those living in disaster-prone areas.

Furthermore, the NAMIC Statement of Principles recognizes that there are low-income people living in such areas who simply cannot afford the premiums. Rather than distorting insurance markets to address this problem through rate suppression – and undermining the important signals sent by insurance pricing – NAMIC supports direct federal subsidies to existing low-income residents of such areas.

In conclusion, NAMIC realizes that the property owners, insurers, mortgage lenders, realtors, and home builders that live and do business in coastal areas will face serious challenges in the years ahead. We believe that the most effective mechanism for addressing these challenges is a private insurance market whose defining characteristics are open competition and pricing freedom. Congress can play a constructive role by reforming the National Flood Insurance Program, creating incentives for states to enact and enforce effective statewide building codes, and providing targeted grants that would enable low-income property owners to pay risk-based property insurance premiums.

NAMIC STATEMENT OF PRINCIPLES ON NATURAL DISASTERS

Introduction

The havoc wreaked by the 2005 Gulf Coast hurricanes has raised important questions about how Americans should prepare for and respond to natural disasters in the future. The likelihood of more frequent and severe natural disasters in the near term, combined with the continuing concentration of the country's population in areas vulnerable to natural disasters, pose significant challenges for government policymakers, insurers, realtors, home builders, mortgage lenders and property owners.

The National Association of Mutual Insurance Companies (NAMIC) will draw upon the experience, insight and expertise of its 1,400 member companies and professional staff to play a leading role in the development of solutions that address the issues associated with major catastrophic events such as hurricanes, earthquakes, windstorms and wildfires.

In December 2005, NAMIC formed a Task Force on Natural Disasters and invited representatives from 20 of its member companies to participate in a discourse on this subject. During the ensuing six months, the task force held regular meetings during which members were briefed by researchers, analysts, and practitioners from a variety of disciplines who were selected for their expertise in particular areas of disaster risk management and insurance. The task force also studied and discussed a sizable body of literature on natural disaster issues. Based on this process, the task force formulated four general principles that will serve to guide NAMIC members and staff as the natural disaster debate evolves.

The principles are:

1. Market freedom and competitive pricing will lead to innovation in developing solutions to problems relating to disaster insurance and mitigation.

2. Competitive pricing and risk-based underwriting are essential to developing and maintaining a viable disaster insurance market.

3. Mitigation must be an indispensable aspect of any disaster risk management and insurance initiatives.

4. The National Flood Insurance Program should be maintained, but must be reformed.

The following is an elaboration on the rationale behind each of the four principles.

1. **Market freedom and competitive pricing will lead to innovation in developing solutions to problems relating to disaster insurance and mitigation.**

    a) Insurance markets function most efficiently in the absence of government rate suppression and underwriting restrictions. A flexible regulatory environment in which insurers are free to price coverage based on risk will create incentives for property owners in high-risk areas to invest in loss mitigation measures. Likewise, risk-based pricing will create incentives for individuals, home builders and mortgage lenders to engage in risk avoidance strategies (such as refraining from purchasing or building homes in high-risk areas).

    b) Risk-based pricing will foster greater competition among insurers and increase the availability of property insurance in disaster-prone areas. Developing sufficient capacity to insure against losses caused by low probability/high consequence events is dependent on the ability of insurers and reinsurers to generate and hold capital. With an adequate rate of return, capital will flow into insurance markets.

    c) The private insurance market is best equipped to provide coverage for most types of natural disasters under most circumstances. Exceptions include flood insurance generally, and earthquake insurance in high-risk seismic zones. NAMIC recognizes that both recent and anticipated increases in the number and severity of natural disasters over the next decade has caused some observers to question whether primary insurers, reinsurers and the capital market will continue to have the ability to finance a "mega-catastrophe," or a series of high-consequence events occurring within a relatively short time frame.

    d) To date, the private marketplace has had the capacity to handle natural disasters. However, in jurisdictions with a restrictive regulatory environment, a significant increase in major storm frequency or the occurrence of a mega-catastrophe (e.g., an earthquake comparable to the 1906 San Francisco event, or a high-category hurricane striking heavily populated areas such as Miami, Houston, or New York City) could test or exceed private market capacity in high-risk regions. Such a mega-event could result in the inability of many insurers to meet their claim obligations and still offer protection on a going-forward basis. This is particularly true where insurers have established single-state companies as a way to manage their exposure. Therefore, consideration of state or federal programs designed to respond to these mega-events may be appropriate.

e) Disaster under-preparedness is not simply an insurance availability and affordability problem. Policymakers must recognize that human psychology strongly influences the decisions people make with respect to disaster risk management and insurance. Attention must be paid to the reasons why property owners as well as government officials tend to underestimate catastrophe risk and fail to prepare adequately for natural disasters. It is also important to acknowledge the tendency among many consumers to view insurance as a financial investment rather than as a protective measure. Studies indicate that this tendency leads people to discontinue coverage after a period during which they suffer no losses and file no claims, on the grounds that continuing to pay premiums "isn't worth it."

f) NAMIC supports the concept of amending the federal tax code to allow insurers to set aside a portion of premium income in tax-exempt policyholder disaster protection funds. NAMIC also supports the concept of allowing homeowners to create tax-free catastrophic savings accounts similar to health savings accounts which could be used to pay hurricane deductibles and costs associated with retrofitting properties.

2. Competitive pricing and risk-based underwriting are essential to developing and maintaining a viable disaster insurance market.

a) Open and competitive property markets are ultimately in the best interest of consumers. Lawmakers and/or regulators sometimes impose rating and underwriting restrictions on property insurers that allow high-risk property owners to pay artificially low premiums, forcing lower-risk property owners to subsidize the insurance costs of high-risk buyers by paying inflated premiums. NAMIC believes that using the insurance pricing mechanism to create hidden cross-subsidies among risk classes is not good public policy.

b) A market-based insurance pricing system in which premiums reflect the actual cost of insuring against catastrophic risk could result in significant premium increases for some property owners in high-risk regions. Policymakers may consider creating programs to provide direct government assistance, funded from general fund revenue, to low-income and other groups according to criteria established by the unit of government providing assistance. In designing such programs, care should be taken not to reduce risk mitigation incentives.

c) In discussions of insurance price regulation, the term "actuarially sound" is often used without definition. This term must be carefully defined, as there is no common definition shared by all participants. For example, many have used "actuarially sound" to mean prices that solely reflect the expected value of the loss costs. However, a definition of "actuarially sound" that is based on expected value pricing cannot apply to catastrophe exposed coverages. This is because "actuarially sound" pricing for catastrophe exposed coverages must also include compensation for the unusually large call on capital that is required to pay catastrophic losses. The call on capital that results from the highly correlated large-scale losses typically associated with extreme events may well be several times greater than the total annual "expected loss" of the coverage. In other words, the term "actuarially sound" should be understood to include not just the insurer's expected loss costs and expenses based on yearly averages. It should also include an adequate "risk load" that takes into account the call on capital.

d) Lawmakers, judges and the general public must recognize the cyclical nature of property insurer profits, how profits relate to surplus, and the role of surplus in ensuring that insurers are able to meet their contractual obligations to policyholders. Using return on equity as the universal benchmark for measuring company profitability, economists have found the return on equity of insurance companies to be lower than that of most other industries. Regulatory decisions and judicial rulings that require insurers to pay disaster-related claims irrespective of the terms of the insurance contract could cause availability problems at best and widespread failures in the market at worst.

3. Mitigation is an indispensable aspect of disaster risk management and insurance.

a) Effective mitigation efforts including the development of strong building codes as well as responsible land-use planning have been shown to greatly reduce the level of property damage and human suffering caused by natural disasters.

b) Government policymakers, insurers, builders, realtors, mortgage lenders and other stakeholders have a shared responsibility to help Americans who live in harm's way understand the nature of catastrophic risk and the threat it poses to their property and personal safety. Government-imposed rate suppression and reliance by private insurers on actuarially unsound government reinsurance programs can have the effect of distorting public perceptions of risk. Risk-based insurance pricing, on the other hand, sends accurate signals to consumers about the relative level of risk associated with particular regions and types of structures.

c) NAMIC supports the concept of federal legislation that would create financial incentives to encourage states to adopt and enforce strong, statewide building codes. With respect to existing properties, NAMIC supports government initiatives to create mitigation grant programs to enable homeowners in high-risk areas to invest in risk mitigation measures.

4. **The National Flood Insurance Program should be maintained, but must be reformed.**

   a) The National Flood Insurance Program (NFIP) has provided flood insurance coverage to homeowners across the country since 1968. While Hurricane Katrina revealed shortcomings in the program, NAMIC believes the NFIP should continue to operate, but it must adopt significant reforms.

   b) NFIP premiums must be actuarially sound for all covered structures. The current method for setting premiums, which is based on average annual losses, has been called "unsustainable" by the Congressional Budget Office. This approach has prevented the NFIP from accumulating the surplus necessary to pay claims during periods when loss costs are above average.

   c) The borrowing authority of the NFIP must be increased so that program administrators will not be required to seek special appropriations from Congress each time a natural disaster involving major flooding occurs.

   d) Additional federal funds should be allocated to the national flood hazard mapping program. Updating and improving flood maps should be a priority within NFIP also in those communities that will benefit most from updated flood maps.

   e) Stiffer penalties should be imposed on financial institutions that either fail to require flood insurance coverage for mortgages on properties in flood-prone areas, or allow the policies to lapse.

   f) The NFIP needs additional resources and a renewed mandate to improve and expand its public education programs to ensure that more people are made aware of the program and the benefits of having flood insurance coverage to protect their properties.

   g) NAMIC urges policymakers and other interested parties to work together to develop additional improvements to the National Flood Insurance Program.

New laws and policies in the wake of Hurricane Katrina seem intended to scapegoat insurance companies rather than protect the public.

Facing Mother Nature

By Martin F. Grace and Robert W. Klein
Georgia State University

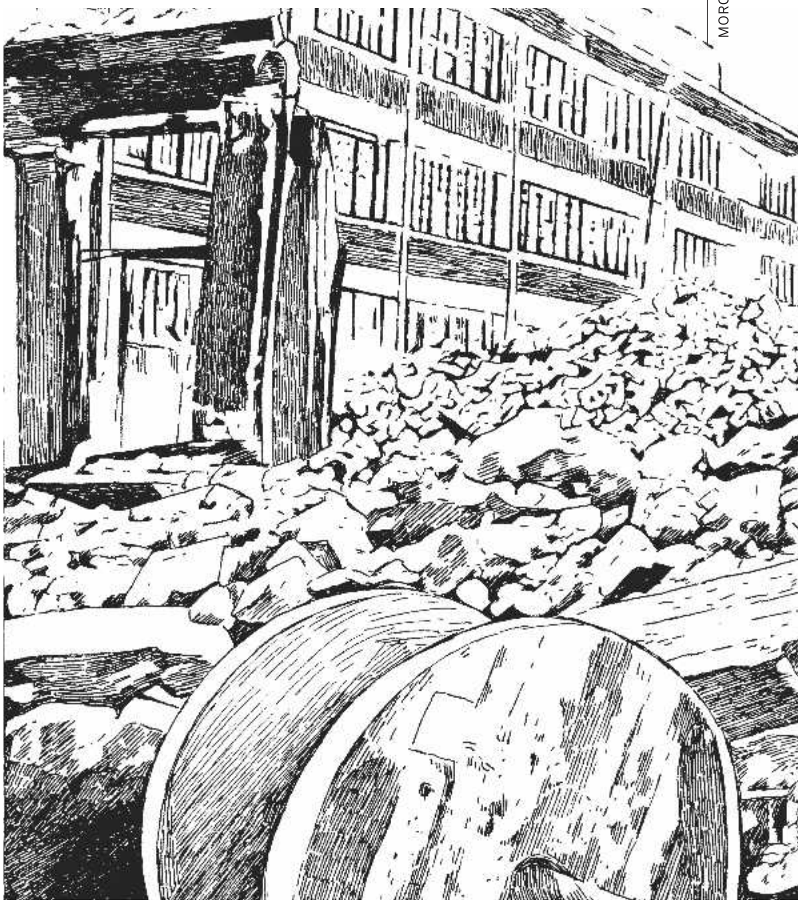
Changes in insurance markets that followed the flurry of hurricanes in 2004–2005, capped by Hurricane Katrina, have been met by a storm of criticism in Congress and state capitals. Rather than addressing the economic realities of increasing catastrophe risk with informed discussion and sound proposals and policies, politicians are attacking its messenger — the insurance industry.

Political attacks on the insurance industry are not a new phenomenon. But the current assault may rank among the most severe, misguided, and damaging campaigns ever waged, with potentially disastrous consequences for many Americans. Government's mismanagement of catastrophe risk is rooted in a climate of public ignorance and distrust of the insurance industry. That enables politicians to weave a fiction that plays well with their constituents as it sows the seeds of their and others' exploitation. There is a pressing need to correct several fallacies that infect the current debate and educate the public about the economics of catastrophe risk, the dangers posed by the current course of policy, and better solutions.

MOTHER NATURE VS. HUMANITY

One common fallacy is the belief that catastrophe perils are like other insured perils. The reality is that catastrophe perils have unique characteristics that are highly relevant to managing the risk they pose. Perils such as auto accidents are relatively stable and predictable (based on historical experience), but catastrophe perils are highly variable and impossible to predict with any degree of confidence.

The occurrence of hurricanes is determined by both long-term and short-term weather patterns. Weather scientists cannot predict exactly how many hurricanes will strike the Unit-


MORGAN BALLARD

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ed States in a given year, but they can calculate the probabilities of various hurricane scenarios over any defined period of time. The scientists are telling us that we are currently in a cycle of greatly increased hurricane activity, and the probability of one or more severe hurricanes occurring in a given year is much higher now than it was two decades ago.

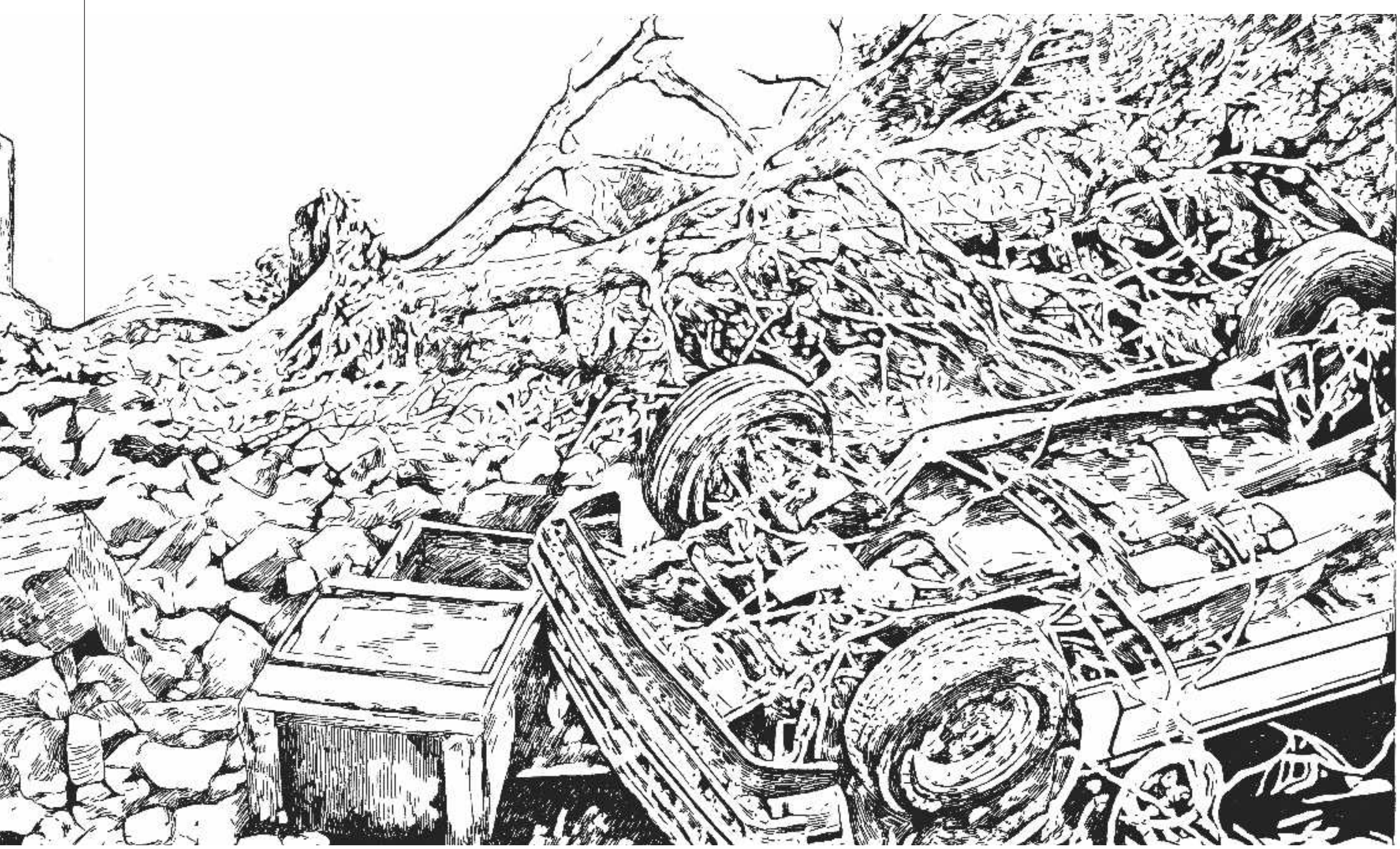
The actual occurrence of hurricanes is analogous to Mother Nature rolling weighted dice. But recent history is consistent with the scientific analysis of how the dice are weighted. Figure 1 displays the number of hurricanes striking the United States by decade for 1920–2004 and also distinguishes the number of more severe — Category 3–5 — hurricanes. Hurricane frequency and intensity increased over the first three decades of this period and then fell during the next three decades. Storm activity intensified again starting in the late 1980s and continues today. Figure 1 also reflects the variability of the number and severity of hurricanes that actually occur from year to year within any given multi-year cycle of increased (or decreased) hurricane activity.

Property losses from hurricanes are a function of both hurricane activity and the value and vulnerability of structures in their path. Because of increases in those factors, the probability of higher hurricane losses is rapidly increasing; this is reflected in historical data on insured catastrophe losses shown in Figure 2. While catastrophe losses vary greatly from year to year, it is clear that catastrophe losses on the whole (even measured in constant dollars) have increased dramatically since 1990, with several "bad years" resulting from one or more severe disasters in those years.

Total insured catastrophe losses (in 2006 dollars) were \$29.3 billion in 2004 and \$63.9 billion in 2005 — primarily caused by hurricanes striking the Southeast. Hurricane Katrina alone generated \$41.9 billion in insured losses — almost twice the amount caused by Hurricane Andrew, which had been the most costly natural disaster prior to Katrina. As devastating as Katrina was, experts are concerned about the significant possibility of a much larger disaster that could cost in excess of \$100 billion in insured losses alone.

GROWTH AND LOSSES The dramatic increase in U.S. coastal development has contributed to the rise in hurricane losses. During the previous active storm cycle of 1920–1950, coastal areas were less developed, so storms striking those areas caused less property damage. During the next three decades there was considerable economic growth in those areas, but storm activity had lessened and did not impede growth.

A 2004 National Oceanic and Atmospheric Administration study estimates that 153 million people lived in coastal counties in 2003, representing 53 percent of the U.S. population but only 17 percent of the nation's land mass. From 1980 to 2003, 33 million people were added to the coastal population, representing a 28 percent increase overall. The pace of growth has been much higher along the southern Atlantic and Gulf coasts where hurricane risk is the greatest. The NOAA study predicts further strong population growth in Southeastern and Gulf coastal areas. Indeed, Florida coastal population growth, alone, has increased by more than 11 percent just between 2000 and 2005. We should also note that Hawaii



faces significant hurricane risk as evidenced by Hurricane Iniki in 1992 and the near miss of Hurricane Flossie in 2007.

Hence, considerable development occurred when hurricane losses were relatively low and property insurance was relatively cheap. That development has continued, even after hurricane activity increased. A myopic sense of security has contributed to large movements of people and the associated property development that is now at significant risk from intensified hurricane activity. At the same time, little attention has been paid to hazard mitigation (e.g., building hurricane-resistant homes). The result is a substantial increase in the potential and actual property losses from hurricanes.

THE ROLE OF INSURANCE

It is important to review some basic principles of insuring catastrophe risk and address several fallacies that permeate the current debate. Those fallacies include:

- The pooling of risk exposures (e.g., homes) within an insurance mechanism implies that everyone in the pool should pay the same premium. Profits from insuring low-risk exposures should cover losses from high-risk exposures.
- Insurers and insurance markets are immune from competition. Unless closely regulated, insurers can charge excessive prices that will generate excessive profits. In this context, insurers are deliberately overestimating the risk of hurricanes to support inflated prices and other actions that they are taking.
- Insurers have earned excessive profits. The fact that they have earned any profits at all means that they should not be raising their prices and managing their exposures in hurricane-prone areas.
- Insurers intentionally seek to "underpay" claims, i.e., pay less than what they are obligated to pay under the terms of the policies they issue. This further contributes to their excessive profits.

Property owners exposed to hurricane risk can manage this risk in different ways. Many prefer (or are forced by their lenders) to do so by transferring their risk to insurers. Fundamentally, any legitimate insurance arrangement to cover potential losses from a given peril must be financed with risk-based premiums that cover insurers' full cost of providing coverage, including their risk-adjusted cost of capital. This means that the premium paid by any insured should cover his or her "actuarially fair share" of the costs, i.e., high-risk insureds must pay higher premiums than low-risk insureds. This is essential to control adverse selection and moral hazard that will otherwise destroy any insurance arrangement that is not subsidized by government funds. Further, fierce competition prevents private insurers from charging higher rates to low-risk insureds to subsidize the rates for high-risk insureds or raising rates in future years to recoup losses from prior years.

Insuring catastrophe losses presents special challenges that are not associated with other kinds of perils. Insurers must deal with the fact that catastrophe losses are highly variable from year to year and the possibility that they could suffer very high losses in a given year that could easily bankrupt them. Insurers manage their catastrophe risk by controlling their exposures (e.g., avoiding large amounts of exposures in high-risk areas), holding extra capital earned in "good years" to help fund "bad years," and diversifying their risk through the use of reinsurance and other financial instruments to cover especially large losses.

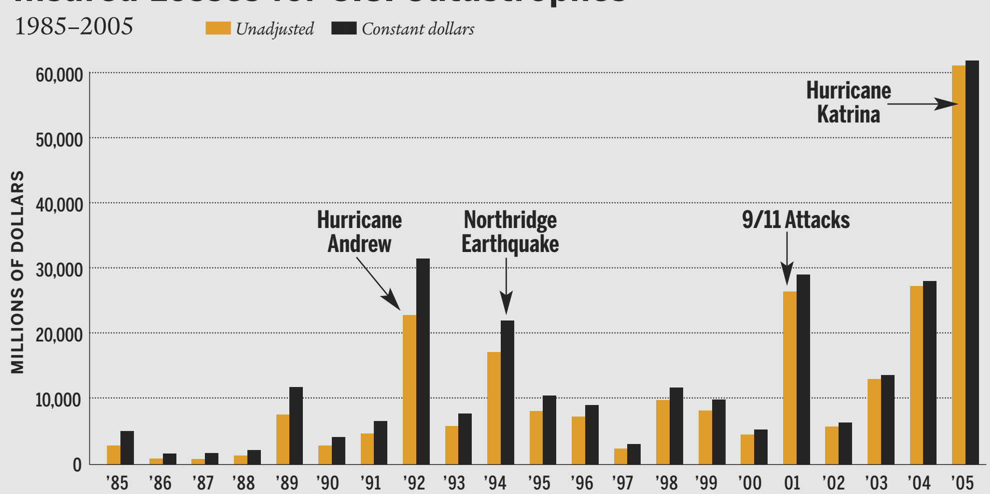
Hence, in order for private insurers to be willing to commit capital to underwrite catastrophe risk, they must be allowed to manage their risk and charge what they perceive to be adequate risk-based premiums to cover all their costs, including the cost of financial diversification and the relatively high cost of capital associated with underwriting a very volatile peril. This leads to two economically desirable outcomes: the supply of private capital is maximized, and the incentives of those who benefit from coastal property are properly aligned by paying the full cost of risk for coastal property.

Contrary to popular opinion, insurers are not immune from competition. In fact, insurance markets tend to be highly competitive because of the large number of insurers and low entry barriers to insurance markets. While it is true that loss shocks and/or the reassessment of hurricane risk can cause short-term tightening of the supply of insurance, over the long term insurers cannot sustain excessive prices. Any insurer that sought to do so would lose business to opportunistic competitors who would offer lower prices and still earn reasonable profits.

Figure 2

Insured Losses for U.S. Catastrophes

1985–2005

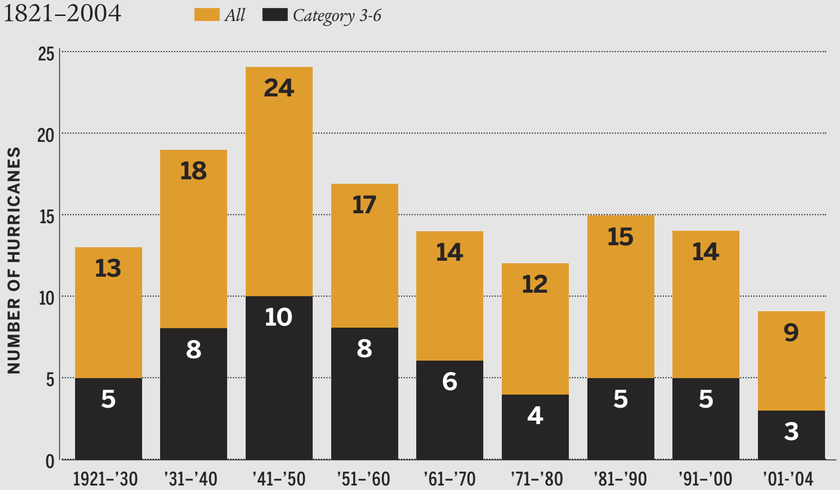


SOURCE: *Insurance Information Institute*

Figure 1

U.S. Hurricane Strikes by Decade

1821–2004



SOURCE: *NOAA*

Estimating and pricing catastrophe risk is a speculative enterprise that requires the use of sophisticated but inherently imperfect mathematical models. The models are plagued by considerable "parameter uncertainty" — modelers and insurers cannot be sure that they have exactly measured the "true" risk of hurricanes. Criticism of the models is one of the tactics used by politicians and their allies to challenge insurers' actions. While no model should be considered perfect and error-free, the firms that are putting their capital on the line need to be the arbiters of what they use to estimate and price the risk they underwrite. Ultimately, market forces and competition will drive insurers to use the most "reasonable" estimates of hurricane risk to price and manage their exposures. Several new companies have formed to mine carefully certain market niches, but the fact that venture capitalists have not jumped in to write large amounts of property insurance in hurricane-prone areas is telling in terms of their assessment of the current market price for the business.

Prior to Hurricane Andrew in 1992, insurers paid little attention to the growing risk posed by hurricanes, so insurance was relatively cheap and readily available. They generally did not use catastrophe models and did little to control their catastrophe exposures. Hurricane Andrew was a wake-up call to the insurance industry, which quickly and dramatically responded to the message. Using catastrophe models to assess their risk, insurers sought to raise their rates and adjust their exposures to reflect the new reality. However, political resistance only allowed gradual adjustments by private insurers and subsidization of government-provided insurance further undermined market price signals, especially in Florida.

By 2004, insurers believed that their overall rates and exposures were close to where they needed to be, with the exception of continued regulatory constraints on rates in the highest-risk areas. Their experience in 1992–2004 was consistent with the models they were using at that time. However, the very active storm seasons of 2004–2005 made them realize that their current models had substantially underestimated the risk they now faced. At the same time, weather scientists were warning that the hurricane cycle that had started in the late 1980s was intensifying and the probability of severe hurricanes was now much higher than it was at the beginning of the cycle.

Catastrophe models were revamped based on new information. Insurers sought to raise their rates further and cut their exposures in high-risk areas to attain new, economically sustainable positions. Coastal property owners and other interest groups vociferously protested the rate hikes — the new rates that were going into effect had finally reached a level that was negatively affecting the value of real estate in coastal areas. Politicians in Florida responded by attempting to create an insurance Disneyland (i.e., a return to the "good old days") by rolling back rates and expanding government subsidization of coastal property risk.

Florida is subject to the greatest problems because of its extensive development and its high exposure to hurricanes. But other states along the Gulf and Atlantic coasts are feeling the pinch of increased hurricane risk. Insurers are seeking to adjust their exposures and raise rates in all of these states, but not to the degree they are doing so in Florida. Northern coastal states face a significant but lower level of hurricane risk than southern coastal states. Still, coastal states besides Florida are facing increasing market and political pressures, and there is a significant danger that some may attempt to follow Florida's legislative and regulatory lead; they have already joined in calling for federal help.

MAKING TOO MUCH MONEY?

So-called consumer advocates and many politicians have strongly criticized insurers' actions, insinuating that the industry earns excessive profits and, hence, does not need to raise rates and control its catastrophe exposure. But most experts believe that insurers have under-priced catastrophe insurance historically based on models that underestimated the risk of hurricanes, and their recent actions are understandable in light of the risks they face. This is reflected in insurers' relatively low rates of return on their overall operations and their negative long-term earnings in high-risk lines like property insurance in Florida. While insurers' historical performance should not be the only basis for evaluating their management of catastrophe risk, it is symptomatic of the catastrophe risk problem.

According to industry analysts, the historical average return on equity (ROE) for the insurance industry is 14 percent, approximately the same as the *Fortune 500*. However, over the last 10 years the insurance industry's ROE was 7.0 percent compared to the *Fortune 500's* ROE of 13.4 percent. Property-casualty insurers have substantially under-performed relative to less risky industries, and homeowners insurance has been one of the worst-performing lines of insurance.

One of the important fallacies we cited above is the common view that insurers' "book of business" is one big pot and that, as long as they are earning profits on their nationwide operations for all lines of business, they do not need to raise rates or manage their exposures in high-risk lines and geographic areas. However, this view is contrary to how insurers and other firms must run their business. In essence, each product line and "block of business," e.g., homeowners insurance in Florida, must be economically viable. Just as any firm would have to jettison or change an unprofitable product line, insurers must make sure that their operations in a particular line and area will earn a fair rate of return over the long term. Otherwise, it becomes a drag on an insurer's performance that owners and investors will not tolerate.

According to regulatory estimates, cumulative homeowners insurance profits in Florida have been negative for the period 1990–2005. Figure 3 shows that profits as a percentage of premiums varies from year to year, but the cumulative sum of profits in Florida is negative for both homeowners insurance and all lines of coverage. The few bad years have more than wiped out any profits that insurers earned in good years. Also, we should note that several Florida insurers went bankrupt or were seized by regulators after the 2004–2005 storms because they did not have national operations to bail out their Florida losses.

Writing homeowners insurance in Florida has been a losing proposition that is getting worse, not better. Hence, it is not surprising that insurers are not enthusiastic about writing large amounts of property insurance on Florida's coasts. For example, State Farm recently announced its decision to drop 50,000 policies in Florida, though regulators are challenging that decision. The reason that most have stayed at all is the size of Florida's auto insurance market and the hope that things will eventually turn around for property insurance. However, public officials are making it much harder for property insurers to stay and wait for better days.

Finally, we need to comment on insurers' payment of hurricane-related claims. Insurers are committed to satisfying their legal obligations to pay claims arising from their contracts because that is the purpose of the business they are in, and because deliberate attempts to underpay claims will result in severe regulatory and other legal sanctions, as well as reputation losses. That said, insurers also do not want to pay any more than they are legally obligated to pay, and disputes between insurers and claimants on how much should be paid are inevitable in some situations.

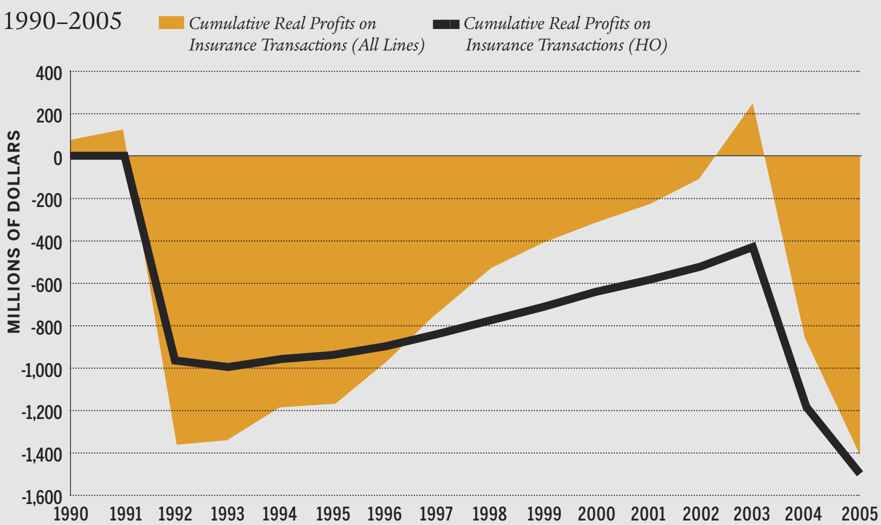
Settling claims arising from a hurricane that causes significant flooding, like Katrina, creates some special problems for claims settlement. First, the large number of claims strains insurers' claim-adjustment resources. Second, when a home suffers damages from both wind and flooding (or flooding alone), the potential for disputes significantly increases. Wind damage is covered under most homeowners insurance policies but flood damage (including storm surges from hurricanes) is excluded because of a government-industry understanding that it should be covered by the federal flood insurance program. However, most homeowners do not buy flood insurance unless forced to by lenders who hold a mortgage on their property. Hence, the many claimants without flood insurance are motivated to ascribe all or most of their damages to wind, while insurers are motivated to just pay for wind damage.

Disputes will naturally arise when the post-storm evidence does not clearly reveal the cause(s) of damage beyond any factual challenge that could be raised. Insurers are not infallible and likely have made some errors or too narrowly construed the cause of losses in some cases. However, this problem is much less significant than the allegation that insurers have deliberately and systematically sought to underpay hurricane claims on a wide scale. The more than $40 billion in insured losses from Hurricane Katrina indicates that insurers have made substantial claims payments even if some claimants do not believe they have been paid enough.

Figure 3

Cumulative Real Profit on Insurance Transactions in Florida

1990–2005



SOURCE: *National Association of Insurance Commissioners*

FLORIDA'S LEGISLATIVE DISASTER

The last fallacy that warrants correction is that the government can substantially lower the cost of hurricane insurance without large subsidies from non-coastal property owners and taxpayers. This was demonstrated by the fact that Florida's insurance subsidization schemes required substantial assessments on all insurance consumers and taxpayers in the state to cover deficits arising from the 2004–2005 storm seasons. Despite that experience, in early 2007 Florida enacted legislation and implemented policies that further expanded and subsidized government-sponsored coverage and tightened constraints on private insurers.

The major changes in Florida essentially allow the state's insurer of last resort, Citizens Property Insurance Corporation (CPIC), to compete directly with private insurers. In the past, the CPIC's prices were mandated to be the highest in the state and its eligibility requirements were structured so that the CPIC would not undercut the private provision of insurance. Under the 2007 changes, its rates have been rolled back and a homeowner will be allowed to obtain insurance from the CPIC if its rate is lower than what the homeowner can obtain from a private insurer.

Prior to the new legislation, the CPIC had been growing rapidly in terms of the number of policies in force and exposure to loss (amount of insurance coverage written). It will grow much larger because of its restructuring. It had been projected that the new legislation will increase the CPIC's growth to a level of 1.36 million policies and over $400 billion in exposures by the end of 2007, but it now appears that this projection will be substantially surpassed. Hence, the CPIC will account for more than one-third of the state's property insurance market, but a much higher proportion of the state's high-risk coastal exposures.

In addition, the state, through its unique Florida Hurricane Catastrophe Fund (FHCF), is offering reinsurance to insurers at below-market rates through its power to assess (tax) homeowners, commercial, and auto insurance policyholders to pay for any future deficit. If significant losses occur, the FHCF can sell bonds and tax all insurance consumers, regardless of where they live in the state, to cover the deficit. A large catastrophic loss will require recapitalization, and current and future taxpayers of Florida will have to pay for the losses. Florida insurance regulators are also tightening their constraints on insurers' rates and requiring insurers to lower their rates based on the lower, subsidized cost of reinsurance from the FHCF (even if they do not buy reinsurance from the FHCF).

Florida further prohibited insurers from establishing Florida-only subsidiaries of national insurers. This prohibition is intended to extract subsidies from insurers' non-Florida operations, which is a flawed idea as we have previously explained. The purpose of single-state subsidiaries is to preserve a parent insurer's option to recapitalize a subsidiary after a major storm (or not) and make an insurer's Florida performance more transparent. While Florida has had a number of insolvencies after Andrew and the 2004–2005 seasons, none of the subsidiaries of national insurers have failed nor have they been abandoned. However, the new legislation and the attitude of the legislature may make insurers rethink their commitment to the Florida market.

The net effect of Florida's legislative and regulatory changes is to arbitrarily lower the cost of risk to Florida consumers (with coastal property owners getting the greatest benefit) and shift the additional risk to consumers of other insurance products as well as Florida taxpayers. The new policies will increase the state's reliance on smaller, unaffiliated insurers and government-subsidized insurance. This is a recipe for an economic disaster when the next major storm hits the state.

CONGRESS: BAIT AND SWITCH

Florida is not alone in assaulting the insurance industry. Many federal legislators from coastal states have attacked the industry and sought subsidies from non-coastal areas. They have criticized insurers for the settlement of Katrina claims, rate increases, and their actions to limit their catastrophe exposures.

Beyond criticism of the industry, there has been the discussion of what the federal government should do. Proposals include eliminating the industry's special antitrust status, constraining insurers' actions through state and/or federal regulation, and establishing some kind of national catastrophe plan. The most prominent proposal would make the federal government serve as a "reinsurer" to augment private insurance/reinsurance and state insurance/reinsurance funds. One objective of the plan would be to encourage more states to establish state reinsurance mechanisms like the FHCF. There is a heated debate among insurers and others as to the need for and soundness of such a plan, but there are many federal legislators who appear to be favoring the scheme.

Government insurers are notorious for failing to charge adequate, risk-based rates because of political pressure. That is why they often run deficits that are covered by people who buy insurance in the private market and by taxpayers. Indeed, one Florida ex-legislator has been quoted as saying that he expects the federal government will bail out Florida's unique hurricane reinsurance fund because of the state's political clout — a factor he suggested figured positively into the Florida's legislature's expansion of the fund. Inadequate self-funding is the all-too-common experience at both the state and federal levels. The two most prominent federal insurance programs — crop insurance and flood insurance — have continued to generate deficits that have been covered by general fund appropriations. Government insurance programs are often sold with the fiction that they will reduce the need for taxpayer-funded disaster aid. The unfortunate reality is that we get the worst of both worlds — taxpayer-subsidized insurance (i.e., a contractual entitlement) and more disaster aid. A recent working paper by David Cummins, Michael Suher, and George Zanjani estimates that the net present value of the federal government's liability for disaster aid related to natural catastrophes (over a 75-year period) is between $1.2 and $7.1 trillion.

The net effect of the federal proposals would be excessive coastal development, reduced motivation to build hurricane-resistant structures or strengthen existing ones, and a reduced supply of private insurance. Taxpayers would end up subsidizing the cost of the additional increase in the risk of hurricane losses because of federal and associated state policies.

A BETTER COURSE

The supply of catastrophe reinsurance has increased since 2005. There has also been rapid growth in securitizing catastrophe risk with other financial instruments, but the amount of such financing has fallen far short of its potential. Even at the primary level, insurers are seeking to move to a new, sustainable equilibrium and some insurers are considering cautious expansion of their operations in hurricane-prone areas. It is not a problem of supply — investors are happy to invest in insurers, reinsurers, or catastrophe securities at the right price. The problem is one of demand. If the federal and state governments are willing to supply under-priced insurance and reinsurance as well as constrain insurers' rates, who will be motivated to pay for adequately priced private capital?

The quickest and best solution would be to remove the constraints on private markets. The government could help by allowing insurers to set aside reserves to fund future catastrophe losses with the same kind of tax treatment that other kinds of loss reserves receive (most European countries allow catastrophe reserves). It also could make it easier to issue financial instruments (e.g., cat options, cat bonds, etc.) in the United States to cover catastrophe risk with the kind of appropriate tax treatment that they receive in other countries.

For those committed to the idea of a government reinsurer (whether its need is demonstrated or not), one might propose that it issue pre-event catastrophe bonds rather than engage in post-event borrowing and assessments that run a greater risk of taxpayer subsidies. Government purchase of catastrophe options also might be more feasible given that its portfolio of exposures would be aligned with the parametric triggers (e.g., total losses for a region or the United States) that would be used for such options. Private insurers and reinsurers could help to facilitate the aggregation of exposures (servicing policies as well as underwriting lower layers of risk) and ceding higher risk layers through adequately priced excess-of-loss reinsurance contracts with a government reinsurer.

The primary advantage of this approach would be that the government would pay for the cost of issuing catastrophe bonds (and/or options) up front, which in turn should be reflected in the premiums paid by those (e.g., property-owners) who ultimately receive the protection. There is precedent outside the United States for this approach: pre-event financing is used by the multi-country Caribbean Catastrophe Risk Insurance Facility. We can learn from innovations such as this and from the policies and institutions of other countries. Indeed, proposals for alternative plans have already begun to surface that may offer more economically sound approaches to pooling and diversifying catastrophe risk.

CONCLUSION

Homeowners insurance, especially in light of recent trends in hurricane frequency and severity, must be priced in accordance with the insured risk and associated costs. Further, any legitimate insurance arrangement, public or private, must manage its catastrophe exposure so that it can afford to pay its claims obligations if a disaster occurs. State and federal legislators do not appear to acknowledge this reality. In fact, Florida's insurance woes will not be solved unless and until the government allows private insurers to manage their risk and price coverage in a manner that will achieve a viable and sustainable property insurance market.

Florida's response to the increased frequency and severity of hurricanes has been to effectively ignore or grossly underestimate the risk. As a result of Florida's policies, hurricane losses will be further understated and regulated prices will be lower. Again, this short-sighted approach will likely yield even greater potential losses and a resulting loss of private market willingness to underwrite catastrophe risk in the state, with rippling adverse effects on other types of insurance. Other states may follow Florida's lead.

Federal legislative efforts in natural disaster financing may encourage the states to take on even more risks. According to a recent survey, state government assumption of exposures has grown from $57 billion in 1990 to $600 billion in 2007. The growth may be partially based on the states' hope for a federal program to bail them out after a disaster. That hope will likely grow if a flawed federal catastrophe program is enacted.

There are private market solutions to the problem of managing and insuring catastrophe risk. Private catastrophe financing would work better if the government did not constrain and compete against it. Tax-deferred catastrophe reserves like those European insurers employ to manage their long-term catastrophic risk would encourage private market participation, as well as the encouragement of catastrophe risk financing instruments. Allowing insurers to earn long-term profits consistent with the risks they face would also encourage insurers to increase the supply of insurance.

Private market solutions should be fully exploited before government financing of natural disaster risk is considered. Further, any government financing mechanisms that are instituted should be confined to fill a gap that private markets cannot fill (if such a gap is clearly demonstrated). Those mechanisms should be fully financed by risk-based premiums paid by those who receive the benefit of government protection, not subsidies from other insurance buyers and taxpayers. Such policies would promote more efficient management of catastrophe risk and avoid subsidies of excessive risk-taking in coastal areas. R

Readings

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- "Federal Financial Exposure to Catastrophic Risk," by J. David Cummins, Michael Suher, and George Zanjani. Working paper, July 31, 2007.
- "Increased Hurricane Risk and Insurance Market Responses," by Martin F. Grace, Robert W. Klein, and Zhiyong Liu. *Journal of Insurance Regulation*, Vol. 24 (2005).
- "The 2007 Review of the Insurance Securitization Market," by Morton N. Lane and Roger G. Beckwith. *Trade Notes* (Lane Financial LLC), April 20, 2007.

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Our Opinion: Override this veto

Lawmakers should revive consumer choice

|

The Florida Department of Insurance Regulation has been claiming that, since 2006, 40 new property insurance writers have brought $4 billion in capital to Florida to cover homeowners in the event a heartbreaker of hurricane turns coastal properties into a rubble.

This new business and big capital coming into the state was, ostensibly, a reason that Gov. Charlie Crist on Wednesday vetoed the Consumer Choice Bill, which might well have made State Farm strongly consider returning to Florida to cover homeowners who have long been loyal customers. State Farm said it was leaving the state following an ugly showdown with the governor two years ago over its homeowner rates.

The veto should be subject to a legislative override, however, and Sen. Mike Bennett, R-Bradenton, said Wednesday afternoon that this is definitely on the table.

An override is a serious move, and a big one requiring lawmakers to come back into session, but property insurance — or the lack of its reliable availability — is a serious, big issue in our state, and hurricane season is well under way.

Along with Mr. Bennett's desire to see Insurance Commissioner Kevin McCarty resign "for making misleading statements and bending facts ... because he has a personal vendetta against State Farm," Mr. Bennett said it's in the Legislature's purview to reaffirm, though an override, this legislation that won strong bipartisan support in both chambers during the session.

New capital and new companies are important, because the state's insurer of last resort, Citizens Property Insurance Corp., is so underfinanced that it couldn't possible pay off claims in the event of major storm damages.

Yet, according to Department of Insurance financial documents obtained Wednesday by the *Democrat*, that $4 billion in new capital is not going to fortify the everyday Floridian who has property insurance despair.

That's because $3.8 billion of that $4 billion is coming from what are known as surplus lines.

What it means

Rep. Bill Proctor, R-St. Augustine, co-sponsor of the vetoed measure, described surplus lines as "companies that operate on a permit rather than a license and typically pick up facilities no one else will insure, like a $4 million house on a key, or a condo high rise on the beach."

"Surplus lines have no regulation on cost, no limits on the upper rates, and they won't be insuring the average homeowner with a home in Live Oak," Mr. Proctor said. "If you're going to drive major companies out of the state on the condition that you've got these budding new companies that will fill the gap, but in reality $3.8 billion of that $4 billion is in surplus line companies, well, that's not money that protects the average homeowner."

The vetoed legislation (HB 1171/SB 2036) would have deregulated rates for large, well-capitalized insurers, perhaps 20, allowing them to charge higher rates provided they made the transactions transparent with respect to fully regulated policies. The bill recognized free-market choices consumers want and are willing to pay for when service and security are at stake.

"When you look at the statewide polling, the broad support from every caucus, the Chamber, Associate Industries," said a frustrated Mr. Bennett, "I think the governor's staff gave him bad advice." He said supporters are talking to other members "to see what the appetite for an override is."

Conversely, said OIR spokesman Ed Domanski, "Commissioner McCarty knows that Gov. Crist carefully considered this bill and has done what is best for the people of Florida."

As we've said before, the "people's governor" should let the people make the decision about who will insure their homes and what they're willing to pay.

He took away this option in vetoing the Consumer Choice Bill. Lawmakers should reconvene and reaffirm support for homeowners by overriding the veto.

Hurricane Charlie
The Republican Barney Frank.

Florida Governor Charlie Crist is running for the U.S. Senate next year, and we wonder if one reason is that he doesn't want to be in Tallahassee when the next hurricane hits his state. His veto of a hurricane insurance reform bill last week all but guarantees a state disaster on top of any wrought by Mother Nature.

The bill would have trimmed the cost of a state-run enterprise that insures homeowners against storm damage. The program has an $18 billion unfunded liability and has taxpayers on the line for tens of billions in property losses from the next major hurricane. The Republican legislature tried to reduce those future losses, but Mr. Crist sounded like Barney Frank rolling the dice on Fannie Mae in declaring there's nothing to worry about.

By way of background, two years ago Mr. Crist gave a big gift to coastal property owners by converting the state of Florida into one of the world's largest property insurers. The Citizens Property Insurance Corporation provides below market-rate insurance policies directly to homeowners. Meanwhile, the Florida Hurricane Catastrophe Fund (CAT) regulates how much private insurers can charge homeowners and requires companies to purchase low-cost reinsurance from the government. Mr. Crist didn't invent these programs, but he vastly expanded their reach -- to about one million policies today. He transformed Citizens from insurer of last to first resort.

Here's the problem: This system isn't even within a coastal mile of being actuarially sound. The state government acknowledges that in many high-storm risk areas the premiums are from 35% to 65% below what is needed to cover potential claims. That subsidy has made Mr. Crist popular with many coastal residents even as the state plays Russian roulette with the weather.

The reform, which passed with wide margins, would have allowed large private insurers to compete with Citizens and charge whatever premiums they wish. This would give homeowners a wider range of choices, and it would let private insurers spread hurricane risk around the world through reinsurance. The big and well-capitalized insurers -- including Allstate, Nationwide and most recently State Farm -- have either curtailed operations or withdrawn from the Sunshine State because they can't make money charging subsidized rates. The companies could be bailed out under the CAT reinsurance program, but the fund may run out of money when a big one hits.

Mr. Crist and the media portrayed the reform as a giveway to the big insurers, and the Governor claims people can't afford "large and unpredictable" increases in premiums. The truth is large increases are precisely what is sometimes needed to cover the risk of living on coastal property. Mr. Crist's program makes the long-term losses much more severe because cut-rate insurance has encouraged overbuilding in coastal areas that are historically in the path of hurricanes. "We are one major hurricane away from an economic disaster in this state," says House bill sponsor William Proctor.

Mr. Crist is also pushing a federal disaster-insurance fund, probably because he knows the risks he's taking and wants all American taxpayers to bail out his Florida schemes when future hurricanes hit. Meantime, he continues to perpetuate the myth that Florida property owners can have billions of dollars of subsidized insurance at little expense or risk. It's this kind of something-for-nothing economics that gave us the debacle of Fannie Mae. With that philosophy, Mr. Crist would feel right at home in Washington.

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