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Call for Reform in the Residential Insurance Market After Hurricane Katrina

The unprecedented level of property losses caused by Katrina and the other hurricanes of 2004 and 2005 profoundly altered the workings of the residential insurance market in the Gulf States. Many private insurers raised rates dramatically and used other strategies to shift risk to residents, and some retreated from coastal regions altogether. Government programs stepped in, but their subsidized premiums raised concerns that homeowners were not being provided with sufficient incentives to reduce risks. Although almost all stakeholders concur that the existing system is unworkable, there is little agreement on the best approaches for reform. Some policymakers call for an increased government role in insuring hurricane losses; others believe the best solution lies in promoting the private sector’s ability to offer effective coverage.

A new RAND study sought to diagnose what ails the residential insurance market in the Gulf States and to help frame the policy debate. By reviewing public records and conducting over 100 interviews—with coastal residents, consumer action groups, insurers, reinsurers, regulators, catastrophe modeling firms, journalists, and legislators—the research team was able to identify serious, ongoing problems in the

Abstract

The devastating property losses caused by the 2004 and 2005 hurricanes threw the residential insurance market in the Gulf States into turmoil. In an effort to inform the current policy debate on insuring hurricane risk, the authors identify key objectives of a properly functioning insurance market, indicate why these objectives cannot be achieved without policy reform, and describe a number of reforms that merit careful consideration, discussing the advantages and disadvantages of each.

way this market functions, explain why neither the private sector nor government programs can effectively address these problems without reform, and offer a framework for evaluating potential reforms.

Losses and Disruptions

The table below shows the extent of insured wind and flood losses to property (both residential and commercial) caused by the 2004 and 2005 storms. As can be seen, these add up to nearly

Insured Property Damage Losses from Wind and Flood During the 2004–2005 Hurricane Season

Hurricane	Category	Year	Insured Losses (billions of 2009 \$)	
			Wind	Flood
Katrina	3	2005	45.1	17.7
Wilma	5	2005	11.3	0.4
Rita	3	2005	6.2	0.5
Ivan	5	2004	8.1	1.8
Charley	4	2004	8.5	0.1
Frances	4	2004	5.2	0.2
Jeanne	4	2004	4.2	0.1
Total	—	—	88.6	20.8

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\$90 billion in insured wind losses, with one-half of that—\$45.1 billion—attributable to Hurricane Katrina alone. In addition, the National Flood Insurance Program (NFIP) paid 167,000 claims amounting to more than \$17 billion for flood damage from Katrina and had to borrow \$20 billion from the U.S. Treasury Department to do so.

The disruptions created by these losses have made the Gulf States residential insurance market largely dysfunctional. Many homeowners in coastal areas now need to buy three insurance policies for one dwelling: a basic policy to cover everything but flood and wind damage, a second from the state-supported windstorm market, and a third from the NFIP to cover flood damage. Disputes about exactly what policies cover—and whether wind insurers or flood insurers should pay for losses—have brought about thousands of litigations, discouraging private insurers from offering policies in high-risk areas.

Objectives of Reform

The research team thinks that efforts to establish a well-functioning residential insurance system in areas prone to hurricane damage should be guided by a combination of the following objectives: (1) create appropriate incentives to mitigate risk; (2) ensure that households and developers factor in wind and flood risk; (3) pay legitimate claims efficiently and expeditiously; (4) encourage market innovation and price competition. Various challenges, however, make it difficult for both private and public insurers to achieve these goals.

Challenges for the Private Sector

Wind losses caused by hurricanes, which occur infrequently, are difficult to predict. Private insurers thus must hold large amounts of capital to prevent insolvency and must seek additional protection from reinsurers, who need to maintain significant amounts of capital themselves. High capital costs can raise insurance premiums far beyond expected annual losses, sending the wrong signals for risk management and making policies less attractive to potential customers. Additional challenges for private insurers are created by pricing controls imposed by regulatory agencies, subsidized premiums offered by government-backed insurers, and uncertainties about contractual obligations, some of which stem from emergency rules issued by state agencies in the aftermath of storms.

Flood risks pose an even greater underwriting problem, partly because they can vary greatly over relatively small distances and partly because flood damage often involves the failure of flood protection systems whose liability is limited by law. Private insurers generally avoid writing flood-damage policies for all residences except high-end homes needing coverage in excess of the limited protection that the NFIP offers.

Challenges for the Public Sector

High premiums, reduced availability, and increased deductibles in the private market have spurred states to create subsidized policies that provide affordable coverage for wind damage. In fact, since Katrina, this state-backed “residual market” has become a primary source of wind insurance for residents in high-risk coastal areas. However, these low-premium public programs may not always support the interests of a well-functioning insurance market. In some states, these programs have run deficits that led them to impose assessments on all private insurers in the state—or to draw on federal grants—to fill the gap, transferring the risk to policyholders in inland areas and to federal taxpayers.

Subsidies in the NFIP have also been substantial. Authorized by Congress when the program was established in 1968, these subsidies apply to about 20 percent of insured properties and cost the program over \$1 billion per year. Because the NFIP has not been allowed to charge full premiums and build up a reserve, it had to borrow \$20 billion from the U.S. Treasury following hurricanes Katrina and Rita. In effect, these subsidies require federal taxpayers to transfer funds to residents holding flood insurance policies. And because the premiums do not reflect expected losses, they do not provide appropriate incentives to avoid construction in high-risk areas or to build structures that can withstand powerful winds.

Options That Merit Consideration

The researchers conclude that a comprehensive national insurance plan that establishes an effective compensation system for future catastrophes is urgently needed. They make no specific policy recommendations, instead offering a range of policy options that warrant consideration. For each of the four objectives identified for a well-functioning insurance market, the researchers list options, in order of increasing government involvement, that should be considered in achieving that objective. They also discuss the advantages and disadvantages of different approaches and provide a framework for assessing the tradeoffs that policymakers need to make in deciding how to proceed.

Create Appropriate Incentives to Mitigate Risk

The private sector now finds it difficult to set insurance premiums that adequately reflect expected wind and flood losses. The research team identifies three basic approaches to overcoming this problem:

- Change government regulations to reduce the cost of capital that private insurers must hold to protect against large losses. Europe offers possible models that allow insurers to set aside loss reserves on a pre-tax basis before catastrophes occur. Providing post-event government

loans to insurers is an alternative means of achieving the same goal.

- Create federal programs offering low-cost reinsurance to private insurers that would allow them to hold less capital and lower risk loads. Similar reinsurance made available to states would enable state wind pools to set premiums closer to expected losses.
- Establish a federal program that would directly provide wind insurance. In principle, such a program could set rates to reflect anticipated losses.

The first option emphasizes the role of the private sector, but the extent to which it would reduce risk loads is unclear. The second and third options could substantially reduce risk loads but might lead to the introduction of subsidized rates and of pricing schedules that create cross-subsidies between wind and flood risk.

Ensure That Households and Developers Factor in Wind and Flood Risk

The failure of many homeowners and builders to purchase voluntary flood insurance suggests that they do not take the actual level of risk into account. Policymakers should consider the following:

- Making the purchase of NFIP coverage mandatory for all homes in high-risk areas, including homes without mortgages.
- Requiring homeowners and builders to carry coverage equal to the value of the structure rather than the outstanding balance of the loan.

Such stipulations would cover the approximately one-third of homeowners without mortgages and would reduce “adverse selection,” the reluctance of homeowners to purchase coverage unless they live in areas especially prone to floods. Policymakers should consider similar approaches to wind insurance. If research finds that a significant share of Gulf States homes do not have wind insurance, a mandatory purchase requirement could be introduced in areas of high wind risk.

Pay Legitimate Claims Efficiently and Expeditiously

Three types of reforms would address the waste and delays created by wind and flood coverage disputes:

- Develop new language that indicates how losses would be allocated when caused jointly by wind and flood or when the cause or timing of damage cannot be ascertained. The National Association of Insurance Commis-

sioners could convene a panel to develop model language that states could then adopt. In addition, regulators and insurers could consider adding a binding mediation and arbitration clause to settle disagreements about coverage.

- Offer public reinsurance for policies that cover both wind and flood. Federal reinsurance could provide the incentive needed by private insurers to issue policies that offer both wind and flood coverage and require policyholders to pay only one deductible.
- Establish a public wind and flood policy. Expanding the NFIP to cover wind damage would not only reduce private insurers’ risk loads, but would also solve the coverage-dispute problem.

The first option, developing policy language that minimizes coverage disputes, makes sense but may not be enough, since the potential for disagreement remains as long as flood and wind risks are not borne by the same entity. The second and third options could reduce or eliminate coverage litigation but would be subject to political pressures to subsidize rates. If such pressures were to prevail, they would frustrate any efforts to create a well-functioning insurance market.

Encourage Market Innovation and Price Competition

Because an insurance market in which the government is the sole provider might limit innovation and foster inefficiency, policymakers should consider reforms that increase the private sector’s willingness to offer wind and flood insurance. The reforms would have to address such issues as the private sector’s concerns about price regulation, post-event reinterpretation of policy language, and emergency rules issued by state regulators. Establishing a federal regulator of private wind and flood insurance might be an especially effective step, because such a regulator is unlikely to experience the political pressures that state regulators face when disasters occur.

Conclusion

New policies are urgently needed to establish appropriate incentives for mitigating the risk associated with flood and wind losses and to create an effective compensation system for future catastrophes. Because these catastrophes occur across a number of states and because federal taxpayers shoulder much of the burden of post-disaster relief, the federal government needs to take a leading role in formulating the new policies. Initial steps, such as establishing a national commission to assess reforms, should begin immediately. ■

This research brief describes work done for the RAND Institute for Civil Justice in collaboration with the RAND Gulf States Policy Institute and documented in *Residential Insurance on the U.S. Gulf Coast in the Aftermath of Hurricane Katrina: A Framework for Evaluating Potential Reforms*, by James W. Macdonald, Lloyd Dixon, and Laura Zakaras, OP-284-ICJ/RGSPi (available at http://www.rand.org/pubs/occasional_papers/OP284/), 2010, 20 pp., \$11, ISBN: 978-0-8330-5088-5. This research brief was written by Laura Zakaras. The RAND Corporation is a nonprofit institution that helps improve policy and decisionmaking through research and analysis. RAND's publications do not necessarily reflect the opinions of its research clients and sponsors. **RAND**® is a registered trademark.

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