

Building a Natural Catastrophe Solution

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Protecting Coastal Homeowners, Taxpayers, and the U.S. Economy

Coastal communities in the United States are experiencing unprecedented population growth. Every day, 3,500 people move to coastal communities along the more than 12,000 miles of the nation's coastline. In fact, 155 million people live and work in U.S. coastal counties. That means about one of every two Americans resides within 50 miles of our shores.¹

In 10 years, 12 million more people will be living on the coast. Despite a decade of concentrated hurricane activity, retirees continue to move to hurricane-prone areas such as Florida.² For every six people that retire in the United States and leave their home states, one settles in Florida.³

The significant development we've witnessed along the Atlantic and Gulf coasts in just the past four years translates into an increase in insured property. For example, it is estimated that Florida and New York each has approximately \$2 trillion of insured value in coastal areas (See Figure 1).

This dense concentration of people, homes, communities, and infrastructure means that our exposure to risk – especially from hurricanes – is growing at an alarming rate. The magnitude of this ongoing coastal development poses a threat to property owners and taxpayers, as well as the insurance industry.



Insuring coastal development is a long-term problem that demands a long-term solution. A brief analysis of hurricane activity in the last 75 or so years makes this more evident than ever.

For instance, of the 10 hurricanes that made landfall in the United States in 2004 and 2005, seven were among the most costly ever. This includes Katrina, which not only demonstrated the catastrophic harm a hurricane can unleash on a thickly populated coastline but also resulted in the single largest industry-insured loss to date – approximately \$40 billion.

However, given the buildup of property values along the coasts and the impact of inflation, a repeat of a hurricane from the past century would inflict losses exceeding much of what happened in 2004 and 2005. In fact, only Katrina would rank in the top 10 industry-insured catastrophic losses.

One need only examine the 18-year period between 1926 and 1944 to understand how real the threat is. During that period, there were four major hurricanes that resulted in significant loss, none greater than a Category 4. Today, those storms would cause estimated insured losses totaling \$220 billion. And that’s not including each event’s considerable uninsured losses and broader economic impact (See Figure 2).

Consider the 1926 South Florida hurricane, the so-called Category 4 “Big Blow” that hit downtown Miami with a 15-foot storm surge and winds in excess of 150 miles per hour. That hurricane killed 372 people. The population of Dade and Broward counties in 1926 was 135,000; today, it’s about 4 million. If the 1926 South Florida hurricane struck today, it’s estimated that insured losses alone could hit \$100 billion.⁴

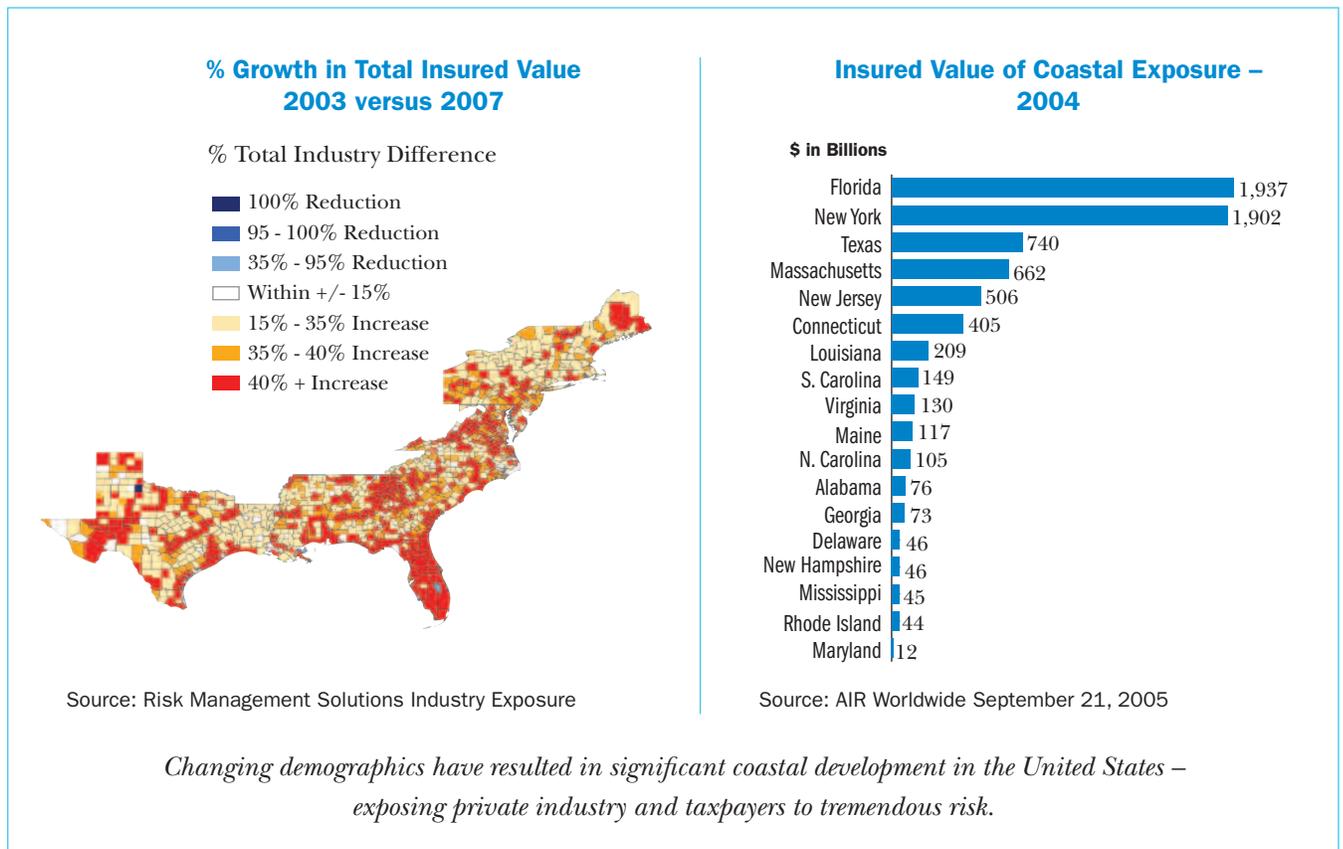


Figure 1

While history has been unkind to Florida, historical patterns actually prove that no area – from Texas to New England – is immune.

Another of the four major hurricanes from the early 20th century included the New England Hurricane of 1938, also known as the Long Island Express. The hurricane, formed off the coast of Africa, raced across the Atlantic as a Category 5 hurricane until weakening to a Category 3 as it made landfall in Suffolk County, Long Island.

After steamrolling across the sparsely populated farms and small towns of eastern Long Island, the hurricane moved north at an unusually high speed across Long Island Sound and smashed into New England. The storm surge in Rhode Island, for example, was 16 feet above normal high tide. The death toll topped

680, and the insured losses were \$23.5 billion in current dollars.⁵

Imagine today if a similar hurricane tracked just 50 or so miles to the west and hit New York City, with more than 8 million residents, the most densely populated city in the United States. The devastation would be severe.

A Public Policy Crisis

On both the state and federal levels, we’re facing a public policy crisis. Simply put, why should states such as Nebraska, Colorado, and Kansas finance the growth we’re seeing in coastal regions such as Florida? Little is being done to address how coastal development exposes private insurers and the public sector to significant, long-term economic peril following a serious weather event.

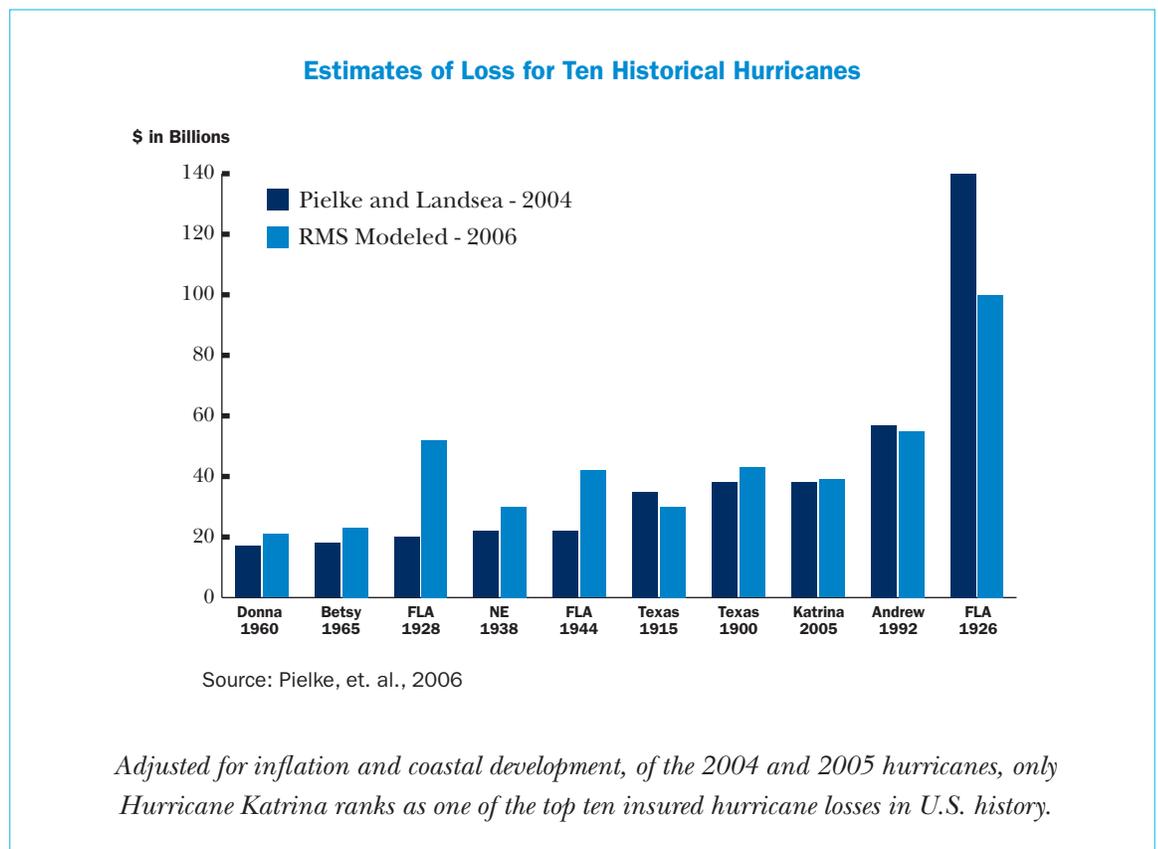


Figure 2

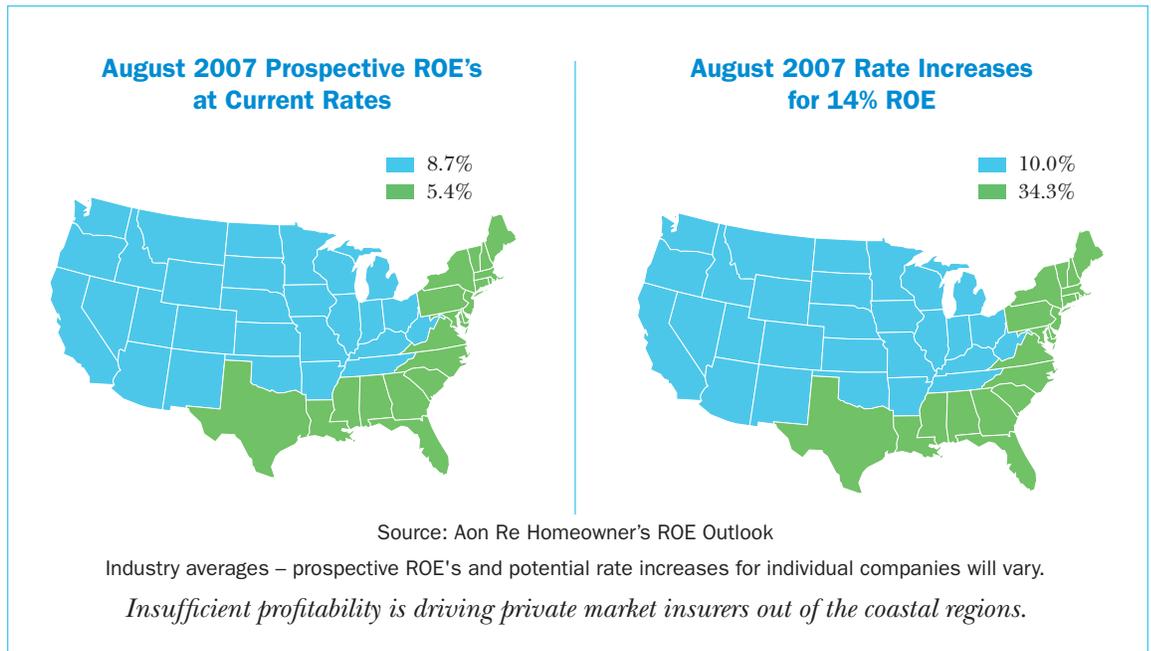


Figure 3

All this leads us to one of the most pressing issues today: the availability and affordability of coastal homeowners insurance. In this extremely risky environment, how do homeowners insure their most important assets against the likelihood of a hurricane? Also, how do federal and state government agencies as well as the insurance industry prepare and respond to catastrophes that are beyond the limits of the insurance sector?

Homeowners are understandably concerned about the affordability and availability of insurance. In fact, in coastal areas such as Florida and Cape Cod, private market insurance is so limited that state-backed insurance programs now dominate the market.

Insurers and reinsurers are often unable to charge rates sufficient to reflect the underlying risk and to provide adequate returns to shareholders (See Figure 3). This is critical in order to attract private investment to cover claim obligations

following a catastrophic event. In addition, the magnitude of potential loss from some events limits the capacity of companies to offer insurance.

With the catastrophes of 2004 and 2005, the insurance industry – as well as its regulators and ratings agencies – has increased its scrutiny of coastal property risk. One key factor has been the suppression of insurance rates, contributing to insurers withdrawing or reducing their business in many coastal areas.

Without the ability to charge adequate rates, the private insurance market has receded and has been replaced by taxpayer-funded, state-sponsored market solutions. At the same time, governments and taxpayers understandably want to minimize public expenditures and limit subsidies to homeowners in harm's way.

The Basis for Success

Given these challenges, there is no

shortage of proposed solutions. In the past year alone, industry, Congress, regulators, and others have presented solutions, some of which rely solely on state or federal government.

A number of proposals provide meaningful solutions for insurers but fall short of creating the workable, public-private partnership necessary for a vibrant homeowners insurance market, one that serves coastal residents, protects taxpayers, shields our economic infrastructure, and provides a vital role for the housing industry that is critical to local economies.

All levels of government have a responsibility for disaster recovery, as well as a role in land use planning, risk mitigation, and disaster preparedness. In addition, public officials have a vested interest in a well-functioning private insurance market that supports economic development and avoids the public financing of risk that could burden governments for decades.

It is The Hartford's hope that officials at the federal, state, and local levels will come together with the private insurance industry and insurance consumers in a partnership to solve this problem. To help reduce our nation's overall exposure to natural disaster risk, we must act now to implement a long-term solution that will expedite recovery, reduce costs, and provide incentives for private insurers to return to the coasts.

The Hartford is asking policymakers at all levels of government to agree on a public policy goal: The creation of a stable coastal homeowner's insurance market that provides consistent and available coverage from private insurers before and after a storm.

Partnering for a Sound Solution

The Hartford's Coastal Catastrophe Partnership (CCP) proposal incorporates six core principles (see "Starting Point for Success" on page 6) in a comprehensive, long-term solution that involves coastal homeowners, insurers, and federal, state, and local governments.

Coastal homeowners, of course, have a significant role to play in this proposal. Their education and engagement is absolutely critical to the success of any solution.

- Coastal homeowners must recognize the substantial cost of insuring homes exposed to hurricanes and other natural disasters. A clear recognition of the actual cost of the risk results in market-based behaviors and creates incentives to reduce risk, ranging from adjusting deductibles to installing storm shutters.
- To help address the "wind versus water" issue, it is necessary to require coastal homeowners to purchase flood insurance. This could be done by requiring certification of flood insurance coverage through the current programs or, as some have proposed, by inserting flood coverage as part of the standard policy, with flood losses reinsured by the federal government.
- To aid affordability, The Hartford proposes the creation of IRA-like savings vehicles – perhaps called "supplemental catastrophic security accounts." For those working families and retirees who still may be unduly burdened by the cost of insurance, we also propose means-tested subsidies. Targeted at low- and moderate-income coastal homeowners, this program would be administered at the state level and outside the traditional insurance mechanism.

As for the federal government's role, it's clear the potential exists for some natural disasters to surpass the industry's and the states' capacity to respond effectively. To motivate the private market to expand in coastal regions, a properly designed federal backstop could relieve state and local sectors of absorbing a growing risk beyond their means.

We should be clear about the proposed federal backstop, lest it prove hopelessly divisive. The federal backstop would be engaged only in the event of an extreme, infrequent, yet entirely possible catastrophic event – striking a balance between the federal government absorbing the entire exposure (such as a flood) and

the private market absorbing all insured losses. A benchmark event for the federal backstop would be a 1-in-100-year loss from a hurricane, but the benchmark could be adjusted higher.

An equally important federal responsibility involves establishing guidelines for states, in order to permit insurers doing business in the state to receive access to the federal backstop. Eligibility criteria would address risk mitigation, land use planning, disaster preparedness, and promote market-based discipline, and regulatory reforms critical to any long-term solution.

Finally, with the federal backstop as an incentive, states would strive to be federally

A Starting Point for a Solution

A comprehensive solution based on six core principles is necessary.

1. Unabated coastal buildup should be addressed through **sensible land use planning** and robust and enforced building codes.
2. We need to **expand – not shrink – the participation of the private market** through effective regulation of all aspects of the insurance industry. The cost of insurance must reflect the risk being insured in order to attract private capital and promote the market-based discipline needed to mitigate risk and support a sound market.
3. We must be sure that state-sponsored alternative insurance providers conform to federal standards, including **risk-based pricing and adequate capital**, so that they return to their original roles as insurers of last resort and not remain a burden to taxpayers at large.
4. To motivate the private insurance market to expand in coastal regions, a properly designed federal backstop for extreme catastrophic events would **relieve state and local sectors of absorbing a growing risk beyond their means**, as well as mitigate substantive tail-risk for private insurers that would be associated with an extreme event.
5. We must encourage lawmakers and courts, when under pressure from claimants, to **reaffirm the legitimacy of state-regulated policy language** and thereby reinforce a policy's contractual integrity.
6. And finally, while the aforementioned propositions may **improve the affordability of insurance for coastal homeowners**, a number of working families and retirees still may be unduly burdened by its cost. They should be offered means-tested financial assistance funded at the state level to help transition through these public policy changes.

certified with the expectation of creating conditions that would expand private market capacity and reduce the exposure of each state to extreme natural catastrophe risks.

Currently, the states perform a critical regulatory role in the homeowners insurance market, which should continue. States also should continue to encourage a robust private market and avoid unsound policies that subject all parties to significant post-event costs. There are a number of measures many states can take to make this a reality:

- States could create their own reinsurance funds for access by private insurers and state-sponsored insurance markets. States establishing these funds would also be bound by federal guidelines. This would alleviate the haphazard and inconsistent creation of state reinsurance funds.
- Costs associated with the federal backstop and any state reinsurance funds would be identified separately on the homeowner's policy statement and passed directly to policyholders. States would not be permitted to deny insurers adequate rates for the risk they retain due to a federal backstop or any state reinsurance funds.
- Finally, any state reinsurance fund would become engaged only where the capacity of the private market begins to diminish seriously. It's been suggested that point is equivalent to a 1-in-50-year loss but, again, this is open to discussion.

There may be circumstances where a state loses its qualification status, through decertification by the federal regulatory authority, state withdrawal from this federal program, or termination of the

program. In this event, the federal backstop would remain in effect for existing policies until their natural expiration, and states would be prohibited from limiting the non-renewal of such policies.

Working Together for a Solution

As Hurricane Katrina reminded us, the coastal homeowners insurance problem is a complex public policy matter that requires a partnership between policyholders, state and federal government, and the private insurance industry.

The Hartford's Coastal Catastrophe Partnership is a comprehensive approach aimed at addressing the many challenges by involving all the constituents in the creation of a long-term solution.

While it may be ambitious and politically challenging, we are convinced that it is the best path to a national solution – one that retains the critical role of private insurance, minimizes taxpayer cost, and ensures quick recovery following a catastrophe.

In 2008, The Hartford looks forward to the insurance industry collaborating with federal and state policymakers to build a solution that provides critical security to coastal homeowners. The time is now for substantive, innovative action on one of the major risks facing our nation.

¹ Rob L. Evans, "Rising Sea Levels and Moving Shorelines," *Oceanus: The Magazine of Research from Woods Hole Oceanographic Institution*, March 13, 2008.

² Penelope B. Grenoble, "Gulf Coast Comeback," *Water Efficiency: The Journal for Water Conservation Professionals*, September/October 2007.

³ "Key Findings from Demographic Analysis of 2005 American Community Survey (ACS)," N.C. Center for Creative Retirement Institute for the Future of Retirement, University of North Carolina, Asheville (2006).

⁴ "1926 Miami Hurricane Historical Marker Dedicated," Press Release of the National Weather Service, Southern Region Headquarters, September 18, 2007.

⁵ David R. Vallee and Michael R. Dion, "Southern New England Tropical Storms and Hurricanes: A Ninety-Eight-Year Summary, 1909-1997," National Weather Service, Taunton, MA.