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OPTIONAL FEDERAL CHARTERING OF INSURERS AND HURRICANE RISK: Can a Federal Regulator Help Restore a Market for Coastal Insurance?

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The 110th Congress considered several bills for Optional Federal Chartering (OFC) for insurance companies. The bills would create a federal insurance regulator and allow companies to organize under federal law, in contrast to the current set-up where firms must organize under state regulation. The plans do not add an extra layer of regulation to an industry already regulated at the state level, but instead provide an alternative way to organize companies, similar to national- and state-chartered banks. A federally chartered insurer would face federal regulation for its operations throughout the country. OFC should reduce the regulatory burden on insurers who opt for federal chartering, as they will have to deal with only the federal regulator as opposed to fifty state regulators, each with their own filing and regulatory requirements. This Mercatus on Policy considers how OFC potentially affects hurricane insurance, which Congress also examined last session.[1]

FEDERAL CHARTERING AND COMPETITION IN REGULATION

Much of the benefit from OFC would be from competition between regulators. If insurers are allowed to but not required to operate under federal regulation, companies will choose a federal charter only if federal regulations are attractive relative to state regulation. Federal regulators would need to offer advantages to induce companies to choose a federal charter; if federal regulation was less attractive than state regulation, companies would not choose federal chartering.

As states either lose or perceive the potential to lose insurers to federal chartering, they could also alter their regulations. This would likely increase consumer protection as inefficient regulations—those which impose significant costs on insurers and few benefits to consumers—are most subject elimination by regulatory competition. This would result in a more efficient industry.

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OFC AND STATE HURRICANE INSURANCE REGULATION

The impact of OFC on the main mechanism of state intervention in hurricane insurance and state-operated beach or wind pools (currently in place in seven Gulf and Atlantic coast states) would be minimal.[2] The wind pools offer coverage for high-risk coastal properties at rates below market equilibria. Because they charge actuarially inadequate rates, these pools inevitably incur losses in excess of accumulated reserves when a major hurricane strikes. When a wind pool incurs losses beyond accumulated reserves, the losses are then passed on to insurance companies and policy holders throughout the state by means of assessments. All insurance companies are formally "members" of the state wind pools, and the pools can assess insurance policies written by member companies (essentially all insurers in the state) to cover losses. These assessments are essentially a tax on the state insurance industry.[3] State regulators would still have to admit federally chartered insurance companies to write policies in a state, just as companies based (or domiciled) in other states must be admitted; thus under current proposals, federally chartered insurers would be subject to assessments. OFC would not immediately halt the shifting of hurricane damages to policy holders who do not live in high-risk coastal areas. Also, because state intervention keeps rates in coastal areas below the market value, federally chartered insurers (who presumably would charge risk-based rates) would be unlikely to write many wind policies in coastal areas.

Although OFC will not directly affect state regulation of high-risk properties, the entry of federally chartered insurers into the property/casualty markets of hurricane-prone states may still have several beneficial effects.

First, **OFC will ease the burden on insurers seeking to encourage mitigation through premium discounts or other terms of coverage**. Under state regulation, an insurer must have discounts or policy provisions approved by each state insurance commission, which can be costly, uncertain, and involve delay. This can be particularly problematic for insurers trying to encourage mitigation across hurricane-exposed states. As Howard Kunreuther of The Wharton School has noted, "The development of premium schedules which provide rate reductions for adoption of certain mitigation measures requires administrative time and energy, both to develop and make a case to the state insurance commission."[4] State regulators vary in how they regulate. For instance, Texas requires that rates be based on loss history as opposed to catastrophe models,[5] which has the twin effects of discouraging mitigation and distorting the perceived risk during long periods between disasters.

The delay and uncertainty in securing approval particularly impacts insurers seeking to coordinate marketing campaigns for mitigation across states. Many experts fear that homeowners will ignore the potential for a hurricane or procrastinate and thus fail to invest in mitigation before a major catastrophe. To overcome this inertia, insurers must alert homeowners about mitigation opportunities and provide incentives for mitigation, perhaps through premium reductions.[6] Duplicative state regulatory burdens raise the cost to insurers of coordinating marketing and premium reductions to promote mitigation.

Second, **OFC can protect insurers from policy swings in states in the aftermath of hurricanes**. Insurers often seek to raise rates in the aftermath of a hurricane both to replenish reserves and because insurers often learn about the potential for losses, which often turn out to be greater than previously expected. Yet, state regulators often restrict rate increases after a hurricane. The aftermath of Hurricane Andrew in Florida provides two examples of adverse regulatory decisions. Many companies decided to reduce the amount of insurance they wrote in Florida after Andrew, due in part to the recognition that hurricane losses might be substantially greater than previously thought. The Florida Department of Insurance blocked withdrawals of companies from the state and imposed a moratorium on the cancellation or nonrenewal of policies.[7] And in the immediate aftermath of Andrew, the Florida Insurance Commissioner announced that his office would not permit any unjustified rate increases—though an elected regulator might easily rate increases necessary for normal operations to be "unjustified." A study found that the Insurance Commissioner's pronouncement caused the price of insurance company stocks to fall. The stock price reduction due to the commissioner's comments was large, almost 80 percent of the stock reduction that Andrew had caused. Regulation had almost as great an impact on insurance companies as the worst hurricane insurance loss to date.[8]

Politically motivated state regulatory decisions after a major hurricane make entering the market more risky. If insurance companies anticipate such erratic decisions, they may choose not to enter a state market initially or exit the state entirely as State Farm did when it announced in January 2009 that it plans to exit Florida's property/casualty market in the next two years. Federal regulation should result in more consistent regulation and increase the number of carriers (and thus price competition) in hurricane-prone states.

Third, **regulated rate setting often involves cross-subsidization, typically equalizing prices paid by high- and low-cost consumers**. In the case of wind insurance, this involves the owners of high-risk properties most vulnerable to losses paying lower rates than they would in a competitive insurance market. Most policy discussions of wind coverage focus on these below-market rates for the highest-risk properties.[9] But some policyholders might face rates set above what would be charged in a non-regulated market since these high rates allow regulators to keep rates low for the highest-risk properties.[10] Federal regulators would be unlikely to force insurers to offer subsidized rates for high-risk properties, and as a consequence these companies might be able to offer better rates to moderate-risk policyholders who may be currently cross-subsidizing high-risk properties.

OFC AND OTHER FEDERAL PROPOSALS FOR WIND AND CATASTROPHE INSURANCE

OFC should not be confused with two measures regarding hurricane insurance considered by Congress in the last session: adding wind coverage to the National Flood Insurance Program (NFIP) and creating a federal backstop for catastrophe losses. Adding wind coverage to the NFIP or creating a new multi-hazard federal insurance program would move wind policies from the market to the public sector while a federal backstop would involve federal coverage for catastrophe losses above a set threshold.

OFC could be passed independent of either of these reforms and would only indirectly affect the case for or against wind coverage or federal backstopping. If OFC did help the market for wind insurance in hurricane-prone states, this might reduce some of the pressure for shifting wind coverage to the NFIP.

CONCLUSION

State Farm's exit from the Florida property/casualty-insurance market—and the attendant reduction in consumer choice—is a result of years of regulatory decisions built around keeping rates for high-risk coastal properties in the nation's most hurricane-prone state below actuarially sound levels. The Florida Department of Insurance and state lawmakers may in fact attempt to prevent State Farm from actually exiting the state market. With such a regulatory environment, what prudent insurance company would seek to enter or expand its book of business in Florida?

Yet such regulation may be politically inevitable in Florida and other coastal states. Within these states, elected officials may make short-term decisions with negative long-term consequences. OFC offers a way to avoid regulation driven by the interests of particular groups. A more stable regulatory environment could encourage nationally chartered insurers to enter the property/casualty-insurance markets in coastal states. Federally regulated insurers could provide stability to markets driven by state regulatory policy pressures. Even if federally chartered insurers do not write many policies normally in high-risk coastal areas, their presence could ease the cycle of insurance availability after major hurricanes. Much consumer support for residual market wind pools arises from the periods when insurance is difficult to obtain in the marketplace. OFC could help reduce the occasional crisis of availability which can drive support for an insurer of last resort.

A more stable regulatory environment could encourage nationally chartered insurers to enter the property/casualty-insurance markets in coastal states.

ENDNOTES

1. The Competitive Enterprise Institute maintains a Web site with more details on OFC at www.ofcfaq.org/.
2. All of the states along the Atlantic coast, except Maine and New Hampshire, have residual market mechanisms, or Fair Access to Insurance Requirements (FAIR) plans. In states without dedicated wind pools, like Virginia and Georgia, the FAIR plans provide some of these same benefits for high-risk coastal properties.
3. Eli Lehrer makes this analogy in "Restoring Florida's Insurance Market," *Backgrounder* 55, James Madison Institute, (February 2008), http://www.jamesmadison.org/pdf/materials/668.pdf.
4. Howard Kunreuther, "Mitigating Disaster Losses through Insurance," *Journal of Risk and Uncertainty* 12 (1996): 180.

5. See Eli Lehrer, *Options for Reforming the Texas Windstorm Insurance Association*, (Austin: Texas Public Policy Foundation, forthcoming).

6. See Daniel Sutter, "The Market for Hurricane Mitigation: Regulatory or Market Failure?" (working paper, Mercatus Center at George Mason University, April 2008), http://www.mercatus.org/PDFDownload.aspx?contentID=16154.

7. Eugene Lecomte and Karen Gahagan, "Hurricane Insurance Protection in Florida," in *Paying the Price*, Howard Kunreuther and Richard J. Roth, eds. (Washington, DC: Joseph Henry Press, 1998), 104–113.

8. See Lazarus A. Angbazo and Ranga Narayanan, "Catastrophic Shocks in the Property-Liability Insurance Industry: Evidence on Regulatory and Contagion Effects," *Journal of Risk and Insurance* 63 (1996): 619–637.

9. See Jeffrey J. Pompe and James R. Rinehart, "Property Insurance for Coastal Residents: Government's 'Ill-Wind,'" *Independent Review* 13, no 2 (2008), 189–207, and Daniel Sutter, *Ensuring Disaster: State Insurance Regulation, Coastal Development and Hurricanes*, Mercatus Policy Series (Arlington, VA: Mercatus Center at George Mason University, 2007).

10. Such regulatory rate setting is known as cross-subsidization and is equivalent to taxing the consumers forced to pay above-market rates and giving the money to the subsidized customers. See Richard Posner, "Taxation by Regulation,"*Bell Journal of Economics and Management Science* 2 (1971): 22–50.

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