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## THE NATIONAL INSURANCE CONSUMER PROTECTION ACT'S POTENTIAL IMPACT ON THE SOCIAL RESILIENCY OF HAZARD-PRONE REGIONS

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## **Mercatus Policy Series**

### **The National Insurance Consumer Protection Act's Potential Impact on the Social Resiliency of Hazard-Prone Regions**

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#### **Introduction**

The social resiliency of a community can be described as the capacity to withstand disruptions, rebuild, and retain essentially the same identity and culture. In addition to the public support from federal, state, and local governments, the ability of a community to recover from a disaster is also heavily dependent upon a functioning insurance market.

The purpose of this paper is to assess the potential consequences of federal regulation, as opposed to the current system of state regulation, on insurers and their ability to provide coverage in hazard-prone regions. Currently, many states' insurance companies are either being heavily subsidized to stay afloat or are hobbled by excessive regulation.

The merits of moving toward federal regulation have been debated for many years to try and alleviate some of the problems faced by the states. Numerous unsuccessful attempts have been made to reform the regulatory system and move to a federal approach. The most common model in recent years is the Optional Federal Charter (OFC). This approach would provide insurers the option of obtaining either a state or a federal charter.

Because social resiliency is closely intertwined with the condition of the insurance markets, it's very important to assess the current insurance regulation system and see what is working, what is not working, and what can be done to fix it. A healthy insurance market is critical to credit markets that provide funding for individuals and businesses after a disaster. Before providing capital, lenders typically will not provide funds without adequate insurance coverage. If lenders are not willing to provide loans, then the ability of people to buy homes or start businesses will be constricted. A community will have a much more difficult time recovering from a disaster without a functioning insurance market.

The first part of the paper provides some background on the insurance industry and the rise of insurance regulation through the states. Section two assesses the benefits and costs of the current regulation system—the state regulation of insurance. The third section analyzes the benefits and costs of the proposed Optional Federal Charter (OFC) system. The final section, focusing on recommendations, compares the costs and benefits of each system to ascertain possible paths moving forward. In addition, a handy appendix is provided at the end of the paper that tells the stories of individual states.

## Background

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

Insurance is regulated based on the existence of market failures. Market failures are due to asymmetric information problems that can result in suboptimal consumer decisions, excessive insolvency risk, and abusive market practices.<sup>1</sup> For example, since insurance is a complex product that is not readily understood by many consumers, insurers could offer inadequate coverage that would leave the consumer unprotected. The financial literacy of much of the public is not adequate to make informed decisions and hence must be protected. Even under the best of circumstances there will be confusion regarding the policy language and coverage terms.<sup>2</sup> Furthermore, policyholders are not in a strong position to monitor the actions of the management of the insurance company. Management could engage in inappropriate behavior or take excessive risks without the knowledge of policyholders.<sup>3</sup> This could endanger the solvency of the insurer and increase the likelihood of claims going unpaid.

Proper regulation can reduce market failures and the information problems. Regulators review forms to ensure readability and fairness, evaluate market conduct, and monitor solvency. Much of the recent efforts of regulators in recent years have been directed at ensuring that the consumer has access to an affordable source of coverage.

Traditionally, it has been the responsibility of the state governments to regulate insurance. The case of *Paul v. Virginia* first established the authority of states to regulate insurance in 1868. The state's authority was confirmed through numerous court decisions until the *Southeastern Underwriters* case in 1944. In this case, the Supreme Court ruled that the commerce clause in the U.S. Constitution did not apply to insurance and therefore the industry was subject to federal antitrust law. In an attempt to clarify, Congress passed the McCarran-Ferguson Act (15 USC § 1011, et seq) in 1945. The McCarran-Ferguson Act states that it is in the public's interest for states to continue as the primary regulator of insurance, except in instances where federal law specifically supersedes state law. It also provides a federal antitrust exemption to the insurance industry. This system has remained in place for decades while the insurance industry has grown and evolved (see appendix). Many insurers now operate on a national and international level and offer an assortment of complex financial products.

## How Insurance Works

The primary elements of insurance are the pooling of risk and the transfer of that risk to another entity (an insurer). Insurance companies do not create the risk; they simply coordinate the

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<sup>1</sup> Martin F Grace and Robert Klein (1999) Efficiency Implications of Alternative Regulatory Structures for Insurance. Presentation from the American Enterprise Institute Conference on Optional Federal Chartering and Regulation of Insurance. June 10, 1999

<sup>2</sup> The thousands of wind versus water claim disputes following Hurricane Katrina are an example

<sup>3</sup> Skipper, Harold D. and Robert W. Klein. (2000) Insurance Regulation in the Public Interest: The Path Towards Solvent, Competitive Markets. Geneva Papers on Risk & Insurance – Issues and Practices 25 (4): 482-504.

sharing of the risk amongst the affected parties and finance the loss payments over time. In order for insurers to be able to facilitate this process, certain conditions must exist. Not all risks are insurable. In order for a risk to be insurable, the following conditions generally must be met: a large number of similar exposure units, accidental and definite losses, calculable loss estimates, manageable catastrophic exposure, and an affordable premium level. When these elements do not exist, it is very challenging for insurers to offer coverage responsibly.

Potential losses attributed to perils such as fire and theft are predictable due to reliable historical measures and the minimal catastrophic exposure. However, damage resulting from catastrophic perils such as hurricanes are much more difficult to gauge because they are not as predictable, have an enormous loss potential, and the losses to the exposure units are correlated. This correlation restricts insurers' ability to reducing their risk through a geographic spread since a single, catastrophic event will impact many of their policyholders at once. Based on the inherent nature of these catastrophic perils, private insurers are quite reluctant to risk their capital to insure properties at premium levels deemed to be "affordable." Insurers (and their stockholders) require a higher return on their capital to justify the higher risk they face when they insure coastal property. Given the nature of the hurricane exposure and the difficulty in obtaining a return to match the risk, many insurers have chosen to reduce their writings or withdraw from the market altogether.

#### Insurance Rating Principles

According to commonly accepted actuarial principles propagated by the Casualty Actuarial Society, rates should be "reasonable, not excessive, not inadequate, and not unfairly discriminatory." Furthermore, "a rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer."<sup>4</sup> In theory, rates should depend on expected claims costs, insurer administrative costs, and the insurance company's cost of holding capital sufficient to pay claims. These principles also guide the actions of state regulators when determining whether rates are acceptable. Of course, what is considered adequate, not excessive, and not unfairly discriminatory can vary from person to person and state to state. Ensuring that rates are adequate, yet not excessive, is a difficult task and requires interaction between insurers and regulators. Given the coastal exposure and the unpredictable nature of hurricanes, both insurers and regulators must contend with considerable uncertainty and political pressures.

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<sup>4</sup> Casualty Actuary Society Statement of Principles Regarding Property and Casualty Insurance Ratemaking <http://www.casact.org/standards/princip/sppcrate.pdf>

## The Role of Guaranty Associations

As previously discussed, prompt insurance claim payments play a key role in helping a community rebuild and maintain social resiliency. Under the current state-based system, when a licensed insurer experiences financial distress, the state insurance department initiates a process in attempt to guide the company back to profitability. If the insurer cannot be rehabilitated and is declared insolvent, the insurance commissioner can seek authority to seize its assets and operate the company pending liquidation. In essence, the state becomes the administrator of the insolvent insurer. After the state conducts an accounting of assets and liabilities, it prepares to distribute any remaining cash among creditors. When a state guaranty fund takes over a troubled insurer, it has two sources of funds available to pay claims. First, any remaining assets from a defunct insurer are put in the estate and the guaranty funds are a preferred creditor. Second, the guaranty fund can assess insurers (typically 2 percent of the premium on eligible lines of business). The guaranty fund uses this capital to pay claims to policyholders who make claims through their state guaranty association. The guaranty association steps into the shoes of a failed insurer and investigates the claims to policyholders. If the claims are valid, the guaranty association will pay at least a portion of the claims. State Guaranty Funds have maximum limits on the amounts payable to a single policyholder, typically \$300,000.<sup>5</sup> The role of the guaranty association and the criteria regarding payments from the guaranty fund are currently defined by state law. Although there is no set of minimum standards that apply to all state guaranty funds, the NAIC does provide guidance to facilitate a degree of uniformity.

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

## **Benefits and Problems with the State-Based Insurance Regulation**

### Benefits of State Regulation

Each state currently has a staff of insurance regulators led by an insurance commissioner (or director). The organization and infrastructure are in place and experienced. Proponents of continued state regulation note that the system is working at least as well as the federally regulated financial sectors.<sup>6</sup> Most Departments of Insurance are staffed by dedicated professionals who focus on market conduct, consumer protection and insurer solvency.<sup>7</sup> They reside in the state capital and are available to state residents.

Perhaps the greatest advantage of state regulation is the connection to the local population and the awareness of regional problems, concerns, and economic conditions. Proponents of continuing state regulation promote this approach as a benefit to the consumer since it allows flexibility and

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<sup>5</sup> Source: <http://www.ncigf.org/>

<sup>6</sup> The collapse of AIG, the world's largest insurer, has been raised as a failure of state insurance regulation. However, the insurance operations of AIG were in a strong position and its financial ruin was due to derivative trading in the Financial Products (AIGFP) division.

<sup>7</sup> The main source of funding for the departments is a required premium tax (often 2 percent of the premium) paid by insurers operating in the state. The primary purpose of the premium tax is to raise general revenues for the state, not to provide funds for regulation. Many departments are underfunded and receive only a fraction of the premium taxes collected.

responsiveness to local needs. It also, however, leads to unique rules and regulations throughout the nation that create inefficiencies for national insurers.

The National Association of Insurance Commissioners (NAIC) attempts to coordinate state insurance regulatory activities to promote uniformity; however there is still a great deal of variation among the states.<sup>8</sup> Some variability can be a good thing because it allows new laws and regulatory models to be tested in a confined system with potential damage limited to one state. It is not possible to say in general terms if state regulation is working or not working. Some states have a healthy market and a collaborative relationship between regulators and insurers.<sup>9</sup> Other states have markets that are in turmoil and a combative relationship. Overall though, despite two decades of unprecedented catastrophes, most state insurance markets have remained functional with relatively few insurer failures. When an insurer has failed, the guaranty funds have raised adequate capital to protect policyholders of the insolvent insurers. There is legitimate concern however over how the state-based system could handle an extreme event such as a powerful hurricane or earthquake occurring in a major population center.

### Problems with State Regulation

The lack of uniformity among state laws and regulations has been the traditional criticism of the state system and a prime motivation for supporters of federal regulation. The lack of uniformity is unavoidable if regulators responsive to local needs. When state legislators and regulators respond to the populace, a patchwork system of rules is created, which becomes awkward and costly to national insurers. Navigating the numerous departments costs time and delays response to changing conditions.

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

Rate suppression and the resulting market problems are another prominent criticism of state regulation. Most of the states employ a prior approval rating system for residential property insurance policies. With this kind of system, insurance companies file rates with the Department of Insurance, and, under certain conditions, must receive the commissioner's approval before their implementation. If rates are not approved, insurers are prohibited from using them. Insurers are usually allowed to challenge the commissioner's decision in the courts. This is a costly and time-consuming process. Prior approval regulations are, by another name, price controls. These operate by allowing state regulators to intervene in setting rates. The system relies more on the judgment of regulators in setting rates that are "adequate but not excessive" than on the forces of market competition. Under prior approval, the market-based pricing signals are interrupted, making the markets less competitive. As rates are held down for the high-risk policyholders, the

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<sup>8</sup> The NAIC members meet regularly to draft model laws and offer recommendations to state legislative bodies. The NAIC has no legal authority to force states to adopt the recommendations.

<sup>9</sup> For example, the Commonwealth of Virginia has a rating system based on competition, a small residual market with a reliable catastrophe financing plan, and a director who is insulated from political pressures.

low-risk policyholders can end up paying too much for their coverage since insurers are forced to make up lost premium by not taking indicated premium reductions for lower-risk property owners. Furthermore, if the high-risk property owners are being subsidized, there is less incentive to mitigate their exposure. Low premiums are attractive to the consumer in the short run, but the true value of insurance is the payment of a covered claim. The ability of a society to recover after a disaster is dependent upon a viable insurance market that not only pays claims, but also remains solvent and provides coverage after the event. It is important to not only have a source of affordable insurance coverage before the disaster, but after as well. The state efforts to manage the insurance marketplace through the use of rate controls have reduced incentives for private insurers to participate and provide a source of coverage.

### The Beginning of the Crisis.

Starting with Hurricane Hugo in 1989, a series of catastrophic events dramatically changed the property insurance market. Hurricane Hugo made landfall near Charleston, South Carolina as a category 4. Hugo moved through the Carolinas and struck Charlotte as a category 3 hurricane. The hurricane caused \$7 billion in privately insured losses, making it the most costly hurricane ever recorded to date.<sup>10</sup> At the time, it was widely viewed as the worst-case scenario. These views quickly change after Hurricane Andrew. Hurricane Andrew struck southern Florida during the summer in 1992. It was a powerful category 4 hurricane that caused \$23 billion in insured damage, the largest insured loss caused by a natural disaster in history. Seven domestic insurance companies and one foreign company became insolvent directly because of Hurricane Andrew. The Florida Insurance Guaranty Association was forced to issue bonds to provide for the payment of claims from insolvent insurance companies.

Insurers were reeling and scrambling to find a strategy to manage the current losses as well as preparing for the uncertain future losses. Insurers needed to better understand their exposure in order to remain financially solvent. They desperately needed to obtain a better estimate of the potential frequency and severity of losses so that they could calculate the appropriate premium levels and manage their exposure. Insurers turned to a relatively new computer-based tool called catastrophe modeling (commonly called cat models). Consulting organizations helped to clarify the potential exposure by creating mathematical models to synthesize extreme events on insurers' portfolios of insured properties. The technology had developed to provide damage estimates based on historical and hypothetical events. The models provided output that quantified the exposure and assigned probabilities to described levels of losses. The output provided a return-period Probable Maximum Loss (PML) event that considered the probability of a threshold value being exceeded in a given time period. For example, a 100-year PML estimate has a 1 percent probability of being exceeded in a year. The results from the cat models generally supported the insurers' concerns that they were over-exposed in hazard regions and had underestimated the exposure.

### The Reaction of State Legislators and Regulators

The severity of the disasters and potential for future financial losses caught the public, insurance industry, regulators, and state legislators by surprise. As insurers began requesting large rate increases and processing massive cancellations of policies, state legislators began developing legislation to suppress the increases, limit cancellations, and offer alternative sources of insurance coverage to the public. The insurance-market problems initially spread from Florida to Hawaii

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<sup>10</sup> Loss estimates provided in this paper are in 2008 dollars, Insurance Information Institute, <http://www.iii.org/media/facts/statsbyissue/catastrophes/>

and California, and then to the rest of the coastal states in the southeast and mid-Atlantic. In some states (Hawaii, South Carolina, and Virginia), competitive forces have worked and residual markets are truly as a last resort. Those markets have stabilized and are functioning, while in other states (Florida, North Carolina), the market is in disarray and the outlook is quite grim. These states have residual markets with billions of dollars in exposure and inadequate capital. They instead rely on post-loss assessments on insurers and policyholders that can further destabilize a fragile market.

### **Benefits and Problems with a Federal Insurance Regulator**

In February 2009, Federal Reserve Chairman Ben Bernanke stated before House Financial Services Committee that establishing optional federal charters for insurers is a “useful idea.” In the following month, Treasury Secretary Tim Geithner testified before the committee and described the need for wide-ranging new authority to oversee insurers that present “systematic” risk. The National Insurance Consumer Protection Act (H.R. 1880), introduced in April 2009, provides a framework for an optional federal charter along with a new regulatory approach for managing systemic risk in the U.S. financial sectors. Given the recent economic crisis, the approval for distribution of Troubled Asset Relief Program funds to several of the nation’s largest insurers, and the prominent troubles of world’s largest insurer, AIG, this issue has received a great deal of recent attention. The implementation of OFC legislation would have a substantial impact on the insurance industry and hence the social resiliency of communities to disasters. The potential impact from adoption of the most recent OFC proposal on the insurance industry and social resiliency will be discussed.

#### **The Optional Federal Charter**

The previous material provides a description of the efforts of state authorities to manage the insurance markets that are so critical to social resiliency. The legislators and regulators have attempted to maintain an available source of affordable coverage through a system of price controls and residual markets. State-specific guaranty funds back the standard insurers should the approved rate levels prove inadequate and they incur financial distress. In the event of a major catastrophe, some of the residual markets and guaranty funds will require post-disaster bailouts via assessments on insurers and their policyholders. The most likely federal approach would involve an Optional Federal Charter (OFC). The next section will discuss the potential impact of the OFC proposal on the existing insurance market and the extensive involvement of state governments.

An optional federal charter would allow eligible insurers to choose federal regulation or continue under the state system. A large insurer that is operating nationally is currently under the authority of 50 state regulators plus Washington, DC and territories, each having unique laws and systems. If an insurer obtains a federal charter, it would no longer be subject to licensing, examination, or supervision by state regulators. Insurers would also be free of the state government controls on rates and products. When free of excessive regulation, the homeowners-insurance market is highly competitive.<sup>11</sup>

There have been numerous proposals over the last decade that would offer insurers the option of choosing a federal charter. Interest spiked after the passage of Gramm Leach Bliley, which

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<sup>11</sup> The Financial Services Roundtable Blue Ribbon Commission on Mega-Catastrophes, a Call to Action 2007.



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

The OFC has not been able to generate the consistent support needed to make progress in Congress. The various sectors and associations within the insurance industry are still divided, though less than in the past (appendix). Following 9/11 and the decision of the federal government to offer federal reinsurance against losses due terrorism through the Terrorism Risk and Insurance Act (TRIA), it seemed that the next step would be for Congress to expand its regulation of insurance. This did not happen in a substantial way. However, the most recent financial crisis has again created a sense of urgency to address the issue.

#### The National Insurance Consumer Protection Act

The closest that the United States has come to pursuing the OFC option was in 2008 when the National Insurance Act was considered by the 109th and 110th Congresses. The bill, like others before it, provided for an optional federal insurance charter similar to the current system that exists in the banking industry. In March 2009, the National Insurance Consumer Protection Act was introduced to the 111th Congress by Representatives Melissa Bean, D-Ill and Ed Royce, R-California. There has not yet been a companion bill introduced in the Senate. A key difference from last year's National Insurance Act and the recently introduced National Insurance Consumer Protection Act is that the "optional" portion would be removed for specified insurers. The National Insurance Consumer Protection Act would require that insurers designated as "systemically important" to be subject to federal regulation.

The National Insurance Consumer Protection Act calls for the establishment of the Office of National Insurance (ONI) within the Department of the Treasury. The National Insurance Commissioner (Commissioner) would head the ONI after appointed by the president with consent of the Senate. The commissioner would oversee the organization, incorporation, operation, regulation, and supervision of the national insurers and insurance agencies, subject to oversight by the Secretary of the Treasury. The proposal calls for a somewhat passive regulatory approach in which the commissioner would "encourage such insurers, agencies, and producers to self-identify and self-correct actual or potential violations of the law (section 111)." The commissioner would be responsible for a full-scope, on-site examination of each insurer at least once every two years (section 112). Producers and agents would be examined in response to a complaint or violation of laws or regulations

The commissioner would establish a Division of Consumer Affairs within the ONI. The director of the Division of Consumer Affairs would receive questions and complaints from consumers regarding the actions of national insurers, agencies, and producers. The director will have the responsibility and authority to resolve such questions and complaints. The Division of Consumer Affairs will establish an office in each state and maintain a centralized call center and Internet address to be available to consumers who have complaints regarding national insurers, agencies, and producers. The ONI will be funded by the collection of assessments on national insurers at a

level determined by the commissioner. The funds collected are not intended to be considered government or public funds.

The National Insurance Consumer Protection Act combines the earlier calls for the OFC with the newer systemic risk regulator concept. The president, after consultation with the Chairman of the Senate Committee on Banking, Housing and Urban Affairs, and the House Committee on Financial Services, would be responsible for designating a systemic-risk regulator for covered institutions. The systemic-risk regulator would have the authority to obtain information on the activities of covered institutions and determine if they would have serious adverse effects on economic conditions or financial stability. The systemic-risk regulator could prohibit such activity or require action to be taken to mitigate the adverse effects. The ONI would work in conjunction with the systemic-risk regulator. The commissioner and systemic-risk regulator would determine which insurers were systemically important and whether it should be covered under this act. If an insurer is determined to be systemically important, it would thereby be required to obtain a federal charter. There is concern that the designated insurers would be considered *too big to fail* and that it could lead to excessive risk taking and a lack of market discipline.

#### State Laws and the Rate Approval Process

Under the proposed bill, federally chartered insurers would not be subject to licensing, examination, reporting, regulation, or supervision by state regulators (section 109). The National Insurance Consumer Protection Act does require national insurers to be subject to state law relating to participation in residual markets with a very important exception. The act specifies that insurers do not have to participate if the state law “results in rates in effect for an assigned risk, mandatory joint underwriting association or any other mandatory residual market mechanism that fail to cover the expected value of all future costs associated with insurance policies written by such residual market mechanism.” Furthermore, national insurers would not be required to participate if the state “requires a national insurer to use any particular rate, rating element, price or form.” These exceptions could allow national insurers to avoid participating in many of the state residual markets. This would be a critically important issue for coastal states with large residual markets that rely on assessments upon insurers for financing catastrophic losses.

The act returns to the issue of state law again in section 701 and states that, “Except to the extent expressly provided in this Act, national insurers, national insurance agencies, and national insurance producers shall not be subject under State law to any form of licensing, examination, reporting, regulation, or other supervision relating to the sale, solicitation, or negotiation of insurance, to the underwriting of insurance, or to any other insurance operations.” The authors of this legislation are making it quite clear that national insurers will not be subject to the authority of state legislators and regulators in regards to their operations.

State taxation of national insurers would still be allowed (section 321). A national insurer would still be subject to all applicable state and local taxes, assessments, and charges just the same as a state-chartered insurer, except for “special assessments and charges that fund services that the State does not provide with respect to the national insurer.” It is unclear what is meant by this exception and to what degree it would reduce the obligations of national insurers to pay state premium taxes.

The National Insurance Consumer Protection Act would allow national insurers to develop and use their own policy forms as long as they file them with the commissioner and meet general

policy requirements. When developing the general policy requirements, the commissioner would be required to take existing NAIC standards, models, and practices into consideration when making the decision (section 312). The act forbids the commissioner to require a national insurer to use any particular rate, rating element, or price. In effect, national insurers would be allowed to develop their own rates and would be required to file their policy forms before using them. The intent to move away from rate regulation and towards open competition is made clear in section 314 where describing that the general principles should be to “encourage innovation and competition by national insurers and national insurance agencies.”

### Guaranty Associations

The National Insurance Consumer Protection Act calls for the creation of a National Insurance Guaranty Corporation (section 601-605). The commissioner would have the authority to appoint a receiver to a national insurer who is insolvent, has substantial dissipation of assets, and the inability to meet obligations. If a national insurer is placed in receivership for purposes of liquidation, claims will be paid in a manner consistent with the terms and limits of the Post-Assessment Property and Liability Insurance Guaranty Association Model Act of the NAIC. This model act limits property and casualty claims to \$300,000 as is common in most states. National insurers would be subject to assessment by the National Insurance Guaranty Corporation, but assessments will only be imposed when funds are actually needed. The amount of the assessment is not yet specified and would be determined by the director of the National Insurance Guaranty Corporation. The act specifies that national insurers would still have to participate in state guaranty funds and would be subject to an assessment rate the same as a state-chartered insurer. It will certainly be unappealing to national insurers if they have to participate in both. However, if they do not have to participate in state funds, that would weaken the funds’ ability to pay claims since the large insurers have the greatest resources.

### Antitrust Exemption

The act retains the current antitrust exemption for any insurers obtaining a federal charter. Section 702 states that the Sherman Act, the Clayton Act, the Federal Trade Commission Act, and the Robinson-Patman Anti-discrimination Act shall apply to national insurers, except to the development of standard insurance forms or to the activities incidental thereto. This exemption allows insurers to share loss data to enhance risk assessment and use consumer-friendly standardized forms that make it easier for the consumer to compare.

### Benefits of Federal Regulation

A federal approach would create uniform regulations for national insurers and would allow savings from the economies of scale and the reduction in redundant compliance costs. These savings could lower expenses for insurers and could lead to lower insurance premiums. This assumes that national insurers would truly be exempt from state regulation and would not be subject to dual regulation from both states and federal authorities.

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

The availability of a federal option would enhance the ability of insurers to set the premiums guided by actuarial and scientific principles and then allow insurers to compete in the

marketplace. Current state rate suppression in hazard-prone regions causes insurers to withdraw from the market and minimize their exposure.<sup>12</sup> The reduction in capacity forces property owners into residual markets that are often underfunded. National insurers who are able to use adequate premiums would reenter the market and increase the number of policyholders.

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

### Problems with Federal Regulation

The consequences of allowing an optional federal charter are unknown. The track record of federal regulation is not particularly strong and recent events have shown that federal regulators can become too closely aligned with the entity they are regulating. One of the greatest potential problems arising out approach is that it will create competition between state and federal regulators to attract insurers. Allowing the regulated entity to choose its regulator is dangerous and could lead to a race to the bottom. On the other hand, having an option could pressure state regulators who have behaved poorly or unprofessionally to modify their behavior for fear of being made irrelevant if insurers select the federal option.

The concept of requiring the vaguely termed “systemically important” insurers to obtain a federal charter is perilous. It may not even be practical to pick such insurers or establish fair and objective criteria. Insurers receiving this designation could be viewed as too big to fail and begin take excessive risk and lose market discipline (the federally regulated commercial banks are examples). National insurers could have an unfair competitive advantage against state insurers who could be perceived as less reliable.

The National Insurance Consumer Protection Act exempts federally chartered insurers from state rate regulation and calls for move to a file-and-use rating system where pricing is based on their assessment of the risk and competitive forces rather than by the state authorities. However, there is a risk that federal regulators will become overly influenced by residents in hazardous regions just as some state regulators have in the current system. Could this approach malfunction in the same way as the problematic states? It would be considerably more difficult for insurers to deal with the federal regulator implementing national changes than it currently is with the problems isolated to a handful of coastal states.

Based on the current form of the National Insurance Consumer Protection Act, it appears that national insurers would still be subject to state premium taxes to fund state insurance departments and assessments from state guaranty funds. Since national insurers will also be subject to assessment to fund the proposed Office of National Insurance, as well as assessments for the National Insurance Guaranty Fund, they would be subject to duplicate charges. National insurers

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<sup>12</sup>Dan Sutter (2009) Policy Uncertainty and the Market for Wind Insurance, <http://www.mercatus.org/PublicationDetails.aspx?id=27434>

will likely eventually seek to completely disengage and avoid funding programs for which they no longer participate nor receive benefit, which will put a financial strain on these state programs.

The National Insurance Consumer Protection Act exempts insurers from participating in residual markets if that residual market is using inadequate rates (sections 109 and 701). This would be a critically important issue for coastal states with large residual markets that rely on assessments upon insurers for financing catastrophic losses. The national insurers are the entities with the greatest financial resources and the primary funders of the residual markets. The disengagement of the national insurers could create a huge hole in the financing arrangement for some residual markets.

<p><u>Benefits of State Regulation</u></p> <p>Experienced Track record is as least as good as federal Responsive to local needs Opportunity for innovation and is a confined system in case it doesn't work out well</p>	<p><u>Benefits of Federal Regulation</u></p> <p>Uniformity and reduction in compliance costs Better position to monitor systemic risk Better position to interact with international insurers File-and use-rating National Insurance Guaranty Fund</p>
<p><u>Problems</u></p> <p>Lack of uniformity Not in good position to monitor system risk Not in good position to interact with international insurers Growth of residual markets Financing arrangements of residual markets Ability of guaranty funds to handle extreme events with multiple large insurer failures</p>	<p><u>Problems</u></p> <p>Unknown consequences Regulator shopping Create unfair competitive advantage Duplicate programs and funding requirements Impact on state residual markets</p>

**Recommendations: Weighing the Benefits against the Problems**

The purpose of this paper is to assess the potential consequences of federal regulation, as opposed to the current system of state regulation, on insurers and their ability to provide coverage in hazard-prone regions. The social resiliency of a community is contingent upon reliable source of insurance coverage. The current state-based system has significant benefits as well as significant costs. The National Insurance Consumer Protection Act would have a substantial impact on the insurance industry if implemented and would create new benefits, but it would also impose new costs and create unexpected problems. The following section provides a set of recommendations for policymakers to consider when evaluating the insurance regulatory system with focus on enhancing social resiliency.<sup>13</sup>

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<sup>13</sup> The recommendations are based upon the features of the initial version of the National Insurance Consumer Protection Act

## 1. Minimize Political Risk

Broadly, political risk refers to the complications businesses face as a result of political decisions or any political change that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives.<sup>14</sup> This is a legitimate concern to insurers since they are highly regulated and subject to the whims of state legislative bodies. Insuring against catastrophes is a complicated business and requires long-term planning. It becomes more difficult when the rules change and authorities are influenced by property owners and developers to suppress insurance rates. Political risk causes insurers to become reluctant to commit resources and capital when rules can quickly change. If political risk can be reduced, insurers will be more likely to participate in the hazard-prone markets and this will strengthen social resiliency.

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

The stakeholders in insurance industry have mixed support for a federal approach, but the one outcome that everyone wants to avoid is dual regulation by both the state and federal governments. Nearly everyone agrees that greater consistency and uniformity would yield benefits, and adding a federal regulator on top of the existing framework would lead to even more variability and increase political risk.

## 2. Allow Competitive Rating and Minimize Rate Suppression

The prior-approval rate approval process found in some of the hazard-prone states is costly and time consuming. The regulatory timeframe does not keep pace with the rapidly changing modern marketplace. The recent increase in the cost of catastrophic reinsurance provides an example of the problem. Reinsurance premiums are based upon competitive forces and can change rapidly. After an active hurricane season, catastrophic reinsurance premiums can increase substantially. Insurers selling coverage in states with prior-approval laws can not adjust their premiums to reflect their increased costs without first having to go through the approval process, which can take months or even years. As insurers are caught between the increase costs of reinsurance and the downward pressure on rates from regulators, they are unable to profitably provide the coverage so they withdraw from the market. So the result is that when insurers are not allowed to earn a premium commensurate with the exposure, they will become reluctant to make coverage available to the higher-risk property owners. When insurers become unwilling to provide coverage, applicants are then forced into a residual market. This is particularly true when faced with a catastrophic exposure such as hurricanes.

The National Insurance Consumer Protection Act allows file-and-use rating for national insurers. This calls for a move to a competitive pricing system that would end rate regulation for federally chartered insurers. National insurers would compete against each other and state-chartered insurers who would still be subject to state rate regulation. Although there would very likely be

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<sup>14</sup> Eurasia Group and PricewaterhouseCoopers, “Integrating Political Risk Into Enterprise Risk Management”

struggles for high-risk property owners to begin paying premiums commensurate with their risk, it would lead to a more stable market in the long term and smaller residual markets.

Insurers should continue to be subject to strict regulation on policy forms covering residential property. Keeping policy language consistent allows consumers to shop based on price and reputation (service, financial strength, claims). Coastal property owners already face a confusing situation in which they have to buy a homeowners policy (possibly excluding wind), a flood-insurance policy, and then a wind/hail policy from the state residual market. Allowing companies to use unique forms would require consumer knowledge that exceeds the financial literacy of the vast majority of policyholders.

### 3. Minimize Immediate Impact on State Residents

If the National Insurance Consumer Protection Act were enacted in the current form, it would have a substantial impact on state residents if large insurers opted for the federal charter. The federal charter would allow national insurers to opt out of state regulation and possibly the residual markets. The catastrophe loss financing of residual markets is major weakness in several of the most hazard-prone states. Post-loss assessments on insurers (based loosely upon market share) make up a key part of the financing plans. If the large insurers disengage, the state residual market plans would be gutted. Eventually, as national insurers are able to charge increased premiums, they will be willing to offer a source of coverage and the residual markets will shrink; but in the short term, it could be chaotic. If a catastrophic event occurs during this time, the residual markets will face a monumental challenge to obtain funds to pay claims. This could have a disastrous effect on social resiliency. A temporary federal backstop could be created to stabilize the market in the short term. For example, U.S. Rep. Ron Klein (D-Fla.) recently reintroduced the Homeowners Defense Act, which would make the Treasury Department a reinsurer during massive events that have a half a percent chance of occurring in any given year. Others have suggested expanding the National Flood Insurance Program to include wind losses in addition to flood. The author is not advocating either of these approaches, but pointing out that policymakers need to prepare for aftermath of national insurers leaving residual markets.

The National Insurance Consumer Protection Act specifies that national insurers are to continue paying state premium taxes. The operating costs of the proposed Office of National Insurance is also to be funded by assessments and fees imposed on national insurers by the commissioner. The costs associated with the systemic-risk regulator will also be supported by assessments on insurers subject to its overview. National insurers may resist being subject to multiple charges for both state and federal regulation. Since the majority of the state premium taxes go towards state general revenue, and not just towards funding state regulators, it is important for policymakers to retain the requirement for national insurers to pay state premium taxes.

Based on current proposal, national insurers would also be required to continue to participate in state guaranty funds. If this remains the case, state guaranty funds would not be affected since the national insurers are still required to participate in financing arrangements. However, there is concern that they would not want to continue to be subject to assessments for funding state guaranty funds and also be required to contribute to the National Insurance Guaranty Associations. Without national insurers, the viability of state guaranty funds would be in jeopardy.

A national guaranty fund approach has elements that could help stabilize the insurance marketplace and enhance social resiliency. First, it seems logical that a national guaranty fund would be more likely to receive a federal bailout in the event of an extreme event than a state

guaranty fund. If so, that would bring additional capacity to the market in the event of a megacatastrophe that bankrupted a substantial number of insurers. The collective capacity of the state guaranty funds is estimated to be at \$7.4 billion per year.<sup>15</sup> It is conceivable that an extreme event, or multiple events, could overwhelm the current system.

#### 4. Maintain Antitrust Exemption

The McCarran-Ferguson Act not only declared that states would be the primary regulators of insurance; it also provides a limited exemption for the “business of insurance” from federal antitrust laws. This exemption remains in place today and the proposed National Insurance Consumer Protection Act would allow this to apply to federally chartered insurers as well. Both acts allow insurers to share loss data and use standardized forms. The limited antitrust exemption does not extend to “any agreement to boycott, coerce or intimidate, or act of boycott, coercion, or intimidation.”

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

The removal of the antitrust exemption would likely have a lesser impact on large, nationally chartered insurers because they have substantial resources and do not rely as heavily on sharing information. If the exemption were ever removed, it could put smaller, regional companies at a disadvantage compared to large, national insurers. It also creates substantial errors and omissions exposure for the independent agents. Consumer could face a less-competitive market and be forced to compare policy language.

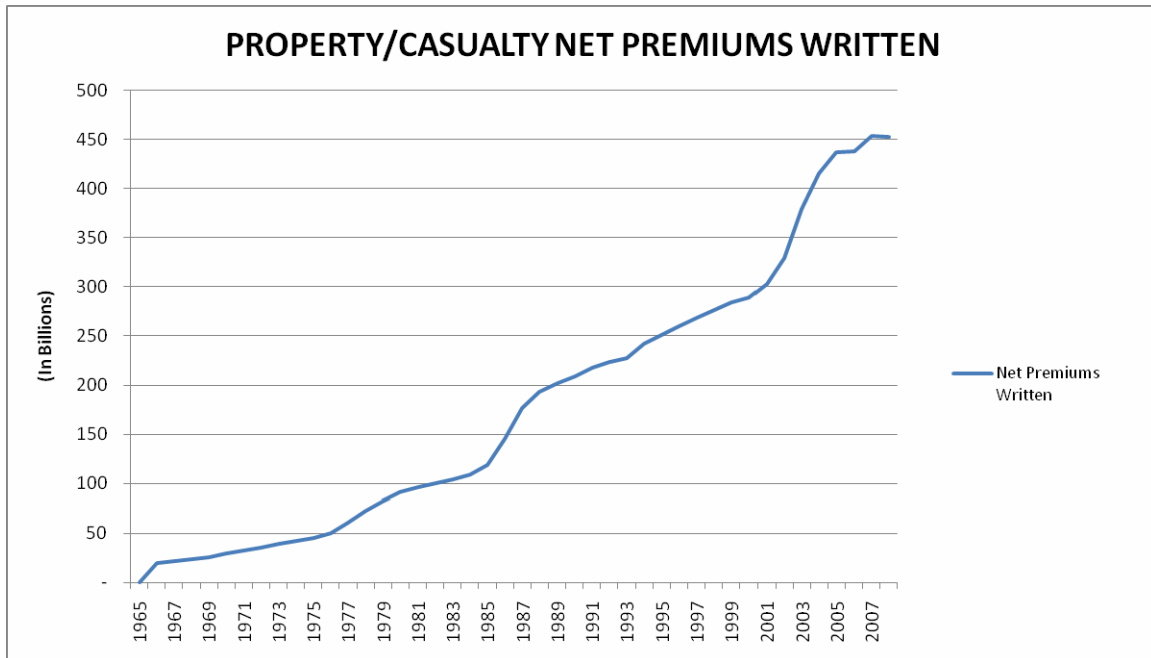
Although it seems strange at first glance to give federally chartered insurers the antitrust exemption, it actually makes sense given the nature of insurance and actually leads to a more competitive market.

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<sup>15</sup> Per Roger Schmelzer, President and CEO of the National Conference of Insurance Guarantee Funds



**Appendix A: Growth of Property and Casualty Insurance Industry**



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

**Appendix B: Top Writers of Homeowners Insurance (2007)**

*source: iii.org*

Rank	Group	Market share (%)
1	State Farm Group	22.1
2	Allstate Insurance Group	11.3
3	Zurich Insurance Group	7.0
4	Nationwide Corp. Group	4.5
5	Travelers Group	4.4
6	United Services Automobile Association Group	4.2
7	Liberty Mutual Insurance Group	3.5
8	Chubb & Son Group	2.9
9	American Family Insurance Group	2.2
10	Hartford Fire & Casualty Group	1.8

## **Appendix C: Insurance in the States**

### **Florida**

After Hurricane Andrew, the residential property insurance market in Florida went from a highly competitive market to one on near collapse. In attempt to provide a degree of stability, the state legislators imposed strict regulations on insurers and greatly expanded the public sector's presence as a residential property insurer. Insurers had underestimated the frequency and severity of hurricanes and the potential damage that could arise. Insurers reduced exposure by refusing to renew thousands of policies. Insurers were very selective in providing new policies, which hampered economic development. They also recognized that they had been under-pricing the insurance coverage in the past and needed to obtain substantial increases. The Florida Department of Insurance often granted approval for rate increases, but not at the amount requested by insurers. The Department of Insurance was caught between the political pressure from consumers wanting lower rates and the economic reality that rate increases were needed. In just a few months, insurers changed from aggressively trying to write new business to taking drastic measures to reduce their market shares. As one would expect, this caused considerable angst among property owners, regulators, and legislators.<sup>16</sup>

The limitation on rate increases did not give insurers the incentive to enter the market and provide coverage. The approved rate increases caused consumers to complain that their residential property insurance was no longer affordable. In an attempt to manage the expanding market crisis, the Florida legislature created two state-sponsored programs in 1993. These programs are the Florida Hurricane Catastrophe Fund (Cat Fund) and the Florida Residential Property and Casualty Joint Underwriting Association. The Florida Windstorm Underwriting Association existed prior to Hurricane Andrew. In 2002, Florida's governor signed legislation creating Citizens Property Insurance Corporation (Citizens) by merging the Florida Residential Property and Casualty Joint Underwriting Association, which provided homeowners property coverage statewide, and the Florida Windstorm Underwriting Association, which provided wind-only coverage in designated coastal areas. Citizens is a not-for-profit, tax-exempt corporation whose public purpose is to provide policyholders with affordable property insurance protection.<sup>17</sup> Following the reforms, Citizens provided wind coverage to those Florida homeowners in designated high-risk areas who were unable to procure policies in the voluntary market and offered multi-peril residential coverage in certain areas throughout the state.

During the 2004 and 2005 hurricane seasons, a total of eight hurricanes made landfall in Florida.<sup>18</sup> These storms caused an estimated \$36 billion in losses based on approximately 2.8 million claims.<sup>19</sup> Citizens incurred billions in losses and required bailout funds from the state legislature as well as the authorization of emergency assessments on insurers and policyholders. A family with a residential insurance policy and two automobile policies could potentially incur

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<sup>16</sup> David C. Marlett, "The Expansion of the Public Sector's Role in Providing Windstorm Coverage in Florida," *CPCU Journal*, vol. 52, No. 2 Summer: 106-114 (1999).

<sup>17</sup> Citizens Plan of Operation, <http://citizensfla.com/about/>

<sup>18</sup> Hurricanes Charley, Frances, Ivan, and Jeanne in 2004; Hurricanes Dennis, Katrina, Rita, and Wilma in 2005. See National Weather Service, National Hurricane Center Archive of Hurricane Seasons, <http://www.nhc.noaa.gov/pastall.shtml>.

<sup>19</sup> Property And Casualty Insurance Reform Committee Final Report, p. 1, Nov. 15, 2006, <http://www.myfloridainsurancereform.com/docs/finalreport.pdf>.

three policy assessments from Citizens, the Florida Cat Fund, and the Florida Insurance Guaranty Association.<sup>20</sup>

The political uncertainty and the combative relationship between the governor and the insurance industry has discouraged national insurers and reinsurers from investing more capital into the market. Citizens's problems continue to worsen as it experiences significant growth and an increasing exposure. Citizens remains the largest property insurer and is the primary source of coverage in the state because the standard market continues to withdraw. State Farm, the largest private insurer in the state, has announced it will withdraw completely from the state over the next several years. Citizens's actuaries and executives testified before the 2008 legislature that their rates are substantially below what would be considered adequate. Furthermore, the rates are frozen through the end of 2009. The capacity of both Citizens and the Cat Fund to pay claims is in question since the majority of its loss financing arrangements relies on a massive state bond issuance. The sheer size of the Cat Fund imperils Florida's fiscal condition. The largest state bond issue *anywhere in the country* to date has been \$11 billion. Florida's \$32 billion proposed issue would nearly triple that and could only be paid with assessments on every insurance policy in the state.<sup>21</sup> Florida Representative Dennis Ross stated that a catastrophic event could translate into added expense of \$1,600 per year, per family assessed on auto and property insurance policies.<sup>22</sup> Even if the state were able to sell the bonds and use future assessments to repay them, it would be soaking up the capacity of funds needed by the state government to rebuild schools, hospitals, etc. If Citizens and the Cat Fund are unable to pay claims, it threatens the claims paying capacity and solvency for the standard market. If insurers are unable to pay, the burden would be shifted to the Florida Insurance Guaranty Association which would also rely on bond issuance and assessments on policyholders. The Florida insurance market is on the brink of collapse, which would devastate the social resiliency of the coastal communities.

### Hawaii

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

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<sup>20</sup> Richard J. Fidei and Fred E. Karlinsky "Florida Insurance Dilemma: Efforts to Manage the Unmanageable," *CPCU eJournal*, March (2009).

<sup>21</sup> Eli Lehrer, First Steps toward Restoring Florida's Insurance Market, The James Madison Institute, No.3 March (2008) <http://www.jamesmadison.org/pdf/materials/625.pdf>

<sup>22</sup> <http://www.insurancejournal.com/news/southeast/2008/02/05/87013.htm>

## California

The Northridge Earthquake occurred in California in 1994 and caused \$19 billion in insured damage.<sup>23</sup> The relationship between the insurers and regulators was particularly poor in the 1990s, which exacerbated the situation. The catastrophe exposure, coupled with the combative regulatory environment, led insurance companies to undertake efforts to reduce their market shares. This created a decrease in the supply of insurance coverage which became particularly acute in mid-1990. Given the extensive publicity of the damage following Northridge, consumers were more aware of their exposure and attempted to obtain earthquake insurance. This has led to an increase in the demand for the coverage and the market was unable to reach an equilibrium that balances the competing interests of insurance companies, regulators, and the public.

The California Earthquake Authority (CEA) was created in 1996 as an attempt to provide an affordable source of basic coverage. State lawmakers, the insurance commissioner, representatives of the insurance industry, and consumer groups negotiated the stakeholders' financial obligations. The result was a privately funded, publicly managed earthquake risk pool designed to revitalize the residential property insurance market.<sup>24</sup> The goal of the CEA is to stabilize the California residential property insurance market by separating the undesirable earthquake peril from the remaining insurable perils. The legislation requires that the CEA adopt actuarially justified rates, although that term is at times subject to interpretation and manipulation. Residents in higher-risk areas do pay a higher premium than those in more stable areas. If the rates prove to be inadequate, the CEA would use a combination of insurance industry contributions, reinsurance, bonds, and debt to fund any revenue shortfalls.

Seismologists with the United States Geological Survey believe that another earthquake at least as powerful as Northridge will occur within the next two decades.<sup>25</sup> Despite the clear risk and a source of coverage, still less than 15 percent of California homeowners purchase earthquake insurance.<sup>26</sup> The problem begins with the homeowners' view that the CEA coverage is costly and inadequate.<sup>27</sup> Not only is there concern that it is too expensive, it has a 10 percent to 15 percent deductible based on the insured value of their homes. Given that property owners must incur substantial damage before coverage, many prefer to give up their equity (if they have any) in their home and simply default on the mortgage and walk away from the property. This leaves the lenders with a pile of rubble and little hope of financial recovery. In effect, much of the earthquake risk has been transferred to the lenders and holders of collateralized debt. This will likely greatly reduce the social resiliency of a community since the abandoned properties will not be rebuilt in a timely manner.

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<sup>23</sup> <http://www.iii.org/media/facts/statsbyissue/earthquakes/>

<sup>24</sup> "Once the CEA is up and running, there will be a healthy homeowners market again, and that is critically important if our economy is going to continue its recovery." Richard Weibe, spokesman for California Insurance Commissioner Chuck Quakenbush. Reuters MSNBC Nov. 30, 1996.

<sup>25</sup> <http://earthquake.usgs.gov/>

<sup>26</sup> Insurance Information Network of California citing a May 1, 2004 article in Claims Magazine

<sup>27</sup> [www.latimes.com](http://www.latimes.com). 4/9/2009. Insurance assurance - With federal help, states could manage risks and make policies more affordable for homeowners.

## Beach Plans and Wind Pools

In addition to the programs in Florida, six other Atlantic and Gulf states have legislatively-mandated programs designed to provide coverage for coastal properties.<sup>28</sup> Although these go by different titles (such as “beach plans,” “wind pools,” “underwriting associations,” etc), the basic function is the same. They are created by statute to provide coverage against hurricanes and other severe windstorms. Residents and business owners in designated areas are eligible to purchase the coverage. The programs act as a market of last resort to property owners unable to obtain wind and hail coverage from the standard market. These programs are often necessary because no rational standard insurer would write coverage in such high-risk areas at a rate acceptable to the public. To remain solvent and financially responsible, an insurer must charge a rate that is adequate to cover their operating expenses, predicted losses, reinsurance costs, and also establish a reserve to pay for the unexpected catastrophic events. So how are these residual markets able to insure something that the private sector views as impossible? The answer is that the residual markets are not constrained by the need to have adequate rates. Evidence that residual markets charge below-market premiums comes from the assessments levied after a major hurricane.<sup>29</sup> While insurers must maintain adequate reserves and have their financial condition closely examined by rating agencies and regulators, the residual markets are not. The rate levels implemented by the residual markets are heavily influenced by political pressure and the desire to keep rates affordable. The residual markets are able to ignore the economic necessity of rate adequacy faced by insurers.

## North Carolina

Residents of North Carolina have been spared the catastrophic events that have occurred in many of the other coastal states. Hurricanes Bertha and Fran in 1996 and Floyd in 1999 each caused substantial damage, but not on the scale experienced in Florida, Mississippi, or Texas. Despite the relatively mild loss experience, North Carolina is experiencing a market crisis along the coast and has a woefully underfunded residual market. Much of the problem lies with the unusual regulatory environment and the efforts of state legislators to keep insurance rates artificially low to encourage coastal development.<sup>30</sup>

North Carolina employs a *prior-approval* rating system for residential property insurance. With this kind of system, insurance companies coordinate their efforts through the North Carolina Rate Bureau (the Bureau) to file standard rates with the Department of Insurance. All of the insurance companies licensed to write residential property coverage in North Carolina must subscribe to and be members of the Bureau. The Bureau’s authority was granted by legislation, with the principal function to establish, subject to the approval of the commissioner, standard forms and rates. Insurers must obtain the insurance commissioner’s approval before their implementation. During the last decade, insurers have not been able to obtain approval for the full amount of the requested rate increases (primarily in the coastal counties). Rate suppression causes insurers to become more selective in who they are willing to insure. Higher-risk property owners are then unable to obtain coverage from the standard market, forcing them to seek coverage from the residual market. As more property owners are put into a residual market, the exposure increases

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<sup>28</sup> The states are Alabama, Louisiana, Mississippi, North Carolina, South Carolina, and Texas. Virginia coastal property owners are insured through a FAIR plan.

<sup>29</sup> Daniel Sutter, Mercatus “Ensuring Disaster: State Insurance Regulation, Coastal Development, and Hurricanes,” Mercatus Policy Series Policy Comment no. 14. September 2007

<sup>30</sup> Additional analysis of insurance markets in North Carolina, South Carolina, and Virginia is provided in Marlett, David C. Journal of Insurance Regulation Summer 2009 (Vol. 27, No. 4).

and it becomes more difficult to administer the plan and responsibly prepare for potential catastrophic events. This is exactly what is happening in North Carolina

North Carolina has two residual markets, the North Carolina Joint Underwriting Association (NCJUA) and the North Carolina Insurance Underwriting Association (NCIUA). The NCJUA is often referred to as the FAIR Plan and the NCIUA is commonly called the Beach Plan. They are administered jointly and share the same mission statement.<sup>31</sup> The overwhelming bulk of the exposure is in the Beach Plan.<sup>32</sup> The exposure has been growing at a rate of \$1 billion per month over the last several years. The Beach Plan offers generous coverage through a homeowners policy and provides a deductible that is lower than what is found in the standard market. The state legislature expanded the eligibility standards and coverage territory in 1999, and also required the Beach Plan to offer a homeowners policy starting in 2003. In March 2009, a Senate bill was introduced to impose a stay on further rate increases and to maintain fixed deductibles instead of matching the percentage deductibles that are offered by the standard insurers.

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

### South Carolina

The regulatory environment in South Carolina has at times mirrored North Carolina. As in North Carolina, insurers in South Carolina were bound to using bureau rates following the enactment of the McCarran-Ferguson Act in 1945. This approach was advocated because individual insurers lacked the ability to develop and implement accurate rates on their own. As insurers became more sophisticated and a more-modern market developed, many states allowed insurers to have greater flexibility in their pricing structure and move toward a more open market. South Carolina (like North Carolina) did not move in this direction. Instead, it retained tight prior-approval requirements and attempted to use legislation to deal with the resulting market dysfunctions.

The *prior-approval* regulations were replaced with a banded *file and use* approach under the Property and Casualty Insurance Personal Lines Modernization Act of 2004.<sup>33</sup> This rating flexibility allows insurers to increase or decrease their rates by up to 7 percent in a 12-month period. If insurers wish to deviate by an amount greater than 7 percent, then they must have the *South Carolina Department of Consumer Affairs* review the filing. If needed, an administrative law judge (not the Director of Insurance) acts as a hearing officer in rate review hearings. The

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<sup>31</sup> “North Carolina Joint Underwriting Association (NCJUA) and North Carolina Insurance Underwriting Association (NCIUA) are insurance industry supported organizations committed to providing a basic property insurance market to protect policyholders while offering quality products and services to producers and insured, as well as protecting the assets of our member companies.”

<sup>32</sup> The combined insured value of the residual markets is approximately \$73 billion dollars as of March, 2009. The 100 Year PML is \$3.8 billion, up from \$1.4 billion in 2004. Source: <http://www.ncjua-nciua.org>

<sup>33</sup> Section 38-73-220. Approval process for rate level changes.

rates are effective within 30 days without prior approval of the Director of Insurance as long as the market is designated as “competitive.” Elements of a “competitive” market are described in the state code of laws.<sup>34</sup> If the market is deemed to be non-competitive, then the flex-band file and use approach is modified and additional information supporting the requested rate change could be required. Based upon the assessment by the Director of Insurance, the homeowners insurance market in South Carolina is competitive.

The South Carolina Wind and Hail Underwriting Association (SCWHUA) was created in 1971 by the South Carolina legislature. It is the residual property insurance market in South Carolina. It provides coverage for the perils of wind and hail in the coastal area of the state as defined by state law by the legislature. Although its official name is the South Carolina Wind and Hail Underwriting Association, it is often referred to as the Wind Pool. All property and casualty insurance companies conducting business in the state are required to participate in funding the plan and share in any losses or profits.<sup>35</sup>

In 2008, the SCWHUA had \$13.2 billion in total insured value based on 32,036 policies in force. The 100-year PML is approximately \$1 billion. The exposure is growing in part due to the expansion of the eligible territory in May 2007. There was a great deal of political pressure to expand the coverage territory that was originally established in 1971. The previous territory had become outdated as the development of the coastal area expanded. Since insurers can only exclude wind and hail in the SCWHUA territory, coastal residents lobbied for an expansion. It is typically less expensive for a consumer in the coastal region to purchase a homeowners policy (excluding wind) and a wind and hail policy from the SCWHUA than to purchase the entire coverage from a surplus lines company. The Omnibus Coastal Property Insurance Reform Act of 2007 expanded the SCWHUA coverage territory and divided it into two zones.<sup>36</sup> The legislation also allows the creation of catastrophe savings accounts for homeowners. The contributions are tax deductible and the funds build tax free. The accounts can be used to fund higher deductible levels, which lower the exposure to the SCWHUA. There has not been much use of these accounts thus far. The legislation also makes state income-tax credits available to consumers for costs associated with wind mitigation. Effective mitigation efforts can reduce the exposure as well. Lastly, it clearly mandates that SCWHUA rates must not be competitive with the standard market.

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

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<sup>34</sup> Section 38-73-230 in South Carolina Code of Laws

<sup>35</sup> [www.scwind.com](http://www.scwind.com)

<sup>36</sup> Leher (2007)



## Virginia

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

The philosophy regarding rate regulation is also in stark contrast to that of North Carolina. In Virginia, the regulatory focus is on standardizing forms and then allowing competition in the marketplace to establish the appropriate rates.<sup>37</sup> Virginia adopted a file-and-use rate filing process in the 1970s (before that, a *Prior Approval* approach was used). As long as market is deemed to be competitive, the Code of Virginia allows competitive rating.<sup>38</sup> In Title 38.2, chapter 19, it is quite clear that regulation should focus on fostering a competitive environment and that will in turn produce rates that “protect policyholders and the public against the adverse effects of excessive, inadequate or unfairly discriminatory rates.” The chapter goes on to specify that regulators should “authorize cooperative action among insurers in the rate making process, and regulate such cooperation in order to prevent practices that tend to create monopoly or to lessen or destroy competition; and provide rates that are responsive to competitive market conditions and improve the availability of insurance in this Commonwealth.” Allowing the insurers to set rates according to risk characteristics in a competitive market will minimize availability and affordability problems. Even with this approach, there will still be a small percentage of property owners who are still uninsurable by the private sector.

Despite the substantial values along the coast, there is no Beach Plan or Wind Pool in Virginia. Instead, the residual market in Virginia is organized as a traditional FAIR Plan is called the Virginia Property Insurance Association (VPIA).<sup>39</sup> The purpose of the residual market is established in the state statutes.<sup>40</sup> The VPIA plan has market penetration of less than 1% of statewide property coverage. What is remarkable is that there is very little coastal property insured (less than 100 policies). The 100-year PML is only \$34.5 *million*. Recall that the North Carolina residual market has a 100-year PML of \$3.9 *billion*. Both states have similar coastal values, and yet markedly different approaches to insuring. Given the relatively minor 100-year PML, arranging loss financing is not a major issue. The VPIA purchases reinsurance coverage to a substantial portion of the PML, but also relies on accumulated reserve funds and the ability to assess. Given the very limited exposure, this does not present a threat to the financial condition of member companies. The VPIA truly functions as a market of last resort. The regulators foster a market based on competition and insurers willing to provide coverage. The state also has a

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<sup>37</sup> § 38.2-1900. B. 1. § 38.2-1904. Rate standards.

<sup>38</sup> § 38.2-1906. Filing and use of rates.

<sup>39</sup> <http://www.vpia.com/>

<sup>40</sup> Chapter 38 “A residual market facility shall be established and maintained by all insurers licensed to write basic property insurance or other insurance containing a basic property insurance component. The plan of operation of the residual market facility shall be subject to approval by the Commission.”

healthy surplus lines market that can provide even better coverage than what is found on the homeowners policy, and certainly better than the dwelling coverage offered by the VPIA.