Getting Ahead
The newest crop of rising insurance leaders is coming from some surprising places.

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Loss/Risk Management: A collection of insurance experts and academics have looked at U.S. disaster policy and determined the only group capable of heading off even bigger disasters is the U.S. insurance industry.

by Lee McDonald

Insurance has always played the primary role in protecting against disasters in the United States. But in a new evaluation of the threats from natural hazards, Howard Kunreuther, Richard J. Roth Sr and a host of other observers show that public policy and the needs of the insurance and reinsurance communities may not be intersecting as planned.

Since the major disasters of the late '80s, insurers have agreed the insurance industry and the nation are not adequately protected against the highest-level "megadisasters." Those are what would have occurred if Hurricane Andrew had veered into Miami or if the Northridge, Calif., earthquake had been followed shortly by another major tremor.

The problem: Everyone agrees on the need for new approaches to covering disasters, but the public is inured to the effects of disasters. In their collection, Kunreuther and his roster of experts argue that the ball is in the insurance industry's court, although there is a need for coordination with other private and public sector groups. In the long run, providing adequate insurance and requiring governments and private industry to build and regulate with disasters in mind is cheaper than government bailouts. But unless insurers take the cause to heart, they will be right only in hindsight.

Kunreuther shed some light on the subject in a question-and-answer session with Best's Review.

Q. What did you and your contributors set out to accomplish with this book?

This book began as part of a broader study that Dennis Mileti and the University of Colorado were doing on an assessment of natural hazards. The entire effort was designed to examine and report on the significant changes that have been taking place in the last few years and then to look towards the future. In the case of insurance, our interest was in considering the role that this policy instrument could play in reducing future losses and providing adequate protection.

Q. Is covering disasters primarily an insurance issue?

A key point in our whole presentation is that insurance cannot do it alone. It is a very powerful instrument in that it provides rewards in the form of lower premiums to those who take loss-prevention and mitigation measures before the disaster and financial protection through claim payment should these individuals suffer a loss to their property. Insurance can only be successful if used in conjunction with other policy instruments from the private and public sectors.

Q. But every time there's a disaster, there's the president or a governor showing up with a check. Haven't people been trained to assume that high-level disasters are covered by an informal system of national insurance in which it just comes out of taxes?

Many people believe this, although they may be expecting more relief than will actually be delivered. After the Alaska earthquake of 1964 and for the next eight years through...
Tropical Storm Agnes in June 1972, there was an enormous amount of disaster assistance in the form of low-interest loans and grants. Even though the federal government has reduced its disaster-relief packages since then, people may still be under the impression that they will be bailed out by the public sector after a major event. Insurance obviously can be a key player in providing financial protection. But if it is going to be purely voluntary, all the evidence suggests that most people are not going to purchase coverage against disasters. That’s been the experience with the flood program where premiums were highly subsidized. Relatively few people have purchased it voluntarily. That’s why legislation was passed requiring property owners to take coverage on any federally insured loan. There is evidence that a significant number of banks did not enforce this requirement. For that reason, Congress recently imposed a financial penalty on banks who do not enforce this requirement.

**Q.** Should banks also require that borrowers have a mandatory earthquake or wind-damage policy?

That’s a very interesting question. Homeowners coverage, which is required by banks as a condition for a mortgage, normally includes losses from wind. Since Hurricane Andrew occurred in 1992, there have been special wind pools established to cover catastrophic losses in Florida. As reported in Richard Roth Jr.’s very interesting chapter on earthquake insurance in California, since 1996 insurance has been offered by the state-run California Earthquake Authority (CEA). The data from California indicates that many property owners are canceling their earthquake insurance policies because of the 15% deductible and rates that are perceived by them to be very high. It’s an open issue as to what is going to happen when there’s a major earthquake in California. Who will cover the very large uninsured losses? At that point there will undoubtedly be a lot of pressure on the federal government to provide disaster relief. There may be special legislation that will give people more aid than they otherwise would be getting if most property owners had been protected by insurance.

**Q.** The book discusses the need for some sort of federal high-level reinsurance program. So far, every proposal has flopped. Are there any that you like in particular?

The federal government is clearly an insurer of last resort. What we stress in this book is that there are opportunities to use other private-sector mechanisms. There has been the emergence of new financial instruments that are now part of the scene. ‘Act of God’ bonds have been provided in both Florida, California and Japan. Our position in this book is to determine first where the private sector can operate and what its limitations are. The CEA is a very creative proposal for bringing the state and private sector together. It’s unfortunate that a lot of people have canceled their insurance policies. Had the premiums and deductibles been set at a level where people were more comfortable—and it is an open question as to what the premium should be—then that’s another way of moving away from the federal government.

After all of that, it seems that the federal government may still have an important role to play in providing protection against losses from megadisasters that cannot be covered by these private mechanisms. But let’s give the capital markets, and even the state programs like the state catastrophe fund in Florida and the CEA, a chance to work and then see where the federal government would come in.

**Q.** Recently Robert Herres from USAA has been promoting the idea of allowing tax-free catastrophe reserves for homeowners writers. Have you seen that work anywhere else?
The book does not spend a lot of time on the tax issue, partly because that was not the expertise of the people who were writing it, and also because it raises some very interesting issues with respect to how do you set up a fund that can be protected in the future. Can you do that within the insurance companies themselves, or do you have to go outside of direct companies?

Q: Leaving taxes aside but sticking with reserves, the industry is pretty nicely capitalized—some say overly capitalized. Doesn't that give you confidence that it could handle these disasters more easily than ever?

Right now the insurance industry appears to be in good financial shape. The reinsurance industry is willing to provide capital or protection at lower rates than they have in the past. That might be one reason why the capital market instruments have not been moving as rapidly as they had been, a couple of years ago. There's competition from the reinsurance side on the price level.

Q: They view it as direct competition?

Yes. Right now we have a fair amount of capital that is coming in to provide that protection. The challenge is going to be when the next disaster hits.

Hurricane Andrew and the Northridge earthquake both created a fair amount of concern by the insurance industry on their ability to survive the next loss. Evidence from studies that the modeling firms such as Applied Insurance Research, EQECAT and Risk Management Solutions have put together suggests that if a megadisaster occurs, then the insurance industry will be in very serious straits with respect to obtaining the same amount of reinsurance coverage as they now have at the going rate.

Q: Have you looked at any other nations' approaches to catastrophe coverage? Does anybody seem to be doing it better?

We restricted our discussion in the book to the United States. We have a great interest in insurance and other arrangements for dealing with natural disasters in other countries. For example, some of us at the Wharton School are currently looking at how the governments in different European countries and the nations' private insurers are dealing with catastrophic risk. We're working with the International Institute of Applied Systems Analysis, a research institute outside of Vienna, Austria, on exactly those issues.

Q: The book mentions building codes and construction standards. Is there any indication that governments are taking preparedness seriously? Are they forcing developers to meet these standards?

The whole issue of building codes and mitigation is essential to loss prevention. Lower damage from future disasters will help on several levels. It will reduce the catastrophic potential of earthquakes, hurricanes and other natural hazards. This should lead to lower prices of catastrophic bonds and reinsurance and reduce the role of the federal government and the states in terms of providing disaster assistance. How well communities are preparing for future disasters is an interesting question. [The Federal Emergency Management Agency's] Project Impact and the Showcase Community program of the Institute of Business, Home and Safety, are examples of programs designed to encourage loss-prevention measures and well-enforced building codes through economic incentives to property owners including lower insurance premiums. There is some evidence that Florida is working hard to do exactly that. There's a showcase community, Deerfield Beach, that is putting a lot of energy into trying to show that loss prevention can be accomplished in a creative way through economic incentives such as lower mortgage rates for more well-constructed homes. But the challenge really is, how do you bring these various stakeholders together—the homebuilders, the contractors, the developers, the banks and financial institutions—so they see this as a win-win situation? Insurance can play an important role here. The book does propose a hazard-management program that may aid this process. Let me illustrate by describing one element of the proposed program. One reason why homeowners are reluctant to invest in loss prevention is that there are large, upfront costs associated with a mitigation measure. For example, if you bolt a house to a foundation in an earthquake-prone area, it might cost several thousand dollars. Most homeowners either do not have this fund readily available or, if they do, feel they have better uses of the money. Furthermore, they feel the annual premium reductions from adopting such measures are relatively small compared to the mitigation cost.

If one could tie the loss-prevention measure to the mortgage with a long-term loan, say 20 years, and at the same time provide the insurance premium reductions, it's going to be a win-win situation. The cost of the loan should be lower than the insurance premium reduction if the loss-prevention measure is a cost-effective one. Furthermore, a loan tied to the mortgage means that the property owners don't have to think about how long they'll be living in the house.

Q: Is anyone backing that proposal?

It's a question of getting the banks and financial institutions to see this as a part of their portfolio of activities. That's easier said than done. One key problem is that, if insurance rates are not based on risk, that is, if they're highly regulated so that people in hazard-prone areas are subsidized by those in nonhazard-prone areas, then you are not going to have the same kind of momentum from the insurance industry in reducing the premiums if mitigation measures are adopted. That's going to hurt this process of linking banks and insurers in ways that could be a very powerful force for loss prevention.

Q: What about people who can't afford insurance?

One of the points that we make in the book is that there is an important role for the government to play at the local, state and federal levels in terms of providing assistance to low-income residents in hazard-prone areas. This could be done by giving them low-interest loans for mitigation and loss prevention. The rationale would be that by giving them protection up front, you will be reducing the disaster assistance that would otherwise be provided afterwards. Also, we as a society should think about how we want to assist those people who are less fortunate than others.