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OP-ED CONTRIBUTOR

Who Will Pay for the Next Hurricane?

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As the second anniversary of Katrina approaches, residents in hurricane-prone areas are still concerned that they cannot obtain insurance to cover damage to their homes from future disasters. Specifically, the decision by State Farm, Mississippi's largest insurer, to discontinue selling new policies on homes and small businesses there has sent shock waves beyond the state. Banks that normally require homeowner's insurance as a condition for obtaining a mortgage are also not sure what impact this will have on their clients' ability to buy such coverage.

The insurer's motivation is economic. Rates are regulated by the states, so insurers are often restricted in the premiums they can charge. In addition, State Farm faced a lawsuit contending it was liable for flood losses from Hurricane Katrina. Homeowners' policies cover only losses caused by wind in such storms; flood coverage is provided by a separate policy as part of the National Flood Insurance Program. The state of Mississippi, however, charged that insurers were responsible for hurricane damage from Katrina because surging floodwaters were caused by the wind. State Farm eventually won the case, but it was a costly process and led to its decision to discontinue selling new policies.

State Farm's decision is only the tip of the iceberg of a much broader problem: how this country can reduce future losses from natural disasters and aid victims in their recovery efforts. Because of increasing development in hazard-prone areas and the effects of climate change, we are in a new era of catastrophic losses from natural disasters. Ten of the 20 most costly natural disasters have occurred during the past five years — all 10 of them hurricanes, typhoons or tropical storms.

The four hurricanes in Florida in 2004 (Charley, Frances, Ivan and Jeanne) collectively totaled more than \$29 billion in insured losses; Hurricane Katrina is estimated to have cost insurers and reinsurers \$45 billion.

At the same time, victims have complained about receiving substantially less than the actual costs of rebuilding or repairing the damage. Many have turned to the Small Business Administration for low-interest loans; however, a property owner is eligible for a loan only if he or she can show the ability to repay it. Hence, low-income residents must find other assistance.

We need a new approach to financing the costs of natural disasters and to encouraging individuals in hazard-prone areas to undertake mitigation measures. Two principles, which

appear to conflict with each other, are guiding a large-scale research study being undertaken by the Wharton Risk Center in conjunction with Georgia State University and the Insurance Information Institute (as well as with firms and organizations from the public and private sectors, some of whom pay for this research).

Principle 1: Risk-Based Premiums. Insurance premiums should be based on risk to encourage individuals to reduce their vulnerability to catastrophes.

Principle 2: Dealing With Equity and Affordability Issues. Any special treatment given to lower-income residents in hazard-prone areas should come from general public funding and not through artificially low rates.

Principle 1 is important because it provides a clear signal of relative risk to those living in areas subject to natural disasters, as well as those who are considering moving into these areas. Risk-based premiums also enable insurers to give discounts to homeowners and businesses who invest in cost-effective loss-reduction measures. If the premiums are not risk-based, insurers have no economic incentive to offer discounts. In fact, insurers forced to charge artificially low premiums prefer not to offer coverage because it is a losing proposition in the long run. More generally, those living in hazard-prone areas should have safer structures and buy enough insurance to cover their losses from a future disaster.

Principle 2 reflects a concern for low-income residents in high-hazard areas who will face large premium increases if Principle 1 is followed. Today, in many Gulf Coast states, premiums in regions subject to hurricane damage are highly subsidized because of rate regulations imposed by state insurance commissioners. If insurers are permitted to charge risk-based premiums, homeowners in hurricane-prone areas will pay considerably more for coverage than they do today.

To deal with the affordability issue, the state or federal government could provide some type of insurance vouchers to low-income residents. It could work like the food stamp program, in which families are given vouchers to buy food based on income and size of family. A homeowner in a hazard-prone area would pay an insurance premium that reflects risk, and then get reimbursed by the state for part of the increased cost. The amount of reimbursement would be determined by income and the premium charged. Under such a voucher system, insurance could reward individuals for undertaking risk reduction measures by lowering premiums.

Principle 1 gives us a better chance of making our hazard-prone areas safer and affordable. Principle 2 implies that we as a society need to recognize that all taxpayers will have to bear a share of this cost. Rather than waiting for the next catastrophe, we can take constructive steps now to protect those in harm's way. In the process we will reduce the likelihood of having to deal with another Katrina-like disaster.

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