

**“Something’s Gotta Give”
A private market-based hurricane wind insurance concept**

**Remarks by Jay S. Fishman
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As we gather here today, the insurance industry is at a crossroads regarding hurricane wind insurance. We, at Travelers, are suggesting that any sustainable solution to this challenge should be provided by the private insurance market, which is ultimately best equipped to handle this exposure. We have a conceptual framework for our proposal that I will share with you today. It is the beginning of what we hope will be a collaborative and comprehensive study, leading to the creation of a private, market-based solution to what is a serious economic challenge.

The focus on hurricane exposure has been precipitated not only by climate experts’ warnings of an increase in the likelihood of severe hurricanes, but also by a very real increase in demand for coastal property – resulting in the past decade’s escalating property values and aggressive development. The 2003 movie, *Something’s Gotta Give*, provided me with inspiration for the title of my remarks today and with an illustration of the lure of coastal property. For those who’ve seen it, I suspect you may remember the setting; many scenes take place in a home presumably in the Hamptons, right on the ocean and feature Diane Keaton and Jack Nicholson picnicking on the property’s beach. It could easily have been Cape Cod, the Florida Keys or Hilton Head instead.

Well, they say life imitates art. Or maybe it's the other way around. In fact, 55 percent of the U.S. population now lives within 50 miles of the coast, and estimates show continued growth – particularly as baby boomers look to their retirement years and envision the next phase of their lives with sand between their toes.

And we're not talking about modest beach cottages. Sprawling homes and skyscraper condominiums are replacing smaller beach bungalows. Planned condominium construction in South Miami Beach alone over the next two years, for example, includes more than 2,000 units, each costing between half a million dollars on the low end to \$16 million on the high end, and with an aggregate property value of \$6 billion.

As we develop and build on the coast, we continue to be warned by climate experts who indicate that we have entered into a period of warming ocean temperatures that will likely increase the size and frequency of catastrophic storms.

So, take today's very expensive, very congested coastal property, add it to the specter of greater frequency and severity of weather – think of the three hurricanes in 2005 – Katrina, Rita and Wilma – and the equation yields a substantial rise in the risk of significant, perhaps unprecedented, catastrophic losses. As a leader in this industry, we believe we have an obligation to bring thoughtful ideas to the table to suggest how to deal with the effects of our changing climate.

With that backdrop, let's take a step back and look at what the past several decades have taught us about the business of insuring wind. Four key issues emerge from that review.

In the 1980s and well into the 1990s, we had a relatively long period of benign weather and experienced few hurricanes – which many believe to be the result of an Atlantic cooling cycle. Prominent exceptions included Hurricane Hugo, in 1989, which produced \$6.8 billion of damage (in 2006 dollars), and Hurricane Andrew, in 1992, which produced \$22 billion of damage (in 2006 dollars) and unprecedented 200 mile-per-hour winds. It is generally believed that Andrew wiped out all of the premiums collected by the industry on property policies in the state of Florida for all of the years leading up to it. As a side note, similarly, insurers providing homeowners coverage in Louisiana and Mississippi are expected to pay claims in an amount equal to all homeowners' insurance premiums paid in the state since 1981 and 1989 respectively.

As a result of Hurricane Andrew, about a dozen insurers went out of business, which led others to worry about their own company's solvency. Insurers began to reassess their coastal exposures, evaluating the additional amount of capital needed to support the increased risk. This led to price increases in order to maintain a minimum level of profitability.

State policymakers became concerned. Influenced by local pressure, certain of them established rules and practices mandating that insurance remain available at what now would be considerably suppressed rates, given the significant increase in risk. Insurance

companies were faced with a situation where the rules in place before the wind blew – in other words, the rules under which those insurers had based underwriting decisions – were not the same as the rules in place following the storm. Insurers were required to continue offering policies, and thus commit capital, on non-economically viable terms. This led insurers to be skeptical about writing additional business and committing capital to these areas long-term. Price suppression and inconsistent regulations led to the first issue: insurance availability and obtaining the right price for the exposure.

Then, between 1992 and 2003, the frequency and severity of named hurricanes in Florida diminished. Questions began to surface about whether 1992's Hurricane Andrew was an aberration. Insurance companies that continued to push for actuarially sound prices, based on a long term view and with the knowledge that another "Andrew" was possible, had a new problem. Industry critics and some political leaders had pegged us as "fear mongers" or "profiteers." These critics didn't understand, or perhaps care, how insurance works. You all know that insurance companies don't mint money. Rather, to pay claims, they must spread the risk of economic loss among as many individuals as possible subject to the same kind of risk and over time. In this case, the industry, recognizing that the risk was greater than previously thought, was trying to price to anticipate another Andrew-type storm and to spread risk over time. So, the second issue was one of perception: the perception that insurance companies were trying to artificially inflate rates and be profiteers at the expense of the public.

That led to a third issue: What's the right price to cover wind for a coastal-exposed property?

It had become clear that severe weather losses are predictable only over the long term. While everyone agreed that rates should be fair and equitable, the problem was that rates could appear to be out of whack in any given year and even in any five years, and significant losses one year could wipe out premiums and profits from several years or more. Let's remember that insurance companies are businesses, and they have to attract private capital to make this all work – and the capital can have a short horizon. So, how could insurance companies set rates and evaluate returns in the short term?

The basic affordability of insurance also had become a related question. If actuarially sound rates were to be set, there would be many middle-income and fixed-income residents who could not afford insurance for the coastal properties they owned, many of which have increased to almost exotic values. This brought up very basic concerns about disruption and dislocation.

Finally, problem number four is that state government and political intervention, such as the over-extension of “residual market pools” has limited competition and increased instability. These pools were initially created as markets of last resort, but local pressures to keep rates low have made them not only the market of first resort but for all practical purposes in some areas, the market of only resort. These and other politically expedient

actions artificially constrained the price of coverage and frustrated marketplace attempts to correct the supply-demand imbalance.

And the intervention itself can be a problem. In the case of Florida Citizens Property Insurance Corp., for example, we are so far away from economic reality, that should a major hurricane hit Florida, Citizens is not sustainable. In an average hurricane season – whatever that means – it is estimated that Florida would experience a total insured loss of \$10.2 billion. Under this scenario, the Florida Hurricane CAT Fund would have a surplus of \$2.1 billion, and Citizens would have a deficit of \$1.9 billion. So, in other words, for an average hurricane season, Citizens would actually lose money.

Furthermore, under many scenarios, the company would require a bail-out. This could mean seeking government support or taxation against individuals or businesses. A federal government bail-out would mean that all taxpayers – even those living in Iowa and Wisconsin – would cover the hurricane losses of those living on the coast. Basically, the 45 percent of the population not living on coastal property would subsidize the 55 percent of the population on the coast – what has been referred in a recent editorial on the subject as “windstorm socialism.”

So, any proposed wind insurance solution needs to address these four historical issues – availability, stability, profitability and affordability – and, at the same time, it needs to respond to the fact that hurricanes don’t recognize state borders.

We have seen various proposals calling for a federal government role in providing wind insurance – whether as a backstop or as an addition to the federal flood program. We believe that private insurers should continue to play a substantial role in providing coverage for wind.

That brings us to Travelers’ proposed insurance concept for hurricane-prone areas. Our concept is to create a private market Coastal Wind Zone along the Gulf and Atlantic Coasts, say from Texas to Maine, in which the federal government would oversee most aspects of wind underwriting, including pricing.

In this proposal, there is no federal government financial role. It is not called for, nor is it anticipated.

I must note that our proposal is a work in progress. We don’t have all the answers, and we are engaging experts to help us think through the related challenges and iron out the details. Overall, we believe that solving this challenge requires collaboration between the insurance industry and local, state and federal governments. This proposal is an attempt to provide a framework to facilitate that collaboration and to sponsor a dialogue to tackle this difficult issue.

So, let’s review our proposal in light of the four key issues that have plagued private market hurricane wind insurance efforts over the past several decades.

With respect to the first two issues regarding availability and stability, Federal oversight along the Atlantic and Gulf coasts would create a more stable environment for insurers and, more importantly, for consumers. Oversight would ensure that rates are actuarially sound and appropriate to cover the volatility of natural catastrophes throughout the defined region. Also, rates would be commensurate with the risks of a particular area within the Coastal Wind Zone so that people living in higher risk areas would pay more than those living in lower risk areas. Insurers would have greater confidence that regulations would be established for the long term, would not fluctuate and change post-event, and would be, therefore, more inclined to underwrite wind exposure in these areas.

The federal government would not underwrite the risk, nor would it provide a financial backstop under this program. Rather, the proposed Coastal Wind Zone calls for federal regulatory engagement to serve an oversight role, perhaps a federal regulatory commission. The commission would provide:

- A single risk-based set of rating rules to determine actuarially sound rates, as well as a single set of underwriting guidelines covering wind exposure in designated coastal areas.
- Application of a uniform set of laws, regulations and policy forms that establish the rights and responsibilities of consumers and insurers in the payment of coastal wind claims.

States would continue their regulatory oversight over the broad spectrum of insurance activities, including licensing insurers, agents and brokers; enforcing statutory accounting

requirements; conducting examinations of insurers' financial positions and market conduct; monitoring insurer solvency in concert with the federal regulatory commission, and administering markets of last resort. Both state policymakers and the National Association of Insurance Commissioners (NAIC) could serve in an advisory capacity to the Coastal Wind Zone Program.

The benefits of the uniform program would pass directly to consumers. Consistency of regulation both before and after a catastrophe would decrease uncertainty, allowing competition to increase, which should in turn lead to more efficient pricing.

That brings us to the third issue, which was one of profitability and perception. Financial metrics within the insurance marketplace – that is, costs for consumers and profits and losses for insurers – can only be reasonably viewed in the long term. A single catastrophic event or a series of events in one year can eliminate profits a company earned over several years.

Identifying sound rates, in this circumstance of relatively low frequency and relatively high severity, requires a “cost-plus” dynamic – in other words, the cost of the loss, including loss adjustment expense (LAE), plus a marginal profit. In order to ensure this fairness, we propose the creation of a policy structure within the Coastal Wind Zone that requires insurers to implement prospective premium adjustments to consumers in periods following significant profits or losses. These premium adjustments should help to address the concerns of critics, which we noted earlier. A rolling 10-year time period

might be an appropriate basis for this framework, over which time insurers' results would be compared against an appropriate combined ratio range. A portion of the profits would be returned if actual losses incurred during that time period were less than anticipated and assessments would be made if actual losses were more than anticipated.

The benefit of this arrangement is a shared management of risk, and the perception of insurance companies "winning" and policyholders "losing" would be eliminated – at least substantially minimized.

That brings us to the fourth issue – the affordability of insurance. Let's face it; some coastal residents can afford actuarially sound rates better than others. In Florida, for instance, 18 percent of the state's residents are over age 65, many of them presumably on fixed incomes and with limited assets. To address the issue of affordability, we suggest the creation of temporary federal tax credits for the purchase of insurance to cover wind exposures along the Atlantic and Gulf coasts. The credit would be based upon need, as determined by income and asset level, property value and cost of wind insurance coverage, and would be targeted to those who are least able to afford the insurance. By way of background, under the rules of the current Congress, when a new federal program is suggested, it is incumbent on the group suggesting the program to identify funding – what has been referred to as the "pay-go rules." This tax credit suggestion is our answer to the question of funding for this program so that no additional funds will be required to implement our proposal.

These tax credits would be funded by increases in taxes for those who live in the Coastal Wind Zone and who can afford it. We recognize that this is a transfer of wealth; however, the tax credits would only be available for a fixed period. In other words, while we don't want to cause major dislocation of current coastal residents, everyone would be "on notice" that after a specific number of years – say 10 or 15, tax credits would no longer be available for their insurance. At some point, individuals need to be able to afford their insurance without a subsidy.

This proposal goes back to the basic tenet of insurance, which is to spread the risk among as many as possible that are subject to the same kind of risk. The proposal spreads the risks among those who are actually subject to coastal wind exposure, not to others who are not, as does a federal government bailout. A recent survey conducted by the American Consumer Institute found that 84 percent of respondents were unaware of cross-subsidies for homeowner's insurance that benefit coastal properties, and 64 percent disapproved of them.

Another subject that has received a great deal of attention in the months following Hurricane Katrina is the topic of "wind versus water." Discussions centered on what damages were caused by flood, and therefore covered by the National Flood Insurance Program (NFIP), and what damages were caused by wind, and therefore covered by the private wind insurance policy. That has resulted in much debate – and could be the topic of another speech – but for our purposes here, we would suggest that the creation of the Coastal Wind Zone may give us an opportunity to provide more clarity regarding what is

covered by the private market through wind insurance and what is covered by the federal flood program. Regardless how damages are attributed to wind or water, we believe it's important for people who live along the coasts and in flood-prone areas to purchase both flood insurance and wind insurance.

In addition, we recognize that responding to a changing climate requires a comprehensive response that will include enforcing stricter building codes, committing to prudent land-use planning, improving construction technology and acknowledging the true costs of coastal development.

As an important aspect of our Coastal Wind Zone insurance proposal, we encourage risk mitigation strategies. Foremost is the adoption and enforcement of building codes that match expected windstorms, for both new construction and renovations. As a resource, the insurance industry created the Institute for Business and Home Safety to assist coastal building code departments in understanding and adopting construction models and materials that withstand natural disasters. The use of storm shutters, impact resistant windows, and other home safety equipment should be encouraged through incentives to lessen potential damage. Under our proposal, coastal states would be entitled to federal grants if they adopt a proposed federal building code and related mitigation programs.

Property land use management is another mitigation strategy that would lessen a storm's impact. For instance, coastal wetlands have been shown to minimize a hurricane's impact upon landfall by soaking up moisture and slowing the speed of the storm. When

overdeveloped, these areas present an elevated exposure to wind and flood losses during a storm. Zoning regulations that take into account the beneficial nature of wetlands and the proper development of coastal land provide long-term benefit to consumers.

With almost \$7 trillion of insured coastal property from Texas to Maine, solving the insurance challenge posed by the threat of hurricanes and implementing correct risk control measures are critical issues to the economic future of the United States.

We are advocating further study and actively facilitating the necessary dialogue with insurance and governmental leaders to further refine our Coastal Wind Zone idea. We believe this proposal provides a promising concept for offering wind insurance on our coasts that benefits consumers.

After all, the primary role of the federal government in regard to coastal wind exposure is to help people prepare for and respond to disasters. The appropriate role of insurers is to help individuals manage their risks and cover their exposures related to their coastal property. By staying true to those roles, we will best be able to assess the true costs of coastal living and facilitate responsible development there.