

INFORMED DECISIONS ON CATASTROPHE RISK

Can property insurance companies in hurricane-prone areas sustain their operations?

The cost and availability of property insurance is becoming a significant problem for some residents in high-risk coastal areas of the United States.

- Insurance is a necessity for many property owners.
- The cost and risk of wind-related losses from hurricanes has risen dramatically since the early 1990s.
- The analysis of developments in the homeowners' insurance markets in the southeastern United States confirms that significant changes are occurring in these markets as a result of increased hurricane risk.
- The increased costs and risks have caused significant restructuring of property insurance markets, which has decreased the supply of coverage and has led to substantial rate increases, especially in the highest risk areas.
- It has become more difficult for property owners to obtain coverage from private insurers in these markets.

Insurers' profits on a cumulative basis have been negative in Louisiana and the Southeast since 1985.

- Insurers suffered substantial losses in 2004 and 2005 due to hurricanes that hit Louisiana, Florida and other Gulf states.
- Cumulative profits in Louisiana and the Southeast have been negative since 1985; cumulative profits have been negative in Florida since 1992.
- Some states, particularly Florida, have constrained insurers' efforts to raise their prices.

Some argue that a federal/state mechanism is needed to assist private insurers in continuing to supply property insurance.

- Catastrophe models indicate that the threat of hurricanes remains high, which is driving the price and supply of property insurance markets.
- National insurers have exited or substantially reduced their exposures in high-risk areas.
- Some insurers and policymakers argue that catastrophe risk is uninsurable.
- The viability of property insurance markets will depend on evolving risk conditions and states' regulatory policies. Recent developments and evolving conditions will have significant implications on the reliance on private insurers and the need for greater government intervention with respect to property coverage.

The price of property insurance has increased significantly in coastal states, particularly in Florida and Louisiana.

- The intense hurricane seasons of 2004 and 2005 caused substantial instability in property insurance markets in coastal states in the U.S.
- The loss shocks of the 2004-2005 storm seasons, as well as the belief that the risk of wind damage from hurricanes has risen to a higher level (higher than that perceived prior to 2004), have been major drivers of the recent market adjustments.
- The availability of property coverage from private insurers has decreased. Residual market mechanisms have grown both in number of policies and amount of exposure.
- Insurance premiums in coastal areas are considerably higher and have increased to a greater degree than premiums in less hazard-prone areas.
- Rates have doubled or even tripled in the highest risk areas in Florida and Louisiana. There are significant availability problems in all coastal areas, most severe in Florida, also in Louisiana.
- Market pressures do not appear to be as great in Louisiana and other southeastern states whose regulatory policies, with some exceptions, have tended to be less restrictive than those of Florida.

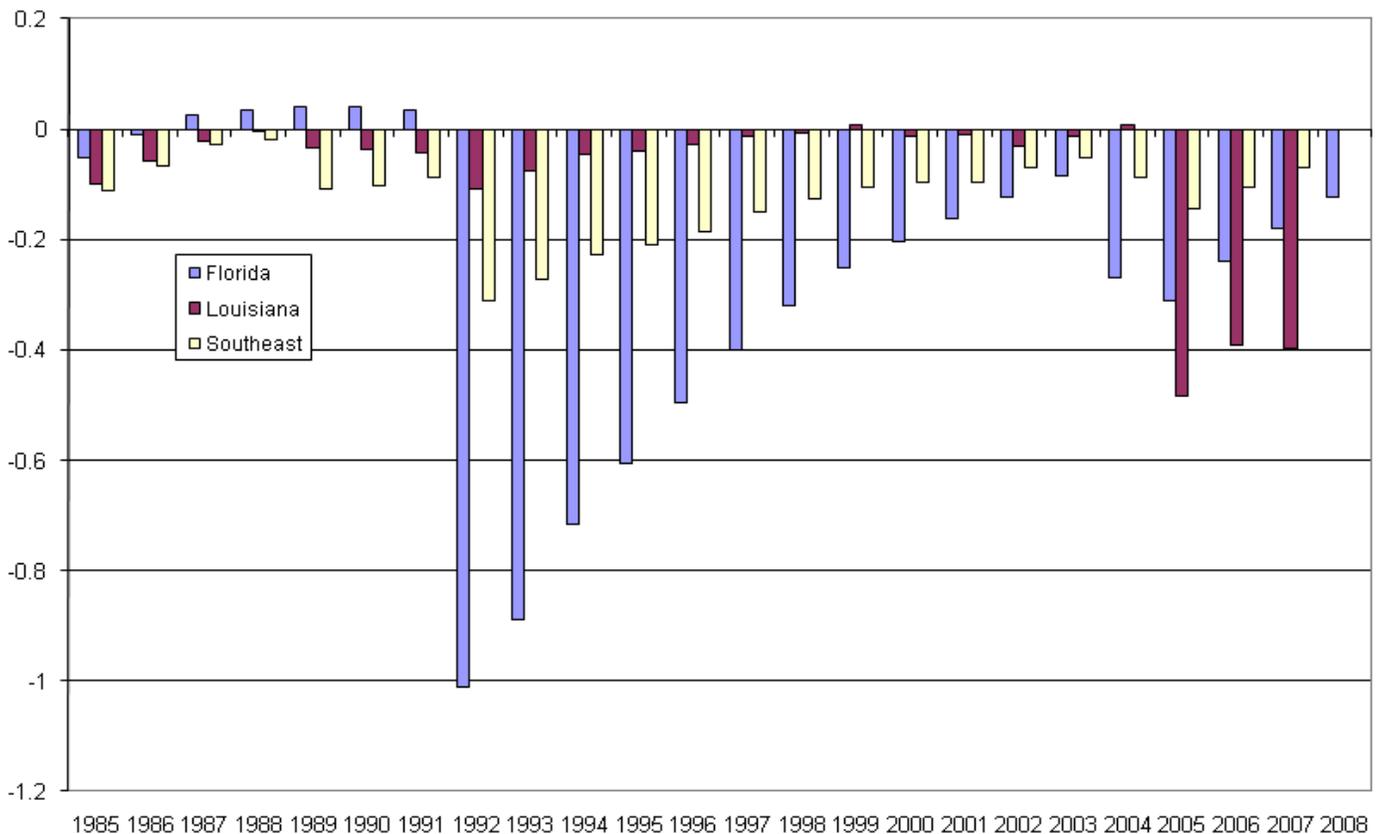
What is happening in Florida?

- Florida has clearly experienced significant market restructuring.
- Availability problems are most severe in Florida. Major insurers have reduced the number of policies they write to the greatest degree in Florida. Florida has experienced the greatest growth in its residual market in absolute and relative terms.
- Florida has significantly limited rate increases since 2006 and also has sought to constrain insurers' efforts to reduce their exposures to catastrophe losses.
- The leading insurers have substantially decreased their market shares and a number of small, single-state insurers have entered the market. This is likely due to the substantial market pressures in Florida and Florida's more restrictive regulatory policies. Some of these small insurers may not have the financial capacity to absorb substantial hurricane losses.
- We may see further market restructuring in Florida, especially as State Farm reduces its exposures.

Insurers suffered substantial losses (negative profits) in 2004 and 2005 due to hurricanes that hit Louisiana, Florida and other Gulf states in these years. Cumulative profits in Louisiana and the Southeast region have been negative since 1985; they have been negative in Florida since 1992. (Yearly profits are computed as premiums plus investment income, minus claim costs and expenses. Cumulative profits/losses in 1987 (for example) are the total of the sum of profits in 1985, 1986 and 1987.) These cumulative losses have contributed to insurers' price and underwriting adjustments and concerns about the economic feasibility of writing homeowners' insurance in high-risk areas under the prices and terms of coverage that preceded these storm seasons.

Insurers were able to improve their positions in 2006 and 2007 as there were no damaging hurricanes in these years, but the 2008 storms had a significant negative effect in Texas and to a lesser degree in Louisiana. Hence, many insurers will likely continue to view their situation as tenuous until their long-term profits approach a level that is more consistent with their cost of capital. This development is especially significant given the higher cost of capital associated with underwriting catastrophe exposures which leads to greater income volatility. It will take several more low-loss years to pull insurers back into the black (see graph).

Cumulative Profits on Homeowners Insurance Transactions: 1985-2008



Source: NAIC Report on Profitability by Line by State, author's calculations.

Note: Southeast states are Alabama, Florida, Georgia, Louisiana, Mississippi, North Carolina, South Carolina and Texas.

SOURCE: Robert W. Klein (2009), "Hurricane Risk and Property Insurance Markets: An Update and Extension" Wharton Risk Center working paper #2009-10-07. *This study examines market concentration, entry and exit, the cost and availability of insurance, and insurers' profitability (or lack of it) in Alabama, Florida, Louisiana, Mississippi, South Carolina and Texas.*

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Established in 1984, the **Wharton Risk Management and Decision Processes Center** develops and promotes effective corporate and public policies for dealing with catastrophic events including natural disasters, technological hazards, terrorism, pandemics and other crises. The Risk Center research team – over 50 faculty, fellows and doctoral students – investigate how individuals and organizations make choices under conditions of risk and uncertainty under various regulatory and market conditions, and the effectiveness of strategies such as alternative risk financing, incentive systems, insurance, regulation, and public-private collaborations at a national and international scale. The Center actively engages multiple viewpoints, including top representatives from industry, government, international organizations, interest groups and academia. More information is available at <http://opim.wharton.upenn.edu/risk>.

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Dr. Robert W. Klein is Director of the Center for Risk Management and Insurance Research, and an Associate Professor of Risk Management and Insurance at Georgia State University in Atlanta. He collaborates on the Wharton Risk Center's Managing and Financing Extreme Events Projects. Dr. Klein is a leading expert on insurance regulation and markets with 30 years of experience as a regulator and an academic researcher. He has published extensively on various topics in insurance and its regulation, including the structure and performance of insurance markets, solvency regulation, monitoring competition, price regulation, catastrophe risk, urban insurance issues, workers' compensation, and international insurance regulation. He has served on the Board of Directors for the *American Risk and Insurance Association* and currently serves on the editorial boards for the *Journal of Insurance Regulation* and *Risk Management and Insurance Review*. Prior to joining Georgia State University in September 1996, Dr. Klein was the Director of Research and Chief Economist for the National Association of Insurance Commissioners. He also has served as staff economist for the insurance department and state legislature in Michigan. He has testified frequently at legislative and regulatory hearings on significant issues affecting insurance consumers and the industry.