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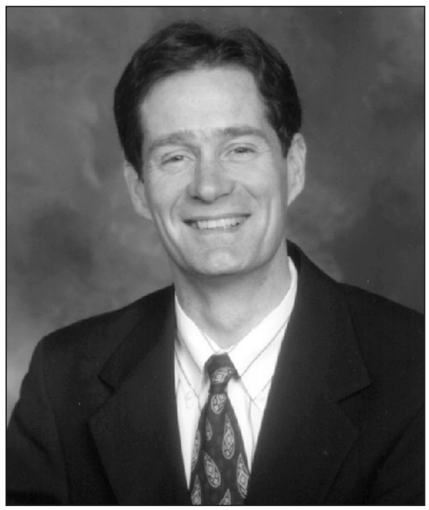
Winds of Change Sweeping Over Homeowner's Insurance

By Geoffrey A. Gordon

THE RATE YOU PAY FOR HOMEOWNER'S INSURANCE here in Massachusetts is affected more and more each year by events happening far away.

In recent months, insurance buyers living within a few miles of the seacoast are being told by their insurance companies that their homeowner's policies now include "wind deductibles" separate from the deductible for all other damage causes. Wind deductibles apply if there is damage caused by the wind, including such things as the tree that lands on your roof during a storm. These are often expressed as a percentage of the house value: a 2 percent wind deductible on a $250,000 house means the first $5,000 of damage caused by wind is the homeowner's responsibility. Wind deductibles are not new, but they are affecting more people and they are being required on properties further from the coast than ever before.

The watershed event for the modern-day insurance industry was in 1994, when Hurricane Andrew, a category 5 storm, wiped out the town of Homestead, Fla., barely missing Dade County (Miami) and its much higher-priced properties. Catastrophes, or "cats" in insurance lingo, are events that cause widespread damage and numerous claims for insurance companies. Andrew introduced a new breed of "super cat." With super cats, damages are inflated further by failure of infrastructure, shortages of qualified labor and material cost spikes, such as the cost of plywood or sheetrock, so that the replacement costs of damaged properties jump far beyond replacement cost estimates suitable during normal times. Hurricane Andrew also revealed to insurers that replacement costs were broadly inadequate, even before the inflationary effect of the super cat. There were so many "total losses" that companies discovered that homes carried far less insurance than they should have.



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What does an insurance company do to protect itself from these huge, but infrequent events? They buy insurance, of course, through a reinsurer.

Reinsurers insure insurance companies for large disasters. The parties draw up contracts (effectively, policies) providing protection for retail insurance companies' assets from the broad damage from hurricanes and other large storms. Most insurance companies invest in reinsurance, just as homeowners pay for home insurance.

For example, suppose a retail insurance company with $50 million in assets estimates that it faces a $100 million probable maximum loss (PML) from a hurricane. The retail company buys $90 million of insurance protection from a group of reinsurers, subject to a deductible of $10 million. The hurricane hits and the retail company sustains the expected $100 million maximum amount in claims. The retail company pays the first $10 million of claims from their own assets (their deductible), and the reinsurers pay the remaining $90 million. The financial integrity of the insurance company is intact; bent, but not broken.

A Move Inland

The reinsurer gives the retail insurance company broad authority to underwrite as it sees fit, since they often share in claims that exceed the agreed trigger point ($10 million in the example cited). However, they also retain the right to audit claims practices by insurers, and will insist on certain underwriting standards. After cats, they can also offer many forms of operational assistance, when retail companies face tremendous administrative challenges.

The next events leading to the current trends in coastal insurance were the hurricanes of 2004 - the infamous "Gang of Four" hurricanes (Charley, Frances, Ivan and Jeanne) that hit Florida and the Gulf Coast in rapid succession between mid-August and late September. Satellite imagery and sophisticated mapping technology had come a long way in the 10 years since Hurricane Andrew. Insurance companies and their reinsurers became much more precise with their mapping, improving forecasting capabilities. Then, while companies were still analyzing data from 2004, Hurricanes Katrina, Rita and Wilma came ashore in 2005 providing new, almost real-time confirming data.

The combined effect of new imaging and forecasting tools has given both retail insurers and reinsurers a more thorough understanding of expected damage from big storms. This is good news for insurers, but bad news for homeowners, who are now seeing the results of this forecasting. As hurricane forecasters

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predict increased frequency and severity of Atlantic storms in the coming years, insurance companies are taking active steps in three areas: First, they are trying to limit their exposure from large, broadly destructive storms by restricting where they'll write insurance at all. The also are requiring wind deductibles further inland where they do continue to write policies. And, of course, they are limiting exposure by increasing rates even further inland to pay for dramatically increased reinsurance costs.

Where is this taking us? Most property owners along the coast already have seen big changes in their insurance. Prices have increased steadily and, for some, private insurance has evaporated altogether. In 2005, one Massachusetts company declined to renew 14,000 policies on Cape Cod; this year another is not renewing 9,000 Massachusetts coastal policies after getting hit with a 50 percent increase in its reinsurance expenses. This leaves many homeowners the single option of insuring with the state's insurance pool, known as the FAIR (fair access to insurance requirements) Plan, at higher costs and with limited coverage options. For those far enough inland to keep their insurance, wind deductibles are now being implemented up to 5 miles inland.

Trends that are likely to continue include severely limited insurance choices within a mile of the coast, wind damage deductibles within 5 miles of the shore and higher costs for all homeowners. Quantifying where the water distance limitations and higher costs will stop is hard to predict, but they will certainly continue to move inland for the next few years until catastrophe models, reinsurance capacity and insurance prices reach a balance. We're not there yet. ■