

Flirting With Disaster

Howard Kunreuther 02.11.08



How long-term insurance can help homeowners in hurricane zones save money and protect themselves at the same time.

Homeowners in hurricane-prone areas are at sea when it comes to insuring their property, and they don't know what to expect when it comes to renewing their policies. Following the wreckage caused by the four hurricanes that hit Florida in 2004, and then by Hurricane Katrina in 2005, some insurers simply refused to renew coastline policies. In February 2007 State Farm, the largest insurer in Mississippi, stopped selling new policies on homes and small businesses there. Allstate Insurance announced it would restrict new homeowners policies in New Jersey, Connecticut, Delaware and New York City, out and out refusing to write policies in spots likely to get hit by hurricanes.

There is a high risk that state governments will regulate prices more than they do now, forbidding insurers to quit even when they lose money or when they're facing unfair tort lawsuits.

To guard against this uncertainty, I propose a new kind of policy, one that would last as long as your mortgage -- 15 to 30 years, that is. The annual premium could be wrapped into your monthly mortgage payments, as it often is today. Your mortgage lender would, of course, inspect your policy as closely as it now inspects your walls for termites. The long-term policy would be a valuable asset that you could transfer to the next owner of your home. Nonrenewal would not be an issue.

For such policies to work, insurers would have to price their coverage in a free market. That is, competition, not a diktat from Tallahassee or Jackson, would determine what you pay, just as it now determines whether your mortgage costs 6% or 8%. It is reasonable to expect that competition among providers would be intense and that at least some property owners would be diligent comparison shoppers.

One reason that insurers have abandoned certain hazard-prone states is that state regulators force them to charge premiums that don't cover their actuarial exposure and the cost of holding the capital they'd need if a hurricane hit. In coastal Florida private insurers have no economic incentive to offer policies, because Citizens, an insurance company run by the state, offers artificially low rates to its customers. In a similar fashion, flood insurance is subsidized, so that homeowners aren't paying the full costs they impose on society. In other words, homeowners aren't getting the right signals about where to build.

But now picture what a free market, a 20-year term and a little imagination might do to give the right incentives. Suppose that a homeowner in Fort Lauderdale could spend \$1,500 to strengthen his roof. Suppose there is a 1-in-100 chance each year that a severe hurricane will strike, and that an upgrade to the roof would reduce the storm's damage by \$30,000. An insurer permitted to charge rates reflecting risk would be willing to lower the annual premium to that homeowner by \$300. Better still, with a 20-year policy the bank would be able to provide a home improvement loan with annual payments that are much less than \$300, to pay for the roof job. No cash flow problem for the homeowner.

There are details that need to be worked out by underwriters, actuaries, investors and other experts concerned with future hazards, so that these policies can be marketed and made attractive to homeowners. Under what circumstances could a property owner change his insurance policy over time? What role would the scientific community studying climate change play in providing estimates for developing premiums that reflect risk? How will rating agencies view long-term insurance contracts? How concerned will consumers be about possible insolvency of insurers providing long-term contracts, and what steps should be taken to protect homeowners should this occur?

State regulators should continue to assure the solvency of insurers but should stay out of the rate setting business. Unless they give insurers the freedom to charge premiums that reflect risk, long-term homeowners insurance is bound to flop.