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Exploring the Idea of Wind Insurance as a Pilot Program

Why a Half-Way Step Could be Very Expensive

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As the House of Representatives and Senate move towards a conference on proposals to reform the National Flood Insurance Program (NFIP) members of Congress and staffers have raised the possibility of adding a "wind insurance pilot program."[1] Rep. Gene Taylor (D-MI), the chief sponsor of a national wind-insurance measure the House of Representatives has passed, has taken a leading role in pushing for such a "pilot program".[2] As of mid-September, nobody has yet introduced specific legislation calling for a pilot program. Thus, this memo deals with general objections to a wind insurance pilot program rather than the particular features of any proposal. In dealing with the concept of a pilot program, this memo makes three interrelated points:

- A pilot program could actually cost taxpayers *more* than a larger program.
- Only a handful of states—all of them on the Gulf and Atlantic Coasts—would benefit.
- Any wind insurance program would destabilize the already shaky National Flood Insurance Program.

Sections analyzing each of these points follow.

A Pilot Program Could Actually Cost Taxpayers More Than a Larger Program

Insurance works by managing risks over large pools of non-correlated perils; a wind pilot program would involve writing coverage for a small pool of heavily correlated risks. This would make its coverage very expensive and very likely to lose money.

[1] The bills are S. 2284 and H.R. 3121.
[2] H.R. 920. Maxine Waters was the other leading co-sponsor.

Some background first: Although no consensus exists as to the best possible risk-pool size, nobody contends that small, very geographically concentrated pools provide a good means for writing insurance. The genesis of the House-passed wind-insurance measure, indeed, comes from the perilous financial straits that state-mandated wind pools (shared insurance markets) find themselves in on the Gulf and Atlantic Coasts. These problems exist because these wind pools concentrate risk in the same place and write only high risk policies. To explain why this happens, it's necessary to explain how private insurers work: A private insurer can manage risk nationally or even internationally by building a non-correlated portfolio of risks. For example, a private insurer might write policies relating to snow damage in North Dakota and wind damage in Florida: snow damage always happens during the winter while hurricanes always take place during the summer and early fall. Intensely snowy years, furthermore, tend to have fewer hurricanes. Thus, by creating a "portfolio" of risk (putting together perils unlikely to happen at the same time) and investing money between years with heavy claims, an insurer can use profits from insurance against one type of risk to pay off the other. Insurers can also buy reinsurance that spreads risks internationally by taking part in risks like Japanese earthquakes and European floods. In every case, insurers take on a mix of risks. Even an insurer operating in only a handful of counties in one state would write a mix of high and low-risk policies and might well purchase reinsurance.

Public wind programs, on the other hand, write only policies to those unable to get wind coverage in the private market. These people are clustered almost entirely on the Gulf and Atlantic coasts and mostly in the areas quite close to the Ocean. If a hurricane strikes, it will hit a great number of insured at the same time. (In the wake of hurricanes Katrina and Rita, for example, *everyone* in the Mississippi wind pool made a claim against the pool.)[3]

Because it focuses risk on one type of event (windstorms) and limits it to one country (the United States) almost any government-provided wind insurance offers a bad risk. Unless it under-prices the coverage and relies on taxpayers to bail it out, *any* government wind program will almost certainly have to charge higher premiums than private insurers in order to break even. The simple fact that it doesn't strive to make a profit won't make the coverage cheaper: all insurers, even government-run ones, need to retain earnings and pay people in order to administer claims. Major insurers like State Farm, USAA, and Liberty Mutual are all non-profit already. A government insurer will have the same problems as the national flood insurance program it will have to either systematically under-price coverage (as NFIP has done since 1973) or sell an extremely small number of policies (as NFIP did from 1968 to 1973). Thus, any talk of "actuarially adequate premiums" should be regarded with extreme skepticism.

A larger wind pool that included policies from a variety of regions would still have significant problems but, like the National Flood Insurance Program that the House has proposed adding it to, the sheer bulk of the pool would mean that it would still contain many weakly correlated risks. (It's unlikely, for example, that hurricanes will strike Florida and Massachusetts at the same time.) Thus, many years, it might be able to break even or derive a small "profit."

Simply because it would be smaller, a government wind insurance pilot program would very likely have to charge even more for coverage than a larger one or underpriced its coverage more. If Congress specifies the areas in which a pilot will take place, furthermore, it's highly likely that the areas most desiring subsidized coverage—those at the highest risk—will make up a majority of the policies in the program. While a larger program might be able to make money off of its own

[3] Mississippi Windstorm Underwriting Association. "Facts," http://www.msplans.com/MWUA/Index.htm

revenues in the best years, a smaller one could very well lose money every year. It would literally require yearly bailouts. It's a bad idea for this reason alone.

Only a Handful of Areas—All of Them on the Gulf and Atlantic Coasts—Would Benefit.

The Congressional Research Service has found that wind coverage ""is cheap and plentiful" in much of the United States.[4] Wind-oriented state-run insurance markets exist only in hurricane-prone areas and, even in states like Alabama and South Carolina, they serve a reasonably small fraction of the market.[5] Even Virginia, which gets hit by a hurricane at least once a decade, manages its coastal risk through a conventional FAIR plan (a system largely set up to provide property insurance in inner-city neighborhoods after urban disturbances in the 1960s) rather than a wind-specialty insurer. More than half of the nation's total coastal exposure to hurricane winds is in one state—Florida.[6] Any benefits would accrue to Florida alone.

One recent study, *Natural Catastrophe Reinsurance and New Loan Programs: Who Pays and Who Benefits?,* performs a complete economic analysis of what would happen.[7] The study, conducted by Robert J. Shapiro (a former Clinton administration appointee) and Aparna Mathur (a researcher at the American Enterprise Institute) concludes that most states outside of the coastal zone would pay enormous amounts. The figures, indeed, are mind-boggling:

> $19 billion for Californians, $11 billion for New Yorkers, $7 billion for Illinoisans, $6 billion for taxpayers in Pennsylvania and New Jersey, $5 billion for those in Ohio, $4 billion each from the taxpayers of Massachusetts, Michigan, and Virginia, and at least $3 billion for those in Connecticut, Indiana, Maryland, Minnesota, North Carolina, and Washington State.[8]

Poorly designed, a "pilot" program could cost even more than this: it would collect less in premiums but might well have similar exposure to catastrophic risk. And few would benefit. It's notable that significantly hurricane-exposed states like Virginia, North Carolina and Massachusetts would all expect to pay as a result of the establishment of a federal wind insurance program. In the end, only one state—Florida—would end up in significantly better financial shape as a result of the program (some other Gulf and Atlantic Coast states would get marginal benefits.)

In this context, it's worth asking a simple question: "Should Congress enact national legislation for the benefit of a single state?"

Any wind insurance program would destabilize the already shaky National Flood Insurance Program.

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[4] Rawle King, "The Flood Insurance Reform and Modernization Act of 2007: A Summary of Key Provisions," Congressional Research Service, September 21, 2007.
[5] Property Insurance Plans Service Office. "Property Insurance Plan Market Penetration Report: 2008."
[6] AIR Worldwide. "Estimated Insured Value of Coastal Exposure, 2007," http://www.air-worldwide.com/_public/images/pdf/AIR2008_Coastline_at_Risk.pdf?src=email.
[7] Robert J. Shapiro and Aparna Mathur. *The Economic Effects of Proposals for Federal Natural Catastrophe Reinsurance and New Loan Programs: Who Pays and Who Benefits?*. Sonecon, August, 2008, http://www.sonecon.com/docs/studies/Report_on_the_Effects_of_Proposed_Hurricane_Legislation-Shapiro-Mathur-August_2008.pdf
[8] Ibid.

In the short term, the United States has little choice but as to renew the existing National Flood Insurance Program and work to stabilize it. Some efforts to cut back the program's subsidies, forgive its debt, and reduce the number of people eligible for subsidies deserve serious consideration and have a found a home in the flood insurance reform bill the Senate has passed.[9] Although nobody contends that any proposal either house has passed "fixes" flood insurance for good, both House and Senate have taken steps that put it on firmer footing.

Adding an untested wind insurance program, the costs of which aren't fully known, would likely serve to stress the entire flood insurance program. Even if theoretically "firewalled" from the rest of flood insurance, it's quite possible that accounting measures could end up comingling "flood" and "wind" funds. This seems particularly likely given the ongoing—and probably impossible to resolve—controversy over the extent to which wind-driven water ought to be considered "wind" rather than "flood." A wind program of any sort, added directly to NFIP, could serve to destabilize the entire flood program.

Conclusion

Congress should approach proposals for a national wind insurance pilot program with extreme skepticism and forbearance. Real problems exist with access and affordability of insurance and national level action may be needed. Possible solutions worthy of quick consideration involve measures to measures to encourage homeowners to reinforce their homes through tax credits and grants, efforts to preserve wetlands and barrier islands, and efforts to allow insurers to take a broader range of risk factors into account. If it wants to help state wind pools directly, Congress might considering legislation authorizing interstate compacts between existing wind pools in order to allow them to pool risk on a broader scale. Finally, it might also consider legislation giving insurers the choice of organizing under federal or state law. A federal wind insurance pilot program, however, simply doesn't make sense.

[9] S. 2284.