Competitive Enterprise Institute

Issue Analysis

South Carolina's Omnibus Coastal Insurance Reform Legislation

Baby Steps in the Right Direction

By Eli Lehrer

October 2007

South Carolina's Omnibus Coastal Insurance Reform Legislation

Baby Steps in the Right Direction

By Eli Lehrer

Executive Summary

In early 2007, South Carolina created a new system for windstorm insurance: It expanded a long-existing state-run wind pool and introduced a number of tax credits to help individuals purchase policies in the private market and mitigate against storm damage while providing modest tax subsidies for private companies willing to write "full coverage" wind insurance. Relative to those implemented in other hurricane-prone states, this set of reforms seems more likely to unleash market forces in a way that makes insurance more affordable for much of the state's population.

Nonetheless, it remains too early to assess the effectiveness of South Carolina's reforms. In any case, the reforms are far from perfect; they represent little more than baby steps in the right direction, and, with poor regulatory authority, could actually end up harming the state. This paper describes the reforms and sketches out a plan to move towards a truly free market for wind insurance in South Carolina or elsewhere.

Introduction

In the wake of 2005's disastrous Hurricane Katrina, nearly every state along America's Gulf Coast has reduced the market's role in the provision of insurance. Since the middle of 2006, Texas, Mississippi, Florida, and Louisiana have all taken actions that will increase the government's liability for homeowner's insurance while reducing the need for individuals to take care of their own property. South Carolina—the primary topic of this paper—has taken a different route. While flawed in several important respects, the Palmeto State's 2007 coastal insurance reforms provide important lessons for states wishing to free their coastal insurance markets, increase their resiliency against hurricanes, provide price stability to consumers, and encourage competition between insurers.

The Palmeto State's 2007 coastal insurance reforms provide important lessons for states wishing to free their coastal insurance markets, increase their resiliency against hurricanes, provide price stability to consumers, and encourage competition between insurers.

Despite the relatively quiet 2006 hurricane season and a 2007 season that, to date, has not seen a major hurricane make landfall in the United States, evidence indicates that the United States remains in the midst of an upsurge in hurricane activity. Through most of recorded history, hurricanes have happened in cycles of roughly 30-40 years—two decades of reasonably mild hurricane activity followed by a decade or two of particularly intense activity.[1] The cycles are largely attributed to the *El Niño* and *La Niña* weather patterns, global climate change (both human caused and naturally occurring), and changes in the Earth's orbit. Some evidence exists for all of these explanations and, most likely, the upsurge in hurricane activity comes from a combination of them.

Two factors, wealth (particularly in the American South) and population shifts, have combined to make the current upsurge in hurricanes particularly relevant. First, the hurricane belt—once a poor part of the country—has grown enough economically to be roughly on par with the rest of the country: Coastal counties are no longer poorer than the inland counties around them and the Atlantic seaboard states that joined the Confederacy have a per capita income of about 89 percent of the national average and a standard of living that is higher in many important respects.[2]

Second, as these areas have grown, Americans have moved there in droves. The South has seen its population explode—based on census data for 1970 and 2000, the Gulf Coast states saw population growth of nearly 40 percent on average. Many of these new residents live in coastal counties, which are the most susceptible to hurricane damage.

This paper advances its argument in three sections. The first section provides a theoretical framework for thinking about coastal insurance and describing South Carolina's current coastal insurance system.

Flood Insurance

The National Flood Insurance Program covers water damage of up to $250,000 in total value. In most of the country, it provides the only available flood insurance. In most cases, purchasing coverage is a *de facto* mandate. For loans under $417,000, Fannie Mae and Freddie Mac, the two massive government-sponsored marketers of mortgage-backed securities, refuse to securitize mortgages that do not have flood insurance. Nearly all private mortgage-backed securities marketers and mortgage writers issue coverage the same way. Implicit subsidies and the sheer size of the pool keep rates lower than those private insurers would charge, so no conventional private insurer covers flood damages below the Flood Insurance Program's $250,000 limits.[1] (A few companies, however, do write private flood insurance for more valuable properties.)

1 For information on NFIP see: Federal Emergency Management Agency, "Myths and Facts about NFIP," April 4, 2006, http://www.fema.gov/business/nfip/myth.shtm.

The second section describes the changes that South Carolina has made to its own system and describes how those changes have worked to date.

The final section assesses the effectiveness of South Carolina's plan and describes how other states might improve and modify it. It concludes that, while South Carolina's insurance reforms have deep flaws and could go much further, they represent an incremental but important step in the right direction.

Insurance in South Carolina

This paper deals mainly with personal wind and hail insurance in coastal South Carolina. This insurance entails contractual relationships that protect consumers from damage to their homes from strong winds and hailstorms. The next few pages describe the coastal area, wind insurance, and ways in which—and principles under which—such insurance might be provided.

To begin with, South Carolina is divided into three geographic regions, each of which comprises roughly one-third of its land area: Upstate, the Midlands, and the Coastal Region. The Coastal Region—sometimes called the Low Country—consists of 13 counties and includes major settlements in Charleston, Myrtle Beach, and Hilton Head Island.[3] For the purposes of this paper, the Coastal region includes all counties in South Carolina which lie fully or in part below the fall line—the place where alluvial gathering gives way to the bedrock of the North American continent. That region is this paper's main focus.

In the coastal region, as elsewhere in the country, wind insurance has and will continue to be a major part of most homeowners' insurance policies, of which nearly all combine personal liability coverage with financial protection against damage from fire, theft, vandalism, falling trees, and other hazards. With the exception of Florida, private entities write nearly all policies to cover these events. By contrast, nearly all flood insurance—which covers hurricane water damage—in the United States comes from the federally run, federally backed National Flood Insurance Program (NFIP).[4] Wind insurance, however, lies somewhere in between: No federal program provides it on a large scale but every state from Texas to North Carolina has developed a quasi-public mechanism to provide wind insurance in high-risk regions.

These mechanisms, known as "wind pools" in most states, represent the most numerous government-backed homeowners' insurance mechanisms in the United States. Along with national flood insurance they make up the heart of the publicly supported market.

South Carolina's Wind and Hail Underwriting Association is typical of the existing pools. Although privately administered by a commission consisting of 11 insurance company representatives, two insurance agents, and one consumer representative, the wind pool remains largely a creature of the state. The government requires all property insurance carriers to participate and indirectly sets rates.[5] Although no state law says so, the wind pool has the implicit backing of the South Carolina state government: All other states that have seen their wind pools threatened with collapse have bailed them out. The National Flood Insurance Program functions in the same way.

All states that have seen their wind pools threatened with collapse have bailed them out. The National Flood Insurance Program functions in the same way. Therefore, both programs subsidize insurance rates for people living in coastal areas at the expense of those living further inland.

Therefore, both programs subsidize insurance rates for people living in coastal areas at the expense of those living further inland.[6] Various mechanisms exist to shield these programs from political pressure, but the political process ultimately determines the way these programs operate: Many may have corporate façades, yet they are ultimately accountable to elected and appointed government officials. The inevitable result is a wealth transfer from the risk-averse—inland residents—to the risk-prone—people living in hurricane zones—that does not consider income or need.

However, these politically run markets comprise only a very small portion of the total insurance markets. Admitted—that is, standard—markets provide most property and casualty insurance, and nearly all homeowners' insurance, for the great bulk of Americans. In South Carolina, as in all states except Illinois, admitted insurance companies subject themselves to state regulation of their rates. In South Carolina, as in 40 other states, the insurance commissioner is charged with ensuring that they charge "sufficient" rates and, at the same time, that those rates are not "excessive." Admitted carriers also participate in state-run guarantee funds that will pay their claims should they become insolvent.

The excess and surplus lines—or residual—market has less direct political oversight. Carriers in this market—the terms for it are interchangeable—do not undergo state licensing and do not participate in guarantee funds. These carriers face no limits on how much they can charge and, in theory, provide only coverage which states determine is "not available" in the admitted market. They do, however, face a *de facto* price floor in that all states require them to charge an "actuarially adequate" rate—that is, a rate that mathematical models determine is high enough

Building a well-functioning insurance market will require a reduction in the political provision of insurance.

to ensure that they can pay claims. Although excess and surplus lines carriers do not theoretically compete against admitted carriers, in practice consumers on the fringes of admitted markets will sometimes have a choice between coverage from two types of carriers.

Building a well-functioning insurance market will require a reduction in the political provision of insurance—the market already provides most insurance and there is no reason to believe it cannot provide wind insurance as well. Getting the wind insurance market to function like other markets will require reforms. The following principles guide other markets and could serve to guide the wind insurance market as well:[7]

- ***Insurance should be based on risk; assessment of risk comes from collection of data.*** Insurance should cost more for people who take substantial risks and less for those who take small risks. Insurers should be able to use all relevant data in order to price like risks alike and different risks differently.
- ***Insurance has nothing to do with relief.*** Nearly everyone agrees that society should develop mechanisms to provide relief immediately following a serious storm. But these efforts have little to do with insurance and conflating the two will undermine both efforts: The careful "dollars and cents" actuarial calculation that makes for good insurance policy can be devastating to emergency relief efforts and vice versa.
- ***Insurance should influence development***. In particular, insurance should do some combination of three things with regard to development:
  1) Discourage development in areas vulnerable to hurricanes;
  2) Encourage mitigation against inevitable hurricanes; and
  3) Pay for a portion of the costs of periodic rebuilding in places where people can afford the cost and mitigation is impossible.

A purely private market should be the ultimate public policy goal. In the short run, wind coverage should work through private means to the extent possible. This does not mean that all residual state-supported markets should be phased out immediately, but in the long term, public policy should encourage the development of an entirely private market. Private insurance covers Americans homes and cars almost everywhere. There is no reason why it cannot cover hurricane zone houses.

South Carolina's Reforms[8]

This section describes South Carolina's wind pool, grant, and tax credit reforms. The process of implementing them began in early 2007, when South Carolina appeared likely to follow the same route as other states faced with rising insurance premiums and rampant policy cancellations. In the wake of Hurricane Katrina, insurance companies, the A.M. Best Company—which rates insurance companies' financial status—and some state regulators decided that "sufficient" rates needed to go up. Resulting rate increases produced outrage from coastal homeowners.

However, because South Carolina had not actually had a major hurricane strike, the rate increases—and attendant outrage—were milder there. Nonetheless, South Carolina House Labor, Commerce, and Industry Committee Counsel Brad Wright notes that "nearly everyone was clamoring for something, anything that would change things and expand the government's role."[9]

And, at first, South Carolina appeared likely to go in the direction of more political oversight. In fact, following news that admitted carriers had dropped over 20,000 policies in the state's coastal areas, the most popular proposals included forcing carriers to write more policies, expanding the state wind pool, and offering implicit state subsidies for coastal dwellers.[10]

State Senate President Pro Tempore Jeff McConnell proposed a bill—supported by other powerful senators—to expand state-run wind insurance while requiring companies to write wind policies to all comers or write none at all.[11] But Governor Mark Sanford and a group of state legislators had different plans. "I looked at it and I saw that fear was largely driving the agenda," he explains. "I wanted to do something different."[12] Sanford joined with two legislators: Henry Cato, the chairman of the powerful Labor, Commerce, and Industry Committee and Nikki Haley, the first Indian American elected to state-level office as a Republican and a rising star in South Carolina Republican circles.

The plan that Sanford, Cato, and Haley announced in the state legislature—the outlines of which the legislature eventually enacted as the

"Omnibus Coastal Property Insurance Reform Act of 2007"—had three major operative components: a larger wind pool (coupled with overall rate increases for wind pool coverage), tax policy changes, and a retrofitting grant program.[13]

All of affluent Hilton Head Island—even areas several miles inland—could receive wind pool coverage, while in poorer—and, in 1971, very sparsely populated—Horry County, the wind pool ended only four blocks from the ocean in places.

The Wind Pool

The wind pool overhaul came first and has had the most consequences to date. It matched wind pool boundaries to the state's population patterns while raising rates.

The boundary increase has attracted the most attention. To a large extent, insurance agents and political leaders interviewed agree that the boundaries established in 1971 had far more to do with political considerations and settlement patterns when the law first went into effect rather than current reality. Prior to its expansion in 2007, in fact, its borders had little to do with actual wind risk. All of affluent Hilton Head Island—even areas several miles inland—could receive wind pool coverage, while in poorer—and, in 1971, very sparsely populated—Horry County, the wind pool ended only four blocks from the ocean in places.[14] "Some people were clamoring for a bigger wind pool," explains insurance agent Mike Hogan of Myrtle Beach-based Puckett, Scheetz & Hogan. "And, it seems to me that the wind pool was a little unfair the way it was structured."[15]

Thus, after some back and forth with the Governor's office and insurance commissioners Eleanor Kitzman, and—following Kitzman's resignation—Scott Richardson, Commissioner Richardson eventually expanded the wind pool unilaterally and roughly doubled its size in Charleston and four coastal counties.[16] Under the legislation passed, the insurance commissioner can expand the wind pool for "emergency" purposes for up to two years without legislative approval.

While expanding the pool, however, Richardson also raised the rates charged to those who purchase policies through it. "We want this to be a real market of last resort," he explains. "We want people to find coverage elsewhere if they can and create opportunities when we can." The wind pool's own policy documents makes this clear:

> The Wind Pool was not created to be the low cost provider of wind and hail insurance. Its rates will be higher than the standard market, but may be lower than some excess and surplus lines companies. This is why it is extremely important that you shop around and try to secure coverage through a standard insurer

> before going to the Wind Pool. The Wind Pool exists to provide coverage for consumers who cannot find that coverage in the standard market...consumers may find broader coverage at a better price in the regular competitive insurance market. In fact, it is highly recommended that an applicant seek to buy insurance in the standard market before applying to the Plan for coverage. The Association is a market of last resort.[17]

Despite the higher rates, the wind pool expansion has still displaced private coverage and encouraged some companies to pull back from covering some areas.

However, despite the higher rates, the wind pool expansion has still displaced private coverage and encouraged some companies to pull back from covering some areas. "They're moving further and further away from the coast where they can or writing coverage ex[cluding]-wind damage," says Hogan, who represents multiple insurance companies. "Where people can get wind pool coverage, the private carriers are often withdrawing."

On the other hand, there is a strong reason to think that the private sector pullback may be temporary. "For some of these houses the residual [excess and surplus lines] market—one way or another—is the right place for them," says Richardson. "The real question is will it be the state or the private sector?"

Indeed, things have already seemed to turn around. In the wake of the wind pool reforms, cancellations have dropped enormously: Allstate announced that it would not cancel over 2,300 policies. Agents around the state say that other carriers, including State Farm and the Farm Bureau, have scaled back or canceled plans to do away with coverage.[18] If rates remain higher than those found in the private market, it should be expected for the private market to come back in and take much of the wind pool in reasonably short order. "The private rates were too low for a long time," says agent insurance Tommy Cooke. "Now they're too high in many places. We may have a chance to get them right."[19]

Grant Program and Tax Credits

A grant program, largely intended to promote retrofitting of homes and small businesses, serves as the second pillar of the 2007 Coastal Insurance reforms. In regulations issued during August, the Insurance Department listed particular things eligible for the grant program, which include:

"• roof deck attachment;
- secondary water barrier;
- roof covering;

The grants will not simply flow as "free money" to homeowners.

- brace gable ends;
- reinforce roof to wall connections;
- opening protection;
- exterior doors, including garage doors;
- tie downs;
- problems associated with weakened trusses, studs, and other structural components;
- inspection and repair or replacement of manufactured home piers, anchors, and tie down straps; and"

A catch-all:

- "any other mitigation techniques approved by the advisory committee."[20]

The grants, however, will not simply flow as "free money" to homeowners, thanks to three important restrictions:

- First, only homes with an insured value of $300,000 or less will be eligible for the program.[21]
- Second, only primary homes—not second or vacation homes—can take part.
- Third, homes participating in the program have to complete insurance industry-sponsored and certified wind mitigation and hurricane inspections.

The program will also attempt to secure matching grants from the insurance industry and others. As of this writing, the grant program is yet to issue any grants.

In addition, the omnibus coastal insurance bill changes the state's tax code in several important ways to encourage the purchase of private insurance. Four stand out.

- First, and perhaps most importantly, the bill creates tax-free savings accounts for people to save against hurricane catastrophes. Although not exempt from federal taxation, the state will not tax money deposited in the accounts.
- Second, state tax incentives attempt to make it more affordable for people with modest incomes to purchase insurance: People who pay more than 5 percent of income towards insurance premiums will get a tax credit up to $1,250 against their premiums.

- Third, taxpayers may claim a tax credit against up to $1,500 of sales taxes paid on materials used for retrofitting.
- Finally, insurance companies who issue "full coverage"—that is, homeowners' insurance that includes wind coverage but relies on the National Flood Insurance Program—to people within the expanded wind pool can also get tax credits.

Since the implementing regulations for these tax credits have yet to be issued, it's difficult to make much of an assessment of their value. "There's been a lot of interest," explains insurance agent Jimmy Rowe, CEO of Kinghorne, one of the state's largest insurance agencies. "But they haven't had a real impact yet since nobody has used them yet."[22]

What to Expect From the Programs

Likely consequences of the programs include retrofitting of existing properties, small-scale return of private carriers to the market, moderately high use of the new disaster savings accounts, and price stability at reasonably high levels.

Retrofitting. The tax credits and grants should work to make South Carolina's coastal properties more resistant to wind, hail, and hurricane. People will likely take advantage of the grants and tax credits to retrofit older properties. (While there is no hard data available, everyone with whom the author spoke seemed to agree that construction of the last 10 to 15 years and foreseeable future is sturdy enough to withstand all likely hurricanes.[23]) The subsidies may also stimulate additional retrofitting activities. Construction companies specializing in retrofitting may be able to purchase new equipment, achieve economies of scale, and do other things to bring the prices down, thus incentivizing people to undertake improvements. On the other hand, some grants will pay for work that homeowners would have done anyway.

Small-scale return of private carriers. Thanks to higher rates, insurance companies will likely return to the market. "They're staying away for now," says Kinghorn's Rowe. "But, in the long term, they're just too greedy to stay away."[24] Since no significant barriers exist to their entry, it also appears likely that more companies will enter the market. It remains to be seen, however, if any will take advantage of the tax credits offered for writing full coverage policies in the wind pool area. So far, companies have not taken up the offer.

The reforms' aggregate consequences will likely create a fair degree of price stability.

Disaster savings accounts. Disaster savings accounts, which are exempt from South Carolina's 7-percent income tax, may provide an additional incentive for people to purchase private insurance. Coupled with a high-interest savings account paying around 4 percent interest, a deposit into a disaster savings account will provide a risk-free return of 11 percent during its first year—about equal to the much riskier annual return of the stock market. To illustrate, consider the following scenario: An insurance policy with a high deductible, all other things being equal, will cost less than one with a lower deductible. An insurance company can always make a policy affordable by raising the deductible or requiring co-insurance. If the deductible or co-insurance gets too high, however, a policy may not provide a real benefit to somebody who purchases it, since a policy with a deductible larger than an individuals' liquid savings still leaves a homeowner unable to pay for damages without going into debt or selling assets intended for future use. At the margin, savings account designated for the disaster changes homeowners' calculus, making it somewhat easier for them to accept higher deductible insurance policies.

Price stability at reasonably high levels. The reforms' aggregate consequences will likely create a fair degree of price stability. Over the past year, coastal insurance rates have risen over 25 percent, according to South Carolina's Department of Insurance.[25] With more carriers entering the market and incentives to make homes more hurricane resistant, sizeable increases are not likely to happen in the future. Insurance agents interviewed by the author indicated that they did not expect any sizeable increases during the remainder of 2007.[26] In the short term, however, it is unlikely that major decreases will happen either, since higher prices likely reflect risk better than they did before. If the insurance companies get the prices wrong, competition from carriers with better pricing policies should bring them down.

What to do Elsewhere

On balance, South Carolina's insurance reforms seem well thought out: They will encourage competition, lead to risk-based pricing, and make it easier for individuals to afford insurance—but they are not perfect, and in fact have several serious flaws. "Perfection is not the goal of the political process and we had to do what we could to advance the ball on market-based mechanisms," explains Governor Sanford. "I can think of ways it could get better but, for now, we have to see how this works."[27]

The legislatures and governors of other states considering coastal insurance reform should follow South Carolina's outlines but improve them with strong controls on further wind pool expansion, plans for transitioning wind pools to the private sector, time limits on grant programs, and overall easing of rate regulation in coastal areas. This section outlines the possibilities for improvements in each of these areas and makes specific recommendations that go beyond South Carolina's reforms.

In the Short Term, Limit Wind Pool Participation

As noted above, South Carolina has charged its wind pool with "providing coverage for consumers who cannot find that coverage in the standard market." Through reasonably high rates, the state government has also done the most important thing it can to make sure that it provides a residual market rather than set up a full-fledged government-run wind insurance scheme. This does not mean that the wind pool itself is a good idea in its current form, but that the state has taken the right interim steps.

But the 2007 plan has a serious flaw: By increasing the insurance commissioners' power to expand the wind pool, the legislature has made it easier for a commissioner or governor to implement the sort of "windstorm socialism" that has so damaged Florida's insurance market. State Representative Henry Cato expresses confidence that "the legislature won't let that happen," but it's impossible to know what will happen in the long term.[28] While the

Florida's System

South Carolina's way of doing things stands in stark contrast to that of Florida, which has engaged in three major market interventions.

Florida Citizens

The State of Florida has created a state-backed insurance company called the Florida Citizens Property Insurance Corporation. A quasi-government entity, Florida Citizens writes homeowners' insurance for anybody who gets a single private quote more than 15 percent above Citizens quoted rates. Unlike Wind Pool policies—which cover only wind and hail—Citizens policies cover fire, theft, and nearly anything else a conventional homeowners' policy covers. Citizens generally charges below market rates, is prohibited from raising its rates until 2009, and has already become the state's largest property insurer.

The Hurricane Catastrophe Fund

Florida has also created a massive hurricane catastrophe fund. By law, private companies operating in Florida, as well as Citizens, must buy reinsurance through the catastrophe fund. To back the fund, the state will issue $30 billion in debt—the largest state debt issue in history, to be paid back through massive new taxes on every property and casualty insurance policy in the state.

"Roach Motel" Laws and Regulations

Private insurance companies aiming to operate in Florida face a great number of restrictions. They often cannot cancel policies at all, must charge the same price for every policy within a given county, and must sell homeowners' insurance in Florida if they sell it anywhere else in the nation under what the state calls an "anti-cherry picking law." This has led to massive cutbacks by some major insurers of their Florida operations, including Nationwide, USAA, Travelers, and the Hartford.

High wind pool rates do not make for a good market in the long term. Over time, the wind pool will end up subsidizing coverage for those who take on the greatest risks because many people will find less expensive coverage in the private market.

legislature ultimately must approve expansions proposed by the insurance commissioner, a governor hungry for votes could well order the pool expanded even further inland and order rate cuts. While the legislature could disapprove these efforts, doing so would put legislators in the unenviable position of having to vote against changes that would provide short-term financial benefits to their constituents. Thus, South Carolina may have already planted the seeds that will undo its own reforms.

The expansion of the wind pool boundaries per se does not mean much since rates went up, leaving room for the private market. In any case, the very peculiar pre-2007 boundaries of South Carolina's wind pool, may have distorted the market even more than the current boundaries by reducing the size of the in-state non-wind pool excess and surplus lines market sufficiently to make it unattractive to carriers without providing any way for many people to get coverage at affordable prices. The current wind pool boundaries may better encourage private market participation by providing universally higher rates over a broader area. Whatever the problems involved in a larger wind pool, the higher wind pool rates have significantly blunted them and appear to be attracting private carriers back into the state to provide coverage at risk-based rates.

All this, however, could change under another administration. Future wind pool expansions should require legislative approval and, insofar as the wind pool exists at all, it should charge rates well above those in the admitted market.

However, high wind pool rates do not make for a good market in the long term. While they vary based on risk factors such as proximity to the ocean, insurance agents interviewed by the author spoke agree that wind pool rates vary tend to vary less than the full spectrum of rates in the private market (at least in places where private coverage is available.)[29] This indicates that, over time, the wind pool will end up subsidizing coverage for those who take on the greatest risks because many people will find less expensive coverage in the private market. Such a true high-risk pool would presumably be small, but it would still represent a wealth transfer to those living in the riskiest areas, creating moral hazard that is bad public policy.

Insofar as the wind pool exists, the state should encourage people to shop around and make its temporary, transitional status clear. To do this, the state might require homeowners to go through a formal application process each year and sign an affidavit stating that they could not find admitted market coverage at any price. Current policy does require wind pool members to re-apply every year, but this is mostly a formality—the wind pool always sends members a pre-completed application.[30]

Recommendation: State-backed wind pools should remain true markets of last resort in all cases. Their growth should be strictly limited and they should never serve people capable of finding admitted market coverage.

In the Longer Term, Privatize the Wind Pools Altogether

The state should not sit still. The South Carolina Wind Pool has generally remained solvent on its own and probably could run as a private company in its current state. It already has private administration and turns a profit in most years. It is public in that insurers must participate and in that it works under the implicit promise of a state guarantee. But even with higher rates, this situation cannot sustain itself in the long term: Eventually, any wind pool will become a subsidy for those living in risk-prone areas.

Privatization would occur in two steps: First, a declaration by the state that it will not bail out the wind pool, and, second, making participation optional. As a private entity, the wind pool would belong to the insurers who participate in it and, under the federal McCarran-Ferguson Act (which regulates insurance across the country) would be exempt from antitrust laws. As they do now, companies participating in private wind pools could also remain active in the admitted market.[31]

It is likely that many insurance carriers—particularly those that write lucrative automobile insurance—would want to participate in some sort of wind pool venture in any case. Unlike a quasi-governmental wind pool, a private wind pool could do more to spread its risk, possibly by merging with other private wind pools in other states. It would also have more freedom to engage in innovative hedging and reinsurance strategies. The single-state nature of most wind pools means that risk is always concentrated, which keeps rates higher. Although rates would still remain high—since writing wind insurance in hurricane areas is a risky business—private wind pools could spread risk more broadly than the public ones and would likely provide lower rates in the long run.

Recommendation: Move towards a purely private wind pool system and take advantage of its broader risk-spreading options.

Time-Limit Market Distorting Tax Credits and Grants

Free market advocates, with good reason, blanch at the idea of grants and tax credits for hurricane coverage, since ideally they would not exist at all—yet short of wholesale reform they may have value as a transitional measure, for three reasons.

First, it is likely that government policy and insurance industry practices have resulted in underinvestment in mitigation measures for some time. State-level rate regulation meant that insurance companies were sometimes prohibited from charging true risk-based rates to encourage people to undertake damage mitigation measures on their own. In these terms, grants and tax credits may be seen as a catch-up measure that corrects for the moral hazard created by too-low rates.

Second, very real and obvious externalities exist when people do not improve their homes, especially in hurricane-prone areas: A home without tie downs on its roof is much more likely to collapse and damage other homes with flying debris. Of course, the owner of the unimproved home may face legal liability, but if somebody fails to improve his home for financial reasons, he may not have enough assets to pay for the damage to neighbors' homes.

Finally, the existence of federal flood insurance—which covers nearly all water damage from hurricanes—greatly distorts the market and makes it less likely that private individuals will improve their homes. In its current form, the program subsidizes flood insurance rates for many older properties.[32] This creates moral hazrd by discouraging people from upgrading their own houses to deal with either wind or flooding, since, in practice, it is often nearly impossible to tell the difference between wind and water damage.[33] A phase-out of the NFIP is desirable but no state can accomplish it alone. Thus, in the interim, tax credits can prove a sufficient—although suboptimal—mechanism to encourage hurricane damage mitigation.

Other mechanisms, including improvements to local zoning codes and mechanisms to let insurers verify participation in mitigation programs, could also help encourage mitigation. On their own, insurers could raise premiums and deductibles to levels that standard market regulators would consider "excessive" and then cut them in return for mitigation (though this cannot happen in the standard market).

In any case, the grants and tax credits should work under time limits. In South Carolina, even the program's proponents agree with this proposition. "As it becomes more *de rigueur* to build homes that are wind resistant. It might be a good idea to sunset the credits," says Sanford Chief of Staff Tom Davis. "As with any subsidy or credit, you want to let the market go ahead on its own eventually."[34] Two of the three major efforts, the retrofitting mitigation grant program and the tax credits for producers to provide insurance, will work better if they are phased out over a period of years. The third, tax credits for low-income homeowners, will probably work best grandfathered out over time. The fourth, disaster savings accounts, would not need to exist in a purely free market but likely should exist until all state regulation of coastal insurance markets ends.

Tax credits to insurers willing to write full coverage policies may encourage insurers to enter the wind market in the first place, but industry should not receive—nor expect—any long-term subsidies for writing coverage. Subsidized, nominally "private" coverage may actually be worse than purely socialized wind pool coverage because government retains responsibility for risk while making it possible for private companies to make profits. The profit motive plays a central role in a market economy, but profits can only reach their full potential as a market mechanism when they are coupled with a full assumption of the downside risk. Time limiting tax credits will encourage insurers to enter the market quickly if they know the credits will go away.

Subsidized, nominally "private" coverage may actually be worse than purely socialized wind pool coverage because government retains responsibility for risk.

The 2007 South Carolina Coastal Omnibus Act states that the grant program "does not create an entitlement for property owners or obligate the State in any way to fund the inspection or retrofitting of residential property in this State," but it does not specify a sunset.[35] The legislature could always decline to fund it, but there is a strong chance that it might continue funding it if it proves popular, effective, or both. Again, offering grant programs without a specific sunset represents an error similar to unlimited tax credits: Without a deadline in mind, people are less likely to take advantage of them to correct the problems the grant programs are intended to solve. Thus, a time limit will actually make the program more effective in encouraging hurricane mitigation.

Consumer tax credits for the poor present a more complex set of circumstances. On one hand, a person living on a low or fixed income occupying hurricane coastal real estate will likely have to move without some sort of tax premium relief unless the state subsidizes rates on a large scale. In the long term, market-rate risk-based insurance will inevitably create incentives to make coastal living affordable only to the well-to-do (or those willing to make large sacrifices). From a purely economic point of view, there is no good case for subsidizing people of modest incomes who live on the coast.[36] The program, in its current state, entails a moral hazard: At the margins, people who would not otherwise purchase coastal real estate may do so simply because the tax credit exists.

Rate regulation almost always subsidizes rates for some groups while raising them for others.

In practice, states considering tax credits for political reasons should consider imposing strong limits on them: They should exist only for the incumbent owners of homes at the time legislation is passed and, even then, they should be limited to the truly poor. There are two good reasons for this. First, by limiting the tax credits to the incumbent owners of the homes, a state government can eliminate the moral hazard problem: Anybody wishing to move into a home will have to make a deliberate decision to pay market rates. Second, as in South Carolina, only people with modest incomes should be eligible for credits at all: There is no reason why well-heeled attorneys who choose to live on the coast should not have to pay full risk-adjusted rates.

Disaster savings accounts should not have a specific phase-out attached. They are simply a mechanism to encourage saving against hurricane expenses—self insurance—and are unlikely to pose any moral hazard or to distort the marketing any serious way. At the margins, they will tend to make insurance more affordable by allowing individuals to opt for higher deductibles. This will increase the likelihood that insurance pools will accurately reflect the risks involved and increase the size of the pools. A shift towards purely risk-based pricing coupled with deregulation of insurance structures would alleviate the need for these savings accounts over the long term, though no good case exists for phasing them out in the short or medium term.

Recommendation: Tax credits and grants should almost always have time limits attached. If they do not, they should exist for clearly defined groups of incumbent residents. Disaster savings accounts appear to tield some positive consequences in the short- to medium-term and should not face any time limits.

Ease All Rate Regulation in Coastal Areas

Rate regulation almost always subsidizes rates for some groups while raising them for others—even under South Carolina's reasonably permissive "file and use" system, whereby companies file rates and then use them unless specifically prohibited from doing so. Thus, it serves as a form of wealth redistribution.[37]

Insurance rates paid on homes draw largely on the relative risk assumed by the insurer. In general, the largest, most expensive properties located near water will face the greatest risks. Not surprisingly, people who live in these properties are almost always well off, and coastal counties, in general, are not particularly poor.[38] Particularly in immediate coastal areas, where property value increase in direct proportion by distance from the coast—and thus, risk of hurricanes—any government effort to reduce rates will tend to redistribute wealth to the already wealthy. A free market for coastal insurance may result in higher rates but it will make coverage available to just about everyone. This total deregulation of rates—with safeguards, which might be privately administrated, to insure actuarial adequacy—would, in the long term, lead to the most disaster resistant and best insurance system.

Recommendation: Deregulate coastal rates altogether.

Conclusion

South Carolina has built a good—though not perfect—system for property insurance. There is much to learn from the state's refusal to engage in additional rate regulation, controlled expansion of its wind pool, and emphasis on mitigation measures. However, South Carolina's reforms still have significant problems and could stand improvement. In particular, states should subject grants and tax credits to time limits while expansions of wind pools, and other government-backed residual markets, should require legislative approval.

Based on the four principles discussed at the beginning of the paper, it is possible to come to a verdict on South Carolina's insurance system.

- By raising rates for the wind pool and encouraging private participation in wind markets, the system moves the state in the direction of risk-based pricing.
- The reforms do not conflate insurance with relief. They focus on the insurance market. With one small exception—tax credits for the poor—they attempt (imperfectly) to improve the functioning of the insurance market.
- The system created in 2007 will likely influence development in a generally positive way. Except for the tax credits for the poor, the policies adopted are likely to encourage more mitigation, more

hurricane-resistant construction, and less overall construction in the highest risk areas.

- The reforms move neither towards nor away from a more private market. By expanding the size of the wind pool, they will tend to increase the number of people relying on government-run insurance. By increasing its rates and encouraging more people to seek private coverage, they will tend to increase the size of the wind pool. In the long term, however, South Carolina's wind pool could well turn into a subsidy scheme. It needs to be watched carefully.

Insurance best accomplishes its social functions when the government stays out of the way and allows market forces to work. South Carolina's reforms—especially compared to those in Florida—appear to be serving their function. Early evidence indicates that the free market is coming back. While South Carolina's reforms have flaws, other states can learn a great deal from what Governor Sanford and the legislature have accomplished.

Notes

1 Jerry D. Jarrel et al., “The Deadliest Costliest and Most Intense Hurricanes,” National Oceanic and Atmospheric Administration (NOAA Technical Memorandum NPC-1), http://www.nhc.noaa.gov/Deadliest_Costliest.shtml.

2 On the relative wealth of Coastal Counties see Dan Sutter, “State Insurance Regulation and Hurricane Katrina,” Mercatus Center, 2007. Wealth based on author’s calculations from 2004 census data.

3 Properly, purists insist that the Low Country includes only the area from Charleston to Savannah. See e.g. Bob Krist and Cecily McMillian, *The Low Country: From Charleston to Savannah,* Portland, Oregon: Graphic Arts Center Publishing, 2006. Nonetheless, some people refer to the entire area below the fall line as the “Low Country.”

4 For more on this topic, see Eli Lehrer, *Watery Marauders: How the Federal Government Retarded the Development of Private Flood Insurance.* Competitive Enterprise Institute, 2007.

5 South Carolina Wind and Hail Underwriting Association, “About Us,” 2007, http://www.scwind.com/about.html.

6 Proponents of both programs will point out, rightly, that neither has ever directly taken any money from its respective treasury. This is nominally correct although the National Flood Insurance has run up enormous debts that the federal government will eventually have to pay. Other states, including Florida, Mississippi, and Georgia have, at various times, diverted general tax revenues to back their wind pools. In any case, by compelling participation, governments place a *de facto* tax on insurers who participate by diverting resources from activities that corporate management thinks likely to provide better shareholder return.

7 This is based a set of principles the author develops at greater length elsewhere. See Lehrer, *Watery Marauders*.

8 Except when otherwise noted, quotations in this section come from interviews the author conducted in person and on the telephone between August 7 and August 17th of 2007.

9 Author Conversation with Brad Wright, August 16, 2007.

10 For an overview of the situation at the beginning of the debate see Jason Ryan, “SC Coastal Insurance,” *The State* (Columbia, South Carolina), February 11, 2007, D1. For a legislative overview, see Associated Press, “Lawmakers Brew Bills for Coast’s Insurance Ills,” *The State,* January 27, 2007. Note that only one bill that would have vastly expanded the state’s role (an expansion of the wind pool larger than the one actually crated in South Carolina bill S. 347 (2007) was actually proffered during the 117th session of the South Carolina legislator.

11 South Carolina Bill S. 412 (February 7, 2007).

12 Author conversation with Brad , August 16, 2007.

13 South Carolina Act Number 78. The final bill was S. 711 (2007).

14 South Carolina Wind and Hail Underwriting Association, “Horry County,” June 1, 2007, http://www.scwind.com/Maps/MAY23-Horry.pdf.

15 Author Conversation with Governor Mark Sanford, August 16, 2007.

16 A complete explanation of the wind pool’s expansion and maps of the areas impacted can be found at: South Carolina Department of Insurance, “Wind Pool Expansion,” http://www.scwind.com/Expansion.asp (June 1, 2007).

17 South Carolina Wind and Hail Underwriting Association, “Wind Pool Expansion Questions and Answers,” http://www.scwind.com/pdf/ExpansionQA-May07.pdf. It is worth noting that the structure of the excess and surplus lines market means and total lack of a price ceiling means that every carrier has some price at which they will write coverage. Thus, the statement that it will be lower than “some excess and surplus lines” companies would be true about any wind pool arrangement including an entirely private one.

18 The state insurance department does not keep statistics on announced policy cancellations that are later undone.

19 Author conversation with Tommy Cooke, August 9, 2007.

20 South Carolina Department of Insurance, “Coastal Omnibus Reform Act Frequently Asked Questions,” https://www.doi.sc.gov/Eng/Public/faqs/Omnibusfaqs.aspx (August 15, 2007).

21 Insured value refers to structure replacement value and does not include coverage for land or contents. In general, it is only a small fraction of a home’s purchase price. The $300,000 value should cover all but the most expensive homes.

22 Author conversation with Jimmy Rowe. August 6, 2007.

23 Author conversations with Tommy Cooke, August 5, 2007; Commissioner Scott Richardson, August 16, 2007; Henry Cato, August 16, 2007; Governor Mark Sanford, August 16, 2007; and Jimmy Rowe, August 6, 2007.

24 Author Conversation with Jimmy Rowe, August 6, 2007.

25 South Carolina Department of Insurance, “Coastal Omnibus Reform Act Frequently Asked Questions,” https://www.doi.sc.gov/Eng/Public/faqs/Omnibusfaqs.aspx (August 15, 2007).

26 Author conversations with Tommy Cooke, August 5, 2007; Commissioner Scott Richardson, August 16, 2007; Henry Cato, August 16, 2007; and Governor Mark Sanford, August 16, 2007.

27 Author conversation with Governor Mark Sanford, August 16, 2007.

28 Author conversation with Governor Mark Sanford, August 16, 2007.
29 Email to author from Commissioner Scott Richardson, August 22, 2007.
30 South Carolina Department of Insurance, "Coastal Omnibus Reform Act Frequently Asked Questions," https://www.doi.sc.gov/Eng/Public/faqs/Omnibusfaqs.aspx (August 15, 2007).
31 True free market purists might point out, correctly, that the existence of state-backed guarantee funds violates free market principles. This is true but a discussion of it lies beyond the scope of this paper.
32 Rutherford Platt. *Land Use and Society: Geography, Law, and Public Policy*, New York: Island Press, 2004, 391.
33 Since hurricanes always form over the ocean, the houses closest to the cost—and thus the most at risk for water damage—are almost always also at the greatest risk for wind damage. In the event of total loss, flood insurance will usually pick up repair bills up to policy limits even if a chance exists that wind caused the damage.
34 Author conversation with Henry Cato, August 16, 2007.
35 South Carolina Act 74 (38-75-485).
36 One might also criticize the structure of the South Carolina tax credits in that they do not take assets into account. Non-working people who keep most of their money in growth assets may have little "income" but still have the capacity to pay for insurance.
37 A form of rate regulation does have a valid purpose in providing for rate adequacy: A company that does not charge adequate rates to remain solvent essentially commits fraud every time it sells a policy that it cannot pay.
38 Sutter 2007.

About the Author

Eli Lehrer is a senior fellow at the Competitive Enterprise Institute, where he directs CEI's studies of insurance markets. Prior to joining CEI, Lehrer worked as speechwriter to United States Senate Majority Leader Bill Frist (R.-Tenn.). He has previously worked as a manager in the Unisys Corporation's Homeland Security Practice, Senior Editor of *The American Enterprise* magazine, and as a fellow for the Heritage Foundation.

He has spoken at Yale and George Washington universities and testified before Congress. He holds a B.A. (Cum Laude) from Cornell University and a M.A. (with honors) from The Johns Hopkins University, where his work focused on the Federal Emergency Management Agency and Flood Insurance. His work has appeared in the *New York Times, Washington Post, USA Today, Washington Times, Weekly Standard, National Review, The Public Interest*, Salon.com, and dozens of other publications. Lehrer lives in Oak Hill, Virginia, with his wife Kari and son Andrew.

$8.00

The Competitive Enterprise Institute is a non-profit public policy organization dedicated to the principles of free enterprise and limited government. We believe that consumers are best helped not by government regulation but by being allowed to make their own choices in a free marketplace. Since its founding in 1984, CEI has grown into an influential Washington institution.

We are nationally recognized as a leading voice on a broad range of regulatory issues ranging from environmental laws to antitrust policy to regulatory risk. CEI is not a traditional "think tank." We frequently produce groundbreaking research on regulatory issues, but our work does not stop there. It is not enough to simply identify and articulate solutions to public policy problems; it is also necessary to defend and promote those solutions. For that reason, we are actively engaged in many phases of the public policy debate.

We reach out to the public and the media to ensure that our ideas are heard, work with policy makers to ensure that they are implemented, and, when necessary, take our arguments to court to ensure the law is upheld. This "full service approach" to public policy makes us an effective and powerful force for economic freedom.

Competitive
Enterprise
Institute

1001 Connecticut Avenue, NW
Suite 1250
Washington, DC 20036
202-331-1010
Fax 202-331-0640
www.cei.org