PCI Property Casualty Insurers Association of America

Shaping the Future of American Insurance

NORTH CAROLINA
LEGISLATIVE RESEARCH COMMISSION SUBCOMMITTEE

SECOND MEETING

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PCI STATEMENT REGARDING
PROPERTY INSURANCE RATEMAKING
IN NORTH CAROLINA

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Property Casualty Insurers Association of America (PCI) Statement: Property Insurance Ratemaking in North Carolina

The Property Casualty Insurers Association of America (PCI) appreciates the opportunity to provide testimony before the North Carolina Legislative Research Commission Subcommittee to discuss property insurance ratemaking in the state. PCI is the leading property casualty trade association, representing more than 1,000 insurers, the broadest cross-section of insurers of any national trade association. Our members write more than 38 percent of the property insurance in North Carolina and more than 35 percent countrywide.

Our comments will focus on the following points:

- The significance of House Bill 1305, passed in August 2009, in introducing reforms to the North Carolina Insurance Underwriting Association (i.e., Beach Plan).
- The impact of the North Carolina Rate Bureau on property insurance rates.
- The importance of territorial rating and risk-based pricing.

The Significance of House Bill 1305 in Reforming the North Carolina Insurance Underwriting Association

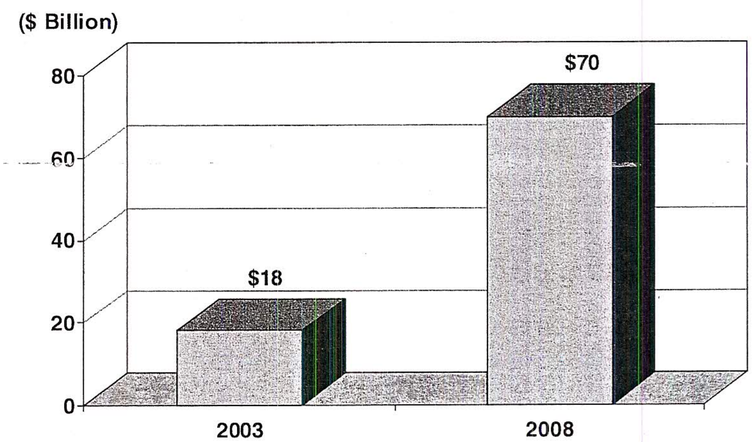
<u>Background of the NC Beach Plan</u>

The North Carolina Insurance Underwriting Association (NCIUA or Beach Plan) was created in 1969 to cover the barrier islands in the Atlantic Ocean. In 1998, it was expanded by the state's General Assembly to include 18 coastal counties for windstorm and hail coverage. Beginning on July 1, 2003, the legislature further authorized the plan to offer a typical homeowners policy, with low wind deductibles, instead of a more limited policy in coastal areas.

Both private market and Beach Plan rates are based on the same benchmark rates filed by the state Rate Bureau and approved by the Insurance Commissioner. Despite the fact that Beach Plan rates are required to be 15 percent above those charged by the private market for homeowners policies and 5 percent above for wind-only coverage, the rates are artificially suppressed and hence seriously inadequate for coastal risks.

Due to its generous coverage and low deductibles at artificially low rates, the Beach Plan became the first and only choice for coverage for most coastal homeowners. According to a leading modeling firm, Risk Management Solutions, Inc., insured windstorm damage in North Carolina could range from $2.4 billion to $6.5 billion, yet its capacity was significantly less than its coastal exposure. From 2003 to 2008, the number of Beach Plan residential policies doubled in size, resulting in insured property value along the coast to grow roughly four times in size, increasing almost $1 billion a month. The Beach Plan was not financially prepared to withstand a major storm.

North Carolina Beach Plan Insured Exposure Quadrupled in Five Years Pre-HB 1305



A 2008 PCI-commissioned study by the independent actuarial consulting firm, Milliman, Inc.,[1] found that the Beach Plan's rates are 76 percent too low. While this benefits some homeowners in the short run, such undercapitalized liability could deal a serious blow to the entire North Carolina economy in the event of a major storm. Since private insurers in North Carolina are statutorily required to support the Beach Plan through rate subsidies and assessments, Milliman determined that a large event could easily result in insurance company assessments of approximately $6.2 billion, while medium and small events could create assessments of $2.9 billion and $1.4 billion, respectively.

Moreover, an internal audit of the Beach Plan found that deficits could threaten the plan's ability to pay claims, bankrupt small insurers and force carriers out of the North Carolina

[1] *Analysis of the North Carolina Beach Plan for Property Casualty Insurers Association of America,* Milliman, Inc., October 10, 2008

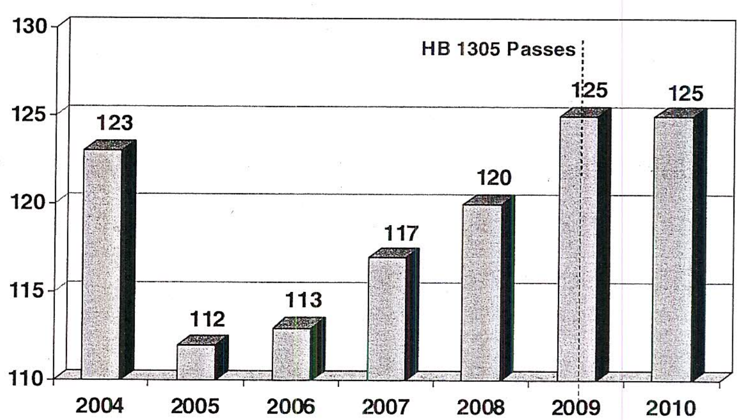
marketplace. Indeed, significant assessments did cause some private insurers to non-renew many of their policies in the state and stop writing new policies. Two companies withdrew from the North Carolina homeowners market in 2008, leaving thousands of coastal and inland residents without insurance.

<u>House Bill 1305</u>

HB 1305, passed in 2009, recognized both the Beach Plan's role as the market of last resort and the higher risk of catastrophic loss to coastal territories. It also recognized the immediate need for the plan to build its reserves, purchase additional reinsurance to ensure solvency and allow it to fully pay claims after a storm. Among other reforms, the law imposed a cap on insurer assessments at $1 billion following a storm, which promoted the availability of homeowners coverage in the private market, and established a catastrophic recovery surcharge (up to 10 percent of premium) to provide an additional layer of funding in the event of a mega catastrophe.[2]

Positive results appear to be taking place due to the passage of HB 1305. Additional reinsurance increased the 2011 claims-paying capacity, providing up to $4.0 billion, double what was purchased in 2007. After a sharp decline in 2005, there are now more insurers in the North Carolina homeowners market than in the previous five years.[3]

NC Homeowners Insurers are Returning



[2] According to the actuarial consulting firm of Milliman, Inc., policyholders could have faced up to 200 percent increases in their premiums without the passage of HB 1305.

[3] National Association of Insurance Commissioners, Annual Statements, Highline Data

By all counts, HB 1305 has been successful in attracting more homeowners carriers to the state, stabilizing the Beach Plan, and helping consumers, lawmakers and insurers to realistically assess how to manage catastrophic risk.

Other positive benefits of HB 1305 include the following:

- HB 1305 encourages private market participation by financing Beach Plan deficits by using sources other than insurance industry assessments.
- H 1305 encourages private market participation by permitting insurers to collect surcharges on a pass through basis to policyholders.
- H 1305 responsibly reduces the overall risk exposure of the Beach Plan by: 1) requiring a minimum 1 percent named storm deductible, 2) decreasing the maximum available dwelling limits from $1.5 million to $750,000, and 3) limiting the maximum available contents coverage to 40 percent of the dwelling limit.
- H 1305 promotes mitigation by requiring that the Rate Bureau establish a voluntary mitigation program for both the residual and voluntary markets.

Clearly without reform, the state's current property insurance system could have resulted in unintended consequences that may have been harmful to all North Carolina consumers, the state's economy and future economic development.

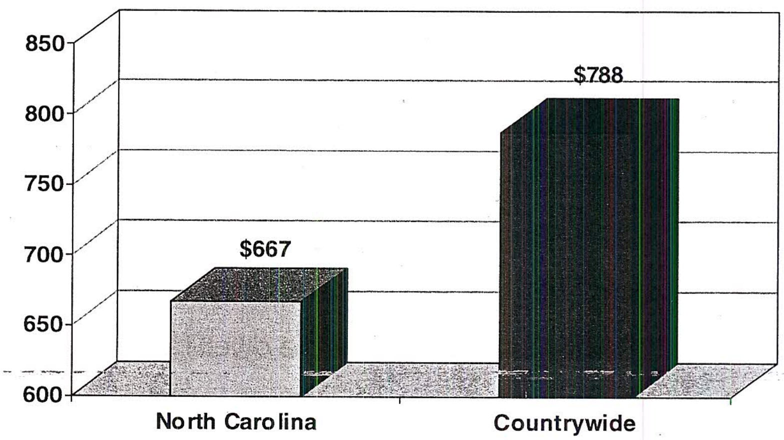
The Impact of the North Carolina Rate Bureau on Property Insurance Rates

The North Carolina Rate Bureau is an independent state agency that develops and files the same proposed benchmark homeowners rates for both the private market and the Beach Plan. North Carolina is the last state in the country to use such a system for property ratemaking. Members of the Rate Bureau (i.e., all property insurance companies in the state) can differentiate from the Bureau plan approved by the Insurance Commissioner, but upward deviations are rarely granted to companies.

Most deviated homeowners rates filed by insurers are lower than Bureau rates. This largely explains why North Carolina has the 20th lowest average homeowners premium in the nation.

Residents in the state pay 15 percent less than the national average,[4] despite their high vulnerability to hurricanes and large losses resulting from severe windstorms. Even homeowners who live along the water are able to purchase coverage at much lower rates that are not commensurate to their level of risk.

North Carolina vs. Countrywide
Average Annual Homeowners Premium



The Importance of Territorial Rating and Risk-Based Pricing

While the Beach Plan is more stable now, thanks to HB 1305, there is still more work to be done in ensuring that its rates – as well as non-Beach Plan rates – are actuarially sound and risk-based pricing is implemented fairly throughout the state.

Territorial rating, i.e., classifying risks by geographical location, has long been used in the pricing of insurance rates. Because of wide cost differences occurring in different areas due to events such as hurricanes, earthquakes and wildfires, insurance companies must be able to distinguish regions with greater loss potential from those with less.

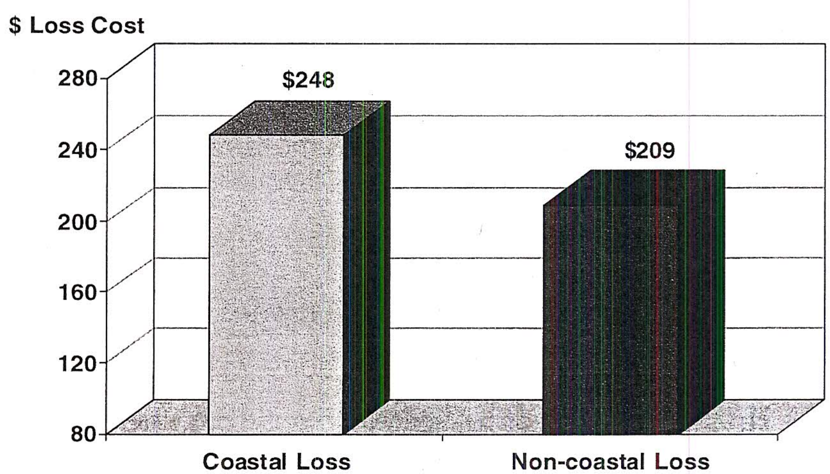
Catastrophe modeling is another tool that has been used, with increasing frequency, to determine maximum probable losses from a single event or multiple events in a single season. This important tool is helpful for insurers, the Plan and the buying public in estimating the exposure to loss from an event.

[4] National Association of Insurance Commissioners, *2008 Dwelling Fire, Homeowners Owner-Occupied and Homeowners Tenant and Condominium/Cooperative Unit Owners' Insurance* (latest available year); average premiums reflect Dwelling and Homeowners Forms 1, 2, 3, 5 and 8 combined.

In order to achieve price equity among policyholders, companies must be able to rate on the basis of the risk insured. The greater the exposure to an insurable loss, the higher should be the premium. If rates do not reflect costs, subsidies will occur whereby lower-risk policyholders must pay more to offset the losses of higher-risk policyholders. This is precisely what has happened in North Carolina, since rates are the same for all residents of the same county.

Property losses incurred by coastal residents are significantly higher than inland residents. PCI has determined that the overall average homeowners loss cost (i.e., loss per housing unit) in the beach areas of Brunswick, Carteret, New Hanover, Onslow, and Pender Counties is roughly 20 percent higher than in the non-beach areas of these counties.[5]

Coastal Losses are Substantially Higher Than Non-Coastal Losses Within Same Counties



Note: Total losses (wind/hail, water damage, fire, theft, etc.) reflect Forms 2, 3, 4 and 6. Counties are Brunswick, Carteret, New Hanover, Onslow, and Pender.

The cost differential between coastal and non-coastal areas during years of heavy storms is even more pronounced. In 2004, when Hurricanes Frances and Charley struck, the loss cost for wind/hail and water damage in the beach areas of the above counties was about 35 percent higher than the comparable loss cost in the non-beach areas of these same counties.[6]

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[5] PCI, based on 2005-2009 data compiled by the Independent Statistical Service

[6] Ibid.

Clearly, while the Beach Plan provides less expensive coverage to coastal residents, it is harming the vast majority of residents who live inland – especially the ones with modest income – who are paying more to subsidize the losses of those living along the water.

The inequitable transfer of costs among policyholders results in market distortions. Prohibiting insurers from developing prices on the basis of risk may cause companies to withdraw from the coastal areas, bringing instability to the competitive market once again. More consumers along the water may not be able to obtain insurance in the voluntary market; they may have to go to the Beach Plan, hence reversing the positive effects of HB 1305.

Conclusion

In conclusion, HB 1305 has vastly improved the North Carolina Beach Plan, not only in terms of slowing its growth but in reforming its funding mechanism. The plan has returned to its intended role of the market of last resort; there is greater transparency to the state's coastal residual market insurance system; the financial resources of the Beach Plan are strengthened; a post-storm solvency plan for the state has been developed; and incentives for encouraging North Carolinians to make their homes more resistant to storm damage are established.

However, it is now time to take the next step and move toward a more market-driven approach to property insurance pricing. More must be done with respect to improving rate equity especially in the coastal counties of the state. Unless something is done to permit actuarially sound homeowners rates, there will continue to be forced subsidies for the vast majority of policyholders living inland at the expense of those living along the water.

PCI would like to thank you for holding this meeting to discuss the positive impact of HB 1305 and the topic of property insurance ratemaking, and for allowing us to testify on behalf of our members. We remain committed to working with North Carolina policymakers to ensure a healthy and stable insurance market and easy access to homeowners coverage at equitable and affordable prices. I am pleased to answer any questions which you may have.