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Frequently Asked Questions about the Multiple Peril Insurance Act

Rep. Gene Taylor, 4th District of Mississippi

How would the new multiple peril coverage fit into the insurance market?

The new multiple peril insurance program will be available only in communities that participate in the National Flood Insurance Program (NFIP), comply with its flood plain management obligations, and agree to adopt and enforce the windstorm building code obligations that will be created by the bill. Windstorm coverage will be available only as part of the multiple peril package with flood coverage. While any local government theoretically could opt into the program, only coastal communities that face both flood and wind risk have an incentive to do so.

Private insurers have stopped offering windstorm coverage in coastal hurricane-risk areas, but have not abandoned inland markets. Disputes about the cause of hurricane damage arise in coastal areas subject to both the highest hurricane winds and the storm surge. Although many inland communities may face both flood and wind risk, there is no dispute that river or creek flooding is a flood and a tornado and hail damage are caused by windstorms. Those communities have no reason to disrupt their current markets where federal flood coverage and private windstorm coverage are available separately.

Another reason that an unintended expansion of the program is unlikely is that almost all multiple peril policies will be sold by private insurance agents. The multiple peril insurance bill does not create a sales force of federal insurance agents. In coastal areas, local agents whose companies have stopped covering wind risk will sell homeowners policies covering fire, theft, and liability, and earn commissions for the selling the federal policy as they do now with NFIP coverage. Once the multiple peril program is in place, a private market should develop for excess coverage above the policy limits of the multiple peril coverage. Some parts of coastal communities are far enough inland to have little or no flood risk, yet may not have access to private windstorm coverage. State-sponsored wind pools probably will continue to serve those homeowners.

If the program is for coastal areas, why should taxpayers from other regions support the bill?

When a natural disaster causes massive destruction, the property losses either are covered by insurance, absorbed by the property owners themselves, or compensated by taxpayers through direct assistance, tax deductions, and other programs. Federal programs also pay increased costs to compensate for the effects of an economic decline caused by a delayed recovery from a disaster. Taxpayers all across America will benefit when more hurricane damage is covered by insurance premiums rather than by federal disaster assistance.

Private insurers paid $17.5 billion in homeowners insurance claims from Hurricane Katrina, and $20 billion in business and commercial claims. NFIP estimates that it will pay approximately $19.5 billion in Katrina flood claims and adjustment expenses.

The federal government has allocated more than $30 billion for direct housing assistance, including $16.7 in Community Development Block Grants for housing repairs, $7.5 billion for FEMA trailers and mobile homes, and $6 billion for FEMA rental assistance and home repair grants. The Small Business Administration has approved $10 billion in disaster assistance loans to home and business owners. Congress also approved $8 billion in Katrina tax relief, with much of it targeted to deductions for property losses and tax incentives for rebuilding.

Where the private insurance industry has been unwilling or unable to offer insurance for certain risks, the federal government has stepped in to create insurance programs to try to manage risks and collect premiums. Every state participates in the National Flood Insurance Program. The federal government also provides multiple peril crop insurance to protect farmers from disaster losses that private insurers will not cover.

Multiple peril insurance will ensure that homeowners will be able to buy insurance and know that their hurricane damage will be covered. Many Mississippi and Louisiana homeowners built their homes to high standards and bought all the insurance that was available to them - homeowners, windstorm, and flood insurance – yet were left with large uncovered losses because the insurers blamed all the damage on flooding. The maximum NFIP policy is $250,000 for a residential structure. H.R. 920 will permit homeowners to purchase up to $500,000 in multiple peril coverage at risk-based rates.

How would the multiple peril program set actuarially sound premiums?

H.R. 920, the Multiple Peril Insurance Act, does not micromanage the program, but anticipates that NFIP would establish windstorm risks and set premiums in precisely the same manner as insurance companies and state-sponsored wind pools and FAIR plans. NFIP would contract for risk models and loss data in order to estimate potential losses in specific geographic locations. From that community risk profile, premiums for specific properties would be set using existing industry products that adjust for location, construction methods, foundation, wall, and roof types, and other building characteristics.

The bill requires that premiums for multiple peril coverage be based on risks as determined by accepted actuarial principles. The premiums also must include administrative expenses and other operating costs. The bill instructs NFIP to establish regulations detailing the terms and conditions of the program, including risks, premiums, eligibility, and coverage. The bill also instructs NFIP to conduct studies and investigations, enter into contracts and agreements as needed, and coordinate with state and local governments.

How would the new windstorm coverage avoid the financial problems of the existing flood insurance program?

The bill requires the new coverage to be priced at actuarially sound rates. The flood program has intentional subsidies for properties that were grandfathered in because they were built before the flood maps were implemented. The new windstorm coverage does not include any subsidies. Furthermore, it is much easier to determine accurate windstorm risk than to compile accurate flood risk maps for several reasons:

- Thousands of insurance companies and most states offer windstorm coverage, so detailed loss data and risk models are available;
- Wind risk data does not have to be plotted on an ever-changing topographical map;
- Flood risk is much more sensitive than wind risk to changes in land use and development;
- Flood risk in many communities is contingent on levees, dams, pumps, sewer systems, and stormwater infrastructure.

H.R. 1682, the Flood Insurance Reform and Modernization Act, would address some of the problems plaguing the flood insurance program. It would accelerate the Map Modernization program, and study ways to improve and expedite more accurate flood mapping. The bill also would phase out the subsidies for some properties.

It should be pointed out that at least $7 billion in NFIP payments (and many billions more in federal relief funds) would have been saved if the New Orleans levee system had functioned to its design requirements. In Mississippi, the flood maps badly underestimated the storm surge risks. If the Mississippi Coast maps had been accurate, properties would have been built to higher elevations and wave-load standards or would have been subject to higher premiums.

Why should the federal government get involved when the states already have wind pools and FAIR plans?

One federal wind and flood pool can spread coastal risk much more efficiently than dozens of isolated state risk pools. The federal multiple peril insurance pool has several economic advantages that avoid the precarious fiscal condition of state risk pools. A federal pool can spread the risk geographically so that even if one or two states are hit hard in a year, the pool as a whole would be stable.

ISO, the insurance industry's own analyst, explains the economic advantage of a geographically dispersed pool rather than a pool concentrated in one location:

> An insurer with policies spread over many areas has a relatively high chance of suffering hurricane losses in any given year. Wherever a hurricane comes ashore, it's likely to hit some of the properties on which the insurer has written policies. But, in any one year, the insurer faces a

relatively low likelihood of suffering losses on a substantial proportion of its geographically dispersed policies.

An insurer with policies concentrated in one geographic area has a relatively low chance of experiencing any hurricane losses at all in a given year. The chance of a hurricane hitting any one place is low. But if a storm *does* strike the area where the insurer has concentrated exposures, the insurer faces a higher chance of suffering losses on a substantial proportion of its book of business than does an insurer with more geographically dispersed exposures.[1]

Mississippi has three counties on the Gulf of Mexico and 79 inland counties. Alabama has two counties on the Gulf. South Carolina and Georgia each have only six counties on the Atlantic. State by state wind pools or FAIR plans are not economically or politically capable of spreading their risk or of building up sufficient reserves to handle the claims from major hurricanes.

Insurance companies are dumping more and more policies into state-sponsored insurers of last resort, forcing those plans to go out and buy more and more reinsurance. Last year, the Mississippi wind pool paid $44 million for $350 million in reinsurance. Since Katrina, the risk in the Mississippi wind pool has risen from $1.6 billion to $6 billion. The state has used $80 million in federal CDBG funds to subsidize the wind pool for two years so that premiums doubled rather than quadrupling. Those federal tax dollars passed through the state and the wind pool to pay reinsurance premiums.

Other state-sponsored insurers of last resort are in a similar dilemma – increasing premiums to pay increasing reinsurance costs without building up their reserves. The Texas wind pool recently agreed to pay $170 million for $1 billion in reinsurance. Last year, the Massachusetts FAIR Plan bought reinsurance for the first time, paying $38.4 million for $455 million in coverage. The insurers of last resort in Texas, Massachusetts, and every coastal state between them have had to take on more and more risk.

The federal government would not have to pay for overpriced reinsurance as the state plans and private insurers have been forced to do. The federal government does not have the timing risk that insurers and state plans face. The multiple peril plan would not have to immediately build up the enough reserves or buy enough reinsurance to pay for a 100-year event. The plan would charge actuarially sound premiums based on annual loss estimates and administrative expenses. If a year has above average losses, the program would need to borrow from the Treasury, but would be able to repay the loan with future premiums.

[1] *Managing Catastrophe Risk,* ISO Properties, 1996.