

Coastal Recovery Commission of Alabama Insurance Subcommittee of the Economic Committee

Discussion Note

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Author
Michael Joe

Subcommittee chair, Walter Bell, opened the meeting by recounting a recent conversation he had had with Ricky Mathews, the chairman of the Coastal Recovery Commission. Mathews told him that the issue of insurance was being discussed among people participating in all three commission initiatives -- economy, environment and health.

The meeting moved to a presentation to frame the challenge facing the committee and to review some solutions being considered here and overseas. A discussion followed about the subcommittee's objective to not only find a way to provide meaningful, cost-efficient hurricane insurance in the region, but to also find ways to incentivize people to mitigate and manage their risk better. Research shows that over the last 30 years, the gap between economic loss and insured loss is widening, primarily because of economic and demographic factors. To narrow that gap, we need to think of ways to expand the insurance footprint.

For instance, although Turkey faces a different natural threat (frequent, severe earthquakes) they still share similar insurance issues that face Alabama. Approximately 15 years ago, Turkey established an institution to make available a standardized homeowner insurance policy. The actual insurance program has now been around for seven or eight years, and has about a 30 percent take up rate. In addition, Turks with higher value homes use additional insurance to top off their coverage.

Here in Alabama, the State Insurance Fund of Alabama in July purchased three years worth of coverage solely for the risk of hurricanes. Under this parametric insurance plan, payments are made to the state when wind speed from a hurricane reaches a certain level. The coverage is considered an alternative form of insurance which offers the state a mechanism to get transparent, quick access to insurance coverage. This same instrument can be used to provide people can coverage in fixed quantities as supplemental insurance -- to cover part of or the full amount of a deductible on a primary policy, a strategy known as "buying down a deductible." A policy holder doesn't need to buy for their whole property, they can just buy in increments of a thousand, two thousand or ten thousand dollars to cover themselves in the event of a catastrophic event.

A third project, which was discussed, is taking place overseas even though the support for it is coming from the U.S. government. At the macro level, governments both federal and state are thinking of how to link insurance to active mitigation. Policy holders struggle with understanding what they would get if they were to install better roofing or other types of better mitigation. The US

government is now supporting overseas work in the area of tying specific levels of mitigation to specific amounts of rebates. In this way the principle works -- which ties in with the parametric (or index) insurance idea -- is if over time a policy holder hit certain benchmarks for mitigation, the risk declines.

One feature of parametric (index) insurance is policy holders can actually see their policy size shrink over time. Tying benchmarks to specific rebates, which are in turn tied to a smaller risk footprint, is maybe one of the objectives the committee should work towards. If we can somehow crystallize that idea for people, we would give them an active incentive to put in place mitigation efforts. People not only see the short-term rebate in insurance pricing, but also the long-term rebate in that their overall exposure is less.

The chair stepped in to say the presentation was meant to show that other areas of the world face similar problems -- that elsewhere in the world things are being done to try to mitigate risk, similar to what we are trying to do in Alabama.

A discussion followed on whether the index insurance program was similar to what the state of Hawaii has done -- basically having a cap in which insurance carriers took on the first portion and the catastrophe-type fund picked up the difference once it hit a certain margin, or certain wind speed.

The presenter indicated that in Hawaii the cap was based on the actual losses sustained and not necessarily the wind speed, but stated that would be another way to approach it. The core concept is: how do we make insurance understandable, accessible and transparent? The idea is that very quickly after an event people aren't wondering what their contract says, but rather they know they are receiving payment. In the end, if people have transparency they can make proper decisions.

The meeting turned to a presentation on captive insurance. At the first subcommittee meeting there was discussion about the concept of captive insurers, and it was noted that some subcommittee members have been deeply involved in a recent proposal for a captive program.

One member who worked closely on the proposal indicated the South Alabama Regional Planning Commission got involved in the commercial captive insurance concept following hurricanes Ivan and Katrina because of the devastating impact on the local economy. Although another member of the subcommittee developed the concept, he had helped promote it to local governments in Baldwin and Mobile counties.

The commercial captive concept was codified in the Code of Alabama in 2006, in Title 27 of the insurance code. After the hurricanes, businesses faced several issues: either they could not afford insurance rate increases, insurance coverage was not available, or they were forced to reduce operations in order to afford the coverage. In each case, the result was reduced tax revenue to government.

A captive insurance company provides another option business can use. He emphasized establishing the captive would not have been a solution to the problem of insurance availability and

affordability. At the time, the only other options were authorized insurers, surplus lines, or the wind/beach pool through the Alabama Insurance Underwriters Association (AIUA).

The proposal involved a three-pronged approach: First, local governments would enter an inter-governmental agreement to issue Tax Improvement District bonds to provide start-up capital for the company, not continuing capital. Secondly, we were advocating that the local governments adopt more stringent building codes. The third prong was to employ external insurers.

The captive involved an initial capitalization of \$20 million. If \$20 million were raised by local governments, the Governor of Alabama had committed to matching that amount with state money. The total capitalization amount -- \$12 million for Baldwin, \$8 million for Mobile -- was based on current property assessment values. If it were to be done today, we would have to find another way to come up with initial capital because property values have since dropped. It was proposed as a for-profit company.

The regional planning staff and other advocacy groups met with planning and engineering departments to encourage them to update building codes. Several subcommittee members had met with numerous reinsurers and received favorable responses. They did not talk about the cost of reinsurance because they did not yet have a company that reinsurers could analyze.

Reviewing what is required of a captive insurer under the Code of Alabama, is that a captive must have a minimum capitalization of \$1 million; must be duly formed and licensed by the state department of insurance; must insure the risk of separate policy holders through contracts, as an insurance company would; must fund its liability to each policy holder through protected cells, or accounts; must segregate each account from the assets of other accounts as well as the captive's general fund; and must maintain a free surplus of at least \$1 million.

Reviewing the tax requirements of captives, he noted non-captive insurers have a 3.6 percent annual premium tax, and surplus lines are allocated a 6 percent annual tax premium. Compared to a commercial captive -- in which the first \$20 million dollars of premium is four-tenths of one percent -- he said a captive provides a pretty good return to the insurers. He reiterated that the intent was to revitalize the local economy with such a captive.

The chair asked how the proposed captive would have turned itself into a profit-making organization after initially using municipal (public) money to capitalize. The member said they gathered legal opinions from attorneys who argued that under the constitution the proposed captive could be construed for the purpose of economic development. He said the attorneys said capital funds could be used to capitalize and promote economic development activities through an industrial board created by the tax improvement districts.

A member asked why the proposed captive did not include residential properties. In response, the member said at the time residential properties could not be included in a captive program, though the legislature later passed law allowing it. He noted, though, that public funds could not be used to capitalize a residential captive because it cannot be construed as an economic development activity -- rather it would be considered as using public money for private gain, which is not allowed.

The member added there was good support for the captive proposal from officials in Baldwin and Mobile counties, but said the City of Mobile did not support it because the city is self-insured and did not like certain conditions.

A question came up how a captive which included homeowners would be different from a state wind pool, such as the AIUA. In the discussion that followed, it was noted in addition to the difference in premium taxes, a captive insurer is different than a state wind pool in a number of ways, including: 1) a captive would be in private hands and part of the private market, 2) a captive would not have a state guarantee fund behind it, as the wind pool does.

A member familiar with the wind pool noted if an insurance company participating in the wind pool is assessed to a point that the assessment puts them into receivership, the loss the company has incurred on a voluntary basis (on a statewide basis) would be covered under the guarantee fund. But any assessment for losses incurred by the windpool beyond the company's capacity to pay would fall back on other member companies who must pick up the tab.

Adding to that, in a captive there are no member companies to fall back on and there is no guarantee fund. "If [a captive] tops out its reinsurance, then the consumers [of the captive] are stuck," the member said.

The chair said a captive is just another option to try to bring more participants into the marketplace; the more competition that is brought into the marketplace, the more choices consumers will have.

It was noted a key concern with a captive that is located in two counties (similar to AIUA's wind pool) is the price of reinsurance for that captive. The reinsurance cost is more expensive than the cost of reinsurance for a statewide carrier, or multi-state carrier, because those carriers have more spread of risk. The concern would be with how the captive is able to charge a low premium for coverage, or even a lower premium for the coverage than any of the voluntary insurance carriers.

In a captive, the spread of risk isn't going to be there. It was never assumed that a captive would be able to charge a lower risk. The idea was that if there was a possibility you would go 10 years without a storm, then those people in the captive could benefit from dividend deductions in the rate they are paying -- the rate can go down based on the dividend deductions. Successful captives we are aware of have had quite a bit of dividend going back off of the premium to their participants.

The member who presented the captive proposal noted once the captive company was operational, the company could insure policy holders outside of Mobile and Baldwin counties. He said he liked an idea that was brought up at the previous meeting, that a captive created along the Alabama coast could partner with another captive in another state that is away from the Gulf Coast in order to spread the risk.

A discussion followed about how captives could help increase competition, and whether there have been captives that are created for a certain period of time and then end -- sun setting after a certain number of years. Indeed, you can have a captive that sun sets. A members firm is currently working on a captive located overseas that is funded by public money, but it will be unwound in five years and the capital would then be dividended back to the international donors who capitalized it.

During the discussion, it was clarified a captive would be an insurance company subject to state statutory requirements for insurers. There are many captives that are doing well. The idea behind the law allowing commercial captives, and later residential captives, was to try to bring insurance options to people in the state. Nobody has been able to develop a captive yet that insures commercial or residential properties.

A member who is familiar with what is happening with insurance in Mississippi indicated a new company has started writing new property policies in coastal Mississippi with the idea of expanding later. The company, whose private investors are local, has been a moderate success. The company is capitalized, is an admitted carrier in state, and is reinsured. The company is looking to expand to South Carolina and Alabama. There was a similar situation involving malpractice liability insurance in which a state set up a captive using public money, but the state was able to sell the captive back and recoup its money when the market for malpractice insurance improved.

The chair reiterated that a captive concept was another option to present in the report -- an option that could be used to assist the property insurance market in finding a floor and stabilizing.

Regarding funding for a captive, the money from BP could be used. If that were to happen, a captive might not need to find money from local jurisdictions or the state. It would be difficult for the state to contribute much toward establishing a captive with overall tax revenues being down.

The chair added it would be good to find a way to move the BP money through the state capital and toward the coast to establish a captive. Such an arrangement would be considered "a hallmark." A member asked whether BP could set up a fund itself and not have the money go through the state capital. Another member with a similar question asked whether it would be possible to set up an arrangement where part of the money would go directly into a fund used to pay for projects the subcommittee recommends. It was noted they were both good ideas.

The discussion turned to the issue of mitigation of properties. The presenter said he and other members have put together a list of recommendations after surveying the problem and looking at how other states have responded. It was important to gain a national perspective about how people look at risk in different states. Unfortunately, a recent article about the level of risk in particular states was not very complementary of Alabama -- other than noting the state had passed legislation establishing wind mitigation premium discounts.

The concept of mitigation has been around for 40 or 50 years, but it has been a difficult sell. Mitigation programs have never had more than 5 or 10 percent of policy holders to participate because mitigation has generally been voluntary. People often see mitigation as too expensive, or do not see a big return on their investment. They also do not recognize the economic impact on the larger community.

A recent study prepared for the state of Florida showed that if 10 percent of the housing stock was mitigated annually, the state's annual adjusted loss would be reduced \$1 billion each year. Other research has shown that for every dollar spent on mitigation saves three dollars in potential loss. After Katrina it was shown that governments save nine to fifteen dollars on emergency response for every dollar spent on mitigation.

Some of the recommendations made by members are based on building codes currently in use and how they are enforced. They have noticed in some jurisdictions the building codes are enforced well, but in other jurisdictions building codes are not enforced at all.

One recommendation is for the immediate adoption of the 2006 International Residential Code (IRC), and the 2006 international code for existing buildings, which is an important component of the code because it contains triggers that cause existing buildings to be brought up to code. For instance, it requires people to bring the entire roof up to code when a certain amount of the roof has been damaged.

The member also looked at building codes and permit fees as a way raise needed revenue. Building inspection departments are being downsized in Alabama and across the country because funding for them has been a problem. Building departments need to look at the building inspection process and, specifically, permit fees -- to perhaps generate additional cash by extending services that enforce more of the code, especially when a property owner remodels. There are a lot of different improvements that are done that are standard building code improvements, or mitigation features, that could trigger a fee. The reason for a fee is every job -- regardless of whether the job is inspected or not -- requires a minimum of plan review to ensure products put on the house meet the requirements of the local building code. The international building code requires inspections and plan review for anything that affects the structure, or its components or cladding.

There is a program which grades out local building codes for effectiveness based on several factors, including whether the code is up-to-date, whether the code has an emphasis on mitigation, and how the community enforces the code. The program, developed by the Insurance Services Office, utilizes a Building Code Effectiveness Grading Schedule (BCEGS) that rates local codes using a grade of 1 (exemplary) to 10. The ratings are currently not used in rate filings for insurers in Alabama -- with the exception of the AIUA -- but the ratings are used in many other states. In Florida communities that do a particularly good job of enforcing the code, the BCEGS ratings have reduced the overall premiums for all the citizens in that community. Turning to a recommendation, if Baldwin and Mobile counties could uniformly adopt the 2006 IRC, and if money could be found to provide funding for building code departments, the BCEGS rating could be brought down about 4 percent, which would have a positive impact on insurance rates and help to bring them down.

Because building codes are designed to save people's lives, rather than protect against property damage, other recommendations include additional mitigation measures, such as banning of use of staples for plywood protection of roofs, and a mandatory requirement for removing existing roofs during a re-roofing. This would have a positive impact on the cost of insurance because each one of these mitigation features added an augment to the building code results in an immediate insurance premium discount. If a home reaches a Bronze Standard, carriers offer at least a 10 percent discount, and up to 20 percent, on the entire premium.

There were a number of recommendations related to flooding and storm surges. New flood maps are being released and are expected to increase premiums for flood insurance. Recommendations include requiring that engineering for foundations protect against scour, surge and toppling; requiring structures with repetitive flood claims to current community rating system (CRS)

elevations using money already available in flood policies; and establishing a development plan to strengthen requirements for structures affected by storm surge.

Regarding the need for funding for mitigation programs, that money is available through FEMA's Hazard Mitigation Program Grants. A \$5,000 to \$7,500 grant will mitigate most homes. Most communities do not apply for the grant money, or apply for it but do not use it. Recently, Mobile county returned several million dollars to FEMA because they were not able find enough matching money necessary to use the grant allocation. Matching funds could come from moderate and higher-income consumers; a portion of the BP money; or a percentage of the premium tax.

The member said the only successful mitigation programs are those which have actually adopted the mitigation measures into the building code. The experience in Florida is the additional mitigation measures, such as requiring stronger re-roofing, have reduced premiums. The cost of those additional mitigation measures are between 2 and 5 percent for a new home. It was re-emphasized it is not enough to just adopt the code, and that additional measures are needed in the code that would make sense for each community.

The chair asked if a member knew how many roofs suffered at least 25 percent damage after Ivan. The response was the vast majority of homes with a claim had that kind of damage. The chair said that those homes seem like a good place to start, so the next time they probably would not have a claim. Huge savings could result.

A question arose if other programs in other states have income standards in grants. A member responded, saying the Rebuild Northwest Florida program has two components, and one is for low and fixed-income households who can't afford to put in a match. Moderate and higher-income households put up a match to a certain point.

Another member noted the mitigation grant program in Mississippi, which is using money from HUD and perhaps will use some money left over from Katrina, is considering a 50-50 match. He added the state will probably begin offering three types of credits by the beginning of next year: wind mitigation credits; Institute for Business and Home Safety (IBHS) credits for reaching certain standards; and BCEGS credits, which have been very popular.

It was noted that in Alabama there are lower to moderate-income families who would need help coming up with matching funds to secure a grant, but at the same time make too much money to qualify for such help from a grant program. The chair noted the money coming in will be BP money and everyone in Mobile and Baldwin counties have been effected, adding it may be possible to not employ a means test for the first pot of money used for a grant program.

The meeting turned to a presentation from a member who discussed communication and public education. The most vital thing the subcommittee could do is succeed in educating and communicating with the public. Because no matter what is done, if nobody knows about it, then we've failed in our mission.

The message has to be concise and it has to be consistent -- "we have to be saying the same things." The message should be positive, but it should not over promise. Part of the challenge is educating people about how the insurance system works.

People often get frustrated when they hear different things from different people involved in the process -- architects, building inspectors, builders, insurers. An example was given that a client who recently came into his insurance office should have built 24 inches higher in order to get a lower premium.

The answer is regional. It was edifying to recently attend a meeting at which all the building code inspectors from surrounding counties were there. It was important to get the message out beyond our region. He suggested going to the industry and to trade journals, and educating reinsurers. Data collection is important -- in that the more information you can gather about properties that have mitigation, the cheaper the reinsurance expense.

There are more stakeholders than we often realize. One argument which eventually worked in Mississippi with state legislators was coastal counties generate a higher share of state revenue than its share of population. At the local and county levels, it is important to get the message to mayors, council members, county commissioners, building inspectors and zoning commissioners. It is important to get to architects and engineers on board, so they understand what credits are offered in Alabama. Nonprofits have already done good work in building and promoting stronger and safer construction. Consumers will be educated if everyone involved in the insurance process is singing from the same hymnal.

It was also noted the importance of getting the message to home builders, realtors and other special interests with influence in the state capitol.

The chair asked what the subcommittee could do to help the member's organization, which is an education and outreach 501(c)(3) called Smart Home Alabama. In response, the member said Smart Home needs people to help, and that if Smart Home were one of the groups charged with developing a unified message, it would need some resources to do so. The chair raised the idea of developing a commission on insurance for the state of Alabama that would do advocating in the way that Smart Home does -- if funding could be found.

A member introduced a guest who is the educational chair of the Mortgage Bankers Association in Mobile. The guest said she looked forward to educating the real estate and banking community in Mobile about the work of the subcommittee.

A member asked whether there were any plans for Smart Home to work with media to educate the public about what retrofitting looks like and what the benefits are. A member involved in Smart Home responded, saying the organization has many ideas. The group has received grants and is applying for more money grant money. One grant competition is for educating building code inspectors, to develop standard ordinances and code enforcement; he noted that code officials in the region are working from six or seven different codes. He said part of helping building code departments is gathering data on homes. Smart Home is trying to raise funds and get more volunteers to help; they have been working with major insurance companies and corporations to try to secure funding. The eventual goal is to have a related organization that will function like Rebuild Northwest Florida.

The chair noted he could see money flowing down from a commission on insurance for Alabama -- if it were established -- to nonprofits like Smart Home Alabama. He said he was sure that insurers, mortgage bankers and Realtors would want to help.

A member who is a building code inspector was asked to speak about challenges facing building code departments. He said a lot of building code departments had experienced budget cuts at a time when educated, experienced inspectors are most needed. Common mistakes are being made by inspectors in some jurisdictions.

The first thing which would help in Alabama would be to adopt a statewide building code. But emphasized a point made earlier that adopting a statewide building code does not solve everything. For example, coastal counties are being pushed to adopt the international standards code but the standard does not have design requirements that can handle a wind speed above 120 mph. He added there is a great need for engineers and architects who know how to design wind-resistant homes.

What Alabama needs is a concerted effort by stakeholders -- with the insurance industry and code officials represented -- to come up with a strong building code and to put some teeth in it with increased enforcement. It is important that city officials and the public begin to see building code departments differently.

Communities need to buy into the efforts. For example, FEMA's voluntary incentive program, called the Community Rating System (CRS), rewards people for going beyond the minimum standard for floodplain management. Communities that require that people build better than the minimum standard are rated better and, as a result, residents receive a community discount on flood insurance. Adopting the use of BCEGS ratings in Alabama could similarly receive community support

A member associated with Smart Home Alabama said there are some building code officials that think what Smart Home is doing is not necessary, while there are others that see benefits to changing the system.

The chair reiterated that the education piece of what the subcommittee does is particularly important. Setting the agenda for the next meeting on Oct. 22, so far the subcommittee has had a great overview of most of the things that are important to trying to create a more viable insurance market in south Alabama. Members raise issues the subcommittee has missed, so presentations could be made. The commission was on a tight time frame and at the next meeting the subcommittee should start working on recommendations -- on captives, on mitigation, on education and Smart Home Alabama, on building codes, and on legislation that may be needed so members who are legislators can take it to Montgomery. There also would be two or three presentations at the next meeting, including one on an insurance transparency bill.

Before the meeting convened, a member associated with the AIUA gave a presentation about its wind pool. The wind pool, which is divided into four rating zones located in Baldwin and Mobile counties, started to grow after Hurricane Ivan. The renewal and retention rate is about 99 to 98 percent, and the pool is adding about 335 policies per month. He estimates the pool will continue to grow in 2011 but the growth rate will slow.

Although the wind pool is writing both commercial and residential insurance, the vast majority is residential. Most wind pool consumers are choosing a 5 percent deductible -- rather than an available 2 percent -- in order to keep their premium price down; he said the average deductible is about 4.5 percent, or about \$8,000.

Regarding mitigation, Alabama's wind pool and Mississippi's wind pool were leaders in offering BCEGS discounts. In Alabama, the discounts range from 1 percent to 10 percent. About 3,100 policy holders are receiving the discount and the average discount is about 4 percent of the premium. To receive the discount, policy holders have to live in a community that has adopted the BCEGS program and also build a home that meets its standards. Other discounts have been used much less by wind pool consumers; the pool also offers an IBHS new construction discount, and more recently added IBHS's Bronze, Silver and Gold standard retrofit discount and a discount for homes constructed to the IRC 2006 building standard. He explained part of the reason for low participation rates is policy holder still do not know about the discounts, and because of the high cost of mitigating homes. "They can't afford the insurance premiums because they are too high, and they can't afford the cost of retrofit," he said. "That's a problem we are going to have to wrestle with."

He further added that the wind pool attempts to keep operating costs down, with an operating expense of 18.3 percent, which is considered a low operating expense in the insurance industry. He pointed out if a captive were to be formed, one thing it would have to do to compete and possibly offer a lower cost to the consumer is operate at a low margin.

Regarding rates, in 2007 the AIUA started to look at rate accuracy and an actuarially sound rate that would allow AIUA to purchase reinsurance to cover for a 1 in 100 year event. The wind pool most recently increased rates in July -- increasing rates by an overall average of about 14 percent -- and it will reevaluate rates annually to come closer to rate accuracy.

It was important to note although there are 471 insurance companies licensed to sell property insurance in Alabama, 292 are exempt to take part in the pool because they do not write property insurance. Another 23 are exempt because they voluntarily write enough policies in Baldwin and Mobile counties to achieve an exempt status. This leaves 156 insurers at risk of the pool's exposure.

Asked how the AIUA might use funds to try to reduce the exposure and policy holders in the wind pool, he said having a grant program for mitigation is clearly the way that we are going to see more homes eligible for private market insurance. The bulk of the homes the wind pool insurer are older homes that were built prior to 2006. Cost to retrofit those homes is so prohibitive that the average consumer would need some help. A member noted that a policy goal should be to offer incentives for private insurers to take policy holders out of the wind pool.