STATEMENT OF ROBERT DETLEFSEN
ON BEHALF OF
THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES
BEFORE THE
MARYLAND HOUSE OF DELEGATES
ON

HOUSE BILL 71: AN ACT CONCERNING HOMEOWNER'S INSURANCE – UNDERWRITING BASED ON GEOGRAPHIC AREA

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ANNAPOLIS, MARYLAND

Good morning. My name is Robert Detlefsen. I am vice president of public policy for the National Association of Mutual Insurance Companies. NAMIC is the largest and most diverse property/casualty trade association in the country, with 1,400 regional and local mutual insurance member companies serving more than 135 million auto, home, and business policyholders and writing in excess of $196 billion in annual premiums that account for 50 percent of the automobile/ homeowners market and 31 percent of the business insurance market. More than 200,000 people are employed by NAMIC member companies. NAMIC members write over $4.3 billion in annual premium in Maryland's property and casualty market, accounting for 48 percent of all P&C premium written.

Introduction

Section 19-107 of the Maryland insurance code provides, in relevant part, that:

> "An insurer may not refuse to issue or renew a contract of . . . homeowners insurance . . . solely because the subject of the risk or the applicant's or insured's address is located in a certain geographical area of the State unless: (1) at least 60 days before the refusal, the insurer has filed with the [Insurance] Commissioner a written statement designating the geographic area; and (2) the designation has an objective basis and is not arbitrary or unreasonable."

On January 25, 2012, the Maryland Court of Appeals ruled that an insurer's decision not to issue or renew a homeowner's policy in a designated geographic area is reasonable and not arbitrary under § 19-107 when the decision is based primarily on a computerized catastrophe model. The Court found that such models have an objective basis and are, in fact, more reliable than historical loss data in predicting future losses from natural disasters such as windstorms.[1]

HB 71 would effectively overturn the Court's decision by amending § 19-107 to make it much more difficult for insurers to justify their desire to reduce their exposures in catastrophe-prone coastal areas of the state. In particular, it would require insurers to file with the Commissioner a

[1] *People's Insurance Counsel Division v. Allstate Insurance Company*, No. 60, September Term 2011.

written "underwriting standard" that includes, among other things, "the data relied on by the insurer in developing the underwriting standard"; "consideration of past and prospective loss experience within and outside the State"; and "consideration of all relevant historical weather data for any restriction that is based, in whole or in part, on a catastrophe model."

HB 71 would impede the ability of insurers to use catastrophe models to reduce catastrophic risk exposure.

Taken together, these provisions would severely restrict the use of catastrophe models for coastal underwriting purposes, forcing insurers doing business in Maryland to return to a bygone era when analysis of historical loss data and weather patterns was the only way to predict the frequency and severity of catastrophic windstorms. And it would do so at a time when catastrophe experts, both inside and outside the insurance industry, have increasingly embraced sophisticated catastrophe models as the most reliable and objective way of predicting future storm activity. Indeed, given the devastation visited upon the mid-Atlantic coast just within the past two years by Hurricane Irene and Superstorm Sandy – neither of which could have been predicted on the basis of historical loss data – not to mention the convergence of scientific opinion regarding changing weather patterns and rising sea levels, the HB 71's attempt to undermine insurers' ability to use catastrophe models to manage their exposure to weather-related losses is hard to comprehend.

The Court of Appeals recognized the value of catastrophe modeling in its January 2012 decision regarding § 19-107. Citing expert testimony, the Court noted that "natural catastrophes can cause devastating damage to homes and businesses. Because such occurrences are rare, however, historical loss data is scarce, making it difficult to estimate losses. From 1900 to 2004, he said, there were only 163 hurricanes that made landfall in the United States. Moreover, given the changing landscape of insured properties, even the historical data that exists has limited usefulness. Rules of thumb based on previous loss experience constitute an inexact approach that may either understate the risk, leaving insureds vulnerable to loss, or overstate the exposure, resulting in an inflated cost."[2]

The Court further observed, again citing expert testimony, that "because of the lack of reliable information, it has become standard practice for insurance companies to use catastrophe models to anticipate the likelihood and severity of potential future catastrophes before they occur. Those kinds of models can be used to address such questions as where future catastrophes are likely to occur, how big they are likely to be, how often they are likely to occur, what level of loss a company can expect to incur in each year over a long term, and the probability of incurring a large loss in the current year."[3]

The scientific community has also recognized and applauded insurers' use of catastrophe models. In a report published last November, the National Climate Assessment, a project of the Oceanic and Atmospheric Administration, observed that the "insurance and reinsurance industry have extensive experience in modeling, pricing, and managing risk, *which can be important in developing a better understanding of and response to climate-change risks faced by coastal*

[2] *Ibid.*
[3] *Ibid.*

communities." Particularly relevant is the report's recognition that "climate change has affected at least one core insurance industry assumption, which is that understanding the past enables insurers to predict what will occur in the future. *Although historically the past has served as a fairly reliable indicator of future events when calculating the risks associated with insurance coverage in coastal and other regions, climate change has introduced new and uncertain risks into these calculations.*" The report notes that the cost of damages from Hurricane Irene, which "made landfall over coastal North Carolina in August of 2011 and moved northward along the Mid-Atlantic Coast through North Carolina, Virginia, Maryland, New Jersey, New York, Connecticut, Rhode Island, Massachusetts, and Vermont," exceeded $7.3 billion. "Private insurance companies," the report adds approvingly, "have in some cases responded with financial strategies to reduce risk in coastal areas, including by raising premiums, increasing deductibles, *and sometimes limiting or discontinuing coverage*."[4]

Understanding the Nature of the Problem

Any serious discussion of coastal insurance underwriting and pricing should begin by acknowledging three simple facts:

1. The exposure of densely concentrated, high-value property to elevated levels of catastrophe risk in certain geographic regions means that property insurance in these regions will necessarily be relatively expensive compared to regions that lack these attributes. Even so, in some instances, premiums collected by insurers will be insufficient to pay the exorbitant loss costs that can result from catastrophic coastal storms, causing some insurers to decline to write new coverage and to non-renew some existing policies.

2. As population growth and commercial development in catastrophe-prone regions increase, the number of people and businesses faced with relatively large potential insured losses will naturally increase as well.

3. The Gulf and Atlantic coastal regions of the U.S. have experienced increased population growth and commercial development at a time when the frequency and severity of catastrophic storms in these regions are increasing.

Simply put, property insurance underwriting in coastal regions is largely about managing exposure to catastrophic loss. Whether because of global warming or cyclical climate change, a consensus has emerged among hurricane experts that the frequency and severity of major storms will increase during the next several years. Last spring, the influential catastrophe modeling firm Risk Management Solutions released RMS 11.0, an updated version of a hurricane catastrophe model widely used by insurers and reinsurers to assess hurricane risk, manage exposure, and price coverage. The revised model predicts increased wind risk for all hurricane-prone states on an industry-wide basis.

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[4] Burkett, V.R. and Davidson, M.A. [Eds.]. (2012). *Coastal Impacts, Adaptation and Vulnerability: A Technical Input to the 2012 National Climate Assessment*. Cooperative Report to the 2013 National Climate Assessment, p. 82-83. Emphasis added.

Coastal Development and Population Growth

Greater frequency and severity of coastal storms would matter less if the affected areas were sparsely populated and contained few valuable assets. But in fact the geographic areas most at risk for increased storm activity contain a disproportionate share of the nation's population, as well as its most valuable real estate. What is more, the movement of people and wealth from interior regions with relatively little catastrophe risk to coastal regions with the highest levels of catastrophe risk is increasing even as the likelihood of severe coastal hurricane activity increases.

Regulation

Many states in catastrophe-prone coastal regions, including Maryland, impose rating and underwriting restrictions on property insurers that act as price ceilings on coverage. Government rate suppression, which allows high-risk property owners to pay artificially low premiums, is the preferred solution of many regulators and state legislators to the property insurance "affordability problem" in catastrophe-prone areas. But rate suppression masks the real problem – the growing concentration of people and wealth in high-risk geographic regions – by forcing insurance buyers in low-risk regions to pay inflated prices in order to subsidize the insurance costs of those in high-risk regions. This outcome is especially likely if insurers are prevented from declining to write new policies or prevented from non-renewing existing policies in high-risk regions.

Insurance underwriting restrictions also remove a powerful disincentive to further population growth and economic development in these high-risk geographic areas. That may seem like a good thing to government and private businesses that thrive on growth and development. But unfortunately, government underwriting restrictions distort the public's perception of risk, thus encouraging the very phenomenon that created the problem in the first place. Risk-based insurance underwriting alleviates this problem by sending accurate signals to consumers about the relative level of risk associated with particular regions and types of structures.

Rate suppression and underwriting restrictions are also largely responsible for insurance availability problems in coastal areas. Like any other business enterprise, insurers must charge a price that covers the cost of the good or service they provide and allows them to make a profit. Historically, profit margins in the highly competitive property/casualty insurance industry have been quite modest compared to other business sectors. But if government rate regulation prevents insurers from covering their claim costs, replenishing surplus reserves to pay future claims, and making a profit, they may have no choice but to exit the market. The surest way to increase the supply of insurance in catastrophe-prone coastal regions is to remove government restrictions on pricing and underwriting.

Conclusion

In conclusion, NAMIC realizes that the property owners, insurers, mortgage lenders, realtors, and home builders that live and do business in coastal areas will face serious challenges in the years ahead. We believe that the most effective mechanism for addressing these challenges is a private insurance market whose defining characteristics are open competition and underwriting freedom. HB 71 represents a major retreat from this goal.