

Introduction

Could More Competition Have Solved the Post-Katrina Insurance Problems on the Gulf Coast?

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An insurance catastrophe seems to be developing along the Gulf Coast. An article in yesterday's *Wall Street Journal* paints this stark picture: commercial insurance companies are going bankrupt or withdrawing from covering hurricane damage in coastal areas, and in Florida and elsewhere, state-owned insurance companies are picking up much of this coverage. If another season of bad storms develops—as the U.S. weather service has predicted—the states with such captive insurers will have to appropriate huge sums to make good on their obligations. In many cases, this will mean that taxpayers in areas that face no significant risk from hurricanes will have to pick up the tab for covering losses suffered by people—often very well-to-do people—who live in vulnerable areas along the coastline.

If insurance markets functioned without rate regulation or government intervention, it is doubtful that this would happen. Rates charged to homeowners who buy or build homes along the Gulf Coast would be commensurate with the risk. Insurance would perform its highly valuable function of spreading the cost of losses of a few among a large group of people who have roughly the same risk. Unfortunately, this is not how homeowners insurance is regulated at the state level. In almost all states, including those on the Gulf Coast, homeowners insurance rates are regulated by the state, and sharp increases—or increases that recognize particular risks such as hurricane damage—are discouraged, limited or denied. As a result, private insurers are no longer willing to assume these risks.

The reaction of the states has not been to free up markets, but to continue regulating rates. In order to offer protection to homeowners, and to encourage banks to continue to lend on mortgages in vulnerable areas, the states have resorted to offering coverage by captive insurance companies, which as noted above will simply spread the risk to the state's taxpayers. Calls for a federal program that would create a national disaster fund are also efforts to spread to the nation's taxpayers losses that could otherwise be covered by insurance markets, and will similarly distort the incentives of both homeowners and insurance companies.

In today's conference, we will consider whether and how an optional federal charter for insurance companies would address the problems of the Gulf Coast. One of the assumptions underlying support for an optional federal charter is that companies with a national charter would not be subject to rate regulation and hence would be available to offer coverage at its true cost. This would make private coverage available, but would it really mean any change in conditions at the state level? As long as states—and to some extent the federal government—are willing to cushion the losses and assume some of the

risks of vulnerable homeowners, private insurers, even those with national charters, would be sidelined. Why would a homeowner pay more for private insurance when the state is offering roughly the same coverage for less? In other words, while nationally chartered companies can add competition to a market, and ultimately drive down rates, this cannot happen as long as the states insist on subsidizing non-market rates.

On the other hand, should a big loss occur in a state, there is bound to be a taxpayer revolt against the policies the states have been pursuing. At that point, there will be very few options available to state insurance regulators. The continued viability of the housing market will depend on the availability of insurance coverage. The market will have to be allowed to work, and the state's homeowners and banks will be looking for insurers that are able to pick up hurricane risk at a market price.

Is this the scenario that makes nationally chartered companies relevant to the insurance problems of the Gulf Coast, or is there some more direct way that an optional federal charter will bring about improvements in Gulf Coast insurance markets?

In this conference, we will consider this and other questions about whether and how an optional federal charter might address the issues that currently plague the Gulf Coast.