

Market Incentives for Private Insurance Markets: Literature Review

Executive Summary

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Background

Texas A&M University at Galveston reviewed studies and identified possible ways to encourage private insurers to provide more windstorm and hail insurance in the 14 first tier coastal counties of Texas and portions of Harris County.

Highlights of the review—which draws on reports, scholarly articles, and information posted by groups including the National Association of Insurance Commissioners—are summarized below.

Catastrophe Insurance Market Features

Insurance helps communities rebound from natural disasters. It can also encourage cost-effective risk mitigation decisions when insurance rates are actuarially sound and mitigation incentives are financially appealing.

Underwriting catastrophic risks is challenging for private insurers due to “fat tails”—where the most extreme event can be much larger than the previous most extreme event—and because many properties can simultaneously suffer losses (spatial correlation of losses). Those challenges are compounded by regulatory or rating agency requirements for minimum capital and surplus, policy coverage or language, underwriting practices, and claims handling.

Other aspects of catastrophe insurance also can hinder market efficiency, including:

- Inadequate pricing of policies;
- Expansion of residual market mechanisms (RMM);
- Reinsurance costs; and
- A lack of incentives for private self-mitigation.

A few notable features of the demand and supply side of the market:

- Insurance demand spikes after a catastrophic event clearly shows the risk.
- Private insurers can assume catastrophic exposures and satisfy regulatory requirements to remain solvent if they can charge actuarially sound rates or adjust them adequately post-event.
- Demand for insurance subject to catastrophic risk is estimated as fairly price elastic, implying that any increase or decrease in the cost of insurance can reduce or drive up demand.

Market Incentives and Potential Consequences

Almost unanimously, scholars agree that incentives fostering private markets for catastrophe insurance should be designed to:

- Increase each insurer’s latitude to set prices and decide where, when, and how much insurance to provide;
- Allow appropriate adjustments after catastrophic events in each insurer’s exposure, rates, and provision of policies; and

- Encourage each insurer to make capital investment, differentiate products, and develop marketing strategies.

Incentives identified in this review include options already implemented in Texas. Some incentives may not work well together, some may even be contradictory.

Possible incentives include:

- Deregulation, including:
 - Price deregulation
 - May drive up rates, raising affordability concerns.
 - Risk-based rates may exceed consumers' willingness to pay for insurance.
 - Few or no underwriting regulations
 - Deregulating underwriting restrictions by allowing insurers to reduce or limit exposure (e.g., cancellations and nonrenewals), or letting insurers exclude windstorm and hail coverage. This would allow insurers to more efficiently adapt to shifts in risk.
 - Allowing higher deductibles
 - Increases "skin in the game" for insured and may encourage insureds to mitigate the risk more (e.g., invest in home retrofits; build a more wind-resistant home).
 - Gives insurers option of charging lower premiums.
- Giving insurers operating in risky areas greater credit against RMM assessments
- Decreasing reinsurance costs and enhancing access to other forms of liquid capital
 - Providing public reinsurance is one way of supporting private insurers.
 - Allowing insurers to get full credit for their reinsurance with non-U.S. reinsurers is another way of supporting private insurers.
- Requiring windstorm and hail insurance as part of standard homeowner's insurance policy, at differentiated prices:
 - Allows insurers to spread risk over all households.
 - This strategy is arguably more equitable than one that provides a direct or indirect subsidy on insurance premiums. It may also incentivize mitigation.
 - Hazard risk appears to be systematically underestimated and, unless the insurance is mandated, individuals may find voluntary insurance unattractive even at subsidized rates.
- Enforcing and improving building codes, and encouraging other types of private mitigation investment using incentives tied to premium discounts:
 - Current premium reductions may be too small to make an investment in risk mitigation financially attractive.
- Eliminating unified rates for policies and differentiating them to adequately correspond to geographically differentiated risks of hazard:
 - Uniform rating lowers the insurance rate for high-risk properties and increases it for low-risk properties, creating the possibility that private insurers may cherry-pick low-risk properties that must pay higher rates.

The review identified multiple other ways to improve market efficiencies. They include:

- Scaling back RMM by tightening eligibility requirements and setting adequate rates to make RMM noncompetitive.
- Encouraging private risk mitigation using grants, enhanced hazard education, and literacy and outreach programs.
- Encouraging long-term insurance policies, which may make mitigation investments financially more attractive.
- Providing state-funded insurance vouchers to low-income residents to address affordability—a strategy believed to be less distortive than subsidizing rates for all residents of high-risk areas.
- Improving the funding structure for guaranty associations by encouraging risk-based post-loss assessments:
 - Non-risk-based assessments creates inherent cross-subsidies benefiting high-risk properties and burdening low-risk properties.
 - Private insurers holding a large market share outside of high-risk areas may face secondary exposure to catastrophic risk through obligations to the state guaranty association.