Revised Risk Assessments and the Insurance Industry

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1. Introduction

Insurance plays an important role in the management of disaster risk. First and foremost, it can protect individuals and businesses from financial losses that would be severe for them to handle on their own. Insurance can also make funds available for rebuilding quickly after an event, helping increase the resiliency of a community. By limiting the risk exposure of individuals or firms, insurance allows certain types of business to take place that would be too risky otherwise, whether it is small farm-holders adopting a higher-yielding crop that is less resistant to drought, or doctors being willing to perform surgeries where human error is possible. Insurance does not lower actual losses, but is a way to manage remaining risk after all risk mitigation measures have been taken.

Insuring disaster or catastrophe risks can be challenging, as discussed in this chapter, particularly if the insurance company does not fully understand the risk or the risk is changing significantly over time. This chapter examines catastrophe insurance with a particular focus on the impact of events that alter perceptions of a risk in the insurance market. The two overarching questions of this chapter are:

1) What types of events lead to updating of risk assessments by the (re)insurance industry?
2) How do companies, consumers, and the government react to updated risk perceptions?

This chapter in general focuses on the United States, although many of the findings, particularly related to the private insurance industry, will likely be globally applicable.

The next section of the paper discusses the challenges of insuring disaster risks. Section 3 discusses the role and impact of disaster events on the insurance industry even in the absence of changing risk assessments. Section 4 then turns to the question of what types of events lead to a revision in risk estimates. Sections 5, 6, 7 then outline the response to such changes by insurance companies, consumers, and the government. Section 8 concludes.

2. Insuring Catastrophes

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1 I would like to thank Will Rafey for his research assistance.

2 It is possible that insurance premiums could be altered to encourage investment in risk reduction. As noted by Woo (1999), however, the market for insurance is inefficient and cyclic, such that in soft market conditions when prices are low, it may discourage risk reduction, and when prices are high, many may simply forgo disaster insurance entirely. Insurance, then, is not likely to be the best tool for incentivizing hazard mitigation.
The theory of insurance rests on the notion that the insured is risk averse and would pay more than the expected value of the loss to transfer the risk. Many authors have discussed the idealized conditions for insurability of a risk, or for risk transfer to an insurance company to occur (e.g., Swiss Re 2005; Charpentier 2008). For the present purposes, I identify five:

1) a degree of randomness to loss occurrences and their magnitude,
2) independent, thin-tailed, and quantifiable risks,
3) determinable losses,
4) no adverse selection or moral hazard, and
5) demand meets supply (market clears).

First, losses must be unintentional and random; that is, not known with certainty (Klein 2005). The second criteria allows for a benefit from pooling risks. Independent risks are those that are not correlated with each other. For example, when one individual gets in a car accident, it does not make it more likely their neighbors also do. Thin tailed risks are those for which the probability of extremely large losses becomes negligible. With independent and thin-tailed risks, the law of large numbers and the central limit theorem assure benefits to the insurance company from combining the risks of many insureds: the average claim converges to the expected value and the tails of the aggregation become thin-tailed (that is, normally distributed). As more and more policies are written, insurers can charge a rate closer and closer to the expected loss (Cummins 2006). The third criteria is that losses must be measurable and verifiable for settlement of claims to occur.

The fourth and fifth conditions have to do with the information and incentives of the insured. Adverse selection occurs when the insured knows more about their risk than the insurance company, such that higher risk individuals or firms are more likely to insure, but the company cannot price for this. Moral hazard occurs when insurance induces the insured to fail to take loss reduction efforts or to intentionally cause a loss. Again, this will make it unprofitable for the company to operate. Finally, insurance will not be sold if it cannot be offered at a price that is profitable for the insurance company and that insureds are willing and able to pay.

Catastrophe risks tend to violate the second and fifth of these criteria,\(^3\) posing challenges for the insurance industry. With catastrophes, claims are often spatially correlated, such that all the houses in a community may be damaged by an earthquake or a hurricane. Catastrophes are also characterized by fat-tailed losses. With fat-tailed loss distributions, the probability of an event declines slowly, relative to its severity. Simply, very large losses are possible. Indeed, many natural catastrophes, from earthquakes to wildfires, have been shown to be fat tailed (e.g., Schoenberg et al. 2003; Newman 2005; Holmes et al. 2008).

With catastrophe risks, claims will be more volatile year-to-year than for other lines of insurance, with companies on occasion experiencing very severe losses. With non-catastrophic risks, premiums received in a given year can largely cover losses experienced in that year. For catastrophe risks, on the other

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\(^3\) They could also violate (3), as demonstrated by the wind-water controversy following Hurricane Katrina.
hand, firms must solve an inter-temporal smoothing problem of trying to match regular premium payments, insufficient in any given year to cover a large loss, with the need for enormous sums of capital in the catastrophe years (Jaffee and Russell 1997). Given this, firms managed to keep the probability of insolvency below a certain level (so-called value-at-risk requirements\(^4\)) will be required to charge very large premiums to cover catastrophic risks because much more capital is needed to be able to pay claims when a disaster strikes. This can lead to rates that seem overly high in “good” years, but they are needed to account for the “bad” years. Take the case of Florida. From 1993 to 2003, the rate of return on net worth for homeowner insurers was 2.8% nationwide but a much larger 25% for Florida. When 2004 and 2005 are included, two years with powerful storms, the situation reverses dramatically, with the national return being –0.7%, and the return in Florida being a devastating –38.1% (Insurance Information Institute 2009).

The higher rates that need to be charged to cover catastrophes could be so high as to lead to a breakdown in the insurance market. That is, there may be catastrophic risks that a company cannot insure at a price that insureds would either be willing or able to pay (Kousky and Cooke 2012). For instance, Munich Re executives have noted that they did not provide more reinsurance to companies with exposure to the 2011 Japanese earthquake because there was not demand at the price they deemed necessary (Munich RE 2012). In these cases, homeowners and firms will forgo insurance or the government will need to step in.

That said, insuring risks is not a yes-no proposition. There is a continuum of risks from the easy to insure to the difficult. Auto insurance is largely easy to insure.\(^5\) Coverage for nuclear terrorist attacks is almost non-existent (unless mandated by government) since it could have unfathomable losses and losses would be highly correlated across lines and with the broader economy. Most risks are somewhere in between and insurance companies have multiple strategies for increasing their ability to cover a risk. For example, reinsurance companies can often diversify over greater geographic areas and over a wider range of perils, such that ceding some portion of risk to a reinsurer can allow a primary insurance company to offer more coverage. Or if alternative risk transfer instruments allow insurance companies to place some risk in the capital markets, that could help them access more capital in large loss years. Companies also limit their exposure in various ways to assume a portion of catastrophe risk that they can comfortably manage, such as increasing deductibles and co-payments, enacting policy limits, carefully limiting underwriting, segmenting markets, or working cooperatively with government on hazard mitigation (Swiss Re 2005).

These strategies also suggest that the concept of insurability of risks is dynamic (Swiss Re 2005). New strategies can alter a firm’s appetite for covering disaster risks and broader economic and political

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\(^4\) This type of management means the firm ensures access to enough capital to cover up to a certain percentile of the aggregate loss distribution (thus guaranteeing solvency with that percent). Regulations in the EU (Solvency II), for example, have set the annual probability of insolvency at 0.5%.

\(^5\) Insurance companies also limit their risk (and moral hazard) in creative ways. For instance, in Germany, insurance companies have refused to pay for accidents caused by excessive speeding, and this has been upheld in court (Stahel 2003).
conditions can also change insurability over time. In addition, new information on a risk could lead (re)insurers to reconsider the insurability of risks or the conditions under which risks could be covered. An extreme event could carry new information (the main focus of this chapter) or it could come from improved science (likely to lead to more gradual changes in risk perception) or risk modeling, for example, or from changes in regulation and policy that influence the size of claims (notable for lines such as liability insurance). The rest of this chapter focuses on what type of events lead (re)insurers to alter their assessments of a risk and then how they respond when this happens, as well as how consumers and governments respond.

3. The Role of Disaster Events in the Insurance Industry

The insurance industry is in the risk business. They undertake detailed analysis and modeling of the perils they choose to cover. One event will thus not usually lead to any dramatic reassessment of risks, as long as it is seen as a draw from a reasonably well-characterized distribution. For instance, after the large 2011 tornado losses, State Farm stated: “catastrophe claims experience tends to be aberrational. We evaluate claims experience over longer periods of time than we do other types of claims experience,” (Berkowitz 2012). The question is when an event is enough to make an insurance company believe it is indicative of a new, changing, or previously mis-characterized risk.

Following major disaster events, changes are often observed in the insurance market. Prices for insurance policies may increase or insurance companies may alter coverage conditions. For example, hard markets—meaning that prices increase and supply is scarce—have been observed following many disasters, such as Hurricane Andrew in 1992, the Northridge Earthquake in 1994, and the 2001 terrorist attacks (Cummins 2006). More recent events have also seemed to trigger price increases. For example, following the terrible flooding in Thailand in 2011, which cost the industry over $10 billion, companies raised rates around 20% and restricted flood coverage (Ng 2012).

It is difficult to untangle the causes of these observed changes in the market, however, and there are multiple reasons that insurance companies could increase premiums or decrease supply following a large event that are not due to a revision in risk estimates. First, the disaster could coincide with other market changes. For example, a 2012 Wall Street Journal article highlighted increasing prices for homeowners insurance, but part of the reason was that insurers have seen low return on their investments (Andriotis 2012), not because they revised their estimates of disaster risk following the large losses in 2011.

It is also the case that while firms ensure access to more capital to cover catastrophic lines, a large event will deplete their surplus. When this occurs, at first glance it suggests that it must be because they did not adequately reserve for it, suggesting they underestimated the risk. There are several studies,

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6 Indeed, 2011 was a huge loss year for the industry globally. For example, the year reduced profits for Catlin, an insurance and reinsurance company, by 82% leading them to increase prices on catastrophe lines by 9% for primary insurance and 17% for reinsurance in the US and 12% for reinsurance elsewhere (Gray 2012).
however, that suggest companies may not be able to adequately smooth the payments of catastrophe losses over time because of institutional and political constraints, even when they are aware of the risk (Jaffee and Russell 1997). Due to the difficulty of preventing negative capital shocks in catastrophic lines, firms may raise rates after an event to re-coup lost capital. In a sense, they spread the disaster costs over later years. This may be done with premium increases if a visible disaster makes it more difficult for insurance companies to raise external capital, either directly because of the shock to surplus or due to investors changing their risk perceptions. While theory suggests investor inability to evaluate risks can make it expensive to raise capital from them, and thus provide a rationale for reinsurance purchases, resinsurers may also charge high prices and restrict supply for similar reasons discussed here post-disaster (Froot and O’Connell 1997). This could cause a primary insurance company to raise premiums as a way to increase capital they cannot obtain (or obtain as cheaply) from other sources. Depleted capital could also cause a firm to be downgraded by rating agencies and the firm could then raise premiums or limit exposure in the highest risk areas to re-establish a higher rating and maintain their financial position.

Yet another reason for the observed market changes after large disaster events may have to do with the politics of rate setting. It has been suggested that state regulators (discussed below) tend to suppress rates, and as such, insurance companies may use major events as an excuse to raise prices, even if the event did not alter their risk perceptions (Kunreuther and Pauly 2005). While difficult to observe, a scandal following Hurricane Andrew suggests this may occur. Major newspapers reported that while the storm was raging over Florida, a memo was circulated to American International Group (AIG) senior managers that the company could use the storm as an excuse to raise rates (Angbazo and Narayanan 1996). Text from the memo quoted by the LA Times suggests that AIG felt the industry could not absorb the loss without rate increases and interview comments from AIG executives indicate they felt the insurance was not priced high enough prior to Andrew (Mulligan 1992).

Finally, a disaster may also lead to changes in demand, as opposed to supply. If demand increases after an event as consumers reevaluate the risk or their need for insurance, higher prices could be observed in the market post-disaster (discussed further in Section 3.4). Unlike other industries, insurance often experiences an upward shock to demand at the same time it experiences a downward shock to supply, since large events can both increase demand and also deplete insurance capital (Swiss Re 2005). This joint effect can lead to large price increases after events and make price and quantity for disaster insurance very “spiky.”

Disentangling all these impacts of a disaster that are not due to changes in risk perceptions from the adjustments that occur when a catastrophe does alter the risk perception of insurers is difficult empirically and there is very little work on this question. The next sections summarize what is known about this topic and offer some initial findings and hypotheses for future investigation.

4. What events lead to a change in risk perceptions?
There are three situations in which the occurrence of an extreme event will cause an insurance company to revise its estimation of the risk. The first is when the distribution of the risk is unknown, often due to very limited data on the risk. This means that one extreme event carries more informational content for the insurance company, or leads to more updating, then when there is a large amount of data on a risk. The second is for risks where the loss distribution is changing over time, such that an extreme event can be indicative of a change in the risk. The third is when an event identifies a new risk that had not been previously identified or incorporated into decision-making.

In practice, however, these need not be mutually exclusive categories. A risk may be unknown, changing over time, and new aspects of the risk may emerge post-event. Take the case of terrorism. The probability distribution of terrorism damages is clearly a distribution that is unknown. Getting an improved understanding of terrorism risk is limited by lack of access to classified governmental information. The risk is clearly changing over time as counter-terrorism policies evolve, as terrorists shift their targets and intentions, and as both government security agencies and terrorists react to and anticipate each other. The changing nature of the risk can also lead to new aspects of the risk emerging. It is thus no surprise that the September 11th attacks provided new information that led to dramatic updating of risks by (re)insurance companies.

While insurance companies were quite aware of the risk of terrorism to the insurance lines they offered, having dealt with previous events both within and outside the United States, many firms prior to September 11th, 2001 had simply not considered an attack of the magnitude experienced. At the time of 9/11, it was the costliest insured event in history (coming in just behind Hurricane Andrew in 1992). As Warren Buffet wrote of General Re in his letter to shareholders in 2001: in “setting prices and also in evaluating aggregation of risk, we had either overlooked or dismissed the possibility of large-scale terrorism losses,” (Buffet 2002). Swiss Re revealed similar sentiments, noting that the September 11th attacks demonstrated a “staggering, previously inconceivable scale of threat scenarios and loss potentials” (Schaad 2002).

The risk of a potentially catastrophic terrorism event was known to academics and some government officials well before September 11th, 2001, and yet insurance companies did not exclude such coverage from their contracts and were surprised by the events as noted by Buffet and Swiss Re. In interviews of insurance officials, it was found that a total loss of the World Trade Center was simply not considered by most companies; their probable maximum loss8 may have included a plane taking out a few floors and a resulting fire, but not destruction of both towers (Ericson and Doyle 2004, p.216 and 221). The 1993 World Trade Center bombing was manageable for companies in terms of losses and it seemed inconceivable that a much greater magnitude loss was possible. In addition, prior to September 11th, terrorist attacks where not uncommon on US interests overseas, but only one-half of one percent of all terrorist actions between 1991 and 1998 were in North America (Cummins and Lewis 2003). The 9/11

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7 It has since been surpassed by both Hurricane Katrina and the 2011 Japanese earthquake in terms of insured losses.
8 Probable Maximum Loss refers to the largest modeled loss for which the company is pricing.
attacks thus changed insurers’ view of terrorism risk: it became something that could be more common within the United States and attacks could be much larger in magnitude than had been previously believed.

September 11th also led to the identification of a new aspect of terrorism risk or a new type of risk. The event drove home for insurance companies that losses across lines of business could be highly correlated in a manner not previously appreciated (Ericson and Doyle 2004). The same one event caused losses in property, business interruption, liability, workers’ compensation, aviation, life, and health insurance lines. Companies also realized after 9/11 that a large claim generating event could also lead to investment losses, further stressing the company, such that disaster events were not necessarily independent of market conditions. In his shareholder letter, Buffet stresses that insurance companies should “accept only those risks that they are able to properly evaluate” and they should “ceaselessly search for possible correlation among seemingly-unrelated risks” (2002). These correlations were made plain by September 11th and afterward were more carefully considered by the insurance industry.

A similar updating of risk perceptions occurred after Hurricane Katrina, when again the type of losses that can be sustained following a large event were surprising. Hurricane Katrina generated the highest level of insured losses in history. Insurance companies often rely on catastrophe models—probabilistic models of different perils that take into account a company’s portfolio to estimate losses—when evaluating their pricing and underwriting. There are three firms that do the vast majority of such modeling: RMS, AIR, and EQECAT. These models under-predicted losses from Katrina. The storm led RMS modelers to realize that when disaster events are extreme, they can result in what RMS called “Super Cats” or events with such large amounts of damage that they “give rise to nonlinear loss amplification, correlation, and feedback” (RMS 2005). Super Cats lead to many more lines of business being impacted and generate damage of types not previously modeled, such as infrastructure collapse, looting and crime, water contamination, prolonged business interruption, and delayed economic recovery (NAPCO LLC 2006). Adding these possibilities to the RMS model increased damage estimates by up to 125% (NAPCO LLC 2006).

Hurricane Katrina also provided new information on how hurricane risks may be changing over time from climate change. When risk models did not accurately predict Katrina’s damage, modelers began examining why. Before Katrina, the RMS hurricane model had relied on hurricane events over the past 100 years, using a representative selection of such storms to model losses. This did not account for any cyclical variations, such as El Nino and La Nina events, nor did it account for increasing sea surface temperature from climate change. In a new 2006 model, RMS drew on a panel of scientific experts to instead take a forward looking view of hurricane activity, determining that higher sea temperatures would lead to increased activity (NAPCO LLC 2006). This led to increases in modeled losses of about 40% for Florida and between 25% and 30% for the mid-Atlantic.

Large events can provide new information on a risk to insurers, particularly for risks that were poorly understood to begin with or changing over time, or can indicate risks not previously identified. The September 11th attacks and Hurricane Katrina are both examples of this type of risk updating by
insurance companies. This suggests a model of learning about risks that is quite jumpy. In actuality, catastrophic risks are continuously changing. Human populations and development patterns change over time; our technologies to mitigate hazards evolve; and other stresses, such as climate change or political conditions, shift. While to some extent all of these potential drivers are constantly modeled by the insurance industry, often it takes an extreme event to give deeper insight into the manner and magnitude of changes to risks. The next three sections address what insurance companies, governments, and consumers do in response to altered risk perceptions.

5. Insurer reaction to changing risk perceptions

When an extreme event causes an insurer to estimate a risk as higher than they previously did, companies may alter their pricing, coverage conditions, underwriting strategies, and/or capital management in response. Often, companies may adjust all of these simultaneously, although they will be discussed in turn here.

Large premium increases have been observed after many of the largest events the insurance industry has experienced. After the September 11th attacks, many companies revised their probable maximum loss to include complete loss of the building they were insuring (Ericson and Doyle 2004, p.221), which led to a large jump in prices. Reinsurance companies made similar revisions and the supply of reinsurance for terrorism was dramatically curtailed after 9/11 and what was available was priced at extremely high rates (CBO 2007), having impacts on the pricing of primary insurance. As an example, one Midwestern airport saw its liability premium increase 280% in 2002, and the exclusion of terrorism coverage (Swiss Re 2005).

Following a re-assessment of the risk, companies will also often change the conditions of coverage to make the risk more insurable. A notable example of this is hurricane deductibles, introduced after Hurricane Andrew. Following the storm, in many coastal states, companies introduced deductibles specific to either hurricanes or wind damage, often set as a percentage of the home ranging from 1% to 5% (McChristian 2012). These have been a lasting legacy of the storm.

Other examples come from the 2011 tornadoes. Those events led some companies to seek broader geographic diversification, to reduce the amount of exposure they had in tornado-prone areas, to increase deductibles, and to change pricing based on new factors, such as the age and quality of a home’s roof (Berkowitz 2012). The Wall Street Journal noted that Allstate was introducing a new policy in Kansas and Oklahoma that would not pay the full cost of roof replacement (Andriotis 2012).

If companies revise their estimate of the risk upward sufficiently, they may believe they need to lessen the amount of exposure to the risk in their overall portfolio. In the extreme, companies may abandon a location or line of business altogether. As already mentioned, after September 11th, many (re)insurers dramatically restricted supply of terrorism coverage. It was widely reported after 9/11 that commercial terrorism coverage was unavailable, even at very high prices (Swiss Re 2005). A 2002 Swiss Re publication noted that in response to the attacks, “the insurance industry is compelled to fundamentally...
review its risk acceptance position, and to reduce and limit coverages granted to avoid unmanageable exposures in the future. In fact, the question whether terrorism risk is insurable at all must be fundamentally reviewed” (Schaad 2002).

Insurance companies also pulled back along the Gulf Coast after Hurricane Katrina, although not as severely as was seen in the terrorism market after 9/11. The trimming of hurricane exposure, however, has continued over many years since Katrina, suggesting companies fundamentally do not believe the risk to be improving. In February 2010, for instance, Farmer’s announced that it would drop more than 10,000 policyholders in the coastal counties of Alabama, joining Allstate, Alfa Mutual, and State Farm in shedding policies in Baldwin and Mobile counties (Amy 2010).

Reducing coverage is not independent of the prices firms can charge. In 2007, State Farm stopped writing new homeowners policies in Florida (Stroud 2012). Part of the difficulty was a struggle over rates. Florida was preventing State Farm from raising rates to what the company thought was needed. Negotiations with the state followed and in December 2009, State Farm agreed to drop 125,000 high-risk policies instead of exiting the state entirely, and Florida allowed it to raise its rates by 14.8% (Fineout 2010). A pull-back of insurance companies after the Northridge earthquake led to a crisis in California. Following the Northridge earthquake, insurance companies paid out $15 billion in claims but had collected only $3.4 billion in earthquake premiums in the preceding 25 years (GAO 2007). Insurance companies began shedding their earthquake exposure throughout the state. California state law, however, required that insurance companies offer earthquake coverage if they wrote residential coverage, so companies began to leave the state entirely. The California Department of Insurance estimated that in the summer of 1996, 95% of the homeowners insurance market in the state had stopped or dramatically limited sale of new policies (CEA 2010). This triggered a housing crisis that led the state to intervene (intervention discussed below).

Finally, insurance companies may alter the management of their capital. They may increase reserves, for instance, or purchase more reinsurance. Following Hurricane Andrew and the Northridge Earthquake, strategies were developed to transfer risk to the capital markets, such as through catastrophe bonds (Kunreuther and Michel-Kerjan 2005). This opened up a new source of capital to firms, although, for many reasons, the market remains small.

There also appears to be some amount of “risk contagion.” That is, when a bad disaster of one type occurs, prices go up for other disaster lines as well. For example, it has been found that the prices for earthquake coverage increased after Hurricane Katrina and that the price of catastrophe bonds for natural disasters increased after the September 11 terrorist attacks (Froot 2008). This could be due to the general decreases in surplus. It could also be, however, that as insurance companies revise their risk estimate of one catastrophe line, it prompts them to reconsider their evaluation of other catastrophe risks, as well. Hurricane Katrina prompted a re-examination of the catastrophe models, as discussed earlier, and while some changes were unique to windstorms, some were broadly applicable to a range of
catastrophes, leading to price increases on other catastrophic lines, like earthquake coverage (Advisen 2006).

What happens after the immediate post-disaster changes? In some cases, changes may be temporary. Insurance companies may find new tools to help insure the risk and access new pools of capital to expand their underwriting. As prices increase and quantity is restricted, it can attract new capital to the market, helping to re-establish lower prices and more availability. Terrorism coverage has improved slightly since 9/11, although partly due to federal legislation discussed below. It may also be due to improved modeling of terrorism losses since the attacks, such as the model developed by RMS (RMS 2008).

In other cases, however, the new assessments of the risk may be such that the market changes after the event are permanent. For example, since Katrina, companies have continued to push for higher prices along the coast and have continued to tightly manage their exposure to hurricane losses. Katrina suggested not only that companies had fundamentally underestimated potential hurricane losses, but also that the risk may be worsening with climate change, not improving.

It is also worth remembering that insurance companies cannot perfectly predict changing risks and cannot possibly guard against every catastrophe scenario. There will always be rare events that stress the industry. For example, one executive noted that while EU regulations (Solvency II) require insurance companies to reserve for the 1-in-200 year event, that means that with 100 large insurance companies, roughly 1 will go bankrupt every two years (Munich RE 2012).

6. Consumer reaction to changing risk perceptions

An extreme event cannot only lead insurance companies to update their risk assessments, but also cause consumers to update their risk perceptions. If individuals assess a risk as higher after an extreme event then they did before, it may lead them to change their insurance purchases. Findings from behavioral economics suggest individuals may even revise risk perceptions following lesser events or over-assess the risk after disasters. This literature has found that individuals can often be poor evaluators of risks, using mental shortcuts and rules-of-thumb. For example, it has been demonstrated that after an event individuals assess the risk as higher as it is now salient for them. This has been termed the availability heuristic (Tversky and Kahneman 1973). When this happens, it too, could increase insurance demand.

Supporting these theoretical arguments, several studies have found empirical evidence that individuals are often more likely to purchase insurance in the wake of a disaster. Brown and Hoyt (2000) find that flood insurance purchases at a state level increase when flood damages the previous year are higher. Looking just at flood insurance purchases in Florida, Michel-Kerjan and Kousky (2010) find that after the 2004 hurricanes, the number of policies-in-force statewide jumped 6%, compared to only 1% to 2% in other years. They also find more homeowners in areas hit by the hurricanes lowered their deductible and chose the maximum coverage level.
September 11th, 2001 also had impacts on insurance demand. CNN reported a month after the attacks that there was a 30% spike in purchase of travel insurance, even though the total number of travelers was still below pre-attack levels (Max 2001). Following the Deepwater Horizon oil spill, firms engaged in drilling began to demand greater levels of insurance coverage (Booz Allen Hamilton 2010). There is also some indication that as the time since the last earthquake increases in California, more people drop earthquake insurance (Wilkinson 2009). Finally, there is also some empirical evidence that catastrophes lead to greater purchases of life insurance (Fier and Carson 2010).

7. Government reaction to changing risk perceptions

Government has intervened in insurance markets in the US at both a state and federal level following extreme events. Government intervention is often motivated by a perception that the insurance market has broken down, with private companies choosing not to offer coverage for a risk or only at prices that are beyond what many consumers can afford. Governments can intervene in insurance markets in a number of ways. The insurance industry is regulated at the state level by insurance commissioners. Commissioners oversee licensing of insurance companies (and thus a firm’s ability to sell insurance within a state), pricing, solvency, underwriting, marketing, and claims handling, among other things. Beyond regulation, many states have created their own insurance programs for consumers who cannot find a policy in the private market. Finally, the federal government also runs several (re)insurance programs. This section will discuss these various interventions.

After an extreme event, state insurance commissioners often work to prevent steep price increases or the exit of firms in an attempt to protect consumers. Following Hurricane Andrew, insurance regulators in Florida prohibited dramatic rate increases and only let companies gradually increases prices over a decade, and the state legislature passed a moratorium on policy cancellations (Klein 2009). Part of this, however, was due to the AIG controversy mentioned earlier. In response to it, the Florida insurance commissioner froze AIG premiums and warned all companies that unjustified rate increases would not be permitted (Angbazo and Narayanan 1996). The state also put in place a three-year moratorium that limited how quickly firms could reduce their market share in the state (McChristian 2012). Following Hurricane Katrina, the state allowed an initial wave of price increases that were generally highest in coastal areas but then began disapproving them in 2006 (Klein 2009). Other states have taken similar measures. After Katrina, the Louisiana Department of Insurance prohibited cancellation or non-renewal of residential dwelling and commercial property insurance for structures damaged by Hurricane Katrina or Rita until 60 days after all repair and reconstruction had been completed (or December 31, 2006) (Klein 2009).

More dramatically, states have set up their own insurance programs after observing a severe hardening of the insurance market (Kousky 2011). These state programs, often called residual market mechanisms, are created for residents that cannot find policies in the voluntary market. They take a
variety of forms, including state FAIR (Fair Access to Insurance Requirements) plans, state wind pools or “beach plans” that provide wind-only coverage in certain high-risk areas, hybrid programs that write both hazard-specific policies and complete dwelling coverage, an earthquake program in California, and a reinsurance fund in Florida. Many programs have eligibility requirements intended to ensure that policies are purchased only as a last resort. Almost all of these programs were adopted in reaction to an extreme event and insurer reactions to that event.

The California Earthquake Authority (CEA) is a good example. It was established following the housing crisis after the Northridge earthquake mentioned above. Insurance companies can comply with the state mandate to offer earthquake coverage with residential dwelling coverage by participating in the CEA. Upon joining the CEA, insurers make a capital contribution and are able to be assessed after an event if available capital and reinsurance do not cover all claims. The CEA began operating late in the year of 1996 and within a year almost all insurance companies were again operating in the state (CEA 2010). The CEA is the largest earthquake insurer in California. While the coverage offered is limited, the CEA has maintained the availability of earthquake insurance in California.

The CEA is well-prepared to cover claims from a severe earthquake, but other state programs are not. Florida’s insurance program has been a source of controversy, for example, with many observers noting it will be unable to pay claims from a severe hurricane and that its pricing is too low, perhaps causing perverse incentives. Many state programs, however, have grown in recent years and play a vital role that is unlikely to be replaced completely by the private market in the near future. With Florida’s program the largest insurer in the state, it is a fixture of the Florida insurance market.

State intervention, though, could be used as a temporary measure to relieve market hardening after a disaster. Hawai’i’s program exemplifies this possibility. The program was established in 1992 after Hurricane Iniki. By 2000, private insurance companies were writing their own policies in Hawaii and the state program has not written any new policies over the last decade. Such short-term intervention is useful when the private market simply needs time to revise strategies and rebuild capital. It will not be possible if the private market fundamentally reassesses a risk as uninsurable.

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9 Following riots and civil disorder in many urban areas, federal legislation in 1968 made federal riot insurance available to states that enacted FAIR plans that offer homeowner coverage to residents who cannot find policies in the voluntary market. Initially, these plans offered coverage only for fire, but many have expanded, and some even offer wind coverage.

10 For instance, Louisiana Citizens and the Alabama Beach Pool were created in response to Hurricane Camille, Hawaii’s fund was created after Hurricane Iniki, the Texas Windstorm Insurance Association was created following Hurricane Celia, the precursor to Florida Citizens was created following Hurricane Andrew, and the California Earthquake Authority was created after the Northridge earthquake.

11 When reserves are not enough to cover claims, the program would be funded by post-event assessments on policyholders in the program. Following policyholder assessments, all property and casualty insurance companies in the state would be assessed, and finally an emergency assessment on all property and casualty policies. This distributes the risk beyond only the at-risk homeowners in the program. Recouping these assessments would take time, however, making the program reliant on issuing post-event bonds.
The federal government has also created its own programs. Most recently, the federal government has intervened in the terrorism insurance market. As mentioned above, reinsurance companies began excluding terrorism coverage in 2002 renewals. This prompted 45 states to allow primary insurers to exclude terrorism coverage in policies as they came up for renewal (Brown et al. 2004). Terrorism coverage, with a few exceptions, was not available and commentators warned of negative impacts on the economy. It was also argued that the federal government could be more effective at inter-temporal diversification required for terrorism risks and that the federal government had a hand in managing terrorism risk and thus should intervene in the market.

The federal government responded by passing the Terrorism Risk Insurance Act (TRIA) in the fall of 2002. It created a federal backstop for terrorism insurance for US property-casualty insurers. Under the Act, the federal government covers certain declared terrorism losses for insurance companies above a deductible and up to a limit (the insurance companies also have a co-insurance amount). The firms pay nothing up front, but the government has the option to recoup costs ex-post with a surcharge on commercial insurance policies that cannot exceed 3%. The act was intended to be temporary, with the thought that the private market would recover but it was extended in 2005 and again in 2007. It is now set to expire in 2014.

The legislation mandated that firms make terrorism coverage available and shared that risk with them. This did lead to more supply after its passage. And there is some indication that many insurers would not offer terrorism coverage if TRIA were not in place. Cummings (2006) notes that in 2004, 90% of insurers wrote coverage that was covered by TRIA, but only 40% wrote coverage for terrorism acts that TRIA did not reinsure. This law did not cap prices, however, and many companies appear to have gone without terrorism coverage rather than pay high prices. That said, premiums for terrorism coverage have fallen and demand for primary terrorism coverage has increased substantially since TRIA’s passage (CBO 2007). Take-up for terrorism insurance was 27% in 2003 but had grown to 61% in 2009 (Marsh 2010). This is despite the fact that the 2005 extension increased the deductibles and co-insurance born by primary insurers. While purchase of reinsurance by primary insurance companies has increased, it is only a quarter of primary insurers’ deductible under TRIA and thus still quite limited (CBO 2007).

The question of when and how governments should intervene in insurance markets is a difficult one. If the price increases and declines in availability of insurance post-disaster are influenced largely by a negative shock to capital, the market should re-equitlibrate after a short period of time as capital is restored. Government intervention, however, can be more lasting than initially intended, and in these cases may be counter-productive. Recent events, however, have led insurance companies to rethink the insurability of some catastrophic lines, such as terrorism and hurricane coverage, sending prices upward and quantities available downward. Governments often see their role as maintaining both availability

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12 Other countries have intervened in the terrorism insurance market. France, for instance, developed a terrorism insurance pool with a state guarantee after 9/11. French law from the mid-1980s made coverage for terrorism risks mandatory and as such, the government had to intervene when the reinsurance market collapsed after the attacks. Britain already had a pooling scheme with a government backstop developed after terrorism incidents in London in the early 1990s.
and affordability of insurance coverage. As we have seen, however, catastrophe risks are expensive to insure. Often government intervention in the name of affordability simply transfers the costs to others. The overall question of who should cover the costs of catastrophic events is a big one worthy of more public discussion and quite beyond the scope of this chapter.

4. Conclusion

The insurance industry and the modeling companies that support it often have some of the best evaluations of risk available. Even in the absence of full information about a risk, such as when risks are unknown, uncertain, or evolving over time, (re)insurance companies will often still offer coverage. While done at a price insurance companies feel can justify assumption of the risk, this provides needed risk management for many homeowners and firms. For these unknown and changing loss distributions, however, extreme events can provide new information on the nature of the peril. When this occurs, insurance firms will re-evaluate their pricing, exposure, underwriting policies, and capital management. Severe events that lead to this type of risk updating, however, also often lead to updating on the part of consumers and governments. This chapter has traced how all three sectors may respond when they assess a risk as higher than they did previously. This may simply lead to temporary adjustments, or can cause new equilibrium conditions in the market or permanent government interventions.
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