Coastal Property Insurance: The Carolinas

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The Carolinas are home to almost 500 miles of shoreline. From the birth of aviation in the Outer Banks, to the historic low country of Charleston – the Carolina coast is hallowed ground to many. Living in these coastal areas has many advantages, but entails the risk of property damage from catastrophic storms which cause wind and flood damage. Tropical windstorms have cost coastal Carolina residents billions of dollars, with threats to increase each year between the beginning of June and the end of November (Lehrer, 2008). With the increase in storm frequency over the past decade, the damage from storms has become much costlier for coastal communities.

Coastal property residents face major exposures of flood and wind damage. The peril of flood can be insured through the United States government. In 1968 Congress created the National Flood Insurance Program (NFIP) which offers flood insurance to coastal residents (Pompe & Rinehart, 2008). The peril of wind is addressed by individual states. Many states have created coastal property residual markets which offer coastal residents wind coverage. These markets were created as "markets of last resort" for coastal residents that are unable to find coverage in the standard and surplus lines markets.

North Carolina and South Carolina parallel each other in terms of geography, demographics and insured values, but they have significant differences in the management of their coastal insurance markets. This paper summarizes the solutions of the coastal property insurance markets in the Carolinas, while anticipating the future of these markets. Even though

the focus of this paper will only speak of the Carolinas, the summary of this paper could be applicable to other states. While there is no perfect way to eliminate the risks of coastal property loss through insurance, the future of these markets has a great effect on coastal property residents.

The Carolinas

The North Carolina coastline stretches 301 miles along the Atlantic Ocean. To ensure the economic welfare of these coastal and beach areas, the North Carolina General Assembly created the North Carolina Insurance Underwriting Association (NCIUA) in 1969. This association operates the North Carolina Coastal Property Insurance Pool, but many refer to it as the Beach Plan. For the purpose of this paper, the North Carolina Coastal Property Insurance Pool and the North Carolina Beach Plan will be used interchangeably.

The South Carolina coastline is almost half the distance of North Carolinas, spanning 187 miles along the Atlantic Ocean. To ensure the availability of essential property insurance coverage, the South Carolina General Assembly created the South Carolina Wind and Hail Underwriting Association (SCWHUA) in 1971. Although the official name is the South Carolina Wind and Hail Underwriting Association, most refer to it as the Wind Pool.

In both North and South Carolina, these associations are known as residual markets. They have been set up by law with the intention of being a "market of last resort" for insuring consumers against wind and hail losses. Table 1 shows the coverages offered by each states respective residual market.

Table 1: Primary Residential Wind & Hail Coastal Property Coverage: North Carolina & South Carolina

	North Carolina	***South Carolina***
Policy Offered	Wind & Hail	Wind & Hail
Deductibles	2% with $1,000 minimum (except Bald Head Island)	Zone 1 - 3% with $1,000 minimum
	Bald Head Island - 5% with $1,000 minimum	Zone 2 - 2% with $500 minimum
Insuring Amount	$750,000	$1,300,000
Actual Cash Value	Yes	Yes
Replacement Cost	Endorsement available. Up to 40% building limit	Endorsement available
		100% of dwelling must be insured

Sources: NCJUA/NCIUA, SCWHUA

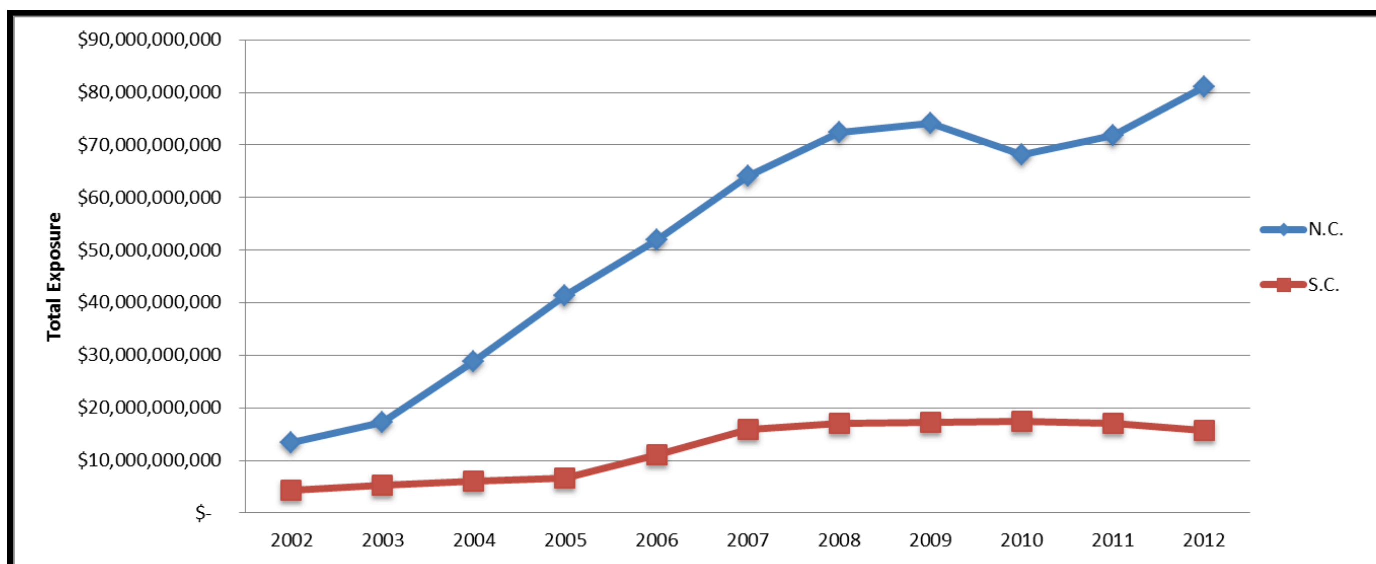
Table 2: Total Exposure and Policy Count: North Carolina Coastal Property Insurance Pool and South Carolina Wind and Hail Underwriting Association

	North Carolina		South Carolina	
Year	Total Exposure	Policy Count	Total Exposure	Policy Count
2002	13,352,737,436	58,084	4,393,999,000	17,849
2003	17,293,594,286	69,877	5,328,556,000	19,751
2004	28,905,006,918	87,760	6,002,519,000	20,519
2005	41,304,716,800	116,758	6,576,213,000	20,840
2006	52,011,170,240	132,626	11,179,098,000	28,607
2007	64,056,581,691	154,818	15,845,945,000	39,555
2008	72,454,379,274	174,247	17,033,649,000	45,214
2009	74,041,498,841	175,095	17,218,614,000	45,885
2010	68,127,909,310	180,403	17,444,426,000	47,054
2011	71,747,092,278	189,140	17,149,152,000	47,083
2012	81,003,748,464	215,039	15,727,549,000	44,274

Error! Not a valid link. *Sources: NCIUA/SCWHUA*

Table 2 displays the total exposure for both the North Carolinas Coastal Property Insurance Pool and the South Carolina Wind and Hail Underwriting Association. There is a staggering difference in the amount of exposure that each plan holds. North Carolina carries over 5 times the amount of exposure, and 4.8 times the amount of policies than South Carolina had in 2012.

Chart 1: Total Exposure Growth: North Carolina Coastal Property Insurance Pool and South Carolina Wind and Hail Underwriting Association



Sources: NCIUA/SCWHUA

Chart 1 illustrates the total exposure growth of the North Carolinas Coastal Property Insurance Pool and the South Carolina Wind and Hail Underwriting Association over the past ten years. South Carolina's Wind Pool has seen total exposure almost quadruple (358%) from 2002 ($4,393,999,000) to 2012 ($15,727,549,000). North Carolinas' Coastal Property Insurance Pool has not only quadrupled, but sextupled (606%) from 2002 ($13,352,737,436) to 2012 ($81,003,748,464).

Reform & Future

Coastal residents of the Carolinas will continually struggle in obtaining insurance for their coastal property. It is nearly impossible to please both the insured, who want low rates and appropriate coverage, and the insurers who want to charge rates adequate to the inherent risk. The changes over the years in North and South Carolina's residual markets have originated from demands of both the insured and insurers. Although North Carolina and South Carolina residents share this similarity, their regulatory environments and residual markets are quite different. The following will examine the major differences and reforms needed.

The major difference found in North and South Carolina begins with the rate approval system used in each state. South Carolina's regulatory environment once used to mirror North Carolina's. When South Carolina moved to a file and use system, they gave rate flexibility to insurers which allowed them to stay competitive in the coastal property market. North Carolina's coastal property market is much less competitive, which can be attributed to their use of a prior approval rate system. For the North Carolina Beach Plan, rate change requests must first gain approval from the North Carolina Rate Bureau before the Insurance Commissioner can accept the Beach Plans rate request. The North Carolina Insurance Commissioner has the final power to approve or reject rate requests sent from the Rate Bureau. The extra time required for rate change approval, hinders the market to stay current of changing market conditions (Marlett, 2009).

In addition to the time consuming process, many requests to increase rates have been denied over the years. The North Carolina Insurance Commissioner is elected every four years by North Carolina residents which keeps a lingering pressure to keep rates low. The Insurance

Commissioner in South Carolina does not face this pressure, as they are not elected but appointed by South Carolina's governor. This allows the Insurance Commissioner to approve rates un-biasedly and fairly equally assess the interests of both the insured and insurers.

There is dire need for reform in the North Carolina Beach Plan. Current North Carolina Insurance Commissioner Wayne Goodwin admits "North Carolina's Beach Plan is a Ticking Time Bomb." The reforms needed would require efforts that would fundamentally change North Carolina's Beach Plan structure. In regards to the Beach Plan, Mr. Goodwin suggests a continuous rise of rates that will be gradual and "painless" for consumers. Once rates reach a level where private insurers can compete with the North Carolina Beach Plan, more companies will enter the North Carolina coastal property market– reducing the Beach Plan's total exposure (Lehrer, 2008).

The method(s) that each state finances their exposure to loss is another area of concern. A typical loss financing arrangement consists of three methods: reserved funds, reinsurance, and the ability to issue post-loss assessments to member companies (Marlett, 2009). While there is an obvious need for loss financing, the method used has the ability to affect homeowners and the stability of the states residual market. In 2011 the North Carolina Coastal Property Insurance Pool spend almost $209 million (68.75%) of the $304 million in premiums earned on reinsurance. Reinsurance is an effective way to minimize insurer's liability, but is costly and can only be utilized in catastrophic losses. Hurricane Irene hit the North Carolina coast in 2011 and the North Carolina Coastal Property Insurance Pool experienced almost $200 million in losses. At the time of Hurricane Irene, the reinsurance purchased by the Coastal Property Insurance Pool

was useless unless the “catastrophic” loss total reached an inordinately high amount of $1.3 billion.

In North Carolina the Coastal Property Insurance Pool has calculated an approximate 3% possibility that a storm with losses of $4 billion will hit the North Carolina coast. Gina Schwitzgebel, General Manager of North Carolina’s Coastal Property Insurance Pool, released this information in February of 2012 (Kelly, 2012). The surplus funds along with assessments charged to companies ($1 billion) would not total the $4 billion that the North Carolina Coastal Property Insurance Pool refers to as “the Big One.” To cover the difference, the North Carolina Coastal Property Insurance Pool purchases reinsurance. As of February in 2012, the North Carolina Coastal Property Insurance Pool was paying $209 million of the $304 million (roughly 68.75%) in total premiums earned in 2011 on reinsurance. Considering the tremendous costs of reinsurance to prepare for a 3% chance of loss, reinsurance might not be the best solution to financing losses of the North Carolina’s Coastal Property Insurance Pool.

Like North Carolina, South Carolina primarily uses reinsurance to fund catastrophic loss financing. South Carolina actually uses 100% reinsurance to finance losses and does not maintain a large surplus like North Carolina.

North Carolina and South Carolina should diversify their loss financing methods since both heavily rely, or completely rely on the use of reinsurance for catastrophic losses. All residual markets should diversify loss financing methods between not only reinsurance but to catastrophe bond and Tax-free bonding. By purchasing reinsurance to cover potential catastrophic losses, residual markets manage annual funds on a “what if the worst storm possible happens” scenario (Kelly, 2012). Many states such as California, Texas, Louisiana and Florida

use Tax-free bonding as a tool to manage potential catastrophic losses while reducing their dependency on costly reinsurance. Currently the use of Tax-free bonding has not been approved by state governments in either North or South Carolina. The state governments of the Carolina's should immediately pass legislation to allow the use of Tax-free bonding. For North Carolina, using Tax-free bonding would allow their surplus to grow, creating a sounder financial stability and further suppressing the risk of member companies obligation to pay up to $1 billion in assessments.

The use of catastrophe bonds would be another effective way for the Carolina's to diversify potential catastrophic loss financing. Catastrophe bonds, also known as cat bonds are risk-linked securities that transfer specific risk (major storm catastrophes) to investors. Catastrophe bonds were first used in the mid-1990s in the catastrophic effect of Hurricane Andrew. These bonds would finance damages not covered by premiums through the returns of premiums received by the sale of the bonds. All coastal property insurance residual markets should look at adding the use of Catastrophe bonds as a loss financing tool.

The final change that could prove beneficial for the Carolina's would be the creation of a multi-state wind pool. The effect on North and South Carolina by creating a joint wind pool would greatly reduce operating expenses and potentially reduce reinsurance costs. Through email correspondence with the author, the Chief Financial Officer from South Carolina's Wind Pool, Rick Amick commented: "Each state has its own culture, its own coastal risk profile, and its own set of political issues….(each states wind pool) has such different operating philosophies that it would be very difficult to agree on a common approach." While there would be obvious

advantages to creating a joint wind pool in the Carolina's, the probability of both states being able to agree on these issues is quite low.

Upon analyzing the residual markets for coastal property insurance in both North and South Carolina, there is an obvious deficiency in the North Carolina Coastal Property Insurance Pool relative to the South Carolina Wind pool. The deficiency in the North Carolina Coastal Property Insurance Pool is predominately attributed to their rate inadequacies, which they have minimal control over. The structure of the rate approval system in North Carolina is flawed by political pressures which the approval process the North Carolina Beach Plan has to comply with. The North Carolina Beach Plan can only take minimal fault for the plans inefficiency because it offers good coverage for a large coastal area.

Aside from better diversification in loss financing methods that would benefit the North Carolina Coastal Property Insurance Pool and the South Carolina Wind Pool, South Carolina functions as a superior residual market. The South Carolina property insurance market is currently balanced so competitively that they are losing business to standard and surplus line markets, which proves they are operating properly. The South Carolina Wind Pool effectively meets its mission of stabilizing the South Carolina coastal property insurance market by meeting coastal resident's needs as a true "market of last resort."

The North Carolina Coastal Property Insurance Pool has moved from its purpose to be a "market of last resort" to a "market of choice" for coastal property insurance. The rate approval system used in North Carolina is to blame for the North Carolina Coastal Property Insurance Pool becoming a "market of choice." Until conditions result in a state-wide assessment of policies, the North Carolina surplus lines market will not see an opportunity for growth because

the current rates charged in the North Carolina are inadequate considering the high-risk of coastal property. Unless there is a dramatic change in the process the North Carolina Coastal Property Insurance Pool has to go through to get rate increases approved, they will continue to be a "market of choice" for coastal property insurance.

Insuring residential property along the coast is certainly a challenging task. Many insured's, politicians, newspaper reporters, and real estate agents will always be discontent with a states coastal property residual market. The balance of looking after the insured and insurers best interest, equally, is critical for every states coastal property residual market. The effect of rate subsidized premiums and financial liability derived from catastrophic storm losses in a states coastal property residual market makes this a pressing issue for the insurance industry's foreseeable future.

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