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Homeowners Insurance

AFTER THE STORM: Post Sandy, regulators in New York and New Jersey ordered insurers not to invoke hurricane deductibles. These Rockaway, New York homes were among many damaged.

Photo courtesy of FEMA

Changing the Rules

Insurance regulators are altering policy terms when major catastrophes strike.

by Joshua P. Broudy and Alexander G. Henlin

By necessity, property insurers have developed extensive expertise in underwriting and adjusting catastrophe claims. California earthquakes, named storms on the coasts, even terror risks—and all of their associated direct loss, time element loss and ensuing loss components—are examples of events that the industry is equipped to address.

Almost inevitably, however, a major loss event will trigger a political response. In the past, insurance commissioners and public officials have tended to shine a light on insurers that do not adjust claims swiftly. Recently, however, state regulators and governmental authorities have begun to inject themselves into the adjustment process as a loss is unfolding, changing the rules of the game while carriers are actively attempting to quantify their liabilities and pay policyholders the amounts they are due pursuant to their contracts of insurance.

Pre-emptive executive announcements, emergency regulations and swift political action in the immediate aftermath of a loss-causing event have caused new uncertainty in the adjustment process. That said, there are steps that both underwriters and claims professionals can take to mitigate the likelihood that these pronouncements will adversely affect how property carriers approach and adjust catastrophe claims.

Two California losses illustrate the traditional role that regulators have adopted toward property insurers.

Key Points

▶ **Things Change:** Major catastrophes used to cause regulators to only make examples of slow-to-pay insurers.

▶ **Shaken and Stirred:** Now regulators inject themselves into the cat-claims adjustment process while carriers are trying to settle with customers.

▶ **World of Tomorrow:** Insurers must do protective underwriting to guard against proactive regulators that alter policy conditions.

The Oakland Firestorm

On Oct. 20, 1991, a small grass fire started on a hillside above Oakland, California. Winds up to 65 miles an hour quickly whipped the fire into a conflagration that overwhelmed firefighting efforts. The firestorm began to generate its own winds, which caused it to spread rapidly.

By the time the fire had been brought under control, it had killed 25 people and injured 150. The fire blackened 1,520 acres, destroying 3,354 houses and 437 apartments. Losses amounted to about $1.7 billion. At the time, the disaster was the costliest and deadliest in California since the San Francisco earthquake of 1906.

One of the issues that arose out of the fire was that homeowners often lacked funds to rebuild.

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Older properties tended to be significantly underinsured, both because the properties had appreciated considerably in value since they were purchased and because the coverage had been written only to pay off the balance of the mortgage loan, not to replace the lost dwelling or personal property. Exacerbating the problem was that Bay Area contractors raised their fees in the aftermath of the fire, some by as much as 400%.

Well after the losses had occurred, the California Department of Insurance, the state's insurance regulator, played its traditional role and responded to perceived delays in adjusting losses. It initiated inquiries and pursued various remedies against insurers that failed to make prompt replacement-cost offers to affected policyholders. In what was the largest fine of its kind at the time, Allstate ultimately paid $1 million following the conclusion of the California insurance commissioner's investigations.

The Northridge Earthquake

Three years later, on Jan. 17, 1994, the Northridge earthquake struck Southern California. The magnitude-6.7 quake began at 4:31 a.m. and lasted 20 seconds. The quake was centered in the San Fernando Valley, about 20 miles northwest of downtown Los Angeles. Ground motion was felt 220 miles away in Las Vegas.

Two major aftershocks, each with a magnitude of 6.0, struck within 12 hours of the quake. The temblor left 61 dead and more than 5,000 injured, and caused about $44 billion in property damage, $15.3 billion of it insured losses (in 1994 dollars), according to the Insurance Information Institute.

Property insurance covered about one-third of the costs of the Northridge earthquake. In 1985, California mandated that homeowners insurers provide earthquake coverage. As a result, at the time of the Northridge earthquake, about 1 in 3 California homes had coverage.

Northridge resulted in unprecedented losses for the property insurance industry. As a result, many insurers simply withdrew from the California market. While the subsequent creation of the California Earthquake Authority helped to stem the loss of earthquake coverage for residential properties, the resulting higher premiums caused many homeowners to forgo coverage entirely. Today, only about 1 in 9 California homes are covered by earthquake insurance.

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To cope with the losses from Northridge, those property insurers that remained in the market tended to raise premiums and also impose earthquake deductibles. Today, the California Department of Insurance recognizes that those deductibles typically range from 10% to 15% of the insured property's value.

The adoption of earthquake deductibles was not driven by any regulatory impetus. Rather, it was driven by the industry itself. The regulator's role was limited to approving policy forms that featured the new deductibles.

Hurricane Sandy

More recently, the property insurance industry had to respond to Hurricane Sandy, which made its way up the East Coast in late October 2012. The storm caused approximately $18.7 billion in insured losses, and it occasioned significant political reaction and emergency measures, particularly in New York and New Jersey. This marked a change from prior practice. In the immediate aftermath of the storm, regulators directed significant attention to a highly political issue: hurricane deductibles. Like earthquake deductibles, hurricane deductibles tend not to be limited to a fixed dollar amount, but instead are a percentage (usually between 1% and 10%) of the insured property's value. They came into widespread use following Hurricane Andrew in 1992, which caused $15.5 billion in insured property damage, as insurers looked for strategies to better manage catastrophic risks.

They are currently in use in 20 states, including Connecticut, Florida, Massachusetts, New Jersey, New York, Rhode Island and Texas.

With Sandy, the National Weather Service reclassified the storm from a Category 1 hurricane to a "post-tropical cyclone" shortly before it made landfall in New Jersey. Based on that reclassification, regulators in both New York and New Jersey quickly issued orders that barred carriers from invoking hurricane deductibles.

But regulators and governments went further. In New Jersey, Gov. Chris Christie issued Executive Order 107 on Nov. 2, 2012. The order warned carriers to "exercise appropriate forbearances on collection, cancellation, documentation and other regulatory requirements," including notices of hospital admissions, claim-filing deadlines, policy premium payments and cancellation procedures.

In New York, the Department of Financial Services issued a complete moratorium on policy cancellations across New York City, Long Island and several other downstate counties for 30 days. The order was extended six times before finally being allowed to expire at the end of February 2013.

In addition, the state required carriers to send adjusters to assess property damage within six days (instead of the usual 15); issued temporary licenses on an expedited basis to out-of-state public adjusters; and created a "report card" system that graded insurers on their timeliness in responding to policyholders' claims.

Coming Attractions?

New York's Department of Financial Services has explicitly advised property carriers that they can expect to see more action along the lines of what was taken in the aftermath of Sandy when the next significant loss-causing event occurs. The DFS's *Insurance Circular Letter No. 8*, dated Oct. 28, 2013, advised that New York regulators may in the future:

- Impose a moratorium on policy cancellations of up to six months.
- Expect carriers to make "reasonable accommodations" for policyholders that experience difficulty making timely premium payments.
- Expect carriers to process and adjust claims quickly, allow insureds to make immediate and necessary repairs and accept a wider variety of documents as proof of loss.
- Take steps to expedite the temporary licensing of out-of-state independent and public adjusters.
- Impose claims-data reporting requirements on carriers for the purpose of creating and posting online "report cards" about individual carriers' claims-adjustment processes.
- Create and implement a mandatory mediation process to resolve contested claims.

New York's authorities have stated that the above list is not exhaustive. That it has been issued at all, however, suggests that increased regulatory activity could become the "new normal" in the wake of a significant claim event.

What is troublesome for carriers is that the effective revision of policy terms by regulation, made after the policies have been underwritten and issued, raises the specter of policyholders receiving more than was contemplated in the original bargain, which the carrier did not take into account when evaluating the risk and pricing the policy.

Risk Mitigation Strategies

As regulators have shifted from reacting to perceived delays in adjusting claims and approving industry proposals to proactively suspending policy terms and modifying their conditions, property underwriters and claims professionals alike may be justifiably concerned about regulators issuing directives in the midst of a loss event. As part of their own planning strategies for addressing the uncertainty of actions by insurance regulators, property carriers can:

- Carefully review the terms and conditions of their policies. Insurance policies are contracts. If the insuring agreements precisely specify what is covered, and what is not, actions by regulators may have little practical effect.
- Ensure that existing policies accurately state what is covered, and what is not. It is desirable to minimize the number of endorsements or blanks in a particular insurance policy, to reduce the likelihood that the policy could be deemed ambiguous.
- Keep reinsurers apprised of the risks being written, and where they are located.

Ceding carriers, particularly, should be aware of the risks they are writing, and should communicate that information to their reinsurers even as they try to ensure that all reinsurance is back-to-back with their policies.

- Prepare to report on claims-adjustment efforts to regulators. Developing internal protocols to measure and report compliance with loss-adjustment deadlines and payment goals could be useful for future "report card" grades. Having plans at the ready for accepting alternative loss documentation and flags for claims in areas affected by emergency regulations would also be helpful.
- Push back against unreasonable proposals and regulations. Industry groups can be particularly helpful in this effort.

These points have particular salience given likely future loss scenarios, such as the long-feared "Big One"—a major California earthquake. To offer an example: Northern California has been bracing for a magnitude-7.0-plus earthquake for decades. The U.S. Geological Survey has stated that there is a 63% chance of one or more earthquakes of magnitude 6.7 or greater striking the Bay Area before 2040.

Just this summer, the *Bulletin of the Seismological Society of America* reported on the possibility that Northern California could experience clusters of large, damaging earthquakes, with events of magnitudes 6.8 to 7.2 occurring every five years. Studies undertaken by the city of San Francisco estimate that a magnitude-7.2 quake along the northern section of the San Andreas Fault could kill up to 300, injure an additional 7,000, and cause up to $30 billion in property damage.

These questions take on new importance in light of the Napa quake on Aug. 24, 2014, where a magnitude-6.0 event in a primarily agricultural area caused an estimated $2 billion in overall economic losses, which included damage to property, infrastructure and wineries. In the city of Napa alone, at least 1,120 homes and other buildings were structurally damaged, according to a Sept. 9 report by Aon Benfield Analytics.

In any loss scenario, government authorities, businesses and individuals alike are all going to look to insurance to be part of their recovery plans. Anticipating whether and how the regulatory ecosystem may change can help carriers be prepared when natural disasters strike. BR