Critical Coverage Gap

Growing populations and rising property values, combined with an increase in high-severity catastrophes, are pushing the insurance protection gap to a critical level.

By Michelle Kerr

Disaster resiliency requires increased insurance penetration combined with widespread mitigation efforts.

Amid discussion of presidential Tweets and Hollywood harassment, catastrophes dominated much of the news cycles of late 2017.

It was a record-setting year. Irma was the longest-lived Category 5 storm in the past 50 years. Harvey set a new U.S. rainfall record for a tropical cyclone. October wildfires in California were the most damaging ever endured by the state. Globally, the overall tally for natural-disaster losses amounted to $330 billion, the second-highest figure on record — 60 percent of it uninsured.

Climate change, sea level rise, increasing global temperatures … these factors and more are increasingly impacting the frequency and intensity of catastrophe-level events. Growth in population and property values are exacerbating the severity of the losses.

"These events, if anything, are getting stronger and more frequent," said Patrick Daley, Head of Large Property for The Hartford. Even normalizing for increased property values, "any kind of bar chart you look at over the last 40 years or so, demonstrates that."

All of which makes the protection gap — the difference between total economic and insured losses — an area of great concern, in terms of the country's ability to rebound from disasters, both physically and economically.

"You need look no further than some of the events we saw in 2017 to see that when you have higher penetration rates for properties that are insured, the recovery is significantly faster," said Daley.

"That's a very big deal, and it's something we don't talk enough about in the industry, something we can bring to bear and should be talking more about."

The property insurance protection gap has risen steadily over the past 40 years. In the past decade, cumulative total damage to global property as a result of natural disaster events was $1.8 trillion. At least 70 percent of those losses were not covered, according a 2015 Swiss Re study titled "Underinsurance of Property Risks: Closing the Gap."

In the U.S., the problem is felt most acutely for special perils such as flood or earthquake coverage. In the event of a mega-earthquake along the San Andreas fault, experts warn that only 9 percent to 13 percent of properties carry earthquake coverage.

A dramatic example of the flood protection gap is still playing out in Texas. Less than 20 percent of homes in the Houston area were covered for flood when Harvey hit.

"I think most people figure, if something that big happens, either I'll walk away from my house and let the bank have it, or I'll take out a loan."

—Michael Korn, *managing principal and practice leader for property and marine, Integro Insurance Brokers*

Nationally, there are more than 29 million properties that are at moderate to high risk of flooding, but are not subject to mandatory flood coverage because they fall outside of Special Flood Hazard Areas, according to a CoreLogic analysis. More than five million of those properties are in Florida — more than half (54 percent) of the state's total properties. Texas and California each have three million properties at risk. Arizona is far smaller, but 68 percent of its properties are at risk, as well as 49 percent in Louisiana.

TROUBLE IN THE GAP

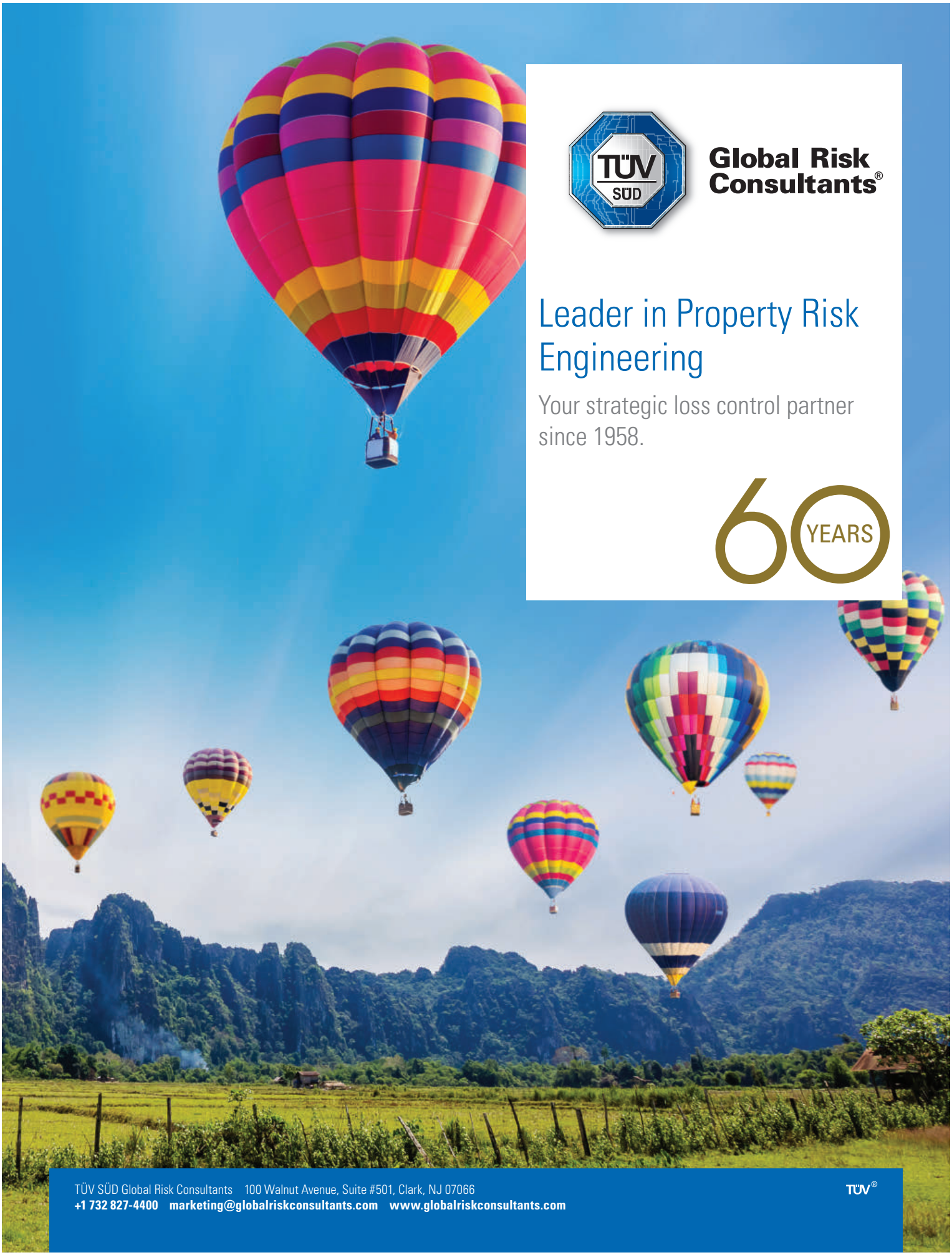
Some are tallying the combined losses of Harvey, Irma and Maria at up to $250 billion. Scientists are already predicting that the 2018 Atlantic hurricane season will be a repeat of 2017 — or worse.

California mega-quake losses are more speculative. For an 8.2 quake, some say a figure close to $300 billion isn't out of the realm of possibility.

"Two or three times what happened in Harvey is a likely outcome," said Tom Larsen, principal of industry solutions at CoreLogic. "It's tragic, it's big numbers, it will be very disruptive."

Modelers have shown how an 8.2 quake could cause a length of the San Andreas fault to rip open like a 300-mile-long zipper running from the Salton Sea to Paso Robles, displacing the earth by 30 feet in a matter of seconds. All of Southern California would be hit hard at the same time.

At particular risk is the Los Angeles basin, where millions live atop a surface of mostly gravel and sand. The U.S. has never suffered a quake of that magnitude so



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close to a major city. The loss of life would be devastating, and the physical destruction – most of it uninsured – overwhelming.

Historically, the rate of uninsured residential losses sits consistently around 70 percent for natural disasters. The commercial gap is less acute but still problematic.

The largest commercial property owners might be adequately insured for a catastrophic loss, especially if their lenders require it. In the event of quake damage, they'd also be better able to absorb the high deductible of an earthquake policy. But many small and medium sized businesses in high-risk regions roll the dice and take their chances without the coverage they need, or carry limits too low to facilitate recovery.

The government aid needed for public infrastructure rebuilding, aid to individuals and disaster loans to businesses is increasingly high. For the next extreme high-severity event, it's possible that supplemental appropriations by Congress could exceed the $43 billion spent in 2005 after Hurricanes Katrina, Wilma and Rita.

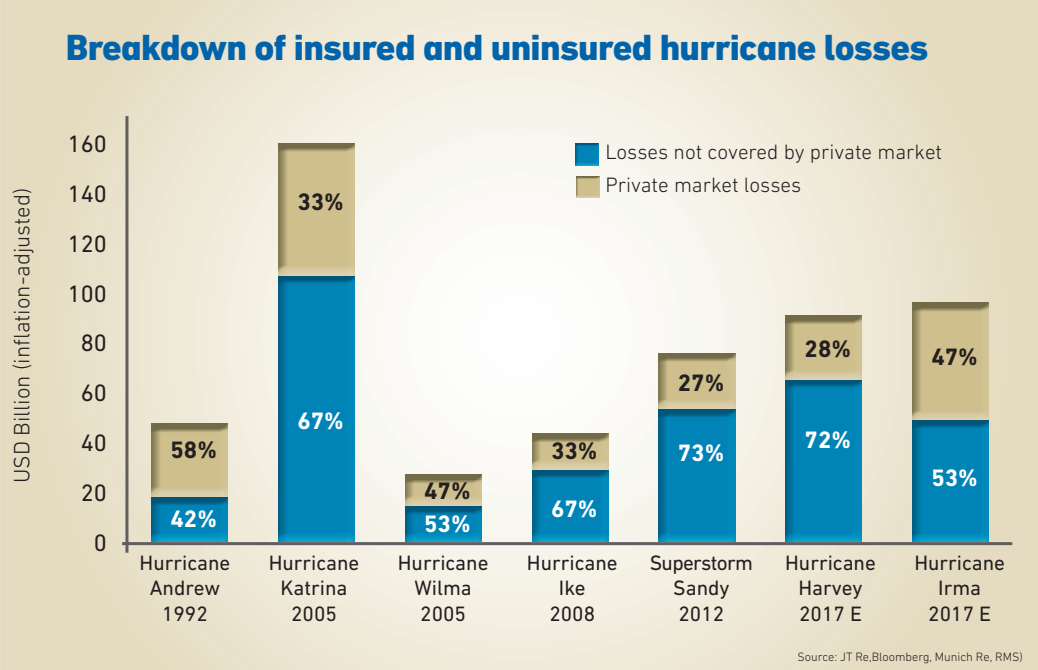
So if the government is footing the bill for infrastructure recovery, and insurers are paying claims for the comparative few who were adequately covered, what about the rest? Private loans might take up some of the slack. But with large portions of a region's population displaced – in some cases permanently – incentive to rebuild or repair could be low. Businesses able to physically rebound will still suffer the loss of customers and suppliers unable to do the same.

Rebuilding efforts, particularly for damaged infrastructure, will help offset job losses and spur growth. But the effect on residential and commercial construction will not be as robust as it might be in areas with higher insurance penetration.

The road back for an affected region is often slow, especially with high levels of uninsured losses. The rest of the country is impacted as well.

Consider the hypothetical 8.2 earthquake. California is the largest contributor (13.3 percent) to the U.S. economy, with $2.44 trillion in economic output. The state's agriculture sector alone is a $45.3 billion dollar industry that generates at least $100 billion in related economic activity. Prolonged disruption of that economy could ripple across numerous industries. There is no precedent for a catastrophic earthquake near a major business center.

Trade pipelines would suffer. Around about 20 percent of all U.S. imports come through the Port of Los Angeles, said Martha Bane, managing director, Property Practice, Gallagher. "The supply chain would be significantly impacted … you may not be located in Southern California, but that one part of that widget you're manufacturing may be here."



"These big events are starting to [spark] bigger discussions in Congress about how much money they can continue to set aside to pay for this."

—Tom Larsen, *principal of industry solutions at CoreLogic*

THE RIPPLE EFFECT

After Hurricane Harvey, $30 billion of securitized commercial mortgages landed on the watch list of analysts and investors worried about the risk of defaults. Of greatest concern were the properties uninsured for flood, as well as rental properties inadequately covered for business interruption or contingent business interruption losses.

That scenario would be magnified after a catastrophic earthquake, creating a destabilizing effect on financial markets.

The greatest threat to security markets "is not so much the damage but the uncertainty coming out of the damage," said economist Barbara Stewart at a Washington, D.C. forum titled "Economic Consequences of a Catastrophic Earthquake" held by the National Research Council Committee on Earthquake Engineering.

"If there is anything financial markets cannot stand, it is uncertainty. They can deal with good news, they can deal with bad news, but uncertainty is the worst."

That's especially true if it causes businesses and governments to postpone financing for critical projects for an indefinite length of time.

Said Stewart, "What is the cost of the things that are not done, the projects that are not built, the activities that are not undertaken?"

IN SEARCH OF SOLUTIONS

Increasing insurance penetration for perils like flood and earthquake will spread the risk and make coverage more affordable, but that's easier said than done.

The nonprofit California Earthquake Authority (CEA) has seen an uptick of interest in the past two years, and recently surpassed one million policies. But the state's population exceeds 37 million, most of whom live within 30 miles of an active fault, according to CEA.

For California homeowners, going without the coverage is simply the smarter financial move. "It's incredibly expensive," said Michael Korn, managing principal and practice leader

"Ultimately, society pays for it either way. So do we do it upfront in a fair and controlled manner? Or do we do it after the fact, when we have to open up the government coffers, and borrow money from the global financial marketplace?"

—Thompson Mackey, *risk management consultant, EPIC Insurance Brokers*