POLICY REPORT

North Carolina's Beach Plan: Who pays for Coastal Property Insurance?

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Executive Summary

North Carolina's little-known Beach Plan imposes an enormous fiscal liability on the state. Intended largely to provide windstorm insurance for coastal residents unable to find coverage elsewhere, the Plan has grown to become one of the nation's largest entities of its type.

By its own accounting, the plan does not have the capacity to survive a once-in-six-years storm without imposing significant taxes (called assessments) on North Carolina residents and businesses. One study from an independent actuarial firm shows that North Carolina could face liabilities of up to \$6.2 billion from the plan – a figure that's almost certainly low. In recent years, the Beach Plan has grown at a rate of roughly \$1 billion a month, growth that shows no sign of stopping.

The Beach Plan's growth stems from deliberate public policy decisions rather than North Carolina's physical environment. By nearly all accounts, neighboring Virginia faces a greater economic risk from hurricanes than does North Carolina, but that state's equivalent plan imposes essentially no burden on the state or its taxpayers.

The risk of special taxes – assessments – from the plan could result in higher insurance costs for nearly all North Carolina residents, lead to a massive withdrawal of insurance companies from the North Carolina market, and cause fiscal turmoil throughout the state. One major company, Farmers, already has withdrawn from the North Carolina market because of the Beach Plan's liabilities, and others may follow.

The Beach Plan needs change, and, fortunately for the state, insurance commissioner-elect Wayne Goodwin seems committed to reform. A credible plan for change would consist of effort –mostly undertaken by the Commissioner and Beach Plan Board – to stop the Beach Plan's growth and stabilize it. Following these stabilization efforts, the legislature, commissioner, and board would do best to consider comprehensive reforms that would return the Beach Plan to its intended place as a true market of last resort for people who cannot find insurance anywhere else.

Stabilization would involve several steps:

- **Raise Beach Plan Deductibles to Stop it From Competing with the Private Sector:** Current Beach Plan policies provide coverage that's more attractive than private sector coverage. To reduce its size and liabilities, the Beach Plan should offer only policies with 2 percent (or greater) deductibles.
- **Encourage Private Insurers to Write More Coverage Outside of the Beach Plan:** Current North Carolina policy reduces or eliminates special taxes imposed on insurers when they write a "fair share" of coverage in hurricane-prone areas. Flaws in the structure for doing this, however, make it unattractive for insurers actually to write additional coverage. Rather than imposing a significant delay – up to two years – in granting these tax reductions, the state should offer them immediately.
- **Shore up the Beach Plan's Tax-Exempt Status:** Unlike private companies, the Beach Plan currently keeps its reserves tax free even though current IRS standards indicate that it can't. This leads to great uncertainty and risk. The Plan should ask the IRS for clarification on the treatment of its reserves, and – if it receives an unfavorable response – consider structural changes that would allow them to remain tax free.
- **Raise Rates Painlessly:** Modest increases in coastal insurance rates would likely serve to move people out of the Beach Plan and could actually cut premiums for some of those currently in the Beach Plan. Because of the way insurers offer discounts and because of limitations of the Beach Plan's own coverage, higher private market rates might actually make it possible for some current Beach Plan customers to find better, less expensive coverage.

Actual reform would take more work, and, in the medium term, the legislature and Beach Plan board might consider several steps.

- **Merge the Beach Plan into the Rate Bureau Organization**: North Carolina's Rate Bureau Organization (which provides a variety of services for the state's insurance industry) does some of the same things as the Beach Plan. Merging the Beach Plan and Rate Bureau could save administrative costs and improve management.

- **Implement a "Turndown" Requirement for People Wanting to Take Part in the Beach Plan:** Rather than letting anybody in the Beach Plan's service area purchase a policy through it, the state should open the Beach Plan only to those who cannot find coverage in the private market at any price.

- **Improve Building Standards Through Stronger Codes and Higher Rates:** North Carolina should strengthen building codes to encourage storm resistance, and, simultaneously, the commissioner should give insurers broad authority to charge higher rates to people who do not take sufficient steps to reinforce their homes against storms.

- **Transition to Overall Higher Coastal Rates Using Tax Credits:** Many coastal North Carolina residents do not pay sufficiently high rates. In the long run, they must pay more for insurance while many of those inland should pay less. To facilitate the transition, the state should offer tax credits modeled on those that exist in South Carolina. Tax credits should be offered to help people of modest means who currently own homes to remain in their homes. They should not serve to facilitate future development or even those who move in.

North Carolina's Beach plan has exceeded its mandate and endangers the state's fiscal future. Fixing it will take hard work but should not cause significant pain to the people of North Carolina. Commissioner-elect Goodwin and the legislature should go about improving the Beach Plan as soon as possible.

Fixing the North Carolina Beach Plan

"North Carolina's Beach Plan is a Ticking Time Bomb."
-Insurance Commissioner-Elect Wayne Goodwin

Each year, between the beginning of June and the end of November, massive tropical windstorms threaten the North Carolina coast. When they hit, North Carolina taxpayers may end up paying billions of dollars to rebuild underinsured private homes and businesses. Taxpayers bear this risk because of an obscure, little-known entity called the North Carolina Insurance Underwriting Association or, colloquially, the Beach Plan.[1]

This paper describes the Beach Plan and makes a case for reforming it. The paper consists of three sections: The first describes the workings of the Beach Plan and its consequences for the state, the second outlines proposals to stabilize the Beach Plan, and the third focuses on the ways in which the state might work to reform the plan, reduce its risks, and provide fairer insurance rates to most North Carolina residents.

The paper reaches a simple bottom line: the Beach Plan needs to become a true "provider of last resort" that sells insurance only to those residents truly unable to find private, admitted market insurance anywhere else.[2] It should not serve as a way of subsidizing insurance for coastal dwellers. On the other hand, the need for an orderly and serviceable transition does mean that certain practical considerations must enter into the debate: the *de facto* mandate that coastal residents purchase property insurance will make some sort of government-supported mechanism a necessity in the short term. In the long term, however, North Carolina will be safest, most secure, and most prosperous if it lets the free market work.

About the Beach Plan

North Carolina's Beach Plan serves to write homeowners' and "wind only" coverage. It is part private/part public and has expanded at a rapid rate.

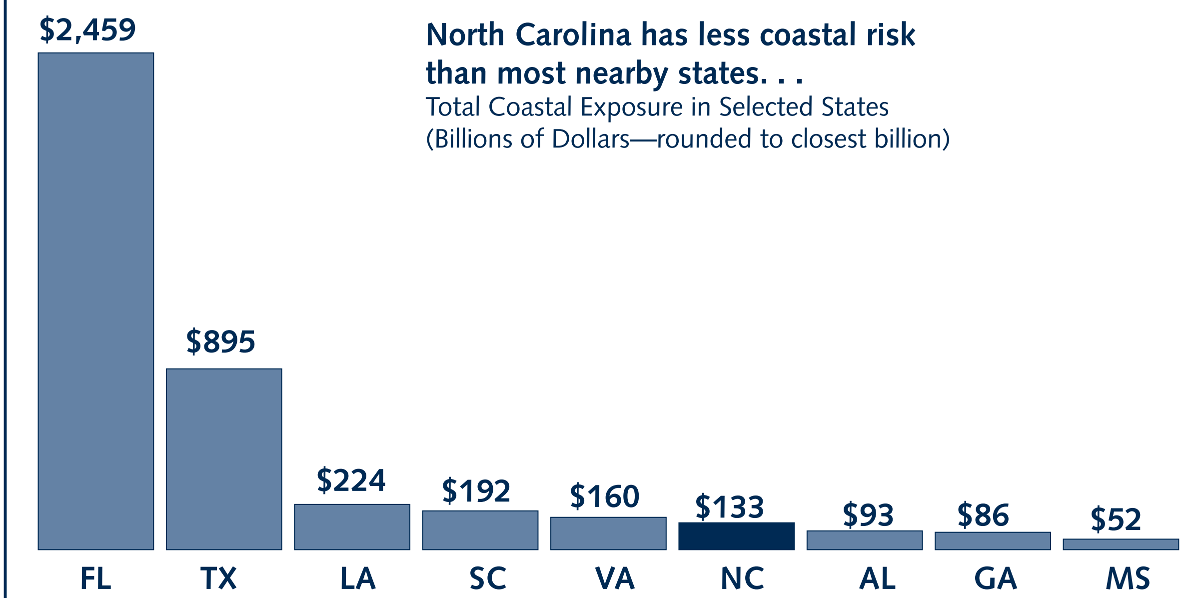
The Beach Plan has a mix of private and public characteristics; the interplay of these characteristics has significant consequences for the plan and the state. The Plan's own website describes its status: "The Beach Plan is not a facility of the North Carolina State Government, but its operation is subject to review by the North Carolina Commissioner of Insurance."

In many ways, the Beach Plan operates like a private insurance company. The insurance industry – broadly – controls the board and calls the shots as to the Beach Plan's operations. It uses standard forms from the Insurance Services Office for establishing its policies, uses a .org rather than .gov domain name for its web page, pays commissions to insurance agents, sends out claims adjusters, and bills its customers.[3] It doesn't have to obey state purchasing and hiring rules and has provided profits for purely private purposes (more on that below). The Beach Plan board consists of seven representatives from the insurance industry, four insurance agents, and three members of the general public (all of them residents of coastal areas.) While the Beach Plan does not attempt to attract new business through advertising or marketing, it explicitly underprices private companies at times and thus competes with them.[4] In all these respects, the plan appears private.

(See Chart 1 on page 6)

On the other hand, many aspects of the Beach Plan's operation make it resemble a governmental entity. To begin with, every insurance company that does business in North Carolina's admitted insurance market (the market where almost all individuals buy their policies) must take part in the Beach Plan.[5] The state's elected insurance commissioner, furthermore, oversees its operations at all times and comments on it. The Beach Plan has the power to assess – tax – every insurance company

Chart I



Source: AIR Worldwide.

in the state when it cannot cover a loss based on its own reserves and reinsurance. Unlike a private business, the Beach Plan does business in only 18 coastal counties and cannot write policies to people in other parts of the state. Although not subject to Freedom of Information Laws, furthermore, the Beach Plan operates more openly than most non-public companies: its revenues and business model are all matters of public record. Unique among the nation's residual insurance markets that aren't explicitly government-run, the Beach Plan holds surplus without paying taxes on it – something no private company could do (more on this below). In addition, the plan's coverage has certain limits: the Beach Plan homeowners' policy does not include liability coverage for things like accidents that befall visitors to an individuals' house (most modern homeowners' insurance does), and, of course, the "wind only" coverage that makes up most of the Beach Plan's business is a product that very few private companies sell.

In recent years, the plan has grown at a significant rate. In 2004, the Beach Plan collected $99 million in premiums; today, it collects $269 million. And, as its revenues have climbed, so have its liabilities.[6] In 2004, its 100-year Probable Maximum Loss (PML) stood at $1.8 billion; today, the 100-year PML stands at $3.8 billion. To back this, the plan has a maximum of $1.5 billion in capacity – only $500 million of which is cash. (Because reinsurance is structured in layers which pay out only after the Beach Plan spends a certain amount of its own money however, it also would have to use up all of its reserves and, simultaneously, assess policies to provide reinsurance.)

(See Chart 2 on page 7)

All this has significant consequences for the state. A report from the actuarial firm Milliman that the Property and Casualty Insurers Association of America commissioned paints a grim picture of the likely future for the plan.[7] According to Milliman's calculations:

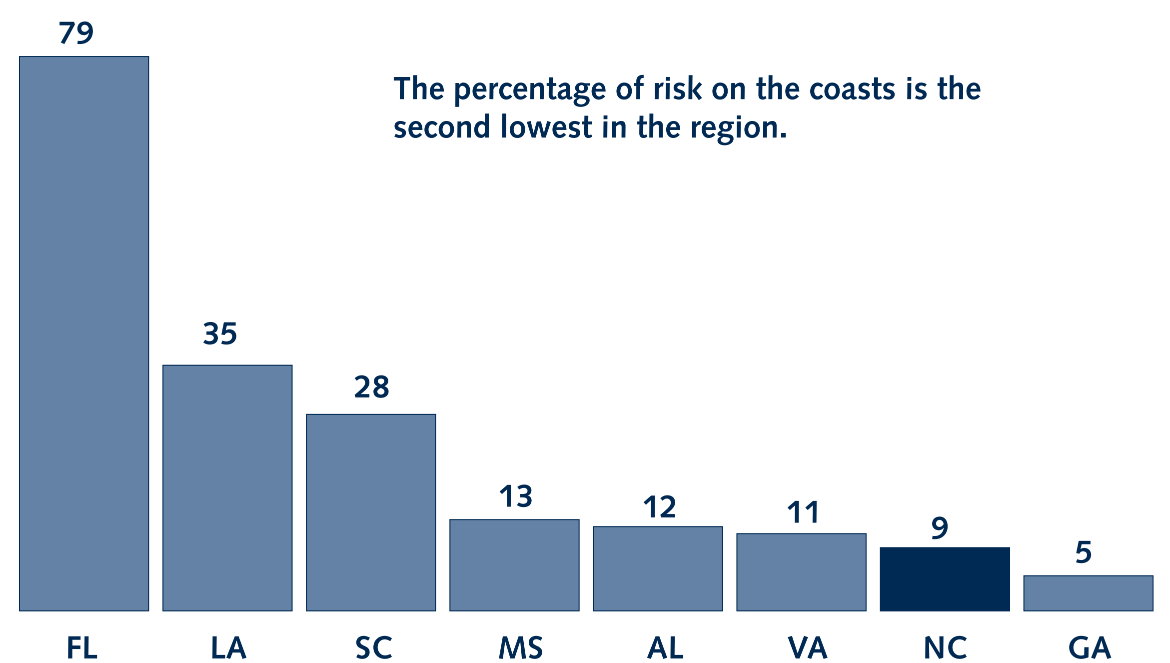
- The Beach Plan will not have more than $1.5 billion in total reserves to pay for a storm – an amount that's almost surely an overestimate for reasons discussed below.
- Any amounts above $1.5 billion will require assessments to member companies, and these assessments could have significantly detrimental consequences for smaller insurers.
- Assessments would range, according to Milliman, from $343 million to $6.2 billion. In the context of North Carolina's overall property insurance market – $3 billion – this would be a tremendous amount of money and could render any number of companies unable to function properly in the medium term.[8]

Milliman, however, greatly overstates the reinsurance capacity, and, therefore, the specific numbers in its report paint a *more favorable* picture of the Beach Plan's situation than is actually the case. While the Beach Plan had about $560 million in cash reserves as of September 2008 –slightly more than Milliman estimated it would a few months before – the actual value of reinsurance it has acquired is only a hair over $700 million, rather than $1 billion.[9] The difference exists because the current reinsurance contract includes "reinstatement fees" that are netted out of its payouts to the Beach Plan. These reinstatement fees function, for almost all intents and purposes, in the same way that deductibles function with regard to personal homeowners' and automobile insurance policies.[10]

As a result, it appears that the Beach Plan will get into serious trouble as soon as losses hit $1.2 billion in a season. The Beach Plan itself estimates that a Category Four hurricane – which the Beach Plan's own accounting manager says is almost certain at some point in the next two decades – would wipe it out altogether.[11] At that level, the Plan would begin needing to assess (tax) insurance companies, and, by the Beach Plan's own estimate, the assessments would be at least $600 million.[12]

The consequences for the state could well be drastic. In particular, massive assessments following a major storm could well lead to a significant exodus of insurers from North Carolina. One major insurer, Farmers Insurance, already has pulled out of North Carolina and has explicitly cited fear of assessments.[13] Speaking at a public hearing conducted by the Beach Plan's study committee, Farmers Executive Jerry Payne made it clear. "We took the form and looked at it, and our loss would be $48 million. We've got to manage our business. That would be a type of loss that we couldn't recover," he said. Speaking with the author on a not-for-attribution basis, representatives of two other sizeable insurers confirmed that they had developed plans to leave the North Carolina market if conditions warranted. While harshly critical of certain aspects of North Carolina policy, Nationwide executive Bradley Lemmons said "North Carolina has a lot of characteristics we see as favorable." In fact, large companies like Nationwide and Farmers can stay in North Carolina as long as they want to without fear of going out of business: Farmers is part of the Zurich Financial Services Group that took in a total of about $48 billion in 2007.[14] North Carolina's liabilities will not bring down Zurich – although failing to manage

Chart II



Source: AIR worldwide via Prof. David Marlett, Appalachian State University.

them would likely result in significant consequences for the Farmers group, which operates as an independent business.

Smaller companies, particularly those that operate only in North Carolina, may face the biggest problems. Bob White of Alliance Mutual Insurance – a small North Carolina-only company – described them. "We understand the niche we're in," he says. "And it's a dangerous one to be in." White explains that a single bad assessment could draw down his own company's reserves to the point it could no longer borrow money or, importantly, receive a high enough rating from A.M. Best and Company (the primary rater of insurance company solvency) for banks to accept its coverage. This would almost certainly drive it out of business. Nearly any company that writes homeowners' insurance only in North Carolina faces the same existential threat as Alliance Mutual.

It's important to note, in this context, that the collapse of insurers would have consequences far beyond their executives and stockholders: insurance consumers would immediately pay more, taxes would rise, and insurance could become impossible to obtain.

Another wrinkle, which has received little consideration, makes the entire situation even less certain. Until recently, the Beach Plan could have likely spread the pain by issuing multi-year bonds in order to pay off its debt. While the total payments as a result would be somewhat higher, companies, particularly smaller ones, would be in much better shape in the short term. The ability to pay off bonds over a period of years would likely improve the balance sheets for large insurers and make the difference between survival and collapse for smaller companies. The recent collapse of municipal bond markets, however, makes it very unlikely that the Beach Plan could sell any significant amount of bonds. Other similar entities including Florida Citizens Property Insurance Corporation and Florida's Hurricane Catastrophe Fund have been unable to sell the amounts of bonds they have wanted to; indeed, even Connecticut's AAA-rated pension fund bonds failed to find buyers during the fall of 2008.[15] The result is that the assessments would almost certainly have to be paid immediately, rather than spread over time. Even a $55 million assessment – which the Beach Plan considers likely within the next six years – would have significant consequences for the state's insurance industry and its consumers.[16]

It's important to note, in this context, that the collapse of insurers would have consequences far beyond their executives and stockholders: insurance consumers would immediately pay more, taxes would rise, and insurance could become impossible to obtain. To begin with, any assessments levied on insurers would represent a cost of doing business in North Carolina. Even if companies did not pass them on directly via a surcharge, an insurance commissioner would have to recognize these costs and allow them to work their way into rates. If the commissioner did not, the insurers would simply leave the state, thus cutting coverage for North Carolina residents. If insurers collapsed, likewise, responsibility for their claims would end up in the hands of the North Carolina Insurance Guarantee Association, which would place taxes on all property and casualty insurance policies in the state in order to pay the claims. In this sort of situation – large assessments, insurer collapses – it would become very difficult to attract private insurers into the state. A Beach Plan that had run out of money could write coverage only through additional assessments, and, at some point, a plan that relied only on assessing other policies would draw extra scrutiny from lenders. Each policy that the Beach Plan writes is a policy that it cannot assess. Seeking to avoid assessments, insurers would flee inland North Carolina as well. The result could well prove a catastrophe: massive liabilities, higher taxes, and no insurance for North Carolina residents.

Without quick, serious change in the way that the Beach Plan works, in short, North Carolina will face a property insurance disaster. Large companies will follow Farmers out of state, and small companies will simply go bankrupt. Property insurance will become unavailable, and more and more people will have to join the Beach Plan. As the Beach Plan's own ability to assess decreases (it can't, after all, gain anything by assessing itself), it will eventually have to turn to general state revenues to pay off its bills. And North Carolina taxpayers all over the state will end up paying off the damaged property of coastal residents. Even without the worst-case possible scenario, the possibility of assessments added to bills will, at minimum, raise prices for everyone in the state.

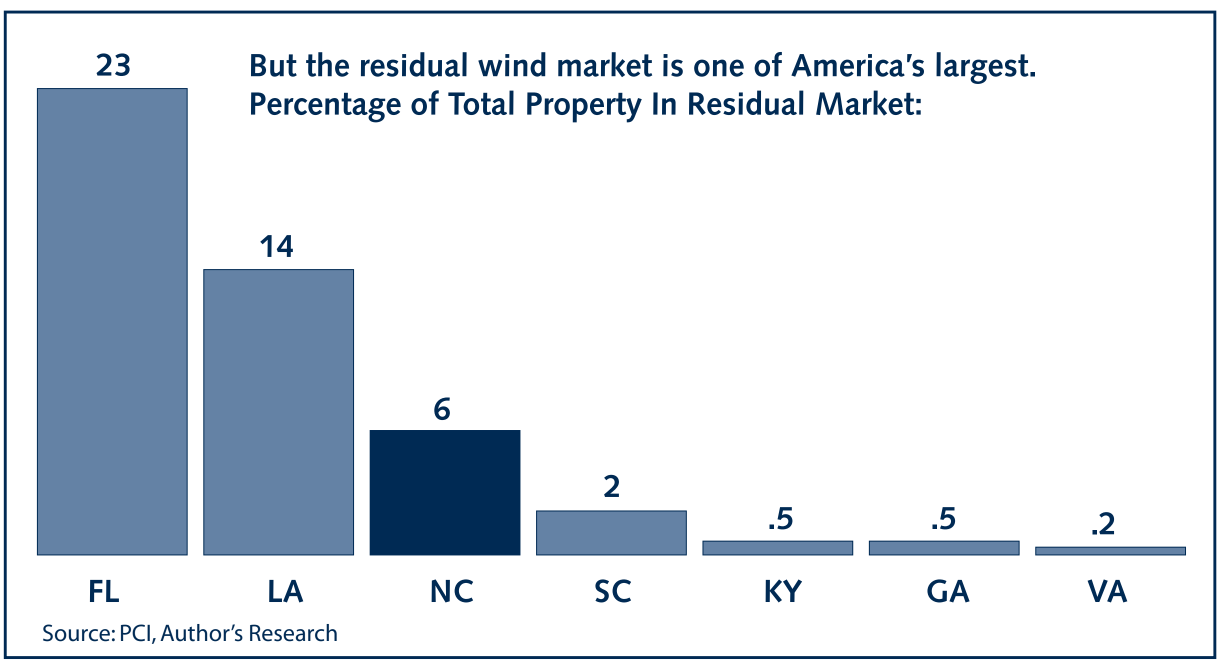
Fortunately for North Carolina, the system's problems stem from flawed regulatory, management, and legal decisions rather than the state's physical geography or built environment. North Carolina is *not* a particularly hurricane-prone state. In fact, only one coastal state in the Southeast – Georgia – has less coastal exposure than North Carolina, and several states that haven't had a hurricane strike anytime recently (Massachusetts, New York, and Connecticut) actually have more coastal exposure than North Carolina.[17] Likewise, states with miniscule state-supported coastal insurance markets – states like Virginia and Alabama – actually have more coastal exposure in dollar volume and/or percentage of total real estate than North Carolina. Some aspects of North Carolina's system, indeed, are simply nonsensical.

(See Chart 3 below)

Nor, for that matter, are North Carolina's coastal counties particularly in need of support on social equity grounds. Like all other coastal states, indeed, North Carolina's coastal counties actually have higher average household incomes than those inland.[18]

The fixes, furthermore, may not cause much pain to the state in the aggregate. The current system, indeed, almost certainly increases insurance rates in the eastern portion of the state and many western counties while offering small discounts to people living in coastal areas. A series of commonsense reforms, many of which don't even require the legislature to act, can do a great deal to stabilize the system.

Chart III



Fixing the Beach Plan's Ills: Stability and Reform

Any effort to fix the Beach Plan will have to take place in two steps: stabilizing the plan and reforming it. Stability would consist of ending (or at least slowing) the Beach Plan's growth, increasing its capacity to pay claims, and improving its structure. Reform of the Beach Plan would consist of efforts that fundamentally change its structure, reduce liabilities significantly, and allow market forces to play the leading role in disciplining North Carolina's property insurance environment.

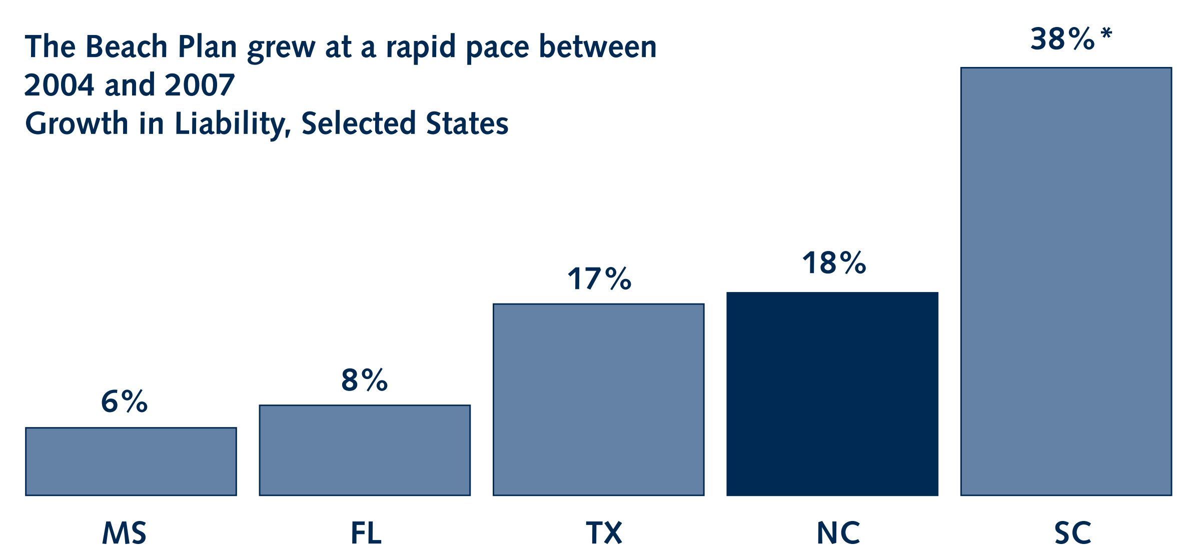
It's impossible to envision any sort of fundamental reform without efforts to stabilize the Beach Plan. So long as the Beach Plan continues to grow at its current rate, add liabilities, and scare away private companies, it appears impossible even to foresee any realistic possibility of an operating strategy that would result in the Beach Plan being phased out. Thus, reform would begin the process.

STABILIZATION

North Carolina's unusually powerful insurance commissioner's position and the nature of the insurance regulatory system both make reform relatively easy. Insurance Commissioner-elect Wayne Goodwin has shown a commitment and interest in fixing the Beach Plan. Without disturbing any of the fundamentals of North Carolina's insurance system – even those aspects that free-market advocates might find problematic – the commissioner and Beach Plan board can make significant, useful changes in the structure of the plan that would put it on stable footing. Goodwin has suggested he wants to do just that.

Although Goodwin is yet to announce a specific agenda – he wants to wait for a report from a study commission – it seems that four changes that would stabilize the Beach Plan appear possible without any legislative action: product-offering reform within the Beach plan, "instant" recognition for insurers that choose to write more coastal coverage (thus encouraging the writing of more coastal coverage), greater openness in Beach Plan operations, and the approval of modest coastal rate "increases" for private insurers. (As discussed below, the approval of "increases" might actually cut rates for many coastal residents.) A discussion of these recommendations follows:

Chart IV



Source: Dan Sutter, University of Texas Pan-American * The statistic for South Carolina is not directly comparable to the others because South Carolina more than doubled the areas eligible for its wind pool and all other states remained static.

RECOMMENDATION: OFFER 2 AND 3 PERCENT OF-HOME-VALUE DEDUCTIBLES (OR GREATER) AS THE BEACH PLAN'S ONLY OPTION.

Current Beach Plan offerings include deductibles as low as $1,000. This makes almost no sense. To the extent a public obligation to provide coastal insurance exists at all, it seems obvious that the capacity should not compete with the private sector. In fact, doing so is arguably illegal under North Carolina's Moorehead Act (which forbids the government from competing with the private sector) in any case. Insurance Commissioner-elect Goodwin tells the author that he favors a 2 percent deductible for the Beach Plan. This makes sense. Many insurers offer 2 or 3 percent deductibles as the highest option. Raising deductibles for insurance will reduce the liabilities for the Beach Plan, cut its operating costs (since it won't have to adjust claims as often), and encourage some customers to seek out coverage in the private sector.

A 2 percent deductible is equivalent to a $4,000 deductible on a typical house with a structure value of $200,000.[19] Repairs in this range, although not cheap, are the sort of things –new roofs, HVAC systems, and carpeting – that nearly all homeowners make at some time. Every homeowner can reasonably expect to pay these types of expenses, and it's difficult to see why the taxpayers should have an obligation to take on an implicit liability from them when they result from storm damage rather than something else. A policy with a 2 percent deductible may reduce the ability of someone to recover damage for a few broken windows but will have just about the same utility in rebuilding an entirely destroyed house, satisfying bank lenders, and doing everything a homeowners' insurance policy needs to do. At the margin, it will also reduce the overall liability of the plan and, by reducing its need to adjust claims, cut its administrative overhead even more.

Depending on market demand, the plan might also offer other, high-deductible options to homeowners who want lower rates. In particular, administrators might consider 3 and 5 percent deductibles as options and provide appropriate discounts for homeowners who select them. Doing so would reduce plan liabilities, cut premiums, and, at the margin, encourage residents to find coverage in the private market.

RECOMMENDATION: CREATE A MECHANISM TO RECOGNIZE INSURERS' INCREASED COASTAL COVERAGE IMMEDIATELY.

A flaw in current North Carolina law makes it very unattractive for companies, particularly smaller ones, to cover more properties in hurricane-prone areas. Like nearly all other states with wind pools, North Carolina allows insurers to "write their way out" of the wind pool by offering more coverage voluntarily. In other words, a company can avoid the special taxes – assessments – that the wind pool imposes by writing coverage in heavily wind-prone areas on their own.

A series of mathematical formulas determine a company's assessment for the wind pool. It works like this: a company that holds a 10 percent share of the state market and writes only 5 percent of the coverage in wind pool-eligible areas receives an assessment (a special tax) to pay a portion of the wind pool's claims following a major storm. If the company decides to withdraw from the coast altogether, this assessment will double. If, on the other hand, the company writes homeowners' policies for 10 percent of all coastal properties, it will not have to pay an assessment at all. This policy serves to encourage all companies, even small ones, to write at least some coverage on the coast but, at the same time, punishes any company that decides not to do so.

The system for determining the assessments, however, has a deep flaw. In North Carolina, companies don't get "credit" for writing coverage until the year *after* they write it. "It's just the way the forms work," explains Dascheil Propes, a former Deputy Director of the Insurance Department. "That's what the basis is."

This makes it very unattractive for any company to write more coastal coverage. A company that greatly increased the number of coastal policies it wrote in a year that a major hurricane hit would have to pay all the claims it receives *and* an assessment – a special tax – based on the number of policies it wrote before. "We just can't do it," says Alliance

Mutual's White. "Even if we wanted to, the rating agencies wouldn't let us. A single bad season, and we'd be wiped out altogether."

The logistical hurdles of collecting information from companies in "real time" appear relatively low. The North Carolina Department of Insurance could simply develop a system that lets companies report new coastal coverage as they write it and, thus, have their assessments reduced as soon as they issue a binder obligating them to provide the coverage. Some safeguards to prevent gaming the system might be needed. But, at minimum, Goodwin should ask his staff to study the possibility of granting "instant" credits for coastal coverage.

A company that greatly increased the number of coastal policies it wrote in a year that a major hurricane hit would have to pay all the claims it receives and *an assessment – a special tax – based on the number of policies it wrote before.*

If it proves impractical to track coverage in real time, the state instead might consider creating a system that allows companies to receive general-purpose tax credits against wind pool assessments. A company that wrote a "fair share" of wind pool coverage in a given year but is unable to get credit against its wind pool assessments might instead receive a tax credit against other taxes it pays. It might be most logical to offer the credit against the premium taxes that the state assesses to pay for insurance regulation and contribute to general revenue. This, for all intents and purposes, means that the state's general fund would end up offering a potential, modest, one-year subsidy to companies that agree to take on more coastal risk. This isn't an ideal situation since it would result in odd distortions and asks taxpayers from the state as a whole to assist the coastal insurance situation. (Texas has long offered credits for its own version of the Beach Plan: the Texas Wind Insurance Association.[20]) Still, as this system reduces the overall size of the Beach Plan, and since the credits would last for only one year, it exposes taxpayers to only a minimal risk.

Offering such credits would save money for coastal policyholders. Right now, at least some insurance companies hold back on writing new coastal policies because they know that they will face a double exposure for one year. Since companies have to offer a lower price to lure customers away from the Beach Plan, increased private coverage will save money for North Carolina residents.

Whatever happens, Insurance Commissioner-elect Goodwin should strive to find a way to remove the perverse incentive structure currently implicit in North Carolina's Beach Plan and, thereby, save money for taxpayers and coastal residents.

RECOMMENDATION: SHORE UP THE BEACH PLAN'S TAX-EXEMPT STATUS

North Carolina's Beach Plan currently operates under the principle that it's better to ask forgiveness than permission when it comes to dealing with the reserves it carries over from year to year. "We made a decision that we would do this [without] a change in law," said Beach Plan counsel Robert Paschal during a public hearing on the Beach Plan. Since 2005, the Beach Plan has retained its yearly surplus without paying taxes on it or returning it to member companies.[21] To obtain tax-free status, other states made their residual markets into corporate-style government bureaus that are exempt from both taxes and some of the strictures – hiring and purchasing rules – that bind government bureaucracies. The current structure of the Beach Plan, however, has important differences from residual market plans in several other states – California, Louisiana, and Florida – where the IRS has clearly ruled that the various residual insurance markets are tax-exempt government functions. In particular, the North Carolina Beach Plan has a board made up mostly of representatives from private industry – insurers and insurance agents – while these states have boards made up mostly of political appointees.

Quite simply, the Beach Plan needs clarity. Either Commissioner-elect Goodwin or the Plan's board should ask the IRS to review the Beach Plan's structure and determine if it owes taxes. If it does, then the Plan will have to pay the taxes and accept the decreased reserves. The current "forgiveness rather than permission" model simply can't endure.

If the Beach Plan were suddenly ordered to pay taxes – something the IRS could do at any time – it would have to surrender hundreds of millions of dollars worth of reserves, significantly reducing its ability to survive even a minor storm.

If the IRS decides that the Beach Plan must pay taxes, then the Plan may wish to consider a change in structure that would place it under firmer political control. While this would clarify the Beach Plan's tax-exempt status, however, it would also strengthen the de facto presumption that the state would bail out the Beach Plan if it were to get into trouble. (The assumption very likely already exists.) Allowing politicians to appoint more members of the Beach Plan board would also increase the chances that political leaders might appoint unqualified cronies to the board and allow the plan to become mismanaged.

Three safeguards, however, could avoid these potential problems and retain the Plan's tax-exempt status. First, it would make sense to divvy up responsibility for appointing the board. Giving separate appointments to the insurance commissioner, governor, and majority and minority leadership of both houses of the legislature could make sure that no single ideology or political leaning gets too much representation. Second, if the board needs to be revised, it should include some inland representatives. All of the current citizens' representatives on the board and, indeed, all of the North Carolina residents on the board, either come from coastal areas or have heavy interests there. Since most North Carolina residents live away from the coast, at least some people on the Beach Plan board should live away from the coast as well. Finally, a preponderance of politically appointed members brought onto the board should have professional experience in the insurance industry or a record of scholarship and advocacy about insurance-related issues. This would prevent politicians from appointing unqualified friends and donors to the board.

Moving toward a politically appointed board for the Beach Plan is not necessarily desirable. But it may well prove necessary to retain the tax-exempt status and avoid further destabilizing activities. Whatever happens, the state would do best to ask permission rather than waiting for forgiveness that may never come.

RECOMMENDATION: FACILITATE MODEST RATE "INCREASES" IMMEDIATELY (WHICH WOULDN'T ACTUALLY INCREASE RATES FOR MOST PRIMARY HOMEOWNERS.)

Goodwin would also do well to encourage insurers to submit modest coastal rate increases through the Rate Bureau, particularly because "increasing" rates in certain ways actually could save money and improve service for homeowners. These modest rate increases could take place without any fundamental change to the process of setting insurance rates in North Carolina and without causing any shocks to North Carolina homeowners. "No regrets" increases in rates appear possible for three reasons: insurance company structure, the Beach Plan's own limitations, and economies of scale.

In general, insurers find it advantageous to sell multiple products to the same customer.

Since most North Carolina residents live away from the coast, at least some people on the Beach Plan board should live away from the coast as well.

Insurance consumers that keep retirement investments and life insurance, homeowners', and auto insurance polices with the same company will likely receive a variety of discounts. In general, these discounts show up in the form of lower automobile insurance rates (since auto insurance is generally the most profitable product.) Consumers that participate in the Beach Plan, however, give up potentially valuable discounts on other products. Even if they pay more for homeowners' insurance from the private sector, consumers' total cost of insurance might well decline if they get discounts on other products from the same company.

Just as importantly, the Beach Plan's coverage just isn't that good: it's limited and provides poor service. In particular, even the "complete" homeowners' policy from the Beach Plan excludes liability coverage: homeowners whose dog bites a guest can face a lawsuit for the limits of the guest's injuries unless they purchase an additional policy. Also, the private insurance industry, quite simply, is better equipped to provide service than the Beach Plan. Because the Beach Plan has a reasonably small pool of customers and, between storms, handles very few claims, it cannot maintain a large full-time staff of adjusters, a major call center, or anything else. "We simply can't be big enough to provide really good service following a storm," admits Jim Oliver, the head of Texas' equivalent of the Beach Plan, the Texas Wind Insurance Association. "It just isn't possible."

Thus, Commissioner-elect Goodwin might also consider immediately allowing even more rating freedom for second homes. Even if he did not, second homeowners might well pay higher rates immediately even if "increases" kept insurance costs stable (or cut them) for primary homeowners. Second homeowners are sometimes out-of-state residents who don't vote at all in North Carolina and might not vote for North Carolina's insurance commissioner. Even those who live in state may vote near home and thus don't deal much with coastal legislators. Electoral concerns, of course, still play a role for such homeowners – particularly since many provide vital tax revenues to the communities where they live – but the consequences of raising their insurance rates may be smaller than those involved in raising rates for full-time homeowners.

Essentially, reform would focus on turning the Plan into a true market of last resort that would provide coverage only for people who honestly cannot find it anywhere else.

The steps outlined above would, at minimum, end the Beach Plan's explosive growth. But they do not solve the Plan's problems. Without additional fundamental changes, North Carolina will still retain a larger residual wind market than its coastal exposure justifies.

REFORM

Efforts to reform the Beach Plan, nonetheless, must follow efforts to stabilize it. So long as the Beach Plan continues growing at least at its billion-dollar-per-month rate, true reform will prove politically impossible, since more and more people will continue clamoring to get into the Plan. Essentially, reform would focus on turning the Plan into a true market of last resort that would provide coverage only for people who honestly cannot find it anywhere else. It would involve comprehensive changes to the Beach Plan's administrative structure, eligibility for coverage, and the setting of rates in the private market. In the end, a private or mostly private market for coastal coverage would emerge.

RECOMMENDATION: MERGE THE BEACH PLAN WITH THE RATE BUREAU

Reforming the Beach Plan would start with significant changes to its structure. In particular, it would make sense to do what many in the insurance industry have suggested – none in public – and merge the Beach Plan into the existing Rate Bureau organization while simultaneously limiting the range of coverage that the Beach Plan writes. Currently, the North Carolina Rate Bureau organization (popularly called the Rate Bureau) runs the Rate Bureau (which serves as the industry's collective voice in rate hearings), the insurance guarantee fund (which provides a mechanism for paying a portion of policyholder claims if a company becomes insolvent), and the Reinsurance Facility (which runs North Carolina's largest-in-the-country auto insurance residual market.) Nothing in statute actually requires the three organizations to co-locate or share interlocking administrative structures, but the economies of scale appear to make all of them more efficient. Although the Reinsurance Facility has significant costs for North Carolina, it is essentially stable and is extremely unlikely to require a bailout. Because they share services, furthermore, they cost less. The companies that participate in the Rate Bureau are largely the same ones – with a few exceptions – that participate in the Beach Plan.

Just about everyone involved with the North Carolina insurance industry agrees that the Beach Plan would do better folded into the Rate Bureau, but none would speak on the record. "It's leadership … but I am not going to go there," says one industry insider. Quite simply, it's not clear why the Beach Plan has grown so quickly, strayed so far from its mission as an insurer of last resort, or why

The Virginia Model

North Carolina might aim eventually to end up with a system something like the coastal insurance system in its neighbor to the North. Virginia consistently tops *Governing* magazine's report card of the best governed states, and the enlightened management of its own residual insurance market — part of the FAIR plan — shows a better overall way to provide coverage for people who can't get it elsewhere.[22] North Carolina also has a FAIR (Fair Access to Insurance Requirements) plan, and it's administered along with the Beach Plan. Like all other FAIR plans, the North Carolina and Virginia FAIR plans arose when major insurers withdrew from many urban areas following civil disorder in the 1960s.

On the surface, Virginia actually has greater risks than North Carolina. Virginia, in fact, has about $30 billion more in coastal exposure than North Carolina.[23] Likewise, 11 percent of Virginia's total exposure exists on the coasts as opposed to 9 percent of North Carolina's. Virginia's FAIR plan, likewise, writes a number of non-coastal risks in inner-city areas. (North Carolina's plan writes these risks through a separate plan that shares management with the Beach Plan.)

Virginia, however, has drastically fewer policies in its beach plan equivalent, and the pool poses no risk to the taxpayers. Even if a Katrina-like once-in-250-year storm were to hit Virginia, taxpayers and insurers would owe the pool a maximum of $16 million — about $2 per Virginia resident.[24] (A major 100-year storm — a much more likely event — wouldn't require a single dime of assessments.) The Virginia plan writes only about $15 million in total premiums. Unique among the nation's coastal property insurance plans, the Virginia plan has actually shrunk over the past two years as its policyholders have found coverage in the private market.[25]

Essentially, the plan provides transitory coverage for people who genuinely can't find it elsewhere and urges them to move on quickly. "We want to depopulate the plan. We don't want people to hang around," said Leeland Nye, the plan's administrator, speaking at a conference on Hilton Head Island. But the plan doesn't skimp on service. "We need to spend money to provide good service for people who can't find insurance anywhere else. We're not going to win awards for saving $10,000 by buying a computer system that doesn't work."

Good management alone, however, doesn't explain why the Virginia model succeeds. Instead, Virginia's success has as much to do with the insurance department's willingness to let the private market work. Essentially, Virginia insurers can charge whatever rates risks in the state justify and can simply "file and use" their rates rather than having to issue them through a rate bureau and submit them to a prior-approval process.[26] This also makes a major difference.

Although there's probably no need for North Carolina to copy every feature of Virginia's plans, North Carolina has a lot to learn from its general principles. It is fiscally sound, poses no threat to the state's taxpayers, and provides good service to those who really don't have another choice.

it has so little capacity to pay its claims. Other states have avoided similar problems North Carolina has encountered. A merged Beach Plan – which still might have its own board – could operate more efficiently and better than the current Beach Plan.

RECOMMENDATION: IMPOSE A FLEXIBLE "TURNDOWN" REQUIREMENT FOR THE BEACH PLAN

The Beach Plan should never write coverage to those who can find insurance in the private market. It should never underprice the market or offer a product that's more attractive than the private market. Currently, its coverage costs less and, in some cases, proves more attractive than what exists in the private market. Given that insurers and agents control the preponderance of board seats on the Beach Plan board, it seems very unclear – at minimum – why and how this has happened. To prevent the Beach Plan from becoming a competitor with the private market in the future, North Carolina should make sure that the plan takes its "provider of last resort" mandate seriously. In the long run, the simplest way to do this is to increase the rates that the plan charges. In the medium term, however, the legislature or the Beach Plan's own board should consider implementing a "turndown" rule that would allow only individuals who have looked for private insurance to purchase insurance from the Beach Plan.

Under such a rule, individuals would have to present evidence that private companies were unwilling to write them insurance before being eligible for insurance through the Beach Plan. The Plan might require 2 or 3 "turndowns" – private insurers unwilling to write coverage at any price – before allowing people to partake in its coverage. Rather than immediately raising the Beach Plan's rates, this would serve to encourage people who can get better coverage elsewhere to leave the Beach Plan on a voluntary basis. Some people currently in the Beach Plan might also simply find that private market coverage suited them better.

Requiring turndowns will run into some opposition because agents, not without reason, would dislike a "turndown" mandate. Such a mandate creates extra work in having to seek additional quotes without earning additional commissions for agents.

The best and fairest solution would be to couple the turndown mandate with a modest across-the-board 1 percent increase in Beach Plan premiums on top of whatever other increases might be justified. Such an increase would do three things. First, it would compensate agents for the extra work in obtaining "turndowns" for their customers. (The additional commission can't be too generous, however, because otherwise it would create an incentive for agents to steer customers toward the Beach Plan.) Agents who refer customers to the Beach Plan after getting "turndowns" would receive this full 1 percent (or more) as an additional commission. Second, while it would not improve the Beach Plan's fiscal status, the additional commission would, at the margins, encourage people to seek private coverage. Finally, the additional fee could provide an "out" for agents: if it's absolutely clear that no private insurer will write a given property, an agent can simply submit it directly to the Beach Plan and earn a standard commission with the Beach Plan keeping the additional 1 percent to strengthen its reserves.

RECOMMENDATION: ENCOURAGE BETTER BUILDING THROUGH HIGHER STANDARDS AND INSURANCE RATES

Building stronger buildings, all other things being equal, will make North Carolina more resistant to storms. Homeowners that reinforce their properties to withstand Category Four hurricanes won't need to trouble the Beach Plan or, for that matter, any private insurer. To upgrade buildings in North Carolina, the state legislature should consider actions that would increase building standards, while the insurance commissioner should allow for rate standards that make building quality a major consideration.

Increasing standards will help a great deal. Actuarial calculations, indeed, show that different roof, shutter, and gable designs can justify premium discounts up to 86 percent on insurance policies (although insurers would, in general, oppose the largest premium discounts).[27] Better standards for new construction in coastal areas make sense even if they increase the cost of new homes. In fact, stronger standards may make the most sense *particularly* if they do this. More expensive housing in disaster-prone areas, all other things being equal, will discourage people from living in these areas who do not have the financial resources to deal with disasters.

No building codes, no matter how well they promote coastal safety or how enlightened they prove, will make much of a difference for a long time. The reason is simple: the state's housing stock turns over very slowly. The Census Bureau finds that North Carolina – which has grown faster than the national average – has added about 120,000 new residents a year since 2000. Many of the new residents will live away from the coast (many of the state's fastest growing counties aren't on the coast), and many will rent housing in large complexes insured through the state's lightly regulated and commercial insurance system. Already, a combination of environmental, mitigation, and insurance mandates make coastal development less attractive than development elsewhere. Tighter standards will not do a lot to improve things for the overwhelming majority of North Carolina residents who live in housing that new building standards won't touch. Quite simply, revised building codes apply only to new structures. Often, furthermore, it proves nearly as expensive to retrofit an existing structure to current codes than to build a better, stronger structure from scratch. Thus, it's likely that a large percentage of housing will *never* be retrofitted. Although forward-looking building codes have an important role to play, they will take time to have any consequences. Therefore, the state and its residents would do best to focus on efforts that will encourage retrofitting of existing houses.

Prices for insurance provide the best information – in the aggregate – as to how to do this best. Few insurers will give large discounts for any *given* mitigation (it's simply too chancy), but many will give discounts for comprehensive efforts to improve a given house. To encourage this, Commissioner-elect Goodwin would do well to grant insurers broad latitude in granting discounts for mitigation and – as a necessary converse – raising prices for houses that don't meet standards. Rather than trying to force the upgrade of houses, which is very difficult anyway, the insurance department should encourage insurers to send price signals as to the most desirable ways to reinforce housing against storms.

RECOMMENDATION: TRANSITION TO SIGNIFICANTLY HIGHER PRIVATE MARKET RATES FOR COASTAL PROPERTIES VIA TAX CREDITS MODELED ON SOUTH CAROLINA'S

Putting the Beach Plan on solid footing in the long term will require higher rates for many of those who live in coastal areas. By one means or another, the state should approve these rates. Because of the controversy it is likely to arouse, in fact, the state's current prior-approval rate-setting system may serve as a useful mechanism for allowing insurers, consumer advocates, and regulators to air the need for higher rates in public.

Following efforts to redefine the wind pool as a true "market of last resort," the Rate Bureau should propose and Commissioner-elect Goodwin should approve a rate plan that reduces homeowners' insurance rates in Western North Carolina, holds them more or less steady in most of Eastern North Carolina, and raises them significantly in coastal counties. Such a plan, most likely, would keep the total amount of premiums paid by North Carolina residents roughly the same (after adjusting for costs external to the insurance industry itself), while providing rate cuts to most of the state's population. Nonetheless, the people paying higher rates would see significant increases – doubling in some cases. And, for people of modest means, this could prove quite unfair, as well as politically unpalatable.

To find a solution, the legislature would do well to look south. South Carolina – as part of a plan that increased the size of its wind pool while raising its rates – offered a series of tax credits to ease the pain for residents. Under South Carolina's tax plans, residents can put money in disaster savings accounts tax free, claim credits against state income taxes (up to $1,250) when overall insurance premiums exceed 5 percent of household income, receive grants for retrofitting homes against hurricanes, and deduct the sales tax paid on materials used for retrofitting.[28] These grants – which apply only to people with modest incomes, only on homes with reasonably low values (less than $300,000 for the structure), and only to primary residences – help much of the state's population handle higher premiums while simultaneously making sure that everyone who lives in a risky area pays a little more.

The particulars of South Carolina's plan don't necessarily need to find exact imitation in North Carolina. For example, the disaster savings accounts, although a good idea in theory, prove a rather cumbersome way to save people a rather small amount of money. In North Carolina, a household earning the state median income of $55,000 would realize a benefit of only $250 if it set aside $4,000 in a disaster savings account.[29] (Wealthy families would actually benefit more.) Likewise, the tax credits may not always help those who need it the most: a couple living off of Social Security and a modest pension in a paid-off house a few miles from the shore might pay a $1,200 yearly premium and find that the tax credit covers it in full. A family of four living a bit closer to the shore and earning a slightly above-median income of $65,000 – but paying $3,600 a year for homeowners' insurance – would find only modest help from the tax credit.

Devising a specific plan for tax credits will take trial and error, but, in general, the legislature would do well to follow three principles: means testing, limited eligibility, and simplicity.

First, any tax credit or grant that's offered should focus on people of modest means. Many people have strived and saved their entire lives to buy a home. They shouldn't have to deal with massive overnight increases in insurance premiums because of changes in a state regulatory structure. Thus, the legislature would do well to limit a tax credit to people with income below the state median *and* who own houses with assessed values below the median in their counties. (The latter provision will deny tax credits to well-off retirees who may have modest year-to-year incomes.) Means testing will also serve to make the tax credits larger for those who qualify for them without requiring a tax increase or program cuts.

Second, the legislature should focus tax credits on people who already live in hurricane-prone areas rather than newcomers. The legislature should offer tax credits to ease the transition for people who live in harm's way, rather than encouraging more people to move into hurricane-prone areas. People who buy in Beach Plan-eligible areas after the date the tax credits go into force shouldn't have the ability to claim the tax credits. Only people who already live in hurricane-prone areas should be able to claim the tax credits. Newcomers should expect to pay higher rates for insurance.[30]

Finally, the legislature should strive for simple tax credits. Although good in many ways, the South Carolina plan has proven difficult for many residents to take part in because it has so many different parts and so many paperwork requirements. North Carolina would do well to make things simpler. It might be best, for example, to focus on offering only one tax credit and letting people use it for either mitigation efforts that make their house safer or simply to offset insurwance premiums.

A higher rate plan for coastal residents makes sense in the medium term. But making it politically practical will very likely require some tax credits and tax relief to dull the pain for coastal residents. In the long run, however, those who live in dangerous areas should simply pay more for insurance.

Conclusion

This paper has described the North Carolina Beach Plan and outlined the risks it poses to the state. It argues that these risks are severe and could well result in significant fiscal problems for all – or almost all – North Carolina residents and that, in the long run, the state should move toward policies that stabilize the Beach Plan and then reduce its size significantly. In the long run, North Carolina should look to turn the Beach Plan into a true residual market that provides insurance only for people unable to find any private company to sell them insurance.

Getting to a better system will prove impossible until the Beach Plan stops growing, and Commissioner-elect Goodwin seems committed to improving the Beach Plan's operations. Although coastal residents will eventually pay higher insurance premiums, it is unlikely that North Carolina's overall costs for insurance will rise significantly. The correct reforms, implemented in the correct order, can relieve the state of the Beach Plan's burdens, make its residents safer, and make North Carolina a better place to live. Real solutions exist. The state needs to implement them.

Notes

1 North Carolina Insurance Underwriting Association. "What is the BEACH [sic] Plan in North Carolina," http://www.ncjua-nciua.org/html/about-nciua.htm, 2008.

2 Admitted Market insurance is the type of insurance that nearly all individuals buy. Its forms are regulated by state governments, and state governments attempt to monitor the solvency of companies that write it. In most states, furthermore, government plays a role in setting the rates that consumers pay. Other types of insurance –

the excess and surplus markets – exist, but, for most individuals, they do not provide practical alternatives.

3 North Carolina Insurance Underwriting Association, 2008.

4 Ibid. "Most people wanting to buy insurance on their properties can sometimes get broader coverage – often at a better price – in the regular competitive market." The other government insurer that frequently underprices the private market is Florida Citizens Property Insurance Corporation. The California Earthquake Authority overtly markets its product as well, but, unlike Florida Citizens and the North Carolina Beach Plan, almost no private-market, admitted carriers compete with it.

5 North Carolina Insurance Underwriting Association, 2008.

6 North Carolina Insurance Underwriting Association. "Facts And Statistics," 2008, http://www.ncjua-nciua.org/.

7 Nancy P. Watkins and Max H. Mindel. "Analysis of the North Carolina Beach Plan for Property Casualty Insurers Association of America," October 10, 2008, Milliman.

8 Ibid, 2.

9 David Marlett. "Presentation to *Select Study Committee on the Potential Impact of Major Hurricanes on the North Carolina Insurance Industry: NCJUA/NCIUA Reinsurance Structure, Effective May 1, 2008,*"

10 Some reinsurance contracts may allow insured individuals and corporations to avoid paying the reinstatement fees. Doing so, however, would mean giving up coverage. In limited cases – such as a hurricane that struck very close to the expiration of a reinsurance contract – it's possible that the Beach Plan might do this.

11 Alvin Ashworth, Accounting Manager, North Carolina Insurance Underwriting Association. "Presentation to Joint Select Committee on the potential impact of major hurricanes on the North Carolina Insurance Industry." October 16, 2008.

12 Ibid.

13 Arthur Postal. "Farmers to Pull out of N.C. Homeowners' Market," National Underwriter Online News Service, August 14, 2008.

14 Zurich Financial Services. "Annual Report: 2007," www.zurich.com.

15 Associated Press. "Nappier says pension fund sound," October 6, 2008, and Beatrice Garcia. "Economy Takes Toll on Hurricane Catastrophe Fund," in *The Miami Herald*, October 16, 2008.

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17 Insurance Information Institute et al. "Coastline at Risk," http://www.air-worldwide.com/_public/images/pdf/AIR2008_Coastline_at_Risk.pdf?src=email, June 11, 2008. David Marlett directed me to this source.

18 Daniel Sutter. "Ensuring Disaster: State Insurance Regulation, Coastal Development, and Hurricanes," The Mercatus Center, August 24, 2007.

19 Note that the sale prices and assessed values of homes will always be higher than the structure value because the sale price includes the value of the land, location, and access to amenities that may impact the value.

20 Texas Department of Insurance. "Hurricane Ike Fact Sheet: TWIA," http://www.tdi.state.tx.us/consumer/storms/documents/windfactsheet.pdf.

21 North Carolina Insurance Underwriting Association. Presentation to Joint Select Committee on the potential impact of major hurricanes on the North Carolina Insurance Industry. October 16, 2008.

22 Governing Magazine. "Grading the States '08: Virginia," http://www.governing.com/gpp/2008/va.htm.

23 AIR Worldwide and iii presentation at Insurance Symposium in Boone, N.C.

http://www.air-worldwide.com/_public/images/pdf/AIR2008_Coastline_at_Risk.pdf?src=email.

24 Virginia Property Insurance Association. "Total In Force Premium" (VPIA.org).

25 Ibid.

26 Virginia State Corporation Commission, Bureau of Insurance. "Rate and Form Filings Review," http://scc.virginia.gov/division/boi/webpages/reviewrates.htm.

27 Donald T. Hornstein. "Mitigation: Sustainably Linking the Beach Plan and the Coast," Presentation to the Joint Select Committee on the Potential Impact of Hurricanes on the North Carolina Insurance Industry, November 18, 2008.

28 Eli Lehrer. *South Carolina's Omnibus Coastal Insurance Reform Legislation: Baby Steps in the Right Direction*, The Competitive Enterprise Institute, 2007, 10-11.

29 Income figures provided by the Bureau of the Census. The family is assumed to be taxed at the 7.75 percent rate. Although the money would be less accessible for immediate purposes, putting the same money into an IRA or 401(k) plan would realize a benefit of nearly $1,000.

30 To some extent, the higher insurance rates will be priced into the value of the houses. All other things being equal, a higher insurance premium will reduce the amount that people can pay for a home mortgage and therefore the value of the house. The legislature might also consider extending some sort of tax relief to people who sell their houses at lower-than-expected prices.

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"To prejudge other men's notions before we have looked into them is not to show their darkness but to put out our own eyes."

JOHN LOCKE (1632–1704)

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