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In Riskier World, No One Wants to Pay

CAPITAL ACCOUNT

By Greg Ip

Insurance is one of finance's great gifts to mankind. Through the statistical magic of risk pooling, an individual can obtain peace of mind and protection against devastating loss.

This remarkable invention shows signs of breaking down. As risks from illness and old age to natural and financial disaster grow, so does Americans' resistance to paying to insure against them.

The latest example is California. Earlier this month, JPMorgan estimated the fires around Los Angeles had inflicted $50 billion in losses, of which only $20 billion were insured.

One reason for the gap: State regulators have prevented insurers from charging premiums commensurate with rising property values, construction costs and wildfire risk exacerbated by a warming climate. Many thus stopped renewing policies.

Hundreds of thousands of homeowners shifted to California's state-run backstop, the Fair Plan, whose exposure has tripled since 2020 to $458 billion. It has only $2.5 billion in reinsurance and $200 million in cash.

If the Fair Plan runs out of money, it can impose an assessment on private insurers to be partly passed on to all policyholders. In other words, the costs of the disaster will be socialized.

California is a microcosm of what happens when insurance breaks down: Either households face potential ruin or the public is handed a financial time bomb.

"What we are seeing is a real disconnect," said Carolyn Kousky, an economist specializing in risk and founder of the nonprofit Insurance For Good. "There are opposing views on insurance: Is it a private market good, or is it social protection, to make sure everyone has the resources to recover from disaster?"

A central feature of insurance is risk pooling: The combined contributions of the community cover the losses incurred by members of the community in a given year.

Another feature of private insurance is actuarial ratemaking, that is, calibrating premiums to the customer's risk. That's to prevent "adverse selection," in which only the riskiest people buy insurance, and moral hazard—the tendency to encourage risk by undercharging for it.

But some activities or individuals are so risky they could never obtain, or afford, private insurance. That's when risk gets socialized. The federal government's expansion since the 1930s has largely been through the provision of insurance: Social Security, unemployment insurance, health insurance for the elderly and poor, deposit, mortgage, and flood insurance and, after Sept. 11, 2001, terrorism insurance.

Nowhere are feelings about insurance more conflicted than in health. Americans want neither the rationing that comes with government-run insurance, nor the risk-management that comes with private insurance. This became painfully apparent when the fatal shooting of Brian Thompson, chief executive of United-Healthcare, triggered an outpouring of fury not at the suspected killer, Luigi Mangione, but at insurers for limiting benefits.

In fact, long before that shooting, the Affordable Care Act had constrained insurers' ability to base premiums on risk, by prohibiting them from charging more to people with pre-existing conditions or denying coverage altogether.

The ACA also stipulated that insurers spend at least 80% to 85% (depending on the plan) of premiums on benefits. So while denials, deductibles and copays may, at the margin, affect profits, ultimately they serve to control premiums.

In finance, where risk supposedly goes hand in hand with reward, losses have been repeatedly socialized, most notably when major financial institutions were bailed out in 2008.

Deposit insurance, on paper, is capped at $250,000. But in 2023, the Federal Deposit Insurance Corp. bailed out all the uninsured depositors of Silicon Valley Bank and Signature Bank. The costs are being socialized via a special assessment on other banks' uninsured deposits.

What financial disaster was to the last era, natural disaster may be to the next. In a World Economic Forum survey, business, government and other leaders ranked extreme weather the most severe of 33 risks facing the world in the next 10 years. Major disasters pose a particular problem for insurers because claims occur all at once instead of randomly.

And as with financial disasters, the cost of natural disasters is being socialized. Numerous states have backstops for homeowners unable to get private insurance, and all struggle to charge premiums that reflect actual risk.

In a 2023 study for California insurers, Nancy Watkins, an actuary with Milliman, an insurance consulting firm, found that plans in California, Washington, Louisiana and Florida, which had doubled in size between 2017 and 2022, all incurred more in losses and expense than they took in through premiums.

In Florida, frequent storms, flood-plain development, inflation, fraud and litigation have pushed home-insurance premiums to the highest in the country. Yet insurers were "discouraged from large rate hikes by public hearings, documentation requirements, and their own customers and agents," Kousky and a co-author wrote last year. In years past, some insurers pulled back, or became insolvent.

As in California, Florida homeowners flocked to the government backstop, Citizens Property Insurance. Like California, Florida has taken steps to make its insurance market financially viable. It has cracked down on litigation and allowed Citizens to raise premiums. Nonetheless, Citizens last year said premiums are 22% below the actuarially sound level.

Taxpayers nationwide are also on the hook. Since 2020, Congress has appropriated an average of $46 billion a year for disaster relief, triple the average of the prior decade (in constant 2023 dollars).

Socializing risk weakens one of the main benefits of insurance: Encouraging the insured to mitigate their risk so as to reduce premiums. Without that price signal, it usually takes direct intervention to modify behavior. After being bailed out in 2008-09, banks have had to submit to far more stringent safety and soundness rules.

The same may be true of natural disasters. If the risk is to be socialized, society has a right to demand the insured mitigate their risk, such as making homes more floodproof, windproof and fireproof or staying out of disaster- prone areas entirely.

"It involves alignment of ordinances, building codes, enforcement, inspection, and finding resources for…communities and homeowners who really can't afford" such measures, Watkins said. "All that is politically difficult. But it's becoming increasingly obvious the old strategy, of denying the risk, has failed."

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