The Debate over Hurricane Deductibles

By Shanique Hall, CIPR Manager

The devastating effects of Superstorm Sandy, which made landfall Oct. 29, 2012, along the Northeast coast, brought the technical distinction of hurricane and named storm deductibles to the forefront. This distinction is important, as it can have significant impact on how much homeowners (and insurers) must pay for losses. Hurricane Andrew in 1992 and subsequent hurricanes have caused insurers to take steps to mitigate future losses in hurricane-prone areas. In recent years, many insurers have added hurricane and named storm deductibles tied to a percentage of the home's insured value. This article will examine the different types of hurricane deductibles and some of the issues that arose following Superstorm Sandy.

◆ Types of Property Deductibles

A deductible is the amount of loss paid by the policyholder before any loss is paid by the insurer. For most "perils" (such as fire damage and theft), the standard deductible is a flat dollar amount (e.g., $500 or $1,000). This means a policyholder would be responsible to pay the flat dollar amount out of pocket for a loss.

In many coastal states, homeowners insurance policies also include deductibles that apply only to damage caused by hurricanes. A hurricane, or named storm, deductible is applied separately from standard perils deductibles and is typically a higher dollar amount, meaning a policyholder would be responsible for a larger portion of any loss. It can be expressed as a fixed dollar deductible or, more commonly, as a percentage of the home's insured value, which can vary from 1% to as high as 10%.

For example, with a percentage deductible, if a home is insured for $200,000 with a 2% hurricane deductible, the policyholder would have to pay the first $4,000 needed to repair the home if the loss was caused by a hurricane or named storm. A 10% deductible on that same policy means a policyholder is responsible for the first $20,000 of a claim. In some areas, policyholders might have the option of paying a higher premium in return for a higher flat dollar amount deductible, although in some high-risk areas, the percentage deductible might be mandatory from the insurer's perspective.

Although definitions vary, a hurricane deductible typically applies to damage solely from a hurricane as categorized by the National Weather Service or U.S. National Hurricane Center. A named storm deductible applies to a weather event declared as a hurricane, typhoon, tropical storm or cyclone by the U.S. National Weather Service, the U.S. National Hurricane Center or the U.S. National Oceanic and Atmosphere Administration, and where a number or "name" has been applied (e.g., Hurricane Andrew, Superstorm Sandy, etc.). Any loss must have been caused or resulted from the named storm event.

Some policies also include a windstorm or wind/hail deductible. These usually apply to any kind of damage from a wind or hail event. For example, if a tree falls on a policyholder's roof on a windy day, the claim would be subject to the wind deductible. Flood damage, however, is covered only if a separate flood insurance policy was purchased, generally from the National Flood Insurance Program or from a private company.

Whether a hurricane, named storm or windstorm deductible applies to a claim depends on the applicable "trigger" selected by the insurance company. These deductibles apply only if certain parameters spelled out in the insurance contract are met, which are often proscribed or limited in state law. While there are similarities among the state laws, no two laws are identical as triggers vary from state to state, as well as from insurer to insurer.

◆ Origin of Hurricane Deductibles

In the mid-1990s, insurers began to implement hurricane and percentage deductibles in coastal states. The origination of these deductibles can be traced back to Hurricane Andrew. At the time, Andrew was the most expensive storm in U.S. history, far exceeding the losses caused by the previous most costly storm (Hurricane Hugo in 1989). After the extraordinary losses of Andrew, reinsurance became more expensive and less available, and reinsurers began encouraging primary insurers to take steps to better manage their catastrophe risk. One of the answers for insurers was to limit potential losses through higher deductibles, transferring risk back to the policyholder.

Hurricane deductibles are part of a broad effort by insurers to keep insurance coverage available and affordable. The number of extreme weather events has dramatically increased over the last decades. At the same time, more and more people and businesses have moved closer to shorelines, and property values have generally increased. Hurricane deductibles were introduced as a risk-sharing mechanism, by having the policyholder bear more of the risk, without raising overall premiums to unaffordable levels. These

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deductibles also give property owners the incentive to protect their property (e.g., installing storm doors or special windows and storm shutters that can withstand high winds).

The following states currently have some form of hurricane deductible in place: Alabama, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Louisiana, Maine, Maryland, Massachusetts, Mississippi, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, Texas and Virginia. Other states allow insurers to include hurricane deductibles in property insurance products.

◆ SUPERSTORM SANDY

Superstorm Sandy raised awareness about hurricane deductibles and the higher out-of-pocket costs that may apply. Sandy's storm surge and high winds flooded New York City and coastal communities. The storm left millions without power and caused an estimated $20 billion to $50 billion in damage. It is expected Superstorm Sandy will be the third most costly natural disaster in U.S. history after Hurricane Katrina and Hurricane Andrew.

Sandy was a unique megastorm: according to meteorologists, it was a tropical storm, combined with a winter storm, combined with frigid Canadian air, combined with a high tide. It was designated a hurricane for much of the time it traveled up the Atlantic coast and hurricane warnings were issued. However, before Sandy made landfall, she was downgraded by the National Weather Service from a Category 1 hurricane to a post-tropical cyclone, the designation for storms maxing out with 73 mph winds. Sandy lacked the sustained wind speeds of 75 miles per hour necessary to qualify as a hurricane when it hit the East Coast.

Noting Sandy's diminished status, several governors issued statements that insurers must treat Sandy as a tropical storm and not a hurricane. They insisted policyholders should not have to pay hurricane or named storm deductibles on insurance claims stemming from Sandy, and urged insurance companies to fully compensate their policyholders. Officials contend the deductibles were not triggered because Sandy was not classified as a hurricane when it made landfall.

New York Gov. Andrew Cuomo said, "Homeowners should not have to pay hurricane deductibles for damage caused by the storm and insurers should understand the Department of Financial Services will be monitoring how claims are handled." Connecticut Gov. Dannel Malloy and New Jersey Gov. Chris Christie also said the lower deductibles would apply to homes in their states.

The no-hurricane deductible order lessens some of the financial burden associated with Sandy by shifting a portion of the claim costs back to insurers.

◆ INSURER AND CONSUMER ISSUES

Both insurers and consumers have issues with the use of hurricane deductibles. Insurers are concerned about the clarity of state laws and the actions of state officials that might limit the use of hurricane deductibles. Insurers want to know the policy provisions containing hurricane deductibles will be enforced so they can rely on the expected loss costs used as the building block for their rates.

Consumers are concerned about what (to them) seems an unjustified cost-shifting at a time when they can least afford it. Consumers also complain about lack of meaningful disclosure regarding the deductibles. They would like meaningful disclosure so they can know what they are buying and prepare for funding the portion of a loss not transferred to the insurer. The NAIC is working on improving transparency and readability of policies and disclosures through the Property and Casualty Insurance (C) Committee and its working groups.

To address these issues, one of the possible solutions NAIC is exploring is the introduction of pre-tax deductible savings accounts. Conceptually, the savings account would allow a homeowner to pre-fund disaster-related costs in a tax-free or tax-deferred manner. The Property and Casualty Insurance (C) Committee will explore the implications of deductible savings accounts to determine whether the NAIC should support legislation to allow or encourage them.

◆ SUMMARY

Superstorm Sandy's unique nature could result in future policy changes and possible changes to state hurricane deductible laws. Shortly after Superstorm Sandy, New York legislators introduced a bill (S01760/A01222) seeking to cap the percentage-based hurricane deductibles for homeowners in New York state at $1,500. The bill also seeks to establish that hurricane deductibles shall only be applicable to losses incurred in windstorms with speeds greater than 125 miles per hour. This is likely to be a hotly debated topic going forward for insurers and homeowners, as percentage deductibles could begin to be introduced for other property insurance perils (e.g., wildfires).

NAIC Central Office
Center for Insurance Policy and Research
1100 Walnut Street, Suite 1500
Kansas City, MO 64106-2197
Phone: 816-842-3600
Fax: 816-783-8175

http://www.naic.org http://cipr.naic.org

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