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SPECIAL REPORT

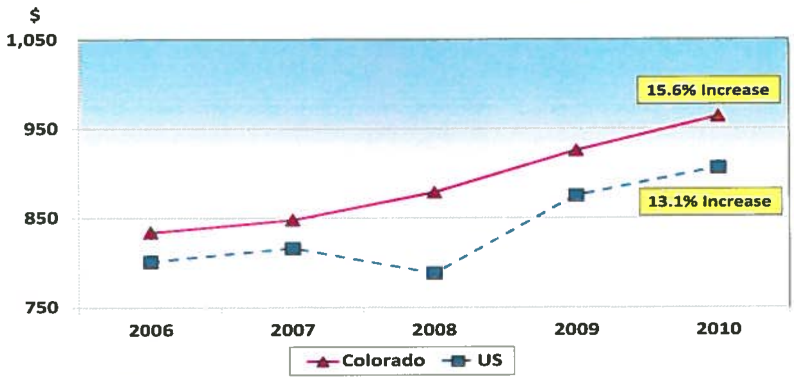
The Colorado Homeowners Insurance Market: The Impact of Natural Catastrophes on Costs and Premiums

Summary: This report examines key underlying factors affecting Colorado's higher-than-average homeowners insurance prices. Colorado is no stranger to natural catastrophes; its wildfires and hailstorms are among the most damaging in the US, causing the state's insured losses and expenses to be greater than the premiums collected and creating a 5-year underwriting deficit of $1.2 billion.

Connected to properties that are often destroyed by wildfires (or other catastrophic events), some states have valued policy laws that enable policyholders to receive the full pre-determined amount of their policy, regardless of their home's actual rebuilding costs at the time of loss. These types of laws conflict with the insurance principle of indemnification, result in higher total costs that are likely passed on to all policyholders, and usually do not return claimants to their pre-loss condition. If a valued policy law is enacted in this state, all Coloradoans may be expected to pay more for their homeowners coverage, which is not sound policy especially during this difficult economic time.

Introduction: Over the years, Colorado's average homeowners insurance premiums have consistently been in the top third of the nation. Latest data (2010) show that Coloradoans are now paying about $1,000 a year for their homeowners coverage. Since 2006, the state's average price has risen faster than the countrywide average (15.6% – CO vs. 13.1% – US).[1]

Colorado Average Homeowners Premiums are Higher and Rising Faster than Countrywide



Source: NAIC

The above-average growth rate in Colorado's premium is influenced by underlying costs that have increased dramatically over time. In 2007, its loss cost (or loss per insured home) – including catastrophes[2] and non-catastrophes – was $446, the same as the national average. By mid-2012, Colorado's loss cost nearly doubled to $838 while the US loss cost remained well under $600. Colorado's large increase in loss cost is primarily driven by a 43% growth in claim frequency, significantly greater than countrywide (11%) and each of its surrounding states (total average of 16%).[3]

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[1] National Association of Insurance Commissioners; premiums reflect Dwelling and HO Policy Forms 1, 2, 3, 5 & 8
[2] As determined by Property Claims Services, natural catastrophes are at least $25 million in insured damage.
[3] Fast Track Monitoring System, a publicly available report prepared by the Independent Statistical Service, Insurance Services Office, and National Independent Statistical Service. Homeowners losses reflect Policy Forms 1, 2, 3 and 5 combined.

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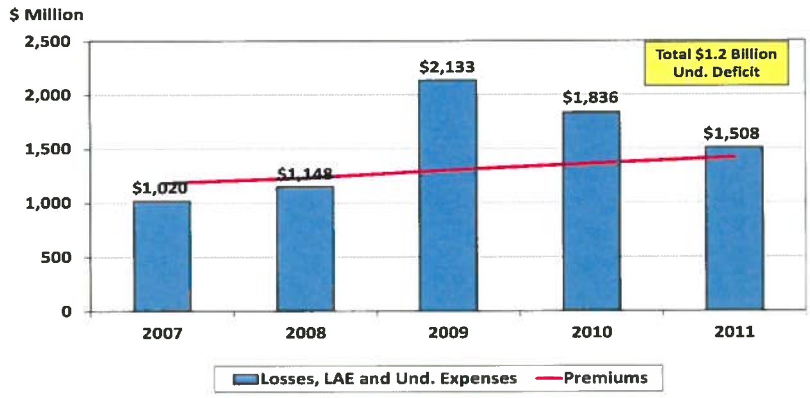
The Colorado homeowners experience has recently taken a turn for the worse. In the last three years, the premiums paid by policyholders have not been sufficient to cover related losses (including loss adjustment expenses, LAE) to settle claims and underwriting expenses. Overall from 2007 to 2011, the state's total homeowners premiums were $6.5 billion compared to more than $7.6 billion in losses and expenses – this has resulted in a five-year underwriting shortfall of about $1.2 billion.[4]

Total Colorado Premiums are No Longer Adequate to Cover Losses and Expenses

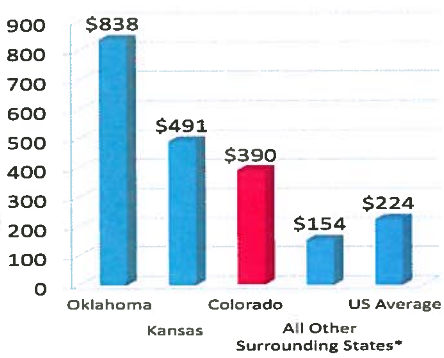


Source: PCI, based on NAIC data

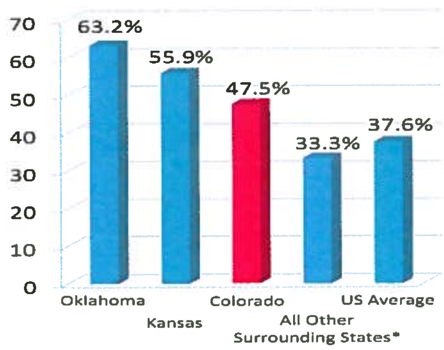
Colorado's Homeowners Costs are Largely Affected by Natural Disasters: A significant factor affecting Colorado's rapidly growing claims is its large vulnerability to natural disasters. From 2007 to the second quarter of 2012, the number of catastrophe claims per insured home rose 213%, almost four times faster than the national average of 56%. With the exception of Oklahoma and Kansas – which are regularly exposed to deadly tornadoes – Colorado's catastrophe loss cost per insured home is much higher than the US and its other surrounding states [$838 – OK; $491 – KS; $390 – CO; $224 – US; and $154 – other states (AZ, NE, NM, UT and WY) combined] *(left-hand chart)*.

While catastrophes and their related damages affect insured losses throughout the nation, their huge impact on Colorado cannot be dismissed. Catastrophes make up almost half (47.5%) of the total homeowners losses here; this proportion is substantially greater than the US average and most of Colorado's contiguous states (37.6% and 33.3%, respectively) *(right-hand chart)*.

Colorado Has a Much Higher-than-Average Catastrophe Loss Cost



Catastrophes Contribute Significantly to Colorado's Total Homeowners Loss Cost



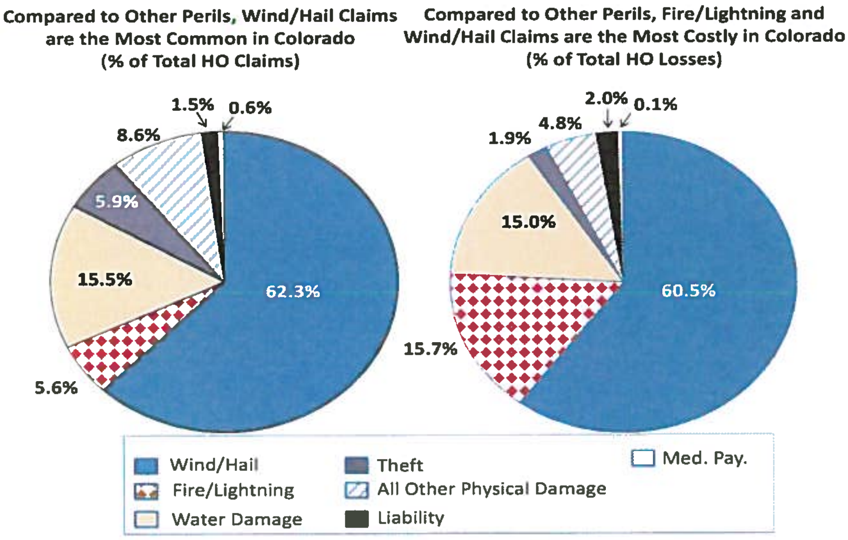
*Surrounding states are Arizona, Nebraska, New Mexico, Utah and Wyoming.
Source: Fast Track Monitoring System, 2007 through 2012(2)

[4] PCI, based on NAIC data; LAE includes defense costs and other costs to settle claims, while underwriting expenses include administrative costs, commissions, taxes, license and fees, dividends, etc.

Colorado Wildfires and Hail Storms – A Double Catastrophic Threat: The two most extreme catastrophic events in Colorado are hail storms and wildfires. Hail storms have historically resulted in much larger, widespread insured losses and in recent years insurers have paid out nearly $2 billion in damage claims. According to the Rocky Mountain Insurance Information Association (RMIIA), Colorado's Front Range is located in the heart of "Hail Alley." This state has the highest frequency of large hail – not only in North America, but in most of the world. Wind/hail damage is the most common cause of loss reported here, making up six out of 10 homeowners claims.[5]

Colorado wildfires have become more prominent over time. In 2012, six major disaster declarations or fire management assistance declarations were approved for this state by the Federal Emergency Management Agency (FEMA)[6] – earlier years have generally seen only 1 to 3 fire-related declarations. Colorado is ranked 5th highest in the nation in terms of FEMA fire management assistance declarations. On average, fire/lightning claims are the most expensive compared to claims from any other peril. Widespread conflagrations can cause considerable damage; e.g., the Waldo Canyon Fire in Colorado Springs and the High Park Fire near Fort Collins (both in June 2012) resulted in total insured losses that are estimated to surpass a half billion dollars.[7] While wildfires can cause more personally devastating losses, these are typically more isolated events and rebuilding costs depend on the insured properties located in higher risk wildfire prone areas.

Together, more than two-thirds of Colorado's homeowners claims stem from wind/hail and fire/lightning perils *(left-hand chart)*. Their combined average loss per insured home comprises more than three-fourths of the total loss cost *(right-hand chart)*.[8]



Source: Independent Statistical Service, 2007-2011 Experience

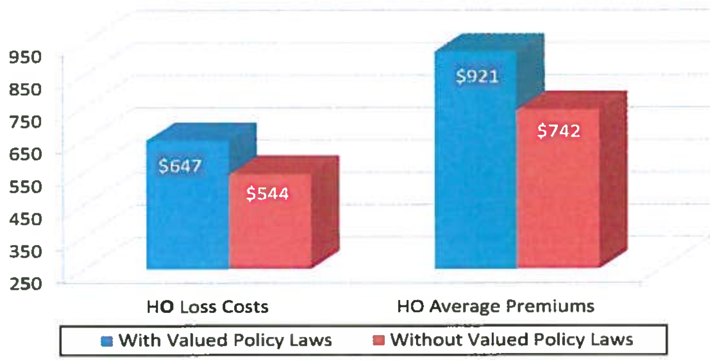
Valued Policies Harm Consumers and Encourage Moral Hazard: It is not uncommon for a wildfire to devastate a large number of properties such as the June 2012 Waldo Canyon Fire that destroyed nearly 350 homes.[9] When there is a loss of property (usually total), some states have

[5] Independent Statistical Service, a subsidiary of PCI, *Homeowners Cause of Loss Report, 2007-2011*
[6] FEMA Disaster Declarations, www.fema.gov/disasters; 2012 major disaster declaration – High Park and Waldo Canyon wildfires (June 28); 2012 fire management assistance declarations – Lower North Fork fire (March 26); High Park wildfire (June 9); Waldo Canyon fire (June 24); Weber fire (June 24); and Wetmore fire (October 23)
[7] *Insurance Journal*, "Report: Insured Losses in Colorado Wildfires Nearly $450 Million," July 17, 2012
[8] Independent Statistical Service, a subsidiary of PCI, *Homeowners Cause of Loss Report, 2007-2011*
[9] Rocky Mountain Insurance Information Association

valued policy laws that require homeowners insurers to pay the full face value of the policy purchased regardless of the actual rebuilding costs. The statutory language varies among states regarding the cause of loss (primarily fire), extent of loss (valued policies may apply to partial loss in some states) and type of covered property (real property and/or contents). At present, 24 states allow valued policies.[10]

Systemic overpayment of claims beyond the actual costs results in higher loss amounts – over time, homeowners loss costs have averaged $647 for valued policy states vs. $544 for non-valued (or "open") policy states. In turn, higher losses have led to higher prices – the average homeowners premiums are $921 for valued policy states vs. $742 for non-valued policy states.[11]

Comparison of States
With and Without Valued Policy Laws



Source: PCI, based on Fast Track Monitoring System (2007-2011) and NAIC (2006-2010)

Proponents of valued policies believe these laws would solve the underinsurance problem and help restore victims to their pre-damage status. This is not true since most residents do not have their property regularly appraised – causing them to remain underinsured – and the cost to fully replace property after a disaster is apt to be higher than the policy value due to the rising cost of building materials. Inflation also makes policy limits inadequate over time. In addition, valued policy laws may encourage moral hazard, such as fraudulently overvaluing one's property or committing arson. Especially in a tough economy, people in need of money may deliberately set their houses on fire just to get an amount greater than the value of their homes – indeed, arson for profit is the leading cause of property loss, totaling millions of dollars in damage and investigation costs each year.

One academic study supports the above findings and states that valued policies do more harm than good: *"Justifications to continue valued policy laws have lost much of their force in light of modern insurance practices. Repealing valued policy laws could provide significant welfare gains to insureds while bringing homeowners insurance more in line with fundamental principles of insurance."*[12]

*The **Property Casualty Insurers Association of America (PCI)** is a trade association of more than 1,000 insurers of all sizes and types, representing 39.6% of the total general insurance business and 32.0% of the homeowners business. In Colorado, PCI members represent 28.6% of the homeowners market.*

[10] PCI *Valued Policy Statutes, 2012*; real property covered: AR, CA, FL, GA, IA, KS, LA, MA, MN, MS, MO, MT, NE, NH, NC, ND, OH, SC, SD, TN, TX, VT, WV and WI; personal property (or contents) covered: CA, LA, MA, MN, MO, MT, NC and VT
[11] NAIC and Fast Track Monitoring System; NAIC premiums (2006-2010) reflect Dwelling and policy forms 1, 2, 3, 5 and 8 combined; Fast Track losses (2007-2011) reflect policy forms 1, 2, 3 and 5 combined. Note that group comparisons are made since data for some individual states may not be meaningful due to insufficient exposure and losses.
[12] Peter Molk, Yale Law School, "Is There Any Value? Reevaluating Homeowners Insurance Valued Policy Laws," 2011

*The **Rocky Mountain Insurance Information Association (RMIIA)** is a non-profit communications organization that represents property casualty insurers in Colorado, New Mexico, Utah and Wyoming.*