Self Insuring:
Property Owners Become Masters of their Own Destiny

In the aftermath of Hurricane Katrina, insurance premiums for property owners in vulnerable coastal regions skyrocketed. The Grand Strand was no exception, even though we have not had a major hurricane since Hurricane Hugo in 1989. Unfortunately, insurers were backed into a corner. Massive losses on Katrina claims changed the risk tolerance of many underwriters. At the same time, rising property prices during the inflating of the real estate bubble necessitated increased premiums to cover more highly valued properties. As many insurers cancelled policies in coastal regions, even those not impacted by Katrina, coverage became much scarcer, further driving up the costs to insure property. Ultimately, property owners throughout the Southeast would bear the burden of this.

Insurance is a calculation of probabilities and risk. What is the probability that an oceanfront property will experience a loss in a particular year? Furthermore, what is the projected magnitude of the loss (partial loss vs. total loss)? These are some of the factors that drive insurance premiums. For example, the risk of total loss of an oceanfront home during a hurricane is far greater than the risk of a total loss of a home ten miles inland. Consequently, the risk of a total loss of an oceanfront home is far greater than the risk of a total loss of an oceanfront condo tower constructed of concrete and steel. Underwriters assess these risks against the replacement value of the property to derive the policy premium and coverage limits.

Following Katrina, many property owners experienced an increased premium for an equal (or in some cases a lesser) amount of coverage with significantly higher deductibles. As many insurers cancelled policies and pulled out of coastal regions altogether, property owners were forced to accept higher costs to insure the property. Though many property owners would have liked to drop coverage altogether, assessing the risk of loss a lower probability event than warranted by exorbitant premiums, the holders of mortgages on the property mandated adequate insurance coverage. Homeowners, then, were trapped in a catch-22.

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As the costs spiraled out of control, property owners along the South Carolina coast encouraged legislators to take action. This action came in the form of an expansion of the wind pool. There were high hopes this would drive insurance premiums down. Surprising to most, the impact of the wind pool expansion has only been minimal. Property owners now want an elected insurance commissioner as opposed to an appointee. But will this solve the problem?

It is unlikely that this will solve the problem or that insurance premiums for property owners in coastal regions will ever be inexpensive. Over time in the absence of any catastrophic events like Katrina, more underwriters may offer coverage to property owners in these vulnerable areas. This additional competition could drive premiums down to more affordable levels and provide property owners with more favourable policies. But another major storm that results in heavy losses would start the vicious cycle of higher costs all over again.

Property owners, it seems, are left with little choice but to bite the bullet and accept higher insurance costs as a way of life in coastal areas or to take matters into their own hands by self insuring their properties as a viable alternative to traditional insurance.

Self insuring, however, is expensive for property owners to initially establish, and many lenders may not accept self insurance on properties. Typically, self insuring involves creating a trust into which funds are placed periodically to help build reserves to cover potential losses. The trust may then buy reinsurance for low probability events that result in extreme losses. Reinsurance is generally less expensive given a high deductible. Thus, self insuring is likely too costly for individual homeowners. However, this may be more feasible for property owners in condo towers where self insuring costs would be widely spread amongst the owners.

From a financial perspective, the cost to insure a $100 million condo tower is more than the cost to insure a $2 million oceanfront home or a $300,000 home ten miles inland. But the oceanfront condo towers, typically constructed of concrete and steel, are built to a much higher standard than many homes. Many oceanfront condo towers, even during Katrina, withstood tremendous damage but were not total losses—the structures and their integrity were not compromised. Most damage was cosmetic—broken windows, roofing, facades, etc or water damage. Whilst insurance would cover some of this damage, property owners are still on the hook for the deductible. With self insuring, property owners' advisors assess the expected amount of loss in the event of a disaster. Contributions may then be made annually, quarterly, or monthly or at one time through a special assessment. In the event of a claim, the funds from the trust are used to cover repairs, etc. In the event of an extreme loss, the reinsurance kicks in after the trust pays the deductible.

There are pros and cons to self insuring. Obviously, if the self insurance trust does not have sufficient funds in the event of a claim, the property owners must come up with the difference. The benefit is that the trust is an asset of the homeowners. The payments are not simply paid to the insurer and gone forever. The trust is held by trustees as an asset of the property regime and can be used for smaller claims that would typically be under the amount of the deductible on a normal insurance policy. Over time, the trust's assets grow, particularly in the absence of any claims, thus raising the possibility that the property owners may not have to make additional contributions at times.

Whilst this could work for smaller homeowners, it is clear such a plan would be more costly for the individual. However, over time, as underwriters do not have the exposure to higher dollar value condo developments, costs to individual homeowners in the same area may fall as the underwriters' concentration of risk in one area falls.

It is clear that climbing insurance premiums are a burden on property owners and a drag on real estate markets. Whilst many proposals have been made, none seem as effective as self insuring. Such self insuring regimes allow property owners to control their own destinies rather than be at the mercy of insurers.

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