

Sowing the Wind: Differential Constituents Consequences, Insurance Market Responses, and Government Policy

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Abstract

In the wake of the catastrophic devastation by Hurricane Andrew, the insurance industry and the consumers of Florida faced massive changes. Utilizing the Actors-in-Time role model for resolving ethical dilemmas, users can evaluate the decisions made by the “actors” (consumers, insurance companies, and the state of Florida) during certain specific “time” dimensions (short-term and long-term consequences). The paper highlights the ramifications of the decisions by the various stakeholders and questions the choices made by the insurance industry in the wake of the catastrophic loss.

“They have sown the wind, and they shall reap the whirlwind.”

Hosea, Chapter 8, Verse 7

From a catastrophic loss perspective in an insurance underwriting cycle, a natural disaster is a significant phenomena, but, not unprecedented or unanticipated. However, a disaster the financial magnitude of Hurricane Andrew is a shock loss of unprecedented proportion. With eleven insurances becoming insolvent due to the losses associated with Hurricane Andrew, with many insurance companies reluctant to stay in Florida, and being faced with the reality that approximately 1.2 million homeowners were in danger of being uninsured, the state of Florida instituted massive changes in the state insurance industry.

When faced with dilemmas such as this, the insurance companies as well as the state of Florida must examine the consequences of their actions, from a short-term and a long-term perspective. This examination must focus not only upon the financial ramifications of the proposed solution but also the examination must address the ethical component of the problem. In addition, the decision making process must include considerations of the effect upon the individuals involved, ranging, in this example, from homeowners to citizens to the state of Florida to insurance companies to shareholders and to other identified constituency groups.

As is evident, the complexity of decisions by the insurance industry and the state of Florida in the wake of Hurricane Andrew highlights the difficulty with which industry must function. A more simplistic and holistic approach could have resulted in different decisions that might have been more beneficial for the various constituency groups.

Thus, the authors propose that this industry could have utilized the Actors-In-Time role model for assistance in arriving at the solution to the problem. With this realistic, real-time Model, the authors can identify key components in the decision making process in terms of long and short term issues as well as the effect of these decisions upon “insiders” and “outsiders”.

Using the Actors-In-Time model in application to a specific catastrophic loss event will highlight the applicability of this Model to other business applications.

BACKGROUND

On August 24, 1992, Hurricane Andrew slammed into South Florida, devastating Homestead, Florida City, and parts of Miami before it turned and continued northwest across the Gulf of Mexico to strike the Louisiana coastline.

With winds hitting 175 mph, Hurricane Andrew caused 15 deaths directly, 25 deaths indirectly and demolished more than 25,000 homes and damaged another 100,000 homes. In Homestead with 1,176 mobile homes, only 9 were not destroyed. It is estimated that it created 30 years of debris. Property damage was estimated to be \$30 billion (St. Petersburg Times, 2002).

An estimated 100,000 residents of south Dade County permanently left the area after Hurricane Andrew. Eleven insurers went insolvent because of Hurricane Andrew and many insurance companies were reluctant to stay in Florida.

With the reality that approximately 1.2 million homeowners were going to become uninsured, the state of Florida instituted massive reforms in the insurance arena. The state of

Florida removed many of Florida's riskiest property-insurance customers -- most of them coastal residents -- from the industry's policies and placed them in a new, government-backed insurance program, Citizens Property Insurance Corp. The state also approved separate, higher deductibles for hurricane damage and tied them to customers' rising home values. Additionally, the state capped insurance companies' hurricane liability by creating the Florida Hurricane Catastrophe Fund, known as CAT. Once they have paid out a certain amount of their own money, insurers are reimbursed for additional losses by the fund, which is maintained by a 4 percent to 5 percent surcharge on Florida homeowner-insurance premiums.

Accordingly, about 70 percent of the risk now belongs to the people of Florida. Legislation has raised the CAT fund's maximum coverage for a single hurricane season from \$11 billion to \$15 billion. The resulting legislation also lowered the trigger point at which insurance companies could begin tapping the fund to cover their losses (Groeller, G. 2004).

ACTORS-IN-TIME MODEL: A REAL-TIME MODEL

Using a simplistic approach to a multi-faceted business decision, this Model allows and encourages a business owner to explore the various short term and long-term effects of their decisions as well as their impact upon “insiders” as well as “outsiders”, as so defined in relationship to the situation. Adopting the philosophy espoused by Herbert Simon in reference to “bounded rationality”, it is presumed that most business decisions are made with incomplete and conflicting information (Simon, 1976). In this Model, a user identifies 4-square boxes, which forces the user to discuss and address any and all issues that arise within those boxes. No box can be missed.

The Model is presented as follows:

Figure 1: Actors-in-Time Quadrants

Actors:	Time:	
	Short-Term Consequences	Long-Term Consequences
Outsiders		
Insiders		

Actors

In terms of the first dimension of the Model, it is necessary to identify who is an “actor”. An actor could be either an insider or outsider. Webster defines an *insider* as a person who is “recognized or accepted as a member of a group...” and defines an *outsider* as a “person who does not belong to a particular group.” (Webster, 2005). Simple distinction but powerful differences. The difference in the extent of power and information access is further highlighted in another definition by Webster of insider being “a person who is in a position of power or has access to confidential information...” and “one ... who is in a position to ... influence the decisions of the company.” (Webster, 2005).

Time

In terms of the second dimension of the Model, the user must identify what constitutes short-term consequences and long-term consequences. The authors posit that a short-term consequence is a response occurring immediately or within the week, month, or less than one year after the specific triggering event. Correspondingly, a long-term consequence focuses upon the consequences of the actions by the actors occurring more than one year after the event.

Despite the fact that the damage after an event such as this will take month or even years to be repaired and completely paid, the insurance companies establish reserves for estimated losses as quickly as possible. This is done, to a great extent, to remove as much uncertainty as possible and provide the financial markets with the industry’s best estimates of the exposure.

Thus, in terms of the insurance industry, the effect of a shock loss of the magnitude of Hurricane Andrew generated both short-term and long-term consequences. Not only did this event generate significant financial consequences financial, but also Hurricane Andrew had significant political, environmental, and ethical consequences. In addition, perceived public opinion of the insurance industry resulted in short-term and long-term consequences.

Impact of the Actors in Time Role Model

Utilizing the Model, a user must identify the possible issues associated within each box. These issues include but are not limited to financial, political, environmental, ethical, and similar topics. Unlike other ethical theories, this Model does not require a user to identify the ethical dilemma first and then focus upon resolving that dilemma. Rather, this Model requires a user to identify all possible issues, including an ethical dilemma if one exists. Since the ethical component is one of many variables, a user can evaluate all essential information at the same time rather than try to resolve one element without taking into consideration its effect upon the other issues raised. Similarly, a user can evaluate the effect of their decision upon the various stakeholders identified and described in each box.

In the following section, an illustration of utilizing this Model in the insurance industry is presented.

Application of the Actors-in-Time Model to Insurance Industry

Regarding the first dimension of the Model that requires identification of the actors, the authors view the state of Florida as well as the people of Florida who suffered losses as a result of Hurricane Andrew as outsiders and the insurance industry as insiders. Legally, the shareholders of the individual insurance companies are the owners of the corporation and thus the shareholders

would represent the insiders. Indeed, Webster's definition of insider delineates an insider as one "who is in a position to influence the decisions of the company" (Webster, 2005) and a shareholder can effect such influence by exercising their right to vote on a new Board of Directors to redirect the vision of the company. However, the reality is that in most corporations, shareholders, as a collective group, typically do not exercise this right and thus, exert minimal influence on the daily decisions and direction of the company. In contrast, the insurance industry executives have "access to confidential information" (Webster, 2005), and can avail themselves of that information in their decision making process. Thus, for purposes of this paper, the authors posit that the insiders are the insurance companies (inclusive of officers, directors, and shareholders) that were affected by Hurricane Andrew.

Regarding the second dimension, the short-term consequences relative to the insurance industry is defined as the day after the hurricane destroyed the affected areas up to the following quarter's earnings. During this time period, there are significant ramifications in terms of emotional and financial support to the outsiders as well as short-term financial viability of the insiders, i.e., individual affected insurance companies.

The long-term consequences are defined as the time period after the first quarter earnings and continuing. During this time period, the perceived public opinion as well as the continuing emotional and financial support are elements that affect the consequences. For the insiders, the long-term consequences show the economic losses from the catastrophic event as well as the revised marketing plan for industry growth.

Insider/Short-Term

In a catastrophic event, the insurance industry (insider) typically responds immediately with emotional and financial support and typically offers such with efficiency. The outsiders perceive that the insiders should respond in such a manner since they are, by contract, legally obligated to fully their financial obligation to the insured. And, in today's society, the consumer (outsider) perceives and expects that a certain level of customer service be present. However, in this particular situation, the perceived expected response in both of these areas was negated by the actual circumstances.

Many insurance companies did respond with alacrity but many did not. Those that did respond had their insurance adjusters hampered by governmental regulations regarding access to the affected areas. The sheer magnitude of the devastation hampered the response by the companies. Over 700,000 claims were processed.

Of course, the total specifics of the financial loss are not known in the short term for the insiders. Public perception could be known and is and was a factor with insiders. These consequences need to be considered when formulating decisions and making policy choices.

Insider/Long-Term

The insurance industry is presented with a variety of scenarios after a shock loss. Insurance companies could fold and about a dozen insurers in the wake of this disaster did fold. Insurance companies could withdraw from the affected areas and some insurers did withdraw from Florida. Insurance companies could stay in the affected areas and continue writing policies and continue insuring the risk.

For those that folded, the financial ramifications are obvious. Loss of business and corresponding loss of jobs nets a significant long-term consequence of insuring in an area known for natural disasters. For those that withdrew, their underwriting loss is clearly diminished. Both of these scenarios netted an affected area that now has a diminished pool of possible providers. With limited competition always arises the opportunity for insiders to raise rates and become more selective of risks to be insured.

For those insiders that remained, they threatened the state lawmakers that they would stop doing business in Florida unless the state provided some relief. The state responded by taking many of Florida's high-risk property areas – mainly coastal residents – from the insiders and placing them in a newly developed government-backed insurance program, Citizens Property Insurance Corporation.

In addition, firms developed sophisticated hurricane catastrophic models to support reinsurance programs. These reinsurance programs are basically a means of spreading the risk to several organizations by allowing other insurance companies to receive part of the original company's premium income in exchange for a willingness to shoulder some of the risk.

Numerous firms began generating weather models in order to attempt to predict possible risk of loss and accompanying measures to protect from such loss. Multi-year financial planning for shock loss was instituted in the firms to provide a financial cushion in the event of continuing losses of this magnitude. Diversification became key. All of these items come as a cost to the insider.

Interestingly, the shock loss from Hurricane Andrew was less than ten percent of the industry's total estimated claims in 1992 (Shuford, 2004). So, the question which must arise is why the exodus from Florida and why the emphasis upon shifting the loss from the insiders to the state of Florida? Was that shift justified in view of the extent of the financial loss?

Aside from the varied long-term financial consequences to insiders, another long-term consequence revolved upon the social contract to society. Outsiders had, for years, been loyal to the insiders - paid their premiums and continued to pay even with increasing rates. However, the insiders seemingly choose to ignore that loyalty by not only withdrawing from the market but also literally dumping the financial obligation of the shock losses upon the state.

Thus, the long-term consequences of the insider's decisions highlighted the conflict between financial gain and ethical choices.

Outsider/Short-Term

Outsiders paid their insurance premiums. They maintained their houses. Now, their houses are gone and the insurance companies were fighting with them about amounts of payouts. Homeowners scrambled to get their destroyed homes appraised, secure their insurance monies, contract with a builder, obtain insurance for future events – all significant short-term events and with significant emotional and financial costs.

The state of Florida depended upon the insurance industry. The insiders insured the risk and paid for the loss due to risk – in total, the system worked well. With a category 5 hurricane ripping through the state, and with insurance companies folding, the state was forced to contribute

significant financial and man-power resources to the clean-up. All of these issues contributed to overall political, financial, and societal consequences from the aftermath of this storm.

Outsider/Long-Term

Approximately 1.2 million homeowners are now uninsured due to the various insurance companies fleeing Florida after Hurricane Andrew hit. The homeowner, if they are insured, is paying higher premiums and higher deductibles. Florida insurance rates are now the third highest in the nation (Orlando Sentinel, 2004). Loss of faith in the insurance industry and their commitment to the homeowners still is prevalent in Florida.

The state now maintains the Citizens Property Insurance Corporation. This corporation essentially capped the insider's hurricane liability by creating the Florida Hurricane Catastrophic Fund, CAT. If a hurricane occurs, an insured under this plan still files a claim with their own insurance company that is only liable now for claims up to roughly 4.5 billion dollars. Any claims over that amount are paid for out of the CAT fund, which is maintained by a 4 to 5 percent surcharge on all Florida homeowner's insurance premiums. Thus, the state now has to maintain and control this program.

It is logical in many ways for the state to have implemented this plan for insurance risk. Other states have pools for insurance loss. Kentucky, for example, was experiencing significant loss of industry due to the high workers compensation rates. The state revamped their workers compensation system and instituted a pool of funds for claim reimbursement. So, similar to what occurred in Florida, Kentucky recognized the need for proactive management to insure stability in the state and responded accordingly.

Summary of Application of Role Model to Insurance Industry

The advantage of using this Model to evaluate the insurance industry is that it forces an insurance executive to consider the benefits to the insider/outsider groups and weigh the alternatives. The short-term benefits, both negative and positive, need to be balanced against the long-term benefits and drawbacks. After that type of review, the various financial, political, and ethical ramifications for the decision to either remain in Florida or pull out of the state become clear.

From a financial perspective, one aspect to consider is that the weather presents possible risk of loss but also the opportunity for financial gain. For those insiders sufficiently bold enough to embrace the risk and remain in Florida, it is possible that a category 5 hurricane may never hit the state again. But, similarly, it is possible that multiple category 5 hurricanes may hit again. While probability dictates that this latter scenario will not occur, one cannot be certain.

In a major study by Sheets and Williams, probabilities of weather phenomena were computed for various areas worldwide. Their study suggests that south Florida has a 26.3% probability of having any hurricane make landfall there in a given year. It also suggests that there is an 11.1% chance that a major hurricane will make landfall annually. Both these numbers are the highest of any area measured by a wide margin (Hurricane Watch, 2001).

From an ethical perspective, the authors posit that the insiders breached their social contract to society and to the outsiders by their actions. Their apparent disregard for the needs of the many in view of the amount of loss overall to the industry nets the clear answer that the

insurance companies value financial gain over any social contract. Indeed, one interesting aspect to consider is that after an insurance company left Florida, what would prevent them from coming back in on a selected basis and taking advantage of the opportunity to reinsure at substantially higher rates.

In a similar concern from an ethical and marketing perspective, it is possible that the insiders knew that their decision was suspect from a moral perspective and realized that from a marketing perspective it will be necessary for them to regain the public's trust in order to maintain continued profitability. Thus, in the wake of Hurricane Charley, State Farm began a marketing campaign advertising their continued presence in Florida. State Farm, the largest property insurer in Florida, wanted to reassure its customers that the company intended to process their claims and were striving to do so as quickly as possible. (Orlando Sentinel, 2004). Although the company denies that there is any correlation between this message and the numerous complaints filed against the company after Hurricane Andrew, since scripts for these commercials were written before Charley hit, the authors would posit that it is very likely that the company was aware of the negative short-term consequences of their actions and was attempting to remedy them for the long-term.

The population density in Florida, 239.6 people per square mile in 1990 grew to 296.4 people per square mile in 2000. These data would suggest that catastrophic events like Hurricane Andrew had little effect on population growth. However, the growth in the Miami-Dade area was significantly lower than the state as a whole. Miami-Dade growth from 1990 to 2000 was 16.3%. The entire state was 23.5%. This could indicate that people moving to Florida are indeed wary of the weather phenomena in the southern part of the state. However, while the 16.3% growth rate in Miami-Dade was below the state level, it represents a significant impact on the state insurance fund because this is the area of the state most deserted by the insurance companies (US Bureau of the Census, 2000).

In terms of an organizational analysis of this situation, the concept of organizational responses to environmental uncertainty may be helpful in our discussion. Organizations exist in competitive environments, and a major issue for firm decision-makers has to do with coping with (reducing) the disruptive impact of complexity, dynamism and a lack of resources in the firm's environment (Burns and Stalker, 1995, 1961; Hall, 2002). Firms may attempt to reduce the uncertainty in their business environments (in this case the unpredictable nature of overwhelming claims by policyholders) by way of: 1) market mechanisms (raising prices to cover increased costs as well as advertising to customers to justify such increases); 2) aggregation (acquiring other insurance companies in the region to pool risk); 3) diversification into other geographic regions and other forms of insurance (to spread risk over a wider probability domain); and 4) cooptation and network building (joining with competitors or lobbying for the creation or expansion of joint public-private insurance schemes) (Hall, 2002: Chapter 10; Miner, 1982: Chapter 7; Terreberry, 1968).

These four strategies for uncertainty reduction are predicted to be selected by decision makers in the above sequence, as market mechanisms are much cheaper and faster to accomplish than cooptation and network building. Efforts by insurance firms operating in Florida have largely followed this predicted pattern.

Interestingly, in the case a key question is whether the wider, public-private network created to "solve" this problem will be able to respond adequately to the inevitable long-term statistical reality of intense hurricanes in this region. Would it not be more "moral" to admit that

hurricanes are inevitable and that rather than trying to “reduce” uncertainty, via the four mechanisms outlined above, that building and materials code restrictions (a form of tax) be strengthened and a moratorium on certain forms of development , i.e., mobile home parks and dense, high rise condominiums, be imposed to reduce the population growth in the region and lessen the impact of these inevitable natural disasters? Are the present efforts to calm concerns by applying market mechanisms, aggregation, diversification, and cooptation and network building – in the long term – of form of a lie?

Are the “insiders” (in this case the insurance companies, property developers and attendant local, state and federal regulators and officials) gaining in the short term at the expense of the “outsiders” (in this case homeowners) in the long term? Is the assumption that the environmental uncertainty can be reduced or managed so unreasonable as to be a form of “hubris”?

Future Research Directions

The proposed Model provides a unique opportunity for the user to review a decision in a real-time scenario with the actors identified. Whether this model is used in the financial services field or in the industry field, the Model requires a reader to examine all aspects of a business situation.

It is suggested by the authors that application of this Model to other fields would net interesting results. As a teaching tool, this Model would provide a fairly simplistic approach to addressing a complex business problem and helping the student arrive at a logical solution. And, since this Model could highlight an ethical dilemma if it is so evident in the problem presented, this Model does not present itself as an ethical “cure-all” model since ethics and social responsibility are simply variables to be considered in arriving at your conclusion.

SUMMARY

Utilizing the Actors-in-Time method for evaluating the decisions made by the insurance industry as well as the state of Florida in the wake of the disaster caused by nature, it is evident that this Model can assist a user to arrive at a reasoned and thorough evaluation of the multiple facets of a business decision. The authors reason that a business espousing the silo effect of decision-making cannot make an informed decision and implement that decision.

In this methodology, a user is required to think “inside the box” in order to encourage a user to arrive at multiple issues addressing an event. Then, the user is required to think “outside of the box” by looking at the effect one box has upon another box. The user could arrive at multiple conclusions but the user will do so after a thorough examination of the issues and their interrelationships.

The authors posit that this Model can be used in any business, or personal, situation in order to force the user out of their comfort zone while requiring them to review multiple facets of an everyday occurrence or a catastrophic occurrence.

For the insurance industry, if faced with another shock loss the magnitude of Hurricane Andrew, if this Model is utilized, the authors suggest that the decisions of the industry might be different. For society, let us hope that neither the people of Florida nor the industry have to face these decisions again.

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