UTILIZATION OF THE MORTGAGE FINANCE AND INSURANCE INDUSTRIES TO INDUCE THE PRIVATE PROCUREMENT OF EARTHQUAKE INSURANCE: POSSIBLE ANTITRUST IMPLICATIONS

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PREFACE

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SUMMARY

This study examines the prospects for using the property/ casualty insurance industry and/or the mortgage finance industry to induce large numbers of private property owners to purchase earthquake insurance, and to assess whether and to what extent antitrust law violations might be risked in any such process.

The study first identifies the general attitude held in 1980 by the property/casualty insurance industry with respect to broad-scale underwriting of earthquake insurance for private property. It also explores the attitude of the mortgage finance industry regarding whether real estate interests held for purposes of loan security should be protected by earthquake insurance. It then illustrates pertinent attitudinal changes that have taken place since 1980, identifies attitudes which are proving resistent to change, and offers reasons for both. It suggests possible approaches that might result in one or both industries' affirmatively and significantly influencing the purchase of earthquake insurance by private property owners. It seeks to identify possible outcomes if such influence were to cause large numbers of private property owners to assume the financial responsibility for restoration of earthquake-damaged real property.

In conclusion, the paper offers an analysis of whether the illustrative examples given present significant risks of antitrust violations, and assesses whether and to what degree such risks can be avoided or substantially minimized.

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PROLOGUE

The Concern Addressed:

It is only a question of when, not if, a major earthquake will occur in the United States. If it hits a metropolitan area, and there is a good chance that it will, the consequences will probably be catastrophic. During the last decade, we have been made aware that well over half the states could suffer such an earthquake. Citizens in those vulnerable states seem to presume that if they are struck by a severe earthquake the federal government will move in quickly with adequate disaster relief to make them whole again, or nearly so.

Contrary to general public expectations, the 1974 Federal Disaster Relief Act and the Robert T. Stafford Disaster Relief and Emergency Assistance Act of 1988 (amending the 1974 act) make no compensatory provision for damage to private property. The act limits federal financial assistance mainly to the restoration of essential public facilities. When "the" earthquake does occur, even authorized federal cost sharing might well reach awesome amounts. The consequences of an unfunded need for reconstruction and restoration of private sector damage similar in scope to that suffered in San Francisco in 1906 could only be chaotic. In such circumstances, the federal government, suddenly faced with such a catastrophe, may be pressured to enact emergency legislation under which it assumes much of the financial responsibility for the private sector restoration effort. History has shown us that such emergency-stimulated legislation will

produce results that often fall far short of basic needs, while producing expenditures that are sometimes excessive and easily misdirected.

As matters stand today, if a large urban area suffers the severe impact of a major earthquake, it is probable that emergency federal legislation will be placed quickly before Congress, carrying with it inherent risks of inefficacy, inadequacy, and excessive expenditures. There are a number of decision makers in government, and in the private sector, who believe that the most viable alternative to these chaotic consequences is for private property owners to be persuaded, or required, to assume the responsibility for providing, in large measure, for their own rehabilitation.

The means for carrying out such an assumption of responsibility is, logically, the well-established institution of privately procured property/casualty insurance. Earthquake insurance, of course, is now and for three-quarters of a century or more has been available; however, it has not often been purchased. A number of studies have pointed out reasons for this reluctance to use insurance to protect private residential property from earthquakes. Thus, if insurance is the most logical means of assuring the financial capacity to rebuild private property following an earthquake, an initial problem is how to induce property owners to purchase such protection.

The Question Posed:

How can private citizens be induced to buy earthquake insurance? The simple solution is for government to order them to do so. Alternatively, government might order insurance underwriters to include such coverage in existing fire, extended coverage, and/or homeowners policies at no, or at a minimal, premium increase. But, of course, both of these alternatives must be ruled out, the first clearly so on constitutional grounds. The second must fall for at least two reasons. First, even if it were possible, in principle, to promulgate a valid regulation which required that any underwriter doing business in the regulating state must include earthquake coverage in all property-damage insurance contracts, the correlative requirement, that the underwriter must not consider that coverage in setting the premium charge, would not be enforceable. The second reason, a pragmatic one, is that the insurance industry, world wide, lacks the financial capacity to underwrite the losses that might be incurred through coverage of such a "captive" market, even if a fair premium were permitted. The reason this peril is considered to be uninsurable by underwriters is that insufficient data exist to determine what a fair or reasonable premium would be. There are a few, inside and outside the industry, who at present are not convinced that existing data are inadequate to permit structuring an economically sound earthquake insurance program. However, the present industry consensus is to the

contrary; for the purposes of this article, that position will be accepted.

How, then, in the absence of a government mandate, can private citizens be induced to purchase earthquake insurance to protect their property against that risk? *If* they can be so induced, how can the insurance industry be persuaded to undertake such a massive underwriting obligation, and how can it be protected against the catastrophic economic losses it could incur if it were burdened with such a responsibility?

The answer to these questions is complex and not yet fully determined, but enough has been learned to justify expectations that this is a solvable problem. The solution will be multifaceted, and will probably require a finely balanced government/industry sharing of financial responsibility that will be more complex than anything previously attempted. Nevertheless, industry and government officials who are working on it confidently expect the solution to be perfected within a fairly short time. We can reasonably expect that the insurance industry's "capacity problem" will not be solved simply by making the insurance industry more competitively attractive to investors. Rather, it will be accomplished through the development of new and sophisticated risk-management techniques, general adoption of a number of already proven risk-avoidance-and-mitigation strategies, and probably by providing some essential restructuring of tax laws which currently limit the reserves that the industry can set aside for such a situation.

After adopting all reasonable risk-management techniques possible, the ultimate success or failure of the attempt to achieve affordability will be dependent on whether the critical element of government/industry affiliation can be achieved in such a manner that premium costs for an earthquake endorsement can be reduced to roughly one-tenth of the present charge, a range that many insurance industry leaders believe can be achieved.

Even if the capacity problem and the affordability problems are solved, the problem remains of persuading a reluctant public periodically to expend funds to procure earthquake insurance. The insurance industry is unlikely to market the coverage aggressively, having long been very apprehensive about even the small amount of earthquake coverage it does have.

The answer to this aspect of the problem is to find an acceptable and constitutionally sound method of requiring such an expenditure. Indeed, there is a process already in place, tried and found functional, for doing just that. The mortgage finance industry, acting at the points of loan origination, has long required, as a contractual condition for making such loans, that the security property be protected by standardized property-damage insurance coverage. By the simple expedient of adding a few select words to the requirement, such a process could, within a very few years, assure that such a large percentage of real property is covered by earthquake insurance that most other private property owners would be induced to follow suit. More-

over, because of the nature of such insurance contracts, each new premium period would provide a window for satisfying the requirement, without posing any basis for constitutional challenge.

This apparently simple and easy solution runs afoul of one basic problem and two corollary problems. The basic problem is that the mortgage finance industry, largely policy-driven by its secondary market forces, is not interested in becoming an integral part of the solution to the root problem. The industry is so highly competitive that, unless all loan originations were bound to the imposition of earthquake insurance, few lenders would feel comfortable requiring it in the absence of a strong showing that their portfolio of investments in the mortgage finance marketplace was seriously at risk without such an indemnification potential.

One of the corollary problems is that a better method of protecting portfolio investment security would be to procure portfolio insurance directly, if for no other reason than that the costs of administration would be greatly reduced and the problem of retention enforcement would be eliminated.

The other corollary problem, under present conditions, is that the insurance industry is generally strongly resistant to any program which would force it to write earthquake insurance on a comprehensive basis.

In spite of the apparent barriers, the mortgage finance industry still appears to be an effective mechanism for assuring widespread private procurement of earthquake insurance coverage.

Mechanically, the federal bodies presiding over our finance institutions, as well as the deposit insurance institutions, could elect (or be elected) to impose the earthquake insurance requirement as a loan prerequisite, with a strong and reasonable probability that the requirement could survive constitutional challenge.

One more problem suggests itself at this point, and it is the primary question this paper addresses. Obviously, to initiate and implement a program of the sort suggested above would require a level of intra- and interagency cooperation, coordination, and decision making that might subject the participants to possible violations of antitrust laws. If risks of antitrust violations are inherent in the program contemplated, it will be necessary either to have such laws relaxed, or, if possible, to avoid them.

To explore and assess that risk, the Federal Emergency Management Agency (FEMA) commissioned the study conducted by The George Washington University from which this paper is derived. The paper first identifies (as it was in 1980) the general attitude of the property/casualty insurance industry and the mortgage finance industry toward being used to induce substantial numbers of private property owners to purchase earthquake insurance; it then moves on to illustrate developing changes in those earlier attitudes, to sort out situations which are proving resistant to change, and to document reasons for both. It further seeks to identify the probable format of a program intended

to stimulate widespread private purchase of earthquake insurance, and to illustrate through hypothecation (since there is as yet no actual process for examining) the many interactions that may or must occur if a functional process is to be established that will shift the responsibility for the restoration of earthquake-damaged real property to the shoulders of the property owners. Finally, the paper analyzes some of these hypothecated interactions for possible antitrust law vulnerabilities and assesses whether any such risks can be avoided or substantially minimized. It concludes with an assessment of the extent to which the two subject industries might be exposed to risks of antitrust law violation if they were to participate in a strong effort to transfer to the private property owner the responsibility for financing the costs of earthquake damage to private property.

Conclusions Reached in the Study

Both the property insurance industry and the mortgage finance industry have the capacity to exert, individually or in concert, considerable influence over whether and to what extent private property owners will purchase earthquake insurance. Neither wants to do so at present. Neither has any incentive to do so. In the case of a widely insured-against catastrophic earthquake, the insurance industry would not be able to pay all the losses and yet continue to meet its other obligations. Individual lenders might either incur catastrophic losses or be little affected, depending on their individual loan portfolios. If they need protection against earthquake-caused depreciation in

the value of properties encumbered as security for loans outstanding, they would probably find it more economical and subjectively beneficial to procure portfolio insurance. The institutional regulatory system governing lending institutions, however, could with procedural ease institute a valid policy-based requirement that all property tendered as collateral for loans be insured against earthquake damage. In any foreseeable program, the federal government would have to establish general policy supporting private procurement of earthquake insurance on a wide scale. In so doing, the government would have to play a critical role in the reinsurance area.

Any functional process for achieving the goal of vesting in the hands of private property owners the primary responsibility for financing the costs of restoration of their property in the event of its damage by earthquake must involve a large number of interactions among and between lenders and insurers which might subject them to risks of antitrust violations.

National policy regarding the function and application of our antitrust laws has undergone significant change during this decade. Recent decisions have rendered the laws not nearly as antithetical to legitimate competitor cooperation that is designed to enhance the availability and attractiveness of products and consumer welfare as was the case previously, and the circle of uncertainty regarding antitrust law has grown narrower. Thus, the analysis and guidelines set forth in the study should reduce the risk that well-intentioned persons would violate these laws.

Indeed, it should be possible to achieve all of the legitimate goals of an active earthquake mitigation program with little risk of successful attack under antitrust law.