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**Competitive Enterprise Institute**

1899 L Street, NW • 12<sup>th</sup> Floor • Washington, DC 20036  
202.331.1010 • www.cei.org

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## **Principles for Property Mitigation Discounts**

By Eli Lehrer<sup>1</sup>

Encouraging property mitigation against catastrophes like floods and storms has become a major area of consensus for people on all sides of the debate over coastal insurance in hurricane-prone areas. Insurance regulators, advocacy groups across the political spectrum, and legislators all emphasize its importance. Mitigation essentially consists of efforts to prevent damage from disasters before the disasters take place.<sup>1</sup> But in a broader sense, mitigation can refer to almost anything, from minor, low-cost activities like picking garden plantings with deep roots in hurricane-prone areas to massive efforts like infrastructure construction and community-wide land use planning. While mitigation is uncontroversial on a general level, specific mitigation measures often arouse debate.

Property mitigation discounts has gained wide support around the country as a way to encourage mitigation. In concept, the idea that stronger homes should pay lower rates is non-controversial; nearly all homeowners' insurers take construction type and characteristics into account for all properties they cover. Certain construction materials and techniques qualify for lower rates than others. To a certain extent, any property insurance policy issued already offers mitigation discounts.

Many states have gone further. For nearly four years, Florida has mandated mitigation discounts that require certain adaptations in order for homeowners to qualify—roof tie-downs, storm shutters, and the like.<sup>2</sup> Florida has backed its mitigation discount mandates with a comprehensive statewide building code and a fair amount of engineering research estimating the value of certain mitigation measures.<sup>3</sup> Louisiana, Massachusetts, and South Carolina also maintain programs to encourage mitigation.<sup>4</sup>

Although certain questions could be raise about the specifics of Florida's findings—they have not been updated to reflect changes in building technology—the fundamental conclusion that

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<sup>1</sup> *Eli Lehrer is a Senior Fellow and the Director of the Center for Risk, Regulation and Markets at the Competitive Enterprise Institute.*

some types of construction are more storm-resistant than others seems a matter of common sense. Yet the desirable scope and nature of property mitigation discounts remains controversial. This paper provides a framework for policy makers and concerned citizens interested in property mitigation and its impact on insurance rates. It outlines three basic principles that ought to guide public policy thinking about mitigation:

1. Risk-based rates provide the best and most flexible mitigation discounts.
2. The value of any *particular* mitigation strategy depends on property location and verifiability. As a result, it is inadvisable to try and set any mitigation discounts by statute.
3. Many effective mitigation measures are beyond the control of individual homeowners for varying reasons; they call for impractical retrofitting, involve public infrastructure, or require community-wide land use decisions.

### **Risk-Based Rates Provide the Best and Most Flexible Mitigation Discounts.**

Florida's experience shows how a lack of risk-based rates makes it difficult for otherwise sensible discounts to work as intended. Rather than allow consumers and insurers to decide on fair prices through market negotiation, the state of Florida essentially sets insurance rates through the political process.<sup>5</sup>

The state government sells insurance through a government agency that charges less than private carriers for many homes and tells insurers what to charge through a "prior approval" rate making process. As a result, rates do not reflect properties' actual risk exposures, and in the long term are likely to force insurers to lose money, leading to insurers turning down business instead. Indeed, State Farm, the nation's largest property insurer, has announced plans to pull out of Florida, and other industry leaders like Allstate, Nationwide, and The Hartford have essentially stopped writing new policies in the state.

Because Florida does not allow insurers to charge risk-based rates, seemingly sensible mitigation discounts do not make sense in the broader context of that state's system. Ideally, all insurers seeking to grow their business would charge less to ensure better construction without need of a government mandate. But when rates are already set below the level necessary to reflect risk, companies will not be able to offer mitigation discounts, or offer discounts that are too small to make a difference in incentivizing homeowners to undertake mitigation.

In any case, mitigation discounts are only one variable that insurers use to set rates. Insurers also frequently provide discounts for people who own other products from the same company, work in certain professions, belong to certain organizations, have desirable credit histories, or go for long periods of time without making claims. A large, sophisticated insurer might offer more than 1,000 potential discounts.

Moreover, there are other types of discounts. Different insurers price their products differently, using different formulas and models. Therefore, the size of mitigation discounts among insurers will almost always vary—even for similar property mitigations. If one insurer finds that a reasonably cheap mitigation is more effective than expected, it can encourage its customers to install it, cut their rates significantly in return, gain business, and expand its market share. A company will have the proper incentives to do these things only when it can charge rates that

properly reflect the initial risk. Mitigation discounts, in short, should not be considered in isolation. They work best in a context where overall rates, as determined by market forces, reflect the real risk to which properties are exposed.

**The value of any particular mitigation strategy depends on property location and verifiability. As a result, it is inadvisable to try and set mitigation discounts by statute.** Laboratory tests and real-world experiments can help determine the value of mitigations, but they cannot determine what mitigations are worth in any particular location. When insurers, homeowners, and regulators consider property mitigations, they have to take location and verifiability into account in setting rates.

Location is usually the most important determinant of a home's resistance to storms. A perfectly built home right on the beach may well be riskier to insure than a less-well built home many miles inland. Dozens of other factors can also impact a home's safety against storms—the shape of the nearby coastline, the presence or absence of nearby hills, and the proximity of wetlands. Furthermore, some mitigation may not benefit certain homes. For example, most homeowners 100 miles inland probably cannot make their homes any safer by installing storm shutters. Finally, technological innovation may increase the value of certain mitigations.

Anyone considering mitigation discounts should consider creating a verification system for them. However, verifying mitigations can be difficult. Most states that mandate mitigation discounts require some sort of inspection to verify that the mitigation has been implemented, but many of those inspections are performed by home inspectors who may know more about things like appliance condition than storm mitigation. Inspections can also cost a good deal of money and lack agreed-upon standards.<sup>6</sup> Given the incentives it faces, the insurance industry appears best suited to determine how—and if—mitigation credits should get verified. Taxpayers should not be responsible for mitigation verification.

The difficulty of verification and the differences of location make it very difficult for legislatures to try to define mitigation specific discounts by statute. Insofar as legislatures exercise control over the variables allowed in rate making, they should encourage insurance regulators to allow the use of mitigation-based variables and encourage flexibility in setting these variables.

**Many effective mitigations are beyond the control of individual homeowners.** Not all homeowners could ever qualify for the most important mitigations. At least three important types of mitigations are almost entirely outside of a typical homeowners' control—those that call for impractical retrofitting, involve public infrastructure, or require community-wide land use decisions.

Some structural mitigation cannot, as a practical matter, be retrofitted onto existing homes. For example, all other things being equal, a house made of brick and stone is more storm resistant than one with simple frame construction, because heavier materials simply do not blow away as easily. But owners of frame houses cannot retrofit them. And retrofitting certain houses may simply not be worth it. Owners of small, run-down houses may be better off buying high-deductible insurance policies and rebuilding out with a combination of bank loans and personal resources rather than spending thousands on retrofitting.

Some effective mitigation measures involve public infrastructure or other public policy decisions. Elevating an entire neighborhood may protect it from storm surge, for example, but an individual homeowner cannot elevate his or her neighborhood alone. Likewise, an individual homeowner cannot control the significant hazard from flying debris created by a poorly built house being located nearby.

Finally, some sweeping land use decisions, such as wetlands preservation policies, can impact storm surge, neighborhood location, and even storm intensity. Communities that make “good” decisions—as determined by insurers or policy makers—may, as a whole, qualify for lower rates as a result, but individual homeowners cannot retrofit these types of mitigations to existing homes. And even with a strong public policy commitment to do so, actually implementing these broad decisions can take years. Thus, it is unlikely that such broad policy decisions could or should quickly qualify a community for lower insurance rates.

**Conclusion.** Mitigation makes sense. Better built properties deserve mitigation discounts and, in a well-functioning market, will almost always get them. Legislators should be wary of efforts to mandate specific mitigation discounts without paying attention to the myriad other factors that can play a major role in determining the value of various mitigation measures.

Insofar as they act to promote mitigation, legislatures should make the free market an ally. The market will promote a holistic focus on mitigation. Mitigation discounts for home adaptations are part of an effective mitigation policy, which should also include decision-making mechanisms for about zoning, development, open space conservation, and a host of other issues. Simply installing storm shutters does not always make things better. Letting market forces work does.

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<sup>1</sup> Federal Emergency Management Agency, “What is Mitigation?”  
<http://www.fema.gov/government/mitigation.shtm>.

<sup>2</sup> Florida Office of Insurance Regulation, “Premium Discounts for Hurricane Loss Mitigation,”  
<http://www.floir.com/Hurricanes/HurricaneLossMitigation.aspx>.

<sup>3</sup> Florida Department of Community Affairs. “Development of Loss Relativities for Wind Resistance Features of Residential Structures,” Version 2.2, March 28, 2002, <http://www.floir.com/Hurricanes/ARAWindmitigation.pdf>.

<sup>4</sup> See e.g. Louisiana Department of Insurance., “Residential Property Storm Mitigation Incentives,”  
[http://www.lidi.state.la.us/consumers/misc\\_pubs/Storm%20Mitigation%20Incentives.pdf](http://www.lidi.state.la.us/consumers/misc_pubs/Storm%20Mitigation%20Incentives.pdf).

<sup>5</sup> Eli Lehrer. “Restoring the Private Property Insurance Market to Reduce Florida’s Risk of Fiscal Insolvency,” *The James Madison Institute*, March 2009, <http://www.jamesmadison.org/pdf/materials/671.pdf>.

<sup>6</sup> For a good idea of how vague the standards for who can inspect a home and what a home inspection consists of, see Department of Housing and Urban Development, “Ten Important Questions to Ask Your Home Inspector,” <http://nhl.gov/offices/hsg/sfh/insp/inspfaq.cfm>.