Special Report

Cursing Katrina

Tomas Kellner, 08.30.05, 6:00 AM ET

After four hurricanes barreled across Florida last summer, **Allstate Insurance Co.** was on the hook for $2 billion in damages.

The loss erased everything the company has made in the state's home insurance market since 1992. That year, Hurricane Andrew wiped clean all profit Allstate (nyse: ALL - news - people) pocketed since it came to Florida in the 1950s.

"We've made zero dollars in that state," says Michael Trevino, company spokesman. To cope, the company dropped 95,000 home policy holders last May, and stopped writing commercial insurance to 16,000 clients.

Today, Allstate, the second largest U.S. insurer, is facing a huge exposure from Hurricane Katrina. It holds 21% of home insurance policies in Louisiana and 10% in Mississippi. The insured toll from Katrina is estimated at $25 billion.

Allstate has many comrades in misery. The 2004 hurricane season cost insurers $27 billion in damages. Bad weather has also tied up their capital that could be otherwise profitably invested. The Insurance Services Office reported that equity capital held by insurers to cover disasters increased from $194 billion to $347 billion from 1990 to 2003, adjusted for inflation adjusted.

Besides unpredictable weather and the danger of climate change, the heavily regulated industry wrestles with government bureaucrats and changing demographics. Since last summer, nine insurers selling home policies in Florida have either completely or partially pulled out of the home insurance market in the state. Collectively, they abandoned premiums worth over $200 million.

At least a dozen more companies filed for a big rate increase with regulators there. Given what's happening in Louisiana and Mississippi today, more insurers across the South will likely follow.

"We're on the leading edge of a multi-decade period of more intense tropical cyclone activity," says Robert Hartwig, chief economist for the Insurance Information Institute. "The insurers are feeling that they are not being allowed to charge the rate that's commensurate with the risk."

Many insurance companies measure their exposure to the elements by sophisticated catastrophe modeling analysis provided by firms like Risk Management Solutions and Applied Insurance Research. AIR's models, for example, let insurers estimate potential hurricane losses by looking at climate forecasts and data such as expected ocean temperature. However, insurers can't raise their rates arbitrarily and have to apply for a rate raise with state regulators. But there's a problem.

"Rate increases must be predicated on loss experience and based on the assumption that the future will be like the past," says Evan Mills, a scientist at the Lawrence Berkeley National Laboratory who deals with climate and insurance issues. "Regulators will not allow rate increase on prognostication."

Mills says that insurers are further squeezed by demographic trends, such as people building homes on disaster-prone coast. "It makes the issue more worrisome because you have people moving into harms way at the same time as we're experiencing more intense weather."

To cover their bottom lines, many insurers switched from fixed deductibles to fees based on home-value percentage, 5% and up in Florida for homes worth over $500,000. Yet some leave even if they get a substantial rate boost. Nationwide, for example, applied for a 28% rate hike in January, got a 21% raise, but left Florida in July anyway. "A lot has changed" since January, said Joe Case, Nationwide's spokesman. The rate "is only one piece of the puzzle."

That leaves the taxpayer to pick up the bill. The federal government already covers flooding damage. In Florida, home owners who can't find anyone willing to sell them insurance can buy a policy from a special outfit set up by the state called the Florida Citizens Property Insurance Corp.

Set up in 2002, the FCPIC provides "70 % or more" of the wind coverage in sections of the tony Palm Beach, Broward, and Dade counties, according to a May report by the General Accounting Office.

Allstate's Trevino now wants the federal taxpayer to jump in and let Allstate provide home owners with much broader catastrophe coverage, much like the national flood insurance program.

"If the federal government has more involvement, home owners can get insurance coverage cheaper," Trevino said. "We've got to charge a premium that allows us not only to cover the losses but also meet shareholder expectations."

So they could build more beachfront mansions, perhaps.