

Restoring the Private Property-Insurance Market To Reduce Florida's Risk of Financial Insolvency

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Foreword

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As Florida faces a worsening crisis involving property insurance—a crisis exacerbated by the recent withdrawal of State Farm, one of Florida's largest private providers—there are lessons to be learned from problems in another line of insurance. Through the years Florida has frequently acted to shut down fly-by-night shops peddling “car insurance.” Regulators often discovered that these storefront offices, many clustered in minority neighborhoods in the state's larger cities, weren't actually selling insurance; rather, they were selling the *illusion* of insurance: pieces of paper that the buyers could present as “proof of insurance” when registering their vehicles and obtaining license plates.

In the more flagrant cases of this kind of fraud, there were no financial assets to back up the insurer's paper promise to compensate the customer in the event of a claim. Often, the customers either did not know—or did not care. What they needed was that precious form attesting that they had the minimum amount of auto insurance coverage required by law—generally “Personal Injury Protection” (PIP). If their clunker of a car were totaled in a crash, so be it; they could always get another one – sometimes for monthly payments that were less than the cost of their pricey “car insurance.”

When one's home is severely damaged, however, the problem of inadequate insurance coverage becomes much more serious—and a huge concern for the troubled mortgage

business, too. Nonetheless, in the field of property insurance, the state of Florida arguably is engaging in practices akin to those practices it prohibited and prosecuted when car insurance was the issue: It is countenancing the sale of property insurance by start-up firms recently formed for the purpose of filling the void left when well-capitalized companies such as State Farm withdrew entirely while others, *i.e.* USAA, substantially reduced their exposure in Florida. Although some of these new firms appear to have a capacity sufficient to cover their risk *unless* a catastrophic storm or storms hit a densely populated area, others do not.

Meanwhile, the state government—through its Citizens Property Insurance—is essentially engaging in the same dubious practice. Although Citizens is not without assets, they are far from adequate to cover the potential claims should Florida suffer severe damage from a major storm or a series of storms. Moreover, the company's backup plan – borrowing to make up for any shortfall—is no longer plausible, given the worldwide problems in the credit and reinsurance market. This leaves Florida's taxpayers and insurance customers on the hook in a way that could threaten the state with financial ruin.

The next hurricane season begins on June 1. As Eli Lehrer's study demonstrates, while there is still time to move toward restoring Florida's private property insurance market, the clock is ticking, the risk is growing, and the need is urgent.

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Restoring the Private Property-Insurance Market To Reduce Florida's Risk of Financial Insolvency

Without swift, sweeping reform, Florida's current system for property and casualty insurance could well place the state in grave fiscal peril. This paper presents an agenda for reforming Florida's property and casualty insurance system in the short term. It presents short-term steps that would pull Florida back from the brink of fiscal ruin, improve the state's fiscal climate, reduce property insurance rates for many Floridians, and make the state safer and more secure against the threat of hurricanes.

The paper consists of two major sections and a conclusion. The first section describes the lay of the land as of early 2009 and outlines the dimensions of Florida's current fiscal crisis. The second section outlines three important but incremental steps—all politically and practically achievable during the Legislature's 2009 regular session—that would improve the health of Florida's property insurance environment. The conclusion outlines a longer-term vision that would restore free market competition to Florida's property insurance system. The paper reaches a simple bottom line: Florida must change its property insurance system, or the misguided reforms of early 2007 could well result in permanent, severe, and lasting damage to the state's economy and its citizens' way of life.

The Situation

Florida faces severe risks from hurricanes and even greater risks from the state Legislature's system of providing property insurance. The next few pages describe the risk of hurricanes and outline the system as it existed as of early 2008.

The United States is currently experiencing a period of heavy hurricane activity that will likely last another decade. Although 1992's Hurricane Andrew often marks the beginning of the upswing in hurricane activity in the public mind, The National Oceanic and Atmospheric

Administration (NOAA) reports that the period "officially" began in 1995.¹ A similar period of heavy hurricane activity ran from 1926 to 1970, NOAA finds.

Two major factors, both of them entirely beyond human control, largely determine the prevalence of storms: a "tropical multi-decadal signal" and "El Niño/La Niña" southern oscillations. The tropical multi-decadal signal involves three interrelated factors: "1) warmer than average waters across the tropical Atlantic, 2) a stronger monsoon in the region of West Africa and 3) a weaker monsoon in the Amazon Basin region."² *El Niño/La Niña*, likewise, involves warming and cooling of waters in the South Pacific. In general, hurricane intensity increases as the world's waters warm. While a look at 20th Century hurricane activity shows a clear up and down pattern, no one has divined a method of guessing the number of hurricanes within a given season with any real degree of accuracy.

Other, less understood factors may also impact the frequency and severity of hurricanes. Two commonly cited candidates are global climate change and changes in solar activity.³ On balance, climate scientists have not reached a consensus on the actual impact of either factor. While both, neither, or a combination of the two may explain the difference between projections and actual hurricane intensity and frequency, even an extreme change in either factor would not have a significant impact on the frequency

1 "NOAA Attributes Increase in Hurricane Activity to Naturally Occurring Multi-Decadal Climate Variability," *NOAA Magazine*, www.magazine.noaa.gov/stories/mag184.htm.

2 *Ibid.*

3 Science Daily. "Global Warming Will Do Little To Change Hurricane Activity, According To New Model," August 13, 2008, www.sciencedaily.com/releases/2008/08/080812160615.htm and J.B. Elsner and T.H. Jagger. "United States and Caribbean Tropical Cyclone Activity Related to the Solar Cycle," *Geophys. Research Letters*, 35, L18705, doi:10.1029/2008GL034431.

"Florida must change its property insurance system, or the misguided reforms of early 2007 could well result in permanent, severe, and lasting damage to the state's economy and its citizens' way of life."

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or intensity of hurricanes in the United States. In short, whatever happens, Florida will almost certainly have several severe hurricane strikes over the next decade or two. Nothing can prevent this.

Florida will take the brunt of any national increase in hurricane activity. The state has over \$2 trillion in total coastal exposure, the most of any state.⁴ Florida, indeed, has more property at risk than the other “hurricane alley” states (Louisiana, Virginia, Texas, North Carolina, South Carolina, Georgia, and Mississippi) combined.⁵ Since the last period of high hurricane activity ended in 1970, Florida’s population has grown from under 7 million to nearly 19 million.⁶ Although no data are available which cover the entire state, metropolitan Miami saw its stock of single-family detached homes expand by about 20 percent more than its overall population growth during the same period.⁷ On balance, in other words, Floridians have also spread out and moved into less dense, and probably larger, homes. This means that Floridians also cover more land and, thus, live in more places likely to suffer from storms. Since 1995, hurricanes have hit Miami-Ft. Lauderdale, Tampa, and Orlando. Only one major Florida city, Jacksonville, has avoided a direct hurricane hit.⁸ More hurricanes will come and Florida’s own geography—nearly all residents live within 50 miles of the coast—suggests that no area can avoid hurricanes entirely.

To summarize, Florida faces a severe, ongoing risk of hurricanes resulting largely from natural climate fluctuations and has increased its population to the point that more people, more property, and more wealth stand in the direct path of hurricanes.

Protecting Against Hurricanes

In seeking to protect themselves and their state against hurricanes, Floridians have three interrelated and complementary options: they can purchase insurance to pay for the costs of storm damage; reinforce their property to make it more resistant to storms; and support measures that restrict development in areas particularly at risk for hurricanes.

Florida’s insurance system currently faces severe problems. The system consists of three fundamental components: the Florida Citizens Property Insurance Corporation (Citizens), the Florida Hurricane Catastrophe Fund (Cat Fund), and the private insurance industry.

Citizens, the largest insurer in Florida, provides full-scale property and “wind only” coverage. Since it took on its current name in 2002, Florida Citizens has existed, in theory, to write insurance for Floridians living “in high-risk areas and others who cannot find coverage in the open, private insurance market.” Although it maintains a private sector façade, Citizens is, in fact, an unusually powerful government agency. Citizens enjoys an exemption from most state purchasing and hiring rules and has a corporate-style structure that puts a CEO at its head. Its web page, at a glance, looks like that of a mid-sized private insurer, and it pays salaries comparable to those available in the private sector.⁹ In many ways, it does operate as a business, albeit a non-profit one. (It’s worth noting in this context that many large insurers such as USAA, Liberty Mutual, and State Farm also operate on a non-profit basis.) Although it faces a few legal constraints on its operations—more about those below—it has many of the freedoms typically accorded to private businesses. Florida’s own statutes, however, make it clear that Citizens is a government agency in every way:

“Because it is essential for this government entity to have the maximum financial resources to pay claims following a catastrophic hurricane, it is the intent of the Legislature that Citizens Property Insurance Corpora-

4 AIR Worldwide via Insurance Information Institute. “Total Value of Insured Coastal Exposure,” in *Insurance and Coastal Risk in Florida*. December 13, 2005.

5 Ibid. Totals are author’s calculations.

6 Office of Economic and Demographic Research of the Florida Legislature. “Florida Population by Age Group Actual and Projected, 1960 to 2030,” <http://edr.state.fl.us/population.htm>.

7 United States Bureau of the Census. “American Housing Survey for Miami-Ft. Lauderdale Metropolitan Area: 2002,” Bureau of the Census, 2003, www.census.gov/prod/2003pubs/h170-02-28.pdf.

8 Very likely, Jacksonville is simply lucky. It’s significantly closer to the coast than Orlando.

9 See e.g. Florida Citizens Property Insurance Corporation. “Our Vision,” www.citizensfla.com/about/generalinfo.cfm?show=pdf&link=/shared/generalinfo/pdf/missionvalues.pdf.

*tion continue to be an integral part of the state and that the income of the corporation be exempt from federal income taxation and that interest on the debt obligations issued by the corporation be exempt from federal income taxation.”*¹⁰

Citizens, in fact, not only serves as part of Florida’s government but has authority to impose taxes on every insurance policy issued *anywhere* in the state of Florida. When Citizens sustains a substantial loss—more than 10 percent—it has the unilateral power to impose taxes (called “assessments”) sufficient that “the entire deficit shall be recovered through regular assessments of. . . insurers [and] insureds.”¹¹

Although originally created to offer insurance only for people legitimately unable to find any policies in the private market, Governor Crist’s 2007 insurance reforms allowed Florida Citizens to write a policy for any Floridian who gets a single insurance quote more than 15 percent above Citizens’ rates.¹² Furthermore, under legislation passed during the 2008 legislative session, Citizens cannot raise its own rates on Floridians until 2010.¹³

Not surprisingly, given its low rates, Citizens has grown very large. As of December of 2008, it wrote slightly less than 20 percent of the state’s property insurance. It does the most business in Broward, Palm Beach, Miami-Dade, and Monroe Counties; together, these counties make up only about a third of Florida’s population but account for two-thirds of Florida Citizens business. The agency has almost \$2 billion in its accounts and sold another \$1.75 billion in securities prior to the collapse of municipal debt markets during early 2008.¹⁴ It claims

to possess a “claims paying capacity of \$20 billion” although this figure includes “reinsurance” that it purchases from the Hurricane Catastrophe Fund.

The Catastrophe Fund

The Florida Hurricane Catastrophe Fund is a state-run reinsurance corporation and—if it hasn’t already—will almost certainly become the largest provider of reinsurance in the state of Florida. Like private reinsurers, the Cat Fund, as it is popularly called, provides insurance for insurers. (See Page 7 for more on reinsurance.) Since its creation in 1993, the Cat Fund has grown from a tiny facility that provided additional reinsurance at the margins to a full-service operation that imposes a liability on the state of up to \$32 billion.¹⁵ When insurers’ total losses exceed certain levels, the Cat Fund, like private reinsurance, promises to pay them given amounts of money. In return for these promises, the Cat Fund collects regular ceding fees from insurers. The Cat Fund, however, is different from private reinsurers in four major ways: participation is mandatory; the Cat Fund has many fewer assets than it needs to pay off its coverage; the Cat Fund’s structure is the same for all insurers; its fundamental cost structure places it at a disadvantage relative to private reinsurers.

All insurers selling property insurance in Florida must buy coverage from the Cat Fund.¹⁶ There’s no choice. If an insurer believes it can find insurance that better fits its business plan elsewhere, it still cannot opt out of the Cat Fund even if doing so would allow it to cover more people at lower rates. Most large reinsurers purchase private reinsurance that, in theory, duplicates Cat Fund coverage.

The Cat Fund also does not have many actual assets or other ways of covering its demands. Currently the Cat Fund offers \$28 billion in reinsurance to Florida’s insurance companies. As of the end of 2008, the Fund’s own actuaries reported that it had only \$2.8 billion in assets plus additional retrocession loans (reinsurer for reinsurers) coverage it secured

“The Florida Hurricane Catastrophe Fund is a state-run reinsurance corporation and—if it hasn’t already—will almost certainly become the largest provider of reinsurance in the state of Florida.”

10 627 Florida Statutes .351(6)(1). For a more readable version of what the legislation does, see: Florida Citizens Property Insurance Corporation. “Citizens2007 Regular Session Legislation for Consumers,” www.citizensfla.com/utilitybar/policyholderfaqs.cfm?show=text&link=shared/faqs/faq_2007_Regular_Session.html.

11 627 Florida Statutes .351(6)(2)(3)(a).

12 627 Florida Statutes .351(6)(1).

13 Insurance Journal. “Southeast News: Fla. Gov. Signs Law Extending Citizens Rate Freeze; Nixes Private Initiative,” May 29, 2008, www.insurancejournal.com/news/southeast/2008/05/29/90435.htm.

14 Florida Citizens Property Insurance Corporation. “Citizens Board of Governors Announces \$1.75 Billion in Pre-Event Finance [sic],” June 19, 2008, www.citizensfla.com/about/pressreleases.cfm?show=text&link=shared/press/articles/06_19_2008.html.

15 Florida Hurricane Catastrophe Fund. “About the Florida Hurricane Catastrophe Fund,” www.sbafla.com/fhcf/AbouttheFHCF/tabid/278/Default.aspx.

16 For the Cat Fund’s organic statute, see: XIV Florida Statutes 215.555.

“However one decides to determine the fund’s claims-paying capacity, it clearly cannot pay everything it promised to pay if a major storm hits Florida.”

through Berkshire Hathaway.¹⁷ (The contract, which expires before the beginning of the 2009 hurricane season, contains a promise that Berkshire Hathaway will loan the fund \$4 billion if needed. In return, Berkshire received a one-time payment of \$224 million.¹⁸) However one decides to determine the fund’s claims-paying capacity, it clearly cannot pay everything it promised to pay if a major storm hits Florida. To cover its expenses, the Fund plans to sell bonds and pay them back by placing assessments—special taxes—on all property and casualty insurance policies sold in the state of Florida.¹⁹ It’s not known how many bonds the Cat Fund could sell and, indeed, the Cat Fund itself will not promise it can actually cover its claims. Raymond James, the Cat Fund’s financial advisor, puts it well: “Financial Experts Say the Cat Fund Would be Hard-Pressed to Meet its Current Financial Obligations.” Indeed, in February of 2008, Insurance Commissioner Kevin McCarty traveled to Washington, D.C., to argue for a federal bailout loan guarantee—essentially a pre-funded bailout—for the Cat Fund.²⁰ Even if the Cat Fund defaults, which it almost certainly would after a major storm, insurers would still have to pay claims stemming from the Cat Fund out of their own reserves and assets.

Finally, the Cat Fund offers a “one size fits all” product. Because of their size and complexity, reinsurance contracts are almost always customized to their individual insurer. The Cat Fund has a number of quirks: for example, it only covers “named storms” and, like most reinsurance policies, pays out in “layers” based on the amount of damage sustained. Intrinsically, there’s nothing “right” or “wrong” about the way that the Cat Fund is structured—although most insurers opt for more coverage than the Cat Fund provides. Because different insurers have different needs, the current structure of the Cat Fund—even if it were adequately funded—could *never* meet the desires

of every insurer. Large insurers with significant assets and minimal coastal exposure, for example, might be willing to take the risk of massive losses in the very unlikely event that all of their insured properties made claims simultaneously. Small insurers with large coastal portfolios, on the other hand, might want to cede nearly all of their risk to reinsurers.

The Cat Fund *cannot* work in a way that reduces Floridians’ insurance prices. It has few real advantages over the private sector and several important disadvantages.

Florida Statutes do give the Cat Fund several characteristics that would tend to reduce its costs. The Cat Fund does not try to earn profits, but, of course, many private insurers (State Farm, USAA, and Liberty Mutual) are also non-profit. It does not pay most federal and state taxes, but many reinsurers operating outside of the United States operate from jurisdictions with little or no corporate income tax. Even its ability to impose special taxes—assessments—on Floridians does not lower its costs of providing insurance (although it may reduce its borrowing costs). Thus, the statutory “advantages” the Cat Fund possesses do not necessarily give it a large price advantage.

On the other hand, the Cat Fund has enormous and crippling disadvantages relative to private reinsurance. To begin with, the Cat Fund, by definition, focuses all of its risk in one place. Insurance works best when an insurer manages risk across a broad pool of uncorrelated risks. Major reinsurers, nearly all of which operate internationally, can pool the risk of hurricanes striking Florida with the possibility of earthquakes devastating Japan. It’s exceedingly unlikely that both events will happen at the same time and, thus, a company that takes losses from Florida hurricanes will generally be making profits from Japanese earthquake-related coverage. The Cat Fund, however, concentrates all its risk in Florida. State residents, after all, shouldn’t automatically be on the hook for disasters in far-away places, and thus have to be charged higher rates. In addition, the Cat Fund does not have the freedom to play the market that private reinsurers do. Both because it is reasonably small by the standards of reinsurance entities—giants like Munich Re and Swiss Re take in yearly revenues 12 times larger than the Cat Fund’s total worth—and because it knows it will often have to tap its capital, the Cat Fund simply does not have access

17 Florida Hurricane Catastrophe Fund. “Claims Paying Capacity Estimates,” www.sbafla.com/FHCF/LinkClick.aspx?fileticket=SZkUQvbAl4Y%3d&tabid=316&mid=998.

18 Florida Office of Program Policy Analysis and Government Accountability. “State Board of Administration: Florida Hurricane Catastrophe Fund,” www.oppaga.state.fl.us/profiles/4042/print.asp.

19 Ibid.

20 Jennifer Liberto. “State insurance chief shops plan to bolster hurricane catastrophe fund,” *Miami Herald*, February 10, 2009.

to the same sort of investment opportunities as the private sector. Most insurers and reinsurers make far more on investments than they do writing insurance policies; this avenue is closed to the Cat Fund.

In order to survive, the Cat Fund would have to issue scads of bonds—around \$25 billion worth. Even if the Cat Fund somehow became stable, in other words, it would almost certainly have to charge more than the private sector does. Its market disadvantages far outweigh its advantages. In its current form, the Cat Fund cannot survive.

The Private Market

After the Legislature passed his sweeping insurance reform proposal in early 2007, Governor Crist announced that he had put “the nail in the coffin of the industry that was hurting our people.”²² The legislation, if nothing else, did what Crist said it would. In the wake of 2007’s insurance reforms, nearly every major private insurer in the country either stopped writing new insurance policies in Florida or significantly cutback. Companies announcing cutbacks included Hartford, Allstate, Travelers,

USAA, Nationwide and others—companies that collectively write over 80 percent of the nation’s property insurance. For all intents and purposes, none of these companies write new policies in coastal areas of Florida: USAA, for example, will only write new policies to people relocating on military orders. State Farm, the state’s largest private insurer, announced a wholesale withdrawal from the state’s insurance market.²³ In short, large, private companies with significant amounts of insurance capital have all fled the state.

Companies that remain go through a “prior approval” rate regulation process that likely ranks as the most stringent in the nation. Insurers must submit a wide variety of data, much of it in different form than what any other state considers. Florida regulators have broad discretion to deny rate increases and decreases for a wide variety of reasons: companies wishing to appeal any decision must file lengthy and expensive court cases. This has scared private companies away in large numbers.

Top state officials, however, claim otherwise. Governor Crist, indeed, has claimed that “40

“In short, large, private companies with significant amounts of insurance capital have all fled the state.”

²² As quoted in Joe Follick and Lloyd Dunkelberger. “Insurance Reform a Highlight of Session,” *Gainesville Sun*, May 5, 2007.

²³ For an overview of the situation see: Jim Sanders. “State Farm Angers Clients, Lawmakers,” *Doytona Beach News Journal*, February 8th 2009.

What is Reinsurance?

For many companies, reinsurance represents a way of spreading risk beyond a company’s own client base. All but the smallest private insurance companies try to build portfolios of non-correlated risks. By simultaneously writing insurance for events unlikely to happen at the same time—hurricanes in Florida and wildfires in California, for example—insurers try to spread risk and provide a steady flow of cash to pay claims. No insurer, however, can do this perfectly. Nearly all will find themselves under (or over) concentrated in one area or another. Thus, many turn to other companies, reinsurance companies, to transfer the risk.²¹ In return for a payment and a fee (called a “ceding commission”) the re-insurer agrees to pay the insurer for some or all of a claim. Reinsurance typically kicks in at reasonably high levels: if a single house burns down, the insured’s insurance company will almost always pay claims out of its own reserves. Reinsurance would kick in to cover the costs of a firestorm that destroyed a whole neighborhood of insured houses. For all intents and purposes, the reinsurance market exists only for businesses: ordinary private individuals do not purchase reinsurance.

²¹ Companies other than reinsurers sell some reinsurance. A significant but dwindling number of primary insurers—Liberty Mutual and Chubb most prominently—sell reinsurance as well. Many hedge funds also engage in reinsurance transactions and a few even maintain ongoing reinsurance operations. Since many reinsurers use reinsurance sales as a way of acquiring capital for activities similar to those of hedge funds, the line between a reinsurer and a hedge fund isn’t always clear.

new companies have come to Florida, bringing more than \$4 billion in new capital.”²⁴ This does not appear to be accurate. The Florida Office of Insurance Regulations’ website lists only 26 new companies that have entered Florida’s property and casualty insurance market since Crist’s 2007 insurance reforms. Table 2²⁵ lists them with some comments about each. Table 1 sums the type of companies they are.

The important question, which the tables answer, is how many of the companies will write new homeowners’ policies to ordinary Floridians. The homeowners’ insurance policy that most individuals want to buy is called an HO-3. An HO-3 “all perils” policy covers 16 named perils—wind, fire, overflowing plumbing and the like—and everything else that isn’t specifically excluded. (Policies almost

24 Charlie Crist. “Florida’s Property Insurance Reforms Are Working,” *The Wall Street Journal*, February 6, 2009.

25 The data in the chart are based on the author’s compilation of data from the Florida Office of Insurance Regulation’s new companies’ page: www.florir.com/ac/New%20Companies/index.aspx.

always exclude flood, war, and insurrection.) Most banks require an HO-3 before they will write a mortgage; an HO-3 is what’s typically called “homeowners insurance.” Nearly all HO-3s are written in the “admitted market”—the market where almost all individual citizens buy insurance policies. The admitted market is what state regulators oversee: companies operating in the admitted market submit to rate and form regulation, and their customers receive a promise that their claims will *always* be paid even if the company they purchase a policy from goes under. (The payments are made through state guarantee funds; Florida’s is called the Florida Insurance Guarantee Association.) Most of the new companies operating in Florida do not sell admitted market HO-3s for typical homes. Table 1 describes what they actually do.

Table 2 outlines the companies that have actually entered the Florida Insurance market since the 2007 reforms.

Table 1

Company Type/Description	Num.
Commercial Property and Casualty (Including Self-Insurance Trusts): Write insurance for commercial properties. Do not write policies at all for individual homes.	3
Citizens Takeout: Companies that exist only to take policies out of Citizens. (Some have announced plans to enter admitted market.) These companies do not add capacity to write HO-3s but, instead, simply take over HO-3s from Citizens.	3
High-Value Homeowners: Two companies, one of which is registered under two slightly different names, offer homeowners insurance only to high value homes. One does not write policies for homes worth less than \$1 million. Although their presence may give additional choices to well off Floridians, they do nothing to expand the market for typical homeowners.	2
Auto: Writes automobile insurance.	1
Subsidiary: Two “new” companies are subsidiaries of one insurer—Nationwide—that was already operating in Florida.	2
Surplus Lines: These companies, which operate with very light government regulation, offer “surplus lines” insurance for people unable to secure admitted market insurance. Surplus lines insurance provides a valuable service and, in fact, is a gain for the state.	5
Condo Insurance: Writes policies for condominiums only. The particular company, furthermore, targets condo associations rather than individual unit owners.	1
Apparently Not Operating/Duplicate Entry: One company, although registered, does not appear to actually be in operation. Another is an obvious alter-ego/subsidiary of a new Florida-based company.	2
Florida-Only Companies Actually Writing New HO-3s in Florida: These five companies, all of which exist only in Florida, write new homeowners’ policies. They may attract out-of-state capital but, by their business models, they cannot pool non-Florida risks with Florida risks.	5
Multi-State Companies Writing New HO-3 in Florida: One company, ASI, actually brings new out-of-state capital and appears to have the ability to pool Florida risks with non-Florida risks.	1

Table 2

Company Name	Date Entered Market	Type of Business	Does it add capacity to write new, admitted market HO-3 policies for typical homes?	Notes
Ace Insurance Company of the Midwest	7/10/2008	Commercial Property and Casualty	No	A major commercial lines insurer.
Amco Insurance Group	4/17/2008	Subsidiary	No	A subsidiary of Nationwide, a company already doing business in Florida.
American Coastal Insurance Company	6/21/2007	Condominium Insurance	No	According to its web page, the company focuses on writing policies for garden-style condominiums and requires a minimum total insured value of 2.5 million. (www.amcoastal.com/). In other words, it will serve condominium associations almost exclusively.
American Keystone Insurance Company	2/8/2007	Personal Lines Property and Casualty	No	Company says that it targets "high value homes." Operates only in Florida.
Arch Insurance Company (Europe) Limited	2007	Surplus Lines	No	An excess and surplus lines insurer.
Ark Royal Insurance Company	11/9/2007	Personal Lines Property and Casualty	Yes	A Florida-only company.
ASI Preferred Insurance Corporation	4/14/2008	Personal Lines Property and Casualty	Yes	Operates in Florida and four other states. The only company bringing in out-of-state capital.
Avatar Property and Casualty Insurance Corporation	4/14/2008	Citizens Takeouts	No	Does not actively market itself but appears to only do Citizens takeouts. ¹
Depositors Insurance Company	4/28/2008	Subsidiary	No	A subsidiary of Nationwide, a company already doing business in Florida.
Hallmark Specialty Insurance Company	1/31/2008	Surplus Lines	No.	Writes surplus lines coverage.
HDI-Gerling America Insurance Company	7/10/2008	Commercial Property and Casualty (Other lines in international markets.)	No	A major European insurer, does not appear to offer homeowners' insurance anywhere in the United States.
Homeowners' Choice Property and Casualty Insurance Company	5/10/2007	Citizens Takeouts	No	Does not engage in active marketing; National Underwriter reports that it only does Citizens' takeouts. ²
Infinity Property and Casualty Insurance Company	4/17/2008	Non-standard Automobile Insurance	No	Focuses on writing insurance for non-standard auto risks.

Ironshore Insurance Limited	2007	Surplus Lines	No	The largest new entrant into the Florida market.
Lancashire Insurance Company (UK) Limited	3/4/2008	Surplus Lines	No	
Landmark One Insurance Company	10/19/2007	Citizens Takeouts	Maybe	Has said since early 2008 that it will soon begin offering new policies.
Legacy U.S. Insurance Company	5/1/2008	Unknown	Unknown	No web page or telephone listing could be located.
Magnolia Insurance Company	4/28/2008	Property and Casualty	Yes	Florida-only company.
Modern USA Insurance Company	5/31/2007	Property and Casualty	Yes	Florida-only company.
Olympus Insurance Company	5/1/2007	Property and Casualty	Yes	Florida-only company.
Palm Beach Windstorm Self-Insurance Trust	1/16/2008	Commercial Self-Insurance Trust	No	A self-insurance trust (as the name suggests.)
People's Trust Insurance Company	3/6/2008	Property and Casualty	Yes	A Florida-only company.
Praetorian Specialty Insurance Company	2007	Surplus Lines	No	Expanded into surplus lines in 2008; previously dealt in reinsurance.
Privilege Underwriters Reciprocal [sic] Exchange/PURE	1/23/2007 and 3/12/2008	Property and Casualty	No	Writes coverage only for homes \$1 million and up in value.

1 Oscar Pedro Musibay. "Florida Gets Spurt of New Property and Casualty Insurers," *Florida Business Journal*, July 18, 2008.

2 No byline. "Florida Counts 8 Recently Arrived Insurers," *National Underwriter*, June 5, 2008.

"All three major components of Florida's property and casualty insurance system, in short, sit on the brink of collapse."

It appears that only one company, ASI, has decided to bring new capital into Florida in order to back new admitted market HO-3 policies. According to its own financial statements, ASI has total capital of \$492 million.²⁶ In-state, Florida-only companies, by definition, keep all of their capital in state (they may attract out-of-state investors, of course) but whatever capital they have is risked entirely within the state of Florida.

This Florida's insurance market faces great problems. Major national companies have withdrawn entirely from the market while only one company has brought in a significant amount of out-of-state capital to underwrite HO-3 policies. In short, Floridians face a sharply diminished

range of choices for insurance throughout the state and the companies that have entered the state, have little capital to spread their risk. In the long term, they will have to attract out-of-state capital, restrict their growth, or grow in a way that results—eventually—in their collapse. Since out-of-state capital has not yet flowed into the state, however, it appears unlikely to materialize overnight. Thus, the new companies will either remain very small, conservative in underwriting criteria, and unwilling to insure the most disaster-prone properties; or, alternatively, become insolvent after a major storm.

Florida's private market seems to face the same, deep structural problems as Citizens and the Catastrophe Fund. All three major components of Florida's property and casualty insurance system, in short, sit on the brink of collapse.

²⁶ American Strategic Insurance. "About Us," Balance Sheets. (Four companies.) www.americanstrategic.com/about_us/financial_info.html.

Part II: Fixing the System

Getting Florida's property insurance system to work will require sweeping, drastic action. In the long term, the free market provides the best solutions to Florida's system: if insurance prices are allowed to reflect the risks that property owners actually take, then new insurance companies will enter the state in large numbers and sell insurance to anyone willing to pay the prices they charge. In theory, simply abolishing Citizens, the Catastrophe Fund, and all rate regulation of insurance would solve Florida's insurance crisis entirely.

The political challenges of eliminating rate regulation, however, appear daunting. For at least 30 years, Floridians have paid insurance prices that were too low: state regulators, through rate suppression, deserve some of the blame for this state of affairs but private companies also deserve some. Property insurance, even in the best of times, is not a large moneymaker for any insurer; across the board, insurance companies tend to make money investing property insurance premiums and using the "entré" from property insurance to sell more profitable products such as automobile, life and investment products. When Florida went through a long, mostly storm-free period during the 1970s, 1980s, and very early 1990s, many insurers cut property insurance rates in order to encourage consumers to purchase other products from them. When property insurance losses escalated—eliminating the profits earned from other products—companies withdrew from the market or reduced the number of new policies they would write. As a result, the availability of property insurance tended to decline as prices rose and the perceived needs increased. In this way, the private insurance industry also played a role in precipitating the current crisis. Moving towards a free market for insurance, however, will take significant work: wholesale elimination of Citizens or the Cat Fund and, indeed, even wholesale deregulation of rates, would have disruptive consequences for all Floridians. Thus, the state needs a gradual, incremental plan—a glide path—towards a better insurance environment. A strong plan would have three major components: a phase out plan for Citizens, a similar plan for the Cat Fund, modest changes to the approval system intended to attract new

out-of-state capital, and an effort to reduce property risk throughout Florida through a comprehensive, environmentally sensitive mitigation strategy.

Citizens: Implement Task Force

Recommendations. . . But Go Further

Citizens, the most visible portion of Florida's insurance system, has received the most attention from the state. A broad-based Citizens study task force convened in 2008 released its final report in early 2009.²⁷ The task force recommendations appear worth considering but do not go far enough. Based on its own analysis of Citizens' policies—similar to what's found above in this paper—the task force comes up with 17 recommendations that can be summarized in three major points:

- A "glide path" that will increase overall rates by 10 percent a year (placing 15 and 20 percent caps on increases for territories and individuals).
- Tighter enforcement of rules requiring Citizens to write policies only when private market policies are unavailable.
- A variety of new limitations on where and when Citizens can write policies.²⁸

Taken as these three major points, the task force recommendations all make sense: The House and Senate would do well to give strong, serious consideration to an omnibus proposal that simply implemented all of them in one fell swoop. They aren't perfect and don't go far enough but, on balance, they are a good start.

Many of them reflect policies already embedded in Florida law, but, as of early 2009, are essentially unenforced. The task force suggests that Citizens actually enforce the long-standing legal mandate that it offer coverage only to people who receive private-market quotes at least 15 percent above Citizens rates. This is a good idea, but Citizens and other agencies of the state government should have already implemented policies to enforce it. Likewise, the task force calls for development limitations for new structures in front of the seaward protection line and in areas defined as barrier islands under the

"In theory, simply abolishing Citizens, the Catastrophe Fund, and all rate regulation of insurance would solve Florida's insurance crisis entirely."

²⁷ Citizens Property Insurance Corporation Mission Review Task Force. *Final Report*, January, 30, 2009.

²⁸ *Ibid*, 3.

“The Legislature may want to consider measures that could mitigate the rate increases for low-income Floridians.”

Coastal Barrier Resources Act. Existing law, if enforced, already makes this type of development very difficult if not impossible. The Legislature might well amend statutes to make enforcement of these provisions better, but all-in-all, existing law should allow regulators to enforce them already.

The contemplated increases, furthermore, appear too mild in some cases and, perhaps, too severe in others. Although the 10-15-20 formula the task force arrives at makes some sense, it seems subject to political manipulation. Since the overall increase is capped, as more contained small areas get full 20 percent increases, rate increases will be smaller for the rest of the state. This appears subject to manipulation by powerful groups. It may make more sense to simply impose a 20 percent cap on individual increases—or some other overall cap—and let actual risk factors sort out the increases.

Rather than such universal caps, the task force also may want to consider certain provisions to provide relief to people living on fixed incomes and receiving Citizens coverage. In fact, the Legislature might even mandate even greater increases—to full actuarial adequacy—for the state’s most expensive houses. The wealthy should not continue to receive subsidies. The Legislature may want to consider measures that could mitigate the rate increases for low-income Floridians.

A few proposed task force steps would move in the wrong direction: the task force, for example, suggests that insurers should face a prohibition on offering “multi-policy discounts” for residents opting for Citizens coverage but would allow other, unspecified “actuarially justified” discounts.²⁹ Insurance regulators have a duty to make sure that *all* discounts have an actuarial justification. Limiting discounts in this way makes no sense.

Nonetheless, the apparently broad constituency for the Citizens Task Force review recommendations means that they all deserve some serious consideration. Although it could use some amendments, an omnibus “implement task force recommendations bill” represents a good start.

²⁹ Ibid.

The Cat Fund: Eliminate the TICL Layer Immediately, Phase Down the Remainder of the Cat Fund Based on Yearly Reviews

The Catastrophe Fund has grown far too large and poses an immediate clear and present danger to Florida’s finances. Although it supports a few in-state companies—some of which might go out of business were it phased down—its threat to the state’s finances exceeds whatever small benefits it produces by lowering rates for some homeowners. In the long term, the Cat Fund needs to go. To eliminate it, the Legislature should eliminate its most egregious feature—the so called “TICL layer” first—and then launch a plan to phase it down over time.

In the short term, however, Florida might do best to target the least necessary and totally impossible-to-fund portion of the Cat Fund: the so-called “Temporary Increase in Coverage Layer.” The Layer, essentially the last \$12 billion of the \$28 billion total authorized amount of the Cat Fund, has never been funded and in all probability could never be funded. If Florida used the Cat Fund’s \$3 billion in existing assets and then managed to issue and assess against a \$12 billion bond issue (larger than any state has ever done in the history of the United States,) it still would not reach the TICL layer (which only starts when the state has to pay out \$16 billion). No rational insurance company would ever depend on the TICL layer in its actuarial calculations and, insofar as the Office of Insurance Regulation allows insurers to consider it, it neglects its obligation to provide for insurer solvency. Thus, the elimination of the TICL layer should have no significant consequence for the state or its residents.

Following the elimination of the TICL layer, the Legislature should authorize a long-term review of the Cat Fund based on yearly reductions that would take place until the Cat Fund is fully solvent. To recommend an exact course for these reductions, the Legislature might consider creating a commission to review the Cat Fund and setting a deadline—perhaps 2014 for creating a Cat Fund able to survive without a significant need to impose special taxes (assessments) on Floridians’ insurance policies.

Private Market: Allow Flex Rating Within the Context of the Current System, Change Standards for Approval

Attracting new companies and out-of-state capital to Florida's insurance environment requires massive changes to Florida's system for reviewing and approving the rates that private companies wish to charge. So long as Citizens exists as a market competitor—something it would do for several years even if the task force recommendations are implemented—the private market will need more flexibility if it hopes to compete with Citizens

Many Floridians feel that the state's current "prior approval" system for insurance rates help to protect them and keep rates down. And they may well be right—in the short term, rates would go up if insurance regulators would allow it. Rather than eliminate prior approval in one fell swoop, the state should adopt a "flex rating" system that allows insurers some flexibility to change rates without unduly disrupting the insurance system Floridians have grown used to.

Flex rating, which about 20 states have adopted in one form or another, allows insurers to make small adjustments in rates rather easily in response to changing market conditions.³⁰ The current prior approval system would continue to exist alongside a system of flex rating: rates outside of a band of, perhaps, plus or minus ten percent per year, would undergo the same review process as now exists. If the Department of Insurance Regulation found a flex-rating filed rate either unfairly discriminatory or likely to damage an insurers' solvency, likewise, it could "claw back" the rate and order an insurer to either refund premiums or impose special assessments on its own policyholders. With the flex-rating bands, insurers could raise and lower rates as market forces dictated.

In the short term, most insurers would raise rates if given the flexibility to do so. The current rates are simply too low in too much of the state. A reasonable cap on such flex-rating, however, would shield Floridians from any dislocations as a result of greater rate liberalization. Although the simple ability to raise rates 10 percent—by itself—would not encourage many insurers to

enter the state, it would likely result in some insurers that currently do not write new coastal business to write at least some. This would provide more new out-of-state capital to back Floridians' insurance policies.

My Safe Florida Home and Wetlands Preservation

Florida cannot solve its long-term insurance problems through changes to state insurance regulation. Instead, long-term improvement in Florida's insurance environment will require steps that actually reduce Florida's risks. Risks will be reduced the most, in the medium and long terms, when insurers can charge risk-based rates. If insurance rates reflect risks—which can be extreme in large parts of coastal Florida—residents will avoid building in dangerous areas and reinforce those properties already built there. In the long term, risk-based insurance rates provide the surest way to protect Floridians. An immediate switch to risk-based rates, however, would cause enormous dislocations in Florida's property insurance markets and leave many people unable to afford property insurance. Two short-term policies, therefore, deserve consideration: full funding for the My Safe Florida Home Program and efforts to preserve and protect coastal wetlands.

My Safe Florida Home, which provides for no-cost home inspections for Floridians and helps residents of modest means reinforce their homes against storms, seems to work. Although the actual efficacy of My Safe Florida Home has never been studied, similar programs have proven their effectiveness around the nation: in general, every dollar spent on My Safe Florida Home can be expected to save at least \$3 in future insurance loss costs (and perhaps as much as \$7.00).³¹ With risk-based rates, the program would not need to exist, but My Safe Florida Home deserves more funding because it simply serves to compensate for the problems the state government has created through artificially suppressing rates. The Legislature cut \$10 million from the programs' budget during its January 2009 Special Session. At minimum,

³⁰ See Eli Lehrer and Michelle Minton. "Rating the States: Report Card 2009," Heartland Institute, 2009.

³¹ Congressional Budget Office. "Potential Cost Savings from Pre-Disaster Mitigation Programs," September 2007, www.cbo.gov/ftpdocs/86xx/doc8653/09-28-Disaster.pdf.

"Flex rating, which about 20 states have adopted in one form or another, allows insurers to make small adjustments in rates rather easily in response to changing market conditions."

“The state’s taxpayers ought not to be obligated to ensure others the opportunity for hurricane-prone coastal living.”

the Legislature should restore this funding: if there is a bad storm season, the Legislature can faithfully predict that at least \$30 million will be lost as a result of the program’s underfunding.

The Legislature may also wish to consider efforts that would give the program a dedicated funding stream. One obvious source would be to place special taxes on premiums paid to Florida-only companies that fail to secure non Cat-Fund coverage. Since these companies benefit most from the enormous tax-payer subsidies that the Cat Fund receives, it seems only fair that they should provide some other benefit to the state. This tax could provide permanent funding to MySafeFlorida Home.

In addition, Florida should consider increased efforts to preserve and protect the state’s wetlands. Although no absolute rule appears possible to develop—the most powerful hurricanes will do great damage no matter how much a state does to protect coastal wetlands—the more wetlands the state preserves, the better it will deal with hurricanes.³² Current federal policies under the Coastal Barrier Resources Act (CBRA) severely restrict all federal subsidies for development in sensitive coastal areas. Citizens, nonetheless, writes some policies in areas where CBRA restricts federal funding. Florida should consider its own version of CBRA, restricting all state funding for development in sensitive coastal wetland areas.

The Legislature may also consider efforts to require “like kind and quality” replacement of whatever wetlands get lost to development nonetheless. Current state and federal policies promise “no net loss” which, very often, results in developers destroying hurricane-absorbing coastal wetlands (often with state assistance) and then replacing them with inland marshes that provide good wildlife habitat but do nothing to protect the state from hurricanes. While Florida has modestly gained wetlands over the past 20 years, it has actually become less storm-resistant as a result of this policy. The current policy, it might be argued, puts wildlife habitat ahead of human interests. A “like kind and quality” policy might actually allow small net losses

³² For a review of the research on wetlands see National Wildlife Foundation. “How Do Wetlands Help Wildlife and People Survive Hurricanes?,” www.nwf.org/hurricanes/hurricanesandwetlands.cfm, no date.

of wetlands in some cases—particularly when it comes to inland wetlands that provide wildlife habitat alone—but would work to increase the amount of coastal wetlands and thus Florida’s protection against storms.

Combined with effective mitigation efforts and risk based rates, protection of wetlands—largely by withdrawing government subsidies that encourage their development—would make Florida safer and more secure against storms.

Conclusion

Florida’s government-dominated insurance system cannot survive in its current form. It makes the state less safe and increases the long-term costs to the state’s taxpayers. Both Citizens and the Cat Fund face severe problems and cannot survive in their current forms. Efforts to attract new out-of-state companies to write homeowners’ insurance, likewise, have proven dismal failures. Florida’s taxpayers, not insurance companies, have assumed massive liabilities on behalf of coastal residents.

The problems with Florida’s insurance environment, however, will never find a single magical solution. The state, instead, must embark on a program of incremental reform that makes sweeping change to Citizens, significantly reduces the Cat Fund’s potential liabilities, encourages mitigation, and protects the environment.

Floridians living on the coast, in the end, will have to pay higher rates for property insurance. Vigorous market competition, however, will likely lower rates for those who live inland and far from the coast. And higher rates will, at least, reflect the risks inherent in living on a hurricane-prone peninsula. Floridians may, in some cases, find that their current modes of living cannot be sustained. The state’s taxpayers ought not to be obligated to ensure others the opportunity for hurricane-prone coastal living. Risk-based, market-driven insurance rates will, in the end, make Florida safer, more secure, and more solvent. The path toward a better system of insurance regulation will take time and will mean some pain for Florida residents. But it’s the best choice. Florida simply can’t afford the status quo.

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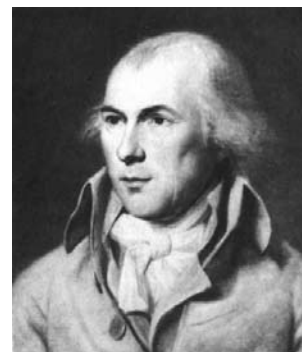
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