THE JAMES MADISON INSTITUTE

Policy Brief

(850) 386-3131 P.O. Box 37460, Tallahassee, FL 32315

"Celebrating 20 Years as Florida's Premier Free-Market Think Tank"

Number 3 • March, 2008

First Steps toward Restoring Florida's Insurance Market

Eli Lehrer
Adjunct Scholar, The James Madison Institute
Senior Fellow, The Competitive Enterprise Institute

As Florida's Legislature proceeds with its 2008 session, several proposals to modify the state's insurance environment appear likely to receive serious consideration and debate. This paper analyzes several of the more prominent ones.

The paper consists of four sections. The first offers a very brief overview of the state's current insurance environment. The second considers a proposal to bifurcate Florida's homeowners' insurance environment into pools respectively liable and exempt from special, unilaterally imposed state insurance premium taxes. The third considers other proposals impacting commercial property and the size of the Hurricane Catastrophe Fund. Finally, the brief conclusion argues that, while all of these proposals deserve serious consideration, none will solve Florida's insurance woes on its own.

The Current Situation

Florida's current system for providing its citizens with property insurance sits on three unsteady legs: the Florida Citizens Property Insurance Corporation, the Florida Hurricane Catastrophe Fund (the Cat Fund), and the private insurance industry.

Florida Citizens Property Insurance Corporation, a state agency, serves as the state's largest property insurer. It writes full spectrum homeowners' insurance against fire, wind, theft, and liability.[1] As of early March 2008, it had issued nearly 1.3 million policies.[2] Anyone seeking coverage from Citizens must present at least one rate quote that is a minimum of fifteen percent higher than Citizens' rates.[3] In effect, this imposes on all property insurance rates in the state a rate cap of Citizens' rates plus fifteen percent. This effort to control rates has proven politically popular but exposes the state to significant financial risk. Citizens has also developed a well-deserved reputation for poor service. During the particularly active 2004 and 2005 hurricane seasons, the company relied heavily on out-of-state independent claims adjusters, lost hundreds—or even thousands—of claims, and paid legitimate claims slowly.[4] A number of reforms contained in Governor Crist's 2007 hurricane reform plan attempt to remedy some of these problems.

The second major pillar of the system, the Florida Hurricane Catastrophe Fund (the Cat Fund), provides mandatory partial reinsurance for all insurers operating in Florida and serves as the only source of reinsurance for Citizens' own risks. (Reinsurance is backup coverage for insurance companies.) As of February 2008, it represented a potential liability of $32 billion for the state of Florida and added over $7 billion to the state debt.[5] Although Governor Crist initially cited state actuaries' claims that the Cat Fund would produce a nearly 25 percent cut in premiums, insurance rates have not fallen as a result of the January 2007 decision to double the Cat Fund's size.[6] Insurers—both disappointed at the level of the Cat Fund's coverage and uncertain if it can actually sell sufficient bonds in the event of a major disaster—have bought the mandatory Cat Fund coverage and then purchased private coverage as well. The sheer size of the Cat Fund clearly imperils Florida's fiscal condition. The largest state bond issue *anywhere in the country* to date has been $11 billion. Florida's $32 billion proposed issue would nearly triple that and could only be paid with special taxes (called assessments) on every insurance policy in the state.[7]

Finally, the private insurance industry continues to write most policies in the state, although its future in Florida's homeowners' market remains doubtful in many ways. Over the past year, Travelers, Nationwide, USAA, Hartford, State Farm, and Allstate—which collectively write more than 70 percent of all insurance in the country—have all cut back or eliminated property and casualty operations in the state. Last month, Allstate announced a wholesale withdrawal from writing new business in Florida. Aside from a few tiny in-state carriers, private companies have essentially stopped writing new policies in coastal areas.[8]

In short, Florida's insurance market offers the worst of all worlds: high rates, little consumer choice, extensive government intervention, and severe risks to the states' taxpayers. Several proposals will come before the 2008 Legislature that promise to change this system—following is a discussion of three.

Consumer Choice Plan

One proposal, filed by persistent insurance system critic Rep. Dennis Ross[9] (R-Lakeland), has attracted significant media attention and some support in the Legislature. The plan, styled the "Florida Windstorm Insurance Consumer Empowerment Program", would significantly change the state's insurance system and reduce the role of political institutions in controlling insurance prices.[10] For all intents and purposes, the plan would abolish both Citizens and the Cat Fund as they currently exist and replace them with a state-run Windstorm Insurance Program and a "pure" private market.

Under the Consumer Choice Plan, insurers would either have to cede all of their risk to the new wind program or take all of it on themselves. Policies written within the Windstorm Insurance Program would remain "assessable." In other words, the state government could impose essentially limitless special taxes on its policyholders to pay for fund deficits. Policies outside the program, however, would not be assessable; once consumers paid premiums, they would not be subject to any further taxes on any policies they write. Initially, non-Windstorm Fund policies would cost more than policies within the fund, but unlike Windstorm Fund policies, their policy holders would not be vulnerable to assessments in the event of a catastrophic storm. To insulate the state of Florida from financial risk, this plan would also require the Windstorm Fund to purchase private property and casualty insurance for at least half of its actuarially calculated 50 and 100 year "probable maximum loss." [11]

Structurally, the program would work similarly to the existing National Flood Insurance Program. Private insurers would market, service, and adjust damages on policies while the state would set rates and assume all actual insurance risk.[12] As a legal matter, the new program would replace the Cat Fund for all private residential property (commercial residential property would continue to receive Cat Fund coverage). Like the Cat Fund, it would ultimately report to the State Board of Administration (SBA)—the constitutional entity made up of the Governor, Chief Financial Officer, and Attorney General. The SBA would set the wind program's rates and standards. Citizens itself would face a ban on selling additional "wind only" policies and have its current policies auctioned off. As a result, it would wither away to nearly nothing.

In summary, the Consumer Choice Plan would create a bifurcated market: a state-controlled market quite similar to what Floridians have today for all insurance and a regulated—but not explicitly price controlled—market for other policies.

Likely Consequences of the Consumer Choice Plan

If enacted, the Consumer Choice Plan would almost certainly encourage private insurers to write more homeowners' insurance, would improve policy service for Floridians, and would reduce the fiscal liabilities associated with the current insurance system. It also would probably result in short-term rate decreases for Floridians living along the coast. Beyond that, the state faces two possibilities in the medium term: a slightly modified version of the status quo or a near total restoration of the private market.

This bifurcation proposal appears highly likely to entice insurers into the private market. Since it allows them to opt out of all wind risk, any insurer that feels uncertain about writing wind risk can simply opt out of that market while still writing policies to insure against liability, fire, sinkholes, and the like. With the single largest insurance risk gone for most companies, they will have little reason to stay out of Florida. Consumers in all parts of the state would gain far more choices for coverage (although the wind portion of the policy would cost the same from every insurer participating in the fund).

As it would leave claims to these private carriers, the Consumer Choice Plan appears highly likely to improve customer service. Fundamentally, Citizens' insulation from market forces, lack of a clear mission, lack of a standing work force, and lack of experience make it nearly impossible for the insurer to ever provide high quality service. Although it's not impossible for government agencies to develop a "culture of service," they typically need a very clear, ongoing mission and "critical task" that orients their actions.[13] Citizens hasn't developed either of these things. Under the Consumer Choice Plan, consumers would deal with existing private insurance companies that generally have more experience dealing with insurance. Although the state will remain the ultimate insurer for all "assessable" wind policies, customers will deal with agents and claims departments they already know. Customers who dislike their particular insurer's service can always switch carriers, an option they do not have under Citizens. This will improve service.

In addition, the Consumer Choice Plan will reduce the overall fiscal liability to state taxpayers. Under the plan, taxpayers will have to cover only wind damage. The other coverage that Citizens provides will come entirely within the private market. Equally important, the reinsurance that the Windstorm Fund purchases will insulate taxpayers from the costs of the enormous bond issues that the Cat Fund would otherwise have to offer following a major storm. While bond issues—even multi-billion dollar bond issues—would remain a distinct possibility, the plan would, at least, halve the total risk to the state through the purchase of reinsurance. This would reduce the chances of special assessments for the state as a whole. Since it would manage risk across a larger, more stable pool, Rep. Ross tells the author that the plan would cut rates for Floridians. This would happen in part because private reinsurers can spread their own risks more broadly than the current Cat Fund is able. Without actually implementing the plan, however, it's impossible to know exactly how it would impact rates. It's possible that the upfront costs of purchasing reinsurance would increase rates in the short term. More actuarial research is needed to determine the exact short-term consequences of the plan on insurance rates.

Although the Consumer Choice Plan certainly would have a more private—and fiscally stable—appearance, there's no guarantee that the plan will result in the restoration of a private windstorm insurance market in Florida. Three major risks make this a possibility: the risk that the State Board of Administration might set below-market rates, the risk of increased regulatory burdens on the private market, and the simple impossibility of insuring some risks.

The State Board of Administration—made up entirely of elected officials—will set the program's rates. Its members will have to walk a very fine line. They must make the rates high enough to facilitate the purchase of private reinsurance and avoid massive special assessments but low enough to satisfy voters. If they fail, policy holders might still have to pay very large special assessments. The Consumer Choice Plan allows rate disapproval for non-assessable policies only if rates are inadequate or unfairly discriminatory. The Legislature most keep this provision in place if it hopes for the market to work. Interfering with this part of the market—even to "protect" consumers from "excessive" rates — would surely doom the plan.

Also, it's possible that some properties within Florida simply are not insurable at rates the incumbent homeowners can afford. In technical insurance parlance, the risks within Florida for certain properties may not be sufficiently diversifiable—capable of being spread—for conventional, admitted market carriers to insure them at all. All of these factors could result in a situation where the Windstorm Fund continues indefinitely, resulting in continuing sizeable liabilities to the state and its taxpayers.

On the other hand, three factors suggest that the plan could work and result in a phase-out of Citizens, the Cat Fund, and the enormous risk that the current situation poses to Florida's taxpayers.

First, an essentially similar plan worked in Hawaii. After 1992's Hurricane Iniki ravaged the island chain, one insurance company became insolvent, two others left the state, and several more pulled back. For several months, only one insurer was writing insurance anywhere in the state.[14] In response, the Hawaii Legislature established the Hawaii Hurricane Relief Fund. As with the Consumer Choice Plan, insurers could either cede all their risk to the fund or take it on themselves. Although the fund had a few difficult years—and had a hard time securing reinsurance—the plan eventually found stable financing through one time taxes and state borrowing.[15] Starting in 1997, insurers began opting out of the fund and cutting their own rates.[16] By 2000, the fund itself shut down for lack of business, and the Legislature declared the private market restored.[17]

This approach did not solve all of Hawaii's problems. In the wake of the insurance industry's catastrophic losses when Hurricane Katrina devastated New Orleans and much of the northern Gulf Coast, Hawaii's premiums rose sharply. In recent years, only one major company has written hurricane-only coverage.[18] In addition, Hawaii's strict limitations on types of coverage, high level of control over prices, and limitations on insurers' ability to take location into account make its market unattractive for many insurers.[19] These woes, however, appear unconnected to the Hurricane Relief Fund but relate, instead, to the state's overall insurance environment. Judged on its own terms, the Hurricane Relief Fund worked.

Second, the careful balancing that the State Board of Administration (SBA) must do under the Consumer Choice Plan will likely provide rates that are adequate but not too high. Although a risk does exist that elected officials may simply decide to set rates too low, the presence of reinsurance will likely discipline the SBA to set rates that make sense for both coastal property owners and Florida's taxpayers as a whole. Under the Consumer Choice Plan, any rate plan that results in the withdrawal of reinsurers would violate the law and, very likely, would be subject to a legal challenge.

Finally, it appears unlikely that Florida has enormous amounts of truly uninsurable real estate. Through the 1990s, private insurers wrote coverage for coastal dwellings almost everywhere in the state except the Keys. Although the state has had more coastal development and two nasty back-to-back hurricane seasons during the 2000s, little evidence exists that anything has changed in a fundamental way. Given time and the opportunity for profit—or, at least, break-even operations—insurers will come back into the state. Particularly in the Keys, private coverage may remain scanty or non-existent. But, because it has done so before, it's likely that the private insurance industry will begin to write significant amounts of coverage in Florida if the Legislature were to adopt the Consumer Choice Plan.

Cat Fund Reduction Plan

A proposal to reduce the state's risk for hurricane damage by shrinking the size of the Cat Fund has been introduced by State Chief Financial Officer Alex Sink.[20] Her plan would simply reduce the size of the Cat Fund by $3 billion immediately, thus reducing the potential size of special assessments.[21] The plan, which unanimously passed the House's Jobs and Entrepreneurship Council, appears to be on the fast track for passage. Although nobody, including CFO Sink herself, sells the plan as an all-purpose fix for Florida's insurance woes, it takes a good first step towards removing the enormous potential burden that the Cat Fund places on Florida's taxpayers in its current form.

The Legislature would do well to build on this proposal—as Ms. Sink has suggested—and move towards phasing down the size of the Cat Fund. Cutting the Cat Fund by the same amount every year for 10 years would drive it out of existence. Because Citizens relies heavily on the Cat Fund—the only place it purchases reinsurance—a phase-out would also serve to increase the urgency of reforming Citizens itself.

The Cat Fund Reduction Plan will not solve Florida's insurance woes on its own, but it is a positive first step that appears to have widespread support.

Commercial Property Exemption Plan

Legal changes that would eliminate assessments on commercial properties to bail out Citizens and the Cat Fund form the basis of a proposal by the Florida Chamber of Commerce.[22] While it meets any number of tests of commonsense and fairness, exempting commercial properties from special assessments will make sense only in the context of broader systemic reforms to Florida's insurance environment.

On its face, the current system seems enormously unfair to businesses. They do not benefit from Citizens' below-market rates but must pay the special assessments that will bail out the state's homeowners following a major storm. When it places special assessments on homeowners' and automobile policies, at least, the state charges its own residents for its own subsidy scheme. Since many businesses have out-of-state ownership, however, business taxes ask people from other states to pay for Florida's own policies. This raises Florida's overall level of business taxation and, at the margin, increases the cost of doing business in Florida. In turn, this makes Florida's climate less hospitable to business and will likely damage both the state's job growth and its overall economy. It's perfectly fair and reasonable for businesses to seek exemption from these assessments.

Absent broader reform, however, simply removing property assessments from commercial properties could result in higher assessments for individual Floridians. Eliminating assessments on commercial property without reforming Citizens or the Cat Fund and reducing their overall liabilities may well mean that taxes on home, car, and boat owners will rise even more following a major storm. People who actually receive a short-term benefit from Citizens' lower rates will pay higher assessments as a result of this, but so could many other people—including Floridians who own cars but not homes. This does not necessarily enhance the overall fairness of the current system and, by reducing its assessment base, could actually make the system less stable.

Any attempt to remedy the unfairness of the current system deserves consideration. Insofar as a repeal of commercial assessment risk will stimulate further reform, it deserves a careful look. However, it does not solve the deep underlying problems in Florida's current insurance structure and, absent reform, could further destabilize an already unstable system.

Conclusion

Florida's insurance environment imperils the state's finances while failing to meet consumers' needs for cost-effective property insurance. The precursors of state intervention in the insurance market date back almost 15 years and restoring a private market for Floridians may well take just as long. At the moment, no politically viable means exist to restore the private market overnight. Simply abolishing Citizens and the Cat Fund while allowing market forces to set rates would result in sizeable, short term rate hikes that many Floridians simply could not afford.

Thus, the current options—and the best options—for the 2008 Legislative Session seem to involve small steps. The Consumer Choice, Cat Fund Reduction, and Commercial Property Exemption proposals all deserve careful consideration—all have their good and bad points. Any one of them would move Florida's insurance market in the right direction.

About the Author

Eli Lehrer is a Senior Fellow at the Competitive Enterprise Institute, where he directs CEI's studies of insurance and credit markets. Prior to joining CEI, Lehrer worked as speechwriter to U. S. Senate Majority Leader Bill Frist (R.-Tenn.). He has previously worked as a manager in the Unisys Corporation's Homeland Security Practice, Senior Editor of The American Enterprise magazine, and as a fellow for the Heritage Foundation. He holds a B.A. (Cum Laude) from Cornell University and a M.A. (with honors) from The Johns Hopkins University, where his Master's thesis focused on the Federal Emergency Management Agency and Flood Insurance. His work has appeared in the New York Times, Washington Post, USA Today, Washington Times, Weekly Standard, National Review, Public Interest, Salon.com, and dozens of other publications. Lehrer lives in Oak Hill, Virginia with his wife Kari and son Andrew.

Endnotes

1 Florida Citizens Property Insurance Corporation, "Citizens: Carrying Florida through the Storm," www.citizensfla.com/

2 Ibid.

3 Florida Citizens Property Insurance Corporation, "2007 Legislation for Agents," www.citizensfla.com/utilitybar/generalinfofaqs.cfm?show=pdf&link=/shared/faqs/2007_Legislation_for_Agents.pdf, 2.

4 Task Force on Citizens Property Insurance Claims Handling and Resolution. "First Report: July 2, 2007," http://taskforceoncitizensclaimshandling.org/images/FirstReport.pdf, 5-6.

5 Ernst and Young, LLP. "Report of Independent Auditors for Fiscal Year Ending June 30, 2007," www.sbafla.com/fhcf/pdf/audited-financials/Audited%20Financials%2007-06%20Corrected.pdf

6 Tom Zucco. "24% Rate Drop Just A Dream; Insurance Nightmare Is Back," *St. Petersburg Times*, March 18, 2007.

7 The largest single bond issue to date was California's $11 billion 2002 bond issue to pay for the costs of resolving its energy crisis. See www.insurancejournal. com/news/southeast/2007/08/27/83021.htm. Although it involved bond issues from multiple agencies, Massachusetts spent even more—about $15 billion—to finance its "Big Dig" to build an underground expressway through downtown Boston.

8 Also, USAA still issues new policies to members relocating on military orders.

9 For Full Text See: H.B. 983 – Windstorm Insurance Coverage, www.myfloridahouse.gov/Sections/Bills/billsdetail.aspx?BillId=38681&SessionIndex=-1&SessionId=57&BillText=&BillNumber=983&BillSponsorIndex=0&BillListIndex=0&BillStatuteText=&BillTypeIndex=0&BillReferredIndex=0&HouseChamber=H&BillSearchIndex=0, February 19, 2008.

10 Beatrice Garcia. "Lawmakers Look Anew at Storm Insurance Rates," *Miami Herald*, February 20, 2008.

11 50 and 100 year "probable maximum loss" refers to the largest loss that actuaries believe that an entity is likely to suffer from a single event.

12 For a plain language outline of the bill, see Dennis Ross, "HB 983: Executive Summary." February 20, 2008.

13 For a discussion of "critical tasks" see James Q. Wilson. *Bureaucracy: What Government Agencies Do and Why They Do It,"* New York: Basic Books, 1989, 25-27.

14 Michael P. Hamnett, Ph.D. and Kristine G. Davidson Oh. "Hawaii Hurricane Relief Fund: Its History, Viability, and Role in Disaster Mitigation," Social Science Research Institute, University of Hawaii, August, 1996.

15 Ibid.

16 Erika Engle. "State Farm Opts to Exit Hurricane Relief Fund," Pacific Business News, December 18, 1998.

17 Insurance Information Institute. "Hawaii Hurricane Deductibles," www.iii.org/media/hottopics/insurance/hurricanwindstorm/, February 2008.

18 Ibid. See also: Greg Wiles. "Hawaii's Hurricane Insurance Gets Costlier," *Honolulu Advertiser,* August 29, 2006.

19 See e.g. Eli Lehrer et al. "National Insurance Report Card," The Heartland Institute/The Competitive Enterprise Institute, 2008.

20 The Legislation is titled: PCB JEC 08-01 - The Florida Hurricane Catastrophe Fund Risk Reduction Bill

21 Current law allows a $4 billion add-on to the $28 billion official size of the Cat Fund. The Sink proposal reduces the risk of this add on so, by some standards, it might be considered a $7 billion cut in the Cat Fund's size.

22 Beatrice A. Garcia. "Florida lawmakers will confront insurance woes when the session begins Tuesday," *Miami Herald*, February 29, 2008.