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Restoring Florida's Insurance Market

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Foreword

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By the end of the 1990s, Florida's property insurance market had largely recovered from the effects of 1992's Hurricane Andrew, one of the costliest storms ever to strike the mainland of the United States. Property insurance was once again widely available and was generally regarded as relatively affordable.

In 2004 and 2005, however, Florida was battered by a series of damaging storms that resulted in huge losses for insurers. Moreover, some of the climate-forecast models suggested that the regions bordering the Atlantic Ocean and the Caribbean Sea were entering one of the periodic cycles in which there are relatively more hurricanes and tropical storms.

Meanwhile, thousands of additional homes and businesses had been built in Florida's vulnerable coastal areas, and a real estate boom had caused the value of those properties to escalate. As a result, several of the insurers gauged their risks and made a business decision to reduce their exposure in Florida. Some did so by declining to renew existing policies. Others did so by deciding not to accept new policies.

As a result, property insurance coverage became harder to find and more expensive, angering would-be policy holders. Moreover, because mortgage lenders require their equity to be insured, the lessened availability and higher cost of property insurance threatened to cause further damage to a real estate market already slowing because of the convergence of several factors, including a rapid rise in property taxes.

Property insurance thus became a political issue in the 2006 election and, in January of 2007, Governor Charlie Crist and the Florida Legislature fashioned a political solution in which the state's taxpayers were left to assume much of the risk for future catastrophic damage.

Nonetheless, many of the fundamental problems plaguing Florida's insurance market have persisted, and some of the legislators who reluctantly supported the insurance legislation now recognize that much remains to be done to restore Florida's insurance market. In this study, insurance expert Eli Lehrer, Senior Fellow of the Competitive Enterprise Institute, analyzes the current situation and recommends corrective solutions.

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Restoring Florida's Insurance Market

Introduction

The Florida Insurance Mess

"Governor Crist believes the insurance industry, rather than the government, should assume the financial risk for hurricanes."

-Official Website of Florida Governor Charlie Crist. (www.flgov.com/reform)

This paper is about the way the State of Florida insures its residents against hurricanes. It describes the history, political environment, and environmental factors that created the state's current system for dealing with property insurance. It focuses, in particular, on the manner in which Florida's government has come to dominate the system and the risks which the current system poses to the state. Quite simply, the paper argues that the current system is dangerously unstable and, if left untouched, will likely have severe fiscal implications for Florida's future. The State of Florida, the paper contends, has taken on a risk of hurricanes that the private sector could deal with more creatively and with greater flexibility.

The paper consists of four major sections. The first section presents an argument for the topic's importance, presents a theory of coastal insurance, and discusses some terminology relevant to insurance markets. The second section describes Florida's system for insuring homes as it currently exists. The third section analyzes a number of proposals for reforming insurance markets while assessing the good and bad points of each one. The brief conclusion sums up the papers findings. The paper reaches a simple bottom line: in the long term, only a free market that bases rates on risk and separates insurance from relief can provide a long term solution to Florida's insurance ills while making insurance more affordable for all Floridians.

Why Hurricanes Matter

Despite the placid 2006 and 2007 hurricane seasons that did not see a major hurricane make landfall in the United States, all available evidence indicates that the United States remains in the midst of a long term upsurge in hurricane activity. Through most of recorded history, hurricanes have happened in cycles of roughly 30-40 years: two decades of reasonably mild hurricane activity followed by a decade or two of particularly intense activity. [1] Nearly all climate scientists agree that *el niño* and *la niña* weather patterns and the resulting natural, normal cyclical changes in ocean temperatures account for most of the change. [2] Scientists generally agree that concentration of natural forces leading to the current upsurge in hurricane activity began with ocean temperature changes starting around 1995. Other factors that may impact the damage that hurricanes cause and their frequency include coastal development patterns, human-caused global climate change and changes in coastal tree cover. Some evidence exists for all of these explanations, and it's fair to consider all of them minor contributing factors that may intensify or blunt the overall consequence of hurricanes. Changing one or more of them—and many of them are unchangeable—would have only a small consequence for the nation's hurricane patterns. In other words, whatever choices the nation might take outside of the insurance realm, the United States will continue to see increasing severe hurricane strikes for many years to come.

Florida, in any case, has seen a particularly large percentage of the total damage: according to the National Weather Service's compilation of hurricane data, Florida has sustained hits from each of the five costliest hurricanes (in nominal dollars) in U.S. history.[3] With good reason, Florida lives in particular fear of hurricane strikes. While it made landfall before the climatologists consider the current upsurge to have started, in the public mind, the increase in hurricane activity really began with 1992's Hurricane Andrew and its direct hit on Dade County and Homestead Air Force Base.[4]

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"Insurance, fundamentally, serves as a way of contracting to transfer risks from one party to another and to manage them."

Two factors, wealth and population patterns, have combined to make the current upsurge in hurricanes more relevant to the country. First, the Hurricane Belt—once a poor part of the country—has risen so that it's roughly on par with the country as a whole: coastal counties are no longer poorer than the states around them and the Atlantic seaboard states that joined the Confederacy have a per capita income that's about 89 percent of the national average.[5] (And a standard of living that's higher in many important respects.) Second, Florida has seen the most growth of all: it enjoys an above average per capita income and, during the 1990s, added the most people (in absolute numbers) of any state. And the Census Bureau expects that the growth will continue.[6] Florida's population has also clustered by its coast to an unusual extent: except for pre-Katrina Louisiana, no area in the Texas to North Carolina Hurricane Belt has nearly the population density of South Florida or the Tampa Bay Area.[7] Florida, in fact, has over $2 trillion in total exposure and, despite having only 5 percent of America's population, accounts for half of all hurricane exposure.[8] Thus, hurricanes that hit Florida are likely to do the very most damage of those that hit any state. As a result, it becomes evident that Florida needs a strategy for dealing with hurricanes and insuring against them. The state's future depends on it.

Basic Insurance Principles

Insurance, fundamentally, serves as a way of contracting to transfer risks from one party to another and to manage them. This paper deals with a subset of insurance: "conventional insurance." Other means of risk transfer (catastrophe bonds, risk retention groups and Lloyd's associations) also exist, but for the great majority of homeowners, these are not practical options. It's quite possible that various regulatory reforms could eventually serve to make these options more practical, but this paper does not deal with them.

Insurance, as most consumers understand it, involves standardized risk-assessment mechanisms that provide for a large degree of price similarity between similarly situated insured, operates on the basis of "utmost good faith" contracts and contains mechanisms that guarantee the solvency of the companies writing the insurance.

These features provide a product that consumers can easily buy. Price similarity between similarly situated insured lets insurance agents and companies achieve economies of scale: they need only maps and basic data about homeowners—not extensive site surveys—to price their product. Utmost good faith contracts, which are typically regulated by states so that language used to describe a given type of coverage is the same for everyone, relieve policyholders of having to read through and understand dense legal documents. It essentially means that policyholders should be able trust whatever brochures and agents tell them about what's covered and what isn't.[9] Solvency regulation, likewise, assures consumers that their claims will be paid even if insurers mismanage themselves.

Insurance, in other words, refers to a particular class of consumer products often subject to a large degree of political oversight. This paper deals almost entirely with homeowners' insurance. This type of insurance—which nearly all lenders require owners of mortgaged properties to maintain—protects homes and their contents. A typical homeowners' insurance policy protects a home and its contents from fires, windstorms, hail, and theft. Policies also include personal liability coverage to protect homeowners' from lawsuits that visitors might file. No conventional homeowners' insurance policy in the United States covers flood damage: the federal government's National Flood Insurance Program provides nearly all coverage against flood damage. Under the program, private carriers service policies, but the government covers all risk. In Florida, as this paper discusses at greater length, a government agency—the Citizens Property Insurance Corporation—covers a large and growing percentage of the state's wind risk and also offers a number of general-purpose homeowners' insurance policies.

A respect for individual freedom and private property suggests four potential principles for dealing with insurance in hurricane areas:[10]

- ***Insurance should be based on risk; assessment of risk comes from collection of data.*** Insurance should cost more for people who take great risks and less for those who take small risks. Insurers should be able to use all relevant data in order to price like risks alike and different risks differently.

- ***Insurance has nothing to do with relief.*** A just and compassionate society should develop mechanisms to provide relief immediately following a serious storm. But these efforts have little to do with insurance and conflating the two will tend to undermine both efforts: the "dollars and cents" mentality of careful actuarial calculation that makes for good insurance policy can be devastating to relief efforts and compassion. Relief, properly distributed, should be based largely on need. Property and casualty insurance should be based on the terms of a binding legal contract that is based on ability to pay.
- ***Insurance should influence development.*** In particular, insurance should do some combination of three things with regard to development: 1) discourage development in areas likely to receive hurricane strikes, 2) encourage mitigation against inevitable hurricanes, and 3) pay for a portion of the costs of periodic rebuilding in places where people can afford the cost *and* where mitigation is impossible.
- ***Finally, to the extent possible, hurricane coverage should work through private means. A purely private market should be the ultimate public policy goal.*** In short, hurricane markets should work just like other insurance markets. This does not mean that all residual state-supported markets should be phased out immediately. But it does mean that, in the long term, public policy should encourage the development private alternatives to government-run markets.

Some terminology may be useful for discussing the section. Throughout the United States, consumers can purchase insurance from three different markets with differing levels of government control: the "social" (or government-run) market, the "admitted" (or standard) market, and the "residual" (or excess and surplus) market.

The government-run market consists of insurance that exists largely under government control: while most social insurance programs are written and administered through private companies, they retain the ultimate backing of the government, sometimes implicitly. Examples of government-run programs include the National Flood Insurance Program, Florida Citizens Insurance Corporation, and the Mississippi Windstorm Underwriting Association. Social carriers serve areas of the market where the government has decided that a "market failure" exists and no private carrier will serve.

Most Americans buy property and casualty insurance in the admitted market. Admitted homeowners' insurance companies always participate in state guarantee funds mentioned above. In all states but one (Illinois) admitted firms also subject themselves to rate regulation. A rate regulated company must charge rates that are high enough that mathematical models suggest it will be able to pay its claims. On the other hand, it cannot charge "excessive" rates that give it "too much" profit. State insurance bureaucracies attempt to balance these two things when they oversee companies' rates. With some significant exceptions, government does not directly tell companies what to charge, but instead lets them set their own rates within certain guidelines.

The residual market, finally, consists of largely unregulated companies. Residual market companies must charge "actuarially adequate" rates (this imposes *de facto* price floor on how low they can cut their rates) but face no regulation as to how high they can raise them. Residual carriers work on the fringes of the admitted market and the social market: often, they write coverage when admitted market carriers will not. In many cases, they compete directly with government insurance carriers.

All state insurance markets in the United States present a mix of these types of insurance: 24 states offer a government-run insurance "FAIR plan" of which Florida's (Citizens) is by far the largest, and the federal government provides flood insurance in all fifty states and the District of Columbia.[11] All states, likewise, have both admitted and surplus lines markets although states with few natural hazards may have very small surplus lines markets for homeowners' insurance.

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"The path that leads to Florida's current insurance system begins with the aftermath of Hurricane Andrew in 1992."

Finally, all types of insurance carriers—including many government agencies—purchase "reinsurance." Reinsurance is essentially insurance for insurance companies. For many companies, it 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. 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.

Finally, it's worth noting that this paper refers repeatedly to the "2007 reforms" or the "January 2007 reforms." In all cases, this refers to a far-reaching insurance reform package that the Legislature passed in a special session during January of 2007 and amended in its regular section. Officially, the reforms are known as Florida House and Senate Bills 1A of 2007 and Florida Senate and House Bills 2498 of 2007.[12]

The Development of the Current System

> *The argument for liberty is not an argument against organization, which is one of the most powerful tools human reason can employ, but an argument against all exclusive, privileged, monopolistic organization, against the use of coercion to prevent others from doing better. -F.A. Hayek,* The Road to Serfdom

The path that leads to Florida's current insurance system begins with the aftermath of Hurricane Andrew in 1992. The storm, generally considered to have kicked off the current wave of major hurricanes, remains the most recent category five (maximum intensity) storm to hit the United States.[13] The storm resulted in 40 deaths and, in nominal dollars, cost more—$25 billion—than any storm ever to hit the United States before then.[14] More than a quarter million Floridians—most of them in Dade County—found their homes destroyed or uninhabitable in the storm's immediate aftermath.

In the wake of this devastation, and several brushes with insurer insolvency, the Florida Legislature convened three separate special sessions in 1992 and 1993.[15] These sessions resulted in the creation of the Joint Underwriting Association, the Hurricane Catastrophe Fund (CAT Fund), and an expansion of the Florida Windstorm Underwriting Association. The three entities intended to provide hurricane related insurance to people unable to find it in the private market: the Joint Underwriting Association theoretically served as a short-term market "safety valve," while the Windstorm Underwriting Association provided ongoing coverage to Floridians who couldn't get coverage elsewhere, and the Cat Fund made it easier for private companies to offer reasonable insurance rates by selling them discounted reinsurance.[16] These three mechanisms—the first two now merged into the Florida Citizens Property Insurance Corporation—still comprise the essentials of government intervention in Florida's system for providing property insurance.

A series of 1997 reforms, furthermore, increased the ability of both entities to levy taxes on their own while simultaneously expanding their capacity to write insurance[17]. The system lasted with few changes until 1999 when a bad hurricane season (that only grazed Florida) caused the Legislature to rethink the Cat Fund. The Cat Fund received a bailout in return for an $11 billion cap on its potential total losses.[18] Also in 1999, then Insurance Commissioner Bill

Nelson approved a plan that resulted in a private company—Clarendon National—taking over many policies the state services.[19]

As hurricanes continued to batter the state in the early '00s—leading to a greater demand for products from the Joint Underwriting Association and Windstorm Underwriting Association—the Legislature, in 2002, combined the two to create the Citizens Property Insurance Corporation. Although it continued to write some wind only coverage, Citizens was, by design, a full-line homeowners' insurer that replaced all homeowners' coverage in certain cases and contracted out little business.[20] (More on Citizens as it now exists below.) Still, homeowners' insurance rates continued to rise throughout the state.

The Catastrophe Fund also grew in 2004 when Governor Jeb Bush signed the first of several capacity expansion bills, raising its limit to $15 billion.[21] Following a particularly vicious 2004 Hurricane season the Legislature debated and finally passed a major relief bill that combined some modest insurance reforms with a major relief effort for those without insurance.[22] Facing continual battering from hurricanes and rising premiums, Governor Bush requested more reforms to the system, and, in 2005, he got them. In Senate Bill 1486, the Legislature agreed to the next-to-last round of major reforms to Florida's insurance system. Among other things the 2005 reforms shrunk the size of the Cat Fund, created a hurricane loss mitigation program, required insurers to offer higher deductibles to consumers who wanted them, mandated discounts for mitigation, and, perhaps most importantly, allowed Citizens to compete freely with the private market in Monroe County (the Keys). This package of reforms would stand—more or less intact—until early 2007. Under these reforms, however, rates continued to soar, doubling in 2006 alone for many in South Florida.

These quickly rising rates, coupled with record insurance company profits, led to a mood of populist outrage. On the campaign trail, then-gubernatorial candidate Charlie Crist called again and again for insurance reforms, and, upon taking office, almost immediately called a special session of the Legislature to consider them. After the only two legislators to vote against the proposal found themselves removed from key chairmanships, the outcome was never really in doubt. And the bill significantly changed the system by which Floridians purchase insurance. Bill 1A's provisions include:

- A rollback of January 2007 rate increases for Citizens Property Insurance Corporation and a prohibition on Citizens raising rates until 2009.
- A major change in the laws covering Citizens. Once only a "carrier of last resort" that required multiple turndowns before it would write a policy, Citizens will now write policies to anybody who receives one insurance quote more than 15 percent above its rates. This imposes a de facto price control on all insurers operating in Florida.
- An elimination of the requirement that Citizens have sufficient reserves to survive a "one hundred year" hurricane.
- A "roach motel" (anti-cherry picking) provision that requires all insurers selling auto insurance in the state to write homeowners' insurance as well if they offer it anywhere in the country.
- Taxes on "excess profits."
- A de facto repeal of the mandate that Citizens buy private reinsurance. (Citizens has not bought any such reinsurance in 2007.)
- A massive expansion of the Hurricane Catastrophe Fund.

Bill 2498 continued in the same vein with a number of tweaks to the fundamental system. Among other things it contained provisions to:

- Expand the Cat Fund and let very small insurance companies buy into it.
- Allow consumers to receive coverage from Citizens immediately after having their applications accepted.
- Make it easier for those who leave Citizens for other companies to go back to Citizens.
- Require insurers to pay or deny a claim within 90 days of receiving it.

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> *"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.'"*

- Make it harder for insurers to exclude contents coverage when writing homeowners' insurance policies.
- Impose new standards for reporting fraud on Citizens.

Finally, a bill passed during June slightly tightened the mitigation requirements imposed on property owners. The law in question—which renamed the hurricane damage mitigation program the My Safe Florida Program—slightly tightened mitigation requirements imposed on property owners desiring coverage from Citizens.

The next several pages describe the three major elements of that system: Citizens, the Catastrophe Fund, and the overall insurance regulatory climate.

Citizens Insurance

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."[23] 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, 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. [24] 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 and State Farm also have non-profit status.) 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 Corporation 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.* [25]

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] insured's." [26] State law places no overall limits on these taxes and applies them to *everybody* in the state including people who have never done business with Citizens.

In other words, despite its corporate front, Citizens may well be the single most powerful instrumentality of Florida's government. If the Department of Highway Safety and Motor Vehicles, for example, wants to expand the hours of its driver's licensing offices, it must ask the Governor and Legislature to add money to its budget. To get the money, Florida must either raise it through taxes or borrow it. Florida Citizens, on the other hand, has the power to impose taxes almost entirely on its own authority.

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.[27] Furthermore, under legislation passed during April, Citizens cannot raise its own rates on Floridians until at least 2009.[28]

Not surprisingly, given its low rates, Citizens has grown very large. As of the end of August 2007, it had issued over 1.36 million policies representing over a third of Florida's homeowner's insurance market.[29] 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. Since it specializes in writing policies in high wind areas, it had built up a surplus of nearly 2 billion as of early August of 2007. Although barred by statute from operating for the benefit of "any private person," Citizens faces few hard-and-fast restrictions on how it spends or invests this surplus.

The Catastrophe Fund

While Citizens maintains a high public profile as the state's largest homeowners' insurer, an agency with a much lower profile plays an even greater role in Florida's insurance system. The agency, the State of Florida Hurricane Catastrophe Fund (FHCF) serves as the largest re-insurer in Florida. (As discussed above, reinsurance is insurance for insurance companies.) Like Citizens, it is a government agency, but despite its vast reach, it exists as an obscure bureau buried deep within the State Board of Administration. [30]

The Catastrophe Fund, originally created in 1993, says that it exists to "protect and advance the state's interest in maintaining insurance capacity in Florida by providing reimbursements to insurers for a portion of their catastrophic hurricane losses."[31] Until the 2007 special session, FHCF remained a reasonably minor entity that sold reinsurance to smaller companies and the then-small Citizens. (Larger companies could almost always get reinsurance for less in the private market.) Today, it has become the largest and most important re-insurer located in Florida: Since it underwrites the great bulk of Citizens' risk, in fact, its existence provides a prop for Citizens. By providing reinsurance at below market rates, it theoretically allows insurance companies, including Citizens, to write insurance policies at lower rates: Governor Crist, *The St. Petersburg Times* reports, predicted a 24 percent decline in insurance rates.[32] So far, for reasons this paper discusses below, this has not happened.

In fact, it appears that the Cat Fund may actually increase costs. Current Florida law requires all insurers doing business in the state to purchase reinsurance through the FHCF. This reinsurance costs less than similar coverage in the private market and, in theory, would allow insurers to cut rates. Unlike traditional reinsurers, however, FHCF does not carry out a serious investment strategy or attempt to grow its business. Instead, like Citizens, it has the authority to impose new taxes (in the form of assessments) to pay off whatever bonds it might issue. In theory, by providing this subsidized reinsurance, the State of Florida allows Citizens and other companies to cut their rates. Earlier this year, the fund decided to issue over $5 billion in debt to build up its cash reserves—the state's largest ever single debt issue to date.

The $5 billion in new bonds—which, alone, increase the state's debt almost 20 percent, would pale in comparison to how much the FHCF might cost the state. Under current law, the fund has the authority to issue $28.42 billion in bonds.[33] No American state or city has ever issued nearly that much debt all at once (in fact, it's unlikely that any non-national government *anywhere* has ever done so): whichever way one cuts it, the new debt will more than double the largest bond issue in history.[34] Fundamentally, neither insurance companies nor bond rating agencies believe that the CAT Fund will actually pay its claims: bond rating agencies downgraded its debt immediately after the new laws passed. Standard and Poors' assessment was typical. Although noting that the fund has strong political support, it also warns, "the potential for significant additional debt has increased for the next three years, and future changes in liability and bonding capacity will continue to be an important part of our credit analysis." [35]

Bond markets appear worried. An analysis prepared by the firm Raymond James for the FHCF itself concludes that, "at a $15B maximum size, FHCF bonds are probably digestible in the market. At larger sizes, this becomes more uncertain." [36] Two major ratings agencies—Moody's and Standard and Poor's—downgraded the FHCF's bonds in the wake of the Legislature's actions. Some evidence exists that even this effort lacked confidence: citing a desire to get a better price, the fund earlier this year delayed a bond sale intended to build up cash reserves ahead of the hurricane season.[37] The state's own most recent estimates, in fact, show that the fund will become insolvent in the medium term unless bond market conditions change for the better: higher interest rates, in fact, could result in insolvency in the short term.[38] Even the State Board of Administration, which oversees the Cat Fund and would issue

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most of the bonds, wouldn't promise that it can find buyers. In response to written questions the author submitted, the Board dismisses the question as "speculative" and offers a dodge: "There's no way to account for all contingencies and twists the economy might take that could impact large debt financing. What is more important is for insurers to study [the Cat Fund] and develop their own confidence based on the information that we provide for them."

Overall Market Regulation

In addition to the two large-scale government interventions, the state of Florida maintains a multi-pronged regulatory apparatus that touches all insurance companies. Overall insurance regulation has three major components: a public rate hearing system, a so-called "anti-cherry picking law" that requires companies to issue insurance in Florida, and a partial ban on so-called insurance company "pups."

Although forty-nine states regulate insurance rates in some form, the 2007 insurance reforms made Florida's regulatory system particularly burdensome. Florida not only requires that state bureaucrats sign off on all rates—something only nine other states require by law—but also mandates that the Insurance Commissioner and insurance companies attend public hearings on just about every major request for a modification in rates. Not only do insurance companies have to go through the burden of hearings but the state has also eliminated appeals panels that quickly decided cases when a dispute existed. In general, insurance companies who dislike the state's decisions have little make choice but to launch expensive court cases. Other restrictions on company conduct include mandates that companies double discounts available to homeowners for installing mitigation devices like storm shutters.

Second, Florida has what those in the insurance industry call a "roach motel" law and the state calls an "anti-cherry picking law." The law requires companies offering a type of policy anywhere in the country to make it available in Florida or withdraw from the state altogether. For companies that sell only one type of insurance—say, only automobile insurance—this changes little. For multi-line companies, which write most policies, however, it makes things more complicated. A company wishing to participate in Florida's highly profitable auto insurance market, for example, must also sell homeowners' insurance even if its management feels that entering the Florida homeowners' market would damage the company. Since the law doesn't set firm minimum number of policies, however, it will have little short term effect

Finally, the 2007 reforms placed high new capital requirements on insurance companies' Florida-only subsidiaries. These companies, colloquially called "pups" carry the same branding and typically use the same back office processes as companies that carry the same names. They exist, however, to insulate parent companies' assets from Florida's regulatory environment. For example, Allstate policies in the state come from a subsidiary called "Allstate Floridian." In theory, if Allstate Floridian sustained enormous losses, it could liquidate its assets and go bankrupt without touching the assets of its parent company. (It's worth noting that no large American insurer has ever actually done this.) In some cases, the existence of these "pups" lets companies avoid certain aspects of state "roach motel" laws; the new laws strongly discourage the creation of new "pups."

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How it Has Worked Out

In practice, the 2007 reforms have not worked as advertised, and, in fact, evidence exists that insurers may soon begin a mass exodus from Florida. In particular, three things have happened: Citizens has written more policies than anyone predicted it would, the Cat Fund has failed to produce promised savings in the rates customers pay for insurance, and the regulations have tended to drive insurance companies out of Florida.

Citizens' growth is not altogether surprising. Barred from raising its rates until 2009, Citizens has seen its market share grow and grow. In Miami-Dade, the number of policies issued indicates that Citizens has assumed essentially all of the hurricane risk. In the South Florida counties where its business is concentrated, it's likely that Citizens has written more than 70 percent of all risk. In a sense, Florida Citizens "works" in that its existence does provide lower rates, but, of course, those rates will only save homeowners' money in the long run if Citizens doesn't use its powers to impose taxes on all Floridians. In fact, since Citizens itself has ample reinsurance from the Cat Fund, it's actually not very likely that Citizens would impose taxes of its own.

The Cat Fund, however, will almost certainly use its own power to raise taxes. Given its already enormous debt load and the possibility that it could grow even more, the Cat Fund will likely have little choice but to raise taxes if a major hurricane hits. The 2005 storm season drained the entire $7 billion that the Cat Fund had built up: even one similar storm season would almost certainly do the same and leave the fund without any ability to pay claims unless it issues more and more bonds.[39] Given its problems to date raising sufficient money selling bonds, it's understandable that insurers do not consider the Cat Fund a truly viable re-insurer and have bought private reinsurance anyway. This situation seems likely to continue absent serious reforms in the manner in which the Cat Fund operates. Cecil Pearce, the American Insurance Association's Southeast Regional Vice President, explains why insurance companies are so worried: "With the expansion of the Cat Fund in the 2007 special session . . . it's now going to cover up to $28 billion. And that's a scary number." One top insurance executive, who spoke with the author on the condition he not be named because he has regulatory filings before the state of Florida, is even more blunt. "No other state could get away with doing all the goofy things that Florida is trying," he says. "There's just so much premium in Florida that companies are bending over backwards to stay in."

The overall insurance environment, particularly for people seeking personal coverage, has succeeded in scaring away carriers. While state officials tout the fact that nine carriers have entered the state since early 2007, they fail to point out that not a single out-of-state company has emerged to write new policies in the admitted market.[40] According to industry trade publication *Insurance Journal,* in fact, four new "personal lines" carriers (all of which write policies only in Florida) apparently plan to work mostly by taking pieces of Citizens business: two appear to see that as their only business.[41] In short, no evidence exists that new private insurance companies have decided to come into Florida in any significant numbers. In fact, they appear to be getting ready to withdraw: As of September 2007 USAA, Liberty Mutual, the Hartford, Allstate, State Farm, and Nationwide had all announced plans to cut back. State Farm even filed paperwork hinting that it might pull out of the state altogether. Denied rate increases, furthermore, full-scale pullbacks appear to have become a real possibility for Floridians. The Hartford, for example, requested a series of rate increases that ranged from 29.5 percent to 225.9 percent and found all of them rejected.[42]

A report prepared for the Property and Casualty Insurers Association by the well-respected actuarial consulting firm Milliman comes to a devastating conclusion. According to the Milliman report, Citizens will face severe problems in the future. Among other conclusions the report predicts a grim long-term scenario including:

- Even in the best circumstances, Citizens will see its surplus shrink to the point it will likely to have to borrow lots of money to pay claims.
- Citizens itself has become more stable but it has done so simply by transferring its risk to the Cat Fund.
- It's highly likely bailing out the system will ultimately require special assessments on all insurance policies including auto insurance.[43]

In short, the 2007 insurance reforms have failed. They have placed more liability on the state, failed to produce savings for consumers, and appear likely to have severe fiscal implications for Florida's future. The next section of this paper examines a variety of proposals for creating a better insurance system for Florida.

"The 2005 storm season drained the entire $7 billion that the Cat Fund had built up…"

"Good and bad, none of these incremental reforms (and others are proposed every day) will have a major consequence for Florida's insurance markets."

Analyzing Possibilities for Change

Something is stirring,
Shifting ground …
It's just begun.
Edges are blurring
All around
And yesterday is done.

—Stephen Sondheim, "Our Time,"
From *Merrily We Roll Along.*

This paper has demonstrated that Florida's insurance system needs serious reforms. This section analyzes a number of reforms that have either been proposed in Florida or elsewhere. It consists of segments analyzing reforms both in Florida and elsewhere. Nearly all of the reforms touch Florida Citizens in some way. Hardly anyone considers the current state of Citizens or the Cat Fund copasetic, and, thus, reforms have long been on the table. New proposals will continue to pour in. The next few pages look at several possibilities on both the state level and the federal level.

State Proposals

Keep the current system in place, but continue minor reforms to fix what's wrong with it.

The reforms passed a Senate Bill 2498 offered an example of future tweaks that some might expect to improve Florida's insurance environment. A few examples of fixes before the Legislature follow;

- Require all agents selling surplus lines coverage (coverage not subject to rate regulation) to offer quotes from Citizens as well as other companies.[44]
- Create expanded programs to encourage mitigation against hurricanes and reform tax laws to make it easier for people to make improvements that would make their own properties more disaster resistant.[45]
- Impose new ethics requirements on Citizens' own business.[46]

Other similar proposals are sure to appear. Operating entirely within the current framework, some of these ideas may make sense: state spending and tax relief on additional mitigation programs, for example, could well serve to reduce the liabilities of Citizens, the Cat Fund, and, thus, the state. Others may simply create more paperwork or undermine contracts: independent insurance agents always comparison shop on their customers' behalf, and, if they have any sense of professional ethics, will almost always provide Citizens quotes anyway. Even if an agent did not do so, it's difficult for a Floridian who ever watches television or reads the newspaper to avoid knowing about Citizens and requesting a quote. The law simply imposes an unnecessary burden

Good and bad, none of these incremental reforms (and others are proposed every day) will have a major consequence for Florida's insurance markets. They amount to rearranging deck chairs on the Titanic.

"Privatize" Citizens by allowing private insurers to service its policies, but have the state retain most of the actual insurance risk through reinsurance arrangements.

This idea, adopted in part in Louisiana and proposed in the Legislature, would remake Citizens on the model of the National Flood Insurance Program.[47] Citizens would no longer maintain sales or claims department but would instead contract out its business operations to a variety of private companies. The state would, however, retain most of the downside risk while private companies would get to keep some of the profits when they did well.

This proposal appears likely to improve Citizens' customer service but might actually reduce its ability to pay claims. Currently Citizens relies largely on contractors to get its work done—many of them with little Florida-specific experience—and is known for providing poor customer service. [48] Private companies could bring in existing infrastructure to process claims and serve customers. Although service would likely improve, private companies (unless they were Florida-only operations) would have no incentive to reinvest profits in the state. Perversely, improved customer service could even increase the risks to the state: private contractors—with no real downside risk—would have every reason to spend freely in order to keep customers and legislators happy between storms. They would not have the discipline of knowing that they actually needed to pay claims out of their own reserves and thus, might "goldplate" service or pay potentially fraudulent claims in order to keep consumers happy. This, in turn, could make the state even worse off in the long run.

Create a task force to review Citizens work and move it back towards a private market.

State Rep. D. Alan Hays, R-Umatilla, has proposed legislation that would set up a commission to review Citizens' work, making it clear that the Legislature wants to return Citizens to a status as a true "insurer of last resort." In its original form the task force would have the explicit goal of liquidating Citizens although the version considered by the Legislature sets the more modest goals of simply returning Citizens to a much more limited role.[49] The task force, appointed by the Legislature, would simply develop a plan for limiting Citizens role. The task force's proposed makeup—which would include representatives appointed by the Governor, legislative leaders, Allstate and State Farm (seats reserved under the legislation for the two largest insurance companies in the state), small and medium-sized insurance companies—would likely give its report some weight. On the other hand, the commission—particularly in the form of the bill that actually received consideration—would have no real "teeth." The Legislature would have no obligation to act on whatever it recommended.

Commissions such as the one Hays proposes prove most useful when studying long term problems. Sometimes—as with the 9/11 Commission—their work can have major consequences for national policy. Most reports issued by commissions, however, have little consequence: President George W. Bush, for example, has convened bipartisan blue ribbon panels to report on Tax and Social Security Reform. Both found their work dead on arrival. A reform panel for Citizens might produce some useful ideas. It's an idea worthy of support. But, given the fact that even a single large hurricane could cause severe fiscal problems for the state, the Legislature should resist the temptation to create a commission and consider the problem solved.

Outlaw Single-State Subsidiaries.

Florida State Senator Burt L. Saunders R-Naples has proposed legislation outlawing so-called "pups"—single state subsidiaries of larger insurers discussed above.[50] Pups, the argument goes, allow larger companies to use their sales infrastructure to sell policies but, by virtue of insulation from the parent companies' finances, could theoretically declare bankruptcy and leave the state guarantee fund with their debts following a major storm. Because they are insulated from their parent companies and thus have fewer resources, pups may also sometimes be able to justify higher rates than their parent companies would. (The State of Florida, however, now requires them to include information about their parent company's finances in letters to policyholders and information provided to state regulators. For all intents and purposes, furthermore, Insurance Commissioner Kevin McCarty seems inclined to consider them as part of their parent companies in rate hearings.)

Stiff new reserving requirements imposed on pups in the January legislation already make it reasonably unattractive to set up new pups: Although they appear to make the pups stronger, requiring more capital to be tied up in the pup operations may actually make them less likely to provide coverage.

"Commissions such as the one Hays proposes prove most useful when studying long term problems."

Since pups are typically wholly owned subsidiaries of larger companies and use the same branding and "back office" systems, any large national insurer that failed to deploy its full faith and credit to bail out a pup would take a major hit to its brand. While major national insurers would not bankrupt themselves to bail out a pup, nearly all would do anything short of that. A company that failed to do so would almost certainly (and, it should be added, with good reason) lose an enormous amount of business throughout the country. Raising capital requirements for pups, in fact, may make them less able to write coverage: with more money tied up in a Florida market companies have less to invest elsewhere and, all other things being equal, less money overall. This reduces the total amount of money actually available to pay claims.

The current laws already make it very undesirable for insurers to set up new pups. Banning

“A group of businesspeople, lobbyists and activists led by former state representative Don Crane has also proposed a ‘Florida Reinsurance Corporation.’”

these single state subsidiaries altogether would likely lead at least some insurers to withdraw from the state altogether and leave many consumers with few options besides Citizens.

Replace Citizens with a publicly-owned hurricane primary insurer and keep this mechanism in place indefinitely.

A group of businesspeople, lobbyists and activists led by former State Rep. Don Crane has also proposed a “Florida Reinsurance Corporation.”[51] CFO Sink and former State Comptroller (the precursor to the CFO) Robert Milligan have also flirted with the idea. Although called a “reinsurer” the FRC would, in fact, serve as a primary insurer for nearly all hurricane risk in Florida. Unlike Citizens it would deal only with insurers rather than consumers, and, unlike Citizens, it would have no autonomous power to levy taxes to make up its deficits. Like Citizens, however, it would be a state agency and a piece of the state government. Formally, it would be created out of the Cat Fund, and, via laws or tax penalties, private insurers operating in Florida would face a de facto mandate to cede their hurricane risk to new company.

The proposal, released only in limited circles and not yet introduced in the Legislature, would borrow heavily from a “Broader Windstorm Coverage Fund” proposal that Alex Vogel, a consulting actuary, floated in a paper prepared for the Florida Association of Insurance Agents.[52] Under the Crane proposal:

> The FRC would charge primary insurers stable rates for hurricane coverage determined by sound scientific and actuarial principles. The FRC, as a single peril reinsurer with no sales force, no federal tax expenses, and no required investor returns, should be able to provide Florida property owners immediate rate relief even while paying the debt service to retire indebtedness undertaken to provide initial capital. This initial capital would be calculated to provide a surplus adequate to pay claims for a one in twenty-five year hurricane event. Post-event funding for larger loss years would be provided by the best available sources including reinsurance, alternative risk transfer mechanisms such as Catastrophe Bonds, and, possibly, a federal catastrophe loan program.

This plan would likely prove better than the current system for covering hurricane damage. Current treatment of insurance company reserves under federal law makes it difficult for private companies to reserve funds for catastrophes, and, without changes to law, companies face enormous financial incentives to purchase reinsurance rather than actually reserving funds themselves. In some cases, however, self-reserving may be more flexible than the purchase of reinsurance. Likewise, although standards of actuarial adequacy require a certain amount of reserving or reinsurance, some people—such a Vogel—think that money paid in premiums could be “exported” out of state. Unlike the current unwieldy Citizens-Cat Fund combination, a large hurricane reinsurance pool would likely bring down the expenses for providing hurricane insurance in the short term. As an agency of state government, like Citizens, a mandatory all-purpose wind pool could keep an almost unlimited amount of money in reserve. If it actually captured all the premiums in the state, it would likely provide more stability than the current system: rather than issuing debt, the state would actually acquire hard assets to pay for hurricanes.

The plan, however, has a severe problem: when the state bans “exporting” premiums, it conversely makes it impossible for in-state insurers to “import” out of state capacity and reinsurance. Although the gross state product (GSP) is about $715 billion—the fourth highest in the country—the state’s per capita income is actually 11 percent below the national average and the total GSP represents less than 5.5 percent of the U.S. total GDP.[53] Keeping in all of Florida’s premiums also means keeping out 94.5 percent of the nation’s economic capacity. The state could, of course, purchase out-of-state reinsurance to bring in capacity, but this would, of course, defeat the supposed purpose of keeping Florida’s premiums “at home.”

Although hardly a victory for the free market by any standard, the Crane proposal would still very likely reduce premiums for those in the state, and likely would not expose Floridians to the enormous financial risks associated with the current system. It would also take away a difficult, perilous part of the insurance business and might well attract some support from the insurance industry.

That said, the project has two major downsides. First, it would turn most Florida insurers into claims servicers and deprive them—and the free market—of its role in managing risk. Second, although the new system would have more stability than the current system, a collapse of the FRC would have the same consequences as a collapse of the Cat Fund or Citizens: It would imperil the state's fiscal future.

The Crane proposal would represent an improvement over the current state of affairs. But, relative to market freedom, it seems undesirable.

Create a limited purpose wind-only Florida insurance fund backed with private reinsurance and abolish Citizens.

State Rep. Dennis Ross (R-Lakeland) has also told the author he plans to introduce a proposal to replace citizens with a state-run wind only insurer. Draft legislation he shared with the author envisions a narrower "Florida Windstorm Insurance Program. The proposal declares Florida's wind risk "uninsurable" by conventional measures and sets up an alternative system.

Under the proposal, a new entitiy, the "Florida Windstorm Insurance Program," would become the major windstorm insurer in the state. The Program would not sell policies directly to Floridians but, instead, provide a backstop for losses that private insurers would sell. Private insurers would service and market policies, but, ultimately, the state would make all major decisions about pricing and coverage. The structure, in short, would have significant similarities to the National Flood Insurance Program's "write your own" guidelines: The government would provide the insurance, and private carriers would work to service claims.

From a fiscal standpoint, the proposal has a lot to recommend it. Rather than issuing enormous amounts of state debt, the new Program would attempt to charge adequate premiums, build substantial assets of its own, and purchase private reinsurance to back its risks. Unlike Citizens, the new fund would charge premiums at least equal to the average annual windstorm loss in the state. Insurers willing to write homeowners' policies that covered everything (including wind) could continue to do so, but all others would have to take part in the wind fund to offer homeowners' insurance. The fund itself would be entirely self-assessing. After a few years, only people who held policies with the fund would pay taxes to support it. Citizens would stop selling policies that cover only wind and cede that business to private companies backed through the fund.

To provide startup capital for the fund, Representative Ross proposes auctioning off blocks of other Citizens' business to the highest bidders and allowing these companies to service policies on their own and finally transferring Citizens' own surplus to the Fund. This would, for all intents and purposes, abolish Citizens.

The plan has several obvious flaws, and, indeed, Representative Ross himself concedes that the plan lies a long way from a truly free market. First, it does not actually require the new fund to charge actuarially adequate premiums. Although this will likely prevent price shocks—and may prove key to making the legislation politically viable—it decreases the ability of the fund to sustain major storms. If the proceeds from the sale of Citizens' business prove too small to make up the difference, the new fund could land the state in the same situation as the current system. Second, the proposal, in the form the author saw, would cover even houses of the very well off—homes up to $2 million in structure value—which would mean that people well able to afford rebuilding their homes would still get state aid. On the other hand, including more valuble homes would increase the fund's financial stability. Representative Ross has said he has struggled with this provision and may change its particulars.

But it would have two major advantages over the current system. First, unlike the current system, it has a good chance of achieving fiscal stability for the state. Through the purchase of private reinsurance and the liquidation of Citizens, it would pull Florida back from the fiscal brink. Second, unlike the current system (which cannot sustain itself without the ability to tax), the proposed system leaves an opening for private companies to begin writing wind insurance. At least some would, and, over time,

"Under the proposal, new entitiy, the 'Florida Windstorm Insurance Program' would become the major windstorm insurer in the state."

"Right now, both Citizens and the Cat Fund can tax just about everyone in Florida—all 18 million people—to pay any of its bills."

it's possible that more people could begin to find decent, affordable coverage on the private market.

The plan would still leave Florida with a heavily state-dominated insurance market, but, in nearly all respects, it would represent an improvement over the current situation.

Make Citizens "Self-Assessing."

If his proposal for a Florida wind insurer fails, Representative Ross has told the author that he plans to introduce a proposal to make Citizens partly "self-assessing." Last year, he introduced an amendement that would have made it fully self-assessing.[54] (A self-assessing insurer—which is the only option in the private sector—levies special assessments on its policy holders rather than people who have never done business with it).

The Ross amendment, which attracted 37 votes, showed the level of problems that many members of the Legislature had with self-assessment. Under limited self-asessment Citizens would function as it currently does and could continue to charge the same premiums, but, under the proposal, people who did not own Citizens policies would not pay assessments to bail out Citizens until the total assessment that Citizens policyholders paid reached a certain percentage (perhaps a quarter) of a total premium.This proposal would essentially limit the tax increases associated with a Citizens bailout to people who choose to do business with Citizens in all but the most severe cases. From a standpoint of simple fairness, the proposal has a good deal to recommend it: Floridians who live inland and have no dealings with Citizens would not see sudden surges in their homeowners' or automobile insurance policies except, perhaps, after the most severe storms.

Citizens policyholders, however, would have the risk of paying a lot more. Right now, both Citizens and the Cat Fund can tax just about everyone in Florida—all 18 million people—to pay any of its bills. Making Citizens self-assessing would limit its immediate reach to only the 1.3 million households (representing about 3.5 million people) who actually own Citizens policies. These policyholders would have to pay significantly more than people elsewhere in the state if a major storm hit. In fact, it's likely that these special assessments—if they came—would wipe out the advantage of purchasing Citizens policies. Rather than providing more predictable costs than private insurance, the actual cost of a Citizens policy would be less predictable than a private one.[55]

The idea has enormous appeal on the grounds of simple fairness—the people who use Citizens coverage would pay for it—but it would not solve the problem altogether In the event of a truly serious storm or series of storms, people who do not have Citizens policies would end up bailing out those who do.

Making Citizens completely self-assessing—as Representative Ross proposed in 2007—would have much more severe implications. Because of its reasonably small policyholder base, a fully self-assessing Citizens would have severe fiscal implications for the state. During a major storm season, policyholders themselves might have a very difficult time paying assessments thus placing the Cat Fund in jeopardy very quickly. This scenario would likely have significant impacts on bond markets and would likely worsen Florida's bond rating.

A proposal for partial self-assessment seems most attractive in the short term and appears worthy of careful consideration provided that efforts to abolish Citizens prove unsuccessful.

Offer Tax Credits.

The state of South Carolina, has offered an extensive series of tax credits in an effort to attract insurers into the private market.[56] They include:

- Subsidies for people of modest means to purchase insurance.
- Savings accounts (exempt from state income taxes) to encourage self-insurance against hurricanes.
- A grant and tax-subsidy program similar to Florida's My Safe Florida to encourage retrofitting.
- Tax subsidies for insurance companies that write policies in hurricane-prone areas.

It's easiest to administer such credits through an income tax, and, of course, Florida does not have an income tax. Although Governor Crist and the Legislature have discussed property tax relief—and some media accounts have tied the push for relief to higher hurricane-related insurance premiums—efforts to date have had a state-wide focus.[57] Focusing property tax relief on coastal areas and tying it directly to insurance—perhaps by offering state subsidies to localities that offer property-tax credits against insurance—could serve to focus property tax relief on the coasts and might encourage a larger private insurance market. New York and Virginia, among other states, have provided state benefits via relief of local tax credits. The administration of such a system would likely prove quite complex and would probably have a higher marginal cost than a plan to administer the same system through the income tax. In any case, it raises questions of overall tax policy that lie beyond the scope of this paper. Focusing tax relief on coastal areas could even have the perverse consequence of encouraging more development in coastal areas that face high hurricane risk. It might also be possible to consider extending the sales tax exemption or offering a sales tax rebate of some sort. The idea of tax reforms, in any case, deserves more study and perhaps some concrete legislative proposals.

Federal Proposals

Create a National Wind Pool.

U.S. Rep. Gene Taylor, D-Mississippi, has proposed a "National Wind Pool," and the House passed his bill in September 2007, with nearly every member of the Florida delegation voting in favor of it.[58] Taylor's bill would add wind insurance to the existing National Flood Insurance Program, require localities wishing to participate to introduce wind-specific building codes (similar to ones that every Florida coastal community already has in place), and require the program to charge "actuarially adequate" premiums to anyone seeking coverage. Since it would be a federal action, the Taylor plan would not immediately displace Citizens: if the plan actually charged actuarially adequate rates, its coverage would almost certainly cost more than Citizens' does and, thus, would attract reasonably few customers in Florida.

Given the history of the National Flood Insurance Program (NFIP), however, it's unlikely that the new federal wind pool would charge actuarially adequate rates in the long term. NFIP initially charged rates that met standards for actuarial adequacy but, after finding that almost nobody purchased wind insurance at the prices it charged, modified its premium structure and essentially did away with the concept of actuarial adequacy.[59] To this day, roughly 20 percent of properties covered by the NFIP do not pay actuarially adequate premiums.

Although they can manage risk across larger pools, government-run insurance programs have a major intrinsic disadvantage: they have a very difficult time writing insurance against risks that will not correlate. A government program that writes insurance for flood and wind could insure against only flood and wind and then, in all probability, would actually sell such insurance only along the Gulf Coast. A private insurance company, on the other hand, can write insurance for risks unlikely to correlate with hurricanes—for example, tornados in the Midwest and car crashes in Montana. A government program also must respond to political forces: if it charges premiums that people feel are unaffordable, they can always pressure politicians to lower prices without regard to the program's stability.

A wind pool likely wouldn't benefit Florida in the short term and has severe problems anyway.

Create a General-Purpose National Catastrophe Fund.

The non-profit protectingamerica.org (backed largely by Allstate Insurance Corporation) and the Property and Casualty Insurers Association of America have pushed a national catastrophe insurance plan partly embodied in the Homeowners' Defense Act of 2007.[60] The legislation would create a federally backed, politically run, but technically private "National Catastrophe Risk Consortium" that would backstop private reinsurance companies mostly (although not entirely) in hurricane, earthquake, and flood-prone areas. As with the National Flood Insurance Program, (which the Catastrophe Risk Consortium would largely replace), states and localities would have to opt-into the program.

Under the legislation, the Consortium

"Focusing tax relief on coastal areas could even have the perverse consequence of encouraging more development in coastal areas that face high hurricane risk."

"The Travelers' Company has floated a proposal—not yet introduced in Congress—that would create a special national wind insurance zone along the Atlantic Coasts."

would serve as a very large-scale re-insurer backing both private companies and state agencies like Citizens. It would issue securities, sell reinsurance, provide a central database of risk information and "perform any other functions deemed necessary to aid in the economic transfer of catastrophe risk from participating states to private parities." The Secretaries of Treasury, Commerce, and Homeland Security would all sit on the board of the fund as would individuals appointed by all states taking part.

Although technically "not a department, agency, or instrumentality" of the government, the heavily political makeup of the Consortium's board would, with good reason, give capital markets the impression that the government would ultimately bail out the Consortium if it had problems. On one hand, this will almost certainly reduce the cost for reinsurance that the Consortium sells, improve the financial position of insurance companies and, perhaps, provide some short-term savings for customers. On the other, the implicit government backing of the fund means that, rather than reducing government risk, it would actually increase it. The legislation, furthermore, does not guarantee any actual savings for consumers: it's only guaranteed consequence would be subsidized reinsurance for large insurance companies. Insurers would do better, and consumers might well see lower premiums, but the free market would suffer.

Florida would do well under this proposal: the new fund would largely displace both Citizens and the National Flood Insurance Program and would replace Florida's own obligations to both with an obligation to the federal government. The costs of these programs, furthermore, would likely be distributed all around the country rather than concentrated in Florida.

On the other hand, the program would almost certainly become more expensive year after year. By taking on nearly all flood, hurricane, tornado, and earthquake risk, the Consortium could become a massive "too big to fail" program analogous to Social Security. Although it would not cause problems overnight, the program could add significantly to the national debt and require new taxes simply to keep it running.

Changing the laws to encourage capital markets to inject more liquidity into reinsurance markets deserves further study. But the proposal currently on the table—while good for Florida—concentrates too much risk with the government and offers too large a potential subsidy to private industry. Even though it might benefit the state, it would hurt the country.

Create a Special Coastal Wind Insurance Zone.

The Travelers' Company has floated a proposal—not yet introduced in Congress—that would create a special national wind insurance zone along the Atlantic Coasts.[61] Within the wind insurance zone, companies could engage in a variety of measures to increase risk pooling and the purchase of insurance: within the zone, the federal government would regulate prices under much the same terms as most states do currently. In addition, companies operating the zone would have the ability to levy special assessments when losses were worse than expected and would have a corresponding obligation to refund "excess" profits.

The proposal retains many of the features of the current insurance system and, for many policyholders, would result in a few real changes. Because it would allow the management of risk over a broader group of policyholders, there's a decent chance that it would result in lower rates. On the other hand, it has a number of features that may prove its own undoing. While requiring the rebate of "excess" profits, for example, has an undeniable populist appeal it could have perverse consequences for the insurance industry: a string of "good" (low hurricane years) for example, could get people accustomed to significant rebate checks from insurance companies. If these checks were stopped, it seems possible that politicians would petition insurance companies to keep sending them anyway and might even pass laws requiring them to do so. This could devastate the private insurance market. In addition, continued rate regulation could have negative consequences for purchasers: people sustaining the highest risks should, theoretically, pay the highest rates. If people facing significant risks manage to use the rate regulatory process to bring rates down for them, insurers would almost certainly raise rates for other people. This could make a federally regulated insurance zone just as bad as the state system it replaces.

The problems with the proposal, however, remain mostly hypothetical while its benefits seem much more real. It deserves further study and serious consideration.

Authorize an Optional Federal Charter for Insurers.

Some parties in the insurance industry have long favored the idea of an Optional Federal Charter (OFC). Essentially, an OFC would let insurance companies do what banks have done since the Civil War and operate under either federal or state law. Two very similar National Insurance Act bills currently before Congress would set up a national regulatory body for insurers.[62] Under both bills, the federal government would set up an apparatus intended to protect consumers but would not do anything to set or regulate the rates they charge. States would keep taxes currently paid by insurers, and federally regulated insurers would pay separate regulatory fees.

The proposal would let insurers out from nearly all strictures of Florida's insurance laws. Unlike the current system for regulating banks, which subjects all banks to Federal Deposit Insurance Corporation oversight even if they otherwise follow state regulations, the system would draw a bright line between federal and state regulation. No company, at least in theory, would find its regulatory burden increased.

The proposal has three major advantages for the insurance business. First, it would do away with rate regulation and make it easier for companies to price based on risk. Second, it would also unleash regulatory competition: states that wanted to keep insurance companies at home would have to change their insurance laws or risk losing them to the federal government. Finally, it's low risk: If it didn't work out, customers and insurers simply would not participate in the new federal agency, and, aside from the (rather small) cost of staffing the agency, taxpayers would lose nothing. All state regulations would remain in force for companies that choose to continue operating under state laws.

Customers around the state would also realize some important gains. First, companies would sell insurance to nearly anybody. With risk-based prices assured, just about everybody could find insurance at some price in the private market. Second, competition between companies would likely result in new types of products: largely because anything new needs separate approvals from every state, no fundamentally new property insurance products have come to market since modern homeowners' insurance appeared on the scene in the late 1950s.

It's not clear, however, what an Optional Federal Charter would do for Florida. So long as Citizens still exists and still sets its rates below those of the market, little incentive would exist for customers to buy coverage from private companies that might enter. Although this coverage would very likely cost less than coverage in Florida's excess and surplus market, it would almost certainly cost more than price-controlled coverage from Citizens. Thus, Floridians would be unlikely to purchase insurance from new federally chartered insurance companies. In fact, some private companies currently hanging on by a thread in the property insurance market could well decide that it simply isn't worth the trouble until Florida changes its own laws. Alone, an OFC might well result in an *increase* in Citizens' market share.

Although an Optional Federal Charter makes a good deal of sense in the general sense, it seems unlikely to create a short-term material change without further reforms to Florida's own laws.

"States would keep taxes currently paid by insurers and federally regulated insurers would pay separate regulatory fees."

Conclusion

Tantae molis erat Romanam condere gentem!

—Virgil, *The Aeneid*, Book I, Line 33.

[Oh what a burden it was to found the Roman people!]

Florida faces a deep insurance mess, and, given the continuing popularity of the January 2007 reforms (despite lack of evidence they have worked), the prospects for reform appear slim in the short term. It may well take a statewide insurance-related fiscal crisis to wake up Florida to the realities of the system Governor Crist and the Legislature have built. While they say that they wish to place the responsibility for

“There is no straight path towards a better system that provides reasonably priced, decent insurance for everyone.”

insurance with private industry, they have in fact placed it largely with Florida’s taxpayers.

Quite simply, Florida has collectivized an enormous percentage of the state’s insurance risk and will face clear problems as a result of having done so. Although Citizens has delivered short-term rate cuts, the current reinsurance plans have not worked as intended, and the costs of bailing out Citizens itself following the next major storm will likely result in long-term special assessments greater than the short-term savings Citizens has delivered to policyholders thus far.

Any solution that Florida embarks on implies costs that may prove difficult to bear: one way or another, Floridians will eventually have to pay the costs of insuring their own homes and property. Even the most ardent critics of the current system — people such as State Rep. Dennis Ross, R-Lakeland — have not yet offered concrete plans to phase out the system altogether. It’s highly unlikely that the Legislature would pass anything close to a total phase-out.

There is no straight path towards a better system that provides reasonably priced, decent insurance for everyone. Plans to increase state reinsurance capacity and have the state take on more insurance for wind would decrease the state’s role in some areas of the insurance market (overall homeowners’ insurance) and increase it in others. Making Citizens self-assessing, likewise, would have severe fiscal implications for both Citizens and the state itself. Inevitably, Florida will have to move forward in baby steps. Eventually, many Floridians will have to pay more for insurance: Florida faces a severe risk of hurricanes, and, ultimately, it’s appropriate that the state’s citizens pay the cost. Floridians will inevitably have to take on new burdens.

The state’s quality of life, ultimately, depends on finding a reasonable solution that everyone in the state can live with. Nobody has all the pieces or a complete roadmap to a better system. But, in the end Florida can, indeed, struggle its way towards a better, more reasonable, more market-oriented insurance system.

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. *He wishes to thank William Ballard, Don Crane, Robert McClure, Michelle Minton, Dennis Ross, and Robert Sanchez for their assistance and counsel on this project.*

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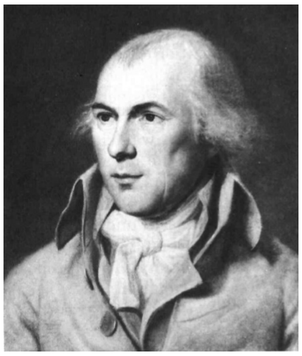

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