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Florida's Financial Exposure from Its "Self-Insurance" Programs:
The Citizens Property Insurance Corporation and the Florida Hurricane Catastrophe Fund

EXECUTIVE SUMMARY

Damages from recent hurricanes raise important questions about Florida's potential taxpayer risk exposure when another storm hits. Key among them is whether Floridians must either choose between affordable, state-provided windstorm insurance or windstorm insurance from more clearly solvent private insurers.

Affordable coverage means little if the provider becomes insolvent in a crisis. The financial stability of property insurance demands our attention because modern economies cannot function without it, and storm victims depend upon its payouts for recovery. An insurer's ability to pay claims depends on the entity's financial position, namely liabilities and liquid assets. In 2009, both Citizens Property Insurance Corporation ("Citizens") and the Florida Hurricane Catastrophe Fund (FHCF) have faced enormous potential shortfalls, despite the absence of 2006-08 landfalling storms, because of limiting bonding capabilities. A 100-year probable maximum loss would have left Citizens with a deficit of $10.6 billion and FHCF with a shortfall of $24.9 billion. Assessments of $35.5 billion, spread over 30 years, at an assumed interest rate of 4%, are $117.9 billion. Annual payments to retire this principal and interest would be $3.9 billion. The FHCF's estimated payment capacity for 2009-10 is $16 billion, to be funded with $8 billion of liquid resources and $8 billion of estimated post-event bonding. The estimated potential deficit is $7.2 billion. State officials are wise to consider Rade Musulin's (1997, p. 2) question, "Can our children afford 'affordable' insurance?"

Efforts to limit the cost of Citizens and FHCF coverage mistake a risk subsidy problem for what is actually a risk pooling problem. While Florida's self-insurance programs ensure that policyholders can obtain insurance coverage, their very affordability tends to concentrate rather than spread risk. Insurance is predicated on pooling; it works effectively when losses from any individual event are embedded in a pool of funds so large that the loss from any single event is immaterial. Yet that is far less likely for events such as hurricanes that affect large numbers of policyholders at once. Citizens' recent rate hike request is a positive sign but insufficient.

Citizens and the FHCF have a substantial impact upon Florida's business climate, even when no storms hit Florida. The possibility of assessments discourages businesses' investment in the state and encourages in-state businesses to diminish or cease their activities. With possible assessments, private insurers, businesses and households must keep additional capital on hand, which is costly and tends to redistribute wealth from inland businesses and households to more affluent, residential coastal property owners.

The crucial question is whether we wish to pay for hurricane damages ourselves in advance or whether to shift that burden to someone else. A new State law, HB 1495, takes modest steps to bolster both Citizens and the FHCF. Perhaps most importantly, it ends the current Citizens' rate freeze but limits the annual rate increases of 10% a year until they reach an actuarial level that enables Citizens to pay claims in a timely manner. HB 1495 also addresses the solvency of the FHCF through a combination of reduced coverage and increased rates. Additional steps to encourage wind-loss mitigation programs and to return Citizens to the original role as an insurer of last resort are needed.

INTRODUCTION

Hurricanes pose enormous financial questions, highlighted recently by the catastrophic 2004 and 2005 seasons, which imposed $33 billion in insured losses on 2.8 million Florida homeowners. Although 2009 was quiet, six hurricanes did hit the U.S. in 2008. Insured losses from Hurricane Ike, which struck near Galveston, Texas, were estimated at $15 billion by Munich Re, the world's largest reinsurer (Munich Re 2009). Future disasters could be even more expensive. A catastrophe modeling firm has estimated that a large hurricane in southeast Florida could cause insured losses of $130 billion and a total economic loss of $260 billion (USGAO 2007). Damages from recent storms have raised many important questions about Florida's potential taxpayer risk exposure when another storm hits. Key among them is whether Floridians must either choose between affordable, state-provided windstorm insurance or windstorm insurance provided by more clearly solvent private insurers. Florida must balance the competing goals of limiting taxpayer exposure and facilitating insurance policies that ensure more residents are protected.

Florida's current homeowner's insurance system is broken. One major hurricane has the potential to bankrupt private insurers, and the State's self-insurance programs, devastating Florida's already weakened economy (*Miami Herald*, 21 Sept 2009). State officials are certainly aware of the problem, as voiced in an op-ed by State Senator J.D. Alexander (*Tallahassee Democrat*, 25 Oct 2009). In her letter to Florida TaxWatch dated 24 October 2008, the Honorable Alex Sink, Chief Financial Officer for the State of Florida, expressed her concerns about the State's financial security in the event of a major windstorm (Appendix A). She requested an economic analysis that would explore Florida's financial exposure from its self-insurance programs, Citizens Property Insurance Corporation (Citizens) and the Florida Hurricane Catastrophe Fund (FHCF).[1] This memo explains the methods, data and assumptions used in this report, following the template requested by CFO Sink:

1. The current financial exposure of the State from its "self-insurance" programs: the Citizens Property Insurance Corporation and the Florida Hurricane Catastrophe Fund

    a. *Financial position*: Assets, liabilities, surpluses; premium revenues; expenses.

    b. *Assessments* facing individual consumers should a major disaster occur.

    c. *State methodology* for minimizing its financial exposure.

    d. *Florida*'s practices, risks, and costs, in comparison to similar "at risk" states.

2. Factors affecting access to reasonable coverage and premiums

    a. *Citizens' premium rates* in comparison to the private sector.

    b. Extent that premiums in the State of Florida are *risk based*.

    c. Effect of *State regulation* on Citizens, the insurance industry and the insured.

    d. Extent State regulation provides for *property mitigation* against catastrophic events—requirements, incentives and enforcement.

The financial stability of property insurance in Florida demands attention because, as recent events have once again shown, modern economies depend upon it. Insurance disperses risk and provides recovery resources in the aftermath of a disaster. Insurance is often required for investments in physical property since it facilitates the use of the property as collateral for loans. Insurers sell a "promise," one crucial to the flow of credit, whose value comes from insurers' ability to pay claims.

Florida faces a property insurance crisis. Citizens is now Florida's largest residential property insurer, with 1 mil-

[1] For an in-depth discussion of the development of Florida's self-insurance mechanisms, see Newman (2005, 2009).

lion policyholders whose premiums are far less than what would be actuarially sound (*CPIC Mission Review Task Force*, Jan 2009). The Florida Hurricane Catastrophe Fund (FHCF), the State-run re-insurer, has faced an $18 billion shortfall as a worst-case scenario for the 2009 season (Florida Senate Committee on Banking and Insurance. Dec 9, 2008). State Farm, Florida's largest private property insurer, has announced it is downsizing its presence and expense in Florida, meaning that it will no longer renew its 1.2 million policies, some of which will no doubt be added to the rolls of Citizens.

What does all this mean for Florida? The basic premise of insurance is to spread risk, thus making loss, when it occurs, manageable. Yet Citizens and the FHCF turn this time-honored logic on its head by concentrating storm risk within State boundaries. The State of Florida and its taxpayers cannot afford this high stakes gamble. Future hurricanes will come, and we must decide in advance how we will pay for them. The bottom line is that Florida may be one major hurricane hit away from depending upon Federal relief and facing a financial crisis the sunshine state has not experienced since the 1930s—exacerbating even more the current economic and fiscal crisis.

1a) FINANCIAL POSITION

Citizens. An insurer's ability to pay claims depends on the entity's financial position, namely liabilities and liquid assets. Citizens is a State-created, not-for-profit, tax-exempt government entity formed to provide property insurance coverage to those unable to find affordable coverage from a private insurer. Citizens is Florida's largest property insurer with 1.064 million policies, coverage for more than $400 billion of property, and 27% of the residential premium in the State (*CPIC Mission Review Task Force*, Jan 2009).

On 29 January 2009, Raymond James, Citizens' financial advisor, presented the 2009 Liquidity Program to the Finance and Investment Committee of Citizens Property Insurance Corporation. Each year an evaluation is done on the financial position of Citizens for the hurricane season. The two main financial goals of Citizens are to have:

1. sufficient claims paying resources to meet a 1-in-100 year probable maximum loss (PML); and
2. sufficient liquidity to pay claims in a timely manner.

In terms of the ability to meet claims, Citizens has benefited from no storm losses in the last four years and has been able to accumulate significant financial resources. Citizens has a surplus of $3.6 billion with a projected income for the end of 2009 of $4.3 billion [across three accounts: High-Risk Account (or HRA), Personal Lines Account (PLA), and Commercial Lines Account (CLA)]. Citizens' PML is $24.4 billion versus the $4.3 billion of surplus, leaving a gap of about $20 billion. Ways to fill in the gap exist, but the sources are not immediately liquid. Most importantly, the FHCF would provide up to $10 billion of reimbursements to Citizens after a storm, but the timing of those payments would depend on FHCF bond sales.

Timing risk, or the smoothing out of cash flows, is a significant issue for insurers, who must pay annual losses out of annual premiums and liquid assets. To ensure sufficient operating funds, each year Citizens issues pre-event bonds and secures lines of credit to pay any policyholders' claims promptly. Citizens' liquidity targets for 2009 are $2 billion to $3 billion in external resources for the HRA and, for the PLA/CLA, a renewed bank line of credit of about $400 million. Citizens has two series of pre-event bonds, worth $1.75 billion, a bond purchase commitment from the State of Florida for $750 million, and a $1.67 billion line of credit with several commercial banks. Citizens also has $1.06254 billion worth of post-event bonds outstanding. These bonds are being repaid from the March 2007 emergency assessment, which is at the rate of 1.4% per year for 10 years (Financial Services Commission, 2009).[2]

[2] The March 2007 emergency assessment was one of several steps taken by the State to close Citizens' $1.8 billion deficit following the 2005 season. The Legislature passed a hurricane insurance bill (SB 1980) in May 2006, which gave Citizens $715 million, reducing the one-time regular assessment from 11% to 2%. A further 10% emergency assessment in March 2007 paid off the remaining $888 million of the deficit and was spread over 10 years (1.4% annually).

FHCF. The FHCF is a State Tax-Exempt Trust Fund created in 1993 by the Florida Legislature to provide a stable and ongoing source of reimbursement to insurers for their windstorm losses, and to encourage additional insurance capacity for the State. The FHCF serves as a catastrophe reinsurer for residential property insurers, who by law must purchase a layer of FHCF reinsurance. As a compulsory State Trust, the FHCF does not face the same capitalization rules as private reinsurers and relies instead upon its ability to assess its customers for any deficits. As a non-profit organization, with a stated public interest mission,[3] the FHCF is not primarily focused on returns on capital as a for-profit would be. Thus FHCF is able to charge lower premiums than private reinsurers. The US-GAO (2007) report estimates that FHCF charges premium rates that are a quarter-to-a- third of the cost of private market reinsurance.

FHCF compensates residential property insurers for their hurricane losses after each insurer meets its retention, or deductible. Beyond the retention, FHCF reimburses up to 90% of losses. FHCF has a mandatory layer of $17 billion in industry-wide coverage. FHCF also offers an optional $12 billion layer (Temporary Increase in Coverage or TICL) over the mandatory layer (Financial Services Commission, 2009).

FHCF had significant liquid resources available for the 2009 season–over $10 billion–which is more than at any previous time. For 2009, the FHCF had a surplus of $4.07 billion and $3.5 billion in pre-event borrowed funds, as well as $3 billion in estimated post-event borrowing capability, for a sum of $10.57 billion in payment capacity. However, the $10.57 billion in liquidity was substantially less than the corresponding $29 billion in potential liabilities, leaving a potentially large shortfall. If this gap, which could be as large as $18 billion, is not closed, there could be insurer financial/solvency issues. The $10.57 billion in liquidity, plus the $7.22 billion deductible or retention, would enable the FHCF to avoid bonding after small events, and would provide a time cushion before bonding was required after a large event (Financial Services Commission, 2009).

The FHCF's estimated capacity for the 2009-10 is $16 billion, to be funded with $8 billion of liquid resources (cash of $4.5 billion and $3.5 billion of pre-event notes) and $8 billion of estimated post-event bonding. The estimated potential shortfall is $7.173 billion. While large, this number is far smaller than the $18.5 billion potential shortfall in 2009 (FHCF, Oct 2009).

1b) ASSESSMENTS[4]

Citizens Assessments: If Citizens incurs a deficit (i.e., the obligations to pay claims exceed the available capital, plus reinsurance recoveries), it may levy assessments on Florida's policyholders. According to the Florida Office of Insurance Regulation**'s (FLOIR)** assessment estimates, 100-year probable maximum loss[5] would mean $52.95 billion in insured claims statewide, including losses of $24.4 billion for Citizens. With an estimated FHCF reimbursement of $9.5 billion, and a surplus of $4.3 billion, that would leave an assessable shortfall of $10.6 billion. FLOIR obtained the loss calculations from the FHCF Ratemaking Formula Report (2008), written by Paragon Strategic Services.

Assessments are one-time levies on insurers, except for emergency assessments, which insurers pay as funds are recovered from insureds over several years. By statute (s. 215.555, *Florida Statutes*), Citizens' assessment protocol has several layers. Each account [High-Risk Account or (HRA), Personal Lines Account (PLA), and Commercial Lines Account (CLA)] has assessment authority, and each account deficit is separately calculated.

[3] As stated in the originating legislation, s. 215.555 (1)(f), *Florida Statutes*, the FHCF was created…"for the purpose of protecting and advancing the state's interest in maintaining insurance capacity in this state."

[4] For the reader curious about his or her own assessment exposure, the Florida Department of Financial Services offers an online calculator: http://www.myfloridacfo.com/AssessmentCalculator/Consumers/AssessmentCalculator.aspx

[5] Probable maximum loss (PML) is the anticipated value of the largest loss that could result from the destruction and the loss of use of property, given the normal functioning of protective features (e.g., roof, windows, and a responsive fire department). The return period, in this case 100 years, indicates how frequently such a PML is expected to occur.

Overlapping assessments may occur with simultaneous deficits in two or three of Citizens' accounts. Previous assessments were for the HRA only. Citizens levies assessments in three tiers: Citizens Policyholder Surcharge; Regular Assessments; and Emergency Assessments (Citizens Property Insurance Corporation, 2008).

1. *Citizens Policyholder Surcharges*. In the first instance, Citizens will levy assessments on its policyholders of up to 15% per account in deficit for a maximum total of 45%. Assuming that all accounts require the full assessment and all of Citizens' policyholders remain on renewal, this assessment could raise $1.4 billion. As with each of the assessments, this assessment only applies at the time a new policy is written or at renewal. So, for example, a policyholder that is with Citizens at the time of a hurricane loss causing a deficit would be subject to the Citizens Policyholder Assessment only if the policyholder renewed with Citizens.

2. *Regular Assessments*. Upon exhaustion of the Citizens Policyholder Surcharge Assessment for a particular account, Citizens may levy a regular assessment of up to 6% (per account) on all admitted and surplus lines policies in the State–but not including Citizens' own policyholders. This assessment could raise about $2 billion per account in deficit, for a total across all three accounts of $6 billion. Assessments do not apply to workers compensation, medical malpractice, or crop or federal flood insurance. Insurers pay assessments to Citizens and recover this cost from their policyholders through a one- or two-year surcharge. Citizens' Regular Assessment Base for 2009 was $33.65 billion.

3. *Emergency Assessments*. Upon exhaustion of the Citizens Policyholder Surcharge Assessment and Regular Assessment for a particular account, Citizens may levy an emergency assessment of up to 10% (per account) on all admitted and surplus lines policies in the State–including Citizens' own policyholders. This assessment could raise approximately $3.5 billion per account in deficit for a total across all three accounts of $10.5 billion. The emergency assessment does not apply to workers compensation, medical malpractice, or crop or federal flood insurance. Insurers would collect these assessments from policyholders and then remit them periodically to Citizens. Emergency assessments are required to be spread over at least 10 years and are typically tied to a bond offering. Because the emergency assessments are spread over time and each account has different exposure to loss, it is highly unlikely that the maximum emergency assessment across all three accounts would be necessary. Citizens' 2009 Emergency Assessment Base was $36.65 billion. Note the Emergency Assessment Base exceeds the Regular Assessment Base by $3 billion because the former includes Citizens' own policies while the latter does not.

The $10.6 billion assessable shortfall that FLOIR estimates would include a Citizens Policyholder Surcharge of $1.4 billion; a Regular Assessment of $6 billion; and an Emergency Assessment of $2.2 billion. Assessments of $10.6 billion, spread over 10 years, at an assumed rate of interest of 4%, are $15.8 billion. Annual payments to retire this principal and interest over 10 years would be $1.58 billion. If Citizens were to spread the assessments over 30 years, at 4%, the cost would be $35.2 billion and the annual payments would be $1.17 billion.

FHCF Assessments: As of 31 December 2008, the FHCF had a present commitment of $27.7 billion per season backed by about $2.8 billion of capital and no private reinsurance. FHCF secured an additional $1.3 billion in premiums to the 2009 hurricane season. In its 2008 ratemaking report, the FHCF estimates a 1.7% chance that it will be required to make full payment on its obligations and a 5% chance that it would exhaust all $10.57 billion of its liquid assets. To fund any deficit, the FHCF may levy an emergency assessment on all policyholders (other than workers compensation, medical malpractice, or crop and federal flood insurance) of up to 6% annually (10% in the aggregate, for multiple storm seasons). That assessment could raise $3.5 billion annually. In the 100-year storm scenario, FHCF would face claims of $27.7 billion and, following the loss of its $2.8 billion surplus, an assessable shortfall of $24.9 billion. Assessments of $24.9 billion, spread over 30 years, at an assumed interest rate of 4%, are $82.7 billion. Annual payments to retire this principal and interest would be $2.76 billion.[6]

If FHCF Has Trouble Selling Bonds, How Might That Affect Citizens? In October 2008, as part of their biannual review of its bonding capacity, the FHCF reported that in their best judgment and under current market

[6] For purposes of comparison, note that projections in this paper of post-event borrowing by Citizens ($35.2B) and the FHCF ($82.7B) are several times larger than the State Direct Debt outstanding, as of 30 June 2008, $24.2B, which took the State more than 150 years to accumulate (FL Dept of Financial Services, 2009).

conditions, the FHCF could count on selling between $1 and $3 billion of bonds post-event. If insurer claims exceed the industry retention (deductible) and the FHCF's liquidity, the FHCF would issue post-event bonds, secured by its assessment authority, to raise funds. These assessments can be no more than 6% for any one season, and 10% in aggregate (Financial Services Commission, 2009). The current assessment base is $36.65 billion, which includes most property and casualty insurance premiums statewide. According to FHCF's bonding estimates, it may be unable to fund $18.43 billion of its obligations on a timely basis (Florida Senate Committee on Banking and Insurance, 2008).

The federal government's unique borrowing capability could provide needed funds in the event of a FHCF shortfall. In February 2009 U.S. Sen. Bill Nelson filed the Homeowners' Defense Act of 2009 (S. 505), which would grant the state access to $200 billion in federal loans if hurricane damages exceed FHCF payment capacity (*Miami Herald*, April 23, 2009).[7] In May 2009, Representative Ron Klein proposed a similar bill (H.R. 2555). These bills would also allow cooperative efforts among states for regional disaster relief. The Act would create the National Catastrophe Risk Consortium, which would manage a fund that states would be able to access after the state's catastrophe fund has been depleted, thus transferring a portion of catastrophic risk. The Consortium would issue catastrophe bonds on behalf of participating states, but would not take possession of bond proceeds. Both versions are similar to legislation previously passed in the U.S. House, but that failed to gain Senate support in 2007 and 2008. Proponents of the legislation say it would help stabilize property insurance markets following catastrophes; critics contend that states may pool risks and enter capital markets already, and that no federal program is needed (Lehrer 2009; Congressional Research Service 2009).

Without a federal bailout or loan, the FHCF's capacity to make timely reimbursements to insurers would be limited. Since the FHCF does not guarantee payment within a certain timeframe and will continue to issue bonds for while they have assessment capacity available, companies may consider additional coverage from other reinsurers for the timing of FHCF reimbursements. Should FHCF exhaust its payment capacity, each claimant would be compensated on a pro-rata basis from available funds. In the economic impact analysis below, it is assumed that the FHCF is able to complete its post-event bonding in full.

Multiplier Effects: Assessments from Citizens and the FHCF act as a tax, in the sense that they divert personal incomes and business profits to the public sector. As a result, consumer spending, investment and employment can all be expected to decline. To measure the economic impact of a tax, we estimate how much worse off Florida residents are with the tax than they would be without it. The scenario discussed focuses on *direct impacts,* which include assumed lost spending that, in the absence of the tax, would have been spent otherwise, e.g., on restaurants, shopping, etc.

The multiplier values used in this study are derived from the technical literature. Different assumptions would yield different results, but these values represent a reasonable starting point. Assumptions include:

- An economic output multiplier value of 1.8, based on values reported in Appendix D, Table 1.1 the U.S. Department of Commerce, Bureau of Economic Analysis' Regional Input-Output Multiplier System, RIMS II. (BEA 1997).
- An economic earnings multiplier value of 0.5, based on values reported in Appendix D, Table 1.4 of RIMS II. (BEA 1997).
- An employment multiplier value of $100,000, based on values reported in Appendix D, Table 1.4 of RIMS II. (BEA 1997). An employment multiplier represents the economic activity necessary to sustain one job for one year.

The Economic Impact of Citizens' and FHCF's 100-Year Storm assessments would include sizable losses in jobs,

[7] As this document went to press, H.R. 2555 remained in the first step in the legislative process. Introduced bills and resolutions first go to committees that deliberate, investigate, and revise them before they go to general debate. The majority of bills and resolutions never make it out of committee. As part of these deliberations, the House Financial Services Oversight and Investigations Subcommittee in July 2009 held a field hearing in West Palm Beach, Florida, titled "The Homeowners' Insurance Crisis: Solutions for Homeowners, Communities and Taxpayers," to review the crisis related to the availability and affordability of homeowners' insurance around the country.

earnings, and tax revenue (Table 1). As an indirect effect, the expectation is that for each 10% rise in insurance premiums, 9% more homeowners would choose to go uninsured (Kunreuther and Michel-Kerjan 2009), page 203). The $3.93 billion in assessments would equal $689 for each of Florida**'s 5.7 million** policyholders, per year. For the purposes of this study, the possibility of Florida Insurance Guaranty Association Assessments (FIGA) assessments are not considered, which would be likely with a 100-year probable maximum loss.[8]

Table: Economic Impacts of 100-year Storm Assessments from Citizens and FHC

	Annual Assessment ($ Billions)	Economic Impact	Earnings	Jobs
FHCF	2.76	4.97	2.48	49,680
Citizens	1.17	2.11	1.06	21,110
Total	**3.93**	**7.07**	**3.54**	**70,720**

1c) State Methodology for Minimizing its Financial Exposure

While Florida's self-insurance programs ensure coverage for residential property owners, their very affordability tends to concentrate rather than spread risk. The State's main tools for minimizing its financial exposure are the eligibility conditions for Citizens coverage, underwriting[9] guidelines, and a depopulation plan that encourages private insurers to take over Citizens policies (*CPIC Mission Review Task Force*, 2009).

When Citizens was created in 1992, applicants for coverage were ineligible unless they were unable to procure coverage from a private insurer. Citizens' rates were required to be actuarially sound. Average rates by county were required to be at least as high as the highest rate charged among the top 20 writers in the State.

Eligibility rules for Citizens' coverage have changed over time, to address availability and affordability. Since 2007, applicants with an offer of coverage from the private market continue to be ineligible for coverage with Citizens unless that offer is 15% higher than Citizens' rates for comparable coverage. Rates for Citizens were frozen at 2006 levels through December 31, 2009. Beginning in January 2010, Citizens rates may raise but those increases are limited by law to 10% a year. The rates recommended by Citizens are filed with and reviewed by the Florida Office of Insurance Regulation.

Compared to the private market, Citizens has less restrictive underwriting guidelines. Private companies may consider many other risk characteristics to either be rejected or surcharged. Examples are: location in the state, loss history, financial history, pets, poorly maintained homes, etc. As an insurer charged with providing coverage to those unable to find affordable coverage from a private insurer, Citizens cannot reject as many applications as can the private market.

Depopulation Programs have been implemented to encourage other insurers to write coverage for risks currently insured by Citizens. Participating companies earn no financial bonus from the State and must renew the policies assumed for three years at rates no greater than Citizens' rates for one year. Since 2006, private insurers have taken more than half a million policies out of Citizens, reducing its exposure. Depopulation Programs tend to put upward pressure on rates because better than average risks are selected by the private insurers.

1d) Florida's practices, risks, and costs, in comparison to similar "at risk" states.

[8] FIGA is a mandatory association of admitted insurers that guarantees (with certain limitations) the claim payments and unearned premium of insolvent insurers. Like Citizens and the FHCF, FIGA depends on post-event assessments and bondings to pay claims. It is possible, as happened following Hurricanes Andrew and Wilma, that a major event could cause insurer insolvencies. FIGA has the authority to levy against admitted property and liability insurers two annual assessment of 2% each for a total of about $800 million. The FIGA assessment base is about $21 billion. Insurers may recover those assessments through surcharges on policyholders.
[9] "Underwriting" refers to the process of selecting and classifying applicants for insurance. See G. Rejda, *Principles of Risk Management and Insurance*, 9th ed. (Boston, Mass.: Addison Wesley, 2005), 587.

While other states experience hurricanes, Florida faces the greatest risk exposure because of the length of its coasts, its historically increasing population and its rapid economic development. In 2007, Florida had 79% of its insured property, worth $2.7 trillion, in its coastal counties; both the amount and percentage were the highest of any Atlantic or Gulf state (Insurance Information Institute, 2007). Not surprisingly, both insurance premiums and the state government's efforts to restrict them are controversial.

Florida's residents and officials alike have voiced their alarm over the increasing cost of coverage. According to Kunreuther and Michel-Kerjan (Chapter 10, 2009), Florida has higher homeowners' rates than do New York, South Carolina, and Texas. These four states have the largest hurricane risk exposure in the nation. Florida's average premium in 2005 was $6,164, compared to $5,000 in South Carolina, $2,375 in Texas, and $761 in New York. In premiums per $1,000 of coverage, Florida is first at $8.13, with Texas at $7.89, South Carolina at $5.14, and New York at $3.94. Florida average premium has also risen the fastest among the four states, from $723 at the start of 2002, to $1,465 in the first quarter of 2007 (Kunreuther and Michel-Kerjan, 2009).

Consumer outrage over past rate increases has discouraged further rate hikes. In January 2007, the Florida Legislature enacted House Bill 1A, which froze Citizens' premiums at 2006 levels through December 31, 2009. HB 1A also expanded FHCF reinsurance coverage, which was priced below private reinsurance. With such bold steps in favor of affordable insurance, it is not at all surprising to find that insurer solvency had become a major concern just two years later.

Rising insurance premia, and the State of Florida's response to them, raise the question of whether coastal properties remain an insurable risk. Here the news is a bit better. Kunreuther and Michel-Kerjan (2009) argue that private insurers and reinsurers could cover most losses from severe hurricanes if three conditions are met: insurers are able to charge risk-based premiums; homeowners protect their properties; and private reinsurance is purchased. Specifically, if insurers devoted 10% of their surplus to provide coverage against a 100-year storm in a given state, they would meet all claims in each of the four states. For a 500-year storm, they would meet all claims in New York and South Carolina, 94% in Texas, and 66% in Florida (Kunreuther and Michel-Kerjan, 2009).

Two major pieces of property insurance legislation passed both houses of the Legislature during the 2009 Session. The first, HB 1171, would have allowed well-capitalized insurers to use higher rates and allowed residential customers to choose them. The ''consumer choice'' bill would have enabled insurers to charge rates higher than filed rates if the insurer met any of three criteria: a surplus of $500 million; a surplus of $200 million and a premium-to-surplus ratio of 2:1; or a surplus of $150 million, with mainly nonprofit clients. Insurers offering such policies would have been unable to purchase optional reinsurance coverage from the FHCF and would have had to provide consumers with a variety of disclosures and a comparative quote from Citizens. The Legislature approved the Consumer Choice Act, but Governor Crist vetoed it on June 24, 2009.

Governor Crist did sign another property insurance reform bill, HB 1495, on May 27, 2009. The legislation takes modest steps to bolster both Citizens and the FHCF. Perhaps most importantly, it ends the current Citizens' rate freeze but limits the annual rate increases of 10% a year until they reach an actuarial level that enables Citizens to pay claims in a timely manner. This provision went into effect on or after January 1, 2010. The incremental rate increase was a recommendation of the Citizens Mission Review Task Force.[10] HB 1495 also addresses the solvency of the FHCF, and does so in three ways. First, it reduces the state's $20 billion exposure on the FHCF by phasing out the upper levels of the Temporary Increase in Coverage Limit (TICL) layer of coverage by $2 billion a year over a six-year period. Second, it increases the price of the TICL layer by an additional multiple each year until TICL is eliminated in 6 years. Third, it raises premiums for the FHCF's mandatory coverage. The FHCF must increase the price it charges insurance companies for the mandatory coverage for reinsurance by 5% annually beginning June 1, 2009 through January 1, 2013.

[10] The Citizens Property Insurance Corporation Mission Review Task Force (Task Force) was created by the Legislature during its 2008 Session. The mission of the Task Force was "to develop a report setting forth the statutory and operational changes needed to return Citizens Property Insurance Corporation to its former role as a state-created, noncompetitive residual market mechanism." In addition, and "at a minimum" the Task Force was directed to provide recommendations on ten specific topics relating to a range of issues regarding Citizens including the availability of property coverage in the private market, rates for coverage, potential Citizens assessments, Citizens' exposure and its purchase of reinsurance (CPIC Mission Review Task Force, 2009).

2a) Citizens' Premium Rates in Comparison to the Private Sector

Citizens' rates are lower than those offered by many private insurers, in part because of its advantages as a public sector entity. Specifically, Citizens avoids many capital costs because of its authority to levy assessments against Florida residents and businesses. Citizens also enjoys tax advantages not available to private insurers. For example, Citizens' income is not subject to state or federal income tax and it may borrow more cheaply by offering tax advantaged interest payments.

Whether Citizens' rates should be lower than those of private insurers is a subject of contentious debate. State officials face difficult choices when seeking insurance premiums that are actuarially sound yet affordable. Market forces suggest that if Citizens prices insurance below the cost of private insurance, policyholders will tend to remain with Citizens despite the availability of private alternatives. Further, in terms of economic theory, insurance premia should be risk-based, to avoid deficits, to signal hazards that policyholders face, and to foster cost-effective mitigation.

As recently concluded by the Citizens Mission Review Task Force (2009), Citizens does not today effectively discourage policyholders from moving into or staying with Citizens through its rates (CPIC Task Force, 2009). Citizens' rates are required by law to be "actuarially sound," though the rate increases Citizens tried to impose in 2006 were repealed by the Legislature and a rate freeze was imposed until 2010.[11] Beginning in January 2010, as a result of HB 1495, Citizens rates may rise but those increases are limited by law to 10% a year.

In October 2009, Citizens made its request to the Florida Office of Insurance Regulation to raise premiums for 636,000 Personal Lines and Commercial Lines Accounts customers, which would mean an average homeowner increase of 5.4%. Some 419,000 customers in "high risk" areas may face steeper increases, in what would be an average increase for homeowners of 7.7%. No policyholder will face more than a 10% rise, while many Citizens customers, particularly those inland, may see rate decreases (*Saratoga Herald Tribune*, 21 Oct 2009).

2b) The Extent to Which Citizens' Rates Are Risk Based

The root problem with catastrophic insurance is an inadequate spread of risk. Insurance is predicated on pooling; it works effectively when losses from any individual event are embedded in a pool of funds so large that the loss from any single event is immaterial. Yet that is far less likely for events such as hurricanes that affect large numbers of policyholders at once. Such events pose correlated risks that require insurers to hold larger amounts of capital.

Consider Rade Musulin's comparison of two insurance companies, one writing hurricane coverage (correlated risks) and the other writing for fire (independent risks). Suppose that the hurricane insurer can expect a single $100 million loss per 100 years, while annual fire losses will vary between $0.8 million and $1.2 million. Annual premiums of $1 million would cover each sort of expected loss. But to meet claims in any given year, the fire insurer would need $200,000 in capital. The hurricane insurer, however, would need $99 million for the single $100 million loss that occurs each 100 years (Musulin 1997).

How big a problem is correlated risk for Florida's windstorm insurers? To show just how big, John W. Rollins of AIR Worldwide Corporation (2007) compared actual windstorm premiums remitted in Florida versus the "actuarially sound"[12] premiums that Citizens is compelled by law to charge. Rollins found that, under generous

[11] This particular decree provided much of the motivation for HB 1495 since it would have mandated stiff premium increases in 2010. "Without this bill, on January 1, 2010, Citizens' customers will likely face *dramatic* overall average statewide rate increases – in excess of *40 percent* for personal residential multi-peril policies, *55 percent* for personal residential wind-only policies, *60 percent* for commercial residential wind-only policies, and *140 percent* for commercial nonresidential properties." (Florida House of Representatives' Majority Office Memorandum 2009).

[12] "Actuarially sound" rates must account for *all costs associated with the transfer of risk*, according to the Casualty Actuary Society's Statement of Principles (1979).

assumptions, Florida in 2007 needed to collect $15 billion residential property premium to fund insurance promises in an actuarially sound manner. The actual figure was about $9 billion. As Florida's largest property insurer, with 27% of the residential premium and a disproportionately large share of high-risk exposures, Citizens is at the heart of this enormous financial problem.

Additional evidence that Citizens' rates are not risk based comes from its history of funding shortfalls. Three hurricanes struck Florida in 2005—Dennis, Katrina and Wilma—after four powerful hurricanes hit in 2004. As a result, Citizens levied a $163 million regular assessment for 2005 and an emergency assessment of $888 million for 2005, to be collected via a 1.4% charge on assessable premiums annually for ten years. Also, the Legislature gave $715 million to Citizens.

2c) Effect of State Regulation on Citizens, the Insurance Industry, and the Insured[13]

Citizens and the FHCF have a substantial impact upon Florida**'s business climate.** Even if a major storm is avoided in any given year, Florida property owners–especially businesses and other non-homestead Citizens policyholders–now confront a substantial *contingent liability***.** That is, a liability they will have to pay contingent upon certain events occurring. While no payment may be required in any given year, the threat of assessments is nonetheless a financial burden to Florida property owners. Maintaining additional cash on hand is costly. Stated differently, Citizens and the FHCF have the right to levy assessments on Florida property owners to cover bond interest and principal payments. Even if never exercised, this right has value to Citizens and FHCF and is a cost to Florida property owners.

Even if no storms hit Florida, the possibility of assessments discourages businesses' investment in the state and encourages in-state businesses to diminish or cease their activities in Florida. Because of possible assessments, private insurers, businesses, and households must keep additional capital on hand, which is costly and tends to re-distribute wealth from inland businesses and households to more affluent, residential coastal property owners. Also, as a tax on capital, Florida businesses will have an incentive to reduce their premiums by not investing in insurable assets such as new structures, technologies, and equipment. Instead, they have an incentive to use more workers and less physical capital in the production of their goods or services. Initially, this incentive may seem to promote job growth. However, job and income growth are closely tied to workers' productivity, and investments in new technologies and equipment are vital for workers' productivity growth. Lagging investments in physical capital will soon diminish workers' productivity growth and, hence, reduce job and income growth.

2d) Extent State Regulation Provides for Property Mitigation Against Catastrophic Events — Requirements, Incentives and Enforcement

Insurance alone will not solve our windstorm problem in Florida. We can limit the size of our windstorm damage problem by making our buildings and other infrastructure more wind resistant through mitigation, which may be defined as "a construction activity that fortifies or hardens the envelope of residential structures" (Task Force on Long-Term Solutions for Florida's Hurricane Insurance Market, 2006). As the 2006 Florida Hurricane Insurance Task Force noted:

> Strong, enforced building codes are the foundation for a sustainable market for Floridians. Mitigation reduces losses, permits homeowners to shelter in place, and is a valuable investment for individuals and governments (2006 Task Force, p.4).

The role for mitigation in limiting the scale of our windstorm insurance problem is difficult to overstate. Kunreuther and Michel-Kerjan (2009) estimated in 2008 that potential mitigations to prevent storm damages could reduce the potential losses from a 100-year storm by 61% in Florida, or about $51 billion in savings [Kunreuther and Michel-Kerjan (2009), pages 269-270]. The percentage savings would likely be larger for less intense windstorm events, since those would result in fewer building failures.

[13] I am grateful to my colleague Stephen Morrell for his assistance with this section.

Unfortunately, windstorm rates that are affordable may be inadequate to foster mitigation. In highly regulated insurance markets, compressed insurance rates may deter mitigation. Efforts to maintain affordable coverage in high-risk areas—where mitigation is most effective and needed—discourage insurers from offering discounts for mitigation. From the point of view of an insurer, why discount a premium that is already too low? In addition, insureds clearly are more likely to respond to higher rates and opportunities to avoid them (Sutter 2007).

Many state insurers offer reduced premium for resilient construction. Notably, South Carolina provides a 10% rebate for homes meeting the guidelines of the Institute for Business and Home Safety's Fortified Homes Program. Other hurricane exposed states, such as Mississippi and Texas, also offer mitigation discounts. Florida must do more to explore and encourage wind mitigation discounts through workable programs.

Conclusions and Recommendations

> "It is almost always more inexpensive to finance disaster recovery before a catastrophe occurs, rather than after the fact. This is precisely the purpose of insurance — to pay prior to the accident, to provide an economic cushion to survive the adverse event." FLOIR Chief Economist Raymond Spudeck, July 2009 Testimony to Congress.

Florida faces a property insurance crisis. The rates and assessment capabilities of Citizens and the FHCF are inadequate to cover their enormous potential liabilities. The financial stability of property insurance demands our attention because modern economies cannot function without it, and storm victims depend upon its payouts for recovery. The ongoing global financial crisis serves as a reminder that we ignore our exposure to systemic, correlated risks at our considerable peril. Those who have lacked the discipline to avoid risks that they did not understand have destroyed wealth on an unprecedented scale. Likewise, insurers in Florida that assume catastrophic risks without holding sufficient capital may not survive the next windstorm crisis. If not, the evidence reviewed here suggests Florida may be one major hurricane hit away from depending upon Federal relief or facing financial crisis. Our timing could hardly be worse.

The purpose of this report is to describe the financial exposure that Citizens and the FHCF pose to the State, not necessarily to recommend how that exposure might best be reduced. However, upon review, Florida TaxWatch concurs with the recommendations recently offered by the Citizens Mission Review Task Force and in the Florida Chamber of Commerce/The Florida Council of 100 memorandum, *Into the Storm*. Among the recommendations to make Citizens and the FHCF more financially viable are:

1. requiring Citizens to serve as Florida's insurer of last resort and for their rates to be actuarially sound;

2. raising awareness of potential assessments by requiring Citizens and the FHCF each year to publish estimated assessments for a 1-in-100 year storm;

3. supporting programs that encourage homeowners to strengthen their homes to better withstand high winds, thus lowering the potential for storm damage claims; and,

4. prohibiting Citizens from insuring new structures in high-risk coastal areas.

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CHIEF FINANCIAL OFFICER
STATE OF FLORIDA

ALEX SINK

October 24, 2008

Mr. Dominic Calabro
President and Chief Executive Officer
Florida TaxWatch
106 North Bronough Street
Tallahassee 32301-7732

Dear Mr. Calabro:

Floridians expect their leaders to do everything possible to protect Florida's financial health in terms of the fiscal and economic impact that an active storm season could have on our state. As you know, my office has actively taken steps, supported measures, and advanced legislation to mitigate Florida's financial exposure to the damage caused by a bad storm season. Yet, despite these efforts, the potential for a financial crisis remains very real if a natural disaster were to occur.

While we cannot control the weather or the potential for major storms hitting Florida, we can – and we must – prepare ourselves for that possibility. I believe there are further opportunities to protect Florida's financial security in the event of a major disaster, but we must first identify our exposure and liabilities before determining the most prudent course.

For this reason, I request that Florida TaxWatch conduct a study of the state's potential risk exposure through the Florida Citizens Property Insurance Corporation and the Florida Hurricane Catastrophe Fund. With this information, Florida TaxWatch could then identify and explore options that could lower the state's financial risk, while still ensuring that Florida residents and property owners have access to reasonable insurance coverage and premiums.

I propose that the study explore the following:

1. The current financial exposure to the State from its "self-insurance" programs: Florida Citizens Property Insurance Corporation (Citizens) and the Florida Hurricane Catastrophe Fund (FHCF)
   a. Financial position: Assets, liabilities, and surplus(es); premium revenue; expenses
   b. Assessments facing individual insurance consumers should a major disaster occur

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   c. State methodology for minimizing its financial exposure

   d. Florida's practices, risks, and costs, in comparison to similar "at-risk" states

2. Factors affecting access to reasonable coverage and premiums

   a. Citizens' premium rates in comparison to the private sector

   b. Extent that premiums in the State of Florida are risk-based

   c. Effect of state regulation on Citizens, the insurance industry, and the insured

   d. Extent state regulation provides for property mitigation against catastrophic events – Requirements, incentives, and enforcement

I will look forward to receiving the results of this important study and analyzing the ways that we can protect Florida's finances in the event of an active storm season.

Sincerely,

Alex Sink

Alex Sink

AS/kl

This Florida TaxWatch *Special Report* was written by **David Letson, Ph.D.**, Professor and Chair of the Division of Marine Affairs, Rosensteil School of Marine & Atmospheric Science, University of Miami, and member of the Florida Council of Economic Advisors at Florida TaxWatch, under the direction of **Stephen O. Morrell, Ph.D.**, Chairman of the Florida Council of Economic Advisors at Florida TaxWatch and Professor of Economics and Finanace at the Andreas School of Business, Barry University, and the Florida Council of Economic Advisors at Florida TaxWatch.

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Florida TaxWatch Research Institute, Inc.

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About Florida TaxWatch

Florida TaxWatch is a statewide, non-profit, non-partisan taxpayer research institute and government watchdog that over its 30-year history has become widely recognized as the watchdog of citizens' hard-earned tax dollars. Its mission is to provide the citizens of Florida and public officials with high quality, independent research and education on government revenues, expenditures, taxation, public policies, and programs, and to increase the productivity and accountability of Florida Government.

Florida TaxWatch's research recommends productivity enhancements and explains the statewide impact of economic and tax and spend policies and practices on citizens and businesses. Florida TaxWatch has worked diligently and effectively to help state government shape responsible fiscal and public policy that adds value and benefit to taxpayers.

This diligence has yielded impressive results: in its first two decades alone, policymakers and government employees implemented three-fourths of Florida TaxWatch's cost-saving recommendations, saving the taxpayers of Florida more than $6.2 billion -- approximately $1,067 in added value for every Florida family, according to an independent assessment by Florida State University.

Florida TaxWatch has a historical understanding of state government, public policy issues, and the battles fought in the past necessary to structure effective solutions for today and the future. It is the only statewide organization devoted entirely to Florida taxing and spending issues. Its research and recommendations are reported on regularly by the statewide news media.

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Florida TaxWatch is supported by all types of taxpayers -- homeowners, small businesses, large corporations, philanthropic foundations, professionals, associations, labor organizations, retirees -- simply stated, the taxpayers of Florida. The officers, Board of Trustees and members of Florida TaxWatch are respected leaders and citizens from across Florida, committed to improving the health and prosperity of Florida.

With your help, Florida TaxWatch will continue its diligence to make certain your tax investments are fair and beneficial to you, the taxpaying customer, who supports Florida's government. Florida TaxWatch is ever present to ensure that taxes are equitable, not excessive, that their public benefits and costs are weighed, and government agencies are more responsive and productive in the use of your hard-earned tax dollars.

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