The JAMES MADISON INSTITUTE
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Backgrounder

www.jamesmadison.org Number 75 / January 2015

Lasting Reforms for Florida's Property Insurance Market

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Introduction

With the 2014 Hurricane Season having drawn to an unremarkable close, Florida has now gone nine years without a hurricane making landfall. This represents the longest such "drought" on record for the state.[1]

However, little has changed to explain Florida's unprecedented streak of good luck. For example, the state's position as a low-lying tropical peninsula jutting 500 miles into the most hurricane-active waters in the world is the same as it was 10 years ago, and 100 years ago. Indeed, many scientists believe climate change could magnify the perils facing that peninsula, with increases in the severity and incidence of storms.

That's bad news for Florida, given that it's been struck by the most hurricanes of any U.S. state. That includes the most powerful hurricane on record,[2] and seven of the 10 costliest hurricanes to have affected the United States (six of these within an 18-month stretch from 2004 to 2005).[3] Therefore, a nearly decade-long respite should not be considered the norm, but rather a fortuitous anomaly. In short, it only means the state is long overdue for another strike.

Moreover, Florida's population, its built environment and, therefore, the lives and property exposed to hurricanes also have grown dramatically. Although the state's population shrank slightly during the recession, it has almost tripled since 1970, growing to more than 19.9 million residents. Florida recently surpassed New York to become the third most-populous state in the country.[4]

This growth has increased Florida's total coastal exposure to more than \$2.9 trillion.[5] Indeed, it has more property at risk than all other "hurricane alley" states (Louisiana, Virginia, Texas, North

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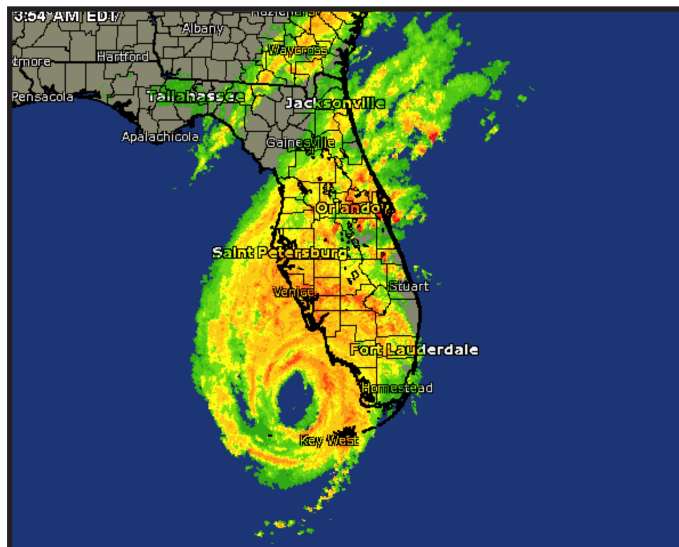

Hurricane Wilma hit Florida as a category 3 storm, but was expected to be a category 1. Damages totaled more than \$20 billion. (Photo courtesy of Robert Giordano)

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Trusted Solutions for a Better Florida

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Lasting Reforms for Florida's Property Insurance Market

(Continued from Front Cover)
Carolina, South Carolina, Georgia and Mississippi) combined.[6]

Nevertheless, instead of taking steps to reinforce its shaky insurance system, Florida's state government has used this period of population and economic growth, coupled with tropical calm, to continue to artificially suppress insurance rates by underpricing the insurance products it sells to consumers as well as primary property insurers.

It's true that the current hurricane-free stretch has allowed Florida's state-sponsored insurance entities to slowly shore up their claims-paying capacity. For instance, Citizens Property Insurance Corp. boasted a healthy $7.6 billion in combined policyholder surplus in 2014.[7] The state-run insurer simultaneously lowered its overall exposure due both to organic migration of policies to the private market, as well as depopulation initiatives to transfer policies to private companies directly. The Florida Hurricane Catastrophe Fund (the Cat Fund) has likewise shored up its reserves to a projected $10.95 billion at year-end 2014.[8]

Despite these encouraging figures, the misplaced public policy goal of insurance rate suppression pursued by the Legislature and past governors has led to a dysfunctional property insurance system. The current system works only in the absence of hurricanes. Only after nine years of fair-weather hoarding can the instrumentalities of Florida's government-run insurance system—Citizens[9] and the Cat Fund[10] —finally declare themselves sufficiently sound to cover a large storm.

But what happens when that storm finally arrives? What happens once a major storm or series of smaller storms wipes out the surplus built over this unprecedented period of calm?

This report looks to offer background on how Florida has chosen to finance its enormous hurricane risk largely through post-event assessment mechanisms that would be levied on almost every Floridian. It also will establish how Citizens and the Cat Fund are essentially "one-hit wonders," designed to cover just one adverse hurricane season with no practical means to cover a second or third season without economically devastating consequences.

Finally, the report explores solutions that could reasonably be implemented during the 2015 legislative session, while Citizens, the Cat Fund and the state's private insurance sector are all in ideal financial positions to absorb reforms without undue adverse impacts

"...Florida's state government has used this period of population and economic growth, coupled with tropical calm, to continue to artificially suppress insurance rates..."

on taxpayers, ratepayers or the state's economy.

Ultimately, Florida's insurance system must be structured to cover multiple hurricane strikes without posing a risk to taxpayers or the state's economy.

Citizens Property Insurance

Citizens Property Insurance Corp. (Citizens), Florida's state-run property insurer, originally was designed to offer coverage to Floridians who legitimately could not obtain it from the private market. In 2007, Citizens' role was greatly expanded to offer policies to any homeowner who receives a quote for coverage from a private insurer more than 15 percent greater than Citizens' rates.[11] Additionally, the 2007 legislation required Citizens to roll back all rate increases approved in the year prior to the bill's passage and to freeze them at that 2006 level, thus imposing a *de facto* price control on Florida's property insurance market.[12]

These changes transformed Citizens from an insurer of last resort into an active competitor with an unfair advantage. Within a few years, Citizens became the state's largest property insurer, and among the nation's 25 largest, with almost 1.5 million policies in force and a total exposure of more than $510 billion.[13]

Subsequent legislation eased the rate freeze, replacing it with a "glide-path" that allows yearly rate increases of up to 10 percent until Citizens' premiums reach an actuarially sound level.[14] After a few years of modest rate increases, some areas of the state now pay actuarially adequate rates, which

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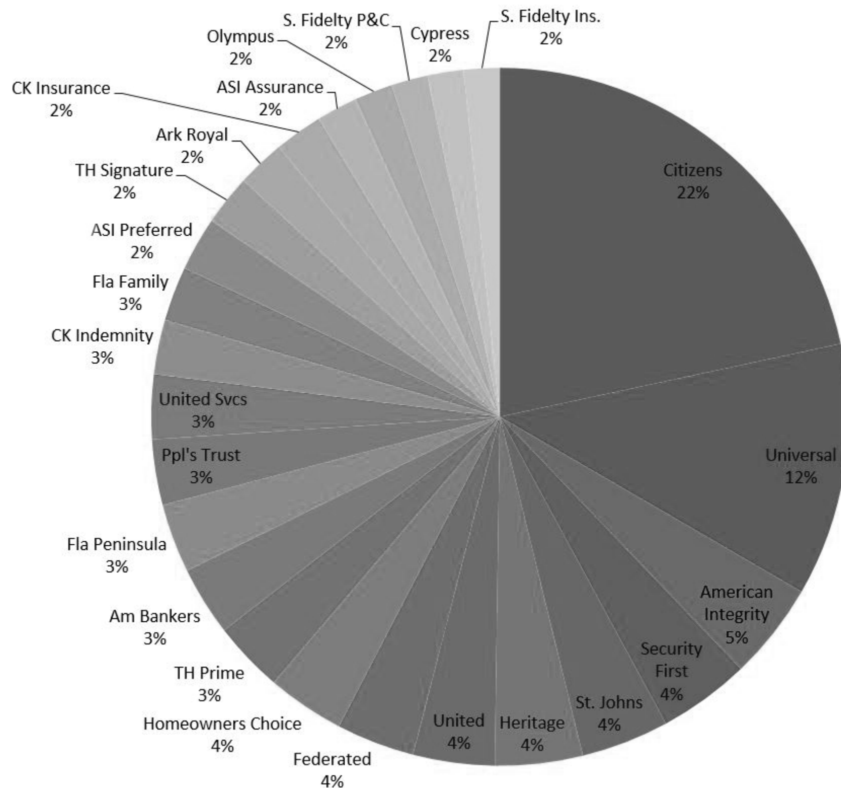

has contributed to the organic flow of a significant number of policies from Citizens to private carriers. However, Citizens coverage remains significantly underpriced in much of the state's coastal and other high-risk regions, and it is estimated that it will take the "glidepath" several years to bring rates in these areas in line with those in the private market.[15] At the current pace of increase, Citizens' rates in Miami-Dade County would continue to be underpriced through at least 2020.[16]

If a major hurricane or tropical storm had made landfall in Florida in recent years, Citizens would have theoretically been able to remain in business, despite underpricing its coverage, because it has the unilateral authority to impose a form of taxation on nearly every insurance policy issued in the state.

For example, if disaster strikes and Citizens were to run a deficit, it must first impose surcharges on its own policyholders, but may subsequently impose so-called "emergency assessments" on policies issued in Florida in every property and casualty line of business except medical malpractice liability insurance and workers' compensation insurance.[17] These assessments amount to a "hurricane tax" that could add up to 30 percent to the cost of each insurance policy paid by the roughly 78 per-

Top 25 -- Policies in Force

Personal & Commercial Residential

Data as of June 30, 2014

Rank	Insurer Name	Policies in Force
1	CITIZENS PROPERTY INSURANCE CORPORATION	912,731
2	UNIVERSAL PROPERTY & CASUALTY INSURANCE COMPANY	493,810
3	AMERICAN INTEGRITY INSURANCE COMPANY OF FLORIDA	189,995
4	SECURITY FIRST INSURANCE COMPANY	178,697
5	ST. JOHNS INSURANCE COMPANY, INC.	171,985
6	HERITAGE PROPERTY & CASUALTY INSURANCE COMPANY	171,483
7	UNITED PROPERTY & CASUALTY INSURANCE COMPANY	159,189
8	FEDERATED NATIONAL INSURANCE COMPANY	152,604
9	HOMEOWNERS CHOICE PROPERTY & CASUALTY INSURANCE COMPANY, INC.	152,337
10	TOWER HILL PRIME INSURANCE COMPANY	137,771
11	AMERICAN BANKERS INSURANCE COMPANY OF FLORIDA	135,716
12	FLORIDA PENINSULA INSURANCE COMPANY	135,095
13	PEOPLE'S TRUST INSURANCE COMPANY	128,295
14	UNITED SERVICES AUTOMOBILE ASSOCIATION	125,524
15	CASTLE KEY INDEMNITY COMPANY	107,040
16	FLORIDA FAMILY INSURANCE COMPANY	106,005
17	ASI PREFERRED INSURANCE CORP.	105,312
18	TOWER HILL SIGNATURE INSURANCE COMPANY	99,276
19	ARK ROYAL INSURANCE COMPANY	93,885
20	CASTLE KEY INSURANCE COMPANY	93,432
21	ASI ASSURANCE CORP.	81,186
22	OLYMPUS INSURANCE COMPANY	74,034
23	SOUTHERN FIDELITY PROPERTY & CASUALTY, INC.	71,016
24	CYPRESS PROPERTY & CASUALTY INSURANCE COMPANY	70,821
25	SOUTHERN FIDELITY INSURANCE COMPANY	70,146
Total for top 25 companies		**4,217,385**

Data submitted to the QUASRng database is not audited by the Florida Office of Insurance Regulation before publication. Beginning with the first quarter of 2014, State Farm Florida Insurance Company is filing QUASR reports as Trade Secret; their current data is therefore not included in this database.

"At the current pace of increase, Citizens' rates in Miami-Dade County would continue to be underpriced through at least 2020."

cent[18] of homeowners, renters, drivers, boaters, businesses, charities and civic organizations statewide who derive no benefit from Citizens' subsidized, underpriced rates.

The assessments could stretch over multiple years, during which time the state's woes could be compounded were it to be hit by one or more additional storms. Private insurers, who cannot levy assessments to cover their losses, are legally required to charge rates sufficient to make good on the coverage they sell. They use reinsurance and other capital management strategies to prepare for the inevitability of unusually high catastrophe losses in some years.

Fortunately, Citizens poses less of a threat to taxpayers and the economy today than it did in previous years. Modest steps taken by lawmakers, as well as responsible decisions by Citizens management, undoubtedly deserve credit. Citizens has shed more than a half-million policies since 2011, reducing its overall exposure by 43 percent from more than $510 billion to just $295 billion.[19] Much of this is owed to depopulation initiatives pursued by Citizens (185,405 policies were transferred to the private market in 2014 [20]), as well as the organic migration of policies from Citizens to the private market as Citizens rates became more competitive.

The rest is owed to sheer luck. The $7.6 billion[21] in surplus Citizens has amassed is almost entirely due to Florida's nine-year stretch without a hurricane landfall. As Florida's luck would also have it, the private reinsurance market currently is awash in capital due to various factors, including cheaper risk transfer alternatives, all of which has resulted in an unprecedented "buyers' market" with rates for private reinsurance and other such coverage that are very low by historical standards.[22]

These promising statistics, coupled with additional risk transfer purchased from the private reinsurance market will, for the first time, allow Citizens to cover a 1-in-100 year hurricane without having to issue assessments.[23]

Despite this promising news, the economic consequences of a 1-in-100 year hurricane strike would be daunting and unprecedented. According to a 2009 economic study by the Florida Department of Financial Services:

"A 1-in-100 year hurricane in Florida in 2009 would far surpass the costliest single hurricane in the United States (Hurricane Katrina at $81 billion in 2005) and more than triple the entire loss associated with the four 2004 storms in Florida ($45 billion). Businesses would be closed, Floridians would be displaced, and the rebuilding process would take years. Additionally, industries like tourism would be significantly impacted, as thousands of leisure visitors would vacation elsewhere following a 1-in-100 year hurricane.

The 1-in-100 year hurricane is estimated to result in $60.86 billion of insured residential property losses, of which $7.91 billion will be covered by deductibles. In addition, there will be approximately $30 billion in insured losses for commercial buildings and contents. Based on this information, the Economic and Demographic Research (EDR) model prediction indicates that there will be between $183.22 billion and $198.99 billion in total damages."[24]

In the years since those projections were offered in 2009, Florida has seen growth in population, and the cost

of labor and building materials, as well as increases in real estate values. As such, loss estimates almost certainly would be higher today. This economic hit also likely would impact the state's bonding capacity.

Therefore, it is imperative that, as Florida's largest writer of homeowners insurance, Citizens be in a position to weather not just one severe hurricane season, but the very real possibility of a similarly undesirable subsequent season. Such a scenario is precisely what occurred in 2004-2005 and brought us to this point.

Unfortunately, despite the gains Citizens has made over the past nine years, it would be woefully ill-equipped to handle even a nominally active hurricane season should its resources be depleted by one large event or a series of events. In order to protect taxpayers, Citizens must be subject to further reforms that return it to an "insurer of last resort" and transfer more of its risk to the private market so that state taxpayers are not left responsible and the state's budget does not take the hit.

The "Cat Fund"

With its imposing size and its power to levy assessments, Citizens has the potential to place Floridians on the hook for billions of dollars if a sufficiently bad hurricane season wipes out the surplus it has slowly accumulated over the last nine years. This serious threat to Florida taxpayers is exacerbated by the extent to which Citizens relies on another taxpayer-backed entity—the Florida Hurricane Catastrophe Fund — to provide roughly $4.63 billion in reinsurance,[25] which accounts for the majority of Citizens' reinsurance support following a catastrophe.

Like private reinsurers, the Cat Fund provides insurance to insurance companies operating in Florida. When insurers' total losses resulting from a hurricane exceed certain levels, the Cat Fund promises to cover a portion of the risk. In return, the Cat Fund collects premiums ceded from insurers. However, unlike private reinsurers, the Cat Fund does not actually keep on-hand the funds necessary to pay the claims it can reasonably expect to receive. Instead, if it runs short on money, it has the authority to issue bonds, which it repays by imposing assessments on policies in a way similar to Citizens. To pay off the Cat Fund's bond debts, dating back to the 2004 and 2005 hurricane seasons, Floridians were forced pay a 1.3 percent assessment on their homeowners, auto, renters and other insurance policies until Jan. 1, 2015.[26]

The Cat Fund turns the principle of diversification on its head by concentrating Florida's peak hurricane risk within the state, rather than spreading it around the world, as private reinsurers do. This means that, even assuming the Cat Fund has management talent and investment opportunities equal to those in the private sector, it must charge higher rates than private reinsurers if it hopes to break even in the long run. Instead, it charges substantially lower rates than the private sector for comparable coverage, because it can rely on post-event financing.

As a condition to transact business in Florida, property insurance companies are required to purchase a portion of their reinsurance coverage from the Cat Fund. Florida law prescribes the aggregate amount of coverage the Cat

"The Cat Fund turns the principle of diversification on its head by concentrating Florida's peak hurricane risk within the state, rather than spreading it around the world, as private reinsurers do."

"Depending on the severity of the storm and the size of the bond issuance, these assessments could increase the overall cost of insurance on Floridians substantially for years."

Hurricane Dennis caused at least 89 deaths in the U.S. and Caribbean and caused more than $2 billion in damages to the United States. (Photo courtesy of *The Miami Herald*)

Fund is required to sell, which is currently $17 billion.[27] Regardless of the Cat Fund's ability to actually deliver on the coverage it sells, only the governor and Legislature can change the mandatory coverage the fund must sell, as it would require an amendment to state law.

Like Citizens, the Cat Fund has also benefitted from Florida's lucky streak. The current hurricane dry spell has permitted the Cat Fund to amass a record $10.95 billion in surplus.[28] This, coupled with $2 billion of "pre-event liquidity" secured from a recent bond offering[29] would allow the Cat Fund to cover $12.95 billion[30] in claims without having to issue additional bonds.

However, once these resources are depleted, the Cat Fund must secure the necessary funds to pay remaining claims by borrowing money in the bond market. Those bonds are paid back incrementally using assessments the fund has the authority to levy on virtually every insurance policy in the state. Depending on the severity of the storm and the size of the bond issuance, these assessments could increase the overall cost of insurance on Floridians substantially for years.

But potentially large assessments aren't the greatest risk posed by the Cat Fund. From 2008 through 2012, the Cat Fund's own financial advisers projected several times that the fund likely wouldn't have been able to borrow enough money in the capital markets to cover its obligations had Florida been affected by a sufficiently bad hurricane season.[31] In short, Florida law required the Cat Fund to take on obligations it couldn't meet. And it continues to do so.

Despite projections that the Cat Fund can fully fund its $17 billion of obligations during an initial season, it is estimated that there would remain a more than $5 billion shortfall in the

subsequent year should the Cat Fund be forced to again pay to its full statutory capacity.[32]

Such a scenario would have disastrous consequences. In 2012, the Florida Office of Insurance Regulation (OIR) estimated that a 25 percent shortfall by the Cat Fund would lead 24 of the state's top 50 insurers to "have less than the statutory minimum of $5 million, which would result in some type of action being taken to increase surplus." These 24 insurers, the OIR said, represent approximately 35 percent of the market and service more than 2.2 million policies.[33]

The insurance rating service A.M. Best Co. has likewise stated that it "remains concerned regarding the ability of the [Cat Fund] to fund all obligations in the event of a severe hurricane."[34] This has been reflected in its ratings—and in some cases, reluctance to offer ratings—of Florida's thinly capitalized homegrown property insurers.

According to data provided by SNL Financial, insurers with less than $50 million in policyholder surplus (as of Sept. 30, 2014) represent more than 26 percent of Florida's homeowners' multi-peril insurance market. Insurers with less than $25 million of surplus account for about 10 percent of the market. Under Florida law, private carrier surplus could be as little as $5 million for insurers authorized before July 2011, or $15 million for those subsequently licensed before being subject to regulatory intervention to avoid insolvency.

Should the Cat Fund face a significant shortfall, it would cause insolvencies that could affect nearly half of the state's property insurers, all at a time when thousands of storm-ravaged Floridians would be depending on getting their claims paid and their lives rebuilt. Given these realities, the Cat Fund must be reformed and right-sized so that its resources can be relied upon year after year.

Solutions

The quickest and most effective solution to avoid assessments would be to reform both Citizens' and the Cat Fund's pricing structures to allow market-based, actuarially sound rates, thereby pre-funding all potential losses. This would significantly reduce or eliminate the future need of a taxpayer bailout to pay for bond issuances and other post-hurricane debt financing.

Of course, that path would require dramatic increases in Citizens' premiums, as well as those of private insurance companies who would pass on the higher cost of their Cat Fund reinsurance coverage to their customers. However, it would effectively level the playing field and allow private insurers to better compete. Eventually, that would spread the risk among more companies and, all other things being equal, lower premiums over time.

Another potential solution—albeit one that would cause very significant short-term disruptions--would simply be to abolish both Citizens and the Cat Fund. This would allow their private market competitors to fill their voids at market rates.

Notwithstanding the political realities that would make any one of these solutions impossible to enact, executing them would almost certainly spark an unprecedented shock in the market that could very possibly plunge the state into

"In short, Florida law required the Cat Fund to take on obligations it couldn't meet. And it continues to do so."

an economic crisis. As such, R Street and The James Madison Institute, and other proponents of reform, have recommended more moderate proposals in recent years that have generally called for gradual, long-term implementation of market-based rates (among other solutions) to allow the market time to adapt.

Some of these proposals, including the 2009 Citizens rate glidepath[35] and the 2013 coastal preservation plan,[36] already have been adopted. Although these and other reforms appear to be making Florida's insurance system stronger and more stable, more needs to be done to ensure that taxpayers and the state's economy are protected beyond one bad hurricane season. Recommendations include:

Citizens Reduction and Reform:

- Continue incremental reduction of Citizens coverage limits for two additional years, to $500,000;
- Remove non-primary residences from Citizens, with exceptions;
- Implement incremental Citizens eligibility reform with a "circuit-breaker:"
- Allow excess and surplus lines carriers to take out policies from Citizens, with conditions; and
- Establish stricter notification requirements for future depopulation initiatives.

Cat Fund Reduction and Reform:

- Gradually decrease the Cat Fund's statutory capacity from $17 billion to $14 billion, with an emergency "override";
- Gradually increase the Cat Fund's statutory "deductible" from $7 billion to $8 billion;
- Surplus protection mechanism to cover second-year claims;
- Explicitly authorize (but not require) Cat Fund managers to negotiate the purchase of private risk transfer;
- Allow flexibility to primary insurers in years when the Cat Fund is projected to experience a shortfall;
- Taxpayer protection in the Cat Fund's mission statement;
- Require reports from financial advisors to explicitly discuss second event and second season claims-paying capacity;
- Redefine "funds" or "cash balance" as any money that does not have to be repaid; and
- Include taxpayer protection efforts in bi-annual reports.

Claims-Paying Estimate and Conflict-of-Interest Reform:

- Require an annual report on the combined post-storm bonding capacity of Citizens, the Cat Fund and the Florida Insurance Guaranty Association, assuming all three may attempt to issue bonds simultaneously after a significant hurricane event or season.
- Enact conflict-of-interest rules to preclude financial advisers from deriving financial gain from bond issuances.

Solution 1: Citizens Reduction and Reform

Despite the ill-conceived insurance reforms of 2007 that dramatically expanded the size and role of Citizens, the Legislature and Gov. Rick Scott have made headway in recent years to gradually shrink Citizens and try to restore it

to its original role as an insurer of last resort. But more needs to be done, and there are sensible ways to accomplish this goal without causing a spike in rates or disrupting the market.

Coverage Limits

In 2013, the Legislature decreased Citizens' coverage limits for residential policies from $2 million to $1 million, with additional yearly reductions of $100,000 for three additional years. Therefore, beginning in 2017, Citizens will only cover structures with replacement costs not exceeding $700,000.[37] Despite these changes, there have not been reports of wealthy homeowners having difficulty replacing their Citizens coverage with private coverage, except in the limited cases of Miami-Dade and Monroe counties.

As such, to continue necessary reductions in Citizens' risk exposure, the Legislature should consider continuing this gradual reduction in coverage limits for an additional two years, to $500,000. Ultimately, residents who can afford to live in a half-million dollar structure should not be subsidized by an inland senior living on a fixed income or by other struggling Floridians.

Removal of Non-Primary Residences

Reducing coverage limits will undoubtedly shrink Citizens and transfer an enormous amount of risk away from taxpayers. However, the Legislature should also examine an effective way to remove non-primary residences from Citizens.

As of August 2013, almost 164,000 policies had mailing addresses outside of Florida; almost 26,000 additional policies had mailing addresses outside the country. Combined, this amounts to 16 percent of all Citizens personal lines policies that presumably cover homes owned by non-Floridians.

According to a 2013 American Consumer Institute study, the median Florida home price paid by people with a primary residency outside of Florida was $194,700, which is well below the $700,000 residential policy coverage limit that will take effect in 2017. The study further reports that 82 percent of these homes were purchased without a mortgage. Canadians, the report states, are the biggest buyers with 90 percent of them paying cash for the properties.[39]

Therefore, if most foreign and out-of-state buyers have the financial means to purchase property in Florida, in many cases paying cash, it stands to reason they can afford the cost of insuring those properties. Ultimately, those who neither live, work, nor vote in Florida should not benefit from taxpayer subsidization.

Lawmakers should work with Citizens to craft legislation that specifically excludes seasonal rental and vacation homes, or at least requires that policies covering such homes be charged a full, unsubsidized and actuarially sound rate to ensure that Floridians are not saddled with assessments to cover properties owned by out-of-state investors.

Citizens Eligibility Reform

During the 2013 legislative session, lawmakers approved a series of reforms to slow the influx of policies into Citizens, including the creation of a "clearinghouse."[40]

The clearinghouse essentially enforces the existing 15 percent eligibility standard by making a property inel-

"But more needs to be done, and there are sensible ways to accomplish this goal without causing a spike in rates or disrupting the market."

igible for Citizens coverage if there is a private company that offers a new policy within 15 percent of Citizens' rates for similar coverage. Renewal policies offering coverage at the same rate from a private insurer are also ineligible for Citizens.

Though a step in the right direction, the current system continues to impose the *de facto* price control on the market that former Gov. Charlie Crist's ill-conceived 2007 reforms established. This continues to encourage the steady flow of new policies entering Citizens.

However, abolishing the 15 percent eligibility standard altogether and replacing it with the pre-2007 requirement that a property owner be unable to secure coverage from a private company as a condition for Citizens coverage likely would result in politically unacceptable rate increases for many current Citizens policyholders.

Instead, the Legislature should explore an incremental approach to Citizens eligibility, whereby the current 15 percent threshold could be gradually increased by 2.5 percent per year until it reaches 100 percent (in 34 years). To avoid rate increases beyond the current 10 percent Citizens glidepath, a yearly "circuit breaker" would assure that the 2.5 percent increase only happens if overall prices decline, as they have recently.[41] This approach would ensure that Citizens shrinks slowly but steadily over time, without sudden unacceptable impacts on incumbent customers.

Include Surplus & Excess Lines in Depopulation Program

Florida law authorizes Citizens to develop a program to reduce its exposure and policy count by transferring policies to the private market.[42] The result is the Citizens Depopulation Program, through which willing private insurers may offer coverage to Citizens policyholders. Currently, only admitted carriers are permitted to enter into "take-out" agreements with Citizens to accomplish this goal.

Surplus lines is a category of insurance focused on risks for which coverage is not available in the regulated, admitted market. Some risks may simply be too large, unusual or complex for standard insurance companies to cover. In these cases, surplus lines carriers can procure a policy specially designed for such risks.

Surplus lines carriers receive less strict regulation from OIR than admitted carriers do, including in regards to rates, but they are generally required to maintain a surplus of $15 million or more in order to be eligible to transact business in Florida. Those formed outside the United States must maintain a trust fund containing at least $5.4 million.[43]

Although the OIR may revoke the eligibility of a surplus lines carrier if it finds it to be in an unsound financial condition or if it fails to reasonably pay claims promptly, surplus lines policies are not covered by the Florida Insurance Guarantee Association (FIGA).[44] Therefore, policyholders receive no protection from the state should they suffer financial losses or delays in claims payments due to the insolvency of a surplus lines carrier.

Legislation has been proposed in recent years to allow surplus lines carriers to participate in the Citizens Depopulation Program,[45] but opponents have cited concerns over consumer protec-

tions, due to the lack of rate regulation and FIGA protection.

The Legislature should nevertheless explore ways to open the Citizens Depopulation Program to surplus lines carriers. This would increase competition, spread risk and protect taxpayers by further reducing the size and potential liability of Citizens. Although surplus lines carriers are not heavily regulated by the state, the Legislature should not needlessly abandon a potentially effective initiative. Surplus lines writers that choose to participate in any Citizens' depopulation effort can and should be subject to additional criteria to protect consumers. This can be accomplished by requiring education and financial protection.

For example, any surplus lines carrier that chooses to assume policies from Citizens could be required to provide an OIR-approved notice to the Citizens' policyholder before assuming the policy. The notice must include the company's A.M. Best rating and explanations that the policy will not be covered by FIGA; regulated by the state for rate; or subject to assessments. The notice must also include an explanation of coverage differences, if any, and a telephone number and website for the policyholder to reach for any questions.

To ensure consumer protection, only surplus lines insurers meeting strict financial criteria should be allowed to take policies out of Citizens. To participate, they should: maintain at least $50 million in surplus (surplus lines insurers are currently required to maintain only $15 million in surplus to transact business in Florida); receive or maintain an A.M. Best Financial Strength Rating of A- or better (Surplus lines insurers are not currently required to be rated by A.M. Best); maintain resources to cover a 100-year probable maximum loss at least twice in a hurricane season (through surplus and/or reinsurance coverage); and agree to provide substantially similar coverage as the Citizens policy does.

For additional consumer protection, the default could hold that incumbent Citizens policyholders must opt-in to an agreement with a surplus lines carrier, rather than the current opt-out default for take-out agreements involving an admitted insurance carrier.

Allowing surplus lines carriers to assume Citizens policies accomplishes the goals of increased choice for consumers and shifting liability away from the state's taxpayers.

Depopulation Notification Requirement Reform

Citizens recently has come under fire for its depopulation program, especially as it relates to notifying policyholders during "takeout" agreements with private companies. Because policyholders have to proactively sign an opt-out form to remain insured with Citizens and reject coverage with the private company, there have been complaints about such forms not being sent through appropriate channels or being confused with junk mail. Consequently, many have claimed they were transferred from Citizens to a "take-out" company without their knowledge.

The Citizens depopulation program has successfully transferred more than 800,000 policies and roughly $245 billion in risk to the private market since 2010.[46] These are policies for which taxpayers are no longer on the hook. As

"Allowing surplus lines carriers to assume Citizens policies accomplishes the goals of increased choice for consumers and shifting liability away from the state's taxpayers."

such, a successful initiative such as the depopulation program should not be jeopardized over an issue that is easy to correct.

Citizens appears to be addressing the concerns,[47] but lawmakers should ensure that any new notification requirements Citizens adopts are indeed clear to those for whom they are intended and that the importance of these notifications be properly conveyed. This may include sending them by certified mail or some other manner that ensures proper attention. Ultimately, consumer protection should remain a top priority.

Solution 2: Cat Fund Reduction and Reform

By design, the Cat Fund is structured to provide Florida's primary insurers with underpriced reinsurance coverage. As such, the Cat Fund does not collect sufficient premiums to break even over the long run and must therefore depend on its ability to sell bonds to make up the difference between the cash it has collected and the claims it must pay.

Coverage Limits

As previously discussed, the amount of coverage the Cat Fund sells—currently $17 billion—is set by lawmakers. To avoid a repeat of the multi-year shortfalls it faced until recently, the Cat Fund must be right-sized.

Florida State Rep. Bill Hager, R-Boca Raton, filed legislation during the 2012 and 2013 regular legislative sessions that would have modestly reduced the amount of coverage the Cat Fund is required to offer.[48] His proposals received wide support from the insurance industry, environmentalists, center-right groups and consumer advocates,[49] who seldom agree on many other issues.

The Legislature should again consider gradually right-sizing the Cat Fund. This can be accomplished by reducing the amount of coverage Florida law requires it to sell by $3 billion over three years, from the current $17 billion to $14 billion. This is an amount many analysts believe is sustainable. To prevent a rate impact on consumers and provide predictability in the reinsurance market, the Legislature may consider an accelerated reduction: $500 million in the first year; $1 billion the second year; and $1.5 billion in the third year.

To mitigate against sudden rate increases on consumers, the Legislature should also consider an emergency "override" that would allow the Cat Fund to return to its $17 billion capacity in an emergency situation or if private reinsurance rates spike. This can be accomplished by enabling the State Board of Administration trustees (governor, attorney general and chief financial officer) to authorize a temporary, one-year increase in the fund's capacity up to $17 billion in case there is an interruption in private reinsurance capacity or other such emergency.

The goal would be for the Legislature to set a reasonable default capacity for the Cat Fund while allowing greater flexibility as the need arises.

Retention Layer

Another way to reduce the Cat Fund's exposure—and by extension, liabilities on taxpayers—is by increasing its retention layer.

The Cat Fund's retention layer acts in a way similar to an insurance de-

ductible. In this case, when primary insurers' total hurricane losses exceed the retention layer (or deductible amount), the Cat Fund's coverage kicks in and begins to cover the remaining claims up to coverage limits. By increasing the retention layer, the Cat Fund would be "tapped" less frequently and for less money. This translates into fewer assessments levied on taxpayers.

The retention layer is currently set at approximately $7 billion[50] (aggregate), with slight adjustments made annually based on the amount of exposure.[51] Amending the law to increase the retention to $8 billion, phased in over two years, would significantly decrease the Cat Fund's potential liabilities. To best fulfill its role as a market stabilizer, the Cat Fund should not be called upon every time the state is struck by a minor storm.

Decreasing the retention, as some have proposed, should be rejected, as this would only increase the Cat Fund's liabilities and frequency of claims, and by extension, further destabilize the market.

Surplus Protection

In order to further protect the Cat Fund from a subsequent season shortfall, it must establish a surplus protection mechanism to carry some of its existing resources over to the next season. Lawmakers should explore ways to set aside some of the Cat Fund's $10.95 billion surplus. For example, it can require the fund to hold a percentage of its current balance or a flat $2 billion for the subsequent season, even if it requires the Cat Fund to finance that amount should a storm strike the first season. As undesirable as issuing debt may be, a shortfall the following year would be far worse for the state's economy.

Private Risk Transfer

The Legislature should explicitly authorize, but not require, the Cat Fund to negotiate the purchase of private reinsurance and other risk-transfer mechanisms to supplement the amount set aside for surplus protection the following year.

As previously discussed, the current state of the global reinsurance market[52] presents Florida with a unique opportunity to export substantial amounts of its enormous hurricane risk at bargain prices. Citizens, for example, increased its 2014 private reinsurance protection by 68 percent over 2013, for less than it had paid the prior year.[53]

The Cat Fund can and should explore ways to do the same. Reinsurance coverage represents money that does not have to be borrowed or repaid by taxpayers when the wind blows. It allows Florida to be flooded with outside capital in the immediate aftermath of a storm rather than be saddled with debt.

Cat Fund Gap Coverage

If it is not properly reformed, it has been estimated[54] the Cat Fund will once again face the prospect of a shortfall the following season. Requiring primary insurance companies to purchase coverage that they and the State of Florida both know does not exist amounts to a Ponzi scheme. It places the state at risk of mass insurer insolvencies. Entire storm-battered regions of the state could go without claims paid in full. The resulting crisis likely would bring the state's economic recovery to a halt. This should not be tolerated, much less required by law.

"Requiring primary insurance companies to purchase coverage that they and the State of Florida both know does not exist amounts to a Ponzi scheme."

"The Legislature should also redefine the Cat Fund's core mission to include protecting taxpayers as a focus of the organization, including taxpayer protection clauses as part of the job descriptions of all senior management."

In order to guard against shortfalls, some insurers purchase private reinsurance that actually duplicates the Cat Fund's coverage. However, current law prohibits such reinsurance costs from being recovered in rates. This serves as a disincentive for insurers and their consumers to be properly covered. The Legislature should repeal this provision and allow insurers to recoup their costs for guarding against any estimated Cat Fund shortfall.

Administrative Reforms

Florida law requires the Cat Fund to publish a statement of the fund's estimated borrowing and claims-paying capacity;[55] these reports should include data concerning second-event and second-season capacities. They should clearly define terms as "funds" and "cash balance" as actual money on-hand that does not have to be repaid.

Reports to the governor and Legislature should also include an overview of taxpayer protection efforts undertaken by Cat Fund managers, including examinations of discretionary expenditures and organizational actions taken to reduce the likelihood or severity of post-hurricane assessments. These may include cost-saving initiatives, the purchase of risk transfer and surplus protection.

The Legislature should also redefine the Cat Fund's core mission to include protecting taxpayers as a focus of the organization, including taxpayer protection clauses as part of the job descriptions of all senior management.

Solution 3: Claims-Paying Estimate and Conflict-of-Interest Reform

As previously discussed, Citizens and the Cat Fund both have the unilateral authority to issue bonds should their cash reserves fall below levels needed to cover potential or imminent claims.

The Florida Insurance Guaranty Association (FIGA) is another state-run entity that has similar authority. When insurers are on the verge of insolvency, they must either be rehabilitated or liquidated by state government. When they are liquidated, FIGA assumes and pays any outstanding claims, so that consumers who bought insurance policies in good faith are not left with their claims unpaid.

To do so, FIGA can levy assessments onto almost every property and casualty insurer in the state. Specifically, FIGA can levy assessments of up to two percent premiums for each of the two accounts it has, a maximum of four percent that must be paid for by policyholders.[56]

All three entities—FIGA, Citizens and the Cat Fund—would likely go to the same municipal bond market to issue their bonds following a sufficiently bad hurricane season. As previously discussed, its own managers have estimated the Cat Fund likely would have faced a shortfall, in the wake of a significantly large event, due to limits on its ability to find sufficient post-event financing in the capital markets. But it stands to reason that any event that would force the Cat Fund to face a shortfall would simultaneously be a source of financial distress for FIGA and Citizens.

As such, the Legislature should direct the Investment Advisory Council

of the State Board of Administration to provide an annual report estimating the bonding capacity of Citizens, the Cat Fund and FIGA, taking into account the potential that all three would seek to execute bond issues in close proximity to one another following a hurricane season that adversely impacts Florida.

Additionally, to ensure these entities receive sound, unbiased financial advice, the Legislature should explore conflicts-of-interest and internal control standards similar to those embodied in the federal Sarbanes-Oxley Act. This law requires auditor independence for publicly traded firms. Companies responsible for auditing a public firm's books are prohibited from subsequently doing business with the firm in other fields—for example, by participating in stock and bond offerings.[57]

Currently, Florida law allows financial firms advising these public agencies and analyzing their bonding capacity to subsequently participate in, and earn fees from, bond issuances that follow such studies. This situation presents an obvious conflict and deprives the Cat Fund, Citizens and FIGA of truly unbiased advice. This change also might discourage reliance on taxpayer-funded post-event bonding, instead of upfront capital and risk transfer mechanisms like reinsurance.

Conclusion

The 2015 legislative session offers Florida's lawmakers an enormous opportunity. Although nine hurricane-free years coupled with modest reforms have allowed the state to largely stabilize its property insurance market, it continues to pose a risk to taxpayers and the economy. This is especially magnified if a severe storm or hurricane season were to follow another.

Although no set of reforms can make Florida entirely immune to all of the problems that it could face if disaster were to strike, some can significantly reduce many of them.

A sensible approach that recognizes the state's role in Florida's property insurance system, but trusts the market to solve many problems, will work best and bring the greatest stability. In particular, the Legislature should continue to further shrink the Florida Citizens Property Insurance Corporation, reduce the size of the Hurricane Catastrophe Fund, and promote reforms that would result in a surge of capital to the state after a storm to help it quickly recover both physically and economically, rather than saddle it with debt.

Recent history has shown that multiple hurricanes can strike within a short period of time. Florida must take steps to be prepared for this very real possibility. We must use this time wisely and not squander our good fortune.

"Florida must take steps to be prepared for this very real possibility. We must use this time wisely and not squander our good fortune."

About the Author

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