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Retreating from the Brink

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Hurricane Irma is undoubtedly the worst storm to impact Florida since at least 2004's Hurricane Charley. Because we are still in its immediate aftermath, it is difficult to predict what the long-term impacts will be. But when the story about Florida's Irma recovery ultimately is written, one thing is certain: tough political decisions and investments made over the past several years spared the state from a much longer and costlier recovery.

As recently as 2012, Florida's government-run insurer of last resort, Citizens Property Insurance Corp., had nearly 1.5 million policies in-force,[1] with barely enough resources to cover the potential losses of just a fraction of those policies were a major storm or series of storms to pummel the state. Likewise, another state agency – the Florida Hurricane Catastrophe Fund—which provides backup hurricane coverage for all of the state's property insurers, including Citizens—

carried multibillion dollar liabilities of its own, with no realistic way to cover them in the event of a bad hurricane season or two.

Simply put, short-sighted politicians more concerned with scoring short-term political points by artificially forcing down insurance rates put Florida's economy at risk. They did this by foisting enormous liabilities on taxpayers who, but for a hurricane-free decade, would have had to bail out both Citizens and the Cat Fund with massive, multiyear post-hurricane assessments (also known as taxes) on their auto, property, boaters, renters and business insurance policies to cover losses. Such a spike in the overall cost of insurance surely would have put the brakes on Florida's delicate economic recovery.

Realizing these long-term economic dangers, Gov. Rick Scott and legislative leaders enacted reforms to transition the state from self-insurance to actual insurance. Many of these reforms were first proposed by research scholars at R Street and The James Madison Institute.[2] Some were politically risky at the time, as they involved unfreezing Citizens' artificially suppressed rates by placing them on a gradual "glidepath" to better reflect risk and encourage more private companies to enter and compete in the Florida insurance market. Other reforms included Citizens' depopulation programs, which have successfully transferred almost 800,000 policies to private companies since 2014.[3]

The Cat Fund's unfunded liabilities, which posed the greatest threat to the state, were reduced by billions of dollars. Previously, the fund sold what was essentially "phantom coverage" to primary insurers, since it had neither the cash reserves nor the

borrowing power to pay for the coverage it sold. Had a strong enough hurricane struck the state as recently as 2012, it likely would have triggered a 20 to 25 percent shortfall in promised aggregate claims payments. State insurance regulators estimated that nearly half the state's top 50 property insurers would have faced insolvency or near-insolvency had such a shortfall occurred;[4] tens or potentially hundreds of thousands of hurricane-ravaged policyholders would have experienced major delays in having their claims paid until the state or federal government stepped in with a massive taxpayer bailout. In the meantime, homes would have remained damaged, businesses would have remained shuttered and the state's economic recovery would have ground to a halt.

But thanks to modest reductions in its upper limits, coupled with a decade of no hurricanes, the Cat Fund entered the 2017 hurricane season in its best financial shape ever. The state Cabinet also authorized managers to purchase private reinsurance[5] to further shield the fund's finances from massive future losses and reduce the likelihood or severity of post-hurricane taxes to pay any debts.

Critics scoffed. They called it corporate welfare. They said rates would rise and that private insurers would "cherry pick" the best policies. And of course, they labeled almost every effort to strengthen Citizens' and the Cat Fund's finances as "anti-consumer."

But the reforms worked. Today, Citizens has returned to its proper role as an "insurer of last-resort" with policies numbering just over 450,000,[6] from a high of nearly 1.5 million in 2012. The Cat Fund is fully capitalized, thanks to a combination of private reinsurance protection and a fair-weather decade. Indeed, there are more private companies competing for policies in Florida than there have been in years, and this is also due to historically-low reinsurance rates that enable private insurers to offer more coverage.

Reinsurance is insurance for insurance companies. It is meant to cover an insurer's losses from largescale catastrophes, such as hurricanes. Reinsurers can both fulfill their obligations and make a profit by spreading risk globally, as they are able to pool the risks of, for example, earthquakes in Asia with blizzards in Europe. Too much of Florida's hurricane risk was, until recently, self-insured by the state; today, roughly 60 percent of the state's hurricane risk is covered by private reinsurance, purchased by a combination of Citizens, the Cat Fund and private insurance companies.

Though exact figures won't be known for several months, initial estimates of Hurricane Irma's insured losses in Florida range anywhere from $20 to $60 billion. As a point of comparison, Hurricane Andrew incurred $15 billion in covered losses (in 1992 dollars). If Irma's ultimate losses amount to $40 billion—a midpoint of estimates—the state is expected to be infused with roughly $24 billion in outside capital by reinsurers. It should be noted, however, that loss estimates have trended lower from those initial figures, as the steady stream of claims data in recent weeks presents a clearer picture.

Nevertheless, had Florida not made the tough choices outlined above to transfer and spread more of its massive hurricane risk, a far greater amount of the storm's ultimate cost would have been financed by debt that taxpayers would have to pay back through years of potentially crippling hurricane taxes—debt that would surely compound upon itself if the state were struck by additional hurricanes in the coming years.

This is why Florida's efforts to invest in pre-event financing of catastrophes, rather than incurring debt after the fact, is the way to go. And recent history validates this principle:

Japan, for example, made the public policy decision to self-insure and finance its recoveries from catastrophes through subsequent debt. Since the earthquake and tsunami in 2011, its economy has been saddled with billions in debt incurred to cover those losses. In contrast, New Zealand took a more proactive approach and elected to export much of its earthquake risk by purchasing insurance and reinsurance before the fact,[7] which resulted in a flood of outside capital into the country and its economy after the catastrophic 2011 Christchurch earthquake. That year, Japan's economy experienced negative GDP growth, while New Zealand's grew by almost 2 percent.[8]

Had Florida continued on the same path as Japan in self-insuring most of its risk with post-event debt, its recovery would have been that much longer and costlier. Indeed, according to recent testimony by Citizens CEO Barry Gilway, if Citizens still had 1.5 million policies in-force, as it did a few years ago, the state-run insurer would face $24 billion in Hurricane Irma losses, which would have certainly triggered multiyear hurricane taxes to pay back the debt issued to cover those claims. Instead, it is estimated Citizens will incur only $1.2 to $1.8 billion in Irma losses, which will be covered by a combination of its own cash reserves, Cat Fund coverage and possibly private reinsurance. In short, Citizens will weather this active hurricane season with a healthy $6.4 billion surplus instead of debt,[9] and insurance regulators believe the private insurance market will likewise finish the year financially stable.[10]

But more can and should be done to protect consumers, taxpayers and Florida's economy.

First, lawmakers must take steps to curb insurance fraud and abuse that needlessly increase insurance rates on consumers. Currently, Florida's insurance market is undermined by a cottage industry that exploits a practice called assignment of benefits (AOB). An AOB allows a third-party contractor—such as a roofer or water-extraction company—to assume control of a homeowner's policy to collect payment directly from the insurance company for a covered loss. Although a normal practice in other areas, such as health insurance, Florida's litigious environment has encouraged bad actors to inflate their bills and file frivolous lawsuits for small, simple and even uncontested claims. The result is higher insurance rates.

This abuse has been mostly limited to noncatastrophe claims, such as water damage from broken pipes, but there is concern that bad actors may apply their playbook to hurricanes, as well. It is still too soon to determine whether this type of abuse has extended to Hurricane Irma claims, but given that noncatastrophe claims filed utilizing AOBs have much higher severity—generally at least 50 percent more costs—it is important that lawmakers address this abuse for three primary reasons:

1. To protect consumers against rising insurance rates to cover the fraud, abuse and litigation;
2. So that rising insurance rates do not produce an economic incentive for policies to return back to Citizens, which still has a 10 percent statutory cap on rate increases; and
3. To ensure that insurance companies—whose hurricane loss models do not include the cost of AOB abuse—have enough resources to cover legitimate claims after a storm.

Secondly, despite its current financial fitness, the Cat Fund is still on shaky ground. Although the fund is fully liquid, thanks to its investments in private reinsurance protection and a hurricane-free decade worth of cash reserves, Hurricane Irma's losses could have easily wiped out most of the fund's surplus had the storm made landfall 100 miles east, as initially forecast. Such a scenario would have devastated the state's urban core and left the Cat Fund nearly depleted and unable to fully cover another hurricane in subsequent years. As such, the Legislature should establish a surplus protection mechanism, so the fund is viable beyond one bad hurricane season. This can be achieved through a combination of additional private reinsurance protection, a decrease in the fund's statutory upper limits and by creating additional optional coverage levels for insurance companies that might find comparable coverage in the private market for less.

Finally, Florida's congressional delegation should monitor and oppose proposals to levy a discriminatory tax on the purchase of offshore reinsurance coverage. Since 90 percent of Florida's reinsurance protection comes from offshore companies, an "affiliate reinsurance tax" would have disastrous consequences for the Sunshine State, including raising home insurance rates by $152 million annually,[11] reversing much of the progress the state has made to spread and export its massive hurricane risk and endangering the state's economy. Congress should instead find ways to build upon the responsible steps Florida has taken to shore up its finances ahead of the next hurricane strike.

Conclusion

Florida has come a long way since it self-insured and concentrated so much of its massive hurricane exposure within the state, at great risk to its taxpayers. Instead of being saddled by debt, Florida's economy will enter 2018 with a welcome infusion of private, outside capital, which will help the state recover quickly while growing its economy. Although more still needs to be done, there is reason to be both proud of Florida's responsible reforms, and relieved that we made them in time.

1 Citizens Property Insurance Corp.: "Policies in force, as of October 31, 2012" https://www.citizensfla.com/documents/20702/100163/snapshot-10-12.pdf/58ab3114-ec09-41d1-81d9-06dc3c446cc3.

2 See, e.g., Eli Lehrer, Senior Fellow. "Solutions to Restore Florida's Property Insurance Marketplace to Protect Taxpayers and the Insured," The James Madison Institute Backgrounder, Number 67, February 2011.

3 Citizens Property Insurance Corp: "Exposure removed 2014-2017," as of Aug. 22, 2017. https://www.citizensfla.com/documents/20702/107431/2014-2017+Exposure+Summary.pdf/87cba369-265a-44e3-9418-a48e245ddf2f.

4 Insurance Commissioner Kevin McCarty Letter to State Senator J.D. Alexander, Jan. 25, 2012.

5 Malena Carollo, Tampa Bay Times, "State Catastrophe Fund ready to pay up to $17B in claims as Irma looms," Sept. 8, 2017. http://www.tampabay.com/news/business/banking/state-catastrophe-fund-ready-to-pay-up-to-17b-in-claims-as-irma-looms/2336782.

6 Citizens Property Insurance Corp.: "Detail by Account," through June 30, 2017. https://www.citizensfla.com/documents/20702/3944819/20170630_Combined+Report.pdf/13a2d12a-b76c-49b2-897a-6c68f04f662a

7 Kosuke Takami, Nikkei Asian Review, "Old habits hold back Japan earthquake insurance," Nov. 28, 2016. https://asia.nikkei.com/Politics-Economy/Economy/Old-habits-hold-back-Japan-earthquake-insurance

8 International Monetary Fund data mapper "Real GDP growth, annual percentage change," http://www.imf.org/external/datamapper/NGDP_RPCH@WEO/JPN/NZL

9 Barry Gilway, President & CEO, Citizens Property Insurance Corp., testimony at Senate Banking & Insurance Committee, Oct. 10, 2017.

10 David Altmaier, State of Florida Insurance Commissioner, testimony at Senate Banking & Insurance Committee, Oct. 10, 2017.

11 The Brattle Group, "The Impact of Offshore Affiliate Reinsurance Tax Proposals on the U.S. Insurance Market, an Updated Economic Analysis," Jan. 23, 2017. http://brattle.com/system/news/pdf2s/000/001/172/original/The_Impact_of_Offshore_Affiliate_Reinsurance_Tax_Proposals_on_the_U.S._Insurance_Market.pdf?1505839622