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FLORIDA FLIRTING WITH HURRICANE INSURANCE DISASTER

By Brent Winans, CPCU, ARM *August 2008*

After seven hurricanes hit Florida in 2004 and 2005, property insurance rates went through the roof and insureds were canceled by the computer full. Consumers put intense pressure on their elected leaders to fix the problem. In January 2007, the Florida State Legislature held hearings in Tallahassee on the insurance crisis. The experience of one state representative was typical. He is a Republican representing ocean-front property owners who traditionally have had a "keep the government out of my business" attitude. But they were up in arms. He related, "One of my faithful supporters shook his rolled up policy in my face and said, 'My homeowners premium went up to $10,000. You do something about this!'"

It is hard to blame the lawmakers for taking quick action to calm the public. The entire state had been traumatized by 2 years of unprecedented storms. Home prices and real estate taxes were going through the roof, and now insurance was hard to find and harder to afford. A state that had been an inexpensive place to live was becoming "high cost," and the growth that had fueled the economy for decades was grinding to a halt.

Unfortunately, the actions lawmakers took in the crisis of the moment have continued, and they now threaten the collapse of both the Florida insurance market and economy. How has Florida put itself in such a risky position? By ignoring the following basic risk management principles:

- Concentrating the risk rather than spreading it.
- Not allowing rates that are adequate to pay for the claims that are likely to occur.
- "Transferring" the responsibility for the claims deficit to those with a questionable ability and willingness to pay—the state's own hurricane-traumatized policyholders.

And what will be the result in the event of a catastrophic storm? A report released on

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April 2, 2008 by the chairman of the Florida House Insurance Committee, Rep. Donald D. Brown, said it clearly: *"Simply stated, it is probable under our current system that hundreds of millions of dollars in storm claims will go unpaid for some time."*[1]

Concentrating the Risk

One of the most fundamental principles of risk management is to spread the risk. "Don't put all your eggs in one basket." Insurers try to spread their risk over a wide geographical area to avoid the possibility of a single catastrophe affecting a large portion of their books of business. State governments often further accomplish this spread of risk by encouraging a healthy insurance market so that many different insurance companies will participate. In contrast, the state of Florida has concentrated the risk of multi-billion dollar hurricane losses in its own hands through the state-controlled Citizens Property Insurance Corporation (Citizens) and Florida Hurricane Catastrophe Fund (the CAT Fund).

Neither this nor anything else in this article should be taken as a criticism of the management or staff of either Citizens or the CAT Fund. They are insurance professionals who have done an amazing job of responding to ever expanding legislative mandates. Managers from both Citizens and the CAT Fund testified before the House Insurance Committee on the dangers of the present strategy. But it is the lawmakers and regulators who are driving the bus.

[1]Report of the Chairman of the Florida House of Representatives Committee on Insurance, April 2, 2008. Available at www.plastridge.com/FLinschairreport.

Citizens

Citizens was created by the state legislature in 2002 as a homeowners insurance safety net. Since then, its mandate has been constantly expanded; today, it is the largest property insurer in Florida, the tenth largest property insurer of any kind in the United States, and the largest property residual insurance market in the world.[2] Citizens estimates that its total exposure to loss exceeds $485 billion and its probable maximum loss from a single

[2]Citizens Presentation to Florida Senate Banking and Insurance Committee, March 11, 2008. Available at https://www.citizensfla.com/about/generalinfo.cfm?show=pdf&link=/shared/documents/Citizens_Presentation_03_11_08.pdf

event (1-in-100 year storm) exceeds $23.9 billion.[3] This is concentration of risk at an unprecedented level.

The CAT Fund

The state has further concentrated its hurricane risk by requiring subject insurance companies to purchase low cost reinsurance coverage from the state-controlled CAT Fund as a condition of doing business in Florida. According to senior CAT Fund officer Jack Nicholson, it has become "the largest catastrophe reinsurer in the world."

At the end of its 2007 fiscal year, the CAT Fund reported that its net assets were in a *deficit* by over $59 million.[4] Its capacity to pay substantial claims relies solely on its ability to sell bonds in the current subprime financial markets and to levy assessments on Florida's insurance companies to pay off those bonds.

In order to pay its claims after a 1-in-100 year storm, it is estimated that the CAT Fund would need to float a bond for $25 billion, and Citizens would be bonding for an additional $2 billion. In response to a question from the House Insurance Committee about the likelihood of successfully completing a bond sale of such magnitude, John Forney, financial advisor for both Citizens and the CAT Fund, stated, "The largest transaction that has ever been done in this market is $10 billion. It is difficult to overestimate the difficulty of this challenge."

So, simply put, the state of Florida requires insurance companies to purchase reinsurance coverage from its own state-controlled reinsurance company which has negative net assets. Lawmakers have chosen to believe that it will be possible to raise the money needed to pay claims by selling bonds in the current troubled financial markets. Experts doubt that could occur. If it does not, up to $25 billion in claims will be paid late or perhaps not at all. In addition some insurance companies who rely

[3] Florida Insurance Council, "Cat Fund: Almost $9 Billion Available Before Bonding," October 17, 2007. Available at www.flains.org/content/view/91/38/.

[4] Florida Hurricane Catastrophe Fund Fiscal Year 2006–2007 Annual Report, pg. 29. Available at www.sbafla.com/fhcf/Home/FCHFReports/tabid/315/Default.aspx.

on the CAT Fund's coverage will surely become insolvent, resulting in additional assessments on the remaining insurers from the state's Guaranty Fund.

The Private Market

Standard insurers have fled the Florida hurricane insurance marketplace. Of course, this is partially because they fear they have an over-concentration of risk in hurricane prone areas. But they have also left because state lawmakers and regulators have made Florida a very difficult place to do business. State mandates are common and the process for rate approvals is challenging and unpredictable. In addition, the insurance industry has often been used as a political whipping boy. Predictably, these actions have resulted in less participation from large insurers with the most to lose, which has further concentrated the hurricane risk in the hands of the state.

Mandating Inadequate Rates

A second key risk management principle is to adequately fund for foreseeable losses. For the last several years, Florida lawmakers and the Florida Office of Insurance Regulation (OIR) have forced Citizens to charge inadequate rates. Of course, an inadequate property rate is one that will not provide the funds needed to pay anticipated administration and claim costs as projected by actuaries and other experts. Admittedly, hurricane insurance losses are inherently difficult to predict, but actuaries bring the very best tools available to this inexact science. Rates being charged by Citizens are essentially set by legislators and are far below the rates that are recommended by actuaries.[5] Citizens' rates were rolled back to 2005 levels and frozen there through 2009. In testimony before the House Insurance Committee, Citizens' top financial executive agreed that it is fiscally unsound for Citizens to continue taking on new risks while rates are inadequate. Because rates have been kept artificially low, private insurers have been unable to compete. In addition, consumers are largely unaware of the true risks they are bearing.

Transferring the Risk to Those Unwilling and Unable To Pay

The law now places the ultimate responsibility to pay for these deficits on the policyholders themselves. Good risk management practice requires that financial risk be transferred only to those who are both able and willing to pay.

[5] Analysis of Florida Legislative Reform: Special Session, January 2007, Milliman Consultants and Actuaries, April 30, 2007. Available at http://tinyurl.com/4pkx4n.

Assuming that a 1-in-100 year storm does hit Florida, after the storm, will Florida's policyholders fit that profile?

Policyholders are now responsible for paying assessments from three separate sources: Citizens, the CAT Fund, and the Florida Insurance Guaranty Association (the Guaranty Fund). Citizens can assess policyholders directly, while the CAT Fund and Guaranty Fund levy assessments on insurance companies who pass them on to policyholders. The report of the House Insurance Committee chairman concluded that in the event of a 1-in-100 year storm, Florida policyholders could be liable for over $35 billion in assessments—$10 billion from Citizens, $25 billion from the CAT Fund, and an additional amount from the Guaranty Fund. To break the problem down to a more personal level, there are presently 6.2 million households in Florida. $35 billion in assessments (excluding further assessments by the Guaranty Fund) would result in an average assessment bill of $5,600 per household. Applied to a commercial setting, a Florida business that presently pays $1,000,000 in property insurance to Citizens and another $1,000,000 in other assessable premiums could easily be assessed for over $2,000,000 under the present plan. Citizens policyholders will be assessed first and most, but in the event of a 1-in-100 year storm nearly all policyholders (except workers compensation and medical malpractice) will be assessed.

Will the policyholders of Florida stand for that if "the big one" hits? And if they do not pay their assessments, and Citizens and the CAT Fund cannot quickly float an unprecedented bond issue, how will the claims get paid? What will be the impact on the state's economy?

When lawmakers put this system into place, they told policyholders that they were saving them from abusive insurance companies. In fact, they were saddling them with a huge IOU. Most Florida policyholders do not know this. A January 2008 survey commissioned by the Property Casualty Insurers Association of America found that 71 percent of Floridians do not know that the law now allows Citizens and the CAT Fund to assess virtually all policyholders in the state.[6]

A Federal Bailout?

Perhaps lawmakers are assuming that if the big one does hit, the feds will bail Florida out. Floridians may not be happy to learn that the state's real hurricane insurance plan is to go hat-in-hand to the federal government and hope for the same prompt and efficient rescue that was enjoyed by the residents of Louisiana and Mississippi after Katrina. Even if

[6] Florida Statewide Poll conducted by Neil Newhouse of Public Opinion Strategies for the Property Casualty Insurers Association of America. The poll was taken January 20–22, 2008 of 800 likely Florida voters. Available at http://tinyurl.com/4dcwc3.