RESEARCH REPORT

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Reducing the Concentration of Risk in Florida's Property Insurance System

Storm damage from Hurricane Charley in Arcadia, © USGS

A Product of the Florida TaxWatch Research Institute, Inc.

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Introduction

Every Florida homeowner lives with the risk of hurricanes and the property damage those hurricanes can cause. Those who purchase property insurance mitigate their potential losses; however, the structure of Florida's property insurance system is such that a large enough storm could cause many insurers to become insolvent and cause some state-backed components of the property insurance system to not have the means to pay out claims.

The state-run components that figure prominently in Florida's property insurance system are the Florida Hurricane Catastrophe Fund (FHCF), Citizens Property Insurance Corporation (CPIC), and the Florida Insurance Guarantee Association (FIGA). The FHCF is a state-run reinsurance-like entity which provides reinsurance at a rate below market value that every residential property insurer in Florida is required to purchase. CPIC is a nonprofit, tax-exempt, quasi-governmental corporation whose public purpose is to provide insurance protection to Florida property owners throughout the state. FIGA is a state-run nonprofit corporation that was created by the Florida legislature in 1970 to handle claims of insolvent property and casualty insurance companies.

The other key parts of Florida's property insurance system are private insurers and reinsurers, and the state and local governments of Florida. In the event of a large enough storm, or series of storms, it is possible that all three public (and quasi-public) components of Florida's property insurance system (FHCF, CPIC and FIGA) plus the State of Florida itself will need to issue bonds to pay for hurricane damage. Because the property insurance system has interrelated effects, bonding to pay for claims and the resulting assessments by FHCF, CPIC, and FIGA could negatively affect the whole private property insurance system. The probability that these entities will need to bond is higher due to the way that the FHCF and CPIC are funded, and from the large amount of exposure these entities cover.

Governor Rick Scott has shown concern over the need for reform of Florida's hurricane insurance system. To date, FHCF has submitted a proposal for reform to present before the state legislature. CPIC is expected to do the same to actively reduce the size of CPIC, and the more than $500 billion in exposure associated with CPIC.

Florida TaxWatch has repeatedly studied Florida's property insurance situation, beginning with a comprehensive look in April 2009, and most recently with an in-depth quantitative analysis of FHCF reform proposals in November 2011.

A Vulnerable State

While all 19 states along the eastern seaboard and the Gulf of Mexico are vulnerable to the onslaught of hurricanes, Florida has a combination of factors that uniquely raise the potential losses from a storm – specifically natural geography and man-made infrastructure.

Obviously, Florida's geographic position places it directly in the highest zone of hurricane activity, but global location is not the only geographic risk factor. Florida has a larger coastline-to-land-mass ratio than any other state, meaning that Florida has the most exposed coastline of any hurricane-prone state. Furthermore, Florida's farthest inland point from the coastline is 90 miles, which is only a portion of the size of a large hurricane. To put this into perspective, Hurricane Andrew's wind field was 120 miles wide and Hurricane Katrina's was 150 miles wide. Therefore, not only is Florida a hurricane-prone state with a significant amount of coastline, but also every square mile of the state is clearly at risk in the event of a major hurricane making landfall.

Florida's rapid growth, especially along the coast, has also led to increased risk to the property insurance system. The concentration of wealth along Florida's coastline means that the cost of damage caused by hurricanes has increased over the past decades, even though the probability of hurricanes hitting Florida has remained the same. Florida now has more than $2.5 trillion of total insured coastal property value. Recent growth along the coast has contributed to this situation; according to the Insurance Information Institute, from 2004 to 2007 there was a 27 percent increase in exposure to insured coastal property from $1.9 trillion in 2004 to $2.5 trillion in 2007.[1]

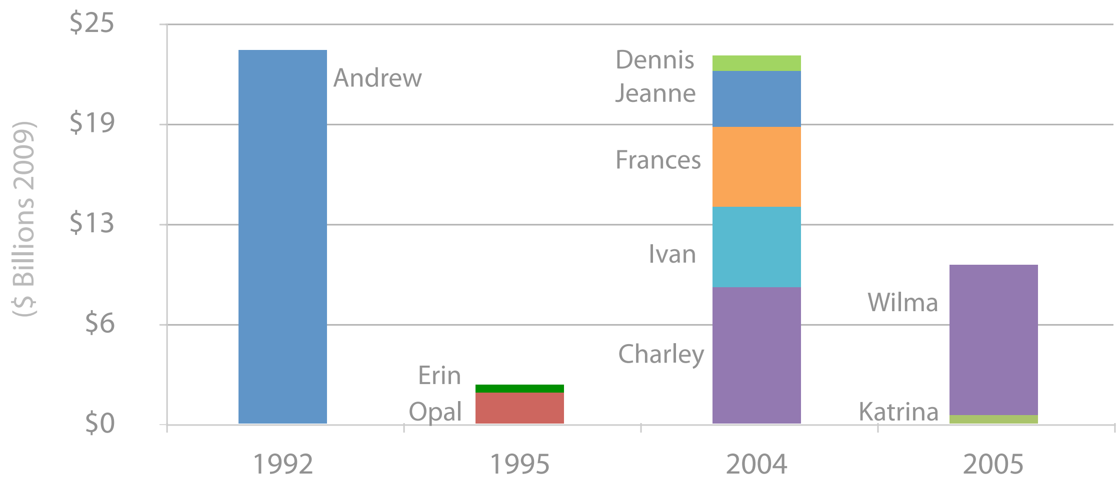
The following chart shows the 10 most costly hurricanes by insured losses to strike Florida over the past three decades (1980 – 2010).

Figure 1: Total Insured Losses ($ Billions 2009)

Note: The losses in this chart do not include flood damage covered under the National Flood Insurance Program
Source: Insurance Information Institute, June 2011

The three costliest years for insured losses from hurricanes in Florida demonstrate two distinctly different patterns. In 1992, Andrew showed how just a single hurricane could account for the worst year on record. Conversely, 2004 and 2005 show how the clustering of hurricanes can quickly add up to billions of dollars in losses.

Figure 2: Florida's 10 Costliest Storms by Year and Insured Damages (1980-2010)



Clearly, the nation's fourth most populous state has the potential of significant hurricane damage losses. While Florida has just seen six years without a hurricane making landfall in the state, each hurricane season brings the risk of a major storm or multiple storms making landfall on Florida shores.

Section 1

The Problem with CPIC: Florida's largest property insurer puts all Floridians at risk

Background

The Citizens Property Insurance Corporation (CPIC) was created by the Florida Legislature in August 2002 as an "insurer of last resort" by combining two public entities: the Florida Windstorm Underwriting Association (created in 1970 to provide wind-only coverage in coastal regions) and the Florida Residential Property and Casualty Joint Underwriting Association (created in December 1992 following hurricane Andrew). Today, CPIC offers three different accounts based on the property location and type (i.e., residential or commercial):

- Coastal Account (formerly known as the High Risk Account or HRA): provides wind-only policies in limited coastal areas of the state;
- Personal Lines Account (PLA): provides multi-peril policies throughout the state of Florida; and
- Commercial Lines Account (CLA): provides commercial residential (mostly condominium) policies throughout the state of Florida.

History of CPIC – Insurer of Last Resort to Largest Insurer in the State

As an insurer of last resort, CPIC was originally required by statute to charge rates that were actuarially sound and not competitive with private insurers, and was limited to residual property and casualty coverage. To accomplish the goal of CPIC remaining in the residual market, the rates charged for each line of business, excluding those charged for wind-only policies, had to be equal to or higher than the rates charged by the insurer with the highest average rate in that county. For wind-only policies, the maximum premium increase was limited to 10 percent per year.[2] In 2006, angry Florida property owners formed *Homeowners Against Citizens,* and actively fought for CPIC to offer lower insurance rates.

A major catalyst for the organization of *Homeowners Against Citizens* was the 2004 and 2005 hurricane seasons when eight named storms made landfall in Florida, causing significant hikes in property insurance rates. During the 2004 season, four major hurricanes hammered the Florida coastline. More than 1.7 million claims were filed, involving all 67 counties. One fifth of Florida residences suffered damages. CPIC suffered a $516 million deficit, which translated to assessments on non-CPIC policyholders. A year later, while most of the nation's attention was focused on the horrific damage Hurricane Katrina caused in Louisiana and the neighboring Gulf Coast states, another four hurricanes made landfall on various sections of the Florida peninsula. One of these storms was Hurricane Wilma, the fourth costliest insured hurricane strike in American history (based on estimated insured losses for property coverage, in 2009 dollars).[1] Wilma clobbered Southeast Florida where CPIC had huge concentrated exposure, triggering deficits in each of the three accounts listed above, including a nearly $2 billion deficit in the Coastal Account.

To fully appreciate the scope of the 2004-2005 period, consider that at the end of the sixteen-month period (which encompassed segments of two hurricane seasons), Florida had averaged one hurricane strike every sixty days. The Florida Legislature appropriated more than $700 million to address the resulting deficits in CPIC's Personal Lines and Commercial Lines Accounts, while any leftover funds were used to reduce the Coastal Account shortfall.

Protests from *Homeowners Against Citizens* got results in 2007, when state policymakers made several changes that made CPIC more readily available to the masses. In 2007 statutory amendments were made so that a CPIC policy could be issued to anyone who could find coverage offered by a private insurer for "basic policy including wind coverage" at least 15 percent greater than the premium for comparable coverage by CPIC.

Now far from an insurer of last resort, CPIC is the largest property insurer in Florida. As of September 2011, CPIC had a 27.6 percent share of all premiums written in Florida for Personal and Commercial Residential lines of insurance. As of October 2011, CPIC had 1.47 million policies extending approximately $508 billion of property coverage to Floridians in all 67 counties.

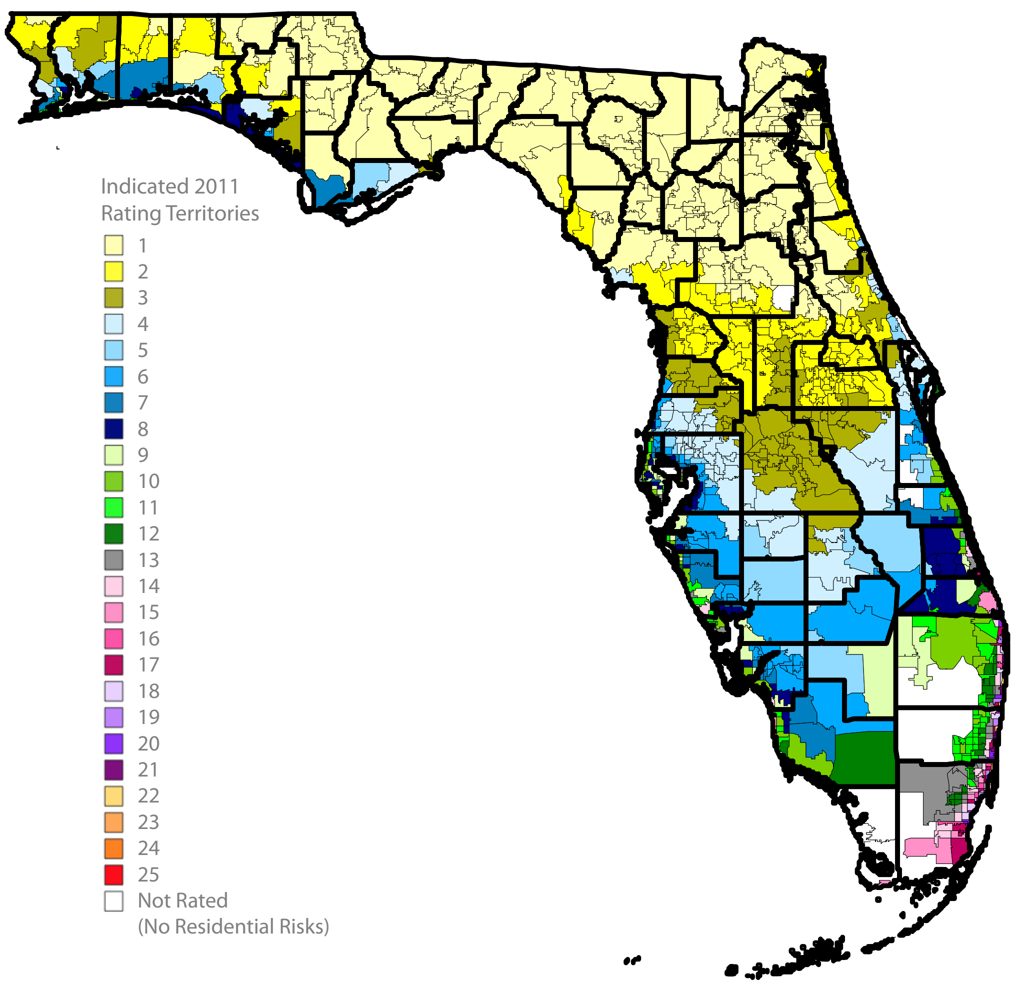
The 2007 statutory changes that expanded eligibility for coverage by CPIC partially explain the growth of CPIC from insurer of last resort to the largest insurer in the state, but another significant factor leading to CPIC's expansion was a rate freeze in 2007, when the premiums for CPIC were statutorily prevented from increasing. Increased competition from CPIC's artificially low rates caused several major private companies to contemplate leaving the state because they were unable to compete with the state-backed CPIC. The rate freeze ended in 2010.

The changes to CPIC have created two artificial competitive advantages that lower its operating costs compared to private insurers: its tax exempt status and the fact that it does not have to keep as large of a surplus of cash reserves to pay off claims because it can rely on surcharges and assessments to raise money after a hurricane hits.

A major problem that should not exist with a competitive property insurer is that CPIC holds a significant amount of the most risky exposure in the state. Figure 3 shows the risk of hurricane landfall in Florida. The pink and red shading indicates areas with highest risk of hurricane losses.[3]

Figure 3: Florida Hurricane Catastrophe Fund

Indicated 2011 Rating Territories by 5-Digit ZIP Code



Clearly, the highest risk is in Southeast Florida. When looking at CPIC's total exposure by county, it is evident that 58.04 percent of all CPIC policies and 64.38 percent of all CPIC exposure is concentrated in just five high-risk counties. The table below shows the top five counties by total amount of exposure from all lines of CPIC property insurance, and the remaining combined 62 counties amount of exposure, premiums charged, and number of policies.

County	Total Exposure	Total Premium	Policies In-Force	Percent of Total Exposure
Dade	$111,526,335,564	$820,871,840	277,011	21.76%
Broward	$79,487,224,227	$511,164,109	215,019	15.51%
Palm Beach	$64,352,583,717	$368,788,852	147,458	12.56%
Pinellas	$48,575,686,553	$284,245,014	151,744	9.48%
Sarasota	$26,002,170,599	$109,173,790	66,373	5.07%
Other 62 Counties	$182,561,999,340	$973,271,579	620,113	35.62%
TOTAL	$512,506,000,000	$3,067,515,184	1,477,718	100.00%

Because there is a high concentration of CPIC policyholders in the riskiest part of the state, a large storm in that area could cause major losses to CPIC. High losses to CPIC increase the probability that CPIC will need to raise money from taxpayers in other areas of the state through assessments not only on CPIC policies, but also on non-CPIC property and casualty insurance policies.

Assessments

Even though it was created as a quasi-governmental corporation, CPIC was empowered to raise money by levying assessments on insurance policy holders if money was needed to pay claims or repay bonds issued to pay claims. This power includes the potential to levy assessments on all property insurance policyholders, not just CPIC policyholders. The three types of assessments that CPIC can employ are: CPIC Policyholder Surcharges, Regular Assessments, and Emergency Assessments.[4] Each CPIC account (i.e., the Coastal Account, the Personal Lines Account, and the Commercial Lines Account) is considered a separate entity with respect to the determination of deficits and the levying of assessments.

CPIC Policyholder Surcharges: CPIC Policyholder Surcharges assess CPIC policyholders as much as 15 percent of their policy premium for each of three CPIC accounts that are in deficit. Therefore, a CPIC customer with only one policy through any one of the three CPIC accounts could be assessed as much as 45 percent of their policy premium if all three accounts have deficits and the maximum assessment is imposed.

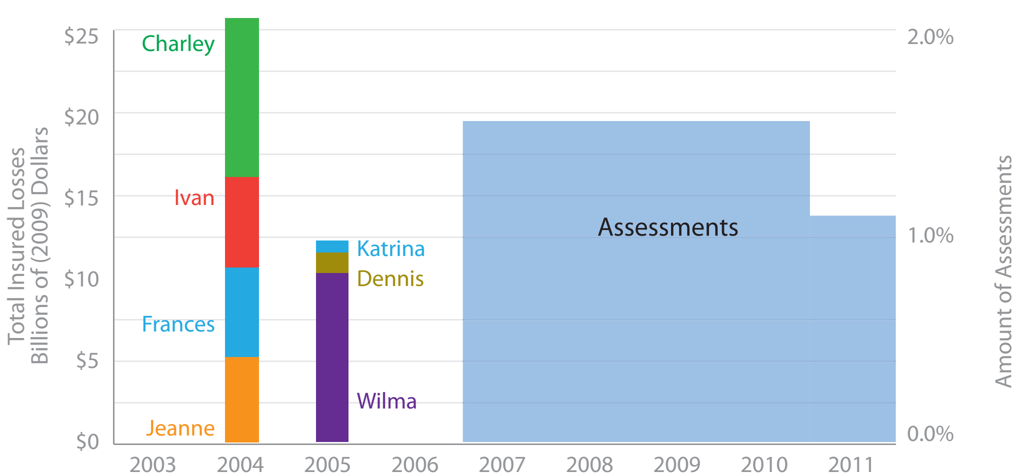
Regular Assessments: If the amount of assessments collected from CPIC Policyholder Surcharges does not raise enough money, Regular Assessments up to 6 percent of the premiums per policy can be implemented for all property and casualty insurance policies issued by private insurers (i.e. all policies except CPIC policies), with the exception of Workers' Compensation and medical malpractice policies.

Emergency Assessments: If CPIC Policyholder Surcharges and Regular Assessments are insufficient to pay CPIC claims, Emergency Assessments can be imposed in one of three ways. Floridians who have any property and casualty insurance policy in the state (except Workers' Compensation and medical malpractice policies) can either be charged up to 10 percent of their premium per policy, or up to 10 percent of the deficit per maximum of 30 percent, or 10 percent of the aggregate statewide assessment base (i.e., the total direct policies written for the prior year), whichever is greater.[5]

CPIC Policyholder Surcharges and Emergency Assessments are levied directly on property and casualty insurance policies (and therefore policyholders). Regular Assessments, however, are levied on the private insurance companies in the state based on the value of premiums they have issued and are due from the insurance companies within 30 days of assessment. The insurance companies are then allowed to attempt to collect the money back from policyholders through assessments on those policies over the following years.

The last Regular Assessment was issued to pay for the 2004 and 2005 hurricane season claims and was issued in 2006. Currently, a 1 percent emergency assessment is still being levied on all property insurance policy-holders in Florida through 2016. The graph below shows the 2004 and 2005 insured damages per hurricane and subsequent assessments applied in Emergency Assessments from CPIC.

Figure 4: Florida Insured Hurricane Losses and Emergency Assessment Amount Levied by Citizens Ins. Co. (CPIC)



Note: 2011 annual assessment of 1% is applicable until further notice Note: Insured damage amount for Rita not available.
Source: Florida CFO P&C General Current Assessments

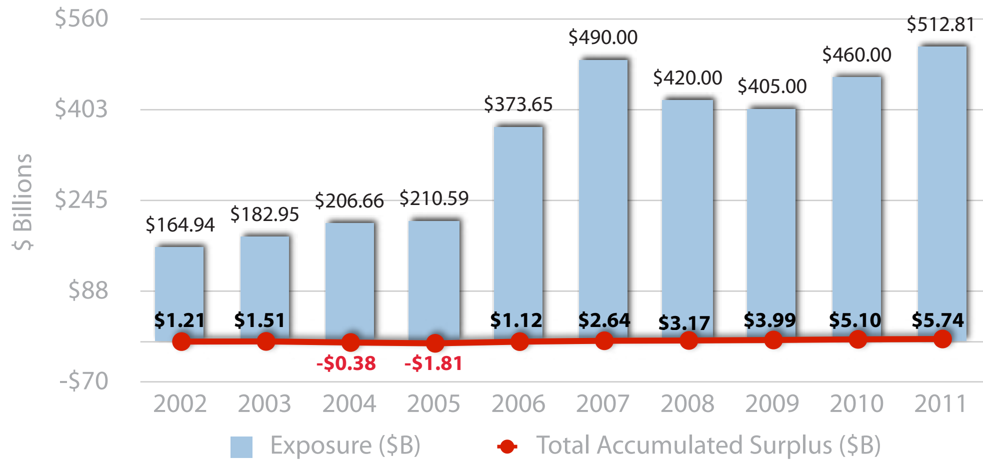
One of the reasons that CPIC was granted the power to levy assessments was that CPIC was designed to be the state's "insurer of last resort," providing affordable policies to those who were otherwise unable to obtain private property and casualty insurance; however, the assessment mechanism creates a financial risk for all Florida taxpayers who own a property and casualty insurance policy. This financial risk grows with the size of CPIC and is especially concerning given the current financial situation of CPIC.

Financial Situation – CPIC Assets & Potential Liabilities

Although CPIC has significant assets, its massive potential liabilities mean that assessments will be a near-certainty following a catastrophic storm. Although the 2011 hurricane season passed without a major storm making landfall in Florida, the assets and liabilities from late 2011 paint a frightening picture. With $5.74[6,7] billion in projected cash-on-hand (termed "accumulated surplus" by CPIC) in October 2011, CPIC has approximately one-quarter of the amount necessary to cover losses in a hundred-year storm, which would total $22 billion.[8] When including $6.95 billion in reimbursements from the FHCF reinsurance (assuming that the state-run reinsurance-like entity can pay out its obligations to CPIC) and $575 million in private reinsurance purchased for the 2011 storm season, CPIC would still have been unable to pay its claims. This shortfall would lead to bonding and the imposition of surcharges and assessments. Assuming CPIC raised the $1.17 billion in possible maximum CPIC Policyholder surcharges and $5.58 billion in possible maximum Regular Assessments, the total amount to cover liabilities increases to $19.66 billion, which is still more than $2 billion short. The regular assessments from CPIC and FIGA are mandatory no-interest loans, due in 30 days, from private insurers. Therefore, CPIC would have to levy Emergency Assessments on all property and casualty insurance policies, in addition to CPIC Policyholder Surcharges on all CPIC policies and the Regular Assessments on all property and casualty insurance policies, in order to cover claims costs.

The graph on the next page shows the amount of insured property exposure that CPIC has maintained annually from 2002 to 2011 compared to the "accumulated surplus". As mentioned above, the "accumulated surplus" is cash-on-hand, not including pre-event bonding that has to be repaid, bonding capacity, or the capacity to collect money through assessments that would be used to repay bonding costs.

Figure 5: CPIC Exposure Compared to Accumulated Surplus



Source: CPIC STAT Audited Financial Statements, Florida Senate Issue Brief 2012-226, CPIC Corporate Financials

The probability that a storm would cause enough damage to equal the full amount of exposure that CPIC has in its policies is extremely minimal – almost impossible; however, it is alarming that the ratio of maximum potential claims to cash on hand is nearly 100 to 1, meaning that for every $100 of exposure that CPIC has from policies, it only has $1 of cash on hand to cover that exposure. A private insurance company would not be able to have such a concentration of policies in Florida without substantial amounts of reinsurance plus liquid assets.

The key reason why this ratio of cash to exposure is so low results from the CPIC rate freeze occurring from January 2007 to December 2009. In order to correct this ticking financial time bomb, CPIC was put on a "glide path" to increase rates toward financial stability through raising rates until they are "actuarially sound." The "glide path" method to reach actuarially sound rates only allows a maximum of 10 percent rate increases to any single policy annually; however, stability could be more than five hurricane-free years away and some say that steeper increases may be needed.

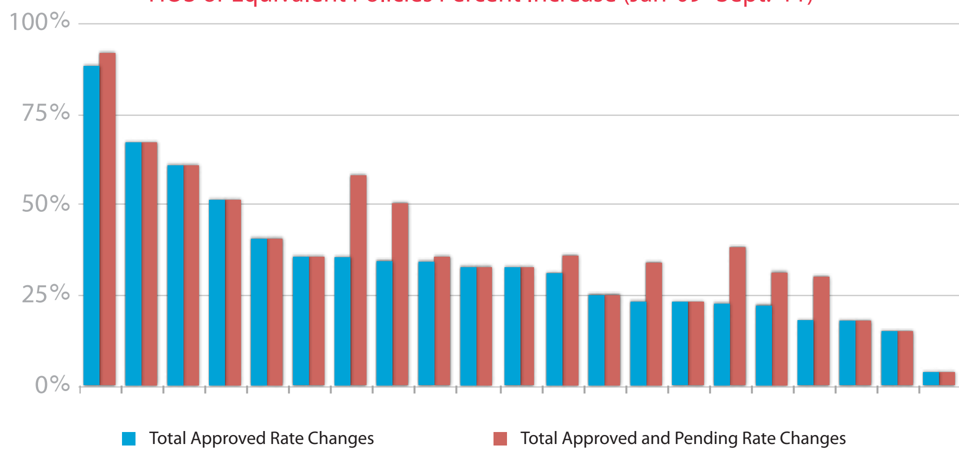
The Glide Path

The glide path was a method implemented in January 2010 to reach the goal of CPIC having actuarially sound rates, however, when comparing the approved and pending rate increases of private insurers in Florida with the maximum allowable premium increases for CPIC (10 percent annually) it is clear that this goal will not be achieved in the near future.

While CPIC does not have to charge rates that are actuarially sound because of its ability to levy assessments, private insurers must or else they will go out of business. Furthermore, private insurance companies must apply to the Office of Insurance Regulation (OIR) for rate increases, which are only approved if OIR determines that they are necessary and reasonable. Once rate changes are requested, it is possible for OIR to reject the change or approve it at a lower, or even higher, amount than requested by the company.

Comparing CPIC rate changes to private companies shows that CPIC rates are artificially low because they have not increased enough to keep up with market rates, even after the rate freeze was lifted in January 2010. The figure below shows the total approved and pending rate changes for "HO3 or Equivalent Policies" in percent change from January 2009 through September 2011 for the top 21 companies writing insurance in Florida. The HO3 policy is an owner-occupied residential policy that covers an occupied home, other structures, contents, additional living expenses and liability coverage. As of June 30, 2011, CPIC had 15.5 percent market share of HO3 policies in Florida.

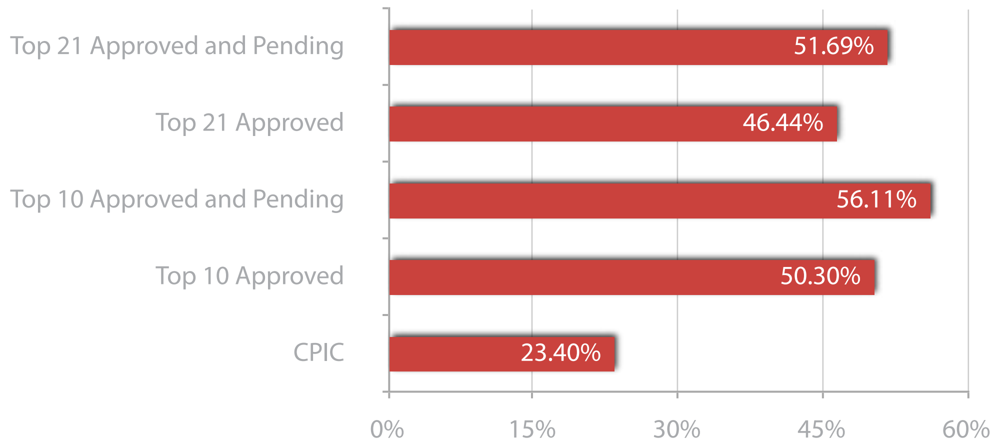
Figure 6: Total Approved and Pending Rate Changes Top 21 Writers - HO3 or Equivalent Policies Percent Increase (Jan '09- Sept. '11)



Source: Merlinos and Associates, Inc. using FREDMS Data

The median increase from January 2009 to September 2011 for an HO3 policy was 35.7 percent. When weighted by "average earned premium" to account for the size of the companies compared, the approved and pending increases for the indicated time period are more than 50 percent. Figure 7 shows for the top 10, as well as the top 21 companies, both the approved amounts as well as the "approved and pending" amounts.

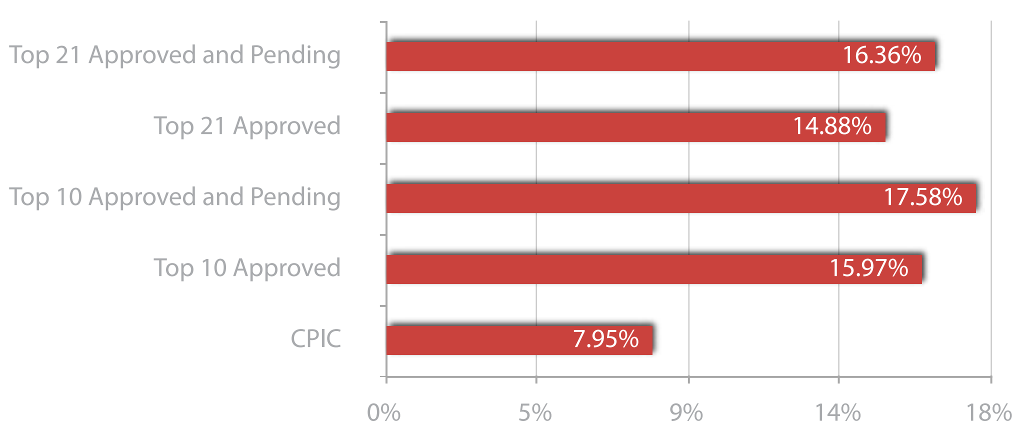
Figure 7: Top Private Insurers vs. CPIC Weighted Average of Percent Increases in Rates



Source: Merlinos and Associates, Inc. using FREDMS Data

Over the period Jan 2009 – Sept 2011, CPIC weighted-share premium increases did not keep up with OIR-approved market rate changes on this type of policy, even after the rates had been frozen since 2007. In fact, CPIC rates have increased less than half as much as its competitors over that 33-month period. Furthermore, the disparity would be higher if the time period went further back because of the rate freeze. If the increase is annualized, as in the figure below, it is apparent that the size of the increase executed by CPIC is not only significantly less than the private market increases, but also less than the maximum of 10 percent allowed by statute. The reason that CPIC rate increases are not at the maximum allowable rate increase is because rates were frozen until December 2009, so the annualized weighted average for CPIC only accounts for 21 months (January 2010 to September 2011) in which rates were able to increase. Also, some policies increased less than the 10 percent maximum, therefore those policies faced smaller premium increases.

Figure 8: Annualized Weighted Average of Rate Increases
Top 21 Private Insurers vs. CPIC



Source: Merlinos and Associates, Inc. using FREDMS Data

The rate freeze and the statutory limit on premium increase for CPIC have increased the disparity of rates between the CPIC rates and the private market rates, making CPIC significantly less expensive for some policyholders. However, the artificially lower rates led to more policyholders choosing CPIC and therefore creating even more financial exposure for Floridians by being held accountable for paying CPIC claims through assessments, effectively subsidizing CPIC policyholder rates.

Subsidized rates cause distortion of market signals; in this case, a policyholder whose rate is significantly subsidized has less incentive to mitigate their home against hurricane damage – creating more exposure for other policyholders of CPIC and private companies, plus FIGA and the state of Florida.

Many prominent and knowledgeable persons argue that the 10 percent glide path is insufficient. Florida Senator Garrett Richter, the chairman of the Florida Senate Banking and Insurance Committee, told the Gulf Coast Business Review that, "the 10 percent glide path is not sufficient to get those rates to an actuarially sound level within a reasonable period of time." Sen. Richter proposed a 20 percent annual increase in the past which he argues would initially be painful to businesses and homeowners, but would also attract more private insurance companies to Florida.

Overall, it is clear that CPIC's rates are too low by the fact that they have not kept up with premium increases that were requested by private insurers and approved by the OIR. Likewise, it is clear that the "glide path" is insufficient to achieve market rates for CPIC policies anytime soon. These artificially low rates put all Floridians at financial risk by increasing the likelihood that Florida policyholders will face assessments when a major storm hits the state.

Furthermore, the artificially low rates have spurred continued growth in CPIC. Even with the glide path in place after January 2010, CPIC added approximately 100,000 policyholders in the last four months of 2010. By the summer of 2011, it was adding an average of 4,200 policies a week. The concentration of risk within CPIC now means that CPIC's total liability exceeds half a trillion dollars.

Section 1 Conclusion

As of November 2011, CPIC had 1.47 million policies extending approximately $512.8 billion of property coverage to Floridians. This is not only a substantial number of policies and percent of the total residential exposure, but also all of the $512.8 billion in exposure (except the approximately 0.1 percent of total exposure that was covered by private reinsurance during the 2011 hurricane season) is entirely within the state.

One of the tenets of insurance is to diversify risk so that losses are not correlated with each other; however, the financial risk of damage from a hurricane hitting Florida is largely concentrated within CPIC rather than being spread around the country and the globe. This concentration of risk within CPIC increases the probability of surcharges and assessments being levied after a major storm – whether they originate from CPIC, FHCF, or FIGA – and makes Floridians vulnerable to paying large amounts in assessments over the coming decades to cover hurricane damage claims. Optimally, Florida should be diversifying the financial risk of a hurricane strike to other states and/or countries with lower probabilities of hurricane loss.

In addition to the concern created by CPIC consolidating financial exposure within Florida's borders, other problems originating from CPIC which adversely affect the rest of Florida's property insurance system and taxpayers include:

- The eligibility requirements to obtain a CPIC policy have been lowered enabling significant growth in policy numbers, making CPIC no longer the "insurer of last resort"
- The concentration of exposure in high-risk areas of the state places financial liability on the remainder of the state's policyholders to pay for hurricane damages
- CPIC's artificially low rates have made it the largest insurer in the state and resulted in the ratio of the amount of exposure held within CPIC to cash-on-hand to pay claims being nearly 100 to 1
- The Glide Path implemented in January 2010, intended to gradually make CPIC rates actuarially sound is insufficient to do so in a reasonable period of time

These important issues regarding CPIC must be addressed when determining the appropriate and most efficient measures of reforming CPIC. The following section discusses and analyzes some of the proposals to reform CPIC.

Proposed Solutions

An examination of Florida's property and casualty insurance system clearly shows that reforms are needed to better protect those who reside in Florida from risk of severe financial pressure from hurricane losses. Both state-backed components of the system, CPIC and FHCF, are underfunded and overexposed. Various reforms have been proposed, and more have been called for by top policymakers and elected officials, including Florida Governor Rick Scott. This section examines some of those proposed solutions.

Privatizing CPIC

In July of 2011, then-Chairman of the Board of CPIC Jim Malone discussed the idea of privatizing CPIC. There are two significant benefits of this proposal – assuming CPIC could be sold. First and foremost would be the reduction of exposure to the policyholders in Florida, given the probabilities of assessments on not only CPIC customers, but also all other (non medical malpractice and workers compensation) policyholders. Secondly, if CPIC could be sold, any cash proceeds would benefit the state.

While it is unknown whether CPIC has a positive value to potential investors, several issues make it unlikely that CPIC could be sold in its current form. One issue is that only a very large company or group of investors would be able to assume the nearly 1.5 million policies with more than $500 billion in exposure. Another issue is the type of policies in CPIC, many of which would be more suited to the residual market. Perhaps the most important issue is that a private company would not be allowed the use of the contingent capital (surcharges and assessments) that CPIC has available, thereby changing the cost structure significantly.

To estimate how many of the 1.5 million policies would be unattractive to a company looking to purchase CPIC, discussions were held with private insurers about what they look for when taking out policies in CPIC. These companies would almost certainly take the best risk, leaving the "adverse selection" risk in CPIC. Here are some of the types of risk they typically seek to avoid:

- 50+ year old homes – Most companies do not write insurance on older homes. Even 20 to 30-year old homes are typically written with restrictions (i.e. water damage).
- Mobile homes more than 25 years old, and 1994 and prior in family (non-adult-only) parks – Private insurers will usually take mobile homes on private lots or in established retirement communities (even pre-1994 mobile homes).
- Anything in the Coastal Account – Although some of these policies are "taken out," these are typically passed over as takeout candidates, because they skew the

company's probable maximum loss (PML). Companies that take these policies typically have multiple policies in the non-Coastal areas to offset the increase in PML.

- Something that has been in CPIC for a long time – Companies have the opportunity to "take-out" the good properties – anything left in CPIC for a long time is likely not considered the best risk.
- Properties with prior claims – especially a history of multiple claims.

According to CPIC, only 59,792 policies were assumed in 2010 (by 6 companies), with only 3.7 percent of those in the Coastal Account. Year-to-date figures for 2011 show that 33,642 "take-out" policies were assumed (by two companies). Given that this small number of policies have been taken out compared to the nearly 1.5 million policies in CPIC, it is unlikely that a private market company would be willing to take the entire amount of CPIC policies and pay for them.

The proposed solution to fully privatize CPIC is unlikely to be achieved because CPIC was conceived as an insurer of last resort and therefore has many extraordinarily high-risk policies that private insurers would not want to acquire. There are also statutory restrictions on privitization, such as limitations on take-out bonuses, and the fact that policyholders do not have to accept a take-out offer.

Hurricane Insurance Coalition Inc., Proposal

In 2006, volunteers from St. Petersburg, Florida, with the leadership from former State Representative Don Crane, began researching solutions to Florida's property insurance market problems. In 2009, Mr. Crane, attorney Bill Ballard, businessman Bud Riser, and others formed the Hurricane Insurance Coalition Inc. (the Coalition), as a nonprofit corporation to continue efforts to find a solution to the uncertainty in Florida's property and casualty insurance market.[11]

The challenge for the Coalition was in developing a low-cost, steady, rate-stable means of paying the costs of property damage and temporary living expenses of Florida homeowners affected by hurricanes.

The Coalition acknowledges the problems with the current system – laid out clearly by Florida TaxWatch in this report and others – but argues that while deregulating property insurance rates in the state may be an obvious answer, it is not the best answer because of the need for significant increases in policy rates in order for the system to become financially sound.

The solution devised by the Coalition is that the FHCF and the wind insurance portion of CPIC be combined and transformed into the exclusive property and casualty insurer of hurricane damage for all of the state's residential wind insurance called the Hurricane Fund (HF). The HF would be a nonprofit, tax-exempt government agency that would be self-financed through charging actuarially sound rates based on risk from multiple-year hurricane strike records and hurricane predictive loss models. If implemented now, the HF could begin with cash-on-hand from the FHCF ($7.369 billion)[9] plus the wind risk portion of the cash-on-hand from CPIC (some portion of $5.742 billion).[10] Even though the HF would start with more than $7 billion in cash-on-hand, it would also assume all of the residential wind insurance exposure in Florida; an amount that is a great deal larger than the initial cash-on-hand.

The HF would determine a total premium to be allocated among all residential insured property. The premium would consider expected annual losses, operating expenses, commissions to primary insurers for their services (providing the HF homeowners insurance), and a surcharge to build a surplus of funds in years that have little or no hurricane damage. Homeowners' wind insurance rates would be determined and incorporated with rates offered by private insurers who would issue policies and deal directly with customers.

Once fully functioning, the HF would build a cash surplus owned by the people of Florida during years when few or no hurricanes hit Florida to pay for future damages. In this way, Florida's state-run property insurer would act as a before the fact funding system as opposed to the current after the fact funding system. The HF would still be able to borrow money against future revenues if claims exceed total assets in any year. One part of the Coalition's solution would be that that the federal government would agree to provide credit to the HF if it needs to borrow money to pay out claims in the event of a catastrophic storm or storm season. In fact, FHCF officials have acknowledged that the federal government is the only funding entity that holds the capacity to bear the timing risk associated with the probability of a catastrophic storm.[11]

The essence of the Coalition's proposal is to determine what Florida residents need to pay, year after year, to fund a stable and reliable residential hurricane insurance fund. In order to ensure financial solvency, the aggregate premiums charged would be adjusted annually for increases and decreases in insured exposure in Florida, but the plan would still provide stability in rates and would reduce or eliminate the risk of assessments to policyholders (depending on how the system was designed to repay any loans that are needed – most likely through future revenues, but possibly through a combination of future revenues and assessments).

The Coalition developed a quantitative model to test their proposal and made the model publicly available in early 2011. The Coalition contends that the model shows that hurricane insurance premiums on average would have to go up, not down, under their proposed system, but they indicate that the increases would be substantially less than the premium increases likely to occur if rates charged if the present system were deregulated.

One positive effect resulting from implementation of the Hurricane Fund is that by continuously building a surplus of funds from hurricane seasons with minimal or no storm losses, the stability and reliability of Florida's insurance system would increase. Also, because the surplus of funds would be owned by the people of Florida, during non-hurricane months it could be invested by the HF to earn interest on the cash build-up which would then be placed back into the fund, providing further rate stability.

Another possible positive effect of the HF solution is that private insurers would be able to eliminate residential wind insurance from their portfolio, but still provide all other forms of property and casualty insurance to their Florida customers. Many well-capitalized insurers have withdrawn from or reduced exposure in Florida's residential property insurance market due to the catastrophic nature of Florida hurricane risk. Elimination of this risk should bring private insurers and private capital back to Florida, which would enhance competition and reduce the cost to homeowners of insuring non-catastrophic risks.

Finally, this solution is viable. The Coalition has developed and made available a quantitative model to test the viability of the proposal. While assumptions can vary, the model generally shows the feasibility of the proposal as long as the federal government agrees to participate.

With the positive of this proposed solution, there are also potential negatives. If a single entity controlled all residential wind insurance in the state, there would exist no competition to keep administrative costs down. While there is no way to predict whether or not administrative costs would be higher or lower for the HF than for private insurers, the lack of market forces exerting downward pressure on costs would likely lead to administrative cost increases over time.

Furthermore, although the HF would start with a cash balance of more than $7 billion from combining the cash on hand of FHCF and the wind portion of CPIC's cash-on-hand, and the surplus could be invested and added to with future premiums, the insured risk in the state would far outweigh the cash on hand (e.g., the total exposure could easily exceed $1 trillion). A significant storm or storm season causing a large amount of damage could deplete the cash on hand and potentially require Florida to borrow money (especially in the first few years the HF is implemented), whether from the federal government or not, and it would be increasingly difficult and take longer for the HF to rebuild a surplus.

Overall, the Hurricane Fund proposal could solve many of the problems with CPIC. It would be financially sound if it were able to charge actuarially sound rates, it could reduce the possibility of assessments on Floridians (depending on how its access to contingent capital is designed), and it would encourage private capital and private insurers to invest in Florida again. It could also offer stable rates for wind insurance, possibly at lower rates than private insurers. However, it would continue to concentrate all the financial liability of hurricanes within Florida, and it depends on the agreement of the federal government to participate as the lender to the HF in the event of a major storm.

The HF solution is a viable one, and the Coalition should be commended not only for proposing this solution, but also for developing a model to test its viability; however, the federal government must first agree to act as a credit source for Florida's homeowners property insurance for this solution to be plausible for Florida.

Other proposals

Due to the concern with CPIC's highly concentrated risk and growing policy count, Governor Rick Scott has asked CPIC to propose solutions to address these problems at the December 6th, 2011 Cabinet meeting. Currently the only proposals given in detail by various groups are those discussed above; however other general proposals have been discussed. Those include:

- A one percent increase in Florida's sales tax to fund the FHCF, thereby reducing the risk that CPIC and private insurers are fully paid their reinsurance claims from the FHCF.
- Creating a trust fund or "hurricane account" to aid in paying for hurricane damage claims by taking a portion of money from the general revenue fund.

CPIC's underwriting committee stated that it could reduce some of the company's exposure by limiting policies on coastal homes to a value of $1 million rather than the current $2 million cap. This would eliminate approximately 7,500 CPIC policies. Furthermore, it was recommended that CPIC limit homeowners' liability coverage to $100,000 from the current $300,000 maximum, and eliminate its optional buyback.[12] There are also other proposals to consolidate risk entirely within a state government entity similar to, but with structural differences from, the Hurricane Coalition Inc.'s proposal. One of these includes funding the entity directly with a percentage of all state tax collections.

Windstorm Mitigation

Windstorm mitigation has been a significant pre-event effort of the Legislature in trying to reduce property damage occurring from hurricanes. Windstorm mitigation gives discounts, credits, or other rate differentials to policyholders as an incentive to harden their homes against the damaging effects of hurricanes. A number of windstorm mitigation efforts have been undertaken without significant success. Furthermore, fraud has been an issue with these programs and there is concern about the effectiveness of windstorm mitigation programs generally. Despite a minimal history of success and numerous widely-acknowledged problems, windstorm mitigation programs should continue to be considered as an important part of the overall solution.

Conclusion

The potential of assessments by CPIC likely dampens capital investment in Florida, which influences the Florida economy even in years without hurricanes. Furthermore, this probability dissuades insurance companies from entering the Florida insurance market, making the market even less competitive.

Reform is clearly needed in the state's property insurance system to reduce taxpayer liability. Although there is no simple solution to such a complex issue with so many interrelated parts, the short-term reforms that should be considered to lessen the economic impact of a catastrophic hurricane include:

- Statutorily setting market-oriented rates for CPIC coverage to ensure that CPIC is financially stable and able to pay claims without the risk of holding all Floridians with private property insurance liable
- Restoring CPIC to its previous status as the "insurer of last resort" while increasing transparency of who would receive subsidized property insurance rates and at what cost
- Reforming the system of giving mitigation credits to promote incentives for homeowners to harden their homes against storm damage

Most of all, any policy reform recommendations, whether comprehensive or focused on a specific part of system, must be carefully scrutinized. These recommendations should include comprehensive quantitative analysis of the costs, benefits, and effects on all the components of the system. We commend the Florida Hurricane Coalition, Inc., for developing a quantitative model to analyze their proposal as a starting point for discussion. Quantitative analysis is a key step to ensuring that sound reform policies are implemented. Whatever reforms are enacted, extensive modeling must be done and tested by actuaries and economists, as there are numerous "moving parts" that must be considered in any plan.

Given the unpredictability of hurricanes, Floridians live in jeopardy of experiencing a catastrophic hurricane season. A reliable property insurance system must be in place so that Floridians are financially prepared to withstand and recover from significant hurricane damage.

Florida TaxWatch looks forward to quantitatively analyzing proposals, including CPIC's and additional credible proposals from other groups or individuals.

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7. Note: According to the CPIC 2011 Budget, the projected surplus 12/31/2011 is $5.174 billion.

8. Note: The projections for the cost of a hundred-year storm vary widely. The estimate used for this analysis, $22 billion, is at the low end of that range. Some, if not many, estimates put the number twice as high or more.

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