Windstorm Insurance Legislative Oversight Board
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I have always been told and am now convinced that one of the least painful ways to learn life's difficult lessons is to study and learn from the mistakes of others.

As a former Florida Legislator I hope to share my perspective about homeowners insurance based upon what I like to call the "Florida Grand Experiment".

If you choose to learn from Florida's mistakes it could just save you considerable pain.

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It is a little recognized fact that in Western Cultures we tend to focus on symptoms rather than the root cause(s) of our problems.[1]

In some high profile cases, such as Band-Aids and Tylenol, this tendency has made some folks a lot of money.

In Florida we have, with the very best of intentions, crafted a solution (HB1A) to the wrong problem (high homeowners premiums).

High homeowners premiums are not the problem, rather they represent one of the painful symptoms.

Unfortunately, in this case Band-Aids and Tylenol are not going to get the job done.

If high homeowners premiums are not the problem then <u>what is the problem</u>?

Simply stated, our "problem" is: 1) Hurricanes and Florida's extraordinary vulnerability to the same and 2) Increased wealth and population patterns such as our stubborn behavior of building in very dangerous places while expecting that someone else will pay the bill – that's the problem.

Any attempt to artificially lower the price of insurance without addressing the cost of hurricanes will be unsuccessful in the long term.

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[1] See: Ominous Parallels: The National Financial Crisis and Hurricane Insurance
By Donald D. Brown, Dennis A. Ross and Leonard Schulte
Published in The Journal of the James Madison Institute – Winter 2009, Page 16-26
http://www.jamesmadison.org/pdf/materials/654.pdf

Political decisions made for the purpose of artificially lowering property insurance rates for homeowners in high-risk areas will expose the state's taxpayers to massive liabilities if a single major hurricane were to hit one of the state's heavily populated areas.[2]

Since we are not yet capable of changing the direction or intensity of tropical storms, the only meaningful way to bring down that cost is to reduce the risk, i.e., building codes enforcement, mitigation, and most importantly, a change in human behavior.

Let's discuss briefly what HB1A did:

Citizens Property Insurance Corp. "Citizens" was originally intended to be Florida's property insurer of last resort. It was formed in 2002 by the merger of two state-created insurers, the FWUA and the FRPCJUA.

"Citizens" had been subject to strict requirements that limited eligibility to property owners who were not able to get coverage from admitted carriers at any price.

"Citizens" was also subject to ratemaking standards that required it to charge noncompetitive rates pegged to the highest rates in the market.

The thrust of HB 1A was to move toward lower rates for "Citizens" and to establish it as a competitor with the private sector, rather than an insurer of last resort.

The biggest change for Citizens was the expansion of its assessment base.

After HB1A all property and casualty premiums except for workers' compensation and medical malpractice were made subject to "Citizens'" deficit assessments; prior law applied assessments only to personal lines and commercial property premiums.

Florida Hurricane Catastrophe Fund ("Cat Fund") The Cat Fund was established in 1993 to provide a layer of reinsurance coverage for all Florida residential property insurers.

As constituted prior to the new law, the fund provided up to $16 billion in coverage for residential losses above an aggregate industry retention of $6 billion.

All residential property insurers are required to participate in the fund.

Cat Fund premiums are generally considered to be roughly 20 percent to 30 percent of the price that the insurer would otherwise pay for comparable private reinsurance.

The fund is exempt from federal taxation and has the power to issue tax-free bonds.

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[2] See Florida Taxwatch Coverage at: http://www.publicbroadcasting.net/wfsu/news.newsmain/article/0/0/1632766/WFSU.Local/Taxwatch.Report.Says.Florida.May.Be.A.Hurricane.Away.From.Financial.Crisis

In the event of a deficit, the fund issues bonds and levies assessments on all Florida property and casualty premiums except for workers' compensation premiums to provide a revenue stream to pay off the bonds.[3]

HB 1A added several new layers of Cat Fund coverage, as follows:

1. New Optional coverage below the standard Cat Fund retention was authorized.
2. Optional coverage in excess of the standard Cat Fund cap up to $28 Billion.

Cautionary Note: A catastrophe fund violates one of the fundamental tenets of insurance – spreading the risk.

It also supplants existing private sector reinsurance, which is fully paid for in advance.

Private reinsurance spreads the risk globally and the cost of that reinsurance is paid up front.

A state catastrophe fund concentrates that risk in one jurisdiction and shifts the financial risk of catastrophic losses from private sector insurers to insurance buyers and taxpayers.

Private reinsurance, on the other hand, promotes spreading the risk and loss.

Risk spreading fosters a viable competitive market; risk concentration among a few insurers and state funds inhibits a competitive market.

Although the Florida Hurricane Catastrophe Fund (CAT Fund) and the state run Citizens Property Insurance Corporation are enjoying an improving financial position we should not conclude that all has been done that should be done to address the extraordinary hurricane risk that Floridians face.

For instance, from its creation in November 1993 until September 2004 the CAT Fund had been able to accumulate $5.5 Billion in reserves to pay claims. By August 2006 those reserves were essentially wiped out due to the hurricanes of 2004 and 2005. It is true that according to the CAT Fund's official "Estimated Claims Paying Capacity" the projected 2010 Year-End Fund Balance will be $5.914 Billion. However, we must not forget how quickly those reserves can evaporate particularly in view of the fact that the CAT Fund's total potential 2010 obligations equal $18.776 Billion.

Again, it is true that in addition to the $5.914 Billion in cash the CAT Fund has an additional $3.5 Billion in borrowed money. Also, assuming interest rates remain low (a big assumption) and that financial market are strong (an even bigger assumption) the CAT Fund estimates that it would be able to borrow an additional $9.363 Billion in "post-event" financing. The only problem is,

[3] See Special Report – Florida TaxWatch: "According to FHCF's bonding estimates, it may be unable to fund $18.43 billion of its obligations on a timely basis (Florida Senate Committee on Banking and Insurance, 2008)."
http://www.floridataxwatch.org/resources/pdf/04022010FloridasFinancialExposureSelfInsurancePrograms.pdf

relying on debt to finance risk is great until 1) the next storm hits and you have no cash, and 2) you have to pay back all that borrowed money.[4]

It is kind of like eating out ever night for a year and charging it to your credit card then paying only the minimum balance each month. At the end of the year you are behind on your payments and over your limit. At this point the card company cancels your card and then demands that you pay the balance off. Your problem is that you don't have enough money to pay the debt but the bigger problem is that you have to continue to eat.

That reminds me of an "old saying": "you can't drink yourself sober and you can't spend your way out of debt".

My good friend Dr. Jack Nicholson, Director of the Florida Hurricane Catastrophe fund is fond of saying: "It is always better to finance risk with capital rather than finance risk with debt."
I believe he is right.

So, if the two primary tools used by the State of Florida, rate suppression and post-loss assessments are not the answer to our problem, then what is the answer?

I believe the advice of Eli Lehrer of the Heartland Institute is very insightful. In his article published in The James Madison Institute Backgrounder in February 2008[5] he said in part:

"A respect for individual freedom and private property suggests four potential principles for dealing with insurance in hurricane areas:

• ***Insurance should be based on risk…***
Insurance should cost more for people who take great risks and less for those who take small risks. Insurers should be able to use all relevant data in order to price like risks alike and different risks differently.

• ***Insurance has nothing to do with relief.***
A just and compassionate society should develop mechanisms to provide relief immediately following a serious storm. But these efforts have little to do with insurance and confusing the two will tend to undermine both efforts…

• ***Insurance should influence development.***
In particular, insurance should do some combination of three things with regard to development: 1) discourage development in areas likely to receive hurricane strikes, 2) encourage mitigation

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[4] The availability of bonding is uncertain. See:
"The 'Build America' Debt Bomb" at
http://online.wsj.com/article_email/SB10001424052748704648604575621062239887650-lMyQjAxMTAwMDAwODEwNDgyWj.html
"States Already Get Bailouts; Some Worry They Could Get Much Bigger" at http://www.firepolicy-news.org/article/28796

[5] The James Madison Institute Backgrounder – Number 55 · February, 2008
Restoring Florida's Insurance Market by Eli Lehrer
http://www.jamesmadison.org/pdf/materials/620.pdf

against inevitable hurricanes, and 3) pay for a portion of the costs of periodic rebuilding in places where people can afford the cost *and* where mitigation is impossible.

• ***Finally, to the extent possible, hurricane coverage should work through private means. A purely private market should be the ultimate public policy goal.***"

Economic theory advises and experience confirms that regulatory restrictions on prices and underwriting will not improve market conditions.

The most beneficial policies will be measures that control claim costs, encourage market entry and help homeowners find sources of coverage.

We can and should have an honest and open debate about homeowner insurance in Florida and in Texas.

But let's have that debate based on the "real" problems.[6]

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[6] Please also see: "Insurance Residual Markets: Historical and Public Policy Perspectives"
By James W. Newman, Jr. – Release Date: July 22, 2010
The Florida Catastrophic Storm Risk Management Center
Florida State University
http://www.stormrisk.org/admin/downloads/Insurance%20Residual%20Markets%20White%20Paper%20-%207-22-10.pdf
Excerpt from Page 7-9:

In making choices about creating and implementing a new residual market solution or restructuring an existing residual market solution, public policy makers can draw on a long history of positive and negative experiences with state and national residual market entities.

With adequate care and attention, public policy makers attempting to address current insurance availability problems can avoid subjecting residents of their state to the kinds of insurance market turmoil and adverse financial effects associated with some of the residual market choices made by public policy makers in other states or in other times. This requires public policy makers to recognize and be guided by the lessons of residual market history listed below:

• A residual market entity works best when it focuses on making insurance coverage available to those who cannot obtain it in the private insurance market. The use of a residual market entity to address insurance affordability concerns is misdirected, particularly if residual market rates are suppressed broadly even though only a small portion of the policyholders have measureable affordability problems. If appropriate, valid insurance affordability concerns can be addressed with a targeted, needs-based program as is the case in other aspects of everyday life.

• A residual market entity works best when the entity's rates are not competitive with rates in the private insurance market. After this is achieved, a further effort can be made to assure that the residual market entity's rates are sufficient to cover all of its costs, including proper recognition of its exposure to catastrophic losses. This will go far toward reducing the likelihood of sizeable residual market deficits and the resulting deficit assessments. Requiring residual market rates to be actuarially sound without understanding and addressing the differences between rate making for a residual market entity and for a private insurance company is unlikely to produce a satisfactory result.

• Failure to follow the two previous lessons will lead to subsidies from one group of policyholders to another, either within the residual market entity or from private insurance company policyholders to residual market policyholders. Absent a clear statement of intent with supporting justification, creating subsidies of these types would seem at best to be unsound public policy and at worst to run the risk of unwelcome economic and political outcomes.

• The essential requirements for avoiding inadequate residual market rates, inappropriate subsidies and unacceptable deficit assessments are (a) a statutory public policy statement that the residual market entity is to be financially self-sustaining and (b) the political will by public policy makers, regulators and others to make it happen. Even a residual market entity with substantial catastrophe exposure can make significant progress toward financial self-sufficiency if, given fully adequate rates, it makes judicious purchases of catastrophe reinsurance.