FEDERATION OF REGULATORY COUNSEL, INC.

THE WINDS OF CHANGE

How Wind Storms Changed the Course of Regulation in Florida

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For decades the property insurance market in Florida differed little from the rest of the country. Competition kept rates affordable and regulatory oversight focused more on company practices than rate management. Historically, consumer protection was addressed through solvency regulation and ensuring that rates were adequate.[1] Everyone seemed oblivious to the storm risk facing the peninsula. The population grew, particularly in coastal areas where large expensive structures replaced modest concrete or wooden structures built on pylons.

1992 -Hurricane Andrew

In 1992 everything would change. On August 24th, Hurricane Andrew struck the southern part of Dade County. Over 25,000 homes were destroyed and more than 100,000 were damaged. The Insurance Information Institute estimated insured losses totaled more than $16 billion. Eleven insurance companies went bankrupt, and 30 others lost up to 20 percent or more of their surplus. Several Florida companies required an infusion of capital from their parent companies to cover the losses and remain operational. Surviving companies took measures to reduce their exposure. Some withdrew from the state entirely, others reduced or stopped writing coverage along the coast, leaving 930,000 policyholders with no coverage options.[2] As insurance companies fled the state, lawmakers and regulators had to find a way for homeowners to get insurance coverage. This noble effort to provide affordable coverage would result in the creation of the largest "residual" market in the country and arguably the most heavily subsidized property insurance market. Two risk pools were established-the Joint Underwriting Association, and the Florida Windstorm Underwriting Association.[3] Another change was the creation of the Florida Hurricane Catastrophe Fund ("Cat Fund") which was created to provide low cost reinsurance to private insurers. Still, public policy focused on creating capacity.

2004-2005 Hurricane Season

In the fall of 2004, four hurricanes made landfall in Florida: Charlie, Francis, Ivan and Jean; as well as tropical storm Bonnie. Reinsurers Swiss Re and Munich Re estimated that the 2004 hurricane season (the four hurricanes and Tropical Storm Bonnie) represented more than two million claims. Total insured losses in Florida in 2004 exceeded $25 billion. [4] In August 2005, Hurricane Katrina made landfall in Florida as a category one storm. While it did not cause substantial damage in Florida, the hurricane strengthened over the Gulf of Mexico and was a category three storm when it made landfall near New Orleans, Louisiana causing catastrophic losses from wind, storm surge, and flooding in excess of $81 billion.[5] Hurricane Katrina impacted the cost and availability of reinsurance, the perception of risk associated with writing insurance coverage in coastal regions, and the rate of return that investors would expect for placing their capital at risk. In addition to Hurricane Katrina, Hurricanes Rita, Wilma, and Dennis made landfall in Florida in 2005. Insured losses in Florida from the four hurricanes were in excess of $10.8 billion.[6] Total insured losses in Florida from the 2004 and 2005 hurricane seasons were approximately $36 billion.[7] After the

2004-2005 hurricane season, insurance carriers reevaluated their exposure to catastrophic risks in coastal states, in particular Florida, where 79 percent of the state's insured value consists of coastal exposure totaling $2.5 trillion in total insured value (including cost to replace structures, contents, additional living expense and business interruption insurance).[8] This resulted in a significant increase in rate filings where a rate increase was sought. The Governor's Property and Casualty Insurance Reform Committee stated that in 2006, "52 of Florida's 167 property insurance carriers requested significant rate increases (over 25 percent) related primarily to the considerable increase in the cost of reinsurance (75 percent) and the heightened expectations of future losses related to hurricanes." This produced a public outcry and the demonization of the insurance industry based upon the belief that insurers were simply using this as an excuse to gouge consumers.

HB 1A

Newly-elected Governor Charlie Crist in his inaugural address declared property insurance reform to be his number one priority: "I pledge the full resources of my office to work with the leaders of the House and Senate along with our new chief financial officer to bring our people the relief they need," Governor Crist announced.

Lawmakers moved quickly. A special session was called in January of 2007 to address property insurance rates and related issues. As a result of the special session, House Bill 1A ("HB 1A") was passed. The Governor signed the bill on January 25, and it took effect immediately. Less than a week after the bill was enacted, the Governor and Cabinet, sitting as the Financial Services Commission, adopted an emergency rule[9] freezing personal lines residential rates and prohibiting non-renewals and cancellations. The legislation represented a public policy shift away from rebuilding a competitive private market and toward rate relief for property owners making major changes in four areas: the Florida Hurricane Catastrophe Fund, the residual market (Citizens), rate rollbacks, and the regulatory process.

All residential property insurers are required to participate in the CAT Fund. Prior to the passage of HB 1A, the CAT fund provided up to $16 billion in coverage for residential losses above an aggregate industry retention of $6 billion. The premium insurers pay to the CAT Fund is based on their exposure; typically 25 percent of what comparable coverage would cost in the private reinsurance market. The CAT Fund does not maintain reserves or a surplus sufficient to cover its exposure. In the event of a deficit, the Fund issues bonds and then levies assessments on all lines of property and casualty insurance except medical malpractice, accident and health, and workers' compensation premiums, to provide a revenue stream to pay off the bonds. Assessments are capped at 6 percent with respect to a deficit attributable to a single contract year, and 10 percent with respect to all deficits combined. HB 1A substantially expanded the reinsurance offered by the CAT Fund through the addition of several new layers of coverage and the additional capacity. The additional coverage was optional, but because the coverage was offered at prices well below private reinsurance market rates most insurance companies purchased the coverage. There was also an additional layer of optional coverage priced above private market rates that was added to create additional reinsurance capacity in a hard market.

When Citizens was formed in 2002, it was intended to be the insurer of last resort and was subject to strict eligibility requirements that limited eligibility to property owners who were not able to procure coverage from licensed insurance companies 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. Perhaps one of the most significant changes made by HB 1A was to establish Citizens as a competitor with private sector insurance companies. Citizens' ability to write coverage was also expanded to enable the company to write full homeowners' policies in areas in which it previously was able to write only windstorm policies. Further, Citizens holds an unfair advantage over the private sector in that it does not pass on reinsurance cost, is a tax-exempt entity and its rates were frozen at early 2006 levels.

Another change implemented by HB 1A was to suspend an insurance company's ability to elect arbitration[10] as an alternative to an administrative challenge of the agency's action on a rate filing. This was a significant change that adversely affected companies' ability to challenge an unfavorable decision by the regulator. Since 1996 insurers making rate filings for property and casualty insurance under Section 627.062, Florida Statutes, other than medical malpractice, have been allowed to elect binding arbitration of a rate filing denial by the Florida Office of Insurance Regulation ("OIR"). If the OIR issued a notice of intent to disapprove a rate filing, insurers had the option of requesting arbitration before a panel of three arbitrators, conducted pursuant to the rules of the American Arbitration Association ("AAA"), or an administrative hearing held pursuant to Florida's Administrative Procedures Act (Chapter 120, Florida Statutes). Under arbitration, the insurer and the OIR each selected one arbitrator, and the third was chosen by the other two arbitrators. An arbitrator had to be certified by the American Arbitration Association and could not be an employee of an insurance company or insurance regulator. Arbitration panels typically conducted a *de novo* review of the rate filing, and the decision of the panel constituted final approval of the rate filing. Either party could have appealed the panel's decision, but the grounds for vacation were very high. Absent a showing of corruption or fraud, evident partiality by an arbitrator, and action beyond the arbitrators' powers or jurisdiction, an arbitration panel's decision could not be overturned. Insurers have fared much better in arbitration proceedings than they have in administrative hearings. Since the 1996 inception of the arbitration provision, approximately fifteen arbitrations have been held, and the OIR prevailed in just one case.[11]

With the suspension (and ultimate repeal) of arbitration, all challenges of agency action with respect to a rate filing are subject to the provisions of the APA. Under the APA, a formal adversarial hearing is held before a state Administrative Law Judge (ALJ) with the Division of Administrative Hearings. Once the hearing is completed, the ALJ issues a recommended order to the OIR. The recommended order contains findings of fact and conclusions of law as found by the ALJ. The OIR then has 90 days to issue a final order which may reject or modify the conclusions of law contained in the recommended order. An insurer may then appeal the OIR's final order to the First District Court of Appeal.

TODAY

As a result of the changes that occurred after the 2004-2005 hurricane season, Florida lawmakers created a system that has adversely affected the private market. State run Citizens, the CAT Fund, and the Florida Insurance Guarantee Association (which handles claims of insolvent property and casualty insurers) do not have sufficient capital to cover their exposure. Many observers have said that Florida's property insurance market is a house of cards that one major storm could bring tumbling down and literally bankrupt the state. Citizens, once the insurer of last resort, no longer is required to set premiums higher than the private market. The company is now free to compete with private market insurers, but in most areas of the state the private market cannot compete with Citizens because its rates are below private markets' rates resulting in Citizens becoming the state's largest insurer with over 1 million policyholders. Citizens' rates are set by the OIR and are not subject to the rate adequacy requirements of Section 627.062, Florida Statutes. In addition, Citizens does not maintain funds sufficient to cover its exposure, and instead relies on bond issues ultimately paid for by assessments to cover any shortfall. According to Citizens' actuaries, its rates must be increased by nearly 50 percent in order to become actuarially sound and to have sufficient funds to pay claims without imposing a "hurricane tax" on all automobile and business insurance premiums.

The CAT Fund's current liabilities top $25 billion; but it only has about $4 billion in hard assets. It would have to pay the remaining balance by selling bonds which would also be paid for by assessments. However, it appears doubtful that the CAT Fund could ever sell enough bonds to cover its deficit, since no state has every issued more that $11 billion in bonds at one time; and the CAT fund failed to sell even $6 billion in bonds intended to provide for pre-event financing. If it could sell the bonds, the resulting assessment on virtually every insurance policy in the state would be substantial. A typical car insurance premium could potentially double. If bonds could not be issued, there would be no realistic way to pay off the debt without some sort of

federal bailout given that Florida's constitution limits the state's revenue raising options. In fact, the CAT Fund still has $654 million in outstanding claims for the 2004-2005 hurricane season -prior to the expansion- that will have to be paid through emergency assessments.

The consequences to the private market have been woeful. The OIR has approved very few double digit rate increases, which insurers have claimed are necessary to maintain solvency. Four of the state's largest insurance companies, State Farm, Allstate, Nationwide and USAA, have all stopped writing new policies. State Farm, the state's second largest insurer after Citizens has announced plans to leave the state. Last year Nationwide cut 39,000 policies, and in October of this year it announced plans to cut another 60,000 policies. While some companies have expressed a desire to pick up polices and start-up companies have entered the market, it is doubtful that they will provide sufficient capacity, and it is likely that Citizens will continue to swell.

Whether lawmakers can unravel the situation remains to be seen. Most measures initiated during the 2008 legislative session did not materialize. The 2009 session did result in some legislation that may help. The Citizens' rate freeze was lifted; but the maximum increase that the company can obtain was capped at 10 percent. However, the OIR recently announced that it will approve only a 5 percent increase; so it does not appear that Citizens' rates will become actuarially sound any time soon.**12**

Lawmakers and regulators face a daunting task. A large part of the state's economy and revenue base is driven by growth and development, and a large percentage of her residents are seniors that live on a fixed income. Floridians have been hit hard by the economic downturn, especially as it pertains to the housing market. Eliminating the CAT Fund. removing the moratorium from Citizens' rate increase, and requiring Citizens to function like a private market insurer would result in substantial rate increases. Many Floridians are currently struggling just to make ends meet. A significant rise in insurance costs could push them over the edge and cause further damage to the housing market and the state's stressed economy. Hopefully, lawmakers will come up with a fiscally sound solution. In the meantime, Floridians are crossing their fingers hoping that the next changes come before the wind blows down the house of cards.

Endnotes

1. C. Nyce and P. Maroney, "Granularity in the Florida Property Insurance Market," Florida Catastrophic Storm Risk Management Center, June, 2009.

2. R. Hartwig, "Florida Case Study : Economic Impacts of Business Closures in Hurricane Prone Countries". Insurance Information Institute, 2002

3. In 2002, the Joint Underwriting Association ("JUA") and the Florida Windstorm Underwriting ("FWU) Association became Citizens Insurance Company ("Citizens"). Citizens' original purpose, like its predecessors, was to provide insurance coverage to those who could not obtain coverage from private insurance companies.

4. P. Maroney, "The Capitalization of Stricter Building Codes in Miami, Florida House Prices," February, 2009

5. E. Blake, E. Rappaport, and C. Landsea. "The Deadliest, Costliest, and Most Intense United States Tropical Cyclones From 1851 to 2006 (and Other Frequently Requested Hurricane Facts)," Table 5. NOAA Technical Memorandum NWS TPC-5, National Weather Service, National Hurricane Center Miami, April 2007.

6. Florida Office of Insurance Regulation, 2006.

7. P. Maroney, "The Capitalization of Stricter Building Codes in Miami, Florida House Prices," February, 2009

8. *Id*.

9. Emergency Rule 69OER07-1 was adopted for the purpose of preventing certain insurer actions prior to the effective date of rolled-back rates.The emergency rule froze rates for residential property coverage to rates that were in effect on January 25 until the insurer makes, and the regulator approves, a rate filing reflecting the cost savings that were or would be realized if the insurer purchased reinsurance from the CAT Fund as well as suspending the cancellation of policies.

10. The arbitration option was repealed in the 2008 legislative session

11. OIR was unable to provide the exact number in time for publication.

12. The legislature gave Citizens four years to implement the 40 percent increase the company said was necessary to establish actuarially sound rates. The rate increase each year is capped at 10 percent. However, this year OIR will only approve a 5 percent increase.