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INVITED ARTICLE

Florida Homeowners Insurance: How Big Is the Availability Problem and Is There a Fair Solution?

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Chris Carlson
Jeff Kucera
Jim Massie

This article features a panel discussion on hurricane and wind insurance organized by Jeffrey L. Kucera for the American Risk and Insurance Association (ARIA) 2008 Annual Meeting in Portland, Oregon. The moderator, Jeffrey L. Kucera, is a Senior Consultant with EMB in North America. He has over 30 years of experience in the property–casualty business, joining EMB after a 24-year career with Allstate and 5 years as a consultant. Jeff's primary practice areas are rate making, class plans, and product development. While knowledgeable about all personal lines, he has particular experience in the homeowners line. He graduated from the University of Nebraska in 1975 with a major in mathematics and a minor in economics. He became a member of the American Academy of Actuaries (MAAA) in 1980 and a Fellow of the Casualty Actuarial Society (FCAS) in 1984.

Three presenters provide a discussion on Florida Homeowners Insurance. The first presenter is Chris Carlson, a consultant with Pinnacle Actuarial Resources, Inc. He holds a bachelor of science degree in mathematics from the University of Oregon. Before joining Pinnacle Actuarial Resources, he was employed for over 25 years with Nationwide Insurance Companies in Columbus, Ohio. He is currently the President of the Casualty Actuarial Society, a fellow of the Casualty Actuarial Society, and a Member of the Academy of Actuaries. The next presenter is Locke Burt, President and Director of Security First Insurance Co. of Ormond Beach, Florida. He has 35 years of experience in the insurance profession, and in 2005, formed Security First Insurance Company. He also owns Burt & Scheld Facultative Corporation, which underwrites property facultative reinsurance on behalf of Liberty Mutual Insurance Co. and Employers Mutual Casualty Insurance Co. He holds both a bachelor of science and a master's of business administration degree from Northwestern University and a juris doctorate degree from Loyola

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University in Chicago. He is a licensed reinsurance broker and a licensed attorney who is a member of the Illinois and Florida Bar Associations. He was a senator in the Florida legislature from 1991 to 2002 and experienced Hurricane Andrew first-hand. While in the Florida Senate, he served as Chair of the Appropriations Committee and Republican Majority Leader. The final presenter is Jim Massie, and he provides the reinsurance perspective on Florida homeowners insurance. He is the Senior Partner of Massie Law Offices in Tallahassee, Florida, specializing in reinsurance and insurance law, seaport issues, and administrative law. He received his bachelor of arts from Miami University in Ohio and his juris doctorate from Florida State University. Interestingly, when he is not working on insurance issues, he likes to breed and race thoroughbreds.

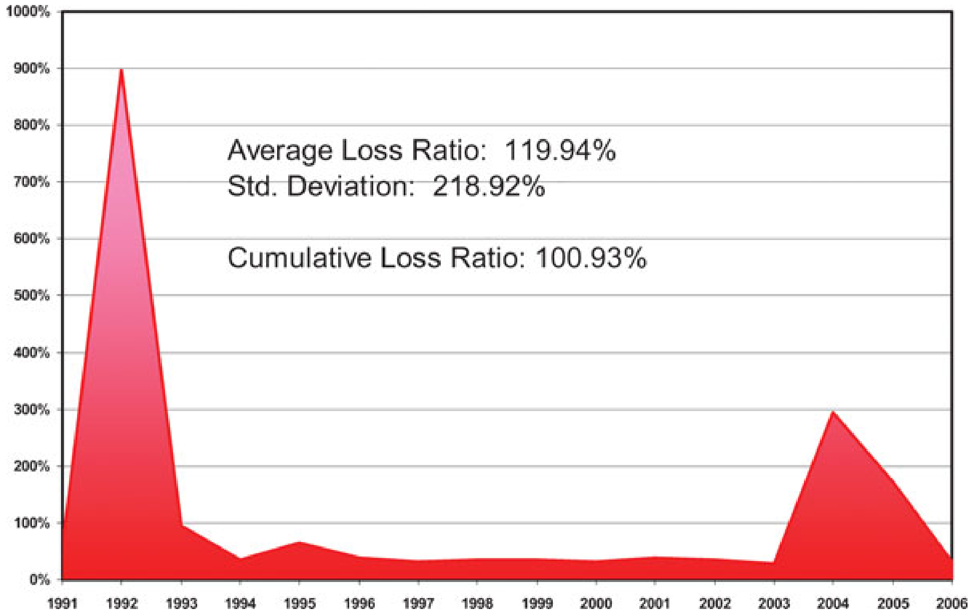
Jeff Kucera: Florida's economic growth and exposure to hurricane losses make it unique from an insurance risk perspective. The potential for catastrophic losses is in the billions of dollars, and the "risk of ruin" is a real threat for many insurance companies. More important, it is not just insurers that face severe economic pressures should the mega-hurricane event occur. Many insureds will also be surprised to learn that their insurance rates could be significantly increased, and these premiums are not just for their homeowners insurance. The three panelists will further describe how the situation has grown and their perspectives of the situation as an insurance company owner and reinsurer.

Christopher S. Carlson: Florida's economic picture is a rather unusual situation of supply and demand interplay. Policyholders demand insurance policies, and insurance companies provide capital to write those policies. Affordability and availability are the key dynamics in the Florida homeowners market. That is, Florida homeowners think that insurance should be affordable, whereas insurers are concerned with the availability issue since their capital is at risk. Higher insurance rates will affect affordability but not necessarily availability if adequate insurer capital is not available.

Frequently, state regulators focus on the mean level of losses when evaluating premiums. But there is a huge variation around that mean—for example, an underestimation of the mean for hurricane losses by as little as 2 to 3 percent represents a tremendous amount of losses. (In contrast, for more traditional homeowners risks, such as the fire risk, the variance around the mean is very small. The distributions for hurricane losses and traditional insured risks are totally different.) Insurers are concerned with obtaining a reasonable rate of return to their exposed capital, but in the homeowners line, an insurer's total exposed capital could be as much as 25 to 30 percent of their total insured value of all homes in Florida. And losses for this line will include contents of a house, the cost to live elsewhere while the structure is being rebuilt, and additional living expenses. This means there is a huge value at risk from catastrophe in Florida.

Key points of contention between homeowners, the regulators, and insurers are whether current rates are adequate, what expected losses are, and the cost of insurer capital. To get a better perspective on this, refer to Figure 1 that shows the direct loss ratios for Florida homeowners insurance from 1991 to 2006. The loss ratios are very high in the years in which there were catastrophes. For example, in 1992 with Hurricane Andrew, the loss ratio was 900 percent. The most important thing to note about Figure 1 is the variance in the loss ratios. It is possible to have a run of many years with reasonable loss ratios. For example, Figure 1 indicates that the loss ratio was below 50 percent for a number of years. If you looked at one of these years in isolation, then you might conclude that homeowners insurance rates were too high, and insurers were making excessive profit. In

FIGURE 1
Direct Loss Ratios: 1991 to 2006



fact, insurers were setting aside some of the apparent "excessive rate" to build up capital. If insurers accumulated capital during these years, then they would be better positioned to pay catastrophic losses when a big storm hits. U.S. laws do not allow for prefunding catastrophe (cat) losses with preevent reserves (or segregated surplus accounts) as in Europe and the United Kingdom. Instead, "profit" during noncatastrophe loss years flows into aggregate surplus. Nevertheless, companies became insolvent as a result of the 2004 and 2005 hurricanes or required capital infusions.

So, to reiterate, it is the variance in losses that is of concern. Hurricane Andrew hastened the introduction of catastrophe modeling in homeowners rate making and cat management for primary insurers and most especially for reinsurers. Reinsurers were probably the first to use cat models with primary insurers catching on much later, perhaps too much later.

The current solution to Florida's homeowners insurance problem is significant governmental and public involvement in the form of Citizens Insurance Company (which began operations in 1992) and the Florida Hurricane Catastrophe Fund. The Florida Hurricane Catastrophe Fund started like any public reinsurance fund, but with a new administration in 2007, things began to expand. Through legislative activity, the Fund introduced two additional reinsured layers for homeowners insurance: a temporary increase in coverage limits (TICL) and a temporary emergency additional coverage option (TEACO), with the latter available for 3 years. The TICL layer provides a layer of coverage for losses above the losses normally paid by the fund whereas the TEACO layer provides a layer of coverage for losses below the level of losses paid by the fund.

Through this government-operated mechanism, the catastrophe component of property insurance in Florida has changed from a "pre-event" funding mechanism to a "postevent" one. Policyholders don't seem to understand that this postevent funding approach is tantamount to the government gambling with their money—that is, gambling about whether there will be enough money available in the system to pay losses. Postevent assessments are likely by Citizens Insurance Company, the Florida Hurricane Catastrophe Fund, and the state's Guaranty Fund after a catastrophe. Citizens Insurance Company (the second largest insurer in Florida) is especially exposed because it is relatively less well capitalized than the other privately operated insurers in the state. The state's Guaranty Fund is responsible for paying losses left behind by insolvent private insurance companies (e.g., companies hit by catastrophic losses). The Guaranty Fund obtains funds to pay these losses from postevent assessments from solvent insurers in the state, and these assessments are ultimately passed through to policyholders in the form of higher premium payments.

Let's look at Citizens Insurance Company (henceforth, Citizens) more closely. It was started in 1992 by statute as an important safety net for Florida homeowners. Citizens is required by law to accept all applicants who are otherwise insurable but cannot find coverage in the voluntary market. It has over 8,500 agents at over 6,000 locations, mostly on the east and west coasts of Florida. It writes policies from three separate accounts, which insure slightly different types of business: personal lines account (PLA), commercial lines account (CLA), and high-risk account (HRA). The PLA writes typical homeowners and mobile homeowners policies. These policies include the traditional coverages for the structure, contents, additional living expenses, and third-party liability. The CLA is relatively new and covers commercial, residential, and nonresidential property (i.e., apartments, condos, and typical commercial buildings). Third-party liability coverage is not sold in this commercial account—only the property coverages. The HRA is for both dwellings and commercial business, but it only covers wind and damage in the designated coastal areas. That is, coastal areas, typically referred to as wind zones, exist in each county. Each county is responsible for setting up the definition of the wind zone that can vary from 1,000 feet to a few miles. In those zones, private insurers can exclude wind coverage on policies, and Citizens will provide that coverage.

Each account has a separate assessment base and separate estimates for required surplus, and the plan-year deficits are calculated for each account. Because each account has a separate assessment base, if one account becomes financially distressed, an assessment is made against the assessment base for that account alone. Citizens is responsible also for the policies of insurers that become insolvent. For example, it has been transitioning the business of an insurer in Tampa, which recently was declared insolvent, to their rates and policies forms.

Citizens underwrites business slightly differently from the rest of the voluntary market. Voluntary carriers seek to optimize their portfolio of property business and use underwriting guidelines that consider home characteristics such as age, value, construction characteristics, and liability exposure. Voluntary insurers guard against unprofitable concentration of risk in any one area and consider premium revenue and required capital in the territories in which they write policies with respect to the pricing and availability of reinsurance.

FIGURE 2
Population Change for Florida and the United States: 1980 to 2020

Year	Florida		U.S.	
	(in thousands)	% change	(in thousands)	% change
1980	9,747	-	227,726	-
1990	12,938	32.7%	248,791	9.3%
2000	15,983	23.5	281,425	13.1
2010 (projected)	19,621	24.6	308,936[1]	9.8
2020 (projected)	23,146	17.9	335,805[1]	8.7

Source: Office of Economic and Demographic Research, The Florida Legislature (October, 2007), and U.S. Census Bureau.
[1] July 1 projection.

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Sinkholes are a problem in four to five counties along the west coast of Florida—depending on the location of the water table and soil construction in those counties, houses may suddenly move slightly or sink dramatically. As a result of the catastrophe nature of this risk, many insurers weren't voluntarily writing policies to cover sinkholes in those counties. Citizens began to write a large number of homeowners policies in those counties. It writes a majority of the policies on mobile homes as well, because the relative capital requirements and the cost of reinsurance for mobile homes are relatively high.

Compared to the business written by the voluntary market, Citizens policyholders typically have a higher probability of loss. All of Citizens' accounts are highly concentrated along the coast. Over 81 percent of the homes covered by homeowners insurance in Citizens' PLA account are over 20 years old, and 46 percent are over 40 years old. Approximately 55 percent of the homeowners policies (HO-3) in Citizens PLA have a structure reconstruction cost value (coverage A amount) under $150,000. The number of policies written by Citizens within the sinkhole-prone areas increased from around 1,000 in 2001 to over 244,000 as of May 2007. Finally, the PLA-manufactured home policy in-force count has grown from approximately 3,000 in 2002 to over 170,000 as of May 2007. Eighty-four percent of the manufactured homes insured by Citizens are over 10 years old, and 60 percent are over 20 years old. Overall in 2005, Citizens had just over 819,000 policies, and $200 billion of exposure, while the most recent figures indicate policies in force of 1.2 million and $425 billion of estimated exposure, a significant increase in this government-operated program.

Locke Burt: One objective of my presentation is to provide an overview of Florida from the perspective of a homeowners insurer with 60,000 customers. Florida is a unique place. It's large and prone to catastrophes. First, let's consider population growth relative to the United States overall. Figure 2 indicates that, since 1980, Florida's population has grown

FIGURE 3
Florida Housing Starts and Construction Values: 1998 to 2008

Year	Housing Starts (thousands)		Private Residential Construction Value (millions of current dollars)	
	Single Family	Multi-Family	Single Family	Multi-Family
1998	95.1	52.2	$11,439.6	$3,572.3
1999	99.1	68.0	12,531.54	4,377.6
2000	97.6	63.1	13,917.84	4,848.6
2001	107.3	60.7	16,182.7	5,318.5
2002	122.4	63.4	19,613.8	5,585.3
2003	146.5	68.7	24,818.0	6,690.5
2004	172.3	80.2	31,581.4	8,927.3
2005	193.1	90.5	38,565.6	11,624.5
2006	132.6	85.8	32,383.7	14,026.3
2007	63.8	54.6	16,513.1	11,008.5
2008[1]	53.9	35.0	11,213.2	5,376.5

Source: F.W. Dodge Statistical Service; Office of Economic and Demographic Research, The Florida Legislature, February 2008.
Note: Private residential construction includes all residential buildings owned by the private sector.
[1] Forecast for 2008 is from the November 2007 Florida Economic Estimating Conference.

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by 9,000,000 or almost 1,000 people a day for 29 years. Recently, though, population growth has decreased dramatically—down from over 400,000 a year in 2004, 2005, and 2006 to an estimated 100,000 this year and next.

Figure 3 provides information on housing starts and construction values from 1998 to 2008. Housing starts have practically evaporated. Housing starts have decreased from a peak of about 200,000 in 2005 to an estimated 50,000 single-family housing starts in 2008 (although the 2008 figure still represents about 10 percent of new homes built in the United States). Sales of existing homes have gone down from an average of 240,000 per year in 2004 and 2005 to 120,000 in 2008, while foreclosures have increased dramatically (i.e., 1 in 79 homes in the last quarter).

Historical direct written property–casualty premiums for admitted and surplus lines' insurers are provided in Figure 4. In the homeowners line alone, premiums have increased from $4.7 billion in 2004 to almost $9 billion in 2007, an 85 percent increase. Even between 2005 and 2006, homeowners premiums increased by 40 percent as a result of storms and increases in reinsurance costs. These rapid price increases were the reason the legislature went into special session in January 2007 and passed House Bill 1A. This bill doubled the size of the Florida Hurricane Catastrophe Fund (the state-sponsored reinsurance company) in an effort to reduce rates by replacing expensive private reinsurance with government-subsidized reinsurance coverage.

The hurricane losses of 2004 and 2005, the passage of House Bill 1A, and the perception of a negative regulatory environment in Florida have combined to dramatically change the market share of the companies that provide homeowners insurance in Florida. According to Figure 5, State Farm is the largest writer of homeowners insurance in Florida if Citizens is excluded from the analysis. Notice that Allstate Floridian Insurance Company

FIGURE 4
Historical Direct Written P & C Premiums for Admitted Lines and Surplus Lines Insurers

(Amounts are in billions)

Year	Homeowner		Auto		Products and Other Liability		Other		Total	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
2004	$4.70	15%	$13.93	44%	$2.73	9%	$10.00	32%	$31.25	100%
2005	5.86	17	14.41	41	3.17	9	11.54	33	34.99	100
2006	8.06	21	14.90	40	4.69	12	9.91	26	37.55	100
2007	8.81	24	14.30	39	3.96	11	9.60	26	36.65	100

Source: FHCF

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FIGURE 5
Top 10 Florida Homeowner Writer (Excluding Citizens)

Company	Florida Homeowners Direct Premium (000) Omitted		Florida Homeowners Market Share				
	2007 Rank	Written Premium	2007	2006	2005	2004	2003
State Farm Florida Insurance Co	1	$1,560,469	22.0%	21.4%	21.0%	22.9%	23.4%
Universal Property & Casualty Ins	2	449,795	6.3%	5.0%	1.4%	0.9%	0.7%
Royal Palm Ins Co	3	246,083	3.5%	0.2%	–	–	–
Nationwide Insurance Co of Florida	4	243,237	3.4%	4.3%	4.8%	5.0%	4.9%
St Johns Ins Co Inc	5	234,957	3.3%	2.2%	1.1%	0.4%	0.0%
USAA	6	234,743	3.3%	2.9%	2.8%	3.2%	3.4%
Allstate Floridian Insurance Co	7	211,097	3.0%	5.9%	6.7%	8.2%	9.7%
Liberty Mutual Fire Insurance Group	8	189,399	2.7%	2.6%	2.5%	2.5%	1.9%
Universal Ins Co of NA	9	173,730	2.4%	2.8%	1.5%	0.2%	–
Federal Insurance Company	10	152,419	2.1%	2.1%	2.0%	2.1%	2.3%

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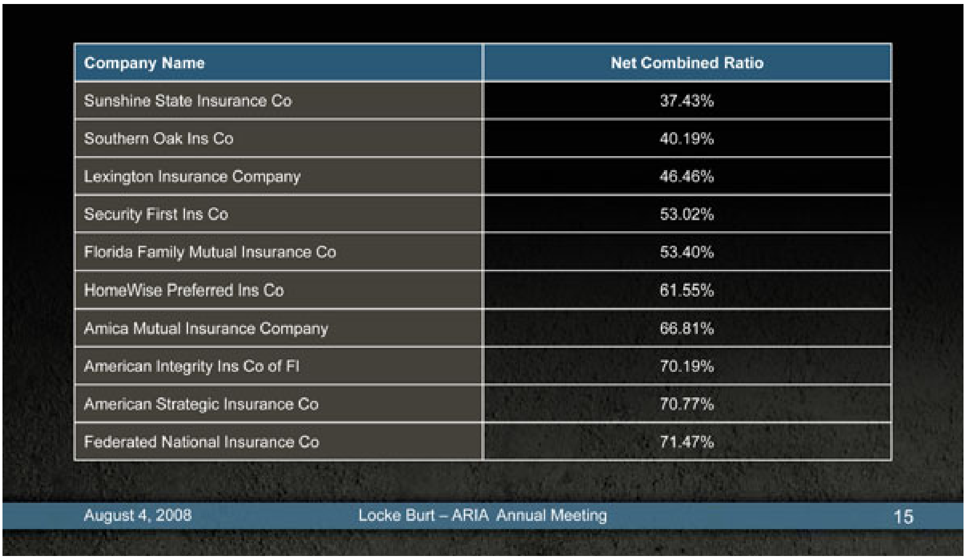
suffered a significant reduction in market share, with Universal Property & Casualty Ins. and Royal Palm Ins. Co. benefiting from their loss. Universal Property & Casualty is a publicly held company that has expanded its homeowners insurance market share recently. Nationwide has significantly cut back their business and announced plans to

Figure 6
Top 10 Performers by Net Combined Ratio



Company Name	Net Combined Ratio
Sunshine State Insurance Co	37.43%
Southern Oak Ins Co	40.19%
Lexington Insurance Company	46.46%
Security First Ins Co	53.02%
Florida Family Mutual Insurance Co	53.40%
HomeWise Preferred Ins Co	61.55%
Amica Mutual Insurance Company	66.81%
American Integrity Ins Co of Fl	70.19%
American Strategic Insurance Co	70.77%
Federated National Insurance Co	71.47%

cancel 40,000 homeowners policies, with a big portion of this business being picked up by Security First Insurance Co.

House Bill 1A had a tremendous impact on consumers. The bill mandated that companies purchase an additional $12 billion in reinsurance coverage from the Florida Hurricane Catastrophe Fund and pass on the savings in their reinsurance program in the form of reduced rates. Overall, the average premium per $1,000 exposure for residential property risks went down by 14 percent. In the homeowners line, the average premium per $1,000 of exposure went down by 15 percent.

House Bill 1A also rolled back Citizens Insurance Company's rates to the rates charged in 2005, affecting 20 percent of the market. As a result, there has been a dramatic reduction in the amount of in-force premium. In-force premium for residential property risks in Florida decreased from $8.8 billion in March 2007 to $7.9 billion in March 2008.[1]

Performance of the top 10 Florida insurers in calendar year 2007 is portrayed in Figure 6. The combined ratio results look very good as there were no major storms. Sunshine State Insurance Co. had the lowest combined ratio. Nationwide's combined ratio, on the other hand, was in the high nineties.

[1] The homeowners insurance policy offered in Florida (HO-3) differs from other states. A consumer can choose to have wind coverage or not, zero contents coverage to as much as desired, full sinkhole coverage, or catastrophic ground collapse (in which the house disappears in a very deep hole and is condemned by the government). The traditional living expense portion of the homeowners policy can have a copay option, and screen coverage is optional. All of these options are offered to help reduce the cost of coverage, although in the process, they have created some operational problems.

An amazing feature of the Florida homeowners insurance market is the entry of new companies. There were 35 new homeowners insurers formed in Florida since 2004 and 30 since 2005. That is almost 1 new homeowners insurance formed in each month since 2005.

The formation of these new companies has been encouraged by the availability of cheap reinsurance provided by the Florida Hurricane Catastrophe Fund and government-subsidized loans to new carriers. Government reinsurance through the Florida Hurricane Catastrophe Fund provides $28 billion of coverage in excess of $6 billion in industry retention. The rates charged by the Florida Hurricane Catastrophe Fund are based on modeled rates that are simply average annual loss costs. The rate-on-line (ROL) charge by the Florida Hurricane Catastrophe Fund is about 4.5 percent, which is very inexpensive (i.e., about one-third the cost of private reinsurance).

The Florida Hurricane Catastrophe Fund can charge these low rates because it doesn't require capital, it doesn't pay taxes, and it has the ability to tax 18 million people for shortfalls. The Florida Hurricane Catastrophe Fund can also borrow money to cover shortfalls, although some question its ability to borrow large amounts of money in the event of a major storm. In fact, the Florida Hurricane Catastrophe Fund has gone to the bond market four times from 2006 to 2008 to raise a total of $8 billion, and it had difficulty in doing this.

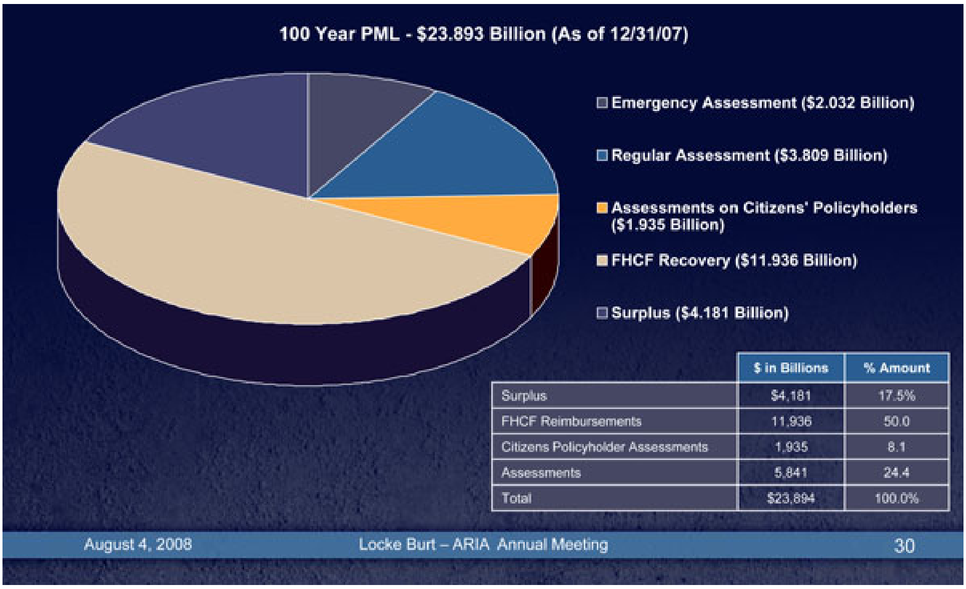
To operate an insurance company in Florida, the insurer must have reinsurance to cover a 1-in-100-year event and demonstrate the ability to withstand two 20-year events. What would happen to Citizens if a 1-in-100-year PML event (i.e., a storm with approximately $24 billion of losses) occurs? Citizens has surplus of $4.1 billion and would receive about $12 billion from the Cat Fund. Citizens' policyholders would be assessed at $2 billion. After this, regular and emergency assessments would contribute the remaining $5.9 billion. This information is summarized in Figure 7.

Now let's discuss more precisely what policyholder assessments would amount to. In terms of Citizens' policyholders, here is what the 1-in-100-year probable maximum loss (PML) event would mean. If a policyholder pays $2,000 in homeowners premiums and $1,800 for automobile insurance, then the policyholder would be assessed at $2,354, or 118 percent of the premiums paid to Citizens.[2] Policyholders can also be assessed by the Florida Guaranty Fund and the Florida Hurricane Catastrophe Fund, and these assessments could be sizable. This is the "house of cards" that some commentators have suggested was created by the decision by the legislature to postfund the liability of paying for a major hurricane in Florida. The advantage to this approach, according to legislators, is that it avoids paying overhead and profit to reinsurers, and there would be a chance that federal funds from Washington might be forthcoming. The disadvantage should be obvious to those of us in the insurance business who prefer to prefund losses and worry about what could happen in the year following a big event if the state-sponsored entities were unable to secure the funding necessary to continue in operation.

Citizens' homeowners rates are very competitive for older properties and for homes on the coast. For example, for a home in St. Petersburg (which is on the west coast)

[2] A Security First customer would be assessed $1,800 (or 91 percent of annual premiums). And these assessments could continue for years.

Figure 7
Citizens After a 100-Year PML Event: Where Would the Dollars Come From?



built in 2002, the annual premium for a $250,000 Citizens' homeowners policy is $1,788 compared to $3,812 from State Farm.[3] State Farm's price is double the Citizens' price. But in the central, noncoastal areas, Citizens is much less competitive. In Orlando, for example, Citizens price for a $250,000 home built in 2002 is $1,390, State Farm's price is $1,604, and most active writers (American Strategic, Royal Palm, and United Property and Casualty) charge about $800. One thing that concerns private companies is if Citizens raises their rates, they will still be inadequate for homeowners insurance risks on the coast but a rate change may allow Citizens to reduce rates in areas where they are noncompetitive now, thereby becoming more competitive and increasing their market share at the expense of the private carriers.

Thirteen Florida insurance companies decided to participate in the Insurance Capital Build-Up Incentive Program offered by the State Board of Administration (SBA). This program was established by the legislature in 2007 to provide low-cost financing to new homeowners insurance companies. These companies accepted matching loans of up to $25 million from the SBA in return for a promise to write a significant amount of homeowners business. The terms of the matching loans were attractive: an interest rate equivalent to the 10-year rate on U.S. Treasury bills and a term of 20 years. In exchange for the matching loan, these 13 companies told the SBA that they would write 1.6 million new policies in Florida (which means these companies would have 43 percent of the market share if the existing business of these companies is added with the new policies).

[3] This premium amount assumes $250,000 Schedule A Coverage, $25,000 Schedule B Coverage, $125,000 Schedule C coverage, masonry construction, 2 percent hurricane deductible, $1,000 all other perils (AOP) deductible, replacement cost coverage, and 25 percent Ordinance Law.

But their promise has been difficult to fulfill. Many policyholders don't want to leave the national companies such as State Farm, and other new carriers are aggressively seeking new customers.

There is also considerable activity with Citizens' "takeouts." If an insurer takes over business previously written by Citizens, then that insurer agrees to some of the restrictions that Citizens faces. For example, if Citizens' rates are frozen, then the takeout insurer's rates for the takeout policies are frozen as well.

A soft market appears to exist in the Florida homeowners market now, with its attendant decline in underwriting standards and increases in commissions. Security First Insurance Co. pursues a different strategy. Our goal is to maintain underwriting discipline, competitive commission levels, and responsible pricing. And we are counting on building brand. We believe building brand is important because policyholders in Florida want to shop for homeowners insurance that has become very expensive in their eyes. And consumers are demanding increased access to information so that there is less reliance on agents. We allow people to go on our website anonymously and get a price quote for their home. Further, we are doing something that no one has done before for Florida homeowners insurance (at least recently)—we are advertising on TV. This has proven to be quite effective for building brand awareness and generating activity for our agents and our website.

Jim Massie: I believe that Florida is undergoing an experiment that will end very badly. Part of the experiment is to substitute state public reinsurance for private market reinsurance. That may work up to a certain point, but what the legislature attempted in January 2007 in House Bill 1A went beyond the state of Florida' ability to cover potential hurricane risk. If we think back to recent catastrophes—Hurricane Andrew, September 11 (9/11), and the eight hurricanes in Florida from 2004 to 2005—the private reinsurance market fulfilled its function. We can continue to fulfill that role today. Just in the last 6 to 8 years, there has been a growth of reinsurers in Bermuda so that Bermuda is the largest property catastrophe reinsurance market in the world. It supplies 40 percent of the U.S. insurance market's reinsurance needs and 50 percent of Florida capacity. Bermuda has 18 of the top 30 Florida reinsurers. Bermuda reinsurers supply 61 percent of wind pool reinsurance in Texas and 27 percent of California Earthquake Authority reinsurance.

After the eight hurricanes of 2004, 2005, and Katrina, reinsurers fulfilled their responsibilities, paying record losses and then increasing capacity after paying those losses. Reinsurers developed new products and worked with capital markets to develop CAT bonds and other financial instruments to deal with catastrophes. They were responsible for the creation of sidecars, which proved to be one of the quickest ways to provide additional capacity to the market. Capital markets products are growing so that they account for about 20 percent of risk capital.

There has been a large increased demand for reinsurance driven by a number of different factors. Increased value growth of properties both increased the demand for reinsurance and accounted for two-thirds of homeowners' insurance premium increases in Florida since 2003. The real estate bubble existed in Florida as it did elsewhere in the country but was even more pronounced. At the same time, the north Atlantic hurricane cycle was perceived by most scientists to be putting the east coast of the United States, especially

Florida, at increased risk. Climate change in the form of global warming is forecast to increase the number of hurricanes. Catastrophe modelers revised their models to reflect the apparent increased hurricane risk in Florida after the 2004 and 2005 hurricane seasons. The rating agencies, such as A.M. Best and Standard & Poor's, reevaluated their procedures for determining rates that resulted in their increasing the amounts of required capital for homeowners' insurers. And demand increased enormously during this period as evidenced by Locke Burt's statistics. All of these factors increased the demand for and the cost of reinsurance.

It takes time for the reinsurance market to adjust after paradigm-shifting events such as Hurricane Andrew, 9/11, and the eight Florida hurricanes in 2004 and 2005. The Florida legislature in designing House Bill 1A was responding to the spike in reinsurance costs in 2006 associated with the most recent catastrophes. But by the time this bill was introduced in 2007, the reinsurance market had returned to equilibrium. The legislature was trying to fix a problem that had disappeared. The reinsurance market had already corrected itself.

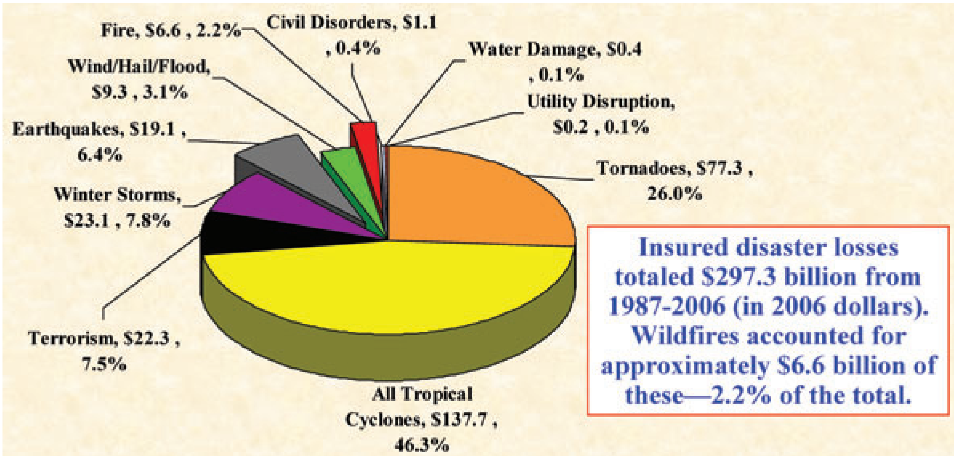
As mentioned earlier, Florida is unique. Florida has 60 percent of the U.S. wind risk, and 50 percent of the most expensive hurricanes have hit Florida. In terms of the category (intensity) of the hurricane, 40 percent of the major (worst) hurricanes have hit Florida. Many believe that Dade and Broward counties are overdue for a major hurricane landfall. Insured property values in Florida are close to $2 trillion, and 80 percent of this property is coastal. So, yes, Florida has a hurricane risk problem.

Figure 8 indicates the inflation-adjusted U.S. insured catastrophe losses by cause of loss from 1987 to 2006. Tropical cyclones account for the largest single block of loss with 46.3 percent of losses costing $137.7 billion. Interestingly, tornadoes are the next largest contributor to catastrophe losses, accounting for 26 percent or $77.3 billion. The remaining contributors to catastrophic losses—such as wind, hail, flood, earthquakes, and terrorism—are relatively insignificant, accounting for less than 10 percent of insured catastrophe losses.

Figure 9 indicates the total value of insured coastal exposure in 2004. Florida has the largest insured coastal exposure at $1.94 trillion, followed closely by New York at $1.9 trillion. After New York, the total amount of exposure drops off dramatically, with Texas having $740 billion and Massachusetts having $662.4 billion of insured coastal property exposed.

Locke Burt talked earlier about assessments that would be made if a major hurricane hit Florida. A Tillinghast study conducted for Associated Industries of Florida indicates that postevent Florida bond issues could range up to $50 billion for a major hurricane. Household assessments could range from $1,700 for a moderate storm to $14,000 for a major hit, with the payments spread over a 10- to 30-year period. These assessments are large compared to the average premium savings of $265 per household with respect to homeowners insurance. But it is not only exposed homeowners that are affected. In Florida, a double subsidy exists. Inland residents subsidize people who live on the coast through assessment payments, and assessments are made on all lines of property–casualty insurance, with the exception of medical malpractice and workers compensation. The fact is that neither the Cat Fund nor Citizens would be able to survive if they had to rely just on homeowners insurance policyholders for assessment purposes.

FIGURE 8
Inflation-Adjusted U.S. Insured Catastrophe Losses by Cause of Loss, 1987 to 2006.



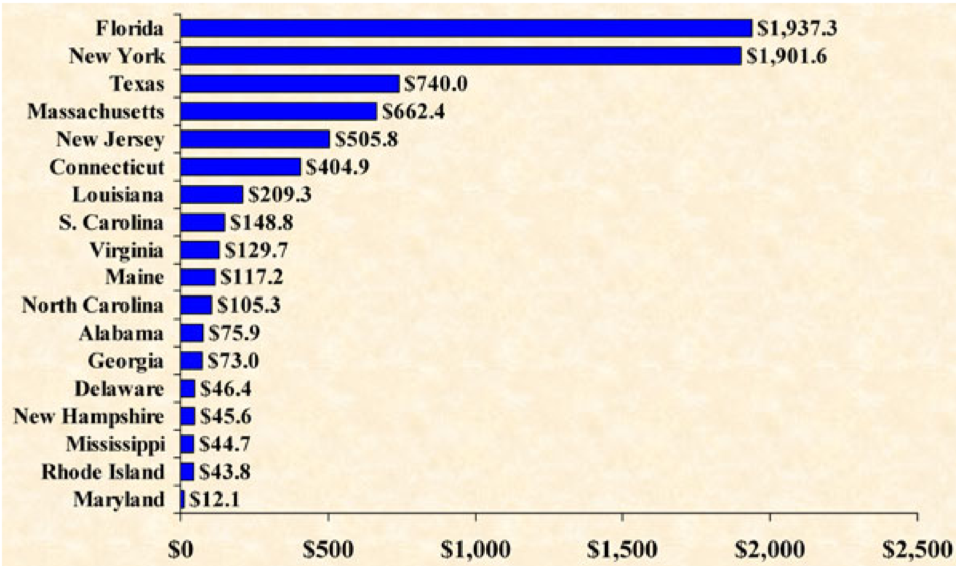
Source: Insurance Information Institute.
Notes: Catastrophes are all events causing direct insured losses to property of $25 million or more in 2006 dollars. Catastrophe threshold changed from $5 million to $25 million beginning in 1997. Adjusted for inflation by the III. [a]Excludes snow. [b]Includes hurricanes and tropical storms. [c]Includes other geologic events such as volcanic eruptions and other earth movement. [d]Does not include flood damage covered by the federally administered National Flood Insurance Program. [e]Includes wildland fires.

It is difficult to see who benefits from the Florida system. Statewide, assessments would exceed by a factor of 10 the average premium savings. For Tallahassee, the potential assessment would be 100 times the average savings, while for Orlando the potential assessment cost would be 69 times the average premium savings. One would expect Miami residents to benefit the most from the Florida system, yet even here the potential assessment cost would be 3 times the average premium savings.

Many people in Florida don't realize that they are subsidizing the Cat Fund and Citizens. Even more interesting, when asked, 64 percent oppose homeowners insurance cross-subsidies. However, this is not what legislators hear from the public. Instead, legislators just hear complaints about insurance costs.

What can policymakers do in this situation? Something that has not been tried since Hurricane Andrew is allowing a somewhat free market to operate. We maintain that the legislature should move gradually to a more free market system. Policymakers can provide insurers with rating freedom so that premiums are based on hurricane risk, as well as promote and fund loss reduction measures. Policymakers should not subsidize developers who build in high-risk areas; this amounts to using tax dollars to put people and property in harm's way. For those who find homeowners insurance unaffordable, policymakers can assist consumers with financial aid through the state's needs-based social service system (not the insurance system), so that they can pay a risk-based premium.

FIGURE 9
Total Value of Insured Coastal Exposure in 2004



Source: Insurance Information Institute.

The Wharton School of the University of Pennsylvania conducted a study in conjunction with Georgia State University concerning the impact that building codes have on insurance claims. According to this study, good building codes can reduce insurance claim frequency by 60 percent. For example, Hurricane Charley hit two neighboring areas, one with new building codes in force and an older neighborhood with older building codes. After Hurricane Charley, the neighborhood with the older building codes was practically destroyed, whereas losses were manageable in the neighborhood with the new building codes. The study also found that good building codes can reduce severity of claims by almost half. Continuing with the Hurricane Charley neighborhood example, claims costs were reduced from $24 to $14 per square foot in the older neighborhood compared to the neighborhood with new building codes. And the study considered the effect of mitigation efforts in other states, for example, for a 1-in-100-year hurricane, the study found that mitigation would reduce expected losses by 61 percent in Florida, 44 percent in South Carolina, 39 percent in New York, and 34 percent in Texas.

Mitigation seems to be a promising avenue for dealing with hurricane risk. The former Chair of the Florida Senate Insurance Committee, Bill Posey, stated, "Mitigation is the surest, more positive, unequivocal, unarguable solution. . . . When everybody in this state does this, the insurance crisis is over" (*Palm Beach Post*, February 8, 2008). The past Speaker of the Florida House indicated that Florida is one hurricane away from the largest tax hike in Florida's history. To put things in perspective, the current amount of general obligation bonds that the State of Florida has outstanding for transportation and other sectors is about $22 billion. It is possible that in 1 year, the Cat Fund would have to issue bonds for $29 billion. So we may wake up one morning after a bad hurricane to learn that homeowners' insurance premiums have suddenly become the state's number one priority, trumping all of the other traditional state services such as education, transportation, social services, and law enforcement. At that point, public officials say, there is always hope that the federal government will come to the rescue. This has become known in Florida as "the Air Force One solution."

Jeff Kucera: As the three panelists have shown, the situation for Florida homeowners insurance is complex. Further, there is not agreement on what is the best solution. What is clear is that the exposure to hurricane losses is continuing to increase, and rather significantly, in Florida. What may not be as clear is what happens to the market if we have that "super" event. The concerns are not only who will pay for the insured losses, but what happens to the Florida homeowners insurance market afterward.

Stay tuned—the situation in Florida is likely to get a lot more interesting before a true solution is found.