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Residual Market Subsidies in Florida's Property Insurance Market:

A CONCEPTUAL AND HISTORICAL FRAMEWORK

Executive Summary

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Residual Market Subsidies in Florida's Property Insurance Market: *A Conceptual and Historic Framework*

Executive Summary

Florida, like many other states, has several state-created insurance and insurance-related entities. These entities, which are sometimes referred to as residual market mechanisms, were created primarily to address problems related to availability of coverage in private insurance markets. Florida has two residual market entities in operation today that play a role in protecting Florida property owners from hurricane risk. Citizens Property Insurance Corporation (Citizens) was formed in 2002 through the combination of the Residential Property and Casualty Joint Underwriting Association and the Florida Windstorm Underwriting Association. Its original mission was to serve as a market of last resort for properties that private insurers will not insure, but that mission has been broadened. The Florida Hurricane Catastrophe Fund (FHCF) exists primarily to provide an important layer of reinsurance for Florida's property insurers (including Citizens). In addition, the Florida Insurance Guaranty Association (FIGA) protects consumers from insurers that become insolvent and are thus unable to meet their claims obligations. All three were formed and operate under state law without adequate capital, and usually do not have sufficient capital to cover losses associated with catastrophic hurricanes striking Florida. When they have deficits, they are required to assess insurers and, in some cases, policyholders in amounts and using procedures prescribed by specific Florida statutes.

Because of Florida's high exposure to hurricanes, the residual market entities involved with the property insurance market in Florida have been particularly controversial since Hurricane Andrew in 1992. The destruction caused by Hurricane Andrew and the five significant hurricanes striking Florida in 2004 and in 2005, has produced a 16-year period of economic stress and almost continuous political attention to property insurance issues. The deficits of Citizens Property Insurance Company in 2004 and 2005, the size and nature of the assessments to fund these deficits, the $715 million legislative appropriation in 2006, and rapidly rising property insurance rates in 2005 and 2006 all raised important questions about the overall health of Florida's property insurance market and the ability and willingness of private insurance companies to meet the needs of Florida residents for property insurance coverage.

Much of the controversy associated with Citizens and the FHCF has been whether the levels at which their rates have been established and the procedures they are required to use in imposing deficit assessments have created subsidies within the state. Discussions of subsidies in Florida's property insurance market are couched in various terms, such as: 1) whether the rates charged to, and the deficit assessments imposed on, policyholders in northern Florida counties are subsidizing policyholders in southern Florida counties; 2) whether rates and assessments paid by policyholders in inland counties are subsidizing policyholders in coastal counties; and 3) whether intra-county subsidies exist with respect to rates charged to and assessments imposed on policyholders. It is important to understand property insurance subsidies in all of these contexts.

Although nothing is inherently wrong with subsidies, they may deserve attention if they 1) exist inadvertently; 2) exist in amounts far different than planned; 3) are inefficient or ineffective in achieving intended goals; or 4) have unintended (or even perverse) consequences. The discussion and observations provided in this paper are intended to be useful to public policy makers and others seeking to understand Florida's residential property insurance market and the issues related to subsidies in the state-created property insurance residual market mechanisms. These observations are not intended to be recommendations for action, but they may assist public policy makers as they identify and consider ways to help improve the performance of Florida's residential property insurance market.

The major points raised in the paper are summarized below:

- The 2007 and 2008 Florida property insurance legislation rolled back Citizens' rates to 2005 levels and froze those rates for four years. This was done as part of the Florida Legislature's efforts at that time to achieve "affordable" property insurance rates. Since its inception, the FHCF has charged "below-market" rates, which, with the passage of time, seems also to be associated with the motivation to keep rates affordable. These actions have produced lower property insurance rates in the short run but over a longer term may have various adverse effects, including, but not limited to, reduced financial resources for Citizens and FHCF to pay catastrophic hurricane losses and the likelihood of much larger deficits in Citizens and FHCF that could cause unacceptably large deficit assessments on virtually all Florida residents over many years.

- The Florida Legislature may not have intended for the deficit assessment processes of Citizens, FHCF and FIGA to produce sizeable subsidies from residential property insurance policyholders in parts of the state with lower hurricane exposure to policyholders in parts of the state with higher hurricane exposure; however, this is the result of the current statutory assessment procedures.

- The implicit nature of Florida's assessment-related subsidies appears capable of producing a wide range of negative effects typically associated with many government subsidy programs, i. e., subsidy leakage, subsidies across time, unintended consequences, and negative externalities.

- While this report refers primarily to inter-county assessment-related subsidy issues, there are similarly important intra-county assessment-related issues in coastal counties.

- Legislative action to substantially reduce the assessment-related subsidies described in this report could have several benefits. In addition to reducing the negative effects of the subsidies and enhancing the financial capacity of Citizens and the FHCF to pay hurricane losses, it may also facilitate the development of greater hurricane loss mitigation incentives and the achievement of greater hurricane loss mitigation activity in both new and existing residential properties.

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