Florida State University

Homeowner’s Insurance in Florida:

An Analysis of Options for State Action

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November 14, 2006

Governor Jeb Bush  
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Dear Governor Bush:

I have the privilege of presenting to you Homeowner’s Insurance in Florida: An analysis of Options for State Action. This report is the culmination of extensive research and analysis throughout the fall months of 2006. Florida is one of the fastest growing states in the Union and the protection of personal property and wealth from catastrophe is of great importance.

After examining several policy options my recommendation is that Florida seek a partnership with other states in the region facing the same issues in order to form a multistate reinsurance fund. This policy was evaluated using three criteria: political desirability, administrative feasibility, and market impact. A multistate reinsurance fund scores highly in all three categories and proves to be the best policy for combating the current insurance crisis.

This policy has the potential to help alleviate the burdens on all stakeholders: the state, insurers, and homeowners. Immediate action is needed if Florida, and the region, is to be prepared for future hurricane seasons. A multistate reinsurance fund would have the ability to lower rates and increase availability. I hope that this report is of assistance to you and your staff in preparing Florida to deal with the catastrophes of tomorrow.

Sincerely,

Joshua Sanderlin
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Executive Summary

Homeowner’s insurance is vital to the protection of personal property and wealth. In Florida, and along the Gulf Coast, both are in danger. Hurricanes are becoming increasingly more common and more intense. That, combined with growing coastal communities is a recipe for disaster. Insurance rates are climbing to astronomical proportions and many insurers are refusing to write new policies and some are even canceling old ones. Unfortunately, there has been little done to combat this insurance crisis.

Homeowners are being forced to pay increasingly higher rates for insurance. Those homeowners whose policies have been dropped are forced to use Citizens Property Insurance. This places a large burden on homeowners because the rates for Citizens are the highest in the state. Simultaneously this overextends the government insurer creating a huge liability for the state. This paper provides solutions to the current crisis and makes a recommendation for state action.

Information for this paper was gathered in three ways. First, the laws and regulations surrounding homeowner’s insurance rates were reviewed. Second, popular newspaper articles were reviewed in an attempt to understand the reaction of citizens and politicians. Third, academic journals pertaining to this issue were consulted. Finally, interviews with stakeholders were conducted in order to give insight into the issue and the legitimacy of the proposed policy options.
This report presents three policy options for homeowner’s insurance: capital market solutions, multistate reinsurance, and a federal backstop. Each of these options was evaluated based on three criteria: political desirability, administrative feasibility, and market impact.

After evaluating the policies against each criterion this paper recommends the implementation of a multistate reinsurance fund. This policy would have the greatest benefit to all the stakeholders. Insurers would have greater security in writing policies. The state would lessen its burden to provide insurance and homeowners would see a drop in rates and a raise in policy availability. Each option would have an effect on the crisis, but the use of a multistate reinsurance fund would be both politically desirable and administratively feasible. Also, it would have the largest immediate impact on the market.
I. Problem Statement

Florida is a dream for homeowners. The sun shining twelve months a year. The weather, while hot in the summer, is warm and mild year round. Florida is home to some of the finest golf courses in the country and provides residents with a myriad of water sports and attractions. The majority of people are drawn to the coastal communities which are plentiful in Florida. However, there is one looming problem for Florida homeownership: the hurricane season.

In the last two years Floridians have seen unprecedented amounts of destruction stemming from hurricanes. Over a fifteen month period Florida was hit by eight different hurricanes. These hurricanes ranged in magnitude from category two to category four. Insured property damage tolled near $39 billion in insured losses. Hurricane Dennis cost insurance companies the least at $1.24 billion and Wilma cost insurers the most at $9.9 billion (Florida Senate Banking and Insurance Committee, 2006). After the storms passed, three insurance providers were deemed insolvent meaning the companies could not provide the funds for the massive amount of claims.

Florida lawmakers (legislative and executive) find themselves in a mad scramble to equip the state and its homeowners with the means to withstand future hurricanes. Homeowners have the ability, if denied private coverage, to participate in the Citizens Property Insurance Corporation. However, guidelines to meet the requirements of eligibility are stringent and coverage is minimal. The state has also been equipped with
the Florida Hurricane Catastrophe Fund, but the legislature was recently forced to issue a $750 million bailout that has had no noticeable effect to insurance market prices.

The state is currently experiencing a population boom. The new citizens are coming from other states and other countries. Not only does this put strain on the economy and natural resources, but it also begs the question of who will insure the new homeowners?

Providing minimal coverage and issuing bail-outs are at best band-aids for the gaping wound that developed following the 2004-2005 hurricane seasons. The minimal coverage policies written by the state do not offer any relief for rates and also fail to adequately protect homeowners against large catastrophes. The funds utilized for bail-outs are assessed from insurance companies respective to the portion of the company’s written policies in the state. This obviously places a heavier burden on the private sector. Administering homeowners insurance in Florida has never been a high profit enterprise, however it has recently become a high-risk venture that could leave corporations insolvent. The government will need to find new ways of working in government- private partnerships with insurance providers, providing for a strong federal backstop, or will need to find a way to use the capital market to increase surplus.

Hurricanes are part of life in Florida. Growth in the number and intensity of storms which damage the state annually has become the trend. The purpose of this Action Report is to examine three policy options that are gaining support for implementation: expanding surpluses through capital market investments, a federal “backstop” program, and a multistate reinsurance program. The different options will be
assessed in order to provide recommendations that will alleviate the current crisis and prepare Florida for the hurricane seasons to come.

II. Background and Literature Review

Background

This section will discuss the current issues regarding the rising cost of homeowner’s insurance coverage over the last three years. There have been recent attempts to counteract the loss of coverage in Florida. The major attempt to counteract the losses can be found in recent legislation passed by the Florida legislature. This action report will focus largely on this legislation and the major losses which it attempts to alleviate.

Hurricanes are not new to life in the state. Unfortunately the frequency and intensity of these storms has increased in the past two years. The major threat posed by hurricanes is not to life, but instead the threat is to property. Winds produced by hurricanes can reach over 150 mph. These winds have the potential to cause the greatest amount of destruction to property. Also, the rain accompanying the winds can flood large areas in a short period of time. Understandably, insurance companies have historically vacillated on the issue of supplying large coverage in the state. These concerns were legitimized during the hurricane seasons of 2004 and 2005. The following is a breakdown of the losses incurred by storm damage in the two hurricanes seasons (by storm):
The losses due to these storms were immense. Many people were forced to wait months for home repairs and reimbursements from the insurance companies.

Since the passing of the storms, insurance companies have either abandoned Florida homeowners or raised insurance rates by unprecedented proportions. The insurance provider Allstate Floridian has refused to renew 95,000 policies in the state. Simultaneously, the company has requested a statewide rate hike of 24.6 percent (“Homeowners look to state”, 2006). The requested rise in rates by Allstate Floridian is small compared to the request of other insurance providers. For example, in Palm Beach County the insurer Florida Peninsula requested a rise of 101 percent and State Farm has similarly requested a rise of 127 percent for the same county (“Premium pressures”, 2006). The private market dictates that insurance companies increase rates to compensate for loss. However, these rate increases are making it impossible for many homeowners to continue to afford insurance.
Those people dropped by insurance providers have the option of receiving coverage from the state. The state provides coverage through the Citizens Property Insurance Corporation. There are two key problems with receiving coverage from Citizens. First, to qualify for coverage a homeowner must be turned down by at least four private providers and the value of the home cannot exceed $1 million. Second, the rates for coverage by Citizens are the highest in the state. Therefore, the process for obtaining coverage is long and the costs are still too high for many Floridians.

The rise in cost and the loss of coverage have Floridians in an uproar. November is approaching and with it the gubernatorial election. The candidates are providing more rhetoric than solutions to the current insurance crisis. The reason candidates do not have any answers is because there are no quick or uncomplicated solutions for resolving these issues. The Florida legislature recently passed, and the Governor has signed into law, an attempt to counteract the great losses. The legislation, Senate Bill 1980, offered many changes to both Citizens Property Insurance Corporation and also to the Florida Hurricane Catastrophe Fund (FHCF). For instance, SB 1980 calls for a one time appropriation of $750 million to Citizens in order to lessen the $1.7 billion deficit incurred by the corporation. Similarly, the new law requires a 25% rapid cash build-up in the premiums paid by insurance companies seeking reinsurance through FHCF (Florida Senate Banking and Insurance Committee, 2006). In light of ever rising insurance rates it would be naïve to suggest that the measures taken have solved the larger problem of future coverage for homeowners.

As the private market for reinsurance creeps further away from the catastrophe-ridden state, the citizens will inevitably see the cost of homeownership rise. Therefore,
the state must take steps to ensure that the homeowners can afford coverage that is extensive and reliable. Hurricanes can destroy more than property; they can also destroy Florida’s economy. If those in the path of the hurricane have to spend every cent they have to repair or even rebuild homes and businesses the net outcomes could be severe. The importance of this issue will not lessen, but instead will grow rapidly with the approach of each new hurricane season.

Until now, all remedies offered have been in the interest of repair. However, there must be a plan for tomorrow, one in which Floridians are covered against catastrophe without being left financially crippled. The state cannot be left to support the weight alone. Whether in the form of a stronger public-private partnership or in more federal assistance, the state and its citizens need assistance.

Literature Review

The research for this report focused on five main themes: who suffers the most from catastrophes, the effect of recent hurricanes on Floridians, mitigating factors in determining insurance company risk exposure, capital market solutions to increase surplus, and the ability of the federal government to provide assistance. These themes are crucial to furthering development of a stable and affordable insurance market.

First, the literature discusses the effect a catastrophe has on different segments of the population. Most of the literature points to the inequity in coverage between society’s affluent and those of lesser means (Peacock and Gillis, 1997). One study concluded “private home insurance disproportionately benefits the relatively advantaged, who are more likely to be insured and who fare better in the insurance claims process” (Baker and McElrath, 1996, p. 260). Economic disadvantage is closely tied to race and ethnicity.
Historically, economic status is lower in the minority segments of the population. Identifying the inequalities in coverage and the insurance claims process is essential to finding new ways of improving the insurance market’s ability to provide full and fair coverage to all citizens.

Second, a plethora of articles pertaining to the effects of the recent hurricanes on Floridians have been printed in newspapers all over the state. In many of these articles the stress on the public is expressed through interviews with homeowners, legislators, and insurers. Many homeowners express their inability to continue to afford homes in which they have resided in for years. For example, one such interview describes a man whose hurricane premium in Fort Walton Beach more than quintupled from $899.54 to $4,830.66, causing his insurance to climb from $1,320 to $5,479 (“I can’t afford to live here,” 2006). This is a trend that is well documented throughout Florida. Legislators are interviewed continuously in an effort to bring forth the answers that will lessen the burden on individuals. One newspaper printed a statement by Senator Bill Nelson in which he declared, “no one state or insurance company can withstand the big one” (“State seeks federal aid,” 2006). Senator Nelson was referring to the need for a federal program to prevent another situation similar to the current crisis. The articles also address the concerns of private insurers. The regional vice-president of Nationwide Insurance expressed his concerns and tried to justify the raising of rates, “we have an obligation to ensure that our homeowner rates are adequate to insure our long-term viability…this rate adjustment will cover rising reinsurance costs” (“Nationwide asks to raise rates,” 2006). The articles provide valuable insight into the attitudes and concerns of those involved in the search for viable solutions.
Third, in order to understand the factors that raise rates, this literature review explores agency reports. The Insurance Services Office provides many illuminating reports on this issue. Past catastrophe experience is an important factor when insurers attempt to project losses and set insurance rates. The past experiences provide insurers with the basis for risk assessment (Insurance Services Office, 1990). There are many complicated computer systems that provide projections for future probabilities, however, there are two key elements that can lower the risk to a company and in turn lower the rates charged. First, the geographic distribution of policies is critical. Companies writing policies primarily in a concentrated area lessen the likelihood of a catastrophe, but the overall impact of a direct hit is magnified. On the other hand if a company spreads out its policies, then it will experience more catastrophes, however, each at substantially lower costs (Insurance Services Office, 1996). The second factor is the ability of insurers to receive affordable reinsurance to cover excess losses. Affordable reinsurance allows companies to withstand large catastrophe losses. Companies that are able to prevent substantial losses are not forced to raise rates (Insurance Services Office, 1996). It is essential that insurers find ways to mitigate loss in order for homeowner insurance to be affordable.

Fourth, the issue of capital infusion is at the forefront of any discussion to provision of adequate catastrophe coverage. Support is growing for greater participation in the capital market in order to provide a capital infusion into the insurance industry. Supporters suggest packaging catastrophe risk as securities that insurers and investors can buy and sell in the capital markets (Insurance Services Office, 1999). The capital markets can give insurers access to far more financial capacity than previously available.
Also, exposure to the capital markets will spread catastrophe risk far more widely than previously possible (Froot, 1999). Through capital markets the insurers will be able to expand surpluses used for paying claims to policyholders.

The final area of concern is the ability of the federal government to provide assistance. Currently there are three roles the government plays in providing insurance: partner to private insurers, federal flood insurance; competitor to private insurers, federal crime insurance; and exclusive provider of insurance coverage, workers’ compensation (Greene, 1976). The literature is split over the actual need for federal government intervention. In support, L. James Valverde states that some risks are simply too large or unpredictable to be insured within the current institutional, financial and regulatory frameworks (Insurance Information Institute, 2006). The CATO institute refers to benefits of federal insurance and reinsurance as “speculative, subject to real uncertainties, and modest at best” (Harrington and Miller, 2005, p. 395). However, there is strong support for a system in which a cooperative effort diversifies losses arising from large-scale natural disasters through a reliance on insurers, reinsurers, and the federal government (Lewis and Murdock, 1996). The federal government has the financial capacity to have a large-scale impact on the private market. These articles point towards a solution with the participation of the federal government.

The literature reviewed provides a framework that can be employed in developing and analyzing possible policy solutions. This report will expand on the literature review by comparing and contrasting the possible avenues for resolution. It is the ultimate aim of this report to combine these sources with personal interviews in order to provide a final recommendation for action.
III. Methodology and Evaluation Criteria

Methodology

Information for this report was collected using the following methods:

- Review of recent laws pertaining to the regulation of homeowner’s insurance in Florida.
- Analysis of newspaper articles discussing the reaction of citizens to the insurance crisis.
- Review of academic journals using JSTOR and OmniFile databases.
- Interviews with staff members from the Florida Senate, the Florida House of Representatives, the Office of Insurance Regulation, concerned citizens groups and one private insurance lobbyists (n= 8)

The review of recent laws pertaining to the regulation of homeowner’s insurance were important to the development of new policy options. Newspaper articles from multiple Florida newspapers were researched in order to provide an understanding of the frustrations of homeowners in the state. Academic journals and agency reports are important in that they provide not only background to today’s crisis, but they also offer criticisms of the current system and demonstrate a need for adequate solutions. The most important resource is the interview. Each personal interview was unstructured and approximately 25-30 minutes in length. The questions covered the current crisis and the possible effects of this report’s proposed solutions.

Evaluation Criteria

In the search for a solution, three policy options will be evaluated against a specified set of criteria. Each criterion is utilized in order to judge the capacity of a specific policy option to fulfill the needs of individual homeowners, the insurance market, and the government. The criteria are defined below.
• **Political desirability** measures the extent to which politicians are willing to support each option. This will encompass politicians’ views as well as the views of citizens. Interviews with legislative staff and homeowners will be used to collect data for this criterion.

• **Administrative feasibility** refers to the ability of each option to be administered efficiently. At issue are the resources and infrastructure needed to implement an option. For example, an agency or department that can handle the implementation of a policy would add credibility to the administrative feasibility. Utilization of academic journals, government reports, and interviews will be sources used to collect data for this criterion.

• **Market impact** denotes the overall effect a particular policy will have on the availability and affordability of homeowners insurance. The data for this criterion will be gathered through reports by the government task forces, government agencies, and lobbying groups.

These criteria do not cover all factors. For instance, cost is not considered because data on the actual cost of each program are unavailable. In addition this report discusses the impact each option will have on the insurance market.

In order to make a final recommendation, the evaluative criteria and policy options will be placed into an alternatives matrix. Each option will be judged comparatively to the other options under evaluation in this action report. The options will be evaluated based on the extent that each addresses the evaluative criteria. For each criterion an option will receive a score of high, medium, or low. The option receiving the most scores of “high” will be considered the best policy.
IV. Policy Options

A review of the current situation in Florida’s insurance market led to the exploration of three policy options. First, implementing capital market solutions is an option that might take some of the burden off of the private insurance market. Second, this report will explore developing a multistate reinsurance program where states facing similar perils would combine resources to provide reinsurance to homeowner’s insurance companies. Finally, a federal backstop program, similar to the proposed version in the Homeowners Insurance Protection Act of 2005, might be able to provide enough reinsurance and risk dispersion to either stabilize or lower rates of homeowner’s insurance. Florida’s growth and future rest heavily on the issue of insurance availability and these three options provide clear paths to achieving the goal of restoring the state to normalcy.

Option One: Capital Market Solutions

The capital market can be used to bolster the surpluses of private insurance companies and the pre-existing Florida Hurricane Catastrophe Fund (FHCF). Surplus refers to the amount of capital that an insurer or reinsurer has available to pay claims in the case of a catastrophe. The ability to extend surplus is valuable to overcoming the current problem of affordability and availability.

The sheer size of the capital market is an attractive trait that has led insurers and reinsurers to explore capital market solutions. According to the Insurance Services Office’s report *Financing Catastrophe Risk: Capital Market Solutions*, “Only two sources may be able to provide the capacity necessary to finance very large catastrophe
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risks – the federal government, with its power to tax, and the $26 trillion capital market” (1999, p. 14). The value of traded stocks in the United States alone is over $5 trillion.

There are many proposed methods to the securitization of risk. The use of catastrophe bonds as means to securitize risk and provide extra surplus to insurers and reinsurers will be examined.

Catastrophe bonds were chosen over other possible methods of securitization because they have been in use for the last ten years. Catastrophe bonds are corporate bonds with special language that requires the bondholder to forgive or defer some or all payments of interest or principal if actual catastrophe losses surpass a specified amount. The amount that would cause the forgiveness of debt is called the “trigger” point. When this point is reached, insurers and reinsurer issuing these bonds are able to use the funds, money that would have gone to bondholders, to pay claims. The use of these bonds will be evaluated based on the criteria laid out in the previous section.

Political Desirability: In order to institute the best policy it is important that the policy is politically desirable. Politicians are hesitant to issue policy changes if they feel that citizens or other politicians do not accept the policy. The issue of homeowner’s insurance is of great consequence to many Floridians. According to William Stander, the Regional Manager of the Property Casualty Insurers Association of America, homeowners want the government to effectuate change in the state’s insurance industry (personal communication, October 17, 2006).

The problem with the use of catastrophe bonds and the capital market is that it requires no significant change imposed by the government. Insurance companies are already free to use these bonds and the FHCF would increase its size without
assessments. To some this is a good thing, but to many it is not. In an interview, one homeowner stated that, “we feel that the government needs to intervene in order to stop the insurance companies from raising our rates” (Kimberly Knight, personal communication, September 20, 2006). Even though using catastrophe bonds would improve the market, the government would appear impotent.

Politicians on the right are generally those who will support this policy according to the Florida Senate Banking and Insurance Committee Staff Director Brian Deffenbaugh (personal communication, October 10, 2006). The role of government in this option is extremely limited. Some, such as James Massie of the Reinsurance Association of America, feel that the current crisis is due in large part to past government intervention into the private market and therefore the private market should be allowed to run freely (personal communication, October 17, 2006).

In summary, the political desirability of capital market solutions is low. Citizens will not be satisfied with this action and therefore politicians will be unlikely to support it. Elected officials must be perceived by the public as taking direct action to resolve the current insurance crisis. The use of the capital market will not accommodate this perception.

Administrative Feasibility: There are three important reasons why the current market for catastrophe bonds is small. First, the risks associated with catastrophe bonds are high. Second, these bonds generally have a high cost associated with transactions. The Insurance Services Office states, “insurers issuing catastrophe bonds may face high transaction costs, because of the need to provide significant amounts of information to multiple investors” (1999, p. 18). The final drawback to catastrophe bonds concerns
administrative feasibility. The administration of catastrophe bonds is structured in a complex manner with investors on one side, insurers on the other and intermediaries serving as a buffer between the two (Appendix A).

The only exchange that currently securitizes catastrophe risk is the Chicago Board of Trade. In order to securitize risk, an insurer or reinsurer must first find a Special Purpose Reinsurance Vehicle (SPRV). This entity serves as an intermediary between insurers, reinsurers and capital market investors. An insurer or reinsurer pays reinsurance premiums to the SPRV to cover specified claims. The bonds can be individually structured to investors desires by raising or lowering the trigger and the amount that the investor must forgive. The SPRV is to hold the funds raised from the catastrophe bond contracts in a trust in the form of Treasury securities and other highly rated assets. The process of establishing an SPRV and tailoring individual catastrophe bond offerings would weigh heavily on the efficient and effective administration of this policy.

While the idea of utilizing the capital market for securitizing catastrophe risk is very appealing, it is also important to note the complexity involved in administering this policy. According to the State Board of Administrators of Florida, “the undeniable complexity of the instrument (SPRV) has been a drawback [catastrophe bond] growth” (A Study of Private Capital Investment Options, 2006, p. 20). In order to expand the FHCF through the use of catastrophe bonds, the state would be forced to find an SPRV or create an entity to serve a similar purpose. Then administrators of the FHCF would need to offer the bonds at attractive rates in order to attract investors.

Catastrophe bonds are attractive and the capital market is enormous, but the administrative feasibility is low. In order to be administered correctly, catastrophe bonds
need a large infrastructure to be established. SPRV require a separate entity to hold and transfer funds, which ultimately make the administration of catastrophe bonds low.

**Market Impact:** The use of catastrophe bonds will have a positive impact on the market. Insurers and reinsurers that use these bonds will be able to increase surpluses. The increase in surplus happens when a catastrophe triggers the provisions in the bonds that require investor forgiveness of the principal. In this case the insurer or reinsurer can immediately write down its liability for these bond causing a rise in the surplus or net worth.

Increasing surplus will enable insurance companies to write more policies, which would increase the availability of insurance. However, this capital market product is unlikely to have a significant impact in the short-term on affordability. In a report by the State Board of Administrators, it is noted that “new capital market products typically take time to catch on, in part due to the time needed for investors to learn how the new products work, for product designs to be fine-tuned and as fiduciaries wait for the products to weather a market cycle” (Private Capital Investment Options, 2006). Also problematic is the individual tailoring of bonds. In order to attract investors, catastrophe bonds are developed to address the specific needs and desires of individual investors. If each bond has a different trigger, then it is almost impossible to forecast the amount of capital that would be available to the insurers.

Utilizing the capital market will only solve half of the problem. In the short-term insurers and reinsurers will be able to write more claims, but it is improbable that catastrophe bonds will bring down rates in the near future. The complex structure, the
use of SPRVs, and individuality of each bond, necessary to attract investors, make the overall market impact medium.

To summarize, catastrophe bonds may be an attractive solution to Florida’s current insurance problems. However, based on the criteria, catastrophe bonds fall short of an appropriate solution. Depending on the private market does not address citizens’ desire for government intervention. The complex structure of catastrophe bonds will make administration difficult and cumbersome. Also, catastrophe bonds will not have an immediate or determinable impact on the current market.

**Option Two: Multistate Reinsurance**

Reinsurance is insurance provided to private insurers to cover losses exceeding a stated amount. There are currently three states that offer reinsurance to those companies providing insurance to the state’s citizens (FL, HI, CA).

Providing affordable reinsurance to insurers is important to sustaining a viable market. Reinsurance in the private sector can be very expensive. States are able to provide reinsurance at a lower cost because the funds for reinsurance are tax-exempt. If companies are not able to receive coverage at affordable rates, then that will transfer into higher rates for citizens. Kevin Campion of the Florida Underwriter asserts that the “need for increased capital restricts the ability of insurers to write policies…the only other option is to raise premiums on policyholders” (Campion, 2006, p. 37).

The problem is that the current systems of state-provided reinsurance are not large enough. Currently, Florida only provides coverage of $15 billion. The reality is that if a large enough storm hits a major city (such as Hurricane Katrina and the city of New Orleans) the costs may well exceed the amount available through state reinsurance.
Therefore, one option is to form multistate reinsurance programs. States facing similar catastrophes form reinsurance funds, similar to that of Florida, which will cover insurers in all the states. For instance, states such as Florida, Texas, Alabama, Mississippi, Louisiana, and Georgia all face the possibility of hurricanes. A program similar to the FHCF could raise enormous amounts of capital simply by combining resources. Then the region could have a large enough pool of capital to provide larger amounts of reinsurance at affordable rates. It is important to remember that reinsurance is activated only if the insured losses reach a specified amount.

Multistate reinsurance will be assessed based on established criteria in order to understand its comparison with the two other policy options.

**Political Desirability:** A multistate reinsurance program has the benefit of providing assistance to the market without overtly imposing the government’s will on the market. This policy will allow the government to demonstrate its commitment to repairing the insurance market in Florida.

Florida is not alone in suffering from the effects of the recent surge in hurricanes. Many states along the Gulf Coast have also been ravaged by storms (Texas, Louisiana, Mississippi, and Alabama). Therefore a coalition of states with similar insurance interests would be politically viable. Politicians in the state are recommending that if the federal government does not take action (in the form of a federal backstop), then states must band together to guard the interests of the region. For example, Democratic senator Walter “Skip” Campbell said, “if we cannot get a national catastrophe fund then we need a regional catastrophe fund and Florida should team up with other states to fund property damage claims” (*Property Insurance Rates*, 2006). Politicians will likely agree with
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Campbell and are generally attracted to the idea of sharing Florida’s burden with other states in the region according to William Stander, Regional Manager of Property and Casualty Insurers Association of America (personal communication October 17, 2006). Therefore, the political desirability of multistate reinsurer is high.

Administrative feasibility: Interstate compacts are in use in myriad areas. The policy areas effected by interstate compact range from adoption to emergency response. The implementation of a multistate reinsurance program therefore is not novel and would not require excess infrastructure. There are two methods that could be utilized to establish this policy.

First, each state would be required to establish a catastrophe fund like that of the FHCF. Once established in each participating state, the state funds would need to establish a regional governing body. This body would use funds from each state to establish a parent fund that would cover the losses in states that exceeded the limits of the state catastrophe funds. For example, if Florida exceeded the FHCF’s limit of $15 billion, then the regional fund would be used to cover the remaining losses. It is questionable that each state would be able to develop a catastrophe fund and this reduces administrative feasibility.

The second method of forming a regional fund would be to establish a fund for the Southeast through the FHCF. Essentially, Florida would expand the FHCF by offering reinsurance to companies writing policies in participating states. A board or commission would need to be established to set retention lines and place caps on the fund. According to Staff Director Brian Deffenbaugh of the Florida Legislature, the
largest problem is the need to build a consensus using actors with different interests (personal communication, October 10, 2006).

The administration of an interstate compact would not be difficult. If the later approach is taken, then the structure and the fund are already established. What is necessary would be the expansion of the fund to incorporate participating states. The largest drawback to the administration of this policy is the possibility of slow consensus building. A multistate reinsurance program is practical and has high administrative feasibility.

**Market Impact:** The use of multistate reinsurance would secure insurance policies written over a large area. The size of the area would depend greatly on the states wishing to participate. By agreeing to participate each state would not only provide insurers with more secure policies, but each state would also relieve some of the post-disaster financial burden on their economy. A multistate reinsurance fund would increase availability and under certain circumstances could lower rates in the short-term.

This policy will increase the availability of insurance to citizens. After the hurricane seasons of 2004 and 2005 insurers became reluctant to write new policies or continue existing ones. Excess losses incurred by the insurers severely undercut their ability to expand business (Insurance Services Office, 1996). Ultimately this has led Citizens Property Insurance Corporation (the state insurer) to become the largest supplier of homeowner’s insurance in Florida. Multistate reinsurance would secure more policies up to a higher threshold making policy writing more appealing.

If the fund were to apply for tax exempt status (like the FHCF) then it would be able to retain larger amounts of capital and offer reinsurance at a lower rate than the
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private market. According to the industry research group Guy Carpenter, “The FHCF is exempt from federal income taxes, which endables it to accumulate funds faster than a private sector reinsurer” (The World Catastrophe Market, 2006, p.14). This would lower rates to homeowners in the short-term. The large size of this reinsurance fund could allow the fund to lower retention lines. Lower retention lines would lessen the burden on insurance companies that in turn could lower rates.

The availability of a large amount of reinsurance at a low rate would invariably allow insurers to provide more coverage at lower rates. Also, lowering the retention line would alleviate some of the burden on the private market and this could manifest as lower rates for individual homeowners. The use of a multistate reinsurance fund ranks high for its market impact.

The establishment of a multistate reinsurance program, then, would meet the needs of the market and citizens as it adequately addresses each criterion. It is politically desirable in that the government is the agent of change. The administration of this program would be facilitated by the existence of the FHCF and the impact on the market would be expedient. Ultimately, this program would go a long way to solving Florida’s insurance problems.

Option Three: Federal Backstop

The use of a federal backstop for catastrophe reinsurance is a fervently debated topic. Some, like James Massie of the Reinsurance Association of America, believe the government should not interfere in the private insurance market (personal communication, October 20, 2006). Others, such as Senator Bill Nelson, support federal government intervention and claim that the size of government’s budget makes a federal
backstop not only possible but also necessary. This section will provide an explanation of the structure of a federal backstop program. Second, it will evaluate the proposed policy through the criteria set forth in previous sections.

It is important to understand the structure of this program. The federal backstop is not insurance like that provided by the National Flood Insurance Program. Instead, it serves as a form of reinsurance provided on the federal level. This program is accurately called a backstop because that is just what it does. It provides coverage above the private insurance market and beyond state reinsurance programs such as the Florida Hurricane Catastrophe Fund (FHCF) and the California Earthquake Authority (CEA). The use of a federal backstop proves to be a three-pronged approach. The first layer of coverage is the private insurer. When losses exceed established retention levels ($5.3 billion in Florida) the state pooling systems activate and pay claims providing the second layer of coverage. In Florida, the FHCF can only hold $15 billion in funds. What happens then if the losses exceed $15 billion? This is where the third layer of coverage would be utilized. Here the backstop would take effect and cover the remaining losses. Programs such as FHCF and CEA would purchase reinsurance from the federal government and this would be used once both the private insurers and state funds met the federal retention line.

Political Desirability: The federal backstop program is concerned with regional desirability; those who live in states along the Gulf Coast, California, Hawaii or any other state with a high frequency of natural disasters will be likely to support this policy. However, citizens who reside in states where there is little occurrence of natural disasters will be less likely to support the federal government in its decision to provide reinsurance.
The largest problem with this policy is similar to its largest benefit, size. Instead of dealing with Floridians, Congress must take into account the political desires of over 300 million people. It is hard to build a consensus in such an environment (B. Deffenbaugh, personal communication, October 10, 2006). Unless Americans are made to believe the truth that they inevitably pay for either preparedness or repair, the idea of federal backstop will continue to fail in Congress. Unfortunately, this has been the case and Congress continually fails similar backstop programs as it did in 2005. In fact, attempts to establish a federal backstop can be found as early as the 1970s with the Federal Disaster Insurance Corporation Act of 1973.

There is hope. Congress recently renewed a federal backstop program for terrorism insurance. The Terrorism Risk Insurance Program (TRIP) was begun in 2002 and scheduled to run for three years. Early this summer Congress renewed TRIP. As of now, the political desirability of a federal backstop is low. According to William Stander, the major roadblock to this policy is that Americans who do not live in catastrophe-prone areas do not want to pay taxes to assist other states facing these perils (personal communication, October 17, 2006). However, TRIP shows that if all Americans are made to feel like stakeholders in catastrophe preparedness then the political desirability of a federal backstop will increase from low to high.

Administrative feasibility: The federal backstop program is by far the most administratively feasible for two reasons. It is important to understand that the reason for past failures deals primarily with low political desirability and not with administrative feasibility. First, since Congress has been trying to pass this legislation for many years, an administrative model of the backstop has already been identified. According to this
model the program would be administered through the Treasury Department and all funds would be held and dispersed by the Secretary of the Treasury. Second, the federal government, through terrorism reinsurance, already performs the functions that would be required of a federal backstop for natural catastrophes. Since past legislation has already identified the structure for the program, the administration would be facilitated.

In 2005, the US Congress voted on the Homeowners Protection Act. The bill was voted down due to its lack of support by congressmen from states not facing major catastrophes; however, it provided a model of the organization and procedures for a federal backstop program. The lobbyist group Protecting America, explains the Homeowners Protection Act in detail (Protecting America, 2005, ¶ 10). The act would have established the Consumer Hurricane Earthquake Loss Prevention Fund (Consumer HELP Fund). The fund would have been housed in the Treasury Department and the Secretary of the Treasury would administer the fund. The 2005 legislation would have required the Secretary to establish a commission to manage the fund. The bill even enumerated who should be placed on the commission. The administration of this policy would not require the creation of a new organization like catastrophe bonds (SPRVs) and would not require consensus by multiple states like multistate reinsurance.

The establishment of the TRIP lends credit to the apparent administrative feasibility of similar catastrophe program. The Terrorism Risk Insurance Act is structured similarly to the model proposed Homeowners Protection Act. The terrorism insurance backstop is housed in the Treasury Department. Also, TRIP functions in a similar manner to a catastrophe backstop by providing additional coverage in the case of a major terrorist attack. William Stander believes that the success of this program lends
credit to the administrative feasibility of a federal backstop for natural catastrophes
(personal communication, October 17, 2006).

This policy has the strongest administrative feasibility of all three policies. Through previously proposed legislation an appropriate department responsible for the administration has been identified. Also, the successful administration of a sister program provides a foundation for the efficient and effective administration of a federal catastrophe backstop.

**Market Impact:** Similar to the multistate reinsurance, the use of a federal backstop would increase availability of insurance and may have a lowering affect on the costs charged to homeowners. In providing a backstop, the federal government would lessen the impact of catastrophe losses on states and private insurers.

In order to understand how the backstop would increase availability and affordability it is important to note the after effects of a catastrophe that exceeds state reinsurance limits. If a catastrophe strikes and the losses exhaust a state fund, the remaining losses are paid through guaranty funds. Essentially, these funds are formed through assessment of the remaining solvent insurance companies writing property lines of business in the state. There are two major problems with this scenario. First, and most obvious, is the crippling effect on insurers whom have already incurred major losses. Second, in order to pay the remaining claims, the state must first assess insurers exponentially raising the time it takes to pay homeowners. A federal backstop could lessen the burden on individual states, insurers, and homeowners.

The use of a federal backstop would take away a state’s need to use guaranty funds. In cases where a state has exhausted its catastrophe fund, the federal government
Homeowner’s Insurance in Florida

would step in and pay the remaining claims. This would further secure policies above and beyond the already established state catastrophe funds. This security would allow insurers to provide more coverage to homeowners. However, the use of a backstop will not have a substantial effect on rates in the short-term. The possibility of a catastrophe that would trigger the backstop is minimal. The backstop would prevent the need for insurers to raise rates following a disaster, but would have little to no impact on the current trend in homeowners’ rates.

In summary, the federal backstop would lessen the pressure on states and insurers following major catastrophes. A federal backstop is a possible option for resolution, but by far not the best. The use of this program would cause a rise in the availability of insurance, but could only hope to cap current rates. An organization has been established and the government is already providing a similar backstop for terrorism disaster. The impact of this type of program on the market would be limited and the effects would not be felt for some time. It is important that the federal government implements some sort of backstop program for catastrophes; however, it would have minimal effect on the current insurance crisis facing Florida and the United States. This policy rates medium for market impact.
V. Recommendation

After a review of the subject, the following alternative matrix was developed using the previous policy analyses.

Table 2: Determined Level of Success for Policy Options

<table>
<thead>
<tr>
<th>Policy Options</th>
<th>Criterion 1</th>
<th>Criterion 2</th>
<th>Criterion 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Political Desirability</td>
<td>Administrative Feasibility</td>
<td>Market Impact</td>
</tr>
<tr>
<td>Capital Market Solution</td>
<td>LOW</td>
<td>LOW</td>
<td>MEDIUM</td>
</tr>
<tr>
<td>Multistate Reinsurance</td>
<td>HIGH</td>
<td>HIGH</td>
<td>HIGH</td>
</tr>
<tr>
<td>Federal Backstop Program</td>
<td>LOW</td>
<td>HIGH</td>
<td>MEDIUM</td>
</tr>
</tbody>
</table>

This matrix shows that the highest scoring policy is the multistate reinsurance. This policy is recommended for implementation. Multistate reinsurance scored the highest in political desirability and market impact and also tied for the highest score in administrative feasibility.

First, political desirability is important in a proper recommendation for action. This policy will have a direct effect on the insurance crisis. Also, the implementation of multistate reinsurance will give the appearance of government action that is desired by citizens. It is also important that an opportune time has developed for implementation.
following the recent surge in destruction along the Gulf Coast. Multistate reinsurance proves to be politically desirable to people and to politicians.

Second, this policy receives the highest score of any policy in the area of administrative feasibility. Multistate reinsurance is made more feasible by the fact that states already work in concert on a range of issues. The ability to use the FHCF as a model for developing a multistate fund also greatly advances the administrative feasibility. It is essential that a chosen policy can be administered without too much friction and this policy accomplishes that end.

Third, multistate reinsurance has the ability to have the greatest impact on the market. Not only does this policy have the greatest market impact, but also the impact would be swift. The creation of a multistate reinsurance would back-up thousands of policies and would allow insurance companies to write more policies and therefore raise the availability of insurance. Also if the reinsurance trigger is lowered, then the rates charged by insurers would likely lower. Ultimately, multistate reinsurance would lessen the burden on homeowners by creating a large public-private partnership.

In summary, multistate reinsurance is recommended. However, it is important to note that all of the policies would have a positive impact. In a perfect world, insurers would use the capital market more, states would work together for a multistate reinsurance, and the federal government would develop a backstop. Since it is unlikely for all three to take place, it is recommended that states facing similar catastrophes to Florida combine the risk and form a large reinsurance fund.
Resources


Appendix A:

Catastrophe Bond Structure

Appendix B:

Florida Hurricane Catastrophe Fund Structure

Source: Property & Casualty Insurance Reform Committee (2006), *Florida Hurricane Catastrophe Fund*, p. 10
Appendix C:

Federal Backstop Structure

![Diagram of Federal Backstop Structure]

About the Author

Joshua Sanderlin (BA political science, Jacksonville University; MPA Florida State University) has served in internships in both the United States Senate and the Florida Senate. Mr. Sanderlin is concerned with policy development and analysis. Currently he is employed as a Legislative Analyst for Greenburg and Traurig in Tallahassee, Florida.