



## White Paper

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# Residual Market Subsidies in Florida's Property Insurance Market

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## Introduction

Everything changed on August 24, 1992, when Hurricane Andrew struck the southern part of Dade County<sup>1</sup> and became the largest natural disaster in U. S. history up to that time.<sup>2</sup> Over 25,000 homes were destroyed and more than 100,000 additional homes were damaged. Insured losses totaled nearly \$18 billion. Hurricane losses on this scale were beyond what most insurance companies thought possible. The impact on the property insurance industry in Florida was immediate as eleven small domestic insurers became insolvent, and numerous other, larger insurers lost enough capital to affect their ability to maintain operations in Florida. Insurers and public policymakers asked themselves how much worse the losses would have been if Hurricane Andrew had come ashore 25 miles to the north. In the years that followed, property insurance would remain one of the most challenging issues in the Florida economy and political landscape.

While hurricanes have always been a part of life in Florida, Hurricane Andrew served as a warning that hurricanes were a bigger economic threat than had been previously recognized. Reasons for this include, principally, the sustained growth in Florida population in recent decades and the corresponding concentration of property values on Florida's coasts. The population of Florida grew from 7.2 million in 1970 to 16.4 million in 2000 by growing 41 percent in the 1970s, 30 percent in the 1980s, and 21 percent in the 1990s<sup>3</sup> with most of this being a period with reduced frequency of hurricane activity. Florida now has over 18 million residents. Because much of this population growth occurred near the coast, Florida had in 2007 almost \$2.5 trillion of insured property located in coastal counties,

which was 79 percent of the statewide total.<sup>4</sup> This is the largest amount and highest percentage of coastal property of any state on the Atlantic Ocean or Gulf of Mexico. Another source reports \$2 trillion of insured personal and commercial residential property in Florida in 2007 with 78 percent concentrated in coastal counties.<sup>5</sup>

Florida's long coast line and its relatively low latitude make Florida particularly susceptible to hurricane landfalls. For the period from 1900 to 1996, Florida's 57 hurricane landfalls far exceeded that of any other state. Texas was in second place with 36, while Louisiana and North Carolina each had 25.<sup>6</sup> Florida is also the leader in the number of major hurricanes<sup>7</sup> making landfall. The number and severity of hurricanes striking Florida in 2004 and 2005 has only increased its status as the leading hurricane state. Florida also has a position of prominence in the list of the costliest hurricanes. The National Hurricane Center's analysis<sup>8</sup> as of 2007 has Florida with four of the five costliest hurricanes, six out of the top eight, and eight out of the top thirteen.<sup>9</sup>

The result of this hurricane activity in Florida, particularly Hurricane Andrew in 1992 and the five significant hurricanes striking Florida in 2004 and in 2005, has been a 17-year period of economic stress and almost continuous political attention to property insurance issues. In many ways the effects of the 2004 and 2005 hurricanes have been more challenging because the Florida Legislature implemented a broad range of aggressive, creative actions after Hurricane Andrew that put the property insurance market back on a reasonably sound footing by 1997. When the Florida property insurance market was severely disrupted again after the 2004 and 2005 hurricanes, the Legislature did not have many good options left that had not already been put in place. One action taken in 2006 was the Legislature's appropriation of \$715 million to

reduce the deficit of Citizens Property Insurance Corporation and, therefore, reduce the size of the assessments that would be imposed on property insurance policyholders to fund this deficit. During the 2007 Special Session and the 2007 and 2008 Regular Sessions, the Legislature enacted a series of statutory changes designed to ameliorate the rising property insurance rates but which placed greater financial risk and responsibility on Florida citizens. The Legislature began to undo some of those changes in the 2009 Regular Session.

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 appropriation in 2006, and rapidly rising property insurance rates in 2005 and 2006 all raised important public policy questions about the overall health of Florida's property insurance market and the ability and willingness of private insurance companies to meet the continually growing needs of Florida residents for property insurance coverage. These recent public policy questions mirror the kinds of issues the Legislature struggled with after Hurricane Andrew in the early and mid-1990s. While this report will describe some of the Legislature's actions in responding to hurricane-generated problems over the past 17 years, it will focus on the Legislature's formation of and reliance on state-created property insurance entities, such as Citizens Property Insurance Corporation and the Florida Hurricane Catastrophe Fund, to address various property insurance issues. Specifically, this report will identify and describe aspects of the state-created property insurance entities that have raised concerns among legislators, regulators, the news media, insurance companies and agents, and the public at large about subsidies that may be inherent in the financial structures of these entities.

The presence of subsidies in Florida's state-created property insurance entities may or may not have been intentional. Either way, a thorough discussion of the origin, size and nature of the subsidies should be of considerable value. Subsidies in insurance or in other areas of the economy are designed to achieve specific public policy goals by, in effect, collecting money from one group and delivering benefits to another group. There is nothing inherently wrong with subsidies, as the enormous number of subsidy programs present at all levels of government in the U. S. would seem to indicate; however, if subsidies (i) exist inadvertently, (ii) exist in amounts far different than planned, (iii) are inefficient or ineffective in achieving intended goals, or (iv) have unintended or even perverse consequences, then they deserve serious attention. In addition, greater awareness of these subsidies may guide legislators and others in their efforts to improve and strengthen Florida's property insurance market.

Part I of this report presents a general overview of subsidies, including generic definitions, a discussion of different types of subsidies and subsidy concepts, and brief descriptions of several large-scale subsidy programs. Part II establishes a framework for understanding subsidy issues in insurance with particular attention to subsidy issues in state-created insurance entities. In addition, Part II describes several situations where the use of subsidies in governmentally-created insurance entities led to unsatisfactory results. Part III discusses the history of legislative actions in Florida from late 1992 through the 2009 Legislative Session regarding rate making goals, requirements, and procedures for state-created property insurance entities. Part IV presents a separate history of legislative actions involving the deficit assessment structures and processes of Florida's state-created property insurance entities and also

with the Florida Insurance Guaranty Association.

Sometimes discussions of subsidies in Florida's property insurance market are couched in terms of whether the rates charged to and the deficit assessments imposed on policyholders in northern Florida counties are subsidizing policyholders in southern Florida counties. These discussions may also focus on rates and assessments paid by policyholders in inland counties relative to policyholders in coastal counties. Subsidy issues, however, may also exist with respect to rates charged to and assessments imposed on policyholders residing in different parts of the same county. The material in this report is applicable to an understanding of insurance subsidies in all of these contexts.

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## Overview and 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. 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.

This report focuses on (i) Citizens Property Insurance Corporation (Citizens, which was formed in 2002 through the combination of the Residential Property and Casualty Joint Underwriting Association (JUA) and the Florida Windstorm Underwriting Association (FWUA), (ii) the Florida Hurricane Catastrophe Fund (FHCF), and (iii) the Florida Insurance Guaranty Association (FIGA). Because these entities were formed and operate under state law without adequate capital, they usually do not have sufficient capital to cover losses associated with catastrophic hurricanes striking Florida. When this occurs, they are required to cover their deficits by imposing assessments in amounts and using procedures prescribed by specific Florida statutes.

Part 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 from residents and businesses in some counties to residents and businesses in other counties. This concern is often posed as whether inland counties are subsidizing property insurance costs in coastal counties. Although subsidies are

widespread in the U. S. economy, public policy makers, the news media, and the general public do not have a useful, commonly understood framework for thinking about and discussing subsidies in insurance. A central purpose of this report is to increase understanding of the nature of subsidies, how they arise, and the kinds of problems they can cause if they are not established with proper care.

The discussion and observations that follow are intended to be useful to public policy makers and others seeking to understand the recent history of Florida's residential property insurance market and, in particular, the issues related to subsidies in Florida's state-created property insurance residual market mechanisms and related organizations. 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.

### A. Residual Market Rates

From December 1992 until January 2007, the public policy of Florida was that the JUA, FWUA and Citizens were to operate as residual market mechanisms providing residential property insurance coverage to policyholders only when they could not obtain that coverage in the private insurance market. Consistent with this policy were requirements that the rates of these state-created insurance entities should not be competitive with rates of private insurance companies.<sup>10</sup> These requirements were designed to assist in (i) keeping the number of insureds in the JUA, FWUA and Citizens as small as possible and (ii) minimizing the size of potential financial deficits and the resulting assessments on Florida policyholders. In 2006 the Florida Legislature provided another perspective on the purpose of these requirements

when it referred to “the public need to limit subsidies within the residual market.”<sup>11</sup>

The 2007 and 2008 property insurance legislation rolled back Citizens’ rates to 2005 levels, froze those rates for at least four years, and required future Citizens rates to be “actuarially sound.” This was done as part of the Florida Legislature’s efforts to achieve “affordable” property insurance rates. The Legislature, however, did not set forth a definition of “affordable” as it has for other rate making terminology, i. e., “inadequate,” “excessive” and “unfairly discriminatory.” In addition, it did not provide any guidance to Citizens or the Office of Insurance Regulation regarding the nuances of developing actuarially sound rates for a residual market mechanism that (i) has enormous exposure to catastrophic loss, (ii) has an inadequate capital base, (iii) is exempt from federal income taxation, (iv) has expense ratios below industry norms, and (v) relies on broad-based assessments to meet its financial obligations in the event of catastrophic losses.

The relationship of rates charged by Citizens to rates charged by private insurance companies has important consequences for Florida’s residential property insurance market. This is true for any state residual market mechanism, but it is particularly true in Florida because of Florida’s susceptibility to relatively frequent and, in some cases, severe hurricanes. If Citizens’ rates are set at levels competitive with or below property insurance rates charged by private insurance companies, two adverse results are likely to occur. First, Citizens would not function effectively as a residual market mechanism and would have more policies in force and more exposure to loss than would otherwise be the case. This is particularly true if there are limited or ineffective barriers to prevent applicants from getting property insurance coverage with Citizens who could get coverage from a private insurance company.

Second, Citizens is likely to have more frequent and larger financial deficits than it would if it had the greater revenue per policy and less aggregate exposure to loss that higher rates would produce. This is significant because of Citizens’ heavy reliance on broad-based assessments to pay catastrophic hurricane losses and the continuing concerns that residents and businesses in some parts of Florida are subsidizing the property insurance costs of residents and businesses in other parts of the state.

Time and future hurricane activity will tell whether the Florida Legislature will remain satisfied with the approach to Citizens rates enacted in the 2007 Special Session and extended in the 2007 and 2008 Regular Sessions, or whether it will return to earlier residual market ratemaking methodologies, which were generally consistent with the views of one state insurance department actuary who studied residual market ratemaking and concluded that

“...a residual market plan whose prices are based on its own experience has no mathematical certainty of reaching any acceptable equilibrium. To achieve the goals normally desired for (a residual market plan), the state should base the (residual market plan’s) rates on the voluntary market and not on (its) own experience.”<sup>12</sup>

The below-market rates charged by the FHCF, as discussed in Section B of Part III of this report, were probably not motivated initially by affordability concerns, but with the passage of time, the maintenance of FHCF rates at those very low levels seems now to be associated with that motivation. The effect of the below-market FHCF rates has been to understate the real, current cost of residential property insurance in

Florida and to produce the conditions relative to the FHCF described above regarding Citizens, i.e., (i) more frequent and larger financial deficits and assessments and (ii) concerns about residents and businesses in some parts of Florida subsidizing the property insurance costs of residents and businesses in other parts of the state.

## B. Rate-related Subsidies

Subsidy programs are widespread at all levels of government – national, state and local. There is nothing inherently wrong with subsidy programs, particularly those that have explicit, agreed upon goals and are designed to operate efficiently and effectively. Unfortunately, there are many examples of subsidy programs that have the kinds of problems described in Part I, including subsidy leakage, unintended consequences and negative externalities. Often, subsidy programs in property and casualty insurance have these problems, especially when the goals of the subsidy programs are not well formulated and the methods of implementing the subsidy programs are not targeted or well designed.

Legislative or regulatory efforts to subsidize certain categories of property and casualty policyholders are not usually done directly or explicitly. For example, methods such as phasing in rate increases over a number of years or capping territorial rate relativities are blunt and often imprecise instruments to achieve particular public policy goals. These and similar methods are likely to produce implicit, or hidden, subsidies, which are also likely to produce the full range of problems often associated with other types of subsidy programs.

The rollback and freezing of Citizens' rates by the Florida Legislature in 2007 and 2008 was intended to make these rates more affordable. The generality and undefined nature of the term

“affordable” produced a set of subsidies that exemplify the problem of subsidy leakage. Some of Citizens' low and moderate income policyholders may very well have found higher Citizens' rates to be unaffordable, as that term is generally understood. The method used to address this (perhaps legitimate) public policy goal, however, was not targeted at those policyholders. As a result, Citizens' rates were also lowered for large numbers of other Citizens' policyholders who had sufficient financial resources to afford the higher Citizens' rates. This overly broad approach to addressing the financial difficulties of some Citizens' policyholders had the unfortunate effect of reducing substantially the revenues that Citizens needs to build its surplus and improve its financial capacity to pay catastrophic losses. The cost of this leakage will be felt the next time Florida is struck by a severe hurricane or a series of more moderate hurricanes when Citizens will likely have larger deficits and may find it necessary to impose larger assessments than it would have if the legislative concerns about affordability of Citizens' rates had been handled differently. The burden of these larger assessments will fall, in part, on the very policyholders whom the Legislature believed could not afford to pay higher rates. Ironically, these policyholders will pay these higher assessments to help make up for the revenue shortfall resulting from reduced rates on policyholders who could have afforded the higher rates.

In addition, the burden of the larger deficits in Citizens and the larger assessments to follow will also fall on millions of Florida policyholders of private insurance companies across a broad range of lines of insurance who did not receive any direct financial benefit from the roll back and rate freeze of Citizens rates. Even if one believes that deficit assessments by Citizens on policyholders of private insurance

companies are valid in some circumstances, it is not clear that increasing the size of those deficit assessments to provide rate reductions to Citizens policyholders who could afford to pay higher rates is sound public policy.

The recent Citizens rate rollback and rate freeze also illustrate the problem of subsidies across time. Because of Citizens' reduced financial capacity, any substantial Citizens deficit could require Emergency Assessments on Citizens policyholders and policyholders of private insurance companies for up to 10 years or even longer. During this extended assessment period, these Emergency Assessments will be levied on many policyholders who were not insured by Citizens during the period when the Citizens rates were rolled back and frozen, and, therefore, could not have benefitted from the reduced rates. To illustrate how this situation can arise, the FWUA (now the Citizens High-Risk Account) received approval for a 96 percent statewide average rate increase in 1999<sup>13</sup>, which the rate arbitration panel required to be phased in over several years starting in 2000, i. e., no policyholder premium increase could exceed 20 percent in the first year, 30 percent in the second year, and 40 percent in the third or subsequent years. The phase in of this FWUA rate increase was lengthened further when the Florida Legislature imposed lower rate increase caps on Citizens' High-Risk Account (HRA) policyholders of 10 percent in 2002 and 20 percent in 2003.<sup>14</sup> The hurricanes striking Florida in 2004 and 2005 produced substantial Citizens deficits and assessments on policyholders in 2006, 2007 and beyond, which may have been avoided or at least ameliorated by the revenues that Citizens was not allowed to receive from its HRA policyholders starting in 2000.

It is not uncommon for subsidy programs to have unintended consequences. Arguably, the reduction in Citizens' financial capacity and the

likely increase in future deficit assessments were unintended consequences of the recent Citizens rate rollback and rate freeze. Unintended consequences typically arise from interference with price signals in the marketplace.

Artificially lowering the price of a good or service usually leads to an increase in demand for that good or service. Because Citizens has a disproportionately large number of policyholders in highly hurricane exposed coastal counties, the principal effect of the recent Citizens rate rollback and rate freeze is to understate the actual cost of residential property insurance from Citizens in these areas. At the margin, this understatement of rates may have led to additional development activity by encouraging some people to move to these counties or encouraging some people to remain in these counties when the developers and residents might have made different decisions with correct information about the cost of residential property insurance from Citizens.

Negative externalities and, in particular, their identification and measurement, are sometimes more elusive than the effects described above; however, they are real nonetheless. For example, if under pricing residential property insurance in a coastal county contributes to incremental population growth, the resulting costs of increased traffic congestion, increased demand for public services, and other growth-related issues are borne by all county residents even though most of them did not realize any benefits from the Citizens rate rollback and rate freeze because they purchased their residential insurance from private insurance companies.

The FHCF's below-market rates present subsidy issues similar to those associated with Citizens rates described in the previous paragraphs. The below-market FHCF rates provide a benefit to all current residential property insurance policyholders, but these low rates limit the ability of the FHCF to build its financial

resources. For example, the low FHCF rates create the situation where Florida policyholders many years in the future could be paying off deficits associated with FHCF hurricane losses of current residential property insurance policyholders whose premiums are understated.

### C. Assessment-related Subsidies

Florida has followed the traditional approach of recovering residual market deficits by imposing identical percentage assessments on full policy premiums of insurance companies and policyholders. This approach may be acceptable for lines of insurance with minimal catastrophic loss exposure because rates for these lines of insurance can be set with reasonable accuracy based on accepted actuarial principles and historical experience that ordinarily does not vary significantly from year to year. Where this occurs, deficits in these types of residual market mechanisms are not usually large and can be covered by modest assessments, unless rates for these entities were established intentionally at artificially low levels.

An important issue identified in this report is the fairness of imposing deficit assessments as an identical percentage of full policy premiums for property insurance residual market mechanisms in Florida where catastrophic losses fluctuate annually from zero to many billions of dollars and where exposure to catastrophic hurricane losses varies significantly from one part of the state to another. An analysis of this issue requires a comparison of the geographic distribution of assessments across counties using the current Florida assessment procedures with assessments calculated based on each county's exposure to catastrophic hurricane losses. While this analysis will be the focus of a separate report by the Florida Catastrophic Storm Risk Management Center, it is important to note here that those results show that using identical

percentage assessments of full policy premiums to recover property insurance residual market deficits in Florida does not reflect with reasonable accuracy the significant variation in exposure to catastrophic losses across the state and leads to policyholders in some counties paying assessments that are too high and policyholders in other counties paying assessments that are too low. This holds even with the substantial variation in full policy premiums that currently exist in Florida.

### D. Summary Observations

- While rolling back and freezing Citizens' rates and the FHCF's use of "below market" rates produce lower property insurance rates in the short run, the longer term effects of these actions appear to 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 the deficit assessment processes set forth in Florida Statutes for Citizens, FHCF and FIGA to produce sizeable subsidies from policyholders in some parts of the state to residential property insurance 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 has referred 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 would seem to 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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## Part I: Overview of Subsidies

In the vernacular, the term “subsidy” has developed a negative connotation in spite of the fact that subsidies are used by governments at all levels to achieve public purposes. Part of the problem is that governmental use of subsidies is widespread and longstanding, which leaves room for different opinions about the importance and relevance of the public purposes, the relative cost of subsidies to the benefits achieved, and the efficiency and effectiveness of alternative methods of subsidizing various personal and commercial endeavors. All of this points to the need for a general discussion of subsidies in preparation for the later, more detailed treatment of the presence and magnitude of subsidies in Florida property insurance. In this regard, an international news organization seemed to capture the essence of the issues surrounding subsidies when it stated the following:

*“Why Do Subsidies Matter?”*

Subsidies – transfers of public money to private interests – have profound and long-lasting effects on the economy, the distribution of income in society, and the environment. Holding governments to account for how they allocate resources is important to citizens, not least because the bill goes to the taxpayers.”<sup>15</sup>

A unit of the U. S. Department of Energy set out what it labeled a typical textbook definition of a subsidy as a “transfer of economic resources by the Government to the buyer or seller of a good or service that has the effect of reducing the price paid, increasing the price received, or reducing the cost of production of the good or service.”<sup>16</sup> Another, more expansive, but still generic definition described subsidies as an

“economic benefit (such as a tax allowance or duty rebate) or financial aid (such as a cash grant or soft loan) provided by a government to (1) support a desirable activity (such as exports), (2) keep prices of staples low, (3) maintain the income of the producers of critical or strategic products, (4) maintain employment levels, or (5) induce investment to reduce unemployment. The basic characteristic of all subsidies is to reduce the market price of an item below its cost of production.”<sup>17</sup> A researcher in the field of international trade, after referring to subsidies as emanating from “government-directed, market-distorting interventions,” stated simply that any such “intervention that alters the price of the good artificially should be recognized as a subsidy.”<sup>18</sup>

Subsidies in the United States, because of their large number and breadth of application, affect virtually every person and business, although the effects vary significantly from one person and business to another. They may be viewed as positive or negative depending on whether the person or business is paying or receiving. A comprehensive discussion of the history of various subsidies, including their reasons for existence, particular methods of delivery, successes or failures in achieving their intended results compared with their costs, and other important considerations of their design and implementation, is beyond the scope of this report. Nevertheless, it is important to discuss certain basic concepts regarding subsidies such as direct (explicit) subsidies versus indirect (implicit) subsidies, subsidies across time, subsidy leakage, intended versus unintended consequences of subsidies, and negative externalities.

### A. Subsidy Concepts

Direct subsidies are probably the most recognizable type of subsidy because they involve direct payments to producers or

consumers.<sup>19</sup> Direct subsidies also include tax expenditures, which are tax code provisions that “reduce the federal tax liability of firms and individuals who qualify because they undertake particular specified actions.”<sup>20</sup> Another researcher referred to explicit subsidies as “those where budgetary outlays are made by the government . . . .”<sup>21</sup> Direct subsidies have the advantage in most cases of greater transparency and minimum distortion of the behavior of producers and their customers but may have higher administrative costs and the need to utilize complex eligibility criteria.<sup>22</sup>

Indirect or implicit subsidies include generally all subsidy activities that are not direct subsidies, i. e., they do not involve direct payments or tax expenditures. This broad category of subsidies includes such activities as tariffs, holding down supply prices,<sup>23</sup> government-provided services at below-market prices, government loans or loan guarantees, and tax-exempt interest on debt.<sup>24</sup>

Another perspective on implicit subsidies focuses on situations where negative externalities exist, particularly in such fields as environmental and energy policy. For example, when a factory discharges pollution into the air or water, people living in the vicinity may incur health or clean up costs that are not recognized in the factory’s cost analysis and price determination. In other words, the factory does not internalize these costs which, nevertheless, are costs imposed on society by the factory’s production activities. As a result, the factory and its customers receive a subsidy from those persons who bear the increased health or clean up costs.<sup>25</sup>

Some subsidies have a significant temporal dimension in that benefits are provided to or realized by a particular group in the present while the costs of the subsidies are imposed on the group paying for the subsidies over many years in the future. The issue here is that for any

number of reasons the group of payers in the future may be people or businesses that did not exist or could not receive the benefits at the time the benefits were provided. This would not include, however, situations such as toll roads where the roads are built with funds generated by the issuance of debt which is repaid by users of the toll road over many years. It would include circumstances where the benefits are consumed in the present and paid for through deficit spending that will be paid for by future generations.

A concept with important implications is subsidy leakage. This arises because subsidies are usually targeted toward certain populations of intended beneficiaries; however, targeting errors often occur because eligibility criteria may be imprecise or administered ineffectively. Two types of targeting errors exist. First are errors of exclusion where “members of the target group are not captured by the eligibility criteria and hence fail to receive the subsidy.”<sup>26</sup> The second type of targeting error are errors of inclusion “when people outside the target group fortuitously comply with the eligibility criteria and consequently receive the subsidy.”<sup>27</sup> Errors of inclusion result in a leakage of funds that increases the cost and decreases the efficiency of the subsidy program. Subsidy leakage would appear to be a fundamental problem, for example, when transfers of public funds are misdirected, even in part, to middle and high income people when the target population of a particular subsidy is low income people.<sup>28</sup>

Subsidies are subject to the very powerful but largely ignored “Law of Unintended Consequences,” which was first explored in depth by the sociologist Robert K. Merton in 1936.<sup>29</sup> This law states that the actions of people and governments often have effects that are unanticipated or unintended. While some unintended consequences can be positive (sometimes referred to as windfalls), more

frequently the unintended consequences have negative and even perverse effects. In fact, these perverse effects are sometimes so significant that, in hindsight, they may call into question the wisdom of engaging in the original subsidy activity at all.

Professor Merton identified several causes of unintended consequences, but the first two are particularly relevant to subsidy programs. The first is that government officials are not able to know about and understand all of the influences that subsidies will have or all of the ways that intended recipients and others will respond. The socio-economic system in which the subsidies are intended to work may simply be too complex.<sup>30</sup> The second is that government officials may simply employ faulty reasoning and analysis. As Professor Merton stated: “we may err in our appraisal of the present situation, in our inference from this to the future objective situation, in our selection of a course of action, or finally in the expectation of the action chosen.”<sup>31</sup>

One impact of government subsidies and other market interventions is that the efficient functioning of markets and market price signals may be disturbed, which can produce a variety of unintended consequences. For example, when the price of a good or service is held below its full market price by governmental subsidy or other governmental action, the incentive for efficient use of the good or service is reduced and excessive use of the good or service may be encouraged.<sup>32</sup> This could have unanticipated effects beyond the narrow market for the good or service.

## **B. Overview of Selected Subsidy Programs**

Before proceeding into an in depth discussion of insurance subsidies with particular reference to Florida property insurance, a brief review of

several non-insurance subsidy programs may be useful. These comments are intended to identify aspects of the subsidy programs that illustrate the subsidy concepts described above.

### **Food Stamp Program**

According to the U. S. Department of Agriculture, Food and Nutrition Service, the purpose of the Food Stamp Program is “to provide low-income persons of limited resources with access to a nutritious, healthful diet.”<sup>33</sup> The Food Stamp Program is an example of a means-tested transfer program under which potential program participants must meet a series of specific income and asset-related tests to determine their eligibility and level of participation.<sup>34</sup> This targeted, direct approach to addressing food affordability issues for a portion of the U. S. population has been used instead of alternative approaches such as food price regulation.

### **Public Water Service in Less-Developed Countries**

In many countries government policy has kept water prices low with explicit subsidies paid to water companies, which has generally benefitted the middle class in urban areas but has not assisted the poor, many of whom are not connected to the water network. Chile introduced a new program in the 1990s that allowed water prices to move to their full economic cost and began paying direct subsidies to consumers who could not afford these prices.<sup>35</sup>

### **Corn Ethanol Subsidies**

For a number of years, biofuels have been seen as one of the answers to America’s dependence on foreign oil and as a way to use more environmentally-friendly fuels to reduce carbon emissions. “The U. S. quintupled its production of ethanol ... in the past decade, and Washington has just mandated another fivefold increase in renewable fuels over the next

decade.”<sup>36</sup> Congress has pursued the biofuels program through biofuels usage mandates, tax subsidies (\$8 billion in 2007),<sup>37</sup> and tariffs on imports of less expensive sugar cane based biofuels. Recent analysis is challenging the early optimism of these biofuels programs. One researcher has determined that more energy is required to produce ethanol than the energy that is actually contained in ethanol.<sup>38</sup> In addition, converting food crops, such as corn, into fuel has contributed to rising food prices, food shortages and in some cases deadly food riots in dozens of countries.<sup>39</sup> Another researcher has found that biofuels programs, as they are being implemented in the U. S. and other countries, are leading to an increase in global deforestation, a net increase in the release of carbon emissions, and a likely worsening of global warming.<sup>40</sup>

### **U. S. Sugar Tariffs**

The U. S. Department of Agriculture limits imports of foreign grown sugar through import barriers and allocates domestic production of sugar between beet sugar and cane sugar producers. As a result domestic sugar prices are about twice the world price, which inflates the price of all domestically produced food products containing sugar. A study by the U. S. General Accountability Office estimates that the cost to consumers for sugar and products containing sugar is about \$1.9 billion per year.<sup>41</sup> Protection of domestic sugar production has encouraged sugar cane producers to expand into the environmentally-sensitive Florida Everglades.<sup>42</sup>

### **Homeownership Tax Incentives**

Homeownership has long been viewed as an important public policy goal in the U. S., particularly for the middle class. In this regard the U. S. government provides subsidies through federal income tax deductions for mortgage interest and real estate taxes to homeowners who itemize deductions on their tax returns. An additional subsidy is provided through the

elimination of capital gains taxes on most home sales. Housing subsidies are also provided to very low-income renters through such programs as public housing. The receipt of these housing-related subsidies, however, is not spread uniformly across income groups. Upper income tax filers, i. e., those in the highest 20 percent of incomes, received 82 percent of the housing subsidies in FY 2005. Upper middle income tax filers, i. e., those between 60 and 80 percent of incomes, received 15 percent of the housing subsidies, while all tax filers with incomes below 60 percent of incomes received only 3 percent of housing subsidies.<sup>43</sup> Because of the way they are structured, “(T)he rental subsidies *in and of themselves* provide an additional barrier for low-income families to own, while the ownership subsidies encourage excessive borrowing and inefficient wealth allocation among households that by and large *already* possess the means to own a home.”<sup>44</sup> (Emphasis in original.)

### **Observation**

While most, if not all, subsidy programs, including some of the subsidy programs described above and numerous others such as agricultural subsidies and various tax-related subsidies, were established to achieve worthy public goals, some of them seem to have become examples of subsidy programs with negative externalities, subsidy leakage or unintended consequences. The presence of these characteristics does not mean that these subsidy programs are not worthwhile, but it may mean that public policymakers should reevaluate the structure and implementation of some subsidy programs to assure that they are efficiently and effectively achieving their intended goals with minimal adverse effects.

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## Part II. Overview of Subsidy Issues in Insurance

### A. Background

The subject of subsidies in insurance is complex and sometimes confusing, as this report will describe. One view is that insurance inherently involves subsidies in that insureds with losses paid by their insurance company are being subsidized by insureds that do not have losses. This is not how insurance works and does not represent what insureds pay for when they buy insurance. Conceptually, insurance involves the transfer of an existing exposure to loss (such as the risk of one's house burning down) through the purchase of an insurance policy and the pooling of a very large number of these loss exposures by the insurance company to assist the insurance company in pricing and managing the loss exposures of all of its insureds. Insureds purchase the promise of their insurance company to pay for their covered losses occurring during the policy period, and all insureds receive this protection whether they have losses or not.

An important concept at the heart of the question of subsidies in insurance is the concept of "actuarially sound rates," and this term arises often in discussions of the development and regulation of insurance rates. The Casualty Actuarial Society (CAS) has stated that "(I)t is important that proper actuarial procedures be employed to derive rates that protect the insurance system's financial soundness and promote equity and availability for insurance consumers."<sup>45</sup> The basic principles set forth by the CAS relevant to actuarially sound rates are as follows:

*Principle 1:* A rate is an estimate of the expected value of future costs.

*Principle 2:* A rate provides for all costs associated with the transfer of risk.

*Principle 3:* A rate provides for the costs associated with an individual risk transfer.

*Principle 4:* A rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer.

The phrase "not excessive, inadequate, or unfairly discriminatory" is important because these are the rate standards typically found in state insurance rate regulatory laws.<sup>46</sup> In addition, insurance companies and regulators have worked over many years to establish classes of insurance, geographic territories, and associated rates so that individual risks can be properly and fairly underwritten and rated. A threshold question is whether the "classes" are appropriate. One of the actuarial standards of practice addresses risk classification and states that the primary purposes of risk classification are to be fair, permit economic incentives to encourage availability of coverage, and protect the soundness of the financial security system. The actuarial standard further states that a classification system is equitable "if material differences in costs for risk characteristics are appropriately reflected in the rate. Classification subsidies result when the price paid by an individual or class of individuals fails to reflect differences in cost among the risk classes."<sup>47</sup>

In general, the use of actuarially sound rating principles and methods has been motivated by the goals of fairness in the insurance rating process and avoiding subsidies across rating classes. The best and broadest measure of success in this regard is insurance market conditions where almost all insureds are able to

obtain coverage from private insurance companies. In insurance markets where a significant portion of insureds are not able to obtain insurance coverage from private insurers, regulatory or structural conditions are often present that produce rates that are not actuarially sound and may involve efforts to subsidize insureds in certain classes or territories.

Most property insurance coverage is provided by private insurance companies. The number of these insurance companies operating in individual states is sufficiently large that the industry usually meets the test of being competitively structured<sup>48</sup>. For example, over 100 insurance companies are licensed by the Office of Insurance Regulation to provide homeowners insurance in Florida. The combination of competitive forces in the market and the longstanding ratemaking methods and requirements relied upon by insurance company actuaries and by insurance regulators has led to a structure of insurance rates intended to prevent subsidies among individual insureds or lines of business in the private insurance market.

The way in which competitive insurance markets on their own will not allow subsidies to exist requires further explanation. For example, in a competitive market, an insurance company that intends to use artificially low (not actuarially sound) rates for personal auto insurance to attract additional business and intends to use artificially high (not actuarially sound) rates for commercial auto insurance to make up for the losses on personal auto insurance would not be successful and would suffer financially. It would be able to write more personal auto insurance at the artificially low rates if it chose to do so, but competitive forces in the commercial auto insurance market would drive its customers to other competitors whose rates had not been artificially increased. A similar result would occur if an insurance company attempted to artificially lower its rates

in certain territories and to artificially raise its rates in other territories. Competitive markets do not allow these types of subsidies to exist.

## B. Insurance Subsidies in Other States

As described above, insurance subsidies do not typically arise in competitive markets but, by their nature, require governmental action and intervention. Before discussing in general how subsidies can arise in insurance residual market mechanisms<sup>49</sup> and how subsidy concerns have arisen in Florida residential property insurance, it is useful to consider how subsidies have arisen in some other lines of insurance and in other states.

### Automobile Insurance

Because private passenger auto liability and auto physical damage insurance is the largest type of property and casualty insurance (approximately 33 percent of all property and casualty insurance based on 2007 written premiums)<sup>50</sup> and because auto insurance rates have been regulated heavily, it is no surprise that auto insurance subsidy issues have been present in various states. The concerns are usually centered on auto insurance residual market mechanisms, which can be disproportionately large in states with particularly aggressive rate regulation. One observer noted that cross-subsidies are “accomplished directly through limits on rates in certain classifications or by channeling subsidies to higher risk drivers by keeping rates low in the residual market.”<sup>51</sup>

Massachusetts – In 1977, the Massachusetts Insurance Commissioner ordered several changes in the way automobile insurance companies had traditionally classified and rated insured drivers, particularly regarding classes based on age, sex, and marital status. In addition, the variation in rates across classes and territories was limited. The expected costs, for

example, of insuring drivers across classes varied by a factor of 4.4, while premiums were allowed to vary by a factor of three. Across territories, costs varied by a factor of 2.7, but premiums varied only by a factor of two. Combining these factors increased the impact of the limitations. The cost of insuring a driver in the highest class and territory was 10.6 times the cost of a driver in the lowest class and territory; however, the premium difference of the highest class/territory was only 4.5 times the lowest class/territory.<sup>52</sup> The premiums paid by drivers insured in the auto insurance residual market were the same as premiums insured in the voluntary market.<sup>53</sup>

During the 1980s about half of drivers in Massachusetts were forced to obtain their auto insurance coverage in the residual market, with the percentage peaking at 72 percent in 1989. While being successful in achieving high levels of auto insurance coverage, "... the cross-subsidies in place to achieve this appear to have gone beyond the level required to enhance social efficiency."<sup>54</sup> More specifically, "(S)ubsidies flow from drivers in rural areas to those in urban areas, from women to men, from the middle-aged to the young and the elderly, from experienced drivers to inexperienced drivers, and from drivers in the voluntary market to those in the high-risk, involuntary market."<sup>55</sup>

South Carolina – In the mid-1970s South Carolina undertook a program of intensive regulation of auto insurance in the form of "tight limits on rates and underwriting ..." and the creation of a type of residual market mechanism called a reinsurance facility,<sup>56</sup> which in combination led to 20 years of controversy before reform legislation was enacted in 1997. Like many states at the time, South Carolina required insurance companies to file auto insurance rates for prior approval, but South Carolina went beyond typical prior approval requirements in that the South Carolina Director

of Insurance was authorized by law "to promulgate uniform classification systems, merit-rating plans, and rating territories and require insurers to grant safe driver discounts of no less than 20 percent."<sup>57</sup> Territorial rate differentials were also capped.

In addition to problems related to structural aspects of the South Carolina reinsurance facility, rates set by the insurance regulator "were severely inadequate to cover costs" due to a "desire to maintain ... rates that were 'comparable' to voluntary market rates."<sup>58</sup> Many high-risk drivers chose to be in the reinsurance facility because of "limits on (reinsurance facility) rates and lax eligibility requirements."<sup>59</sup> Insurers also placed drivers in the reinsurance facility because the mandated class and territory plans did not allow insurers to charge rates commensurate with the drivers' risk characteristics.<sup>60</sup> As a result, the proportion of South Carolina vehicles in the reinsurance facility rose from 20 percent in 1980 to above 40 percent from 1992 to 1995,<sup>61</sup> and the reinsurance facility's cumulative deficit through 1999, when the reinsurance facility was eliminated, was \$2.4 billion.<sup>62</sup>

New Jersey – New Jersey's history of auto insurance problems dates to the early 1970s following the creation of an assigned risk plan (NJAIP) along with the implementation of a new no-fault law and other regulatory changes. From its inception in 1972 until its elimination in 1982, the number of drivers insured in the NJAIP more than tripled to 1.37 million, which represented about one third of New Jersey drivers.<sup>63</sup> In 1982 the NJAIP was replaced by a new residual market mechanism called the New Jersey Automobile Full Insurance Underwriting Association (NJ Auto JUA).

The NJ Auto JUA was to be funded in part by a residual market equalization charge (RMEC) to be charged to all auto insurance policyholders.

The RMEC was to help make up for the shortfalls in the NJ Auto JUA revenues resulting from the NJ Auto JUA charging the high-risk drivers it insured rates comparable to rates in the voluntary market. By 1990, more than half of the state's auto insurance policyholders were insured in the residual market. The RMEC, even though it was a subsidy from low-risk drivers to high-risk drivers, could have prevented the subsequent massive NJ Auto JUA deficits if it had been used as intended. In 1985, however, the insurance commissioner disallowed the RMEC because the Auto JUA had positive cash flow. This failure in the early years of the NJ Auto JUA to recognize the necessity to establish reserves for future claim payments related to current loss occurrences led in a few years to huge financial deficits.<sup>64</sup> By the early 1990s, the NJ Auto JUA and the Market Transition Facility, which succeeded the NJ Auto JUA for two years, developed deficits approaching \$5 billion.<sup>65</sup>

One scholar summed up the situation as follows: "For the insurance economist, New Jersey is a dream. Its auto insurance system has offered a series of natural experiments in incentive response, regulatory lag, market failure, binding price constraints, 'excess' profit law, barriers to exit, and cash flow residual market financing."<sup>66</sup>

### **California Property Insurance**

Fires in Southern California are often in the news. Less attention, however, has been given to related public policy issues, such as "(S)hould the state and federal government encourage Californians to build in high-risk brush-fire zones?"<sup>67</sup> Stated more harshly, "... many rich folk who build mansions in canyons – and their less rich compadres who build McMansions in foothills – do so with subsidized, artificially inexpensive, actuarially unsound, government-secured insurance of last resort ...."<sup>68</sup> While most states that created Fair Access to Insurance Requirements Plans (FAIR plans) following the

urban riots in the late 1960s and the federal legislation<sup>69</sup> thereafter focused their efforts on insurance availability problems in inner cities, the law allowed the FAIR plans to provide coverage for properties in "high risk" areas. California has taken a broad view of "high risk" areas and has included properties in "pockets of Malibu, Topanga Canyon, Laurel Canyon, Glendale, Pasadena, and Arcadia."<sup>70</sup> Malibu is a particularly interesting case because of its notable residents and the fact that it was declared a Federal Disaster Area five times between 1993 and 1996. The Southern California experience with frequent and severe fires in areas with expensive real estate continues to raise issues regarding residual market pricing and subsidies as well as growth management and development policies.

2008 may be California's most expensive fire season on record. The state incurred \$285 million in firefighting costs in just six weeks compared to the \$44 million it spent ten years ago.<sup>71</sup> Because of the severe impact of the firefighting costs on the state budget, which is already in deficit, Governor Schwarzenegger "has proposed a 1.4 percent surcharge on residential and commercial property insurance premiums in areas at high risk of fires, floods or earthquakes – about 80 percent of the state. Homeowners in the other areas would pay a 0.75 percent premium."<sup>72</sup>

### **National Flood Insurance**

The U. S. Congress enacted the National Flood Insurance Act<sup>73</sup> in 1968 "in recognition of the increasing amount of flood damage, the lack of readily available insurance for property owners, and the cost to the taxpayer for flood-related disaster relief ...."<sup>74</sup> While the intent of Congress over the years was that the National Flood Insurance Program (NFIP) would be the principal means of flood-related disaster relief, the NFIP has been only partly successful in this regard. One reason is that participation in the

NFIP is low with less than one-half of the structures having flood insurance coverage in special flood hazard areas, where flood insurance in some cases is mandatory.<sup>75</sup> Another factor affecting the NFIP's financial success has been the premium subsidies to structures located in a flood plain before the NFIP's flood insurance rate maps were developed for the area. In the NFIP's early years, Congress appropriated funds to cover the subsidies, but those appropriations stopped in the mid-1980s.<sup>76</sup> Congress recognized that the full actuarial rate for the existing structures would be "unattractively high."<sup>77</sup> A third factor has been claim payments for structures with repetitive losses.<sup>78</sup> Over time, properties with multiple losses, which make up only about two percent of NFIP policies, were estimated in 2003<sup>79</sup> to account for about 38 percent of NFIP losses and were estimated in 2005 to account for about 25 percent of NFIP losses.<sup>80</sup>

The NFIP has operated with an actuarial rate imbalance throughout its history, primarily because the NFIP has a substantial number of policies with subsidized premiums – estimated at 29 percent in 2003<sup>81</sup> and 24 percent in 2005.<sup>82</sup> The premiums for these policies are about 35 to 40 percent of the actuarial rate.<sup>83</sup> Since 1988, the NFIP subsidized rates have been set to cover losses in the "historical average loss year," which did not include any truly catastrophic loss years until 2005.<sup>84</sup> In addition, the NFIP rates do not include any factor "to reflect the cost to the taxpayer of bearing the risk of the insurance contracts."<sup>85</sup> The NFIP's transactions, i. e., premium receipts, claim payments and expenses, are included in the federal budget on a cash basis. "The focus on annual cash flows ... may not reflect the government's cost because the time between the extension of the insurance, the receipt of premiums, the occurrence of an insured event, and the payment of claims may extend over several fiscal years."<sup>86</sup>

A more recent U.S. Government Accountability Office (GAO) analysis of NFIP ratemaking procedures raised additional issues. One of these issues is that when the NFIP remaps its flood zones, it allows the properties moving to a more risky flood zone to retain their lower rates in spite of the fact that "property owners that obtained grandfathered rates for their homes are being cross-subsidized by other policyholders in the same zone that are paying higher rates."<sup>87</sup> Further, the GAO reports that Federal Emergency Management Agency officials, while they had various reasons for their decision, acknowledged "that grandfathering presented a disincentive for sound floodplain management because grandfathered owners would be unaware of the true risk of flooding to their properties and would therefore be less likely to mitigate."<sup>88</sup> In addition, the GAO, after describing some changes in NFIP rate making processes and policies made in the past few years, stated that the policies and processes used to "set both full-risk and subsidized premium rates have contributed to NFIP's inability to generate enough in premiums to cover the program's operating costs, claims losses, and debt to the Treasury."<sup>89</sup>

### C. Residual Market Rates, Deficits and Subsidy Issues

Residual market mechanisms are special insurance entities. They are usually created by acts of state legislatures and are often heavily regulated by state insurance departments, in large part because they are viewed as serving a public or quasi-public purpose. The typical actuarially sound rate making criteria used in regulating insurance rates for private insurance companies may be supplanted for residual market mechanisms by other criteria for political, public policy or technical reasons. Whatever the reasons, rates for residual market mechanisms are often held below the level of rates that would meet the actuarially sound rate

standards. This may not always produce significantly adverse consequences, particularly where the rate suppression is modest and catastrophic loss potential is minimal or nonexistent.

Other characteristics that residual market mechanisms usually have in common include the lack of capital contributions by the state, the absence of any state responsibility for financial deficits, and the inapplicability or irrelevance of the traditional regulatory relationships applied to private insurance companies between premium writings and capital. As a result, residual market mechanisms often have annual financial deficits and usually do not have the funds on hand to cover the deficits. To address this situation, state legislatures typically require that “member” insurance companies provide the necessary funds in proportion to their share of the lines of insurance relevant to the insurance coverage provided by the residual market mechanism. (Note: with some residual market mechanisms, the “member” insurance companies receive a financial benefit in the infrequent years when profitable operations occur, again on a pro rata basis.)

The “member” insurance companies that provide the funds to cover the deficit are typically entitled to include the amount of the funds provided to cover the deficit as a cost of doing business in subsequent rate filings. As a result, the rates charged to the insurance companies’ policyholders are higher than they would otherwise be due to residual market mechanism deficits. This rate increment represents a subsidy from policyholders of private insurance companies to policyholders in residual market mechanisms with financial deficits caused by artificially low rates.

In some cases, for statutory or regulatory reasons private insurance companies may not be allowed, or may not be confident that they will

be allowed, to include the amount of the funds provided to cover residual market deficits in subsequent rate filings. As the size of the residual market deficit and the amount of funds from private insurance companies rise, the profitability of these insurance companies may be adversely affected, which can be a disincentive for insurance companies to participate fully in the state’s insurance market. This may lead to further increases in the number of policies written in the residual market because an insurance company can reduce the relative amount of the funds it is required to pay to cover deficits of residual market mechanisms by reducing the amount of business it writes in the state. If this occurs, the size of residual market mechanism and its deficits may increase further, putting even more pressure on private insurance companies to reduce even more the amount of business they write. At the extreme, this situation creates what is sometimes called a “death spiral.”

With this background, it is useful to think carefully about residual market mechanisms that have significant exposure to catastrophic losses, e. g., floods, hurricanes or earthquakes. Even if these entities have actuarially sound rates or even rates higher than actuarially sound rates, a catastrophic event is almost certain to create a financial deficit in the residual market mechanism. The funds to cover these deficits have to come from somewhere, and state and national governments have developed special funding processes in this regard. Deficits in the NFIP are funded by Congress through appropriations of federal tax dollars. At the state level, particularly in California and Florida, deficits in residual market mechanisms with catastrophic exposure are funded by complex, multi-layered assessments levied on insurance companies, individuals and businesses in the state. These assessments are usually designed to make principal and interest payments over many

years on debt issued by the residual market mechanisms to allow them to meet their obligations to claimants.

An important public policy (and perhaps political) question is whether the assessments levied by residual market mechanisms to cover deficits caused by catastrophic events can be correctly referred to as subsidies. Similarly, is it accurate to refer to the deficit assessments as a “bail out” of the residual market mechanism? The answer to these questions may depend on whether the residual market mechanism’s rates were actuarially sound. Arguably, there is a difference between deficit assessments for a residual market mechanism whose rates had been held artificially below actuarially sound levels and deficit assessments where rates were actuarially sound. At the very least, when a residual market mechanism’s rates are set at actuarially sound levels, a deficit may not occur in some situations or the deficit may be smaller than it would have been if the residual market mechanism’s rates were held below actuarially sound levels.

Another relevant issue, once the need for a deficit assessment exists, is the method of imposing and collecting the assessments. Often, deficit assessments are imposed on insurance companies and policyholders in lines of insurance directly or at least closely related to the line of business in which the residual market mechanism operates. For example, deficit assessments from a residual market mechanism writing auto insurance are usually imposed on the state’s auto insurance companies and passed through to their auto insurance policyholders. This approach can work reasonably well for residual market mechanisms focusing on auto insurance and other large lines of insurance such as workers compensation insurance and homeowners insurance, but it may not work well for residual market mechanisms focusing on smaller lines or classes of insurance. In the mid

1990s when the Florida Legislature revised the statutory provisions regarding the residual market mechanism providing property insurance for condominium associations, apartments and homeowner’s association (i. e., commercial residential insurance), consideration was given to having deficit assessments associated with this class of business imposed on and collected from only commercial residential insurance policyholders. This was not done, in part, because potential deficits were likely to be large relative to the size of the premium base on which the assessments would be imposed. The assessment base actually used for this residual market mechanism was all commercial property insurance.

Nevertheless, state legislatures have to make a very clear, specific decision on the assessment base structure, i. e., the lines of insurance to which assessments will be imposed, for each residual market mechanism. These decisions can be changed from time to time by the state legislature, but a change would apply only to future deficits and related assessments. The considerations affecting the legislature’s choice of an assessment base for a residual market mechanism include the following:

- Will the lines of business included in the assessment base be considered fair by the insurance companies and policyholders paying the assessments? A narrow assessment base may be considered fairer than one that includes unrelated lines of business.
- What is the size of the assessment base in relation to the size of the assessments that may have to be made? A narrow assessment base may produce unacceptably large percentage and dollar assessments. Including a broader range of lines of business would increase the assessment base size and could lower the likely percentage and dollar assessments to a more acceptable level, although this approach does not

change the total dollars that need to be raised by the assessments.

- How important are issues related to geographic variations in loss exposure in the state or to the rationale for including or excluding certain lines of business?
- What is the potential that the assessment base structure would create significant political concerns or generate litigation?

Once the assessment base decision is made, the principal remaining issues involve the specific processes by which assessments are levied and collected.<sup>90</sup> The first issue is who has the responsibility to pay the assessment. In most cases, especially where catastrophic loss exposure does not exist, assessments are imposed on “member” insurance companies. These insurance companies are required to pay the assessments levied on them to the residual market mechanism within a specified time, usually 30 days. As discussed above, these insurance companies may then be able to include the assessment payments in subsequent rate filings as a cost of doing business and to recover the assessment payments over time from their policyholders. In cases where sizeable assessments are involved such as those associated with deficits caused by catastrophic events, this approach may not be feasible. Another approach used by some states is to have insurance companies collect the assessments directly from their own policyholders and to pay the funds to the residual market mechanism as they are collected. The disadvantage of this approach is that insurance companies typically can collect assessments from their policyholders only when policies are renewed or when new policies are issued. As a result, this approach has been used primarily by residual market mechanisms to collect deficit assessments associated with principal and interest payments on debt issued by the residual market mechanism rather than to pay claims directly.

The second issue is how the assessments are calculated for individual insurance companies or policyholders. Residual market mechanism deficit assessments have traditionally been levied on insurance companies on a pro rata (market share) basis. For example, an insurance company whose written premium represents five percent of the line or lines of business making up the residual market mechanism’s assessment base would be assessed an amount equal to five percent of the deficit. The pro rata amounts, which are sometimes referred to as “participation ratios,” are recalculated annually to reflect accurately the increases and decreases in business written by individual insurance company from one year to the next. In some cases the residual market mechanism reduces the participation ratios of insurance companies that write certain risky classes of business or write business in high-risk territories, because their writing this business usually lowers the business written in the residual market mechanism and may reduce the size of future deficits.

In those cases where deficit assessments are imposed directly on policyholders and merely collected by insurance companies, state legislators have usually required the assessment percentage to be calculated by dividing the amount of the deficit by the amount of the assessment base. For example, if the residual market mechanism’s deficit is \$8 million and the assessment base is \$100 million, policyholders would be required to pay an amount equal to 8 percent of their policy premium. In the case of a deficit in a property insurance residual market mechanism, a policyholder whose homeowner’s insurance premium is \$4000 would pay an assessment of \$320, while a policyholder whose premium is \$1000 would pay an assessment of \$80. This approach has been used because it is simple, understandable, and seems to address certain fairness concerns; however, specific

analysis is required to determine the extent to which this approach addresses the fairness issue.

Another issue that may seem unusual at first glance is the question of whether policyholders of a residual market mechanism should be assessed for their pro rata share of the deficit produced by the residual market mechanism. Unless special provision is made in this regard, the traditional deficit assessment process would allow residual market mechanism policyholders to avoid paying any portion of the deficit even though the deficit arose from losses on their policies. When deficit assessments are levied on and paid by “member” insurance companies, who are able through one means or another to recoup the assessment payments from their own policyholders, no portion of the deficit is paid by policyholders of the residual market mechanism. This would seem to be particularly troublesome when policyholders in the residual market mechanism had the benefit of rates that had been held below actuarially sound levels. Part IV of this report includes information on the various ways that the Florida Legislature addressed this issue.

The final issue for state legislators is the visibility of residual market mechanism deficit assessments imposed on individual policyholders. When deficit assessments are levied on and paid by insurance companies and then later included in the insurance companies’ rates, the effect of the deficit assessment on the premium paid by policyholders may not be evident. In some states<sup>91</sup> an insurance company is able to recoup the amount of its deficit assessment through an explicit (or visible) surcharge on the premium paid by each of its policyholders. When deficit assessments are levied on and paid directly by policyholders, the amount of the assessment is inherently visible. The importance of the visibility issue is relevant to the purposes of this report to the extent that residual market mechanism deficit assessments

may be perceived as subsidies, may contain subsidy elements, and may have been intended by the legislature to be subsidies.

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## Part III. Florida Residual Market Ratemaking

Fundamental to developing an understanding of property insurance subsidies in Florida is knowledge of how residual market property insurance rates are established, how deficit assessments of residual market mechanisms are levied, and where the deficit assessment burden falls. Florida is particularly complex in this regard because of the number of residual market mechanisms involved and the amount of legislative activity on these matters since 1992.

Prior to Hurricane Andrew in 1992, Florida had one operational property insurance residual market mechanism,<sup>92</sup> i. e., the FWUA, which provided property insurance coverage only in certain coastal areas. The FWUA was authorized by the Florida Legislature in 1970 and began operation in 1972. It provided insurance coverage for the perils of windstorm and hail to applicants who were “in good faith entitled to, but are unable to procure, such insurance through ordinary methods...” Initially, the FWUA’s principal purpose was to provide windstorm insurance coverage to residents of Monroe County, although by the mid 1990s, it was authorized to provide coverage in 29 of Florida’s 35 coastal counties.

In the few months following Hurricane Andrew, the Florida Legislature met in special session to begin addressing the stresses that were apparent in the state’s residential property insurance market. Eleven small property insurers had become insolvent, and many of the large property insurance companies were expressing serious concerns about the effect of the hurricane losses they incurred on their capacity to continue insuring the amount of property exposures they had insured before Hurricane

Andrew. In fact, some of them were announcing the nonrenewal of significant numbers of personal residential property insurance policies.

One of the significant actions taken by the Florida Legislature during the December 1992 Special Session was to enact legislation creating the Residential Property and Casualty Joint Underwriting Association (JUA)<sup>93</sup> to address the growing availability problems related to multi-peril personal residential property insurance throughout Florida. The JUA expanded dramatically during the 1990s, and it became the largest property insurance residual market mechanism in the U.S. based on any of the following measures: number of policies in force, amount of written premium, or aggregate exposure to loss.<sup>94</sup>

Three other important regulatory and legislative actions in the aftermath of Hurricane Andrew were (i) adding portions of four large coastal counties<sup>95</sup> to the FWUA’s eligible areas, (2) authorizing the Florida Insurance Guaranty Association (“FIGA”) to levy special assessments<sup>96</sup> on Florida property insurance policyholders for as long as necessary to repay the \$450 million in debt issued to pay claims of the eleven insolvent insurance companies, and (3) creating the Florida Hurricane Catastrophe Fund (“FHCF”) to “provide a stable and ongoing source of reimbursement to insurers for a portion of their catastrophic hurricane losses ....”<sup>97</sup>

## A. Overview of Florida's Property Residual Market Ratemaking History

With the discussion of insurance subsidy issues in Part II as a backdrop, the history of actions by the Florida Legislature from the December 1992 Special Session through the 2009 Regular Session relating to the establishment of rates for the FWUA, the JUA and Citizens Property Insurance Corporation ("Citizens,"), which was formed in 2002 when the FWUA and the JUA were combined by the Florida Legislature, illustrates dramatically how changing insurance market conditions, evolving public policy objectives, and political factors can affect ratemaking for residual market mechanisms. A chronological history of these statutory changes is presented in the appendix to this report.

The early JUA legislation indicated clearly the Florida Legislature's policy regarding JUA's rates relative to rates charged by private insurance companies. Initially, the Legislature required the JUA's rates to be based on the rates of the five largest private residential insurance companies with a 25 per cent increment in anticipation of poor loss experience.<sup>98</sup> The Legislature went further in 1993 when it stated in the JUA's rate requirements that the JUA "function as a residual market mechanism to provide insurance only when the insurance cannot be procured in the voluntary market."<sup>99</sup> The Florida Legislature amended the JUA's statutory rate requirements several more times during the 1995 to 2006 period to further its policy that the JUA function as a residual market mechanism. The list below includes some of the additional JUA rate requirements<sup>100</sup> that show how far the Legislature was willing to go to achieve this policy goal:

- Stated that JUA's rates were not to be "competitive with approved rates in the admitted voluntary market." (1995)

- Required that the JUA's average rates be higher in each county than the highest average rates in each county of the ten largest insurers in the state. (1995)
- Authorized the JUA to make filings on a "file and use" basis under Florida law, which meant that the JUA could implement new rates without the prior approval of the Department of Insurance. (1995)
- Required that the JUA's average rates be higher in each county than the highest average rates in each county of the 20 largest insurers in the state. (1996)
- Authorized the JUA to use the rate arbitration process available to private insurance companies to more promptly resolve rate disputes with the Department of Insurance. (1997)
- Required Citizens to notify the Office of Insurance Regulation (OIR) at least twice a year that its rates met statutory standards. If adjustments were needed to be in compliance, Citizens was to make the necessary rate changes. The OIR could require adjustments, if needed to assure compliance, but the adjustments could only impact JUA rates prospectively. (2003)
- Required Citizens to send a notice to its applicants and policyholders that Citizens' rates were intended to be higher than rates charged by private insurance companies. (2003)
- Recognized "the public need to limit subsidies within the residual market." (2006)
- Required rates in the Citizens Personal Lines Account to be sufficient to pay claims and expenses expected to result from a 100-year probable maximum loss event without requiring any assessments or debt. (2006)

In the January 2007 Special Session and in the 2007 and 2008 Regular Sessions, the Florida

Legislature reversed the course it had followed for more than 14 years. Citizens' rates were rolled back and frozen until 2010. Much of the authority given to Citizens regarding its rates was removed. Instead, the OIR was given the authority to set Citizens rates, and Citizens was not allowed to seek any administrative or judicial review. In combination with other statutory changes, the Legislative policy appears to have transformed from one that saw Citizens as being a residual market mechanism that did not compete with private insurance companies to one where Citizens is an active competitor with private insurance companies. Under this new vision of Citizens, the Legislature is not concerned that Citizens was writing a large and growing number of property insurance policies in Florida.

The Legislature did establish during the 2008 Session a Citizens Property Insurance Mission Review Task Force to address the statutory and operational changes that would be required to return Citizens to its former role. This was perhaps a meaningful indication that the Legislature might be willing to rethink the legislation enacted in the January 2007 Special Session that altered the role of Citizens so significantly.

Based on the recommendations of the Citizens Property Insurance Mission Review Task Force<sup>101</sup> and legislative concerns about the potential size of Citizens' assessments and the difficulty that Citizens would have in issuing debt to pay claims in the event of large hurricane losses, the Legislature established what it generally referred to as a "glide-path" to move Citizens' rates toward actuarially sound levels. This involved limiting rate increases on any single policy issued by Citizens to ten percent each year excluding coverage changes and surcharges.<sup>102</sup>

## B. FHCF Rates

Throughout its history, the FHCF has charged rates for its coverage substantially below the rates charged for comparable coverage by private reinsurance companies. By charging below-market rates, the FHCF has helped hold Florida residential property insurance rates lower than they would have been otherwise. While the Florida Legislature's principal purposes in establishing the FHCF were to provide additional reinsurance capacity and help stabilize Florida's property insurance market,<sup>103</sup> the beneficial effect of the FHCF charging below-market rates became apparent over time.<sup>104</sup>

The FHCF is required by statute<sup>105</sup> to charge an "actuarially indicated" premium to insurance companies purchasing FHCF coverage. The FHCF's traditional approach to developing actuarially indicated rates was to add an administrative cost factor to the average annual hurricane loss estimates developed from a weighted average of several hurricane models.<sup>106</sup> The reasons why the FHCF can comply with the statutory standard and still have rates as much as one third to one fourth of the rates charged by private reinsurance companies are as follows:

- The FHCF is exempt from federal income taxation.
- The FHCF has very low administrative expenses.
- Because the FHCF is a mandatory insurance program, it has no underwriting or marketing expenses.
- The FHCF does not include a profit load or contingency factor in its rates.
- The FHCF rates do not recognize its reliance on future debt issues, which will be repaid by Emergency Assessments, to cover large parts of the coverage it provides.

The Florida Legislature addressed this matter in part in 2002 by authorizing the addition of a 25 percent “rapid cash buildup factor” to FHCF rates so that the FHCF could build up its financial resources more quickly and be better prepared to meet its expected claim payment obligations. This authority, however, was not used by the FHCF until 2006 when the Florida Legislature mandated its use. The rapid cash buildup factor was removed in the legislation<sup>107</sup> enacted during the 2007 Special Session as part of the Legislature’s efforts to reduce current residential property insurance rates as much as possible.

In addition to the provisions discussed in the previous section affecting Citizens’ rates that the Florida Legislature enacted during the 2007 Special Session, the Legislature expanded significantly the coverage provided by the FHCF.<sup>108</sup> The apparent purpose of this additional \$12 billion of FHCF coverage was to displace a portion of the reinsurance coverage previously provided by private reinsurance companies to property insurance companies in Florida. The Legislature required that savings in reinsurance costs that property insurance companies would realize from substituting less expensive FHCF reinsurance for more expensive private reinsurance would be passed through to property insurance policyholders in the form of lower rates.

The OIR retained outside actuarial personnel to assist it in developing the FHCF rates for the expanded FHCF coverage and estimates of the amount of property insurance rate reductions that would occur. The actuarial analysis and recommendations were set forth in an extensive report, titled “House Bill 1A Presumed Rating Factors” and dated March 1, 2007 (the “OIR Report”).

It is important to note that the lower the rates charged by the FHCF for the additional layer of

coverage in relation to the rates charged by private reinsurance companies the greater would be the reduction in property insurance rates paid by Florida policyholders, everything else being equal. In this regard, the OIR Report noted that “Although actuarially priced, the additional reinsurance coverage offered through the (FHCF) will be sharply lower in price relative to coverage being sold by private reinsurance companies.”<sup>109</sup> The OIR report also stated that “a reasonable estimate of the rate on line for the private reinsurance being replaced by the new (FHCF) layer is 20 percent.”<sup>110</sup> The rate on line<sup>111</sup> actually charged by the FHCF for the 2007-2008 policy year for the additional \$12 billion of reinsurance coverage was 2.20 percent,<sup>112</sup> which, as the OIR report accurately characterized, was “sharply lower” than the OIR’s estimated private reinsurance market cost of 20 percent. (Please refer to the list of generic reasons on the previous page why the FHCF rates are lower than rates charged by private reinsurance companies for comparable coverage.)

An indirect method to evaluate the 2.20 percent rate on line charged by the FHCF for the 2007-2008 policy year (and the 2.155 percent rate on line charged by the FHCF for the 2008-2009 policy year) is to consider that, after approval by its Board of Trustees<sup>113</sup>, the State Board of Administration on behalf of the FHCF entered into a put option agreement with Berkshire Hathaway, Inc. on August 8, 2008 at a cost of \$224 million. The put option required Berkshire Hathaway to purchase up to \$4 billion of bonds from the FHCF if a single hurricane caused the FHCF to have hurricane losses and loss adjustment expenses during the 2008 Hurricane Season of more than \$16 billion. The bonds that Berkshire Hathaway would purchase would have annual maturity dates from 2011 to 2039 and an interest rate of 6.50 percent.

While entering into the put option agreement was a controversial decision by the State Board of Administration Board of Trustees<sup>114</sup>, it is admittedly difficult to evaluate the merits of the put option given that the FHCF otherwise may have been unable to borrow large sums in the troubled U. S. and international credit markets in late 2008 or early 2009. It is interesting to note, however, that the total amount of premium collected by the FHCF from property insurance companies for the additional \$12 billion layer was \$220 million for the 2008-2009 policy year.<sup>115</sup> Assuming the correctness of the \$224 million fee paid to Berkshire Hathaway for agreeing to loan the FHCF up to \$4 billion, all of which would have to be repaid, it would appear that the premium charged by the FHCF to property insurance companies for promising to pay up to \$12 billion for the same hurricane losses represents a very different assessment of the catastrophic risks involved and raises fundamental public policy questions about the long-term economic viability of continuing with the current FHCF rate methodology.

During the 2009 Regular Session, the Legislature began to undo some of the changes it made regarding the FHCF's rates and coverage in 2007 and 2008.<sup>116</sup> First the Legislature began a six-year phase out of the additional \$12 billion FHCF coverage it required in 2007. Next the Legislature mandated that the rates charged by the FHCF for this additional coverage be increased by a factor of two in 2009, a factor of three in 2010, a factor of four in 2011, a factor of five in 2012, and a factor of six in 2013. Finally, the Legislature reinstated the cash buildup factor it passed in 2002 and removed in 2007. The new cash buildup factor is 5 percent in 2009, 10 percent in 2010, 15 percent in 2011, 20 percent in 2012, and 25 percent in 2013.

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## Part IV. Deficit Assessment Structures and Processes

While deficit assessments levied by the JUA, FWUA and Citizens, and to a lesser degree by the FHCF and FIGA, have been of concern to legislators, policyholders, insurance companies and the media, little attention has been given to specific aspects of these assessments that relate directly to the nature and amount of subsidies that may be present in the deficit assessment structures and processes. Before those subsidy issues can be identified, measured and evaluated, it is necessary to review the deficit assessment structures and processes in detail. There has not been as much legislative activity on deficit assessment structures and processes as on residual market rates. As a result, the deficit assessment structures and processes in Citizens are similar in many ways to the earlier deficit assessment structures and processes in the JUA and FWUA, particularly from 1997 to 2002 before they were combined to form Citizens.

In Part II of this report, the question was raised as to whether a deficit assessment by a residual market mechanism with “actuarially sound” rates constituted a subsidy by those persons or entities paying the assessments to those persons receiving the benefits. This is a particularly relevant question for assessments paid by insureds of private insurance companies to help cover deficits in Citizens. Because most property owners in Florida are not insured by Citizens, there are questions about the basic fairness, for example, of middle and low income residents of counties with relatively low hurricane exposure being assessed to pay for hurricane losses of wealthy property owners on Florida’s coasts where the hurricane exposure is greater. While it is not the purpose of this report

to reach a conclusion on this specific issue, it may be useful to set out some of the arguments why, everything else being equal, the existence of deficit assessments may not be inherently unfair.<sup>117</sup>

1. Citizens, by providing property insurance coverage to those who could not obtain the coverage from private insurance companies, helps support key components of Florida’s economy, i. e., home construction, real estate sales, mortgage banking, and others, which benefits all Floridians.
2. Depending on weather and other factors beyond a property owner’s control, every property owner in Florida has a chance of a hurricane loss and, at one time or another, may be forced to obtain property insurance from Citizens due to adverse property insurance market conditions.
3. Because property insurance premiums vary significantly throughout Florida based in part on differences in hurricane exposure, policyholders already pay substantially different amounts when they are assessed depending on where they live and the value of their properties.

The last point above is susceptible to analysis. The important issue is whether the current Citizens’ assessment processes produce assessments on individual policyholders across the state that accurately reflect differences in exposure to hurricane losses from one property to another.

### A. Overview of Citizens’ Deficit Assessments

When Citizens has a financial deficit in any of its three accounts,<sup>118</sup> it has statutory authority<sup>119</sup> to levy two types of assessments – Regular Assessments and Emergency Assessments. Other types of deficit assessments exist (as discussed below), but Regular Assessments and

Emergency Assessments are the foundation of the Citizens' deficit assessment process. Regular Assessments are imposed on, a liability of, and collected from private insurance companies by Citizens. These assessments are also imposed on and collected from policyholders purchasing relevant types of insurance policies from surplus lines insurers.<sup>120</sup> The principal purposes of Regular Assessments are to cover smaller deficits quickly and to generate an early flow of funds to Citizens when larger deficits occur. Insurance companies have the authority<sup>121</sup> to recoup the amount of the Regular Assessments they pay to Citizens by adding a surcharge to the premiums they charge their policyholders. The principal purpose of Emergency Assessments is to allow Citizens to make principal and interest payments on debt it issues to pay the claims associated with large hurricane losses. When needed, Citizens levies Emergency Assessments on its own policyholders and on private insurance companies' policyholders and surplus lines policyholders subject to assessment. The Emergency Assessments are collected when the policies subject to assessment are renewed or when new policies are issued.

The other key component is the Citizens Assessment Base<sup>122</sup>, which is the aggregate of all premiums written in a specific year for the lines of business subject to assessment. While the operation of Regular Assessments and Emergency Assessments has changed little over the past ten to twelve years, the nature of the Citizens Assessment Base has changed considerably during this period, but these changes will be discussed separately.

An interesting change in nomenclature made in the 2002 legislation<sup>123</sup> that created Citizens was to no longer refer to insurance companies subject to assessment as "member insurers" and to refer to them instead as "assessable insurers," principally because the insurance companies

subject to assessment were not actually members of anything and had no rights of membership, such as electing the board of governors. At the same time, the Florida Legislature made many policyholders of surplus lines insurers subject to assessment by Citizens and referred to these policyholders as "assessable insureds."

Until 2008, if Citizens had a deficit that was less than 10 percent of its assessment base, Citizens would levy Regular Assessments on the insurance companies subject to assessment in the amount necessary to cover the deficit. If the Citizens' deficit exceeded 10 percent of the Assessment Base, Citizens would levy the maximum 10 percent Regular Assessment on the insurance companies subject to assessment and then would levy an Emergency Assessment to be collected by insurance companies from their policyholders subject to assessment for one or more years until the deficit was covered. The maximum percentage of an Emergency Assessment is limited to the greater of 10 percent of the applicable Assessment Base or 10 percent of the deficit to make principal payments on debt plus an additional amount necessary to cover interest, fees, and other periodic debt costs. As a result, in the event of very large hurricane losses Emergency Assessments by Citizens can be substantially larger than 10 percent of policyholder premiums.

In the 2008 Regular Session<sup>124</sup>, the Legislature reduced the maximum percentage for Regular Assessments from 10 percent to 6 percent while leaving the maximum rate for Emergency Assessments at 10 percent. The Regular Assessment percentage reduction seems to have two main effects. First, it reduces the amount of cash that insurance companies subject to assessment would have to pay to Citizens at a time when many of these insurance companies may have sizeable demands on their finances to cover hurricane claims of their own policyholders. Second, the amounts to be

recouped by insurance companies from their policyholders would be reduced accordingly. This would reduce the aggregate first year impact of the deficit assessments imposed on private insurance company policyholders subject to assessment.

## B. Special Citizens' Surcharges

In the mid-1990s the Florida Legislature required the JUA and the FWUA to impose a special assessment on their policyholders when either entity had a deficit and imposed Regular Assessments on insurance companies subject to assessment. This assessment, called the Market Equalization Surcharge, was designed to assure that the cost of policies issued by the JUA and the FWUA did not become less expensive in relation to the cost of policies issued by private insurance companies that were recouping Regular Assessment payments from their own policyholders. Because the JUA's and FWUA's deficits would be fully covered by Regular Assessments and Emergency Assessments, the funds generated by the Market Equalization Surcharges were not used to cover any part of the deficit but to help restore the JUA's and FWUA's capital for the next hurricane season.

In the 2006 Regular Session the Florida Legislature<sup>125</sup> made the first substantive change in the concept and process of assessing Citizens policyholders since the mid-1990s. If Citizens had a deficit in an account, the first step would be for Citizens to levy an immediate assessment of up to 10 percent of premium on each of its "nonhomestead property"<sup>126</sup> policyholders in all Citizens' accounts. If this did not cover the deficit, Citizens was to levy an additional assessment of up to 10 percent of premium on all Citizens' policyholders to be collected when the policies were renewed or new policies were issued. In addition, the Legislature changed the name of the Market Equalization Surcharge to Citizens Policyholder Surcharge and required

that the amount of the Regular Assessment be reduced by the expected amount to be received by Citizens from both the Citizens Policyholder Surcharge and the additional assessment described above. It appears that the Legislature in 2006 intended to place the initial burden<sup>127</sup> of paying for deficits on Citizens' policyholders before Regular Assessments were levied on the policyholders of private insurance companies.

In the 2007 Special Session, the Florida Legislature deferred the special assessment on nonhomestead property policyholders until 2008. No further changes were made in this regard during the 2007 Regular Session; however, the Legislature again made significant changes in the 2008 Regular Session. First, the Legislature eliminated references to assessments on Citizens' policyholders with nonhomestead properties. Second, the Legislature eliminated the reference to the additional assessment of up to 10 percent on all Citizens' policyholders. Third, the Legislature retained the Citizens Policyholders Surcharge, increased the maximum rate from 10 percent to 15 percent of premium for each of Citizens' three accounts, and required that the expected amount of this surcharge reduce the amount of the deficit before Regular Assessments and Emergency Assessments were considered. The 2008 changes seem to represent a backing away from the aggressive position taken by the Legislature in 2006. The maximum aggregate assessments on Citizens' policyholders with a nonhomestead property were decreased from 90 percent to 45 percent, and the maximum aggregate assessments on Citizens' policyholders with homestead properties were reduced from 60 percent to 45 percent. (Note: These aggregate assessment percentages do not include the possibility of Emergency Assessments.)

## C. Overview of the Citizens' Assessment Base

In the late 1990s and early 2000s, the JUA had two assessment bases (one for the Personal Lines Account and one for the Commercial Lines Account), and the FWUA had one assessment base. These assessment bases were similar but not identical, and they provide a useful starting point for understanding later developments. The statutory definitions of the JUA<sup>128</sup> and FWUA assessment bases in 1997 were as follows:

- JUA Personal Lines Account – Any personal lines policies defined in Section 627.4025, Florida Statutes, which are "... the type of coverage provided by homeowner's, mobile home owner's, dwelling, tenant's, condominium unit owner's, and similar policies ...."
- JUA Commercial Lines Account – "... all commercial property and commercial fire insurance."
- FWUA – "... insurance on real or personal property, as defined in Section 624.604, Florida Statutes, including insurance for fire, industrial fire, allied lines, farmowners multi-peril, homeowners' multi-peril, commercial multi-peril, and mobile homes, and including liability coverages on all such insurance, but excluding inland marine as defined in Section 624.607(3), Florida Statutes, and excluding vehicle insurance as defined in Section 627.605(1)(a) other than insurance on mobile homes used as permanent dwellings"<sup>129</sup> but not including "... premium for liability coverage and for the

following if included in allied lines: rain and hail on growing crops; livestock; ... ; National Flood Insurance Program direct premiums; and similar deductions specifically authorized by the (FWUA) and approved by the (Department of Insurance)."<sup>130</sup>

The JUA and the FWUA were combined by the Florida Legislature in 2002 to form Citizens Property Insurance Corporation; however, for various reasons, including particularly the interests of the large banks and note holders of the several billion dollars of lines of credit and pre-event notes issued by the JUA and the FWUA, the JUA's Personal Lines Account and Commercial Lines Account and the FWUA's renamed High-Risk Account retained a separate financial identity.<sup>131</sup> This is important because the calculation of deficits and resulting Regular Assessments and Emergency Assessments continued to be determined separately for each of the accounts as it had prior to the formation of Citizens. What did change with the formation of Citizens was the creation of a common definition of assessment base for all three accounts. The common assessment base definition was, in fact, the old FWUA assessment base definition, as set forth above except for the verbiage from "but not including" to the end. As a result, the assessment base for the Personal Lines Account and the Commercial Lines Account were larger than they had been previously. The more important effect, however, was that if either the Personal Lines Account or the Commercial Lines Account had a deficit, they would each be able to levy Regular Assessments and Emergency Assessments on both personal property and commercial property policyholders where that had not previously been the case.

Another important change in the Citizens legislation in 2002 was the expansion of the

assessment base definition (along with changes in the statutory provisions regarding Regular Assessments and Emergency Assessments) to include policyholders of surplus lines insurance companies in the lines of business included in the assessment base definition. These surplus lines policyholders, now referred to as “assessable insureds,” had previously not been subject to recoupment surcharges of Regular Assessments because surplus lines insurance companies were not (and still are not) subject to these assessments. They were similarly not subject to Emergency Assessments. Including these policyholders in the Citizens Assessment Base not only served to increase the size of the assessment base but also to eliminate an issue that had concerned the large banks and other institutions that were involved in the lines of credit and pre-event notes. These financial institutions had been concerned that if the JUA or the FWUA had a large deficit and were forced to levy significant Emergency Assessments, many of the policyholders to whom these assessments applied would terminate their existing insurance policies and seek coverage from surplus lines insurance companies to escape the assessments.

In the 2007 Special Session, the Florida Legislature achieved an even bigger expansion of the Citizens assessment base.<sup>132</sup> This expansion was accomplished by removing the previous assessment base definition and replacing it with the following:

“... insurance written by assessable insureds or procured by assessable insureds for all property and casualty lines of business in the state, but not including workers’ compensation or medical malpractice. ... the term “property and casualty lines of business” includes all lines of business identified on Form 2,

Exhibit of Premiums and Losses, in the annual statement required by authorized insurers by Section 624.424, Florida Statutes, and any rule adopted under this section, except for those lines identified as accident and health insurance and except for policies written under the National Flood Insurance Program or the Federal Crop Insurance Program. ... the term “workers’ compensation” includes both workers’ compensation insurance and excess workers’ compensation insurance.”

While numerous lines of insurance were added to the Citizens’ assessment base definition, the largest lines of insurance added were those involving private passenger automobile liability and physical damage insurance. Taken together, these have by far the largest amount of premium and probably involve even more insureds than personal residential insurance. The purposes of the Florida Legislature in significantly expanding the size of the Citizens Assessment Base may have included increasing Citizens’ ability to generate funds through the assessment process to pay for very large hurricane losses in a shorter amount of time or allowing Citizens to generate a given amount of funds using a lower assessment rate. For example, a doubling of the assessment base would allow Citizens to raise funds twice as fast or at half the previous assessment rate.

#### D. Florida Hurricane Catastrophe Fund Deficit Assessments

The Florida Hurricane Catastrophe Fund (FHCF) was created by the Florida Legislature in 1993<sup>133</sup> as a mandatory reinsurance mechanism for property insurance companies in Florida. It provides reimbursement for a portion

of an insurance company's hurricane losses above the company's required FHCF retention. Insurance companies that write covered policies must enter into a contract with the FHCF and pay an annual premium for the coverage provided. Since 1995, covered policies have been limited to those providing coverage for personal and commercial residential properties.<sup>134</sup> While the FHCF charges premiums for the coverage it provides, much of its capacity to meet its obligations to insurance companies is based on the assessments it is authorized to levy on insurance companies.

Because of its exemption from federal income taxation, the FHCF can accumulate premium payments from year to year on a tax-free basis to pay catastrophe losses when they occur. This has been beneficial because the FHCF was able to accumulate \$6 billion by 2004, which was used to pay some of the losses resulting from the hurricanes hitting Florida in 2004 and 2005. From its beginning, however, the amount of coverage provided by the FHCF has exceeded its cash on hand because the coverage limits have been set by the Florida Legislature based on a combination of the FHCF's cash on hand and its borrowing capacity. The FHCF's ability to borrow is a function of the FHCF's assessment rates, the size of the FHCF Assessment Base, and conditions in national and international credit markets. The assessments levied by the FHCF are called "Emergency Assessments," but they are not the same as the Citizens' Emergency Assessments.

### **1993 to 1998**

The maximum rate for Emergency Assessments was two percent of the FHCF Assessment Base unless the Governor of Florida declared a state of emergency, at which time the maximum rate for Emergency Assessments was four percent. The FHCF's Assessment Base included all lines of property and casualty insurance written by

authorized insurance companies in Florida except for workers compensation insurance and accident and health insurance. The Emergency Assessments were levied on insurance companies by the state insurance department, and the insurance companies were allowed by statute to recoup the amount of the Emergency Assessments in subsequent rate filings.<sup>135</sup>

### **1999 Regular Session**

The Florida Legislature expanded the FHCF's assessment authority<sup>136</sup> by allowing assessments of up to four percent for deficits arising out of hurricane losses occurring in one year and up to an aggregate of six percent for hurricane losses in multiple years. The initial season capacity was limited to \$11 billion, and the additional assessment authority was used to create capacity for subsequent hurricane seasons.

### **2004 Regular Session**

The Florida Legislature again increased the FHCF's assessment authority<sup>137</sup> by allowing assessments of up to six percent for hurricane losses in one season and up to an aggregate of ten percent for hurricane losses in multiple years. The initial season capacity and the capacity for subsequent seasons were each increased to \$15 billion. This additional capacity arose from the FHCF's increased assessment authority and from the Legislature expanding the FHCF's assessment base to include premiums from surplus lines insurance similar to the expansion of the Citizens Assessment Base in 2002, as discussed above. The Legislature also modified the Emergency Assessment collection process to have insurance companies collect these assessments at the same time they collect policyholder premiums, which eliminated the need for statutory language about insurance companies recouping the Emergency Assessments payments in subsequent rate filings. Medical malpractice insurers were

exempted from emergency assessments for hurricane events occurring prior to June 1, 2007.

### **2007 Special Session**

Because the FHCF charges rates for the coverage it provides that are substantially lower<sup>138</sup> than rates for similar coverage charged by private reinsurance companies, the principal tool used by the Florida Legislature in the 2007 Special Session in its efforts to lower property insurance rates was to significantly expand on a temporary basis the limits of coverage provided by the FHCF.<sup>139</sup> While the specifics of that coverage expansion are complex and beyond the scope of this report, it is important to note that the Legislature increased the amount of FHCF coverage from about \$16 billion to at least \$28 billion at a time when the FHCF had less than \$2 billion of cash on hand.

Large hurricane losses in Florida in the few years following the passage of this legislation in the 2007 Special Session could have had two potentially serious effects: (1) the huge amount of debt the FHCF would need to issue to meet its obligations would require many years of assessments on Florida policyholders for almost all lines of property and casualty insurance, and (2) if adverse capital market conditions did not allow the FHCF to issue the amount of debt needed, the FHCF would not be able to meet its expected obligations, which would mean that private insurance companies and Citizens would not have the funds they expected to have to pay their hurricane claims. This could have led to the insolvency of a number of private insurance companies.

### **2007 Regular Session**

The Florida Legislature extended the exemption of medical malpractice insurers from emergency assessments by the FHCF to include hurricane events occurring before June 1, 2010.<sup>140</sup>

## **Observations**

Certain aspects of the assessment procedures used by Citizens and the FHCF present potential subsidy issues. First, the very broad nature of the Citizens' and the FHCF's assessment bases means that insurance policyholders in many lines of insurance are being and will be assessed who do not receive any insurance coverage from these entities.<sup>141</sup> Second, because of variations in exposure to hurricane losses among lines of insurance and geographical areas in Florida, the question arises as to whether levying various types of assessments on total policy premium creates situations where some policyholders are subsidizing other policyholders. The important issue, which is susceptible to analysis, is whether the current assessment procedures used by Citizens and the FHCF produce assessments on individual policyholders across the state that accurately reflect differences in exposure to hurricane losses.

## **E. Florida Insurance Guaranty Association Deficit Assessments**

The Florida Legislature joined many other states in 1970 to address concerns about the adverse effects of insolvent insurance companies by creating the Florida Insurance Guaranty Association (FIGA).<sup>142</sup> The purpose of FIGA was to "provide a mechanism for the payment of covered claims under certain insurance policies to avoid excessive delay in payment and to avoid financial loss to claimants or policyholders because of the insolvency of an insurer."<sup>143</sup> FIGA does not accumulate funds in advance of an insurance company's insolvency, and, therefore, when insurance company insolvencies occur, FIGA must obtain the funds it needs through pro rata assessments levied by the state insurance department on insurance companies subject to assessment. Insurance companies may be required to pay these assessments in as little as 30 days.

For many years FIGA assessed its “member” insurance companies through four separate accounts:<sup>144</sup> (1) the worker’s compensation account, (2) the auto liability account, (3) the auto physical damage account, and (4) the account for all other insurance required to be part of FIGA.<sup>145</sup> The reason for having these four accounts is that some insurance companies write insurance in only one or two of the accounts, and it seemed fair to have the cost of an insurance company insolvency borne by the other insurance companies writing that type of insurance and by their policyholders and not by insurance companies and policyholders in other lines of insurance. This is particularly true for auto insurance and worker’s compensation insurance because these are large lines of insurance with a substantial number of insurance companies that specialize in those lines of business. The “all other” account, however, contains many lines of insurance.<sup>146</sup> In 1997, the worker’s compensation account was transferred to a newly formed Workers Compensation Insurance Guaranty Association,<sup>147</sup> which left FIGA with three accounts.

The Florida Legislature required that FIGA assessments “levied against any one insurer shall not exceed in any one year more than 2 percent of that insurer’s net direct written premiums in this state for the kinds of insurance included within such account during the calendar year next preceding the date of such assessments.”<sup>148</sup> The Legislature also allowed insurance companies paying FIGA assessments to recoup in their rates the assessment amounts they had paid.<sup>149</sup>

This approach had worked well in the years preceding Hurricane Andrew in 1992, but the size of the losses caused by Hurricane Andrew required a flow of funds beyond that produced by a two percent assessment per year in the “all other” account. The Florida Legislature authorized the issuance of debt by a unit of local

government to generate the funds necessary to pay the Hurricane Andrew claims of eleven insolvent insurance companies and created an additional FIGA assessment of up to two percent that would be pledged to repay the debt.<sup>150</sup> This additional assessment was to be included in the rates of insurance companies being assessed through a special rate filing for this purpose, but many insurance companies simply showed the two percent assessment as a visible surcharge on policyholder premiums when policies were renewed or new policies were issued.

In 2006, the Florida Legislature permanently enhanced FIGA’s ability to meet its financial responsibilities to pay covered hurricane claims of insolvent insurance companies in the “all other” account by creating the conditions under which FIGA could have access to tax-exempt debt on an on-going basis. First, the Legislature “... authorized municipalities and counties of this state substantially affected by the landfall of a hurricane to issue bonds to assist (FIGA) in expediting the handling and payment of covered claims of insolvent insurers.”<sup>151</sup> Second, the Legislature amended the FIGA statute to formalize the distinction between the traditional assessment of two percent and the special hurricane-related assessment of an additional two percent. The first two percent assessment is now called a Regular Assessment, while the second two percent assessment is called an Emergency Assessment. The new Emergency Assessments can be used to pay hurricane claims directly or can be assigned to the governmental unit issuing bonds to assist FIGA so that the governmental unit can “provide for the payment of the principal of, redemption premium, if any, and interest on such bonds, the cost of issuance of such bonds, and the funding of any reserves and other payments required under the bond resolution or trust indenture pursuant to which the bonds have been issued ....” The newly enacted law also directed insurance companies

to make a rate filing with the OIR within 90 days of receiving a notice from FIGA to reflect the amount of the assessment.<sup>152</sup>

Five Florida-domiciled insurance companies writing property insurance in Florida became insolvent after the 2004 and 2005 hurricanes. Depending on the number and size of property insurance companies that become insolvent following hurricanes striking Florida in the future, it is likely that FIGA will need to levy from time to time its own Regular Assessments and Emergency Assessments to meet its hurricane claims payment obligations under Florida law. While these assessments are smaller in size than assessments of Citizens and the FHCF and because of FIGA's three accounts, the issues regarding whether the FIGA assessment structure and process contain subsidy elements may not be critical. Nevertheless, the question remains of whether recouping FIGA assessments based on total policy premiums fairly and accurately addresses the variations in exposure to hurricane losses among lines of business and geographical areas.

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## Appendix

Ratemaking requirements and procedures for Florida's property insurance residual market mechanisms occupied the attention of the Florida Legislature for much of the period from late 1992 (after Hurricane Andrew) through the 2009 Regular Session. This appendix describes in general terms the actions taken by the Florida Legislature during this 17-year period to achieve legislative goals for residual market rates in relation to rates charged by private insurance companies writing residential property insurance coverage in Florida.

### **December 1992 Special Session**

The initial JUA statute<sup>153</sup> required JUA rates to be based on the "average loss costs of the five largest residential insurers, by premium volume in this state, plus appropriate factors for catastrophe loading, projected expenses, and a 25-percent increment for presumed adverse selection." The JUA was to make a rate filing each calendar year if the JUA board determined it was necessary based on "the loss and expense experience and other relevant factors." The state insurance department was to evaluate the rate filing "to determine that the proposed rates are not inadequate, excessive, or unfairly discriminatory ...." The Legislature appeared to want the JUA rates at the outset to be higher than those charged by the market leaders.

### **November 1993 Special Session**

A year later, the Legislature revised the way that JUA rates were to be set. The new rate requirements<sup>154</sup> stated that the JUA rates were to "be actuarially sound and that the (JUA) function as a residual market mechanism to provide insurance only when the insurance cannot be procured in the voluntary market. Rates of the (JUA) shall be based on the (JUA's)

actual loss experience and expenses, together with an appropriate catastrophe loading factor that reflects the actual catastrophe exposure of the (JUA)." The JUA board was required to make a rate filing no later than March 31 and September 30 of each year.

The JUA made a rate filing in early 1994, but the filing was not approved for several months. The JUA made another of the required, twice-a-year rate filings in the fall of 1994; however, following the election of a new Insurance Commissioner in November 1994, that rate filing was withdrawn and replaced by a new rate filing in early 1995, which was approved as modified a few weeks later.

### **1995 Regular Session**

The JUA's rate filing experiences in 1994 led the Legislature to alter significantly the JUA rate filing requirements in 1995<sup>155</sup>. The requirement that JUA rates were to be "not competitive with approved rates in the admitted voluntary market" was added. The Legislature still wanted JUA rates to be based on its actual loss experience, expenses, and catastrophe exposure, but "as an interim measure," the JUA was to set its average rates in each county at the average rates of the insurance company with the highest average rates in each county among the ten insurance companies with the largest statewide direct written premium. The "top ten insurer" approach applied to the various types of homeowners' insurance policies; however, the statute required a "top five insurer" approach for mobile homeowners' insurance policies.

The Florida Legislature also required the JUA to make a rate filing "at least once a year, but not more often than quarterly," and, in a dramatic departure from standard insurance regulatory practices, the JUA was authorized to make the rate filings on a "use and file basis" under Florida law. This allowed the JUA to put new rates in effect before getting the rates approved

by the Department of Insurance. Finally, the JUA's policies were to have a maximum term of six months to allow the JUA to realize the financial benefit of higher rates more quickly. The Legislature apparently believed that a straightforward, formulaic approach would produce better results for the JUA than relying on approaches where more actuarial and regulatory judgments were involved.

### **1996 Regular Session**

The Florida Legislature modified the 1995 formulaic approach because at that time almost all of the "top 10" premium-writing property insurance companies in Florida were large, national companies that historically had low property insurance rates in Florida for competitive reasons. As a result the rates of these insurance companies did not serve well as a base for JUA rates. The "top ten insurer" approach was increased to the "top 20 insurer" approach for homeowners insurance, while the "top five insurer" approach was increased to the "top eight insurer" approach for mobile homeowners insurance. Also, the provision adopted in 1995 to require JUA policies to terms of six months was repealed.<sup>156</sup>

### **1997 Regular Session**

With respect to the JUA rate making requirements, the Florida Legislature removed the requirement that JUA rates be based in the future on the JUA's "actual loss experience and expenses." The "top eight insurer" approach was returned to the "top five insurer" approach for mobile homeowners insurance.<sup>157</sup>

The Legislature for the first time set forth rate making requirements in the FWUA statute when it required that FWUA rates "be actuarially sound and not competitive with approved rates charged in the admitted voluntary market such that the (FWUA) functions as a residual market mechanism to provide insurance only when the

insurance cannot be procured in the voluntary market."<sup>158</sup> This new approach was to be implemented no later than January 1, 1999. One reason the Legislature acted at that time may have been that the FWUA had not changed its rates since it began operations in 1972, even though the number of FWUA policies in force had increased from about 50,000 in 1992 to about 300,000 in early 1997.

In another aggressive move to assist the JUA and the FWUA in achieving rates higher than those in the admitted voluntary market, the Legislature specifically authorized both entities<sup>159</sup> to take advantage of the rate arbitration process<sup>160</sup> available to private insurance companies to promote more prompt resolution of rate disputes with the Department of Insurance. While the JUA never took advantage of this authority, the FWUA did on two occasions, the most notable of which involved a filing for a very large rate increase that was reduced in size by the arbitration panel and required to be implemented over a three year period starting in 2001.

### **2002 Regular Session**

After the residential property insurance market improved in the late 1990s with the JUA policies in force decreasing from 937,000 in September 1996 to below 60,000 in April 2000, the property insurance market began to harden again in the early 2000s.<sup>161</sup> For unrelated reasons, the recently-elected State Treasurer and Insurance Commissioner, Tom Gallagher, proposed legislation in 2001 to combine the JUA and FWUA into a new administrative entity to be called Citizens Property Insurance Corporation (Citizens). That legislation<sup>162</sup> passed in 2002, and Citizens came into being on August 1, 2002. The JUA (multi-peril) portion of Citizens is made up of two separate accounts: the Personal Lines Account (PLA) and the Commercial Lines Account (CLA), while the FWUA (wind and

hail perils only) portion of Citizens is referred to as the High-Risk Account (HRA).

The principal rate-related changes made by the Legislature directed at the PLA and the CLA (but also applicable to the HRA) were the removal of (1) the authority for Citizens to require use of the arbitration process to resolve rate disputes with the Department of Insurance and (2) the authority to file rates under the “use and file” provisions of the Insurance Code. The requirement that a rate filing had to be made each year was retained.

The requirements for wind-only (the HRA) rates were changed extensively even though the language requiring these rates to be “actuarially sound and not competitive with approved rates charged by authorized insurers” was retained. The FWUA’s earlier 96 percent statewide average rate increase that was being phased in over several years pursuant to an arbitration decision<sup>163</sup> was to be capped in 2002 at no more than a 10 percent increase for any policy pending a new rate filing to take effect on July 1, 2003. The insurance department was to develop and provide to Citizens by March 1 of each year average wind-only rates for relevant geographical areas charged by the “top 20 insurers” for personal lines residential policies and the “top 5 insurers” for mobile home policies. The average Citizens rates in each county for the HRA were then required to be “no lower in each county than the average rates provided by the department.” Citizens was also required to impose a rate surcharge on HRA policies with seasonal occupancy.

### **2003 Regular Session**

While well intentioned, the detailed procedure set forth in the 2002 legislation for wind-only rates proved technically unsound in that it produced highly variable and inconsistent rate indications. The approach in 2003<sup>164</sup> was to continue phasing in the earlier wind-only rate

increases with a 20 percent cap on any policyholder’s rate increase. The Florida Legislature then delegated to Citizens and the Office of Insurance Regulation (OIR)<sup>165</sup> the responsibility to develop a wind-only rate making methodology, which was to be used by Citizens for a new rate filing by January 1, 2004. The authority of the OIR to review Citizens wind-only rate filings was limited to notifying Citizens that the rate filing did not comply with the rate making methodology developed under this provision, if the OIR so determined. Citizens was required “to amend its rates or rating factors to come into compliance within 90 days ....”

The Legislature enacted another nontraditional procedure for Citizens to follow with respect to PLA rates, which again appears to have been motivated by the objective of assisting Citizens in achieving property insurance rates higher than the admitted voluntary market. Citizens was required to certify to the OIR at least twice a year that its rates met specific statutory standards.<sup>166</sup> If any adjustments in rates or rating factors were needed to comply with the standards, Citizens was to “make and implement” the necessary adjustments. If the OIR determined that the revised rates and rating factors did not meet the statutory standards, it was to notify and require Citizens to amend its rates and rating factors in its next rate filing. Note that the OIR did not have authority to prevent Citizens from implementing its rate filings or to require Citizens to make any retroactive adjustments or refunds for policyholders.

In addition, the Legislature required Citizens to develop a notice to its applicants and policyholders stating that Citizens rates “are intended to be higher than the rates of any admitted carrier and providing other information (Citizens) deems necessary to assist consumers in finding other voluntary admitted insurers

willing to insure their property.” This notice requirement seems entirely consistent with the longstanding legislative policy that Citizens (and the JUA before it) were to provide property insurance coverage only when such coverage was not available from private insurance companies.

### **2005 Regular Session**

The rate filing requirements for Citizens were largely unchanged even after four hurricanes<sup>167</sup> struck Florida during the 2004 Hurricane Season. The only change of substance was a “pilot program”<sup>168</sup> to have rates for Citizens in Monroe County (the Florida Keys), where private insurance companies were not competing for business to any appreciable degree, established using traditional insurance regulatory standards, i. e., “actuarially sound and not excessive, inadequate, or unfairly discriminatory ....” This approach was to be used for Monroe County rates if the OIR “determines that a reasonable degree of competition does not exist for personal lines residential policies.”

### **2006 Regular Session**

In what may have been the high-water mark in the Florida Legislature’s efforts to push the rates of Florida’s property insurance residual market mechanisms above those in the admitted voluntary market, the Florida Legislature<sup>169</sup> stated its intent to “reaffirm the requirement of rate adequacy in the residual market.” The Legislature recognized that rates could be actuarially sound and not competitive and still be inadequate, and it also recognized “the public need to limit subsidies within the residual market.” This seems to be the first occasion that the Legislature formally acknowledged its concern about subsidies associated with the property insurance residual market. In addition, the Legislature stated that it was establishing “statutory standards for rate adequacy ... to

supplement the standards” generally applicable to insurance rates.<sup>170</sup> The Legislature’s first step was to modify its previously stated “intent” that Citizens rates be actuarially sound and not competitive to a requirement that Citizens rates “shall” meet these standards.

Second, the Legislature established, in effect, a new method of setting Citizens rates. For policies in the PLA and the CLA issued or renewed after March 1, 2007,

“a rate is deemed inadequate if the rate, including investment income, is not sufficient to provide for the procurement of coverage under the Florida Hurricane Catastrophe Fund and private reinsurance costs, whether or not the reinsurance is procured, and to pay all claims and expenses reasonably expected to result from a 100-year probable maximum loss event without resort to any regular or emergency assessments, long-term debt, state revenues or other funding sources.”

A similar standard was established for wind-only rates in the HRA except that the new HRA rates were to be based in 2008 on the 85-year probable maximum loss event and the 100-year event in 2009. The Legislature also established new regulatory rate filing procedures to assure that Citizens wind-only rate filings would receive either a notice of approval or disapproval from the OIR within 90 days.

Even though the Legislature established a new rate methodology for PLA rates, as described above, the “top 20 insurers” and “top 5 insurers” methodology was left in the statute.

### **January 2007 Special Session**

In 2006, because of rising reinsurance rates for Florida catastrophe exposures and other reasons,

many insurance companies made homeowner's rate filings requesting, and some received approval for, large percentage rate increases. Because of the public attention these rate increases and filings received, the Florida Legislature met during a special session in late January 2007 and essentially reversed course on Citizens' rates.<sup>171</sup> The requirement that Citizens' rates be actuarially sound was retained, but the "not competitive" requirement was deleted along with all of the rate methodology language adopted less than a year earlier during the 2006 Regular Session. In addition, the Legislature deleted the requirements that (1) Citizens' rates be no lower than the highest of the "top 20 insurers" and "top 5 insurers," which had been in the statutes since 1995, (2) Citizens certify to the OIR at least twice a year that its rates meet the specific rate standards in the Citizens statute, (3) Citizens make and implement rate filings to assure compliance with these standards, and (4) Citizens develop and provide a notice to its policyholders that Citizens rates are intended to be higher than rates of admitted private insurance companies.

The Legislature's new approach to Citizens ratemaking included the following:

1. Deletion of the 2006 provision requiring Citizens' rate filings to take effect on March 1, 2007.
  2. The Citizens' rate filings originally made in 2005, which because of various delays had taken effect until January 1, 2007, were rescinded except for rate decreases. Citizens was required to use the rates in effect on December 31, 2006 for all of 2007 and was required to make refunds to any policyholders that had paid a higher rate.
  3. If Citizens wished to increase any rates, it was required to make new rate filings that could not take effect until January 1, 2008.
  4. Citizens was to file "recommended rates" with the OIR, and the OIR was to "consider the recommendations ... and issue a final order establishing the rates for (Citizens) within 45 days ...."
5. Citizens was not allowed to "pursue an administrative challenge or judicial review of the final order of the (OIR)."

### **2007 Regular Session**

The Florida Legislature found that "private insurers are unwilling or unable to provide affordable property insurance coverage in the state to the extent sought and needed" and declared that "the state has a compelling public interest and a public purpose to assist in assuring that property in this state is insured and that it is insured at affordable rates ...."<sup>172</sup> The Legislature went on to state its intent that "affordable property insurance be provided and that it continue to be provided, as long as necessary, through (Citizens) ...."<sup>173</sup> With this preamble the Legislature extended the rollback of Citizens' rates through 2008 in addition to 2007 by extending the limitation on Citizens' ability to increase its rates until January 1, 2009.

### **2008 Regular Session**

The Florida Legislature again extended the rollback of Citizens rates by deleting the reference to January 1, 2009 and adding a requirement that Citizens submit a new rate filing by July 15, 2009 for each of the lines of business it writes with the effective date of the new rates to be January 1, 2010.<sup>174</sup> The Legislature, however, also created the Citizens Property Insurance Corporation Mission Review Task Force, which was directed "to develop a report setting forth the statutory and operational changes needed to return (Citizens) to its former role as a state created, noncompetitive residual market mechanism ...."<sup>175</sup> Included in its charge was direction that the Task Force study "The relationship of rates charged by (Citizens) to rates charged by private insurers with due consideration for (Citizens') role as a noncompetitive residual market mechanism."

### **2009 Regular Session**

During the 2009 Session, the Legislature began what may turn out to be a retreat from its policy during 2007 and 2008 regarding the role of Citizens. Based on recommendations of the Citizens Property Insurance mission Review Task Force<sup>176</sup> and legislative concerns about the potential size of Citizens' assessments and the difficulty that Citizens would have in issuing debt to pay claims in the event of large hurricane losses, the Legislature chose not to extend the Citizens' rate freeze for another year. Instead, the Legislature established what it generally referred to as a "glide-path" to move Citizens' rates toward actuarially sound levels. This glide path involved limiting rate increases on any single policy issued by Citizens to ten percent each year excluding coverage changes and surcharges. In addition, the Legislature allowed Citizens to increase its rates further to reflect the cost of the FHCF's cash buildup factor.<sup>177</sup>

# End Notes

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<sup>1</sup> Now known as Miami-Dade County

<sup>2</sup> Hurricane Katrina in 2005 is now the largest natural disaster in U. S. history.

<sup>3</sup> Florida Office of Economic and Demographic Research, “Florida Population and Components of Change,” July 9, 2008 <http://edr.state.fl.us/population.htm>

<sup>4</sup> Insurance Information Institute, “Value of Insured Coastal Properties Vulnerable to Hurricanes By State, 2007,” <http://www.iii.org/media/facts/statsbyissue/hurricanes/>

<sup>5</sup> Florida Hurricane Catastrophe Fund, *2006-2007 Annual Report*, page 20, [http://www.sbafla.com/fhcf/pdf/reports/2006-2007/06\\_07.pdf](http://www.sbafla.com/fhcf/pdf/reports/2006-2007/06_07.pdf)

<sup>6</sup> The National Centers for Environmental Prediction, “U. S. Mainland Hurricane Strikes by State, 1900-1996,” <http://www.nhc.noaa.gov/paststate.html>

<sup>7</sup> Category 3, 4 or 5 hurricanes on the Saffir/Simpson Scale

<sup>8</sup> Blake, Eric S., Edward N. Rappaport, and Christopher Landsea, “the Deadliest, Costliest, and Most Intense United States Tropical Cyclones from 1851 to 2006 (and Other Frequently Requested Hurricane Facts),” National Hurricane Center, NOAA Technical Memorandum NWS TPC-5, April 2007 [http://www.nhc.noaa.gov/Deadliest\\_Costliest.shtml](http://www.nhc.noaa.gov/Deadliest_Costliest.shtml)

<sup>9</sup> Andrew (1992)(#2), Wilma (2005)(#3), Charley(2004)(#4), Ivan (2004)(#5), Agnes (1972)(#7), Betsy(1965)(#8), Frances(2004)(#11), and Jeanne(2004)(#13) all adjusted and ranked in 2006 dollars. National Hurricane Center, page 9

<sup>10</sup> See Part III.

<sup>11</sup> Chapter 206-12, Laws of Florida

<sup>12</sup> Amundson, Richard B. “Residual Market Pricing,” 1996 Discussion Paper Program of the Casualty Actuarial Society

<sup>13</sup> The FWUA had received a 12.5 percent statewide average rate increase in 1997, which was considerably less than it requested and was the first FWUA rate increase since it began operation in 1972.

<sup>14</sup> The combination of the two sets of rate increase caps had the anomalous effect of allowing the full rate increase to be implemented for FWUA policyholders with below average rate increases and preventing the full rate increase from being implemented for FWUA policyholders with above average rate increases.

<sup>15</sup> [http://www.ipsnews.net/new\\_focus/subsidies/index.asp](http://www.ipsnews.net/new_focus/subsidies/index.asp)

<sup>16</sup> U. S. Department of Energy, Energy Information Administration, “Federal Energy Subsidies: Direct and Indirect Interventions in Energy Markets,” May 1, 2000, Page 1

<sup>17</sup> <http://www.businessdictionary.com/definition/subsidy.html>

<sup>18</sup> Porter, Gareth, “Natural Resource Subsidies, Trade, and Environment: The Case of Forests and Fisheries,” *Journal of Environment and Development*, vol. 6, no. 3, September 1997

<sup>19</sup> U. S. Department of Energy, page 2

<sup>20</sup> U. S. Department of Energy, page 2

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- <sup>21</sup> Valdes, Alberto, “Explicit versus Implicit Food Subsidies: Distribution of Costs,” Chapter 5, page 77 – 78, in *Food Subsidies in Developing Countries: Costs, Benefits, and Policy Options*, International Food Policy Research Institute, Washington, DC, <http://www.ifpri.org/pubs/books/ppa88/ppa88ch05.pdf>
- <sup>22</sup> Foster, Vivien, Andrés Gómez-Lobo, and Jonathan Halpern, “Designing Direct Subsidies for the Poor – A Water and Sanitation Case Study,” The World Bank Group, Note No. 211, June 2000
- <sup>23</sup> Valdez, page 78
- <sup>24</sup> U. S. Department of Energy, page 2
- <sup>25</sup> Porter
- <sup>26</sup> Foster, et al
- <sup>27</sup> Foster, et al
- <sup>28</sup> Valdes, page 80
- <sup>29</sup> Merton, Robert K., “The Unintended Consequences of Purposive Social Action,” *American Sociological Review*, Volume 1, Issue 6, December 1936 <http://www.compilerpress.atfreeweb.com/Anno%20Merton%20Unintended.htm>
- <sup>30</sup> Merton, pages 899 - 900
- <sup>31</sup> Merton, page 901
- <sup>32</sup> Foster, et. al.
- <sup>33</sup> Gunderson, Craig and James P. Ziliak, “The Role of Food Stamps in Consumption Stabilization,” *The Journal of Human Resources*, Volume 38, Special Issue on Income Volatility and Implications for Food Assistance Programs, (2003), page 1059
- <sup>34</sup> Gunderson and Ziliak, page 1053
- <sup>35</sup> Foster, et. al.
- <sup>36</sup> Grunwald, Michael, “The Clean Energy Scam,” March 27, 2008, <http://www.time.com/time/magazine/article/0,9171,1725975,00.html>
- <sup>37</sup> Grunwald
- <sup>38</sup> Cornell University News Service, July 5, 2005 <http://www.news.cornell.edu/stories/july05/ethanol.toocostly.ssl.html>
- <sup>39</sup> Brown, Larry and Jonathon Lewis, “Ethanol’s Failed Promise,” *Washington Post*, April 22, 2008, Page A19 <http://www.washingtonpost.com/wp-dyn/content/article/2008/04/21/AR2008042102555.html?hpid=opinionsbox1>
- <sup>40</sup> Brown and Lewis
- <sup>41</sup> “subsidies and tariffs: sweetening the pot,” Tampabay.com, <http://tampabay.com/specials/2008/graphics/sugar-prices/>
- <sup>42</sup> Edwards, Chris, “why Congress Should Repeal Sugar Subsidy,” Center for Trade Policy Studies of the CATO Institute, June 25, 2007, [http://www.cato.org/pub\\_display.php?pub\\_id=8381](http://www.cato.org/pub_display.php?pub_id=8381)
- <sup>43</sup> Carasso, Adam, C. Eugene Steuerle, and Elizabeth Bell, “Making Tax Incentives for Homeownership More Equitable and Efficient,” The Urban Institute, June 8, 2005
- <sup>44</sup> Carasso, et. al., page 15

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<sup>45</sup> Statement of Principles Regarding Property and Casualty Insurance Ratemaking adopted by the Board of Directors of the Casualty Actuarial Society, May 1988

<sup>46</sup> See Section 627.062, Florida Statutes.

<sup>47</sup> Actuarial Standard of Practice No. 12, Adopted by the Actuarial Standards Board on October 12, 1989

<sup>48</sup> The Herfindahl–Hirschman Index is often used to measure market concentration.  
<http://www.usdoj.gov/atr/public/testimony/hhi.htm>

<sup>49</sup> Insurance residual market mechanisms are created by or under state laws and regulations to make certain types of insurance coverage available to individuals or business that need or are required to have the coverage but are unable to purchase it from private insurance companies.

<sup>50</sup> “U. S. Property/Casualty Results by Line – 2007,” *Best’s Review*, August 2008, Page 78

<sup>51</sup> Litan, Robert E., Testimony before the Subcommittee on Oversight and Investigations of the U. S. House Committee on Financial Services on behalf of the AEI-Brookings Joint Center on Regulatory Studies. August 2001

<sup>52</sup> Blackmon, B. Glenn, Jr. and Richard Zeckhauser, “Mispriced Equity: Regulated Rates for Auto Insurance in Massachusetts,” *The American Economic Review*, Vol. 81, No. 2, Papers and Proceedings of the Hundred and Third Annual Meeting of the American Economic Association, (May, 1991), page 65

<sup>53</sup> Blackmon and Zeckhauser, page 69

<sup>54</sup> Tennyson, Sharon, Mary A. Weiss, and Laureen Regan, “Auto Insurance Regulation: The Massachusetts Experience,” in *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency*, edited by J. David Cummins, AEI-Brookings Joint Center for Regulatory Studies, 2002, page 26

<sup>55</sup> Blackmon and Zeckhauser, page 66

<sup>56</sup> Grace, Martin F., Robert W. Klein, and Richard D. Phillips, “Auto Insurance Reform: Salvation in South Carolina,” in *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency*, edited by J. David Cummins. AEI-Brookings Joint Center for Regulatory Studies, Washington, DC, pages 148-149

<sup>57</sup> Grace, Klein, and Phillips, pages 152-153

<sup>58</sup> Grace, Klein, and Phillips, pages 156-157

<sup>59</sup> Grace, Klein, and Phillips, page 157

<sup>60</sup> Grace, Klein, and Phillips, page 157

<sup>61</sup> Grace, Klein, and Phillips, pages 157-158

<sup>62</sup> Grace, Klein, and Phillips, page 158

<sup>63</sup> Worrall, John, “Private Passenger Auto Insurance in New Jersey: A Three-Decade Advertisement for Reform,” in *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency*, edited by J. David Cummins. AEI-Brookings Joint Center for Regulatory Studies, Washington, DC, 2002, page 107

<sup>64</sup> Worrall, pages 108-109

<sup>65</sup> Joel, Dana C., “Rhetoric vs. Reality: New Jersey Regulatory Reform,” *Regulation*, Cato Institute, Volume 19, number 2, page 59

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- <sup>66</sup> Worrall, page 82
- <sup>67</sup> Welch, Matt, “UnFAIR: The failure of ‘market-failure’-driven fire insurance,” *Reason Magazine*, November 5, 2003
- <sup>68</sup> “Life ain’t FAIR,” *Los Angeles Times* Opinion, October 2007, <http://opinion.latimes.com/opinionla/2007/10/life-aint-fair.html>
- <sup>69</sup> Housing and Urban Development Act
- <sup>70</sup> Matt Welch citing a *Los Angeles Times* article dated September 29, 2003
- <sup>71</sup> Thompson Don, “Bigger, Tougher Fires Bring California to the Brink; Schwarzenegger Proposes Insurance Surcharge,” *Insurance Journal*, August 15, 2008 at <http://www.insurancejournal.com/news/west/2008/08/15/92792>
- <sup>72</sup> Thompson
- <sup>73</sup> Public Law 90-448
- <sup>74</sup> U. S. General Accounting Office, “Flood Insurance: Challenges facing the National Flood Insurance Program,” GAO-03-606T, Testimony before the U. S. Subcommittee on Housing and Community Opportunity, Committee on Financial Services, April 1, 2003, page 3
- <sup>75</sup> GAO 2003, page 9
- <sup>76</sup> GAO 2003, page 7
- <sup>77</sup> Congressional Budget Office, “The Budgetary Treatment of Subsidies in the National Flood Insurance Program,” Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, January 25, 2006, page 1
- <sup>78</sup> GAO 2003, page 7
- <sup>79</sup> GAO 2003, page 2
- <sup>80</sup> Gaul, Gilbert M., “Repeat Claims Strain Federal Flood Insurance,” *Washingtonpost.com*, October 11, 2005
- <sup>81</sup> GAO 2003, page 2
- <sup>82</sup> CBO, page 4
- <sup>83</sup> GAO 2003, page 2
- <sup>84</sup> CBO, page 5
- <sup>85</sup> CBO, page 6 and footnote 8 on page 7
- <sup>86</sup> GAO 2003, page 5
- <sup>87</sup> U. S. General Accountability Office, “Flood Insurance: FEMA’s Rate-Setting Process Warrants Attention,” GAO-09-12, October 2008, page 19
- <sup>88</sup> GAO 2008, footnote 36 on page 19
- <sup>89</sup> GAO 2008, page 29
- <sup>90</sup> The role of the state insurance department in the assessment process with respect to such matters as reviewing the accuracy of the deficit determination and assuring that the assessment process is carried out correctly are important but will not be considered further in this report.

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<sup>91</sup> For example, see Section 627.3512, Florida Statutes. The Florida Legislature amended this statute during the 2009 Regular Session to simplify and streamline the assessment recoupment process by insurers and the OIR's involvement therein.

<sup>92</sup> The Property and Casualty Joint Underwriting Association (PCJUA) was created by the Florida Legislature in 1985, but it was not activated until after Hurricane Andrew. The Legislature formally activated the PCJUA in 1994 to provide property insurance coverage to condominium associations, apartments and homeowners' associations that could not obtain such coverage in the admitted voluntary market. That coverage was transferred to the RPCJUA by the Legislature in 1995, and the PCJUA was deactivated. There are subsidy issues present in covering commercial properties in residual market mechanisms, but those will not be addressed in this report.

<sup>93</sup> Prior to the creation of the JUA in 1992, Florida did not have a residual market mechanism to address residential property insurance availability problems throughout the state. Presumably, the Florida Legislature had not perceived the need to establish FAIR plans as did over 30 other states following the passage by Congress of the Urban Property Protection and Reinsurance Act of 1968.

<sup>94</sup> For a more in depth discussion of the development of Florida's property insurance residual market mechanisms, see Newman, James W., Jr., Winds of Change: A retrospective and proposal for reform of Florida's windstorm insurance market, published by the Florida Association of Insurance Agents, 2005. The document is available at [http://www.stormrisk.org/admin/downloads/Winds%20of%20Change%20\(FAIA\).pdf](http://www.stormrisk.org/admin/downloads/Winds%20of%20Change%20(FAIA).pdf)

<sup>95</sup> Miami-Dade and Broward Counties in 1993 and Palm Beach and Pasco Counties in 1996

<sup>96</sup> Chapter 1992-345, Laws of Florida

<sup>97</sup> Chapter 1993-409, Laws of Florida

<sup>98</sup> Chapter 1992-345, Laws of Florida

<sup>99</sup> Chapter 1993-410, Laws of Florida

<sup>100</sup> See the Appendix for more discussion and citations. Note some of these requirements were also applicable to the FWUA.

<sup>101</sup> Report of the Citizens Mission Review Task Force, January 30, 2009

<sup>102</sup> Chapter 2009-87, Laws of Florida

<sup>103</sup> Section 215.555(1), Florida Statutes

<sup>104</sup> Senate Committee on Banking and Insurance, "Options for Transferring Risk from the Florida Hurricane Catastrophe Fund. Interim Project Report 2008-104." November 2007. Page 56

<sup>105</sup> Section 215.555, Florida Statutes

<sup>106</sup> Senate Committee on Banking and Insurance. Pages 56 and 57

<sup>107</sup> Chapter 2007-1, Laws of Florida

<sup>108</sup> See Section D of Part IV for more information.

<sup>109</sup> OIR Report, page 16

<sup>110</sup> OIR Report, page 19

<sup>111</sup> "Rate on line" is a particular method for stating the cost of a layer of reinsurance coverage. It is defined as the cost of coverage divided by the amount of coverage. The rate on line will vary depending on the probability of attachment for the

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various layers of reinsurance and the reinsurer's expenses and profit factors. For example, if a reinsurance company offers a \$1 million layer of reinsurance coverage to a property insurance company at a 15 percent rate on line, the property insurance company will pay \$150,000 to purchase the reinsurance layer, which is 15 percent times \$1 million.

<sup>112</sup> Florida Hurricane Catastrophe Fund 2007 Ratemaking Formula Report to the State Board of Administration of Florida, March 20, 2007, Exhibit XVII <http://fhcf.paragonbenfield.com/pdf/07ratereport.pdf>

<sup>113</sup> The Board of Trustees of the SBA is the Governor, Chief Financial Officer and the Attorney General.

<sup>114</sup> The Board of Trustees approved the put agreement with Berkshire Hathaway by a vote of two to one.

<sup>115</sup> Florida Hurricane Catastrophe Fund, "2008/2009 Coverage Selections and Premium Calculations, as of 12/31/2008" [http://fhcf.paragonbenfield.com/pdf/08fin\\_pre.pdf](http://fhcf.paragonbenfield.com/pdf/08fin_pre.pdf)

<sup>116</sup> Chapter 2009-87, Laws of Florida

<sup>117</sup> *Winds of Change*, pages 84-87, at [http://www.stormrisk.org/admin/downloads/Winds%20of%20Change%20\(FAIA\).pdf](http://www.stormrisk.org/admin/downloads/Winds%20of%20Change%20(FAIA).pdf)

<sup>118</sup> The Personal lines Account (PLA), the Commercial Lines Account (CLA), and the High-Risk Account (HRA) for wind-only policies as defined in Section 627.351(6)(b)2., Florida Statutes

<sup>119</sup> Section 627.351(6)(b)3., Florida Statutes

<sup>120</sup> Surplus lines insurance is defined in and regulated pursuant to Part VIII of Chapter 626, Florida Statutes

<sup>121</sup> Section 627.3512, Florida Statutes

<sup>122</sup> "Citizens Assessment Base," as used in this report is referred to in the relevant statutes (Section 627.351(6)(b), Florida Statutes) as "the aggregate statewide direct written premium for the subject lines of business."

<sup>123</sup> Chapter 2002-240, Laws of Florida

<sup>124</sup> Chapter 2008-66, Laws of Florida

<sup>125</sup> Chapter 2006-12, Laws of Florida

<sup>126</sup> The terms "nonhomestead property" and "homestead property" were defined in Chapter 2006-12, Laws of Florida

<sup>127</sup> This burden could have been substantial. A Citizens' policyholder with a policy covering a nonhomestead property could have received a series of nine assessments not counting Emergency Assessments if each of Citizens' three accounts had deficits.

<sup>128</sup> Section 627.351(6)(b)3.f, Florida Statutes

<sup>129</sup> Section 627.351(2)(b), Florida Statutes

<sup>130</sup> Section 627.351(2)(b)2.a.(I), Florida Statutes

<sup>131</sup> Section 627.352(6)(b)2., Florida Statutes

<sup>132</sup> Chapter 2007-1, Laws of Florida. This definition is essentially the same as the Assessment Base definition in the FHCF statute (Section 215.555, Florida Statutes).

<sup>133</sup> Chapter 1993-409, Laws of Florida

<sup>134</sup> Chapter 1995-276, Laws of Florida

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- <sup>135</sup> See Section 627.062(5), Florida Statutes (1997)
- <sup>136</sup> Chapter 1999-217, Laws of Florida
- <sup>137</sup> Chapter 2004-27, Laws of Florida
- <sup>138</sup> See discussion on FHCF rates in Section B of Part III.
- <sup>139</sup> Chapter 2007-1, Laws of Florida
- <sup>140</sup> Chapter 2007-90, Florida Statutes
- <sup>141</sup> The Internal Revenue Service noted this in its Private Letter Ruling PLR -110715-97, page 8 that the FHCF's Emergency Assessments were a "tax of general application ...." This appears to have assisted the FHCF in achieving Federal tax-exempt status.
- <sup>142</sup> Chapter 1970-20, Laws of Florida
- <sup>143</sup> Section 631.51(1), Florida Statutes
- <sup>144</sup> Section 631.55(2), Florida Statutes
- <sup>145</sup> See Section 631.52, Florida Statutes for the lines of insurance not covered by FIGA.
- <sup>146</sup> The principal lines of insurance in the All-Other Account are Fire, Allied Lines, Farmowners Multiple Peril, Homeowners Multiple Peril, Commercial Multiple Peril, Inland Marine, Other Liability, Products Liability, and Boiler and Machinery.
- <sup>147</sup> Chapter 1997-262, Laws of Florida.
- <sup>148</sup> Section 631.57(3)(a), Florida Statutes
- <sup>149</sup> Section 631.64, Florida Statutes
- <sup>150</sup> Chapter 1992-345, Laws of Florida
- <sup>151</sup> Section 631.695, Florida Statutes
- <sup>152</sup> Chapter 2006-12, Laws of Florida
- <sup>153</sup> Chapter 1992-345, Laws of Florida
- <sup>154</sup> Chapter 1993-410, Laws of Florida
- <sup>155</sup> Chapter 1995-276, Laws of Florida
- <sup>156</sup> Chapter 1996-194, Laws of Florida
- <sup>157</sup> Chapter 1997-55, Laws of Florida
- <sup>158</sup> Chapter 1997-55, Laws of Florida
- <sup>159</sup> Chapter 1997-55, Laws of Florida
- <sup>160</sup> See Section 627.062(6), Florida Statutes (1998)
- <sup>161</sup> *Winds of Change*, pages 6-7, at [http://www.stormrisk.org/admin/downloads/Winds%20of%20Change%20\(FAIA\).pdf](http://www.stormrisk.org/admin/downloads/Winds%20of%20Change%20(FAIA).pdf)

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<sup>162</sup> Chapter 2002-240, Laws of Florida

<sup>163</sup> The rate arbitration panel approved the 96 percent statewide average rate increase with the requirement that no premium increase in the first year could exceed 20 percent, no premium increase in the second year could exceed 30 percent, and no premium increase in the third and subsequent years could exceed 40 percent.

<sup>164</sup> Chapter 2003-281, Laws of Florida

<sup>165</sup> The Florida Insurance Department was reorganized in 2003 as part of the creation of a new governmental entity, i. e., the Florida Department of Financial Services. The OIR's principle responsibilities include financial regulation of insurance companies, regulation of insurer forms and rates, and regulation of insurer market conduct.

<sup>166</sup> These include the actuarially sound and noncompetitive standards and the highest of the "top 20 insurer" and "top 5 insurer" formulas.

<sup>167</sup> Hurricanes Charley, Francis, Ivan and Jeanne

<sup>168</sup> Chapter 2005-111, Laws of Florida

<sup>169</sup> Chapter 2006-12, Laws of Florida

<sup>170</sup> Section 627.062, Florida Statutes

<sup>171</sup> Chapter 2007-1, Laws of Florida

<sup>172</sup> This may be the first time that the Florida Legislature used the term "affordable rates" in the Insurance Code; however, it did not define the term.

<sup>173</sup> Chapter 2007-90, Laws of Florida

<sup>174</sup> Chapter 2008-66, Laws of Florida

<sup>175</sup> Chapter 2008-66, Laws of Florida

<sup>176</sup> Report of the Citizens Mission Review Task Force, January 30, 2009

<sup>177</sup> Chapter 2009-87, Laws of Florida