PROPERTY INSURANCE IN FLORIDA - OUTSIDE THE BOX

A couple weeks ago you asked me to start looking at the property insurance issues this state is currently facing and to come up with some ideas from a different perspective than those currently under consideration. Issues surrounding Citizens and the CAT Fund are being discussed very thoroughly in various forums, so I did not spend a lot of time on them.

Also as I have learned more about the problems we face, I believe that many of the solutions will require long-term focus. The insurance industry does this itself by responding to past losses by insureds with demands for better future performance by insureds. Government can only do this by taking a forward-looking and consistent approach. The nature of hurricane cycles will strain our ability to do both. For example, we must never see a large CAT Fund balance after years with no hurricanes and consider spending that balance on any other purpose.

The nature of the potential windstorm losses Florida faces are outside the types of risk with which companies with annual reports to shareholders have typically dealt. While the order of magnitude of the loses from fire or theft may be relatively predictable from year to year, the losses due to hurricanes in Florida are not. No model can smooth losses that may be $0 for several years, then jump to $10s of billions for a year or two, then back to $0.

I believe there are actions that government (local, state, and federal) can responsibly take to further the interests of our citizens by promoting stable growth and a predictable financial environment. The private market should be expected to do everything of which it is capable. Likewise, homeowners need to be on the front line of responsibility. Government should encourage and educate where it can, regulating or taxing only when the broadest interests of the public health, safety, and welfare are implicated.

With those comments in mind, here is my list of outside-the-box ideas. I take full blame for any non-starters, but I was serious when I asked you "What box?" when the request was made

PROPERTY INSURANCE

CITIZENS

Allow Citizens to compete on windstorm coverage since the private market will never cover all windstorm risk in Florida. This addresses the current adverse selection that occurs for Citizens as the private market takes the least at-risk properties and leaves Citizens with only the most at-risk properties, which is contrary to the concept of insurance spreading risk.

- Remove requirement that Citizens have the highest rates - just require them to be actuarially sound on the same basis as the private companies.
- Subsidize Citizens to get them capitalized (this is unfair competition with the privates, but they won't take the risk). **$$$$$**
  - Would need billions for any meaningful capitalization. How this would be raised would depend on how the burden was spread among assessments for insureds and taxes of the general public.

Could limit Citizens coverage on new construction in the worst areas (to $100,000) unless construction is built to voluntary building code standards.

Require private property insurers to have a minimum percent of their book of business in the state's designated high-risk areas.

Create a sidecar or catastrophe bonds for Citizens. This is probably a last resort in a situation where hurricane losses have been out of control for several years and the state is willing to seek extreme solutions. Some analysis of this option (along with any other new reinsurance financing schemes that evolve in the private market over the next few years) ahead of time could prove valuable.

- Might be very had to sell based on the adverse selection that drives Citizens.
- State would have to default on bonds in order for sidecar to pay off.
- [Reinsurance sidecars, conventionally referred to as Sidecars, are financial structures which are created to allow investors to take on the risk and return of a group of insurance policies (a "book of business") written by an insurer or reinsurer (henceforth re/insurer) and earn the risk and return that arises from that business. A re/insurer will only pay ("cede") the premiums associated with a book of business to such an entity if the investors place sufficient funds in the vehicle to ensure that it can meet claims if they arise. Typically the liability of investors is limited to these funds. These structures have become quite prominent in the aftermath of Hurricane Katrina as a vehicle for re/insurers to add risk-bearing capacity, and for investors to participate in the potential profits resulting from sharp price increases in re/insurance over the four quarters following Katrina. An earlier and smaller generation of sidecars were created after 9-11 for the same purpose.
- [Catastrophe bonds (also known as cat bonds) are risk-linked securities that transfer a specified set of risks from the sponsor to the investors. They are often structured as floating-rate corporate bonds whose principal is forgiven if specified trigger

conditions are met. They are typically used by insurers as an alternative to traditional catastrophe reinsurance. For example, if an insurer has built up a portfolio of risks by insuring properties in Florida, then they might wish to pass some of this risk on so that they can remain solvent after a large hurricane. They could simply purchase traditional catastrophe reinsurance, which would pass the risk on to reinsurers. Or they could sponsor a cat bond, which would pass the risk on to investors. In consultation with an investment bank, they would create a special purpose entity that would issue the cat bond. Investors would buy the bond, which might pay them based on a common interest rate index plus 4%. If no hurricane hit Florida, then the investors made a healthy return on their investment. But if a hurricane hits Florida and triggers the cat bond, then the principal initially paid by the investors is forgiven, and is instead used by the sponsor to pay its claims to policyholders.

In order to reduce Citizens' rates, which are required by law to be higher than most private insurers, allow citizens policyholders to opt for higher deductibles that the law currently allows. Amend the law for higher deductibles only for Citizens, not for the private companies, to recognize that Citizens is the insurer of last resort. This would reduce both homeowner premiums and Citizens risk.

- Banks could still demand coverage within the limits of the deductible by requiring a preapproved letter of credit, second mortgage, etc.

REINSURANCE

Consider doing more of the SB 1980 encouragement of private insurance reserves. This should be done based on evaluation of the current program authorized in SB 1980 (2006) indicating that the program has had the positive effect anticipated. **$$$$**

Appropriate $10M (or more) non-recurring GR to the CAT Fund every year that there's enough money a) to offset the statutory $10M spent on mitigation and b) to show the IRS continuing state involvement in the Fund (skin in the game). **$$**

Institute a voluntary certification program for reinsurers that submit to meeting minimum Florida qualifications. Offer property insurers an incentive to use such reinsurers though an insurance premium tax rebate or discount. **$$$**

REVENUES FOR CITIZENS OR THE CAT FUND

A one-cent increase to the state sales tax has been raised in the Property and Casualty Insurance Reform Committee as a possible way to provide funding to capitalize Citizens or to build reserves in the CAT Fund. Such an increase would raise over $3.5 billion a year for the period during which it was in place.

An alternative revenue source would be documentary stamp taxes, most of which are related directly to real property. A 10 percent increase in the doc stamp tax rate would generate $225 million a year. **$$$$**

- [The documentary stamp tax is actually two taxes imposed on different bases at different tax rates. The tax on deeds and other documents related to real property is at the rate of 70 cents per $100, though in Miami-Dade County the rate is 60 cents. Certificates of indebtedness, promissory notes, wage assignments and retail charge account agreements are taxed at 35 cents per $100. Revenue from documentary stamps is divided between the General Revenue Fund and various trust funds used to acquire public lands or support affordable housing.]

Insurance premium tax - 85% of the roughly $650M revenues from this tax are deposited in the General Revenue Fund. If we want a recurring source of funding for property insurance related issues, we could explore a) dedicating a portion of the tax or b) reducing the tax and requiring an equal amount to be paid by the industry into the CAT Fund. **$$$$**

INSURANCE RESERVES

Insurance companies operate on an annual basis (reporting profits, paying taxes, answering to stockholders) but hurricane impacts do not average out each year (like auto accidents). Consider (in addition to modeling for 100-year storms, etc.) the rate stabilization mechanism used by the Florida Retirement System. It limits the use of certain surpluses in the retirement fund from being used in recognition that market conditions in a future year could erase those surpluses.

- Section 121.031(3)(f), F.S., provides that the actuarial model used to determine the adequate level of funding for the Florida Retirement System should maintain as a reserve a specific portion of any actuarial surplus. That reserve is used solely for the purpose of offsetting future unfunded liabilities caused by experience losses, thereby minimizing the risk of future increases in contribution rates. The use of any excess above the reserve to offset retirement system normal costs is to be in a manner that will allow system employers to plan appropriately for resulting cost reductions and subsequent cost increases.

Require or allow insurance companies to have a higher ratio of assets to premiums in order to decrease the need for the most expensive reinsurance - that at the lowest layers (below the CAT fund).

PRE-HURRICANE MITIGATION

LOCAL GOVERNMENT AND BUILDING CODE

Establish a voluntary building code in statute.
- High standards for coastal construction.
- Require heavy insurance discounts for anyone who builds or retrofits to code.
  - Or place a premium surcharge on new homes build in high-risk areas that do not meet the higher code.

Make local governments financially responsible for their planning and zoning decisions related to coastal development **$$**
- Doesn't have to be a lot of money.
- Might make them contribute to Citizens based on the number of existing or new (either or both) Citizens policies in their areas.

Allow local governments to add more stringent requirements to the building code in the most critical coastal areas.

State licensure of building inspectors.

Grade Florida communities on building code effectiveness to promote local government involvement.
- This could involve financial rewards or penalties (possibly through state-shared revenues) to local governments based on their grades.
- As an example, ISO's Building Code Effectiveness Classifications helps the insurance industry distinguish between communities with effective building code enforcement and those with weak enforcement. Their concept is simple: municipalities with effective, well-enforced codes demonstrate better loss experience when catastrophe strikes. Buildings located in such communities — constructed according to current codes — likewise experience less severe loss. ISO collects information on the building codes in effect in a particular community, as well as how the community enforces its building codes. They then analyze the data using their Building Code Effectiveness Grading Schedule (BCEGSTM) and assign a grade from 1 to 10. Grade 1 represents exemplary commitment to building-code enforcement; Grade 10 indicates no recognizable enforcement. Insurers use the gradings to grant premium credits for buildings constructed under strictly enforced codes.

AD VALOREM TAXATION

Constitutional amendment to provide ad valorem exemption for the extra costs involved in "hardening" any home beyond current building code windstorm standards.

- Probably needs to have a dollar limit on the additional exemption for any home.
- Should it include the value of bringing an old home up to the current windstorm standards? **$$$**

STATE LANDS

Start buying land in storm surge areas that aren't built up. **$$$$$**

- Use all the environmental lands money plus whatever else you can scrape together.
- Limit purchase price to 95% or 99% of appraised value to prevent inflation.
- Even buy land with houses, and hire someone to rent them out - when a storm flattens them, the land becomes permanent beach.

Prohibit rebuilding of homes in high-risk areas after any loss of 95 percent or more. The state could buy the land or pay the owner the difference in the value of the land when it can not be developed. **$$$**

In coastal areas that are built up, begin to harden the coast. **$$$$**

- Huge increases in beach renourishment, dune construction, artificial reefs, etc.
- We do $30M a year of beach renourishment now. The industry currently has only a limited capacity to do more, but with commitments of recurring funding in the future, more capacity could be developed.
- After the 1993 floods in the Midwest, the federal government, under then-FEMA director James Lee Witt, offered to buy out flood prone properties to prevent repeat disasters. Several communities accepted, and the feds in partnership with the state bought 25,000 properties. The thousands of acres left behind were converted to wetlands, which act like a sponge in storms. In 1995 the floods came again. "And guess what?" says Witt. "We never spent one dime on responding. Nobody lost everything they worked for." *Time*, August 28, 2006.
- Seek participation from the federal government, since hardening will directly address flooding and the feds already have an interest in the costs of flooding through the federal flood insurance program.

CONSTRUCTION

Provide research funds for better construction materials (in addition to any funds for such purpose provided from the CAT Fund under s. 215.555(7)(c), F.S.). **$$**

Provide research funds for better construction methods (in addition to any funds for such purpose provided from the CAT Fund under s. 215.555(7)(c), F.S.). **$$**

Offer free inspections to homeowners, based on the most comprehensive hurricane loss data available, to indicate the most critical steps they can take to harden their homes.
- Texas requires inspections in designated windstorm areas (with some financial assistance available for homeowners). **$$**

Do more of the SB 1980 grants to harden homes. **$$$$**

MOBILE HOMES

Prohibit any development or redevelopment of mobile home parks in high-risk coastal areas or put local governments at risk financially for permitting such development.

Reduce the number of mobile homes in high-risk coastal areas.
- Partner with local governments (and the federal government?) to buy out the highest risk mobile home parks.
- Offer small relocation grants to mobile home owners willing to relocate their homes in areas that are not high-risk. **$$$**

OTHER

Promote consumer education on hurricane/disaster preparedness.
- Have a formal class, which covers the most common home retrofits, and which might be offered online like classes for Florida driving schools or dissolution of marriage (Parent Education and Family Stabilization).
  - Provide an incentive for completing such a class through a small, one-time property insurance rate reduction or doc stamp tax rate reduction (for those situations where purchase or refinancing of a home is involved).
  - Require that as a condition of receiving coverage from Citizens, a homeowner must complete such a class.

Have high impact fees for development in high-risk areas. Such fees should cover not only the costs of extending/expanding current infrastructure to support the development but also the probable costs of maintaining/repairing that infrastructure based on storm damage.

- Could make this revenue neutral by pairing it with reduced impact fees for development areas that are not designated as high risk to provide a further incentive for development that will prove to be insurable by someone other than Citizens.

Create a Florida version of the federal Coastal Barriers Resource Act.

- The Coastal Barrier Resources Act (CBRA) of 1982 established the John H. Chafee Coastal Barrier Resources System (CBRS), comprised of undeveloped coastal barriers along the Atlantic, Gulf, and Great Lakes coasts. The law encourages the conservation of hurricane prone, biologically rich coastal barriers by restricting Federal expenditures that encourage development, such as Federal flood insurance through the National Flood Insurance Program. CBRA is a free-market approach to conservation. These areas can be developed, but Federal taxpayers do not underwrite the investments. CBRA saves taxpayer dollars and encourages conservation at the same time.
- Would require creative thought about ways to provide incentives. An example might be to encourage something like wetlands mitigation banks in coastal areas.

POST-HURRICANE MITIGATION

LAW ENFORCEMENT

Allow law enforcement to assist building supply stores to stock and restock critical hurricane materials. (Home Depot or Lowes might want a cruiser to get a couple trucks of plywood through the traffic.)

Train specific nation guard units in post-hurricane mitigation and allow them to go into neighborhoods to help enclose houses to minimize further damage. **$$**

LIABILITY

Limit the liability of certain persons engaged in post-hurricane mitigation efforts (contractors boarding up windows and placing blue tarps, etc.).

PRE- AND POST-HURRICANE MITIGATION

INSURANCE

Require homes over $1M in coastal areas 1) to have insurance, 2) to show proof of self-insurance over $1M (line of credit, pre-approved second mortgage, etc.), or 3) to certify that they are going bare above $1M. (This concept is tied to the SB 1980 provision limiting Citizens coverage on homes valued at $1M or more.)

CONTRACTORS AND LICENSURE

Pre-approve out-of-state contractors who can work in Florida without a Florida license in case of emergency -- activate such pre-approvals only upon specifically including them in an emergency order to control the timing and the trades activated.

Require all building trades licensees to be trained in pre- and post-hurricane mitigation -- pre-hurricane mitigation could include installation of shutters, etc. -- post-hurricane mitigation could include enclosing the house to minimize further damage.

Allow all building trades licensees to perform pre- and post-hurricane mitigation -- this will require a specific triggering event such as an emergency order and will require amending licensing laws to expand contractors authorized activities.

$$$$$ billions
$$$$ hundreds of millions
$$$ tens of millions
$$ millions