



# **AT THE TIPPING POINT:**

## **THE HOMEOWNER INSURANCE MESS IN FLORIDA AND HOW TO FIX IT**

### **Principal Contributors:**

Joanne Doroshow of the Center for Justice & Democracy  
J. Robert Hunter of the Consumer Federation of America

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The scale of destruction caused by the hurricanes of 2005 may have been the worst in recent history, but the pattern of insurance industry response to policyholders in the wake of these devastating events, worsening the suffering of many, is something that Florida residents have known well for years.

In 1992, Hurricane Andrew became a seminal event in Florida history not only in terms of the amount of destruction it caused, with about \$25 billion worth of damage, but also how the industry decided to respond to hurricanes. Following Andrew, the industry threatened massive non-renewals of homeowners insurance as they tried to dump as much risk as possible. Close industry observers were not surprised. As co-author J. Robert Hunter told *U.S. News and World Report* in 2003, “Insurers are the ultimate risk avoiders.... If there’s any hint of risk, they dump out of it.”<sup>1</sup> Had lawmakers and regulators not stepped in following Andrew and thwarted the industry’s actions, the blow to the Florida’s residents and to the state’s economy resulting from insurance carriers’ abandonment of homeowners would have been crushing.

As recent events demonstrate, nothing much has really changed in the way the insurance companies respond to disasters. More and more private carriers have left the state, others are again threatening massive cancellations and prices are through the roof.<sup>2</sup> One August 2005 report noted, “No less than 11 insurers have said adios to Florida since December, according to the Florida Office of Insurance Regulation, and a 12th, Safeco, announced several days ago that it too would be exiting the state. Allstate Floridian, the state's second largest writer of policies at about 750,000 homes is dropping about 95,000 policies from areas it deems high-risk.”<sup>3</sup> This is despite the fact that “from the mid-1990s through 2004 [Allstate] earned \$6 billion more in

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<sup>1</sup> Christopher H. Schmitt; Edward Hof, “Risky Business,” *U.S. News & World Report*, June 2, 2003.

<sup>2</sup> David Sedore, “Citizens' Windstorm Policy Hike Of 100% Looms,” *Palm Beach Post*, May 10, 2003.

<sup>3</sup> Ryan Conley, “Insurers bail Florida as homeowners’ insurance rates rise,” *Ocala Star-Banner*, August 7, 2005.

premiums in Florida than it incurred in losses. Add to that the premium earnings for last year, and the total rises to more than \$6.6 billion.”<sup>4</sup>

Indeed, these continuing cutbacks in coverage come at a time of record insurance industry profits as insurers get rid of more and more risk. In 2005, property/casualty insurers made \$44.8 billion, more money than ever in its history despite Hurricane Katrina. And it did so partly on the backs of policyholders. As the *Los Angeles Times* recently reported, this profit

reflects a dozen-year effort by insurers to insulate themselves from the most extreme financial consequences of catastrophe by, among other things, shifting risks previously borne by companies to policyholders and the public. ... The effort has included industry adoption of increasingly sophisticated techniques for analyzing catastrophic risk, as well as self-imposed limits on how much firms will cover and where. It also has included successful campaigns to get states or state-created entities to shoulder such dangers as earthquakes in California and wind in Florida ... And it has involved tightening policy language — by, for example, narrowing the definition of “replacement cost” for homes — in ways that leave individuals bearing more of the burden of putting their material lives back together after trouble strikes.<sup>5</sup>

The traditional fixes are not working. And continuing to try to fix this problem the same way by placating the private market, giving in to their demands in a desperate effort to keep them in the state, is a road to continuing disaster. A new and far-reaching solution must be considered. This report argues for the removal of the private sector from the hurricane insurance business in Florida, and establishing a privately run state plan for the hurricane wind portion of homeowner’s insurance coverage.

## **HURRICANE ANDREW AND THE ATTEMPTS TO RESPOND**

For almost 30 years before Andrew hit, the state did not have a horribly destructive hurricane. But that changed when Andrew, a Category 4 hurricane, hit Southern Florida. Fifteen people in South Florida were killed. The hurricane caused more than \$25 billion in damage and about \$16 billion in insured losses. Since then, hurricanes and severe storms have hit periodically, including 1995’s Hurricane Opal (\$2.1 billion in insured losses), 2004’s Hurricanes Frances (\$4.6 billion insured losses), Jeanne (\$3.7 billion insured losses), Ivan (\$7.1 billion insured losses) and Charley (\$7.5 billion insured losses), and in 2005, Hurricanes Dennis (\$1.1 billion insured losses) and Wilma (\$5.0 billion insured losses).

After Andrew hit, a number of insurers pulled out of Florida and restricted coverage. When Allstate Insurance, the state's second-largest writer of homeowners policies with 1.1 million residential policies, announced that it would not renew 300,000 policies, the state stepped in, imposing a moratorium that prevented insurers from dropping more than 5 percent of their total

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<sup>4</sup> Peter G. Gosselin, “Insurers Saw Record Gains in Year of Catastrophic Loss; They say the profits are a fluke, but the industry has worked to shift risk to clients and the public,” *Los Angeles Times*, April 5, 2006.

<sup>5</sup> *Ibid.*

policies in Florida or more than 10 percent in one county in any given year. The moratorium was periodically renewed by the Florida legislature until it expired in 2001.<sup>6</sup>

In 1995, the legislature created a Hurricane Academic Task Force, to solve “the attrition of home insurance in the state,” and recommend reforms which included allowing rate hikes, the use of hurricane models, creation of a state CAT fund, reduced coverage through flexible deductibles, and building codes. For example, after Andrew, insurers were permitted to allow deductibles up to 5 percent of a home’s insured replacement costs – per hurricane-related claim (so homeowners were paying more than one deductible in a year if more than one storm hit.)<sup>7</sup> In 1995 and 1996, legislation was passed to require insurance carriers to give consumers a lower premium if they choose a higher deductible.”<sup>8</sup>

While building codes did strengthen after Andrew, such as requiring insurance carriers to give premium credits to consumers who install storm shutters, more and more development has occurred along the state’s coastal area. As Bill Newton of the Florida Consumer Action Network, told Americans for Insurance Reform, “Florida’s population and development boom is benefiting developers and insurers alike. They are in it together. Insurers don’t want to tell developers not to build in coastal areas, because that’s where a lot of their business is.”

This has led hundreds of thousands of policyholders in high-risk areas to be dumped into the post-Andrew state-run “insurer of last resort.” The company, Citizens Property Insurance Corp (the result of a merger between Florida Windstorm Underwriting Association and Florida Residential Property Joint Underwriting Association) has seen astronomical rate hikes.<sup>9</sup> And while policyholders in high-risk areas are dumped into this system, private insurers keep the lower risks for themselves. Said Newton, “The state high risk pool takes the windstorm risk in those areas, and the insurers just take the balance of the risk [in less risky areas]. That deprives the state of the profits from the more lucrative part of the business.” Citizens now faces a \$1.8 billion deficit.

In line with the task force recommendations, the legislature created another cushion for insurers – a multi-billion dollar Hurricane Catastrophe Fund,<sup>10</sup> or “another sweetener,” as described by *U.S. News & World Report*:

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<sup>6</sup> After Hurricanes Francis and Charley in 2004, short-term non-cancellation rules were put into effect: All insurance policies may not be cancelled until after October 15, 2004, with the exception of commercial insurance policies for firms or companies principally based outside of Florida; Florida homeowners' insurance policies may not be cancelled or non-renewed through November 30; No homeowners' insurance policy can be canceled solely as a result of claims resulting from Hurricane Charley or Hurricane Frances; All Property and Casualty insurers must report monthly all policy cancellations and non-renewals; Insurers are prohibited from instituting rate hikes without prior approval of the Office of Insurance Regulation. Joan Collier, “Florida’s Second Wind,” *Florida Underwriters*, October 2004.

<sup>7</sup> “Calm before the storms,” *Sarasota Herald-Tribune*, December 12, 2004.

<sup>8</sup> Michael H. Adams, “Fla. Freezes Homeowners Rate Hikes,” *National Underwriter*, February 10, 1997.

<sup>9</sup> David Sedore, “Citizens’ Windstorm Policy Hike Of 100% Looms,” *Palm Beach Post*, May 10, 2003.

<sup>10</sup> Joan Collier, “Florida’s Second Wind,” *Florida Underwriters*, October 2004.

In 1993, the state created a “reinsurance” fund--essentially, insurance for insurance companies, to cover losses in case of a big payout to policyholders. But Florida offers its reinsurance coverage at about a half to a third the price it would cost insurers in the marketplace--a discount worth perhaps a billion dollars a year. “It’s a tremendous bargain,” says Jack Nicholson, chief operating officer of the reinsurance fund, called the Florida Hurricane Catastrophe Fund. Florida regulators claim that providing insurers with cheap reinsurance helps keep the lid on premiums. Consumer advocates scoff. “They never pass along any benefits to consumers,” says Bill Newton, executive director of the Florida Consumer Action Network. “It goes right to the bottom line.”<sup>11</sup>

Indeed, since Andrew, homeowners insurance rates in Florida have still increased more than 150 percent, many increases taking place beginning in 2001<sup>12</sup> despite efforts to impose rate freezes in the mid-1990s.<sup>13</sup>

Perhaps even more significantly, following Andrew, the property/casualty industry, as a whole, completely changed the way it set rates for hurricanes. The purpose was to institute some stability in pricing and prevent huge price hikes after one storm. However, even these new models are now apparently being manipulated.

Specifically, immediately after Andrew, the legislature created the Florida Commission on Hurricane Loss, to “create standards for judging when a hurricane model is reliable and when it ought to be used.”<sup>14</sup> The Commission approved the “AIR” model from Applied Insurance Research, although at the time then Florida Insurance Commissioner Bill Nelson strongly objected to the AIR model as inaccurate projecting wind damage. He called the AIR model “bought and paid for by the insurance companies.”<sup>15</sup>

However, the concept of models should have provided some rate stability. Models project, by segment of the coastline called “reaches,” the anticipated storm damage for different category hurricane storms. The projections are for at least 10,000 years of virtual “experience” based on the best hydrological, meteorological, actuarial and other inputs available.

One of the advantages of this approach is that the 10,000 years of projected experience includes periods of many and very large hurricanes (like multiple hurricanes hitting the state in one year and a category 5 storm making a direct hit on Miami and causing \$200 billion in insured loss) and also periods where no hurricanes make land fall on our nation’s coasts. This means that the absence of storms for a decade should not lower rates as this is anticipated in the results projected by the models. Also, the happenstance of multiple storms in a state in a year or one

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<sup>11</sup> Christopher H. Schmitt; Edward Hof, “Risky Business,” *U.S. News & World Report*, June 2, 2003.

<sup>12</sup> Wes Smith, “Hurricane Amnesia; hits many during storm season,” *Orlando Sentinel*, June 8, 2004; Rebecca Cason, “Study Released on Homeowners Insurance Issues in Florida,” *Northwest Florida Daily News*, May 31, 2002.

<sup>13</sup> Press Release, “Florida Insurance Commissioner Nelson Halts Homeowner Insurance Rate Increases; The Insurance Commissioner Questions Whether Consumers Are Receiving Their Fair Share Of Premium Discounts And Credits Recently Authorized By Law,” January 30, 1997.

<sup>14</sup> Tauhert, Christy, “FL Dept. of Insurance fights use of models,” *Insurance & Technology*, August 1997.

<sup>15</sup> Jeff Alexander, “Hurricane Insurance Discussed,” *Jupiter Courier*, June 18, 1997.

large hit should not raise rates as this is likewise anticipated in the modeled projections. Karen Clark, president and CEO of modeling firm Applied Insurance Research, recently noted “the science of cool and warm cycles underlying hurricane activity,” stating, “We can be in a period now [where there is] a clustering of events. You have to be prepared for that.”<sup>16</sup>

However, that is all changing. Specifically, on March 23, 2006, Risk Management Solutions (RMS) announced that it was altering its hurricane model upon which homeowners and other property/casualty insurance rates are based. RMS said that “increases to hurricane landfall frequencies in the company's U.S. hurricane model will increase modeled annualized insurance losses by 40 percent on average across the Gulf Coast, Florida and the Southeast, and by 25-30 percent in the Mid-Atlantic and Northeast coastal regions, relative to those derived using long-term 1900-2005 historical average hurricane frequencies.” This means that the hurricane component of insurance rates will sharply rise, resulting in overall double-digit rate increases along America’s coastline from Maine to Texas.<sup>17</sup>

While RMS claims that this massive increase is necessary for scientific reasons, the evidence indicates that the primary reason for the change appears to be not science at all, but politics. This is because RMS has dramatically altered the methodology that is being used to predict wind events and set consumer rates, breaking promises that were made to consumers over a decade ago when more sophisticated weather modeling was introduced. RMS is now projecting wind events for just five years at a time during a period of cyclically high hurricane activity.<sup>18</sup>

This approach is the complete opposite of that promised by insurers when these models were introduced when consumers were told that, after the big price increases in the wake of Hurricane Andrew, they would see price stability. Consumers were assured that, although hurricane activity was cyclical, they would not see significant price decreases during periods of little or no hurricane activity, nor price increases during periods of frequent activity. That promise has now been broken.<sup>19</sup> Even industry experts are warning that companies are “play[ing] games” with catastrophe models under pressure from rating agencies, and that the impact will extend to pricing and create the very problem that modeling was supposed to eliminate.<sup>20</sup> One insurance CEO complained that “rating agencies are ‘double-counting’ or ‘compounding’ the impact of catastrophes in their formulas,” suggesting that “both rating agencies and modelers are overreacting” to cyclical storms.<sup>21</sup>

In sum, the process for achieving price stability in Florida is being undermined and insurers are making out incredibly well not only because the models have worked in their favor, but because

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<sup>16</sup> Susanne Sclafan, “Cat Model Games Worry Prognosticators; Katrina's lessons extend beyond modelers, to rating agencies and underwriters,” *National Underwriter*, March 20, 2006.

<sup>17</sup> See, Letter to Honorable Alessandro Iuppa, NAIC President, from J. Robert Hunter, Director of Insurance, Consumer Federation of America and Birny Birnbaum, Executive Director, Center for Economic Justice, March 27, 2006.

<sup>18</sup> *Ibid.*

<sup>19</sup> *Ibid.*

<sup>20</sup> Susanne Sclafan, “Cat Model Games Worry Prognosticators; Katrina's lessons extend beyond modelers, to rating agencies and underwriters,” *National Underwriter*, March 20, 2006.

<sup>21</sup> *Ibid.*

they dumped high-risk properties into Citizens and kept the lower risk business for themselves. As *U.S. News & World Report* noted, “Over the past decade, the insurance industry has ranked among the most profitable in America. And one way it boosts the bottom line is by forcing more high-risk insurers into special plans.... The plans are a windfall for insurers for several reasons: They can write policies offering less coverage at higher prices, spread losses among participating companies, and win tax subsidies from state legislatures.... Although the special plans are billed as markets of last resort, they're actually commonplace.”<sup>22</sup>

Indeed, in Florida the problem has reached crisis proportions, perhaps best described in a recent editorial in the *St. Petersburg Times*:

More than 800,000 homeowners are now insured by Citizens, the insurer of last resort. There will be a 10 percent surcharge on all homeowners policies this year, but it turns out that will cover only half of Citizens' deficit. Its 2005 deficit has mushroomed to more than \$1.7-billion, and Citizens appears to need another assessment of an additional 10 percent. Meanwhile, windstorm rates have nearly doubled over the last two years in some areas. Even middle-class Floridians can't continue to absorb such dramatic increases without real pain. The situation can't be good for the cooling housing market or the overall state economy.

One reason [Governor] Bush and state legislators aren't talking about homeowners insurance every day is that there is no easy solution to making coverage more available and affordable. A House committee voted last week to use more than \$750-million in tax revenue generated by hurricane recovery to lower the Citizens deficit and start to rebuild reserves in the Hurricane Catastrophe Fund, which provides reinsurance for insurance companies. Bush has said he is open to such a move as long as it is accompanied by reforms, and there is no other way to provide homeowners with immediate relief.

There are some long-term proposals that have merit. One would prohibit Citizens from providing windstorm coverage for homes worth more than \$1-million. This change alone would reduce Citizens' exposure by more than \$800-million. But the rush to sock owners of second homes and seasonal residents with higher rates and surcharges looks more like political expediency than actuarial soundness and needs some more thought....<sup>23</sup>

There seems to be widespread agreement that something must be done, but massive confusion as to what to do. As one state lawmaker put it, “Some of (the insurers) need to know, ‘If you want to be in Florida, this is what it’s about. It’s about taking a risk’.... We may need a little bit more of a commitment that you aren’t going to take off the first time something goes bad. They can't say, ‘I want to be in Florida, collect premiums, but not pay out.’” On the other hand, there may be some companies that truly may not be able to afford to stay here. In that case, we need to figure out how we are going to protect our citizens.”<sup>24</sup>

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<sup>22</sup> Christopher H. Schmitt; Edward Hof, “Risky Business,” *U.S. News & World Report*, June 2, 2003.

<sup>23</sup> “No way to address a crisis,” *St. Petersburg Times*, March 26, 2006.

<sup>24</sup> *Ibid.*

Unfortunately, the Florida legislature is now toying with measures that would give insurers the tools to further increase prices and restrict coverage. Arguing that to make “the Florida market more appealing to private insurers and prevent rates from spiraling further,” a House bill would actually, “allow insurers to *increase* rates 10 percent statewide and 25 percent regionally without regulators’ approval,” requiring public hearings on rate increases of more than 25 percent, up from the current 10 percent. ‘I think that is absolutely absurd,’ said Sen. Les Miller of Tampa, the leader of Democrats in the Senate.<sup>25</sup> The House bill would also create a “\$100 million endowment fund” as loans to help homeowners strengthen their home, somewhat stronger building codes, limits Citizens property exposure to \$1 million per home and requires private insurers to handle Citizens’ windstorm claims.

Consumer advocates like the Florida Consumer Action Network are supporting another approach, Senate Bill 780, which will require stronger rate regulation and other consumer-friendly provisions. While a good first start, even FCAN believes that this approach is too limited.<sup>26</sup>

All of this leads to the obvious question: Have we reached the tipping point where the reliance on the private sector is no longer warranted? Has the coverage become too little and the prices too high and the instability too great for Florida to continue to rely on the system that is in place? How long can Florida stand to see homeowners insurance offer less and less coverage for more and more money, with many people unable to afford premiums and having to live in fear of filing legitimate claims?

## **THE SOLUTION – Time to Remove The Private Sector From this Equation**

Americans for Insurance Reform believes that we are at the tipping point and that new ideas must be discussed with the goal of bringing homeowners insurance stability to the people of Florida.

Specifically, Americans for Insurance Reform proposes the creation a privately run state insurer for the hurricane wind portion of homeowner’s insurance coverage. All of the wind business in Florida should be put in this state plan. This would end low-risk cherry-picking by the insurers. Moreover, by competitive bids, an insurer (or multiple insurers if needed) would service the policies and would be responsible for claims adjustment after a hurricane event occurred.

Under this plan, private insurers would continue to sell homeowners policies, excluding hurricane wind coverage, that wrap around the coverage sold by the privately run state insurer. In other words, the policyholders would get insurance in two parts: private coverage that would not cover hurricane wind (at a much lower price), and wind coverage from the state. If writing only the hurricane wind portion of the coverage proves too narrow to get proper spread, consideration should be given to using this approach to write the entire homeowners’ insurance policy for all Floridians.

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<sup>25</sup> Beatrice E. Garcia, “House bill to give insurers leeway; A House bill to reform the state's insurance industry calls for a stronger building code and allows insurers to raise rates in smaller doses without state approval,” *Miami Herald*, February 14, 2006.

<sup>26</sup> See, [http://www.fcan.org/insurance/consumer\\_insurance\\_agenda\\_2006.htm](http://www.fcan.org/insurance/consumer_insurance_agenda_2006.htm).

As contemplated in the Americans for Insurance Reform plan, each homeowners' insurer would charge the appropriate rate set by the state as part of what it sells the insured and pass this amount on to the state. There would be no commission or other payment to the insurer for collecting this premium. The premiums would be kept in the state Treasury and earmarked only for use in paying insurer servicing fees (after competitive bids were secured), losses and loss adjustment expenses (LAE). The remaining premiums would be invested in appropriate financial instruments. The premiums would not be subject to any taxes; nor would the investment income received on the investment of the premiums. The net income would be in a separate fund earmarked only for the payment of claims and the cost of administration. In the event of a declared hurricane, the state would charge the private insurer contractor to pay every penny owed, even helping consumers perfect their claims. In cases where both flooding and wind damage occurred, the state would work with the National Flood Insurance Program to assure consumers of fair payment at once and fair allocation between the two programs of the costs over time.

Policyholders would benefit immediately. Removing wind from the private insurer policies would result in huge drops in premium charges by the private home insurers. The state would set rates for the hurricane wind part of the coverage using state developed models with long-term projections, not five year projections, avoiding the RMS proposed 40 percent increase and assuring the public that the models are fair and use assumptions that do not result in hidden profits. The rate would vary by proximity to the beach and by the wind resistant quality of the home being insured, with steep discounts for properly built and/or retrofitted homes. The state would guarantee, through transparency, that the models and other assumptions used to base rates are fair and reflect state of the art science.

Rates will be actuarially sound so that, over time, the program will be self-sustaining. In the event of timing loss (hurricanes in the early years of the program before reserves build up sufficiently), the privately run state insurer will have the ability to assess private property/casualty insurers for shortfalls, with the cost passed through across all property/casualty lines of insurance in the state. Eventually, as reserves build, this assessment will be phased out.

This plan would eliminate both the profit motive, as well as overreaction at times of crisis, lowering prices and assuring stable prices. Focusing all of the wind in one carrier will also enable maximization of reinsurance at high layers and offers a real chance of securitization. The total capital in the U.S. market is about \$47 trillion (per the New York Stock Exchange). An insured wind loss of even \$200 billion would be a swing in the market cap of less than ½ of 1 percent, a swing the markets experience almost daily. Further, the hurricane risk would not be tied in any way to the risk of stock movements, potentially allowing investors a way to diversify risk and earn new profits over time.

This potential way of spreading extreme risk must be tapped in Florida. The legislature should be charged with doing just that by establishing this new state plan.

## **CONCLUSION**

The ease with which the insurance industry has been able to exploit the occurrence of hurricanes in Florida to the detriment of Florida's homeowners says a great deal about the vast power and economic control that this industry exercises. History shows that private insurance companies have repeatedly threatened to pull the rug out from under the state economy - dumping risk, raising rates and abandoning policyholders altogether - freely intimidating lawmakers and regulators and creating an atmosphere of "crisis" to promote its legislative agenda. The time has come remove the private sector from the hurricane insurance business, and establish a privately run state plan for the hurricane wind portion of homeowner's insurance coverage. Only this substantial step will stop the industry from continuing to cause periodic massive instability and cost to Florida homeowners and the state economy.