

October 2008

## Wall Street's Woes Plus a Major Storm Could Send Florida to Bankruptcy Court

*By Eli Lehrer*

The crisis currently enveloping America's financial markets seems likely to hit every state in the Union. But Florida, thanks to its misguided homeowners' insurance regulations, may fare worst of all. In fact, if things don't change soon, a single medium-sized hurricane could land the state in bankruptcy court.

Understanding why requires a little background on Florida's insurance system. To keep homeowners' insurance prices from rising, the state government assumed massive risks on behalf of its coastal residents. Two government entities -- the Florida Citizens Property Insurance Corporation, which sells homeowners' insurance, and the Hurricane Catastrophe Fund ("Cat Fund"), which sells the reinsurance that backs up primary insurers -- serve as the linchpins of these schemes.

Both entities charge less for coverage than the private sector would. They can do this largely because the Cat Fund, which provides almost all of Citizens' backing as well as significant backing for every private insurer in the state, doesn't back its promises with actual assets; instead, it plans to issue as much as \$32 billion in bonds if need be. No state has ever issued more than \$11 billion in debt all at once.

Although the Cat Fund's overseers at the State Board of Administration never promised that they could sell more than \$30 billion worth of bonds, the scheme previously seemed plausible at lesser amounts. As recently as early August, the financial markets would have easily gobbled up \$3 billion to \$4 billion of Cat Fund bonds. Today, even that seems nearly impossible.

In fact, on September 30 state Bond Finance Director Ben Watkins told the Governor and Cabinet that the Florida couldn't borrow money for *any purpose*, even though the state government can count on a predictable flow of mandatory taxes, none of which the Cat Fund gets. If the state government with its guaranteed cash flow has trouble borrowing, it means much more serious problems for the Cat Fund.

In fact, the Cat Fund likely won't be able to raise even a dollar from bond sales anytime soon. Without bonds, any event that uses up the few billion dollars that Citizens and the Cat Fund have stocked away would need to come out of the state's general revenues.

Worse, given that Florida already faces a yawning budget gap, surging entitlement spending, and has a Constitution that makes new broad-based

taxes nearly impossible, the state doesn't have many practical options at its disposal.

If the sales tax maintained a reasonable number of exemptions, for instance, the state sales tax rate might have to go as high as 17 or 18 percent to get bond markets interested in snapping up Cat Fund debt. And, by all accounts, taxes at that level – atop the “resort taxes” already applied to many tourist expenditures -- could devastate the vital tourism sector by rendering the state uncompetitive with other destinations.

Against this background, it seems quite possible that Governor Crist and the Legislature would find themselves drawn towards default on state debts and bankruptcy court. Governor Crist's recent threat to sue the insurance industry over its supposed failure to pass on existing savings resulting from the Cat Fund's existence may well make things worse, hastening the already significant flight of well-capitalized insurers, increasing Citizens' liabilities, and bringing the state even deeper fiscal trouble.

Against this background, the state needs to get serious about figuring out a way to eliminate the Cat Fund. State CFO Alex Sink had the right idea when she proposed cutting the Cat Fund's total size by \$3 billion earlier this year. While not a total fix, any reduction would move the state in the right direction.

Meanwhile, the Cat Fund can use some of its surplus in the short term to buy reinsurance of its own, thereby transferring some liability from the state's taxpayers to private companies. Citizens itself, which relies entirely on the Cat Fund for reinsurance, should also wind down its operations, raise its rates, and change itself into a niche insurer for coastal Floridians of modest means who can't find private market policies at any price.

Eventually, Floridians who live along the coast will have to pay higher insurance rates. But a few extra dollars in insurance premiums makes a lot more sense than a state trip to bankruptcy court and greatly increased taxes.

*Eli Lehrer is an Adjunct Scholar of The James Madison Institute, a nonpartisan policy center based in Tallahassee, and a Senior Fellow at the Competitive Enterprise Institute.*

***As a 501(c)(3) organization, The James Madison Institute does not support, endorse, or oppose candidates or proposed legislation. For more information, visit <http://www.jamesmadison.org> or contact Tanja Clendinen (850) 383-4633 [tanja@jamesmadison.org](mailto:tanja@jamesmadison.org)***