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Shoring Up Florida's Property Insurance Market

Proposed reforms help to eliminate cost drivers, ensure fiscal stability in active storm season.

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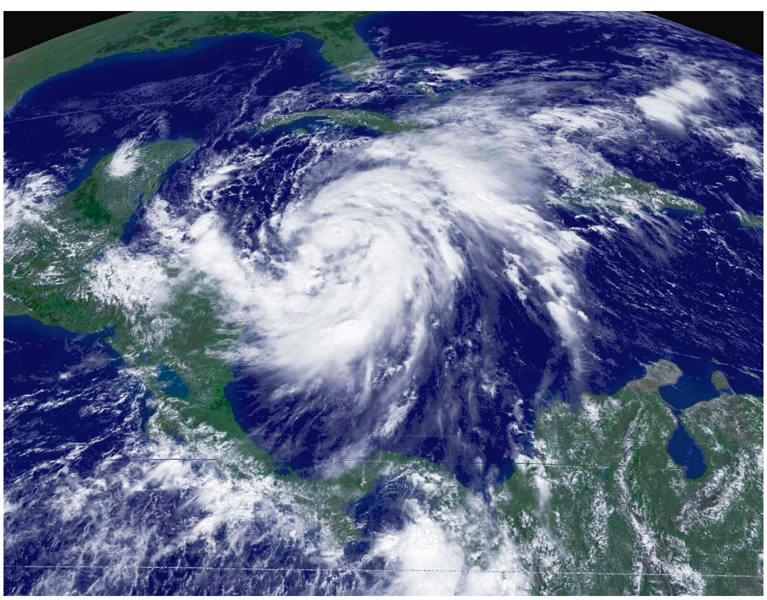
Introduction

Hurricane Wilma's Oct. 24, 2005, landfall in Collier County capped an historic two-year period during which Florida reeled under the unrelenting blitz of seven back-to-back major hurricanes. Six of these storms were, at the time, among the 10 costliest ever to strike the United States.[1]

Florida has subsequently enjoyed a hurricane-free decade, representing the longest period on record without a tropical cyclone making landfall in the state.[2] There are no meteorological explanations as to why Florida has experienced this unprecedented streak of good luck. Florida's position as a low-lying tropical peninsula jutting 500 miles into the most hurricane-active waters in the world is the same today as it was 10 years ago or 100 years ago. Indeed, many scientists believe climate change will only increase the severity and incidence of storms in the future.



Oct. 17, 2005: Wilma became the season's 21st named storm, tying the seasonal record first set in 1933. Hurricane records date back to 1851. *(NOAA satellite image for larger view of Hurricane Wilma taken at 1:15 p.m. EDT on Oct. 18, 2005. Photo credit: NOAA)*

While the state's geography and risk profile haven't changed, its built environment and the number of lives and amount of property at risk of hurricanes have grown dramatically. Though the state's population shrank slightly during the Great Recession, it has almost tripled since 1970 and is continuing to grow. At more than 19.9 million residents, Florida recently surpassed New York to become the third-most-populous state in the nation.[3] **Florida's total coastal exposure now stands at more than $2.9 trillion,[4] with more property at risk than all of the other "hurricane alley" states (Louisiana, Virginia, Texas, North Carolina, South Carolina, Georgia and Mississippi) combined.[5]**

This concentration of population and property

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in high-risk coastal areas, in addition to the costs associated with the 2004 and 2005 storm seasons, all contributed to property insurance premium increases in the years following Wilma. As of 2012, the average Florida homeowner's property insurance policy premium was $2,084, more than double the national average of $1,034.[6]

More recently, however, events in the global financial markets have had a transformative effect on Florida's property insurance market. In the aftermath of the 2008 financial crisis, global investors began looking for ways to diversify their portfolios. They discovered that gains or losses in the catastrophe and reinsurance markets were not tied to global economic cycles. In short: hurricanes, earthquakes and other catastrophes strike at random, uncorrelated with the ups and downs of the rest of the economy.

This has resulted in capital flooding into catastrophe markets, which in turn have produced new and innovative risk-transfer products and seen fierce competition among traditional reinsurers. Primary insurers have been able to write more policies, as they are able to transfer more risk to the private reinsurance market at affordable rates. Despite major losses in Japan and elsewhere in recent years, experts believe global reinsurance pricing will continue to soften.[7] Indeed, the catastrophe market is so awash in capital that many reinsurers have announced stock buybacks to return cash to investors, as they simply can't find enough opportunities to deploy capital profitably.[8]

Florida has benefited handsomely from this "buyers' market." The state-run Citizens Property Insurance Corp., for instance, has shed more 1 million policies since 2012[9] and lowered its overall exposure by more than 60 percent over the past four years.[10] This is due, in large part, to the organic migration of policies to private companies. In 2014 alone, 416,623 Citizens policies were transferred to private companies through Citizens' depopulation program.[11] Citizens projects that its policy count will be slashed to no more than 450,000 policies by year-end 2016, from a high of 1.5 million in 2012.[12]

Additionally, Citizens itself has taken advantage of low reinsurance rates to transfer some

of its enormous hurricane risk to the private market. This investment has almost completely eliminated the once-ominous threat of assessments on state taxpayers.[13] In 2014, Citizens transferred $3.27 billion of its coastal risk to private reinsurers for about $216 million; this year, the total was more than $3.9 billion of risk transfer, at a cost of just $201 million. In sum, Citizens bought $640 million more in reinsurance protection for about $15 million less.[14]

The Florida Hurricane Catastrophe Fund (Cat Fund) also has taken advantage of historically low global reinsurance rates. In early 2015, the State Board of Administration (SBA) approved a $2.2 billion risk-transfer package, which included $1 billion in reinsurance protection.[15]

Provided that Florida's unprecedented hurricane "drought" extends through the remainder of the 2015 season, the Cat Fund expects to hold an estimated surplus of $12.8 billion, the result of 10 years of fair-weather hoarding. Coupled with its purchase of reinsurance and pre-event bonds, this surplus has for the first time allowed it to be fully funded up to its $17 billion statutory limit without the need for post-hurricane debt or, by extension, taxpayer-funded assessments.[16]

Government has a responsibility to foster a competitive environment among private insurers. To do so, it must regulate the industry sensibly in ways that ensure consumers' legitimate claims are fully paid in a timely manner. However, a healthy and affordable property insurance market may also be greatly helped or hindered by forces like nature and the global economy, which lie completely outside the control of politicians, insurance companies or policyholders. In this vein, fortune has greatly favored Florida over the past decade.

Ten years ago, Floridians were recovering from the unprecedented series of hurricane strikes and reeling from high insurance and reinsurance rates. No one at the time could predict the state would be granted an unprecedented, decade-long reprieve by Mother Nature, while simultaneously enjoying the most favorable global reinsurance and catastrophe market in memory.

Yet despite this remarkable streak of combined luck, average property-insurance premiums are still on the rise in some parts of Florida. Consumers have legitimate concerns when they ask why this is the case, when insurance companies have had a decade to save up for the next strike.

It appears human behavior and cost drivers disconnected from the state's most obvious risk factors continue to drive some insurance rate increases. According to the New York-based Insurance Information Institute, non-catastrophe claims have increased roughly 17 percent per year over the past decade,[17] and are growing rapidly both in frequency and in severity.

Assignment-of-Benefits Abuse

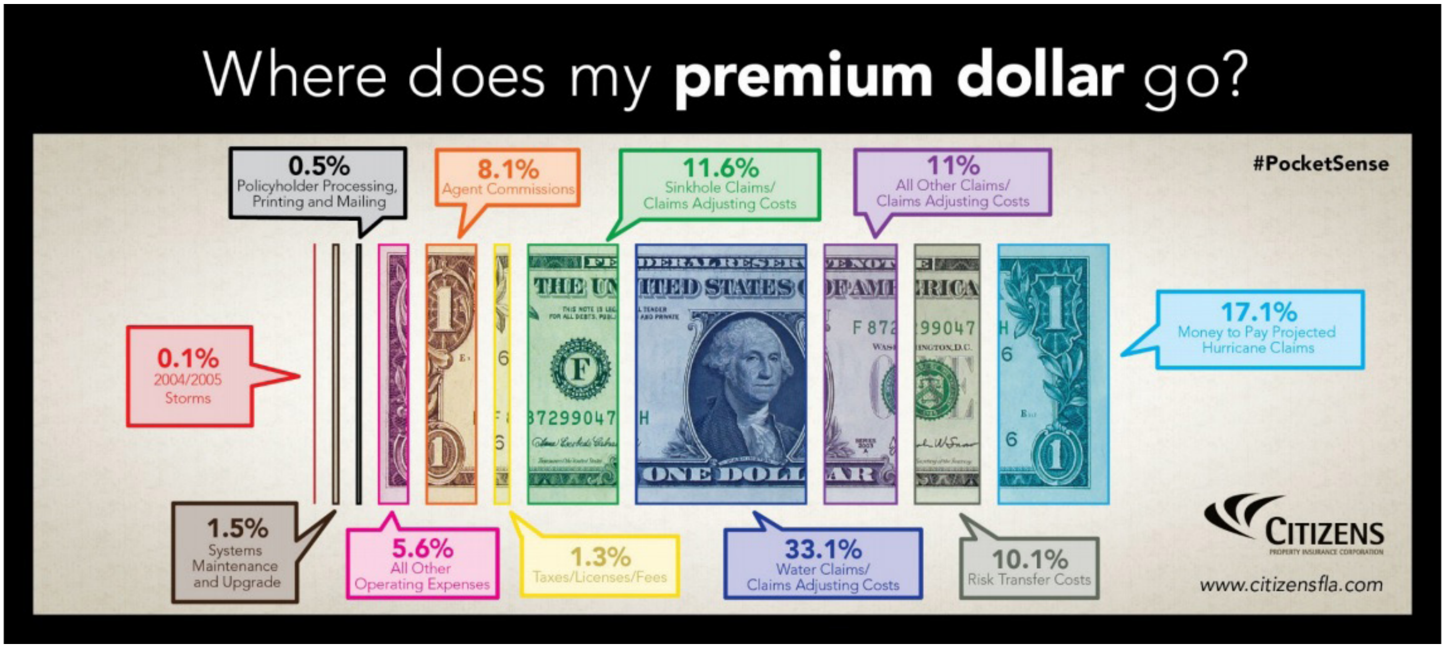
In Florida, the spike in non-catastrophe claims has been exacerbated by exploitation of laws and court decisions governing "assignment of benefits." An assignment of benefits allows a third party – such as a contractor, a water-extraction company or other vendor – to assume a policyholder's benefits and collect payments directly from the insurer for a covered loss. The insured also transfers to the third party the right to negotiate and adjust such claims. Hence, no payments are made directly to the policyholder, who has been paid by the third party to transfer his or her claim.

Most health insurance and personal injury protection (PIP) auto policies function under this arrangement, which allows health care providers to collect insurance payments directly for covered medical services. Benefits can be assigned either before a claim happens (pre-loss assignment) or after a specific first-party loss occurs (post-loss assignment).

Florida law allows insurers to include policy provisions that prohibit pre-loss assignments without an insurer's consent.[18] However, the courts have held that such prohibitions cannot prevent a policyholder from undertaking post-loss assignments. Once a loss occurs, the policyholder has full rights to assign benefits for the specific loss in question.[19]

Most contractors and other professionals in the construction, repair and restoration business that receive assigned benefits from policyholders conduct themselves appropriately and skillfully complete the projects for which they were hired. However, there is significant anecdotal evidence that some abuse these assignments, contributing to what has become an emerging cost driver that results in higher rates for consumers.

For example, unscrupulous vendors may require policyholders to sign over benefits as a condition to begin repairs or other work. In water-related claims, homeowners who are desperate to



prevent further damage and get their homes dried before mold sets in may reluctantly agree to sign over their rights to water-extraction companies.

With the policyholder out of the way, contractors commandeer the policy, billing the insurer directly for payment and suing for bad faith if that payment is not rendered promptly. The process grants them leverage to inflate their bills, charging for repairs that were unnecessary or unrelated to the specific loss and/or at rates far above reasonable standards. In some cases, the contractor may partner-up with a trial lawyer, availing themselves of bad faith rules that were designed with ordinary consumers in mind. A recent case cited by Florida's state-appointed insurance consumer advocate included billings that totaled to more than the house was worth.[20]

Ten years ago, such lawsuits were rare in Florida. Between 2004 and 2005, there were just slightly more than 9,400 assignment-of-benefits related suits filed statewide. In the years since, they have multiplied by nearly 1,000 percent, with 92,000 such lawsuits filed between 2013 and 2014.[21] In 2013, water losses represented 50 percent of new claims against Citizens and 75 percent of the state-run insurer's litigation.[22]

Among the most striking pieces of evidence that the system is being abused is the prevalence of vendors who retain counsel before they've even filed a claim. According to Citizens, 8 percent of the lawsuits filed against it in 2009 were filed at first notice of loss; by 2014 that figure had jumped to 24 percent.[23]

Given Florida's litigious environment, many insurance companies simply opt to pay claims –even when they believe they are excessive – to avoid further litigation costs. This, of course, is paid out of an insurance company's surplus, and ultimately is recovered through higher insurance premiums paid for by other consumers.

One factor that may be contributing to this litigation explosion is Florida's "one-way attorney fee" law. State law permits plaintiffs' attorneys to collect payment for their legal fees from the defendant insurer if they win, but does not allow insurers to do the same if they are victorious.[24] The law was intended to create balance between aggrieved consumers who usually cannot afford high-priced legal representation and insurance companies who can. Unfortunately, it appears to have provided sufficient incentive for the birth of a veritable cottage industry of vendors and trial lawyers who "sue first and ask questions later," knowing they will be owed attorney fees even if the insurer does not fight the claim.

This may explain why law firms have taken the time and incurred the expense of holding free seminars around the state in recent years for restoration contractors, mold remediators and other vendors interested in learning about "creative tactics" to grow their businesses using assignment of benefits. One such firm bills itself the "Johnny Appleseed of Assignment of Benefits."[25]

According to Demotech Inc., a national ratings agency with an extensive focus on Florida insurers, **while assignments of benefits are relatively common nationwide, the extent of abusive behavior and litigation truly is unique to Florida, where the average costs of assigned benefit claims**

are three times as great as other claims. Demotech has warned that, if left unaddressed, the issue may prompt the withdrawal or downgrade of dozens of insurance carriers in Florida,[26] undermining the state's still-fragile insurance market.

In the meantime, inflated bills and the litigation to fight them are driving increased insurance rates in some parts of the state. Barry Gilway, Citizens' president and chief executive, recently testified: "… water losses are THE major reason Citizens is seeking rate hikes for the coming year, especially in South Florida. Were it not for water loss, even South Florida policyholders would see rate reductions" (emphasis his).[27]

Indeed, South Florida – especially Miami-Dade County – is "ground zero" for this type of insurance fraud. More than 56 cents of every insurance premium dollar paid by the county's Citizens policyholders goes toward water claims and related costs; the statewide average is about 33 cents, which still represents the largest expense of every premium dollar paid to Citizens, which remains Florida's largest property insurer.[28]

In 2016, most Citizens multiperil policyholders in Miami-Dade County will see rate hikes, which range from 5 to 11 percent and average 7.6 percent countywide.[29] If Miami-Dade's water claims experience were in line with that of the rest of the state, its Citizens policyholders would actually experience an average countywide rate decrease of 8.5 percent.[30] **The rate increases are, in effect, a "trial lawyer tax" that amounts to a 16-percentage point swing in average rates.**

Legislation has been filed in recent years that would allow insurers to prohibit policyholders from entering into an assignment-of-benefits agreements altogether.[31] The bills, or their assignment-of-benefits provisions, all ultimately failed to pass.

In a free market, an individual's right to enter into contractual relationships should be preserved. However, the original insurance policy also is a contract entered between the insurer and the insured. If benefits are to be assigned to a third party, the conditions for payment also should be assumed. That is, any third party to whom benefits are assigned should be bound by the original policy requirements for recovery and for allowing the insurer to conduct its investigation, such as requiring the third party to provide proof of loss, supporting documentation and to submit to examination under oath, if necessary.

Additionally, an opt-out period should be made available to consumers who may have felt compelled into signing over their insurance benefits under pressure by a vendor or the stressful circumstances surrounding a claim.

Finally, and most importantly, the rules for attorney fees in assigned-benefit disputes should be revisited. **Existing law appears to be a catalyst for unnecessary litigation, providing ample incentives to file suit even in cases where a claim is unwarranted.** Consumer access to prevailing party or "one-way" attorney fees should be preserved, but trial lawyers should not avail themselves to it when representing vendors as a result of an assignment, especially when the policyholder has surrendered control. If a vendor's grievance against an insurer has merit, there will be attorneys willing to take the case on a contingency fee or other conventional payment.

Cat Fund Reform

Before Florida's spike in non-catastrophe claims, one of the chief drivers of the state's high property-insurance rates long had been the cost of reinsurance. While reinsurance is far more affordable for Florida property insurers than it was in years past, it continues to be an important factor in the calculation of insurance rates.

The Cat Fund is a state-run corporation that is the largest provider of property reinsurance in Florida. Like private reinsurers, the Cat Fund provides insurance to insurance companies. When insurers' losses from certain events, or an aggregate over a contract period, exceed certain levels, the Cat Fund, like private reinsurers, promises to cover a portion of the risk. In return for these promises, the Cat Fund collects ceding premiums from insurers.

While virtually all private reinsurers of any size have an international scope, the Cat Fund covers only Florida windstorm risks. Where a private company would balance the risk of hurricanes in Florida by taking on, for example, the risk of earthquakes in Japan or the liability risk of large lawsuits against corporations' directors and officers, the Cat Fund does not. **In sum, the Cat Fund turns the principle of diversification on its head by concentrating Florida's peak hurricane risk within the state, rather than spreading it around the world.** This means that, even assuming the Cat Fund has management talent and investing opportunities equal to reinsurers in the private sector, it would have to charge a much higher risk load than its private counterparts if it hopes to break even in the long run.

In fact, the Cat Fund was established by the state purposely to charge rates lower than the private sector for comparable coverage. As such, it is not required to actually keep on-hand the funds needed to pay the kinds of claims it reasonably can expect to receive. Instead, if it runs short on money, it has the authority to issue bonds, which it repays by imposing assessments on policies in a way similar to Citizens.

All residential property insurers doing business in Florida are required to purchase coverage from the Cat Fund. Participating insurers may select coverage levels of 90 percent, 75 percent or 45 percent. The vast majority has always chosen the 90 percent coverage level,[32] since selecting lower coverage levels would require them to substitute with coverage from the private reinsurance market, which ordinarily would be more expensive.

However, given the previously discussed flood of capital into the global catastrophe markets, private reinsurance rates have fallen to levels that are competitive with those charged by the Cat Fund. This has prompted 26 of Florida's property insurers to select the Cat Fund's lower coverage options (six have shifted to the 75 percent level, while 20 have shifted to the even lower 45 percent level).[33] Thus, these 26 companies have replaced much of their Cat Fund-provided reinsurance coverage with private reinsurance at a better price. If private risk-transfer rates continue dropping as projected, the number of insurers procuring more of their reinsurance from the private market instead of the Cat Fund is almost certain to increase.

This creates a unique opportunity for Florida as it seeks to lower property-insurance rates while also reducing the enormous liabilities of the state-sponsored insurance mechanisms. **Florida law should not and need not force insurance companies to purchase coverage from the Cat Fund at rates that are higher than those found in the private market.**

Therefore, the Legislature should consider giving insurers greater flexibility by creating a 25 percent coverage level option, as well as the option to eschew Cat Fund coverage altogether. This change would allow insurers to better negotiate risk-transfer deals with private carriers at rates potentially even lower than the Cat Fund's and to extend those savings to policyholders. Even if current projections prove to be off and the cost of private risk transfer increases in the future, this would not preclude insurers from going back to previously purchased levels of Cat Fund coverage. In the meantime, they could take greater advantage of the global reinsurance market's attractively priced coverage.

This proposal also would help establish a needed surplus protection mechanism for the Cat Fund. Currently, the Cat Fund is required to tap all its cash before it issues debt to cover its liabilities after a particularly active hurricane season. **While it currently has the resources to cover a significant hurricane event, the Cat Fund would be left bare and potentially unable to meet its $17 billion obligation in the subsequent hurricane season.** Such a shortfall would have disastrous consequences.

In 2012, the Office of Insurance Regulation (OIR) estimated that if the Cat Fund experienced a shortfall of just 25 percent, 24 of the state's top 50 insurers would "have less than the statutory minimum of $5 million, which would result in some type of action being taken to increase surplus." These 24 insurers, the OIR said, represent approximately 35 percent of the market and service over 2.2 million policies.[34]

Therefore, Cat Fund surplus protection for subsequent seasons should remain a priority for the Legislature. Under the proposal outlined above, the Legislature may consider dedicating part or all of the unused capacity resulting from insurers selecting the proposed 25 percent and 0 percent coverage options to the subsequent season.

Additionally, the Legislature should consider authorizing the Cat Fund's managers to negotiate the purchase of private risk transfer. This year, the State Board of Administration (SBA) empowered the Cat Fund to negotiate a risk-transfer package, and ultimately signed off on a transaction that resulted in $2.2 billion of total risk transfer, including $1 billion in reinsurance.[35]

In order to secure the best risk-transfer deals, the Cat Fund should have the ability to enter the market and negotiate with greater flexibility, so that it may have more and better options to present to the SBA for final approval. Indeed, the SBA should maintain its authority to approve or reject proposed deals, but the Cat Fund's professional staff should not be impeded from effectively negotiating by having to seek approval for every step of the negotiation process.

Conclusion

Given Florida's unprecedented streak of combined luck from Mother Nature and the global markets, the 2016 legislative session offers state lawmakers an enormous opportunity to enact insurance reforms needed to address cost drivers that are needlessly driving up rates, while also shoring up the state's insurance instrumentalities for less sunny days in the future.

The Legislature should act to address the explosion in the number and cost of non-catastrophe claims that, if left unaddressed, could undermine the state's fragile insurance market recovery. In particular, the state needs to take steps to stop the rampant assignment-of-benefits abuse that serves as a windfall to a few unscrupulous vendors and their lawyers, to the detriment of all consumers.

The Legislature should also take the new state of the global catastrophe markets into account and modernize the Cat Fund. Insurers who can find comparable coverage in the private reinsurance market at lower rates should be free to pass those savings on to their policyholders. Additionally, lawmakers should take advantage of the Cat Fund's fiscal health by restructuring it to ensure it has the resources necessary to cover losses from subsequent hurricane seasons.

For the past several years, some lawmakers have blocked commonsense, bipartisan property-insurance reforms because they feared a political backlash if they increased rates on consumers. Many times, even modest re¬forms were rejected if there was just a small chance of negligible rate increase. Meanwhile, the fraud and abuse that was left unaddressed has contributed to rising rates more than any law proposed in the past several years would have.

Although the reforms outlined in this study would not solve all of Florida's insurance-related problems, they could put a halt to unnecessary rate increases, as well as protecting taxpayers and the state's economy from future liabilities.

About the Author

R.J. Lehmann is senior fellow, public affairs director and co-founder of R Street. He is an award-winning business journalist who spent nine years covering the insurance, banking, and securities industries. He is author of R Street's "2012 Insurance Regulation Report Card" and the forthcoming 2013 edition, and numerous other briefs and policy studies.

Prior to joining R Street, he served as deputy director of the Heartland Institute's Center on Finance, Insurance and Real Estate. He previously was senior industry editor with SNL Financial, leading the news service's coverage of the Dodd-Frank Act, the Patient Protection and Affordable Care Act, and legislative and regulatory developments at both the state and federal level. Prior to that, he spent six years with the A.M. Best Co. as manager of its Washington bureau.

He is a three-time award winner from the American Society of Business Publication Editors and was the youngest-ever winner of a first place prize from the New Jersey Press Association. His writings have appeared in the *San Francisco Chronicle*, *Wall Street Journal*, *Townhall.com*, *RealClearPolicy*, *American Spectator*, *Travel Weekly*, the *South Florida Business Journal*, and *Folio* magazine, among other publications.

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