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Insurance Residual Markets: Historical and Public Policy Perspectives

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I. Introduction

Most buyers of personal or commercial property and casualty insurance purchase their coverage from an insurance company that is licensed and regulated by the state insurance department in the state where the buyers are located. These are often insurance companies with well-known names because of their marketing activities and because, in many cases, policyholders have been buying their personal or business insurance coverage from the same insurance companies for many years. In insurance terminology, these licensed and regulated insurance companies are said to operate in the “admitted market.” In a particular state, the admitted market includes both insurance companies domiciled in that state and usually a larger number of insurance companies domiciled in other states that have applied for and received a license to operate in the state as an admitted insurance company.

In some situations and circumstances, however, insurance companies in the admitted market choose not to provide certain types of insurance coverage to people or businesses that want to purchase coverage.¹ Some applicants may have unusual risk characteristics, and admitted insurance companies may not believe they have the expertise to underwrite and rate the risks presented by these applicants. This is especially true if there are only a limited number of applicants with these unusual risk characteristics in the state. Insurance companies may also choose not to offer coverage to applicants or continue to provide coverage to existing policyholders whose previous claims history or other characteristics indicate a higher likelihood of future claims than expected of other applicants and policyholders. In addition, exposure to a specific peril can be concentrated geographically or be potentially catastrophic in nature, either of which can cause insurance companies to eliminate coverage for the peril or to reduce the aggregate amount of coverage they provide where their exposure to these perils is high.² For example, insurance companies ceased offering coverage for the perils of flood and earth movement (e. g., earthquakes and mine subsidence) many years ago. In the past two decades, insurance companies have become much more concerned about their exposure to catastrophic hurricane losses along the Eastern Seaboard and the Gulf Coast, which has led a number of national insurance companies to withdraw from certain coastal states or reduce significantly the number of property insurance policies they provide in these states. In portions of some

¹ For a discussion of these circumstances in the property insurance market, see Klein, pp. 7 -8.

² Maroney, et. al., “An Examination of Issues Pertinent to Establishing A Single Peril Facility,” pp. 3-6

states (with Florida being a prime example), actual and alleged losses from sinkholes have become a major concern for insurance companies.³

In addition, the attitudes of insurance companies about the type and amount of insurance coverage they are willing to provide at a particular time in a particular state is affected by, among other things, the state's judicial, legislative and regulatory environment. Because these elements can vary over time in a particular state and can differ substantially from one state to another, the amount of insurance coverage an insurance company is willing to provide may vary from time to time in a particular state and may also vary from state to state. As profit-seeking enterprises, insurance companies are inclined to provide more insurance coverage in those states where they expect to be able to achieve a reasonable rate of return and to provide less coverage in those states where they do not expect to be able to achieve a reasonable rate of return. These differences in rate of return expectations can also exist within a single state if the overall environment for writing some lines of insurance, e. g., personal lines of insurance, is not as attractive as the environment for writing other lines of insurance, e. g., commercial lines of insurance.

Finally, the property and casualty insurance admitted market is also affected by fundamental economic and financial factors, such as the rate of inflation in the general economy and the level of investment returns in the equity and debt markets. In recent decades, the admitted insurance market in the U. S. and even at the individual state level has been affected by international economic trends and, in some lines of insurance, by flows of capital into and out of reinsurance companies located outside of the U. S. These economic and financial factors may affect the willingness and the capacity of admitted insurance companies to provide the insurance coverage needed by their current and potential customers and these factors are inherently not subject to the control of individual state legislatures and insurance regulators.

The fact that insurance companies in the admitted market are sometimes not willing to make available all of the needed insurance coverage creates a variety of problems. First, some types of insurance coverage are required by state laws or regulations, e. g., automobile liability insurance and workers compensation insurance. Other types of insurance coverage are

³See Maroney, et al, *Insurance Study of Sinkholes*, pp. 2-3.

required by normal business practices, e. g., property insurance where a mortgage is involved. In addition, sound risk management practice typically compels individuals and businesses to purchase various types of insurance coverage, even if they are not required by others to do so, to protect their assets against the many loss perils they routinely face.

Over the past several decades, one response to admitted market availability problems has been the creation of special methods under the auspices or at the direction of government to make specific types of insurance coverage available to individuals and businesses for which they were otherwise eligible but could not obtain in the admitted market. In insurance terminology, these methods constitute what is generally referred to as the “residual market.”⁴ When admitted insurance companies are adversely affected by any or all of the factors discussed above, they may reduce the amount of insurance coverage they are willing to provide and may seek to raise the rates they charge for the insurance coverage they do provide. In this type of market, known as a “hard market,” the residual market generally increases in size, significance and the attention it receives. In the opposite type of market, known as a “soft market,” insurance companies may increase the amount of insurance coverage they are willing to provide and may reduce the rates they charge. In a soft market, the residual market generally decreases in size, significance and the attention it receives.⁵

From time to time various private mechanisms have been created to provide types of insurance that were not readily or consistently available from property and casualty insurance companies in the admitted market. In addition, the creation and growth of some of these private mechanisms has been motivated, at least in part, by sophisticated business financial and tax strategies. While these private mechanisms are not considered to be part of the residual market, they will be discussed in Chapter III to illustrate the range of insurance options available to public policy makers as they address short falls in admitted market capacity.

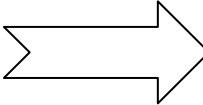
⁴ The term “involuntary market” has sometimes been used as a synonym for “residual market” to contrast it with the “voluntary market,” which includes private insurance companies in both the admitted market and the nonadmitted market. Private insurance companies operating in the nonadmitted market are referred to as surplus lines insurance companies. These insurance companies will be discussed in Chapter III.

⁵ Hard and soft markets comprise different parts of what is generally referred to as the insurance underwriting cycle. Informative discussions of the nature and causes of the insurance underwriting cycle can be found in reports prepared by Barbara Stewart (1984) and by Barbara Stewart, Richard Stewart, and Richard Roddis (1991).

The methods of addressing inadequate admitted market capacity or other abnormalities in the admitted market over time can be arranged conceptually along a spectrum. Private market methods are at one end of the spectrum depicted below. These methods in some cases operate under a legislatively-created framework; however, they are characterized by substantially private motivations and the relative absence of traditional insurance regulatory oversight. The methods in the middle and at the other end make up what is traditionally referred to as the residual market and have been motivated by or created at the federal level or by individual states, sometimes in cooperation with private insurance companies and sometimes not. As will be discussed in Chapters III through V, the dividing lines between the categories of market solutions along this spectrum are not always clear; however, solutions further to the right have increasing governmental participation and control.

Spectrum of Market Solutions to Admitted Market Problems

Private Market Solutions	Shared Market Solutions	Public Solutions
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Increasing governmental involvement 

The purpose of this paper is first to describe the essential features of the private sector solutions, the shared market solutions and the public solutions for providing insurance coverage that the admitted market cannot or will not provide. In addition, the report will identify and address a number of relevant public policy issues associated with residual market solutions that may assist legislators, regulators and others in understanding the special nature of the residual market and the various components of that market. Because of their number and current significance, the report will focus particularly on issues related to the residual market for property insurance; however, the discussion of these issues is applicable to other lines of insurance.

II. Observations and Conclusions

Observations

The term “residual market solution” (or “residual market entity”) applies to an insurance arrangement established at the behest of or required by government whose purpose is to make insurance coverage available to those individuals and businesses that are not able to obtain the coverage they need from private insurance companies licensed and regulated by state insurance departments.⁶ The reasons why private insurance companies are sometimes not willing or do not have the capacity to provide the insurance coverage their customers need include (a) customers with unusual or unattractive risk characteristics, (b) the insurance company’s need to limit its exposure to catastrophic losses, (c) an unfavorable judicial, legislative or regulatory climate in a particular state or line of business, and (d) adverse economic and financial conditions.

A variety of residual market solutions have been created to address insurance availability problems. Some of these solutions involve private insurance companies forming and administering residual market entities at the direction of state legislatures. Other solutions are created specifically by state legislatures as free-standing residual market insurance entities operating under substantial governmental oversight and control. As presented graphically in the Introduction and discussed in more detail in Part A, these solutions can be thought of as falling along a spectrum from greater private involvement and control to greater public involvement and control.

Residual market entities that fall in the middle of the spectrum, such as assigned risk plans and joint underwriting associations, and those at the end of the spectrum with greater government involvement, such as state workers compensation funds, the Florida Hurricane Catastrophe Fund, and the California Earthquake Authority, operate in an environment that is more public and political and that involves more legislative and regulatory control than regulated private insurance companies experience. As a result the public policy issues associated with residual market entities, while similar in some respects to those associated with private insurance

⁶ These insurance companies constitute the “admitted market” and are the insurance companies that individuals and businesses know about and deal with most often.

companies, have a particularly broad range and complexity. The residual market public policy issues discussed in Part B include (a) the role of residual market entities regarding availability and affordability of insurance, (b) whether residual market entities can be financially self-sustaining, (c) how rates should be established for residual market entities, (d) the degree and kind of subsidies associated with residual market entities, (e) special residual market tax issues, and (f) two important operational and finance issues.

Experience with the variety of residual market entities described in Part A and elsewhere⁷ indicates that the relative success or failure of a particular residual market entity depends less on the nature of the entity's structure and administration than it does on the manner in which legislatures and insurance regulators address the public policy issues listed in the previous paragraph and discussed in Part B. There is not a perfect residual market structure for a particular line of business or market condition. Choices made regarding, for example, the size and makeup of the board membership or whether certain operations are outsourced or performed by staff of the residual market entity are less important than such matters as whether the residual market entity has a clear, appropriate statement of purpose; whether the entity is intended to be financially self-sustaining; how the entity's rates are established; and the degree to which rate-related or assessment-related subsidies are permitted or encouraged.

The final and perhaps most important observation is that the principal public policy issues associated with residual market entities are strongly interrelated. For example, a residual market entity with rates that are inadequate statewide or in certain geographic regions will likely produce the following negative results:

- Residual Market rates that are competitive with private insurance company rates,
- Disproportionate growth in the number of residual market policyholders,
- Some residual market policyholders subsidizing other residual market policyholders,
- A residual market entity that is not financially self-sustaining,
- Increased likelihood and expected size of residual market financial deficits and deficit assessments, and

⁷ Newman, *Residual Market Subsidies*, pp. 15 -18

- Increased likelihood and expected size of residual market deficit assessments on private insurance company policyholders, which may be viewed as tax subsidies from these policyholders to policyholders of the residual market entity.

Another example is that a state policy, properly designed and implemented, for a residual market entity to be financially self-sustaining will likely produce the following positive results:

- Residual market rates are likely to be fully adequate and not competitive with private insurance company rates,
- More policies written by private insurance companies and fewer policies written by the residual market entity,
- No subsidies from some residual market policyholders to other residual market policyholders,
- Decreased likelihood and expected size of residual market financial deficits and deficit assessments, and
- Decreased likelihood and expected size of assessments on private insurance company policyholders with a decreased concern about whether these policyholders are subsidizing policyholders of the residual market entity.

Conclusions

Insurance availability problems may continue to arise in particular lines of insurance or geographic areas. In some cases the causes of these availability problems are under the control of public policy makers at the state level, but in other cases the causes are outside the control of state-level public policy makers. Whatever the circumstances, public policy makers have available a range of residual market solutions to address insurance availability problems. These solutions involve different degrees of governmental involvement and control and have different financial structures.

In making choices about creating and implementing a new residual market solution or restructuring an existing residual market solution, public policy makers can draw on a long history of positive and negative experiences with state and national residual market entities.

With adequate care and attention, public policy makers attempting to address current insurance availability problems can avoid subjecting residents of their state to the kinds of insurance market turmoil and adverse financial effects associated with some of the residual market choices made by public policy makers in other states or in other times. This requires public policy makers to recognize and be guided by the lessons of residual market history listed below:

- A residual market entity works best when it focuses on making insurance coverage available to those who cannot obtain it in the private insurance market. The use of a residual market entity to address insurance affordability concerns is misdirected, particularly if residual market rates are suppressed broadly even though only a small portion of the policyholders have measureable affordability problems. If appropriate, valid insurance affordability concerns can be addressed with a targeted, needs-based program as is the case in other aspects of everyday life.⁸
- A residual market entity works best when the entity's rates are not competitive with rates in the private insurance market. After this is achieved, a further effort can be made to assure that the residual market entity's rates are sufficient to cover all of its costs, including proper recognition of its exposure to catastrophic losses. This will go far toward reducing the likelihood of sizeable residual market deficits and the resulting deficit assessments. Requiring residual market rates to be actuarially sound without understanding and addressing the differences between rate making for a residual market entity and for a private insurance company is unlikely to produce a satisfactory result.
- Failure to follow the two previous lessons will lead to subsidies from one group of policyholders to another, either within the residual market entity or from private insurance company policyholders to residual market policyholders. Absent a clear statement of intent with supporting justification, creating subsidies of these types would seem at best to be unsound public policy and at worst to run the risk of unwelcome economic and political outcomes.
- The essential requirements for avoiding inadequate residual market rates, inappropriate subsidies and unacceptable deficit assessments are (a) a statutory public policy statement that the residual market entity is to be financially self-sustaining and (b) the political will by public policy makers, regulators and others to make it happen. Even a

⁸ Specific needs-based programs paid for from general tax revenues include those that address the needs of people who are not able to afford adequate food, housing and health care.

residual market entity with substantial catastrophe exposure can make significant progress toward financial self-sufficiency if, given fully adequate rates, it makes judicious purchases of catastrophe reinsurance.

Part A

Overview of Solutions to Admitted Market Issues

The variety of circumstances described in the Introduction has created adverse market conditions over the past 100 years in various lines of insurance. Numerous and very diverse methods have been developed and implemented to help individuals and businesses obtain the insurance coverage they need when that coverage is not available from insurance companies operating in the admitted insurance market. These methods were usually developed as the result of and have evolved through complex interactions among legislators, regulators, insurance companies and other affected parties. The purpose of Chapters III, IV and V is to describe in general terms the full range of solutions that have been and are being used in the U. S. to address insurance availability problems.

III. Private Market Solutions

Some solutions to insurance availability problems in the admitted market have arisen from individual and collective actions by insurance companies and insurance buyers. Four of these solutions are described in this chapter.

Surplus Lines Insurance

As far back as the 1800s, when state insurance regulation was first being developed, buyers of insurance coverage sometimes found it necessary to purchase some of their coverage from insurance companies not licensed to do business in their state. Over the next several decades, most states (beginning with New York in 1890) passed legislation to control and tax the sale of insurance by unlicensed or “nonadmitted” insurance companies.⁹ These nonadmitted insurance companies¹⁰ made up what is more commonly referred to now as the surplus lines market. Insurance agents who are licensed to place business in the surplus lines market are referred to as surplus lines brokers.

The rates and policy forms of surplus lines companies are not regulated by state insurance departments, and the companies are not members of, and their policyholders receive no protection from, state insurance guaranty funds. State insurance departments achieve some level of regulation of the surplus lines market by licensing and regulating surplus lines brokers. These regulations¹¹ include the following:

- Insurance coverage can only be placed with a surplus lines company by a licensed surplus lines broker, who must meet more rigorous requirements than those necessary to be an agent for an admitted insurance company.
- The surplus lines broker must report to the state information about each policy placed with a surplus lines company.

⁹ See Cameron Brown, pp. 1014- 1018 for an overview of the early history and development of the surplus lines market.

¹⁰ Most surplus lines companies are domiciled in and regulated by the insurance department in another state. There are also a number of insurance companies participating in the surplus lines market that are domiciled in other countries. The most notable of these is Lloyds of London.

¹¹ Brockett, Witt, and Aird, pp. 242-243

- The surplus lines broker must verify that a “diligent” effort was made to obtain the coverage from insurance companies in the admitted market.¹²
- The surplus lines broker is responsible for collecting and paying the surplus lines tax to the state.¹³

In general, states have tried to achieve a balance between the sometimes legitimate need for an individual or business to go outside the admitted market to obtain insurance coverage and the benefits associated with having policyholders in the state insured with insurance companies required to operate under state insurance laws and regulations. The diligent effort requirement is directed at assuring that insurance coverage is obtained in the surplus lines market only when it is not available in the admitted market. Further, states commonly forbid surplus lines brokers from obtaining insurance coverage in the surplus lines market at a more favorable rate or at more favorable policy terms than is available from the admitted market.¹⁴ Because of the complexity of the insurance needs of individuals and businesses seeking coverage in the surplus lines market, these types of requirements often present difficult enforcement issues. Nevertheless, the surplus lines market seems to have functioned reasonably well as a “safety valve”¹⁵ for the admitted market for many years.

Insurance Company Pools

While some of the residual market mechanisms to be described in Chapter IV may be referred as pools, the insurance company pools described here are those where insurance companies joined together voluntarily to allow them, using some type of reinsurance or other loss-sharing arrangement, to provide insurance coverage when they would not be able to do individually. The insurance companies may have been “reluctant to cover such exposures because the potential monetary loss is very high, the probability of loss is very high, the exposure is not well understood, or some combination of these and other reasons poses a threat.”¹⁶

¹² The requirements related to “diligent” effort vary from state to state.

¹³ Because the state has no jurisdiction over an insurance company in the surplus lines market, the tax is collected directly from the policyholder obtaining coverage in the surplus lines market. The surplus lines tax rate varies from state to state.

¹⁴ Keith Brown, pp. 285-286

¹⁵ Brockett, Witt, and Aird, p. 243

¹⁶ Webb, p. 290

Workers Compensation – Between 1910 and the early 1940s, all states enacted workers compensation¹⁷ laws requiring employers to provide specified benefits to employees injured on the job on a “no fault” basis and requiring employers to show financial responsibility by, among other options, purchasing insurance coverage. By 1918, three different associations of insurance companies were formed to voluntarily share this “new, unknown, and untried”¹⁸ form of insurance among the members. The insurance companies that formed these associations may have also been motivated by their wish to head off the widespread use of state workers compensation funds to provide the mandated coverage.¹⁹ With the passage of time, these associations evolved into, or were replaced by, different types of assigned risk plans, which will be discussed in Chapter IV.

Other Insurance – Throughout the 20th Century, insurance companies in various numbers and combinations formed several insurance pools to allow pool members to share complex, potentially large loss exposures. The exposures covered by these entities have included, but are not limited to, the following: nuclear power plants, large ship hulls, negatives of Hollywood films, large industrial facilities, railroad rolling stock, oil refineries, and aircraft. The methods used to underwrite and rate policies, adjust claims, and provide related services vary among these insurance pools, but in many cases the pools functioned substantially the same as traditional insurance companies.²⁰

Market Assistance Plans

Knowing that availability problems in some lines of insurance have been of relatively short duration, the property and casualty insurance industry has often suggested that state-by-state market assistance plans (MAP) be established instead of more formal (and likely more long term) residual market entities, such as those discussed in Chapter IV. MAPs are intended to be temporary and voluntary arrangements through which individuals or businesses (depending on the line of insurance) are able to submit applications for insurance. The insurance companies participating in the MAP agree to review the applications, usually on a rotating basis, with the intention of offering coverage to as many applicants as possible. In many cases, MAPs have served as a useful mechanism for relieving some of the pressure caused by short-term

¹⁷ When originally enacted, these laws were referred to as “workmen’s compensation” laws.

¹⁸ Webb, p. 304

¹⁹ Webb, p. 306

²⁰ Haugh, pp. 971 - 977

insurance availability problems, and many of them ceased to exist when the availability problems abated.

Florida and New Jersey have established more or less permanent MAPs. The Florida MAP was created by statute²¹ in 1985 to address the liability insurance crisis in the mid 1980s. It was administered by the Florida Insurance Council²² until the end of 1997 when the responsibility for administering the Florida MAP was assumed by the Florida Residential Property and Casualty Joint Underwriting Association, which was a residual market mechanism created by the Florida Legislature in 1992 after Hurricane Andrew.²³ The principal focus of the Florida MAP has been for several years and continues to be helping people obtain residential property insurance from private insurance companies rather than from the state-created residual market entities.²⁴ New Jersey has also created an ongoing MAP called the Windstorm Market Assistance Plan (WindMAP) to assist people living in certain coastal areas to find residential property insurance coverage.²⁵

Florida also created a workers' compensation insurance MAP²⁶ in 1993 to assist employers in obtaining the workers' compensation insurance coverage they need from insurance companies in the admitted market rather than from the Florida Workers' Compensation Joint Underwriting Association (FWCJUA).²⁷ This MAP, which is administered by the FWCJUA, assists those employers who are applying for insurance coverage from the FWCJUA and employers already insured by the FWCJUA.

Cooperative Buyer Arrangements

As the insurance market cycles move from soft to hard markets and insurance coverage becomes less available and more expensive, buyers of insurance, particularly buyers of

²¹ Chapter 85-92, Laws of Florida

²² The Florida Insurance Council is a trade association of insurance companies admitted to do business in Florida.

²³ The FRPCJUA will be discussed in more detail in Chapter IV.

²⁴ Newman, *Winds of Change*, pp. 34 - 36

²⁵ Newman, *Winds of Change*, p. 13

²⁶ The FWCJUA MAP is intended to meet the requirements of Sections 627.311(5)(c)4.d. and 627.311(5)(c)24., Florida Statutes.

²⁷ The FWCJUA will be discussed in more detail in Chapter IV.

commercial insurance, sometimes look for ways to meet their insurance needs by methods other than buying insurance from private insurance companies. Very large commercial insurance buyers may pursue self-insurance approaches; however, most commercial insurance buyers are not large enough individually to self-insure their loss exposures effectively. They sometimes look for ways to join with other commercial insurance buyers (usually in the same industry) to meet their insurance needs collectively. Three of the more notable collective buyer arrangements, which function in many respects as insurance companies, are described below.

Workers' Compensation Group Self-Insurance Associations – By the early 1980s, more than half of the states permitted employers to form workers' compensation group self-insurance pools, funds or associations (referred to here as "workers' compensation groups") to meet their obligations under the state's workers' compensation statutes.²⁸ Some of these states (but not all) required the employer members of a workers' compensation group to be in the same industry. The industries that seemed most interested in forming workers compensation groups included builders and general contractors, automobile dealers, roofing contractors, retail merchants, health care facilities, local governments, and school districts.²⁹ One of the key aspects of most workers' compensation groups of private employers is that members agree to be jointly and severally liable for the unpaid workers' compensation obligations of group members. Small to medium-sized employers seemed to be attracted to workers' compensation groups for several reasons, including (1) workers' compensation insurance was not consistently available from private insurance companies, (2) the perception that the cost of coverage from the workers' compensation group would be lower than from private insurance companies, and (3) the expectation that the level of service provided by the workers' compensation group would be better than that provided by private insurance companies.³⁰

Risk Retention Groups – In the 1970s, products liability insurance became less available and more expensive for a variety of reasons.³¹ A Federal Interagency Task Force, created in 1976, studied product liability problems and ultimately recommended that product manufacturers and sellers be allowed to purchase product liability insurance on a group basis. Congress enacted the Product Liability Risk Retention Act in 1981. The narrow scope of the Act and

²⁸ By 1992, Florida had 30 workers' compensation groups, which reported more than \$1 billion in premiums and made up almost 30 percent of Florida's workers' compensation insurance market. See Nelson-Morrill, Chapter 9.

²⁹ "Regulating Workers' Compensation Groups," p. 6

³⁰ "Regulating Workers' Compensation Groups," P. 5

³¹ Ling, pp. 386 -387

resistance from state insurance regulators limited the number of risk retention groups (RRG) formed in the early 1980s.³² Efforts by proponents of RRGs and state insurance regulators led to the Liability Risk Retention Act of 1986, which both allowed RRGs to provide coverage for all commercial liability insurance coverage (except workers' compensation, no-fault auto and personal lines insurance) and established a more substantive regulatory framework of RRGs by state insurance departments.³³

An RRG under the 1986 Act can be formed by associations of businesses, nonprofits, churches, hospitals, governmental entities, etc. as long as its members have the same or similar liability risks. The RRG must be a licensed insurance company in one state but does not have to be licensed in the other states in which it operates; however, the RRG may be subject to certain types of regulatory requirements in these other states as spelled out in the 1986 Act.³⁴

Captives – Although RRGs are thought of as one type of captive, captives have existed in various forms and have provided insurance protection for their owner or owners for several decades. Captives were limited in their early years to insuring certain exposures of a single parent company and its affiliates and were referred to as a pure captive. The scope of captive structures has broadened, and they can now be defined as “a closely-held insurance company owned by one or more organizations (parents) whose original purpose was (and may continue to be) to insure some or all of the risks of shareholders or affiliated organizations.”³⁵ This definition is broad enough to include pure captives, group captives, and association captives. Captives can be organized and regulated under special captive laws of several states or under the captive laws of other countries such as Bermuda, the Cayman Islands, and Guernsey.³⁶

³² Ling, pp. 388 - 390

³³ Ling, pp. 390 - 392

³⁴ Ling, pp. 391 - 395

³⁵ Costle and Schauer, pp. 304-312

³⁶ Costle and Schauer, pp. 312-321

IV. Shared Market Solutions

Starting with Massachusetts in 1927, states adopted either compulsory insurance laws or financial responsibility laws to compensate victims of auto accidents. This rapidly increased the number of persons buying auto insurance, but it also increased the number of persons who wanted to purchase auto insurance but were unable to do so from private insurance companies because of their driving records or for other reasons.³⁷ Also, during the first few decades of the 1900s, all states enacted mandatory workers compensation laws to compensate workers injured on the job without their having to prove the employer's negligence.³⁸ For these lines of insurance in particular and for other lines of insurance that increased in importance (such as residential property insurance and medical malpractice insurance), insurance companies in the admitted market have cooperated with state and federal governments by establishing and operating different types of insurance facilities to make needed insurance available. Because these facilities typically have involved insurance companies sharing in different ways the burden of covering financial deficits in these facilities, they have been referred to as the "shared market." The three principal types of residual market entities that make up the shared market will be discussed below. As will become apparent, the dividing lines between the various forms of these entities are not always clear.

Assigned Risk Plans

In simple terms, assigned risk plans are state-level organizations to which insurance agents submit applications for their clients who have not been able to obtain insurance coverage from admitted insurance companies in the state. The assigned risk plans then distribute the applications among the insurance companies in proportion to each company's share of the admitted market for that type of insurance coverage in the state. An insurance company receiving an application is required to issue and service the policy, including adjusting and bearing the financial responsibility for any claims that occur during the policy period. The principal lines of insurance for which assigned risk plans have been used are private passenger automobile insurance and workers compensation insurance.

³⁷ Webb, p. 296

³⁸ Hall, pp. 510- 517

While the traditional assigned risk plan model is conceptually straightforward, certain difficulties led to modifications over time. First, some smaller insurance companies experienced financial and operational problems from worse-than-expected losses from their assigned risks in addition to their losses on the policies they wrote voluntarily. This situation can be particularly troublesome when circumstances in the state cause the number of assigned risk insureds to be disproportionately large. In some automobile assigned risk plans,³⁹ insurance companies with smaller volumes of auto insurance business are able to arrange for another insurance company to take their assignments for which they must pay a buy-out fee.⁴⁰ Some states have gone further by restricting the number of insurance companies that receive auto insurance assignments. These insurance companies are referred to as “servicing companies.”⁴¹

While some of the early workers compensation assigned risk plans resembled auto assigned plans in their reliance on direct assignment of applications, these plans have evolved to function more like joint underwriting associations, which are described below.

Joint Underwriting Associations and Syndicates

With knowledge of the concerns among many insurance companies about some of the issues inherent in assigned risk plans (and perhaps for other reasons), state legislators, regulators and insurance companies developed an alternative method of sharing the financial burden of providing insurance to the residual market. Rather than have individual applicants assigned on a proportional basis to insurance companies writing a particular line of insurance, some states authorized the creation of an entity of which insurance companies were required to be “members.” The entity is the focal point for providing insurance to those applicants that cannot obtain the insurance coverage they need from private insurance companies. These entities, which sometimes are referred to generically as state-mandated pooling mechanisms, differ in certain respects regarding their operations and financial structures, but they share the

³⁹ The official name now for automobile assigned risk plans is automobile insurance plans (AIP). This name change occurred in part to address concerns that a stigma was attached to auto insureds who could only get automobile insurance by being assigned to an insurance company.

⁴⁰ This modification to the original method of assigned risk plan operation is called Limited Assignment Distribution (LAD) for the private passenger auto assigned risk plans and Commercial Limited Assignment Distribution (CLAD) for commercial auto assigned risk plans with direct assignment of commercial auto applications. See AIPSO, “Automobile Insurance Plans (AIP)”

⁴¹ I.I.I., “Residual Markets”

essential feature that no insurance company is exposed to the risk of loss of an individual policyholder in the residual market. Rather, the premiums and losses of all policyholders insured through the entity are shared (in sometimes different ways) by the insurance companies collectively.

A joint underwriting association (JUA), which is one type of residual market pooling arrangement, typically selects one or more insurance companies to operate as a servicing company for the JUA. Insurance agents are assigned to a servicing company, and the agents submit any applications to the assigned servicing company, which collects premium, issues policies and adjusts claims on behalf of the JUA. This approach is typical of JUA's for private passenger automobile insurance and JUA's for certain other lines of business, such as medical malpractice insurance. At the end of the year, the JUA's premiums and losses are distributed to the member insurance companies on a proportional basis.⁴² The insurance companies then enter the premiums and losses on their financial statements with the premiums and losses of their own insurance business. If the JUA has a net loss for the year, the member companies are required to provide to the JUA the necessary funds on a proportional basis to cover the JUA's deficit. If the JUA had a profit for the year, the profit is reflected on the financial statements of the member insurance companies.

The second type of residual market pooling arrangement is the syndicate, which is also referred to as a pool. These entities are similar in many respects to JUAs, but there are some differences. While some syndicates use one or more servicing companies, most issue and service policies with their own employees and, therefore, function in this regard similarly to private insurance companies. The principal residual market syndicates are FAIR plans,⁴³ which provide residential and commercial property insurance, and beach or windstorm plans (sometimes referred to as "wind pools"), which make insurance coverage available for losses from hurricanes and other windstorms in coastal regions.⁴⁴ Many of the FAIR plans and wind

⁴² See Webb, p. 298 and I.I.I. "Residual Markets".

⁴³ Beginning in the early 1970s and following the urban riots of the late 1960s and the passage by Congress of the Urban Property Protection and Reinsurance Act of 1968, FAIR Plans have been established in over half of the states. See Webb, pp.308 – 312 and Newman, *Winds of Change*, pp.10 – 13 and p. 133.

⁴⁴ Beach or Windstorm Plans were established in seven states beginning in the early 1970s. Florida's wind pool was authorized in 1970 and began operation in 1972 as the Florida Windstorm Underwriting Association. It became part of Citizens Property Insurance Corporation in 2002.

pools distribute their financial results to member companies similarly to JUAs and have the same ability to assess them for the funds needed to cover any deficit.⁴⁵

The financial structure discussed above for JUAs, syndicates and wind pools has been referred to as the “full participation model” in that insurance company members of these entities share fully in the profits and losses of the entity each year.⁴⁶ An alternative approach, referred to as the “assessment model” is perhaps best illustrated by the Florida Residential Property and Casualty Joint Underwriting Association (FRPCJUA), which was formed in 1992 after Hurricane Andrew. The financial structure of the FRPCJUA required that “... if premium and investment income attributable to a particular plan year are in excess of projected losses and expenses of the plan attributable to that year, such excess shall be held in surplus.”⁴⁷ The Florida Windstorm Association (FWUA) moved from the full participation model to the assessment model in 1997 when the Florida Legislature required that “Surplus of the (FWUA) shall be retained for the payment of claims and shall not be distributed to the member insurers.”⁴⁸ One motivation for the assessment model is that, where catastrophic loss potential exists (as in Florida), having the residual market entity send significant profits to member insurance companies following a year with no hurricane losses and then assessing the insurance companies the next year when hurricane losses occur is inefficient and counterproductive. Another motivation would be to assist the residual market entity in obtaining exemption from federal income taxes.⁴⁹

Florida created another JUA variation in 1993 when it developed the Florida Workers’ Compensation Joint Underwriting Association (FWCJUA)⁵⁰ to replace the Florida Workers’ Compensation Insurance Plan, which operated similarly to workers’ compensation plans in many other states.⁵¹ The FWCJUA has several notable features.⁵² First, the “members” of the FWCJUA include commercial self-insurers, group self-insurance funds, and assessable mutuals

⁴⁵ Over time, some FAIR plans have chosen for tax-related or administrative reasons to retain any plan year surpluses they may have realized.

⁴⁶ Klein, p. 9

⁴⁷ Section 627.351(6)(c)7., Florida Statutes (1997)

⁴⁸ Section 627.351(2)(b)2.a.(l), Florida Statutes (1997)

⁴⁹ See Chapter X.

⁵⁰ For an overview of the FWCJUA history, go to <http://www.fwcjua.com/About/Default.aspx>.

⁵¹ These “assigned risk” plans exist in a majority of states with most of them being administered by the National Council on Compensation Insurance. See I.I.I., “Residual Markets.”

⁵² Section 627.311(5), Florida Statutes

in addition to admitted insurance companies authorized to write workers' compensation insurance in Florida. Second, the FWCJUA is intended to be self funding. While the FWCJUA currently has the ability to make up for deficits associated with certain types of policyholders by imposing assessments to be collected by the "members" on their policyholders, the assessment authority expires on July 1, 2012. Deficits associated with other types of policyholders written by the FWCJUA are to be covered by assessments levied on these policyholders directly. Finally, the FWCJUA's rates are required to be actuarially sound and are to be filed with the Office of Insurance Regulation on a use and file basis.

Reinsurance Facilities

A few states have taken a very different approach to constructing residual market entities, at least in part to address concerns about the stigma that may be attached to someone who must obtain necessary insurance coverage, such as automobile insurance, from a residual market entity. Originally, four states (and now three)⁵³ structured their automobile insurance residual market entities as reinsurance facilities.⁵⁴

The principal attraction of a reinsurance facility seems to be that it is invisible to drivers placed in the facility. This is possible because drivers in these states can apply to and obtain auto insurance coverage from any insurance company in the market. The insurance companies are required to issue and service the policies for all drivers who apply to them for coverage. After it issues an automobile insurance policy, an insurance company evaluates the risk of loss it believes is associated with the driver in relation to the premium the company is allowed to charge the driver under the rates approved by the state for that driver. The insurance company can decide to retain the premium paid by the driver and the financial responsibility for any losses that may occur, or it can send the premium and transfer the financial responsibility for losses to the reinsurance facility.⁵⁵ For those policies placed in the reinsurance facility, the

⁵³ Massachusetts, New Hampshire and North Carolina still operate automobile reinsurance facilities, while South Carolina shut down its reinsurance facility over three years beginning in 1999 as part of a significant overhaul of its automobile insurance regulatory structure. For more information on South Carolina, see Grace, Klein and Phillips, p. 159.

⁵⁴ Webb, pp. 297 -298

⁵⁵ In reinsurance terminology, the insurance company is "ceding" the premium and responsibility for losses to the reinsurance facility, and the reinsurance facility is "assuming" the premium and responsibility for losses from the insurance company.

insurance company provides normal policyholder services including adjusting claims, and it is reimbursed for its expenses and loss payments for these policies by the reinsurance facility.

Typically, the premiums sent to the auto insurance reinsurance facilities have not been sufficient to pay the expenses and claims associated with the policies placed in the facility. Reinsurance facility deficits are covered either by assessments on insurance companies in the market, which may be able to include the assessments in their rates, or by recoupment fees charged directly to all auto insurance policyholders in the state.

Reinsurance facilities have not been restricted at the state level only to automobile insurance. Five states created funds between 1979 and the mid-1980s that operate as reinsurance facilities to assist in covering the peril of earth movement arising from mine subsidence related to extensive below-ground coal mining activity.⁵⁶

⁵⁶ These states are Kentucky, Illinois, Indiana, Ohio and West Virginia. Pennsylvania created a mine subsidence fund in 1961 that operates as a direct insurer. See Maroney, et al, Insurance Study of Sinkholes, pp. 45-56.

V. Public Solutions

For a variety of reasons, a number of government-run insurance entities have been established to assure that individuals or business needing certain kinds of insurance coverage would be able to obtain that coverage. These entities vary in age from almost 100 years to less than ten, and they provide kinds of insurance as diverse as workers' compensation, private passenger auto, earthquake, flood, residential property, and residential property reinsurance. While most of these entities have been created by states, some have been created by the federal government; however, only a few of the federal insurance entities are relevant to this report.⁵⁷

State Workers' Compensation Funds

The monopolistic⁵⁸ state funds for workers' compensation insurance were established in the initial decades of the twentieth century when workers' compensation laws were first being enacted at the state level. Advocates for state workers' compensation funds expressed concerns about insurance company solvency and fair pricing in addition to concerns about availability problems.⁵⁹ Monopolistic funds are the only insurance entity allowed to provide workers' compensation insurance to employers in the states that have taken this approach. For several decades, six states – Washington (1911), Ohio (1912), West Virginia (1913), Nevada (1913), Wyoming (1915), and North Dakota (1919)⁶⁰ – have had monopolistic workers' compensation funds; however, Nevada beginning in 1999 and West Virginia on July 1, 2008, have transitioned to a market open to private insurance companies.

Several states have competitive state funds for workers' compensation insurance that compete with private insurance companies for business and also provide coverage for employers that have otherwise been unable to obtain the workers' compensation insurance coverage they

⁵⁷ A valuable but dated overview of federal insurance programs is at Greene, pp. 127 – 152.

⁵⁸ Sometimes these funds are referred to as exclusive funds.

⁵⁹ Webb, p. 306

⁶⁰ Greene, footnote 26, p. 187

needed.⁶¹ As a result, these states typically do not have a workers' compensation residual market mechanism involving private insurance companies.

Maryland Automobile Insurance Fund (MAIF)

The Maryland Legislature created MAIF in 1972,⁶² and the entity began operation on January 1, 1973. As an independent agency of state government reporting to the Governor, its purpose is to provide personal and commercial automobile liability insurance for Maryland residents who are not able to obtain the coverage from private insurance companies. Two declinations from private insurance companies are required before MAIF can provide coverage. MAIF receives no state funding, and the State of Maryland has no responsibility for any of MAIF's debts or obligations.⁶³ Deficit assessments, if needed, are paid by MAIF policyholders⁶⁴ and by assessments on auto insurance companies in Maryland on a proportional basis.⁶⁵ MAIF does not compete with private insurance companies, and it does not use service companies to conduct its auto insurance activities.

California Earthquake Authority (CEA)

Because of severe problems in the California homeowners' insurance market following the Northridge earthquake in 1994, the California Legislature created the CEA in 1996. The CEA, which is exempt from federal income taxes, is an instrumentality of the state but has a separate financial status. It offers earthquake insurance to homeowners in California through agreements with participating insurance companies⁶⁶ which operate under these agreements similar to servicing companies for many other residual market mechanisms. A private insurance company writing residential property insurance in California is required by state law to make earthquake insurance coverage available to its customers either as a participating insurance

⁶¹ Arizona recently enacted legislation to convert SCF Arizona, the state-backed workers' compensation insurer that was created in 1925 as the state's "insurer of last resort," to a mutual insurance company by 2013. SCF Arizona had a market share of nearly 50 percent. *Best Wire*, A.M. Best Co., May 14, 2010

⁶² Chapter 73, Maryland Acts of 1972

⁶³ MAIF website, <https://www.maif.net/emaif/>

⁶⁴ Section 20-406(b), Code of Maryland

⁶⁵ Section 20-407, Code of Maryland

⁶⁶ Participating insurance companies represent about two-thirds of residential property insurance market in California.

company with the CEA or by offering its own earthquake insurance policy.⁶⁷ The CEA is a competitor with those insurance companies who choose not to be participating insurance companies with the CEA.

The CEA offers “no frills” coverage with high deductibles and limited or restricted coverage for other structures, contents and loss of use.⁶⁸ The purpose of this approach is to focus on restoring the habitability of the insured’s residence. Because of the catastrophic nature of its exposure, the CEA has a complex capital structure involving pre-event and post-event debt, private reinsurance, and assessments on participating insurance companies. In the event that the CEA does not have sufficient resources to pay claims from a severe earthquake in a populated area, it will either pay a pro rata portion of claims or pay claims on an installment basis.

Citizens Property Insurance Corporation (Citizens)

The Florida Legislature created Citizens in 2002 by combining the Florida Residential Property and Casualty Joint Underwriting Association (FRPCJUA) and the Florida Windstorm Underwriting Association (FWUA) into a single administrative entity.⁶⁹ One of the main reasons for the combination was to achieve exemption from federal income taxation for Florida’s property insurance residual market entities with catastrophic hurricane exposure.⁷⁰ Although Citizens is a single administrative entity, the existence of multiple billion dollars of pre-event debt and other credit facilities previously issued or obtained by the FRPCJUA and the FWUA required the maintenance of separate accounts, deficit assessment processes, and reinsurance arrangements within Citizens. The Florida Legislature continued its previous residual market policy by requiring Citizens to function as a residual market mechanism providing property insurance coverage only to those applicants who could not obtain such coverage in the private

⁶⁷ An overview of the CEA is available at <http://www.earthquakeauthority.com/index.aspx?id=7&pid=1>

⁶⁸ The policy is referred to in California as the “mini-policy.” See the previous footnote. Insurance companies that are not participating insurance companies with the CEA also offer the mini-policy to their customers.

⁶⁹ Chapter 2002-240, Laws of Florida

⁷⁰ The FRPCJUA had achieved federal tax exempt status in February 2002 as the result of a decision handed down in the Federal District Court of North Florida finding that the FRPCJUA was an “integral part of the state.” (See Chapter X.) There was a widely held view at the time that the FWUA would not be successful if it pursued similar litigation. The Internal Revenue Service issued a private letter ruling in February 2002 granting federal tax-exempt status to Citizens if legislation were enacted into law in substantially similar form to that presented to the IRS for review. This is discussed further in Chapter X.

market. This included the requirement that Citizens rates not be competitive with rates charged by private insurance companies in the admitted market.⁷¹ Also, an applicant for insurance coverage with Citizens or a Citizens' policyholder who had an offer of coverage from a private insurance company in the admitted market was not eligible for coverage from Citizens.

The severe hurricanes in 2004 and 2005 and the resulting increases in reinsurance rates led to substantial increases in residential property insurance rates in Florida in 2006, which happened to be an election year. The Florida Legislature during the January 2007 Special Session, the 2007 Regular Session, and the 2008 Regular Session passed legislation that significantly altered Citizens' role in the property insurance market. The statutory changes involved in part (1) rolling back and freezing Citizens' rates (except for rate decreases) for four years, (2) removing the language requiring Citizens' rates to be noncompetitive with rates of private insurance companies in the admitted market, (3) requiring Citizens to file "recommended rates" at the end of the rate freeze that are to be "actuarially sound" but giving the Office of Insurance Regulation to authority to "establish" Citizens' rates annually, (4) giving a Citizens' policyholder the ability to remain in Citizens even if a private insurance company offered to insure the policyholder, and (5) authorizing Citizens to write multi-peril commercial non-residential property insurance statewide.⁷² In the 2007 regular session, the Legislature altered Citizens' mission by stating that "... affordable property insurance be provided and that it continue to be provided, as long as necessary, through (Citizens) ..." and that "... (Citizens) shall strive to increase the availability of affordable property insurance in this state"⁷³ During the 2009 regular session, the Legislature began the process of unfreezing Citizens' rates,⁷⁴ but it has not yet addressed explicitly the issue of whether Citizens will operate as a residual market entity or continue to operate as a competitor in the Florida property insurance market.

⁷¹ For a history of the FRPCJUA, FWUA and Citizens up to mid-2005, see Newman, *Winds of Change*, Chapters IV, V and VII. Also, Newman, *Residual Market Subsidies*, Chapter III, Chapter IV, and the Appendix provide a detailed history of Florida's property insurance residual market rate making and deficit assessment requirements and procedures through the 2009 legislative session.

⁷² Chapter 2007-1, Laws of Florida

⁷³ Chapter 2007-90, Laws of Florida This is likely the first time the Florida Legislature has referred to "affordable" insurance in the Insurance Code; however, the Legislature did not define the term "affordable" property insurance and did not set forth any guidelines or standards that Citizens and the OIR could use in evaluating whether such insurance would be affordable at the rates it required to be rolled back and frozen or whether even lower rates might be required.

⁷⁴ Chapter 2009-87, Laws of Florida

Florida Hurricane Catastrophe Fund (FHCF)

Another significant development in the evolution of Florida's residential property insurance market was the creation of the FHCF in 1993.⁷⁵ "The Legislature's purpose in creating the FHCF was to provide additional reinsurance capacity and thereby to stabilize the property insurance market and assure that property insurance remained available."⁷⁶ The FHCF provides a layer of catastrophe reinsurance to Citizens and private insurance companies in the admitted market that write personal and commercial residential property insurance. These insurers are required to purchase this layer of reinsurance coverage from the FHCF, but they have the option to purchase coverage equal to 90 percent, 75 percent, or 45 percent of the layer.⁷⁷ Two important distinctions exist between reinsurance coverage provided by the FHCF and that provided by private reinsurers: (1) FHCF coverage has been priced in the range of 70 percent to 80 percent less than comparable private coverage and (2) the FHCF's obligation is limited by statute and contract to its ability to pay from cash on hand and debt it can sell.⁷⁸

In the January 2007 Special Session as part of its effort to reduce residential property insurance rates, the Florida Legislature expanded the coverage provided by the FHCF by adding a number of required and optional reinsurance layers,⁷⁹ which increased the FHCF's exposure from its traditional layer of \$16 billion⁸⁰ to an aggregate exposure of potentially over \$30 billion. The most important of these was the Temporary Increase in Coverage Limits (TICL), which added a series of twelve \$1 billion layers on top of the FHCF's traditional layer. Insurance companies were allowed to purchase the amount of TICL coverage they needed, but they were not allowed to forgo purchasing TICL coverage, buy corresponding coverage from private reinsurance companies, and take credit for the cost of the private reinsurance coverage in setting their rates. Rates were set by the FHCF at about 10 percent to 12 percent of the rates charged by private reinsurance companies for comparable coverage. This was one of the devices used by the Florida Legislature to reduce residential property insurance rates.

⁷⁵ Chapter 93-409, Laws of Florida

⁷⁶ Senate Committee on Banking and Insurance, "Options for Transferring Risk," p. 56

⁷⁷ Citizens is required by statute to purchase FHCF coverage at 90 percent of the layer.

⁷⁸ Section 215.555, Florida Statutes. Additional information about the history and structure of the FHCF, its pricing, its assessment process, and other related matters can be found in (1) Newman, *Winds of Change*, pp. 41 - 45, (2) Newman, *Residual Market Subsidies*, Chapter III and Chapter IV, (3) Senate Committee on Banking and Insurance, "Options for Transferring Risk," and (4) the FHCF Website at <http://www.sbafla.com/fhcf/>.

⁷⁹ Chapter 2007-1, Laws of Florida

⁸⁰ Although the traditional FHCF layer changes from year to year based on a number of factors, the estimated coverage amount for the 2007 hurricane season was expected in early 2007 to be \$15.85 billion.

In the 2009 Regular Session, the Florida Legislature began unwinding the expansion of the FHCF coverage, although the wind down is scheduled to be spread over six years. The Legislature also added factors to increase over several years the rates charged by the FHCF for its traditional layer and the TICL coverage, and it eliminated the mandatory aspect of TICL purchases by private insurance companies⁸¹

National Flood Insurance Program (NFIP)

The U. S. Congress created the NFIP with the passage of the *National Flood Insurance Act of 1968* to help reduce the amount of disaster assistance being paid periodically by the federal government following significant flooding in communities across the country. This was necessary because private insurance companies excluded coverage for flood damage from their property insurance policies. The NFIP has become largely a public/private partnership in that private insurance companies can contract with the NFIP to issue and service the standard NFIP policy in their own name, retain a portion of the premium to cover their administrative expenses, and be reimbursed for flood losses under their flood policies.⁸²

The NFIP did not receive any capital contribution from Congress at its inception, and it has been paying its expenses and claim costs out of policyholder premiums and investment income. Although it carries forward any surplus it has from one year to the next, it has on several occasions had flood claims substantially more than its available surplus. In these circumstances, the NFIP borrows funds from the U. S. Treasury to cover its claim obligations and then repays the loans with subsequent years' earnings. This process worked reasonably well until the flooding associated with Hurricane Katrina in 2005.

⁸¹ Chapter 2009-87, Laws of Florida

⁸² See Newman, *Winds of Change*, pp. 21-29 for a description of the NFIP, its rating structure, and other matters.

Part B

Residual Markets and Public Policy

The previous chapters described a wide range of solutions created by state and federal governments, by private entities, or by governments and private entities working together to address conditions in property and casualty insurance markets where some individuals and businesses needing insurance coverage do not have coverage available to them from licensed and regulated private insurance companies. In particular, the portion of the insurance market where the shared market and public solutions focus is usually referred to as the residual market. Many of these residual market solutions have evolved over time as business and political conditions changed and as practical experience showed that modifications and improvements were either necessary or appropriate. What has not changed are a number of fundamental public policy issues that relate to the following:

- The purpose and nature of a residual market solution,
- The extent to which a residual market solution is successful in achieving its purpose, and
- The kind and degree of effects a residual market solution has (a) on providers and consumers of insurance products in the larger insurance market and (b) on the broader state economy.

The discussion below will address aspects of these fundamental issues through consideration of several areas of concern with reference to Florida's experience with its residual market solutions. It will become clear that these areas of concern are interrelated in critically important ways and that an understanding of one area of concern is not possible without understanding other areas of concern.

VI. Availability and Affordability of Insurance

The principal reasons why insurance coverage is not fully available to individuals and businesses that need or are required to purchase coverage were described in the Introduction. In addition, insurance coverage may be available to potential buyers but some buyers legitimately may not be able afford the price being charged. It is sometimes argued that if a person cannot afford to purchase insurance, it is not available to them; however, this does not seem to be a constructive approach because concerns about availability and affordability of insurance can be analyzed and understood best if they are treated as distinctly different matters. Specifically, methods to address availability of insurance are functionally different from methods to address affordability of insurance,⁸³ and experience has shown that combining the two can have adverse macro financial consequences and produce insurance market distortions.

Given the variety of economic, regulatory, and underwriting reasons why private insurance companies do not make insurance coverage available to all and given the difficulty of identifying rational, effective methods of addressing insurance affordability concerns, public policy makers and regulators have not always been clear about what they expect a residual market entity to achieve. This does not, however, excuse the lack of specificity and consistency that has typically been associated with the creation and oversight of residual market entities.

Historically, the primary reason for creating residual market entities has been to address insufficient availability of needed or required insurance coverage from private insurance companies. A very clear, comprehensive statement of purpose was set forth by the Florida Legislature in the 2002 legislation that created Citizens Property Insurance Corporation (Citizens).⁸⁴ The relevant portion of this statement is presented below:

The Legislature finds that actual and threatened catastrophic losses to property in this state from hurricanes have caused insurers to be unwilling or unable to provide property insurance coverage to the extent sought and needed. It is in the public interest and a public purpose to assist in assuring that property in the state is insured so as to facilitate the remediation, reconstruction, and replacement of damaged or destroyed

⁸³ Kramer, *Rate Suppression and its Consequences*, p.1

⁸⁴ See Section 627.351(6)(a)1., Florida Statutes (2002). This and certain other language in the preamble to the Citizens' statute were also designed to assist Citizens in obtaining exemption from federal income taxes.

property in order to reduce or avoid the negative effects otherwise resulting to the public health, safety, and welfare. It is necessary, therefore, to provide property insurance to applicants who are in good faith entitled to procure insurance through the voluntary market but are unable to do so. The Legislature intends by this (act) that property insurance be provided and that it continues, as long as necessary, through an entity organized to achieve efficiencies and economies, all toward the achievement of the foregoing public purposes.

The statement of purpose above differs from language in the statute creating the Florida Residential Property and Casualty Joint Underwriting Association (FRPCJUA) in 1992, which stated simply that the FRPCJUA was to provide insurance "... covering residential property, for applicants who are in good faith entitled, but are unable, to procure insurance through the voluntary market."⁸⁵ While the amount of verbiage in the two purpose statements differs substantially, both purpose statements describe an entity whose purpose is to assure availability of residential property insurance in Florida. Neither statement refers to concerns about the cost of residential property insurance. In fact, the public policy of Florida from the FRPCJUA's creation in December 1992 until January 2007 was that rates charged by the FRPCJUA and Citizens were to be higher than those charged by private insurance companies in the admitted market. In fact, the Florida Legislature amended the FRPCJUA and the Citizens statutes several times over this fourteen-year period to provide direction to insurance regulators on how to achieve this goal.⁸⁶

The residential property insurance residual market framework in Florida changed substantially as a result of amendments to the Citizens statute (and others) enacted by the Florida Legislature during the January 2007 Special Session and during the 2007 and 2008 Regular Sessions.⁸⁷ Included among the many amendments to existing law were revisions to the lengthy purpose statement set forth above for Citizens to refer throughout to "affordable property insurance coverage," "affordable property insurance" and "affordable rates." The Legislature also rolled back and froze rates charged by Citizens. The implication of the Legislature's action is that the rolled back and frozen rates would be affordable; however, the Legislature did not define "affordable rates"⁸⁸ and did not provide any evidence or analysis

⁸⁵ See Section 627.351(6)(a), Florida Statutes (1997)

⁸⁶ See Chapter VIII below and Newman, *Residual Market Subsidies*, Part III and the Appendix

⁸⁷ Chapter 2007-1, Laws of Florida, Chapter 2007-90, Laws of Florida, and Chapter 2008-66, Laws of Florida

⁸⁸ This is in contrast to the Legislature providing operative definitions of "excessive rates," "inadequate rates," and "unfairly discriminatory rates" in Section 627.062, Florida Statutes.

otherwise that its actions to roll back and freeze Citizens' rates made them affordable for all Citizens' policyholders.

Although the Florida Legislature's purpose in creating the Florida Hurricane Catastrophe Fund (FHCF) in 1993 was to serve as a "stable and ongoing source of (reinsurance) to insurers for a portion of their catastrophic hurricane losses" and to "create additional capacity ...,"⁸⁹ the Legislature has come more and more to view the below-market rates charged by the FHCF as a short-term method of holding down the cost of residential property insurance in Florida. The extreme example of this occurred during the January 2007 Special Session when the Legislature authorized a substantial increase in reinsurance coverage provided by the Florida Hurricane Catastrophe Fund (FHCF)⁹⁰ at a cost significantly below the cost of corresponding reinsurance from private reinsurance companies.⁹¹ These "savings" in reinsurance costs were to be passed along to insurance company policyholders in the form of lower rates. The Legislature did not state explicitly that its goal in expanding the reinsurance coverage provided by the FHCF was to make residential property insurance affordable, but it nevertheless moved aggressively to force insurance company rates lower with the potential of significant financial damage to Florida residents if a large hurricane struck Florida.⁹²

With this background, it is useful to step back and look more carefully at the concept of affordable insurance rates and the consequences of efforts to achieve this goal. One approach is for legislative efforts to focus on the cost of insurance for selected groups, such as (1) groups of the economically disadvantaged, (2) groups deserving of special treatment as a matter of government policy, and (3) groups thought to be subject to inequitable treatment by private insurance companies.⁹³ The alternative is to focus on the cost of insurance across all insurance policyholders, although this approach seems to be the most inefficient and least likely to lead to a satisfactory economic result.

⁸⁹ Section 215.555(1), Florida Statutes

⁹⁰ This was the Temporary Increase in Coverage Limits (TICL) program. See Chapter V above; Newman, *Residual Market Subsidies*, p. 26; and Chapter 2007-1, Laws of Florida. Other layers of additional reinsurance coverage were also authorized, but these were structured and priced differently.

⁹¹ Newman, *Residual Market Subsidies*, pp. 25-27

⁹² The Florida Legislature expanded the FHCF's coverage amount in January 2007 from approximately \$16 billion to between \$28 billion and \$34 billion depending on how much coverage would be selected by private insurance companies. At year end 2006, the FHCF had less than \$1 billion in cash on hand not including pre-event debt that it had issued earlier in 2006. See FHCF 2006-2007 Annual Report at <http://www.sbafla.com/fhcf/>.

⁹³ Webb, p. 293

There are few examples of legislative actions to make insurance coverage affordable for economically disadvantaged persons, although Hawaii has required the state's auto insurance JUA to provide free insurance coverage to people receiving welfare benefits with the costs being spread to other auto insurance policyholders. States do not seem to have seriously pursued the possibility of developing programs similar to the Food Stamp Program to address directly the insurance affordability problems of very low income residents.

States would appear to be treating drivers with poor driving records or with other high-risk characteristics as a "group deserving of special treatment as a matter of government policy" when the automobile insurance plans insuring these drivers are required to charge rates equal to rates charged by private insurance companies for drivers with good driving records. Likewise, the Florida Legislature has appeared on more than one occasion to treat people living in coastal regions with high hurricane exposure as a "group deserving special treatment as a matter of government policy." It has done this by enacting legislation⁹⁴ to spread the implementation of indicated Citizens' rate increases over several years with the primary beneficiaries being Citizens' policyholders with the largest gap between their current Citizens' rates and the indicated Citizens' rates. These favored Citizens' policyholders are concentrated in the more hurricane-prone coastal regions while residents in other regions (including other coastal regions) of Florida are more likely to be paying the indicated Citizens' rates for their geographic locations.

Some states have identified classes of risks that they believe insurance companies were mispricing. In the 1970s, for example, states such as Massachusetts and New Jersey prohibited the use of age, sex and marital status as rating factors for auto insurance, and Massachusetts required rate relativities between urban, suburban and rural rating territories to be artificially reduced.⁹⁵

All of the actions described above, along with many other similarly motivated actions in other states, have produced or helped to produce large financial deficits in state residual market entities and related distortions in insurance markets. While state legislators and insurance regulators may have good intentions for their actions to suppress rates in residual market

⁹⁴ Chapter 2002-240, Laws of Florida, Chapter 2003-281, Laws of Florida, and Chapter 2009-87, Laws of Florida

⁹⁵ Newman, *Residual Market Subsidies*, pp. 15 - 18

entities (or even rates charged by private insurance companies), they cannot stop bad drivers, homes highly exposed to hurricane losses or businesses with unsafe work environments from having disproportionately large losses. By one means or another, these excess losses in residual market entities have to be paid for, and that financial burden falls primarily on the broad range of individuals and businesses insured in the state by private insurance companies.

State laws seldom set forth an explicit public policy that certain groups of drivers, property owners or other types of insureds are to receive insurance coverage through residual market entities at rates subsidized by other insurance policyholders. If a state legislature adopted an explicit affordability standard for setting insurance rates (even for a residual market entity), it would force insurance regulators “into the thicket of determining who can afford to pay how much, and which insureds should subsidize those deemed unable to pay rates reflecting their expected loss costs ... It transforms the insurance regulator into an arbiter of income redistribution policy.”⁹⁶ One could argue, however, that the suppression of residual market rates and the deficit assessment arrangements inherent in the financial structure of residual market entities implicitly anticipate these subsidies and may even be designed to encourage them.

When residual market entities incur large deficits and when insurance markets function poorly, state legislators should look carefully at both the stated and unstated public policies and regulatory practices operative in their state with particular attention to the extent to which these policies and practices are influenced by the notion that residual market insurance rates should be affordable for everyone. The one lesson that comes through from any comprehensive study of insurance markets across states and types of insurance is that residual market entities can be designed to effectively address insurance availability but that attempts to have residual market entities address affordability of insurance come with costs and other consequences that may in the end be unacceptable.⁹⁷

⁹⁶ Kramer, p. 1

⁹⁷ See Newman, *Residual Market Subsidies*, Part II. There may be ways that legislators and regulators can reduce insurance costs and enhance insurance affordability by addressing such matters as the judicial system, public safety and security, building codes, and insurance fraud, but these topics are beyond the scope of this report.

VII. Self-Sustaining Residual Market Entities

Residual market entities have certain characteristics that make it difficult for them to be financially self-sustaining. Some of these characteristics are inherent in the nature of residual market entities; however, many of the characteristics appear susceptible to change if legislators, insurance regulators and the “member” insurance companies take the initiative to do so.

Three characteristics inherent to residual market entities work against a self-sustaining financial structure. First, state-created residual market entities traditionally begin operation without any financial resources as a long-term capital base. This, of course, is in contrast to private insurance companies that must meet initial and ongoing capital requirements to enter and remain in the insurance business. In lieu of initial capital, states typically require financial deficits of residual market entities to be covered through pro rata assessments on the “member” insurance companies or in some cases through assessments directly on policyholders.⁹⁸ The second characteristic is that residual market entities, because their purpose is to provide a solution to insurance availability problems, cannot limit the number of policies they issue or the aggregate amount of exposure they insure.⁹⁹ As a result, the number of policies and the amount of insured exposure in residual market entities can vary significantly from year to year and may become very large under certain insurance market conditions. The third characteristic working against a self-sustaining financial structure is the exposure to catastrophic losses in some residual market entities.¹⁰⁰ Exposure to catastrophic losses can pose difficult problems for private insurance companies, but in combination with the first and second characteristics discussed previously, this characteristic is particularly challenging for residual market entities.

⁹⁸ The burden of deficit assessments ultimately falls on insurance policyholders. See Newman, *Residual Market Subsidies*, pp. 19-22 and Part IV.

⁹⁹ The insurance regulatory requirements and oversight to which insurance companies in the admitted market are subject regarding relationships between insurance premiums written and capital are not applicable to residual market entities.

¹⁰⁰ The residual market entities most affected by catastrophic loss exposure include Citizens, the California Earthquake Authority, the National Flood Insurance Program, the Windstorm Plans in several states, and FAIR Plans in coastal states.

Historically, many residual market entities have operated under statutes, regulatory oversight and practices that increase both the likelihood of financial deficits and the magnitude of the deficits. The list below is not intended to be complete, but it should be sufficient for the purposes of this discussion.

- Legislatures have seldom identified financial self-sufficiency as a goal to be achieved by residual market entities. The absence of this public policy goal allows legislators, insurance regulators, and the residual market entity itself to adopt practices and to act in ways counter to the achievement of financial self-sufficiency.
- A necessary component of financial self-sufficiency is the accumulation of an appropriate amount of capital to support the residual market entity's insurance operations. Some residual market entities accumulate no capital from year to year because they distribute all revenues and expenses to member insurance companies annually.¹⁰¹ Some other residual market entities have instituted the practice of accumulating capital but may not have statutory authority or direction to do so. In contrast, Citizens, as well as the FRPCJUA before it, has explicit statutory direction to retain net income each year as a way to accumulate capital to pay future losses.¹⁰²
- While private insurance companies in the admitted market are subject to highly formalized rate making methods and procedures, these methods and procedures are not always applied consistently to residual market entities or with the recognition that they should be applied to residual market entities only with important modifications. Even where a state legislature has attempted to mandate a particular approach to making residual market rates, as in the FRPCJUA's and the Citizens' statutes, the results have often not been satisfactory.¹⁰³ Usually, this is due to the difficulty in applying actuarial concepts designed for private insurance companies to residual market entities. The result too often has been rates for a residual market entity that are not sufficient to cover all of its costs and to overcome the entity's capital shortage. (More will be said about this in Chapter VIII below.)
- Related to the discussion in Chapter VI about affordability of insurance, a residual market entity will have particular difficulty in achieving financial self-sufficiency if the state's public policies or insurance regulatory practices are aimed at having the residual market entity compete with private insurance companies or achieve social or political

¹⁰¹ This is referred to as the "full participation model" and is discussed in Chapter IV.

¹⁰² Section 627.351(6)(c)7, Florida Statutes (2009)

¹⁰³ Newman, *Residual Market Subsidies*, Part III and the Appendix

goals related to insurance affordability. These types of goals usually produce rates for a residual market entity that are inadequate statewide or inadequate for certain classes of insureds or geographical areas of the state. Inadequate rates for a residual market entity limit the ability of the residual market entity to build (or rebuild) capital, which leads to more frequent and larger financial deficits, the costs of which are spread to other policyholders through assessments or surcharges.

- Residual market entities with catastrophic exposure do not always purchase reinsurance to spread their exposure to loss beyond the state boundaries. Private insurance companies purchase various types of reinsurance coverage to enhance their ability to remain solvent. Reinsurance is essential for private insurance companies with catastrophic loss exposure and is an important part of the insurance regulatory oversight of these insurance companies. Residual market entities may believe they do not have the financial resources to purchase reinsurance (and with inadequate rates they may be correct) or they are satisfied to have the risk of catastrophic losses borne by insurance policyholders in their state.¹⁰⁴

The Florida Workers Compensation Joint Underwriting Association (FWCJUA) is an informative case study of the benefits of creating a residual market entity intended to be self-sustaining and of the perils of introducing affordability concerns into the process.¹⁰⁵ In the early 1990s, the predecessor of the FWCJUA was insuring about 35 percent of the Florida workers compensation market and generating over \$200 million in underwriting losses annually. The FWCJUA was created in 1993 as a self-funding plan in which employers insured in the plan would pay “actuarially sound rates,” which would nevertheless be higher than the rates charged by private insurance companies. Initially, three sub plans were established to which insured employers were assigned with the riskiest sub plan being issued assessable policies. In 2003, the Florida Legislature added a new sub plan for small employers (generally with 15 or fewer employees) and charitable organizations, and it set upper limits on the rates these favored employers

¹⁰⁴ The Mississippi Insurance Commissioner, after announcing that the Mississippi Legislature had made \$20 million available to the Mississippi Windstorm Underwriting Association to absorb fluctuations in reinsurance costs, said: “Reinsurance is the driver of the rate in almost all of these wind pools now.... The coastal states have got to get off of trying to subsidize these risk pools. We’ve got to figure out a way for the risk pools to stand on their own.” **BestWire**, A.M. Best Co., “*Miss. Commissioner: Wind Pool Getting \$19M, Will Stabilize Rates Along Coast*,” December 28, 2009

¹⁰⁵ This discussion is a summary of information about the FWCJUA in “FWCJUA History,” which is available on the FWCJUA website at <http://www.fwcjua.com/About/Default.aspx>. The FWCJUA is also described in Chapter IV.

would pay. The result of the rate caps was that the new sub plan quickly generated a substantial deficit. The Legislature was compelled to develop a more realistic rate structure, increase the rate caps, and develop a special process to cover the deficits. The Legislature, however, did not modify its policy that the FWCJUA is to be self-funding. As a result, the large deficits in the early 1990s have turned into modest operating profits in recent years, and the FWCJUA's share of Florida's workers compensation insurance market dropped to two percent by 2005 and to .3 percent in 2008.¹⁰⁶

¹⁰⁶ In addition to the legislative focus on the FWCJUA being financially self-sustaining, the Florida Legislature made important changes in the workers' compensation system that improved the system's efficiency and effectiveness. Chapter 2003-412, Laws of Florida, addressed such topics as attorney fees, officer exemptions, definition of permanent total disability, anti-fraud provisions, insurance company claim responsibilities, and medical fee schedules. These changes in the structure and operation of the workers' compensation system were an essential component leading to a substantially improved voluntary workers' compensation insurance market in Florida and the large reduction in the number of employers purchasing their workers' compensation insurance coverage through the FWCJUA in subsequent years.

VIII. Residual Market Rates

An understanding of issues related to rates charged by residual market entities must begin with a discussion of how rates are developed and regulated for private insurance companies. A private insurance company wants rates that are adequate to cover losses and expenses, provide for a reasonable profit, and are competitive in the market. Other considerations include rates that are reasonably stable over time, are reasonably responsive to changes in loss exposure, have adequate provision for contingencies, encourage loss control, and are understandable to insurance agents and consumers.¹⁰⁷ The task of insurance regulators is to assure that rates charged by private insurance companies meet statutory standards, which usually are rates that are not excessive, inadequate or unfairly discriminatory.¹⁰⁸ Both private insurance companies and insurance regulators rely on actuarial principles and methods to achieve “actuarially sound rates.” These principles and methods include principles stating that rates are an estimate of the expected value of all future costs associated with the transfer of risk to the insurance company.¹⁰⁹ The Casualty Actuarial Society has said: “It 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.”¹¹⁰

Two important aspects of actuarially sound rates for private insurance companies deserve special mention. First, the concept of affordability is not applicable to the development and regulation of actuarially sound rates. Affordability, which is not a statutorily prescribed and defined rating criterion, should not be confused with the consideration by insurance regulators of whether insurance rates are excessive. The excessiveness standard relates to whether rates “... are likely to produce a profit from Florida business that is unreasonably high in relation to the risk involved in the class of business or if expenses are unreasonably high in relation to services rendered.”¹¹¹ Further, the difficulty of actually setting rates based on whether they would be affordable to policyholders is insurmountable. Insurance companies would have to have access to financial information on individual applicants and insureds in addition to the

¹⁰⁷ Webb, Launie, Rokes, and Baglini, pp. 1- 5

¹⁰⁸ Webb, Launie, Rokes, and Baglini, pp. 6-8

¹⁰⁹ See Newman, *Residual Market Subsidies*, Section A of Part I, pp. 14-15, for further information.

¹¹⁰ Statement of Principles Regarding Property and Casualty Insurance Ratemaking adopted by the Board of Directors of the Casualty Actuarial Society, May 1988

¹¹¹ Section 627.062, Florida Statutes. The “excessiveness” standard is defined differently in so-called competitive rating laws where excessive rates are expected to be prevented by competitive forces in the insurance market.

information they have now about a property's location, replacement value, construction type, distance to the nearest fire hydrant, etc.

The second aspect is that actuarially sound rates are structured to prevent subsidies from one class of policyholders to another.¹¹² A private insurance company operating in a competitively-structured market cannot sustain the use of rates with subsidies between classes of policyholders or between lines of insurance.¹¹³ Subsidies in insurance markets as in other markets require government intervention, which explains why they occur in residual markets where government intervention and control has a long history. (More will be said about subsidies in Chapter IX.)

Arguably, rate making for residual market entities is more difficult than for private insurance companies in that, while both have the same technical rate making issues to contend with, residual market entities have additional considerations that come into play. This, combined with the greater interplay of the rate making process and short-term political considerations, has led to many situations where residual market entities have not been permitted to be financially self-sustaining and have incurred substantial deficits followed by troublesome levels of assessments and/or surcharges. A private insurance company whose rates have been suppressed by the insurance regulator can (a) continue to operate with an increased chance of becoming insolvent, (b) decrease the amount of business it writes to reduce its financial losses, or (c) withdraw from the line of business or from the state entirely. Insurance regulators are not usually happy about liquidating insolvent insurance companies or about insurance availability problems, and they may in time ease the suppression of insurance rates. In contrast, when suppression of residual market rates occurs, residual market entities must continue to provide insurance coverage and to pass along financial deficits through assessments.

The Florida experience, particularly with respect to personal residential property insurance rates in the FRPCJUA¹¹⁴ and Citizens, serves as an example of "how changing insurance market

¹¹²The existence of subsidies between classes of policyholders is related to the consideration by insurance regulators of whether rates are unfairly discriminatory.

¹¹³ Newman, *Residual Market Subsidies*, p. 15; Kramer, p. 71

¹¹⁴ The FRPCJUA also had a Commercial Lines Account for commercial residential property insurance; however, the discussion in this section relates principally to the FRPCJUA's Personal Lines Account, which continued as the

conditions, evolving public policy objectives, and political factors” affect rate making for residual market entities.¹¹⁵ The Florida Legislature has prescribed several rate making approaches for the personal residential property insurance residual market since 1992¹¹⁶ with varying results. The approaches relevant to the FRPCJUA and Citizens fall generally into one of two broad categories: (a) residual market rates based on rates of private insurance companies or (b) residual market rates required to be actuarially sound. As the chronology below illustrates, however, the Florida Legislature has also set forth rate making approaches representing combinations of these two categories:

December 1992 Special Session – At its inception, FRPCJUA rates were to be based on “the average cost of the five largest residential insurers ... plus appropriate factors for catastrophe loading, projected expenses, and a 25-percent increment for presumed adverse selection.” Subsequent rate filings were to be made annually if necessary based on “the loss and experience and other relevant factors.” The state insurance department was to “determine that the proposed rates are not excessive, inadequate or unfairly discriminatory”¹¹⁷

November 1993 Special Session – The Legislature revised the FRPCJUA rate requirements to require that the rates “be actuarially sound and the (FRPCJUA) function as a residual market mechanism to provide insurance only when the insurance cannot be procured in the voluntary market ... (and) shall be based on the (FRPCJUA’s) actual loss experience and expenses, together with an appropriate catastrophe loading factor that reflects the actual catastrophe exposure of the (FRPCJUA).” Rate filings were to be made twice each year.¹¹⁸

1995 Regular Session – The Legislature added a requirement that the FRPCJUA’s rates were to be “not competitive with approved rates in the admitted voluntary market.” The FRPCJUA’s rates were still to be actuarially sound and based on its actual loss experience, expenses and

Personal Lines Account of Citizens when it was created in 2002. The FWUA became the High Risk Account of Citizens. See Newman, *Winds of Change*, p. 46. The legislative treatment of FWUA rates began in 1997 and has its own history similar in many respects to that of the FRPCJUA. Both are described in Newman, *Residual Market Subsidies*, pp. 37-42.

¹¹⁵ Newman, *Residual Market Subsidies*, pp. 4-6, Part III and the Appendix

¹¹⁶ Newman, *Residual Market Subsidies*, Part III and the Appendix

¹¹⁷ Chapter 1992-345, Laws of Florida

¹¹⁸ Chapter 1993-410, Laws of Florida

catastrophe exposure, but “as an interim measure” the FRPCJUA 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 for homeowners’ insurance. In addition, the FRPCJUA was allowed to make its rate filings on a “use and file basis,” which was rare if not unique among residual market entities in the U. S.¹¹⁹

1996 Regular Session – The “top ten insurer” approach adopted in 1995 was expanded to the “top twenty insurer” approach for homeowners’ insurance to recognize that most of the top ten insurance companies were large, national companies that historically had low rates in Florida and did not serve as the best starting point for FRPCJUA rates.¹²⁰

1997 Regular Session – The statutory language requiring FRPCJUA rates to be based on its “actual loss experience and expenses” was removed. In another move the Legislature intended to lead to higher FRPCJUA rates, the FRPCJUA was authorized¹²¹ to take advantage of the rate arbitration process previously available to private insurance companies.¹²²

2002 Regular Session – As part of the legislation¹²³ creating Citizens in 2002, the FRPCJUA’s authority to use the rate arbitration process and to file rates on a use and file basis was removed. This was not a major problem because for practical political reasons the FRPCJUA had never availed itself of this authority.

2003 Regular Session – The Legislature established an extraordinary, innovative rate filing process for Citizens that (a) required Citizens to certify to the Office of Insurance Regulation (OIR)¹²⁴ at least twice a year that its Personal Lines Account rates met statutory standards and

¹¹⁹ Chapter 1995-276, Laws of Florida

¹²⁰ Chapter 1996-194, Laws of Florida

¹²¹ Chapter 1997-55, Laws of Florida

¹²² Section 627.062(6), Florida Statutes (1997)

¹²³ Chapter 2002-240, Laws of Florida

¹²⁴ The previously named Department of Insurance was renamed the Office of Insurance Regulation as part of a larger governmental reorganization in 2003. The duties of the OIR are limited to financial regulation of insurance companies, regulation of forms and rates, and regulation of insurance company market conduct.

(b) if the rates did not meet statutory standards, Citizens was to “make and implement” any necessary adjustments. The OIR was to notify Citizens if it determined that the “implemented” rates did not meet statutory standards, and Citizens was to make any adjustments needed in its next rate filing. The OIR could not prevent Citizens from implementing rates that Citizens believed were necessary to comply with statutory standards and could not order Citizens to make retroactive adjustments or refunds. Citizens was also required to develop a notice to its policyholders informing them that Citizens rates “are intended to be higher than the rates of any admitted carrier”¹²⁵

2006 Regular Session – The efforts of the Legislature to move residual market rates higher than rates charged by private insurance companies peaked in 2006. The Legislature said that Citizens’ rates “shall be actuarially sound and not competitive”¹²⁶ It enacted language to “reaffirm the requirement of rate adequacy in the residual market” and to “establish standards for rate adequacy ... to supplement the standard established (in the Insurance Code) ...” because it recognized that “rates may comply with the (actuarially sound and not competitive requirement) and yet be inadequate” It also “recognized the public need to limit subsidies within the residual market.”¹²⁷

The Legislature’s new standard of rate adequacy for Citizens required rates along with investment income to be “sufficient to provide for the procurement of coverage under the (FHCF) and private reinsurance costs, whether or not 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.”¹²⁸ The new rates were to apply to any Citizens’ policies issued or renewed on or after March 1, 2007.

2007 and 2008 Sessions – As previously discussed in this report,¹²⁹ the Florida Legislature made significant changes in the Citizens statute in a special session held in late January 2007 designed to achieve lower residential property insurance rates in Florida. The result as far as Citizens was

¹²⁵ Chapter 2003-281, Laws of Florida

¹²⁶ Previously, the Legislature had said that its intent was that the rates be actuarially sound and not competitive.

¹²⁷ Chapter 2006-12, Laws of Florida

¹²⁸ The requirements for the High Risk Account were similar but were to be phased in over two years.

¹²⁹ See Chapter V and Chapter VI for discussion of actions by the Florida Legislature in 2007 and 2008.

concerned was a reversal of the fourteen-year public policy that Citizens was a residual market entity and that its rates should be established accordingly. The principal changes regarding Citizens' rates were as follows"¹³⁰

- The actuarially sound requirement was retained, but the “not competitive” requirement was deleted along with all of the language related to the “top 20 insurer” approach, which had been part of the Citizens’ rate statute since 1995 and 1996.
- All of the language regarding the innovative “make and implement” rate filing process and the notice that Citizens’ rates were intended to be higher than private insurance company rates, which was adopted in 2003, was deleted.
- A new Citizens’ rate filing that had taken effect on January 1, 2007 was rescinded except for rate decreases.
- All of the language adopted in 2006 about Citizens’ rates being high enough to fund a 100-year storm was deleted, and the authority for the rate filing to take effect on March 1, 2007, was revoked.
- A new set of rate filing procedures was put in place that allowed Citizens to submit “recommended rates” to the OIR, which was to “consider the recommendations ... and issue a final order establishing the rates for (Citizens) within 45 days.” Citizens was not allowed to “pursue an administrative challenge or judicial review of the final order of the (OIR).”
- Citizens was prohibited from making a rate filing to increase any rates to take effect before January 1, 2008. This was extended in the 2007 Regular Session until January 1, 2009¹³¹ and in the 2008 Regular Session until January 1, 2010.¹³²

The Florida Legislature appears to have taken a small step in 2009 moving away from the position taken during 2007 and 2008. While it retained the language empowering the OIR to establish Citizens’ rates, it did not extend the rate freeze beyond January 1, 2010. It did, however, limit any premium increases for individual Citizens’ policyholders to ten percent except for coverage changes, surcharges, and a small increase in FHCF rates.¹³³ Regarding the

¹³⁰ See Newman, *Residual Market Subsidies*, Part III and the Appendix and Chapter 2007-1, Laws of Florida.

¹³¹ Chapter 2007-90, Laws of Florida

¹³² Chapter 2008-66, Laws of Florida

¹³³ Chapter 2009-87, Laws of Florida

FHCF, the Legislature also put in place a schedule to gradually reduce the new layers of coverage offered by the FHCF and to gradually increase the cost of FHCF coverage.¹³⁴

Two important inferences can be drawn from the above chronology of residual market rate-related actions by the Florida Legislature. First, the frequency of legislative changes and the willingness to try different approaches, including some that were ground breaking, during the period from late 1992 through 2006 indicates the Legislature's difficulty in achieving its goal of having the FRPCJUA and Citizens function as a residual market entity with non-competitive rates. This seems to have been based in part on the Legislature's belief that the state insurance department usually found ways to avoid increasing residual market rates as much as the Legislature expected.¹³⁵

Second, the Legislature seems to believe that residual market rates should be actuarially sound. This is the only consistent element of the FRPCJUA's and Citizens' rate statutes, even though the Legislature also seemed to realize intuitively the need to add further language to expand the actuarially sound rate standard. While the Legislature added qualifying language, such as (a) "function as a residual market mechanism ...," and (b) "not competitive with rates in the admitted voluntary market," to the actuarially sound rate standard, it does not appear that this ever worked satisfactorily. The language added in 2006 to require that Citizens' rates be sufficient to fund a 100-year storm did lead to a substantial rate increase scheduled to take effect on March 1, 2007; however, this rate increase was revoked by the legislative actions during the January 2007 Special Session.

Given the residual market rate history in Florida, the Florida Legislature once again may become dissatisfied with the current rate language requiring that Citizens' rates "shall be actuarially sound and subject to the requirements of s. [627.062](#),"¹³⁶ The premium increase limit of ten percent for any individual policyholder means that some groups of Citizens' policyholders may not achieve actuarially sound rates for many years while other groups of

¹³⁴ The coverage reduction and cost increase are scheduled to phase in over six years.

¹³⁵ This observation is based on the author's discussions with legislators and his experience with residual market rate filings during much of this period and on the innovative rate making procedures put in the FRPCJUA and Citizens rate statutes in 1997 and 2003.

¹³⁶ Section 627.351(6)(n)1., Florida Statutes (2009) The reference to Section 627.062 provides, among other things, that rates not be excessive, inadequate or unfairly discriminatory.

Citizens' policyholders are already at or will quickly achieve actuarially sound rates. This rate cap approach prevents Citizens from making meaningful progress toward being financially self-sustaining and perpetuates the subsidies built in to the Citizens rate and assessment structure.¹³⁷

Leaving aside the effects of phasing in individual policyholder premium increases over many years, the Florida Legislature does not appear to have analyzed carefully whether the actuarially sound rate standard is appropriate for a residual market entity, particularly an entity such as Citizens. Actuarially sound rates are based on an insurance company's own loss experience, expenses, applicable taxes, and appropriate rate of return on its capital base. Developing actuarially sound rates for a residual market entity without recognizing the important differences between residual market entities and private insurance companies may produce rates that are competitive with or even below rates for private insurance companies. Consider the following:

- If rates for a residual market entity are established substantially below the fully adequate level, the residual market entity may attract policyholders that would normally be written by private insurance companies and whose loss experience is better than that associated with policyholders typically found in the residual market. Basing the rates of the residual market entity on its own loss experience "has no mathematical certainty of reaching any acceptable equilibrium."¹³⁸
- Residual market entities typically have expense ratios below those of private insurance companies.¹³⁹ To the extent this is true, using the residual market entity's own expense factors will lower its rates relative to rates of private insurance companies.
- Some residual market entities have been able to obtain exemption from federal income taxes,¹⁴⁰ which is not characteristic of private insurance companies. Basing the residual market entity's rates on its income tax-free status will lower its rates relative to rates of private insurance companies.
- Because residual market entities typically begin their existence with no capital and seldom achieve a capital base properly related to their written premiums and exposure

¹³⁷ See Chapter VI and Chapter IX.

¹³⁸ Amundson

¹³⁹ The reasons for lower expenses may include lower (1) salaries, (2) agent commissions, (3) marketing costs, and (4) underwriting and other administrative costs.

¹⁴⁰ See Chapter X.

to loss, they have statutory authority to levy assessments directly or indirectly on policyholders of private insurance companies. “When the State has the authority to assess its citizens for debt to fund insurance losses, the State is substituting capital of its citizens for insurance company capital.”¹⁴¹ Basing the residual market entity’s rates on a “reasonable margin for profit and contingencies”¹⁴² that is not adjusted properly for its reliance on capital being provided by the state’s citizens will lower its rates relative to rates of private insurance companies.

- Because the cost of catastrophe reinsurance to supplement the coverage provided by the FHCF is the among the largest expenses incurred by residential property insurance companies in Florida, the failure of Citizens to purchase catastrophe insurance equivalent to amounts private insurance companies are required to purchase lowers Citizens’ rates substantially relative to rates of private insurance companies.

These five items are not intended to be an exhaustive list of areas where the methods used to develop actuarially sound rates for a residual market entity may need to differ from the methods used for private insurance companies; however, they indicate that simply relying upon standard actuarial procedures in developing actuarially sound rates for residual market entities is not likely to produce rates that achieve relevant public policy goals.

¹⁴¹ State Board of Administration, p. 5. Note: A state’s reliance on the capital of its citizenry to pay for residual market entity deficits is of greatest concern for entities with exposure to catastrophic losses.

¹⁴² Section 627.062(2)(b)12, Florida Statutes

IX. Residual Market Subsidies

While the term “subsidy” has acquired a negative connotation in both political discourse and general conversation, governments at all levels continue to develop and use subsidy programs for a wide variety of public purposes. This is true of discussions of subsidies in residual markets whether in Florida or elsewhere. Subsidies have been defined in various ways,¹⁴³ but “the basic characteristic of all subsidies is to reduce the market price of an item below its cost of production.”¹⁴⁴ One researcher described subsidies as arising out of “government-directed, market-distorting interventions” and then said that any such “intervention that alters the price of the good artificially should be recognized as a subsidy.”¹⁴⁵ Direct subsidies involve payments directly to producers or consumers and include tax expenditures. Indirect or implicit subsidies¹⁴⁶ include all other kinds of subsidies and are more likely to have the types of subsidy-related problems listed below:

- Subsidy leakage – Subsidy programs aimed at a particular population may end up either providing subsidies to some persons outside the intended population or may not reach all members of the intended population.
- Unintended consequences – Because of the complexity of the socio-economic system in which subsidy programs operate and the possibility of faulty reasoning or inadequate understanding by governmental officials, subsidy programs sometimes have unexpected negative and even perverse effects.
- Negative externalities – All of the economic consequences of a course of action may not be fully internalized in its cost, which can lead to a subsidy being realized by one person or group from another person or group where the unaccounted economic consequences fall.¹⁴⁷

¹⁴³ Newman, *Residual market Subsidies*, p. 10

¹⁴⁴ <http://www.businessdictionary.com/definition/subsidy.html>

¹⁴⁵ Porter

¹⁴⁶ Sometimes these are referred to as hidden subsidies.

¹⁴⁷ Newman, *Residual Market Subsidies*, pp. 6-8 and pp. 10-12

The rollback and freezing of Citizens' rates by the Florida Legislature in January 2007 can be used to illustrate the subsidy-related problems listed above.¹⁴⁸ The Legislature's across-the-board rate reductions to achieve affordable rates for Citizens' policyholders without defining "affordable" led to substantial subsidy leakage. While some Citizens' policyholders may not have been able to "afford" the Citizens' rates, the Legislature made no effort to define, identify and target subsidies to these policyholders. Instead, it reduced rates for all Citizens' policyholders, most of whom could afford the Citizens' rates. As a result, the financial impact of the Citizens' rate subsidy program was far larger than it needed to be to address legitimate affordability concerns. Most of the financial benefits associated with the Legislature's actions went to Citizens' policyholders who could afford the Citizens' rates, which caused a significant adverse effect on Citizens' financial resources and its ability to pay future hurricane losses. This illustrates the futility of using across-the-board rate reductions to address isolated affordability problems.

Unintended consequences of the Citizens' rate rollback and freeze included reducing the revenues that Citizens would have received, decreasing the growth of Citizens' capital base, increasing the size of future Citizens' deficits, and increasing the size of future deficit assessments. Ironically, a proportional share of the financial burden of larger deficits and assessments in the future will fall on the policyholders who the Legislature thought could not afford Citizens' rates. Another unintended consequence of the Citizens' rate rollback and freeze will be that private insurance company policyholders in Florida, who received no benefit from the rate rollback and freeze of Citizens' rates and who are far more numerous than Citizens' policyholders, will be compelled to pay higher deficit assessments and the greater portion of any large Citizens' deficit. It is not clear that sound public policy justifies increasing the size of deficit assessments imposed on these policyholders to provide short-term rate reductions to Citizens' policyholders who could afford to pay higher rates.

Finally, the Legislature's rollback and freeze of Citizens' rates interfered with legitimate price signals in the market by understating the real cost of residential property insurance, particularly in coastal counties highly exposed to hurricanes. To the extent that some people may move to or remain in these counties when they may have made different decisions with accurate information about the cost of residential property insurance, most of the resulting societal costs from increased traffic congestion, additional school construction, and increased demand

¹⁴⁸ This discussion is from Newman, *Residual Market Subsidies*, pp. 6-8 and pp.10-12.

for public services falls on the residents of the county who are not Citizens' policyholders. This represents an additional subsidy to Citizens' policyholders.

The concerns about rate-related subsidies in Florida's residential property insurance residual market have usually been expressed as North Florida counties subsidizing South Florida counties or inland counties subsidizing coastal counties.¹⁴⁹ The Legislature addressed concerns about rate-related subsidies, which can also be referred to as pre-event subsidies, in 2006 when it "recognized the public need to limit subsidies in the residual market."¹⁵⁰ Unfortunately, the Legislature's subsequent actions in the 2007 Special Session removed this language and took other actions that magnified the previously existing rate-related subsidies.¹⁵¹

In addition to the rate-related subsidies that exist in Florida's residential property insurance residual market, subsidies are also inherent in the processes used by Citizens and the FHCF to levy deficit assessments. These assessment-related subsidies, which can also be referred to as post-event subsidies, have received little attention from the Florida Legislature, the media and the general public. Nevertheless, these subsidies are real, are being paid currently, and, following a large deficit in Citizens or the FHCF, will be substantial.

Concerns about assessment-related subsidies arise in three contexts. First, residential property insurance policyholders of private insurance companies are assessed when hurricane losses create a deficit in Citizens.¹⁵² This may be viewed by some as a subsidy from the private insurance companies' policyholders to Citizens' policyholders; however, arguments can be made that these deficit assessments are not subsidies, particularly if Citizens' rates were set at fully adequate levels.¹⁵³ If Citizens' rates are not at fully adequate levels, which is now and has generally been the case, the position that Citizens' deficit assessments on residential property insurance policyholders of private insurance companies are subsidies becomes stronger. There are questions, for example, about the basic fairness of middle and low income residents of

¹⁴⁹ There are also intra-county rate-related subsidy issues in addition to the more commonly discussed inter-county rate-related subsidies.

¹⁵⁰ Chapter 2006-12, Laws of Florida

¹⁵¹ Chapter 2007-1, Laws of Florida

¹⁵² Citizens' policyholders are assessed first, and small deficits may be covered by the assessments on Citizens' policyholders. See Newman, *Residual Market Subsidies*, Part IV.

¹⁵³ Newman, *Residual Market Subsidies*, p. 28

counties with relatively low hurricane exposure being assessed to pay for hurricane losses of wealthier property owners on Florida's coasts where the hurricane exposure is greater and who have been paying less than fully adequate Citizens' rates.

The second context where assessment-related subsidy concerns arise is that private insurance company policyholders in lines of insurance other than residential property insurance are assessed to pay deficits in both Citizens and the FHCF. The Citizens' assessment base was expanded during the 2007 Special Session to include all lines of property and casualty insurance except workers compensation insurance and medical malpractice insurance. The FHCF has had a similarly broad assessment base throughout its history.¹⁵⁴ It is tempting to view as subsidies the deficit assessments imposed by Citizens and the FHCF on private insurance company policies such as personal and commercial auto insurance policies, personal umbrella policies, and business property and liability insurance policies. Perhaps a more important issue is whether these deficit assessments are actually taxes.¹⁵⁵

The third context, which has received the least attention but may be the most significant, involves the method by which the amount of the deficit assessments levied on individual Citizens' policyholders and policyholders of private insurance companies are calculated. The traditional residual market approach is to determine a percentage factor so that multiplying the full policy premium of each policy being assessed by the identical percentage factor will generate the amount needed to cover the deficit.¹⁵⁶ The identical percentage factor method, which is used by both Citizens and the FHCF, has the appearance of fairness because a person with an expensive home in a coastal county will have a much higher homeowners' insurance premium and pay a proportionately larger assessment than would a person with a modest home in an inland county. For example, if the percentage factor is three percent, a policyholder whose homeowners' insurance premium is \$5,000 would be assessed \$150, while a policyholder whose homeowners' insurance premium is \$1,200 would be assessed \$36.

The important public policy issue is whether the identical percentage factor method produces assessment-related subsidies among groups of policyholders and whether the subsidies, if they

¹⁵⁴ Newman, *Residual Market Subsidies*, pp. 31-34

¹⁵⁵ See Chapter X.

¹⁵⁶ Newman, *Residual Market Subsidies*, p. 8 and pp. 21-22

exist, are significant. Citizens is unlikely to have a financial deficit that is not caused by hurricane losses. The FHCF exists only to help insurance companies meet their obligations to pay claims caused by tropical storms and hurricanes, but any deficit it incurs will be produced almost entirely by hurricane losses. For this reason, the essence of the assessment-related subsidy issue is how accurately full policy premiums measure variations in hurricane loss exposure from one area to another. The initial analysis has shown that the traditional method of calculating deficit assessments for Citizens and the FHCF does not accurately reflect the variation in exposure to hurricane losses across Florida.¹⁵⁷ The result of using the traditional method is that policyholders in some parts of Florida pay deficit assessments that are too high while policyholders in other parts of Florida pay deficit assessments that are too low. This finding takes into account the substantial variation in residential property insurance premiums that currently exists.

¹⁵⁷ *Subsidies in the Post-Loss Assessment Structure of Florida's Property Insurance Market*, pp.39-40

X. Residual Market Tax Issues

Residual market entities that fall into the Shared Market Solution category or the Public Solution category¹⁵⁸ have attributes that differentiate them from private insurance companies. They are created by state governments for the public purpose of providing insurance to individuals and businesses that cannot get insurance from private insurance companies, typically have authority granted to them to levy deficit assessments, and generally are regulated with more control and involvement by state insurance regulators than are private insurance companies. The presence of these and other governmental attributes has led some residual market entities to seek exemption from federal income taxation, which allows them to accumulate surplus more quickly to better withstand future losses and may allow them to issue tax-exempt debt to pay for post-event losses. Four different approaches have been used to achieve tax-exempt status for residual market entities. The fourth approach, while achieving the same financial benefits as the other three, provides additional insight into the fundamental nature of deficit assessments.

IRC 501(c)(6)

A number of state FAIR Plans¹⁵⁹ achieved tax-exempt status as a “business league” under Section 501(c)(6) of the Internal Revenue Code (IRC) during the 1970s and 1980s. While these residual market entities no doubt deserve tax-exempt status, being classified as a business league is to some degree surprising. “A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit.... even if the business is operated on a cooperative basis or produces only enough income to be self-sustaining.”¹⁶⁰ Another of the business league requirements, which FAIR plans typically meet, is that no part of the net earnings of the organization can inure to the benefit of any of the entities comprising the organization. Because the kinds of organizations typically classified as business leagues include trade associations, chambers of commerce, and boards of trade, the business league classification does not seem applicable to residual market entities. More

¹⁵⁸ See the diagram in the Introduction and Chapters IV and V.

¹⁵⁹ See Chapter IV.

¹⁶⁰ See <http://www.irs.gov/charities/nonprofits/article/0,,id=96107,00.html>. More information regarding business leagues can be found at <http://ftp.irs.gov/pub/irs-tege/eotopick03.pdf>.

recently, residual market entities seeking federal tax-exempt status have pursued one or more of the approaches discussed below.

IRC 501(c)(27)

In the mid-1990s Section 501(c)(27) was added to the Internal Revenue Code (IRC) to grant tax-exempt status to state-sponsored workers' compensation reinsurance organizations established by a state before June 1, 1996, and that meet several additional requirements set forth in the IRC to assure the governmental character of the organizations. The additional requirements include, but are not limited to, (a) the organization operates on a nonprofit basis by "returning surplus income to its members or ... policyholders on a periodic basis and by reducing initial premiums in anticipation of investment income," (b) the majority of the organization's board of directors "are appointed by the chief executive officer or other executive branch official of the state, by the state legislature, or by both," and (c) the organization's assets "revert to the state upon dissolution or the organization is not permitted to dissolve under state law."¹⁶¹

At the suggestion of the FWUA, the FRPCJUA and the FWUA worked together in the late 1990s on legislation at the federal level amending Section 501(c) of the Internal Revenue Code to create a new exemption from federal income taxation for residual market entities with substantial catastrophic hurricane exposure and that had other governmental attributes. The amendment sought by the FWUA and FRPCJUA was included in an omnibus tax bill that passed both houses of Congress; however, the omnibus tax bill was vetoed by President Clinton for reasons unrelated to the 501(c) amendment. The President's veto proved fortuitous from the perspective of the FWUA, the FRPCJUA and Florida because of subsequent events, which are described below.

Integral Part of the State

Before the CEA, FHCF, and Citizens came into existence, they achieved exemption from federal income taxation as an "integral part of the state" through private letter rulings issued by the IRS. The IRS denied the FRPCJUA's request for a similar private letter ruling, in part because the FRPCJUA had been in existence for several years and was seeking refund of previously paid

¹⁶¹ See <http://www.irs.gov/publications/p557/ch04.html>.

federal income taxes. As a result, the FRPCJUA had to file a lawsuit against the United States and prevail in federal district court to achieve federal tax exempt status. Following the federal district court's decision in February 2002¹⁶², the FRPCJUA received a refund of previously paid federal income taxes and interest totaling \$232 million.

Neither the Internal Revenue Code nor U. S. Treasury Department regulations define "integral part of the state." This concept, as developed through several IRS private letter rulings,¹⁶³ requires an entity to meet the following requirements:

In determining whether an enterprise is an integral part of the state, it is necessary to consider **all of the facts and circumstances**, including the **state's degree of control** over the enterprise and the **state's financial commitment** to the enterprise. (Emphasis added)

The factors considered by the IRS do not constitute a "bright line" test but instead require a weighing of the evidence, i. e., considering all of the facts and circumstances. Residual market entities are not state, county or city governments and they are not private insurance companies. In terms of their governmental attributes they fall between the ends of the public/private spectrum. Some residual market entities have more governmental attributes than others. At some point on the spectrum, a residual market entity has enough governmental attributes to be an integral part of the state.

State control begins with the structure of the residual market entity's board of directors and how board members are appointed and removed and by whom. Government officials appointing all or a majority of the board is a strong indicator of state control. The degree of control over the residual market entity's plan of operation by the state insurance department is also relevant. The state's financial commitment can take several forms, including (a) requiring the residual market entity to collect the state premium tax and permitting it to retain the taxes collected, (b) exemptions from state corporate income tax and other state taxes, (c) direct appropriation of state funds to the residual market entity as a capital contribution, and (d)

¹⁶² JUA v. US, 207 F. Supp. 2d 1344 (N.D. Fla. 2002)

¹⁶³ For example, see IRS Private Letter Ruling 250815-96 for the CEA and IRS Private Letter Ruling 31-295-95 for the Hawaii Hurricane Relief Fund.

granting the residual market entity the power to impose assessments and surcharges on member companies, the entity's own policyholders, and policyholders of member companies.

As important as state control and the state's financial commitment are, the presence of other governmental attributes is also very important. The list of other governmental attributes is potentially long; however, some of the attributes of the residual market entities found to be an integral part of the state include the following:

- A clear statement of public policy related to the benefits the state and its citizens receive from the residual market entity making insurance coverage available when private insurance companies are unwilling or unable to do so.¹⁶⁴
- A statement that the income of the residual market entity cannot accrue to the benefit of any private person.
- A requirement that the residual market entity is subject to the state's "government in the sunshine" and public records laws.
- A requirement that the residual market entity's rates are not to be competitive with rates of private insurance companies.
- Employees of the residual market entity are issued state identification cards and allowed to utilize state travel and hotel discounts.
- A grant of immunity from lawsuit to the residual market entity's member insurers, employees, members of the board of directors, and members of committees.
- Regulatory approval required before the residual market entity can issue pre-event debt.
- Regulatory approval required before the residual market entity can cease operations and dissolve.
- A requirement that all of the residual market entity's net assets become the property of the state upon dissolution of the entity.

¹⁶⁴ See the Citizens' statement of public policy quoted in Chapter VI.

Political Subdivision

After the success of the FRPCJUA in obtaining federal tax-exempt status and after the business of the FWUA was transferred to the High-Risk Account of Citizens in 2002, the Citizens board (which was also the FWUA board) authorized an attempt to obtain tax-exempt status for the FWUA for the period from 1997 to 2002. After initial discussions with the IRS were unproductive, the FWUA filed a lawsuit in 2005 to achieve tax-exempt status and the return of previously paid federal income taxes. The FWUA argued that it was either an "integral part of the state", as discussed above, or a "political subdivision." The ensuing litigation ended in 2006 with an agreement arrived at during mediation between the FWUA and the United States under which the FWUA received \$168 million in previously paid federal income taxes and interest for the years 1999 through 2001. In addition, the IRS gave up its claim against the FWUA for \$200 million in back taxes.

While the FWUA's argument that it was a political subdivision was not addressed specifically in the settlement agreement, the arguments presented by the FWUA are relevant to an understanding of residual market entities and, particularly, their assessment authority. The term "political subdivision" is not defined in the Internal Revenue Code, but it has been defined in U. S. Treasury Department regulations. For the purposes of this discussion, the three essential characteristics of a political subdivision are the following:

- A political subdivision is a division of the state.
- The revenues and assets of a political subdivision accrue to the benefit of the state.
- A political subdivision has been delegated the right to exercise a sovereign power, i. e., the power of eminent domain, the power to tax, or the police power.

The arguments and evidence on political subdivision status presented by the FWUA are too lengthy and complex to be covered fully here. The first and second characteristics above involve state control, public purpose, and other matters that are similar in many respects to the arguments and evidence associated with integral part of the state status. The discussion below

will focus on the power to tax,¹⁶⁵ which differs in certain respects from the state's financial commitment discussed previously.

The word "tax" has been defined in several revenue rulings as an

"enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes and not as a payment for some privilege or service rendered."

Policyholder premiums charged by a residual market entity are not taxes because they are charged to and collected from policyholders who receive the benefit of insurance coverage from the residual market entity.

In a 1998 FHCF private letter ruling¹⁶⁶ that addressed the FHCF's ability to issue tax-free debt, the IRS defined the term "generally applicable tax" using language consistent with the definition of "tax" above. The private letter ruling then stated that the FHCF assessments "charged to all insurers writing property and casualty insurance (except workers' compensation and accident and health insurance) is a tax of general application" The IRS rationale for this statement was based on the following points:

- The FHCF assessments "are not a payment of special privileges granted or services rendered" because the assessments, unlike the premiums charged by the FHCF, "are not paid solely by the insurers writing covered policies."
- The FHCF assessments "are levied solely for the purpose of raising revenue for a governmental purpose and are applied at a uniform rate to all entities of the same classification in the State (i. e., all property and casualty insurance companies except workers' compensation and accident and health insurance)."
- There is nothing to indicate that FHCF assessments do not have "a generally applicable manner of determination and collection."

¹⁶⁵ This discussion of the power to tax is intended to be an overview of the issues involved and their relevance to other matters previously discussed and is not intended to be a legal opinion.

¹⁶⁶ IRS Private Letter Ruling 110715-97, pp. 7-8

- The class of insurance companies assessed by the FHCF is much larger than the class of insurance companies obtaining benefits from the FHCF.

In its effort to achieve federal tax-exempt status and the return of previously-paid federal income taxes, the FWUA argued that its regular assessments and emergency assessments, and in different ways its market equalization surcharges¹⁶⁷ possessed the same characteristics as the FHCF assessments. The argument went as follows:

- The FWUA regular assessments and emergency assessments were levied pursuant to statutory requirements when the FWUA had a financial deficit and was otherwise unable to meet its public purpose.¹⁶⁸
- Regular assessments were levied on member insurance companies, who received no benefit or service from their membership and who were authorized to recoup the amount of the regular assessment from their policyholders. Further, these policyholders received no benefit from the recoupment because they were not policyholders of the FWUA and most of them were not eligible to be FWUA policyholders because they did not reside in the narrow coastal regions of Florida where FWUA coverage was available.
- Emergency assessments were collected directly from all property insurance policyholders in Florida, the majority of which did not reside in the in the narrow coastal region of Florida where FWUA coverage was available.
- Both regular assessments and emergency assessments were levied at uniform rates on member insurance companies and the policyholders being assessed.
- At its peak population of approximately 500,000 policyholders in 1999, the number of FWUA policyholders represented about ten percent of the residential property insurance policyholders in Florida.

¹⁶⁷ Newman, *Winds of Change*, pp. 78-84; Newman, *Residual market Subsidies*, Part IV

¹⁶⁸ Section 627.351(2)(a), Florida Statutes directs the FWUA to make windstorm insurance available to “applicants who are in good faith entitled to, but are unable to procure, such insurance through ordinary methods.” Section 627,351(2)(c)2.a., Florida Statutes states that the FWUA is authorized to provide windstorm insurance coverage in a county if the Department of Insurance finds at a public hearing that “Due to a lack of windstorm insurance coverage in the county or area so affected, economic growth and development is being deterred or otherwise stifled in such county or area, mortgages are in default, and financial institutions are unable to make loans”

- When the FRPCJUA had a financial deficit and levied a regular assessment on its member companies, the FWUA was required to levy an equal percentage market equalization surcharge on FWUA policyholders who received no benefit from the market equalization surcharge.
- Emergency assessments and market equalization surcharges were not considered premium and were not subject to premium taxes, commissions or fees.¹⁶⁹

The IRS seemed to place great weight on the fact that the group of persons assessed by the FHCF was much larger than the group of persons who received benefits from the FHCF or were even eligible to receive benefits from the FHCF. In contrast, the FRPCJUA assessments in the Personal Lines Account, while they were levied on non-policyholders of the FRPCJUA, were levied on persons who were at least eligible to be policyholders of the FRPCJUA. As described above, most of the persons assessed by the FWUA were not eligible to be policyholders of the FWUA. Assessments in the Commercial Lines Account of the FRPCJUA, however, were analogous to the FWUA in that all commercial property insurance policyholders were assessed for deficits in the Commercial Lines Account, although only commercial residential properties were eligible for coverage in the Commercial Lines Account.¹⁷⁰

When Citizens was created in 2002, the assessment bases for the three accounts were redefined and broadened.¹⁷¹ Basically, the assessment bases for each account were combined so that all personal lines or commercial lines property insurance policyholders could be assessed for deficits in any one account. The significant result of this change was that, if two of the Citizens' accounts had deficits, all property insurance policyholders would receive two assessments. If all three accounts had deficits, all property insurance policyholders would be assessed three times.¹⁷² The Florida Legislature expanded the assessment bases for the three Citizens' accounts again in the 2007 Special Session when it included all lines of property and casualty insurance except workers' compensation insurance and medical malpractice insurance.¹⁷³ At that point, all three Citizens' account met the standard used by the IRS in

¹⁶⁹ Section 627.351(2)(b)d.(III) and (V), Florida Statutes

¹⁷⁰ Newman, *Residual Market Subsidies*, pp. 20 and 31

¹⁷¹ Newman, *Residual Market Subsidies*, pp. 31-32

¹⁷² Because each account determines the size of its deficit and its assessment percentage separately, the three assessments would differ percentages of premium.

¹⁷³ Newman, *Residual Market Subsidies*, p. 32

evaluating the FHCF assessments that the assessments were imposed on a much larger group of persons than the group that received benefit from the FHCF.

Sometimes deficit assessments have been referred to in Florida political discourse as “taxes,” apparently because “taxes” has a harsher, more ominous sound than “assessments.” Based on the discussion in this chapter, references to deficit assessments as taxes may have been more accurate than the speakers realized.

XI. Residual Market Operations and Finance

In addition to the substantive public policy issues discussed in Chapters VI through X, those persons directly involved in organizing, financing and operating residual market entities have additional, important decisions to consider, including many of the decisions associated with the creation and operation of any insurance enterprise. While a discussion of the full range of these decisions is beyond the scope of this report, this chapter will address two such decisions that have particular significance for the longer term success of residual market entities.

An important operational decision is whether the residual market entity should hire sufficient staff and acquire the necessary office space, furniture, computers, and other equipment needed to handle internally all of the policy and claims administration work required for the residual market entity to meet its responsibilities. The alternative is for the residual market entity to contract out to qualified vendors these (and perhaps other) essential insurance functions.

While some private insurance companies and other businesses may from time to time consider the decision to outsource some business functions, the stakes are higher for residual market entities for two reasons. First, the operational demands on residual market entities tend to be much more cyclical with even higher “peaks” and lower “valleys” than experienced by private businesses. This arises primarily from the purpose of residual market entities to provide insurance coverage to any person or business entitled to the insurance coverage but not able to obtain it from private insurance companies. In a hard insurance market, private insurance companies tend not write new business and often will not renew some of their existing policies. As a result, the flow of business to the residual market entity increases significantly. The reverse happens in a soft insurance market when private insurance tend to increase the amount of business they write, which can cause the business written by the residual market entity to decline substantially. Importantly, the residual market entity cannot, and probably should not, exercise any control over the flow of business into or out of the entity.

The uncontrollable nature of the flow of business over time has often led decision makers to choose the outsource model for residual market entities. One justification for this is that

private insurance companies have resources available in a hard market to service residual market business because they are writing less of their own business. When the soft market returns, private insurance companies can shift resources from servicing residual market business to servicing the additional business they are writing for their own account. This approach substantially eliminates the challenges associated with the residual market entity having to acquire and manage the full range of human and physical resources for changing levels of business over which it has no control. The Florida Automobile Joint Underwriting Association and the Florida Residential Property and Casualty Joint Underwriting Association both used the outsource model by contracting with a limited number of private insurance companies, which are referred to as “servicing carriers” or “servicing companies.”

The outsource model, however, is not without its own challenges. Quality control may be more difficult for work being performed by servicing companies at remote sites, although arguably servicing companies have more knowledgeable staff. Also, because these are for profit companies and because they are aware of the business risks they have taken on, the fees charged by servicing companies are likely to be higher than the costs the residual market would incur in the short run by performing the work itself. Meaningful cost comparisons are difficult because they are affected dramatically by the magnitude and speed of changes in future residual market business volumes. If residual market business volumes hold relatively constant for an extended period, then costs will almost certainly be lower if the residual market entity does not outsource principal insurance functions. If residual market business volumes are marked by wide swings of a few years duration, the outsource option is likely to be more cost effective because the residual market entity will not have to add human and other resources in peak volume years when it may have difficulty shedding the cost of these resources in years of low volume.

A related issue is the level of service expected of a residual market entity. It is unlikely that any residual market entity has ever adopted the strategy, either formally or informally, of providing inferior service to its policyholders, claimants and agents. Also, residual market entities and their servicing companies (if any) are usually audited periodically by both financial and market conduct auditors who evaluate operational error rates and compliance with statutory timeliness requirements. Nevertheless, public policy makers and insurance regulators have typically not set out specific service standards for residual market entities. The Florida Legislature stands out in this regard by the language it added in 2005 to the Citizens Property Insurance Corporation’ statute. First, it added language to the preamble to the Citizens’

statute, which already required that Citizens “achieve efficiencies and economies,” an additional requirement that Citizens provide “service to policyholders, applicants, and agents that is no less than the quality generally provided in the voluntary market...”¹⁷⁴ The Florida legislature separately added the following much more specific provision:

It is the intent of the Legislature that policyholders, applicants, and agents of the corporation receive service and treatment of the highest possible level but never less than that generally provided in the voluntary market. It also is intended that the corporation be held to service standards no less than those applied to insurers in the voluntary market by the office with respect to responsiveness, timeliness, customer courtesy, and overall dealings with policyholders, applicants, or agents of the corporation.

While these additional requirements appear to have been motivated largely by the difficulties Citizens had in handling the sizeable number of claims arising from the four hurricanes striking Florida in 2004, it is not clear how carefully the Legislature thought through the implications of its actions. For example, what would be required for Citizens, the largest residual market entity in the U. S., to exceed the performance of private insurance companies that can control the number of policies they write and the number of agents from which they receive business. Citizens has added hundreds of additional employees and no doubt has improved its level of service. Is this the “highest possible” level of service that Citizens can provide? Could it improve its “responsiveness, timeliness, customer courtesy, and overall dealings” further by adding hundreds more employees, the additional space to house them, and the additional furniture and equipment they would need? What would the Legislature expect Citizens to do with all these employees, office space, furniture and equipment if the residential property insurance market improves in Florida (as it did in the late 1990s)¹⁷⁵ and Citizens has far fewer policies than it has now? Did the Legislature evaluate the cost of incremental service improvements by Citizens in relation to the benefit of having more financial resources available to pay hurricane claims? Finally, how is Citizens to reconcile the directive to “achieve efficiencies and economies” with the directive to provide service at the “highest possible level?” These directives are not necessarily mutually exclusive, but taken together they pose a significant challenge for Citizens as they would for any other residual market entity.

¹⁷⁴ Chapter 2005 – 111, Laws of Florida

¹⁷⁵ The number of policies in the FRPCJUA’s Personal Lines Account decreased from 937,000 policies in force on September 30, 1996 to fewer than 60,000 policies in force on April 30, 2000. Likewise, the number of policies in force in the FRPCJUA’s Commercial Lines Account declined from over 2300 to under 100 during the same period.

In the residual market finance area, various types of residual market entities providing property insurance along the Gulf Coast and the Atlantic Seaboard have to address an important issue that other residual market entities probably can ignore. An aspect of the significant exposure of these coastal property insurance residual market entities to catastrophic losses from hurricanes is the fact that their normal deficit assessment processes may not produce a sufficient flow of funds to allow the residual market entities to meet their claim payment obligations in an acceptable timeframe. One solution to this timing problem is for the residual market entity to issue debt following the catastrophic event and then repay the debt over a period of years as deficit assessments are levied and received.¹⁷⁶ The residual market entity's ability to issue and repay debt depends on the entity having assessment authority that allows deficit assessments to be levied for as many years as necessary to repay the debt.¹⁷⁷

The Florida Legislature, recognizing the state's outsized exposure to catastrophic hurricane losses, began addressing in the mid 1990s the likely need of the Florida Hurricane Catastrophe Fund, the Florida Residential Property and Casualty Joint Underwriting Association, and the Florida Windstorm Underwriting Association to issue large quantities of debt. Most significantly, the Florida Legislature specifically authorized the FRPCJUA and the FWUA to issue pre-event debt, i. e., debt issued prior to Florida being struck by a hurricane causing catastrophic losses.¹⁷⁸ In 1995, the FRPCJUA acquired a \$1.5 billion line of credit and the FWUA acquired a \$1 billion line of credit, both of which were obtained from worldwide consortiums of very large commercial banks.

By 1997 the Florida Legislature had amended both the FRPCJUA statute (Section 627.351(6), F. S.) and the FWUA statute (Section 627.351(2), F. S.) to address certain highly technical issues raised by bond lawyers and debt market participants, which allowed the FRPCJUA and the FWUA to issue a broader range of debt instruments. Based on the 1997 legislation, the FRPCJUA executed a new \$1.5 billion line of credit and issued \$500 million of five-year, seven-year, and ten-year notes. The FWUA executed a new \$1 billion line of credit and issued \$1 billion of 20-year bonds.

¹⁷⁶ A useful (although not identical) example is the \$450 million in debt the Florida Insurance Guaranty Association issued in early 1993 following Hurricane Andrew. This debt was fully defeased in 1997, which was earlier than expected, due in large part to a special, multi-year FIGA assessment authorized by the Florida Legislature during a special session in December 1992. See Chapter 1992-345, Laws of Florida.

¹⁷⁷ Newman, *Residual Market Subsidies*, Chapter IV

¹⁷⁸ See Newman, *Winds of Change*, pp. 71 - 78.

An important question remains – why would a residual market entity issue pre-event debt, particularly when there is a cost of doing so? The State Treasurer and Insurance Commissioner, who had oversight responsibility for the FRPCJUA and the FWUA, and the individual boards of the two residual market entities considered this question carefully, and for the reasons discussed below,¹⁷⁹ all concluded that issuing pre-event debt was the proper course.

Without pre-event financing, the entity would have to issue post-event debt as soon as possible after the hurricane when “headline” risk would be the greatest, which would put upward pressure on interest rates. Issuing pre-event debt would allow the entity to delay the issuance of additional post-event debt (if any were necessary) until the headline risk subsided. In addition, without having pre-event debt the entity would be issuing post-event debt at the same time as the Florida Hurricane Catastrophe Fund. This could produce an overload of Florida debt issues in the capital markets and could lead to higher interest rates for all Florida debt issuers. Issuing pre-event debt would allow the entity to delay the issuance of additional post-event debt (if any were necessary) until the FHCF had issued debt to permit it to provide critically needed funds to both the entity and private insurance companies.

Because obtaining hundreds of millions or several billions of long-term financing requires significant time and effort of the entity’s executives and lawyers, this effort is better spent before the catastrophic event than afterwards when the entity’s management resources should be focused on meeting the entity’s obligations to its policyholders. Further, the entity would be able to negotiate better terms and conditions before a hurricane event than after the event when the entity’s bargaining position would be weaker. Finally, it is advantageous for the entity to obtain investment ratings from the principal rating agencies and to become known to bond insurers and various other capital market participants before a hurricane creates an immediate need for long-term financing.

Florida’s experience with funding hurricane claims in Citizens and the FHCF following the multitude of hurricanes striking Florida in 2004 and 2005 proved the benefits of having pre-event financing in place. Although the FHCF had not issued pre-event debt, it had previously obtained investment-grade ratings from the principal rating agencies, had obtained approval

¹⁷⁹ Newman, *Winds of Change*, pp. 71 - 78

from the Internal Revenue Service of its ability to issue post-event debt on a tax-exempt basis, and through a series of presentations had become known to potential buyers of its debt. Citizens was able to take advantage of the earlier efforts of the FRPCJUA and the FWUA, to use the pre-event financing previously arranged by these entities, to issue pre-event financing on its own prior to the 2004 hurricane season and to issue additional pre-event and post-event financing more recently.

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