Consumer-Focused Property Insurance Reform

LESSONS LEARNED FROM FLORIDA

PELICAN INSTITUTE FOR PUBLIC POLICY

INTRODUCTION

Following the catastrophic losses from Hurricanes Katrina and Rita in 2005, Louisiana lawmakers and regulators faced a battered insurance market and grim outlook. Combined, these storms caused roughly $29 billion in insured losses due to almost 1 million insurance claims.[1] This resulted in many large, nationally recognized insurance carriers dramatically reducing their exposure or withdrawing from the Louisiana market altogether; higher insurance premiums; and a massive migration of policies into Louisiana Citizens Property Insurance Corporation (Louisiana Citizens), the state's insurer of last resort. Indeed, by 2008, Louisiana Citizens swelled to almost 10 percent of the market, with more than 174,000 policies in force.[2]

Thanks to commonsense reforms by Louisiana lawmakers and regulators, which included depoliticizing the ratemaking process, strengthening the statewide building code, and an innovative Louisiana Citizens depopulation program, Louisiana's property insurance market largely recovered within a few years. Louisiana Citizens, for example, went from the third largest property insurer in the state post-Katrina, to the ninth largest in 2014 with a market share of only 1.8 percent. Although national carriers had reduced their presence in the state, they were largely replaced by smaller local and regional insurers at competitive rates. By 2015, there were an additional 22 private insurers in Louisiana that either did not exist in 2005 or were writing policies elsewhere but decided to expand into the state.[3]

In 2020 and 2021, however, Louisiana was again battered by a number of storms. Combined, they impacted virtually every resident of the state and resulted in massive losses for insurers and state-run Louisiana Citizens. 2021's Hurricane Ida alone—due to her path, strength, and sheer size—affected most of the state's territory and accounted for $36 billion in insured losses, making it the second costliest insured natural disaster in U.S. history (until Hurricane Ian struck Florida in 2023 and relegated Ida to third place).[4]

This series of natural disasters, coupled with social inflationary pressures caused by regulatory burdens and excess litigation, have caused massive insured losses that have fleeced and destabilized Louisiana's insurance market.

FLORIDA PARALLELS

The recent history of Florida, another hurricane-prone state, offers useful lessons for Louisiana.

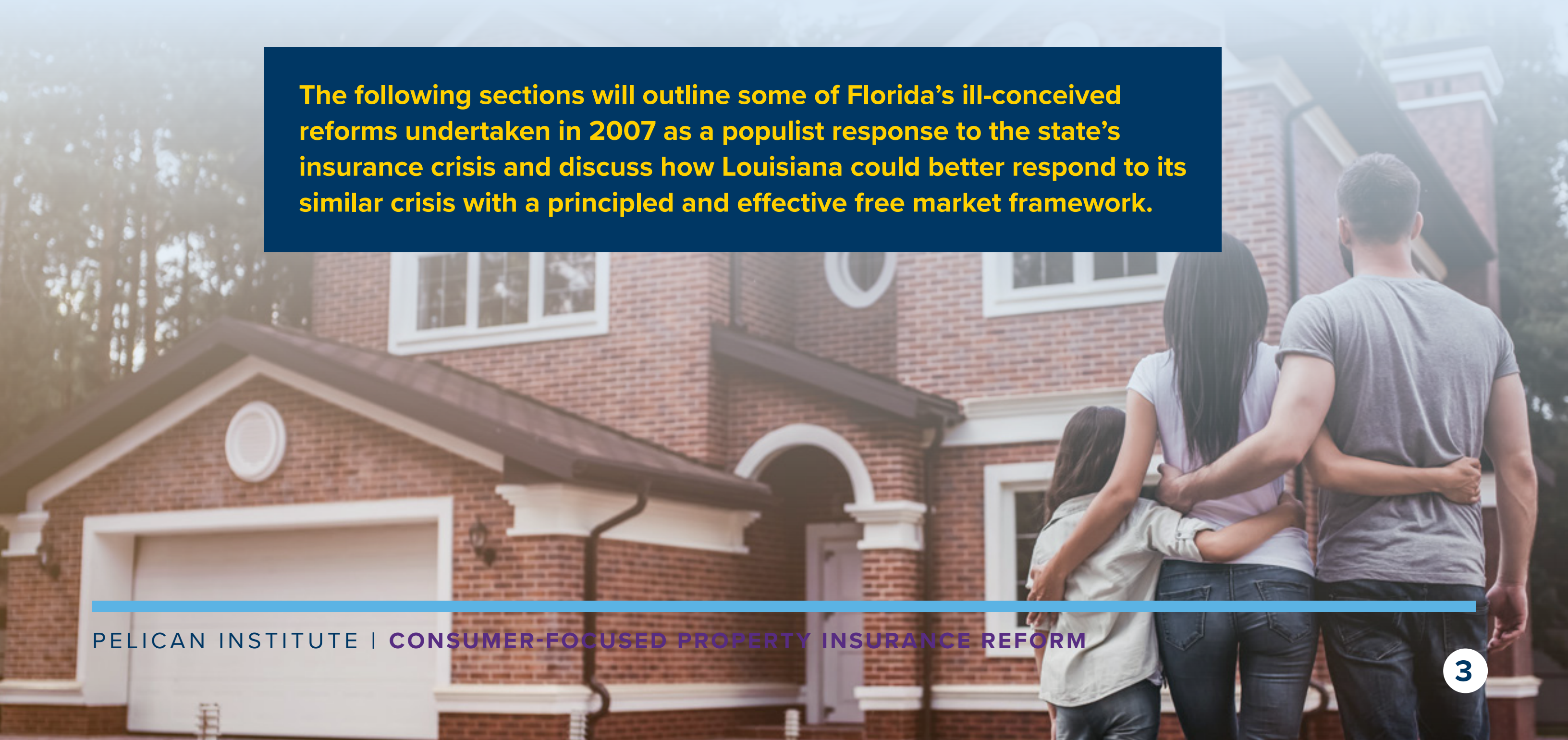
Much like Louisiana prior to Hurricane Katrina, most Floridians relied on national carriers for their property insurance coverage through 1992.[5] Following Hurricane Andrew's devastating landfall that year, a number of insurers went insolvent, and national carriers either dramatically scaled back their exposure or withdrew from the Florida insurance market entirely. This forced Florida lawmakers to hold three special sessions to address the insurance crisis in 1992 and 1993,[6] during which several reforms were enacted to provide relief to homeowners legitimately unable to find coverage. These reforms included:

- the creation and expansion of state-run insurers of last resort,[7] which eventually merged into Florida Citizens Property Insurance Corporation (Florida Citizens)[8]
- limits on insurers' ability to non-renew policies or exit the market[9]
- the formation of the Florida Hurricane Catastrophe Fund (Cat Fund),[10] a tax-exempt trust fund administered by the state to provide primary insurance carriers with reinsurance coverage at discounted rates to pass those savings on to their policyholders. Reinsurance is essentially insurance for insurance companies—coverage kicks in after losses from a largescale event exceed a pre-negotiated retention, similar to a deductible.

Florida Citizens and the Cat Fund still comprise the two government-run legs of the state's three-legged property insurance market stool, with private carriers being the third.

By the end of the 1990s, Florida's property insurance market had largely recovered from the losses and market effects of Hurricane Andrew, and much like Louisiana post-Katrina, the void left by national carriers was largely filled by new local and regional carriers, as well as Florida Citizens. However, this relative market stability would come to an end in the aftermath of the particularly vicious 2004 and 2005 hurricane seasons, when seven hurricanes and multiple tropical storms made landfall in Florida. Four of those hurricanes—Charley, Francis, Ivan, and Jeanne—came in quick succession, battering the state along its eastern, western, and panhandle shores within only six weeks in 2004.[11] By 2006, affordable insurance coverage was difficult to obtain, especially in Southern Florida, where rates nearly doubled.

Today, Louisiana is roughly where Florida was after its catastrophic 2004 and 2005 hurricane seasons.



The following sections will outline some of Florida's ill-conceived reforms undertaken in 2007 as a populist response to the state's insurance crisis and discuss how Louisiana could better respond to its similar crisis with a principled and effective free market framework.

FLORIDA'S SOCIALIZED INSURANCE SYSTEM

While campaigning for governor in 2006, then-candidate Charlie Crist repeatedly called for property insurance reforms and promised to reduce rates and punish the insurers perceived to be fleecing Florida homeowners. Almost immediately after taking office in January 2007, he made good on his promises. The result was a set of transformational property insurance changes that leveraged the state's insurance instrumentalities (i.e., Florida Citizens and the Cat Fund) to artificially suppress rates and create what was essentially phantom coverage, all of which repelled private insurers and their much-needed capital.

FROM INSURER OF LAST RESORT TO UNFAIR COMPETITOR

Created as an insurer of last resort, Florida Citizens originally required its customers to have received at least three denials by insurers to be eligible for coverage, and to pay rates intentionally above those of private carriers. After the 2007 reforms, Florida Citizens was required to cover any applicant who received even one insurance quote more than 15 percent above its rates. What's more, lawmakers arbitrarily and artificially reduced Florida Citizens' rates and froze them for two years, notwithstanding any actuarial considerations.[12]

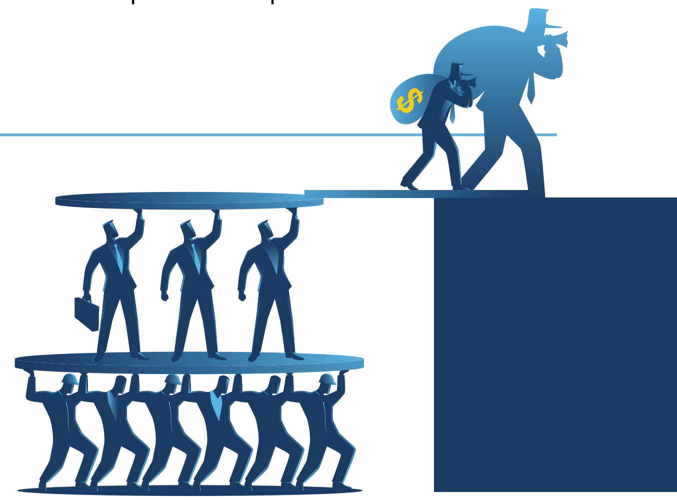
These changes essentially imposed a de facto price control on private property insurers, who are legally and universally required remain actuarially sound to ensure they can make good on their promises. Florida Citizens, on the other hand, was no longer required to be actuarially sound; in fact, these changes made being actuarially sound virtually impossible. But unlike its newfound competitors in the private market, Florida Citizens has the unilateral authority to impose long-term assessments (taxes) not just on its own policyholders, but virtually every property and casualty insurance policy in the state, from homeowners and auto policies to boaters and commercial policies, sufficient that "the entire deficit shall be recovered" should it ever find itself without sufficient reserves to pay claims.[13] Private carriers do not have the luxury of such post-event funding mechanisms to cover risk; as such, those without the ability to pay their claims would go insolvent and out of business.

This framework artificially reduces rates well beyond actuarial bounds, imposes price controls on competitors, and foists liabilities on those that derive no direct or indirect benefit from this anti-competitive behavior. It would be illegal in the private sector.

PUNISHING PRIVATE CARRIERS

As if the changes to Florida Citizens were not enough to discourage private carriers and their capital, lawmakers explicitly decided to do just that by enacting an anti-cherry picking provision. This required all carriers selling auto insurance in Florida to also write homeowners insurance if they offered it in any other state.[14] Additionally, lawmakers imposed a de facto tax on what they deemed "excess profits" on private insurers.[15]

THE CAT FUND PONZI



Despite Florida Citizens' high-profile role as the state's largest insurer and its household name recognition, the Cat Fund serves an even more important role in the state's property insurance system. Prior to the 2007 reforms, the Cat Fund was a relatively small agency buried within the State Board of Administration that sold lower levels of hurricane reinsurance coverage to smaller companies and Florida Citizens; larger, nationally-recognized companies would generally leverage their purchasing power and historical claims handling experience to get better reinsurance rates in the private global market. Since the 2007 reforms, however, the Cat Fund was expanded both in terms of the amount of reinsurance coverage it could sell and the number of insurers it would sell its coverage to, as every insurance carrier in the state was now mandated to purchase a minimum level of coverage from it.[16]

Before 2007, the Cat Fund could sell no more than $16 billion in coverage, but the reforms dramatically increased the fund's coverage capacity to over $27 billion—despite having only $2.08 billion in reserves at the end of 2007.[17] Additionally, lawmakers repealed the fund's "rapid cash buildup" factor (essentially a surcharge on the premiums insurers paid to the fund to more quickly replenish its reserves after a loss).

The fund is designed to be self-supporting and funded with premiums paid to it by property insurers and investment income. It also has the discretion to obtain pre-event financing paid for out of its reserves. However, should losses exceed the fund's reserves and reimbursements from any pre-event notes, the Cat Fund has the authority to issue debt by selling bonds in the capital market that are repaid through assessments on insurance policies statewide. Indeed, days after Governor Crist signed those reforms into law, Fitch downgraded the Cat Fund due to the "potential size of a future borrowing needed to pay claims after a catastrophic hurricane," and the "additional pressure on the state to increase the FHCF's bonding capacity or craft another solution to maintain the availability of affordable hurricane insurance within the state."[18]

But massive debt is not the worst of it. Florida faced a worst-case scenario in 2012 when the Cat Fund faced a potential shortfall due to an inability to issue enough debt. As Eli Lehrer of the R Street Institute noted,

> [T]he threats posed by the Cat Fund go beyond potentially large assessments. According to its own managers, the Cat Fund may not be able to issue enough bond debt to cover its obligations in the wake of a major storm season. Cat Fund officials have stated publicly that the fund likely would have fallen roughly $1.5 billion short had a sufficiently bad hurricane season required it to pay out its full statutory coverage limit of $17 billion in 2012. Simply put, Florida law required the Cat Fund to sell more reinsurance coverage than it could pay for.

It should be noted that the $1.5 billion shortfall estimate is inherently optimistic, as it did not take into account that a devastating hurricane season would have likely provoked both Citizens and the Florida Insurance Guaranty Association[19] to tap the same markets for post-event financing to cover their losses. Florida's chief insurance regulator noted that if the Cat Fund had experienced a shortfall of just 25 percent in 2012, nearly half of the state's property insurers might have faced insolvency.[20] This would have come in the aftermath of a catastrophic situation where thousands of displaced Florida residents and the businesses that employ them would be depending on them to recover. Allowing property insurers to purchase reinsurance on the open market would have mitigated this risk.

Simply put, Florida socialized a great portion of its property insurance system—from a primary insurer perspective via Florida Citizens to reinsurance through the over-extension of the Cat Fund—and mistreated private capital for good measure. Luckily, Florida's ponzi-like insurance scheme of selling more coverage than it could pay for to artificially lower rates mostly worked, but for *only* one reason: luck. Despite jutting 500 miles into the warmest, most hurricane-prone tropical waters in the world, the state enjoyed an unprecedented cyclone drought. No hurricane struck Florida in the decade between 2006 and 2015.

Within a few years of their ill-conceived reforms, Florida legislators began to grow concerned about the massive liabilities that could very well bankrupt the state should a major hurricane strike. With the election of a new governor and legislative leadership in 2010, lawmakers began to walk back those reforms. They have since taken meaningful steps to reduce the size of the Cat Fund, attract outside capital, and depopulate Florida Citizens. But had a major hurricane or series of storms struck Florida at the peak of its over-exposure, it may have well plunged the state into an unprecedented crisis requiring a federal bailout.

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LOUISIANA'S PATH FORWARD

Louisiana finds itself in an insurance crisis after its vicious 2020 and 2021 hurricane seasons, just like Florida after 2004 and 2005. Louisiana also faces a litigation crisis stemming not only from its recent hurricanes, but also from its insurance regulatory system, tort laws, and other manmade factors. Louisiana lawmakers are poised to tackle these issues during the 2024 Regular Legislative Session.

Any solutions that Louisiana embarks on will come with costs. Ultimately, Louisiana residents will bear the cost of insuring their properties, whether that happens now, through higher insurance premiums; or later, when an even higher bill arrives to cover the cost of cheaper, subsidized insurance today. As lawmakers and regulators deliberate, there are four principles they should keep in mind to avoid the costly and existential risks Florida foisted on itself and its taxpayers, which took years to undo.

PRICE SHOULD REFLECT RISK

Prices always convey a message. Usually, when something costs more, it is in shorter supply, and/or in higher demand. When it comes to insurance, price has more—though not everything—to do with risk than with supply or demand. The risk may be based on natural factors such as a location's propensity for storms, flooding, or earthquakes; policyholder behavior such as claim history and credit worthiness; macroeconomic considerations such as inflation and increased costs of construction materials; and social inflation factors, such as fraud and litigation, that increase the frequency and severity of claims. Supply and demand usually play a role when there are limits on insurance capacity due to a hardened global reinsurance market or problems plaguing a particular primary insurance market.

A major benefit to risk-based pricing is that it can become a powerful regulator of human behavior. Developers seeking to build on high-risk storm- and flood-prone barrier islands may think twice if they know that their eventual buyers will not be able to procure insurance coverage at viable rates. Such risk-based pricing would encourage them to build resiliently as to attract coverage at more reasonable prices. Likewise, in a risk-based

pricing environment, policyholders can mitigate their exposure to inherent risks in exchange for lower premiums. In Florida, insurers are required to grant discounts for hurricane mitigation, including the installation of shutters, metal roofs, straps, and other such measures,[21] but many insurers in other states already do so because it is in their financial interest. Indeed, according to the Congressional Budget Office, every dollar invested in disaster mitigation yields at least three in future insurance loss savings,[22] which eventually translates into lower rates.

Conversely, subsidized insurance undermines the organic incentive to engage in responsible conduct ahead of eventual catastrophic events. It does not incentivize precautions by individual policyholders or discourage developers from building in high-risk coastal areas—they know that a Louisiana or Florida Citizens will always be there to cover their buyers at affordable rates. In short, subsidized insurance—be it a state-run insurer or any other government program designed to suppress the true price of insurance using taxpayer funds—distorts the actual cost of living in regions at high risk of severe weather. It is a perverse incentive that allows individuals to take on excessive risk, oftentimes unbeknownst to them, and to then transfer the eventual cost onto others.

Hence, it foists enormous liabilities on taxpayers, especially those who live in low-risk areas and derive little to no benefit from subsidized rates. It is a regressive cross-subsidy that mostly benefits the affluent (who generally live closer to the coast) to the detriment of those of lesser means who live in generally less desirable, but lower risk areas further inland.

Finally, subsidized insurance also concentrates risk and repels private capital. Hurricane alley states like Florida and Louisiana are best served when they are able to export their enormous hurricane risk beyond their borders through reinsurance. Reinsurers can diversify their risk portfolio by, for example, paying billions of dollars in claims for hurricane losses in Louisiana, while collecting generous premiums to cover earthquakes in New Zealand, tsunamis in Japan, and wildfires in California, since it is highly unlikely that these would all happen simultaneously.

When disaster strikes, this allows for the infusion of billions in outside capital and a quick economic recovery following a natural catastrophe, rather than long-term economic malaise due to massive post-event debt and financing that takes years to repay, during which time Mother Nature can batter the state again (and again). Subsidizing rates discourages potential investors from deploying their capital into the state because they are unable to compete against the state's subsidized insurance instrumentalities. This also affects the cost of risk transfer products, as reinsurers generally analyze a primary insurer's risk exposure, which risk-based rates reduce by incentivizing policyholders to take precautions, as discussed earlier.

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Louisiana lawmakers should therefore resist the impulse to expand insurance subsidies or otherwise artificially suppress rates (for example, by imposing rate caps on Louisiana Citizens) and instead focus on ways that the state can help low-income residents reduce their risk exposure. One solution would be to scale back or eliminate the Insurer Incentive Program created last year, which directs taxpayer funds to private carriers in exchange for them to write more policies in the state.[23] Although a well-intentioned and likely necessary stop gap measure to stabilize the market at the time, paying insurance companies out of general revenue to write policies is an unsustainable corporate welfare model. It also creates uncertainty, since it depends on annual legislative appropriations that may or may not materialize. If lawmakers preserve the program, they should enact a sunset provision of no more than five years and create a recurring funding source, such as a small home closing surcharge or insurance policy renewal fee, to sustain it in the interim. This will create a level of predictability for the program, which potential entrants into the market will look upon favorably.

The most meaningful and long-lasting way to lower the cost of insurance using taxpayer funds would be to fortify the state's built environment. As such, lawmakers should redirect funds from the Insurance Incentive Program to expand eligibility for the Louisiana Fortify Homes Program. Created in 2022, it provides inspections and grants residents up to $10,000 to upgrade their roofs to better withstand hurricanes.[24] These are a far better and tangible use of taxpayer resources that will reduce actual losses, lower insurance premiums, and even create jobs.

Lawmakers can also harness the incentivizing power of the market to promote more resilient building along the state's highest risk coastal areas by limiting where Louisiana Citizens will offer coverage. In 2013, the Florida Legislature restricted25 Florida Citizens from writing policies covering structures built after 2015 if they lie directly on most beaches or in any federally designated wetlands (existing structures were grandfathered for coverage eligibility). This has served a dual purpose:

1. Prospectively reducing the growth of Florida Citizens' risk exposure by prohibiting it from covering the newest, most expensive structures in the state's most storm- and flood-prone areas; and
2. Keeping this enormous risk in the appropriately-priced private market, thereby encouraging any new development in these high-risk areas to be built stronger and more resiliently in order to obtain the most affordable coverage possible.

Louisiana lawmakers should consider a similar restriction, which would limit the growth of Louisiana Citizens in areas at highest risk of natural disasters and serve as a disincentive to over-develop and concentrate more wealth and people in the state's riskiest zones. It would have positive environmental impacts and incentivize insurers that specialize in coastal properties to enter the state.

TACKLE SOCIAL INFLATION

Social inflation is a relatively new term that is widely used in the insurance industry. Generally, it refers to manmade factors that artificially and unnecessarily inflate insurance losses beyond the modeled inherent risks and macroeconomic realities, including inflation itself. A more specific definition in a property and casualty insurance context would be the fraud, claims practices, frivolous litigation, and unpredictable political or regulatory environment in a given market that drive up the frequency and severity of insurance claims.

Although the recent catastrophic hurricanes are the main cause of Louisiana's current insurance crisis, the state has been plagued by excessive litigation in recent years, which has arguably amplified insurance losses from the storms. The primary culprit appears to be the state's onerous laws governing bad faith.

Currently, insurers who fail to pay a claim or make a written offer to settle within a 30-day window may be found to be acting in bad faith and face penalties of up to 50 percent of the amount due.[26] This provision was designed to protect ordinary consumers and to punish insurers who legitimately and willfully engage in bad behavior.

Unfortunately, unscrupulous attorneys oftentimes will engage in schemes intended to set up an insurer into a condition of bad faith on a technicality to trigger the payment of exorbitant fees and other penalties. This contributes not only to massive payouts above policy limits, but also creates a perverse incentive for insurers to settle for amounts greater than they otherwise would have to avoid costly litigation. All this eventually results in higher rates.

Until recently, Florida was experiencing a similar exploitation of its bad faith rules. In December 2022, it created a new requirement: before a claimant can sue for bad faith, a court must issue a ruling that their insurer has indeed breached their contract.[27] Such a requirement helps to filter out frivolous lawsuits while preserving the spirit of the bad faith law. Mere disagreements on prices when both sides have consistently acted in good faith should not incur massive payouts for lawyers. Instead, any differences can and should be resolved through appraisal processes and other conflict resolution methods. Louisiana should approach its bad faith dilemma similarly.

AVOID UNCERTAINTY; RESTORE PREDICTABILITY

When it comes to insurance, risk can be quantified, measured, modeled, and appropriately priced. There is no way to model political and regulatory uncertainty, however, nor is there a greater repellent to capital investment. Such was the case after Florida's ill-conceived 2007 reforms that shifted the state's focus away from restoring the market and toward rate reductions at any cost. Their actions were not just anti-competitive or punitive against private property insurers, they were largely knee-jerk reactions to appease intense anti-insurance industry public sentiment. Indeed, Governor Charlie Crist famously said "good riddance" when State Farm announced its intention to withdraw from the state entirely.[28] Ultimately, most of the state's larger, capitalized insurers withdrew. A mass migration of policies into state-run Florida Citizens followed, along with enormous unfunded liabilities that very well may have bankrupted the state had a hurricane struck.

Today Louisiana finds itself in a similar predicament, albeit a less dire one than Florida after 2007. In an effort to both stabilize the market and address consumers' grievances following the destructive 2020 and 2021 hurricane seasons, lawmakers imposed mandates and burdensome claims-related requirements on insurers,[29] as well as expanded government subsidies in the insurance market. Although private carriers have taken advantage of the Insurance Incentive Program subsidies, lawmakers must decide whether paying insurers to enter the state is really a long-term solution.

One way to inject predictability into the market and attract much-needed investment and outside capital is to create a level of measurability to transferring Louisiana Citizens policies to the private market. Florida recently eliminated the ability of policyholders to opt-out of a Florida Citizens depopulation agreement, and Louisiana should consider doing so as well. This important change would allow private insurers looking to expand into the Louisiana market to quantify how many policies they could realistically assume from Louisiana Citizens. Additionally, lawmakers should consider allowing Louisiana Citizens to enter into depopulation agreements year-round, rather than only during pre-determined windows (or "rounds").

"Any other reforms lawmakers might consider, especially those meant to be temporary stop gap measures, should be done methodically with clearly defined timeframes, sunsets, or automatic circuit breakers that trigger phase-downs (or ramp-ups) based on objective variables so they are not contingent on inherently unpredictable future legislative action.

Finally, in whatever steps lawmakers take next, they should aim to create predictability rather than increase uncertainty. Any other reforms lawmakers might consider, especially those meant to be temporary stop gap measures, should be done methodically with clearly defined timeframes, sunsets, or automatic circuit breakers that trigger phase-downs (or ramp-ups) based on objective variables so they are not contingent on inherently unpredictable future legislative action. It took Florida more than a decade and countless legislative fights to undo many of the impulsive stop-gap measures enacted in 2007; Louisiana should not make the same mistake.

ENSURE REGULATORY RELIABILITY

According to the Insurance Information Institute, Louisiana's current insurance troubles have much to do with insurers being undercapitalized and not having enough reinsurance coverage to withstand the losses incurred during the 2020 and 2021 hurricane seasons.[30] These shortfalls have led to the current crisis and some of the recent ill-conceived legislative responses to it. Indeed, although the three principles above are fundamental to a healthy property insurance market, they matter little if the government fails to ensure that the insurance products being sold under its watch can fulfill their promises and obligations.

Lawmakers and the newly elected insurance commissioner must reevaluate the Louisiana Department of Insurance's practices as they relate to regulating, analyzing, and determining the financial health of insurers. Additionally, given the increasing cost of construction materials, the state's previously discussed increasing social inflation, and other loss factors that may not have been as prevalent when current financial requirements were codified, lawmakers should reexamine the state's surplus and reinsurance coverage requirements for admitted carriers. One insurer insolvency is usually a sign of internal mismanagement; mass insolvencies are almost always a failure of regulation.

In its reevaluation, lawmakers and the Department should take steps to modernize its approach to regulating new or innovative insurance products and services. One way is through a regulatory 'sandbox,' which allows companies to develop and test new products or services in the market by temporarily exempting them from certain regulations or restrictions. Generally, the process involves a company applying for an innovation waiver, which the insurance regulator grants on a case-by-case basis if certain conditions are met. These waivers would be permitted within a certain area, cohort, or timeframe. A politically diverse handful of states, including Vermont,[31] Kentucky,[32] and Utah[33] have recently created an insurance sandbox in some form or other. It not only gets government out of the way of insurers deploying and testing potentially transformative innovations, but it also gives regulators time to analyze these innovations in practice and promulgate better informed, commonsense regulations, if necessary. Such regulatory flexibility would also attract new companies to enter Louisiana and potentially make the state a hub for insurance market innovation.

CONCLUSION

Louisiana is likely to pass insurance reforms this year to stabilize its insurance market. Will lawmakers and regulators restore predictability to the market by tackling the underlying regulatory deficiencies and legal loopholes that triggered the current crisis, or will they follow the ill-conceived, politically expedient Florida model that imposed artificial price caps, punitive measures, subsidies, and enormous liabilities?

Throughout the deliberations of the 2024 Regular Legislative Session, lawmakers should act with the following four principles in mind:

1. Enable risk-based pricing and focus on ways that the state can help low-income residents reduce their risk exposure.
2. Tackle manmade factors that artificially and unnecessarily inflate insurance losses beyond inherent risks, inflation, and other realities. This includes fraud, claims practices, frivolous litigation, and an unpredictable political or regulatory environment that drives up the frequency and severity of insurance claims.
3. Restore predictability to the insurance market, ensuring that any temporary stop gap measures are done methodically with clearly defined timeframes, sunsets, or automatic adjustments based on objective variables.
4. Ensure regulatory reliability and ensure that insurance products being sold can fulfill promises and obligations. This will necessitate evaluating the Louisiana Department of Insurance's practices to regulate, analyze, and determine the financial health of insurers; reexamining the state's surplus and reinsurance coverage requirements for admitted carriers; and modernizing the state's approach to regulating new or innovative insurance products and services.

Louisiana must ensure its residents are adequately covered for a reasonable price rather than taking the Florida route—an easy road now that goes over a cliff at some point in the future.

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