



“Market Implications of Public Policy Intervention: The Case of Florida’s Property Insurance Market”

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Introduction

Insurance and regulation have always been intertwined with regulators weighing the interests of insurers, consumers and claimants in their efforts to maintain a robust market. One important question not completely explored is whether regulation hurts or helps the insurance market? Regulations, implemented to protect the insured, often have unintended or opposite effects, as is the case in Florida. Florida’s legislative and regulatory policies made in response to past catastrophic losses and the increased likelihood of future natural catastrophes have had a direct and undesirable effect on the homeowners’ insurance market.¹ In Medders et al., the authors give proof of market failures in Florida, such as “suppressed property insurance prices, cost shifting from one policyholder to another and from current to future policyholders and disincentives for homeowners to engage in mitigation activities.”² The authors describe the events, problems and policies that have taken place in the Florida property insurance market and have led to the recent failures, and make recommendations on how to improve the insurance market.

Review of the Literature

The authors give context to their study by exploring prior research on public policy responses to catastrophe insurance marketplace problems and the tie government intervention has to market performance. Past research has found an inverse relationship between both structural mitigation and insurance demand and the potential of government disaster relief, meaning that individuals are less likely to purchase insurance if there is an increased amount of disaster assistance available.³ Past literature on the supply-side conveys that solvency limitations constrain the available capacity of the marketplace.⁴ Within markets that are prone to catastrophes, such as Florida, a decrease in the price ceiling, or government controlled limit on how high a price is charged for insurance, tends to result in private insurers decreasing their market exposure, which then leads to market failures.⁵

As noted by the authors, there is an abundance of past literature that looked at the relationship between legislative and regulatory intervention and property insurance market performance. One study found that as an insurance issue becomes more complex and important, the amount of regulation also increases. Furthermore, the importance of and necessity for property insurance in Florida resulted in pressure on regulators to implement policies desired by the public, such as homeowners, developers and real estate agents, rather than those desired by the insurance industry.⁶

Many studies have researched the relationship between regulation and the insurance industry. One particular study, by Dumm et al, looked at the effect of the special legislative session in 2006 on

¹ See Medders, Nyce and Karl, 184.

² See Medders, Nyce and Karl, 209.

³ See Kaplow, L., 1991; Kelly, M., and A. E. Kleffner, 2003; Kunreuther, H., and M. Pauly, 2006.

⁴ See Stone, 1973; Herring and Vankudre, 1987; Grace, Klein, and Kleindorfer, 1999.

⁵ See Klein, R. W., and P. R. Kleindorfer, 2003.

⁶ See Meier, K. J., 1991.

insurance regulation caused by record high property insurance rates.⁷ The authors of the study found that as a result of this special legislative session, publicly-traded insurers that sold homeowners and commercial multiple peril business exposure in Florida experienced a decrease in stock price. Overall the conditions created by regulatory changes resulted in insurance prices below appropriate levels and created market conditions that induced reduced homeowners' loss-mitigation incentives.⁸

Findings on Negative Market Externalities

In Medders, the authors focus their study on the negative externalities facing the Florida property insurance market and how government intervention created or negatively affected these externalities. In the Florida homeowners insurance market the authors believe that there are three externalities that have been created or made worse by government intervention. Two pertain to subsidies in the risk financing system and the third is focused on property owners' underinvestment in mitigation.

In the Florida insurance market, subsidies have existed among homeowners of otherwise different risk who live within the same zip code because zip code based pricing gives all houses within the same zip code the presumption of the same risk for loss even though two houses in the same zip code may have different risks for loss due to, for example, construction quality. In 2007, government intervention made pre-loss subsidies by zip code worse: the new policies placed restrictions on residual insurance rates which resulted in below actuarially fair insurance rate for Citizens insurance which shifted the cost of large loss events to taxpayers. Furthermore, the policies made it almost impossible for private insurers to price their contracts competitively with Citizens.

A second defined negative externality offered by the authors is the cost shifting from current homeowners insurance policyholders to future policyholders and policyholders in other lines of business. In Florida, post-loss assessments levied by state sponsored insurance entities will finance a substantial portion of the catastrophic risk exposure, but legislation in 2010 reduced the amount of exposure that the Florida Hurricane Catastrophe Fund's, or FHCF's, covers. Furthermore, post-loss subsidies can also occur due to timing because new policyholders are required to pay for prior losses, yet they do not get the lower rates that they would have if assessed before the catastrophe. This is bad for the Florida economy which is dependant on net migration to the state because it will be too costly to become a new policyholder from these large assessments. People may elect to move out of state to avoid these assessments.

The third externality deals with policyholders not spending enough on mitigation. In Florida there has been an underinvestment in risk reduction efforts. Two mitigation policy changes, My Safe Florida Home and the Mitigation Discounts program, have exaggerated insurance discounts for existing mitigation features, which actually discouraged most homeowners from further mitigation efforts, rather than rewarding mitigation.⁹ It has been found that "insurance subsidies within the Florida property insurance market are correlated with statistically significant reductions in mitigation practices."¹⁰ The authors conclude that programs intended to encourage mitigation have actually discouraged investment in mitigation and reduced the ability for policyholders to reduce their risk.

⁷ See Dumm, R. E., A. P. Liebenberg, I. A. Liebenberg, and J. Ruhland, 2010.

⁸ See Medders, Nyce and Karl, 186-187

⁹ See Florida Catastrophic Storm Risk Management Center, 2010b, and Florida Commission on Hurricane Loss Projection Methodology, 2010.

¹⁰ See Carson, J. M., K. A. McCullough, and D. M. Pooser; Medders, Nyce and Karl, 208.

Findings on the Effects of Government Intervention

Typically, government intervention is utilized to lessen market problems, but in the case of Florida’s residential property insurance market, the legislation and regulations focusing on reducing price has resulted in “increased solvency constraints and negative first-order effects on private industry capacity.”¹¹ Another effect of the legislation and regulation changes in Florida is uncertainty for private insurers and an increase in the cost of doing business. In particular, the passing of House Bill 1A and the implementation of the Windstorm Mitigation Discount program have been the two main drivers of the previously discussed market failures.

The 2007 House Bill 1A, which decreased current rates, froze future rates and no longer required policyholders to first be rejected by the private insurance market before they are allowed to purchase Citizens policies. However, this bill was so detrimental to the Florida homeowner’s insurance market that it was followed by “glidepath” legislation in 2009, which slowly reversed the previous bill. Yet, the glidepath legislation placed a 10 percent per year limit on increasing premiums.

The Windstorm Mitigation Discount Program was implemented with the intention of promoting mitigation, such as building stronger homes that will incur less damage when hit by a catastrophe. However, this program ultimately resulted in unchanged premiums and premium reductions, instead of premium increases for those homeowners who do not invest in mitigation, because it required that the weakest structure be set as the base house for adjusting rates, rather than an average house which was what insurers typically used to calculate base rates. Thus, homes that were built better than the weakest base structure received a decrease in premiums without having to actually invest in mitigation to reduce the risk of loss. At the start this decreased credits by 50 percent and then in 2007 with the program in full effect some insurers were unable to adjust their base rate to reflect the weakest structure as the base house.

The legislative and regulatory changes had a significant effect on the property insurance rates. In 2006, rate levels rose 15 percent and then in 2007, homeowners’ insurance rates declined below year-end 2005 rates. Furthermore, the rate levels have remained below the 2005 level in nearly every region of the state. This volatility of the rate level, created by regulatory intervention, is important because rates are the main factor in determining financial profitability for insurers.¹² The premium-to-surplus ratio is another marker of the challenges facing the Florida market, as it has increased over the past decade.

Table 1: Premium-to-Surplus Ratio

Time Period	Ratio	Explanation
1985	Nearly all ≤ 1.0	Prior to Hurricane Andrew
1994	Most at or below 1.0, only a few potentially overextending their capital	Two years post Hurricane Andrew
2003	22 insurers above 1.0, three companies between 6.0 and 7.0	Abrupt change due to either the formation of Florida pups and/or entrance of domestic insurers
2010	32 insurers above 1.0, two above 7.0	2004-2005 storm season depleted PHS, regulatory-legislative interventions increased pricing pressures on insurers (no major storms since 2005)

¹¹ See Medders, Nyce and Karl, 199.

¹² See Medders, Nyce and Karl, 201.

Formed from the data displayed in Panels A through D on pages 203 and 204, Table 1 below displays the change in the premium-to-surplus ratio. It is important to note that after 2005 there were no more notable storms that would have further led to a decrease in surplus and increase in the premiums-to-surplus ratio.

Conclusions

While the authors note that Florida is ahead of other states in forming a financial market for catastrophes and modeling catastrophe risk, government policies have led to market failures. These market failures can be seen in the cost shifting between policyholders, suppressed property insurance prices and a lack of incentives to invest in mitigation. The regulatory and legislative changes in 2006 and 2007 which called for lower insurance rates and mitigation credits ultimately resulted in healthy insurers moving out of the Florida property insurance market.¹³ The authors recommend “a return to risk based pricing and incentives for appropriate property mitigation,” for these two conditions are vital to a healthy property insurance market.¹⁴

¹³ See Medders, Nyce and Karl, 209.

¹⁴ See Medders, Nyce and Karl, 183.

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