Insurance Information Institute

RESIDUAL MARKET PROPERTY PLANS

From Markets of Last Resort to Markets of First Choice

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I. The Changing Residual Property Market

At the start of the 2009 Atlantic hurricane season finances of a number of residual market property plans in hurricane-exposed states were again under duress. The 2008 hurricane season with the double-hit in Texas of Hurricanes Dolly and Ike exposed the vulnerability of that state's beach and windstorm plan. Meanwhile the credit crunch and prolonged economic downturn had exacerbated the already volatile financial conditions in certain plans by making it difficult for states to borrow funds. Subsequently, state-run insurers had been increasingly at risk due to their reliance on volatile bond markets to issue debt to pay for hurricane losses. Ill-advised legislative steps over the course of several years had also expanded the exposure base of a number of plans yet at the same time curbed the rates they can charge. Such moves put state finances under threat and leave taxpayers facing the potential for increased assessments in the years to come. In 2009, legislation passed in several key states has started to address some of the problems facing certain plans, while credit markets and bonding capacity have begun to improve. At the same time, there has been a noticeable reduction in the number of policies and exposure in some parts of the residual property market during the last two years.

1. Overview

A myriad of different programs in place across the United States provide insurance to high risk policyholders who may have difficulty obtaining coverage from the standard market. So called residual, shared or involuntary market programs make basic insurance coverage more readily available.

Today, property insurance from the residual market is provided by Fair Access to Insurance Requirements (FAIR) Plans, Beach and Windstorm Plans, and two state-run insurance companies in Florida and Louisiana: Florida Citizens Property Insurance Company (CPIC) and Louisiana Citizens Property Insurance Corporation (Louisiana Citizens). Established in the late 1960s to ensure the continued provision of insurance in urban areas, FAIR Plans often provide property insurance in both urban and coastal areas, while Beach and Windstorm Plans cover predominantly wind-only risks in designated coastal areas. Hybrid plans like Florida and Louisiana's CPIC, provide property insurance throughout those states. It is important to note that in addition to windstorm risk, these plans routinely cover a range of other exposures, such as vandalism and fire. In addition to these residual property plans, a number of federal legislative proposals regarding the financing of natural catastrophes are under consideration. A detailed analysis is beyond the scope of this paper, but a summary of the various proposals is available in Appendix 1.

In the course of the last four decades these FAIR and Beach Plans have experienced explosive growth both in terms of policy count and exposure value. Further, in the 19-year period from 1990 to 2008—a period characterized by major catastrophes such as Hurricane Andrew and Hurricane Katrina—that growth has accelerated. Total policies in force (both habitational and commercial) in the nation's FAIR and Beach and Windstorm Plans combined practically tripled from 931,550 in 1990 to 2.6 million in 2008. Total exposure to loss in the plans surged from $54.7 billion in 1990 to $696.4 billion in 2008—an increase of 1,173 percent (Fig. 1 and 2).

U.S. Residual Market Exposure to Loss (Billions of Dollars)

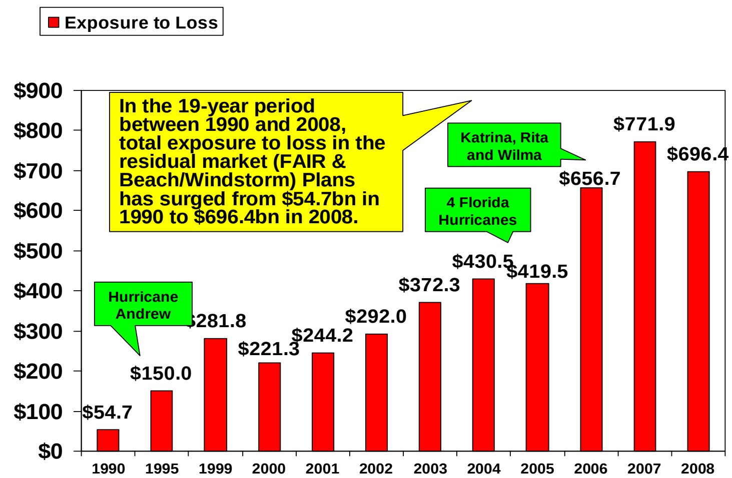


Fig. 1

Source: PIPSO; Insurance Information Institute

U.S. Residual Market: Total Policies In-Force (1990-2008) ($ 000)

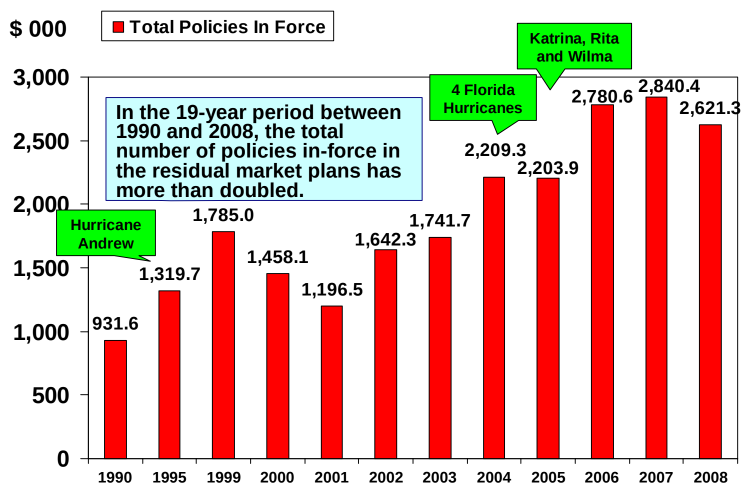


Fig. 2

Source: PIPSO; Insurance Information Institute

The nation's FAIR plans account for by far the majority of policies and exposure in the overall residual property market. For example, total policies in force (both habitational and commercial) in the FAIR Plans tripled from 781,188 in 1990 to 2.3 million in 2008 (Fig. 3).

U.S. FAIR Plans: Total Policies In-Force (1990-2008) ($ 000)

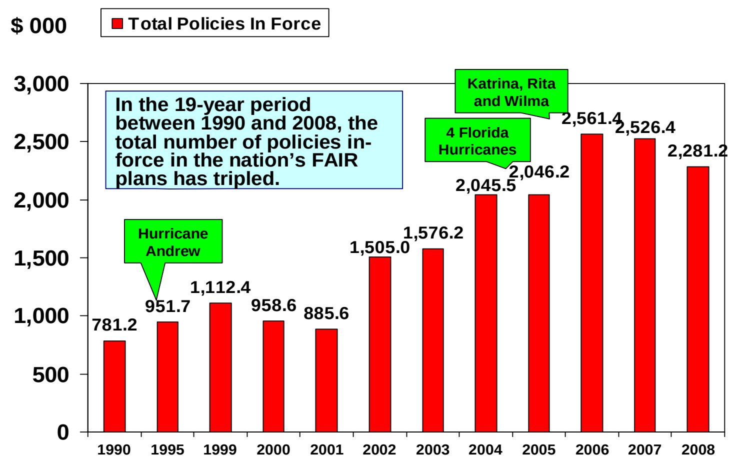


Fig. 3

Source: PIPSO; Insurance Information Institute

During the same 19-year period, total exposure to loss in the FAIR Plans also surged more than 15-fold from $40.2 billion in 1990 to $612.7 billion in 2008 (Fig. 4). Similarly, total exposure to loss in the Beach and Windstorm Plans surged by 477 percent from $14.5 billion in 1990 to $83.7 billion in 2008 (Fig. 6).

U.S. FAIR Plans Exposure to Loss (Billions of Dollars)

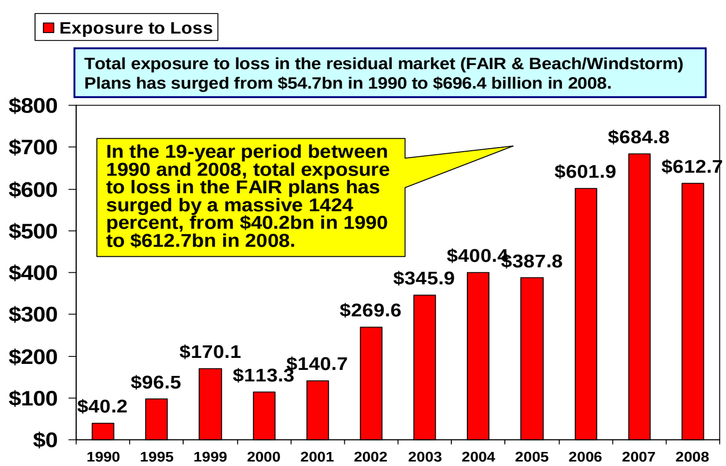


Fig. 4

Source: PIPSO; Insurance Information Institute

While a number of factors have contributed to the overall growth of the plans in the course of the last 20 years, it is clear that in some states such plans have shifted away from their original purpose as predominantly urban property insurers. As a result, many have evolved from their traditional role as markets of last resort into much larger insurance providers, in some cases even becoming the largest property insurer in a state.

After the record hurricane seasons of 2004 and 2005 and amid predictions of increased storm activity over the next 15 to 20 years, this shift of high risk exposure away from the private insurance market is placing an enormous burden on these plans. Arguably many of the plans have become home for the most highly exposed, wind-only risks—in other words the least attractive types of business. In some cases, this has left plans with huge concentrations of risk. Consequently, it is not surprising that many of the plans experience severe financial difficulties in certain years (see section on financial results).

In 2008, the latest year for which complete data is available, the FAIR Plans reported a slim aggregate operating gain of $532.7 million, a decline of 71 percent from the $1.9 billion operating gain reported in 2007 and an 85 percent decline from the $3.6 billion operating gain reported in 2006. The three consecutive years of gains followed successive operating losses of $1.9 billion in 2005 and $1.5 billion in 2004 (Fig. 5). The turnaround in fortunes in 2007 and 2006 can be attributed to the less active hurricane seasons, after the record hurricane losses experienced in the two prior years (2005 and 2004).

Florida Citizens, by far the largest plan by policy count, reported an operating gain of $585.6 million in 2008, following gains of $1.7 billion in 2007 and $3.5 billion in 2006, and compared with an operating deficit of $2 billion in 2005. Amid the credit crunch and current sustained economic downturn Florida Citizen's financial situation became highly unstable due to a variety of factors. It is important to note that the figures for 2005-2007 exclude the results of Louisiana Citizens Property Insurance Corporation, a plan severely impacted by losses arising from Hurricane Katrina in 2005 and the third largest of all the FAIR/Beach plans by number of policies in 2004. In 2008, Louisiana Citizens reported an operating loss of $22.5 million.

Of the 31 FAIR plans for which data are available, 28 have incurred at least one operating deficit since 1999. Of the six Beach and Windstorm plans for which data are available, all have sustained at least one underwriting loss since 1999. In the decade from 1995 to 2005, the FAIR Plans saw a more than 30-fold ballooning of their aggregate operating loss. If Louisiana Citizens' reported 2005 operating deficit of $954 million is included, the FAIR Plans' 2005 deficit rises to a staggering $2.8 billion—a more than 50-fold increase in the aggregate deficit over the course of the decade.[1]

[1] *Citizens finishes report,* by Ted Griggs, Baton Rouge Advocate, April 11, 2008.

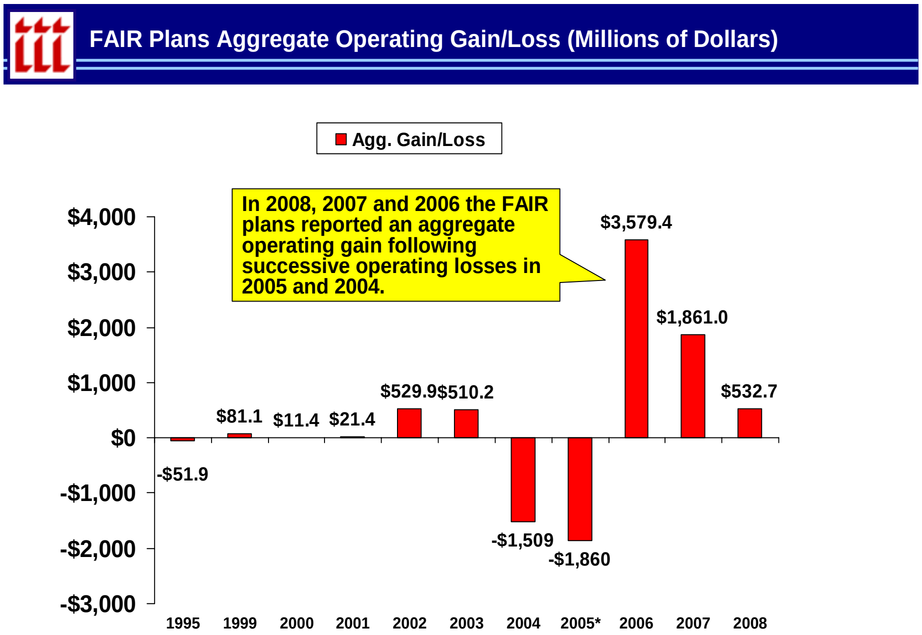


Fig. 5

Source: PIPSO; Insurance Information Institute

*** Est. deficit for 2005 does not include Louisiana FAIR Plan's est. deficit of $954 million that would push the Plans' 2005 aggregate operating deficit to approximately $2.8 billion.**

Such frequent volatility in the financial results of the plans raises key questions not just about heightened risk in coastal areas and coastal development, but about rate adequacy. The funding that underpins the plans is in many cases not adequate to offset the rising coastal exposures. Benign hurricane seasons such as 2006 and 2007, while welcome reprieves, do not provide a solution for this situation as experts predict that hurricane losses will only continue to grow in the long term. The large volume of insurance being provided under the plans also has serious implications for the private property insurance market and state fiscal policy.

2. Growth in Size and Population

The FAIR and Beach and Windstorm Plans have experienced explosive growth in the course of the last two decades. However, the number of policies in force and exposure to loss in each plan can rise or fall from one year to the next due to legislative and regulatory developments—in addition to actual catastrophic loss activity.

According to Property Insurance Plans Service Office (PIPSO), in 2008 the nation's FAIR plans had some 2.2 million habitational policies and 90,876 commercial policies in force for a total policy count of 2.3 million (Table 1). Between 2005 and 2008, the number of both residential and commercial policies in force increased by 11 percent. However, the total number of policies in force in the FAIR plans appears to have peaked in 2006 at 2.6 million and has since declined by 11 percent.

It is important to note that flat policy counts are not necessarily mirrored by a reduction in exposure to loss. Total exposure to loss in the residual market (FAIR and Beach/Windstorm plans) rose from $419.5 billion in 2005 to $696.4 billion in 2008 -- an increase of 66 percent -- and since 1990 exposure to loss in the plans has surged by 1,173 percent. Still, total exposure to loss in the FAIR plans appears to have peaked in 2007 at $684.8 billion and has since declined by 11 percent.

Florida Citizens, a plan that accounts for the vast majority (67 percent) of the total FAIR plans exposure to loss, saw its exposure more than double from $210.6 billion in 2005 to $485.1 billion in 2007, reflecting rising coastal property values and higher building and reconstruction costs. However, Florida Citizens' exposure to loss declined to $421.9 billion in 2008 and by June 30, 2009 to around $400 billion.

Florida Citizens also accounts for 61 percent of the total FAIR plans policy count. Of the 2.3 million total policies (habitational and commercial) insured by the FAIR Plans in 2008, some 1.4 million were in Florida Citizens. Latest data indicate that total policies in force in Florida Citizens dropped to 1.0 million at June 30, 2009. The decline in exposure and policies is likely due to increased takeout activity and a decline in new business written (see later section on Florida Citizens). Direct premiums written by Florida Citizens dropped to $2.8 billion in 2008 from $3.7 billion in 2007 – a nearly $1 billion decline.

After Florida, Massachusetts had the next largest number of policies, with 231,659 or 10.2 percent of total FAIR plan policies (Table 3). The Texas Beach and Windstorm plan (Texas Windstorm Insurance Association) insured 238,938 total policies in 2008, making it one of the largest Beach and Windstorm Plans.

Table 1

INSURANCE PROVIDED BY FAIR PLANS, 1997-2008 (1)

Year	Habitational policies	Commercial policies	Exposure (2) ($000)	Direct written premiums ($000)
1998	1,466,626	52,173	$169,994,265	$576,296
1999	1,068,525	44,893	140,281,262	415,749
2000	919,703	38,868	113,333,445	376,456
2001	912,829	36,748	143,459,479	438,241
2002	1,422,990	81,887	269,566,059	1,202,010
2003	1,510,665	65,532	345,909,146	1,770,353
2004	1,907,337	138,163	400,413,034	2,164,546
2005	1,928,292	117,942	387,780,124	2,234,493
2006	2,389,299	172,070	601,859,916	4,063,324
2007	2,412,252	114,053	684,829,667	4,431,381
2008	2,190,279	90,876	612,749,753	3,728,130

(1) Data from 2002 to 2008 include Florida's Citizens Property Insurance Corporation, which includes FAIR and Beach Plans; data after 2002 includes the Texas FAIR Plan; data for 2004 and 2005 include Louisiana's Citizens Property Insurance Corporation.
(2) Exposure is the estimate of the aggregate value of all insurance in force in all FAIR Plans in all lines (except liability, where applicable, and crime) for 12 months ending September through December.

Source: Property Insurance Plans Service Office (PIPSO).

In the Beach and Windstorm Plans, the policy count varies significantly from year to year due to the shifting size and nature of some of the Plans, described below. In 2002, Florida combined its Windstorm and Joint Underwriting Association to create Florida Citizens, so these policies were counted under the FAIR Plans from that date. Between 2006 and 2008, the number of policies in the Windstorm Plans grew by 40 percent from 219,269 in 2006 to 306,462 in 2008 as the Plans continued to experience burgeoning growth.

Total exposure to loss under the Beach and Windstorm Plans, as under the FAIR Plans, has ballooned by more than 450 percent from $14.5 billion in 1990 to $83.7 billion in 2008, demonstrating the rising values at stake (Fig. 6) (Table 2). However, total exposure to loss in the Beach and Windstorm plans appears to have peaked in 2007 at $87.1 billion and has since declined marginally by 4 percent.

Between 2006 and 2008, the Beach and Windstorm Plans reporting results to PIPSO have shown acceleration in exposure growth rates albeit at a slower pace compared to earlier periods. During this period, total exposure to loss in the Mississippi Beach Plan increased by 16 percent, in the Texas Beach Plan by 53 percent and in the South Carolina Beach Plan by 52 percent.

Table 2

INSURANCE PROVIDED BY BEACH AND WINDSTORM PLANS, 2008 (1)

State	Habitational policies	Commercial policies	Exposure (2) ($000)	Direct written premiums ($000)
Alabama	10,280	210	$1,820,725	$24,294
Mississippi	42,140	1,910	6,253,054	77,886
South Carolina	44,841	1,824	17,033,649	96,671
Texas	220,456	18,482	58,585,060	331,058
Total	**317,717**	**22,426**	**$83,692,488**	**$529,909**

(1) Does not include the Beach Plan of North Carolina; Florida and Louisiana Beach Plans merged with their FAIR Plans.
(2) Exposure is the estimate of the aggregate value of all insurance in force in each state's Beach and Windstorm Plan in all lines (except liability, where applicable, and crime) for 12 months ending September through December.

Source: Property Insurance Plans Service Office (PIPSO).

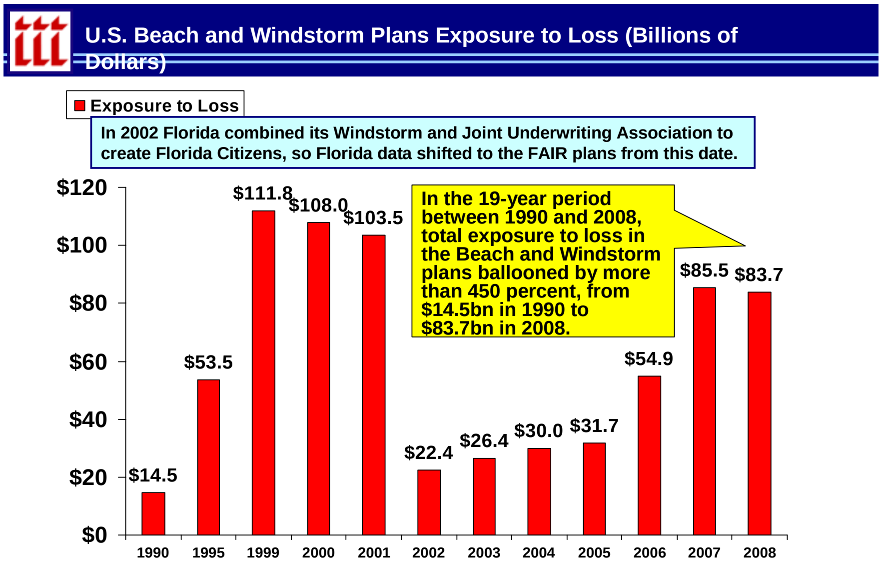


Fig. 6

Source: PIPSO; Insurance Information Institute

While certain coastal states have also shown particularly rapid growth in terms of policy count in recent years, data for 2008 and preliminary data for 2009 indicate that policy counts have flattened out in some states such as Florida and Louisiana, as depopulation plans take effect and as new construction slows due to a deteriorating economy and credit crunch. Under these plans state-run insurers can transfer policies back to private insurers, subject to regulatory approval.

For example, Florida Citizens' total policies in force amounted to just over 1.0 million at May 31, 2009, down 25 percent from 1.4 million at year-end 2008. In 2007 and 2008 some 632,971 Florida Citizens' policies with total exposure of $175.2 billion were removed from its books through the depopulation process. As of April 21, 2009, Florida Citizens reported that a further 64,395 policies with total exposure of $18.2 billion had been removed.

Louisiana Citizens was reported to have 165,000 policies in-force at June 1, 2008, prior to the removal of around 40 percent of its policies by private insurers. The depopulation of LA Citizens is the result of an incentive program created by the legislature in 2007 to increase the availability of property insurance and to decrease the business written through LA Citizens. In its 2008 annual report, LA Citizens said it completed two rounds of depopulation during 2008 with 40,000 policies and $8.4 billion of exposure transferred to private insurers.

Table 3

INSURANCE PROVIDED BY FAIR PLANS BY STATE, 2008 (1)

State	Habitational policies	Commercial policies	Exposure ($000)	Direct written premiums ($000)
California	159,380	9,582	$43,690,861	$69,522
Connecticut	3,817	208	710,897	4,231
Delaware	2,446	106	280,533	714
D.C.	635	150	175,326	681
Florida (CPIC) (2)	1,330,550	63,803	421,900,358	2,771,846
Georgia (3)	23,322	1,991	4,018,181	18,409
Illinois	6,900	148	538,250	5,258
Indiana	2,543	79	170,529	1,482
Iowa	919	46	63,294	594
Kansas	10,127	214	470,552	4,757
Kentucky	10,365	713	107,144	6,413
Louisiana (Citizens)	NA	NA	NA	279,970
Maryland	4,330	135	550,484	2,375
Massachusetts	230,890	769	81,538,212	305,546
Michigan	40,812	1,266	5,474,271	46,839
Minnesota	7,735	3	1,219,672	5,908
Mississippi	12,875	(4)	749,194	8,468
Missouri	6,500	369	331,146	2,712
New Jersey	30,548	1,074	3,822,631	14,688
New Mexico	11,255	351	620,657	3,509
New York (3)	57,542	5,776	13,706,101	34,588
Ohio	40,589	837	8,019,884	22,198
Oregon	3,314	139	243,299	1,271
Pennsylvania	29,732	2,031	1,808,558	10,121
Rhode Island	19,390	160	4,667,860	24,084
Texas	106,561	(4)	14,060,851	64,488
Virginia	33,206	724	3,757,927	15,426
Washington	52	38	18,888	153
West Virginia	910	100	34,193	582
Wisconsin	3,034	64	NA	1,317
Total	**2,190,279**	**90,876**	**$612,749,753**	**$3,728,130**

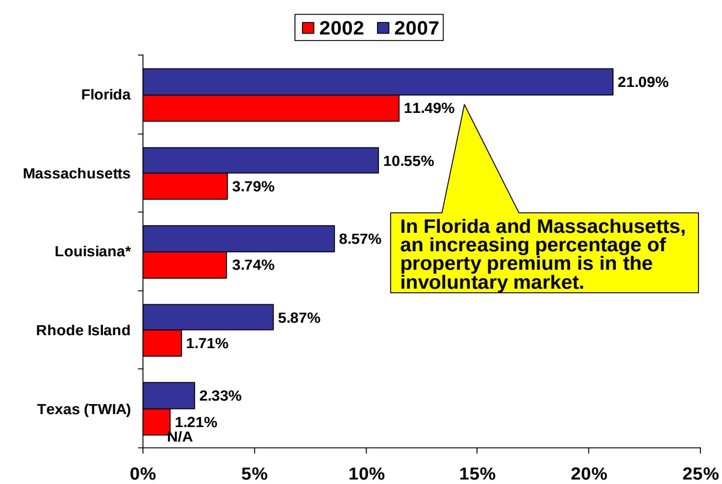
(1) Does not include the FAIR Plans of Arkansas, Hawaii and North Carolina.
(2) Citizens Property Insurance Corporation, which combined the FAIR and Beach Plans.
(3) Includes a wind and hail option for any dwelling including those in coastal communities.
(4) The Mississippi and Texas FAIR Plans do not offer a commercial policy.

NA=Data not available.
Source: Property Insurance Plans Service Office (PIPSO).

It should be noted that in terms of the percentage of premium in the residual market, there are few states where the involuntary market represents more than 1 percent of total property premium. However, for several states, a significant percentage of the property insurance market is in the involuntary market (Fig. 7).

Florida and Massachusetts are two notable examples. For example, in Massachusetts around 10.55 percent of property premium was in the involuntary market in 2007, while in Florida, 21.1 percent of the market was in the involuntary market in 2007. Louisiana is another state that has experienced rapid growth in its residual market, with 8.6 percent of property premium in the involuntary market in 2004 (the latest available data), compared with just 3.7 percent in 2002. Rhode Island's residual market also accounts for close to 6 percent of its property market.

FAIR/Beach Plan Earned Premium as Percentage of Overall Property Market (Top 5 states) 2002 vs. 2007*



* Louisiana figures are for 2004 vs. 2002

Fig. 7

Source: PIPSO

Reasons Behind Explosive Growth

There are a number of factors that have contributed to such rapid growth in the plans. One key factor is the changing shape and size of the various residual market mechanisms in a number of states. While in the past there was a clear delineation between coastal and urban plans with coastal properties insured under Beach and Windstorm Plans, and urban properties under FAIR Plans, increasingly these distinctions are blurring. FAIR Plans are acting as an insurer of last resort for residents who live in shoreline communities in states that do not have a Beach and Windstorm Plan, such as New York State. Beach and Windstorm Plans in some states are being merged with FAIR Plans or joint underwriting associations as in Florida and Louisiana, or are administering new FAIR Plans as in Texas. As a result, it is difficult to make a direct comparison of the number of properties insured under any plan with numbers from earlier years. What is clear, however, is that the rapid growth in the FAIR Plans is due in part to these mergers.

Another factor fueling the increase is the rise in coastal properties. A 2004 report by the National Oceanic and Atmospheric Administration (NOAA) found that in 2003, 53 percent of the nation's population—153 million people—lived in coastal counties (including those that abut the Great Lakes).[2] Between 1980 and 2003 the population of coastal counties grew by 33 million people, or 28 percent. The state of Florida grew by 75 percent and further growth is expected (Fig. 8).

Leading States in Coastal Population Growth, 1980-2003

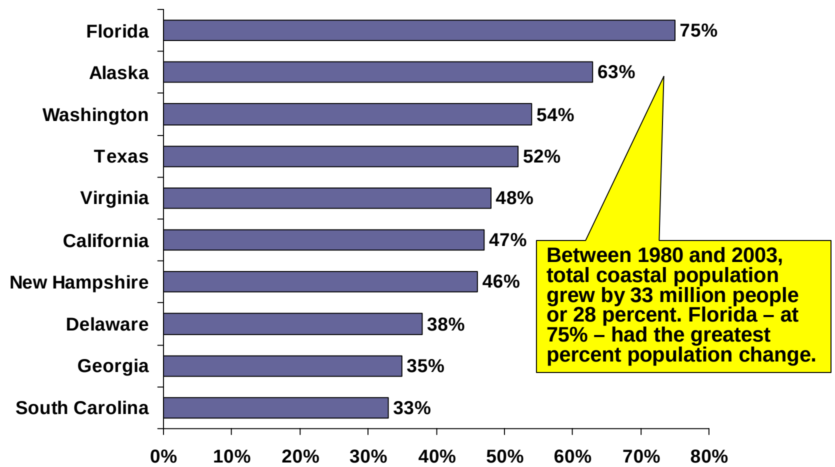


Fig. 8

Source: U.S. Census Bureau and NOAA

According to the U.S. Census Bureau, the population in hurricane exposed states will increase by 43.8 million, or 36.3 percent between 2000 and 2030, accounting for 53 percent of the increase in the population for the entire United States. Florida, already the most hurricane vulnerable state in the country, will lead the way with an expected population increase of 12.7 million or 79.5 percent by 2030 (Fig. 9).

[2] National Oceanic and Atmospheric Administration (NOAA), *Population Trends Along the Coastal United States: 1980-2008*, http://oceanservice.noaa.gov/programs/mb/pdfs/1_front_matter_introduction.pdf

Population Growth Projections for Hurricane Exposed States (2000 to 2030) (Thousands)

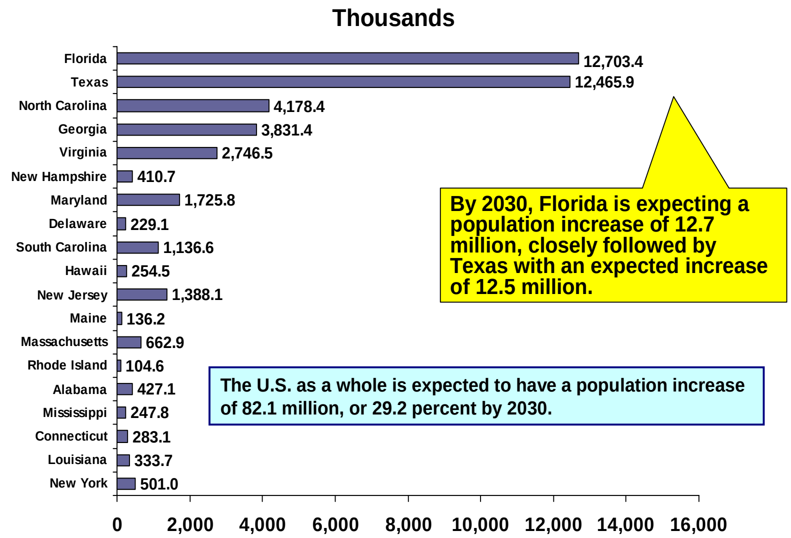


Fig. 9

Source: U.S. Census Bureau and NOAA

Exposure to windstorms and high property values combine to make Florida the state with the highest potential for losses and New York City and Long Island the second highest. An updated study by AIR Worldwide puts the value of insured coastal property in hurricane prone states—states bordering on the Atlantic Ocean and Gulf of Mexico—at $8.9 trillion in 2007, up 24 percent from $7.2 trillion in 2004.[3] In Florida alone the value of residential and commercial coastal property is $2.5 trillion (Fig. 10). This represents 79 percent of the state's total insured property values (Fig. 11). In New York it is $2.4 trillion, representing 62 percent of the total. In terms of insured residential coastal exposures, Florida, New York and Texas are the top three states on the list (Fig. 12). However, the value of New York's commercial coastal property, at $1.7 trillion, is higher than that of any other state on the list (Fig. 13). Other states where insured coastal property values exceed 50 percent of the state's total are Connecticut, Maine and Massachusetts.

[3] AIR Worldwide, The Coastline at Risk, 2008 Update to the Estimated Insured Value of U.S. Coastal Properties, and The Coastline at Risk, September 2005.

TOTAL VALUE OF INSURED COASTAL EXPOSURE IN 2007 ($ BILLIONS)

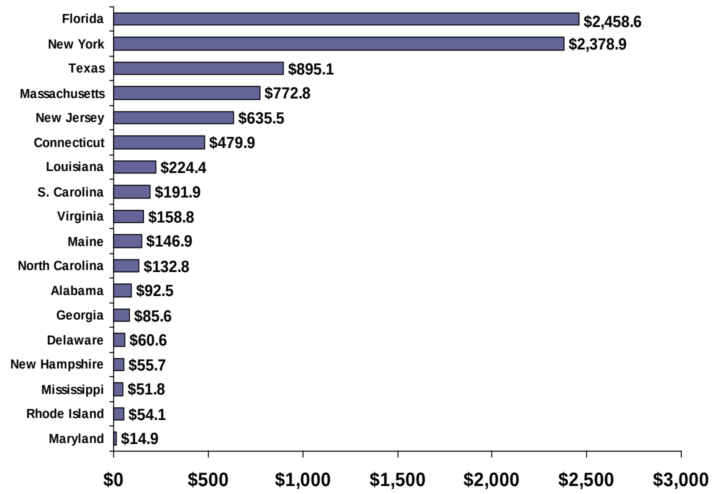


Fig. 10

Source: AIR Worldwide

INSURED COASTAL EXPOSURE AS A % OF STATEWIDE INSURED EXPOSURE IN 2007

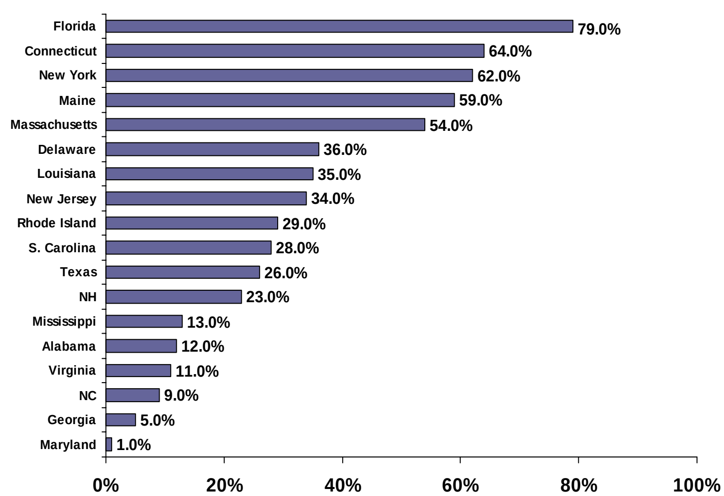


Fig. 11

Source: AIR Worldwide

VALUE OF INSURED RESIDENTIAL COASTAL EXPOSURE IN 2007 ($ BILLIONS)

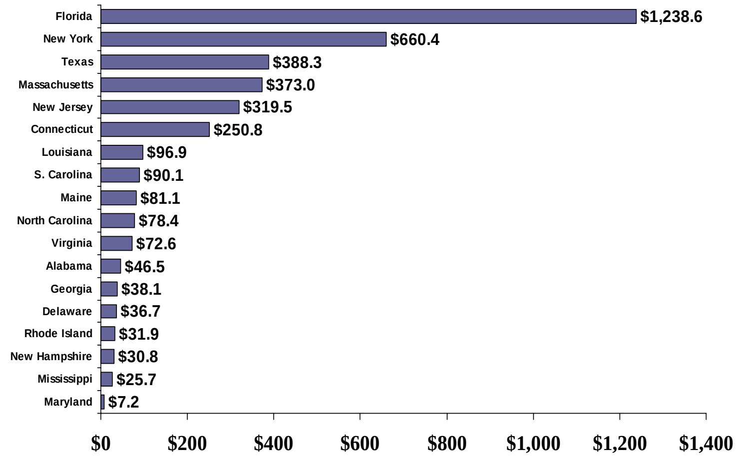


Fig. 12

Source: AIR Worldwide

VALUE OF INSURED COMMERCIAL COASTAL EXPOSURE 2007 ($ BILLIONS)

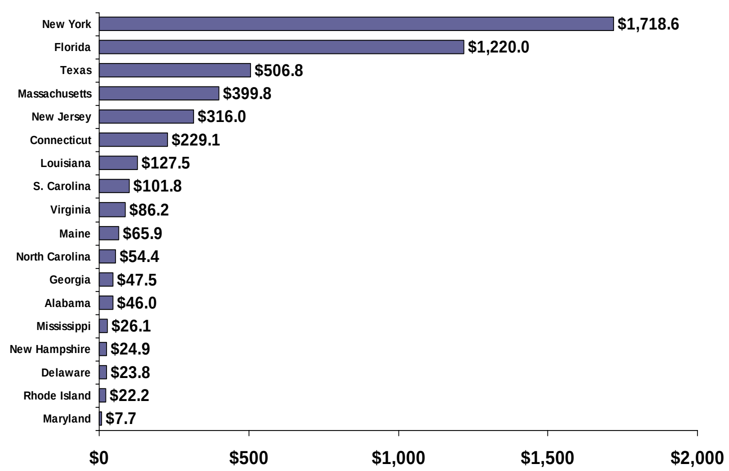


Fig. 13

Source: AIR Worldwide

Even in states where the value of insured coastal property values represents a relatively small percentage of total insured property values it does not mean that the residual markets are not experiencing rapid growth. For example, North Carolina ranks 11th on AIR's list with $132.8 billion in insured coastal exposure, representing just 9 percent of the state's total insured values. Yet as of

March 31, 2009, North Carolina's beach and windstorm plan, the North Carolina Insurance Underwriting Association (no longer a PIPSO member), reported a total of 175,877 policies, up from 94,612 policies reported at the end of 2004. Total exposure to loss under the plan also increased from $31.6 billion in 2004 to $73.6 billion at March 31, 2009 – an increase of more than 100 percent.

Public Attitudes Toward Subsidized Insurance for Coastal Dwellers

Evidence also shows that the growth in residual market mechanisms may be due in part to the implicit support of residents of coastal communities. According to the Insurance Research Council (IRC), geographic proximity to the coast plays a major role in influencing opinions about the fairness of policyholder and taxpayer property insurance subsidies for natural disasters.[4] The IRC found that those living in non-coastal areas are more likely to disapprove of taxpayer and policyholder subsidies of insurance costs for those living in high risk areas. Some 63 percent of those from interior counties and non-coastal states believe policyholder subsidies for wind damage coverage in coastal areas are unfair, compared to half of those from coastal counties (Fig. 14). Similarly, when asked about taxpayer-subsidized insurance for natural disasters, such as the National Flood Insurance Program, 59 percent of those from interior counties and 61 percent from non-coastal states found these to be unfair, compared to just 51 percent of those in coastal counties (Fig. 15).

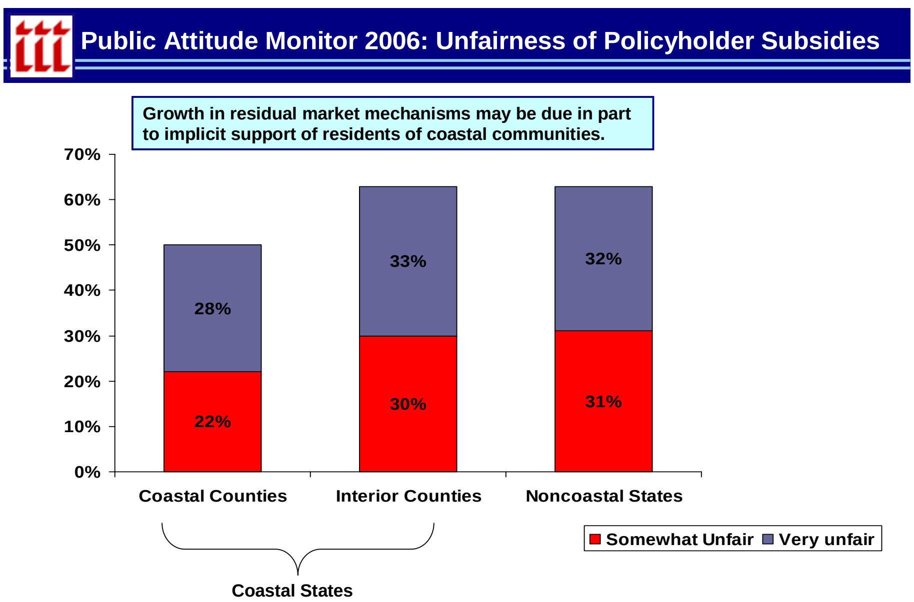


Fig. 14

Source: Insurance Research Council

[4] Insurance Research Council (IRC), Public Attitude Monitor (PAM) 2006, Issue 2, October 2006.

Public Attitude Monitor 2006: Unfairness of Taxpayer Subsidies

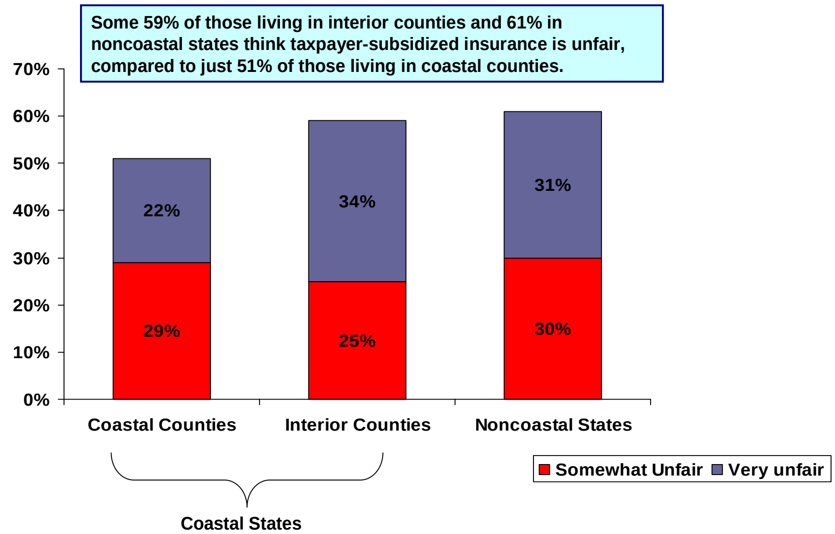


Fig. 15

Source: Insurance Research Council

Availability and affordability of property insurance in the voluntary market also has an impact on the rate of growth of the FAIR and Beach and Windstorm Plans. Applicants rejected by the voluntary market may apply to the residual market where acceptance is usually contingent upon proof of inability to obtain coverage in the voluntary market, with some pools requiring evidence of rejection from two or three companies. Therefore, the inability of insurers to be able to charge a rate commensurate with the risk to be assumed (due to regulatory suppression of rates) is a major factor in their decision to reject an applicant in the voluntary market. In addition, the concentration of property risks in coastal areas means insurers are unable to diversify and spread their portfolio, and that can lead to a reduction or even withdrawal of voluntary capacity in certain markets. For example, in early 2009 a leading Florida property insurer announced plans to withdraw from that state. Such a situation inevitably will increase the volume of property policies being written by the residual market mechanisms.

3. Financial Results

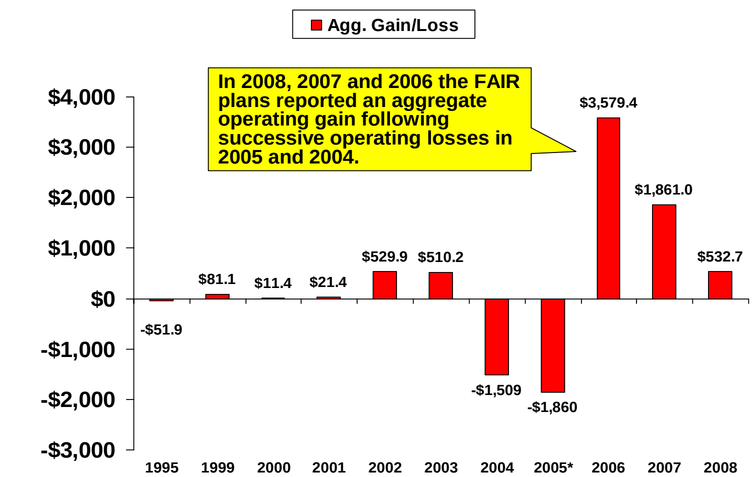
Today, many residual property market plans have shifted away from their original mission as insurers of urban properties into major providers of insurance in high-risk coastal areas. It is important to recognize that many operate at deficits, or from slim positions of surplus, even in years with little or no catastrophe losses. A variety of factors are at play here, including the fact that state plans may be prohibited from charging a rate that is commensurate with the risk being assumed.

Rates charged by state plans are controlled by state regulators and legislators and are therefore vulnerable to political manipulation. The tendency of regulators and/or legislatures to suppress rates in the private sector is a major contributing factor to a pull-back by private insurers in many coastal areas, which leads directly to more property owners seeking coverage through the state's residual market facility, often at rates that are inadequate.

As noted earlier, in 2008 the FAIR Plans reported an aggregate operating gain of $532.7 million, a 71 percent decline from the $1.9 billion operating gain reported in 2007 and an 85 percent decline from the $3.6 billion operating gain of 2006 (Fig. 16). The three consecutive years of gains followed successive operating losses of $1.9 billion in 2005 and $1.5 billion in 2004. The turnaround in fortunes in 2007 and 2006 is due largely to the relatively benign hurricane seasons, after the record hurricane losses of the prior two years (2005 and 2004).

It is important to note that the figures for 2005-2007 exclude the results of Louisiana Citizens Property Insurance Corporation, a plan severely impacted by losses arising from Hurricane Katrina in 2005 and the third largest of all the FAIR/Beach plans by number of policies in 2004. In 2008, Louisiana Citizens reported an operating loss of $22.5 million.

FAIR Plans Aggregate Operating Gain/Loss (Millions of Dollars)



*** Est. deficit for 2005 does not include Louisiana FAIR Plan's est. deficit of $954 million that would push the Plans' 2005 aggregate operating deficit to approximately $2.8 billion.**

Fig. 16

Source: PIPSO

In the decade from 1995 to 2005, the FAIR Plans saw a more than 30-fold ballooning of their aggregate operating loss. If Louisiana Citizens' reported 2005 operating deficit of $954 million is included, the FAIR Plans' 2005 deficit rises to a staggering $2.8 billion—a more than 50-fold increase in the aggregate deficit over the course of the decade.

In 2005, by far the largest deficit—$1.77 billion—was reported by Florida's FAIR Plan, Citizens Property Insurance Corporation. Both Florida and Louisiana's 2005 deficits resulted in the levying of assessments on virtually all residential property owners in their states.[5] Insufficient rates, inadequate cash reserves and insufficient or nonexistent reinsurance have contributed to the problems in Florida, Louisiana and other states.

[5] Florida's Citizens can assess even property owners that are not its own insureds; people who live on the coast and people who have filed no claims.

The financial results of the Beach and Windstorm Plans show a similar trend. While the operating results of these Plans are not available, the underwriting results are illustrative of the fact that in years of low hurricane activity operating margins are slim, and in years of high hurricane activity, losses mount.[6] Even in 2008, a less active year for hurricanes, the Beach/Windstorm Plans incurred an aggregate underwriting loss of $1.4 billion. This compared with aggregate underwriting losses of $68.3 million in 2007, $95.4 million in 2006 and $833.1 million in 2005. Over the six-year period from 2003 through 2008, the Windstorm Plans incurred an underwriting loss in five of those years. The only year in which an underwriting profit was achieved during that period was 2003, due to no major hurricanes that year. As a result of losses from Hurricane Ike and Hurricane Dolly, the Texas Beach Plan reported a huge underwriting loss of $1.38 billion in 2008.

If their claims-paying capacity is exhausted in a particular year, FAIR and Beach and Windstorm Plans have a number of capital-raising options available to them:

- ***Levy of assessments*: When losses exceed claims-paying capacity in a given year, FAIR and Beach and Windstorm plans are required by state law to assess participating insurers. Assessments typically are based on an individual insurer's market share in the state. In many states insurers are allowed to recoup these assessments by imposing a rate surcharge on policyholders. In some states like Florida, the assessment is a percentage of premium and is passed through directly to consumers.
- ***Issuance of bonds*: Plans also have the ability to finance losses and raise additional capacity via the issuance of bonds. In the wake of the 2004 and 2005 hurricane seasons, a number of plans went ahead with post-event bond issues. Pre-event bond issues were also completed by some plans for funding future hurricane seasons. The cost of issuing bonds may be passed onto policyholders via assessments and surcharges. In recent years, plans have become increasingly dependent on the issuance of debt.
- ***Purchase of reinsurance*: Many plans also buy reinsurance, providing them with additional layers of catastrophic coverage and ability to fund losses. While costs can be high, reinsurance is playing an increasingly important role in the financing of mega-catastrophes. For example, private reinsurers paid an estimated 45 percent of 2005 hurricane losses. More recently, certain plans have chosen to reduce or eliminate the coverage they purchase from private reinsurers, effectively "rolling the dice" when it comes to bearing these catastrophic risks.[7]

In addition to assessments and debt, increasingly plans are being bailed out by a diversion of tax revenues from state coffers. Certain plan funding mechanisms may also expose state funds to excess hurricane losses. For example, losses from Hurricanes Dolly and Ike in 2008 left the Texas general revenue fund exposed after the Texas Windstorm Insurance Association's funds were depleted (see later section on Texas). In an effort to offset the 2005 deficit of Florida Citizens Property Insurance Corporation, state legislators provided for a $715 million appropriation of state general revenue dollars to the fund. Similarly, in December 2006 the Louisiana legislature passed a law creating a state income tax credit for policyholders facing assessments from Louisiana Citizens. Diversion of state and federal funds to the Mississippi Windstorm Underwriting Association (MWUA) also followed the passage of reforms by the state legislature in 2009 and 2007 (see later section on Mississippi).

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[6] Investment income for the Windstorm Plans is not reported by PIPSO, so only underwriting income is reported for these plans.
[7] *States Shed Reinsurance and 'Run Naked' Through Storm Risks*, by Evan Lehmann of ClimateWire, New York Times, August 17, 2009.

These subsidies effectively shift the cost of assessments from the plan's policyholders to taxpayers across the state or country. Such temporary political salves for policyholders in coastal areas are hardly a long-term solution to the financial distress in which some of the residual market plans find themselves. At the same time, they dilute the message of risk that actuarially sound premiums send to coastal dwellers. The effect is to encourage and enable even more vulnerable coastal development, further increasing residual market exposure and increasing the burden on taxpayers.

Pricing to Risk

All insurers must file rates and forms with the state insurance regulator and residual market plans are not exempt from this requirement. However, each state has different rate-setting rules and individual plans write different types of risks, so the exact parameters vary from state to state. In general, residual market mechanisms have been designed to work as a complement to, rather than in competition with, the private market. Therefore, historically the rates charged by the residual plans have been higher than those in the voluntary market. The idea has been to charge a risk-based premium that is commensurate with the specific type of business being written. Today, a number of state legislatures have eliminated the requirement for the rates charged by residual market plans to be noncompetitive with the private market (i.e. below actuarially indicated rate levels). This means that private insurers face an uphill battle when trying to compete on price.

As noted earlier, the availability and affordability of property insurance in the voluntary market has a direct impact on the rate of growth of the FAIR and Beach and Windstorm Plans. Post-2004 and 2005, property insurance market conditions changed rapidly, and a number of private insurers and residual market plans in hurricane zones came under considerable financial strain. Recent record catastrophe years may have amplified the problems, but even before 2004 and 2005, it was clear that many of the residual market plans had not lived up to their original objectives. The current financial positions of the most at-risk markets reflect the growing problems exacerbated by the confluence of rising catastrophe losses, burgeoning exposure values and policy counts, and inadequate financial resources. Legislative and political meddling in a number of states has also created operating rules and conditions that assure that the rates charged by these plans are not actuarially sound or that their capital base is inadequate.

The state of Florida is a good example. Since Florida's FAIR Plan Florida Citizens was created in 2002, its policy count has surged from 658,085 policies in 2002 to just over 1 million policies as of May 31, 2009. Total exposure to loss under Citizens has also grown, from $154.6 billion in 2002 to $421.9 billion in 2008. As for its operating position, Citizens went from a slim operating gain of $533.5 million in 2002 to a massive operating loss of $2 billion in 2005. These figures came despite a depopulation plan that returned around 500,000 Citizens policies and $100 billion of exposure back to the private insurance market between 2003 and 2006. In 2006, Citizens reported an operating gain of $3.5 billion following the relatively benign hurricane season.

In 2009 and 2008 Citizens' policyholder count has been flattening out, as newly formed insurers implement plans to take over policies covered by Citizens. In 2007 and 2008 some 632,971 Florida Citizens' policies with total exposure of $175.2 billion were removed from its books through the depopulation process. As of April 21, 2009, Florida Citizens reported that a further 64,395 policies with total exposure of $18.2 billion had been removed. Florida Citizens' total policies in force amounted to just over 1.0 million at May 31, 2009, down 25 percent from 1.4 million at year-end 2008. In 2008 policies in force had declined by 17 percent. Direct premiums written by Florida Citizens dropped to $2.8 billion in 2008 from $3.7 billion in 2007 – a nearly $1 billion decline.

Florida Citizens remains the largest property insurer in the state. Reforms enacted in 2009 are widely regarded as a step in the right direction for the state's property insurance market after legislation passed in 2007 and 2008 had significantly expanded Citizens exposure base and frozen the rates it was able to charge (see later section on Florida Citizens). Under the 2009 legislative package, Citizens is now allowed to increase rates by up to 10 percent per year until rates are actuarially sound.

When Citizens incurs a deficit following a storm, it is required to impose assessments on insurers doing business in the state that are then passed on to their policyholders in the form of a surcharge. Following the legislative reforms enacted in 2007 the base for assessments to pay for Citizens deficits expanded from property insurance to auto, liability and other lines of insurance, with the exception of medical malpractice and workers compensation, thus placing the burden of paying for the next big storm on all Floridians, even those with no exposure at all to hurricane losses.

In a report released in March 2009, the Florida Department of Financial Services estimated that a 1-in-100 year hurricane event in Florida would result in $61 billion in residential insured losses. Such an event would leave Citizens with a deficit of $2.5 billion and the Florida Hurricane Catastrophe Fund with a deficit of $20.1 billion. These deficits would be paid with emergency assessments levied on Florida's property/casualty insurers and passed on to insurance consumers. As a result, it estimated homeowners insurance rates would have to increase by 13 percent to 33 percent.

4. Impact on the Voluntary Insurance Market

When the losses of FAIR Plans and Beach and Windstorm Plans exceed their claims-paying capacity in a given year, the plans impose an assessment on every participating insurer, typically based on their homeowners or property insurance market share in a state. In many states, insurers may then recoup this amount from policyholders when their homeowners policies come up for renewal. The plans may also buy reinsurance. This means that people far away from the coast and property owners who may have never filed a claim are called upon to subsidize coastal insurance rates.

In 2005, the extent of losses from Hurricane Katrina pushed all the residual market plans in the affected states into deficit (Fig. 17). This followed the record hurricane losses of 2004, when Florida Citizens also reported a deficit. As a result the plans were required to assess participating insurers in order to remain solvent. While the assessment formulas vary from state to state, the record losses created substantial financial strains on private insurance companies in some Gulf coast states. This led a number of companies to file a class action lawsuit against the Mississippi Windstorm Underwriting Association (MWUA) board of directors, claiming that the Pool did not buy adequate and reasonable reinsurance, which led to the excessive assessments.[8] Over time it is likely that private insurers operating in high-risk states will have to make additional adjustments to account for their increasing exposure to the residual market. Going forward, it will be critical for private insurers to better understand their risks to the residual market.

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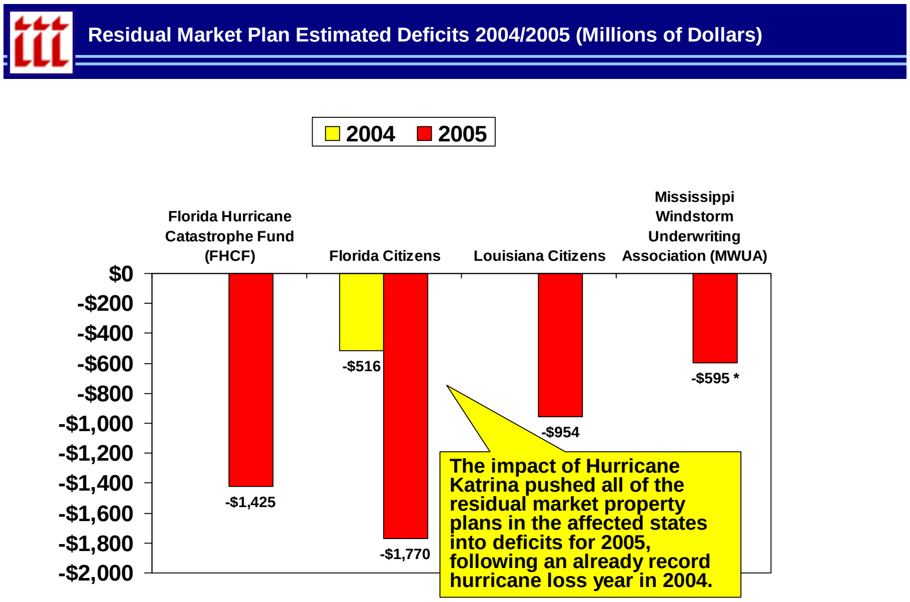
[8] Case 1:06-cv-00954-LTS-RHW; United States District Court for the Southern District of Mississippi Southern Division; Filed 09/15/06.



* MWUA est. deficit for 2005 comprises $545m in assessments plus $50m in Federal Aid.
Source: Insurance Information Institute

Fig. 17

Source: Insurance Information Institute

Another important consideration is that as private insurers pull back from writing business in coastal areas, a significant share of premium is being ceded to the residual market. This means that private insurers, while reducing their exposure to catastrophic loss, are missing out on significant growth opportunities in certain states. In 2008, the property/casualty industry recorded negative premium growth of 1.4 percent, breaking the previous record decline of 0.6 percent in 2007.

While this is a result of a combination of different factors, one reason is the leakage of premium to residual market mechanisms. This has the ultimate effect of reducing options in the private marketplace, another negative for insurance buyers.

5. Conclusion

While residual market property plans fulfill a key role by ensuring that policyholders can obtain insurance coverage, their exponential growth in the course of the last two decades has key implications for insurers and insurance buyers going forward. In particular, there are a number of public policy considerations that will need to be addressed as insurers, regulators and legislators seek a long-term solution to managing and funding catastrophic risks in future. Some of those public policy impacts are as follows:

- As residual market plans go from markets of last resort to markets of first or only choice in certain states, a significant amount of property insurance premium is exiting the private marketplace (both the admitted and non-admitted insurance market). This reduces growth opportunities for carriers and choice for policyholders.
- When premiums charged are not commensurate with the risks assumed in highly vulnerable coastal and other areas, this can lead to increased development, unwise land-use policies and buildings that are not sufficiently well-constructed to withstand the exposures.

- When, due to political and/or regulatory constraints, insurers are unable to charge a premium commensurate with the risk they assume in coastal areas, this distorts the true cost of insurance coverage. This has two key public policy implications:
  - Firstly, rate and underwriting restrictions on property insurers can result in a situation where high-risk property owners actually pay lower premiums, while low-risk property owners pay artificially higher premiums. This leads to unfair cross-subsidization among risk classes and discourages mitigation.
  - Ultimately policyholders in both coastal and non-coastal areas pay the price of inadequate premiums in the form of additional payments, such as assessments and taxes following federal/state bailouts, which are passed on to them. Even policyholders of unrelated risks, such as auto and liability, have to pay assessments too.
- In contrast to the private market, state-run insurers concentrate risks on the state itself—on its property owners, businessowners and even its drivers—and, ultimately, the state's taxpayers. While private insurance transfers and spreads risk ensuring that sufficient funds will be available in the event of a loss, state-run schemes act rather as a conduit to pass along their cost to other insurance buyers, even those who have never filed a claim, live nowhere near the coast and in some cases have no property exposure at all.

II. How FAIR and Beach and Windstorm Plans Operate

FAIR Plans and Beach and Windstorm Plans are run by state insurance regulators in conjunction with private insurers and basically operate as pools (an association of organizations or individuals that combine resources to economically finance recovery from accidental losses). The pool acts as a single insuring entity, and premiums, losses and expenses are shared among pool members (i.e. insurers) in agreed-upon amounts.

Each state has enacted its own legislation in response to local market needs, so there is considerable variation in the types of coverage provided and the methods of operation among the 35 jurisdictions with FAIR Plans. The state government does not typically provide financial support for these plans though exceptions do occur. Plans may also float debt and benefit from the state's credit rating, which is ultimately linked to its authority to tax. In addition, each state has a guaranty fund in place to pay the claims of failed insurers. Guaranty funds are supported by assessments on solvent insurers doing business in the state. Some FAIR Plans employ their own staff to handle underwriting, processing and even claim adjustment, while others contract with specific insurers to act as servicing carriers. These insurers, for a percentage of premium, perform underwriting, policyholder service and claim settlement functions.

In all states except California, residents in any part of the state can apply for insurance through the FAIR Plan as long as they meet Plan criteria. In California, applicants for fire coverage must live in areas specifically designated by the insurance commissioner. These include not only urban communities and some entire counties but also certain areas that are prone to brush fires.

Underwriting Criteria

A property owner unable to obtain property insurance in the voluntary insurance market may apply to the state's FAIR Plan through a licensed agent or broker. To be eligible for FAIR Plan coverage, the insured must have the property inspected. Only property that meets the FAIR Plan's inspection criteria will be insured in the program. Owners of properties failing to meet basic levels of safety, typically older houses and commercial establishments, may be required to make improvements as a condition for obtaining insurance. Such improvements may include upgrading the electrical wiring, heating and plumbing and ensuring that the roof is sound, for example. Where deficiencies are not remedied, FAIR Plan administrators may deny insurance as long as hazards are unrelated to the neighborhood location or to hazardous environmental conditions beyond the applicant's control, such as being located adjacent to a fireworks factory.

Under most FAIR Plans, the following types of exposures are considered uninsurable:

- Vacant property
- Property poorly maintained
- Property subject to unacceptable physical hazards, such as storage of flammable materials
- Property in violation of law or public policy, such as a "condemned building" (one that is considered unfit for human habitation)
- In some states, property not built in accordance with building and safety codes

Seven Individual State Plans

1. Florida Citizens Property Insurance Corporation (CPIC)

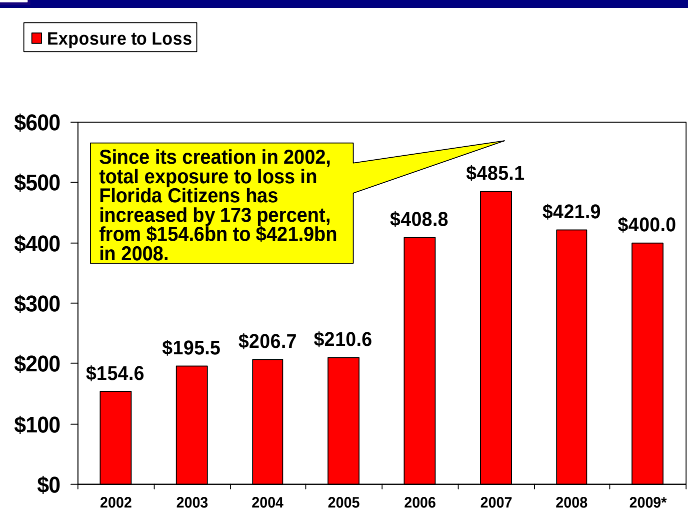
Overview

Since its establishment in 2002, after the state passed legislation combining two separate high risk insurance pools, known as the Florida Windstorm Underwriting Association and the Florida Residential Property & Casualty Joint Underwriting Association, Citizens Property Insurance Corporation (CPIC) has experienced exponential growth. As a result Florida Citizens has evolved from a market of last resort, becoming the state's largest property insurer in 2006.

According to PIPSO data, of the 2.3 million total policies (habitational and commercial) insured by the FAIR plans across the U.S. in 2008, 1.4 million or 61 percent were in Florida Citizens. This compares with the 658,085 policies or 44 percent insured by Florida Citizens in 2002. As of June 30, 2009, Citizens had 316,030 high risk policies in force (those that were in the old windstorm pool). The CPIC also had about 623,733 personal/residential policies in force, and about 8,484 commercial/residential policies. Total policies in force in Florida Citizens dropped to 1.0 million at June 30, 2009.

Meanwhile, Florida Citizens also accounts for the vast majority (69 percent) of the total FAIR plans exposure to loss. Its exposure more than doubled from $210.6 billion in 2005 to $485.1 billion in 2007, reflecting rising coastal property values and higher building and reconstruction costs. However, Florida Citizens' exposure to loss declined to $421.9 billion in 2008 and by June 30, 2009 to around $400 billion (Fig. 18). The decline in exposure and policies is likely due to increased takeout activity and a decline in new business written. Direct premiums written by Florida Citizens dropped to $2.8 billion in 2008 from $3.7 billion in 2007 – a nearly $1 billion decline. The collapse in home and condominium construction throughout the state due to the subprime mortgage and credit crisis and ensuing recession is also a significant factor in the decline in new business.

Florida Citizens Exposure to Loss (Billions of Dollars)



*** Estimate as of June 30, 2009**

Fig. 18

Source: PIPSO; Insurance Information Institute

Citizens is a state-regulated association and historically has provided property insurance where it is not available from the regular market. It has tax-exempt status and provides insurance to homeowners, commercial residential properties and a limited number of commercial businesses in coastal high-risk areas and others who are unable to obtain coverage in the private insurance market. Citizens rates have been competitive with the private market following a legislative package passed in 2007.

As noted earlier, a depopulation plan created by Florida's legislature is designed to reduce the number of policies in Citizens, encouraging new or existing private insurers to take on policies covered by Citizens. From 2003 to 2006, approximately 500,000 policyholders were returned to the private market. In addition, Citizens reduced its exposure by $100 billion. However, the insolvency of major insurance group, the Poe Insurance Companies after the hurricanes of 2004 and 2005, added thousands of policies to Citizens at a time when many other insurers were cutting back on policy renewals in coastal areas.

In 2007 and 2008, takeout activity increased. Seven insurers approved to assume Citizens' policies removed almost 248,000 personal residential policies (with an exposure value of some $68 billion) from Citizens' books in 2007. In 2008, 14 take-out companies were approved that removed a further 362,974 personal residential policies (with an exposure value of $99.9 billion). As of June 19, 2009, another 74,940 personal residential policies with an exposure value of $20.5 billion had been removed.

Legislative Developments

In May 2009, Florida Governor Charlie Crist signed major new legislation (HB 1495), making wide-ranging changes to the property insurance market in Florida. HB 1495 has been described as a step in the right direction for Florida's property insurance market.

The 2009 legislation followed Citizens rapid growth in exposure and increasingly volatile financial position after legislative changes in 2008 and 2007 that extended the freeze on rate increases for Citizens and significantly expanded the overall role of the state as an insurer and reinsurer of Florida homes.

HB 1495 includes the following changes:

- Allows Citizens to increase rates by up to 10 percent per year until rates are actuarially sound. This provision goes into effect on or after January 1, 2010 and was a recommendation of the Citizens Mission Review Task Force.
- Allows Citizens to increase rates to pay the Florida Hurricane Catastrophe Fund's (the Cat Fund) "cash build up" program for five years. Estimated rate impact to be less than one percent.
- Implements provisions to decrease the capacity of the Florida Hurricane Catastrophe Fund by reducing the $12 billion Temporary Increase in Coverage Limit (TICL) layer of coverage available from the Cat Fund over a six-year period at a rate of $2 billion a year. The TICL premium will also be increased in each of the six years.
- Authorizes insurers to buy private reinsurance to replace or back up the Cat Fund TICL reinsurance coverage. To compensate for the increased reinsurance costs, insurers are also allowed to make an expedited rate filing to increase rates by up to 10 percent to recoup the additional cost of replacing TICL coverage.

- Allows the Cat Fund to implement a cash build up factor which would increase the reimbursement premiums that the Fund charges property insurers for the mandatory layer of reinsurance provided by the Fund.

A rate deregulation bill (HB 1171) was also passed by the Florida legislature in 2009. The bill, which was subsequently vetoed by Governor Crist, would have allowed certain insurers to use rates in excess of the otherwise applicable filed rate. Though not a legislative development, it is worth noting that Governor Crist in 2009 announced his intention to run for the U.S. Senate in 2010.

Claims-Paying Capacity

When Citizens losses exceed its claims-paying capacity, it is required to impose assessments on insurers doing business in the state that are then passed on to their policyholders in the form of a surcharge. Following the legislative reforms enacted in 2007 the base for assessments to pay for Citizens deficits expanded from property insurance to auto, liability and other lines of insurance, with the exception of medical malpractice and workers compensation, thus placing the burden of paying for the next big storm on all Floridians, even those with no exposure at all to hurricane losses.

Citizens also has the ability to finance loss payments by issuing tax-exempt bonds that carry low interest rates, piggy-backing on the state of Florida's strong credit rating. The credit crisis that began in mid-2007 raised serious concerns about Citizen's ability to raise significant sums in the bond markets should a major hurricane strike. However, since then there has been a gradual improvement in credit markets and bonding capacity.

Citizens' ability to pay claims is partly dependent on the state-run reinsurance fund – the Florida Hurricane Catastrophe Fund (the Cat Fund) – which reimburses Citizens a stated percentage of hurricane losses once a retention level is reached. However, in the event of a major storm the Cat Fund's ability to pay claims may also be impacted due to the potential difficulty of raising funds in the bond markets amid the credit crisis. As of July 2009, the Cat Fund has $7.8 billion to pay claims from the 2009 hurricane season before it would have to sell additional bonds.

Citizens was hit hard by 2005 and 2004's hurricane seasons, suffering record hurricane damage claims and incurring a deficit in both years. As a result of losses related to Hurricanes Dennis, Katrina and Wilma, Citizens reported an operating deficit of just over $2 billion in 2005. This followed an operating deficit of $1.6 billion in 2004, after Citizens incurred around $2.4 billion in losses from nearly 120,000 hurricane damage claims, of which $1.8 billion came from its high-risk windstorm account.

To offset Citizens' 2005 deficit legislation (SB 1980) passed in May 2006 provided for a $715 million appropriation of state general revenue dollars to the fund. This reduced the regular assessment on policyholders from 11 percent to 2 percent. A further 10 percent emergency assessment to pay off the remainder of the deficit was spread over a 10-year period (1.4 percent annually until 2017).

2. Louisiana Citizens Property Insurance Corporation

Overview

Louisiana Citizens Property Insurance Corporation (Louisiana Citizens) was created by the legislature in 2003 to oversee the state's Coastal and FAIR (Fair Access to Insurance Requirements) Plans. This state-run entity acts as a market of last resort for residential and commercial property insurance in Louisiana. For coverage purposes, the Louisiana Citizens FAIR Plan and the Louisiana Citizens Coastal Plan operate as separate programs under Louisiana Citizens.

Louisiana ranks seventh highest on the AIR Worldwide coastal exposure list with $224.4 billion in insured coastal exposure in 2007, representing 35 percent of the state's total insured values (Fig. 19).

TOTAL VALUE OF INSURED COASTAL EXPOSURE IN 2007 ($ BILLIONS)

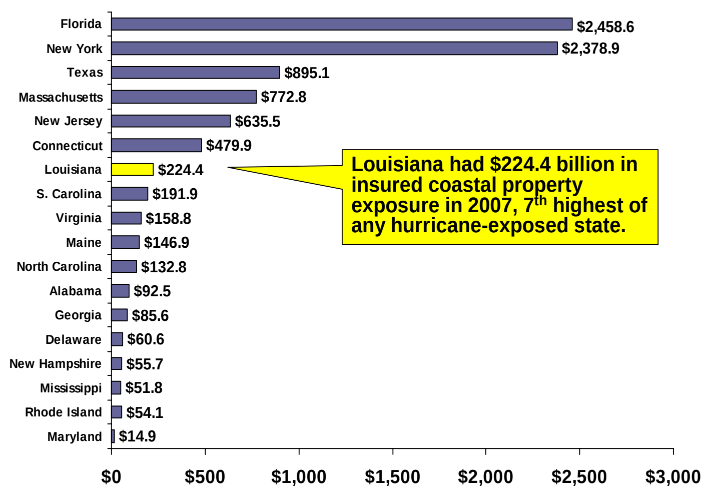


Fig. 19

Source: AIR Worldwide

Louisiana Citizens is the state's third largest homeowners insurer, accounting for 9.8 percent of the market in 2008. By law, Citizens rates historically have had to be at least 10 percent above the private market, but Citizens is no longer required to impose the 10 percent rule where it has 50 percent or more of the market and the insurance commissioner has declared that there is little competition. In these areas, Louisiana Citizens' rates can be equal to those of the largest insurers in the area, or at a level that is actuarially sound.

Louisiana Citizens was reported to have 165,000 policies in-force at June 1, 2008, prior to the removal of around 40 percent of its policies by private insurers. The depopulation of LA Citizens is the result of an incentive program created by the legislature in 2007 to increase the availability of property insurance and to decrease the business written through LA Citizens (see below). In its 2008 annual report, LA Citizens said it completed two rounds of depopulation during 2008 with 40,000 policies and $8.4 billion of exposure transferred to private insurers.

A 7 percent rate increase was approved by LA Citizens in 2009 and a further rate increase of 10 percent is likely in 2010. The rate increases follow LA Citizens paying out some $330 million in claims arising from Hurricane Gustav and higher reinsurance costs and are expected to further reduce the plan's policy count.

Hurricane Katrina produced severe losses for Louisiana Citizens when the Category 4 storm struck the state in late August 2005. The FAIR Plan was left with a $954 million deficit for 2005, after incurring estimated hurricane losses of up to $850 million. Louisiana Citizens issued $978 million in revenue bonds to help fund the shortfall. Emergency assessments to pay off those bonds began in 2007 and will continue into 2025.

The Coastal Plan offers coverage in Zone 5, south of the Intercoastal Waterway, the most hurricane-vulnerable area. The Fair Plan offers coverage in the rest of the state. Louisiana Citizens provides coverage statewide. It offers coverage up to $750,000 for residential properties.

Legislative Developments

Legislation passed in 2007 is designed to make the state more attractive to insurers and to help property owners deal with increased insurance costs. For example, the legislation allows Louisiana Citizens to solicit bids from private insurers to take over its policies. In addition, the state is providing financial incentives to new insurers entering the homeowners market on the condition that 25 percent or more of their new business consists of policies taken over from Citizens.

In April 2008 the insurance department announced that five companies had been awarded $29 million in grants under the incentive program and another two were in the process of applying for $10 million in grant money.

In a special session in December 2006, state legislators passed a law taking $56 million from a state emergency fund to reimburse policyholders who had been assessed to pay for Citizens' losses. At the same time, a law has been approved that creates a state income tax credit for policyholders facing assessments from Louisiana Citizens.

Claims-Paying Capacity

In the normal course of business, Louisiana Citizens utilizes its cash to pay claims, liquidating investments as necessary to meet demands. The Plan also buys reinsurance to supplement its claims-paying capacity in the event of a catastrophe. The amount of reinsurance purchased and the structure of the program may vary year to year.

Under the 2008 reinsurance program, in the event of a catastrophe Louisiana Citizens would pay the first $200 million of losses. After that reinsurance would cover 90 percent of the next $500 million in losses. LA Citizens is in the process of negotiating a new reinsurance program for the 2009 storm season as the 2008 program expired on June 1, 2009.

In the event of a deficit in either the FAIR or Coastal Plan, Louisiana Citizens has the ability to assess its member insurers to an amount up to 10 percent of industry premium for the assessable lines of business. Insurers may then choose to recoup that amount from their policyholders over the course of the next year. Policyholders may, in turn, claim that amount as a credit against their Louisiana state income taxes.

If the plan year deficit exceeds the amount that can be recovered via regular assessments, Louisiana Citizens may fund the remainder by issuing revenue assessment bonds in the capital markets. It then declares emergency assessments each year to provide debt service on the bonds until they are retired. Insurers writing assessable lines must surcharge their policyholders in the percentage established annually by Louisiana Citizens. As in the case of regular assessments, policyholders may claim amounts paid as a credit against state income taxes.

3. Mississippi FAIR Plans

Overview

Mississippi has two residual market plans that act as a market of last resort for residential and commercial property insurance in the state. The Mississippi Windstorm Underwriting Association (MWUA) was established by the legislature in 1987 to provide an adequate market for windstorm and hail insurance in the coastal areas of Mississippi. The Mississippi Residential Property Insurance Underwriting Association (MRPIUA) was established by the legislature in 2003 to provide an adequate market for residential property insurance in both rural and other areas of the state. It was formed by expanding the state's former Mississippi Rural Risk Underwriting Association to offer coverage across the entire state.

All insurers writing property insurance on a direct basis in Mississippi are required to be members of the associations. MWUA and MRPIUA are funded by the premiums from the insurance issued by the plans and assessments made against the member companies to cover any shortfall between revenues and exposure. The plans may also buy reinsurance. The member companies are assessed based on a percentage of their total written property premiums. Insurers doing business in Mississippi are now able to recoup the assessment amount by surcharging their policyholders, following legislative reform approved by the state legislature in March 2007.

MWUA provides windstorm and hail coverage only in the coastal counties of George, Hancock, Harrison, Jackson, Pearl River and Stone. Coverage is available up to $1,000,000 for one- to four-family dwellings and $250,000 for contents. MWUA policies contain a hurricane deductible of 2 percent of the insured value of the home. The hurricane deductible is triggered by windstorm losses resulting from a named storm as declared by the National Hurricane Center of the National Weather Service and remains in effect until a tropical storm warning is over.

At year-end 2008, MWUA had a total of 44,050 policies in-force for a total exposure value of $6.3 billion. Total exposure to loss has surged by 1,672 percent from $352.9 million in 1990 to $6.3 billion as of December 31, 2008. (Fig. 20).

Mississippi Windstorm Plan: Exposure to Loss (Millions of Dollars)

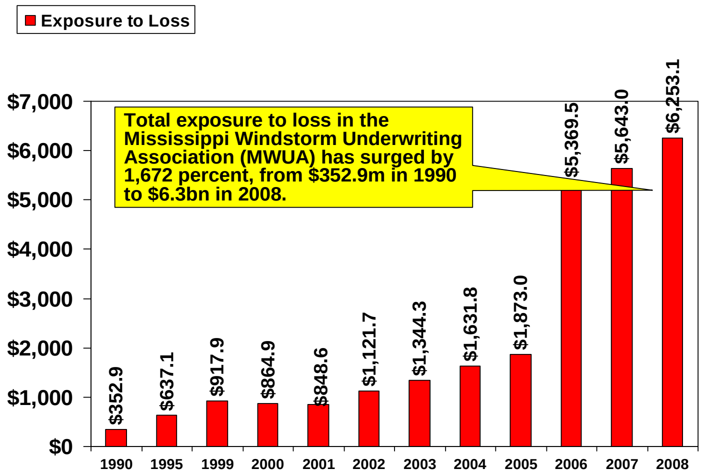


Fig. 20

Source: PIPSO; Insurance Information Institute

MRPIUA provides fire and extended coverage throughout the state. However, properties located in the three lower coastal counties of Mississippi (Hancock, Harrison and Jackson counties) cannot obtain wind and hail coverage through MRPIUA. Coverage for these perils is available through MWUA. Coverage limits under MRPIUA are up to $200,000 for buildings and $75,000 for contents. MRPIUA policies contain a standard deductible of $500 for all perils. At the end of 2007, MRPIUA had a total of 12,789 policies in-force for a total exposure value of $730.2 million. In 2008, policyholder count had flattened to 12,785 as of December 31, while total exposure value grown to $749.2 million.

Insurers that write new wind and hail insurance policies in coastal areas in Mississippi may now be granted credits against the payment of state insurance premium taxes following passage of the 2007 legislative package. In addition, policyholders statewide can be surcharged directly if the MWUA has to issue bonds or repay loans or assess insurers for pool deficits. MWUA assessed its member companies around $545 million for Hurricane Katrina claims, after reinsurance.

Legislative Developments

After a special extraordinary session of lawmakers ending at midnight on June 30, 2009, legislation that puts an additional $20 million into the MWUA was signed by Mississippi Governor Haley Barbour, bringing the total state subsidy for MWUA reinsurance funds to $40 million. The infusion of funds is designed to protect policyholders against rate increases.

It follows the passage of legislation in 2007 (HB1500) that created the “Mississippi Windstorm Underwriting Association Reinsurance Assistance Fund” whereby the state provides a portion of the revenue received from state insurance premium taxes (up to $20 million a year) over a four-year period to help the MWUA pay its reinsurance premiums. It also allowed a one-time $80 million diversion of federal and state funds to the MWUA to boost the pool’s reserves for windstorm damage claims.

In April 2008, the legislature approved the transfer of $25 million from the state’s tax coffers to the fund, as part of the 2007 legislative package.

4. Texas Windstorm Insurance Association (TWIA)

Overview

Hurricane Celia, which struck the Texas coast on August 3, 1970, was one of the most damaging hurricanes in the state's history, causing an estimated $310 million in insured losses in 1970 dollars ($1.55 billion in 2005 dollars). Following the extensive damage caused by the hurricane, many insurers decided to stop writing business in the state's exposed coastal communities. As a result, the state stepped in and created the Texas Catastrophe Property Insurance Association (now called the Texas Windstorm Insurance Association) in 1971.

The Texas Windstorm Insurance Association (TWIA) provides wind and hail coverage for Texas Gulf coast property owners in the event of catastrophic loss. It is the state's insurer of last resort for wind and hail coverage in 14 coastal counties and parts of Harris County, as follows: Aransas, Brazoria, Calhoun, Cameron, Chambers, Galveston, Harris County (partial), Jefferson, Kennedy, Kleberg, Matagorda, Nueces, Refugio, San Patricio and Willacy.[9]

How It Operates

All companies licensed to write property insurance in Texas are required to be members of TWIA. Their percentage participation is based on their company's statewide sales versus sales within TWIA's territory. TWIA is governed by a nine member board of directors comprised of five insurance company representatives, two agent representatives and two consumer representatives. The board meets on a quarterly basis.

Coverage for both residential and commercial property owners is available under TWIA. In addition, the Association also provides coverage for miscellaneous items, such as signs, fences, swimming pools, and flagpoles. As of May 31, 2009, TWIA insured 225,641 residential and commercial policyholders. This represents an increase of 4.7 percent or 10,104 policies since January 1, 2009, and an increase of 151,826 policies or more than 200 percent since 2001.

Effective January 1, 2009, residential and commercial policyholders can purchase TWIA coverage up to the following new statutory limits:

- Residential—Dwelling Building and Contents: $1.71 million
- Apartment, Condo, Townhouse—Contents Only: $359,000
- Mobile Home—Building and Contents: $84,000
- Commercial—Commercial Building and Contents: $4.2 million

Claims-Paying Capacity

After the 2008 hurricane season, TWIA funds were depleted after paying losses from Hurricanes Ike and Dolly. Solutions were sought to reform TWIA and its funding mechanism and to avoid compromising the state's general revenue fund in the event of another major hurricane making landfall in Texas.

[9] Part of Harris County—When located inside Houston city limits and east of highway 146, the following portions of Harris County are also included: LaPorte, Morgan's Point, Pasadena, Seabrook, Shore Acres.

New legislation (House Bill 4409) was passed in June 2009 that reforms the TWIA funding and claims-paying structure. HB 4409 clarifies that TWIA is intended to serve as a residual market insurer of last resort. It establishes a more rational plan for the growth of TWIA reserves and premiums and eliminates the unlimited assessments on insurers. The legislation also moves TWIA towards a more actuarially-sound rating system though it will not implement an immediate rate increase for coastal policyholders. The new structure does not call for TWIA to purchase reinsurance, however, though insurers can purchase it to cover their individual exposures.[10]

Under the new financial structure for the 2009 hurricane season, the pool will make available up to $2.5 billion to fund losses via the issuance of post-event bonds (Fig. 21). First, TWIA premium and cash on hand, available reserves of TWIA and the Catastrophe Reserve Trust Fund (CRTF) would be used. Currently, there are no reserve funds available to pay claims.

Losses in excess of this amount would be funded by utilizing up to $1 billion in Class One public securities or other financial instruments to be paid from TWIA premium. The next layer would tap up to $1 billion in Class Two public securities to be repaid in no more than 10 years. Some 70 percent of these costs will be funded by a premium surcharge on all property/casualty insurance policies (except federal flood, workers compensation, medical malpractice) in the 14 coastal counties. TWIA member insurers would be assessed 30 percent without a recoupment provision or premium tax credit. There is then another bonding layer where up to $500 million in public securities could be utilized that would be repaid via non-recoupable assessments on TWIA member insurers.

Texas Windstorm Insurance Association (TWIA) New Financial Structure

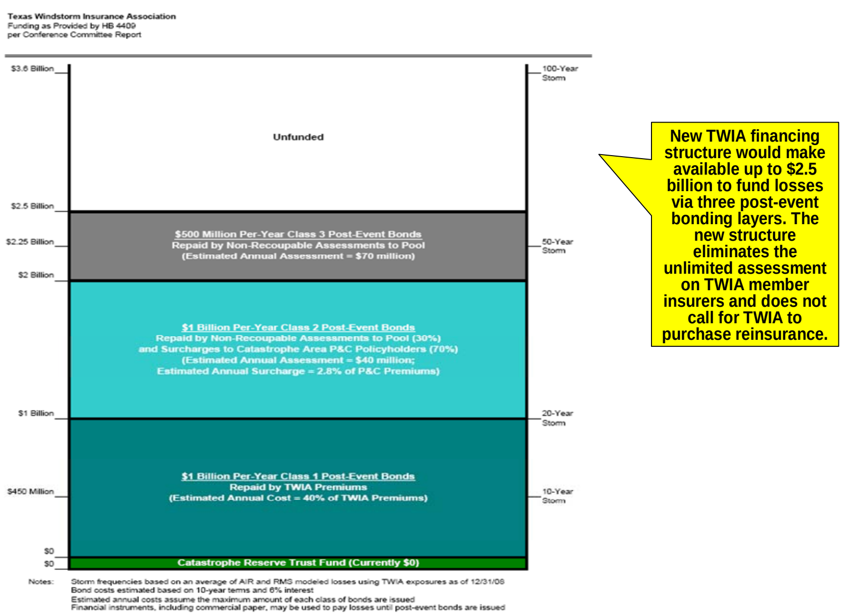


Fig. 21

Source: Southwestern Insurance Information Service (SIIS); TWIA.

[10] *States Shed Reinsurance and 'Run Naked' Through Storm Risks*, by Evan Lehmann of ClimateWire, New York Times, August 17, 2009.

Previously a substantial component of TWIA funding was its ability to assess its member insurers for losses. Assessments for losses were based on an individual insurer's share of the overall Texas market. In the event of a major storm an unlimited assessment of member insurers would be utilized after initial TWIA assessment layers, reserves, surplus and reinsurance were exhausted. These unlimited assessments were recoverable through premium tax credits, potentially compromising the state's general revenue fund.

A $100 million assessment of member insurers was made after Hurricane Dolly hit in July 2008 causing major damage in Cameron and Willacy counties. Member insurers were then assessed $430 million to pay for excess losses resulting from Hurricane Ike which struck the Texas coast in September 2008 causing major damage in Brazoria, Chambers, Galveston, Harris, Jefferson and Matagorda counties. Some $230 million of this assessment was subject to premium tax credits based on the previous statutory funding structure.

A $100 million assessment of member insurers was also made in 2005 after Hurricane Rita struck the upper Texas coast causing major damage in Jefferson, Chambers and Galveston counties. Hurricane Alicia, which struck Galveston Island in 1983, also led to a $157 million assessment, of which some $57 million was subject to premium tax credits based on the funding structure at the time.

Increasing development together with a reduction by some insurers of the number of coastal policies they will issue has led to dramatic growth in TWIA's exposure to loss and policy count in the course of the last decade, even as the number of structures insured by TWIA decreased significantly as a result of Hurricane Ike. According to TWIA figures, by year-end 2008 TWIA had grown to 215,537 policies in-force and exposure to loss for buildings and contents of $58.6 billion (Fig. 22). By May 31, 2009, TWIA's total policy count had grown to 225,641 and total exposure had reached $68.1 billion (including additional living expense (ALE) and business interruption) (Fig. 23). Under state law, insurance rate increases are capped at 10 percent each year unless the Insurance Department determines that a higher increase is necessary due to catastrophic events.

Texas Windstorm Insurance Association (TWIA) Growth In Exposure to Loss (Building & Contents Only) ($ Billions)

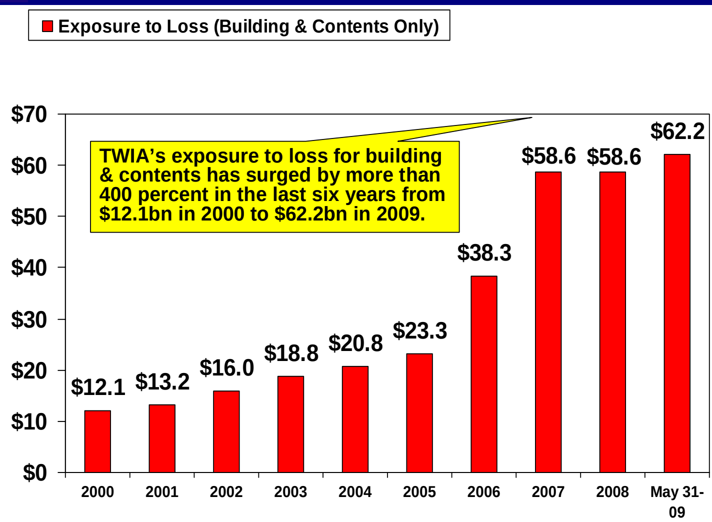


Fig. 22

Source: TWIA; Texas Department of Insurance; Southwestern Insurance Information Service (SIIS)

Texas Windstorm Insurance Association (TWIA) Total Exposure to Loss (Millions of Dollars)

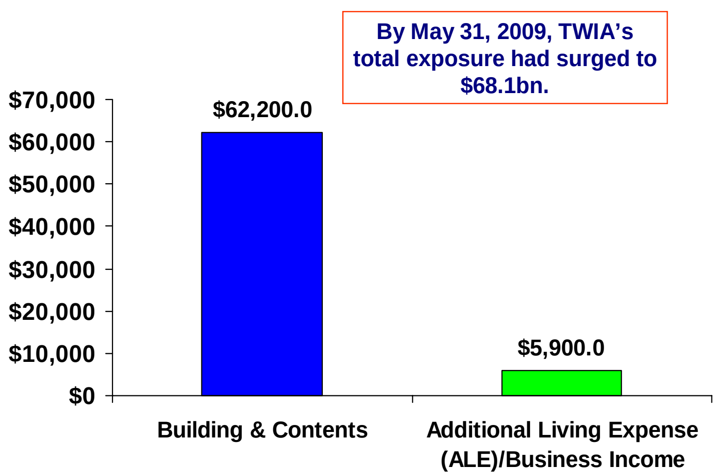


Fig. 23

Source: TWIA at 05/31/09, Texas Department of Insurance

5. Massachusetts Property Insurance Underwriting Association (MPIUA)

The Massachusetts Property Insurance Underwriting Association (MPIUA) was formed by the Massachusetts legislature after passage by Congress of the Housing and Urban Development Act of 1968. This legislation made federal riot reinsurance available to those states that instituted such property insurance pools.

All companies writing basic property insurance in Massachusetts are required to participate in the plan with losses shared among member companies on a premium volume basis. The plan uses a windstorm/hail deductible for any type of wind damage. Coverage for both residential and commercial property owners is available under the MPIUA. The plan offers policies under the homeowners, dwelling fire and commercial property forms. The maximum limits of liability under each program are $1 million for a single building/at any one location and $1.5 million for multiple interests/building and contents coverage.

Like other Eastern seaboard states, Massachusetts is experiencing rapid coastal growth. The combination of its exposure to windstorms and high property values makes it a state with significant potential for losses. An updated 2008 study by AIR Worldwide puts the value of insured coastal property (residential and commercial) in Massachusetts at $772.8 billion, ranking it fourth behind Florida, New York and Texas. This represents 54 percent of the state's total insured property values. AIR estimates that Massachusetts faces a 15 percent chance of a catastrophic storm within the next decade that would cost insurers $5 billion or more.

The FAIR Plan has grown rapidly in the course of the last decade, mirroring rapid growth on Cape Cod, Martha's Vineyard, Nantucket and other coastal areas. MPIUA's policy count surged by 367 percent from 49,628 total policies (habitational and commercial) in 1990 to 231,659 policies in 2008, although the number of policies fell by 1.2 percent between 2007 and 2008 (Fig. 24). The FAIR Plan is the largest insurer on Cape Cod and islands of Martha's Vineyard and Nantucket with about 40 percent of the homeowners market. It insures some 150,000 homeowners statewide. Exposure to loss under the plan has also skyrocketed, from $4.1 billion in 1990 to $81.5 billion in 2008 (Fig. 25). MPIUA's operating results have been variable over the years. In the nine-year period from 2000 to 2008, it reported an operating deficit in three years (2001, 2002 and 2003) and an operating gain in six years (2000 and 2004-2008) (Fig. 26).

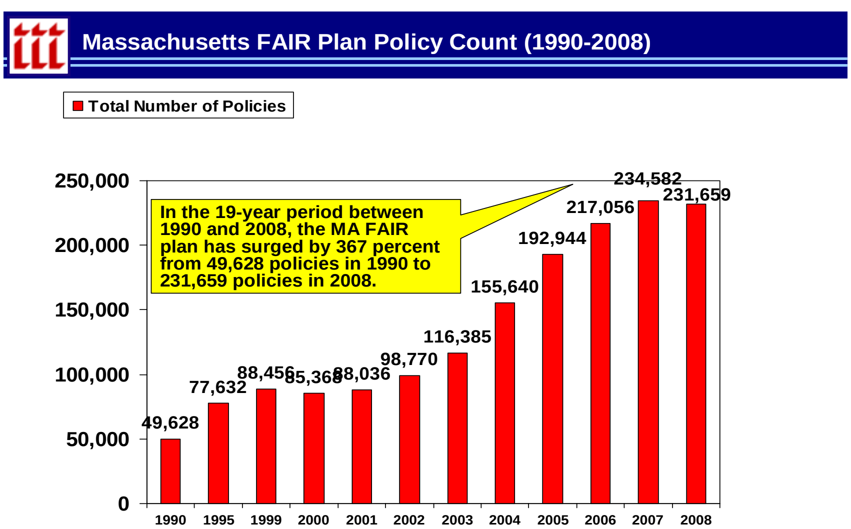


Fig. 24

Source: PIPSO; Insurance Information Institute

Massachusetts FAIR Plan Exposure to Loss (Billions of Dollars)

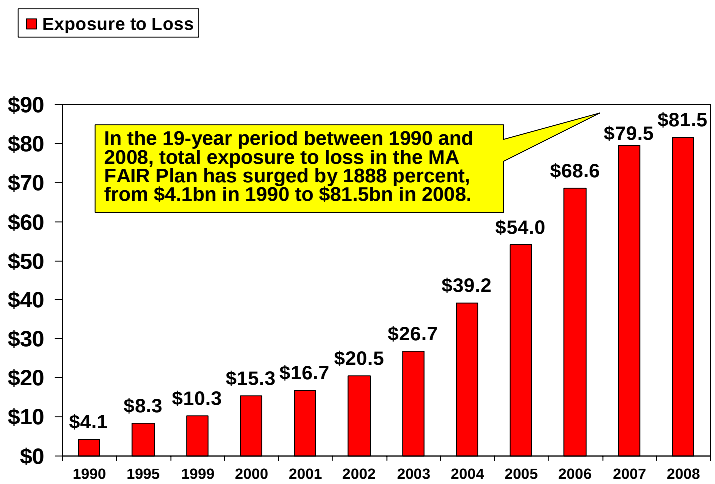


Fig. 25

Source: PIPSO; Insurance Information Institute

Massachusetts FAIR Plan Operating Gain or Loss 2000-2008 (Millions of Dollars)

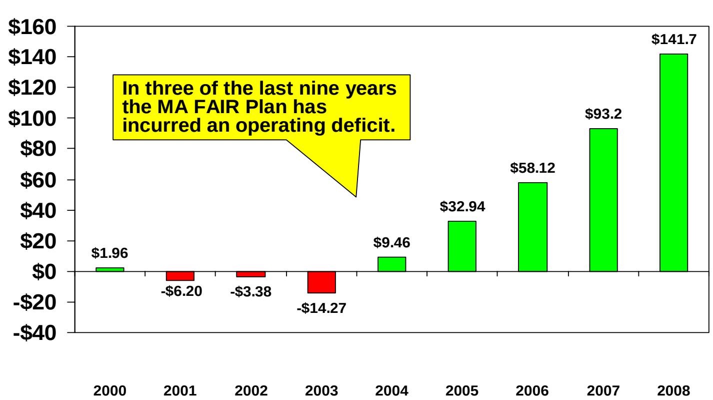


Fig. 26

Source: PIPSO; Insurance Information Institute

Prior to 2004, homeowners' rate changes under the MPIUA were restricted by statute. In territories where its market share was extensive, the plan was permitted to increase pricing only by the statewide average of the top 10 companies. As a result, in the eight-year period from 1997 to 2004, the annual average price increase was capped at 1 percent. However a bill passed in December 2004 allowed the insurance commissioner to consider predicted hurricane losses and cost of reinsurance when reviewing the pricing of the plan. As a result starting from 2006, the rates could be adjusted upward, thereby giving the FAIR plan an actuarially sound pricing basis going forward.

MPIUA is one of the few plans that offer coverage almost comparable to a homeowners policy. The plan also offers a form of guaranteed replacement cost coverage, which pays up to $1 million to rebuild a home. Legislation that would have revised the plan's coverage and allowed the plan to stop offering unlimited replacement cost coverage failed to pass the Massachusetts legislature in 2008.

Earlier in 2008, the state's insurance commissioner denied the FAIR plan's request for a rate increase. The commissioner found the FAIR Plan failed to use reasonable, accurate and timely data to support its call for a rate increase. The Plan had requested an overall state-wide rate increase of 13.2 percent in 2007, but many coastal residents on the Cape would have faced rate increases of 25 percent. State attorney general Martha Coakley had appealed the rate hike to the insurance commissioner. In 2006, the insurance commissioner granted the FAIR Plan an average rate increase of 12.4 percent and a rate increase of about 25 percent in certain coastal areas.

Under the plan, the first $250 million of losses are funded by a layer of cash and short-term securities. Losses in excess of this layer are funded by reinsurance. The MPIUA purchased reinsurance for the first time in 2006. In 2009, it has reinsurance coverage up to a total value of $900 million. Any loss in excess of the investment and reinsurance layers is funded by company assessments. Assessments for losses are based on an individual insurer's market share. Insurers doing business in Massachusetts may recoup the assessment amount by surcharging their policyholders.

6. North Carolina and South Carolina Property Markets of Last Resort

The North Carolina Joint Underwriters Association (NCJUA) and North Carolina Insurance Underwriting Association

North Carolina has two residual market plans that act as a market of last resort for residential and commercial property insurance in the state. The North Carolina Joint Underwriters Association (NCJUA) was created in 1969 to make basic and broad property insurance available to those unable to buy coverage through the standard insurance market. The FAIR plan covers the entire state except those barrier islands adjacent to the Atlantic Ocean. The North Carolina Insurance Underwriting Association (Beach Plan), also created in 1969, provides windstorm and hail coverage as well as homeowners policies for properties located in the state's beach and coastal area (18 coastal counties).

As noted earlier, North Carolina ranks 11th on AIR Worldwide's coastal exposure list with $132.8 billion in insured coastal exposure, of which about 59 percent is residential and 41 percent is commercial. North Carolina's insured coastal exposure represents just 9 percent of the state's total insured values.

Yet as of March 31, 2009, North Carolina's beach and windstorm plan, the North Carolina Insurance Underwriting Association (no longer a PIPSO member), reported a total of 175,877 policies, up from 94,612 policies reported at the end of 2004. Total exposure to loss under the plan also increased from $31.6 billion in 2004 to $73.6 billion at March 31, 2009 – an increase of more than 100 percent.

An October 2008 study by Milliman, an actuarial consulting firm, for the Property Casualty Insurers Association of America warned that the beach plan was financially unprepared to weather a severe storm. It noted that the beach plan's exposure to liability is increasing but its ability to pay claims from a storm and the timing of those payments is dependent upon assessments from member companies. In a season with a large storm (1-in-250 year scenario), the plan would likely face a $6.2 billion deficit. This could result in assessments which may significantly impact the financial conditions of some insurers, according to Milliman. Even a small storm (1-in-50 year scenario) would leave the plan some $1.4 billion in the red.

In August 2009, legislation (HB1305) aimed at reforming the beach plan was passed by the state Senate and subsequently signed into law by North Carolina Governor Bev Perdue. The legislation would: cap insurers' assessments for losses incurred in one year at $1 billion; allow insurers to assess a 10 percent surcharge on every property insurance policy statewide after a major storm if the plan hits the $1 billion deficit threshold; and reduce coverage limits for residential property to $750,000 from $1.5 million.

The bill is based on recommendations made in January 2009 by a Joint Select Study Committee to restore the beach plan to its intended role as a market of last resort. In addition to these legislative recommendations, in December 2008 changes were made by the beach plan and the Department of Insurance (DOI) without the need for legislation. These changes, which included increasing homeowners policy deductibles, raising rates and allowing the plan to retain more capital, were intended to increase the plan's surplus and decrease its exposure to loss.

The South Carolina Wind and Hail Underwriting Association

The South Carolina Wind and Hail Underwriting Association (SCWHUA), known as the Beach Plan or Wind Pool, provides wind and hail coverage for residential and commercial properties in the coastal area of the state.

As of December 31, 2008, the South Carolina Beach Plan had a total of 46,665 policies in force, an increase of 14 percent from 40,917 total policies in force at the end of 2007. The SC Beach Plan's total in-force liability increased by 52 percent from $11.2 billion in 2006 to $17.0 billion in 2008. In 2009, the SC Beach Plan's total policies in force have declined slightly but its exposure continues to increase. As of April 30, 2009, the plan had a total of 46,053 policies in force and its total in-force liability was $17.2 billion.

South Carolina ranks eighth on AIR Worldwide's coastal exposure list with $191.9 billion in insured coastal exposure, representing 28 percent of the state's total insured values. The state is also experiencing accelerating coastal population growth. Between 1980 and 2003, its coastal population grew by 33 percent, ranking it 10th among leading states in terms of coastal population growth.

From January 1, 2008, the state insurance department has required wind pool policyholders choosing replacement cost coverage to purchase flood insurance. Around 70 percent of wind pool policyholders already had flood coverage and several thousand additional policyholders are now covered for flood damage.

Legislation expanding the Beach Plan's coverage territory was approved in June 2007. Residents who make their homes more resistant to wind damage would also be given tax breaks. In addition, insurers would receive tax-credits for writing coastal policies that did not exclude windstorm losses.

Appendix 1

Natural Disaster Bills Under Consideration In Congress

Source: Reinsurance Association of America (www.reinsurance.org) and the American Association of Insurance Services (www.aais.org)

Homeowner's Defense Act of 2009 (H.R. 2555)
Summary: Would create a federally-facilitated "consortium" of states that would pool their natural catastrophe risk and lay it off to the capital markets or reinsurance; provide a federal guarantee of tax exempt bond issued by state cat funds; and create a federal reinsurance program in the Department of the Treasury to sell cheap reinsurance to state cat funds.

Homeowners Insurance Protection Act of 2009 (H.R. 83)
Summary: Would create a federal reinsurance program in the Department of the Treasury to sell reinsurance to qualifying state catastrophe funds.

Homeowner's Defense Act of 2009 (S. 505)
Summary: Would establish a National Catastrophe Risks Consortium and a National Homeowner's Insurance Stabilization Program. The federal consortium would assist states in pooling their natural catastrophe risks. The stabilization program would provide low interest federal loans to state catastrophe funds.

The Catastrophe Obligation Act of 2009 (S. 886)
Summary: Would provide a federal guarantee of tax exempt bonds issued by state catastrophe funds. Credit markets provide price discipline.

Multiple Peril Insurance Act of 2009 (H.R. 1264)
Summary: Would amend the National Flood Insurance Program (NFIP) to include wind as a covered peril.

Extend the Authorization of the National Flood Insurance Program (H.R. 3139)
Summary: Would extend the National Flood Insurance Program through March 31, 2010.

Hazard Mitigation for All Act of 2009 (H.R. 3026)
Pre-disaster Hazard Mitigation Enhancement Program Act of 2009 (H.R. 3027)
First Responder Innovation and Support Act of 2009 (H.R. 3028)
Summary: Each of the bills would provide federal grants to assist homeowners, businesses, public officials, and first responders to better prepare for catastrophic events. The bills encourage mitigation efforts—such as increasing the structural integrity of homes and commercial buildings, creating water barriers to prevent property flooding, coordinating the use of natural and man-made storm barriers, and providing incentives for states to improve state mitigation programs and identify and implement innovative first responder programs.

Property Mitigation Assistance Act of 2009 (H.R.1239)
Summary: Establishes a homeowner mitigation loan program within the Federal Emergency Management Agency to promote pre-disaster property mitigation measures.

Hurricane and Tornado Mitigation Investment Act (S. 1364)
Summary: Senate companion to H.R. 308. The measure provides a tax credit, equal to 25 percent, of mitigation expenditures.