

## RESIDUAL MARKET PROPERTY PLANS

**From Markets of Last Resort to  
Markets of First Choice**

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## I. The Changing Residual Property Market

### 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 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 15-year period from 1990 to 2005—a period underscored by major catastrophes such as Hurricane Andrew, 9/11 and Hurricane Katrina—that growth has accelerated. For example, total policies in force (both habitational and commercial) in the nation's FAIR Plans more than doubled from 781,188 in 1990 to 2.1 million in 2005 (Fig. 1).

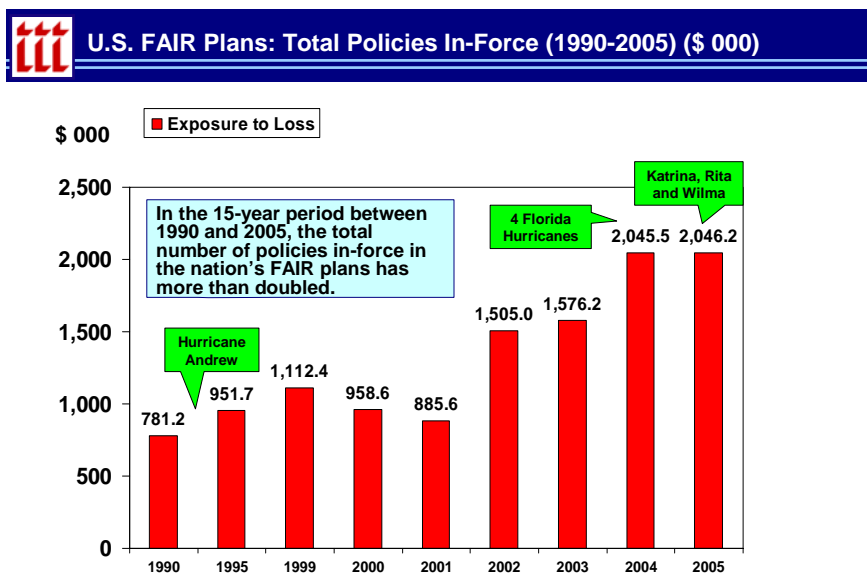


Fig. 1

Source: PIPSO; Insurance Information Institute

During the same 15-year period, total exposure to loss in the FAIR Plans surged by nearly ten-fold from \$40.2 billion in 1990 to \$387.8 billion in 2005 (Fig. 2). Similarly, total exposure to loss in the Beach and Windstorm Plans surged by over 100 percent from \$14.5 billion in 1990 to \$31.7 billion in 2005. While a



number of factors have contributed to this overall growth, 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 are evolving 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.



### U.S. FAIR Plans Exposure to Loss (\$ Billions)

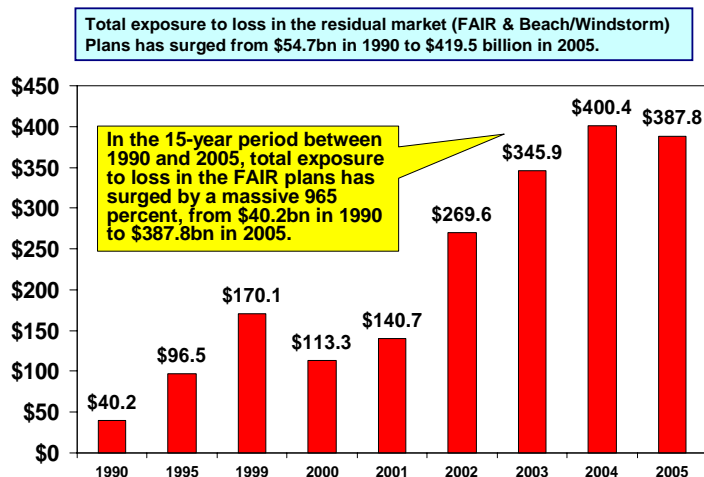


Fig. 2

Source: PIPSO; Insurance Information Institute

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 are experiencing severe financial difficulties (see section on financial results).

In 2005, the latest year for which data is available, the FAIR Plans reported an aggregate operating deficit of \$1.9 billion (Fig. 3). Notably this figure includes the results of Florida Citizens but excludes the results of Louisiana Citizens Property Insurance Corporation, a plan severely impacted by losses arising from Hurricane Katrina. It also compares with an aggregate operating loss of just \$51.9 million for those FAIR Plans reporting back in 1995. This means that the FAIR Plans have seen a more than 30-fold ballooning of their aggregate operating loss in the course of the last decade. If Louisiana Citizens' estimated 2005 operating deficit of \$954 million is included in the data, the FAIR Plans' 2005 deficit rises to a staggering \$2.8 billion—a more than 50-fold increase in the aggregate deficit in the last decade.



## FAIR Plan Operating Gains/Losses 1990-2005 (\$ Millions)

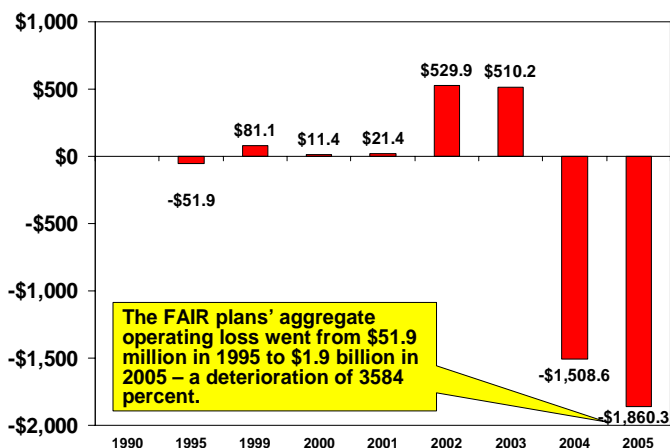


Fig. 3

Source: PIPSO; Insurance Information Institute

Such deterioration 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. The benign hurricane season of 2006, while a welcome reprieve, does 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 are experiencing explosive growth. According to Property Insurance Plans Service Office (PIPISO), in 2005 the nation's FAIR plans had some 1.9 million habitational policies and 117,942 commercial policies in force for a total exposure to loss of \$387.8 billion (Table 1). Between 2003 and 2005, the number of residential policies in force increased by 27.6 percent and the number of commercial policies by 80 percent. Total exposure to loss rose from \$345.9 billion in 2003 to \$387.8 billion in 2005, and since 1990 exposure to loss in the plans has surged by 965 percent. Though final data are not yet available, FAIR and Beach and Windstorm Plan policy counts and exposure increased markedly in 2006, with significant increases in Florida, Louisiana, Texas and Mississippi.



**Table 1**  
**INSURANCE PROVIDED BY FAIR PLANS, 1996-2005 (1)**

<b>Year</b>	<b>Habitational policies</b>	<b>Commercial policies</b>	<b>Exposure (2) (\$000)</b>
1996	1,004,826	64,767	\$122,492,899
1997	1,035,941	57,932	124,410,722
1998	1,466,626	52,173	169,994,265
1999	1,068,525	44,893	140,281,262
2000	919,703	38,868	113,333,445
2001	912,829	36,748	143,459,479
2002	1,422,990	81,887	269,566,059
2003	1,510,665	65,532	345,909,146
2004	1,907,337	138,163	400,413,034
2005	1,928,292	117,942	387,780,124

(1) Data from 2002 to 2005 include Florida's Citizens Property Insurance Corporation, which includes FAIR and Beach Plans; data for 2005 include Louisiana's Citizen's 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 the five year-period from 2001 to 2005, the number of policies in the Windstorm Plans went from 310,940 in 2001 to 157,708 in 2005. 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.

Total exposure to loss under the Beach and Windstorm Plans, as under the FAIR Plans, has ballooned by more than 100 percent from \$14.5 billion in 1990 to \$31.7 billion in 2005, demonstrating the rising values at stake (Fig. 4) (Table 2).



Table 2

INSURANCE PROVIDED BY BEACH AND WINDSTORM PLANS, 2005 (1)

State	Habitational policies	Commercial policies	Exposure (2)	
			(\$000)	Percent change 2004-2005
Mississippi	14,710	1,082	\$1,872,999	14.8%
South Carolina	21,131	937	6,576,213	9.6
Texas	106,350	14,038	23,279,429	11.9
<b>Total</b>	<b>141,651</b>	<b>16,057</b>	<b>31,728,641</b>	<b>11.6</b>

(1) Does not include North Carolina, which has a Beach Plan, but does not submit data to PIPSO, Florida and Louisiana Beach Plans which are combined with their respective FAIR Plan in the Citizens Property Insurance Corporation, and Alabama.

(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 (PIPISO).



U.S. Beach and Windstorm Plans Exposure to Loss (\$ Billions)

In 2002 Florida combined its Windstorm and Joint Underwriting Association to create Florida Citizens, so Florida data shifted to the FAIR plans from this date.



In the 15-year period between 1990 and 2005, total exposure to loss in the Beach and Windstorm plans has more than doubled, from \$14.5bn in 1990 to \$31.7bn in 2005.

Fig. 4

Source: PIPISO; Insurance Information Institute

Of the 2.1 million total policies (habitational and commercial) insured by the FAIR Plans in 2005, just over 1 million or 49 percent were in Florida Citizens. California had the next largest number of policies, with 214,741 or 10 percent of total policies, followed closely by Massachusetts with 192,944 or 9 percent of the total (Table 3). While PIPISO 2005 policy count data for Louisiana Citizens is unavailable at this time, in 2004, Louisiana accounted for some 195,504 or 10 percent of total policies insured by the FAIR and Beach and Windstorm plans that year, following Florida and California respectively.



Certain states have shown particularly rapid growth in recent years. For example, the Massachusetts' FAIR Plan rose from 84,287 habitational policies in 2000 to 191,828 habitational policies in 2005—an increase of 128 percent. California's policy count is also on the rise, though at a more modest growth rate of 3 percent, from 195,084 habitational policies in 2004 to 201,043 such policies in 2005.

**Table 3**  
**INSURANCE PROVIDED BY FAIR PLANS BY STATE, 2005 (1)**

State	Habitational policies	Commercial policies	Exposure (2) (\$000)	State	Habitational policies	Commercial policies	Exposure (2) (\$000)
California	201,043	13,698	\$48,663,725	Missouri	9,748	608	\$458,939
Connecticut	5,040	342	756,193	New Jersey	47,402	1,756	5,887,162
Delaware	3,299	123	307,108	New Mexico	12,319	488	657,182
Florida (CPIC) (3)	922,359	80,563	210,590,508	New York (4)	61,504	8,002	12,021,650
Georgia (5)	29,491	1,084	2,656,721	Ohio	69,233	1,530	13,440,019
Illinois	12,426	300	925,872	Oregon	4,893	214	373,247
Indiana	4,631	259	339,389	Pennsylvania	41,061	2,797	2,189,147
Iowa	1,586	68	110,028	Rhode Island	21,745	187	1,052,631
Kansas	7,443	263	326,883	Texas	120,913	(6)	14,133,423
Kentucky	14,985	861	148,488	Virginia	37,274	921	3,774,646
Louisiana (CPIC) (3)	NA	NA	NA	Washington	109	53	36,845
Massachusetts	191,828	1,116	53,958,244	West Virginia	1,517	126	58,432
Michigan	89,938	2,360	12,743,849	Wisconsin	6,463	129	NA
Minnesota	10,042	94	2,169,793	<b>Total</b>	<b>1,484,069</b>	<b>101,037</b>	<b>331,527,008</b>

(1) Does not include Arkansas, Washington D.C., Hawaii, Maryland, Mississippi and North Carolina which have FAIR plans but do not submit data to PIPSO, and Louisiana's Citizen's Property Insurance Corporation, for which data is not available.

(2) Exposure is the estimate of the aggregate value of all insurance in force in each state's FAIR Plan in all lines (except liability, where applicable, and crime) for 12 months ending September through December.

(3) Citizens Property Insurance Corporation, which combined the FAIR and Beach Plans.

(4) Includes wind and hail coverage for any dwelling, including those in coastal communities.

(5) Includes a wind and hail option for certain coastal communities.

(6) Texas FAIR Plan does not offer a commercial policy.

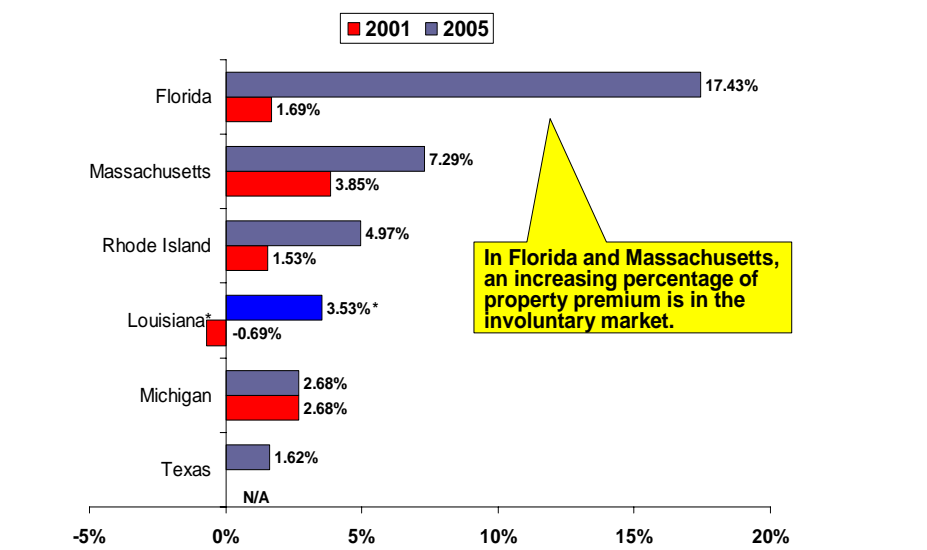
NA= Data not available.

Source: Property Insurance Plans Service Office (PIPISO).

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. 5).



**FAIR/Beach Plan Earned Premium as Percentage of Overall Property Market (Top 5 states) 2001 vs. 2005\***



\* Louisiana figures are for 2004 vs. 2001

**Fig. 5**

Source: PIPSO

Florida and Massachusetts are two notable examples. For example, in Massachusetts around 7.3 percent of property premium was in the involuntary market in 2005. In Florida, 17 percent of the market was in the involuntary market in 2005, a percentage that has grown significantly in the course of the last five years, from just 1.7 percent in 2001, and will grow even more rapidly once the state's new insurance law (CS/HB 1A) takes effect June 1, 2007 (this law is discussed in detail on page 21). Louisiana is another state experiencing 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 0.6 percent back in 1990. Rhode Island's residual market also accounts for close to 5 percent of its property market.

**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.

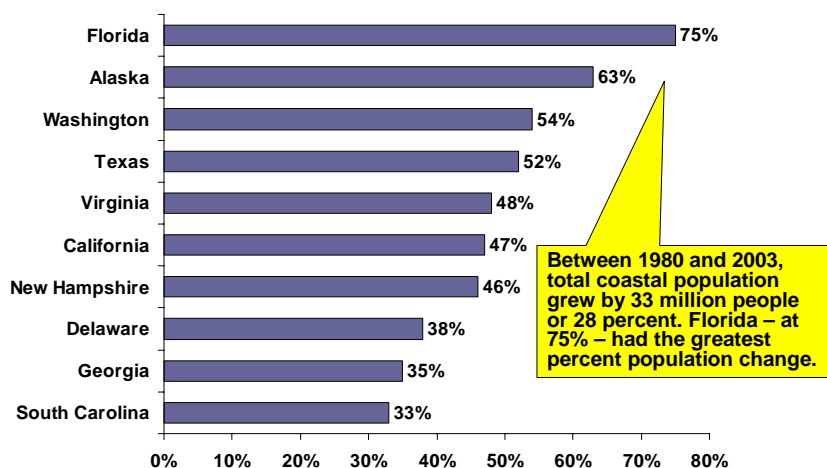
Another factor fueling the increase is the rise in coastal properties. A 2004 report by the National Oceanic and Atmospheric Administration (NOAA) found that in 2003, 53 percent of the nation's



population—153 million people—lived in coastal counties (including those that abut the Great Lakes). 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. 6).



### Leading States in Coastal Population Growth, 1980-2003



**Fig. 6**

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. A 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 \$6.86 trillion in 2004.<sup>1</sup> In Florida alone the value of residential and commercial coastal property is \$1.94 trillion (Fig. 7, Fig. 8). This represents 79 percent of the state's total insured property values (Fig. 9). In New York it is \$1.90 trillion, representing 61 percent of the total. However, the value of New York's commercial coastal property, at \$1.3 trillion, is higher than that of any other state on the list (Fig. 10). Other states where insured coastal property values exceed 50 percent of the state's total are Connecticut, Maine and Massachusetts.

<sup>1</sup> AIR Worldwide, *The Coastline at Risk*, September 2005.



### Total Value of Insured Coastal Exposure in 2004 (\$ Billions)

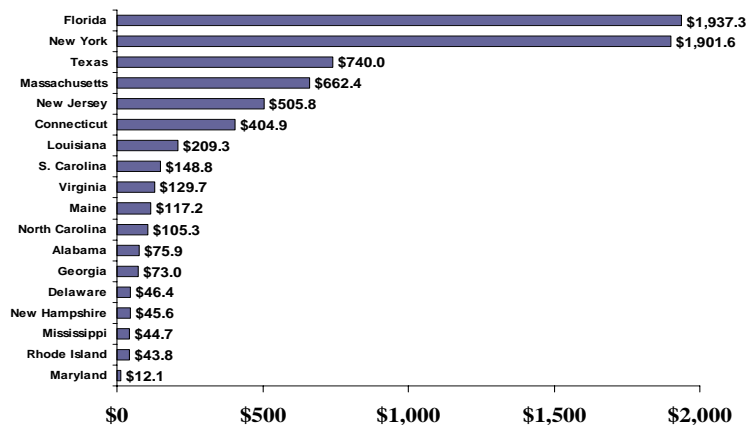


Fig. 7

Source: AIR Worldwide



### Value of Insured Residential Coastal Exposure in 2004 (\$ Billions)

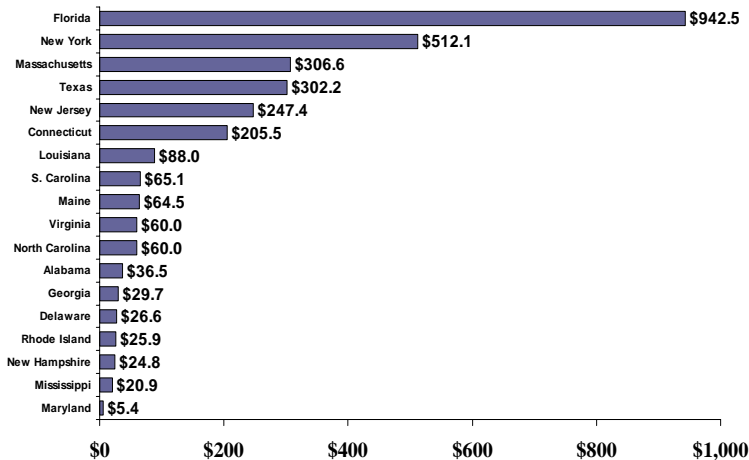


Fig. 8

Source: AIR Worldwide



### Insured Coastal Exposure as a % of Statewide Insured Exposure in 2004

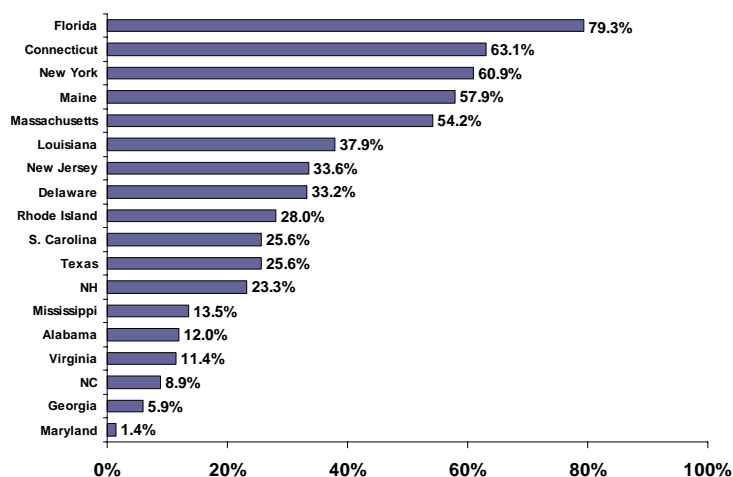


Fig. 9

Source: AIR Worldwide



### Value of Insured Commercial Coastal Exposure 2004 (\$ Billions)

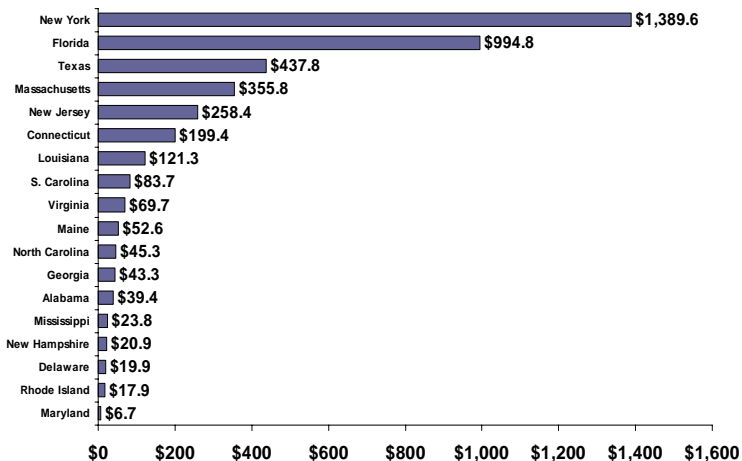


Fig. 10

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 11<sup>th</sup> on AIR's list with \$105.3 billion in insured coastal exposure, representing just 9 percent of the state's total insured values. Yet as of September 30, 2006, North Carolina's beach and windstorm plan, the North Carolina Insurance



Underwriting Association (no longer a PIPSO member), reported a total 124,858 residential policies and \$43.7 billion in associated exposure, double its 68,544 residential policies and \$17.8 billion in exposure reported at the end of 2003. As of February 2007, total exposure to loss in the Beach Plan is estimated to be in excess of \$52 billion.

### 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.<sup>2</sup> 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. 11). 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. 12).

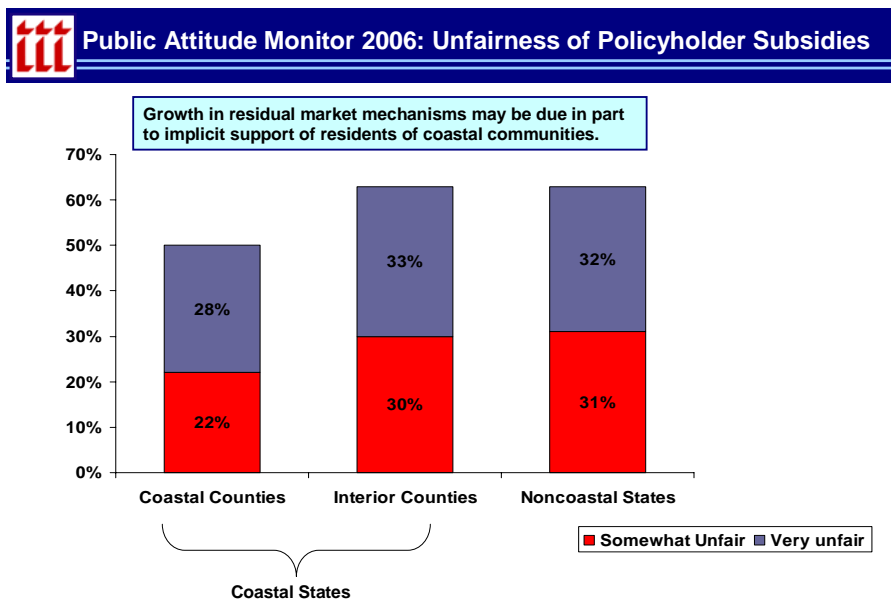
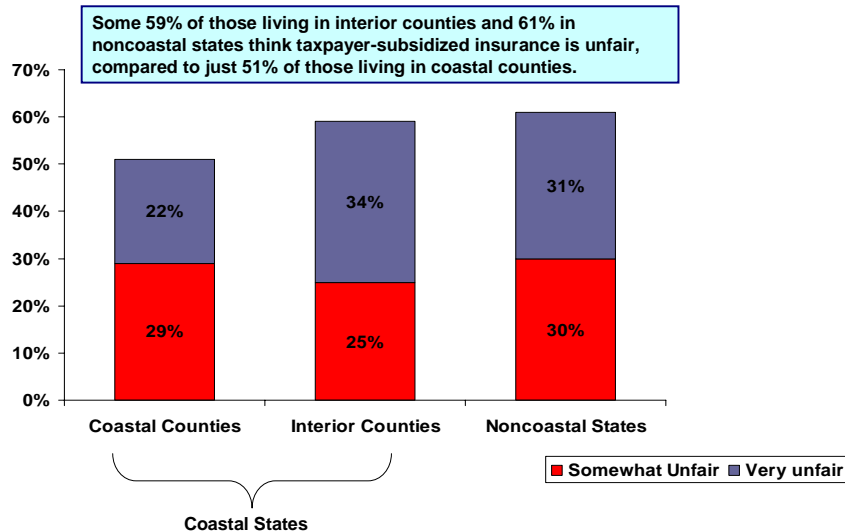


Fig. 11

Source: Insurance Research Council

<sup>2</sup> Insurance Research Council (IRC), Public Attitude Monitor (PAM) 2006, Issue 2, October 2006.


**Fig. 12**

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 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. This situation refers to the well-known problem of adverse selection, whereby the insurer is left with a portfolio of risks that consists primarily of those policyholders who are the most likely to file claims. Such a situation inevitably will increase the volume of property policies being written by the residual market mechanisms.

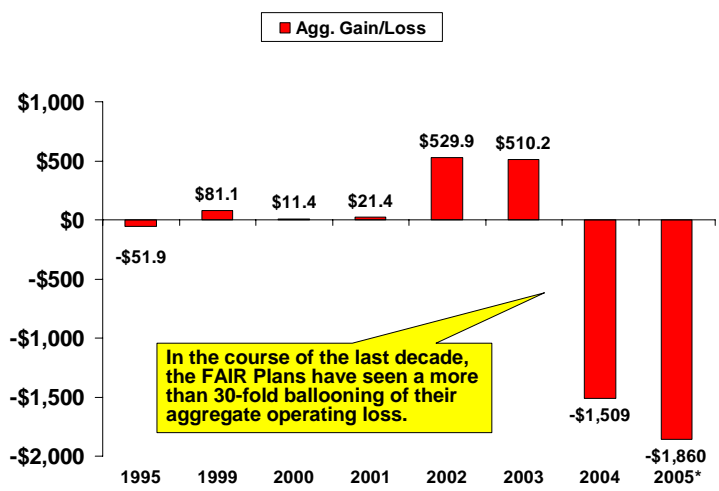
### 3. Financial Results

Today, many residual property market plans have mutated from their original concept 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 the course of the last decade the FAIR Plans have seen a more than 30-fold ballooning of their aggregate operating loss, from a \$51.9 million loss back in 1995 to a \$1.9 billion deficit in 2005. Further, the estimated \$954 million 2005 deficit of the Louisiana FAIR Plan would push the aggregate operating deficit of the plans to approximately \$2.8 billion for the year (Fig. 13).

**FAIR Plans Aggregate Operating Gain/Loss (\$ Millions)**



**Fig. 13**

Source: PIPSO

\* 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.

The FAIR Plans reported an aggregate operating loss following the record hurricane losses of 2004 and 2005. In the prior three years, the plans reported slim aggregate operating gains. In 2005, the latest year for which data is available, 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.<sup>3</sup> Insufficient rates, inadequate cash reserves and insufficient or nonexistent reinsurance have contributed to the problems in Florida, Louisiana and other states.

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.<sup>4</sup> For example, in 2005, the Windstorm Plans incurred an aggregate underwriting loss of \$833.1 million, with by far the largest loss reported by the Mississippi Windstorm Underwriting Association (MWUA). Over the five-year period from 2001 through 2005, the Windstorm Plans incurred an underwriting loss. The only year in which an underwriting profit was achieved during that period was 2003, due to no major hurricanes that year.

<sup>3</sup> 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.

<sup>4</sup> Investment income for the Windstorm Plans is not reported by PIPSO, so only underwriting income is reported for these plans.

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.
- **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.

In addition to assessments and debt, increasingly plans are being bailed out by a diversion of tax revenues from state coffers. For example, 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. Mississippi's governor also set aside \$50 million in federal aid to help the Mississippi Windstorm Underwriting Association (MWUA). Further diversion of state and federal funds to the MWUA is set following passage of new reforms by the state legislature in March 2007 (see later section on Mississippi). 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 tax payers.

### ***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 are designed to work as a complement to, rather than in competition with, the private market. Therefore, typically the rates charged by the residual plans are higher than those in the voluntary market. The idea is to charge a risk-based premium that is commensurate with the specific type of business being written.

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 have changed rapidly, and a number of private insurers and residual market plans in hurricane zones are 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 1.3 million policies as of March, 2007. Total exposure to loss under Citizens has also grown, from \$154.6 billion in 2002 to \$434.3 billion in 2007. So has its deficit. Citizens went from a slim operating profit of \$533.5 million in 2002 to a massive estimated operating deficit of \$2 billion in 2005. These figures come despite a depopulation plan that has returned around 500,000 Citizens policies and \$100 billion of exposure back to the private insurance market between 2003 and 2006.

The insolvency of Florida's third largest private insurer, Poe Insurance Group, following the record hurricane claims 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. The failure of Poe also led the Florida Insurance Guaranty Association in 2006 to impose two assessments on all insurers doing business in the state, based on their 2005 net written direct premiums. A 2 percent assessment imposed in June 2006, and a further 2 percent emergency assessment levied on insurers in December 2006, will raise an estimated \$450 million to help cover Poe's outstanding claims. These assessments are passed onto policyholders in the form of surcharges on all policies except for auto and workers compensation, resulting in yet another assessment for Florida insurance buyers. The failure of Poe represented the largest loss of insurance capacity in Florida since Hurricane Andrew in 1992 when 10 Florida insurance companies became insolvent.

Citizens is now the largest property insurer in the state. Despite its precarious financial position, at a special legislative session held in January 2007 focusing on Florida's property insurance difficulties, legislators approved a new state insurance law that will significantly expand Citizens exposure base and reduce the rates it is able to charge (see later section on Florida Citizens). An emergency order subsequently signed by Florida Governor Charlie Crist would prevent insurers from raising rates or canceling/non-renewing policies prior to June 1, 2007, when the new law takes effect.

#### **4. Impact on the Voluntary Insurance Market**

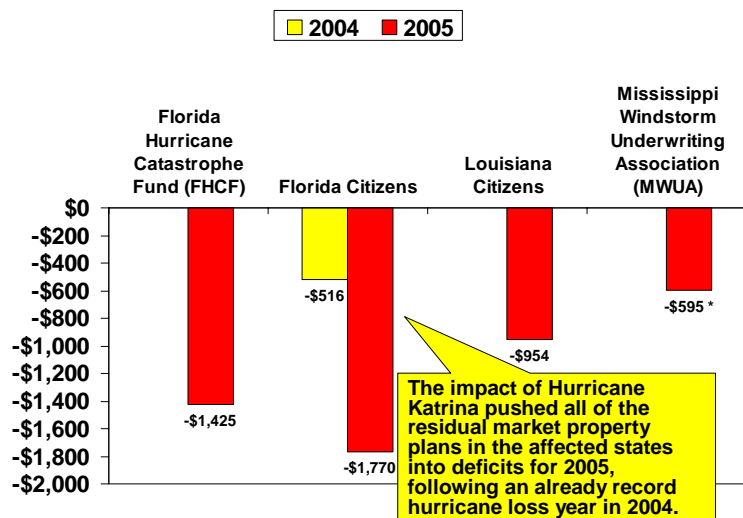
When the losses of FAIR Plans and Beach and Windstorm Plans exceed their claims-paying capacity in a given year, the plans impose an assessment on every participating insurer, typically based on their homeowners or property insurance market share in a state. In many states, insurers may then recoup this 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. 14). 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.<sup>5</sup> 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.

**Residual Market Plan Estimated Deficits 2004/2005 (\$ Millions)**



\* MWUA est. deficit for 2005 comprises \$545m in assessments plus \$50m in Federal Aid.

**Fig. 14**

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 are missing out on significant growth opportunities in certain states. In 2007, the property/casualty industry is expected to record its second slowest rate of growth (1.8 percent) since 1998. 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.

<sup>5</sup> Case 1:06-cv-00954-LTS-RHW; United States District Court for the Southern District of Mississippi Southern Division; Filed 09/15/06.

## 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 competition among carriers and choice for policyholders.
- When the 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, rating 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.
- 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 or live nowhere near the coast.

## ***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 (see earlier discussion on Florida and the insolvency of Poe Insurance Group). 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

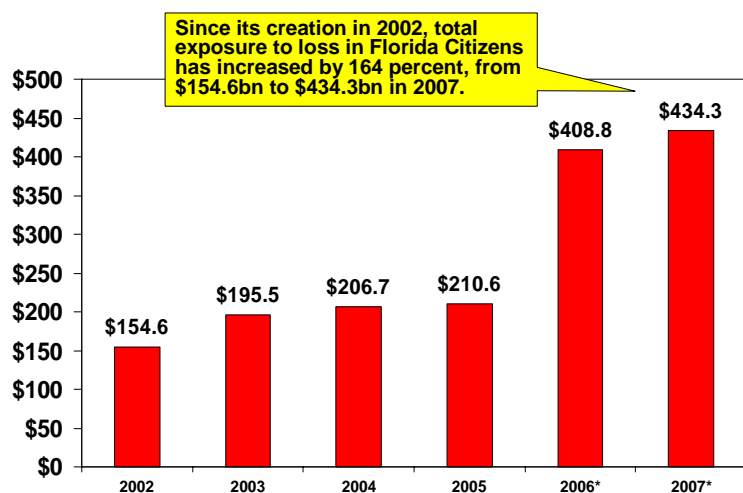
Since its establishment in 2002, after the state passed legislation combining two separate high risk insurance pools, known as the Florida Windstorm Underwriting Association and the Florida Residential Property & Casualty Joint Underwriting Association, Citizens Property Insurance Corporation (CPIC) 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 2.1 million total policies (habitational and commercial) insured by the FAIR plans across the U.S. in 2005, just over 1 million or 49 percent were in Florida Citizens. This compares with the 658,085 policies or 44 percent insured by Florida Citizens in 2002. 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. Following a new legislative package passed in January 2007 (discussed below), Citizens rates are now competitive with the private market.

CPIC's policy count/exposure is extremely high. As of December 31, 2006, Citizens had 400,509 high risk policies in force (those that were in the old windstorm pool) and \$178.3 billion in associated exposure. The CPIC also had about 743,592 personal/residential policies in force with \$137.1 billion in exposure, and about 8,841 commercial/residential policies with \$58.2 billion in associated exposure. 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 have been returned to the private market. In addition, Citizens has reduced its exposure by \$100 billion. However, the insolvency of major insurance group, the Poe Insurance Companies, has added thousands of policies to Citizens at a time when many other insurers are cutting back on policy renewals in coastal areas. As of December 31, 2006, some 142,384 residential policies with \$30.3 billion in exposure were in the process of transitioning into Citizens. A further 596 commercial policies with associated exposure of \$4.9 billion were transitioning into Citizens. Overall, the CPIC had total policies in force of 1.3 million with total exposure to loss of \$408.8 billion. As of March 31, 2007, total policies in force remained at 1.3 million, while total exposure to loss had increased to \$434.3 billion (Fig. 15).



## Florida Citizens Exposure to Loss (\$ Billions)



\*FL Citizens data, as of Dec 31, 2006 and Mar 31, 2007 respectively.

Fig. 15

Source: PIPSO; Insurance Information Institute

## Legislative Developments

Despite its growing exposure, Citizens is set to experience even further growth following a special legislative session in January 2007 at which a new insurance law (CS/HB 1A) was agreed. The new law significantly expands the overall role of the state in insuring homes and in the reinsurance markets and includes the following specific changes for Citizens:

- Requires Citizens to be competitive with the private market by lowering its rates and lowering eligibility standards.
- Authorizes Citizens to write multiperil policies (in addition to wind-only policies) in areas eligible for coverage in the high-risk account, and transfers business from the commercial Joint Underwriting Association (JUA) into Citizens.
- Expands the Citizens assessment base more than four-fold to all lines of property/casualty insurance except for workers compensation and medical malpractice.
- Requires executive officer review on routine rate filings (threatens perjury charges and administrative penalties).
- Requires premium discounts, even if they are not actuarially justified.

The upshot of this new law is that the exposure of Florida's policyholders to post-catastrophe taxes and assessments will increase dramatically. At the same time, the law does almost nothing to encourage property insurers to offer policies in Florida over the long-term, nor does it reduce the actual risk from hurricanes facing Florida property owners.



## Claims-Paying Capacity

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 follows 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.

When Citizens losses exceed its claims-paying capacity in a single year, it is required by state law to impose a statewide assessment on every insurer based on its homeowners line market share in the state. By law, insurers may recoup the amount from policyholders as part of the homeowners insurance rate-making process in the state. The surcharge is shown separately on premium notices when homeowners insurance policies come up for renewal. To cover 2004's shortfall, Citizen's imposed a 6.8 percent surcharge on policyholders, amounting to about \$100 per \$1,500 in premiums. To offset Citizens' 2005 deficit, hurricane insurance bill (SB 1980) was passed by the state legislature 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 will be spread over a 10-year period (1.4 percent annually).

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. As part of its financial structuring for the 2006 hurricane season, Citizens undertook a \$3.05 billion bond issue in early July 2006 to raise additional capacity. As a result, Citizens had \$5 billion in reserves to deal with potential losses in the 2006 hurricane season.

As a result of the special legislative session held in January 2007, a number of rate-reducing measures will now be implemented. These include requiring Citizens to use rates that are competitive with the private market and freezing its rates at December 31, 2006, levels.

Hurricane insurance bill SB 1980 addressed the need to reduce Citizens' policy count going forward. For example, beginning July 1, 2008, owners of \$1 million-plus homes and vacation and second homes of any value will no longer be able to obtain coverage through Citizens. Instead they will have to obtain coverage from the voluntary market or from surplus lines insurers, companies that provide coverage for risks that standard insurers have rejected in return for generally higher and less regulated rates. Citizens coverage will only be available if an applicant can prove that coverage is unavailable elsewhere, and then only for a limit of three years. As of March 31, 2006, more than 6,000 of the homes Citizens insured were worth more than \$1 million. In South Florida, the riskiest part of the state, some 2,800 homes were worth more than \$1 million. In total, these homes represent \$13.7 billion or 10 percent of the insured value of its high-risk policies but only 2 percent of the total number of policies written. This suggests that a disproportionate share of Citizens' potential liability arises from insuring the homes of relatively wealthy property owners.

## ***2. Louisiana Citizens Property Insurance Corporation***

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 \$209.3 billion in insured coastal exposure, representing 37.9 percent of the state's total insured values (Fig. 16).

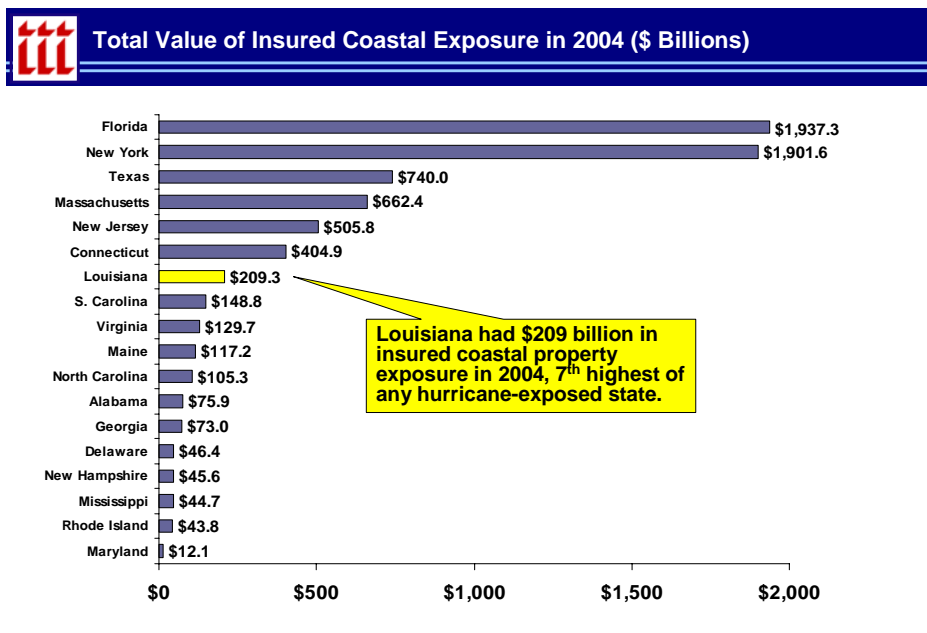


Fig. 16

Source: AIR Worldwide

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 hurricane losses of \$1.07 billion. Louisiana Citizens issued \$1 billion in revenue bonds to help fund the shortfall.

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 \$350,000 for the home, additional structures, contents and liability. Coverage up to \$225,000 is available for the dwelling only.

As of December 31, 2005, Louisiana Citizens had a total of 134,169 policies in-force, for a total exposure value of \$14.9 billion (Fig. 17, Fig. 18). Following Hurricane Katrina, Louisiana state officials announced that policyholders could see a 20 percent homeowners premium surcharge, a combination of insurers' passed-on assessment (an average of 15 percent) and the cost of issuing bonds (5 percent) to pay for Katrina claims and to boost its reserves. Surcharges for the bond issue, which would be on top of any regular premium increases, would continue for as long as it takes to pay off the \$1 billion in bonds.



### LA Citizens Policy Count (2004-2006), All Wind Zones

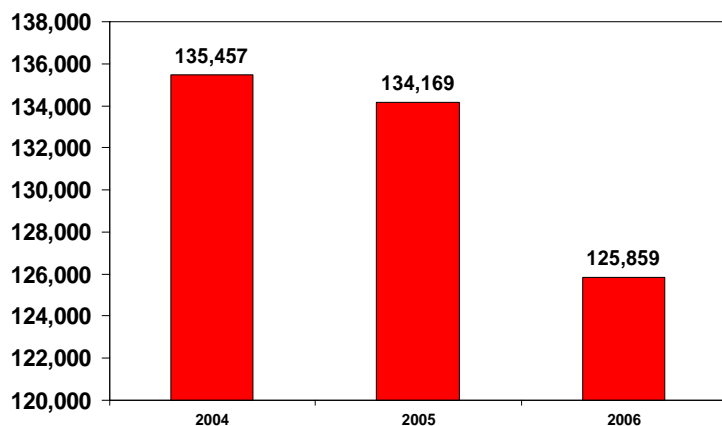


Fig. 17

Source: LA Citizens



### LA Citizens: Amount of Insurance, All Wind Zones 2004-2006 (\$ Billions)

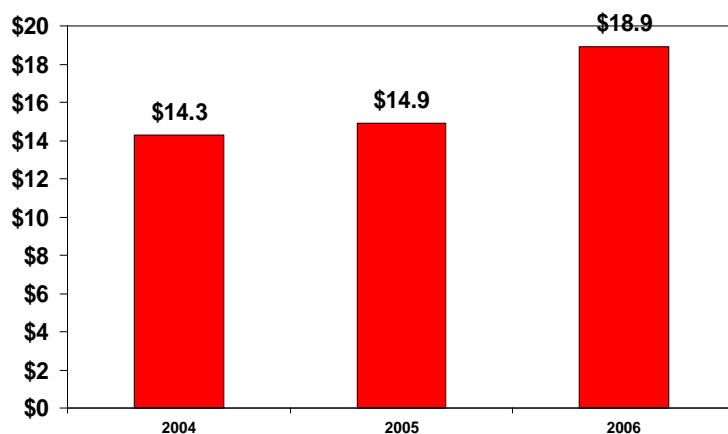


Fig. 18

Source: LA Citizens

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. Meanwhile, the Louisiana Insurance Rating Commission has refused to approve rate increases for Citizens, saying the state should take necessary steps to make sure the insurer functions more effectively before rates are increased.



Louisiana Citizens is expected to grow by as much as 50 percent and to become the state's third largest homeowners insurer by the end of the year, as private insurers reduce exposure in high-risk areas. By law, Citizens rates must be at least 10 percent above the private market. In early 2007, a number of state legislators indicated they would file legislation to change the 10 percent rule. The senators served notice at a meeting of the state's Senate Property Insurance Task Force. However, the state insurance commissioner has acknowledged that such a move would ultimately hurt the state.

In December 2006, in a ruling on the wind versus water issue, a state district court judge said that both the Louisiana Citizens application form and the policy itself must include the flood exclusion for the exclusion to apply. Otherwise, in cases where there is wind and flood damage and the home is a total loss, under the state's valued policy law, Citizens is liable for the full value of the homeowners policy. Insurers are appealing the ruling, asserting that valued policy laws were not intended to pay for noncovered perils.

### ***3. Mississippi FAIR Plans***

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 will now be able to recoup the assessment amount by surcharging their policyholders, following legislative reform approved by the state legislature in March 2007 (described below).

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 the end of 2005, MWUA had a total of 15,252 policies in-force for a total exposure value of \$1.9 billion. Total exposure to loss has surged by 431 percent from \$352.9 million in 1990 to \$1.9 billion in 2005 (Fig. 19). At year-end 2006, MWUA's total exposure to loss had ballooned to \$5.4 billion.



## Mississippi Windstorm Plan: Exposure to Loss (\$ Millions)

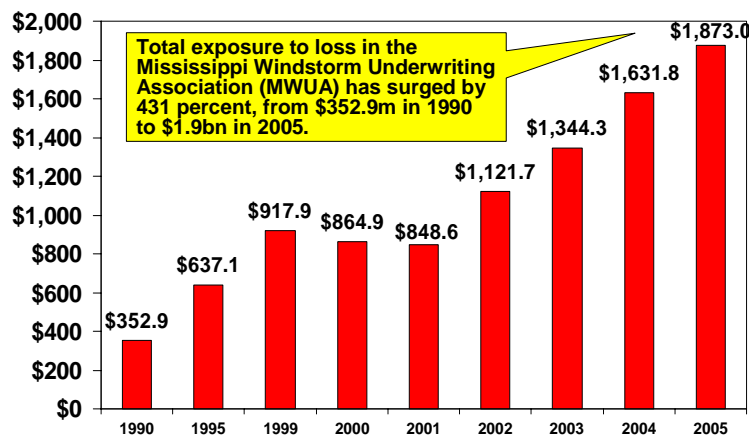


Fig. 19

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 \$150,000 for buildings and \$75,000 for contents. MRPIUA policies contain a standard deductible of \$500 for all perils. At the end of 2005, MRPIUA had a total of 8,032 policies in-force for a total exposure value of \$410.1 million.

Following Hurricane Katrina, the MWUA incurred a loss of around \$700 million. As a result, it originally requested a 397.8 percent rate increase for private homes (the request was subsequently amended to 192.8 percent), a 268.3 percent increase for commercial properties and a 60.4 percent increase for mobile homes. The proposed increases reflected in part the rising cost of reinsurance. For 2006 the MWUA purchased \$350 million in reinsurance coverage at a cost of \$43 million, double the amount of reinsurance purchased in 2005.

While the insurance department approved the rate increases for commercial properties and mobile homes, the eventual rate increase approved for homeowners was substantially less at 90 percent. This was after an injection of \$50 million in federal funds to help rebuild affected communities and cover the pool's rising reinsurance costs.

Some \$30 million of the federal funding would be applied to the pool's reinsurance bill for 2006 and the remainder to the bill for 2007. MWUA assessed its member companies around \$545 million for Hurricane Katrina claims, after reinsurance. As noted earlier, insurers doing business in Mississippi, unlike other states, may not surcharge their policyholders to recoup the assessment amounts.

In March 2007, the state legislature passed a bill (HB1500) designed to put the MWUA on a firmer financial footing going forward. The bill allows a one-time \$80 million diversion of federal and state funds to the MWUA that will boost the pool's reserves for windstorm damage claims. A portion of the revenue received from state insurance premium taxes (\$20 million per year) will also be diverted to the



pool over a four-year period so that it can build up reserves. In addition, the bill allows the pool to surcharge policyholders directly if it has to issue bonds or repay loans and insurers will be able to pass on to policyholders their share of assessments for deficits.

#### **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.<sup>6</sup>

##### **How It Operates**

All companies licensed to write property insurance in Texas are required to be members of the 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 the TWIA. In addition, the Association also provides coverage for miscellaneous items, such as signs, fences, swimming pools, and flagpoles. On November 30, 2006, the TWIA insured 126,228 residential and 12,474 commercial policyholders. In 2007, TWIA's policyholder count continues to experience rapid growth, reaching 160,281 as of March 31.

Effective January 1, 2006, residential and commercial policyholders can purchase TWIA coverage up to the following new statutory limits:

- Residential—Dwelling Building and Contents: \$1.5 million
- Apartment, Condo, Townhouse—Contents Only: \$163,000
- Mobile Home—Building and Contents: \$84,000
- Commercial—Commercial Building and Contents: \$1.9 million

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<sup>6</sup> 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.



## Claims-Paying Capacity

TWIA has the ability to assess its member insurers for excess losses. Assessments for losses are based on an individual insurer's share of the overall Texas market. To date, TWIA has made only two assessments of its member insurers. A \$100 million assessment was made in 2005 after Hurricane Rita struck the upper Texas coast causing major damage in Jefferson, Chambers and Galveston counties (see below). Hurricane Alicia, which struck Galveston Island in 1983, also led to a \$157 million assessment.

Under the plan, member companies are assessed the first \$100 million of losses. Losses in excess of this assessment layer are funded by reinsurance and the state's Catastrophe Reserve Trust Fund and a further \$200 million industry assessment layer. Losses in excess of a certain threshold—\$1.04 billion for the 2006 hurricane season—are also paid through company assessments, but are recoverable through premium tax credits (Fig. 20). This means that the state's general revenue fund is vulnerable in the event a major hurricane strikes.

### III Texas Windstorm Insurance Association (TWIA) Current Financial Structure

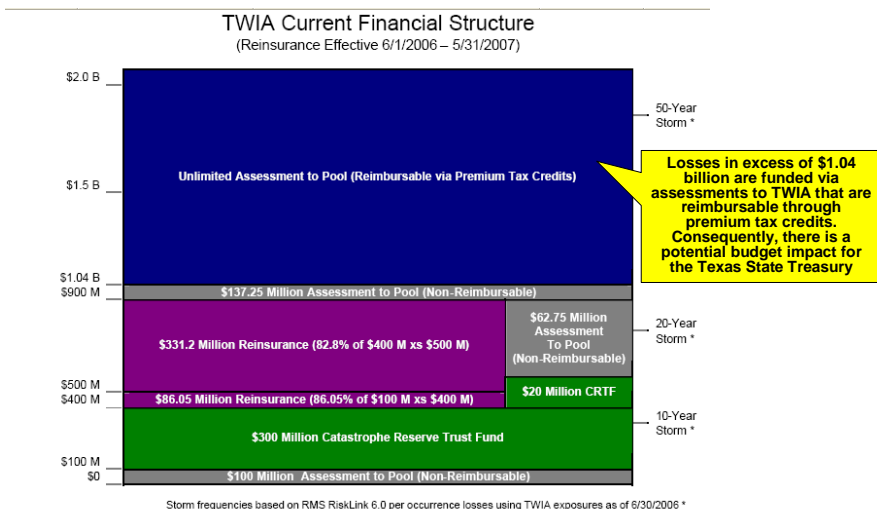


Fig. 20

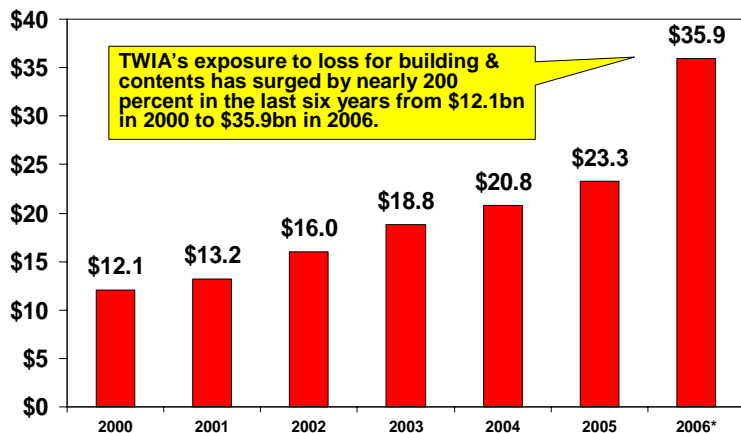
Source: "Presentation for Joint Senate/House Interim Committee on Windstorm Coverage and Budgetary Impact", August 30, 2006, Texas Windstorm Insurance Association.

Increasing development together with a reduction by some insurers of the number of coastal policies they will issue is pushing up the TWIA's policy count and its exposure to loss. According to PIPSO figures, in 2005 the TWIA had grown to 120,388 policies in-force and exposure to loss for buildings and contents of \$23.3 billion (Fig. 21). By November 30 2006, the TWIA's total exposure had nearly doubled to reach \$40.9 billion (including additional living expense and business interruption). As of March 31, 2007, total policy count had increased again to 160,281 and total exposure was in excess of \$47 billion, with officials predicting it will soon reach \$50 billion (Fig. 22). 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) Exposure to Loss (Building & Contents Only) (\$ Billions)**

■ Exposure to Loss (Building & Contents Only)

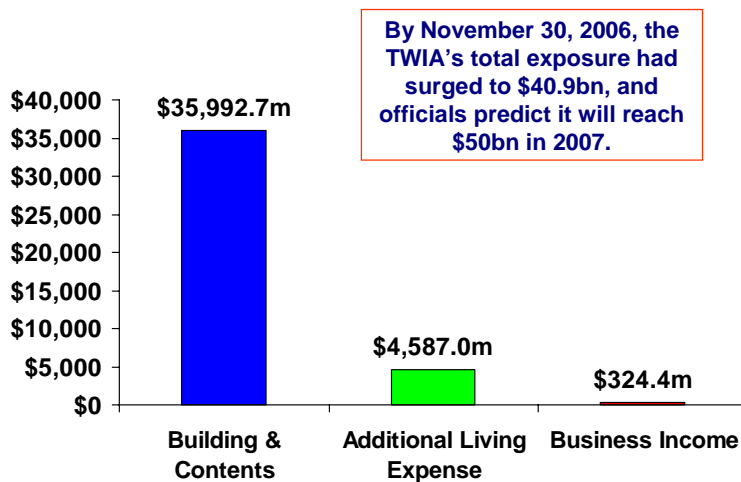


**Fig. 21**

Source: TWIA at 11/30/06; Insurance Information Institute



**Texas Windstorm Insurance Association (TWIA) Total Exposure to Loss (\$ Millions)**



**Fig. 22**

Source: TWIA at 11/30/06; Insurance Information Institute

Hurricane Rita produced estimated losses of between \$160 million to \$165 million for the plan when the Category 3 storm struck the state in September 2005. The payment of some 11,000 Rita-related claims resulted in a deficit and a \$100 million assessment on companies. As a result, TWIA was in need of additional funding. In the wake of Rita, TWIA requested a 19 percent rate increase for homeowners and 24 percent rate increase for commercial policyholders. In November 2006, the insurance department



granted the TWIA a homeowners rate increase of 4.1 percent and a 3.7 percent rate increase for commercial properties.

To raise additional funds, the TWIA recommended bond issues of \$800 million to supplement its reinsurance and the state's Catastrophe Reserve Fund, both of which provide funding in the event of a major hurricane. Pre-event bonds would be purchased through a 2 percent surcharge on coastal auto and homeowners insurance policies. If there was a major storm, an additional 0.5 percent surcharge would be imposed on all property/casualty insurance policies in the state to pay for a post-event bond issue, with the exception of workers compensation, medical malpractice and health insurance policies. However, before bonds can be purchased, the legislature must approve the funding plan. The issue is being considered in the regular state legislative session in early 2007.

### ***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. A study by AIR Worldwide puts the value of insured coastal property (residential and commercial) in Massachusetts at \$662.4 billion, ranking it fourth behind Florida, New York and Texas. This represents 54.2 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 is growing rapidly. MPIUA's policy count has surged by nearly 300 percent from 49,628 total policies (habitational and commercial) in 1990 to 192,944 policies in 2005 (Fig. 23). By December 2006, the FAIR Plan accounted for more than one-third (37 percent) of the homeowners market on Cape Cod and islands of Martha's Vineyard and Nantucket with around 43,000 policyholders. Exposure to loss under the plan has also skyrocketed, from \$4.1 billion in 1990 to \$54 billion in 2005 (Fig. 24). MPIUA's operating results have been variable over the years. In the five-year period from 2001 to 2005, it reported an operating deficit in three years (2001, 2002 and 2003) and an operating gain in 2004 and 2005 (Fig. 25).



### Massachusetts FAIR Plan Policy Count (1990-2005)

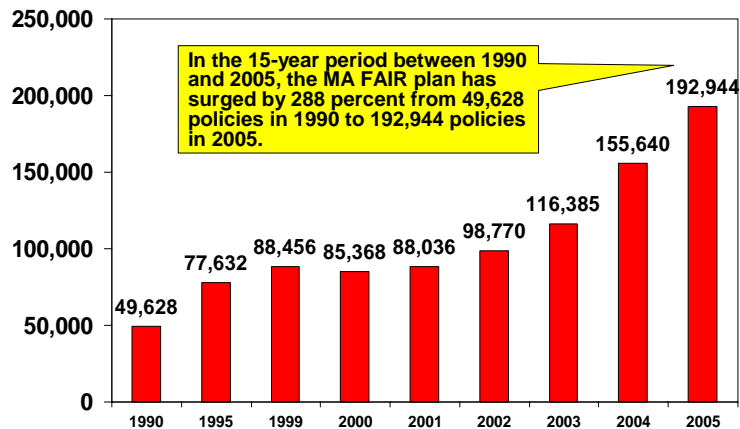


Fig. 23

Source: PIPSO; Insurance Information Institute



### Massachusetts FAIR Plan Exposure to Loss (\$ Billions)

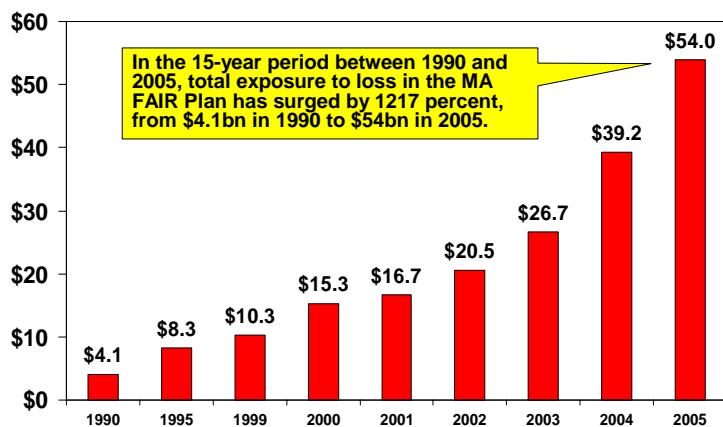


Fig. 24

Source: PIPSO; Insurance Information Institute



### Massachusetts FAIR Plan Operating Gain or Loss 2000-2005 (\$ Millions)

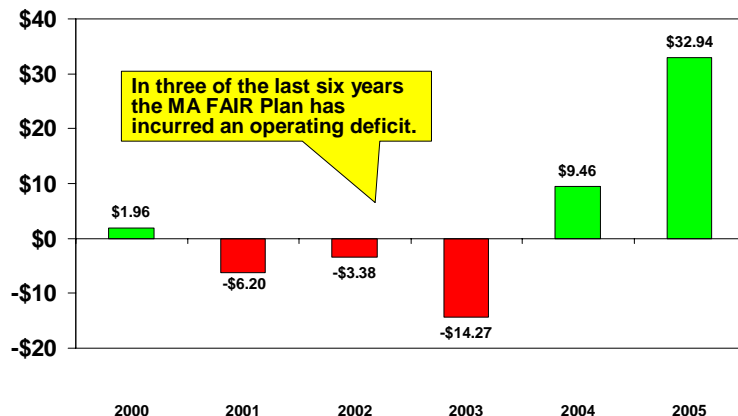


Fig. 24

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 now allows 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 can be adjusted upward, thereby giving the FAIR plan an actuarially sound pricing basis going forward. In October 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. The plan is also preparing another rate filing for the first quarter of 2007, as its rates still lag behind the regular market.

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. It has five different layers of reinsurance coverage up to a total value of \$455 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 11<sup>th</sup> on AIR Worldwide's coastal exposure list with \$105.3 billion in insured coastal exposure, of which about 57 percent is residential and 43 percent is commercial. North Carolina's insured coastal exposure represents just 9 percent of the state's total insured values. Yet as of September 30, 2006, the state's Beach Plan (no longer a PIPSO member) reported a total 124,858 residential policies and \$43.7 billion in associated exposure, double its 68,544 residential policies and \$17.8 billion in exposure reported at the end of 2003. As of February 2007, total exposure to loss in the Beach Plan is estimated at in excess of \$52 billion.

Rates under the state's Beach Plan are seriously inadequate. In 2005 rates were raised by 15 percent for beach areas and 10 percent for coastal counties instead of the actuarially appropriate 143 percent and 115 percent, respectively.

### **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 October 31, 2006, SCWHUA had a total of 28,607 policies in force, a more than four-fold increase over the 6,622 total policies in force back in 1990. SCWHUA's total in-force liability amounted to \$11.2 billion as of October 2006.

South Carolina ranks eighth on AIR Worldwide's coastal exposure list with \$148.8 billion in insured coastal exposure, representing 25.6 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 10<sup>th</sup> among leading states in terms of coastal population growth.

Legislators are currently discussing the possibility of expanding the Beach Plan's coverage territory.