Welfare for the Rich: How Citizens Insurance Corporation Harms Floridians

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I. Executive Summary

Over the years, regulations in Florida have attempted to hold private homeowners insurance prices low; so low that, in some cases, prices are being set below cost, particularly in hurricane-prone coastal areas. The resulting consequence of this price regulation has led some insurers to pull away from higher risk coastal areas. In effect, price regulation has made it harder for consumers to find insurance in the voluntary market – most notably in areas along the coast. As a result, Florida's state-run "insurer of last resort," Citizens Property Insurance Corporation (Citizens) filled the gap and increased its market share.

Because Citizens was able to set its prices substantially below costs and pass its financial losses to consumers in the form of assessments, its homeowners insurance market share has expanded to 23%. Effectively, the state-run insurer has used a cross-subsidy mechanism to undercharge its own customers by overcharging the consumers served by private insurers. That cross-subsidy accelerated the withdrawal of insurers that serve the coastal homeowners, led some insurers to stop writing new policies, and caused other insurers to leave the state entirely.

Experts and academicians have generally called for reforms – namely, returning the market to risk-based pricing, attracting private capital back into the state, and reducing the market share of Citizens. However, these solutions require the undoing of the cross-subsidy mechanism and raising Citizens' rates. That has led to opposition claiming that higher rates are unaffordable for Citizens' customers. This is topic of this paper.

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If higher rates are not affordable, as claimed, then this could be a roadblock to reform. Evaluating the question of affordability requires an assessment of those benefiting from the subsidized rates in contrast to those paying for the subsidy. In other words, there are winners and losers to the cross-subsidy scheme and knowing the affordability of each group is necessary in evaluating the credibility of this claim. Can the other 77% of consumers afford to pay for the subsidy?

This study assesses the winners and losers of the Citizens cross-subsidy mechanism, and finds that Citizens' below-cost pricing generally benefits higher income and wealthier consumers at the expense of somewhat lower income and less wealthy consumers. Specifically, this study finds that these cross-subsidies tend to:

- Benefit homeowners, who are typically more affluent, at the expense of non-homeowners.
- Help investment, vacation and second homeowners along the coast, who are more affluent, at the expense of primary homeowners and renters, and at the expense of those consumers living away from the coast.
- Benefit out-of-state homeowners at the expense of Floridians, including the subsidization of coastal insurance for foreign homeowners, 82% of whom pay "all cash" to buy their vacation homes. If consumers can afford an all cash transaction to buy their homes, why can't they afford to pay the market price to insure their homes?

Our analysis also finds that those paying to subsidize Citizens customers are more likely to have lower incomes and be less wealthy than those benefiting from the subsidy. While a proper analysis would require a deeper look into proprietary information from Citizens, based on the public information available, we reject the notion that Citizens' customers (collectively speaking) cannot afford to pay risk-based prices. Considering that the other 77% of non-Citizens customers must pay 100% of their own insurance and a portion of the Citizens subsidy, there is nothing fair about the cross-subsidy.

Fixing the insurance problems detailed in this paper require undoing the faulty regulatory solutions that created them. The positive steps needed to accomplish this include setting prices closer to risk, immediately ending subsidies for second homes, encouraging pricing flexibility in the market, requiring Citizens to procure a "consumer protection surcharge" to transfer its high risk, and rewarding consumers for mitigation. These steps, among others, will encourage private capital back into the market and downsize Citizens' market share, while better protecting all Floridians from catastrophic losses.

II. How Public Policy Created a Dysfunctional Private Insurance Market

With its locality and exposed coastline, the risk of hurricane damage is a major factor influencing Florida's high homeowners insurance prices. Over the years, major storms have hit the state, including eight hurricanes and two tropical storms during the years 2004 and 2005.[2] This risk was incorporated into rising private homeowners insurance prices, which are regulated by the state. However, price regulation limited the ability of private homeowners insurers to set prices that reflected full risk, leading many of these "admitted" insurers to pull back from exposed coastlines, and leaving unregulated surplus lines insurers as the primary source of private homeowners insurance in these areas.[3] The apparent shortage of insurers along the coastline led to an expanded role for Citizens as the state-run insurer-of-last-resort.

What is Citizens?

Citizens is a Florida government-owned nonprofit corporation that was created by state law to provide homeowners insurance for those unable to find coverage in the state, including coverage for consumers and businesses. While Citizens primarily serves coastal areas, it can operate throughout the state, providing property and casualty insurance, including wind, dwelling and renter, mobile home, condo and condo association policies. Although homeowners insurance can be costly near the coast, Citizens has and continues to offer homeowners insurance in these areas below cost. For example, the Citizens' CEO Barry Gilway recently testified that only 10% of basic coastal homeowners insurance policies (termed *HO3*) were actuarially sound in 2012, and that Citizens rates would need

[2] Jaeger PT, Langa LA, McClure CR, Bertot JC., "The 2004 and 2005 Gulf Coast hurricanes: evolving roles and lessons learned for public libraries in disaster preparedness and community services," *Public Library Quarterly*, 2006, 25(3/4), pp. 199-214.

[3] Very generally, admitted insurers are those approved and regulated to operate in the state. Surplus lines insurers are outside insurers that are free to set prices and often write policies that admitted insurers see as too risky.

to increase by nearly 30% (excluding sinkhole policies) during 2013, in order to make Citizens financially sound.[4]

Because Citizens may have inadequate capital to cover the full costs of a major or multiple storms, the Florida statute allows Citizens to levy surcharges on its customers, and (secondly) levy assessments on other property and causality insurance companies. These private companies are allowed to pass these assessment costs along to consumers in the form of higher homeowners insurance prices. In addition, another surcharge, called an emergency assessment, can be levied on all insurance consumers, should Citizens funds still remain insufficient. To be clear, Citizens bills its customers at rates that are inadequate to cover the claims of its policyholders in the event of catastrophic losses; and then to make up this shortfall, it levies assessments on all consumers for various types of insurance, including those served by competitive insurers. In this way, below-market pricing in primarily coastal areas leads to higher prices for renters, small business, churches, nonprofit organizations, schools, consumers living inland, motorcycle and car owners, and others. This market distortion has consequences, as will be discussed in this paper.

A Regulatory Failure

In recent history, when Florida's private homeowners insurers were not permitted to set rates that fully reflected market risk, these insurers began to pull out of the homeowners insurance market and, particularly, away from the coast. In their wake, Citizens was well positioned to fill the void. Given the fact that it typically sets its prices below costs, Citizens was able to gain a considerable share of coastal homeowners insurance market. While artificially low prices mean financial losses for Citizens, as pointed out earlier, it is able to make up its financial shortfalls by levying surcharges on all other insurers – homeowners and non-homeowners, including consumers living inland.

[4] This is according to testimony during the Senate Banking and Insurance workshop held on January 16, 2013. See http://www.flsenate.gov/Media/VideoPlayer.cfm?VideoPath=201301/sbi_011613edit.mp4 to view the testimony.

Price regulation and the cost of subsidizing Citizens have meant that private homeowners insurers cannot compete with Citizens. This has further discouraged private insurers from serving coastal homeowners insurance customers, has caused some insurers to stop writing new policies, and caused a number of insurers to leave the state. As a result, the number of larger well-capitalized firms offering homeowners insurance on the coast has declined. Today, all of this has given Citizens the largest share of Florida's homeowners insurance market at 23%, and it has put other Floridians on the hook to cover its financial losses. In short, the shortage of private homeowners insurance along the coast is still being caused by regulatory policy that – first, held private insurer rates too low, which caused insurers to pull out of markets; and second, replaced the private market with a government-run insurer that sets predatory prices sustained through a cross-subsidy mechanism.

The problems outlined in this study are not politically easy to correct, since it would require some homeowners along the coast to pay more for insurance. While that solution may be justified, many lawmakers oppose fixing the problem, citing an issue of "affordability" – namely, that coastal consumers would be unable to afford higher homeowners insurance prices.

In the next section, we address whether coastal property owners are less able to afford insurance that inland property owners. In fact, some have suggested that Citizens may be subsidizing the rich, second homeowners and consumers who live out of state – and even out of country. This is a testable hypothesis.

III. Insurance Affordability

Most policymakers understand that Citizens and the Florida Hurricane Catastrophe Fund (Cat Fund) need to be downsized and private capital needs to be encouraged to flow back into the state. In fact, recent statements by the insurance commissioner, the Chief Financial Officer of the Cat Fund and others have all referred to these goals.[5] However, the political will to make this happen is absent among some lawmakers. The alleged reason for this is that raising homeowners insurance prices on some coastal homeowners could make insurance unaffordable for them.

No one has ever empirically demonstrated that there is an affordability issue on the coast that exceeds the affordability issue for those non-Citizens consumers who pay for these subsidies. When taking a closer look at the demographics, it appears that, on average, coastal homeowners have higher incomes, are wealthier and can better afford to pay more than other consumers, though there are certainly exceptions with pockets of low-income consumers along the coast.

Like any subsidy, the Citizens' rate mechanism produces both winners and losers. Undoing the subsidy, even if it is fairer to do so, may not be politically popular for some lawmakers representing coastal communities. Whatever the motives for continuing the present subsidy system, recognizing the winners and losers are of paramount importance to developing the proper public policy.

1. *Coastal Homeowners Tend to Have Higher Wealth/Income than Other Floridians*

When discussing affordability and the fairness of Floridians subsidizing insurance prices for coastal homeowners, there are a number of important facts to consider:

[5] For example, public hearings held by the Senate Banking and Insurance Committee provides this conclusion and is available in video format at this website http://www.flsenate.gov/committees/show/BI.

- Homeowners are generally more affluent. Homeowners have much higher incomes on average and have many times the net wealth compared to non-homeowners.[6] Since Citizens passes its financial losses, in part, along to non-homeowners, there is a high likelihood of it adversely impacting lower income Floridians.
- Somewhat richer coastal counties. In Florida, the average consumer living in the coastal counties served by Citizens has a somewhat higher per capita income than the average consumer living elsewhere in the state.[7]
- Towns directly on the beach have the highest incomes. As you move south and closer to the coast, incomes in the state tend to increase, particularly immediately on the coastline. In 2011, per capita income in the Census designated places of Tallahassee ($25,118), Jacksonville ($24,510), Ocala ($21,809), Gainesville ($19,895), Orlando ($23,010) and Clewiston ($18,587) were all near or below Florida's average ($24,905). In contrast, income data for a sample of 30 coastal Census designated places between Juno Beach and Miami Beach, as well as in the Florida Keys, produced only four towns with below average incomes.[8] In fact, several coastal towns had income nearly five times as high as the Florida's average. For example, a U.S. Census survey estimates Fisher Island's mean household income at $716,554.[9]
- Second homeowners are more affluent. As will be discussed in detail, coastal areas have a substantially higher percentage of vacation and investor homeowners, who typically have significantly higher incomes and wealth than primary homeowners or renters.

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[6] One source found 46 times higher wealth for homeowners than renters, because the value of the home is the predominant source of wealth. See Danielle Hale, "Net Worth: Home Owners vs. Renters," *Economists' Outlook*, National Association of Realtors, Nov. 16, 2010, http://economistsoutlook.blogs.realtor.org/2010/11/16/net-worth-home-owners-vs-renters/; and historical Census data suggest that owner-occupied income is more than 100% higher than renter-occupied income (for example, see http://www.census.gov/housing/ahs/files/ahs09/2-12.xls).

[7] The counties served by Citizens tend to have higher incomes than the counties not served by Citizens, based on Citizens' percent distribution of policy count, premium and exposure. For Citizens' county-level data, see https://www.citizensfla.com/about/corpfinancials.cfm?show=pdf&link=/shared/exposure/reports/PIFByCounty-12-12.pdf.
https://www.citizensfla.com/about/corpfinancials.cfm?show=pdf&link=/shared/exposure/reports/PIFByCounty-12-12.pdf.

[8] These Census designated places are listed on the map labeled Figure 1 (on page 11) in this paper.

[9] American Community Survey 5-year estimates, DP03, U.S. Census Bureau, 2011 data.

While the Citizens' subsidy has been justified based on affordability, this justification does not consider the ability of other (non-Citizens) consumers to pay for these subsidies. When considering the evidence on income and wealth, there is no sound public policy basis or economic rationale for having consumers who, on average, have lower incomes to be subsidizing those who, on average, have higher incomes. There is also no rationale to subsidize consumers that live in riskier coastal areas by taxing those who live in less risky noncoastal areas.

2. *Vacation and Investment Homeowners Typically Have More Wealth and Higher Incomes*

Since income data only include the incomes of local residents (those occupants living or renting in the geographic area), these data omit the typically higher incomes of vacation and investment homeowners whose primary homes are elsewhere. Consider for a moment that if a homeowner can afford to own multiple homes, can afford to have a vacation home be vacant for most of the year and can often pay cash for a second home, would these homeowners be better able to afford homeowners insurance, compared to other residents who rent or only own just one home? In order to understand insurance affordability, it is helpful to know the prevalence of second homebuyers along the Florida coast.

The U.S. Census, the most comprehensive and accurate source for demographic and housing statistics, can shed some light on this issue. The U.S. Census provides data on vacant homes, which are defined as homes that are not renter-occupied or owner-occupied.[10] Because of the depressed real estate market, we adjust the Census estimates to exclude those vacant homes that are "for rent" or "for sale." This adjusted definition provides a good measure for homes that are second homes, family getaways, seasonal homes and vacation homes. Using this measure to compare the vacancy of homes in

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[10] To clarify, a home is occupied if it is owner-occupied or renter-occupied. Otherwise, the Census classifies the home as vacant. The owners of the vacant homes live somewhere else and their census information (including income) is counted elsewhere too.

coastal cities and towns (again, referred to as *Census designated places*) provides insight into some of the homes subsidized by Citizens.

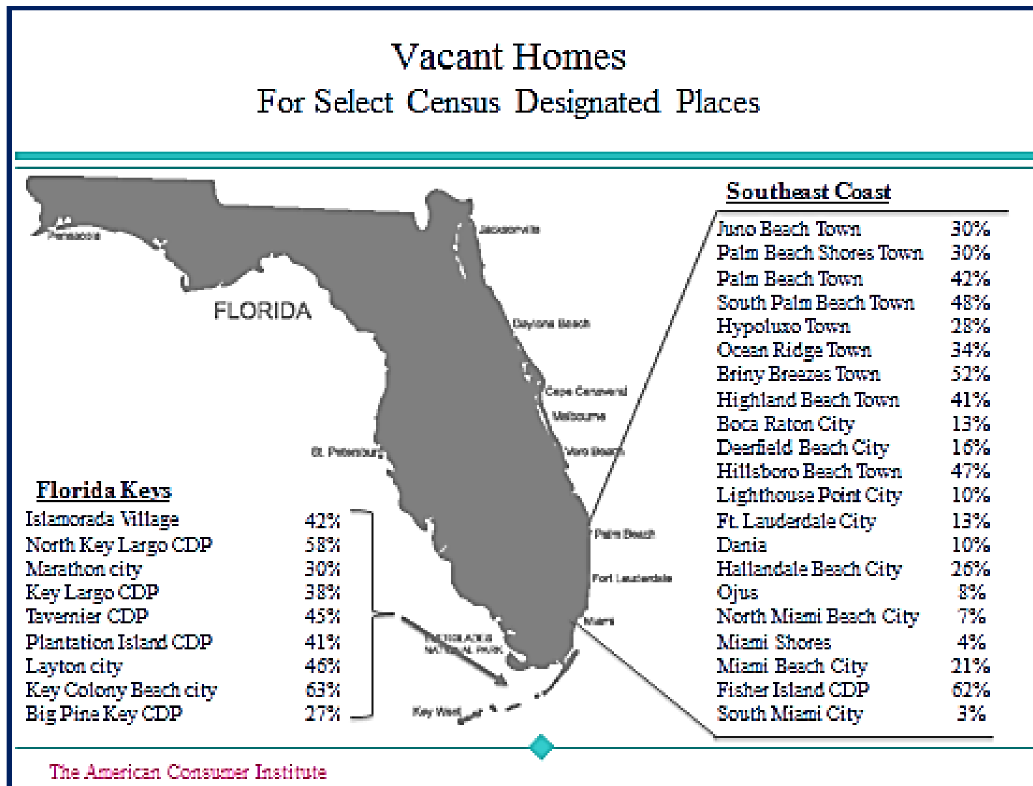
Analysis of the vacancy rates in Florida shows some interesting differences. In the northern and inland portion of the state, Florida's vacancy rates appear modest, as exemplified by the Census designated places of Tallahassee (3%), Gainesville (3%), Ocala (5%), Orlando (3%), Tampa (5%), Jacksonville (4%), Sanford (4%) and Titusville (7%). However, moving south and to towns along the coast, the vacancy rates skyrocket. In a sample of Census designated places along the southeast coast – from Juno Beach to Miami Beach, as well as towns along the Florida Keys – vacancy rates surged to 30%, 40% and higher. In fact, several locations had vacancy rates above 60%, suggesting that the majority of the homes in some areas are vacant most of the year and are not primary homes.

For example, Fisher Island, mentioned earlier as having among the highest per capital income of any place in the U.S., has a vacancy rate of 62%, reflecting a high percentage of second homes. It would take the median household income of twenty households in Gainesville to equate to the median household income on the Island.[11] Moreover, there are nearly twice as many homes to insure on the island than the number of people living there, according to data from the U.S. Census.

Figure 1 (below) shows a sample of places and their vacancy rates. From this analysis, it appears that Citizens operates in areas that have a large number of vacation homeowners, investors and second homebuyers – some of whom may live elsewhere and possibly out of the state or the country. This means that Citizens may be subsidizing these non-primary homes. Alternatively, those financing the subsidy are primary homeowners, renters and others.

[11] Steve Pociask, "Welfare for the Rich," *Tampa Bay Tribune*, February 6, 2013, available on line at http://www2.tbo.com/news/opinion/2013/feb/06/naopino2-welfare-for-the-rich-ar-626179/.

Figure 1:



Higher incomes and higher vacancy rates are not unique to the sample of 30 towns along southeast Florida. Along the west coast of Florida, for example Longboat Key, Sanibel (Island) City, Marco Island City and Captiva have vacancy rates of 51%, 52% ,44% and 74%, respectively; and the per capita income in these Census designated places are at least twice as high as the state average.[12]

What is the profile of a vacation home buyer? The National Association of Realtors (NAR) has conducted a number of surveys that provide a useful profile of investment and vacation homebuyers. Its national survey finds that vacation and investment homebuyers have 20% higher incomes than primary homebuyers.[13] According to their survey, 28% of primary homebuyers have income above $100,000, compared to 44% and 43% for

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[12] As before, vacancy data excludes homes for rent and for sale are cover the period of 2010. Per capital income data is for 2011. All of these data can be retrieved and compared online by visiting the U.S. Bureau of Census at http://www.census.gov/2010census/.

[13] Data in this paragraph come from the report "Investment and Vacation Home Buyers Survey 2012," National Association of Realtors, March 2012.

vacation and investment homebuyers, respectively. It is worth noting that the incomes along the coastal areas would be even higher if these investor and second home buyer incomes were included in these statistics.

This further suggests that Citizens subsidies benefit owners of these vacant homes, who tend to have higher incomes and more wealth, while primary homeowners and consumers with lower incomes and less wealth are paying the subsidies. Because about 20% of homeowners have two or more homes and one-quarter of these homeowners have three or more homes, it is also logical to assume that someone owing multiple homes would be on average wealthier and have higher incomes than renters or primary homeowners. [14] Again, some percentage of these unoccupied homes is being subsidized by Citizens, and the costs are being supported by other Floridians.

3. Investment and Vacation Homeowners May Not Live in Florida

Another interesting fact is that most vacation and investment homeowners in Florida have their primary home located in another city and sometimes in another state or country. According to the NAR 2012 Survey, the median distance from the homebuyer's primary property to their second property is over 300 miles, and 40% of these properties are over 500 miles away. For Florida, this means that many, and perhaps most, second homes are owned by out-of-state residents. This also means that Florida residents are subsiding non-Floridians. For lawmakers, these homeowners are not their constituents. Data provided by Citizens found 16% of its policyholders did not live in the state.[15]

A large number of vacation and investment homes in Florida are purchased by foreign homebuyers.[16] According to NAR surveys, 26% of the nation's international

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[14] The incidence of second home buying comes from "NAR Survey of Home Buyers and Sellers Shows Dual Income Couples Fueling Market," News Release, National Association of Realtors, Nov. 12, 2012, at http://www.realtor.org/news-releases/2012/10/nar-survey-of-home-buyers-and-sellers-shows-dual-income-couples-fueling-market.

[15] These data were provided as a result of an information request by The American Consumer Institute covering data as of January 18, 2013. This reported figure may be on the low side and we are currently investigating its accuracy.

[16] These data come from various NAR survey reports, most notably "Profile of International Home Buyers in Florida 2012," National Association of Realtors, August 2012.

transactions are in Florida and 19% of Florida sales are by "non-resident foreigners."[17] Again, these homebuyers tend to have higher incomes compared to primary homebuyers who, in turn, tend to have higher incomes than renters and those living inland.

In Florida, the median home price paid by foreign vacation and investment buyers was only $194,700 – well below the $1 million Citizens policy limitation.[18] In fact, 82% of foreign sales in Florida were paid with no mortgage – an "all cash" transaction. Canadians are the biggest buyers, with 90% of them paying all cash for their home. If many foreign buyers have the means to pay cash, why would it be unaffordable for them to purchase homeowners insurance?

4. The Welfare Mechanism for the Rich

This report has shown that coastal property owners tend to have higher incomes and wealth than others, and that vacation and investment homeowners are typically more affluent than primary homeowners. In addition, many vacation and investment homeowners do not even live in Florida, yet they benefit from Citizens' below cost rates. This begs the question – who benefits and who loses from Citizens?

As Figure 2 (below) shows, many Floridians are on the hook for assessments and hurricane taxes to make up Citizens' financial shortfall. These include consumers who are not policyholders of Citizens; and they are renters, small business owners, churches, boat owners, motorcycle owners. The beneficiaries, as previously noted, are Citizens policyholders, including many more affluent individuals and some that live out of the state. There is nothing fair about policyholders living in Gainesville paying the full price of their insurance policy as well as paying a surcharge to subsidize Citizens customers.

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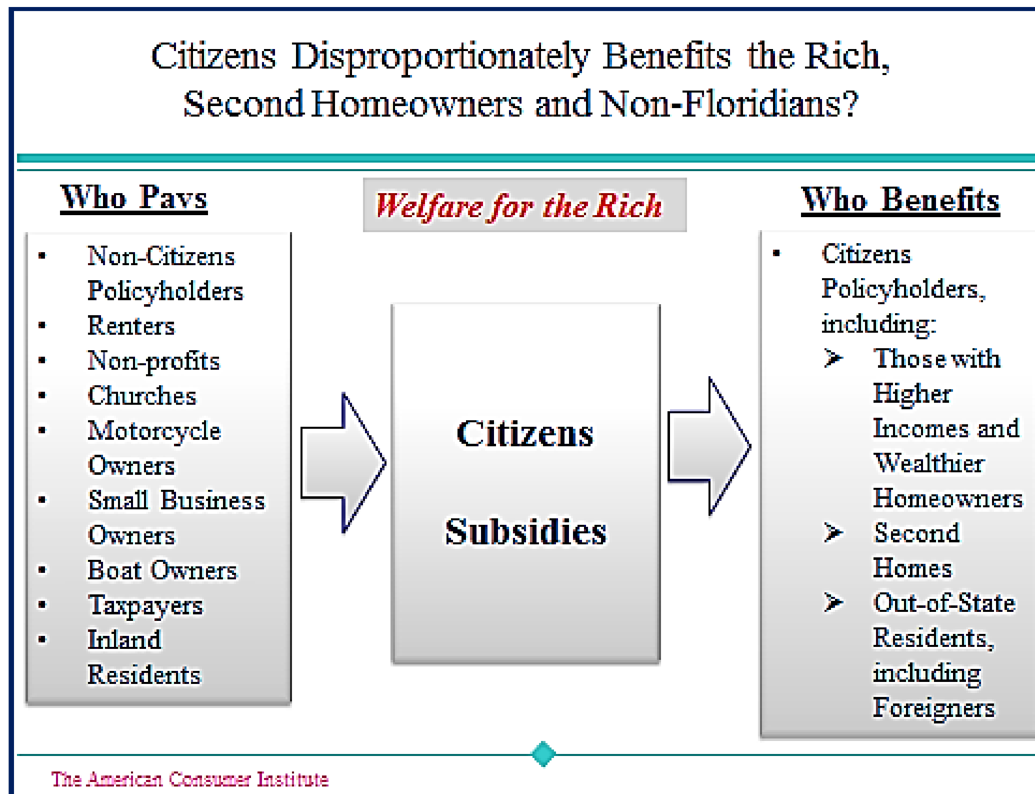
[17] Ibid, at p. 4 and Appendix I.

[18] In order to stem subsidies for wealthy and high income homeowners, Citizens imposed a $1 million cap on its policyholders. This means that an ocean front property worth $2 million could only qualify for Citizens, if the dwelling is worth less than $1 million. While this limitation is useful in keeping some of the most wealthy individuals from receiving subsidized homeowners insurance, the fact is that most vacation and investment homebuyers buy second homes that cost less than their primary home. For information on second homebuyers having more income and buying lower valued homes (versus primary homebuyers), see "Investment and Vacation Home Buyers Survey 2012," National Association of Realtors, March 2012.

Figure 2:



When all of the pluses and minuses are considered, Citizens tends to function as a welfare system that gives more to those who can generally afford to pay and takes more away from those who are generally less able to afford it. While there are always exceptions and some towns along the coast may have below average incomes and needy consumers, collectively speaking – there is no evidence that Citizens' customers are poorer on average than other consumers in the state and, in fact, the opposite seems true. Therefore, we reject the notion that coastal property owners are less able to pay for their insurance, whereas other Floridians are.

In summary, when it comes to insurance affordability in Florida, public policy should be more concerned about those who are paying the subsidy than receiving it. Moreover, policymakers should realize that some of the beneficiaries of Citizens subsidies are not even Floridians, and protecting the subsidy maintains a hardship for their own

constituents. For these reasons, public policy needs to move in the right direction toward reform. The next section will recommend ways to accomplish this.

IV. Recommendation for Reforms

This paper has shown that the divergence from risk-based pricing has caused private insurers to move capital out of the state and, in the void, allowed Citizens' (through predatory pricing) to become the largest homeowners insurance company in the state. The resulting loss of capital in the market now threatens consumers' ability to get legitimate claims paid, and it has led to an unfair cross-subsidy that helps somewhat more affluent consumers at the expense of less affluent ones. Fixing the problem means undoing this damage and attracting private capital back into the state.

How can that be accomplished? Citizens' prices need to be risk-based. The current "glide path" approach makes modest steps in raising coastal homeowners insurance rates toward actuarially sound levels, but the glide path will take many years. The following are general ideas for lawmakers to consider in reforming insurance regulation and ultimately protecting all Floridians:

- Citizens should only be allowed to take on new customers at the market price. Market price could be established similar to the Louisiana model that averages rates for private insurers in the same territory plus a factor, say 10%.
- Citizens should collect a "consumer protection surcharge" of up to 5%, which is to be used only for investing in catastrophic reinsurance or other bona fide risk transfer mechanisms.[19] Then, the Cat fund could then be downsized with greater reliance on capital sources, not debt.
- For primary homeowners, the glide path could be increased modestly to speed up the time needed to reach a sounder financial footing for Citizens.[20]
- Non-primary homes should be excluded from Citizens, except at the full market price, similar to recent changes in the National Flood Insurance Program.[21]

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[19] These funds should be explicitly "firewalled" from marketing, overhead and compensation or other like expenditures, in order to assure that they secure additional capital to protect consumers from losses.
[20] It is crucial that primary homeowners demonstrate their permanent address.
[21] The new National Flood Insurance Program "immediately phases-in actuarial rates for other subsidized properties including: second properties, severe repetitive loss properties, properties that have incurred flood-related damage that exceeds the fair market value of the property, and commercial properties." See Biggert-Waters Flood Insurance Reform Act (2012), at Section 100205.

- Citizens could use a clearinghouse to help transfer policies back into the private sector.
- Admitted insurers should be given increased pricing flexibility, including consent to rate, in order to increase consumer choice, encourage price competition and bring private capital back into coastal areas.

The result of these policy changes would downsize Citizens, attract capital back into the state, end harmful cross-subsidies, encourage price competition, and provide more protection to consumers who live in the state. Once rates are more aligned with risk, problems with adverse selection and moral hazard will be minimized. At that time, mitigation policies can be added that reward consumers for investing in building weather-hardened homes. That, in turn, would minimize the potential damage from storms, and it would provide discounts (or tax credits) and lower insurance prices for consumers. Setting risk-based prices will send the right market signals and incent the right behaviors.

In conclusion, these policies will protect consumers by getting adequate capital back into the state and end the cross-subsidies that provide no "net benefit" to Floridians as a whole.